THE BROOKINGS INSTITUTION

THE UNITED STATES AND CHINA:
THE NEXT FIVE YEARS

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

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

Moderator:

WANG SHUO
Managing Editor
Caixin Media

Panelists:

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

ESWAR PRASAD
Senior Fellow
The Brookings Institution

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

* * * * *

P R O C E E D I N G S

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Anyone has a question? Please.

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

MR. JIN: Thank you very much for the question. We just concluded the third meeting of the International Forum of Sovereign World Fund in Beijing and at the last dinner, Governor (inaudible) who just rushed back from U.S. after SED was invited to make a keynote speech at dinner. And he said, "and I really don't like the term, the so-called internationalization of RMB, I don't like it." He said, "I would prefer to use the term more role for RMB in settlement, in trade, and cross border investment."

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

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

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

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

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

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

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

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

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

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

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

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

U.S. technology levels, then start to slow down in terms of TFP growth. At least for the next two decades, there's plenty of room for China to continue.

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

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

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

SPEAKER: Think tanks.

MR. JIN: -- yes, think tanks are -- there's no reflection on the quality of think tanks, but we need somebody to do something. And when I watch the automobiles moving in Beijing, I told my driver, do you have trouble waiting in line for my car to be, you know, tuned in?

Oh, lots of trouble because we are short of people working the garage. Right? And I told my driver, I said, I have very good experience in -- when I was in Manila I had a Mercedes, you know, to be fixed, some of the problems I found the German engineer would have to say, okay, the car should be released and then I could get back my car. We need people of that kind.

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

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

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

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

MR. WANG: The gentleman standing over there?

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

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

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

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

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

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

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

MS. BERGMAN: My name is Mary Bergman, I'm with the Executive Intelligence

Review. Dr. Kharas made what I thought was a very interesting point about the stable Renminbi as an anchor on, you know, world manufacturing prices and in this whole context of world inflation there would be a real question of what would happen if it were -- exchange rates changed.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

* * * * *