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CHINA’S OUTBOUND INVESTMENT:

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U.S.-CHINA RELATIONS AND SHIFTING GLOBAL ENERGY SUPPLY:

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P R O C E E D I N G S

MR. POLLACK: Good morning, everyone. I thought we would get off to a timely start here. I'm Jonathan Pollack, Director of the John L. Thornton China Center here at Brookings, and I welcome all of you to what I'm sure is going to be a very, very lively day of discussion.

This is the third year in a row that Brookings has collaborated with Cain Media in this forum, and we value this relationship very, very much. I want to acknowledge Hu Shuli, the driving force behind Caixin Media, who of course is with us today and will appear on the second panel.

Now, I think we have a very, very challenging set of issues here to address today as part of all the continuing challenges that China faces as it makes its continued transition to a modern economy, all in the context of course of the just completed transition in the Chinese leadership.

In four separate panels today, we will try to tackle specific elements of China's economic paths that have both domestic and of course broader international implications beginning first with what I think will be a very interesting panel on China's outbound investment, particularly as it begins to affect increased Chinese investment in the United States. We'll then turn to the very large questions related to transitions in China's financial system. We've got some very, very innovation presentations that will be made today. We will then switch to the strategic context of the U.S.-China economic and energy relationship. And we're thrilled to have with us this morning Zhang Guobao, who has been with us in the past, who will provide important insights I think from his senior leadership in the Chinese energy sector. And then, finally, some of the overall challenges that are faced to both sustaining and implementing the reforms underway in China today.

All of us look forward to a wide-ranging debate. It's interesting that in today's *Financial Times* we see reports -- not unexpected reports but telling nonetheless -- of China's leaders acknowledging a slowing of economic growth and of the need for, frankly, a different economic model as China pushes to the next stage of innovation and growth in its development process.

So, without further delay, I'm going to ask the first panelist to come up to the stage.

Wang Shuo, good to see you.

MR. WANG: Good morning, everyone, and welcome. My name is Wang Shuo. I'm the managing editor of Caixin Media and am the moderator for this session. We are going to discuss China's overseas investment, and this topic has been very hot for the past decade and I believe that it will continue to be even hotter in the coming years, because our foreign reserve is still getting bigger and bigger, and we must find a way to spend it wisely, and everybody is trying to help.

With no more ado, let me introduce our panelists today: John Frisbie, President of the U.S.-China Business Council; Arthur Kroeber, Nonresident Senior Fellow of the Brookings-Tsinghua Center; and Zhang Lanlan, Managing Director and CEO of CICC U.S. Securities. I'm sure we will have a very rich discussion today.

Arthur, why don't you kickstart.

MR. KROEBER: Thank you very much Wang Shuo.

I just want to make a few comments that hopefully will put the discussion of China's outward direct investment into context. So, what I'd like to do is share with you kind of an overview -- we look at China's outward capital flows broadly speaking, what the characteristics are, some data on the direct investment specifically -- and then a few comments on some of the things, some of the issues that I think get involved in discussing what's the potential growth path for Chinese outward investment and what kind of issues it's likely to create with partner countries.

So, if we look at sort of the three major types of outward capital flows, those would be direct investment by companies; portfolio investment by financial institutions and asset managers; and loans.

What we can see is that on the direct investment side China's outward capital flows are growing quite rapidly and becoming much more diversified in terms of both the types of entities that are making these investments and the types of investments that are getting made.

If we look at portfolio investment, basically there's very little. There's almost none from the private sector. Portfolio investment flows are still overwhelmingly dominated by a couple of official agents, mainly the State Administration Foreign Exchange, which manages the official reserves, which now exceed $3 trillion, and the China Investment Corporation, which is the main sovereign wealth fund. There basically is not any significant private outflow of portfolio capital, and I'll poke it back to some of the issues involve with that later.

And then if we look at the loans, again this is overwhelmingly dominated by the official sector. The international activities of Chinese commercial banks are pretty limited, and in fact my impression is that after kind of a flurry of interest in sort of 2007, '8, and '9, commercial banks have kind of retreated to their home shores. So, again, if you look at outward loans, it's dominated by official entities, notably the China Development Bank.

So, I think what we have is a picture where China is seeing a significant increase in its outward investment flows, but the channels through which these investment flows go are still very narrow and still highly state dominated.

When we look at the direct investment specifically -- I think that's probably going to be a big part of the discussion that we have with the other panelists -- what we can see is up until about eight or nine years ago China really didn't have any outward direct investment. There was a tiny, tiny number of sort of big-ticket resource deals. But then around about 2006 or so you began to see a big increase, and depending on how you measure it, China's outward direct investment flows are probably running in the order of about $70-80,000 billion a year, which is a pretty large number. That makes China one of the biggest sources of outward direct investment in the world, along with the United States. And the total stock of Chinese outward direct investment is probably on the order of about $400 billion U.S., which is a significant number, but I think it's worth remembering that the comparable figure for the United States would be about $3.25 trillion. So, China is still -- in terms of its total stock of outward investment, it's only about one-tenth the level of the U.S. stock even though the economy is about half the size of the U.S. economy. So, I think that gives you, again, a reminder that for all its size, China is still relatively limited in terms of its international engagements, although those engagements are growing quickly.

If we look at the composition of that word, “direct investment,” the data that we have for 2012 from various private consulting firms basically look at mergers and acquisitions activity, so this doesn’t include greenfield investment in, you know, for example, mining assets. We can see that there was just shy of $40 billion of Chinese mergers and acquisitions activity internationally last year, which was up significantly from the previous year. The biggest single target area was Europe, which accounted for about 60 percent of the total outward investment. U.S. accounted for I think about half as much as Europe did.

Chinese investments in Europe have accelerated dramatically in the last two years, and I think there’s a broad perception that a lot of what’s going on is that because of Europe’s economic difficulties, there are a lot of industrial assets that are available fairly cheaply, and so Chinese industrial firms are picking these up. And, indeed, Europe accounts for about 60 percent of China’s outward direct investment M&A activity but nearly 90 percent of China’s outward investments in industrial firms. So, that clearly that is a big part of the story. And there are a couple of big names -- German machinery companies and so forth -- that were acquired last year by Chinese firms.

Broadly speaking, however, it's still the case that about 60 percent of China's outward direct investment is accounted for by resource assets -- so coal, oil, gas, and so forth -- and that has basically been the story for a number of years. I think it's slowly changing, but there's still a very strong preference for resource assets.

The other characteristic that's very clear is that despite a significant increase in the volume of private sector companies going out and doing acquisitions globally, outward direct investment, at least in the M&A area for which we have good numbers, is still dominated by state-owned firms. Last year about 86 percent of outward direct investment was conducted by state-owned enterprises, only 14 percent by private enterprises.

So, state-owned corporations in China I think are sort of a more complicated entity. We can't really describe these as being purely official in the sense that the State Administration of Foreign Exchange and the China Development Bank are essentially official channels of outward capital movement. But still what we see broadly is a picture where state actors of one kind or another are, by far, the dominant players in all types of outward capital flows.

I want to make a brief detour, just for a minute before I conclude, on a distinct but I think related issue, which is the role of the international renminbi market that the Chinese government has tried to set up in Hong Kong over the last few years. Partly this is a matter of advertising, because as you'll see outside I have a monograph that just came out under the Brookings imprint on the question of the internationalized renminbi. But I think it's worth considering the relationship here, because basically both outward investment and the renminbi internationalization program are aspects of a capital account that is very, very slowly, gradually opening up after years of China essentially operating as an island where both capital outflows and capital inflows were very tightly regulated. I think there's been a lot of excitement about the opportunities both of the renminbi offshore market in Hong Kong and sort of more generally the idea that as China's financial sector liberalizes over the next several years, this will necessarily bring and train with it a substantial liberalization of inward and outward capital flows. And I think there is some very interesting motion there, but I think it's worth stepping back.

I've painted a picture in terms of the outward capital flows of our capital still going through a very narrow set of channels, most of them dominated by the state. And despite efforts to increase the opportunities for outward portfolio investment by Chinese individuals and institutions, I think that's likely to maintain itself for a long period of time. And similarly, if you look at the role of the renminbi market in Hong Kong, it's grown quite quickly but from a very small place, so it's still quite modest. And I think that it has yet to live up to its promise as a mechanism by which different kinds of foreign capital can flow into China. So, if you look at the inbound capital into China, it's still heavily, heavily dominated by the traditional direct investment channels, and I don't think that's going to change much in the next few years.

And the reason, I think, is quite simple. Fundamentally, you can talk in abstract terms about sort of an asymmetric capital account opening where you open it more on the inflow side than on the outflow side, or whatever. That's sometimes talked about on the basis that the Chinese government is very concerned that if they open the capital account to outward flows, then they'll just get huge amounts of capital flight, et cetera.

I think the reality is that you can have a little bit of asymmetry, but fundamentally as you open the capital account, you're going to have to open up both outward and inward flows at, over time, roughly the same pace. And I think that China really, over the next three or four years, is not in a position to do this. And the reason is that, as we'll discuss in the financial legalization panel later this morning, China is essentially trying to move out of a system of financial repression and artificially low interest rates to an environment where interest rates are determined more by the market and are probably higher. And they're doing this at a time where everyone else in the world -- all of the other major economies -- is trying to keep their interest rates as close to zero as possible.

So, if China aggressively opened its capital account, I think what would happen in the short term is that instead of having capital flight, which some people worry about, you'd have the opposite. You'd have an enormous inflow of short-term capital from the rest of the world simply because the returns on short-term investments in China would be much, much higher than in the rest of the world.

So, I mention this because I want to conclude with a few comments on sort of the constraints and the issues involved in China's outward direct investment. I think the fact that China is essentially stuck in a position where the capital account for safety's sake has to remain relatively closed for the next three or four years probably is one constraint that operates on the patterns of outward direct investment, because I think what that means is that the governments going to be very, very reluctant to allow outward direct investment to go out of its current, relatively narrow channels.

I think there will be diversification at the margin, but the basic picture of outward investment being dominated by state actors of one kind or another I think is not likely to change in the next two to three years.

So, I want to conclude just with a couple of other thoughts about the difficulties that Chinese entities face in terms of their outward investments and the constraints on expanding this, and I think in China there's a lot of focus, particularly in the media, on the political constraints that various other countries, particularly the United States, are not welcoming to Chinese direct investment. There is suspicion here, and I think that is severely overblown. I think there are a couple of sort of high-profile instances where you can point to political factors, but if you look at the patterns of on-the-ground, direct investment in both the United States and Europe, you can see that there's been very rapid growth despite these problems in the vast majority of Chinese investment proposals whether it's in the U.S., Europe, Australia, Latin America, Africa, et cetera. They go forward without political constraint. So, I think that's an understandable concern, but I think it's overblown.

Instead, I think I would focus on some other problems. Number one, state-owned enterprises account for a dominant proportion of the foreign direct investment coming out of China, and some people make the case that because they have a low cost of capital they have kind of an unfair advantage on that. But I think it's also the case that they've run into a lot of operational difficulties in many of their investments in the failure, in many cases, to execute properly on deals I think offset some of the capital cost advantage. And I think that the difficulties of operating in external markets are becoming more and more clear to Chinese entities, and that's making, in some cases, people a little bit more cautious.

I think another thing is that we're now in the midst of what appears to be a very sustained drop in global commodity prices to the extent that Chinese outward direct investment has been driven by a notion that commodity prices are high and it's important to gain access to resources. I think a substantially lower commodity price environment, which I think is permanent, will act as a break on some of these deals.

And then, finally, I think there are big problems at home, both for the state-owned enterprises that are doing a lot of these deals and for the banks that are financing them. As we'll discuss later in the morning, China's undergoing a very substantial transition to a different type of growth model, and the state-owned enterprises that played a major, major role in the success of China's high-growth model over the last 10 years do not have an obvious place in a more consumer- and service-driven economy in the future. Already the return on investment and return on assets among the state-owned enterprises in industry has stagnated and is dramatically lower than it is for private enterprises. So, I think as we go ahead, my suspicion is that the state-owned enterprises that have driven a lot of the foreign direct investment from China over the last few years will find themselves more and more constrained by their operating difficulties at home and will, at the margin, face some constraints in both their willingness and their ability to execute on large-scale deals internationally.

I think with that I'll pass it over to the next speaker. Thank you very much.

MR. WANG: Thank you, Arthur. Arthur has presented us with a very comprehensive picture of China's (inaudible) investment. Now let's hear from Zhang Lanlan, a Chinese banker in America.

MS. ZHANG: So, good morning, everybody, and thank you very much. It's a great honor to have a chance to speak at Brookings again this year. I feel very honored to be invited here, given we just had about three years' experience, relocated from China, and working for a Chinese investment bank trying to help some of the capital outflow from China, as just mentioned by Arthur, and I think it was a very good summary of what's going on and all the statistics. So, my focus will actually be linked to exactly what we saw on the ground and what was happening.

So, for CICC our main business model here includes self-trading, asset management, and investment banking. So, that will basically cover the majority of the outflows that we were hoping we can catch. For example, our self-trading business model was catering to the institution of investors who would want to invest in the U.S. We have the U.S. equity trading capabilities here on the ground, and the investment banking group hopefully were trying to very hard to catch some of the merger acquisition opportunities, and as a management is another form of how can the Chinese want to invest and diversify their portfolio into the rest of the world.

So, let me start with what we saw of the on the ground. One thing I think Arthur mentioned was that because of the capital control and isometric capital control, well, seemingly the Chinese government is encouraging more inflow into China rather than outflow to diversify in -- to invest in the rest of the world.

What we saw, interestingly, on the statistics is actually quite different. If you'll look at the QDII -- Qualified Domestic Institution of Investors -- we actually have a lot more quota than that being used. Roughly, we had about $80 billion U.S. quota. A very limited amount of that quota was actually being used for investing outside of China.

Well, what's going on there? What happened? I think if you'll look back in year 2007 when the famous story about the direct trade

-- direct through trade -- which allowed the Chinese investors to invest in Hong Kong, that wasn't going very well. It was almost at a peak of Hong Kong market. The Chinese retail investors were allowed to invest in Hong Kong. And that was a huge blow to the domestic investors. Years after that, we all know the reason for the financial crisis global-wide. A lot of those investors saw 50 percent loss in that portfolio. I think that was the first step that wasn't faring well. And most recently, I think the last couple of years, we do see the QDII start to perform a little better than in the past, not just in Hong Kong but also I think a very limited exposure to the rest of the world as well.

But, unfortunately, if you'll look at those QDII mainly consisting of banks, insurance, investment banks -- if you'll look at where they were heavily investing in the last couple of years, it was the Hong Kong market. Again, that strategy didn't work out. We all know that the Hong Kong market was underperforming in the developed countries for the last two years.

So, the QDII -- the Qualified Domestic Institution of Investors -- strategies didn't work very well for the domestic investors. So, what does it tell us? For me, I think what I saw was really a lack of knowledge on the global asset allocation.

If you'll look at what happened in the past number of years, first of all, we didn't get the region right; second, we didn't get the asset class right. So, you know, if you couldn't get your strategy right, if you don't know how to allocate your assets global-wide, just to say that you stick to one strategy, which was equity strategy -- in the past it was what the Chinese investors focusing on when they were in the domestic market -- that's not going to work out.

Chinese need to learn how to look at the world from a global perspective rather than looking at the world from a Chinese perspective, and that's a huge knowledge gap over there. And that's understandable. Look at how this part of the world had been investing global-wide. There's a much longer history, and we just started, you know, less than 10 years ago.

So, I think that knowledge gap over the next decade is going to be narrowed, and hopefully, you know, it will be narrowed. And we start, as a Chinese investment bank, to introduce our perspective, and we start to not in terms of covering the U.S. multinationals, but we start to follow them, their Chinese strategies, what they're doing. And that is gaining a lot of attention, the domestic institutional investors. And I think that that's very, very positive. And we're also working with some of the multinationals here, for they are China -- not NDR, which is non-deal roadshow. So, we brought Chinese the management from multinational companies to do their roadshow in China, to visit the Chinese institutional investors.

At the very beginning this year, we brought one of the Fortune 500 CEOs to China, and surprisingly, a lot of the Chinese institutional investors found it very difficult to take on that meeting. I told them this is like the greatest opportunity, you'll learn the strategy, you'll learn how they view the world. But the problem is that they don't -- the Chinese institutional investors, since they haven't been spending as much time on the rest of the world, they were even very hesitant to take on the meeting, because they felt "am I going to be able to ask the right questions?"

So, I all over the times, I see very positive trends. I see there is a desire for that knowledge, and I think it's going to happen in the next 10 years.

So, that's more on the portfolio side, what we need to see before we get to see people moving on to the next stage.

And now I move on to the investment banking side, and that part is, in fact, gaining the most attention both politically and for their economic cooperation in the last number of years. And so whenever people are talking about the market situation, they will always -- on the Chinese side they will be quoting, you know, "look at what happened to the banks; it took us, like, 20 years to get lessons." And another widely quoted example would be, "(inaudible) -- you know, we just cannot get through CFIUS. We don't know what CFIUS is requesting. And that's the difficulties we cannot expend in the U.S."

And, of course, on the U.S. side it also hurts that, you know, that there are a lot of business difficulties for the U.S. multinationals to invest in China.

Well, let's put that aside. In the early '90s I was working for one of the greatest companies in this country, General Electric. Back then I heard similar complaints. You know, people were complaining about it's so difficult to do business in China. But it took Jack Welsh the commitment, the long-term vision to stay in China. And I helped General Electric to build their first joint venture on the industrial side in China. It was closed two years afterward. I mean, there are bound to be some failures. There are bound to be some difficulties. But it takes persistence to stay in that country and really, in the end, to see the great profit. I think today G.E. is -- the Chinese operation is one of their most profitable operations in the world as well.

So, put that political side aside. What we really see -- the difficulties in terms of investing in the U.S. -- I think, again, knowledge is to stay on top of the priority list the way I understand how to do business here. I think many of us are seeing the difficulty, and maybe we have to admit that we don't understand it very well, and that's understandable. You know, we are only here, you know, for less than 10 years, and if you're lucky, for the U.S. companies that invested in China it's 30 years, and they're still claiming they don't know how to do business in China.

So, how much do we know? And also I noticed that a culture-wide -- these are two different cultures. The people not only just in the business world but also during their day life they are doing things differently, and both parties need to learn.

I think the positive side is that we do see China as a very open-minded nation. If you'll look at -- from the top leaders to the ordinary Chinese, we're sending kids to study in this country. We believe this country has the best education. So, with that kind of a commitment in the investment, I think over time, that knowledge gap is going to be narrowed, and the way of doing business is going to converge as well. I think that both parties are very practical, so over time that's likely to happen. But the knowledge gap is something that will be ranked as the number one priority as well.

Secondly, I think it's really how do you view investing in North America outside of China? Is that just because it's driven by the central government? I think the government is having a very long-term vision. They know they understand -- from my point of view, they understand that China needs to become a global citizen, and the way that you become a global citizen is to mingle, to blend well into a different culture by investing. Of course, at the very beginning you're going to probably pay the tuition and lose money on that. But over the longer term I think it has a very important step that China is becoming part of the world and becoming more integrated with the world.

So, I think that's a very strategic view from the central government, from the CEOs, but at the execution level things are always turning a little bit different, because at the execution level people probably view that as a very optimistic way of doing business. You know, they will think, you know, because the U.S. is recovering, maybe we can make some quick money out of that, and that's why you're seeing all the investment coming out of China.

I think there was one statistic we failed to mention just now. It was the real investment at both the private level and also I think probably at the public sector level as well.

So, people take that as an opportunistic view in terms of investment. But that's not going to work. It's not going to be something -- you know, you're coming in for two or three years and you're going to make money and then you don't know what your next step is. It has to take a long-term view. You have to be able to know what you plan to do in the next 10 years.

But a lot of these situations we saw on the ground when we were helping our clients was that there wasn't a clear strategy; there wasn't a clear long-term strategy. So, it was more sort of, oh, you know, my boss asked me to do that, I have to do it. And that's not going to work. So, I think, secondly, we need to have a different approach to this strategy.

I think the third one that I'm seeing is that because the Chinese corporates are working in a totally very different team environment, basically we have a lot of the sectors in China already very market driven, but there are also sectors, that certain companies have the privilege to have access to capital, human resources, and even, you know, government subsidy, government support. But now they're working a market economy, which is going to be slightly different. So, how do you work in a totally different market mechanism? How do you become part of the community, the investment community, the corporate community? I think that's another challenge we need to face.

And I think that, lastly, what we saw is that for all of what's going on in this part of the world for the investments, we do need to see reform back in China, because, you know, organizational structures, human resources, how you pay your employees, every single detail about running a company -- that needs to be changed back in China before you can really mingle yourself well into the U.S. economy.

So, lastly -- I just want to wrap up -- of course we're feeling a lot of difficulties, and I think those noises that we are making -- it was totally legitimate. But in the meantime, don't give up, be persistent, and in the next 10 years, no matter what's going to happen we're going to see more investment into this country either from portfolio or from the Chinese corporates. I don't think it will be stopped. Temporary setback might happen, but if you look at the trend in the last 30 years, every 10 years we jumped one step, and it was a major step. We're about 10 times above the investment of 10 years ago, so that's not going to change.

Thank you.

MR. WANG: Thank you, Lanlan.

And Lanlan identified deep, (inaudible) gap for both the foreign investors and the business investors from China into the U.S. market and other international markets, and the (inaudible) you suggest is to (inaudible) keys to study in the United States. I wonder whether we can get a (inaudible) solution. (Laughter)

All right, let's hear more from (inaudible) and business perspective.

John, please.

MR. FRISBIE: Thank you Wang Shuo, and thank you to Hu Shuli and Jonathan for asking me to participate on this panel. I'm probably going to end up reinforcing some of the messages you've already heard this morning from the other two panelists. As Art said, there are different types of investments to look at -- portfolio, financial, and the Treasuries and equities and so on -- and there's foreign direct investment, which is going to be my focus. Let me put a couple of numbers on the table that I think will fit in with what Art was talking about. These are from the Rodean Group up in New York, which does a pretty good job of tracking inbound investment from China (inaudible) various sources.

Clearly, Chinese foreign direct investment in the United States is increasing dramatically. If you go back five years to 2007, maybe you had about 10 deals, less than a billion dollars, something like that. If you go to last year, 2012, you probably had over 60 deals with about $6½ billion in investment. Those numbers are complete. They really can only capture the bigger deals that they might get through filing. Some of the smaller deals may not get included, but nonetheless I think it's indicative of what you heard from both speakers, that Chinese direct investment in the United States is growing rapidly.

If you break that down into the different types of foreign direct investment between M&A deals versus greenfield, M&A deals clearly outnumber greenfield investments here in the U.S. for Chinese investors. In terms of numbers of deals, there are about twice as many M&A deals as there are greenfield investments. If you do it by dollar value, even more so. Probably 80 percent of the foreign direct investment from China in the U.S. is in M&A deals. But the bottom line, as we heard, is that we should all expect these numbers to increase -- period. And I think that's a good thing.

Why do we like foreign direct investment? Growth -- economic growth and jobs. Very simple. At the same time, I think we all know there's a lot of concern from the Chinese side about whether they're welcome to invest in the U.S. or not. I was actually just in China twice in the last three weeks and got to hear this directly from some of the investment leaders, the China Investment Corporation, China Development Forum in Beijing. The chairman of China Investment Corporation, (inaudible), on the panel, talked directly about barriers they face in investing in the United States. And at the (inaudible) forum, Gao Xiqing, also China Investment Corporation also articulated that view, too.

What are their concerns? Well, one, there is the CFIUS review process here in the United States to review mergers and acquisition deals; and it's very important to remember that CFIUS only looks at mergers and acquisition deals, not at greenfield deals.

You want the numbers around the CFIUS reviews? CFIUS? CIFIUS does put out numbers. The last full year I think was 2011. 111, I think, M&A deals globally -- this is inbound -- were reviewed. Ten of those were from China, so a little under 10 percent were from China. Just for context, the U.K. had 25 deals reviewed; France, 14; Canada, 9. So, China is clearly higher on the list of getting CFIUS reviews. But it's not just the CFIUS reviews; it's actually outside of CFIUS, too, that's causing concerns, and that's the political outcry that has cropped up and led some deals to go astray without ever reaching the CFIUS process or even a deal that might not have required a CFIUS review.

