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CHINA'S THIRD PLENUM: REFORM AND OPENING UP 2.0?

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P R O C E E D I N G S

MR. POLLACK: Good morning, and welcome. I'm Jonathan Pollack, director of the John L. Thornton China Center here at Brookings, and we're delighted to have you all here this morning for what I am confident is going to be a very, very lively discussion.

We meet in advance of the much anticipated Third Plenum of the 18th Central Committee of the Chinese Communist Party, and there's one thing we know now for sure -- we know when the plenum will meet. Beyond that, all remains to be determined. So the plenum will meet November 9 through 12, so a little over a week from now, and of course, this has been so anticipated for a period of time that the question of whether or not those big expectations will be met remains to be seen.

Several of us have just returned very recently from a trip to China and, you know, there's the old adage that those who know don't talk, and those who don't know, talk. So there's a great deal of speculation, but I think it's fair to say that those who are in a privileged position to be aware of what the precise deliberations might be within the leadership are being noticeably circumspect, suggesting to me that they're still in a great deal of bargaining that is going on even as we speak. But at least by setting the dates, you force outcomes in the system of one kind or

another.

So the questions here, it seems to me, are pretty self-evident. Xi Jinping, even within recent days, has spoken about a package of "comprehensive reform." The question is what does that comprehensive reform package look like? How does the leadership propose to get from here to there? And over what spectrum of issues? How much of Xi Jinping's personal standing and reputation as general secretary of the party rests on outcomes here.

Now, at this point, it seems to me, despite all the expectations of a reenergized reform process, we confront and observe enormous contradictions, uncertainties, and mixed messages coming in the media, coming from statements in the leadership beyond kind of the broad anodyne language that tends to get featured in these discussions. Certainly, for some period of time there has been presumption that the reform process in China has been seriously stalled over the last five to 10 years, so the question is can it now be re-energized -- excuse me -- and again, over what spectrum of interests. But that process in itself involves enormously complicated institutional and bureaucratic interests, a very, very diverse set of directions about China's longer term strategy, a question of whether or not these can all be reconciled in some sort of

satisfactory fashion.

So to me, at least, and our colleagues, of course, will speak in more detail about this, what I'm asking myself is can China simultaneously loosen economically while it attempts to tighten politically? We see, for example, the opening of a Shanghai free trade zone -- pilot free trade zone -- which in theory means that doors will open more to the inside of China, but at the same time lots of gates -- moats we might even say -- are blocking that process in terms of what will even go on within the zone. Is it even realistic given the conception of what will happen in the zone or what we think will happen, that you can, in effect, isolate it to this small part of Shanghai to the exclusion of other parts of China. That's a question that I suspect we will address.

At the same time, so much of what we have heard from the leadership, including in their discussions with the United States, presumes a process that will be more welcoming to foreign investment. The United States and China are in the midst now of renewed negotiations over a bilateral investment treaty. Will that have standing and credibility if you see any number of restrictions that are placed in the way of an effective set of arrangements between China and the outside world? So how much is China really prepared to open the door to the inside world? And with

what potential consequences? That's really much of what we will address this morning.

I'm delighted that I have three of my colleagues here who are prepared to speak about it. Cheng Li, David Dollar, and Erica Downs. Cheng, as you would expect, having just been with him in China, I just asked Cheng, do you feel you learned things on this trip? He said, "I always learn things when I'm on the trip." So he will report to us.

David, who is our newest colleague here in the Thornton Center, I think will speak to the whole question of what does a rebalancing strategy look like in China? What would it entail? What does it require? And how realistic is the top leadership and our top planners confronting these questions?

And the finally, Erica Downs will talk more about the implications of revised policies in China and revised economic policy for China's going out strategies that have been so predominant and much heavily featured over the last five to 10 years.

So without further adieu, Cheng, the floor is yours, and then David, and then Erica. Please.

MR. LI: Thank you, Jonathan.

Those who do not know, talk. So I'm very humble to talk to

you this morning.

The upper coming Third Plenum of the 18th Party Congress has been characterized by China's top leaders and advisors as a landmark event similar to the Third Plenum of the 11th Party Congress in 1978, during which Deng Xiaoping announced China's decision to reform and open up. New leaders have recently claimed that the decisions made at the meeting in November will herald the 2.0 version of China's market development.

Now, but at the same time, widespread cynicism has pervaded scholarly communities, both in China and abroad, regarding the agenda and the impact of this meeting. In my observation, this cynicism consists of three prevailing pessimistic views. First, some critics believe that even if the top leadership is determined to pursue bold market reform -- that's the special interest group as Jonathan just mentioned -- are too powerful to be contained.

The second pessimistic view is President Xi Jinping is not going to pursue a meaningful and much needed political and legal reform without which even bold economic reform cannot go far.

The third pessimistic view is that the Chinese top leadership, namely the Politburo Standing Committee, and especially the 25 members

of the Politburo may have difficulty reaching consensus on new policy initiatives and the priorities. As this view goes, factional in-fighting will deepen and undermine both effectiveness of policy implementation and the unity of the leadership.

Now, while each of these three pessimistic views have some validity, I believe that none of them adequately express the momentum that new leadership carries. In the next 12 minutes or so, I will assess each of these pessimistic views, elaborating on the respective merits and more on their inadequacies. My cautious optimism is not based on political naiveté or neglect of the daunting challenges that a new leadership confronts, but quite on the contrary, my optimism is based on the top leadership sense of urgency and the collective understanding of the need to do something big, broad, and bold to gain public support before it's too late.

Now, let me expand on the first pessimistic view about a potential strong resistance from the special interest groups. These special interest groups include state-owned enterprises, corrupt officials, bureaucratic institutions, and the local officials or local governments. It is true that some of the proposed market reform initiatives will undermine their interests and therefore will not be easy to implement. The

monopolized SOEs are not only the main source of official corruption, but they are also the most formidable obstacles for market reform.

Now, it is important, however, to point out that recently, three SOE monopolized industries -- namely oil, telecommunications, and the railways -- all were subject to purges of a senior executive on corruption charges, which is an important step towards controlling these vastly special interest groups. The Minister of SASAC, the person in the head of all these state-owned enterprises actually has been arrested. We have an expert, Erica Downs, is really specialized in the oil industry. She will certainly answer questions if we have any in that regard.

