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PARTICIPANTS:

PANEL 1: NEW DYNAMICS IN CHINA'S STATE-SOCIETY RELATIONS

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PROCEEDINGS

MR. LIEBERTHAL: I'm Ken Lieberthal, the Director of the John L. Thornton China Center at Brookings. We are convening for what has become an annual event, a joint Brookings-Caixin Media Conference on the economic developments in China. We've sometimes added the United States to this. This year we are focusing especially on the Chinese side, but looking at the coming five years or so with two panels this afternoon. The first is on new dynamics in China's state-society relations.

Before I introduce the panelists, I want to introduce the head of Caixin Media, Hu Shuli, who is enormously well known in China and abroad. She has gotten a list of awards, most of which say "one of the top 100 most important thinkers in the world" or "one of the top 10 thinkers in Asia" and so forth. So Shuli, we're delighted to have you here. She will be moderating our second panel, but I just wanted to introduce her at the start of our program.

For our first panel, we have three speakers. I will introduce all of them now so I don't keep interrupting as each one finishes. When all three are done, we'll then have a substantial amount of time for Q&A from the audience. When we turn to Q&A from the audience, we'll have roving mics. So I'll ask you to please identify yourself by name and affiliation and then feel free to direct a question to a particular speaker or to the panel as a whole.

Our first speaker is Ambassador Zhou Wenzhong. Ambassador Zhou's last foreign ministry posting was as Ambassador to the United States. He now is the head of the Boao Forum in China. He is also vice president of the China-U.S. People's Friendship Association. He had a long and distinguished foreign ministry career, diplomatic career, at times serving as ambassador to Australia, and early in his career as Ambassador to Barbados and to Antigua and Barbuda. I've never heard of Barbuda, but anyway -- forgive my ignorance -- but anyway, really a pleasure to have you here, Mr. Ambassador.

Our second speaker will be Vikram Nehru who is now a senior associate in the Asia Program at the Carnegie Endowment. He spent 30 years at the World Bank where he had a variety of positions. His research overall has focused on economic, political, and strategic security issues involving Asia.

And then our third speaker is professor of finance at the Yale School of Management, Professor Chen Zhiwu. He spent a good part of his career focused on overall financial theory and global financial issues, but in the last decade or so has especially focused on issues in China. When I see the number of people that follow his postings in China and his writings in China, it is staggering. It makes a Western scholar like me drool. So he has become a very well known figure there and is a well known scholar of international finance overall.

Let me step down and ask our speakers to come up one after the other. Each will speak for about 15 minutes, and then we'll have the panel up here and welcome questions from the audience. Ambassador Zhou?

AMB. ZHOU: Thank you, Ken. I would like to thank Brookings and also Caixin for their kind invitation. It's very nice to be back and to see so many old friends.

Today's theme of this forum is state and society. As you know, as far as the state is concerned in China, the most important event in the last some 40 years or even longer is the reform, the beginning of the reform program. So I think when we try to discuss the relationship between the state and the society, we need to take a close look at the future and the prospects of the reform program of the state. So I would like to start by presenting to you my views with regard to the reform program and also China's ambitions for modernization.

And I think two words -- you hear two words very often when we discuss this subject. One is the middle-income trap and the other is the high wall before China. So the question is China has joined the ranks of the middle-income countries. Will China be trapped in that middle-income trap? That's a question we hear very often, a question put to us. At Boao Forum there is an actual panel discussing that subject. So my view is this. In 2010 the per capita GDP of China has reached 7,864 international dollars based on the 1990 international dollar. That has surpassed the per capita GDP of most of the Latin American countries of 4,000 international dollars when those countries fall into that middle-income trap. And also that has surpassed the 6,000 international dollars per capita GDP for most of the East European countries and the former Soviet Union when they fell into that trap. And judging by the trend of growth of China's economy, I think in three to five years time the per capita GDP in China will probably reach 11,000 international dollars based on the figure for the 1990 international dollar. So that

is to say in three to five years time, in per capita terms China's GDP will be more than those who have successfully climbed over that high wall. So this sort of forecast holds water. So I think probably China will not be trapped by that middle-income trap in the context of current growth of China's economy provided that growth rate will continue.

So the challenge is after China's over that high wall, what would happen? And I think the main challenges, of course, are as follows: That China needs to effectively resolve the problems it will be confronted with in terms of all kinds of structures. And secondly, whether or not China will be successfully transformed in its growth pattern that is so far based on low cost, driven by low cost? And will China be successful in changing that into one based on innovation? That is to say, the growth would come from innovation-based development.

As far as this is concerned, there are pros and cons. And the pros are as follows: Unlike Latin American countries, China started as opening to the outside and started its export-oriented development strategy much earlier when its per capita GDP was still at a very low level. So that made it different from most of the Latin American countries. And unlike most of the East European countries, China started its reform of marketization also very early when its GDP was still at a very low level. So what we have seen happening in China is the industrialization going hand in hand with marketization. So that is also the difference between China and most of the East European countries and the former Soviet Union. Besides, as you know, China is a big country with a very large population, and it has very large market potentials.