What are some examples of this? Let's just choose the wind deals that got a lot of attention. There is a Chinese investment in Oregon that was following a CFIUS review. Turned down and denied after the fact. That's a good example of the need to consult early, by the way, in the review process to avoid those types of situations. But the problem there apparently was proximity to a military installation. On the other hand, there was a successful Chinese investment in wind in Texas, which was a greenfield investment, and I think that's an important reminder of the fact that it's not just that wind is off limits; there was another reason for that.

What do the surveys say about Chinese attitudes towards investing here in the United States? Because we have the anecdote -- only read the headlines -- and we listen to what some of our friends in China say. But it's always good to go some survey data to get a little bit better grounded. There's no shortage of these out there, actually. The China Council for the Promotion of National Trade has been doing a pretty good annual survey of Chinese investors every year for the last three years.

I'm going to cite a recent one that was actually done by *China Daily* and APTCO for China's executive views of investing in the United States. And I won't go through it all. You can find the survey online I'm sure, but one of the questions is around market entry into the United States through the investments, and 94 percent said that they were very or somewhat successful entering the United States. That's a pretty high percentage. Wasn't problem-free. When asked about conducting business in the United States, something like 60 percent said it was very or somewhat easy, but a fair number cited problems. But when they talked about the problems, actually less than 20 percent cited investment restrictions or anti-Chinese bias as a serious problem. Instead, the types of problems that were cited I the survey that created difficulties for the

Chinese companies trying to operate here were around operating costs, HR issues, business culture differences we heard a moment ago. regulatory compliance, which I think we can all understand, could be a bit daunting. Those were all cited as higher challenges than an anti-China bias toward investment. Lots of Chinese investment is under the radar, so to speak, in a variety of industries. Ranges from consumer products, automotive components, machinery, oil and gas, and, yes, even financial services. ICBC -- the Industrial Commercial Bank of China -- for example I think bought something like 80 percent of the Bank of East Asia's U.S. assets. So, successful investment here in our financial services sector.

Another complaint that I hear from Chinese investors, and I've heard this from CEOs in China when we've had our board of directors for the U.S. China Business Council over there is about the problems in getting outbound investment approvals from China's government as well, excessive delays that can undermine getting a deal done. So, it's not just all issues here. I think China's investors would also tell you they have a need to see more efficiency on their side in terms of government approvals to invest overseas.

So, what are some of the solutions to these issues? Well, first thing I think I would come to is this, just for a little context. U.S. foreign direct investment in China in 2012 -- this is based on China's statistics -- was around $3-3½ billion. And remember a moment ago I said that Rodean Group here in New York says that Chinese and foreign direct investment in the U.S. is about $6½ billion.

Neither of those numbers is probably completely accurate, but I think the one thing that we certainly could take away from it is that the numbers are pretty small. U.S. foreign direct investment in China is about 3 percent of their total foreign direct investment. Not very significant. And as we heard earlier, China's investment here also small, low single digits. That should be the striking takeaway, I think, from those numbers, particularly when you have the two largest economies in the world involved.

When we talk about U.S. investment in China, we have seen through our own survey of our membership in the past three years a little bit of a decrease in confidence. It's not turning to pessimism. U.S. investors in China are still largely optimistic or somewhat optimistic. No doubt about that. All for good reasons. But clearly the investment and licensing barriers that U.S. companies that faced in China are undermined in that confidence a little bit, all right?

This brings me to the first thing I would say, which is that both governments need to be doing all they can to mutually reduce investment barriers. And barriers in China that U.S. companies face do impact, I think, attitudes toward Chinese investment here, and that's why it matters. One possible way to get at this is through something like a bilateral investment treaty. There are discussions underway. But I would say that for a bilateral investment treaty to be successful, it's going to be necessary for it to be meaningful. And by that I mean it would have to address those investment ownership barriers that are in so many industries in China. We keep a list. There are close to a hundred areas where U.S. investors are limited in their investment amounts whether it's insurance or cloud computing or whatever. Maybe owning 50 percent may be a minority. I think it's very important for both sides to try to reduce those barriers. Bilateral investment treatment would be one way to do it. I don't know if we want to wait that long to have that play itself out. It would be good to be taking some barrier reduction measures in the meantime.

We need to continue what's called around here a sub-national dialog, and basically that means outside of Washington all the work that's done at the state and municipal levels to try to attract Chinese investment here.

I just mentioned that, you know, I was in China a couple of times in the last three weeks. So was former mayor of Chicago Richard Daley in part I think doing just that. California governor Brown was there this week -- last week? I'm losing track of time. Same thing. Looking to attract investment. Iowa's Governor Branstad going soon with a couple of other governors. This is going all the time. Again, we wouldn't see that in Washington, but governors are doing this for one simple reason, what I said earlier. It's economic growth; it's about jobs. They want foreign direct investment to come in. I think that's an important message and an important channel to continue to work. I think Beijing's major is actually planning to go to Los Angeles as well in mid-May perhaps. So, that'll be another thing to do.

A third one would be to continue education programs. I think we just heard about the importance of that for Chinese investors to better understand the environment here. And it comes out in that survey data. The Chinese investors find that it can be a challenging environment here to operate in. It's a different one for them. It's a new one for them. Our organization and others need to continue to do as much as we can. The Department of Commerce has its Select USA program to try to help Chinese investors get smarter about the environment here. I agree with what was said just a moment ago. U.S. investors had to get smart about China. It has taken a long time to do that, and they're still learning all the time. Chinese investors have to go through the same process here. They just need some help.

I would also say as part of that, as I mentioned earlier, where a deal might get caught up by a CFIUS review is to have those consultations with Treasury early rather than later. And a positive example of that would be the Wanda investment where they bought AMC Theatre chain here, a big transaction, but they did do that early. I'm not sure that would have been considered a strategic threat, by the way, movie theaters. But, nonetheless, they did it the right way, and I think that's something we should also be encouraging, too.

There are a few other things here, as well, around the margins of this that matter, and that's around building trust around trying to change attitudes. I think more transparency, efforts to improve governance, particularly around the state-owned enterprises, are important. Level playing field issues are important, too, like I said, because I do think that we're at a point in the relationship now where, you know, the last three decades were about China building up its trade volume.

The next 10 years and beyond ahead of us are really going to be about bilateral investment and relationship. It's enormously important to make sure that goes right. It's not just about the investment issues themselves. There's a lot of other trust and confidence issues that matter. Yes, things like cyber security matter. But it's time, I think, for both sides, like I said, to be working together to try to remove those barriers and try to build trust to make sure that this aspect of the relationship becomes as successful as some of the things that have happened in other parts of the relationship.

And, finally, in regard to CFIUS, the one thing I would say about it is let's let it do its job. We need to de-politicize the view over here about inbound Chinese investment. CFIUS is set up to work. Let's let it work.

Thanks very much.

MR. WANG: Thank you. Thank you, John.

And, yes, we agree that the U.S. market is open to international investment, including Chinese investment. Yes, no matter what happens in the future years, Chinese investment into the U.S. market will grow no matter what happens. But we also cannot avoid talking about Huawei, cases like Huawei, because Huawei is symbolic. Huawei represents the most aggressive Chinese companies investing in the international markets, and in the U.S. market, its effort to expand has been repeatedly frustrated.

So, I want to ask a question to the whole panel. What kind of specific suggestion can you make to a company like Huawei? How can they -- what should Huawei do before its expansion to the U.S. market becomes successful?

John, how about --

MR. FRISBIE: My simple answer would be one of the ones I closed on, and it's transparency and governance are important things.

MR. WANG: Mm-hmm. So, (inaudible). You mean, for example, if (inaudible) in the United States (inaudible) market, would that help?

MR. FRISBIE: I think it also has to do with their decision-making structure back in China.

MR. WANG: Mm-hmm, yes, and --

MR. KROEBER: I'd say the simplest thing they could do is publish a register of shareholders.

MR. WANG: Mm-hmm.

MS. ZHANG: I took that out slightly different. I think in Huawei's case people can definitely say, you know, transparency, governance. But it's a bit shocking why ZTE was also on that list.

MR. WANG: Yes.

MS. ZHANG: It was publicly listed in Hong Kong, and the shareholder structure was relatively clear. I think, you know, also -- I just happen to be a telecom analyst for the last 10 years -- the way I look at the world and at the way I look Huawei, I think Huawei -- one suggestion that I want to give them is to learn how to operate in the global environment, how to make sure you compete in a way that is widely accepted by different cultures and the different rules.

If you'll look at what happened, I think (inaudible) or not if you look at what happened from a decade ago to now with the rising Huawei and the ZTE, the landscape of the telecom equipment sector has been dramatically changed. There are companies rising. There are companies always where they have been suffering. It just happens to be a factor that is changing very quickly, very fast, and it takes investors -- it takes the competitors to absorb that. But how you can make sure that the way you compete is widely accepted and understood, and probably in another way that will become more transparent to the others.

But that was a myth that has been going on for a long time, that people said how Huawei can compete and become so competitive in a short period of time. But if you go back to China, if you visit their research center, if you talk to their engineers, one thing you can start to understand much better is that one Huawei engineer, a telecom engineer, is only one-tenth of the cost of the telecom engineer here. And that sometimes will tell you it wasn't just the support of the credit from the government; it was really the competitiveness, the slowing down of the technology development in the last ten years in that particular space after the Internet bubble that gave Huawei and also ZTE the opportunity to compete in the global market. I think that part -- I think the world also needs to understand it wasn't just government support. I think every telecom company, every telecom equipment manufacturer in this world is one way or another getting government project. I mean, if you look at Motorola where their business is the most profitable, it was in Iraq. I mean, that sort of thing -- we have to accept that it happens.

But, on the other hand, I think the people need to understand investors. Competitors need to understand how Huawei and ZTU were able to be very successful in the last decade. If Huawei and ZTU can explain to the rest of the world very clearly how that happened, I think that probably will help them a little bit in the global --

MR. WANG: Thank you. So, the knowledge gap is mutual, right?

MS. ZHANG: Yeah.

MR. WANG: Yes, thank you.

And the discussion is open to the floor.

Please identify yourself.

MR. LAW: Hi. My name is Eric Law. I'm with the *Free Observer*.

My question is that I think that there are a lot of things that I've been concerned about, you know, because of course, like, firms and

China, like Huawei or others, are actually owned, partially owned by the government and are talking about, like, private companies haven't been able to make a big headway. I think that's a lot of -- it actually has been a long time since Americans have very jittery about any kind of Chinese investment.

I remember, you know, like when you talk about, you know, like, when Hutchinson got the two ports in Panama and they always talk about, like, oh, China is owning the canal already. So, that kind of thing -- even though it's a Hong Kong company, it has China links in everything. So, I think that in opening up the private sector will give people more transparency and more confidence, that they're investing in a company not a government-controlled environment.

MR. WANG: And what's your question? Do you have a question?

MR. LAW: The question is the (inaudible) of the private sector.

MR. KROEBER: Yeah, I would agree with that, and just to respond both to that and to the comments that Lanlan made. I mean, I think it's not just a matter of a company like Huawei or ZTE communicating more effectively what they do. I think the problem is that the entire system in China is a system of very high levels of state involvement either in direct ownership of companies or in the allocation of resources to companies.

This is not comparable to the situation in any other country. I think we have to be very clear about that. The Chinese system of relationship between government and companies is different than in any other country in the world substantially, and to the extent that most of the outbound investment continues to be either by companies that are explicitly state owned, like ZTE, or ones that, despite repeated efforts by journalists and analysts to understand what their relationships with the government are, they can't explain them, which is Huawei's situation.

It's been 15 years that Huawei has been the subject of extensive scrutiny by international (inaudible). We still don't have any clear answers as to what their ownership structure is and what their relationship is with various government entities, right? So, this is not a problem of communication of this or that company.

This is a systemic question, and it leads to very understandable suspicion, not just in the United States but in many other countries, which have also had difficulties with companies like Huawei proving investments. It's a systemic failure to get a straight answer about our companies that come out of China. Are they purely commercial? Or are they representing some kind of state agenda that we can't figure out what it is? So, I think it's not just the individual companies that have to be more straightforward about this. There's a systemic issue there, and I would agree that --to the extent that more and more of the direct investment is by unambiguously private companies, like Wang Chung, the automaker that has made a lot of investments in the United States, and as far as I know has not encountered any problems -- I think that clearly it would be helpful in terms of the overall picture.

MR. WANG: Thank you.

And, yes, please.

SPEAKER: My name is (inaudible), and I teach finance at Johns Hopkins University. So, my question is to Zhang. Basically, four days ago the biggest (inaudible) investment of a Chinese firm -- China Development Bank -- to (inaudible) to $1.7 billion in size fell apart. And part of the reason is the China Development Bank insists on the commission using a China construction company, the China Railway Construction Firm, as a general contractor. But I assume that they cannot handle the local labor union conditions really well so that it still basically was canceled.

So, my question is: If the foreign investment from China comes with attached condition, like, you know, not only the capital but also the provision of technology and the labor, how will that affect the business side of the local trade union and labor union?

Thanks.

MR. FRISBIE: Well, as I said earlier, one of the benefits of foreign direct investment is economic growth and job creation, and if you're trying to build support for making an investment somewhere, the more you are creating jobs, the more likely you're going to get a positive reception. So, things that would come with that, that might reduce the local jobs' impact might make a deal less attract. So, that's one point.

We have to remember that when some of these deals are going in, it's very important to make sure that Chinese investors engage early with local stakeholders so the messaging going out is going to be a positive one about the job creation and other things. Staying silent early and allowing those who might oppose a deal to speak means you're losing that part of the public affairs stage.

The second thing, though, I would point to is -- and I don't know the specifics of the deal you're talking about, but I think it supports the point that comes out clearly in all those surveys that I mentioned. Probably one of the top inhibiting factors for Chinese investors in the U.S. is a lack of understanding about the regulatory environment, the HR environment, and so on. It is very different. And it sounds like that might have been one aspect of that.

MR. WANG: This gentleman.

MR. VICENT: Mike Vicente, PBS Online News Hour. Following up on the HR, I know that European firms or some European firms come here and they have real problems with the American workforce. There was a good story in the *FT* over the weekend that Sieman's -- one of the companies in South Carolina, a German company -- opened up an investment and they got 2000 applications, of which 10 percent of the people were qualified to do this fairly high-tech work. So, are the Chinese firms facing the same thing?

And then the follow-up question I had was how effective are the various mayors and governors in terms of appealing to Chinese investors? I presume they can be deal openers, but there's no way that they're going to be deal closers.

MR. WANG: To which is your question addressed? Sorry. How about to you, Arthur.

MR. KROEBER: Well, on the question about HR issues, again, I can only point to the Chinese survey data. I'm not going to speak for Chinese investors. They do fine. The HR rules at least are challenging. I don't know if they're finding any talent shortage or not. But I think you raise an important point for the U.S. more broadly, and that is in our economic future the greater determinant is going to be not necessarily what happens with China but it’s what we do ourselves here to get our own house in order and make sure we’re competitive, and obviously having a competitive workforce, educated workforce, is a big part of that. That’s a whole separate issue. But I think that message about our economic future being closely tied to what we do here at home is an important one to remember.

MR. WANG: That gentleman over there.

MR. OKUN-KOZLOWICKI: Hi. My name is Jeff Okun-Kozlowicki, and I had a comment and a question regarding issues of trust and confidence that I think several of the panelists mentioned, and my comment is when I was working at the Department of Commerce, the U.S. Department Commerce e-mail systems and computer systems were hacked through computers originating in China. That same year, Huawei came in to meet with myself and several other Department of Commerce officials to stress, as they have done repeatedly, that they have no links to the Chinese government. I think there seems to be a disconnect between what we want and what we’re doing. So, my question is, broadly, what can governments on both sides do short of perhaps eliminating CFIUS and completing radical transparency in the financial and business system in China? What can both governments do to increase trust and confidence?

MR. WANG: Arthur, how about you first.

MR. KROEBER: I guess the first comment I'd make is that I think -- I mean, if you look at CFIUS and the analogous processes that exist in other countries for vetting foreign direct investment, typically what they do is they address a very small percentage of the total transactions. And in most cases, they approve everything, all right? So, and what CFIUS I think was in fact designed to do when it was created in the late 1980s was -- it was originally designed in response to concerns about Japanese direct investment in the United States. I think the function of these things is, yeah, they may be viewed as obstructive to particular deals, but I think in a broader context what they do is, because they allow for -- if you will, they're kind of a political pressure valve, so it gives people who are scared about this or that particular foreign investment wave a way of expressing their concerns, and by, you know, basically obstructing one or two deals it gives the broader investment wave greater credibility, because people have the sense that, oh, okay, things have been properly qualified so we don't need to worry. So, I would actually agree with John's comment that I think the CFIUS process is extremely important, because it validates the broader investment terrain. And I think we sometimes get a little bit too hung up on the particular deal that CFIUS or a foreign investment review board in Australia or comparable organizations might obstruct. I think you're losing sight of the forest for the trees there.

So, I think point one is: Having mechanisms like CFIUS, even though, like, they might be annoying for particular firms, is very important in creating a wider culture of consent for these things.

And then the other thing is -- I mean, I think -- again, I would agree with John that fundamentally the issues of obstructing investment I think on both sides are not so much political, they have to do with various kinds of investment protectionism that we have are regulatory barriers, and so the issue is just how can we reduce the regulatory barriers? I think that is, in terms of increasing the flow of investment, just doing practical things to reduce the number of regulatory barriers and to make sure that there are enough mechanisms in place to create political consent. I think that's all that you need to do.

MR. FRISBIE: I don't think there's a fast fix to the trust-and-confidence issue, but it's an enormously important one. I would say we need to continue to expand engagement like we saw at the end of the Bush administration, like the Obama administration's done between the U.S. and China in all facets of the relationship. We need to size the engagement to fit the size of the relationship. So, it needs to keep getting bigger, not smaller. Relationships only get more important with time, not less important. And, yes, all aspects matter, including the strategic and military side.

So, that would be the thing that I would emphasize has to continue to go on. At the same time, I think we heard, you know, on the CFIUS process that perhaps we can do a better job trying to explain it as well, but I think it's important that Chinese investors understand that they can go to Treasury early and consult on a particular deal and maybe avoid some of these outcomes or at least be able to mitigate them rather than have it be a problem after the fact.

MR. WANG: And then Lanlan Zhang has something.

MS. ZHANG: Yeah. Well, so, my part -- I think that the trust and confidence probably won't be changed overnight, improved overnight, but always our intention to try to improve that. I think over the years what I've noticed is that maybe on the U.S. side we need to understand that China is a different country. It's going to improve the transparency. It's going to improve how it communicates with the world. But it's always going to be a country with a very different culture. So, it's not going to be, over the years, expecting China to look exactly the same as U.S. I think eventually it's still probably going to have a completely different set of values over the time. But hopefully they're going to be looking more and more alike.

And I think on the Chinese side, the Chinese also need to understand that they're now just an individual country. They're working and operate under a global system. The more they can get themselves understood, the more they can better communicate themselves, the more they can be responding quickly to what's going on in the world, that trust then can be established. I think they will always need more effort.

Regarding the CFIUS, I don't know, I think it's a bit of a luxury for us to expect that's going to be removed any of the time, and even if China (inaudible) as you go there, for your investment, you still need to get approval for certain sectors, and so I think --

MR. FRISBIE: Actually, no. Every single deal has to have government approval in China. (Laughter)

MS. ZHANG: Well, that's what I'm saying, you know. I don't -- but eventually -- I was being asked in the past do you think the Chinese economy is more open or the U.S. economy is more open? And I can only say, using numbers, if you're looking at industrial output, if you're looking at industry value added, this country has much less contribution from foreign-owned companies. China has over 20 percent of its industrial output coming from foreign-owned companies. So, I don't want to go through the procedures (inaudible) says which one is better than the other ones. But the outcome -- it seems China is more open, because China was able to get more foreign companies making contributions and manufacturing in their own country.

But that being said, I think that we need to learn on the Chinese side. I think we need to learn the procedures and the process. Every country has its own set of rules. We just need to learn and follow -- and how to survive and operate in that environment.

MR. FRISBIE: Let me come back to the cyber security piece of this, because it's important.

You know, what should companies be doing -- American companies be doing? My analogy -- it's like if you live in a high-crime neighborhood, you've got to make sure that you have the best locks on your house, the best security system in place to protect yourself, and that's what companies need to be doing. Who's outside your house, who the perpetrators are. You don't know that. And that's not your job to be able to try to investigate or figure it out. That's where governments come in. So, U.S.-China Business Council board of directors in January, as part of our annual statement of priorities, highlighted the cyber security issue and basically said that commercial espionage doesn't have a place in the relationship regardless of where anything might be coming from. It can undermine a constructive commercial relationship, and the two governments need to get together to try to come up with a way to reduce the cyber security problem.

I think that the two governments are talking now. We would encourage them to move along that path sooner rather than later. China says it's a victim itself of hacking, and I have no reason to not believe that. We know that some of the IT systems over there don't have the best protections in place. I would say, however, that would be even more reason for the two sides to work together if China's a victim, too, to try to reduce this problem. But it is one that needs to be addressed bilaterally sooner rather than later so it doesn't become more destructive in the relationship, and it gets right at the heart of your question about trust and confidence.

MR. WANG: And the discussion -- sorry, it's (inaudible) (Laughter)

SPEAKER: In the past I worked for a long time with the Chinese government, so two years ago I retired from being a government official, and so they gave me a position. I became the head of the Chinese Investment Association, but that's my job now.

After I retired, I felt that there are a lot of things that the two countries haven't learned from each other. It seems like -- I feel like when you go to each other's country, there's so much that you don't know about that country, because being the head of this organization I can have a lot of data in my hands.

Last year the Chinese investment only accounted for 0.5 percent of all the foreign investments. Someone gave me 3 percent just now, but mine is 0.5 percent. So, whether it's 0.5 percent or 3 percent, I feel that this, when you compare it to the U.S. China trade relations or the international positions of the two countries, I can say that this number is really not compatible to our positions.

So, someone said that 60 percent of the foreign investment accounts for 60 in Europe and then only 30 percent in the United States. So, I think these are all the things -- these are all food for thought for us. Do you think that the problems have to be attributed to companies like Huawei, or are there issues that we need to consider?

So, when I listen to the discussion, it seems like everybody -- or (inaudible) we're talking about Huawei not other issues that had caused a small investment in each other's country.

Someone also mentioned that the restrictions of investment, Chinese investment, in the United States haven't exaggerated, because 40 percent of Chinese investors feel that they feel very comfortable investing here. I think that is quite a very liberal number. My data shows that of the .5 percent that came to the U.S., most of them -- they came here to invest in companies, in retail, in wholesale, not necessarily in, like, mining or anything. Maybe they came here to open up a restaurant or they invested in some kind of chain store or a supermarket.

So, this kind of investment -- yes, there are a lot of main cases, but the number is small, the dollar sign is very small. So, of course, CFIUS would not investigate. Even if they investigate them, they would find that they're okay to invest here and therefore they don't experience any problems in the United States. But if there are more major investments, and you can see that investigation on them would be larger, for example, Huawei and also Cnook, and when Cnook was trying to acquire Unical was also rejected because of security concerns.

And then also like the (inaudible) heavy industry in Oregon. They wanted to invest in the windmill, and then they were also rejected because of security concerns. Now, if you want to go back many years, even (inaudible), what he wanted from Hong Kong, he wanted to buy a port here. Again, he was rejected because of security concerns. So, these are -- it seems like all the more major investments would be a probability (inaudible) United States. But if you invest in a restaurant, invest in a supermarket, then you don't have a problem.

Then among the two American friends, I think John just has said that when you go to China you have to get every budget approved. I can tell you 80 percent of the projects do not need to be approved. I know this.

Now, if you want to open a restaurant in China, you don't need to get an approval. So, likewise, for more major cases (inaudible), we do need to have a (inaudible). For example, we need to review it by NDRC if the investment is over $300 million U.S., but if you want to open a restaurant, that's not a problem. But of course you need to have a business registration, as in any country.

So, I think this kind of basic knowledge is what we need to have, and it seems like we have this huge knowledge gap between our two countries.

