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MANAGING THE CHINA CHALLENGE:
HOW TO ACHIEVE CORPORATE SUCCESS IN THE PEOPLE'S REPUBLIC

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P R O C E E D I N G S

MR. DERVIS: Good afternoon, everybody. Thank you very much for coming. It's a great pleasure and honor for me to introduce the two panelists and my friend Ken and Jeff Bader, on a topic which I'm sure is of great interest to all of us. The book is of course about China and I've read it over the last two days, so it was fascinating reading. And it is, of course, a topic that will only grow in importance. I'm a macroeconomist working in the Global Economy Program of Brookings, and, you know, whichever way you measure it or you take it, China will account for about 20, 25 percent of world economic activity over the next decade or two. Predicting the much longer run is more difficult, but it really has emerged as almost equal in size now, not quite, but soon to be equal in size economically to the U.S. and to the EU.

And so what happens in China, how China develops, what the interactions are between China and the U.S. economy, the world economy, Europe, is a topic that is number one topic, really, for all the economists these days. And more specifically the book focuses on business, doing business in China. It has advice for those who invest or those who engage with China, and I think it's embedded in a very deep and well-researched analysis of the Chinese economy. So, I enjoyed it tremendously.

As you know, Ken is -- Ken Lieberthal is the senior fellow in Foreign Policy and in the Global Development, a joint appointment here at Brookings, and he's the director of the John Thornton's China Center at The Brookings Institution. He is, at the same time, professor emeritus at the University of Michigan where until 2009 he was Arthur F. Thurnau Professor of Political Science and William Davidson Professor of Business Administration.

It's great to have him as a colleague and he often comes to our brainstorming sessions and I'm always so happy that we can engage with him. I think there are few people who know more about China and China-U.S. relations than Ken.

And with us also we have Jeffrey Bader. Bader is a visiting scholar with the John Thornton's China Center at Brookings right now. He returned to Brookings after serving in the Obama Administration as senior director for East Asian Affairs on the National Security Council from January 2009 to April 2011. Prior to his appointment, Dr. Bader was the first director of the John L. Thornton China Center and senior fellow of the Foreign Policy Program at Brookings, so we have two Brookings insiders here, but they have done so many other things in their life, many publications, many books. Dr. Bader was very active both in the private sector and in public policy, and so I am really looking forward to the presentation by Ken, and then the comments by Jeff to follow, and then we'll try to have a conversation.

We do have to end at 3:30 contrary to what was, I think, advertised in the last advertisement. So, we'll try to -- we'll have to keep the discussion so that we can end at 3:30.

So, now it's my great pleasure to ask Ken to take the podium.

MR. LIEBERTHAL: Thank you very much, Kemal. I really appreciate your introduction and your chairing this program. I'm very appreciative of Jeff coming over to participate in this. Jeff and I have done a lot over the years, but he's never been in a position before where he's stood up to critique a book I've just written, so I'm a little nervous.

But anyway, this book is about China's political economy and its implications for multinational corporate strategy, somewhat unusual combination for a Brookings book, I'll admit. Let me begin with the business side of that and I'll come back to the business side at the end, but in the middle I'll focus on China's political economy and what's important to understand about it.

But first of all let me say business ties are a major part of U.S.-China relations and of China's relations, frankly, with most of the industrialized world, and understanding China's political economy -- by "political economy" I mean something very simple. It's how the political system, how the state engages the economy at all levels, so it's, you know, from the center to the provinces, to the municipalities, to the counties, to the townships, party and government, right, how the whole state apparatus engages with the economic side in China. How understanding that political economy, I would argue, is a necessary component for developing corporate strategy for success in China where that strategy will be viable over the long run.

Let me give you the macro picture on the corporate side first and then get into the political economy. You know, most corporations from the West went into China with what I would term a stop of the pyramid strategy. Essentially they developed great products abroad, took them to China, aimed for the top of the pyramid in terms of the Chinese consumption pyramid, mostly in the major East Coast cities, modified their products a little bit to give them more of a Chinese flavor, right, for Chinese market, and have done quite well. I mean, good strategy, right? But I would argue that this strategy is not going to remain successful for much longer and there are basically two reasons why it won't. One is that the Chinese state is massively engaged in the economy and is increasingly focused on developing Chinese companies that can compete effectively with foreign firms.

So, this is no longer a matter of Chinese companies being subordinate to and simply part of the chain of foreign production companies, their ambition is to have Chinese companies eventually be highly competitive with the major multinationals. The state is playing an active role in making that come about. You have to understand how the state is doing that if you're going to develop appropriate strategies to cope with it.

And secondly, Chinese wealth is increasingly concentrated in tier 2 and tier 3 cities, not in the tier 1 cities, the biggest metropolises along the eastern coast, but in the more than 100 cities, both in coastal provinces and inland, generally with a population of well over a million people apiece that are rapidly developing middle and upper classes and forming a major set of markets.

Chinese competitors are growing in those cities and seeking to gain scale there. If not challenged successfully there, once they've gained scale, they're going to come after multinationals in the major tier 1 cities at the top of the pyramid. And by the time they are able to do that, you're dead because their cost structures, their product lines, et cetera, are simply going to render multinationals noncompetitive at the top of the pyramid.

So, effectively, to my mind, multinationals have to become effective in tier 2 and tier 3 cities with the appropriate product lines, price points, and that kind of stuff, in order to preempt their own Chinese competitors. This is not a matter of all love and sweetness here, this is a matter of who is going to capture markets and be successful over the long run.

Let me note, this is a broader significance, too, from a corporate perspective. Global GDP is growing increasingly because of the emerging markets, not because of the advanced industrial markets. If you look at global GDP growth over the past two years, in other words, since the financial crisis really took off, 75 percent of that growth was in the emerging markets. If you look at expectations of global GDP growth over the coming two decades, it is expected that 80 percent of it will be in the emerging markets. So, creating a corporate strategy that enables one to develop successful products for China's tier 2 and tier 3 city markets will position companies far better to beat the growth and global demand for the kinds of products that that demand will require. These are emerging market products, right, so the shape of the demand curve, if you will, is going to be determined increasingly not by the 1 billion people in the advanced industrial countries that have driven global demand in the past period of decades, but rather by the 3 billion people in emerging markets who are going to drive future demand and China presents a tremendous opportunity for multinational corporations to develop the capability to meet that kind of new demand in a flexible dynamic, and let me say, profitable fashion.

My book tackles these issues, first of all, by analyzing the core features of China's political economy to date and its repercussions and it then applies that analysis to recommendations for multinational corporations. So, let me get into what's likely to be of more interest to more of you, which is China's political economy and its repercussions. At the end I'll come back with a few words about the multinational corporate side of this.

China's political economy has very distinctive features that are critical to understand, both for their implications for multinational corporations and also for their implications for China's future development. I want to make some remarks about that in a few minutes.

