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SECURING A MORE SUSTAINABLE GROWTH PATH IN CHINA

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P R O C E E D I N G S

MR. PRASAD: Good morning. And welcome to this discussion about the Chinese economy. China remains an eternal source of intrigue, interest and, to some extent, mystery as the second largest economy in the large, and the largest contributor to world growth. There is enormous interest about what is happening in China, not just within the country, but around the world.

So, this morning, we have an extremely distinguished panel here to help us sort through the issues.

On my left is Markus Rodlauer. He's the deputy director in the Asian Department of the IMF, and also the IMF's mission chief to China. Markus actually has studied not just economics by also law and international relations, which I think makes him perfectly suited to help us figure out not just what's happening in China's economy, but also what the broader implications for the world might be.

On my right, we have Steve Roach, who spent a long and distinguished career at Morgan Stanley, and is one of the most prominent China economists in the private sector, and now he's jumped to my side of the fence, in academia, he's now a professor at Yale University.

And finally, we have David Dollar who, until very recently, was the U.S. emissary, so to speak, at the embassy in China, Treasury's

emissary, and he's now also jumped to what I think of as the right side of the fence, he's now a senior fellow at the John Thornton Center in the Global Economy and Foreign Policy programs at the Brookings Institution. And before that, he was the head of the World Bank office in China.

So, these are all people who know China intimately and intricately. And what we'll start off with is a presentation by Markus, who will tell us a little bit about the main findings of this year's annual report that the IMF writes on China. And that will give us a basis for discussion, and we'll then bring in the two panelists. And we will leave some time at the end for questions and answer.

So, to begin with -- Markus.

MR. RODLAUER: Good morning, and thank you to Brookings for inviting us here. Thanks to Eswar and my friends Steve and David to agree to be on this panel with us here. It's a great honor to be here. And thanks to you all for coming.

Before I start, I'd like to acknowledge what the Fund has done on China, and does on China, of course is a team effort. So, all that you see here today, and what you see in our reports, which are published on the website, is due to Steve -- please -- Steve Barnett. He's the head of our China Division. And Malhar Nabar, who is the senior economist in the division. And, of course, the team has many other members, as well.

Let me start by giving you just the main messages of our report this year. A lot of concern early in the year about a sharp slowdown, potentially, in China -- we were then already, in April, May, quite confident that although growth has been moderating, we don't really see a major risk of a very sharp, imminent decline of growth, a hard-landing in China. At the same time, however, vulnerabilities have been growing for years. They have continued to grow over the past year. And if you compare the tone of last year's IMF report and this year's, you will detect some heightening of concerns about the growing vulnerabilities in the Chinese economy, and a greater urgency to financial and structural reforms that now must be accelerated to contain the risks and to put this economy on a more sustainable growth path.

Growth in China is typically must more policy-dependent than it is for many other large economies. And the actual growth projection in China always is very closely linked to what one thinks about the government's policy reactions -- how strongly will they counteract any decline or cyclical risk to growth. And so far, quite positively, we would say, the government has signaled a tolerance for growth in line with its own target, which around 7, 7-1/2 percent.

So, in contrast to the past, whenever there was a sign of slowdown in the economy, the government would move in quite strongly,

with strong investment, and strong credit push, this year the response has been significantly more moderate, and the authorities have not appeared to want to prop up activity about the target as in past years.

So, the data that are coming out of China now, the high-frequency indicators that we monitor -- and there is many of them, over a hundred -- through the third quarter into the first few days of August, show that activity is indeed stabilizing into the third quarter, or the second half of the year. There has been a little bit of slowing in retail sales -- they're still well in the double-digits. Fixed asset investment, we don't see any decline. It's way above 20 percent still. So -- and also the trade data recently have come back somewhat. So we are confident that our assessment in April, May, when we were there, of growth around 7-1/2 to 7-3/4 for the year as a whole is about right.

But, as I have emphasized, since the global crisis, really a mix of investment, credit, and fiscal stimulus has underpinned activity. And while this has been good in many ways for China and the world economy, clearly, this pattern of growth is not sustainable, and it's becoming increasingly apparent that it's not sustainable because the signs of risks are growing.

So, while there still are significant buffers to weather shocks -- we're not in imminent crisis mode -- the margins of safety are clearly diminishing.

What are those risks? When we look at the Chinese economy, three risks really jump out: the financial sector, the vulnerabilities in local government finances, and real estate.

These three risks sort of which jump out at us when we look at the financials of the economy, they sort of reflect deeper vulnerabilities underlying problems in the economy along the current growth path, which remains based largely on capital accumulation and credit-financed investment. So, in a nutshell, these three risks that you see here on top, they reflect a process whereby capacity is being accumulated well ahead of final consumer demand. It's financed by credit expansion. And this has led to widespread excess capacity, pressure on corporate profitability, diminishing returns to investment, and rising corporate and local government debts.

As I will discuss ahead, in order to sustain growth, the economy now needs to be transformed away from this pattern of growth based on capital accumulation, to one that is more based on total factor productivity growth.

Let's look at bit closer at the financial sector. China's stock of credit -- on the left-hand scale -- is among the highest in the world at its level of income. You see the red dot, China, "net domestic credit," "banking credit," close to 150 percent is clearly an outlier in its income class. And not only the level, but on the right-hand, you see it's growing extremely fast, especially in the non-bank segment, which is not included in the left-hand chart.

On the right-hand side, you see total "social financing," as it's called in China, is bank credit and credit given outside the banking channel. That total social financing has increased by 60 percent of GDP in just four years. And while the predominant source of this funding still remains in the banking sector, traditionally, an increasingly larger share has come through other channels, such as the high-yielding wealth management products and other non-traditional, non-banking sources of financial intermediation. And while this is very positive in many ways, because it moves the financial intermediation closer to the market, it also carries tremendous risks, and is a problem because, first of all, it is basically a process of arbitrage, where intermediation is trying to move away from the better regulated banking sector. It's an area of weaker supervision, where supervisors have a hard time catching up with what is happening in the so-called "shadow banking." And simply the speed of

growth, the speed of expansion of some of those projects is nearly overwhelming.

So the consequence of what you're seeing here, this nearly explosion of credit, is a steady buildup of leverage, which is eroding the strength of the financial sector, it's eroding the strengths of balance sheets -- local governments and corporates.

So, this combination of rising leverage, worsening profitability, means that, of course, the corporate debt service burdens have also risen. And if you look at average leverage levels in the corporate sector, they are still manageable. A growing share of firms -- at least in those that we can see, which are the listed firms, where there is data available -- a growing share of those firms are showing interest coverage ratios below 1. And, you know, while this is still a share which looks manageable -- it's not, again, at crisis proportions -- continuing this recent trend would suggest worsening strains on the corporate sector and macro economically.

Second point: local government debts. The buildup in credit has been accompanied by a large increase in local government debt. Infrastructure spending by local governments is an important countercyclical tool in China. A lot of the fiscal spending comes through the local governments, both social and investment. And it has become

more so, much more so, since the global financial crisis. And a large part of this local government spending, investment spending, is being done off-budget. It's not recorded as part of general government spending.

Now, to better assess the macroeconomic scale, the impact of this off-budget spending, we at the fund have tried to construct what we call an "augmented fiscal balance" that puts the recorded official general government data together with the off-budget fiscal transactions that are going. And, of course, looking at this together shows us that the actual debt of the public sector, the augmented public sector, is much higher than the official one -- 22 percent official. But augmented debt, including this sort of off-budget spending comes to somewhere around 50 percent of GDP. We have 45, because we don't include something.