It's hard to imagine -- now, let's go back to Huawei. It seems like everybody has something to say about Huawei, thinking that you might have some kind of relationship with the government and so on. You can take my word for it. In the past I was in charge of the information technology. When Huawei was a small company, I already knew its owner. He really did not want to have any government involvement in the company, because when his company grew and its reputation grew and (inaudible) actually went to his company (inaudible) and I went with (inaudible). And after visiting the company, (inaudible) said Huawei is really doing very well, do you want the government to help you? I can give you a loan of 300 million renminbi, and (inaudible) did not want to offend (inaudible), and he did not say no. However, later on he said that, no, I do not want any loan processed or arranged by the government.

So, this is his company, and now he came to invest in the United States. It was rejected, so I thought this was some kind of strange. And (inaudible) is of my generation. We both were born in 1944. And so he indeed has served in the Chinese military, but I don't think he was a good soldier, because my understanding is if you retire from the military in China, you could become a member of the Communist party, but he could not -- but he could become a Communist member. So, he must have been a very bad soldier. So, tell me that you don't think that an American CEO is (inaudible) American CEOs, and none of them are really (inaudible) to country or have served the country. So, you think that because they have served in the military, they should be bad people? Because I know that in America, even serving in the military you are so well respected. So, I think, again, there's a lot of political bias. I don't think it's just any kind of ordinary bias but -- political bias.

Yes, Huawei had become very competitive, but to say that it has some connection to the military and so this therefore poses a security concern in the U.S., I don't think that's reasonable.

If you think that communication devices are bad and may be threatening the United States and Australia, then we in China are threatened by you, because I'm using an iPhone. So -- and of course when I'm on the phone you can listen to every conversation I have, and also in many Chinese factories a lot of components and parts are bought from the U.S. So, if that's the case, then we cannot use computers from the U.S., because it's not safe. So, I really am very taken aback by the kind of knowledge gap between us.

MR. WANG: And I think our discussion is getting better and better. (Laughter)

And (inaudible) actually just launched a systematic attack on the American side of the perception. (laughter) And there is a huge perception gap between the American side and the Chinese side, and I think -- but (inaudible) speech is a vivid example of what to point out what's going wrong on both sides. And with this, unfortunately our time is up with this. We have to conclude our discussion.

Thank you.

(Recess)

MR. KROEBER: Okay, we're going to start the second panel. We're going to start the second panel. We've got a tight schedule because we have four presentations in the financial reform segment and this is a very important component of -- this is a very important component of what's going on in the Chinese economy today, so I want to make sure that we have full time for each of our presenters and plenty of time for questions afterwards. So, I would ask you please all to take your seats and then we'll begin.

So, the four panelists we have, you have the bios here so I won't spend a lot of time, but we'll first have some remarks by Douglas Elliott, who's a fellow at the Brookings Institution who will give us an overview of the Chinese financial system. Then we'll have some comments from Hu Shuli, the editor in chief of the Caixin Group, who's been following financial sector reform in China for many, many years.

Then we'll have some comments from Yukon Huang, who spent some time in China as the head of the World Bank mission there years ago and again as a long time student of the Chinese financial system, and then we'll have some concluding remarks by Eswar Prasad, whom I'm sure you all know as one of the leading scholars of the Chinese financial system today.

So, I will ask each of them to come up in turn, and then after we've completed all the presentations we will be joined at the front by Andrew Zhang and all of the panelists, and we will take some questions. So, please, Doug, can you start us off? Thank you.

MR. ELLIOTT: Okay. Thank you, Arthur, and I'd like to thank the sponsors for inviting me here today.

I've been asked to lead off with an overview of the Chinese financial system. For those of you who are particularly interested, following Arthur's lead, I'll give my own brief advertisement, which is, in the near future I'll be having a more detailed paper coming out on the Chinese financial system. If you're not on the John L. Thornton Center website -- mailing list, please let me know if you'd like to receive the paper.

Broadly speaking, the Chinese financial system has done a good job in the last two decades in keeping up with the truly impressive growth of the Chinese economy. There are definitely ways it could have performed better, but we shouldn't underestimate the sheer difficulty of the financial system evolving fast enough and growing fast enough to keep pace with the underlying economic growth.

And my base case is that the future performance of the financial system will also remain pretty good. But there are major risks and there's a real possibility that the financial system will either trigger or worsen serious economic problems.

One of the things that has struck me as I've studied the Chinese financial system is the very wide range of views among people who are each experts in the Chinese financial system. This conflict of views makes it a particularly interesting area of analysis and it means, unfortunately, none of us can tell you for sure what's going to happen, but we can't even do that with the U.S., which is a comparatively simpler situation.

So, what does the Chinese financial system look like? Well, it's still very bank-dominated. About three-fifths of the credit in the system -- in the formal credit system -- comes through the banks. Now, let me just make one technical note here because there are a number of true experts. China tends to report financing as total social financing, and it gives the breakdown of that. That includes some non-credit items, like equity financing, foreign direct investment.

I'm going to try to give you figures that focus just on the credit component, so the role of banks, for example, will sound higher than if you look just at total social financing.

So, banks still do provide about three-fifths of the credit, at least that provided by the formal sector. This is down from four-fifths, maybe seven years, ten years ago, and down from even higher levels, 90 percent or more, going back further. So, you have a very bank dominated system, but one that is increasingly having credit provided by other parts of the financial system that I'll describe in a moment.

Within the banking system, roughly half of the credit is provided by five large banks that are partially owned by public share holders but are primarily owned by the central government, and the bank sector, as again I'll go into a little more detail on later, mostly sends money to state-owned enterprises, particularly the large ones. Not just that, they do wider provision of credit, but there's a very strong bias towards the state-owned enterprises.

The next big component is the corporate bond market. It's still relatively small compared to, say, developed western economies, but it's rising rapidly. The corporate bond markets provided about one-fifth of the credit that was provided last year to the private sector. And as I said, that's been growing rapidly.

There's every reason to expect it to grow rapidly, and that is a good development. Everyone, I think, agrees that in a true market economy it's helpful to have a good chunk of the financing provided through markets for those companies that are large enough to be able to be understandable, to provide the proper disclosures, and to have the kind of trading volume that would warrant a bond market.

Third component of the trust companies, they provide about a tenth of the credit last year and that's up, oh, I think it's about tripled from three years ago. It's gone up very rapidly and it's a little difficult to predict, but it may rise significantly further from the levels at -- trust companies in China are an odd hybrid that you don't see in most countries in that they're partially effectively banks in that they make loans and hold those loans on their balance sheets, but they're also asset managers, they're probably a little more asset manager than bank. And they're also kind of an odd mix in terms of what business they generate themselves and what loans, for example, actually come through banks or other sources that they then package and sell on.

Many of the concerns about the Chinese financial system relate to the trust companies. There's also, outside of the formal sector, there is the so-called "shadow banking sector". That's harder to understand and certainly harder to get numbers for because it's all those activities which are kind of like banking, but aren't done by the banks or the bond market or the trust companies, and it ranges from straight out loan sharking that's clearly illegal to pawn shop type activities, loans by corporations to other corporations that are, at best, quasi legal, and many people put parts of what the trust companies do into this area as well.

It's hard to get good figures. *The Financial Times* has gone out on a limb and suggested it's about 20 percent of the credit origination in China, so it's quite significant. The authorities are understandably ambivalent. You might think they'd be outright against it because it seems to be an awkward situation to have so much of the credit provided by areas that are lightly regulated, at best, and sometimes flat out illegal.

However, the formal sector is significantly too biased towards providing funds to the state-owned enterprises and other favored private entities. The small really private firms without big political connections are a key very dynamic part of the Chinese economy, but it's much harder for them to get money from the formal sector. The shadow banking sector has stepped in to fill that gap.

So, the authorities are looking for a way to allow the lending to small- and medium-sized enterprises to continue to flow while bringing as much as possible of that shadow banking sector into a more regulated, more transparent environment.

Moving beyond credit, stock markets in China are relatively developed, not nearly as much so as in the U.S., for example, but they're reasonably developed. The market capitalization of the Chinese stock market is about half of the size of the economy, of gross domestic product in a single year. Unfortunately, the stock markets are extremely speculative and in Q&A, if you want, I can talk more about why they're speculative, but it does mean it's certainly not in an ideal situation for raising funds for companies. What you'd really like is a market that's more dominated by longer-term institutional investors that are better informed.

But that is one thing that China distinctly lacks, knows that it lacks, and wants to change, which is a large mass of institutional investors. For instance, asset managers, the equivalent of, say, our mutual fund managers. Asset managers, in total assets, are only about 5 percent of the size of the economy. For comparison, not that China has to become the U.S., but just as a comparison, the U.S. figure is two times GDP, not 1/20th of GDP. Massive difference.

Another form of institutional investor that they need to grow larger is the insurance companies. The size of their assets is about 14 percent of GDP. That's about maybe a third of the level of the U.S. or of Europe. That would be good not just because of their role as institutional investors, but also because insurance through the private sector is one of the best ways of taking care of societal risks without having to make the government directly do that.

So, this is kind of the overview. I have, I am told, quite limited time, so let me just touch briefly on two other issues. One is, a major theme in China is there's a moving away from government and party control of the financial system towards something that looks a bit more like what we have here or in Europe, more sort of commercialization as it's often referred to.

One of the things I find fascinating about China is if you look at the narrow question of how commercial the decisions are made by the banks on their loans, you get extremely different views ranging from they're really not commercial at all and they basically just lend to the things the government wants to have money lent to, to the other spectrum that says, hey, they're not that different from western banks right now.

There's a wide range of views in there. This is a theme to keep an eye on.

I'd also stress something that, to me, is one of the major risk factors within China in terms of the financial system. There are so many implicit guarantees throughout the system that could go wrong, and by this I mean most of the lending activity, in some ways, relies on the assumption that somebody stronger than the borrower is actually standing behind the borrower.

So, you have the central government and regional governments backing the state-owned enterprises, central governments seeming to back the local government, governments seeming to back the banks, the banks seeming to back some of the trusts, banks and trusts backing up the loans the pool together and sell as wealth management products, government backing the banking system in deposits. There is no formal deposit insurance in China, but everyone assumes the government will protect depositors, and you could go on.

The reason I emphasize this as a risk is in good times, implicit guarantees can work fine. In a crisis, if there is a misunderstanding about the extent to which those guarantees truly exist or if, because they're not written down, they morph and somebody backs away from what they seem to have been guaranteeing, you can get terrible panic that produce bank runs, things like that. So, that's an underlying theme.

But just to wrap up, let me say again, the financial system, I think, has done quite a good job the last 20 or so years. I think it will do reasonably well going forward. I'm not panicked about it, but there are a lot of challenges. The system's going to have to adapt to very different circumstances and there may be some failures that will cause serious difficulties. Thank you.

(Applause.)

MR. KROEBER: Thanks, Doug. Shuli, it's your turn.

MS. HU: Hello, everyone. Distinguished guests, old and new friends, we are here talking about the Chinese economy. Let me borrow the concept of the Internet age. What's the killer app? What would be the magic formula to bring us comprehensive, sustainable growth?

Here is my simple answer: continue market (inaudible) reforms of the financial sector. If we up package this simple answer, you will find a lot of things -- better allocation for capital, remove of financial restrictions, deeper reform of the financial system, and so on. And before we move forward, we should look back and see what has been done and how well it has been done.

As many of you know, China's financial sector has been through reforms in the past decade. There were significant changes including deeper reform of state banks, liberalization of interest rates and exchange rates, and better management of security companies.

But many more things are left undone and they can't afford any more waiting. Through a series of official reports, Chinese government has charted the path to market liberalization and they mapped out specifics on interest rates, on expanding the band of exchange rate fluctuation, and direct convertibility under the capital account. These are good.

But more important, bank progress in each of those topics is holistic institutional change. Following are some of the most critical institutional changes in my mind: first and foremost, the further opening for private sector and for market players. The financial market has changed, not only in the sense of product, but also players. But the state still has a stake of more than 80 percent in the big four state-owned banks, and all the commercial banks are controlled by local government.

There should be concrete measures to increase shares owned by private players in these banks as well as the active participation of private players in wealth management business and other financial institutions. We need new policies, and to make that possible (inaudible) of regulators.

Second, in China's financial sector, there is both over regulation and the (inaudible). So, it's extremely important to define the low of the market and the government and make them pay the low they should pay.

Now, financial regulatory powers are divided and segmented. Unlike the regulatory regime, however, the market has witnessed a trend of comprehensive business and universal financial companies. The financial regulators need to catch up and be able to tackle the companies such as universal banks, let a spread across industries.

One solution could be putting in place a coordinated regulatory system led by the central bank so that policies are in sync and there are more tools to carry out policies and more effective implementation.

Finally, while deleveraging is happening in the developed world, China is the other way around adding layers and layers of leverage to its economy and increasing the debt ratio. If economic growth stagnates, banks will face a tough bad debt problem and the result will ripple through society.

Chinese financial regulators must be prepared and be able to tackle severe crises. With that, I will stop here and look forward to hearing insights from the final panelists. Thank you.

(Applause.)

MR. HUANG: This is going to be a graphic and spatial presentation. When I say rethinking China's financial reform is what I say, rethinking, because I think that the general menu is fairly straightforward. If you talk to anybody you'll say you should liberalize interest rates, you should strengthen the governance and regulatory framework, you have to deepen the capital markets, you have to liberalize exchange rates and open capital account.

This package of recommendations is what I would call non-controversial. But if you go back 10 years, 20 years, you will actually see that the same recommendations are on the list.

China's made progress in many of these areas, but the question is, is there something we should be doing in the future that we've actually missed? What are the priorities?

Now, here in Washington, if you ask people, the main authorities, they would probably come up with two points they want to make. They'll first say that China's interest rates are too low, and this is a major issue, and they see that these low interest rates penalize savers and subsidize borrowers, and they would argue that this is leading to too little consumption, too much investment, and macro imbalances. So, interest rate liberalization raising them is what many people would say the major priority. The former secretary treasurer, a couple weeks ago, basically an op-ed in *Fin Times* essentially said raise interest rates.

The second corollary that most people would say is too much lending to the state sector, too little to the private sector. So, these are what I would call the two issues that people would basically say is wrong with China's banking sector.

Now, if these issues are the major problems, and they've been around for decades, why is it so hard to adjust the rates and why is it so hard to lend more for the private sector? And what I'd like to basically point out is that the solution is a problem because it actually works against the source of China's success, so you're actually asking the system to change its policies in a way that historically has worked really well.

And the major person who designed this was Deng Xiaoping and I will call Deng Xiaoping what I would call the unbalanced reformer. Now, Deng Xiaoping, 30 years ago, basically said, I've got a problem. I've got to revive growth. And what he did was, I'm going to concentrate among the coast and I'm going to give all my incentives to the coastal provinces and those red circles in Guangdong, Fujian, Zhejiang, and on the coast. Those are all special export processing zones where he gave tax invested privileges and then he did down the Yangtze River, he did along the north, along the Russian border, into central Asia, into the southeast. And the basic principle was, incentives only for production in export and I want a financial system that supports this.

Now, he had a problem. When he looked in his budget, the budget had collapsed in China. Revenues, as a percentage of GDP, used to be above 30 percent when he started out and you can see that it fell to as low as 10 percent by the mid-'90s.   So, how do you implement an infrastructure investment program, production oriented, when you have no money? And that's essentially the problem that China was facing for much of the last three or four decades and he basically said, I'm going to use the banking system, I'm going to use financial repression rather than taxes, I'm going to basically channel the household savings to investments that the state would like to support, and he basically did this by controlling interest rates and limiting the opportunities for money to actually flow.

Now, is this actually illogical? Not necessarily. If you actually control the interest rates on savers in the banks, lower the interest rates you pay them a little bit below normal, is this a progressive tax or a regressive tax? It's actually a progressive tax on wealth. It's very easy to collect. It's already there. I don't have to tax anybody. I don't have to move it around. I've got it right away.

So, financial repression in the Chinese system is an extraordinarily effective, progressive means to get money to support investment.

Now, the alternative would have been to have a sales tax, because incomes are too low, but if you have a sales tax increase, it's regressive, extremely hard to collect, and to administer it in a way that you want, really, really difficult. So, Deng Xiaoping was actually using a tool, and the system was using a tool, that was extraordinarily effective in promoting and getting the resources of growth. The question is, do I spend it well, because I can get it, but I have to spend it well.

And he spent it mostly on infrastructure, and I'm using roads as a symbol, and if you go back to 1978, what is remarkable in China is that the road network is essentially even throughout the country. Under a socialist system, your infrastructure is evenly spread out, but totally illogical, it doesn't support production or commercial development, and you can see what the system did. It started investing infrastructure on the coast, gets darker and darker red, and then eventually is moving inland and today it's basically everywhere.

But the critical point I wanted to make here is, you financial system and your fiscal system is not spatially neutral. Not only do you want to raise the money, you want to actually figure out where you want to put it, and the financial system is extraordinarily effective at doing that rather than working with 28 local provincial budgets, which the center can't control, working with four to five banks and basically saying, where should you put the money, very quickly, efficiently, over three decades, extraordinarily efficient system in the financial system.

And you can't argue against success. This is the growth rate of China's GDP, but I've broken it down spatially. The blue line is the coast, the red line is the national, the green line is the central, and the orange line is the inner provinces. And you can see, aside from the dip in the (inaudible) years, an extraordinary burst of growth, led by the coast, which really pulls out, and then today has reversed itself. The inland provinces are growing faster than the coastal.

Now, this is an extraordinary, interesting story because it says an unbalanced growth process can lead to balanced outcomes, which is counterintuitive to anything we, in the United States, would ever think about, but this financial repression is a key vehicle.

But China's economy is becoming more complex, market-driven. It cannot rely upon the same kind of financial model that was very successful in the past for the future. The 2009 stimulus program created a major debt problem; therefore China cannot rely upon credit expansion in the future. It's going to have to reform the banking system.

But contrary to what we actually read or talk about, the key to reforming China's financial system doesn't lie in the banking system, it lies in the fiscal system because that earlier chart I showed you, the big problem in China is its budget doesn't have any money, and you have to then use the banks.

But if you want to ease the pressure on the banks, you have to reform the budget.

Now, here is the banking sector in China, and what you can see is savings, credit flows, money supply, as a share of GDP, is really large in China and excessively so, and that's a legacy of two things, the reliance upon the banking system to do the work the budget should be, and secondly, the extraordinary high savings rates of Chinese, which is sitting in the banks.

So, one thing you don't want in the future is that the banking sector actually gets any bigger, as people has emphasized, you have to deepen the capital markets in other areas.

But what's really unique about China is the budget is so darn small. Here you have a socialist system, it controls all the resources, it provides a range of services, which is extraordinarily broad, you would think the revenue to GDP, the expenditure of the budget to GDP ratio would be large. In fact, it's way below normal, it's way below normal compared to the OECD countries and it's way below normal even compared to other developing countries, and it's excessively below normal in relation to social expenditures, and you have this odd kind of a situation, a socialist system where the budget is actually too small rather than being too big.

And here in the United States, of course, we're debating about the role of the government, whether it should be larger and smaller, but here's a socialist system where the budget is way too small.

So, the problem, first, is you cannot cure the financial sector; you cannot solve the financial sector problems until your budget becomes strong enough to carry out the duties that a budget should be carrying out.

Now, the focus on interest rates, if you ask anybody, any analyst, they'll probably say to you, China's interest rates are too low. It must be raised. But factually, it's not even correct. China's interest rates, even adjusted for inflation, are actually higher than most economies. So, this argument that interest rates in China are too low are, in terms of what's happening today, just basically not correct.

Here is savings interest rates in China, the red line is the China deposit rate, and the China inflation rate. Now, what this diagram does tell you is that right now interest rates in China are positive, but there are periods when it's been negative, and you see those blue inflation periods where China's interest rates are negative, and there are times when it is positive.

What it does tell us is a couple things. There is a rigidity in the Chinese system, the red line doesn't change very much in response to cycles, and the flexibility of China's system in terms of the need to improve flexibility is clearly an issue, but it's not necessarily the absolute level of the interest rates.

Now, the bottom line is the U.S., and what you can see here is, in fact, real negative interest rates are much more of an issue in the U.S. than they are in China, but if you read the newspapers, you would think it's the opposite way around. And similarly for lending rates, lending rates in China are more positive in real terms than in the West, so to argue that lending rates or interest rates are too low is what I would call actually not a real high priority issue. And I'm borrowing a diagram from Arthur Kroeber's GaveCal which basically shows that actual lending rates in China have actually started to become much more flexible and very high, actually, because of shadow banking and other product lines.

So, I think the interest rate structure is actually starting to behave in a way that we would all say is really working or moving in the right direction. So, I don't think the focus on that needs to be as tense as it is, but it obviously needs to be encouraged a bit.

So, how do you improve what I would call the major issue in China, the government or the state banks? And the problem is, you have a state-owned banking system, so to tell everybody to behave and to lend on commercial terms and do the right things only gets you so far. It just doesn't work after a certain point in time. But yet, that's what most people would say you have to do, you have to improve the governance of the banking system.

And the big problem here is, China's big four commercial banks are too big to manage. Here in the U.S. we talk about too big to fail, but in China it's too big to manage, and they're too profitable to feel competitive pressures. The banks actually are very, very comfortable. They pay high dividends, their NPLs are very, very low, even though the definition is flawed, they have massive amounts of savings. If you ask the banks, they don't feel any problem, so when you tell them to reform, why would they reform? They're actually too comfortable.

Where do I put my money? I live half time in China; I live half time in the United States. Should I put the money in the Bank of America down the street or the Bank of China? Interest rates at the Bank of America pay me these days is actually way below 0.28, I'm getting a tenth of 1 percent. I'm getting 3.88 in a normal savings deposit in China. I get implicit government guaranty, which is unlimited, whereas Bank of America gives me $250,000, and if I worry about exchange rates, I think the renminbi is going to appreciate, so I have all my money in China.

And this is the problem. The banks in China really feel like they have a very nice life. So, then you tell them, please reform, improve your governance. Why will they? They won't.

So, how do you deal with this system? Because you can't privatize these banks, and here's where I want to be a little bit radical. How do you promote competition in a state-owned banking system? China's big four banks are too big to manage, too politically tied to Beijing, so I say, break them up. Break them up into three banks each, possibly along regional lines, but allow them to compete across regions. The states should become a passive shareholder. They should no longer appoint the CEO of the big banks. An active shareholder board and not Beijing should appoint the shareholders. Move their head offices out of Beijing so that they don't have to be under the thumb of the state council every day and no longer visible, and when there are twelve of them rather than four of them, no single bank is that powerful. Right now they're extraordinary powerful individuals.

But you have to provide Beijing or the state the confidence to let these banks go. And you have to strengthen the fiscal system so that they can play around with the budget rather than play around with the banks. You should preserve these three policy banks, the Agriculture Development Bank, the China Development Bank, the Export/Import Bank, and if you want to play around with them for strategic or state purposes, so be it, but don't mess up the commercial banks. Let them become really commercial.

Now, if you broke up the big four into, let's say, 12 banks, you start to do something which doesn't currently exist, you can create a constituency, which would favor more foreign banks coming in, because right now these banks don't want foreign players, that's too much competition, but if you have 12, some of them will, and then you start increasing the force of competition from externally, on the domestic sector, and you start getting change in a state-owned system.

Thank you very much.

(Applause.)

MR. PRASAD: Finance is crucial for growth. That is a self-evident proposition to most economists who believe that once you look around the world, unless you have an economy that can intermediate domestic and foreign savings into productive uses in the economy, that economy is not going to grow. And then there's China.

As we've heard, Chinese financial system has a variety of problems. It's very easy to catalog all the risks building up in the system, all the ways in which the system is not efficiently allocating capital, and yet it seems to work. So, Yukon suggested an answer to that, and I think the reality is that given the state of China's development to this point, the financial system may have delivered, in some ways, and there were work-arounds in the system, but the big question now is whether the Chinese financial system as it is now structured, is equipped to deal with the challenges of a much more complex and market-oriented economy.

So, in my remarks I'm going to talk about financial market development, regulation, and the reform strategy. On the development front, China still remains largely bank dominated, although for the last year, and Doug pointed this out, there has been something of a shift towards non-bank finance. Now, at one level, this is a good thing. You do want the banking system in a country to have competition. You do want to have debt in other markets, and China still doesn't have very much debt in certain markets that would be very useful for savers as well as for firms trying to get finance, such as corporate bond markets, and here the government is working hard to get those markets opened up.