What's the bottom line here? The bottom line is that the Chinese state has become a bureaucratic capitalist machine that produces rapid economic growth as a necessary result of the way the state itself functions. Okay? So, if you look at the details, and I'll explain this in just a minute, but if you look at the details of the dynamics of the party and government in China, rapid economic growth is a necessary outcome of those dynamics and the nature of that growth is -- put it this way, the nature of those dynamics has grown up around the model of development that China has pursued to date and therefore the kind of growth that it produces is tilted towards staying in that same model of development. This, to me, is always -- I always think of it as the opposite of India, where in India the state is in many ways a major obstacle to growth. In China the state is integral to growth and, in fact, growth is integral to the way the state functions.

Let me spell that out in the following sentence. The core of the Chinese system, for the purposes of the issues we're talking about today, is characterized by what I would term a deal that is done between the top leaders of each territorial level of the system and those who are at the next territorial level down. Let me make two explanatory comments. China has 5 territorial levels of the system: national, then provincial, 31 provincial level units; then municipal, roughly 650 of those; then county, more than 2,500 of those; and then townships, as I recall around 40,000 of those. That number has varied quite a bit over time. Nested hierarchy: every township is under a county, every county is under a city with almost no exceptions, every city is under a province, every province is under the center. Right? So, what I'm talking about is the deal that's done effectively between the leaders at one of those levels and the leaders at the level right below it. Okay?

So, say for a county, the leaders of the city and the leaders of the county that lies within the jurisdiction of that city or for city with the province. Okay? When I say a deal, this is not anything that's written down. I'm using the term deal to kind of capture what the reality of the relationship is and what the reality of expectations are on both sides. Okay?

With that having been said, what does the higher level do? Let's say city and county, so what does the city level leadership do vis-à-vis the county that's under it? The city will appoint the leaders at the next -- at the county level. You know, there are procedures that kind of fuzz that up a little bit, but fundamentally the city leaders decide who the county levels will be and put them in position. Having put them in position, they grant them sufficient flexibility to enable them, if they are creative and effective, to make their GDP in the county grow every single year.

This flexibility includes the flexibility to engage the enterprises in the county, enterprise-by-enterprise. I mean, you know, in every modern economy in the world the government engages the economy through monetary and fiscal policy, law and regulation, and sometimes sectoral policies. In China it is enterprise-by-enterprise. Not from the top of the system, but through multiple levels of the system. That's why we're calling it microeconomic engagement rather than macroeconomic engagement.

Thirdly, the city levels reward high performance by the leaders of the county. The most important single criterion for high performance is that you've grown your GDP over the previous year. There literally is an annual written evaluation where you get points for different things. You garner more points directly and indirectly for GDP growth than for any other single kind of activity and they know it.

There are other boxes you need to check, if you don't check them you're in real trouble. One is to maintain social stability; major incidents of social instability are a very large black mark. Also avoid incidents that will embarrass higher-level leaders, for example a major product safety scandal that, you know, produces great embarrassment. And then, also, of course, they have to implement the birth control program, and you cannot openly criticize your own patrons and do well in the system. But if you've checked these boxes of social stability, no major embarrassing incidents, that kind of thing, the number one thing is GDP growth. You make your GDP grow and you're going to be in better shape.

The other part of this deal -- well, there are two things, one is that the upper level leaders effectively will look the other way if in the process of growing your GDP you also grow your family's wealth, your personal wealth and your family's wealth. There are a lot of ways to do that in China and pretty much every local leader knows all of those ways. Secondly, if you do well on your performance evaluations, over time you'll get promoted to where you govern a richer economy with the same kinds of incentives and the same kinds of rewards.

Now, from the perspective of lower level leaders, lower level leaders follow a variety of particular strategies, different folks are different, of course, and they have different situations in their different localities, but on the whole, their priorities reflect the incentives that I've just laid out and they produce phenomena that are very much characteristic of the economy as a whole, even not of every single locality.

What are the common phenomena that you see as you go around China? First of all, not surprisingly, a focus on GDP growth, maintaining social order, and covering up embarrassments. That GDP growth is of a particular kind, though, it is shaped around major capital-intensive projects. Why? Well, first of all, they employ people immediately. Many of them get subsidies or very cheap loans that generate a lot of cash flow from which everyone can skim. They produce visible accomplishments. In other words, they're clear winners.

The real cost of those projects often is a long-term issue. You know, you build a bridge and it's not clear what the income from tolls and that kind of stuff will be, that plays out over a period of years, but you get tremendous points for having built the bridge and you've moved on before anyone figures out what the long-term costs actually are. Right? Same is true with high-speed rail; it's true with almost every big infrastructure kind of thing you can name, so the incentives to go for that kind of effort are very, very strong.

Leaders also protect local enterprises from competition from elsewhere. If products from elsewhere don't compete with what your own enterprises are doing, that's fine, they're welcome. If they do compete, there are a lot of ways to restrict their access to local markets, so local protectionism tends to be a very serious problem within the Chinese market.

They also in some areas protect local pirate firms, counterfeiters, from the law, because what is a pirate firm from the perspective of a legitimate enterprise in Shanghai, for some locality where the pirate firm is located, it's perfectly downright upright firm that employs people, pays taxes, produces a product that it sells, and keeps the game going in a very serious way, and the law in China says that when there is an intellectual property rights violation, the trial takes place in the locality where the counterfeiter is located, not where the products were sold, but where they were produced. But of course the local government has a lot of incentives to make sure that that trial doesn't produce a verdict that would actually shut down the pirate firm versus being managed reasonably easily and let the game continue.

This also produces incentives for overriding constraints imposed by environmental laws and regulations because GDP growth is rewarded, not environmental preservation, and it produces a lot of competition for investments and, therefore, a lot of duplicative infrastructure that duplicates what was built in nearby localities, because every place wants to build out because there are tremendous incentives to local leaders for doing that.

This basic deal also helps to explain some other major features of the Chinese system as a whole. Let me name eight of them just quickly.

One, although the system is authoritarian, certainly, the state's component parts are dynamic, competitive with each other in many instances, and entrepreneurial, so it's an extraordinarily dynamic one-party authoritarian system.

Secondly, generally, the people who get promoted, if you think of these criteria, are highly capable entrepreneurs who also know how to manage politics, so promotion is based on performance and performance, in no small part, is based on capacity to grow economies. It's not surprising that you get a lot of very good talent rising up to high levels in this political system.

Thirdly, these same individuals typically are quite corrupt, it's built into the system by now, and are effective in a system that allows a lot of discretion at each level of the hierarchy that permits microeconomic engagement of the economy and that does not permit law and regulation to rise above necessary measures to sustain growth, so that's the kind of combination, if you will, of mindset that goes forward.