Now, in addition, the Ministry of Railways was dismantled this March, and the government recently announced that the private sector will be allowed to invest \$200 billion Chinese yuan in railways over the next two years.

Now, princeling leaders, as we know those leaders who come from prominent Communist veteran families are now in charge. Top princeling leaders, like Xi Jinping and Wang Qishan, given they are privileged in their family background, have more political capital and the resources than their predecessors Hu Jintao and Wen Jiabao when it comes to reigning in SOEs, and coordinating various government

agencies. So they are in a better position to crackdown -- if we use the term "crackdown," actually, I don't think crackdown is the right term--to control these SOEs.

It is important to mention that the top leadership actually does not need to go too far to firmly crack down the SOEs. Just containing their monopolies and reducing favorable policies towards them will be sufficient enough in my view to open space for growth of the private sector and bring in foreign competitors.

Now, the second pessimistic view is the valid argument that economic development and the political change are closely linked. According to this view, Xi Jinping's governing strategy, which can be characterized as politically conservative and economically liberal, will not be sustainable. While I agree with this assessment, I believe that the pessimistic outcome that they predict is unlikely to happen for two reasons. First, it overlooks the importance of implementing reforms in a sustainable sequence. Second, given the close linkage between economic development and the political changes, some of the deeper market reform will not only pave the way for political changes but will also provide the necessity or necessary political capital for Xi Jinping and his team to pursue political reform in the near future.

Now, let me very briefly explain these points. It is appropriate to identify Xi Jinping and his leadership as politically conservative and economically liberal. None of the seven members of the Politburo Standing Committee, the superior decision-making body in the country, are famous for being strongly interested in pursuing political reforms. The politically conservative nature of the top leadership became evident early this year when instructions were sent to Chinese university think tanks and other research institutions ordering public intellectuals to avoid speaking about seven sensitive issues, including universal values, freedom of speech, civil society, citizens rights, past mistakes made by the party, state capitalism, and judicial independence or constitutionalism.

Now, this directive has resonated very poorly with Chinese public intellectuals. In addition, media censorship has undoubtedly tightened under the new leadership. Liberal legal scholars and human rights lawyers are often among the primary targets for harsh treatment, including imprisonment.

Now, for the top leadership, tight political control is much easier than to pursue political reform. The recent scandals and most noticeably, the Bo Xilai case, have led the largest legitimate crisis of the party since the 1989 Tiananmen. The trial for Bo Xilai made it crystal

clear to the Chinese public that the inner circle of the high-ranking party leaders have decadent lifestyles filled with drugs, sex, money laundering, and even murder.

Now, as for cases of corruption, the former Minister of Railways, Liu Zhijun, was nicknamed “Mr. 4 Percent” for receiving 4 percent of every railway business deal has become representative of the official corruption. Although the full extent of his corruption was not reviewed at his recent trial, the prosecution revealed Liu Zhijun’s ownership of 374 condos and villas. Now, why did he need so many homes? The Chinese public can easily point to the answer. Because he would give any woman who slept with him one condo. Minister Liu was certainly very well prepared.

Now, therefore, we should understand that Xi Jinping and his leadership team have their own public support or praise for their tough anticorruption campaign which they launched just a few months ago. Some critics may be cynical about the methods and the fairness of the anticorruption campaign, but the campaign has already changed the behavior of many Chinese officials. If one visits the vacant VIP rooms in Macau casinos, one will immediately sense the effectiveness of this campaign. I have never been to Macau; I should visit.

Now, at least for now Xi Jinping's new leadership unambiguously wants to leave its mark on the economic front. In spite of or because of their weaknesses and liabilities in terms of fundamental political reform, the new top leaders apparently are willing to undertake bold and more liberal economic reform to uplift public confidence. Xi Jinping has identified his mandate as the Chinese Dream, which he defines as the rejuvenation of the Chinese nation and opportunity to realize a middle class lifestyle. The overall objective of his new economic policy is to make the Chinese middle class happy. The Chinese middle class was not happy during a decade of Hu Jintao, Wen Jiabao, although the reason for that is complicated.

The dominant economic trend in China over the past few years was what the Chinese call the state advances at the private sector retreat, *guojinmintui*. The state banks hardly give any loans to small and intermediate size private firms as the Chinese stock market was sluggish almost all the time. The middle class did not have any investment opportunity beyond real estate. This has led to other serious economic problems, including excessive shadow banking, huge local debts, overcapacity, and the property bubble. Now, meanwhile, it remains very difficult for people of low classes, like migrant workers, to obtain middle

class status or lifestyle. A widespread Chinese joke is if a migrant worker wanted to own a decent housing unit in a large city in China, he or she should start saving beginning in the Tang dynasty 1,000 years ago.

Now, to reverse such a dominant economic trend requires enacting comprehensive and drastic changes in economic policies and economic structure. This is exactly what Xi Jinping and his leadership team aimed to do at the Third Plenum. Agenda items at the meeting are expected to include financial liberalization, especially to promote small and intermediate size private banks, fiscal form, especially of central local tax divides, deregulation, urbanization, including large-scale changes to the house for the registration system, the so-called *hukou* system, land use rights, pricing for natural resources, and SOE reform. My colleague, David Dollar, I think he will provide his expert analysis of this reform agenda.

Now, I'm optimistic about most of these reform initiatives because they rightly address some of the most important problems in the country. The Third Plenum is also expected to outline a timetable and a roadmap for the next 8 to 10 years. For example, in terms of financial liberalization, the year 2015 was the target for interest rate liberalization. They also plan to move gradually towards capital account convertibility in

a few years as well.

Now, Xi Jinping's politically conservative and economically liberal approach make good sense because he needs first and foremost to set the Chinese economy back on the right track. The term that Hank Paulson used in his opinion piece recently. However, I do believe that without equally bold political reform, the next phase of economic reform will not be sustainable. Innovation-led economy requires political openness and media freedom.