But the reality is that banks still are the major game in town. A lot more needs to be done, and here the tricky issue is how one thinks about matching up the development with regulation, and this is a very complex challenge that virtually every emerging market faces. And here we academics perhaps bear some of the blame for this because we can very well tell you where you are right now, where you ought to be, but getting from here to there is complicated and there are enormous risks, no matter how you do it. So, how you do it turns out to be really important.

So, let's take the banks in particular. Now, there are these four large banks that are dominant, but there are many other banks as well that have become increasingly important over time, especially the Joint Stock Commercial Banks, and then there is, of course, a part of the banking system, development banks that have a completely different function and are not even expected to operate on commercial principles.

Now, it is important to recognize that while we think about the banks as doing funky things, lending in ways that don't seem to make sense, the banks are being perfectly rational. Like every other economic actor, they're responding to the incentives. So, the right question to ask is not how can we get the banks to do something else, but how can we get the incentives right so that banks do the right thing?

And this is where, again, things become very murky because in a second-best world where there are lots of distortions already out there, it becomes very hard to figure out how to make incremental moves that can actually make significant progress without actually pulling you backward.

If you think about the state owned banks, they've been allowed to have much more liberal interest rates, especially in terms of lending, and it has had some traction in terms of banks lending more to the private sector, to smaller enterprises, which are intrinsically riskier, so if you can't price in the risk of lending to them, it doesn't make commercial sense.

But yet when you think about the incentives from an individual bank's point of view or from an individual bank manager's point of view, it's still very risky, not just in terms of the loan, but in terms of reputation. Right now we hear that there is an attempt to try to deal with corruption issues. In this environment, if you think about a bank that has made a loan to a private enterprise, that enterprise goes sour. This might be a normal commercial assessment that the bank would have made, but there is always the question whether there was some corruption implicit in this transaction.

On the other hand, you lend to a state-owned enterprise, there's probably a lot more corruption inherent in that transaction, but it is to a state-owned enterprise. So, this is why actually despite the interest rate liberalization, although there has been some gap opening up between the actual lending rate, which is the weighted average of rates at which loans are actually made to firms, and the baseline lending rate, it's still a pretty small gap if you think about the enormous growth possibilities in China and how dynamic the private sector is.

So, in that sense, getting the incentives right, I think, is going to be crucial. And this ultimately is the difficult issue for banks, because banks now have much more liberal interest rate structures, especially on the lending side, but they don't have good risk management systems in place yet, and this is where the regulatory part becomes much more complicated, because by the books, Chinese banks look in some ways like the best banks in the world. They have very low non-performing loan ratios, they have enormous amounts of credit that they're lending out without huge amounts of risk apparently building up, they are very profitable, and yet we know that something is not right. And what is not right, of course, is the way credit is being allocated by these banks.

So, getting that part fixed is going to be the key regulatory challenge, making sure that banks not only have the right incentives, but have the right sort of regulatory mechanisms in place that allows them to do this. And, again, the transition to a more commercially oriented banking system is going to be risky. And of course, once one thinks about those risks, the question is, where does a deposit insurance system fit into all of this.

As Doug has pointed out, there isn't a comprehensive deposit insurance system in place yet, and yet, there is an attempt to try to introduce a more formal, comprehensive deposit insurance system going away from the implicit deposit insurance system right now.

The implicit deposit insurance system works great for the banks because essentially people like Yukon are not going to question twice where they put their money because it is implicit.

What I think the system needs is not only a more explicit deposit insurance system, but that system needs to be tested. Now, this is, I think, the dream of every economist and every policymaker to have a small manageable crisis, perhaps one bank failing so that everybody learns. Now, this is very difficult to engineer, and the Chinese, I think, have been a little careful about this, but I think ultimately this is what it is going to come down to.

If you want to get to a better banking system, there are going to have to be some risks taken and I think the right approach will be to have some of these risks come out in the open rather than stay hidden, in some sense, as they are right now.

And of course, in terms of thinking about what needs to be done on the regulatory front and on the development front, the list is very long, and this brings up the question of the strategy of reforms, and here, of course being in Washington, any attempt at actually getting reforms done can be very impressive to one, but the Chinese have actually been going about it in a very sensible fashion.

Let's take the banks again, and Yukon alluded to this. Life is very good for the banks right now because there is a much more liberal interest rate structure, but what is crucial is that there is a floor on lending rates, a ceiling on deposit rates. So, the banks are going to make money for every one they take in and lend out, and that spread cannot be competed away. So, while it is true that banks have a lot more liberal interest rates, the fact is that that spread reduces competition enormously and it prevents smaller banks from playing a much more active role.

So, I think we still have a long way to go in terms of interest rate liberalization, although just the notion that interest rates in China are too low may not be the only marker. We really do need to be thinking about the spread and what the entire interest rate structure means.

So, the banks find this to be very comfortable. The large state-owned enterprises and the provincial governments all are very happy with the present set up, so why would they want to change? It's not just the banks that don't want to change.

And here, again, I think the way the Chinese government has been approaching this in terms of thinking about frameworks for reforms is really important and strategically something that I think is going to work much better.

Let me give you two specific examples. One was a plan announced earlier this year to reduce inequality. Now, when a government says we are going to work towards reducing inequality, it's usually a very bad thing because that means its redistributive policies are going to take over, but once you started looking through this plan, it turned out many of the specifics -- and there weren't that many specifics -- but in terms of the broad contours, it is exactly what the Chinese economy needs -- more financial market reform, liberalization of interest rates, trying to liberalize capital flows, trying to think about getting the state enterprises to pay more dividends, strengthening the social safety net, but once you put it in this set up, then it becomes much harder for the banks and the provincial governments, which would like things to remain the way they are, to say that we don't really want this because this is going to hurt the people. Because the entire framework is actually one of helping the people, so I think that strategic approach of having a framework is very useful.

And in addition, when you look at the specifics, China still remains tied to this approach of incremental reforms, which perhaps is not such a bad thing given the enormous risks that I pointed out of going from where we are right now to the first best outcome.

And if you think about the incremental moves in opening up the capital account, if you think about the ways in which they actually liberalize deposit rates to some extent at a time when they cut deposit rates, so basically what they did last year was to cut the baseline deposit rate, but at the same time say that there is a little bit of flexibility that banks have in terms of offering rates above the deposit rate.

So, from the bank's point of view, it was flexibility coming at just the right time. So, the timing is crucial as well.

So, the second issue, which I'll conclude with, is how this ties in with the overall process of a Chinese capital account opening and making the renminbi an international currency and I know our moderator Arthur has written extensively about this even in a recent paper.

Here, again, I think the issue is not whether China is going to have an international currency, which intrinsically and in and of itself is a great thing, but it provides a framework. China is a great power. If you can convince the people at large that the Chinese are a great power and also need a powerful currency to match it, that gives you a framework for reforms domestically, because if you want your currency to become an important global currency, you need to do certain things domestically.

You need to have a more flexible currency, you need to have better financial markets, you need to have a more open capital account, and then all of these things can start happening.

So, I think the approach that the Chinese have taken, both in terms of thinking about where they want to go and how they are moving there strategically in terms of frameworks and in terms of specific steps, does provide some room for optimism. Thanks.

(Applause.)

MR. KROEBER: So, thank you very much. I'd like to congratulate our speakers on being so concise. Could the panelists please come up and take their seats here at the front? Shuli, could you come up? And we'll open it up for Q&A. I think we'll have -- we'll break at about -- just a little bit before noon for lunch and I've been instructed to say that lunch will be served that way across the hall at the conclusion of this session.

And then Andrew, could you come up and join us? We have a special extra guest star on the panel, Andrew Zhang, who was formerly advisor to the China Banking Regulatory Commission and is now with the Fung Global Institute in Hong Kong.

So, we have a very distinguished panel. I'm not going to exercise my traditional right as the moderator to ask the first question.

Instead, I will throw in one statistic, which is that based on our -- my company's estimates, 2012 was the first year in which loans outstanding from the banking sector -- from the banking system to the private sector, exceeded loans to the state sector. I think that's a very important point as we talk about these financial liberalization issues to recognize that, in fact, the financial system in China is changing very rapidly, much more rapidly, I think, than is recognized outside of China. And while a lot needs to be done, there have been enormous increases in the availability of credit to the private sector over the past three years.

And with that, I'm just going to open the floor for questions. So, who do we have?

SPEAKER: Our first speaker talked about expanding the role of insurance companies in the Chinese financial system. I have to admit, I don't know much about insurance companies except to say in this country everybody but members of Congress hates them.

MR. KROEBER: Does anyone want to address the question of insurance companies?

MR. ELLIOT: Sure, I'd be happy to. Look, there are many essential services where people don't love the companies that provide them. Insurance is something where you pay them money, and in the good state, you never get the money back. So, there's an intrinsic reason that people don't like them, and I think in the U.S., a lot of it right now is the healthcare system is very messed up, and so healthcare insurers are particularly disliked.

But if you look at a country like China where the insurance system is fairly undeveloped, it means it's hard for private individuals and smaller companies to truly protect themselves in a good way from the things you worry about, your home burning down or the breadwinner dying early or whatever. Insurance really does provide quite essential functions, and it's there in China, it's just not at the level that it needs to be at.

And then, as I mentioned, for the financial markets, they're very useful investors. They can take a long-term timeframe, they can look in a professional way and manage large pools of money.

MR. KROEBER: I think, was there a question -- in the back.

SPEAKER: My name is (inaudible), I'm a graduate student from Georgetown Public Policy Institute. Since you are all experts in the financial system in China, so I'm going to ask you a specific question about microfinance. So, what's your opinion about the microfinance future in China? Thank you.

MR. KROEBER: Who'd like to take that? Andrew?

MR. ZHANG: I mean, by and large, I think there is no doubt that microfinance can only grow in China. The problem is, that as we all know, if you actually give it too much attention, some abuses can happen, as has happened with some of the Indian microfinance companies.

Let the market decide for itself.

MR. KROEBER: Okay. Thank you. Here.

MR. MARTIN RAYO: Thank you. I'm Francisco Martin Rayo. A lot of you mentioned this idea that the government has an implicit guaranty on a lot of the deposits and loans, but that seems to create somewhat of a perverse incentive that you know that you can loan to companies or businesses that aren't necessarily going to pay you back but you know that if they don't, you know, the savings that you're putting at risk will be backed by the government, so, you know, it's in your best interest as a bank to continue to lend as much money as possible, even if you don't necessarily think that the investments or the loans that you're making are good investments in the long-term.

But then a lot of you also spoke about the need to have greater participation of individual consumers, right, as shareholders of the banks they're using, you know, there's more transparency, but if you're an individual consumer in China, doesn't it seem difficult to get comfortable investing in banks when there's not enough transparency about what's actually in the bank portfolio. Does that make sense?

MR. PRASAD: As an individual investor, actually, the

Chinese look pretty good because they are very profitable given the structure right now. The question is whether the banks are serving the broader public good.

So, the investors are doing fine. The savers, Yukon seems to be doing fine, but some other savers have a problem that they don't have alternatives, and over the years they haven't been getting great returns on their saving. Capital doesn't seem to be allocated very efficiently, so I'd be less concerned about the investors and the banks, but there is an interesting question. If one improved the corporate governance structure in these banks, could one actually get the banks responding to market incentives not only in terms of their saving and lending, but also shareholders' interest, and in fact, one of the approaches the government took to improving corporate governance when things were stuck in 2005, 2006 was to bring in foreign strategic investors.

Now, in retrospect, maybe, bringing in western banks to improve corporate governance wasn't such a great idea, but the concept was a very good one, that you want to have foreign investors who could bring in better governance practices and use that to shake up the system. It's not worked very well so far.

MR. KROEBER: Yukon.

MR. HUANG: I think that implicit guarantees is a big problem in China because if you're a bank and you lend to local authorities and you lend to them for building these ghost towns or other properties and they don't repay you, you don't care too much because you think the government's going to come in or no one's going to penalize you, so that's a problem.

If you're a saver and you put your money in the banks and you think that they're perfectly safe and everything's going on, you're also not very selective. So, ultimately, Chinese do move to the states where implicit guarantees don't exist. And then, if that happens, the bank's going to have to worry a little bit more about who they're actually lending to, and savers have to worry a little bit more about where they're putting their money. And savers also have to worry that if they're getting paid too high interest rates and something funny is going on, maybe they shouldn't be putting their money with that lending vehicle.

So, I agree with you on the general presumption; this is a vulnerability in the system. It creates tremendous distortions and you have to move beyond that.

MR. KROEBER: Here.

MR. LOWE: Hi. My name is Eric Lowe. I'm with *The Fair Observer.* My question is that, you know, like now with the situation with the EU and our system basically the banks are too big to fail and we don't know what the banks are investing and everything and a lot of times the government has to bail out some of these banks.

So, it will be actually a better solution that, you know, like the government sort of has more of a lid on the banks then the banks have more freedom to make bad loans. So, I don't know how you balance the two sides up, you know, if you want to liberalize, to a certain extent, of how the banks can invest.

MR. KROEBER: Doug, you want to address that?

MR. ELLIOTT: Sure. I think we're dealing with a fairly basic point here. Do markets and individual players in markets collectively do a better job of allocating funds than governments do? And I think most of us believe in the long run, private players collectively do a better job. But they're going to make mistakes.

I don't think anyone can observe the world financial system without recognizing that not only do individual lenders make mistakes, but whole banking systems can get carried away in one direction or the other.

So, there's no way to eliminate problems in financial systems, it's a balancing act, but I think we probably all up here believe that the right place to eventually get to is significantly less state control, because that's more distortive than the distortions that a freer market would have.

MR. KROEBER: I think there was a question back there. Yeah.

SPEAKER: Thank you. Akira (inaudible), Japanese embassy. So, why is the Chinese financial market so speculative? Is it because of an innate structural problem or is it because the Chinese prefer Mahjong to the game of golf?

MR. ELLIOT: Since I virtually asked for the question, may I take it? I find it a fascinating question, because of course there are people who bring up these cultural stereotypes that, you know, Chinese love gambling, so of course they gamble on the stock market. But, no, I think it's a more fundamental issue.

Markets are supposed to operate so that if you make an investment, you're looking at the long-term prospects of the company you're investing in because you'll get the money back through dividends or you'll get the money back through selling your shares. And if management is not operating in your interest, in a truly free market, you can basically sell the company and let somebody else come in and install a better management.

Well, if you look at China, the investor has almost no control over any of the things that matter at the company. First, there's an excellent chance that the company is majority owned by the state, so the investor has effectively no governance power with that. Even if it's not, takeovers are pretty rare in the Chinese markets, so you don't have -- you don't so much have that option of kind of bringing in a new team.

Dividends are lower than in many markets, so you're not getting your money back soon. And you don't have the ability to really effect what the dividend rate is because your voting power doesn't mean that much. And, not as bad as in some developing countries, but you do have to worry to some extent that management will find a way to move the money into their accounts through transactions on the side rather than have it stay in there.

So, you've got a market where putting it at an extreme, you'd almost have to be a fool to judge based on fundamental values like we want them to because there are all these other factors, including whether a company is in or out of political favor.

So, you can kind of see why the people who go into the stock market might focus on these speculative features.

Now, I've probably overstated all this, but that's just to try to explain why there are structural elements here.

MR. KROEBER: Shuli, you and your team have been following the Chinese stock market for many years. I wonder if you have a view as to why the stock market in China seems more like a wild west than --

MS. HU: Because investors are not very confident about the future of the market, so they intend to get short money instead of (inaudible).

MR. ZHANG: As a former securities regulator, can you name me which market in the world is not speculative at the present moment?

(Laughter.)

MR. KROEBER: Fair point. Yeah, over on this side.

MR. JONES: Yeah, Bill Jones from Executive Intelligence Review. I'd just like to pose a question with regard to the panel. We're talking about reforming China's financial system. Nobody has really talked about the problems in the world financial system, and it's funny because China came into the international financial system as a low wage producer when things were relatively good, but we were right on the cusp of a major crisis. And now that system is falling apart. China seems to be doing much better than, say, Europe or the United States because of that and here we're trying to say, these are the rules that we abide by, and they're looking at what the results of those rules were and maybe they're a bit skeptical as to whether they should go exactly in that direction.

I don't know, I hope that Mr. Zhang's comments would be translated. Maybe he addressed some of these issues, but it seems to me that when China is developing, that they're also coming in as an independent player and they're coming into a system that is rife with crisis and therefore maybe they have some ideas of their own to add to that situation which would help resolve some of the problems we have, because right now that system is not functioning, it's falling apart, and what we're doing to our populations is certainly not a good example for the Chinese who have a lot of problems of bringing their populations up and not pushing them down as is now happening. If anybody would like to address that --

MR. KROEBER: Thank you. Eswar, do you want to take a crack at that?

MR. PRASAD: My hope is that we will move towards a situation where we have something of a convergence between where the emerging markets are right now and where the advanced economies were some time ago.

Perhaps underlying your comment is this notion that in advanced economies, finance had gotten a bit ahead of itself, and Andrew has written extensively on this about the notion that finance should be there to serve the real economy rather than the other way around.

My sense is that in a country like China, finance is well behind where it ought to be in terms of supporting the level of development that China could have, which, although it's been very good in terms of bottom line or top line GDP growth, in terms of the balance of growth, in terms of the sustainability, I think a lot more could be done, also in terms of the equitableness of that growth.

The reality, however, is that even if you look at the emerging markets, there is a lot of demand for certain products. We think about things like derivatives as being exotic, speculative things, but these are things for which there is a real demand among traders, among households who invest abroad, so I think the notion that financial market development and things like derivatives are intrinsically a bad thing, it's a problem and the sense that we should abandon principles that, for instance, Doug has been talking about corporate governance, better transparency, and so on, I think it's not the right lesson to learn.

The lesson is perhaps that these were not applied in the West the way they ought to have been, so for a country like China to say these guys talked about corporate governance, but look where it got them, I think would be the wrong lesson. The right lesson would be, these guys talked about corporate governance, they did the wrong thing. Perhaps we should learn to do the right thing.

MR. KROEBER: Thank you. Ken.

MR. LIEBERTHAL: Ken Lieberthal, Brookings Institution. Everyone notes that there are significant implicit guarantees or contingent liabilities in the Chinese system, that they are wide ranging and multi layered. I'm wondering whether anyone has a good handle on what the magnitude of these are, what the structure of them is, and how specific major changes in the macro economy would reverberate through these implicit guarantees, in other words, how much changes if the growth rate were to slow for some period of time to 4 percent, you know, with a real downturn? Does that have a snowballing effect?

In other words, you know, all financial systems have some implicit guarantees built in and they can be hard to track, but in China they seem to be large, but I've never seen something that really gives you a grip on it other than to say, well, they're there. In a real crisis, that could be a real problem, otherwise they seem to be managing fine.

Can you enrich that story at all or is that the story that we have to stick with?

MR. KROEBER: Who wants to pick that up? Eswar, why don't you start and then Andrew can follow up.

MR. PRASAD: One way to try to get at that question might be to think about where bank credit is going and which of the firms that are financed by the banks are state-owned, and in particular, a relatively weak state-owned enterprises, because there is, again, this paradox in China that a lot of financing is going to state enterprises, although that has shifted over time, but the state enterprises that are making profits have a lot of retained earnings and they're not the ones going to the banks. So, it's the weaker state enterprises, and this also creates an interesting issue because I talked about this difficulty in a second best world of moving to the optimum.

If today you told the banks, you're on your own and any loans that you make, we are not going to back up, if you think about it from a bank's point of view, if you've already made a lot of loans to a weak state enterprise, if you pull the plug from that state enterprise, that immediately shows that there's a nonperforming loan in your banking system -- on your books, so, in fact, you have an incentive, and this is what happened when they initially liberalized lending rates that the discrepancy between actual and baseline lending rates rose up, and then it plummeted back to zero. Why? Because the large stock of loans was already with the weak state-owned enterprises.

So, the transition is going to be very difficult because you need to figure out how to deal with the legacy problems, and I think you're asking, Ken, what is the size of the legacy problem. I don't know.

MR. KROEBER: Andrew, do you know?

MR. ZHANG: I think when we're thinking about the problems, we need to be a little bit more creative thinking about this problem of implicit guarantees because every country has an implicit guaranty. There's no way you can define it specifically, but one way of looking at this over the last experience is that, who got into trouble in the Asian crisis, who got into trouble in the European crisis. There are countries with net investment positions, net owing foreigners to net what you owe foreigners of 50 percent of GDP. In Asia, it was Indonesia, it was Philippines, it was Malaysia, you know, Thailand, all these were 50 percent of GDP, all went into crisis, right? And in the European case, all the countries that you can see the PIGGS countries are -- all the ones that were 50 percent of GDP.

So, you know, China today instead has a NIIP of $1.8 trillion, don't owe any foreigners, just like Japan, basically any implicit guaranty domestically can be solved, you know, through its external surplus position.

So, you know, the question then is, how big is that? Now, as you know, the Chinese state-owned enterprises are not allowed to take any net derivative positions. So, there are relatively few, you know, in that derivative position. The net below the line foreign liabilities -- below the line liabilities of the Chinese banking system is about 17 trillion renminbi, which is roughly $2 trillion U.S., which is very small compared to the off balance sheet -- the shadow banking of the United States, which is $23 trillion, and $67 trillion internationally.

So, by and large, Chinese off balance sheet liabilities are considerably smaller than its net asset position.

Now, a lot of people talk about, you know, oh these credit numbers look too large or grow too large. For every credit, there's an asset. Where is the asset? I mean, that's the key. What is the quality of the assets that's most (inaudible), right, and whether you're investing for the long-term.

Now, you know, so a lot of people talk about the local government financing platforms. What they don't realize is that, yes, the financing platforms have a lot of liabilities, but nobody has measured how much the cities have in terms of huge assets, which are available to counterbalance the liabilities.

Now, if you really look at the last growth in China, a lot of growth is in the cities. So, the bank -- they own banks, they own part of the large infrastructures, they own a lot of state-owned enterprises at the city level. Actually, the opportunity for China to deal with some of these so-called shadow banking issues is actually to go the second round of privatization, which enables those liabilities to be cleared up, and I have no doubt from the macro point of view, there is more than enough assets to clear up all this fast growth and liabilities, particularly in those aspects.

So, I think we should not get it overblown, the major issue is not just the liability side, but where is the credit side, where is the asset side?

MR. KROEBER: Thank you. Yukon, I think you wanted to get in.

MR. HUANG: I don't think there's been any overall comprehensive study of the points you made, but if you look at the local infrastructure authorities and their borrowings, people have tried to look at that and ask how much of that is okay and how much is not, and maybe 20 percent of it is not and they realize something's going to have to be done.

If you look at the railway system, you realize they have a huge debt out there. Some of it cannot be repaid, so they have an estimate of how much that means.

If you look at the overall lending of the banks, broadly speaking, you can make some estimates, and I've seen some estimates it the past based upon what happened 10, 15 years ago in terms of non-performing loans showing up later, and I think you might say to yourself that these non-performing loans, based upon what I would call excessive credit flows to wherever the state sector might be something like a half to 1 percent of GDP annually. So, maybe eight or nine years down the line you might see a write off of 8 or 9 percent of GDP. Less than it was the last time they did it, but still significant.

Then you have conditional liabilities, the pension system, welfare system, which you're building up and how much of it is going to be covered by the state and how much does it have to come from other sources. So, I've never seen one which -- I've seen ones which try to look at some of these, but never really tried to make it precise.

MR. KROEBER: Yeah, and I think basically any country would look pretty bad if you added up all of the implicit guarantees.

A question over here. Yeah.

SPEAKER: Hi, my name is (inaudible) from Johns Hopkins University. And Professor Zhang just mentioned the shadow banking system, so I'm wondering whether you and the other panelists can elaborate a little bit about that, especially given the mass wealth management products issued by banks and cooperation between trust companies and banks. To what extent do you think they will cause the next bubble or are they under sufficient regulatory system with the government? Thank you.

MR. KROEBER: Who wants to take that? Doug, do you want to start with that?

