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P R O C E E D I N G S

MR. LIEBERTHAL: Delighted you're here. I'm Ken Lieberthal. I'm director of the John L. Thornton China Center at Brookings.

Our program this morning focuses on a very important set of developments. The People's Republic of China, in March of this year, adopted the 12th Five-Year Plan. That Five-Year Plan, to a startling extent, really lays out a new development model for China -- effectively changing a lot of the parameters of development from what we've seen in the highly successful Chinese economy in recent decades.

The program today is designed to lay out some of the key elements in that new model, and to discuss them.

We have, I think, two of the best speakers possible for those dual tasks. Mr. Cheng Siwei is a prominent Chinese economist. He's former Vice Chairman of the Standing Committee of the National People's Congress. He currently serves as Chairman of China's International Finance Forum -- among other positions, I might add. His collected works have been published in Chinese, and will be published later this year in English under the title, *Economic Reforms and Development in China*.

Chairman Cheng is the recipient of the Asia Foundation's Chang-lin Tien Distinguished Visiting Fellow Award. This fellowship honors the late Dr. Chang-lin Tien, who was former Chancellor at the University of California-Berkeley, marking his elevation in 1999 to Chairman of the Board of Trustees of the Asia Foundation.

The Chang-lin Tien Distinguished Fellowship Program was established to foster leadership exchanges for distinguished and emerging leaders to meet and interact with their counterparts in Asia and the U.S. And as a recipient of that award, Cheng Siwei has been touring the United States with stops, I know, in California and New

York, Boston, Florida, and here -- speaking in each place on various aspects of China's economic development and the future of the Chinese economy.

We're delighted to have him here today.

Let me note also, finally, that in his long and distinguished career, he has also served as Vice Minister of the Chemical Industry in China, from 1994 to 1997.

Cheng Siwei will give remarks of roughly 30 minutes to lay out some of the key parameters of China's Five-Year Plan, with special reference to the green economy. He has done an enormous amount of work especially on clean energy issues in China.

And then I'm delighted, also, to welcome Professor Barry Naughton, who is an economist and professor at the University of California at San Diego. As anyone who has studied the Chinese economy knows, Professor Naughton is one of the leading macro-economists focused on China in the United States. He has focused generally on four interrelated areas: on economic transition, industry and technology, foreign trade, and China's political economy. His book on *Growing Out of the Plan* won the Masayoshi Ohira Memorial Prize. His more recent book *The Chinese Economy: Transition and Growth* has become a standard text in courses on China in the United States.

And, finally, I want to note that Professor Naughton was named the -- I hope I'm pronouncing this correctly -- Sokwanlok Professor at the Graduate School of International Relations and Pacific Studies at the University of California-San Diego. He has held that chair for now more than a decade.

So we will lead first with Cheng Siwei. Then Professor Naughton will come up. At the end of Professor Naughton's presentation, our two speakers will sit in the two chairs here and I will moderate Q&A from the audience.

So let me get out of the way and let the speakers begin.

Chairman Cheng -- please.

MR. CHENG: Ladies and gentlemen, I'm very glad to be hear and to share my thoughts with you. But, first of all, I have to make an announcement, since I'm officially retired from the National People's Congress. So I'm not longer speaking on behalf of the Chinese Parliament. So what I'm saying here is based on my research and my thoughts as a scholar.

Today I was requested to speak on the 12th Five-Year Plan. But because the time limit, I only can take a few focus. I want to talk four highlights.

As you know, since 2003, China enjoyed a two-digit growth from 2003 to 2007. In 2007, it got a 13 percent growth rate. And then, from 2008, under the influence of global financial crisis, so our growth rate dropped quite a large part. And so, in the fourth quarter of 2008 we launched a 4 trillion RMB stimulus package. According to my research, without this package our growth rate maybe only 2.4 percent. But with this stimulus package we got a 9.2 percent growth rate.

But in the year 2010, starting from the year 2010, the negative effects emerged. So, for example, the investment overheat caused the excess capacity, the over-inventory, the lower investment return, and a more environmental problems. And also, the excess of liquidity caused the bubble of the financial assets, especially the real estate assets. And also the increase of local government debts, and also the danger of inflation.

So we did research on the lessons from the global financial crisis for China. And actually, we found that the former development pattern, relying heavily on the investment and foreign demand, is not sustainable. So in the 12th Five-Year Plan, the first thing is we need to change our development pattern from relying on investment and net export, to relying more on domestic consumption.

But this is not an easy job. Because if we want to rely more on domestic consumption, first we have to raise people's purchasing power. So I proposed three

arrangements. One is to synchronize people's income with economic growth. I think we almost reached this target. Last year, the people's income, after adjustment of inflation, were 9.8 and 8.5 in rural area and urban area respectively.

And second is to link the salary with inflation rate. And at this time being 30 provinces in China all linked the minimum salary with the inflation rate.

And the third is we need to increase workers' reward along with the increase of productivity. And we are still to doing this.

And besides, we have two additional measures. One is to raise the floor of personal income tax, from 800 RMB to 1,600 RMB, to 2,000 RMB. And recently we raised it to 3,500 RMB. So at this time being, only 9 percent of Chinese people should pay personal income tax. So I just tease my American friends, if I were the Presidential candidate in the United States, I will add one more "9" to the "three 9s." (Laughter) Only 9 percent of the people needs to pay the income tax.

And on the other hand, we need to promote credit consumption. Because at this time being, our banks -- 15 percent of bank loans is the personal credit, and in developed countries it's 60 to 70. So, what we need is to promote the credit consumption. And we're encouraging Chinese people to save less and spend more, to improve the global imbalance.

And secondly; so this is first: we need to raise people's income that people can consume. And secondly, we need to improve our social security system that people have less hesitation in spending their money. So that means that people dare to consume.

And last but not least is we need to development more innovative new products that people will consume. So, as I said, we need more Steve Jobs in China so we can have more, you know, innovative products like the Apple, you know, iPod,

iPod nano, iPodTouch, iPhone 2S, iPhone 3S, iPhone 4, iPhone 4S, iPad 1, iPad 2.

(Laughter)

So this is the first that people can consume, dare to consume, and will to consume. So only by this we can, you know, rely more on domestic consumption.