Fourth, GDP growth, every year, is typically several percentage points above what the national level seeks to attain. This system incentivizes growth. It does not incentivize restraint. So, if you look, for example, the 11th Five-Year Plan proposed 7.5 percent a year annual growth and what they got was over 10 percent despite that plan's having covered the years of the financial and economic crisis. The current Five-Year Plan has lowered it to 7 percent target growth. My guess is it will average 9 to 10 percent because the top leaders can't effectively constrain growth the way they want to in order to avoid bubbles, inflation, et cetera.

Fifth, markets in China are fragmented by local protectionism. Everyone talks about the China market. The reality is, if you look at manufacturing facilities in China, very few of them produce at economies of scale and it's because even where you have national companies that say produce motorcycles or something like that, if you talk to their managers what you find is they distribute their production facilities around the company in order to get around local protectionist walls, and each of those facilities produces below economies of scale. Of if you look at concentration within Chinese industries compared to U.S. industry, in segment after segment after segment where you don't have a sector that's a state monopoly, where you have one or two enterprises that simply have a monopoly for the sector, in most sectors in China you have, you know, the top 10 players will have 8 percent of the market. In the U.S. they may have 45 percent of the market or that kind of thing. I provide numbers in my book to kind of illustrate that across an array of sectors.

Six, despite effective local efforts to grow the GDP and overall stellar GDP growth, the national economy as a whole is not very efficient. It's not very efficient because you have enormous duplication and you have much too much emphasis on capital-intensive development where you need a more balanced approach to development to be efficient.

Seventh, the physical environment really takes a serious beating in China, at no small part at the insistence of local leaders. I remember the head of the EPA in 2007 gave a wonderful press conference where he announced that over the previous 3 years, as I recall, there were 70,000 serious violations of environmental laws and regulations that had been reported to the Center, to the EPA at the Center, of which 500 had been addressed. He didn't say "resolved," he said "addressed." So, one of the reporters who was awake raised his hand and said, how come only 500? And he said, because almost all of these violations were at the orders of the local government. And if you read the environmental law you'll find it empowers the local government to be the level of government to deal with violations of environmental laws, so there was nothing they could do.

And eighth, the system is better at building facilities than at operating them. Building facilities is a profit center, operating them is a cost center. China built 500 water treatment facilities in 2002 to 2005, did inspections in 2006, found that half of them had never been turned on. They had all been built. For about half of them you have a sewage pipe going up to the facility, around the facility and right into the river because they didn't want to spend the money to run the facility having built it. Again, the incentives encourage that kind of behavior.

All of this presents very tough issues for China and very tough issues for multinational corporations that want to succeed in China. Now China now wants to shift significantly the development model that has produced such spectacular GDP growth over recent decades, so the 12th Five-Year Plan that they just adopted in March, really if you look at it, it lays out a different model of development for the Chinese economy. There are good reasons why they want to change their model of development, it's because the current model is no longer sustainable.

There are key assumptions underlying that model that are basically exhausted. These assumptions include virtually an unlimited supply of young, cheap, and flexible labor; the demographic pyramid no longer permits that in China. Secondly, that you can develop now and clean up later. The environmental costs are so huge that Chinese experts judge that they cost the economy between 8 and 15 percent of GDP every year and that may be on the low side. That people will tolerate growing corruption and inequality as necessary problems during a transition from a planned to a market economy. Surveys in China indicate that that tolerance is no longer there, that the inequality is so egregious, the corruption so irritating, linked to environmental degradation that is causing cancer of villages and other things at such a scale that this is no longer sustainable or at least it is very high cost to try to sustain it.

And then it also has assumed that export markets will continue to absorb rapidly increasing levels of Chinese exports, but the advanced industrial economies are not growing as rapidly as was originally anticipated and protectionist sentiment is out there, so there is, again, a feeling that that assumption has been exhausted.

So, the 12th Five-Year Plan charts a distinctly different course that includes higher value added production, much greater role for services, significantly enhanced household consumption, much more economic efficiency, especially energy efficiency, better protection of intellectual property to become a more innovative society, better social services to reduce social discontent, more measured pace of GDP growth, a lot of very good things. Frankly, I hope they can do it because it’s in our interest and their interest that they be able to shift the direction of development in the ways they’re trying to do.

The problem is, that in order to achieve these laudable goals, the incentives for local leaders -- province, municipal, county, and township -- need to be changed away from those in the deal that I just mentioned. But that would require major restructuring of the way the political system currently functions, including major restructuring of the grounds for promotion in that system.

China's already in a succession. I think there is no chance that they will attempt seriously to restructure the incentives for core political leaders at every level of that system until that succession has been completed, the new leaders are firmly in place, and then they will decide whether to take this on or not because it will take using a lot of political capital to do that, but that means effectively it's going to be at least 2014 before we see the first possibility of this type of political reform and the problems are growing very rapidly.

Before then, the 12th Five-Year Plan will have the national level throw money at the new priorities, I mean, they are serious when they articulate these priorities. But a lot of the actual outcomes are going to remain very close to what we've seen to date. Let me give you an example. Someone I know who's in a position to do this in China recently went around to the provinces and looked at the data on their provincial plans for this year. The national plan has them going at about 7.5 percent for this year. The provincial plans assume 11 percent growth for this year. No relationship to the national plan, right, because every provincial leader is trying to show his stuff and get the rewards for doing that.

So, it's going to be very hard to get growth down in the way they want to get growth down. Inequality of wealth, corruption and environmental devastation therefore are likely to continue to worsen but they are already sources of substantial social unrest and are imposing already very high costs on the system overall.

In sum, the political economy is deeply embedded and has produced rapid growth of a certain overall shape and has done this as a necessary -- has produced this kind of growth as a necessary outcome of the way the political system functions. That shape of growth is literally unsustainable over time.

I had the privilege of meeting with a ministerial level official this morning whose job enables him to make very sophisticated judgments of these issues and we discussed some of this. And his statement was, we've got 5 years to get a new growth model in place through the 12th Five-Year Plan, and if we fail to do that, we will not be able to sustain growth for 10 years. This model will run out fully within the decade, and he's of course hopeful that they can do it in time, but the political economy needs to change in order to change significantly the growth model. Rapid GDP growth may still continue for some years to come, but it's increasingly growth that breeds social instability and creates deeper problems for the system in the future.

Let me take finally five minutes to go over some corporate strategy implications of this for those of you more interested in that dimension of it, and that's the last part of my book. Now, the first part of the book makes the argument that I've just made in more detail, and then the second part of the book says, what are the implications for corporate strategy across the board, and they are really quite wide ranging.

At a first cut, multinational corporations are in what I would call the solutions business, so that China's successes present opportunities for multinationals, but China's deep problems also present opportunities for multinationals, they come up with solutions, so the fact that China may be getting into trouble is not necessarily bad news for businesses that know how to address the particular issues, whether it's environmental cleanup or whatever, that are becoming more difficult under this current development model.