Service sector development needs a stable environment for rule of law. A vibrant consumer culture must be accompanied by a maturing civil society. These are currently quite weak. It is encouraging, however, to learn that the Third Plenum will likely address the idea of so-called compressive reforms, which include economic, social, political, cultural, and ecological transformations, instead of solely economic reform. This offers hope that as soon as President Xi Jinping makes substantial improvement and gains support from the Chinese middle class over the next couple of years, he will likely embark down the path of the political and legal reforms.

Finally, the third pessimistic view about the lack of consensus within the leadership and the factional in-fighting, it is true that

we cannot understand Chinese politics without a grasp of factional tensions. And after past months, no one understands the importance of factional tension better than we do in Washington.

Do you agree?

Well, Chinese leaders in the past Deng era, are generally divided into two coalitions -- the Jiang Zemin camp currently led by President Xi Jinping, and the Hu Jintao camp, currently led by Premier Li Keqiang. President Xi Jinping now holds a six to one majority on the Politburo Standing Committee. Premier Li seemed to have had the cooperative partnership thus far. For example, publicly, Premier Li has been seen as the leader, pushing for the establishment of the Shanghai free trade zone, although the real driving force is, in fact, the Jiang Zemin camp, whose power base is in Shanghai.

But the strong influence of President Xi and his protégé in China's economic and financial circles may make Premier Li uneasy. Also, a majority of senior officials, one or two levels below the Politburo Standing Committee actually belong to Hu Jintao's camp, particularly 376 Central Committee members. The majority of them belong to Hu Jintao's camp. I just did a study about over 90 of them belong to the so-called *tuanpai*, the Communist Youth League. These are the protégés of Hu

Jintao and Li Keqiang. They are surely interested in gaining more seats in the top leadership or having someone occupy the top driver seat in the years to come. Their policy agenda and the regional priority may differ from President Xi's. In four years, China will have another round of leadership in-fighting as five out of the seven Politburo Standing Committee members will retire. This means that a new run of vicious fighting for seats on this superior leadership body now occurs on a five-year cycle rather than its general 10-year cycle.

Now, it is possible that a vicious power struggle may get out of control leading to a Chinese style government shutdown. Luckily, for the Chinese, if such a shutdown occurs, they can still watch the American panda cam. No, we cannot see during the shutdown. But all of these observations will actually encourage Xi Jinping and his coalition to more forcefully carry out their market reform agenda. Failure to deliver will significantly undermine Xi Jinping's credibility, reduce middle class support, further alienate the liberal intellectuals, marginalize China from important international economic integration, like the potential TPP. And most importantly, make accountable China's strategic condition to a consumption-driven economy.

In conclusion, the stakes of this November meeting for

President Xi Jinping and the Chinese leadership are very high, and so are public expectations. In my view, the new leadership simply cannot forsake this great opportunity.

Thank you very much.

(Applause)

MR. DOLLAR: Good morning, ladies and gentlemen. It's really a great pleasure to share the stage together with other Brookings colleagues. One of the nice things about moving from government to a think tank is that I don't have to be aligned perfectly with the other colleagues. So maybe I'll introduce a little bit of factualism, but not too much.

I'm going to talk about the implication of the Third Plenum for China's economic policy, and I want to start with a little bit of background. There's widespread agreement that China really needs to transform its growth model. Why does China need to transform its growth model? Well, in recent years, China has been relying very heavily on investment and at the same time total factor productivity growth has declined. Total factor productivity growth is the effort of us economists kind of very imperfectly to try to measure or capture improvements in technology, you know, catching up with the frontier. It's been very important for China, but

in recent years, total factor productivity growth has slowed down. There are a number of different experts who have estimated this, and investment has risen. And the problem with this pattern of very investment-heavy growth with relatively very little productivity growth is that the return to capital drops and you need more and more investment to keep up the growth rate. And there's a limit to how much an economy can invest.

So this is the pattern we're seeing -- diminishing returns to capital in China, lack of productivity growth, unsustainable growth pattern. And this creates for China what I call complementary challenges on the supply side and the demand side. On the supply side, China needs to encourage more innovation and productivity growth, and also reduce wasteful investment. And as the investment rate comes down, then consumption has to grow. So on the demand side, there needs to be a shift from investment towards consumption, and on the supply side there needs to be more reliance on productivity growth, innovation. China can continue to grow well for at least another decade, but I think the current pattern is really unsustainable.

Now, there's a range of measures, mostly structural measures, that could help China with this transformation, and economists and policymakers in China have been discussing this for many years.

These include things like opening up oligopolized sectors where state enterprises dominate. Many of these are service sectors, financial services, telecomm. Railway is another service sector. There are also some sectors outside of services that are oligopolized. So the general issue is you've got a number of important sectors where a small number of state enterprises dominate and there's often restrictions on competition from the private sector. And then probably most importantly, there's restrictions on foreign competition. These service sectors are relatively closed in China -- closed to foreign trade and foreign investment. So a lot of talk about opening up some of these sectors, particularly opening up service sectors. I think it would be good to allow more private investment into these areas, but if you restrict that only to domestic private investment, you're likely to get rather modest results because it's going to be hard for the Chinese private sector to come in and take on some of these big state enterprise incumbents. So I think that opening up to foreign investment, foreign trade, is an important part of that agenda.

In his introduction, Jonathan Pollack mentioned that the United States and China are negotiating a bilateral investment treaty that would require China to open up a lot of these sectors. It could be a very important anchor for reform. But as far as my point this morning, that's a

very important structural reform that would create more competition and innovation, should lead to faster productivity growth, and would help with this transformative agenda.

Another important structural reform concerns the *Hukou* registration system in China. You're all familiar with this system that tends to restrict the mobility of people and families to move around. One of the striking things about China is that there are big productivity differences across locations, so if you free up the movement of people, people will naturally tend to move to the more high productivity locations, and that's a very important source of aggregate productivity growth. You know, some of that is people moving from the countryside to cities where they have much higher productivity. Some of that is moving from less efficient, more corrupt cities to better managed cities that have more efficient investment. So freeing up the Hukou system should help with that issue of aggregate productivity growth, and also, the current system constrains many rural families to relatively low income. So as people move to cities, their income rises, their consumption rises, so *Hukou* reform could really help with both the supply side and the demand side of the challenges that China faces.