And the second is we should pay more attention to the sustainable development. According to our research, in the year 2005, our environmental cost, including the low-energy efficiency, the environmental pollution, and the damage of ecosystem consists 13.5 percent of our GDP. But that year our GDP only increased by 10.4 percent. So it means we will leave our environmental debts to our children and grandchildren. So this cannot be sustainable.

So indeed, we have to pay more attention to the environmental issue to sustainable development domestically. Internationally, because the global warming is a hot issue all over the world. So China also needs to take our responsibility to reduce the CO₂ emission per GDP. So in this case we have to develop our green economy.

In my opinion, the green economy includes the low-carbon economy, recycling economy, and eco-economy. And low-carbon economy at this time being a very hot topic.

And in my opinion, there are four measures in the low-carbon economy. One is to develop the green industries which do not emit CO₂ or emit very little amount of CO₂. And the second is revamping the existing enterprises to reduce the CO₂ emission. Third is to utilize CO₂ as raw materials. At this time we only some Coca Cola and some beverage use CO₂. But in the future, I think chemical industry should play a more important role in utilizing CO₂ as the raw materials. For example, the polycarbonate -- I was the Vice Minister of Chemical Industry, so I know this -- you know, the polycarbonate used in the CDs and DVDs, they use -- in the past they used phosphine as the raw

material. This is toxic. And if we can use dimethyl carbonate as raw material, it will utilize more CO₂ and so this is very good.

And last is we need to promote the CO₂ capture and storage, CCS. But certainly, at this time, it cannot be cost-justified. According to our research in China, now to capture and store one ton CO₂, at least needs 160 RMB. So at this time it's not cost-justified.

So in China's case, I will remind you -- I would like to remind you, firstly, China is a developing country. So we are still developing. So in this case, we cannot promise to reduce the CO₂ total amount. But what we need is to promise to reduce the CO₂ per GDP. Our government already announced that by the year 2020 we will reduce our CO₂ emission by 40 to 45 percent on 2005 basis. And in the 12th Five-Year Plan, we will reduce our CO₂ for 17 percent per GDP.

So at this time -- and also, on the other hand, China is a country relying heavily on fossil energy. At this time being, our energy consumption -- 90 percent of energy consumption is fossil energy: 70 percent coal and 20 percent petroleum and natural gas. So in this case, even we put a lot of effort to develop new energy, still by the year 2020 we only can reduce the fossil energy percentage in our energy consumption from 90 percent to 85 percent.

So at this time being, in the short period our target is low energy consumption, low pollution, and low emission -- three lows. This is very important, because we have to put reducing the CO₂ emission in our existing industries as the first priority.

So, for example, our coal-fired power plant, at this time being average coal consumption is 350 gram standard coal. And the most advanced plant only consume 284 grams. So if we can reduce the coal consumption, average coal

consumption, to 300 grams, it will be a big saving of coal, and also will reduce CO₂ emission.

Second is we need to develop new energy, green economy -- green industries, mainly including new energy, modern service industries, cottage industries, et cetera. And we launched a very ambitious new energy development plan. But the year 2020 the total investment will be 5 trillion RMB. And by the year 2020, our hydro-power will increase from 200 million kilowatts installation capacity to 300 million.

Our nuclear will increase from a little more than 10 million to 60 to 70 million. But now we are reconsidering this plan, and will like -- we will still need to develop nuclear, but we need to put safety at the first priority.

And our wind power will increase from a little more than 20 million kilowatts to 120 million by the year 2020. The solar energy will increase from 6 million to 13 million. So you can see this is very ambitious new energy development plan. And certainly it needs to be approved by the National People's Congress in the next year.

And also, the new service -- the modern service industry is also very important, including the modern financial service industry, information industry, logistics industry, exhibition industry, consulting industry, and management industry. They are all the industries which do not emit CO₂.

And the third is cultural industry. Along with the income increase of Chinese people, the demand of cultural products and cultural service is growing. So in China, at this time being, culture industry only 3 percent of our GDP. And in the developed countries, it's over 10 percent. So there is a big room to develop culture industry.

And on the other hand, through developing other cultural exports, culture industry will promote a better mutual understanding between Chinese people and foreign people. For example, I am a Tai Chi practitioner, but I found out Tai Chi is not so

popular, well known, comparing with yoga, India yoga. So I would like to encourage you to practice Tai Chi. I'm 76 years old. I can still stand here and speak. (Laughter)

So, I think green industry also is very important. We need to develop them. And recently, the CPC Central Committee, the Sixth Central Committee, passed the resolution to develop our culture, the Chinese culture. So the culture industry is also an important part in the resolution.

And the third is we need to improve our opening policy. In the past, especially after we joined the WTO, World Trade Organization, our foreign trade increased quite fast. But because the financial crisis, the developed countries are de-leveraging. So China, the result is, we need to de-capacity. So, in this case, we need to rethinking of our opening policy, and improve the policy.

I think, mostly, first is we would like to make our trade more balanced. People are talking about the trade imbalance between China and the United States. But how can we solve this problem? I think we need to solve this problem by the effort from both sides. Because at this time being, China export to the United States is in the lower end, and the United States exports to China is on the higher end. So in the lower end, you cannot -- we cannot buy your products because our products are more cheap than yours. And in the higher end, you should release some limitations to make the trade more balanced.

I tease my American friends. I said, if you can sell a space shuttle to us, it will improve the trade imbalance. But you won't, right? So in this case, we need to balance the trade by export more from the United States to China.

And the second is, you don't need to politicize the trade imbalance issue. Several years ago, when I was in the United States, my friends told me there is an American Congressman said, "You see all the ships come from China are fully loaded. All ships go to China are empty. So how serious the trade imbalance is."

I said, "Nothing surprising. Because what we sell to you is shoes, toys, color sets. They have to be shipped by vessels. But what do you sell to us is chips and high-tech products. They are shipped by air cargo." So don't politicize this issue -- right?

And the third is we need to solve this problem through consultation instead of confrontation. There will be no winner in a trade war. But from the Chinese side, we have no intention to pursue a very high surplus, trade surplus. We would like to make more balanced. So in this case, I think we can control our surplus less than 4 percent of GDP. That's requested.