And, in fact, it's not such a novel exercise. If you look on the right side, this is sort of a plot of the market, various market estimates, and even government estimates which have been around for the last two or three years, of the size of this government debt -- which always is somewhere between 50 and 60 percent, depending on what you include on the liability side.

And, of course, the corollary to that, this official debt is much higher, it means also that the public deficit, if you include the augmented part, is much higher than what is measured, the official deficits -- it's

always on the order of 1, 2, or 3 percent of GDP -- but the augmented deficits, including these off-balance sheet items, were as high as 14 percent of GDP during the crisis, and have now oscillated around, you know, 8 to 10 percent of GDP.

Real estate -- on the left-hand side you see that real estate now accounts for a very significant share of GDP already. It's about 12-1/2 percent of output -- and urban employment, about 14 percent. And it does remain, is in our key engine of growth. However, one has to realize that existing distortions make this market susceptible to very large cyclical swings, boom-and-bust cycles.

On the supply side, we have local governments which rely on land sales for financing and real estate development for growth, which often leads to excess push supply into the market. On the demand side, the market is prone to bubbles because housing represents a uniquely appealing investment opportunity for the private sector, given that real deposit interest rates are close to zero. Given the capital account restrictions that savers can't put their money abroad, there's a history of robust capital gains, and there's also favorable tax treatment. So, on the demand side, there is this huge incentive in there for demanding real estate.

So, this is a risky situation. And clearly, over the medium, real estate development will have to slow down to a more sustainable pace as the market matures, and the challenge now is to do this in a way -- not just by always just restricting price growth, or trying to control it from the top, but by really removing the underlying distortions that create the incentives to this risk.

So, as we have said, these three risks that we mentioned, they sit on top of the underlying deeper vulnerabilities related to China's growth model which remains based on investment and capital accumulation.

Investment, which is being implemented through a mix fiscal, quasi-fiscal off-budget local government spending, state-owned enterprise investment, that investment has been used to support domestic activity and to offset the impact of external shocks. And while this, of course, has had positive spillover effects for the global economy, it has exacerbated tremendously the domestic imbalance between investment and consumption.

There are signs in the last one or two years that this imbalance is no longer worsening, but a decisive shift towards a more consumer-based economy has yet to occur. For example, last year investment rose as a percent of GDP slightly, while private consumption

remained flat as a share of GDP. And the urban household savings rate has actually increased rather than falling, which would mean more consumption.

So, on the left-hand side you see that China, of course, clearly remains an outlier, with investment as a share of GDP much higher, and consumption much lower than in other countries.

On the right-hand side of the chart you see, from the supply side, what's the composition of China's growth. The secondary sector, industrial sector, remains the main driver of growth over the whole past decade.

Now, these are sort of the economic, financial imbalances that China has to grapple with in its growth pattern. Let us also not forget about the other challenges, other aspects of rebalancing and of the challenge which is, for example, that while there has been a major reduction of poverty in China over the past years, inequality, at the same time, has increased tremendously over the past two decades. And if you look at the staff report, we have a chart in there that shows how much the Gini coefficient has actually increased in the past two decades, which is the largest increase of all the emerging market economies.

And last but not least, the environmental challenges, of course, of this growth pattern of adding factors of production and

investment and resource-intensive growth are tremendous, and not sustainable.

So, clearly, the time is running out on the current growth model. We have done a little growth-accounting exercise that assesses and analyzes what's the source of growth of China over the past two, three decades and, clearly, it is mainly factor accumulation. It's putting labor and new factories together, and producing for exports.

Clearly, this growth can no longer continue. If it continues -- and under -- you see the orange line here on the bottom is China -- if it continues, maybe it can go on for a few more years, but it will run out of steam. Eventually, you will create too much excess capacity, capacity utilization of enterprises will fall, profitability will fall, bad loans will rise. So, at some point in time, there will either be a crisis, or there will be a sharp slowdown.

And China's convergence process, which is measured here, the ratio of China's GDP to the U.S., which has proceeded continuously and steadily over the past three decades, the risk is that the convergence process might just simply stall, as it has actually done for many other middle-income economies at that stage of development.

So, the choice for China, the challenge is to either change its growth model and sustain the convergence process -- so if there is a

successful shift in the growth model from investment and capital accumulation to more factor productivity growth, it can actually continue to converge close towards advanced income levels.

Just briefly, what are the key policies? They're all, of course, explained in detail in our report.

Successful transition in China will require, now, a decisive new round of reforms that will combine to unleash these new sources of growth which are based on productivity growth. At the same time, they need to address these growing risks in various parts of the economy, and at the same time make growth more inclusive and more environmentally sustainable -- and, not to diminish the challenge, all of this, of course, in an external environment which very likely will remain difficult, at least for some years.

So, the challenge is tremendous. It may entail, over the next few years, somewhat slower growth in China -- not in the 8, 9, 10 percent range, but maybe somewhat slower. But it is, in our view, clearly a tradeoff that is worth making.

What's the strategy? At the strategic level, I think we should highlight three points: an increasingly greater role to market forces through continued liberalization and reduced government involvement; stronger governance -- and that's very important that we mention this -- as

we increase the role of market forces, we need to see stronger governance at the lower levels of economic units -- local government, state-owned enterprises, and state banks; and, at the same time, shifting income towards households and increasing consumption. So these are the sort of three strategic prongs.

And in terms of economic policies, the agenda includes a broad set of fiscal, financial sector, exchange rate and other structural measures that need to be taken over the next three, four, years.

Many of these reform directions and policy objectives have actually, indeed, been outlined in the government's recent announcements. So we are confident in our dialogue with the authorities, we do see a great recognition of the challenge, a clear understanding of the policy areas that need to be addressed, and of the direction that policies need to take, and you have seen it in the various announcements that have come out over the last six months. What is now needed is clear and specific policy measures, and timely and focused implementation.

So let me sum up again with our key take-aways this morning.

Near-term outlook in China -- we are confident, growth around 7-1/2 percent this year, maybe even slightly higher. But the vulnerabilities are growing along the current growth path. And while

margins are still there they are diminishing, and financial and structural reforms must be accelerated to contain the risks and transform the growth model.

Thank you.

MR. PRASAD: Thank you, Markus, for the very nice overview. (Applause)

Let me start with you, David. You've been back from Beijing for just a few weeks -- do you agree with Markus' assessment of the short-term and medium-term prospects for the Chinese economy? And, specifically, do you think what he laid out, in terms of what China needs to do, the policy reforms, are the right ones? Do you have anything to add, subtract?

MR. DOLLAR: Okay. Thanks.

I like the IMF report a lot – you know the bottom line, growth of about 7-1/2 percent this year, no hard-landing, but risks building up, and the need to transform the growth model. So, I like the report a lot. I basically agree with it.

As an opening remark, what I'd want to do is just briefly emphasize that I think the risks are really quite serious, the risks that building up are quite serious, and then add a couple of additional issues to

the structural reform agenda. I agree with the issues that Markus touched on, I just want to broaden the agenda a bit.

First, on the risks, I really like his figure, you know, that shows China's private consumption and investment as a share of GDP compared to other countries. You know, China really is extraordinary. It has very, very high investment, very, very low private consumption. You know, we really haven't seen this before.

On the investment side, if you invest 50 percent of GDP at this stage, you basically double the capital stock in six years. So that means during this big investment push of recent years, the capital stock's been doubled. If the model continues, it will be doubled again in six years. There's already evidence that the return to investment is dropping, and so I'm pretty convinced that if you double the capital stock looking forward the next six years, there's really not going to be demand to use that capital stock. You're going to run into some kind of financial or fiscal problems -- and the IMF report brings that out. And I just want to emphasize that I think that's quite serious.