So the conclusion is probably China will be able to climb that high wall. But then after that, judging from what happened to those who successfully caught up with the more advanced countries, the rate of growth will drop after China is over that high wall. So that will be the largest challenge to China and the window of opportunity, as some scholars predict, would be between 2015 and 2017. For instance, in 2016 if the per capita GDP is based on 1990 figure, it would be 11,608 international dollars. So if what happened to those who successfully -- as compared with those which successfully caught up with more advanced countries, the growth rate probably would sort of come down by as many as 3 percent. So that is to say the forecast is during the '12 five-year plan will be 9.7 percent and during the '13 five-year plan will be 6.5 percent. Of course, this is just a point of view. So that will be the most

serious challenge. So once China is over that high wall, will China be successful in changing the development model to one that is based on innovation and efficiency and equality of the economy?

So what to do? I think the first is to continue to carry out the industrialization, urbanization, and modernization. So I hope China's economy, society, population grows, and other structures will be effectively transformed so it will become a major force in China's sustainable development.

In 2011 China's urban population ratio reached over 50 percent. So this means that there will be billions of new population entering the cities in the future. According to statistics, this will jumpstart domestic consumption and investment needs. So we can see that in China's future urbanization process that our country will become the world's biggest manufacturing base as well as the largest consumer market in the world.

Secondly I think what we should do is to work hard to improve people's livelihoods. And during the process of economic development and transition, programs sprung up all over China to support and help the poor, ensure that the middle- and lower-income class will have sufficient living conditions, health care for all, as well as large-scale social programs to help out the poor. So the reform to the social welfare system and government structure was sped up. This was not only meant to decrease the gap between the rich and the poor, but also meant to equally distribute the benefits brought by economic reform to all social groups so that each individual will acquire equal benefits during the process of development. At the same time the social risk brought by fast economic growth will be reduced. The numbers of people with large incomes will be increased and domestic consumption will be triggered.

Certainly we need to look at the deepening of reform in terms of structural innovation and management improvement. China has experienced three decades of reform and opening up, and we can conclude that up until now we have changed all that can be changed and opened all that can be opened. Things that have remained the same are the issues that have deeper structural problems so that changes cannot be easily pushed forward and implemented. Due to this reason, the Chinese government brought forth new reform goals so that structural and managerial innovations can further deepen the reform in fiscal policy, taxation, finance, price, income distribution, government management structure, as well as

state-owned enterprises. So through the reforms in China's core economic structure and in management, we can create a more transparent, fair, predictable, market environment and a legal environment so that a mature and stable market and legal framework can be sustained.

So I will stop here for now. Thank you.

MR. NEHRU: May I also extend my thanks to Brookings and to Caixin Media for inviting me to this event.

The topic, "New Dynamics in China's State-Society Relations," I made the mistake of taking the subject heading very seriously, and I actually applied my mind to it because I thought to myself, what a topical topic given what's going on in China today. One can't help thinking about when one thinks of state-society relations, one can't help but think about the events surrounding the Bo Xilai case and now the Chen Guangcheng case. And these events have sort of raised to the surface concerns that I know many hold in China and have for a very long time about a range of factors -- things like corruption, inequality, absence of the rule of law, lack of accountability, seemingly the part of the state contrasting with the seeming lack of institutions protecting individual rights. And there is now media speculation about these events triggering perhaps political and constitutional changes.

So many of these issues that seem to have been raised by these two events also apply in my view very centrally to the key economic challenges facing China. And I believe that there are just two key challenges. The first is how does China maintain a relatively rapid pace of growth? And the second is how does China ensure that it improves the quality of growth? This is nothing new. This is something that the Chinese have been discussing for quite a long time. The key point I want to make here is that trying to achieve the first is very difficult. Trying to achieve both is going to be very difficult indeed. And both will require a significant change in state-society relations.

Now let me start by making the point that there's a sort of general belief that growth in China is going to slow. As Ambassador Zhou just pointed out, one of the projections that he had showed that between the '12 and '13 five-year plan there would be a decline in greater growth. And the reason for the decline in greater growth is rising capital labor ratios. As more capita per unit labor increases, the marginal productivity of capital will decline. The fact that China has already penetrated export markets to a great extent, and the fact that many industries in China are already approaching the global technology

frontier. But in addition to these three factors, the supply of savings is also expected to diminish in China primarily because of an aging society; but also because as the Chinese government introduces social reforms, the incentives to save amongst households will also decline. So not only will capital labor ratios decline and the amount that each unit of capital can provide towards growth will decline, but the amount of capital available is also expected to decline.

Now the combination of these two points about capital, both the availability as well as the use of capital, means that in order to maintain the same pace of growth or at least to ensure a relatively rapid pace of growth requires China to become more efficient. To be more efficient, it needs to either become more innovative or become innovative and allocate free sources more efficiently and ensure that it has a system which allows for the churning of capital, the Schumpeterian creative destruction of capital. In many countries this process has been a very, very important driver of growth.

But adding to the growth question are two other objectives which the Chinese have and which they very clearly enunciated in their '11 and '12 five-year plan and that is improving the environment. After all, the environment, the physical environment, in China has degraded enormously. And second, to reduce the inequalities that currently prevail because inequalities have been rising rather dramatically.