And also, we should not accumulate a very high foreign-exchange reserve. As you know, China's foreign exchange reserve is over \$3 trillion U.S. now. It's really a heavy burden to us. Because on the one hand, it will limit our -- the independence of our monetary policy, because when one U.S. dollar comes in, we have to pay 6.15 RMB. All right? So it will limit the independence of our monetary policy. On the other hand, we will bear the risk of devaluation of the U.S. dollars.

According to our research, 20 percent of our GDP reserve is enough, both including strategic and tactical foreign reserve. So in this case only \$1.2 trillion U.S. foreign reserve should be enough for China. But now we are much higher than this number. And around 1.4 trillion is invested in the American governmental bond, treasury bonds.

And third is we are going to move to internationalize our currency. We already liberated our capital current account by the year 1996. And according to IMF, there are 43 sub-accounts in capital account -- at this time being up around 20 sub-accounts already liberated. So we still have around 20 sub-accounts to go.

And this year, as you know, we took a few steps. One is we announced to allow the foreign company to be listed in our share market. And also, we are testing our off-shore RMB business in Hong Kong. So this means we are moving toward the

direction make RMB fully convertible. But certainly we have to be very careful. Because first we have to choose a good timing. Second is we have to improve our capability to control the situation. And the third is it cannot -- we should not announce a timetable. Because if we announce a timetable it will encourage speculation -- right?

So there are some differences in China on this issue. In my opinion, the sooner the better. But I think, generally speaking, I think that the pace of the internationalization of the RMB will be accelerated.

And also, we are encouraging the FDI from China, encourage our companies to go out. Until now, the FDI to China is \$1.15 trillion U.S. And FDI from China is a little over \$300 billion. So I think that we need to still need to encourage the FDI from China. But the problem is we need to -- in the U.S., you need to reduce the limitations. I think some people may be too nervous. I don't think a washing machine has some relationship with national security. I really cannot think about that. Do you know the case? The washing-machine case? Okay.

And so, last but not least, is we need to improve our education system. In my opinion, the goal of the education system, one is to foster, to raise the level, culture, of culture, science, technology, moral of our people. And secondly, it's to foster innovative spirit of -- to foster innovative talent.

So in this case, we need to reform China's education system to pay more attention to foster innovative spirit. So, as I said, we need more Steve Jobs, Bill Gates. But I'm not encouraging the students to give up their efforts to get a bachelor's degree. I'm not saying this. (Laughter)

And so I think today the competition between countries -- mainly the competition between human resources. And behind that is the competition of creativity.

So in this case, I think the economy only can guarantee our today. Science and technology can guarantee our tomorrow. But only education can guarantee our day-after-tomorrow.

So I said invest in education is invest in our future. So I think this is very important, to reform Chinese education system. Certainly, I heard the *Tiger Mother* story in the United States. That means, on the other hand, that in the United States maybe you need to pay more attention for the basic trending of the students. But in China, I think we need to shift the form to foster more straight-A students to some students with innovative spirits.

So I think I'll give you the four highlights.

One is the changing our economic development pattern from relying on investment and net export to domestic consumption.

Second is develop green economy.

Third is to improve our opening policy.

Fourth is to reform our educational system.

Certainly, in our 12th Five-Year Plan there are many other topics. But because of the time limit, I only can speak to these highlights.

Thank you very much for your attention. (Applause)

MR. NAUGHTON: That's a tough act to follow. Cheng Siwei has laid out a vision for the transformation of the Chinese economy that I think encapsulates a whole set of goals that I think are goals that many of us share. These are visionary goals about the Chinese economy.

So I can't really add anything to the goals. The goals are the fundamental adaptations that a system like China needs as it moves from being a low-income developing country, to being a middle- and even upper-middle-income developing country.

I want to raise a set of questions, though. And the set of questions are: how do we get there? Every one of the goals that Cheng Siwei mentioned represent an end-state in which the kinds of economic activity and the incentive system that drives people are different from the economy that we have today.

It's a huge advantage to China that they have individuals and, for that matter, government institutions whose job is to think about the way the economy develops -- the challenges that emerge and the new types of situations that emerge.

China, I often think, we can understand it best in terms of thinking of it as going through a turning point from a labor-surplus, low-income economy to a middle-income economy, where labor is no longer cheap and surplus, but increasingly skilled, more expensive, and generates more complex and more diverse demands on the economy, as well.

In other words, China is going through a turning point from a low-skilled economy to a diverse medium-skilled, middle-income economy. And it's a huge impact on the world. It's a huge impact on the lives of all of us.

Now, Chinese thinkers, Chinese economists, Chinese planners, started really to envision what this change would mean a little more than five years ago. When the 11th Five-Year Plan was produced in 2005, it laid out most of the fundamental themes that have been on the table ever since -- and, frankly, most of the themes that are expressed today in Cheng Siwei's talk. The need to move away from external demand, the move away from an unbalanced economy. The need to move away towards a more environmental-friendly, resource-light economy -- all those things have been discussed and brought to the fore of Chinese economic policy-making for about seven years now.

So when we look at these goals for the future, one of the fundamental questions we should be asking is: how are we doing? Have we begun to make this

transition to a more modern, lighter, more technologically sophisticated and more green economy? Have we begun to make the transition towards a more balanced economy?

If we have, what have we done well, and what haven't we done well?

And, most important, do we have the set of institutions and the set of policies that are necessary to bring us in that direction?

Now, when we look at it in this way, I think our analysis has to be a kind of firmly "yes and no." There is one aspect in which I think we can say the Chinese have done extremely well, and deserve a great deal of praise, and that's for the beginning of the development of a green consciousness, and the beginning of a development of green industry.

We know that, particularly when we look at the energy sector, China has emerged as a very significant producer of new energy technologies, in terms of wind power and solar power, in particular. And we know that there were a lot of problems in the initial stages of the development of these industries -- in particular, the industries that were developed as industrial sectors, and only slowly became actual producers of power.

Today, though, I think we can see that policy has begun to shift in a way that means wind power has become significant in China. Wind developed 1.2 percent of China's electric power in 2010. Not quite as much as in the United States, but close -- and a very dramatic improvement over previous years.

Solar power -- China is a big producer of solar panels. Not yet, however, much of a generator of power from solar panels. Last year solar generation accounted for .006 percent of China's electrical power, still pretty tiny by any standard.

But the key point here is we see the beginnings of a process that are leading to the incorporation of green technologies into the production process. So an important start has been made -- an important effort to reduce carbon emissions, and to reduce pollution, as well. It's important we recognize that.