I agree with the reform agenda that was touched on. I would add two areas that I also think are important. The first is *hukou* reform, that is, reforming the household registration system. If you look at China, there's obviously been some rural-urban migration, but it's rather limited,

you know, if you compare it to the historical experience of other countries. If you include the migrants, China's urbanization rate right now is about 52 percent. When South Korea was at the same level of per capita income, the urbanization rate had already reached 68 percent.

You know, so the household system obviously restricts mobility. You know, the result is China has this very large rural-urban income difference. And by restricting the ability of migrants to move to the cities, you restrict the ability of many rural people to move and find higher income.

It's particularly difficult for people to bring their families, to bring their children, bring old people. And if they did move to cities, you know, that would provide quite a bit of additional demand for social services. The government would have to find the resources for those, so there would be challenges. But if you're thinking about shifting from such an investment-driven model to a more consumption-driven model, I think easing up on the *hukou* system, and encouraging more real migration of families from the countryside to the city, enable people to find higher income and consume more, and encourage greater provision of government services.

The other area I would briefly mention is state-enterprise reform. You know, China still has a large state-enterprise sector. You

know, we can argue exactly how big that is, but in the official statistics, it takes more than 40 percent of the investment of recent years has been in the state-owned sector. And there are a lot of enterprises with mixed ownership, so that's probably a low estimate.

State enterprises, they operate in quite a few sectors, but I see them as being especially visible in modern services, like financial services, media, telecom, logistics, airlines. These are all sectors in which there's a small number of state-owned incumbents. The Chinese often refer to these as the "monopolistic sectors," "monopoly sectors." You know, these firms earn a lot of profit -- or perhaps, you know, we would call it, economists would call it "rent." They pay very little dividend to the government. The nice thing in the IMF report, that statistic that in recent years centrally-owned state enterprises have paid 0.4 percent of dividends into the central government budget. So, basically, you know, you have a system in which protected enterprises earn profit, and then they reinvest it, created a heavy bias toward investment in this system. If you took more of that income into the government budget, just as a simple reform, and expanded the social services, that would be shifting some resources from investment to consumption.

So my general point is there are important institutional features of the Chinese system that encourage investment and discourage

consumption. And so as we look at transformation of the model, it makes sense to target some of those reform areas. And I strongly agree with the report that the financial system, the repressed financial system, is an area for reform -- but I'm also adding the labor market institutions and the state-enterprise institutions as important areas for reform.

So we look to the new leadership, I look to the new leadership, hoping that there will be some relatively bold reforms that are announced over the next few months, that tackle these issues comprehensively.

MR. PRASAD: Thank you, David.

Steve -- you're the private sector guru on China and your view are carefully watched by everybody. And you've generally tended to be much more optimistic about China, both in terms of its prospects and its ability to undertake reforms.

Do you share the general assessment of risks? And, also about the endpoints, about where China ought to go?

MR. ROACH: I do, Eswar. And I, like David, I really commend Markus, and Steve, and the team for once again laying out a very comprehensive assessment of the agenda that China faces in trying to deliver on this important and critical growth transformation.

The only bone I would really pick with, you know, the assessment, Markus, is I honestly -- and in keeping with what you, you know, the sort of billing you just gave me, Eswar, as "the optimist" -- I would really prefer to call much of these issues, many of these issues you raised as "challenges" rather than "risks." I think, in assessing the prospects for any major economy in the world today, we could point to a broad menu of "risks" for every single one of these economies, that are equal to, if not more severe, than the ones that you outline for China -- including the United States, Europe, and, you know, the new poster child for economic revival, Japan. There's a lot of risk in every single one of these economies today.

The one area that I would just pick up on -- and I really agree with the points that David made on the *hukou* and the SOE reform -- but I'm a little bit on the other side of the issue that you raise with respect to investment and the doubling of the capital stock. And Markus, you and your team, and you've pointed this out to me before, have pointed out that this capital stock growth in China, while it's high, and consistent with the extraordinarily high investment share, the level of the stock is low -- especially in looking at the capital per worker, which is what economists prefer to look at as the driver of long-term productivity growth.

So, I'm not nearly as worried about rapid growth in the capital stock as many are. I recognize that lacking a market-based system of capital allocation, that there are some areas to be very critical in the way in which that capital is allocated. But I want to see this capital-labor ratio continue to rise off a very low base, and I think that is going to happen, in light of the point you made on urbanization. Urbanization is a capital-intensive endeavor. There's a lot more urbanization to go. You made the Korea point. But, I mean, China's at 52.6 percent last year on the urban share, probably headed to 70 percent over the next, you know, 10 to 15 years, and that's got to require a lot more capital.

The final point I would make is that in looking at progress on rebalancing -- and I have to give a lot of credit to my friend Nick Lardy, sitting here, who has really written a lot on Chinese rebalancing, and developing indicators to gauge the progress of rebalancing -- my view is that sort of the last thing that tells you that the economy is rebalanced is to look at the major shares of the big sources of demand, like consumption, investment, exports, and the like.

I prefer to look at the building blocks that drive those shares as early warning signs. And one of the ones that I'm most encouraged about -- and Nick has got this as one of his components of his rebalancing gauge -- is the accelerated growth in the services sector. And I think it's

impressive right now. And you have a chart in there, Markus, and you showed us -- it just shows the shares through 2012.

But if you look at the growth rates of those shares, or the sectors, in the first half of this year the service sector has grown, by Chinese data, 8.3 percent, whereas the secondary, or manufacturing and construction sector, has grown 7.6 percent. So there's a positive gap of about 7/10 of a point, service sector growth relative to the big traditional engine. And you have to put that in the context, over the last 30 years, it's been the other way around: manufacturing and construction has grown, on average, for 30 years, 2.7 percentage points faster than services. And now it's flip-flopped, where service is growing about 7/10 of a point faster. In six months, you don't know if it's going to be sustained, but I like, you know, the fact that you are beginning to see very early signs of growth momentum shift to this tertiary, or services, sector, which is less resource intensive, it's more labor intensive, it's more environmentally friendly, and it allows the economy to grow at a slower rate and still achieve a lot of China's daunting labor-absorption objective.

So, yeah, China's got a lot of challenges. And if, you know, you want to push me, I'd say "risks." We do, too. I don't see us addressing our challenges and risks nearly as aggressively as I do in China.

Thank you.

MR. PRASAD: Thank you, Steve. I knew I could count on you for the realistic but optimistically shaded view of China.

Let's turn back to the short term for a little bit. You talked about how you anticipate growth being 7 to 7-1/2 percent. But what are the big things that could set this off? And what do you see as the sort of worst-case scenario for China? Because the rest of the world cares a great deal about what happens to China.

But if the external environment unfavorable, if these reforms don't get put into place -- although those are more of a medium-term issue -- do you think there is a prospect of growth slowing very sharply? Do they have enough space to respond to that?

MR. RODLAUER: In the near term, we don't see significant risk of a sharp slowdown -- I repeat. I think the authorities have the policy levers to respond to contingencies. There are downside risks to the external environment, but we have seen, again, now domestic demand picking up quite strongly, and could probably be picking up even more. When you say "7 to 7-1/2," we actually see 7-1/2-plus for this year.

So, near term, you know, short of an outlying calamity that we don't envisage, we don't see major risks of a sharp slowdown.

MR. PRASAD: Do both of you share that assessment, that in the short term, growth is fairly secure?

MR. DOLLAR: Yes, I agree that, you know, that authorities have enough fiscal space to keep growth at 7-1/2 percent or a little bit higher -- and, to me, the risk buildup over the medium term.

So, growth is going to be at about that rate, and the question then is, is there going to be rebalancing that puts that on a sustainable path for the long term, or is it going to be the old growth model for a few more years and then, you know, the risks start building up, and then you could get something unpredictable in the world, and you could imagine a rather sharp growth slowdown. But I would expect that in the near term.