The key is to understand not only China's goals but also the forces that will shape its outcomes, and the analysis, which is elaborated more fully in the book, should contribute to an ability to do that. This analysis also tees up elaboration of the types of risks that multinationals face in China, from supply chain risk to reputational risk to risks of loss of intellectual property to cyber risks and so forth, and identifies both the risks and strategies to mitigate them. And it embeds all of that analysis in an overview of how the Chinese system elaborates authority both horizontally and vertically. In other words, in addition to what I've just said about the deal, you know, China is the world's largest bureaucracy and it helps to understand how the matrix of authority in the Chinese system operates and how you know. You know, what questions do you ask? What's the vocabulary they use to describe their own lines of authority and division of responsibility and so forth?

Frankly, that stuff generally is not published in China, but it's also not secret. So if you know how to ask, they're happy to tell you, and it's extraordinarily important if you want to know how to operate. I found, unfortunately, very few foreign businesses know to ask and so the book seeks to address that issue and provide some pertinent guidance.

The bottom lines of all this are that authority is allocated in a way that necessitates a lot of consensus building within the state in order to reach most decisions and to implement them. Let me give you just one example of why this is the case. China has a system of bureaucratic ranks. Bureaucratic ranks include all non-private units, so not only the entire government and all state-owned enterprises, all universities, all think tanks, all hospitals, all museums, you name it, they're all on the ranking system. Right? No two units of the same rank can issue binding orders to each other, so if another unit is the same rank as you are, you can't issue an order to it.

It's worth keeping in mind in China, for example, that provinces and central ministries are the same rank, so no central ministry can issue an order to a province. The national government is the same rank as the national military. The government cannot issue orders to the military. SOEs, state-owned enterprises, have different ranks depending on their history and characteristics. Very often they outrank the government of the city that they're located in. City can't issue any orders to the SOE, and so forth. So, you need to sort out ranks and that kind of thing in order to figure out, you know, who you deal with on what. But the bottom line is, almost any serious decision requires a lot of internal consensus-building within the system in China in order to get a decision because it involves folks who do have the same rank and who cannot -- there's no one person who is willing to step forward who can actually resolve the issue on their own.

Asking the right questions, such as about ranks and solid line versus dotted line relationships, and so forth, can permit a company to map out the decision-making landscape far beyond the typically very limited circle of officials that normally deal with the company, and this can permit the company to develop a more effective strategy to help forge a consensus, a consensus in the direction of the decisions that the company would like to see occur.

As explained in some detail in the book, all of this is quite feasible if the company has the right talent and the right strategy to participate effectively in China's political economy, but the implications for strategy are really quite profound. They involve shifting resources within multinationals to put more resources in a Chinese-country level unit, more talent there, more risk capital there, more product development and design capability there, and so forth, than most multinationals currently are comfortable with, so there are a lot of implications for this in terms of the way multinationals actually function. If you want to pursue that in Q&A, I'd be happy to do it; there's a lot of detail to go into.

Let me sum up with just four summary points. First that China's political economy, again, how the political system interacts with the economy at all five levels of the political hierarchy. That political economy explains a great deal of China's success and a lot about China's core problems, and it also provides a good agenda for analyzing China's future prospects.

Second, this has implications for China's overall performance because the core political economy will change only very slowly. This took a long time to develop; you don't change it with a decision of the central committee. This is the heart of politics of an entire continent.

Thirdly, it also has major implications that in toto are very challenging for multinationals, not challenging in the sense that they can't be managed, the challenges allow tremendous opportunity, but you've got to understand what's going on in order to develop the strategies to seize those opportunities.

And fourth, and finally, at multiple levels -- since this is Brookings I have to conclude on this note -- at multiple levels, by shaping the likely outcomes of China's economic rebalancing program, by impacting on the level of multinational corporate, business confidence in china, so forth, in a lot of ways directly and indirectly, all of this is going to exert a major influence on U.S.-China relations. Thank you. (Applause)

MR. DERVIS: Jeff?

MR. BADER: Good afternoon, everyone. It's great to be back at Brookings and to be in an environment and a setting where I can turn off my BlackBerry for an hour and not feel that I'm risking my livelihood by doing so. My previous life, if I did that I was sure to be greeted upon exiting of the arena with a message in large capital letters saying, "Where are you?" I'm hoping that won't happen today.

Ken and I have been trading places, playing musical chairs for much of our adult lives and, as Ken says, this is a rare opportunity for me to critique him. For years you've been in the opposite position and Ken's been very gentle with me. I won't be gentle with Ken, I'll be truthful. I enjoyed his book immensely. I found *Managing the China Challenge* to be a rare combination of a very informative and educational read for the analysts of China trying to understand the decision-making process, at the same time a great primer for the business practitioner in thinking about how to establish a presence in China. I'm quite sure it will be read with interest and benefit in both circles.

It's hard to separate the insights into the analytic and the practical since like any truly perceptive insight, these insights illuminate both challenges, so I won't try to make that distinction.

What do I see as the main insights and lessons in Ken's book? Let me just innumerate a few. First, it's important to understand, as Ken says, that "the state is always your silent partner." That may mean a highly intrusive and smothering partnership that is not as silent as you would like, or a true silent partnership, but it may be more than the role of, say, limited partners and limited partnership. The ability of state actors to influence your livelihood as a business, China is always there. You may wish that that were not so, but to assume that is not a practical way to proceed.

Ken's description of the way in which instructions and guidance are conveyed in the Chinese economic decision making apparatus should be drummed into every would-be investor, indeed, any student of Chinese politics. The gist, as Ken writes, and as he just explained, is that China is not a federal system, as any Chinese will tell you, but in fact very substantial authority, has devolved to the provincial and subsidiary local levels, and Beijing ministries simply do not have the authority to instruct provincial secretaries and governors who are of the same rank.

Ken properly cautions against reliance on the rule of law or the instruments of the legal system to enforce ones claims. China has been moving toward greater use of the law to resolve commercial disputes but as a general matter, foreign companies who go to court to enforce claims live to regret it whether they win or lose. The law may be thought of as a kind of guideline or exhortation, not as an enforceable instrument.

I think it's important to go back to rule number one, the state is always your silent partner. If you're opposing litigant is powerful, you'll probably lose since the courts are not independent, but even if you win, you lose. If you win, the silent partner is likely to become much more obstreperous. This is not a theoretical conclusion, this is something that I have experienced with companies in China and I'm sure Ken has as well.

Ken's description of the obstacles caused by the system is a checklist that provides a good starting point for anyone looking for opportunities. Five factors -- local protectionism means your market is likely to be very constrained geographically. Secondly, accordingly, there are many small local players with no one having a dominant share of the market. Third, protection of intellectual property is a constant and enduring challenge. Four, you will be faced with corruption which comes in many disguised and gray forms, and fifth, there is overly developed infrastructure not based on need or market, but on politics.