Now, let's take a look at the other side of it: the movement from a more unbalanced economy that's dependent upon investment, dependent upon heavy industrial development, and dependent upon export surpluses. How are we doing in this respect?

Well here we have to say that not only has overall progress not been made but, in some ways, there's been regression. If we take as our benchmark the year 2005, when the 11th Five-Year Plan was established, China's economy today -- by virtually any measure -- is more unbalanced. Investment is a larger share of overall economy. The export surplus -- granted, it was higher at an interim period, in 2007, early 2008 -- but still the export surplus is considerably larger than it was back in 2005.

And in other respects, as well, the economy still shows the characteristics of an extremely unbalanced economy that reflects a growth strategy that's over reliant upon investment, over reliant upon industry, and over reliant upon exports.

So what's going on here?

We're looking at a system, a system in which economic planners have a lot of influence, where economic planners are influenced by a vision of a lighter and more sophisticated economic, and more balanced economic path. Where planners have been calling for that path to be adopted. Where Cheng Siwei says, "This is the correct direction for the future," and yet, in general, we would have to say that the economy is not shifting onto that superior kind of growth path -- even though that's the growth path that is especially necessary for the transition as China reaches a middle-income status.

So we have to ask a fundamental question. And that is, are the measures and the institutions that China is using today the appropriate ones to realize this program of economic transition?

And I think to a certain extent we have to argue that those institutions are actually not the right institutions. And let me ask a question, in particular, about the

development of new green industries. China has made a huge commitment to new industries. And that commitment has involved a substantial investment of resources, as well. It seems to me, though, that the problem is this development of new industries remains far too much under the influence of government and government-run enterprises.

And this has two important results. One is that the entrepreneurial genius of the Chinese people is less effectively harnessed in the development of these industries. And the second is that government tends to reproduce the excessive expenditure of resources on investment. And so even though the industries that are now the focus of investment are better industries, they're still drawing in an enormous amount of resources that's preventing the rebalancing of the economy and the shift to a lighter, more consumption-friendly growth path.

The industries that Cheng Siwei has laid out are part of a program that the Chinese call the "strategic emerging industries." Many of these strategic emerging industries have very, very positive environmental implications. They are also, without exception, industries that are technologically extremely demanding. And they're also an extremely ambitious, wide spectrum of new industries. There are 35 of these strategic emerging industries, and they include just about every industry that you would think of when you think of the things that the United States should be developing -- or Germany should be developing, or Denmark should be developing. They include not only the whole spectrum of new energy technologies, but also new materials, new biotech industries -- a whole range of very, very ambitious sectors.

Now, the question is, who are the firms that are going to be the cutting-edge of developing these industries? And do they require large sums of money -- and, in particular, do they require large sums of government investment -- to be developed?

I would suggest that an alternative institutional strategy that relies more on small firms, start-up firms, research-intensive private firms would be more effective than the strategy that China is actually following today, in which the development of these firms rests primarily on government support, government incentives, and, to a significant extent, direct government investment from both fiscal and banking sources.

Cheng Siwei, one of his many accomplishments is to be known as the father of venture capital in China. He played a predominant role in pushing for the institutions that would support new firms through new financial institutions that would channel funds to start-up enterprises.

We need to know how that process is working in the field of green energy, in the field of the green economy. I have the impression -- and I'd love to be corrected -- that these young venture capital institutions are being swamped by a flood of government money, by a flood of preferential policy, by a flood of support that tends to distort the incentive system within these newly emerging sectors.

It's funny -- here in the United States we have a big debate going on about the company Solyndra, which received government loan guarantees for \$500 million. Whatever you think of the Solyndra process, this was a case where you clearly had an independent firm that was clearly pursuing an innovative technology, that then got government support for it.

I'm worried that what we see in China is less that pattern, and more a pattern where existing technologies -- sometimes mature, sometimes not -- are ramped up rapidly, expanded quickly, because they have access to government support across a range of different activities. That kind of support has a danger because it distorts the overall global environment for these newly emerging technologies -- technologies that are important for all of us. The question is: what standards will China use to evaluate their programs? When will we know that their successes can be expanded? When will

government decide that there are failures -- because there have to be failures, as well -- that should be terminated and cut down as far as a government priority?

With 35 different sectors in the strategic emerging industries, it's a crucial question how we select among them. First of all, how we get there. But second of all, how we decide when to stop when individual initiatives don't meet with our success.

In terms of the trajectory of the Chinese economy, what worries me even more is that the across-the-board priority given to a wide range of industrial sectors means, inevitably, that the old pattern of economic development gets recreated in the future. If we give priority to 35 different industrial sectors, that means government priority is to encourage investment into those priority sectors. And that means, to a certain extent, government policy is to encourage investment, period.

When you look at the 12th Five-Year Plan, there's a big difference between the first draft, which primarily stressed re-balancing, and second draft, approved by the National People's Congress last spring -- this spring -- which, in addition to calling for re-balancing, also spends a great deal of time stressing the importance of investment in these newly emerging strategic industries. Does the plan call for an increase in investment, or a moderation in the pace of investment? The truth is, the plan is contradictory, and we don't know what the outcome is going to be.

If we look at the outcomes so far, in the year 2011, China's investment rate is increasing. Consumption as a share of GDP is not increasing. The trade surplus - - which definitely did drop toward the beginning of the year -- is now stabilizing at a relatively high level.

So we need to ask the question: what are the proper institutions, what are the proper policies, designed to push China towards a better, more sustainable, more stable economic growth trajectory, and how will we know when we get there?

I'll stop there. (Applause)

MR. LIEBERTHAL: I want to thank the speakers for two really outstanding presentations. It left me with a whole series of questions. But I'm going to have a change to talk to them after this, and I'll get my own questions answered then.

We have 40 minutes for Q&A. Let me ask you to be mindful of several things.

One, feel free to direct your questions to one speaker or another, or to both of them together.

Secondly, we have roving microphones. So, please, when you're identified, stand up and say who you are.

And then, thirdly, keep in mind that questions end in a question mark.

With that in mind, the floor is opened.

Yes, sir. Back here. Yes.

Well -- okay, go ahead. And then we'll go to this gentleman.

Sir.