MR. PRASAD: Okay, so since we have the short term, sort of, let's turn back to the medium term.

Now, we talked about China having enough fiscal space to respond in the short term. But, as Markus pointed out in his charts, there are lots of problems building up when you take the overall fiscal accounts in the country -- it's not just the central government debt which looks very benign, but once you start adding in contingent liabilities, the local government debt and so on, it starts looking a lot more bleak.

So, on the fiscal front, do you see major risks continuing to build up and really holding back long-term growth?

Steve, would you like to take that?

MR. ROACH: Well, I think, Eswar, it's really interesting to look at China's response, in terms of fiscal policy, to the current slowdown -- which, I agree with David and Markus, and actually you -- you haven't divulged your position yet, but we were talking earlier, and I will tell this group that you're probably very optimistic on near term. But there was a slowdown over the last couple of years that, if you look at China's policy response to earlier slowdowns, would have evoked a pretty strong fiscal stimulus, and they didn't do it. You know, they've done a little bit at the margin, but they're willing to accept slower growth, and they're trying to wean the economy off these major, you know, construction spending, infrastructure-type packages. And, of course, you know, the biggest one that they've engaged or indulged in was the one after the crisis in late '08, or early '09.

So, whether you call this, you know, fiscal deleveraging, or just a more prudent, cautious, disciplined approach, but the fiscal -- and I don't know whether they had monetary policy -- I think this is a striking contrast of this new leadership relative to the, basically, the two generations we've seen previously.

Now, it's early on in the leadership, but they do not want to go back to debt-intensive growth. That's not to say that -- you know, your

first question is, you know, the China disaster scenario. If China collapses for reasons, or if the environment collapses for reasons that we have not figured out, they'll go back to another big stimulus. But Markus rules that out, and I agree with Markus, that's unlikely -- highly unlikely.

And so I think there is a lot of focus in dealing with the debt-intensive strain of economic growth, especially for the, you know, the shadow-banking system, the wealth management products, the non-big institutions that are now really coming under heightened scrutiny by the financial regulators.

MR. PRASAD: Well, that's a good segue into the next issue I'd like to raise. And, Markus, you talked about how one of the essential reforms that's needed is financial system reform. And I think there's general agreement on this panel that to achieve this balance, to growth over the long term, to get the economy onto a more sustainable growth path, we need a better financial system.

Now, they have been making progress on that dimension. Just a few weeks ago, they removed the floor on lending rates. Just today, or I guess -- yes, today in Beijing time, they announced that they're reopening the government bond futures market. So they seem to be taking steps in the right direction towards liberalizing financial markets.

Do you see this as significant progress? What are the big things that remain to be done?

MR. RODLAUER: I think it is progress, and it has been progress. Let's not forget that we are looking today at a financial sector that's already totally different from what it was 5 to 10 years ago -- all this private sector activity that's going on. We have basically free lending rates today. We have margins around the deposit rates. So I think a lot of progress has been made.

Now, going forward, if -- you know, we clearly see the need to make a decisive break into a truly marked-based financial system. And for that, we need a number of things. We need liberalized interest rates. Now, I mention that first, even though I, myself, always want to say for you to be able to liberalize interest rates, and actually thereby achieve what you want to achieve, which is a market-based, competitive financial system, you need not just liberalized interest rates, but you also need entities that are able and willing to compete on a market-based system, which means you need the financial constraints and discipline that, rather from administering interesting rates and lending limits then has to come from an ability and willing to take risks, but also a punishment if I take the wrong kind of risks -- which means that investors who make bad investment decisions because they take too high returns for too risky

investments have to be able to go broke and lose money, and receive haircuts. Banks, or savers, who intermediate in an efficient and overly competitive way have to be resolved out of the market in a transparent and clear way, which means you need deposit insurance on hand, but on the other hand, also, resolution framework for those who compete too aggressively.

You need to remove the current moral hazard in the system, where basically all deposits, and virtually all fixed-term investments are being guaranteed. You know, there is failures in the stock market, but so far, we haven't seen a failure of one single fixed-interest instrument. There's a perception that virtually everything here is guaranteed.

And so, these things have to change for interest, liberalized interest rates to work effectively, and not to raise new risks of crisis. We have seen, you know, in the United States, what liberalizing of deposit rates created in the savings and loan. And everywhere else in the world, liberalizing too early and too quickly, without supportive reforms on the ground that actually make it work, is very risk.

Hence, continued progress towards liberalization, but that's not the end-all-and-be-all. We also need true reforms in the banking system, a true resolution framework, strengthening of the monetary

system, so that instead of controlled deposit interest rates, we'll have a new anchor in the system, a new policy rate.

So, it's a whole host of reforms that need to move together. So, rather than looking for one big headline item, "interest rate liberalization tomorrow," I look for a consistent, coherent approach that lays out the steps what are we going to do over the next two, three years to achieve what we need to achieve urgently, which is a truly market-based financial system.

MR. PRASAD: You've nicely laid out what we economists would like to see: a little failure, a little mini crisis, that can be managed, but introduces discipline into the system.

But that is risky. And the whole process of reform is somewhat risky, although the government seems to understand that there is no alternative financial market reform.

Do both of you see this as proceeding in the right direction? Do you see big risks to the reform process itself? And what are the things that you think they should do up front?

David?

MR. DOLLAR: Well, there's a lot of talk in Beijing recently about, you know, liberalizing the capital account fairly dramatically. And, frankly, I'm kind of surprised -- you know, I think Markus alluded to this --

you know, there's definitely risks in, you know, moving quickly to liberalize the capital account when other institutional features are not in place.

So, one thing I would introduce into the discussion is I think opening up foreign investment and financial services is related to opening the capital account, but it's actually a different issue. China has a rather restricted system, in terms of openness to foreign investment and financial services. It's pretty much the most restrictive of the G-20 countries, for example. And, in general, opening up the financial services investment and trade strengthens the financial system.

So, I think that the sequencing issue is hotly being debated in China. I think it should be debated. I would personally favor opening up financial services. I agree with the point about liberalizing interest rates. China's done a lot. There's room for China to move more quickly on liberalizing interest rates. I would think opening up the capital account would come later in this sequence.

But, as I said, right now there seems to be a pretty active debate in China about moving ahead more quickly on liberalizing the capital account.

MR. PRASAD: Do you agree with that characterization, Steve?

MR. ROACH: Yes -- can I comment on that?

Actually, it's more of a question -- and maybe, you know, you're not just, you know, a moderator here. I mean, you're a real, you know, live expert on China. So maybe I can ask you a question, if I might. (Laughter)

MR. PRASAD: This wasn't planned.

MR. ROACH: No. But, you know, modern China got going, you know, late '70s or early '80s, with reforms in opening up, Deng Xiaoping, aggressive reforms eventually implemented by former premier Zhu Rongji. I mean, reforms were the driver -- aggressive risk, reforms that took on a huge risk, both internal and external political risk.

Do you think china's forgotten what they got out of reforms? Have they grown so rapidly, have they gotten so strong, has the power structure coalesced around state-owned enterprises and these sort of local-government fiefdoms where it's really hard for them to go back and replicate the intensity of reform that we saw in the early stages of this post-Deng Xiaoping era?

MR. PRASAD: This will be the only question permitted to the moderator. (Laughter)

So, thanks for the question, Steve. That's, of course, a very perceptive question, based on your very deep understanding of the history of reforms in China.