As for Ken's description of how a U.S. company should think of establishing its presence in China and what kind of goods it should design for the market, Ken lays out a number of criteria, most of which I agree with, although I note that some of these are evolving. First, he notes that American products are almost always over-engineered for the China market. I think that's true. Secondly, he says that China operations should have autonomy and I agree, as a rule, that's the case. The days when expatriates could occupy the commanding heights of foreign invested enterprises in China are ending. There may still be some exceptions when a company has a need to make a statement about the attitude of corporate headquarters towards China, and so an expatriate leadership could make sense in such instances.

Ken points to the need to squeeze costs out of products by as much as 50 percent to make them saleable and attractive in China. I would say historically that's true, although high end products are becoming much more attractive in China than before and this may reduce the cost cutting imperative. Ken notes that retaining Chinese management personnel is a challenge. I absolutely agree with that. From what I've seen it's becoming more and more difficult as Chinese management finds domestic alternatives as attractive as foreign invested enterprises.

And finally Ken notes that it's important to aim at tier 2 and tier 3 cities rather than the handful of cities that have dominated the interest of foreign countries. I think that's absolutely true.

Risks, Ken cites three general categories, political stability and associated reputational risk, the impact of U.S. sanctions, possible anti-foreigner sentiment, secondly, supply chain issues, and third, intellectual property and rule of law.

Now, all this said -- and Ken properly spends much time on the obstacles and the challenges -- we need to remember that China remains a business friendly environment. This is not an absolute judgment but a relative one.

As for some of the negative factors that Ken mentioned, corruption, yes, but compared to other developing countries, arguably it's less of a factor in China than it is in many other major developing countries. Indeed I have spoken to a number of senior executives involved in China who are adamant that they have not found the Foreign Corrupt Practices Act to be an obstacle and to insist that a high standard of ethics can be helpful, not harmful, to their business interests.

Decisions on investments do indeed sometimes get politicized, but at the same time look at rulings by anti-trust authorities in the European Union effecting, for example, GE and Microsoft. Most CEOs, despite some movement backward in recent years, will still tell you they regard China as a much better environment for investors than say India or Indonesia, no less slow growth, advanced economies.

Political risks of instability, yes, certainly, but the economy has enough stakeholders, enough economic infrastructure, and enough people who know what they're doing in the economic commercial sector, so the prospect of a collapse, like Russia in the 1990s when its political system imploded, does not seem likely. This continues to be a culture that invites and attracts foreign investment.

Investors need to understand that entry into the market doesn't mean 1.3 billion potential buyers. Ken lays out the limitations in market size very clearly. All that said, global companies that I've spoken to say, uniformly, they cannot afford not to be in China, that it remains a primary growth opportunity, indeed, the primary growth opportunity for many. That's the bottom line. Thank you. (Applause)

MR. DERVIS: Well, thank you very much for the presentation and then the comment, and let me just start the discussion, and kind of turn it over to the audience very quickly, by perhaps making one point and then asking Ken a question. I think Jeff referred me (inaudible) comparison to the Soviet Union, but I think one thing that's very important to remember is that while in the Soviet system one had these rapid growth rates and so on, they were measured at prices that had nothing to do with world prices. And if anything, of course, the Soviet ruble was very much overvalued so that when the system finally opened and so on, and the real prices became possible, then one realized that much of that growth had been miscalculated and overstated.

In China it's really the opposite. I mean, if anything, the Chinese currency is undervalued and because of the export orientation and the engagement with the world market of the Chinese economy, actually, the measurements are pretty correct. The relative prices are roughly the right ones. So, in that sense I agree with Jeffrey, much that while there may be some similarities historically and so on, we're dealing with a very different type of economy and with a very different type of performance than what was the case in the Soviet Union, which also invested 40, 45 percent of it's GDP, but with results that were very, very different. I think the pricing exchange rate context is very important.

And that's what brings me to a quick question, I mean, you know, you can just react quickly and then we'll go on from there, but somehow I got a little bit of a message from your presentation, Ken, that you expect a significant, substantial slowdown in Chinese growth, maybe not next year or 2 years from now, but over the next 5 to 10 years, unless some very dramatic things happen but, you know, with the chance of these dramatic things not very high. Did I misunderstand you? Is that where kind of your bottom line is in terms of the overall projection to 2020 or maybe I misunderstood you somewhat?

MR. LIEBERTHAL: Well, look, I think the chances of Chinese growth remaining at 10 percent a year through 2020 are very small. Let me say, the Chinese leaders pray it doesn't remain at that level through 2020 because they would have teed up a disaster in their minds. I agree with them. They need to moderate growth and get growth that is less resource intensive, less energy intensive, provides more services, more of a social safety net, higher value-added in China rather than being at the bottom of the value-added part of the spectrum. There are lots of changes they need to make to make growth more sustainable and that also involves lowering the total rate of GDP growth and my concern is whether that occurs smoothly or whether it does not occur smoothly.

Let me say, there's nothing I've said about China in my remarks here that Chinese leaders would disagree with, to my knowledge, and I have privately talked with a lot of people at a ministerial level or above who say, yes, of course. I mean, if anything, you're understanding the problem.

So, I mean, one thing I admire about them is they recognize this analysis very well. They don't have their head in the sand at all. My -- you know, the remarks here were in part to kind of explain what's going on. The book is intended to help corporations through understanding what's going on to develop more effective strategies to deal with it. And let me say, my assumption -- I don't recall comparing this to the Soviet Union or the Soviet economy -- my assumption is that it is extremely important to be able to do well in China because China's so important. So, I'm not assuming that China's going to become a failure, but it is not -- you can do much better there, as in any country, but given the level of government engagement with the economy, you can do much better there if you understand the way all that works. So, that's what I've tried to do here.

Let me say one thing on prices, if I can. You're right, the renminbi is undervalued. I think no question about that. Retail prices in China are market driven, so they're pretty much, you know, supply and demand. But factor prices in China are affected a lot by state action, so cost of capital, cost of major resources, are not market prices, and generally are cheaper than they should be through state intervention. So, I think it's actually quite complex. It's not simply that Chinese currency is undervalued and therefore statements of the size of the Chinese economies are understatements. There are so many distortions within the economy, especially on the factor input side, that is really very hard to get a really accurate set of measures with this, I think.

MR. DERVIS: Okay, well, I mean, I think that's quite true, although, you know, the undervaluation of some of the factor inputs in a way is part of the overall undervaluation of the currency, so if anything, you know, that would drive the real exchange rate up if there's a liberalization and rationalization --

MR. LIEBERTHAL: I think it will go up.