Now the allocation of resources towards the environment and the allocation of resources to reduce inequalities by providing greater access to social services are not income generating necessarily. They have low financial rates of return even though they have very high social rates of return. They're very valuable to society, but they don't necessarily generate growth. So for that reason, too, one would expect that if China seriously attacked the quality of growth issue, it would mean the GDP growth -- as it's traditionally measured, not in the welfare sense but in the output sense -- would also be expected to decline.

So what are the recommendations that people have come across? And Ambassador Zhou just put several recommendations to you. There are recommendations that are included in the '11 and '12 five-year plan. There are recommendations that have come out from a range of academics within China and outside China. And if I were to summarize them, I would say that there were about six. The first is that China needs enterprise, output, and factory market reforms. China needs to develop an

innovative society. China needs to address its environmental problems by developing a pattern of green growth. China has to attack its social -- has to introduce social reforms in large part to try and reduce the inequalities that currently prevail. And in order to do all of those above, China has to reform its fiscal system. And finally China has to ensure it has lasting, good relations with the rest of the world -- six different elements to a possible future strategy for China, and this in order to have rapid, sustainable, growth. And by sustainable I mean socially, environmentally, and globally sustainable growth.

But the common theme running across all of these areas of possible reform is really one common thread in my view and that is the changing role of the state, a new relationship between state and society, and I want to illustrate this with just three points. The first is the need for greater even-handedness -- and I'll come to this in a second. The second is a need for greater transparency. And the third is the need for more equality of access and opportunity.

Now what do I mean by the need for greater even-handedness? I mean two things: The first is the need for greater even-handedness between the private and the public sectors, and the second is the need for greater even-handedness in the relationship between private and public goods. With respect to the private and the public sectors, I think there's a lot of evidence now to show that state enterprises in China have a very privileged position in the economy. State enterprise leaders have close connections with senior leaders in the government. Many state enterprises in many sectors, especially in the strategic and pillar industries as they're termed in China, are protected to a large extent from competition either formally or informally. State enterprises have privileged access to finance, whereas private enterprises find it very difficult to get access to finance. And for state banks there has been a history of periodic refinancing efforts by the Huijin Corporation, which is the domestic arm of the China Investment Corporation.

But there's also recognition that if state enterprises are given this privileged position, there's also recognition that state enterprises are not necessarily going to be the drivers of innovation in China. Already we see very rapid growth in the private sector. We see very rapid growth in the total factory productivity growth in the private sector, which is a measure of efficiency, and a large amount of the innovation that is coming out of China is being driven by the private sector.

So if there's something that needs to happen in this area of even-handedness, it means that there should be greater competition between the private and the public sectors, that there should be greater ease of entry into areas where the public sector currently, where the state enterprises currently are protected from competition. And that's not enough. It's also important that state enterprises have harder budget constraints. By that I mean that they don't necessarily have access to finance quite often in the financial sector in order to rollover debts which they have to pay. So in other words even if they make losses, currently the arrangements are that they would be covered one way or the other, usually through the financial sector. But if budget constraints are hardened, then state enterprises will be forced to improve efficiency when they compete with the private sector.

Now to do this, it means the government has to take a very different role in society. It means it no longer should be a direct participant in the production process. It means it has to step back. It has to create the rules for competition. It has to ensure that the playing field is level. And that is a very sharp distinction from the kinds of actions that it currently takes, and the question is, is the government, is the state, ready to do that?

The same would apply with even-handedness between the public goods and private goods. There's recognition that there has not been enough emphasis placed on the delivery of public goods in China. And again, many of those actions will actually this time require more government action, greater implementation, and better implementation of existing rules, a better designing of those rules. For example, in the environmental sector, many of the laws are in place, many of the rules are in place. The issue is, is the government prepared to apply them even-handedly between the private and the public sectors and actually make the tough decisions necessary in order to arrive at its environmental goals?

The next item that I want to talk about is the need for greater transparency, and I'm using this in a very economic sense, not in a political sense. Take the example of the repression of the financial sector. The repression of the financial sector in China has been brought about largely through lower interest rates, which essentially have taxed household savings. Now, this indirect form of taxation of household savings has been remarkably successful in a sense because it's allowed the financial sector, largely through state banks, to finance enormous levels of investment. This has been actually a success story in many ways in China. But it has also meant an under-delivery of public goods because the

financial sector normally doesn't finance public goods. It tends to finance goods from which it can earn a high financial rate of return and, therefore, it's meant an under-delivery of public goods.

Now the role of the financial sector clearly has to change. I talked about the need for greater efficiency, and the financial sector has to play a very important role in improving the allocation of capital in the system. It has to play a very important role in ensuring that the state enterprises have a hardening budget constraint. And, willy nilly, if the authorities are keen, that the Renminbi is internationalized, it is very important that the financial sector becomes much more market driven.