MR. ELLIOTT: Sure. And I know -- many of my fellow panelists know more about aspects of this, but I -- look, to me, looking as an outsider, it's almost certain you're going to have some sort of blow up in the shadow banking sector that will be significant. Now, I think it will be at a level that can be handled by the larger system. I'm not suggesting this creates the doom of China or something, but you've got quite large sums of money that are being lent to particularly risky enterprises, which is why they have more trouble getting the money in the first place, without the backing of the implicit guaranty of the state in some way, and you don't have that much scrutiny of it and you have them -- the lenders operating with much less capital or other buffers.

So, it's ripe for something to go wrong, and it's been growing rapidly, which is another thing that creates risks. So, I think you will have something go wrong. I couldn't tell you precisely what, but, yeah, I do worry about it. But again, I think it will be manageable at the end of the day.

MR. KROEBER: Shuli, what's your view of the riskiness of the shadow financing system?

MS. HU: I think the short-term everything will be all right, but it's difficult for China to avoid a real crisis in middle or long-term. China faced challenges or threatenings from financial crisis in middle of 1990s, the Asian financial crisis, and in 2008, with the world financial crisis, and China avoided all that, but I think the crisis will come within China, not influenced by international world, and it's very challengeable, and I cannot imagine, actually, what would be China's crisis. It will be very different from what we have ever seen.

MR. ZHANG: Could I just answer that question of shadow banking? This is a very, very important point. A lot of people think that this is a crisis. This is not. This is market forces working. This is very different from the Financial Stability Board's definition of shadow banking.

Shadow banking in China, one, it's a large regulatory arbitrage; the second one is actually market forces working. First of all, if you pay depositors -- and I agree with Yukon, the numbers are much better in China than a lot of other places, but the fundamental problem is that the economy is growing at 6, 7 percent or more, right, in real terms, and you're being paid only 3. Actually, you know, there is financial repression, so that's the heart of the issue.

Therefore, Chinese depositors would like, as they increase their wealth -- would like more return on their wealth, and that's perfectly legitimate. That's a market demand issue -- on the demand for a good product that gives you higher returns, so that's not a problem.

From the demand for loans, what had happened was that as the Chinese economy began to tighten on a monetary policy, the property developers are -- and the infrastructure developers and even the SMEs face a fundamental credit crunch. You know, either they continue investment or their property becomes a hole in the ground, as all property developers know, you know, right, and all infrastructure. You can't stop. So, a lot of them actually ask for short-term liquidity loans in order to continue. And they were willing to pay high interest rates, and a very good indicator of this is the Winjo shadow banking rate, which actually gives China a new market determined rate to assess this.

So, there is a difference between the market rate and the official rate, lending rates. Now, these are beginning to narrow, as you can see, once the monetary policies begin to relax. So, the crucial question, therefore, is ultimately the quality of the shadow banking assets, and there are basically three elements in there. There are the lending to real estate, the lending to property development platform companies, and then the lending to SMEs issues, right. In fact, the property development area, unless there's a major crash in the property market, which I don't think will happen, but it would -- you know, there are, by and large, pockets of bubbles in select cities, but there's -- you know, China is a very large continental economy like the United States. It's fairly rare for China to have a nationwide property crash, okay, in that regard. I don't think that would be major, but individual property companies could have problems, individual banks will lend to that (inaudible) problems, but the system as a whole was not that problematic.

On the platform companies, my view is, here is a huge opportunity for the Chinese to reform the municipal tax system, the municipal financial conditions. By the way, the municipals actually don't publish balance sheets and income statements, and this is an important fiscal reform that needs to be done, right, and you can develop the municipal bond market issue.

The real area that is complicated and much more difficult to understand is actually the SME area and that's an area related to the property rights reform, so in my personal opinion, the shadow banking system, what I call the scare, is actually a very good opportunity for China to make major reforms in the property rights and the whole financial market.

MS. HU: So, if we had property rights reform, what will happen for China's financial market? Is that kind of systematical?

MR. ZHANG: No, no, the thing is interactive. You know, financial systems determine property rights and property rights are actually determined by, you know, the changes in the law, right? I mean, the banks basically enforce property rights. So, then the question you have in China, which is very unusual -- a lot of people don't understand this, okay, you need to understand this very, very clearly -- in China, if you have a property right dispute between an investor and a bank, you normally ask the regulator to sort this problem out, not a court, okay, because that's the way it's done. People always feel that they need to go to the regulator to solve this problem.

But that's not the function of the regulator. In Hong Kong, for example, the regulator never gets involved in property rights dispute, you go to the court or you go to an arbitration panel, right, so actually, this is an area where China can reform this to get the regulator out of the dispute between the investor and the regulator. In shadow banking, if you pay -- if you get high interest rate for a product, is it buyer beware or is it the seller is responsible? Who's responsible? You can't get the regulator to determine who is right or who is wrong, you have to get the courts to do this.

But, you know, that's a market practice issue that will take time for China to evolve in this area, and I think it would be a very major reform in the Chinese banking system when you get the property rights clarity that you need to develop in the system as a whole.

MR. KROEBER: Great. Thank you. I want to have time for at least a couple, three more questions. So, there and then in the back, please.

SPEAKER: Hi. I'd like to ask, what role should China play on the greater global scale in terms of the world financial -- trying to bring some more stability in terms of the world financial system? Thank you.

MR. KROEBER: Thank you. Doug, do you want to address that?

MR. ELLIOTT: You know, one thing I've felt for some time, and I suspect there's broad agreement here, is we need the developing countries to play a significantly greater role in international financial agreements. You know, there's a Basel Committee of Banking Supervision, there's the Financial Stability Board, there's some other global bodies that try to bring together the key regulators and central bankers to create coordinated global approaches.

China is represented in those places, as are some of the other developing countries, but certainly my sense in talking with people who are on these bodies is they've been relatively passive until quite recently and I don't think -- I think in one of the earlier questions was asking if we shouldn't be getting more input from the developing world, I think we should. We don't want to flip everything and go from a completely western-centric approach to a completely developing country approach, but there's a balance. Everyone has a stake in this and they ought to all be heard in a fair way.

I think there are things we could do to help that along.

MR. KROEBER: Thank you. There's a question in the back.

SPEAKER: Hello, my name is Iwa. I'm a current student from University of Minnesota Law School. I used to work for a commercial bank in China like a loan officer. I have two questions. First is, what's your opinion about the state-owned company -- between state-owned company and the banking system? Because when I work as a loan officer, whenever I contact clients, when I go back to report to my boss, the first question they ask is not how the cash flow of that company is or maybe how profitable it is, it's, is it a state-owned company. So, it's my first question.

And the second question is, when I do the loan to a company, banks ask for the collateral as a security, especially the real estate. So, my question is, what if the real estate market collapsed in China, how will it affect banking system? Thank you.

MR. KROEBER: Who wants to volunteer to --

MR. ELLIOTT: I'm happy to, but I feel I've been talking too much. All right, by the way, that's a rare thing for a think tanker to actually feel.

No, I'm glad you asked the questions because those are both very central questions. On the collateral one, first I'd say, as compared to other financial systems around the world, I think the Chinese are somewhat too reliant in the banking system on collateral, but collateral is important in lending in every market, including the U.S., that's always a key thing.

One good thing is, it seems from the outside anyway, that in China the level of collateral compared to the loan is high enough that it gives very considerable security. So, I'm hopeful that short of a truly major real estate collapse, the collateral really will provide very considerable protection.

You know, with home mortgages, down payments are 40, 50 percent in China compared to U.S. average might be 10 percent at this point. It's not -- there's a big difference.

In terms of the commercialization, what you're touching on, it's a really key question and I keep hearing different answers from different people who should know. So, it's hard to tell. To what extent is it that the first box you check is it a state-owned company in some way, second box probably would be, you didn't say it, but I'm sure you would have volunteered your boss, oh, it's not state-owned, but by the way, this is these guys and they're really close to the governor, or whatever.

So, how much are those the factors? Or, for example, is a lot of the SOE lending because SOEs make more of the profits in the system than is -- they make disproportionate profits on average, so you've got that. You've got the implicit guaranty. You've got, perhaps, stronger business structures for other reasons. What you're touching on, we could probably talk about for a full day, it's a really fundamental question, and I'd love to know what the answer is.

MR. KROEBER: Okay, thank you. I'm going to try and squeeze in two more questions before noon. So, we've got one there and then one in the back. So, up here in the front, please.

SPEAKER: Hi, my name is (inaudible), professor of Johns Hopkins University. I happen to work in the real estate finance sector and making quick comments. I think the average down payment in the U.S. now is about 20 percent and in China I know it's much higher, maybe 30 percent to 40 percent, so I think that is the reason why the Chinese banking think they have adequate capital to cover probably collapse, probably price collapse.

But I think they haven't really identified the systematic risk or systemic risk. It's not only the real estate, the (inaudible) mortgages, but it's also the builder loans and the collateral of the governments and the collateral for a lot of other companies.

So, it's possible that there is going to be a nationwide real estate price drop and if that happens, I'm wondering whether the banking sector would have enough capital to cover their loss and still remain solvent. Thank you.

MR. KROEBER: Yukon, do you want to take that?

MR. HUANG: Just a couple issues. As Andrew said earlier, the property marker is extraordinarily differentiated. You go to Beijing, you'll find projects which are highly very valuable and projects which, I would say, are not going to make it. You have 70 to 80 percent of the people who bought property who've found that they've appreciated 200, 300, 400 percent. You'd have to have a very sizable collapse to bring them down.

You have others who've basically got into the market in the last year and done it in a very speculative way who could, actually, have a problem.

So, I don't see a systemic national issue, but I see problems here and there for different kinds of reasons.

MR. KROEBER: Okay. And I'm -- thank you very much for all the questions being so concise and for the panelists being concise. I know we could go on for another hour or two, but this is going to have to be the last question before we break for lunch.

MR. JARVIS: Mark Jarvis with Ashmore, we're an investment management company. So, I do agree that development of the bond market is a good thing and the growth of the bond market. I am hearing anecdotally that a lot of the bonds that are being issued recently are basically repackaging of loans that are being underwritten by the banks. These are loans that are maturing that maybe the borrower wouldn't be able to repay, but rather than being rolled over, they're just being issued bonds -- or the borrower is issuing a bond using the proceeds to repay the loan and then the bond ends up on the balance sheet of the bank.

So, my question is, is this an accurate depiction? And if so, any idea what the quantity of that is, how much of new bond issuance would that be?

MR. KROEBER: Okay, Eswar, I wonder if you want to address that briefly and then we'll let Shuli have the last word.

MR. PRASAD: It's a problem. The Chinese bond market is not quite the crapshoot that the stock market is, but there are severe regulatory issues that need to be dealt with.

The concept of the bond market, I think, is exactly along the right lines, but in terms of the players right now, in terms of the debt, there are many issues that need to be addressed and what you've pointed out is exactly along those lines.

I don't have a good estimate of how many of the corporate bonds being issued are essentially repackaged loans. I have heard about this problem, but I don't have a magnitude to share.

MR. KROEBER: And then, Shuli, do you want to finish up?

MS. HU: Okay. I just want to add that so far there is no one case of default on bond market even we heard so many noises or speculations, we warned as well, but there is not one case for that. Why? Because everything -- when something happened, even for a very small case, then local government would do themselves or suggest some certain SOE to help the problem companies to pay for their debt.

So, there is no one default, I think it's not normal. That's my answer about if it is good for Chinese bond market.

MR. KROEBER: Okay.

MR. ZHANG: I just want to --

MR. KROEBER: Very quickly because we need to break for lunch.

MR. ZHANG: Just factually, Chinese banks are not allowed to guarantee bonds. Factually. That's absolutely deregulation in China Banking Regulatory Commission. So, you know, if you ever see a bond guaranty by Chinese bank, that's illegal.

MR. KROEBER: Okay, and that, I think, is a very nice note on which to break for lunch. Thank you very much, the panelists. Lunch is across the hall. Thank you.

(Recess)

MR. POLLACK: Thank you for coming back so promptly. We actually are more or less on time at the moment, and we will try to stay on time.

Our third panel I think is going to be a very, very interesting one as well. It is going to focus on questions not only of economic interactions, but, of course, the energy equation, supply and demand, as it affects China's long-term development. At the same time there are important strategic implications to the patterns of energy, production and energy consumption, and very interesting stories here in terms of comparing the United States and China.

Our panel today, if I could introduce them: To my farthest on the right is Charlie Ebinger who heads the Energy Security Initiative here at Brookings and will, I'm sure, give a very, very enlightening presentation. Ken Lieberthal is in the middle, although I should introduce Zhang Guobao to his left only because the sequence we will go in will be Dr. Ebinger, then Zhang Guobao, and then Ken Lieberthal.

Zhang Guobao, of course, needs very little introduction. A vital role as former deputy head of the NDRC in China, he was centrally involved in the energy process in China. And I can assure you, having sat next to him at lunch, Zhang Guobao knows every number and every kind of production and need in the Chinese energy equation, and he wasn't even looking at a piece of paper.

And then my good colleague and former head of the Thornton Center, Ken Lieberthal, who will try to draw out some of the strategic implications that will follow from the presentations that will precede him.

So without further ado, Charlie, do you want to sit from there or do you want to talk from here? Okay, good.

MR. EBINGER: Good afternoon, ladies and gentlemen. As he said, I am Charlie Ebinger, the Director of the Energy Security Initiative, and I'm delighted to have the opportunity to share the podium today with our distinguished visitors and my professional colleagues here at Brookings.

Since our guest knows every statistic on China known to mankind, I am not going to bother. What I've been asked to do is kind of talk about while the events of the last ten years or so in China have led China to both make amazing strides in energy, but also have some serious constraints remaining in terms of the pollution arising from energy consumption and a host of other areas we'll hear about, I've been asked to kind of talk about while that's been going on, the transformation that has been occurring in the U.S. energy situation because I think many times people that don't follow the U.S. energy situation would be truly amazed.

It is quite remarkable that when you think back to about 2008, the so-called shale gas revolution was hardly envisaged in the United States. Going back to just a few years before that in 2005, we had predictions that within ten years from 2005 that the United States would be importing 40 percent of our natural gas, our crude oil production was continuing its historic decline, our nuclear power program was in the doldrums, people were growingly concerned about emissions from coal -- albeit we were passing environmental legislation to deal with that -- we were actively pursuing renewables and while they were growing in some cases faster in percentage terms than any other energy source, the reality is we remained terribly dependent on fossil fuels and incredibly dependent on oil and in the future projected natural gas imports.

Nothing could be further from the reality today because just in the last five years, the shale gas revolution has seen a transformation. The number of LNG plants, roughly nine, that we had built to import natural gas now are all in line at various degrees of the regulatory process, asking the federal government to allow them to become export facilities. We have another whole set of projects behind them, some absolute greenfield, meaning brand new, projects looking to become exporters of natural gas. And we have seen a dramatic reduction in coal emissions as natural gas has become so bountiful that it has led to the closing of a number of our more aged coal facilities. And ironically, as a country that did not sign the Kyoto Protocol under great criticism from our international friends and neighbors, as in my belief they should have been critical, we now find ourselves having basically met and perhaps even exceeded the targets for carbon reductions that we would have made had we signed the Kyoto Protocol.

But this is not necessarily all good news because while we’re seeing in the short run tremendous benefits from cleaner burning natural gas backing out coal, we all know that in the long run as we move towards a more gaseous economy in the absence of proving that carbon capture and sequestration of both natural gas and coal is both commercially and technically feasible. If we can’t do that, at some point we will see a rising trajectory of fossil fuel emissions, carbon emissions, and other greenhouse gas.

But we are now in a tremendous changed posture. We have gone from coal accounting for just under 50 percent of our electricity pretty steadily over the last number of years that it's now down 33, 34 percent. Roughly coal and gas are now pretty much equivalent in electricity generation. We have the prospect in the near term, albeit it will be a slow transition, of seeing natural gas very likely begin to replace the diesel fuel that we use in our 18-wheeled trucks for long distance freight across the country. Replacing this diesel will obviously further reduce the U.S. demand for petroleum, which will be good news for the rest of the world. Whether we can replace the 2 million barrels a day roughly equivalent that we use in diesel fuel in trucks over what period of time one can debate, but it is a process beginning to happen. Major corporations like Cummings, GE, and others are investing in the technology as they are investing in technology to make our locomotives run on LNG, again backing out diesel fuel. And we also see the prospects, albeit with some real institutional obstacles, of natural gas beginning to replace diesel fuel in marine transportation on our Great Lakes, our coastal waterways, and our major rivers.

So we see the prospect of natural gas becoming a much greater fuel source. And this is not only going to occur in the United States; it has the prospect, albeit with some sharp differences I'm sure we'll hear about, in China. There's large promise of shale gas in places like Argentina, South Africa, Algeria, ironically in France, but the French don't want to develop it for fear that it might hurt their wine industry. I like that prioritization of industries there, but the point is there is large-scale shale gas in Russia. This is a transformation.

But it's not just a natural gas story that's been transformed in the United States. We also, using much the same technology that has allowed us to break up the rocks in which this natural gas is trapped, a process call fracking, is now extended to the unconventional oil universe so that for the first time we are, with the exception of one year in the last 30 or so, we have seen a continual decline in U.S. oil production. We now see U.S. oil production rising and rising quite dramatically. No one would have believed just several years ago that we would be producing just under a million barrels a day in North Dakota of all places. But as we look towards the future, I think we can see the prospect easily of another 2.5 to 3 million barrels a day of oil production in the Lower 48 states going up.

We also, of course controversially, but we also are deeply involved, of course, in the heavy oil sands in Alberta, which also have the prospect of rising dramatically. This is the whole part of this, the whole controversy over the Keystone Pipeline that will bring that oil to the United States. And many environmentalists are, of course, adamantly opposed to that development, but right on track we see now the prospect, the very real prospect. People will argue about whether it's ten years, 12 years, 15 years, but we see the prospect that North America -- and notice I say North America -- will be for all intents and purposes energy independent.

We will, of course, continue to import from our friends to the north in Canada. But we are also beginning to see a fledgling energy revolution in our neighbor to the south in Mexico with changed policies that are, after nearly 50 years of not welcoming the international energy industry, beginning to at least talk about bringing the international energy industry in as partners, no sense of privatizing the long-established strong governmental role in Mexico, but at least working in partnership with international oil and gas companies. And if this comes to pass, I think we will see a situation where it truly is a North American energy independence involving the United States and our two neighbors to the north.

So in the interest of time, let me just conclude by saying I think we’re on the cusp of a transformation certainly of the U.S. and North American universe. But this has profound implications for our friends in China and elsewhere in Asia because if one looks to all the forecasts for the growth in world energy consumption over the next ten to 15 years, it is clear that the vast bulk of Middle Eastern oil and gas demand will shift to Asia principally, of course, to China, also to India and Japan. But China and India will be the two biggest claimants for this enhanced oil flowing from the Gulf. And what role that portends for China in its foreign relations with the nations of the Gulf, what role it portends for China and India hopefully in partnership rather than rivalry for access to those vital resources, who guards the sea lanes. I will argue -- I know this is controversial and my colleagues at Brookings will take strong exception, many of them -- but I would argue when the United States finally gets serious -- hopefully we do some day -- about our budget deficit and a Congressman or woman has to choose between food stamps for their constituencies or another aircraft carrier for the Gulf, I think I know which one they will choose. But others at Brookings say our strategic posture will not change because of other vital interests we will continue to have in the Gulf.

So thank you very much. I hope that will place in context what is happening in the broader world market. And now we'll concentrate on what is the thrust of our discussion today, namely the tremendous energy challenges and opportunities facing China.

MR. ZHANG: It's my pleasure to have an opportunity to join this conference. It's not my first time to visit Brookings, sadly I'm still nervous. I never studied the English in the class all by myself really, so I can't speak English so grandly. I still want to use the Chinese. But when I participated at international forum, I find most foreigners tend to use

Airfone. But today if you really want to listen to what I said, please use the Airfone if you can't understand the Chinese. It's okay?

So next I'll continue with English because I feel better expressing myself in Chinese. Energy has always been the important topic in international economic activities. Secretary of State Kerry, who visited China recently, said that he actually gave a speech at one of the energy panels, which I helped organize. And in the U.S.-China energy cooperation and dialogue foreign and that's the platform where he gave the speech. This to a certain extent reflects the importance attached to the issue of energy, especially if the cooperation in energy is between the two countries.

I have also managed to use a phenomenon called a butterfly effect to describe the interactive impact on each other in energy. Everybody knows about the theory. You know that in the Eastern Hemisphere if butterfly flips his wings, there will be a storm in the Western Hemisphere. So in the area of energy, it may not really be a swarm; however, whatever happens in Western Hemisphere will impact the Eastern Hemisphere.

So in recent years energy actually is an area where we have seen a lot of changes. As it has been mentioned, they talk about the self-efficiency of energy in North America. We know that in the year 1973, when the first oil crisis took place, the United States put forward this concept that would be an effort to actually try to reduce their reliance on the Middle East oil, which some countries use as a weapon. However, because of the huge demand for energy by the United States and Soviet Union after so many years, it’s hard to have a self-efficient supply of energy. However, we can see the United States has made significant progress in that direction.

So based on the numbers that I know, 2005 is the year when the United States imported the largest amount of oil. Because of that year, the daily import of crude oil is over 13 million barrels. However, to last year, that’s the year 2012, the daily import is only like 10.65 million barrels per day. The self-sufficiency actually in the year 2005 reached 69 percent, so that means the reliance on foreign oil is 31 percent in terms of total energy demand. So in last year that number has increased to 81 percent. So the foreign reliance has now decreased to 19 percent.

At the same time in the year 2005 China imported 146 million tons of oil. However, in 2011 it’s over 270 million tons of oil imported by China. So that means there is an increase of over 100 million tons every year. So in the international energy supply, people see clearly that in the past years the increase in energy consumption is mostly in the developing countries and again mostly in China and India. That’s self-evident.

For the United States to improve their self-sufficiency energy supply as the previous people said, it actually has benefitted from the new the technology in shale gas. The production of shale gas last year in the United States I believe is 180 billion cubic meters. So the output actually passed the entire consumption by China. So last year China consumed in terms of natural gas 140 billion cubic meters, including about 100 billion produced in China with the rest imported through either LNG or pipelines from overseas. Because of the success in shale gas and the increase of the supply of shale gas, in the U.S. market natural gas is very cheap.

The price for 1 MMBTU was only US$2.2. A few days ago David Sandalow, the Deputy Secretary of Energy, came to China and we asked him about the price for MMBTU. He said it's now close to US$4 per MMBTU. And so there's a slight rise, but I don't know. The numbers can be debated because we have other experts here today, so maybe we can check on this number.

Now in the Asian market in Japan it would be US$16 to US$18 per MMBTU. In China basically it's about the same for China, so very close to US$15 per MMBTU. In Europe it's US$9.1 per MMBTU. So these numbers tell us one thing; that the natural gas in the United States is the cheapest in the world.

So about three months ago I asked Mr. Sandalow now if the natural gas is so cheap in the United States, how do you make money? Are you suffering from losses? He said “I think we are losing money.” Well, then if you are losing money, why do you still want to produce it? What he says, “Well, you’re still in China also losing money. Why are you producing it, too?” Well, because you already have the economy of scale, but then we do not have enough facilities for exporting it. I know that in the U.S. along the coast you have had 16 terminals, container terminals. You’re hoping to receive LNG from Qatar of the Middle East. But once the terminals are built and you have a chance to receive the LNG from Qatar, you are already able to lower the price of the LNG. So how are you going to transfer or convert these terminals into terminals for all other types of fuel? So we want to see whether Chinese and other people are trying to hope to buy LNG from the United States. I said it’s not possible in the next few years. And I also asked the Deputy Secretary of Energy, I said so how many cases or applications you have not approved? He said “We still have 16 applications, which are now stacking up on his desk.” Only one has been approved, which is Korea. But I have not approved the other applications. Now, even if I approve all of them because, for example, all the manufacturers or producers of LNG had also put a lot of pressure on the Department of Energy and said why don’t you allow us to export because it sells so well in Asia? But for the United States to convert these terminals for importing LNG to exporting LNG, you need a certain kind of equipment that would take three years to build up. So even if you have the intention to do that, it might take a little bit before you have time to export your natural gas to the markets in Asia.