MR. DERVIS: -- of those prices. And that, I mean, in terms of comparisons of the Chinese economy to the U.S. economy or, you know, if you look at the IMF projections, I think the project something close to 8 for the next 5 years at least, but then they add there will be probably about a 1 percent reevaluation -- real appreciation of the exchange rate. Now, you know, most people project much more than 1 percent because the real exchange rate is not just the nominal appreciation, but it's also differential in Chinese inflation and U.S. inflation or world inflation. So, I think it's not difficult to say, well, maybe on average the Chinese real appreciation will be of the order of 2 or 3 percent.

So, in dollar terms, even if the constant price of Chinese growth rate falls to say 7 percent, which is the target in the plan, if you add 3 percent real appreciation in dollar terms, you know, you get back to 10 percent.

Anyway, Jeff, any comments on this? Okay, so we'll open it to the audience now. First here --

MR. LIEBERTHAL: We have roving mics and if you identify yourself first.

MR. POLLACK: Jonathan Pollack from the Thornton Center. I don't want to make this an all Brookings show, but, Ken, you've made a very compelling argument about the non-sustainability of the course on which China's directed. At the same time you characterize a process that almost sounds like a runaway train, that no level of decision-making authority has the ability to put the brakes on let alone direct in some meaningful sense. So, when I'm trying to think about what happens next, lest there not be, to use the analogy again, a train wreck, what is it -- will it require some kind of a precipitating event in your judgment that might ultimately elicit some kind of a larger response from the system.

MR. DERVIS: Let's take two or three -- it makes for a better -- yes?

MR. MITCHELL: Thanks. I'm Garrett Mitchell and I write the Mitchell Report. And I think this is a question that may attach itself to the one that Dr. Pollack just asked and that is I've been thinking about -- you talked about rank and how that complicates who can give orders to whom, and the way in which this system has developed. Who have been the drivers of this? Who have been the architects? It's a kind of how did we get here, irrespective of whether one describes it as the runaway train or the fastest growing economy, if one looks at some of these specific elements that you've been talking about, have these come out of a kind of purposeful strategic thinking mindset? Are there key architects or players who get the credit for this?

MR. DERVIS: Maybe one more before we go. Yes?

MS. CHEN: Hello, this is Sharon Chen from (inaudible) policy studies. And I know of a California company that is able to transform carbon dioxide into cement but they have been really cautious about entering the Chinese market because they are afraid that their property rights cannot be protected well, so what would be your suggestion for this company? Thanks.

MR. DERVIS: Okay, so a very concrete question here and then the two --

MR. LIEBERTHAL: It was a very cement question, not a concrete question. My short recommendation is that they export cement to China. You have to think about that for a minute. In other words, don't take their core technology to China would be my suggestion.

On the first two issues here which are really quite important, this did not develop by chance. I think the key architect initially was Deng Xiaoping who was very strategic in thinking that you had to have a system that enabled mobilization of resources in a targeted way, but also allowed increasing flexibility, because almost anything dictated in detail from Beijing was not going to be very viable in a lot of different localities with very different conditions in China. So, the reforms that he implemented bureaucratically, that he encouraged bureaucratically, obviously working with many others, but he really was the -- if you will, the political godfather of this -- were basically to strengthen the territorial units in China, in other words, you know, the townships and counties and municipalities and provinces, at the expense, to some extent, of a national functional unit like, you know, an energy ministry hierarchy or steel ministry hierarchy or whatever it may be. They've changed those over the years.

At times those have been very strong. He said, fundamentally, we need to have good coordination, locality by locality with people who know how to grow things in those localities, but we also need discipline. The danger of the kind of presentation I just did, and it's one that I have a part of the book that addresses it, is that it may create the impression that the Center has almost no power. That is not true. The Center has a lot of leverage in this system, but for 98 percent of the issues, it doesn't want to use that leverage because it wants the advantages of flexibility and dynamism, incentivizing creativity along broad directions that the Center encourages, encourages through money, encourages through propaganda, encourages, if necessary, through promotions, and can encourage in more direct ways than that.

If there's -- this system is amazingly disciplined and capable in a very centralized fashion if three conditions are met. One is that all of the top leaders say all the standing committee members agree on an issue, secondly, they agree the issue is top priority, and thirdly, the results of their decision are measurable in a reasonable period of time. Those of you who've studied public policy know that almost never is the third condition met in public policy, it takes a long time, a lot of different complicating factors, it's very hard to know whether people are doing what you've instructed them to do.

But where you get those three conditions met, this system is unbelievable. Let me give you an example of that. When they finally reached agreement at the Center over how to handle SARS, back in 2003, this -- you saw the capability of what this system is able to do. Just utterly -- the U.S. could never do something like that, right, but those three conditions are almost never all met and so generally speaking there's a lot more flexibility where they're able to clamp down on truly undesirable behavior, but they need to keep the whole thing going.

That relates to a second dimension here, which is that there have been a succession of key architects of this, Deng was number one, I would argue Zhu Rongji played a huge role, especially in the late '90s, in making critical changes in the banking system, in the state-owned enterprise system, in the housing situation -- developing private housing, and so forth -- and others have obviously played a role. But what's happened over time is we think of China in terms of a society that is always moving toward reform and the reform is generally in more of a market dominated direction. And one of the big questions in China now that I, frankly, don't know the answer to is whether sufficiently strong interests have built up around the current structure and dynamics of the system, that effectively what we're seeing now is a long-term system that can no longer reform very much or whether we should still anticipate reform going forward. Clearly the 12th Five-Year Plan stipulates significant reform. We'll have to see what the new leadership coming in in the coming two years, whether they're going to have to graft the mettle of that and use the capabilities they have, especially early in the first time, you know, after they're in office, set up, everyone knows they've got eight more years or so, right, to really go after it. If so, probably some serious things will happen.

But the interests built up around the current system are now enormous and so the degrees of freedom, if you will, the ease of significant structural reform, I think, is becoming more of a problem.

MR. DERVIS: That was also an answer to your --

MR. BADER: Just to add one point on that. I mean, I agree with Ken entirely in his description of the historical path the Chinese system to get there and the role of Deng Xiaoping and Zhu Rongji. I would probably go a little bit further in judging -- in assessing how I think Zhu judges where the system has gone in the last few years. I think that he would regard where we are today as not exactly what he had in mind in the early 2000 period. I think that he did not think he was empowering local -- sort of this synergy between local officials and local enterprise that Ken has described as the core of the system now. I think he thought that he was enabling a less bureaucratic, more market-oriented system. He ran into enormous resistance. He was probably the most -- I think the most unpopular man in the Communist Party among other party members throughout that period precisely for that reason, and I'm quite sure he'd be disappointed by the evolution that has occurred in the last few years.

MR. LIEBERTHAL: In fact, he's said as such.

MR. DERVIS: Yes. First, and then there.

MR. MALLOY: I'm Pat Malloy with the U.S.-China Economic and Security Review Commission, a kind of congressional think tank on China, bipartisan. Thank you both. These were great presentations. This book will be very valuable.