Third area, important area I would mention, concerns land. I

think this is a well-informed audience that knows that in China, local governments can dispossess peasants. There's a lot of corruption involved in this, frankly, but even if there's not corruption, it's an aspect of the system that biases it toward investment, because local government can take the land, pay relatively low compensation to farmers, and then even without corruption they auction it off for developers to expand. And so it tends to encourage investment and it's something that makes farmers poorer than they would otherwise be. So if you strengthen those rural property rights over land, you'd be really enhancing the wealth of farmers, and they're likely to generate more income from that and that will support their consumption.

So interesting aspect of China right now is many of the important structural reforms would help both on the supply side challenge of generating more productivity and innovation, and then it would also help with the demand side challenge of rising household income and providing more of the demand through consumption.

Now, these ideas are being discussed a lot and you probably saw very recently a leading think tank in China. The Development Research Center under the State Council came out with the so-called 3-8-3 report that had very specific reforms in most of these areas I just

mentioned and other areas of structural reform, so that's very encouraging. Cheng Li told us a lot of these issues are on the agenda for the plenum.

Now, I'm not quite as optimistic as Cheng because I can't see the future, but I think it's unlikely that the plenum will come out with a detailed bold plan for reform in all these areas. So I'm sure you've seen some commentary about that DRC report, you know, many experts saying don't be confused. This is one opinion. This is not a draft of the report that's going to come out of the Third Plenum.

So I read those assessments. That seems right to me that this is staking out one position which is a pretty coherent pro reform position. The issues are going to be discussed, but there are a lot of interest groups that are opposed to the specific reforms I just mentioned. State enterprise and local governments in particular may oppose some of these aspects of reform, and of course, state enterprise managers and local governments are very well represented on the Central Committee. So I'm going to be very interested to see what comes out in the next couple of weeks, but I think it's unlikely there would be a detailed bold plan that would address all of these different areas.

So that may seem a little bit pessimistic -- definitely a little bit

more pessimistic than Cheng, but now let me take the last part of my few minutes to go in a more optimistic direction because there are a couple of important areas of reform that I haven't mentioned that I want to single out because I think there are in the financial area and the fiscal area -- I think the relevant technocrats have very specific plans that they're developing, and I'm cautiously optimistic that either at the Third Plenum or shortly afterwards we'll see some very concrete reforms in the financial sector and in fiscal policy, and these are other important reforms that can support the transformation I was talking about.

In the financial system, a key issue is to continue to liberalize interest rates, and generally over time that's going to lead to higher interest rates in China, and that should lead to more efficient investment and discourage some of the very wasteful projects, and it also gives a better return to households who have a lot of financial savings put into the bank. So I'm looking for interest rate reform, probably coupled with deposit insurance and other reforms of the financial system, which would tend to make it more efficient in directing the allocation of capital, getting to a more market-oriented allocation of capital and giving households a better return. Again, those reforms that can help on the supply side, reducing wasteful investment, can also increase household income and

lead to more consumption on the demand side.

In the fiscal area, the key problem is a mismatch between the responsibility of local government and their revenue sources. To put it very simply, local government is responsible for most of the expenditure, most of the public expenditure in China, but it gets a rather small minority of the total tax revenue. So this requires ad hoc transfers every year, puts a lot of pressure on local governments. It's one reason why they are often anxious to take land away from peasants and develop it because that can become a source of local government revenue.

So what's being discussed is introducing a property tax, which could be a very stable source of revenue for local government, can help address some of the issues in the property market, and take away some of the incentive for investment. Another important fiscal issue -- both fiscal and financial -- is talk about allowing local governments to float bonds. Local governments currently have these investment companies that borrow from banks, you know, often relatively short term, finances a lot of the local infrastructure investment. Moving to a system where local governments can float bonds potentially could be more transparent, you know, if it's a system where local governments have to disclose their finances and rating agencies and other market players are looking at the

debts of different local governments. That can kind of create a kind of market discipline.

There are also risks. It could just make it easier for local governments to spend a lot of money and invest more, so I think not reforming carries big risks for China, but most of these specific reforms also carry risks and it's important to recognize that.

So I want to end by stressing that I think there's still a lot of uncertainty. We were a little bit nervous about scheduling this event because I certainly don't want to suggest that I can predict what's going to come out of the Third Plenum or in the next few months after that. I think we can help people think about the issues and some of the realistic possibilities. What actually comes out of the plenum we'll know in a couple of weeks. As I said, I think it's unlikely to be a detailed bold plan, but I would expect some very specific reforms in the financial and fiscal area. Perhaps some initial steps in some of those other structural areas that are very important. So that could be a very good signal if there are at least some initial steps in areas like Hukou reform or opening up the service sectors and other sectors to more competition.

I think there's also a lot of uncertainty. Even once we see the plenum document, it's not going to have -- even if it's quite a positive

statement about reform, there's going to be the important issue of implementation. So I think it will take six to 12 months to really have a sense of whether reforms have accelerated significantly. So over the next six to 12 months I'm going to be looking to see if there's implementation and if there's progress in these different areas. And then, even if reform accelerates, we know this is going to be a gradual process, so there's uncertainty remaining about will this transformation be fast enough to keep up a healthy growth rate in China? So frankly, over the next three to five years I think we're going to be looking for evidence that this transformation is occurring and that it's fast enough to sustain China's growth.

So I know you'd like to get all the answers this morning, but I'm being honest. These are things that I'll be looking for in the next few weeks, in the next few months, in the next few years.

Thank you very much.

(Applause)

MS. DOWNS: Good morning. I'm going to pick up on one of the themes of David's presentation, which is the need for China to change its economic growth model. And I'm going to talk about what that means for the international expansion of Chinese companies, otherwise known as the going-out strategy. The overseas investments of Chinese firms are

very much a product of China's economic growth model, and so as China's growth model changes from one that's been heavily reliant on investment and exports to one in which we see productivity and consumption playing a larger role, we're likely to see some changes in what Chinese companies are doing overseas.