So this kind of butterfly effect I think has a lot of repercussions; for example, now you're not importing as much from Canada as you used to do before in the past. Natural gas from Canada was so popular they didn't even care about selling it to Asia. They could just sell it to the United States. But now United States is not getting so much from Canada, and now they have to think about other options. And so even it can sell to U.S. because it's so cheap, the best way to go is to sell it to the Asian markets. And so now Canada is more interested in selling natural gas to Asian markets than it used to do before. And then also Qatar I remember when I was still helping the Guangdong Province to negotiate on importing natural gas, and we were considering Qatar. But then we didn't do it. We imported it from Australia because at the time our production capacities were still low. But now the production capacity has gone up.

And then South Korea also has all these containers or oil tankers. Why? They want to export the natural gas to the United States.

But the United States does not need anymore. So now they are seeking markets in Asia and in Europe. Now all this fleet of all these oil tankers are not completely consumed, so they are there having a sand bath -- that's what we say in China. Now Europe has a lot of options. They can buy from Russia natural gas. They can buy from Qatar. They can also buy from other places and so now Europe is a big buyer so now it has more chips in the negotiation. So every year the price of natural gas going to Europe from Russia is going down.

Now, Deputy Secretary of Energy also came to China another time and someone said in the delegation that recently President Xi Jinping visited Russia and Russia has agreed to build pipelines to send the natural gas to China. And this American said China needs the natural gas from Russia. I said, but Russia also needs China to export their natural gas because the natural gas that goes to Europe where the market is shrinking so it also needs China, so not just that China needs them. So these are all the repercussions or the results of the butterfly effect as created by the United States.

Now, we're in the United States because of the great production of shale gas. Our gas price here in the United States is going down. So the price of coal is becoming less competitive. So last year, when the United States exports 14 million tons of coal to Europe, making

Europe the second largest coal consumer behind China. So Europeans who talk about cutting down on emissions now they are more quiet on this particular topic.

Now, China is so far away geographically, it's an ocean away from the United States. I never would have thought or imagined that we would actually buy this cheap coal from the United States across the ocean. I can't believe that we actually imported last year 5 million tons of coal from the United States. Again, this is another result of the butterfly effect.

In Europe, the European Union when they negotiate with Russia on the natural gas, there are always a lot of conflicts in the negotiations and now Europe has a lot of options and now it can haggle or bargain better with Russia because now it has many options. So Russia, in order to protect this market, not only it has built this South pipeline, it's also talking about a North Stream pipeline. They are working on these two projects together. These are pipelines they have been talking about for a long time because of different opinions and conflicts. So these two projects will not be about to be launched, but under this backdrop now Europe is in a better position to negotiate and Russia is afraid of losing the European market. So now it has started to construct the South Stream pipeline. So all these changes around the world all have to do with the massive production of shale gas in the United States.

Russia also wants to send natural gas. It's just a design. It's something that they are proposing that they can build pipelines eastward into China. So it means that Russia is taking the Chinese market very seriously as well.

Another butterfly effect is in Japan. In 2011 we have the Fukushima accident -- actually Japan wants to have a revival of the used nuclear energy, but because of Fukushima accident, everything changed. And a lot of countries are also falling behind in terms of using nuclear energy, and some countries actually have given up nuclear energy usage completely so all these stock prices on this nuclear energy has also gone down. And Japan has over 50 nuclear plants, but they have closed all 56 of them because of accidents. And they really had a power shortage in Japan, and because of that they restored two of them. So of the 56 reactors, 54 of them are not in operation. Only two are in operation in Japan right now. So what how they going to deal with a power shortage? So now they import a lot of LNG, causing the price of LNG in Asia to go up, which is now about US$16 to US$18 per MMBTU, which is another result of the butterfly effect.

So I think the energy landscape in the world is really changing and all politicians who care about this matter or ordinary people who care about this, they say now the U.S. is less dependent on the oil or the fuel from the Middle East. And so China is now more dependent on this energy so now China should also take responsibility in protecting the sea lanes. I think all people who are researchers and politicians will all talk about this, but I think the United States is moving towards a big step, taking a big step, to move towards energy independence. However, the Middle East is still a very important strategic location, a geographical location, for the United States and also for importing crude oil.

So I read an article in preparation for this talk. Even though when I did mention that the U.S. is depending less and less on outside energy, but the U.S. on the contrary is depending more and more on importing crude oil from the Middle East. So I feel that under this backdrop, I think the whole world is actually paying attention to the future of renewable energy and a new energy. And I think this is an inevitable trend.

Someone is telling me to stop talking, so I'm ready to stop talking, so here I am. Thank you.

MR. LIEBERTHAL: Good afternoon. It's a real pleasure to be on this panel. The previous two speakers covered so much that I've been sitting here wondering what I might contribute to this. Let me seek to make a contribution in the following way. We've heard a lot about the energy revolution in the United States. We've heard a lot about -- I know more about butterflies and their effect now than I ever thought I would know, but seriously -- a lot about the almost unintended repercussions globally of this kind of fundamental change in U.S. energy production.

Let me focus if I can on the strategic implications for U.S.-China relations of the energy revolution in the United States and its ripple effects because energy is really a truly strategic issue. And it has in a lot of ways affected U.S.-China relations in the past and will in the future. So let me kind of focus on several dimensions of that.

As we've heard, there's been a U.S. shale gas revolution and also a revolution in tight oil in oil production in the United States so that within a few years there will be no U.S. direct energy imports from the Persian Gulf, a really dramatic change in the wake of many decades of substantial dependence on energy from that area. It also means there's greater competitiveness for U.S. domestic manufacturing, especially in industries such as petrochemicals. And we are beginning to have -- and I'll get into this a little more in a moment -- a potential substantial U.S. impact on international prices for natural gas. And we are already having a significant impact on U.S. combustion of coal for energy purposes and, therefore, on U.S. greenhouse gas emissions. So there's a whole lot going on here within the United States.

So with that as background, let me focus on two strategic issues in U.S.-China relations that are directly impacted by this energy revolution in the United States. The first is the issue of climate change. Climate change -- I will show my bottom line very clearly and I hope that all of you agree with me -- is existentially one of the most important issues the world confronts. It isn't the most important for tomorrow or for next month or next year, but as we look to the long-term future, it is hard to imagine an issue with such wide-ranging and consequential impacts overtime. This issue, though, is one that has been extremely hard to handle politically in the United States and also in China and in many other countries. It sets up badly for political resolution. It crosses political boundaries. It doesn't respect sovereignty or boundaries of cities or states or whatever. Its cause and effects are separated by very long periods of time. So if a political leader is going to do something about it now, it is the successor five terms subsequently that begins to reap the benefits of those investments.

Fossil fuels are at the core of the issue, but every major government is built around fossil fuel interests because those interests have driven every major economy as they've developed overtime. And even as we anticipate the increasing impact of climate change, where the science is weakest is on determining the geography of that impact. What specific areas will get more rain or less rain or this or that? So global impacts are clear, but the specific geographies are not. And, of course, we're organized politically around geographies.

So all of that has made this a very difficult issue to manage, and neither the U.S. nor China has managed it well. But the U.S. and China do share one thing and that is we are the two largest greenhouse gas emitters in the world with India coming in third. The whole world now puts us in the same category, not one developing country and one developed country, but the two biggest emitters in the world with another developing country, India, catching up rapidly.

It's in this context that shale gas becomes important in a variety of ways. Shale gas, as one of our speakers commented, emits about half of the CO2 when burned than its coal equivalent emits. U.S. coal consumption is, therefore, going down and U.S. greenhouse gas emissions are going down. While our coal combustion is going down, our coal production has remained very high. And the difference, of course, is we've become a major coal exporter partly to Europe, but also to China; so that the net impact of use of more natural gas in the United States has not been as dramatic on greenhouse gas reduction as one would have hoped.

We're taking our high greenhouse gas fossil fuel and simply sending it to other places to burn. Given the way climate change works, that is not helpful let me say.

Now, China has very large shale gas reserves, recoverable reserves, estimated technically to be about one and a half times the size of those in the United States. So China is, at least in theory, positioned to have a shale gas revolution fully the equivalent of that in the United States or perhaps even more dramatic than that overtime. Using a climate change framing for the issue, it is enormously in America's interests that that shale gas revolution occurs in China. It will produce the kinds of reductions in greenhouse gas emissions there with potential spillover effects elsewhere that will benefit us all.

There are two dimensions to that issue, shale gas between the United States and China now to my mind. One is whether China can acquire the technology that we have developed so rapidly to apply it in China. And the answer is, frankly, it's not easy. And it isn't only because of concerns about intellectual property protection, which is what most people tend to think of. That's actually the minor part of it. It's in part that China shale gas deposits are generally much deeper underground than American deposits are. Secondly, fracking, which is key to exploiting a lot of these reserves, is very water intensive, but a large part of China's reserves are in parts of the country where there is no water to spare, where the water cannot be used for this purpose in requisite quantities. So you have to develop an approach to fracking that is not water intensive and while there is research on that, that is not available at this time.

And then thirdly I'm told by people in our industry that even if you transfer the technology, the key in shale gas revolution fracking is the engineering well by well, that this is very, very particular. We have about 100 engineers in the United States who can really do this stuff, and it will not surprise you to know they are all very well employed and enjoying their incomes. No one wants to move to China in that group. I'm serious. So this is not simply a matter of China buying into, for example, Chesapeake, which is a major shale gas producer in the United States in part to acquire technology. You need to acquire the specific engineering capabilities to operate in a very different environment, plus you have to have the resources such as water to be able to do this. And so it's going to be a long time before China is really in the midst of its own shale gas revolution, but it is in our interests to accelerate that process as best we can and to figure out ways to try to make that happen.

The second element of this is for natural gas to replace coal as much as possible in China's energy mix and if China isn't producing itself, certainly there is a price element to this that's very important. What I don't think came out clearly in the presentations to this point is there is, in fact, an enormous debate in the United States about whether we should export natural gas. It seems like a no-brainer: Our prices are low, our production is more than we need, there's money to be made out there, and there are all kinds of good spillover consequences. Those who oppose that are those who benefit most from very low prices of gas in the United States, such as the petrochemical industry. So, in fact, there hasn't been a firm political decision made to make the huge infrastructure investments necessary and make the regulatory changes necessary in order for us to become a major shale gas exporter. But if we were to do that, China would be primed to buy and this could have a significant substitution effect which would help bridge from now to when China is producing its own shale gas.

So we have two opportunities here. One is in working with the Chinese to accelerate their own capacity to develop their shale gas deposits, and then the other is to adopt the changes necessary to put a lot of American shale gas on the international market, a fair percentage of which will actually find its way into the Chinese energy structure.

Let me shift to the other area. That's all good for climate change and helps to put the U.S. and China on the right side of that issue or more toward the right side of that very important issue. The other strategic issue here is in the Middle East, and I define the Middle East as including the whole Persian Gulf. As has been noted, within a short period of time, maybe five years or so, the U.S. will no longer take any energy directly from this region. We will nevertheless maintain very strong strategic interests in the relatively free-flow of reasonably priced energy out of the Gulf. Our allies and friends around the world depend on that, especially the Japanese and South Koreans. In addition to that, oil is a global commodity. If the price of oil goes up elsewhere, it goes up in the United States. So it isn't like we have no interests there. We've retained substantial interests, but I think, frankly, the chances of our fighting another oil war go down dramatically, that we are no longer directly getting energy out of that region.

China now gets more than 50 percent of its imported energy out of the Middle East. It's tried like crazy to diversify, and it still gets more than 50 percent out of the Middle East. My understanding is that will go to well over 70 percent within a decade, assuming ongoing efforts to diversify. So essentially, given availability and prices and everything else, that's where most of the energy is going to continue to come from. I'm sure that Minister Zhang Guobao will correct me if my numbers are wrong here, but that's my understanding.

So as the U.S. dependence on Middle East energy, direct dependence, is going to zero, China's dependence is becoming truly strategically fundamental. But if you look at the security situation in the Middle East, despite the U.S. conclusion of the war in Iraq and determination to basically end the war in Afghanistan by the end of 2014 with just a small residual presence there, nevertheless U.S. military capabilities in the Gulf region will be by far the largest and most effective of those of any outside power in the region over the coming decade. You have to look at our base near Bahrain. Fundamentally, we're going to have more power there, external military power, than anyone else will. My sense is that the Chinese PLA will not have the military capability to shape any outcomes in the Middle East in the coming decade. It is still daunting, but it is a long way from having that level of force protection capability.

So we have a lot that is shifting in the Middle East. China's becoming involved because of its investments in a way that it has not been involved before, where it cannot rest on statements of principle and encouragement of everyone to solve problems. It is becoming an active player in the issues of the region. The U.S., which has long been an extremely active player, will remain engaged, but not with as strong a direct interest as we had before.

I think this highlights one of the fundamental realities of the U.S.-China relationship, which is as China's footprint has become increasingly global, third areas of the world, especially the Middle East as one of the prime examples, become areas that become integral to the nature of the U.S.-China relationship. And we need to figure out how to work more effectively together in the Persian Gulf area in the mix of security, diplomatic, and economic strategies that we're pursuing in order to maximize the chances of ongoing stability and an ongoing uninterrupted flow of energy out of that region of the world. And in that I would argue also India should become a part of the equation.

So in conclusion the energy revolution in the U.S. is having impacts of a truly strategic nature potentially on U.S.-China relations. Neither side I think at this point has fully thought these through, and neither side has effectively engaged on them although we have begun the conversation on both the Middle East and on shale gas and on climate change. These energy issues are now at the center of the major areas in which the U.S. and China can elevate their cooperation. You've all heard comments recently about the notion of developing a new type of major power relations between the United States and China. To my mind, that new type of relations has to extend to include an essential way our ability to do what we have not done before in terms of cooperation on these vital energy issues. And so I look forward to our two governments hopefully engaging on that along with our corporate sectors and scientists. Thank you very much.

MR. POLLACK: Thank you, Ken. I think all three speakers have done a very, very effective job of capturing -- I'm not wired for sound, but I think you can hear me even if we're waiting.

What strikes me is how you cannot think of either the United States or China in isolation here; that's obvious because those worlds intersect. If the United States has both increasing energy production and diminishing need for foreign resources, overtime I would argue it is probably going to be much more prepared to export energy. I know that that's not something that the United States is really presently undertaking, but it seems to me the inextricable trends here are very, very obvious long term. There's no reason to believe that China's energy requirements are going to diminish meaningfully. Quite the contrary, they are going to increase significantly. And this has impact not only on the geographic focus of where China seeks to meet its energy needs, but on a whole host of other consequences, including obviously questions for China's production of greenhouse gases and how much those will increase, that production will increase overtime as China's development continues.

In addition, the impact of China's growing energy usage domestically in terms of environmental conditions in China is profound. China is going to have an inescapable need in my view to find ways to address what is obviously a crisis in China's cities and the expectations of China's own citizens for fundamentally clean air, quite apart from clean water and safe food. This is something people experience every day. It's not something that is unfamiliar to them as they deal with these consequences.

So Charlie Ebinger's point at the outset I think could not be more true; none of us would have anticipated these kinds of developments even two or three years ago. It's really a remarkable phenomenon that the world does not stand still in these areas and that technological breakthroughs have enabled a very, very different kind of energy equation, one which as Ken noted will find the United States not in need of energy resources from abroad ultimately. And even the presumption that North America as an energy unit, if we could call it that, will be in some sense energy independent. When I think back about how often these goals were propounded beginning with President Nixon and often people would almost laugh at the prospect, but that day now seems to be arriving. So how these factors intersect is something that I hope we can have a bit of a discussion with here, both in terms of the panelists and also the audience as a whole.

But I'm wondering since on this panel we have three Americans and one Chinese and that whether Zhang Guobao might want to make some observations about rather than China and the United States being in the same energy boat, we are headed in very, very different directions. Do you think, Minister Zhang, that this argues for increased Chinese collaboration with the United States or do you see possibilities of a more conflict-full future as a function of our different kinds of energy needs? I'm wondering if you might want to make a comment on that.

MR. ZHANG: China and the United States are the two greatest energy-producing countries and also the biggest consumers. So in terms of the amount there's not a lot of difference, but in the past we were far behind and the United States was number one. But right now in terms of total production consumption, I think they are both neck and neck, maybe China is even a little bit bigger. So in terms of the power generating possibility, China is also neck and neck with the United States.

So in the energy area of the entire world, the two countries, United States and China, have to have close cooperation. And many researchers, scholars, and politicians visit China and sometimes we have meetings. One of the issues that we talk about is talk about energy governance, the global energy governance. They believe that the previous structure is no longer fit for the current energy situation. The International Energy Agency, IEA, was actually set up after 1973 when there was the first oil crisis. It consisted of the OECD members. So that firm actually is dominant in the energy affairs of the world, but right now people are beginning to realize that IEA, which consists of mainly OECD countries, they can now represent the interests of all partners in the entire world. For example, in Libya when there has been this political turmoil, IEA actually came to China. And it said that in order that the Libya conflict would not cause the price rise in the international market, OECD countries will actually tap the oil reserve even though China was not a member of IEA, was not a member of OECD. However, there was still the hope that China would help coordinate. They knew that China didn't have a lot of reserves, but China would do at least some gesture in support of this action. So, therefore, in the current world without the participation of certain countries, it's hard to say that would be the correct evaluation of the world situation.

So right now a lot of people are discussing the new energy governance structure, so some people say would it be possible to have a mechanism under G-20. Well, there were people who said before that maybe we should use the framework of G-8, but then they said that would be too small. Well, who should actually use the framework of G-20? Based on the IEA, we should invite China, India, and Brazil to participate, to talk about the issues.

Between China and the United States there has been a lot of cooperation. Over lunch I actually had a talk with some of you and the United States has 104 nuclear reactors even after Fukushima accident, and the conclusion was that all 104 reactors are safe and China has only 16. And the nuclear energy consists of less than 2 percent of the power generation in China and that of the United States is bigger.

So China consumes a lot of coal and that has to do with the energy structure of China because in developing countries, nuclear provides about 15 percent of the power generated and China has less than 2 percent. So even with the impact of the Fukushima, China will still actually explore actively to expand nuclear power generation. And what we are doing is to import advanced technology, the third generation technology, from the United States which the United States actually created, but never put it into practice. So, therefore, there will be a bright future for cooperation between the two countries even in the areas of new energy.

In new energy resources there have been unpleasant events like for the domestication of the solar energy industry and also increased tariff barrier for import of solar energy panels from China. But in terms of the wind power generation some windmills, some hardware, has been exported by China to the United States. We know that a lot of private companies are investing in power generation like wind generation or some others, and they take an active part in that new energy exploration. So in this area I believe the two countries can cooperate.

And Secretary Kerry, when he was visiting China, actually arranged a small exhibit. Over 60 energy companies in the United States were organized, and China actually gathered some other energy companies. Secretary Kerry visited all the exhibits and they talked about let's not only just show the pictures or some exhibits, but you'd better have something more concrete. And he asked a lot of questions, and I believe he was impressed. So the cooperation in the energy between China and the United States is being expanded and deepened. Thank you.

MR. LIEBERTHAL: This didn't fit in the topic of our session, which was about shifting global energy supplies and U.S.-China relations, but the areas as Zhang Guobao just highlighted for U.S.-China cooperation and greater development of clean energy and in the use of energy in ways that are more climate friendly, the areas of potential cooperation are enormous. One of the biggest to my mind and one that is still in its very early stages concerns carbon capture and sequestration in the coal sector. When you burn coal to produce power, there is a major problem of greenhouse gas emissions, primarily CO_2. And there is technology to capture that CO_2 and then either sequester it permanently or use it for enhanced oil recovery or other things.

We have a lot of complementarity there, but still cooperation is quite limited for a variety of reasons. I focus on that for a very simple reason. My sense, and Minister Zhang may have a thought about this, but my sense is no matter how much China does in the coming decade on investments in wind, more hydro, more nuclear, importing of more natural gas, and so forth, coal consumption is still going to have to grow dramatically. And China in recent years I believe has added each year -- the amount of coal it uses for power generation has increased by 200 million tons per year. It's just absolutely startling. It's breathtaking. And that reflects the growth of the Chinese economy and the structure of the Chinese economy and the relative availability of different sources of energy. So if we can't get to some way to mitigate the climate impact of that kind of enormous consumption and growing consumption of coal, we're in deep, deep trouble. So this to my mind is one of the areas where U.S.-China cooperation may move ahead quite a bit.

MR. EBINGER: Can I just amplify --

MR. POLLACK: Please, please, do.

MR. EBINGER: Because I think it directly relates. Apart from what the United States and China -- and I agree wholeheartedly with what Dr. Lieberthal just said -- but we shouldn't forget the rest of the world. A lot of people, particularly those concerned about climate change and the environmental community in this country which takes great pride in that we've reduced the use of coal, at least in power generation, fail to note that to the rest of the world, coal is growing apace. In fact, a study we released, my program released, last May on LNG pointed out that we think after 2020 one of the greatest competitors to world LNG and particularly LNG from the United States is going to be coal because the reality is there are huge coal mines under development around the world today as we speak in places like Kazakhstan. People don't realize the coal resources of Kazakhstan and BTU equivalent dwarf those of oil and gas. You've got coal coming out of Mozambique, Indonesia, and a whole slew of places. These are world-class coal plants, which means that in the Asian power market particularly where coal remains extremely competitive, unless there is a global price put on carbon, coal is going to remain extremely competitive against LNG, against pipeline gas, against oil, and in many cases against renewables for far into the future.

MR. POLLACK: That's a very relevant point. I don't like hearing myself echo in my ear here. There was another implication -- I thought I might draw you out, Charlie, before and you raised it a bit about the tradeoffs between food stamps and aircraft carriers, which is kind of an unusual characterization. But it would seem to me that the logic of what you lay out is that America's traditional role in sea lane security will persist in one form or another, but the imperative of that may look somewhat different; whereas for China, this becomes much more of an operative consideration now. Frankly, this is not something necessarily that ought to cause great vexation except maybe in some quarters of our defense establishment.

But it's not intrinsically the case that, for example, if you argue that China plays a larger role here that this is at cross purposes to the United States. Quite the contrary. But it does seem to me inexorable as you look at China both having a growing array of maritime interests even, if you will, in a global context that its efforts in these areas will increase even as, as you also point out, that because of developments in Central Asia and the like, it's not as if China makes a choice. China does both. And I think that's a very, very important strategic implication to keep in mind.

I'd like to open it up to the audience. I'm sure there are lots of questions here. I see a hand right here from Mr. CNN.

SPEAKER: Wrong network, PBS.

MR. POLLACK: Oh, PBS. I'm sorry.

SPEAKER: Quite different.

MR. POLLACK: Very different.

SPEAKER: But following up on your question, the implications of what Dr. Lieberthal said, and this is really for Minister Zhang. In addition to a military buildup, and there are a lot of people in the United States that are already nervous about what China's doing in that area already. If you're going to get involved securing the Middle East, the history of both the British and the Americans is that that runs directly counter to a fundamental Chinese principle of non-interference in internal affairs. The history of the Brits and the Americans in the Middle East is very heavy involvement in the internal affairs of Middle Eastern countries. So can China take this expanded role in securing its Middle East oil supplies without violating this basic principle of Chinese foreign policy?

MR. LIEBERTHAL: You have to speak for the 1.4 billion Chinese people.

MR. POLLACK: And I will comment on your answer.

MR. ZHANG: I think, as we mentioned earlier, China also has imported a lot more than ten years ago, but I would also like to give you another number. The dependency of China on foreign energy is still quite low if we compare ourselves to the United States. I said that the energy independence of the United States has gone up to 81 percent. China on their reliance on foreign energy is only 10 percent. You think I'm making up this story, but go back and look at the data and you can tell that I am telling the truth. You know why? Because we only import crude oil, and then now in recent years we also import about 40 billion tons of natural gas, only lately. But coal is still our primary fuel that can be produced within China. And so we did import 5 million tons compared to the 60 billion tons that we already produce, that's nothing. So maybe people want to sell to China, not that we need it, but then you can get good prices here. So I think our coal accounts for 69 percent of our primary energy consumption. So power generation relies on 83 percent, relies on coal, now it's 78 percent.