At the same time, the fiscal policy, China's fiscal policy, has to become much more important for four reasons. The first is that the financial sector can no longer take on many of the quasi fiscal policies that it was asked to take on in the past if it is to be more market driven. Secondly, there are going to be much greater claims on the budget if state enterprises are to be covered for their losses and they can't go to the financial sector, they're going to have to go to the fiscal system. The third, China needs a fiscal system that allows the country to absorb shocks to the system -- domestic shocks, external shocks of various kinds. And lastly, but more importantly, it's the fiscal system that's going to have to deliver the incremental resources for the environmental and social agenda.

Now for all these reasons it means that if the fiscal system is going to have to deliver these resources, the government is going to have to raise the revenue from somewhere. Those indirect, hidden, taxes in the financial sector are going to have to become direct taxes of corporations and individuals either in the form of consumption taxes, income taxes, or corporate taxes. And as soon as you have direct taxes in a system, it forces then the government to explain what those resources are going to be used for. It forces transparency on governments, especially in countries like China where there's a rising middle class, demanding a greater accountability on the part of government. A fiscal system which is required to take on these additional requirements, these additional responsibilities, is going to also be asked to become more transparent, to publish their accounts, to explain where these resources are going to, and that will significantly alter the current way the fiscal policy is practiced and will change the way that state and society relate to one another.

And the last point that I want to talk about is the need for greater equality of access and opportunity. I just mentioned the growth of the middle class. And normally when you have a rising middle

class in any country, a middle class usually is more educated, has greater knowledge of its rights and responsibilities, has a greater understanding of what it wants, and demands a much higher level and a much higher quality of public services from the government, and this is true of China today.

I think there have been quite a few surveys in China which have shown that there's a lot of distrust and a lot of dissatisfaction with two specific aspects of government. The first is the justice system and the second is the delivery of services. And in both it is because there is a huge inequality in access, inequality in access to the justice system and inequality in access to service delivery. The reason for this inequality in access to service delivery is because there's a huge inequality in the availability of fiscal resources, of government resources, across the country, large spending disparities between local governments across China, and, of course, now there is a greater demand for better services and, therefore, a greater desire by the public to participate in some of the decisions that local governments are making.

So given these three, to my mind the forces that have been unleashed in China, many of the reforms that have been considered in China, many of China's recent events, all point to a very rapidly changing state of relations between the state and society. The government has a choice, the choice of whether it wants reforms that will make it have indirect as opposed to direct control of the economy, whether it wants to increase the empowerment of the private sector and of households, whether it wants to increase the accountability of government and the accessibility of services including access to justice institutions, whether it is willing to allow increased scrutiny of the government and of its own actions. These are difficult and uncomfortable questions. To my mind, of course, the choice is clear as to what needs to be done. The real question is what is in the minds of the Chinese leaders? Thank you very much.

MR. CHEN: First I want to thank the Brookings Institution and also Caixin Media, especially when I heard that Shuli, my long-time friend, spent almost 48 hours in order to get from Hong Kong to Washington. She's always energetic, but today she is going to appear tired and it's really understandable.

So I want to stress three points, using my 15 minutes or so. The first point is -- in terms of the state and society relations in China, the first point is the size of the state or the government in China is historically unprecedented. It's very big in both absolute terms and also in relative terms.

And then my second point -- if it's okay I will just use my printout -- so the second point I want to stress is the state is still rising, it's still growing pretty fast. I don't see real efforts or even a real possibility for this trend to be reversed unless political reforms, fundamental political reforms, really take place. So that's my second point I want to stress.

Then my third point is that, in fact, the state being too big. It's really the root cause for the economic growth model that everyone has been talking about, which is too dependent on investment and too dependent on export. So in order to change this, clearly then again we need to see more fundamental reforms. Otherwise personally I don't expect the very nature of investment-driven growth is hard to change.

And then related to this also with the state being too big is also the root cause for the lack or the difficulty of legal development. So what do I have to substantiate my three points I just mentioned? First, in historical terms how big is today's state in China? Why do I say it is unprecedentedly large? Of course, many of us know that the Chinese state has been pretty large, larger than in Ancient Greece or Ancient Rome, or probably goes back to at least the Qin state, about 2,500 years ago. But actually even though the Qin state and then the different dynasty imperial course may have been always pretty big, but they're not as big in relative terms or absolute terms as today's state. Why do I say that? Well, according to estimates by historians, back in 1766 our high-growth period in the 18th century, the imperial government's total tax revenue was roughly 49 million taels of silver. So that translates into roughly the total annual income of 2 million Beijing residents. So in other words, back in the middle of the 18th century, it would just take 2 million residents income to support the whole imperial government's revenue.

Of course, in those years on average the fiscal surplus by the Imperial Court was between 5 million to 10 million taels of silver. It's almost like 10 to 20 percent surplus. Of course, that would make the Obama Administration very envious. But they did not really spend that much money. So 2 million residents income was roughly equal to the total government expenditure or revenue during the middle of the 18th century. But today, according to the official numbers, if I just use the within budget tax

revenue for 2010, the total tax revenue for 2010 without including land sale proceeds and SOE income and so on, it was roughly equal to the disposable income of 430 million urban residents. So 430 million urban residents versus 2 million urban residents back in the middle of the 18th century. That's why you see in relative terms, it's really much bigger.