My sense is that China is now a much more complex economy, and the low-hanging fruit, in terms of reforms, has been plucked already. And China is now at a stage where there is a certain inevitability to reforms to keep moving forward, but also each of these reforms carries enormous risks. As economists, we can very well lay out what the first-best ought to be, in terms of a freely functioning financial market with market discipline. We know that doesn't exist anywhere.

And for China, especially given the initial conditions it's starting with -- a poor legal framework, a poor institutional framework -- the risks on the path to the endpoint are very significant.

But, having said that, my optimism that you referred to earlier comes from the fact that the Chinese are very effective, I think, at using external triggers, and also good narratives for reform. The external triggers, like the WTO accession, have been used in order to sort of shake free the domestic obstacles to reform.

But, having said that, the question is how do you manage to get around the enormous political opposition to reforms? Because the system, as it is structured, works very well for a lot of politically powerful people.

And this is where I think the Chinese have been very clever at creating this narrative around reform. So, if you think about capital

account liberalization, the notion of a big and important country having a big and important currency in the world economy is not, ultimately, an end in itself, but it does create the right sort of momentum for domestic reforms. It forces you to think: What do you need to do domestically in order to have the currency be a world power? You need better financial markets, you need a more open capital account. You need a better legal framework. So that's one narrative.

Earlier this year they announced a plan to reduce inequality. Usually, when the government says "we're going to reduce inequality" that's a very bad idea. But what -- the limited specifics in that plan were: Let's reform the state-owned enterprises, let's liberalize interest rates, let's undertake some reforms of the labor market.

So these are all the right things to do. But once you say these are going to benefit the masses, I think it's a much more effective way of sort of getting around the obstacles to reform. The obstacles to reform are still very great, but I think they have their hearts in the right place.

MR. ROACH: That's a great answer. Thank you.

MR. PRASAD: Thanks. We go back to our traditional roles.

But, once again, you've given us a very good segue, Steve, into what we should be thinking about. I mean, we've talked about what

reforms are needed, and, Markus, you referred to the fact that the leaders have talked about this in their 12th five-year plan, and otherwise.

But it does take political will. Do you sense that there is political will right now among the senior leadership to get around the reforms?

Maybe we start with you, Markus. In other words, they know what they need to do, are they prepared to pay the price and take the risk of doing it?

MR. RODLAUER: I think we'll see over the next six months. Who knows?

MR. ROACH: Well, I would just say, I think there is political rhetoric, and it's strong, in addressing this issue than we've seen in a long time come out of the senior leadership. I mean, it started, you know, literally, the day that Xi Jinping first addressed the media after being appointed General Secretary of the Party.

But, you know, rhetoric and actions are two different things. So there is this very important Central Committee meeting in November that will really put down some important markers in judging whether there is teeth to the rhetoric, teeth to the types of reforms that you really did an excellent job of describing, Eswar.

And, you know, some people -- and there have been some commentary pieces written recently about the significance of this third plenum of the Central Committee in November, comparing it with the, you know, the third plenum of -- I want to say the 11th Central Committee meeting back in 1978, which was the platform for Deng Xiaoping to really put down what, in retrospect, were historic markers for the transformation to the modern Chinese economy.

So, we'll see. And Markus' answer is right -- we'll know, I think, in a surprisingly short period of time, as to whether or not this is rhetoric or a plan for action.

MR. PRASAD: Let me push you a little bit on this, Steve, because you have the ear of many in the Chinese leadership. If you were asked to sort of define the Steve Roach action plan for China, what would the key elements be that you would like to see in there?

MR. ROACH: Services is one, because it's -- you know, it's a critical building block of the consumer transformation that I alluded to earlier. Urbanization -- as David has alluded to -- is also important, because of the reason he mentioned -- huge income leverage, provided you can couple urbanization with services like job creation.

And the third one is one we haven't really talked about today, but it is really making the social safety net in China far more robust. The

focus thus far has been on the number of people enrolled in the retirement plans nationally, or locally, or the number of people covered by the quasi-universal health care plan. But the benefit levels are pathetically low. And so these plans are in massive need of an injection of funds. And if you don't do that, you can generate a lot of labor income, but it won't be spent. It will be saved.

And, you know, the point that Markus made on the rising urban saving rate is an example of fear-driven, precautionary saving in the absence of a robust, secure social safety net.

So, services, urbanization, safety net.

MR. PRASAD: David, from your perch at the U.S. Treasury in Beijing, you've worked very closely with the senior Chinese leadership. What is your sense of whether they have the stomach for reforms, and what we might hope to see at the plenum in November?

MR. DOLLAR: Well, I think expectations are so high that they will definitely come out with some reform plan in the fall that, you know, will touch on probably all the elements that we've raised. So I think they'll announce something that sounds pretty good. There may very well not be a lot of detail in some key areas.

So, you know, I agree with the colleagues up here that it's probably going to be six months or longer until we know how very serious they are.

But one way to look at this is they're going to announce something, and they're going to seriously pursue reform in most of these areas that we're talking about. You know, this being China, they're probably not going to do anything radical. And you, yourself, Eswar, talked about, you know, some of the risks involved in reform are such that, you know, you'd have to think hard about whether you'd want to encourage them to do a lot of radical things quickly.

So they're going to have reforms. They won't be radical. They'll roll out gradually. We'll definitely see rebalancing.

And, to me, the interesting question will be whether this is fast enough reform to really put them on a sustainable path, or whether or not some external shock, or they build up these vulnerabilities we've talked about, whether it will derail them. And I don't see how anyone can confidently predict that, because there are so many variables involved.

But it is going to be fascinating to watch, over the next few years, whether you get gradual reform that succeeds, gradual rebalancing that succeeds, or whether you end up with some kind of more of a dislocation.

MR. PRASAD: You've referred to these external triggers to reforms, and one of the things that's being discussed, of course, with U.S. Treasury is the Bilateral Investment Treaty.

What do you see as the prospects of that becoming a reality? And do you think that will help, again, to shake free some of the political structures in China that could help move along reforms?

MR. DOLLAR: Right -- that's a very good question.

So, if you've followed our economic dialogue between the U.S. and China this year, one of the important outcomes was an agreement to move ahead, you know, seriously, to try to negotiate a bilateral investment treaty between China and the U.S. And this is very significant, because it would require from the Chinese side liberalizing a lot of sectors toward foreign investment that are not currently liberalized. So I mentioned financial services, for example. Many of the other sectors I mentioned would have to be opened up to direct foreign investment much more so than they are now. So this could become kind of an important anchor for one aspect of China's reform.

China, in turn, feels that its investment is often not welcome in the United States. So China is looking at a BIT and asking whether this can create a more secure investment -- sorry, more secure environment for growing Chinese investment into the United States.

So there's actually very much potential for a win-win agreement there. It's going to be difficult to negotiate the details. I predict it will take at least a year.

But, to me, that's going to be one of the signals about whether the leadership is really serious about reform. If they can bring that about, that will be quite important, both as a signal as a real structural reform.

MR. ROACH: But, David, how likely is that to get through the U.S. Congress?

MR. DOLLAR: Well, you probably could answer that better than me. I've been living in Beijing for the last nine years.

But I do think -- you know, I think a good bilateral investment treaty would create benefits for both sides. You know, U.S. business interests would definitely be behind it -- can you agree with that? You know --

MR. ROACH: Yes -- but, you know --

MR. DOLLAR: You think it --

MR. ROACH: -- when it comes to getting something through the U.S. Congress, which is, you know, fearful of anything associated with the Chinese, this will be very difficult. I really -- I agree with the

significance, and the importance of pushing ahead on a bilateral investment treaty. It would be absolutely phenomenal.