So there are three things I'd like to do in my allotted time. First, I'd like to briefly discuss what going out has looked like under an economic growth model that relies heavily on investment and exports. Second, I'd like to talk about what going out is likely to look like under a growth model in which productivity and consumption play a larger role, and finally, I'm going to say a few words about what these anticipated changes may mean for the United States.

So the first point I'd like to make is that the investment and export-led growth model contributed to the surge in China's demand for and imports of commodities in the last decade, and this demand surge in turn made acquiring commodities the major driver of Chinese outbound investment from 2005 through the end of last year.

And just to give you a bit of background, China had been relatively self-sufficient in many key commodities throughout the 1990s, and then in the middle of the last decade, China suddenly found itself

heavily dependent on commodity markets for things like oil, copper, and iron ore as a result of infrastructure construction and housing construction driven by urbanization. And not only I think was it very disconcerting for a lot of people in China to suddenly find the country to be heavily reliant on global commodity markets, but a lot of people didn't understand how those markets worked to the extent that they do today simply because China had been relatively isolated from those markets for so long.

So I think these two factors -- sort of the unexpected and dramatic increase in China's dependence on imports and the relative unfamiliarity with commodity markets created a context in which we saw a lot of sort of frenzied buying the natural resources abroad. That really started in the middle of the last decade and continued right through the global financial crisis.

Now, the second point I'd like to make is that as China shifts towards the economic growth model in which we see greater reliance on consumption and productivity, we're likely to see some changes in what Chinese firms are doing overseas. And there are three that I'd like to highlight. The first one is that while commodities will probably remain an important driver of outbound investment, they are likely to be not quite as an important driver as they were in the last decade. On the one hand,

commodities will remain important because China still has a lot of urbanizing to do, so China is still going to need things like iron ore and copper and coal. Moreover, I think that Chinese companies are also likely to continue to acquire oil and natural gas assets abroad, and this is not just because Chinese oil companies need to grow reserves and production, but they're also increasingly after know-how. They want to buy assets that can help them learn things that they don't know how to do, such as developing and operating unconventional oil and natural gas projects.

However, I think as China moves away from investment-led growth, as investment share of GDP falls, we're likely to see the energy and metals intensity of economic growth in China decline, so we'll see slower growth rates for the demand in imports of commodities. And so I think we'll see somewhat reduced buying -- overseas buying in this space.

Moreover, I think that Chinese companies are likely to make more careful and disciplined overseas investment in the space, and it's not only because of anticipated slower demand in import growth rates, but also because of evolving ideas about what can enhance resource security and also learning from some high profile overseas investments in natural resources made in the last decade that have not gone as planned.

The second implication I see for the going out strategy of a changing growth model in China is that Chinese construction companies are likely to look for more opportunities to invest overseas. Again, as I mentioned before, China still has a lot of urbanizing to do, so there will certainly still be stuff for Chinese construction companies to buy in China, but as China's infrastructure build-out become more complete, we're likely to see those companies looking for stuff to build in other countries.

And then the third implication for the going out strategy of the changing growth model is that I expect that companies in service sectors, like the ones that David had mentioned -- telecommunications, logistics, finance -- are likely to become more active overseas. If we see a China in which consumption plays a larger role in driving economic growth, we're going to see the consumption of more services, and this may, in turn, prompt companies in these sectors in China to want to buy assets overseas that can make them more competitive, that can give them a leg up on competition for domestic market share.

And so this brings me to the last part of my talk, which is what does all of this mean for the United States? And here I also have three points that I'd like to make.

The first one is that the United States is likely to remain an

increasingly important destination for Chinese companies, and not just for oil and natural gas investments. I mention oil and gas because it has been the most important sector of the U.S. economy for Chinese investments to date. I wouldn't be surprised if we continue to see investments in this sector; however, I also expect that Chinese companies will increasingly look to buy assets in the United States and other OECD countries that can help them increase their productivity and competitiveness.

And there are two recent examples of acquisitions in the United States that I'd like to mention that illustrate this point. The first one is Shuanghui's acquisition of Smithfield Foods, which closed last month. And I see this as an example of what I'd call a productivity-seeking investment. China's pig farming industry is not as productive as the one here in the United States, and so as China's demand for pork has been growing, it's not surprising that Shuanghui would want to acquire what was America's largest pork producer.

And then the second investment I wanted to highlight was the acquisition by ICBC, Industrial and Commercial Bank of China, last year of an 80 percent stake in the Bank of East Asia's United States subsidiary. And I guess I would term this a competitiveness-seeking

investment in that it seems to me that one of the benefits of this acquisition for ICBC is that it might learn how to attract customers in a much more competitive and liberalized environment.

The second implication for the United States is that as Chinese construction companies look for more opportunities to invest overseas, they may find the United States to be a very attractive destination. In fact, a recent study published by the U.S. Chamber of Commerce argues that the substantial capital requirements for modernizing U.S. infrastructure is creating a lot of opportunities for Chinese companies at a time when Chinese construction companies are starting to look at diversifying their portfolios away from China because of uncertainty over China's future economic growth. This report has an estimate which they say is conservative that between 2010 and 2030, the U.S. is going to need to invest \$8.2 trillion in water, transportation, and energy infrastructure alone, and many Chinese companies have both the capital and the experience building stuff to help fill that gap.

And finally, the third and final implication for the United States I'd like to mention is that the more Chinese companies invest in the United States, the more interested China is likely to be in signing a bilateral investment treaty or BIT with the United States, and this is

because the more Chinese companies acquire or try to acquire assets in the United States, the more concerned they're going to be about the protection of their interests in the United States. And as many of you know, one of the big concerns that Chinese investors have here is that they have been or will be discriminated against by virtue of being domiciled in China, and in my view, such concerns should increase the attractiveness of a BIT in China because if such an agreement were reached, it would undoubtedly include a nondiscrimination clause. And so for a lot of Chinese companies that would, I think, reduce some of the uncertainty about whether or not their deals will go awry because they might be discriminated against by virtue of being a Chinese company.