MR. LOSEN: My question is for Mr. Cheng --

MR. LIEBERTHAL: I'm, sorry -- you are -- MR. LOSEN: I'm Ben Losen, from the Department of the Army, Department of Defense.

I think everybody knows that there's a lot of distrust of China in the U.S. I think less people know that China doesn't really trust the U.S. that much, either. And this impacts on the economy.

So, for Mr. Cheng -- how can the U.S. build trust with China?

MR. CHENG: Oh, well -- actually, I think two years ago, in Davos, there was a panel discussion, "What's the most important issue between U.S.-China relations?" I said, "Mutual trust." Because without mutual trust, you can do nothing.

So, in this case, in my opinion, some Americans are ignorant about China. Some have some misunderstandings, and some even have some bias.

So the only way to solve this problem is to promote mutual communication, to promote dialogue between, you know, different groups of these two

countries. I think it is only through mutual -- through communication that we can develop mutual understanding and mutual trust. Then we can talk about friendship and cooperation.

So, that's why I came here. And also I wish more and more Chinese scholars, politicians, and other people can come to the United States to talk to the American people. And also vice-versa.

So I think to encourage mutual communication, I think is the most important issue.

MR. LIEBERTHAL: Thank you.

Okay, this gentleman.

SPEAKER: Hi, my name is Raymond, and I work at the Carnegie Endowment.

I guess I just had a question for both of the speakers regarding the issue of political will, or the political momentum necessary to actually implement the 12th Five-Year Plan. It seems that there are several challenges that would face any effort to implement it, including interest groups such as local governments, or construction firms, an overall emphasis on stability, which means avoiding, you know, possible shocks to the economic system.

And the leadership transition means that the new leadership will take several years to consolidate its role and implement the program.

So I guess my question, then, is what makes the next five years different from the past five years, in terms of implementation?

And do you believe, then, that the balance of power, or arguments, or whatnot, in the central leadership has shifted, to actually implement this plan?

Thank you.

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MR. CHENG: Okay. After opening up, I think China already established a systematic power transition mechanism. So in this case, I think the policy will be persistent. So I think the transition of the leadership will have little impact on the implementation of the 12th Five-Year Plan.

Actually, I have a theory. The first generation of leaders are military people, because they were the ones to seize the power. And the second generation is the scientists and the engineers, because they need to do the construction. And the third generation should be economists and lawyers.

So you can see next generation, Xi Jinping, is a lawyer, actually. He studied law in Tsinghua. And Li Keqiang studied economics in Bei Da. You can see the transition is getting towards more practical and more -- I think we have more efficient implementation, along with the existing policy.

MR. LIEBERTHAL: Barry, do you have any --

MR. NAUGHTON: Well, I have the same question. So I don't think I can answer it, because it's such a good question.

But, I mean, we have seen that in the case of Hu Jintao and Wen Jiabao, they came to power through a very orderly succession process. And yet, still, it made a lot of difference who they were and how they chose to solve problems.

So, since the 11th Five-Year Plan really hasn't been implemented -- and I guess the question is whether you think the new plan, and the new leadership, are more likely to be implemented. And if so, why?

MR. CHENG: Well, I think, actually, the plan is implemented smoothly, in my opinion. Certainly, some targets may be not -- can be not met in the 11th Five-Year Plan because the global financial crisis. But generally speaking, I think we are moving

toward the implementation of our Five-Year Plan. And I think in the 12th Five-Year Plan we can also implement smoothly.

Certainly, you reached a very important question, is changing the people's ideology, this is very important, from GDP worship to really pay attention to sustainable development. So this takes -- it takes some time.

But you can see we are moving towards that direction. Because in China's system, if the Central Committee of the CPC made the resolution, everyone have to follow it. Certainly, there maybe some resistance and inertia. But generally, the ball is rolling toward that direction. There's no doubt for that.

MR. LIEBERTHAL: Let's see -- back there.

MR. DONG: Thank you. Dong Weiyu, with the China Press. My question is for Mr. Cheng.

More and more people are getting concerns about a local debt problem in China right now. And some western economists even predicting the next sub-primary crisis will be happening in China.

What do you think about this issue?

And secondly, the Chinese President, Hu Jintao is visiting Europe right now. And do you think China should put some money into the Fund to rescue the Europe debt crisis? Because somebody said it's a very good opportunity for China to diversify its foreign exchange.

What do you think about that?

Thank you.

MR. LIEBERTHAL: I was just at a meeting in Europe the last few days, and I will say every European raised exactly the same question. (Laughter)

MR. CHENG: Actually, as I said in Dalian and in the summer Davos, that was China's GDP is only 8 percent of the world. We cannot bail the Americans out, neither Americans out nor the Europeans out. But, certainly, we would like to help. Because if the Euro Zone collapse, it will be a disaster, not only for the European countries, but for the countries all over the world.

But I don't think we can have a -- we can play a very important role in bail the Europeans out. Because although we have \$3 trillion U.S. reserve, \$1.4 trillion is in the United States. Can we cash the American bonds to buy the European bonds? I don't think so.

MR. LIEBERTHAL: And the local debt problem?

MR. CHENG: Yes, the first question.

Actually, that's because in 2009 we need to stimulate our economy, so the local government got a lot of debt. That's the reason.

Actually, in the -- I think in fourth quarter of 2009, I said the sub-prime in the United States is to give the money to the people who don't have the capability to pay back. The sub-prime with Chinese characteristics is to -- banks give the loan to the local government, which it doesn't have the opportunity -- doesn't have the capacity to pay back.

According to our audit agency, by the end of June this year the total debt is 10.7 trillion RMB. And one third of the local governments don't have the capability to pay back. So this is a big problem, and we are now trying to solve this problem.

But I don't think it will have the same impact as the sub-prime to the United States. Because, one is, our central government has a strong capability to bail them out.

But in my opinion, we should not encourage the default of the local governments. So the central government only can help them in those projects related to people's living, and to education or social security. So, in this case, I think the central government will help to solve this problem.

MR. LIEBERTHAL: Barry, do you want to weigh in on that? Okay, fine. Thank you.

Yes -- here.

SPEAKER: Yes, I'm Ma Yuge from University of Oxford, currently a researcher at John L. Thornton China Center in Brookings.

My question follows up to Professor Naughton's question that how do we achieve the transformation in economy in terms of institution?