If I were to use the peasants' per capita income for 2010 within budget, the tax revenue would be equal to the total income of 1.45 billion peasants income for the year 2010. Of course, there were not so many peasants in China, so that makes it even much bigger. Okay, so that's the first point. In historical terms, it's the biggest government within today in China over the last 2,500 years.

The second point is it is still growing very fast. I could give you a lot of different numbers, but let me try to make it less confusing for you. Over the last 16 years, from 1995 to the end of 2010, the total tax revenue -- again using the budgetary terms not including the other off-budget, off-balance sheet income sources for the local government and the central government -- over the 16 year period after adjusting for inflation, the total tax revenue and other government revenues increased on a cumulative basis by 9.2 times. So that's very large growth. Of course, many of us would like to invest in private equity deals, right? We always look for gains of multiple times -- 9 times, 5 times. The Chinese state has done pretty well over the last 16 years -- 9.2 times cumulative growth.

But in contrast, for urban residents the cumulated growth after adjusting for inflation over the same 16 year period was 2.6 times and for peasants 1.8 times. So you can see who's getting an increasingly larger share of the Chinese GDP even without taking into account the SOEs and so on. So clearly the size of the state has been expanding over the last 16 years very fast. Of course, you wonder why there have not been real results in terms of containing or limiting the growth of the state. Well, that takes us back to the balance of power among the different branches because after this point, the executive branch pretty much is free to introduce new taxes or increase existing tax rates without having to go through real public hearings at the National People's Congress or the standing committee or the different subcommittees. No public hearings have been really called for. Of course, the Chairman of the National People's Congress would like to emphasize the separation of power. It's absolutely not what we want to adopt from the West. Don't talk about the three branches of government checking on each other. That's too Western. We cannot do that.

Let me also give you another set of numbers just to see. Yes, the tax revenue has been increasing. But hey, maybe the tax revenue has been spent on the right things, not just on the government itself. So in order to give you some idea about the actual administrative power or apparatus and how that has been changing in monetary or financial terms, back in 1955 the administrative expenditure by the government at all levels in China was roughly equal to 7 percent of the total fiscal expenditure by the government in China. So 7 percent of the government expenses or budget was going into the operations and administration by the various agencies, ministries, and so on.

In 2008 and 2009 this relative number increased to 22.5 percent, so almost like one-quarter of the government expenditure was just to support the administrative expenses. If you like more numbers, back in the Qing Dynasty, roughly speaking for every employee on the government's payroll in China in the 18th century, it would take roughly 250 to 300 citizens so that the ratio between government employees to the population was 1:250 to 300. So today there are many estimates. I think they give an estimate of 1:26. It's pretty reliable because many different scholars have come up with assessments. So the ratio between the government employees and the population is 1:26, so it has come down -- or it has increased from 1:250 to now 1:26, so there is a 10 times relative increase. Today's ratio for China is about 4 times as big as for India. So roughly speaking in India today, the ratio is 1:100 between official employees and the Indian population.

How big is this 22.5 percent government administrative expenditure as a percentage of the total fiscal expenditure in China when compared to other countries? Russia's ratio as of 2007 was 20.6 percent, so that's pretty high. For the U.S. back in 2007 about 11.2 percent of the government's budget went into administrative costs and so on. The lowest I think is actually Norway, so it spends about 9 percent of the government's budget on administrative costs. And for China in comparison, even though administrative costs took up 22.5 percent of the government expenditure, roughly 15 percent of the fiscal budget went to health care, social security, and unemployment benefits. So in that sense the actual expenditure on items, things, programs related to real people's lives, is actually lower than the administrative cost amount.

So in short you can see the state in China is not really shrinking. It's still expanding at a very fast pace. And this cannot be reversed or changed unless, as Premier Wen Jiabao put it, unless

political reforms really take place and unless the National People's Congress and other people's congresses at the local levels really do what they are supposed to do according to the Chinese Constitution, that is to provide real checks and balances on taxation power.

Of course, I'm making such comments without really taking into account what the SOEs take in the national income and also the SOEs' percentage as a total percentage of the popular productive wealth in China. So let me not go there because of time.

My last point is so why do I say that the state being too big is really at the root cause of the investment-driven and export-oriented growth model? This is something I tried to stress last time when I came to Brookings almost a year ago. So let me just simply say that when it is the government that decides how to spend money, how to make investments, they generally have a tendency to prefer physical structures, infrastructure projects and big industrial projects, because those projects are very tangible. So for performance evaluation -- so as an economist, we always talk about performance evaluation and asymmetric information -- when you put the money into buildings and industrial projects, then right away you have results. Your performance will be so visible. You don't have to really do that much to convince your boss that you have done a good job.

But on the other hand, if it is up to the private sector, to society, to decide how to spend money and what to spend money on, then they don't necessarily have to show to other people that they have done a good job. So then they tend to spend more on health care services and consumer products. So this is why when we say in China the service sector has such a tough time to grow. Well, it's not surprising. When the government controls most of the spending power and makes the spending decisions, investment decisions, not surprisingly they want to focus more on the more tangible things rather than on services such as education and health care that are not so tangible. In fact, there are a lot of statistics that can show this.