And I also think a bilateral investment treaty would help Chinese companies in another way, by helping U.S. firms. I think a well-structured bilateral investment treaty would also result in China having to open more sectors of the economy wider to investment by foreign companies, including U.S. companies. And if we do see more U.S. companies being able to invest more in China, that would sort of help address another sort of key complaint, sort of a key objection that some people have in the United States to Chinese companies investing here, which is a lack of reciprocity. If a U.S. company can't buy a Chinese oil

company or a Chinese food company, why should we let Chinese companies, you know, buy U.S. food companies or U.S. oil companies. So I think if the door to investing in China is opened wider to U.S. companies, that will help them as well.

I'll stop there. Thank you.

(Applause)

MR. POLLACK: While my colleagues are being mic'd up, let me just raise a few issues for discussion at the outset and then we'll open up to the audience since we can talk to one another all the time but it does seem to me that these presentations in different ways highlight some very, very important issues.

Let me go to each of you. First, Cheng Li. Cheng, at the start of your talk you dropped a very loaded phrase. You said that there was an urgency to the reform "before it's too late." I'm going to put you on the spot and ask you what that implies. At the same time, it seems to me you raised the possibility or the reality of a new or a slightly modified factional model, a continuation of the past, but because of the predominance of Youth League participation membership in the Central Committee, you really suggest that there is a pretty intensely factionalized or competing interest model. I wonder how far you want to take that or

whether -- would there not be collective incentives to reach deals of one kind or another rather than let these things become so sharp in terms of the divides?

David, for you, there are extraordinary parallels here with things China needs to do and what kind of an external voice is in that process. We've all heard Chinese economic officials and the like acknowledge or make reference to what, in America, when Japan seemed so dominant, we talked about a jisatsu policy; that the outside world can pressure the inside politics of a system and internal decision making to force the pace of changes within various economies. The downside of that it seems to me is that it creates potentially a vulnerability for those who, in effect, want to see more of that external pressure, just given that it might look as if they're catering to foreign interests, if you will. But I must say there's a clear difference I think between Cheng and David on the question of the urgency of the current situation. Cheng seems to imply that they've really got to act and they've got to act big -- a big bang theory, if you will. David seems much more looking at, you know, incrementalist logic. Maybe this is a perspective between political scientists and economists, I don't know, but in effect, what are the things that can be done that are easier to do but that would facilitate a longer term transition

but not so overloading it with unrealistic or unattainable objectives.

And finally, for Erica, I think that you raise, to me, a very, very interesting question that the future of China's economic reforms is in separable from China's relations with the outside world and with the United States in particular. That has enormous policy implications, obviously. It suggests, yet again, that for all the attention in strategic circles to the idea of this latent or emerging military competition with China, that the real driving force in the future of the U.S.-China relationship will be much more economic than anything else broadly defined.

Those are what I take away from this discussion. So I don't know if any of you would want to make a quick comment on that and then we'll open it up to the floor for discussion.

Cheng?

MR. LI: Well, a sense of urgency is not what I said but what China's top leader said. And even when Hu Jintao, Wen Jiabao, the constant walk about the really imminent challenge for the party for the country if they do not clean up the house, if they do not reach out for public support. And Xi Jinping recently said that if we make a mistake, this will be really like an earthshaking change they will face. They need to

be very, very careful. But that means they should do nothing, but rather should do the right things. And Li Keqiang used a Chinese proverb called *zhuangshiduanbi*. This means a brave soldier, a warrior should be willing to cut his wrist if the wrist is poisoned by a snake. So that shows the determination. That also you cannot say even more urgent than this kind of metaphor. So this is the sense they have. I think it's the right sense, so long as the leader is not indulging in old achievements but to really look at these challenges, I think there's hope.

Now, factional politics, yes. After the 18th Party Congress, the lineup, it's very, very important that it reflects the direction China will go. If people like Li Yuanchao or Wang Yang get the Standing Committee, I think you will see more aggressive policy political reform, but now this is the leadership. It's not famous for political reform, but they are good in terms of economic administration. Many of them serve as the governors, mayors, the party secretary in coastal regions, coastal cities, like Shanghai, Beijing, Guangdong, et cetera. So these leaders are very capable to carry out economic reform. Usually, the provinces are market orientated. And they're also supported by a group of technocrats to support them.

Now, at the same time, you do see the lower level is still

dominated by other leaders. You can see that their policies are quite different. Hu Jintao and Wen Jiabao talk about harmonious society, talk about rebalance -- more balance in a regional approach. So the resources are going inland. But now with Xi Jinping and also several people in Shanghai, that will come back to center. You see the wind blows again in Shanghai's favor. So Shanghai's free trade zone is (inaudible). But in 10 years under Hu Jing Tao and Wen Jiabao, Shanghai's GDP growth rate is the lowest -- bottom three -- sometimes the very lowest in terms of GDP growth. So that will change. Shanghai will return to be the frontier of China's economic growth, particularly with financial liberalization. When you talk to Shanghai leaders, you cannot miss this kind of enthusiasm, this kind of hope that will let them perform.

I think this is healthy. This kind of faction, in-fightings, I mean, we tend to -- well, some people hear it's a vicious power struggle, but sometimes they know how to cooperate because they constantly cut a deal. And of course, things could be out of control. Things could be ugly. This is human nature. This is politics. But in the moment they emphasize cooperation. It's in their interest to see that the country will avoid a revolutionary mood. It's in all the elites' interest. And yes, I have different policies, but then you try. If you succeed, that's fine. If you do not

succeed, let's try my approach. So in a way that will make the Chinese political system healthy. Of course, it's not really a democracy yet, but this is the Chinese faction of politics within the part that you do see the different factions. They are not completely in the dark. If you ask a taxi driver, they will tell you six versus one lineup of the Politburo Standing Committee. So that in a way is transparent.

So I think this is a good moment. So let Xi Jinping's team perform with the agenda to emphasize economic reform, to make the middle class happy, financial liberalization. Let's see whether they can succeed or not. Now, when they do so, they also understand the need for some other comprehensive reform. That's why the term that they are going to use for the Third Plenum is called comprehensive reform. So it will pave the way for future change. So it's not completely closed the door, but it's not a priority. Political reform, legal reform, it's not a priority, but it's something maybe later if we can be successful. So that's the point --

MR. POLLACK: Sequencing.