The question I have is that Dr. Ralph Gomery, who ran the Alfred P. Sloan Foundation for many years, testified last week at the China Commission that corporate interests have diverged from the national interest, meaning that corporations can earn profits by helping other countries build GDP rather than help the United States build GDP.

MR. LIEBERTHAL: You mean U.S. corporations.

MR. MALLOY: Yes, U.S. corporations. And that other countries can incentivize them to do so. And you talked about the cost of capital in China being not market-based, but lower than -- so, there are various incentives that happen.

Now -- and then Jeff mentioned that many companies, and maybe would be advised, to invest in developing countries rather than the developed countries because they're growing so much faster. Since China entered the WTO 10 years ago, we have $2 trillion worth of trade deficits with China. Some people think that this has slowed down the U.S. economic growth and has incentivized economic growth -- been part of incentivizing economic growth in China. So, you've given good recommendations for corporate behavior. What is the public policy recommendations that you would make to U.S. officials? And we have to recommend things to the Congress. I would be very interested in what you would recommend as public policy for the U.S. Government to implement to help us build our economic growth in the face of this kind of China that we're now facing.

MR. DERVIS: Thank you. Yeah?

MR. KLEIN: Hi, Brian Klein. I'm currently self-affiliated, but formerly U.S. diplomat who served in China and was a CFR fellow based in Japan working on China-Japan issues.

On the political situation in China now, there was a movement to use Confucius as an ideological grandfather of sorts and then his statue disappeared from Tiananmen and now you don't hear too much about Confucius, but you're starting to hear about a Maoist revival and some high-level government officials, provincial-level officials, are using Maoist sayings and they're using quotes from his Little Red Book. Do you feel that that is an actual -- I don't know if you can call it a neoconservative movement in China that would maybe pull back on some of the growth that they've been seeing and try to turn the attention toward some of the problems, or do you see more economic liberalization as the solution for those problems? Because depending on which way China goes, U.S. businesses would be affected rather dramatically. If it goes back towards a more state-centric, more control over the economy versus a more liberalization of the economy.

MR. DERVIS: Yes. Anybody else? Yes.

MR. COLOPY: My name is Michael Colopy and I'm the head of ICCI. Quick question to follow up on Pat Malloy's comment. Many companies that I've dealt with over the last 20 years dealing with China are now changing their tune about how they are represented in their relations with China, specifically pointing to the fact that the very largest companies that make up the leadership with the U.S. Chamber do not really speak for them, that many key members of AmCham in China no longer really speak for them, and they point to the fact that leverage through targeting companies that criticize China policy or express publicly any reservations about their success in China are readily punishable and, therefore, the larger companies have a divergent agenda. Could you address that?

I also want to mention that recently a company has written a memo referring to their situation as hostage capital, meaning that they could not go forward with planned agreements because of an executive criticizing them and now they're being pressured to make investments they would not otherwise make.

MR. DERVIS: We'll take one more in the back and then we'll go back to the --

MR. CHATTERJEE: My name is Samar Chatterjee and this -- from Safe Foundation. This question is for the author and I think it's an interesting book where you talk about political economy and how the politics and business of course they are always in bed works in China and that's true in this country too, as a foreigner who is coming to this country from 1970 to now, it seems like it's very similar to the United States. Given that situation, I would like to ask you, since you presented all this and you say it is, *Managing China: How to Achieve Corporate Success*, I'd like to know your corporate success in the Chinese economy and do you have a track record? And if we follow your book, would we be successful therefore?

MR. DERVIS: Okay, maybe I'll add one question on my own which kind of follows from the gentleman from the Congress think tank. What about Chinese corporations? I mean, are they beginning to develop truly multinational characteristics in terms of making, you know, some of their profits outside and then becoming really more involved? Or is this still a very, very minor kind of phenomenon?

So, Ken, five questions, last round.

MR. LIEBERTHAL: Let me take two and a half and leave two and a half for Jeff, and I'll exercise the prerogative of being the author to determine which two and a half I'll take.

Let me start with Kemal's. Chinese -- you have to differentiate Chinese firms here. Some of the major natural resource firms now generate a substantial amount of profit outside of China, especially the national oil companies but also others. Increasingly, infrastructure construction companies are making money outside of China. In fact, they're building infrastructure all over Asia at this point and seeking to go far beyond that, but on the whole, Chinese companies still remain very, very domestic. Most of them have felt that China has a lot of low hanging fruit in an economy developing at 10 percent a year and they know how to operate there. When they go outside of China, you know, things become more difficult and having said that, there is now a strong push by the government, it's been going on for some years, but it's now ramping up, for Chinese companies to go abroad.

Many of those that do go abroad go abroad because their margins in China are too small, and so they go abroad for frankly richer markets. I think it's going to -- first of all, that presents an opportunity for the U.S. because there is a potential for substantial Chinese investment in the U.S. I think like as with the Japanese, it's going to take at least one to two decades before most Chinese firms that come here will learn how to operate effectively here, so, you know, it's going to be a bumpy road, but you have to pay those dues to figure out how to be effective abroad.

Right now there are a handful of Chinese companies that you could say are somewhat like a classic multinational corporation, you know, (inaudible), you know, that kind of thing or higher, where they do major business around the world. But I think probably within 20 years you'll have a substantial number that's going to be an uneven transition from here to there.

The -- for my own corporate success in China, I have a book that came out in Chinese that has sold much better than any book I've sold in the United States, so I rest my case. I've made my career on China; I still put food on the family plate, so I'll leave it at that.

The question -- and then I'll leave the rest to Jeff -- the question of whether this economy is moving toward more state control or implicitly more of a liberal market with private sector being key actors, I think it's very -- first of all, it's very hard to determine at this point. The statistics here are terrible, but beyond that there are clearly very different priorities among different national level political figures. Xi Jinping, who will become the head of the party in 2012 had the major part of his career in the two provinces that have the largest private sectors in China and he knows a lot about the private sector. Wu Bangguo, one of the current top leaders, in fact, ranked second in the party, has come out and said very clearly that he doesn't see a big role for the private sector in the future, and you get every opinion in between.

So, I don't think that that is a predetermined outcome one way or the other. I think a lot is going to depend on how the economy just develops over time. I -- one thing that, frankly, surprises me a little bit is that recent lending through the formal banking system has begun to flow in at a significant level to the private sector, which was not the case before, and so we're beginning to get the private sector accessing relatively cheap capital for at least some of their financing needs. But we have to keep in mind that roughly a third of all financial intermediation in China is totally off the books. No one has any idea what's going on, right, and my guess is that most of that is in the private sector financing and most of it's probably pretty high priced financing.