Then lastly, just quickly, let me spend one minute. I've done some studies on the connection, on the relation between SOE share in an economy, in a society, and the rule of law development. Not surprisingly, if I use the SOE share in total national investment back in 1980 as a basis and divide roughly 65 countries into three groups, then clearly those countries whose economy is dominated by SOEs have much lower rule of law ratings than the countries in the other two groups. Of

course, we can get into the reasoning as to why this is the case, but believe me I've spent many years doing research on this topic. The conclusion to me is so convincing that when the SOEs' share in a national economy is too big, then that presents a lot of challenges to private enterprises and to citizens in terms of how much they can protect and enjoy their own individual rights, including various civil rights.

So I should stop here. Thank you.

MR. LIEBERTHAL: Is this microphone on now? Thank you very much. We want to open this up to the audience in just a moment. I just want to ask one question before we do it to get this started.

This is on the changing dynamics, the new dynamics, in China's state-society relations. All of you ended up talking more about the state than about society. There are huge changes going on in Chinese society obviously, and one of the most dramatic of these is in social media, the advent of Weibos and so forth. So just an enormously greater amount of information available to society and the expression of opinions from society to the state. So the pressure is on for reform of the state.

And as I understood the three presentations, what you had in common here was essentially saying that without political reform, the economic objectives stipulated in the '12 five-year plan are not really fully achievable because the current incentives in the political system are built around the game plan to date, the model to date, and that model now needs to be changed. That's been recognized at the top, but the question is whether you can change the incentives within the political system in ways that are necessary in order to fully achieve the goals of the '12 five-year plan, the more innovative, et cetera, type of economy.

So I guess my question is what is your expectation about changes within the political system necessary to achieve the economic objectives? You've each stated them in somewhat different terms, but I think they all revolve around, in part, that core issue. Do you see any dynamics here that suggest that we should be optimistic about that or should we be looking more to ways in which developments within the state are likely to constrain the changes in the economy that all of us have pointed to?

I'd be happy to have anyone take that up.

AMB. ZHOU: I am from the very beginning of the reform program, and we realized we need both political restructuring and economic restructuring. But we also believe that we need to combine all these things. That is to say, we need to combine political restructuring and economic restructuring. And we need to combine democracy and also the reform of the legal system, put emphasis on institutionalize and legalize of the democracy. And we also believe we need to combine the political restructuring with improving the livelihood of the people and protecting the citizen rights of the people. And we also believe we need to combine putting in place a system of democracy at the grassroots level and administering the country by law. So I think we understand all these things.

On the other hand, I think we really need to have this in mind. China is a very big country with a very large population and many of them are still illiterate, and development is very uneven in different regions. So both the economic restructuring and the political restructuring have to be a very long process. And so that's why we have come up with the idea of having some places to undertake the pilot program. So I think people here, friends here, are very familiar with that practice.

So I think as we have already reached a certain point in terms of economic growth, and we have reached a certain point of the reform of political restructuring, I think we -- there are a number of decisions we'll have to make with regard to the future -- with a plan for the future sort of execution and enforcement of this strategy.

MR. LIEBERTHAL: Thank you. Any other comments?

MR. CHEN: I think maybe I was sounding a little bit too pessimistic because part of me -- I personally hope that real fundamental reforms can take place as the Premier has mentioned so many times over the last two years. But on the other hand, there are a lot of new dynamics definitely, especially the two-term limit for each president and also age-based retirement for different levels of officials, have created this unintended consequence that you have so many still able and energetic retired officials whose personal safety and whose children and other family members' safety are not necessarily so ensured.

So I think there is now this growth trend for there to be more consensus, that a rules-based system supported by checks and balances will become the common consensus among the different factions, especially next year there will be three presidents living at the same time and all being

supported by his own political base. So from my experience when you have a two-person game, it's different from when you have a three-person game. So the three-person game dynamics can create different challenges depending on their matter or issue being addressed.

Of course, at the same time Weibos is one of the real gifts that has really made many people, like myself, able to express our opinions even though I'm not as popular as Shuli. So you're going to get a real joy out of her remarks in a moment.

MR. NEHRU: You can never ask a World Banker about political reform. He will always find it very difficult to answer that question.

I think the real question in my mind is what are the obstacles to reform? And is political reform a necessary condition for economic reforms to take place? I must admit that I cannot, probably not that is to say, that many of the points that I made about greater transparency, greater ability to treat private and state enterprise in the same way, increase competition, greater entry, these are not -- they don't require political reform necessarily.

Why are there obstacles to reform? I do believe now that China after one generation of reforms -- exactly from 1970 and onwards -- has created a very large set of vested interests which would be threatened by reforms. And these vested interests have very close connections between the government, the Party, and the state enterprise system or the state banking system. And the challenges -- can the government deal with those vested interests in a way that they don't become an obstacle to reform, but without necessarily having fundamental political reforms?

Having said that, of course, if there are greater moves towards democracy, and politically one could welcome that personally provided they had done it in a way they do not destabilize society.