MR. LI: That's right. It's got to work.

MR. DOLLAR: Jonathan asked me two very good questions. The first one is about the role of outside pressure. So in my

experience I've asked a lot of Chinese officials at different levels about this. I always got different answers, so there definitely were some Chinese officials who said it's very helpful for the United States to be raising specific issues like liberalization of the financial sector. Other officials said it's not helpful for the United States or other countries or groupings like the EU to be loudly criticizing China. I came away from this convinced that the one thing I think from the outside that's really useful is, in fact, international agreements, particularly international agreements with teeth. So I'm a big fan of the World Trade Organization. I think that's sponsored a lot of reform in China. China has largely lived up to its commitments to WTO. I think the U.S. negotiating the Trans-Pacific Partnership with a group of countries, it's had a very positive effect in that China felt a little bit left out, but I see a lot of Chinese counterparts now thinking seriously about the TPP looking at it. So I think trade agreements or the surveillance of the International Monetary Fund, these kinds of external institutions that are multilateral can play a very positive role. I've become skeptical that outsiders loudly criticizing China is particularly useful.

MR. POLLACK: Very good.

MR. DOLLAR: The second question, just briefly, I'm glad

you asked it because I want to clarify. I personally would be in favor of bold reform, so this report from DRC, for example, you know, I think it's got a lot of the right measures. There's no reason why China cannot move aggressively to implement those. So I just want to be clear. I would favor bold reform. I was saying I personally think it's unlikely the plenum will come out with the detailed bold reform. It would be nice if there were some noises and direction of some of the things that Cheng and I both talked about. That would be a first step. But I wouldn't expect a detailed bold reform. But I personally would favor that.

And as far as there are certainly some economists who think that the old model is about to collapse, and I'm not one of those economists. You know, we had a nice session here with the IMF a few months back, and I think what came out of that was a largely balanced message. There are a lot of strengths in China in terms of the savings rate and the overall fiscal situation. The old model can continue to work, but this process is going to be difficult and gradual, and that's the reason to get started on it as soon as possible.

MR. LI: Can I add one thing? Because David mentioned about the way we would not expect the detailed announcement. Well, my answer to that point is twofold. On one hand, the 11th -- the Third Plenum

of the 11th Party Congress, which really started to open up the reform by Deng Xiaoping, did not have the detailed rule plan but it showed the direction of reform opening up. Is that important? It's fundamentally important. So if the Third Plenum next month also can lay out the direction, deepen economic reform particularly with financial liberalization, that will be fantastic; just send a very, very important signal.

Now, on the other hand, there are detailed outline, the document is very long. If you look at the 383 Plan, a lot of the detail is in percentage of change, in terms of the timetable of change. So this is my take. Because on the one hand, yes, you're absolutely right. We cannot expect all these details in terms of how much foreign companies should own, et cetera, but on the other hand it provides the direction, which really legitimizes certain efforts. But at the same time you do see some more policies. I agree with you that they should wait for six months or a year to see the implementation. The implementation is as important as the announcement, but the announcement itself is vague. It's not important. I think it's a very important signal. So let's see what happens. I just want to add that. It's not that I disagree with you, but I just want to add my explanations.

MR. POLLACK: Erica?

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MS. DOWNS: Sure. Yeah, Jonathan had commented that the future of economic reform in China is inseparable from China's relationship with the outside world, including the United States, and I think I do agree that there is -- that China's reform initiatives and China's economic relations with the United States do influence each other. I spoke mostly about investment in my remarks, and one of the things I said is that as we see changes in the drivers of economic growth in China, we're in turn likely to see changes in what Chinese companies are doing overseas, including in the United States, and one of the changes that I expect to see here in the United States is more companies investing more money in a broader number of sectors.

And then to pick up on the point that David made, I think that as we see more Chinese companies coming here, they're going to be more interested in signing certain international agreements -- BIT, TPP, and I think that these agreements both, you know, as David mentioned, really can serve as an anchor and a driver of reforms in China.

Just to go back to the point I had made in my remarks and that David had spoke about as well, you have a lot of service sectors in China that are closed to foreign investment, and if China signs a BIT, TPP, they're likely to have to open up these sectors. And this could be good for

China I think in a number of ways. One, it's likely to help grow and increase the competitiveness of these sectors, and on top of that, it's likely to take on some of these vested interests that we've been hearing so much about that a lot of these sectors -- telecomm, logistics, railways, are dominated by a few SOEs. And if they are forced to sort of open up and to let other companies -- private Chinese companies, foreign companies, you know, into those sectors, it's likely to erode some of their influence.

MR. POLLACK: Very good. Very good.

The floor is open. I see -- I'm just going to see hands as they go up. The first one I saw is right here. And we'll continue. There will be a mic, and if you could identify yourself and ask your question briefly. Thank you.

MR. HARRIET: Judd Harriett, documentary filmmaker.

I have a question for David Dollar. I'd like to pressure you on the issue of financial sector liberalization. As I understand it, the local governments and the SOEs are gorged with debt brought about by the subsidized interest rate regime. So what's going to happen here if we really have meaningful financial interest rate liberalization?

And secondly, as I understand it, individual banks really have very few portfolio -- ability to make portfolio choices. They pretty

much lend to who the central authority tells them to lend. So is that likely to change?

MR. DOLLAR: So let me take the second part first. So I think that second part, things have improved more than your question implied. The large state owned banks are doing quite a bit of commercially-oriented lending. You know, there's a lot of mortgage lending, for example, under pretty safe conditions compared to the United States. You know, people put down a large amount. They get a mortgage, they pay an interest rate that's higher than here in the United States, so I would say the mortgage market looks to me relatively commercial. And there is a growing amount of lending to small and medium private firms. So I would, you know, I would paint a more balanced picture. But then having said that, an awful lot of the bank lending goes to state enterprises, either in commercial sectors, you know, like telecomm, or as I mentioned, local governments set up these special - what are really essentially special enterprises to finance infrastructure. We should consider that part of the government, local government. And there are estimates that if you take all that debt, all of their debt plus the center, you get to a number like 50 or 60 percent of GDP and debt, which is frankly low compared to the United States or other advanced

economies. So I think the public sector debt at the moment is not at an alarming level but it's been growing at a rate that's alarming. So they need to change the model because if it continues for a few more years, they'll start getting into danger.