But, I mean, I look at this -- you know, all the hand-wringing over this Shuanghui-Smithfield deal, involving pigs, and, you know, the Senators' claiming that this is, you know, cuts right to the heart of food security in the United States, and they accuse Shuanghui of floating 15,000 pigs down the Huangpu River in Shanghai, when they have no pig farms anywhere near the Huangpu River. I mean, it's absurd.

So, you know --

MR. DOLLAR: Well, let's wait and see what happens to that deal.

MR. ROACH: I hope you're right. I hope you're right.

MR. DOLLAR: So you think that deal's not going to go through?

MR. ROACH: No, they sent some signals that it looks like it's -- you know, fingers crossed, will go through.

MR. PRASAD: Let's leave the U.S. Congress aside for another day, and turn away from such depressing topics.

But since we are on the subject of Washington, I do want to get your views on one thing that the IMF had prodded for a long time, and

which is of considerable interest in Washington, which is the Chinese currency regime.

Now, things have sort of stabilized, that the did widen the band of flexibility around the renminbi, and there don't seem to be huge pressures of the renminbi right now.

Do you still see this as a big priority? Because, again, here one hears a great deal about how China needs to move forward in currency liberalization. Is that still a priority?

MR. RODLAUER: Absolutely. While the discussion about the level of exchange rate has obviously diminished, China has appreciated, in real terms, by about 40 percent since it started opening up its system in 2005. Even this year, in the face of a slowing economy, of a risky external situation, they have appreciated by about 6 or 7 percent in real terms -- so, you know, it's not the issue of the level.

But clearly, the exchange rate is still very tightly managed. Even though there is a band, we consistently see the exchange rate, for example, a long time at the upper side of the band. So it is very tightly managed.

And I think if you want to truly liberalize, gradually, the capital account, if you want to truly open up the financial sector, you need a more flexible exchange rate system -- which means that the exchange

rate can go either way. But less intervention, less management, gradually further opening up the band, but then also gradually flexibilizing how you manage the exchange rate within the band, how you set the reference rate every morning after it maybe reached one end of the band the previous day -- that giving more leeway to the exchange rate to act as a shock absorber. If you have sudden flows of capital in and out, the exchange rate is a very important tool, both to help manage the balance of payments, to absorb shocks that come externally, but also to foster greater market orientation and markets domestically.

So I think flexibilizing the exchange rate is a key priority in the agenda.

MR. PRASAD: I suspect, David, that you don't have enough distance from the U.S. Treasury yet to have a different view on that.

But, Steve, I want to ask you about this. Do you think this is still a priority? I know you've held in the past that the U.S., rather than trying to force China to make its currency flexible, should take care if its own policies.

But just from China's own interest, as Markus has laid out, do you think it's a priority now?

MR. ROACH: The point on the cushion, the buffer, is very important. And as China commits to increasing market-based

transformations, having a flexible currency is an important part of the adjustment mechanism for any market-based economy. And they know that. They have managed it, you know, a good deal higher over the last -- what? -- eight years. But management and market-based flexibility are two different things. They're going in the right direction.

And, you know, there's no doubt in my mind that's where they're headed. And there's a number of pieces that have to fall into place before they get there.

MR. PRASAD: Now, both of you talked about urbanization as something that the government is keen on, and is promoting.

Given what you said, Steve, about where things stand with the social safety net -- and David, you talked about issue with the labor market -- do you see urbanization as an end in itself? And, given where things stand with the cities right now, in terms of the support systems and so forth, again, is urbanization essentially a sort of umbrella for other reforms that they need to do? Or what do you hope that the urbanization project, itself, will accomplish? Why is it so important to them?

MR. DOLLAR: Right. So, I'm thinking of a number of underlying reforms. You know, I already mentioned *hukou* reform. You know, listening to the other panelists, some of the issues them mention really bring up the larger issue of fiscal reform in China. You know, local

governments often feel that they don't have the resources to provide the services they're supposed to provide. They turn to land sales, which is, you know, inherently an unsustainable pattern of revenue-raising.

So I think, you know, intergovernmental fiscal reform that ensures that local government have the resources they need to provide social services -- you know, Steve mentioned what is essentially entitlement reform in China, you know, reform of the pension system, and some of the labor contributions which are very high. I mentioned *hukou* reform.

So, to me, it's a set of reforms which would tend to make the economy more efficient, and that I think would have the effect of leading to more urbanization. But I see it as a result of people's choices, you know, and not so much as a deliberate, directed effort. And I think that's an important distinction.

There is a debate in China right now about the pattern of urbanization in the future. And, you know, some voices would like to create whole, large new cities in the center of the country. Most farmers now live in the center of the country. So you can imagine building a lot of cities in the center, take a lot of capital investment -- so that would be, you know, a channel for investment over the next few years. But the risk is that these will not be efficient platforms of production.

You know, I would prefer to free things up, and I predict you'd see a lot of people move to the existing coastal cities, where productivity is very high. Chinese cities are actually small in many ways, and so there's a lot of room for more people to move to the city.

There will be need for more investment, but it should be a less intensive path than building up whole new cities.

MR. ROACH: David, as somebody who's lived in China for as long as you have, you want more people in those big cities?

MR. DOLLAR: Yeah, I want more people, but more efficient --

MR. ROACH: How long does it take you to get -- oh, no, you didn't have to worry, you had a car, and all that.

MR. DOLLAR: No -- yeah, but no, just in my nine years, the traffic time increased fourfold for me, the commuting time increased fourfold for me, basically, in a nine-year period. But that's an irrational pattern of urbanization that is encouraging the use of automobiles, under-investing in public transportation. Beijing's a relatively flat city, if you look at it -- right? There's actually a lot of potential to build up much more dense cities in China.

So, you know, there are going to be a lot of policies involved, but there's room for a lot more people to move to coastal cities in China.

MR. PRASAD: Anything to add, Steve?

MR. ROACH: Yes, just quickly -- the urban share of the Chinese population in 1980 was slightly less than 20 percent. In 2012, it was 52.6. It's headed up to 70, you know, by 2030. So, you know, in 50 years this is the most dramatic urbanization we've ever seen.

Is it an end? No way. I mean, it's a transitional shift from a peasant society to a, hopefully, a more modern, higher productivity economy.

In the Article IV report that Markus and the team put out, they stress, you know, the critical transition between extensive and intensive growth in China, with the latter being, really, an economy that focuses increasingly on an increase in total factor productivity.

So, you know, the transitions that we're talking about, you know, this is the factor accumulation story, and it's not a sustainable story. So the agenda shifts dramatically. And now, with more than, you know, well more than half the urbanization behind China, the focus really needs to be on this intensive productivity story, as you guys describe very well in this report.

MR. PRASAD: Okay, we've covered a fair bit of ground, thanks to our panelists, but I'm sure there are burning questions among those of you in the audience.

We have time for a few questions. Please identify yourself -- and no commentary please, very short and brief questions. And if you can, address them to a particular panelist.

MS. LEE: Thank you. I'm Jennifer Lee, with Hong Kong Phoenix TV.

My question is about recent global capital flow. So, during the G-20, the Chinese side also emphasized that the Fed should be cautious on the spillover effects if they are going to withdraw the QE. So, even the Chinese side always emphasizes that the impact on the impact on their economy will be less than other emerging countries.

But do you still see there's going to be an impact if the Fed starts doing any moves afterwards?

And the second is, we've seen a lot of fluctuations in emerging countries. Do you see it's going to be a similar situation later this year?

Thank you.

MR. PRASAD: Do you want to take it, Steve?

MR. ROACH: Yes, look, QE was an accident waiting to happen -- for the U.S., and for global markets. And we're seeing the accident right now.