MR. CHEN: Can I just add a point? I think many economists like to say that you can have real competition whether you have state-owned enterprises in an industry or in an economy or not. I think logically you cannot have real market-based competition whether you have SOEs in the economy or in any industry. The very fact that the shareholders behind SOEs are the state, and the shareholders behind a private enterprise are private citizens who don't have enforcement power or legislative power to change the rules. So I just don't see the logical foundation expressed in many of the economists' remarks at all. You can have SOEs or private enterprises. Don't worry because as long as they all

compete in the same place, as long as the market disciplines are being -- the rules, the principles relied on to determine resource allocation and entry to an industry and so on. But the problem is as long as you have SOEs, then you don't have a real basis for fair competition.

MR. LIEBERTHAL: I will say my own sense is one of the biggest problems here is in the specific career incentives for local territorial leaders and the difficulty of altering those, and they now have a tremendous capacity to intervene in the actual allocation of capital and a whole array of things in how their local economy functions. But anyway, it's a tough issue.

I want to remind you, please, wait for the roving mic and say who you are and then feel free to direct a question at one panelist or at all of them. This gentleman over here with the beard.

SPEAKER: My name is Arnold Zietland and I teach in Guangzhou. And basically I want to ask a variation of your question, which is simply do any of you have suggestions on how you convince the leadership that the Communist Party can keep control and still reform the economy?

AMB. ZHOU: I think the part of the political restructuring is to separate a party and the state. I think looking back we have come a long way in the enforcement of that strategy. China is a multiparty state with the Communist Party being the leading party, and there are a number of parties which are participating in the running of the country. There is always room for improvement, but I think we have to do this step by step.

So I think, if I understand your question correctly, you are asking whether the Party could maintain its control while running the country. Actually I think the actual situation is sort of like this. The country is being run at different levels by the National People's Congress, by the local authorities, and of course, at the national level is run by the National People's Congress and also the State Council. So the Party makes recommendations to the State Council, and policy needs to be debated at the National People's Congress. And unless it is adopted at the National People's Congress, sometimes I think the policy can't be implemented. So maybe there is still room for improvement, but I think that's a path we'll continue to travel.

MR. CHEN: Actually, I don't think the party has to worry about losing control after conducting reforms. That's why Premier Wen Jiabao has been calling for political reforms. You think that he would not have thought all of this out with his advisors before he called for political reforms?

MR. LIEBERTHAL: Actually it's a measure of our lack of full understanding of China that some would argue that the Party can't maintain control if it institutes major reforms. Others would argue the Party can only maintain control if it institutes major reforms. So you can kind of see the tension here. Yes, sir?

SPEAKER: Thank you very much. I'm Randall Doyle. I teach at Central Michigan University, East Asian History and Modern China. I think what hasn't been spoken here, which needs to be addressed, is the Bo Xilai situation which is having some serious reverberations and will. It's the most serious situation politically in China since 1989 in Tiananmen. And as you well know, it took a number of years for Deng Xiaoping to get the momentum back with the southern tour and everything. Now with this situation happening, reforms and all this other stuff you're talking about will not take place until there's some kind of political stability.

And also another thing is that the Chinese ruling families, the Immortals or whatever they're called, were basically untouchable. Now Mr. Chen, what happens, as you brought up, if the political situation becomes triangular with Jiang Zemin, Hu Jintao, Xi Jinping, how is reform going to take place in a country where basically if productivity starts to go down and panic starts to break out in the leadership and this fractionalization takes place, what do you think is going to happen? This is very serious because the country can't move forward until there's some consistent leadership in the upper ranks of the party.

MR. CHEN: Of course, Ambassador Zhou can speak much more about this than I can, but I would say this time it's very different from 1989. So back in 1989, it was more the reform side that had been put in this defensive position. So the left, the antireform, factions were gaining more momentum as a result of the 1989 events. But this time it's the left that is losing momentum. They are more on the defense now. They have to make sure their house is in some uniformity or has some place to stand. So this time is the reform side, I would say, that is gaining more momentum.

And then also the very fact that all three of them will be alive and healthy at the same time, they will realize that at the end of the day in order to make sure that their own future, their relatives and securities, will be more ensured, the rule of law is the way to go. So I'm much more optimistic than you sounded on this point.

MR. LIEBERTHAL: From my perspective I'm only seeing questions from the right, not from the left. We're trying to achieve balance here. If we could get a microphone over there, please?

SPEAKER: Am I on the right or on the left, Ken?

MR. LIEBERTHAL: You're to my left always, Hank.

SPEAKER: That's fine, thanks, I think so. Hank Levine with the Albright Stonebridge Group. I was interested in and Professor Chen referred several times to comments by Premier Wen Jiabao, and it strikes me that over the last six months or so we have seen increased comments, both by the Premier as well as others on specific economic reform initiatives, related primarily I think to the financial system. But I'd be interested in the view of the panel. As we're talking about then the outlook for economic reform, what do you think these recent experiments and announcements indicate for the prospects for revived economic reform over the coming year, two, three, five years, whether again it's before the new leadership team takes over or indeed in the years after they take over? Are we seeing -- are these the initial real concrete expressions of a serious renewed drive toward economic reform? Thank you.