And I would like to give you another number. I think most of you do not know this number. Last year the power generated from renewable energy has already accounted for 23 percent. What renewable energy means? Water, solar, and also wind energy. Now solar is very limited, but water, hydro, and then also wind, which is now the third largest energy source for us. I think a lot of people don't know that. Now wind energy is our third source of energy in China, but most people do not know last year you know how much power? Over 10 billion kilowatts, 10.4, 104 billion kilowatt hours. That is from wind energy alone. So there is more power generated from wind energy than from nuclear energy. So we also have hydro energy and then we also have some biomass energy and this renewable energy has already been accounted for, 23 percent of power generation in China.

A few years ago when I came to California beaches, I saw a lot of windmills. That was something that we never saw in China before, but now we see that installed capacity has now exceeded 63 million kilowatt hours. So I think that this kind of development is going to pick up speed. And the big difference between us and the United States is that nuclear energy accounts for 15 percent of the power generation. For China it's only 2 percent. So if we can raise the 2 percent to 8 percent, then we are going to depend less on foreign energy.

So what I want to say is that we don't really need to send our naval fleets to protect our sea lanes. I think that's still a long, long way to go. Why don't the Americans do the job for now?

MR. LIEBERTHAL: I think the question was about the Middle East, and I think Mr. Zhang gave a very accurate portrayal of the electricity sector in China, power generation sector. But when you look to the Middle East in China, you're talking about transportation and petrochemicals, things other than power generation, and there the dependence is growing very rapidly. And you see that reflected in China's own activities in the Middle East.

I have had fun in the last six months or so when I have talked with Chinese colleagues in Beijing and elsewhere, teaching them a new term that even the best English speakers trained in China tend not to know. I'm sure Americans will know what I'm talking about. It's the term "tar baby," and the Middle East is a tar baby. We have found that. Everyone who has participated in the Middle East has found the Middle East to be a tar baby. I see everyone of Chinese background here sitting here saying what is he talking about? So I'll describe very briefly what a tar baby is. You know, tar is blacktop on streets. If it's warm, it gets a little softer and stickier. Tar baby is this story about a -- basically it looks like a snowman, but it's made out of tar.

Well, fundamentally you get involved in the Middle East. You always think you can get involved and make an impact and then pull out, and you find you can't pull out. You simply get more involved, and you have even more trouble pulling out. And China is now sufficiently engaged, whether it's in Iran or Saudi Arabia and in other parts of the Middle East, that it cannot sit back and simply articulate principles of non-interference in internal affairs. It's getting drawn into internal affairs, and it has kicked the tar baby. And so that's why I say that the U.S. and China and others need to cooperate a lot more than we have in order to maximize the chances of outcomes in the Middle East that we can all live with.

MR. POLLACK: Thank you, Ken.

MR. ZHANG: Let me give you another number because we talk about the dependency of the United States on the Middle East. It's going up instead of coming down even though overall dependency on foreign energy is going down. But your dependency on the Middle East is still up. So here's the data. In 2001 the U.S. imported over 2 million barrels a day from the Middle East -- that's 2001 -- which accounts for 22.8 percent of your imported oil from the world, but this number has gone down. By the year 2009, it hit the bottom. You only imported over 1.6 million barrels a day from that region, which only accounts for 13.99 percent of your overall energy imported. But in 2010, you imported more from the Middle East again, almost 2.7 million barrels a day again. So again, it accounts for 20 percent of your imported energy from the world, but you import less from Africa and South America. So when someone asks a question, I think you the Americans should continue to protect the sea lanes; otherwise you are not going to make up for that 20 percent.

MR. POLLACK: Let's turn to more questions in the audience. There's a question right there. Can you wait for the microphone?

SPEAKER: Thank you very much for your remarks. It's very enlightening and the next question --

MR. POLLACK: I'm sorry, your identification was what?

SPEAKER: I'm Michael Collopy, ICCI.

MR. POLLACK: Okay.

SPEAKER: Given the changing, really tectonic shifts in balance of energy usage in the economies you've described, how will these changes perhaps mitigate the tangents in the competition for resources in the South China Sea, such as in the Palawan Straits and elsewhere?

MR. POLLACK: Is that directed at anyone in particular?

SPEAKER: No.

MR. POLLACK: You want to make -- go ahead.

MR. LIEBERTHAL: I'll make an initial comment about it. One I think, while the level of tension they have been informed in part by visions of undersea resources in contested areas, there is also a strong component of simple nationalism involved here. We're talking about sovereignty over maritime jurisdictions and sovereignty issues are never easy to resolve.

In terms of what the undersea resources are, there was actually a recent study done by a United States entity -- I've forgotten which one right now -- that concluded that, in fact, there are very few recoverable reserves of energy in these contested areas in the South China Sea. I think the reality is because they are contested, they've never been fully explored and so no one really knows. So different people will have their own images. But I would not count on -- I think the image of those resources has perhaps fed some of the fervor over this, but the fervor having been ignited, I don't think it will disappear as resource estimates change because I think that there's a strong nationalist and emotional dimension to this now that will not easily be set aside.

MR. POLLACK: Very good. Other questions? Yes, the gentleman there, waving his hand.

SPEAKER: Thank you. When Secretary Kerry made his visit to Tokyo, he made a speech in Tokyo University, and he put a lot of attention to the energy issue and the climate change. And he said that our energy policy could be part of the climate change solution. And he also mentioned that China ten years ago just invested US$1 million in United States energy sector, but last year increased to US$9 billion. So he seems to be attaching more importance on U.S.-China energy cooperation, but I'm wondering what is the major obstacle between the two countries that needs to be overcome? What practical recommendation would you like to make to Obama Administration? Thank you -- for both Mr. Lieberthal and Mr. Zhang. Thank you.

MR. ZHANG: Let me take on this first -- I don't think I can hide away from this question. Actually I already said this earlier. China and U.S. are the two largest energy producing and consuming countries, but we invested very little in the energy sector. This morning I gave a number. Last year among the foreign investments, only like 0.5 went to China, which is a very small amount of the overall foreign investments. Someone mentioned 3 percent, which is still very small, but I think it's 0.5.

So the two countries should have a lot of space for further investment and cooperation. As you said, a lot of private companies recently made investments, but they were not taken note by the media. And you know that these companies did their work on the investment very quietly. They had already invested in solar energy, in wind energy, and other types of energy. But because it's a small amount and they have done so quietly, nobody is paying any attention.

Actually we can put in more investment in this sector. For example, CNOOC acquired Nexen for US$15 billion and most of the

Nexen assets were in the United States and the United States approved it and that's why there's a deal striking between China and Canada. And in the past when CNOOC tried to acquire Unocal, we did not have the same results. So if both sides understand each other better and do not allow the ideologies to affect our cooperation, then I believe that our two countries have a lot to do in the future together.

MR. LIEBERTHAL: Maybe two points to it because I think the potential for U.S.-China energy cooperation is enormous, and that potential has only begun to be acted on. If you look at what has constrained it in the past, a couple of the problems on the American side have been very sharp restrictions that China applies to foreign direct participation in energy exploitation in China. I mean it's just not a very open sector.

And secondly, major concerns about protection of intellectual property rights in technology, and we've had issues there in the wind sector, in solar, almost across the board. So I think those things can be addressed and are being addressed, but those have been constraining elements to this point.

I think one of the big stories that should have come out of the Kerry visit to Asia -- remember he spent 24 hours in China and basically a day in South Korea and a day in Japan. The China visit, the American reporting on it, was 99.9 percent North Korea. But, in fact, if you look at it, the U.S. and China issued a joint statement during the Kerry visit on cooperation on climate change. And it was a statement that two years ago no one could have imagined. This was forward looking. It was detailed. It was scientifically sound. We are now establishing a working group to build toward the strategic and economic dialogue that raises the climate change issue to ministerial level consideration in an ongoing process. This is a different world out there now, and it shows in part the way the media works that no one bothered to mention it. But it may be one of the more important long-terms things that came out of the visit.

MR. ZHANG: Let me add to that. In the energy sector, if we cooperate, two countries will enjoy wind. If we have conflicts in energy sector, then we're going to lose both ways. Take solar energy, for example. Some American businesses said that they actually want to invest in the export of solar energy products by Chinese companies. There is a group of other American businesses who actually are opposed to raising tariffs on the Chinese exports. Of course, the whole incident ended with the rise of tariffs by the United States.

There's another issue I'm not sure whether the media has paid enough attention. In terms of the materials like silicone, I mean that actually China imported 40 tons of it from three vendors. One is from the

American company. One is a German company. The third vendor is a company from South Korea. There is only a little bit from Dow Corning, an American business that exported 20 tons of silicone to China. But because of the investigation, our solar industry in China actually talks about whether there is this dumping of the silicone by American businesses, and the Chinese government hasn't started yet. But once the investigation starts, there will be a stop of imports. So Dow Corning, actually the CEO, visited China and he complained to me that the export to China has come down to almost zero. So wouldn't that be a loss to the United States? I believe the ultimate loss actually is suffered by the clean energy industry if we have a trade war.

MR. POLLACK: We only have time for one or two more questions, so the woman right here, please. And I apologize that we'll have to avoid giving everyone a chance to ask questions, but we're on a very tight schedule.

SPEAKER: My name is Mary Burdman from *Executive Intelligence Review*. Dr. Lieberthal brought up the question of water and this is in my understanding an enormously important issue in China. Professor Biswas recently of one of the world-leading international water institutes said China may have two decades to solve this question.

And what I wanted to raise is the issue of the development of energy in China. Not only does gas extraction and coal, of course, use enormous amounts of water, but the amount of energy that would have to be allocated to something like desalination projects and so forth. To what degree is this being factored in because I've done some research on the North-South water project? I mean the amount of pollution and cleaning up the polluted water, these are all energy-intensive but absolutely vital projects for China's future. And I'd just like to know to what degree this is being factored into China's energy projections.

MR. POLLACK: Mr. Zhang, I think that would be yours.

MR. ZHANG: The question you raise is actually a concern of China. This is a serious problem faced by China because China actually lacks water resources in a lot of the region, especially in the western region where there has always been a shortage of water and there are also some coastal areas. And shale gas is an excellent idea; well, of course, the extraction of it will consume a lot of water. You need to have high-pressure water actually to put the water deeper into the ground. Would that actually increase pollution? Would that actually cause earthquakes and everything? It is a controversial issue. However, we do not have lack for capital water resources compared with the United States. When you do the shale gas, China actually will have to solve the issue of water because that will be the key issue to whether China can actually tap shale gas.

The forum actually was visited by a lot of American companies. Their representatives had a roundtable discussion, and I gave a talk at the table. I said maybe I'm not an expert. If I make a proposal, don't laugh at me. Dr. Lieberthal who talks about CCS, so the carbon sequestration. So if you actually put the carbon dioxide that deep into the ground, can you actually make it into water? So after I put forward the proposal, some experts both from China and the United States thought it not like I'm telling a story of *Arabian Nights*. The issue needs further exploration. There's another CEO from a Chinese company that also agrees with me because you make so much effort to sequestrate and actually all the carbon dioxide deep into the ground. Why don't you convert it into water? You need over ten units of pressure to do it, and if you make it into water you need 33.

MR. POLLACK: Go ahead.

MR. EBINGER: China obviously has an acute water problem, but one of the biggest problems that may loom in the future is the amount of energy China needs to use to move water from where it isn't to where it needs to be.

But the other problem I think China has to be very sensitive to is that in the course of solving its own water problems, it doesn't create more problems for its neighbors. Because the diversion of waters from the Tibetan Plateau is desperately threatening the subcontinent's water supply. And you can make projections that in 20 years the whole subcontinent has a dire water crisis.

And likewise when we see some of the problems that have arisen with some of the plans to construct dams on Myanmar's territory adjoining China and the problems that has created with ethnic strife inside Myanmar. I'm just saying as part of your overall water solution, you may engage in a little bit of water diplomacy as well.

MR. POLLACK: One last comment from Ken and then we'll have to wrap up.

MR. LIEBERTHAL: Just to highlight the ongoing theme of climate change in this. Climate change is dramatically worsening China's water problems. It's worsening it in three ways. One it is melting the glaciers on the high Tibetan Plateau, which is the water tower of Asia for parts of South Asia or for most of Southeast Asia and for all of China. So as those glaciers melt, this vast system is being thrown into a future of great uncertainty.

Secondly, sea levels are rising. Shanghai is at sea level. Other major Chinese economic centers are at sea level or very near it. And thirdly, North China is drying out. You put that combination together and you've got yourself a huge crisis that continues to build in future years. It's probably the biggest single crisis that China faces going forward.

MR. POLLACK: A sobering set of comments I must say, Ken. Your use of the term sequestration today reminds us that maybe it has a good context as well if we can do something about it.

MR. LIEBERTHAL: Well, our sequestration problem is minor by comparison.

MR. POLLACK: Indeed, indeed. Please give all of our panelists a round of applause; an excellent panel. We have to change quickly and then bring a new set of panelists on the stage. If I could encourage the next set of panelists to come up on the stage.

(Recess)

DR. ZHOU: (in progress) -- the council. So, it fell through the cracks, as far as attention being paid to it is concerned. But I think it's really important, because we're talking about the reform of the government structure, and it looked at the constitution of China, and, also the organization law, the state council, to issue this paper.

Mr. Xi Jinping and, also, Premier Li Keqiang -- after they came to office, and after they participate in an 18th conference, he said that we all need to abide by the constitution of a country.

This is something new and refreshing, because, in the past, when we have a new government coming to office, no one would remind you that you need to abide by the constitution. And this is the first time we've heard of it.

And then next, it also talks about we need to execute democratic decision making, and, also, we need to make government affairs more transparent and more public, because, in the past, a lot of decisions were made after different agencies talk to each other. But now they have to make those decisions, and the process of reaching that decision to be open to the public.

And then it also says that we need to accept the oversight of the NPC and its standing committee, and, also, obviously, PPPC and People's Court.

And so they need to accept the oversight of these organizations, and, also, abide by and comply with the legal effective judgments of the People's Court.

I think this is showing us that the NCP -- or National People's Congress -- and the government, through the legislature -- we're looking at a kind of check-and-balance between these three different arms of the government.

Now, judging from the 18th Congress and, also, the Second Plenary -- and according to the working rules set out by the Premier and his state council, we can see that this is hoping that this will push forward, propel the government-related political restructuring. In other words, you need to work -- administer within the framework of the constitution.

And you need to, also, have to formulate a check-and-balance system or mechanism among the three different arms of the government. This will also help advanced democratic decision making, and make our own affairs more public, and, also, you would delegate more power to NGOs that include, like, associations, and chambers, and so on, so forth.

So, I think the 18th Congress and the Second Plenary have produced these documents that will push forward a political reform. I guess this would at least give them some ideas as to how to do it.

For example, ask them that they would do all this -- administer within the framework of the constitution, which is -- I think it's very important.

During this 18th Congress, we are not looking only at the big picture; we're also looking at details, for example, and the next Plenary, for example. During the Third Plenary, you can see them fine-tuning this framework they have set out or laid down for us during the First or Second Plenary.

Also, the emphasis is now placed on transferring government functions. In other words, they have the separate enterprise public services and to -- well, he flipped it too quickly.

Anyway, so then they also need to supervise more food safety and, also, on pollution.

Premier Li Keqiang placed emphasis on this, and it's also being incorporated into the working report -- that we need to cut down on the number of departments and, also, employees, and a budget. So, it's kind of a natural -- in other words, they also want to control the institution as a person, in terms of budget.

Our budget was basically within the range of $17 trillion to about $18 trillion, which accounts for about 35 percent of our GDP -- so meaning that a lot of things are not accounted for in the budget, because in the past, we had these documents. We could say, "You cannot take this kind of sedan. You cannot eat lavishly," and so on, and so forth, but we cannot control the officers, because we did not actually do something with the budget.

And, therefore, you can issue a lot of papers and orders telling people not to do this and that, but then if the budget's there, then they can continue to do it. So, now, if you control or restrict the budget, then I think it will become more effective, and it will also try to slow the growth rate of government revenue.

New Minister of Finance said that, you know, a bigger tax revenue is not necessarily a big thing, because, I think, in the U.S., if your revenue's bigger than the budget, then it may be termed as illegal.

So, this time, we also have the same tone. We say that too big revenue may not necessarily be a good thing. So, we also talk about cutting the scale on administrative expenses, gradually rationalize it in the budget, because we have a lot of administrative expenses. So, that, we need to cut down, as well. And, also, we need to publicize the income expenditure of government, and make it under the review of the NPC.

I'm glad someone is reminding me -- I have two minutes left.

And then, also, we need to address and reform the relationship between the central governments and local authorities. We need to enlarge -- or give more power -- to local governments, and delegate power to the counties. We also need to reduce interferences of the ministries in local governments, in approval (inaudible) we want to hit the target over the kind of orders or instructions that we give, and then so there's kind of things that we're just trying to get results. And so there's a lot of interferences.

Now we say that we have to reduce the number of administrative approval from 82 cases to even less.

And then, also, we need to draw a clear line demarcation between central and local government authorities, public service authorities. In the past, the line is very, very blurred.

And we also set up a stable tax mechanism for local governments. So, all these transfer payments are very messy, because we don't see very clear lines of demarcations.

I'm given a very short time, so this is all I can -- I don't have time to elaborate.

Thank you.

MR. WANG: Well, thank you, Professor Zhou, for giving this description of the reform agenda, as just announced after the new People's Congress.

When we come back -- actually, I would like to ask both you and other panelists to think about -- given that the title of this panel is "Challenges to Implementing Reform," I would ask you to address further, what are the challenges, actually, to re-implement this reform agenda?

So, later on, Professor Zhou, I would ask you and others to actually comment more on how these goals can be achieved. What are the challenges to achieve these goals?

So, now, let's move to the second speaker, Professor Cai Fang, from the Chinese Academy of Social Sciences.

DR. CAI: In addition to reform, another word -- magic word -- you have to think about, if you talk about China, is population. So, I'm going to talk about the demographic transition and social issues -- also, with the implications to the economic growth.

First of all, we are reaching a turning point. Let's see. If you remember, in the past so many years, the Chinese leaders always wanted to keep at least eight percent annual growth rate of GDP. But last year -- actually, at least the central government didn't try very hard to maintain eight percent. Actually, last year, it was only 7.8 percent.

At the same time, the significantly reduced GDP growth rate didn't cause very significant unemployment issue or employment pressure. The urban registered unemployment rate was only 4.1 percent. This is registered unemployment rate. And, also, the wage rate (inaudible) for the unskilled workers continued to increase. The job supply and demand ratio remained at high, above 100 percent. That is, there are more jobs created than more new entrants who wanted jobs. So, this is a year of significance.

So, what happened, that we shift to the demographic transition? In the past, over 30 years, along with the fast economic growth, there has been a tremendous decline of fertility rate. So, you can see this. Currently, the total fertility rate in China is about a 1.4. It is lower than the average of developed countries -- about the same as in Japan.

So, as a result of the demographic transition, we will have a different structure of population -- particularly in terms of age.

A few years ago, in China, people debate about whether or not China arrives at a lowest turning point. That is the point at which the labor shortage appears, and the wage rate for unskilled workers increases.

But if you debate about this phenomenon in Japan -- say you have at least 30 years to debate about whether or not the turning point comes -- until you run out demographic dividend. But in Korea, you can do it within 40 years.

But in China -- first of all, you know, the labor shortage appears in 2004. And at the beginning, it was a phenomenon in the coastal areas. And afterwards, it widely spread to nationwide.

Since then, the growth rate of, say, migrant workers' wages has been at least 13 percent per year, in real term.

And then you haven't finished the discussion about the turning point. The working age population -- that is, the population aged between 15 and 59 -- stopped increasing in 2010. And last year, and the year before last year, the working age population were a negative growth.

So, if we consider the lowest turning point as a turning period, we finished the period. So, we don't need to debate it anymore.

And, as a result -- because in the past 30 years, we have benefitted from a demographic dividend -- that all the population factors fueled the fast economic growth in capital accumulation, in supply of labor, supply of human capital, or the total factor of productivity improvement.

In that case, if we run out the demographic dividend, we will face lower growth.

First of all, you know, in the future, labor supply will be negative, given the labor force participation rate. And we suppose the total factor productivity will continue the same trend as it was previously.

And then the growth rate of investments were relatively slower, because, in the past, it was too fast -- average annual growth rate of investment was something like 16 percent. But in the future, we assume it's lower -- at 13 percent. But I believe if we can reduce it further, that would be more balanced economic goals. With all these assumptions, we can estimate the potential GDP growth rate for the future.

So, in the 11 five-year plan period, the potential GDP growth rate was 10.5 percent. It will decline to 7.2 percent in the 12 -- the current five-year plan period. And a further decline to 6.1 percent in 13's five-year plan period. That is, you know, I think a conservative estimation of the potential GDP growth.

So, this is how the demographic transition changed the future growth rate of the Chinese economy.

And so we didn't see unemployment problem when the growth rate declined, but that means the labor market is tight. But the labor force is still vulnerable, which will result in social issues in the future -- in very near future.

First of all, let's see -- who are the vulnerable in the labor market? Remember, I mentioned the urban registered unemployment rate was 4.1 percent last year. But in the past almost 10 years, it's about 4.1.

At the same time, if you estimate the natural unemployment rate, it's about the same. That's the pink line. So, that means, you know, the unemployment registration is only applied to the urban resident, with the local hukou. That means the urban resident with local hukou suffered that natural unemployment, but they don't have a problem with cyclical unemployment.

Who are those people, who suffer cyclical unemployment? The migrant workers -- every time, when the economy booms, they come to the cities, and they find jobs easily. And when the crisis hit, they were forced to go back to their home villages. So, they are not necessarily counted as unemployment people, but they actually lose jobs when the economy goes up and down.

So, this is two different groups.

So, what's the composition of urban labor force? Totally in the urban labor market, about 1/3 is migrant workers, who live and work in urban areas, but they don't have a local hukou. 2/3 are people who have local hukou.

In terms of the increments -- that is, incremental amount in labor market of urban areas in 2011 -- 2/3 of the new entrants are migrant workers in urban labor market. So, they are very significant.

And why we need labor from rural areas? Because they have a totally different demographic characteristics. You know, you'll see. We draw the map, putting the urban hukou residents on the left, and the urban non- hukou migrants on the right. You can see it. They have significantly different characteristics of a population. So, that is the new entrant -- mainly dependent of migrant workers.

So, that's the two groups in urban labor market.

So, for the urban people -- because in China we have this phenomenon -- that is, as the ages go up, the education, the years of schooling go down, very dramatically. That is their picture, describing the urban residents.

So, therefore, if somebody -- you know, in China, there is a widespread debate about whether or not we should postpone the retirement age as a labor shortage appears. But, you know, when people reach their 40s or 50s, they actually have a very low education attainment. They are very vulnerable. They couldn't find a job, actually. So, this is the problem with the urban hukou labor force.

At the same time -- let's see. This is what the migrant workers look like. Currently, more than 60 percent of migrant workers are so-called new generation. That is, they were born after 1980. So, they are younger than 30 years old. But these people -- actually, you know, if you ask them -- actually, we have done surveys by asking some questions.

One is, where did you live before 16 years old? 1/3 of them actually lived in urban areas; even though you'll call them (inaudible), they are not.

And if you ask, where did you go to primary school? 38 percent answer by saying, "I went to primary school in urban areas." So, that's the totally new profile of migrant workers.

And these workers, because the labor market is tight -- therefore, there is a convergence in wage rates between the skilled and the unskilled workers. That is, unskilled workers tend to earn more money. They have seen faster growth in their wage rate.

Therefore, there are some negative incentives for migrant workers to stay at school. They quickly move to the labor market after graduation from junior high school -- and even they drop out during their junior high school.

But in the future, the industrial structure change, where put them in a further vulnerable position. You'll see currently, the average years of schooling for migrant workers is 9.6 years. They are quite suitable to the labor-intensive secondary sector that requires nine years' schooling. And quite good for the labor-intensive tertiary sector that requires exactly 9.6 years' education.

But if, in the future, the capital-intensive secondary or technology-intensive tertiary sectors expand, they were not fit for these new jobs. In the late 1990s, we have had a problem with the older workers who have much lower education. We were seeing the same situation, at much younger ages.

And, also, migrant workers -- only because they don't have a local hukou, they are poorly covered by the social insurance programs -- the five major programs.