We know that currently the heavy industries still lack the incentive to reduce coal consumption. So, in your opinion, apart from technologies, what are the main institutional challenges to make those stakeholders in the highly polluted industry to take action to reduce the carbon emission?

MR. CHENG: Okay, actually, you know China is in the middle stage of industrialization. So heavy and chemical industry still have a very important position.

Now China is the largest steel producer in the world. This is not surprising, because if you look at the history for UK, then U.S., then former Soviet Union, then Japan, now China, maybe 10 years later India will be the largest.

But China is now in this stage. So, what I'm saying, so we need to reduce the -- raise the energy efficiency and reduce CO₂ emission in those heavy and chemical industries.

Actually, Chinese government enforced a very rigorous requirement for those state-owned enterprises. They have the target to reduce their CO₂ emission. If

they cannot meet the target, the top management will be punished. So this is very rigorous.

So on the other hand, I disagree with you. It's actually, in our solar energy industry, the private sector plays a more important role. The top three in China -- one is Changzhou, the other in Wuxi and the third, in Baoding are all private sectors -- two of them are the party member of my party, the China Democratic and National Construction Association. So I know they are very -- the solar energy at this time, the giants are the private sector's. That's just for your information.

MR. NAUGHTON: That's great. And so why not expand that model to the other strategic -- and non-strategic -- industries? I mean, it seems to me steel is a good example, where, "Yeah, we've done a pretty good job of imposing tougher energy requirements on the state firms."

But if you're talking about a real fundamental restructuring of this huge industry, it hasn't happened. And the reason it hasn't happened, in my opinion, is because there are just too many limitations on what private firms can do. And, of course, no foreign firms. And that prevents a really fundamental qualitative improvement in the efficiency and energy-efficiency of this sector.

So I think we're in the same camp here, but how we evaluate the steps taken might be a little different.

MR. LIEBERTHAL: Here -- in the second row?

MR. DEMWATH: Charles Demwath, General Electric. I have a question for both of you.

Would you talk about the competition between state-owned enterprises which report to the central government, and ones that are controlled by municipalities? And specifically in the renewables sector, China's leading wind turbine manufacturer,

Sinovel, is owned by -- it's state owned, but by a municipality. And China Guodian, and its renewables subsidiary, Longyuan, is now getting into manufacturing, as well.

And so I'd love to hear about how you see these central SOEs competing against sub-central SOEs. And also, perhaps, their relationship with NRDC, or with the central government. Do they -- are the central favored over -- ? Or just how they would interact (inaudible).

MR. LIEBERTHAL: So is there this competition within the state sector between centrally owned --

MR. DEMWATH: Exactly.

MR. LIEBERTHAL: -- and locally-owned state firms.

MR. DEMWATH: Right. And I think when renewables, and especially wind turbines.

MR. CHENG: You mean between the SOE and the private sectors?

MR. LIEBERTHAL: No, between the state-owned enterprises -- basically the SASAC enterprises and local state-owned enterprises.

MR. CHENG: Oh.

MR. LIEBERTHAL: What kind of different treatment do they have, and how do they deal with each other?

MR. CHENG: Well, we have a hierarchy. As you know, we have a hierarchical structure in this. Some big SOEs belong to the state, and some -- the relatively small -- belong to the provincial governments.

So I think, generally speaking, their behavior, I think, mainly has depended of the market, you know, orientation. Because they are profit, they are making their profit. But in some places they have to take the advice, orders, from the government.

So, I don't think they have a severe confrontation. But in some cases these reflect the contradiction between the central government and the local government, because this is a dilemma between centralization and decentralization. So in some cases there are some contradictions.

But generally speaking, I don't think it's a big problem. The big problem is between the state-owned sector, the public sector and the private sector. I think this is a major problem in China now.

MR. LIEBERTHAL: Major problem in the sense of -- what?

MR. CHENG: Because they are not equal at this time being. You know, the state-owned sector get more privileges, in terms of, you know, investment, bank loans and other policy supports.

MR. LIEBERTHAL: If I could jump in with just one question of my own that I'm dying to ask, which is -- you commented that the for foreign exchange reserves of China have become a big burden because they exceed \$3 trillion U.S., and in reality, the appropriate level for China would be more like \$1.2 trillion U.S. -- right?

MR. CHENG: Yes.

MR. LIEBERTHAL: And my question is, how do you go from 3 trillion to 1.2 trillion? (Laughter)

MR. CHENG: So, actually, as Premier Wen said, we will have to convert our debt into investment in the United States -- right? So then we can --

MR. LIEBERTHAL: Two trillion of investment? Good. Okay. (Laughter)

Ahh -- yes, sir. Back over here.

MR. MA: Hi. Damien Ma from Eurasia Group. I have a fairly simple question.

So, if you had to give two grades on the 12th Five-Year Plan, one on the aspirational aspects of it, and one on the capacity to actually realize those aspirations, which two grades would you give to those two characteristics? For the both of you.

MR. CHENG: What's your question? I didn't get it?

MR. MA: Two grades. So one on the aspirations --

MR. CHENG: Uh-huh.

MR. MA: -- and the targets in the 12th Five-Year Plan -- which I suspect you guys will probably both give it an A.

But on the second, what grade would you give on the actual capacity and the ability to execute that plan? What grade would you give on that characteristic?

MR. CHENG: You mean, do we have the capability to implement the plan?

MR. LIEBERTHAL: Yeah, basically that's the question.

MR. MA: Well, what grade would you give it? Would you give it an A, a B, a C, a D, or --

MR. CHENG: You mean the 11th Five-Year Plan?

MR. MA: No, this plan.

MR. CHENG: This plan?

MR. MA: Yes.

MR. CHENG: This plan is now in the process of implementing. So how can I get the grade?

MR. MA: Hypothetically. What do you think? (Laughter)

MR. CHENG: Generally speaking, it's very difficult to predict the future, you know. So I cannot give you an exact grade.

I think we would like to achieve an A. But if we can achieve a B, it's also not bad. (Laughter)

MR. LIEBERTHAL: The real answer is he wants to wait until he can read the final exam, and then grade it. (Laughter)

Barry, do you have a comment on that?

MR. NAUGHTON: Since I'm a practicing college professor, I'll boldly give some grades.