MR. LIEBERTHAL: I don't know, Vikram, you kind of spoke about this.

MR. NEHRU: I think it was addressed more to you, Professor Chen.

MR. CHEN: Okay, thank you. I think the window financial zone experiment that was announced recently and also the stated 7.5 percent target growth rate for GDP for this year and the coming years, both to me are results of the reform side winning the policy argument. That's why earlier I was saying that maybe this Bo Xilai, this whole episode, is only helping the reform side because the other side would probably want to push for faster growth regardless of the quality or the structure of growth.

But it is the more critical thinkers' side that has called for more balanced, higher quality, growth. Why is 10 percent growth always the best thing? So from my conversations with some officials on the reform, they would really like to see slower growth, but make sure that the long-term cost of growth is under control so that the future generations of leaders and people in China have a better opportunity set. I may sound too abstract.

MR. LIEBERTHAL: We have time for one last question back here, please.

SPEAKER: Donald Burns, Ranchi University. I'd like to follow up on that last comment. Each of the speakers has done a fine job of describing their view of the future. Most of those descriptions were in the context of GDP as a measure of growth and a measure of somehow goodness. In some people's points of view, that is not a measure that we ought to be using anymore, that that's sort of 20th century if you will.

I'd like to have your views on how you think if there's any movement towards viewing growth and the betterment of society in terms other than GDP. For example, the experiment that was used three or four years ago in Shanghai and other places where they talked about a green GDP, people were talking about a goal of a moderately well-off society. In all of your comments, you seem to be suggesting that there should be continued growth into the foreseeable future, if it's not 10 percent, then 7.5 percent and so on. And yet I don't understand how all of that is sustainable and whether or not it's really desirable.

MR. LIEBERTHAL: Okay, so the question is whether we should keep looking at rapid GDP growth as really the key measure or a major measure of success. Why don't we go down the line and get a brief comment from each of you, and then I'm afraid we'll have to draw this to a close.

Professor Chen?

AMB. ZHOU: I think GDP is, too, very important for China. We have these for Shanghai, Beijing, Guangzhou, maybe five of them, which have already had very high per capita GDP, more than 10,000. But we also have places where the level of GDP is still very low. So without GDP being the material base for more social progress, for the social security net, it's very hard for us to discuss other standards, other measurements, of happiness. So that's why I think we still need to -- I still remember when Wen Jiabao was interviewed by Wallace.

MR. LIEBERTHAL: Yeah, Mike Wallace.

AMB. ZHOU: Yes, Mike Wallace. And he made a statement that was to be rich is glorious. That's the first time I heard something like this. So I think in his mind, for us, for most of the people in China, the number one priority at that time was to become rich, become better off. But maybe we have already reached that point, so we need to pay more attention to other things.

MR. NEHRU: Well, four very quick points: First, the '12 five-year plan and the '11 five-year plan already had many more indicators than GDP as targets. So there were environmental indicators, social indicators, and I think in all the government wanted to monitor about I think 17 to 20 indicators and therein lies the rub. The second point is that there is no one comprehensive indicator of welfare that we have yet. The third point is that there is a commission, which was headed by Joe Stiglitz and a couple of others called Beyond GDP, which President Sarkozy had asked, had commissioned, to try and come up with a measure which brings together measures of welfare which go beyond just the utility that one derives from income.

And lastly what's really encouraging about what's happening in China is that there are now quite a few, not terribly many, but a few local governments that are using measures which go beyond GDP in assessing the performance of local government officials. And one of the problems has been that the competition between local government officials, which has been based on GDP, has led to a hell-for-leather quest for growth. And this change in the performance measurement, the key performance indicators, the KPIs of local governments, is significant and hopefully will go beyond these few local governments to change actual behavior on the part of local leaders.

MR. CHEN: I would say it's good to have more indicators, but in China you can have many indicators but as long as any indicator becomes inconvenient, you're not going to see the new readings for these indicators. But on the other hand, we are agreed that the Chinese society has gone through, has experienced so many fundamental changes. One way to look at this is to compare the lifestyle, the way of life and values of the 60-something generation to those of the 40- or 30-something generation and now to those in their teens and 20s. So from one generation to the next, the change in the way of life is so dramatic, especially when compared to similar indicators in how they have changed for the American society.

I know this sounds very abstract. One place to look for such changes is marriage as an institution and the family, especially in ways I've noticed with the Weibos and other technologies available, extramarital affairs, divorce rates, have really skyrocketed. So how is that going to change the values and sense of personal security for every Chinese citizen? There will be very, very fundamental changes. I don't know how our children's and their children's lives would be affected, but it's not pretty.

So I have to say, it's not going to be that pleasant. So that's why I enjoy the work by my colleagues at Yale who study social and anthropological issues focused on China.

MR. LIEBERTHAL: Thank you for introducing a new quality-of-life indicator that I never thought of before. The next panel, which will begin after about a 10 minute break, will focus more on the dynamics of economic reform itself. So this has keyed that up very well, but also added a lot on its own. And I hope you'll join me in thanking our three panelists for their presentations.

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