And this is an indication how they attempt to involve in labor disputes. 2008 is something like a legislation effect, but the general train is increased of labor disputes.

So, I think I will have time to discuss about the reform, so I stop here.

Thank you.

MR. WANG: Thank you, Professor Cai Fang. Our last panelist for this whole day -- and, also, of course, for this panel -- is Professor Wang Jisi, and he'll have the floor to address whatever reform issues he chooses to do.

But afterwards, we're going to have all three panelists up on the stage, and then we can further discuss reform issues. Okay.

Professor Wang, please.

DR. WANG: Thank you very much. I'm the last speaker, but I don't want to take too much time, because I would like to leave enough time for general discussion.

But I don't know what reform is. So, the topic of this panel is how to implement reform. And I'm a scholar, and I'm an administrator at a school. So, I'm thinking about what reform measures I'm faced with. I don't see reform. I see a lot of changes.

Wang Feng just raised the question of, what is reform? So, I start from here. That is, what is reform? And I'm studying international politics. And I linked China's reform to international issues. This is what I can do. That is, from the -- you know, we talked reform and opening.

When China first introduced reform measures, it was the late 1970s/early 1990s. And the world at that time was very different from what we see today. There's this Mrs. Thatcher in Britain, President Reagan, United States. The world was turning to the right -- if the right description is the right. I mean, the United States is a right nation, we say.

And, at the time, the reform was aimed at that direction. We saw the direction there, if I'm not politically incorrect. That is, the world is moving into that direction, and China, in the path, was into a different direction. So, China needed reform at that time.

So, the first target -- the four little dragons: South Korea, Taiwan, Hong Kong, and Singapore. And then the next target at that time, to some leading economists I know in China, they said that the next target would be Japan. And the ultimate destination would be the United States.

But today, the four little dragons are far behind, in terms of the size of their economy, and even the efficiency is not very impressive. And then Japan -- we bypassed Japan. And the next target, the United States -- but the United States is not in very good shape.

So, what is the target? What is the destination of reform? And that is the question. And as an intellectual, I pose the question to you.

And the world we see today in China is debatable, because some people say, this is still the world we saw 30 years ago. That is, this is not dominated by Western countries.

And we see this international economic order is somewhat intact, even after the financial crisis, even after September 11, and the United States is still the leading power. So, this is one view, but people don't say that very directly.

Another view we can hear very frequently in China today -- that is, the world is changing so rapidly -- and the United States is no longer the leading power; it is declining, and other countries are rising up. The BRICs and newly-emerging countries are rising up.

So, we don't accept this existing international order as we said we would in the past. And, although at that time, we didn't say we accept the international order, but we said, you know, we could do some reform.

So, this is the larger background of reform. But this reform is different from the reform 10 years ago or 20 years ago we were talking about that time. That is my understanding of reform.

Listening to Professor Zhou Tianyong very carefully, I sensed some direction there. That is, more transparent government, less role of the governed in society and the economy. But I do not know whether I am entirely correct in saying so, because in my real life -- where I'm an educator -- I see a stronger role of the government in my academic work, in the sources of income, in the sources of financial support -- you know, schools and so on.

So, this is another challenge -- to put myself into another topic -- that is, whether we should do some reform in China's diplomacy.

I had some contests with China's diplomats. They say, "Well, diplomacy's not exactly foreign relations, because diplomacy's between government and government. We are very strong in diplomacy. Our diplomats are very able, and they speak different languages, and so on." But the foreign relations are not in very good shape, according to some diplomats.

So, we have to improve our decision making processes. Many people know that. That is how to better coordinate among different government agencies -- the military, the foreign affairs bureaus, big enterprises, ocean administration, and, you know, intelligence organizations -- a lot of organizations. Government agents are involved in foreign policy.

So, we need to do some reform on whatever changes to improve the coordination -- and this is not the reform we are really talking about -- that is, to reduce the role of the government; actually, we are going to strengthen the role of the government in that regard.

Another slogan, another concept is public diplomacy. And, still, I don't know very much about public diplomacy, because we talk very much, but I don't know whether this -- between the Chinese government and foreign governments, including NGOs -- and whether this is also more about foreign affairs agencies with the people -- not only abroad, but people in China.

If the latter is true, then we should listen more to the Chinese people, who are asking for a more assertive Chinese foreign policy, rather than the more moderate one.

And so this is a state society relationship, and China is, you know, in my analogy of state society relations -- you know, this is not the political science understanding, but in my study of U.S./China relations -- China is a state, and then our state's a society. And we are not very able to deal with a society as large as this. And this applies to the whole world.

Now China is faced with immense challenges around the world -- not only from foreign governments -- African and Latin American -- but more from global society. And that goes to soft power, and we talk a lot about soft power. Is soft power generated from the state, from the government, or is it all related to society? And that is a big challenge.

And so I'm putting forward some questions, rather than your answers. And listening to the previous speakers today, I'm really puzzled.

The conclusion of my listening to the first panel is, China's overseas investment is expanding.

And the second panel, the impression that I had was, Chinese banks are profitable.

And the third panel, I didn't listen to the full, but I think Mr. Zhang Guobao was very eloquently telling us that we don't have too much problem with that. You have a lot of problem. You can correct, though, your mistakes or your misunderstandings of China. Then we are in a better position. Although I know he is very strongly promoting reform in China, but I think, you know, the question is also yours.

So, finally, the steward -- I have the question about the destination or the purpose of reform, rather than specific answers. It's because I'm an intellectual; I'm not very practical. So, sorry for the very intellectual and very abstract questions to you.

Thank you.

Mr. WANG: Thank you, Professor Wang Jisi, for raising those hard questions. I think we'll try to answer some of those in the remaining time we have.

Now may I invite you to come up to the stage? And I think we need to be connected with right mic.

All right. So, we have about the last half-hour to both, I think, discuss the subject of this particular panel, and for the whole day, I suppose.

Now each of the panelists has had time to address the specific topics they choose to do. I still have a number of questions, but I would not give you time to make speeches instead. But instead, I will raise these questions, and I'll ask audience to raise questions, and, hopefully, some of the questions would be the same, and then you can address these.

I think, as Professor Wang Jisi, just raised, the question is, when we talk about the reforms now, what do they mean, and where are we going? What are the purposes of reforms, right?

Clearly, this has been a term that's been used to cover everything under the sun in China for the last 30 years and more, and then the content of the reform actually has been an evolving project.

So, what are we talking about at this particular time point? That's number one question, I think. Later on, we'd like to have more focus.

The second question I would raise is, what do you think are the most important reforms in your mind?

And then third one is in what order those reforms should be carried out.

And then the last one is, what challenges or the difficulties in implementing one or more of the reforms that are high on your agenda?

So, we heard about government reforms from Professor Zhou Tianyong, and Professor Cai Fang's talk certainly mentioned household registration system, rural urban migration, and Professor Wang Jisi's remarks involved state, and society, and China, and the world.

So, clearly, these are some of the themes we want to address. But I would not give you time right now to do so, because, otherwise, we'll only have time to entertain questions.

So, I will open the floor. Okay. So, yeah, over there.

MR. JONES: Yeah, Bill Jones, EIR. Professor Cai, I'd like to ask you a little bit about the much-discussed hukou reform. There's been a lot of demands about this. This has been debated back and forth.

I was wondering, what effect would it have on the employment situation, either positively or negatively, if there were a serious reform of the hukou?

And in terms of the employment situation and the unemployment situation, how is this reflected regionally?

Of course, there's been an attempt now for debate in the

Western countries. There's been a lot of activity, industrial activity, that's been located more centrally, rather than on the coast. How has that developed over the last few years, and how is it reflected in unemployment regionally, coast versus the central areas?

MR. WANG: Who wants to -- sure.

MR. CAI: Yeah, I think, first of all, I want to combine your question with Wang Feng's. Number one reform for me is hukou reform, because I talked about the potential GDP decline in the field trip.

But we should think, should we see the declining GDP growth? We shouldn't. We don't do something like stimulation or industrial policies to stimulate the mine site things, but, actually, we can increase the potential growth rate from supply side.

Actually, we have simulated one effect -- that is, if you increase labor force participation rates by one percentage point every year, it will, in 2011 and 2020, have almost one percentage point GDP growth during the period.

Another simulation is if you increase one percentage point total effect of productivity during this period, you'll gain the same percentage point of potential GDP growth rate.

So, if we have the hukou reform -- first of all, we will have a larger supply of labor force, because, you know, the total working age of population declines. So, if you want to increase labor supply, the only way you can do it is to increase the labor force participation rate.

But with other hukou, the migrant workers expect to go back to their home villages. Therefore, in most cases, they quit from urban labor market at about 40 years old. So, you lost 20 years of labor supply.

And, also, if you continue to support the labor mobility from low-productivity agricultural sector to high-productivity sector in urban areas, you will continue to gain the (inaudible). That is, total effect, a productivity gain. So, that's very important reform -- something is about the regional part in change.

I think that in the past -- let's say 10 years -- we have seen three kinds of rebalancing among regions. First of all, the central government implemented, government-wise, the strategy -- that is, allocating more infrastructure constructions, with government-led investment in the central and the western regions. So, we can see a very significant effect, actually.

Secondly, the western areas are resource-abundant areas. Therefore, a lot of state-owned enterprises invest heavily in those areas. That's generally GDP growth.

But, basically, those projects are not labor-intensive. They didn't absorb much employment. But in various areas, you can see there's so-called "flying peas" effect. That is, the labor-intensive manufacturing tends to shift from coastal to inland areas. That's actually very good for absorbing the local migrant workers.

Currently, actually, the older migrant workers who used to work in the coastal areas are now being employed locally -- maybe at the same company.

So, that's what my observation is.

MR. WANG: Okay -- this gentleman over here.

MR. SHIN: Hi. My name's Richard Shin. I'm with the Economists Incorporated. I'm an economist by training.

You talked about maybe purpose for reform. I mean, obviously, depending on the country's status, you could have different types of reform. I mean, do you want to maintain power, like North Korea's doing -- try to fight for your existence, or are you trying to make your population be happy by having stable growth in the economy, do you project your power in the world?

There are a lot of different types of issues that are involved, and the different reforms would match the goals that you would have for your government and your people.

So, you know, I think you put a very nice touch by saying, you know, what are the reforms that's needed, and what is the order that's needed in China? And I'll let the experts answer that.

My question, really, comes down to rule of law and predictability. So, for example, if China wants to develop and have foreigners come in and invest -- and this is true also for Chinese companies -- the foreigners have to have an environment in which there's a predictability in their business. That is, you know, what is the regulation? Is the regulation ad hoc, or is there a rule of reason there, that you know if you do certain actions, that you will thrive in your business?

And if some, you know, dispute occurs, is there a very reasonable rule of law that's in existence that will allow adjudication of those disputes?

And I was wondering, you know, what is the state of that type of situation in China, and whether or not there's a reform needed in that part.

MR. WANG: Okay. Well, actually, there are two sets of -- kind of two sides of this question about rule of law. One is the examples you try to allude to -- meaning, with foreign companies, with foreigners, the others, really, with the rights of the people within China. I think both are quite important.

I don't know who would like to address this. Professor Zhou Tianyong, would you want to talk about rule of law?

DR. ZHOU: I think that the purpose of reform comes in many shapes and forms. I think there are three major ones. First, you want to keep the economic vibrancy to be sustainable, like what Premier Li said -- that you need to gain some reform dividends.

And then, also, you need to take care of the life of the people -- that they will have equality, they will be happy.

But if you look at it as a system, then I think the ultimate goal would be to build a modern country rule by law, and, also, with democracy.

I think if you want to talk about reform, I think these three aspects are quite important to make that reform happen.

I think there that are all kinds of proposals for reform in China. For example, when you talk about fiscal system or the financial system -- actually, in the year 2005, some ministries or departments have already proposed ways to reform. And in political reform, we also talk about in 2007.

But I think maybe because of all kind of objective reasons, even though we have had the proposals, we are still looking at how to implement.

We were not talking about how we should reform. I feel that, with its new administration coming to office -- and I really studied their speeches and their presentations, and have noticed that, for example, Xi Jinping, he proposed about China Dream.

So, everyone is saying, "What do you mean by 'China Dream'? What is China Dream?" And I couldn't sleep for the last few days, because I was trying to think, "What is China Dream?"

Someone said, "Well, why?" I said, "I can't make any dreams." So, they said, "Well, now that you are in America, aren't you having the American Dream now?" I said, "No, it's still a China Dream."

So, what I'm trying to say here is that the Chinese dream of a presidency has been quite cleverly elaborated by him. In the past, when we talk about Chinese dream, we talk about China being strong, but during these two important conferences, he defined the Chinese dream as to give opportunity to every individual in China -- that if you work hard, you will get there.

I think he's trying to marry the two different definitions of the Chinese dream because when you talk about individualism, you are looking at more like opportunities being provided by the state to the individuals.

For example, when you apply for business licenses and all that, all of these procedures have to be reform; otherwise, you will not be able to give what people want, even if you talk about the Chinese dream.

So, as I listen to him, I feel that he is kind of drafting a path for us to take as (inaudible) reform is concerned.

And Premier Li, in his speeches and remarks, talks about trying not to become more market-oriented, and to reduce approvals for all the business, and, also, to reform the business license and registration system. So, I think he meant to give access to people first.

SPEAKER: I believe that he means (inaudible) has to provide opportunities for our people. As long as you make efforts, there's a chance of success, and the state has to have the framework in place to ensure that people can do that. This is one point.

The other point is that the country actually has to have a modernized system. So, basically, I'm not sure whether their leaders actually -- they want to run the country where people don't have enough to eat; that cannot be possible.

However, because of the limitations for a lot of reasons -- maybe a lack of experience or a lack of knowledge about modernized concepts -- for example, take Deng Xiaoping and Mao Zedong, for example. There was a great difference between the two of them.

So, the Secretary General -- she and, also, Premier Li both expressed the will that they want the country to be modernized -- at least to move toward that direction.

However, during the process, there are difficulties and challenges. There would be interest groups that would probably try to deviate the reforms. So, that's why reform is a difficult task.

SPEAKER: Listen to the person who asked the question. He used the wording "rule of law." But in China, we don't have very much the distinction, at this moment, between the rule of law and rule by law. And what Professor Zhou Tianyong said in his presentation -- I think he emphasized the rule by law.

The government should rule the country by law, and the government should abide by the constitution and the laws, and there should be some kind of balance of power between the government, the judiciary part, and then the People's Congress.

But then the question I ask is, where's the Communist Party in this? So, the Communist Party is above the other three, right?

So, we go to the very basic question of, what is reform? And Professor (inaudible) just mentioned, we should establish a modern state. And to be a modern state is a state of rule of law, rather than rule by law.

But this has a long way to go, because I think maybe we should have the first stage of rule by law. You have your own laws, and then you act according to the laws. You, yourself, creates it.

And then, finally, we'll have that stage. It's my destination of reform. But this is not a very distinctive destination yet.

MR. WANG: Thank you. Professor (inaudible), do you want to add -- okay.

Let me take a question from this side -- this gentleman in the middle.

MR. ROBERTSON: Hi. Thank you. Fascinating discussion. My name is Matthew Robertson. I write for *the Epoch Times*.

My question is exactly on this question of the role of the Communist Party. Do you think that, in terms of reform and the challenges to reform -- is a challenge, an impediment, or is it something that's, you know, helping China reform?

And then, you know, secondly, does the reform that China needs -- does it require a modification of the leading role of the Communist Party, or any modification at all? If so, of what kind?

MR. WANG: Okay. Who would like to take on this question? Professor Zhou, you are with Central Party School. Would you?

DR. ZHOU: I think that if we talk about the reform in China, which started in 1978, it was initiated by the Communist Party itself, and the changes that we have seen the past three decades are huge.

So, if we talk about the political system in China, that's significantly different from what it was 30 years ago, and the change of that actually helped boost economic growth (inaudible) GDP in '97/'98 for China is 155. And right now, it's a lot more.

And there have been a lot of changes structurally. However, people tend to look at the problems. They tend to say, "Oh, the problems are really to the system." Maybe they're right. So, maybe the next three decades -- and, probably, we'll have an even more difficult task, in terms of carrying out reform.

My personal belief is that the reform rate will still have to be initiated and led by the Communist Party, because there is no other force available. The Communist Party has over 80 million members. I'm not talking about that every Party member all has the same view toward reform.

I mean, each member, you know, he talks about the interests of the country, the interests of the Party, and, also, their own interests.

So, they tend to have different views, which, I think, is normal. That's my second point.

The third one is that maybe the next stage of reform, like Premier Li Keqiang said -- that it will be like a career warrior, who has the courage to cut his own hand off.

I actually sensed in the report by Premier Wen Jiabao -- it was a political transition, but he did say that there has to be further reform, including the reform of political system.

So, I believe that -- I don't think the Chinese Com Party would be an obstacle, would be, like, impeding the reform itself. I don't think there is much possibility of that.

On the other hand, there are interest groups. For example, if you want to implement property taxes, those who have more properties will be opposed to it. And maybe a lot of them are Party members.

Another one is that if you want to carry out reform, you want to reform the state-owned enterprises, especially the big ones. Probably they have different views, because the ACOs or the higher executives of the state-owned enterprises are all Party members. They're appointed by the Party. So, it's complicated.

But what I'm thinking is that, you know, we have had some plans for reform, and all the plans are talking about reform, as led by the Communist Party. A lot of people criticize us. They talk about us like a constitution under the Party.

But I still hold the same view -- that, you know, we need to have a constitution, also, at the Party leadership, because, in China, if you want to have another, you know, political group significant enough to promote reform -- probably, you know, it's hard to say. However, the Communist Party has to view the situation in the right way -- how to lead a country on a path towards a modern country, with modern system.

So, for each transition of leadership, I can see progress in each transition.

MR. WANG: Another question on this -- yeah, here.

MR. COLOPY: Thank you -- Michael Colopy, ICCI.

In the transition, we heard very clear statements from the outgoing Party Secretary, Hu Jintao -- former President -- and from Premier Wen Jiabao, as you referred. But we also heard a very clear statement from Xi Jinping, in his capacity as Party Secretary, that, if the Party did not reform itself, it would be fatal to its own future.

These are very dramatic and clear pronunciations, which were said before the international press -- and not just in private settings.

Many of us who've worked in China, around China for a long time, know that the Party's the ultimate power. But what the Party says about the constitution in Harbin is not the same in Chengdu or Wuhan.

So, therefore, my question is, if there is to be reform, at what point does *guanxi* give way to merit, and at what point does quality supersede payoff?

MR. WANG: Okay. So, could we ask Professor Zhou to address this again, or others?

DR. ZHOU: So, you talk about *guanxi* -- or connections. You know, we have had a lot of reforms by, like, issuing new documents and giving out speeches -- or initiate a campaign or something. However, this time, I think the base is to respect the constitution, so as to perfect the current system.

For example, I think that one of the rules of the city council is that, by the end of June next year -- as everything takes take -- however, by the end of June next year, you have to register all the real estate you hold. That applies to everyone. I believe this is systematic progress.

We all talk about transparency or exposure of your personal wells, but if you don't register, if you don't put it -- how do you say -- so now I don't talk about making your own property public.

However, I want you to register. Then everything would be connected through internet. So, that is, in effect, exposure of all personal wells.

So, people say that there is one year to go before June next year (inaudible). But mostly, the Chinese government is actually trying to promote progress in terms of the system.

So, for example, if everybody registers his or her property, then you have to pay property tax on it; so what's the point of having too many properties? So, you rely on systems. Like the public expenditures on cars, and banquets, and everything -- you know, the general public has been complaining about it all the time.

So, to solve things like this is not just -- you cannot solve the problem by, you know, a document issued by the, you know, disciplinary committee, saying that, "Okay, did you eat your Camembert? Did you see some other seafood?" You know, because there is no budget for seafood in front of -- the seafood, you pay for yourself.

And so once you have a better system of the budget, then it's better to carry out the oversight of the public expenses.

And one of the hardest debates is on whether budgets should be actually made transparent to the general public. I think that, as Premier Li Keqiang said, well, it has to be made public. So, that's one obstacle less for a new legislation. So, there will be a faster pace in the reform.

Once you have, like, an open budget, and you would know that the personnel are to use government cars, or using government money, like, for meals, or for other things -- you have yourself a problem at the root.

So, for me, the Party has to set rules for itself. I believe that if we look at the rules of work by the city council, that is like setting some rules for itself. If you don't have rules that you also abide by, what's the point of issuing just documents for other people to do this and do that? So, I believe we have some progress.

SPEAKER: A political economy framework that is -- if the party in power is -- you know, the legitimacy of the party in power heavily stakes at, you know, reform, you know, because the central party now will recognize the major issues -- the corruption in *guanxi*, or a misallocation of resources -- all from unlimited power, of locating resources by the government.

So, therefore, as Professor Zhou Tianyong explained, there are a lot of new reforms announced about reducing the power of the government, in that respect.

And, also, you know, because if -- in the past, the government has been supported by the people because of the fast economic growth and the improvement of living standard -- but in the future, if, you know, the previous sources stimulating the economic growth were no longer accessed -- therefore, you have to gain new sources to support the economic growth.

Premier Li Keqiang recognized that that one is the reform dividend. So, apart from debating about whether or not the power is legitimate in there -- but, first of all, we need to know the Party will gain its legitimacy through further reform and continuing the economic growth.

MR. WANG: So, what you're saying is that term -- now we're getting an answer -- that reform actually plays to Communism, as the new kind of ideological cover, shall we say, where instead of pursuing the goal of Communism, now we are just pursuing the goals of reform.

SPEAKER: Yeah, that's why I said that. I provide the political economy framework.

MR. WANG: Okay, yeah.

SPEAKER: Reform is the first stage of Communism.

MR. WANG: Yeah, that's another ideological framework.

SPEAKER: Reforms --

MR. WANG: Okay. Arthur -- yeah.

MR. KROEBER: Hi. I'm Arthur Kroeber, from Dragonomics in Brookings. I have a question for Professor Cai.

We're anticipating that the government will soon release kind of a blueprint for the next stage of urbanization, and that this will be one of the most important early policy announcements of the new government.

I wonder if you could share with us any understanding that you might have of what that policy is likely to contain, and whether it is likely to address some of these issues, like hukou reform, that you think are important, from your perspective.

PROFESSOR CAI: Yeah. If you read the report of 18th National Congress of the Party, you'll notice that there were some new expressions well-written.

First of all, it's not only urbanization. It's to turn the migrant workers into permanent, legitimate urban residents. That's very important.

Secondly is the full coverage of public services for all citizens, with or without urban hukou.

So, if you put all this together, that new type of urbanization means that urbanization was people-centered urbanization.

Probably, I think, that maybe some local government would think of urbanization as a very good opportunity for us to further invest in infrastructure, construction, or land developed for the IPD, for Premier Li Keqiang -- well means about the migrant-centered urbanization.

And I believe that that's more than important to support the further -- that's a reform itself, by the support, for the growth from supply side.

So, I believe that's the very right way to go.

MR. WANG: Okay, thank you. Now we only have time for one more question. I will give it to this person here, in the front.

MS. YEN: Thank you. My name's Shu-Wei Yen, and I'm from George Washington.

I'd like to ask Professor Wang Jisi a question about -- you mentioned that a public diplomacy -- and what would you suggest to the Chinese government to better communicate its intention to the public audience, like the U.S. audience?

Thank you.

DR. WANG: Actually, I'm not only thinking about how to do diplomacy toward the U.S. audiences, but, also, you know, how we have organizations -- what we call social organizations -- assisting in China. We don't call them NGOs.

But, you know, the government is working on the U.S. Congress, and the U.S. businesses, and many others. Our embassy here is very active, but I'm also thinking about, you know, horizontal connections between the two societies.

You know, many people come here -- you know, like ourselves (inaudible) they are doing their public diplomacy. This is very effective.

So, I like that idea, and I think, you know, we should always be part of it. Chinese working on the U.S. population -- and the embassy people are also working on that. They have parallel roles to play, and no one else can replace it. They cannot replace each other.

MR. WANG: Okay. I think with that question, we should conclude our last panel. Clearly, we don't have enough time to address all the reform agenda issues and the challenges, but this is a conversation I think will continue.

So, let's thank our panelists for their contributions.

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