So, it's just hard to know what's going to happen here. I would just say it's very dynamic. I certainly don't see Hu Jintao pushing for priority growth for the private sector, but whether Xi Jinping will lean more in that direction or not, is just something we're going to have to see.

Jeff, do you want to pick up there?

MR. BADER: Sure. Just a word or two. Pat, in talking about what U.S. companies should do in China, I was not trying to offer a normative judgment about what is the right course, I was simply reiterating what I've heard from numerous companies about the relative attractiveness from a profit point of view of the China market. I was not making a normative judgment about it. I understand in your role, in your Commission, you are looking for normative judgments, if I understand it right, for how we should think from a public policy point of view about the impact of decisions that corporations make based on profit and loss, and we presume we would not want them to make the decisions on any other basis, presumably. We do not have -- you know, Hu Jintao had a going out policy in 2002, 2003, where the Chinese encouraged corporate investment overseas. That would not be consistent with our system to have a policy of identifying targets for foreign investment or discouraging them unless there were strong policy reasons and distinctions we could make among countries and markets for them, which I think is hugely challenging.

There perhaps could be some distinctions made about inward investment to the United States based on the track records of Chinese companies, for example, in protection of intellectual property, whether they have been involved in theft of intellectual property, and then they are trying to pillar goods that are the product of theft in the United States.

I'm sure you, in your position, understand better than I do the difficulty in trying to draw lines around one market and making distinctions between a China and some other country, how one embodies those distinctions in law is, I think, enormously challenging, particularly when most of the Fortune 500s see China as a huge opportunity and they don't see many of these other markets as comparable opportunities.

I think one area that we may want to think about in the years to come is the whole issue of tech transfer, of forced tech transfer by the Chinese government. That is contrary to the spirit of the WTO. There is language in the WTO about the impropriety of compelling technology transfer as a price for admission to a market, but it's very, very hard to enforce when it appears to be a private commercial deal between a Chinese company and an American company, even when one knows that the Chinese government stands behind it. I think that's an area that perhaps we could look at more to see if there is some way we can level the playing field, because I think that's what the American companies are really worried about. They're all subject to that kind of pressure for the transfer of technology. Some of them are comfortable with it, many of them are not, but that is the price of admission, so some creative thinking in that area might perhaps be helpful.

The question about who speaks for business on China and the pressures that are brought to bear against companies, that's absolutely right. The Chinese are capable of marshalling pressures in a way that we cannot, frankly. They -- if a company runs afoul of the Chinese authorities, they can do things that we cannot do here. That's inherent in the nature of our systems. Now, that doesn't mean that we are toothless or have no ability to react. I mean, last year when Chinese -- the Chinese government was threatening American companies that had been involved in the Taiwan arms sale, you know, I spoke to Chinese officials and made it clear what the consequences would be if they were to move in that direction. I was speaking without instructions and without consultations with anybody, but it was -- how should I say -- a meaningless threat that would become meaningful pretty quickly if they had retaliated against any of the companies that they were making noises about retaliating against. It's easier in their case because they can do it all by administrative fiat whereas in our case we would probably need law to respond, but in that particular case I was comfortable in my belief that law would have been quick to follow had there been Chinese action.

MR. LIEBERTHAL: If I could just add one --

MR. DERVIS: One last -- well, let's take one quick --

MR. LIEBERTHAL: Can I make one quick comment before we go --

MR. DERVIS: Let's take this one and then you have the final -- yeah, one last question from the floor.

SPEAKER: Thank you. (inaudible) from Institute for Policy Studies. So, as Professor Lieberthal mentioned, China's current growth model is unsustainable and has a lot of corruption, so I was wondering what stays at the core of the corruption? Is it the purpose incentive of growth promotion related -- sorry, the growth related promotion, or is it something else? Can you provide some policy solutions for the corruption problem? Thank you.

MR. DERVIS: Thank you. Okay, that was the last question, so now Ken has the last word and concluding --

MR. LIEBERTHAL: Jeff may want to add a word; I would make two comments. First of all, on your question, very good question on corruption, drivers of corruption. The way I would put it is corruption has passed a tipping point long ago. If you're going to function effectively in the Chinese political system now -- by the way, my advice in my book and in every consulting opportunity I have ever had is to tell companies never, ever engage in corruption, period, dead loser. So, I'm not saying for foreigners, but if you're in the Chinese political system now, it is very hard to get ahead if you aren't corrupt. In other words, if you don't play in that part of the system -- I've talked to Chinese officials about this. The way I put it is what would you do if someone joined your office and really would not engage in the side payments and this kind of stuff that is typical, and the answer, generally, is they would not last long because the system just functions that way. They aren't playing within the system.

So, obviously, there is personal aggrandizement, conspicuous consumption is now all the rage in China to show that you have actually -- you know, that you're actually a family of means, at this point, but the system itself just builds this in, so to my mind, to get rid of it, you would have to establish an independent anticorruption capability, independent of the current system. So, something like what Hong Kong did with the ICAC back in the 1980s, the Independent Commission Against Corruption, which started off -- it established its credibility by going after the police that everyone knew were the most corrupt and tossing them in jail. Right? But China is not prepared to go down that path. Instead they keep adding additional layers of supervision, you know, in order to ferret out corruption. Well, of course every new layer of supervision is a new set of opportunities for corruption, so that really has not worked and the statistics that China occasionally lets out about their own assessments to the level of corruption are absolutely jaw dropping.

So, I think this is just a core problem. I don't see without much more dramatic efforts than they are prepared to make, systemically, I don't see this problem coming under control, frankly, and my fear is that China will move from its current system, which I would term bureaucratic capitalism, to crony capitalism, and that would become a much less desirable system to my mind.

The other point I just wanted to make, and it kind of was inspired a little bit by Pat Malloy's question in terms of, you know, kind of what can the U.S. do? Frankly, the number one thing the U.S. can do to do well is to take the measures domestically we need to do to get our economy going, you know, investments in infrastructure, in R&D, in education, in clean energy, in -- you know, these kinds of things that we really need to do -- get our financial systems, get our fiscal problems under control, and our financial system on a more sustainable -- you know, a less risky basis. If we do well, there is nothing that will impress the Chinese more than the U.S. getting its act together. They are very pragmatic. If they see us really getting ahead of our problems and mobilizing the unique capabilities, or nearly unique capabilities of our system, they're, in a sense, much nicer to us. They really respect that a great deal.

So, there are some things we can do with China, you know, to affect them. Frankly, they're limited. I think Jeff was exactly right in his remarks, but boy, we can do a lot ourselves about ourselves, and that's really where the game is at the end of the day.

MR. DERVIS: That's a very forceful conclusion. Jeff, do you want to add anything? No. Well, thank you very much. I hope you enjoyed, as I did, these two (inaudible) presentations, and I hope for those of you who haven't done it yet, you pick up the book and read it. It's a wonderful read. Thank you very much. (Applause)

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

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