You know, I think the 11th Five-Year Plan gets an A for objectives. And the 12th Five-Year Plan, maybe a B+. In other words, it's actually less clear. It has a less compelling vision. You can see more the workings of the political compromise process, in terms of what gets into the plan.

Neither of them have an implementation mechanisms in them. So it's pretty hard to grade the implementation mechanism.

But if you -- the 11th Five-Year Plan, you could more arguably say, well, it kind of got blown off course by the global financial crisis, and bad exchange rate policy. Those two things together, you know, knocked it off course.

The 12th Five-Year Plan, I don't know that it has a course. I don't see that there are implementation mechanisms yet. And most of the implementing documents haven't come out yet. They're behind schedule. They haven't come out. So I think it shows there are problems with that. So that's a C.

MR. LIEBERTHAL: Yes, sir. Back here.

MR. OTTEMAN: Scott Otteman, with Inside U.S.-China Trade.

Mr. Cheng, what does the new Five-Year Plan say about China's commitment to implementing intellectual property protections? And how does that play in?

A lot of the focus of the United States government in the upcoming meetings of the JCCT -- the Joint Commission on Commerce and Trade -- is going to be on getting implementation of commitments to protect immigration policy, buy more software from the government -- by the government, of private firms, that's legal, et cetera.

And I'm wondering if that and indigenous innovation are not forcing the transfer of technology through immigration policy requirements -- is that something that the government has thought through in trying to move forward in this Five-Year Plan?

MR. CHENG: Yes. This is a big issue -- IPR protection. Right. This is a big issue.

Actually, in the year 2005, I talked to the Deputy Secretary of Justice, Department of Justice, in the United States. I said, first is we spend less than 20 years to build up our IPR protecting system. We now have our trademark law, copyright law, and patent law.

Second is if you look about the development degree, we are only -- at that time, only equivalent to the United States in the 1930s. But now we are in the 21st century. So we cannot just copy your Sherman Act to implement in the 21st century. So we have to make some modifications from your -- we learn from you, but we have to make some modifications.

And third is, you need to see the whole picture of China. We are making efforts to improve our IPR protection. I myself, at that time, led a task force to supervise the implementation of patent law, and we made some proposals to revise our patent law.

Fourth is we cannot deny there are some individual cases, "So if you have some individual case, please just write to me." Not now, but that time. I'm now retired, so don't write to me. At that time, "Please write to me. We will treat this."

So, actually, I think that the IPR protection is improving. But certainly, I cannot promise there will be no individual cases. But if there is an individual case, you will take some measures, or sue the -- or take them to the court. I think that there are some examples, some foreign companies sue the Chinese companies and they won. So I think you can do this.

MR. LIEBERTHAL: Okay? Yes. Back there. This young lady. Yes.

MS. ZHANG: Hi, my name is Kejia Zhang, from International Fund for China's Environment. We're an NGO headquartered in D.C., and six different offices in China.

And my question for Mr. Cheng is, where do you see the roles of NGOs, non-profit, non-government organizations in China for the new Five-Year Plan?

Are we even in the picture? Where are some opportunities and some challenges that we might have?

MR. CHENG: Well, I think NGO will play a more and more important role in China. Actually, now, because along with the development of China, along with the increase of people's income, they want to express, you know, more of their opinions. And also because the development of micro-blogs, Weibo, you know, like the Twitter in the United States, and Renrenwang, like the Facebook in the United States -- you know, the information flow is getting faster and faster. And also, the transparency is increasing.

So, in this case, the NGOs will play a more important role. And now we are talking about the third party -- right? -- third party, that means besides government and enterprises, we have to have the third-party force, you know, to make the society more healthy.

But if you look about the United States, "Occupy Wall Street" also reflects some kind of this kind of problems.

Just do your work. And I bet you will have a bright future. (Laughter)

MR. LIEBERTHAL: This gentleman right here.

MR. CLARKE: Thank you. Don Clarke, George Washington University Law School. My question is for Mr. Cheng.

You said that you felt trade disputes should not be politicized. And my question is: why not? (Laughter)

I think Professor Naughton, in his remarks, showed very clearly that, you know, China's current trade relationship with the rest of the world is really a necessary outcome of a lot of political decisions that have been made. For example, the growth strategy, that's a political decision, to have over-reliance on investment, industry, and an export surplus. The policy of the PBOC--People's Bank of China -- to buy U.S. dollars at a particular rate, that's a political decision.

So why is it not legitimate to talk politics, when talking about trade?

MR. CHENG: Maybe we have different definition "politicization."

In my opinion we need to take a more objective attitude towards the trade imbalance issue. Don't take China as a scapegoat. You know, that's my point -- just as I said in my example.

So, certainly, non-economic activity is not related to the policy. That's right. If you say this, I agree with you. But don't just, because of political reasons, to attack the others, you know, using an unobjective language. That's my point.

I don't know if you agree or not.

MR. LIEBERTHAL: Yes, sir.

MR. CHEN: Yes, Xiao Chen, freelance correspondent.

First, Mr. Cheng, thank you for your comments. My question primarily is for you. But if Dr. Naughton wants to join, if you wish.

First is China is quite a success in anti-poverty plan. And should China use, have lots money, should use to make this anti-poverty plan more deep and more broad? And in this case, maybe also could make a trade not quite rely on export.

And second is this. As to the economic growth, should also add the real value, in addition to the percentage? And is domestic product, is also that instead say how much a nation, in terms of nation, also add in terms of individual.

Thank you.

MR. CHENG: He puts the question to both of us. I will let you go first.

MR. NAUGHTON: Why don't you go ahead. I'm not sure I--

MR. CHENG: I don't want to dominate the questions.

MR. NAUGHTON: I'm not sure I understood the question.

MR. CHENG: Okay. Okay.

So, the first question is ant-poverty. Yes, China get quite big progress. But still, on a relatively low level. If you take the definition of poor people, you can see in the United States, I think is around \$10,000? I mean, poor people? Individual incomes will be less than \$11,139, as I remember? Maybe not correct.

And according to the World Bank, it's \$456 per year. And in China, we are much lower than this.

So that means if you use the criterion of the World Bank, we are still lower than this, so we have more people. So that means we still have a long way to go -- objectively. Right.

So in this case, we still have to promote the anti-poverty program in China. Actually, we are now not only by the government, but also by some social, some third-party force to help the poor people.