And, you know, the good news for China is that it's not getting hit, in large part because it's running a current account surplus. It's the current account-deficit economies in the developing world, especially India, Indonesia, Brazil, Turkey, South Africa, with big deficits, that are getting really hit hard. These are countries that were lax in addressing their own structural problems during these, you know, five years of free money, courtesy of yield-seeking capital flows sparked by QE. And, you know, with the yield arbitrage now swinging back to the United States, those flows are leaving quickly. And for countries that need external funding -- and China's not one -- they're in serious trouble.

And this is a big, destabilizing event for current account-deficit developing economies who have been inattentive to their reform agendas.

MR. ZEITLIN: Good morning. My name is Arnold Zeitlin, and I've been teaching in Guangzhou the past 10 years. And I hear my father-in-law in Guangzhou complain about the cost of food in the wet market, and the difficulty of finding a better place for him to live, so forth and so on.

So I wonder about the impact of the slowdown on a population in China that has been accustomed to 30 years of relative high growth, without much sacrifice -- especially now that the talk of reform

seems to be accompanied by an increased crackdown on dissent and criticism.

MR. RODLAUER: If you look at the pattern of growth over the past, which was relying mainly on capital accumulation, it was holding back wages, to be frank. It, of course, provided a tremendous shift of rural populations to the more productive (inaudible).

But if you look at the actual average wage growth and income growth, it has actually been very small compared to the amount of resources that have been spent on investment and other things. So, we would think that part of the strategy is precisely to improve the livelihood of the broad population by shifting more of the fruits of growth towards household incomes, towards more consumption.

So, that can come from a variety of forms: by raising wages, raising social benefits, allowing a transition further from under-remunerated, unproductive activities to services in the cities, opening up opportunities for small-scale service expansion, et cetera.

So, we see the strategy of transformation actually benefitting income distribution, and inequality, and incomes in the lower levels much more than the current growth pattern.

MR. PRASAD: Yes -- Albert?

MR. KEIDEL: Thank you. I'm Albert Keidel, of the Atlantic Council, and formerly, the U.S. Treasury Department.

I just want to follow up on what Markus was just talking about -- wages falling -- and comment, ask a question about your outlier diagram. It shows China's an outlier in its share of investment in GDP -- but the cluster of countries are not really very stellar performers. And so you're really criticizing China for being outside, sort of, this club of failure.

And if you look -- and there's a diagram -- I read your Article IV this summer, and it has a figure in which this leading comment is: "...per capita household income declining for much of the last decade." I'm sure that's a typo. Income has not declined. The share has declined, but income's been growing at 8 to 10 percent in real terms.

So I really -- I think there needs to be a voice of sort of sober reevaluation of the report, and your comments, major conclusions, that China is facing these vulnerabilities. And, you know, for example, the non-bank financial growth of 60 percent, well -- over four years -- the nominal economy grew 65 percent over those four years, so the share declined.

So I wonder if you could comment. It seems to me there's sort of a bias in the report, trying to look for trouble in an economy that -- where government may need to optimize markets pretty heavily, as many

of you pointed out -- it's doing very well, and it's being compared to sort of pretty poor performers.

MR. PRASAD: Markus?

MR. RODLAUER: Yes, I think that goes partly back to, I think, what Steve also mentioned. There's an issue about levels. It is obvious that capital (inaudible) is still very low. There's obvious a huge investment needs.

I think what we're talking, really, is about the speed and absorptive capacity. When you invest half of your income, when you grow your financial sector by 60 percent of GDP over four years, when you have period of credit growth of 60, 70, 80 percent, in certain sectors even 100 percent, with supervision that is, at best, trying to catch up, I think you just have to look a little bit at the speedometer and say, wait a moment, maybe we need to look again at the risks we are building here. You're looking at a real estate sector that, in some areas -- of course, we cannot speak about "the real estate sector" of China -- that doesn't exist. It is hugely diverse. It's, you know, an economy that's four times as large as Europe. There is vast amounts of under (inaudible) real estate. There's vast amounts of bubbles, of excess supply, and excess demand.

But, then, you look at the speed of growth, you look at the speed of credit growth, and you just have to say, in general, these are

signals that point to increasing risks of a calamity. And you need to be careful not to overextend yourself.

MR. PRASAD: Yes?

MS. LU: Leah Lu, from Voice of America.

There have been a series of investigations of foreign companies doing business in China, over bribery and price-fixing issues. And the European Chamber of Commerce just issued a report yesterday saying that these foreign companies believe they are being unfairly targeted by government probes.

So, I'm just wondering if you can talk, if the panelists can talk about the possible intentions of the Chinese government of doing so.

Thank you.

MR. PRASAD: David, do you want to take that? No? Nobody wants to take that.

MR. PRASAD: It's not really part of --

MR. PRASAD: Yes, I think we will leave that out, because it's not really part of the economic focus of this discussion.

Yes -- back there?

MR. MULLOY: I'm Pat Mulloy. I'm former general counsel of the Senate Banking Committee, so I wanted to talk about that BIT issue

that came up here, and explain some of the concern, and ask Steve whether this is a realistic concern.

We've run around $3 trillion worth of trade deficits with China since they joined the WTO. They now have about $3.4 trillion worth of foreign currency reserves. Much of the investment coming into the United States from China is from state-owned, Party-controlled enterprises. So that's why some in the Congress have a concern, because traditionally, we have not wanted our own government owning chunks of our economy.

Is there a -- is it a legitimate concern to be worried that the Chinese state-owned enterprises, Party controlled, would own chunks of our economy? And the fact that the Chinese now have so much in the way of foreign currency reserves, that could be a pretty good chunk of our economy over time.

MR. PRASAD: Steve, I'd like you -- and David, also, to comment on this, given your Treasury background.

MR. ROACH: Yes, my view is that those concerns are a foil for our inability to accept our own responsibility for an unprecedented shortfall of national savings, and the need to run -- to import surplus savings from abroad to fund the growth in our economy, and the requisite need to run massive current account deficits to attract the foreign capital.

Last year, 2012, America ran trade deficits with 102 countries in the world. China was the largest. By higher math, though, that leaves 101 other countries. So we have a massive, multilateral problem because we don't save.

China's bilateral deficit with the United States is large, but it's hugely distorted by supply-chain dynamics that puts China in the role as being an assembler of a lot of inputs from other countries, in Asia and elsewhere, of final goods that are shipped out. Your point on recycling Chinese foreign exchange back into dollar-based assets -- basically the implication of your comments is that we would like China to buy our Treasuries, because we don't want to control our deficit, but stay away from our companies.

I don't think we can have it both ways. If we don't like Chinese accumulation of U.S. assets -- whether they're fixed or financial -- then we need to act more responsibly as a nation, save more, and cut back on our deficits in the Federal sector, as well as in the household sector.

MR. DOLLAR: Yes, my reaction to the question is that right now, is Chinese ownership of real assets in the United States -- you know,

productive assets -- is rather minor. And then, frankly, U.S. ownership of productive assets in China is also rather minor.

So, if we can negotiate a treaty that would enable significantly more two-way investment, then I'm convinced that that would be a good deal for both the United States, for China, and for the world economy. Whether or not we negotiate that is an important question.

But that would be -- part of the Bilateral Investment Treaty is China would have to open up a lot more sectors to direct foreign investment that are currently restricted, and then the United States would have to be more welcoming in sectors that, you know, go well beyond Treasury bills.

My second reaction is that, as you know, the United States has a careful system in place, the so-called Committee on Foreign Investment in the U.S., that looks at national strategic issues involved in any investment. A bilateral investment treaty does not --

MR. ROACH: A lot like pork, really --

MR. DOLLAR: It reviews a relatively small number of transactions every year, as Steve knows. And that essentially is not really touched by a BIT, basically. That -- you know, the CFIUS can look at the

national security implications of an investment, including from countries with which the United States has signed a bilateral investment treat.