So I put forward a conception, it's a third distribution. First distribution is the salary, by the market. Second distribution is by the government, by the transfer payment. And the third distribution is the rich people voluntarily to help the poor people. So we are promoting the charity position in China as a complementary -- as a supplementary measure to anti-poverty.

MR. LIEBERTHAL: Thank you.

What I think we'll do -- we're running short on time. Let me collect three questions, and then I'll give each of you an opportunity to respond to what you wish to, or make any other summary comments you wish to make -- okay?

This will be the first, this young lady here? Mira? Or, well, either of you.

SPEAKER: Hi, my name is Ariel. I work for a Japanese Trading company called Mitsuni. And I have a question regarding on improvement of Chinese education system.

As we know, that there's a lot of Chinese students in China and limited resources, so they have a limited opportunity to pursue what they want to do, and have only a stringent subject they can learn. And there's also gaokao system, the entrance exam system that determines people's future, so that that kind of hinders innovation, or innovative spirit in China.

So I'm wondering, for the new Five-Year Plan, what the policy is. Or do you see a drastic change of the entire education selection system, such as gaokao, where you are trying to encourage more investment from Western educational system in China, how to keep Chinese talent to stay at home, not to go overseas for undergrad or postgraduate.

Thank you.

MR. LIEBERTHAL: Thank you.

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Yes, sir. Back here. Actually, I was pointing right behind you.

MR. CHENG: Do you want me to answer --

MR. LIEBERTHAL: No, let's collect three questions --

MR. CHENG: Oh, collect questions. Okay.

MR. LIEBERTHAL: -- and then you can respond as you wish.

MR. CHENG: Okay.

MR. LIEBERTHAL: Just because we only have a couple of minutes left.

MR. MELAAS: Hi. I'm Aaron Melaas, from McLarty Associates. I was wondering if each of you could speak perhaps briefly to how this Five-Year Plan might impact China's trade and economic relationships with other regions of the world, not just the U.S.? In particular, I'd be curious to hear about Latin America, where a number of countries, including Brazil, have started to take some measures of their own to try to address their trade imbalances? And whether this is being taken into account at all by the Chinese government? And whether it might be in this plan, or perhaps a future one?

MR. LIEBERTHAL: Thank you.

Yes. Back there.

MS. DAWSON: Thanks. Stella Dawson at Reuters.

Ten years after China's accession to the WTO, a number of U.S. corporations complain that the bargain that they anticipated of access to the Chinese market has not been lived up to. And in particular, with regard to state-owned enterprises and intellectual property rights and indigenous innovation.

MR. CHENG: Could you speak a little louder?

MS. DAWSON: Oh -- sorry.

So, 10 years Ten years after accession to the WTO, do you see the relationship becoming more adversarial between the U.S. and China? And how do you respond to those charges from the U.S. corporations?

MR. LIEBERTHAL: This is on market access?

MR. CHENG: The market entry, right?

MR. LIEBERTHAL: Yes, basically, expectations in terms of market entry and treatment in China, from the WTO, 10 years later how do you see this?

MR. CHENG: Please.

MR. LIEBERTHAL: Barry, do you want to begin?

MR. CHENG: You go first.

MR. LIEBERTHAL: And feel free to respond specifically to any of the last three questions raised, or other issues that you think you want to.

MR. NAUGHTON: Well, I mean, I'd just like to contribute to the de-politicization trend by saying that, you know, I'd like to see a lot of these issues de-politicized by getting the discussion within China more firmly focused on the basis of what's good for the long-run development of China in the context of these Five-Year Plans, and in the context of a turning point in the Chinese economy -- where we look at Chinese society and it's exploding with diversity and creativity and, you know, people who have been released from decades of poverty, and have a whole new set of demands on the economic system.

Now, in that context, is the education system responding quickly enough? It's doing pretty well, but probably needs a little more. Definitely we could see further educational reforms of this type.

WTO bargain -- well, let's put that in the context of the Chinese domestic bargain. I mean, I think there was explosive progress in economic reforms through the

1990s. That's slowed down. And I think it's a disadvantage for multinational corporations -- yes. But, frankly, I'm more worried about the fact that it's a disadvantage for the healthy development of the Chinese economy, given this explosion of creativity and diversity.

I don't think China has violated its WTO commitments, but there hasn't been as much positive progress as we had hoped for. And as I think many people in China had hoped for, as well.

So -- that's my side.

MR. CHENG: And for the education, I just mentioned, you know, we need to reform our education system. And actually, we formulated a mid- and a long-term education plan, as we published it, I think, earlier this year. But certainly to change the gaokao system is a bit difficult issue. Because China has so huge a population, so how do you select the people, the students, to the universities? I don't think it's an easy job.

But what I'm saying is that we need to pay more attention to encourage innovative spirit in our universities, rather than to foster the straight-A students. That's my point.

And for the WTO, I think we have a basic attitude is we are post the trade protectionism, but that the problem is it still needs to improve our environment -- our investment environment.

So in this case, I think both -- even in the United States, it also needs to improve your investment environment.

So I think at this time being, China, although we are not so satisfactory to the foreign investors, some foreign investors not so satisfactory, but generally speaking, we are making a lot of progress -- just like the chairman of Coca Cola mentioned, you

know, the investment environment in China is improvement, maybe better than in the United States.

MR. LIEBERTHAL: Thank you very much.

Let me say, this discussion has raised a lot of fundamental issues about how China has done in recent years, and then what are the prospects.

We will be having another program this Thursday afternoon -- I assume all of you have received notice of it, since you're on our mailing list -- that will consider the evolution of the Chinese economy since 2002, in various sectors, and then what the prospects are for the future. So that, in a way, is a continuation of the issues raised here. And, in fact, Professor Naughton will be one of the speakers, as will Nick Lardy, sitting in the front row here.

So it will be a distinguished group. And if you haven't signed up for that, please don't hesitate to do so.

I want to thank, again, the Asia Foundation for bringing Cheng Siwei to the United States on the Cheng-lin Tien Fellowship.

As always, we want to thank the Thornton Center staff for the yeoman work they always do in putting on these programs.

And I especially want to thank our two speakers for their remarkably candid and informative and helpful set of comments today. Please join me in thanking them. (Applause)

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