MR. MULLOY: If I could just respond to Steve and make one point -- you should know that the Chinese company asked CFIUS to review that transaction. CFIUS did not go out and grab that transaction to review it. The Chinese company asked CFIUS to review that pork transaction.

MR. ROACH: Is that bad?

MR. MULLOY: No, I'm just pointing it out, that they didn't go out and seize it, and look at it. The Chinese company asked CFIUS to review it. I was involved in writing the CFIUS statute in 1988, so I follow that very closely.

MR. PRASAD: Thanks for clarifying that, Pat.

We don't have much time left, but there are many questions. So let me take four or five questions, and then the panelists will have a chance to respond to selectively, and offer closing remarks.

We'll take a couple of questions here.

MR. BOUCHER: Jean Boucher, from George Mason University -- probably a fundamental question.

Considering the climate change, carbon emissions, and the correlation between GDP and carbon emissions, is there any hope for a zero-growth model?

SPEAKER: Hi. David mentioned earlier, we know that there is a serious imbalance in local and central government budgets in China.

So, my question is, is there a plan from Beijing to address this imbalance? And if we don't see any changes to it, will you be more worried about the local government deficit sustainability?

Thank you.

MR. PRASAD: Yes.

MS. RAPHAEL: I'm Helen Raphael. I've taught environmental science at Citroën University for a couple of years a decade ago. And I want to add on to the question that was asked before.

There's an increasingly important water shortage because all across northern China because of the shrinking of the Himalayan glaciers. The Yellow River has a water shortage part of the year. The aquifers are being depleted in the north. The Gobi Desert is spreading.

And I wonder, then, what will be the longer-term impact of lack of agricultural products all across the north, and the need for China to be more dependent for its food on other countries?

MR. PIERCE: Hi. Matthew Pierce, from Four Seasons Hotels.

Just to build off hers and his questions, what is the standing committee thinking? Presumably, they have an economic strategy, but we see the crackdown. I mean, they're in total disagreement with your thought of liberalization. We see the crackdown on foreign companies. We see state enterprise growing. Aside from the free-trade zone being developed in Shanghai, I don't see an agreement with you. I presume that they've read your report -- what are they thinking? What is their strategy?

MR. PRASAD: We have other questions? Yes -- we'll take one last question.

MR. MA: Okay, thank you. Gene Ma, from Tudor Investment.

I have a question -- I wonder why PBOC is so afraid of RMB depreciation, not appreciation? For example, earlier this year, in the fall of 2012, when markets believed RMB should have depreciated, and put depreciation pressure, PBOC came out and defended RMB, it should have backed up.

So, why are they so afraid of depreciation?

Thank you.

MR. PRASAD: Okay -- so you all have a minute each.

Just to review the questions: There was the zero-growth model -- I guess the Europeans are doing that very effectively, but I don't think that's what you have in mind.

Natural resources.

Then there was the issue about what the Central Committee is thinking.

RMB depreciation.

And local government finances.

So why don't we go in reverse order, perhaps starting with you, David. We'll do Steve, and then Markus to wrap up.

MR. DOLLAR: Okay. So, I wanted to grab the two natural resource-related questions -- at least two questions. Yes.

So, it came out a little bit in the discussion, but the kind of rebalancing that we've all talked about -- you know, this should be a less natural resource-intensive path. So it should help china with air pollution, for example, with carbon emissions. You know, we will see carbon emissions peak and decline in China, and key question is will it peak and decline by 2020, or will it peak and start to decline in 2030, and that will have a significant impact for China and for the world.

So the path we're talking about is definitely a resource-saving path, and that includes for water. Urban living is less water-intensive than rural living -- you know, primarily because rural living is mostly based on agriculture.

You've raised a really interesting, challenging question for China. An economist would say that it's rational for China to import significantly more food. You know, China could feel quite food self-sufficient, and still important significantly more food than it does now, and that would help China deal with its water situation.

Migration also matters, because China, the southern part of China, is not so water-scare. The northern part of China is very water-scarce. So, rationally, millions of people should move from the north to the south. And if you really free up the *hukou* system, that will be possible, whereas more partial reform of *hukou* that allows people to move to a nearby city is not going to address that kind of water issue.

MR. PRASAD: Steve?

MR. ROACH: All right, I agree with everything David said -- the broad range of topics. The only thing I'd add on water is, don't forget about the south-north water transfer project. You know, they're moving the water up north, too.

But, you know, I guess the point I would like to end on is the point I began with, and that is -- and it's more of a rhetorical question: Why is it that we in the United States continue to view China through the lens of "risks" and "catastrophes" and "threats," and things that are about to go wrong?

You know, there was -- Gordon Chang wrote this book, *The Coming Crash of China* about -- *Collapse* -- sorry, 15 years ago. And, you know, he is still out there with his website saying it's going to come any day now.

What is it about us in the United States that continues to see China as the threat that we do? What is it about us that uses that perceived threat as a foil to prevent us from doing a lot of heavy lifting in our own structural and bilateral agenda with China? And, you know, what is it about us that uses China as the lightening rod to deflect attention from the Congressional and policy agenda every couple of years that there is an election?

So I don't have an answer to that, but I think it's an important question that we need to think about pretty carefully.

MR. PRASAD: Okay, Markus, you have the last minute, and the last word.

MR. RODLAUER: Yes, just on the three points, quickly.

On environment, we have a little section in our report that tries to look at that. We do see tremendous scope for green growth. I think there is untapped potential to shift investment from building -- if not bridges to nowhere, but maybe parks and other things -- to moving a factory from the inside to the city to the outside somewhere else, and make it a lot greener. And I think there is huge potential there.

Local governments -- clearly a threat, but our judgment is it is coming under control. We are quite confident that the unchecked growth of liabilities and problems and risks there are being managed. At the same time, reforming, as David has said, the whole system of intergovernment relations, and local government finances is a very complex problem, and will take years to accomplish.

I don't see the PBOC at all to be afraid of depreciation. I think they would, at some point, like the exchange rate to also depreciate, which would help investor two-way bets. So, I think the issue is more that there's a structural, still, imbalance towards appreciation, because you have a current account surplus, and you have foreign direct inflows, direct investment inflows, so that this creates that structural surplus that depresses values.

To close, I would say, you know, there has been this point made by Steve -- you know, we shouldn't talk about risks but about challenges, this is more about challenges. So, that, you know, where do we come down in the end? Are we optimists? Are we bulls, or are we bears?

So, you know, at the Fund, we like to say we are cautiously optimistic that China will again find the way through these challenges going forward. We are optimistic because, again, China, over the past 30 years, has many times found a way to overcome seemingly insurmountable challenges. And that makes it reasonable, in our view, to give them the benefit of the doubt, and think they will again transition successfully into a new area of growth.

We are cautiously optimistic -- cautious, I would say, because there is a lot of uncertainty out there. How the global economy will evolve, how policies in China will evolve -- there is, frankly, a lot of uncertainty about what's happening. There is still a number of, a degree of opacity about developments in China that make it simply impossible to be sure that these problems and challenges will be mastered.

So, in the end, you know, both the authorities and the outsiders, we will just need to watch carefully. And rather than being

bears or bulls, we'll be China-watchers -- and, at some point, you know, advising them, as well, as much as we can.

So, with that, I would like to thank you again for having us here.

MR. PRASAD: Thank you, Markus.

On that note, let me thank our very distinguished panel: Markus Rodlauer, for his excellent overview and presentation, and to Steve and David, for sharing their deep insights with us.

And thank you for being such an attentive audience and for your very probing questions. Thanks for coming. (Applause)

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