But then when you bring in the SOEs -- not those local investment platforms but the commercial SOEs -- then I think it's a little bit less transparent. The total amount of debt in the Chinese economy relative to GDP is very large for a developing country, and that definitely creates some risks. As you say, as interest rates rise, that's going to put a lot of stress on many of the borrowers, so I did briefly hint that not reforming is risky. Reforming is also risky. I mean, if you don't get the sequence and the timing right. But to me that's always an argument to get started, not an argument to not reform. There's a very small amount of flexibility in interest rates. They could quickly double that flexibility and observe what happens over a six-month period. You don't have to completely eliminate interest rate controls at once. So I would get started on the financial reform because it's tricky business.

MR. POLLACK: I see someone who seems desperate to ask a question, right there. Please, identify yourself.

QUESTIONER: Good morning, Yiyi Fang from SAIS Johns

Hopkins.

I really appreciate your comprehensive explanation of the Third Plenum, which will happen next month. But I'm also wondering, do you think military reform is going to be covered within the comprehensive reform? Anyone up for it?

MR. DOLLAR: Jonathan?

MR. POLLACK: We're involved to some extent in a guessing game here. And I would be, for one, reluctant to make predictions. But you raise a very, very interesting point. Our focus has been so much on the expectations of this economic reform package that we really haven't asked what else might be rolled out for the occasion. Xi Jinping has been clearly very, very active on a range of military policy-related issues, so in a way I would not be surprised. But as always, we have to go from the label. What do we mean by reform? What are the goals? What are the means of getting there? With what kinds of implications? On that I think we're going to have to wait and see, but we'll be watching. We won't have long to wait.

MR. LI: Can I also add?

MR. POLLACK: Please.

MR. LI: The answer is yes and no. Let's start with no.

There is no constitutionism, which means there is no discussion whatsoever about the state army rather than party army. Period.

MR. POLLACK: Good point. Yeah.

MR. LI: But yes is that the central leadership is very much concerned how to effectively make sure that the military will do their own business, their own job, national defense. And also, that this anti-corruption also now is in the military as well. So that area will be more -- a lot of disciplinary things because the issue that we raise is an important one. But there may not be on the headline. May not be even in the detail, but that has been a concern. So this is the way I answer your question.

MR. POLLACK: I see a lot of other hands. I'm going to go first to this gentleman. And then there's a gentleman way in the back of the room there that I'll go to next. Right here, to Peter.

MR. BOTTELIER: Thank you. Pieter Bottelier, Johns Hopkins SAIS.

Question on the interaction, the relations between economic changes, reforms, and political reforms, I think both Cheng and David stressed or suggested a relatively high likelihood of bolder economic reforms than political reforms in the coming plenum. Now, if you look at the history of the economic reforms and the political changes, which have

been quite dramatic in the last 35 years, not system changes but practical changes, looking ahead, my question is if indeed the leading edge of the economic reforms is in the financial sector, as both of you suggested, especially David, could it be that financial liberalization through the back door will force a certain degree of political reform? Maybe not system reform but breaking down the pressure groups that currently block major political reforms?

Let me elaborate. Perhaps unintentionally, a large degree of financial intermediation in China today is already liberalized. We call it shadow banking. There's no state control over interest rates or the allocation of funds in shadow banking. That's already almost half of the financial intermediation in the system according to the last quarter financial statistics. And that is galloping ahead. It suggests to me that unintentionally or intentionally, shadow banking is allowed to take over a large part of the financial system. That will eventually create a level playing field once the final stage towards financial liberalization is actually happening. The changes are to some extent reminiscent of the changes in dual pricing that took place in agriculture in the late '70s and early '80s. Something like that is actually happening in the financial sector. Could it be that these financial sector reforms intentionally or not will force political

change? Thank you.

MR. POLLACK: David, I think that's your --

MR. DOLLAR: Yeah. So you're right. The shadow banking sector has been expanding rapidly. I think the technocrats that you and I both know have favored that because they were frustrated with the liberalization of the formal financial sector so it kind of let this shadow sector develop. But you know there are risks involved in that. Households act as if these are guaranteed deposits even though they've actually signed things saying they understand the risks, but household behavior suggests that people think this is all backed by the state. So that's why I think actually they're trying to bring that back into the regulated system now to some extent and things like deposit insurance and actually liberalizing the interest rates in the formal sector could definitely move things ahead.

But I like your idea that some of these financial reforms definitely have a political dimension. I mentioned the possibility of local governments floating bonds. People discussing that in China, what they would like is that that would go hand-in-hand with much more disclosure of local government finance, including what the local government investment vehicles are doing so that you know what is the total debt of Suzhou

municipality and what is the total expenditure of it. So if they actually made that transparent so the public knew that and the financial markets could use that information, I would consider that kind of disclosure a small but significant political reform. So I like your idea that some of these economic reforms contain elements of political reform in them.

MR. LI: Well, let me just quickly --

MR. POLLACK: Please.

MR. LI: I think that certainly these are linked in my talk actually directly addresses that linkage. Having said that, certainly from Chinese official discourse, as a new term starts to emerge called *daobi* which means use one area to force the change in other areas. Using opening up to force reform domestic economy, use economic reform to force some other changes in the different dimensions. This is the term the leaders use, *daobi*.

But having said that, and we should know that we really did not see much in terms of the election, in terms of media freedom, in terms of constitutionism. Now, these are the real political reforms in people's minds. These are very, very difficult challenges. You're talking about political reform cannot just ignore these very, very important aspects.

Now, certainly, I think Xi Jinping is smart to emphasize the

area he has expertise. He can do relatively well, but the window of opportunity is getting closer, unlike in the Deng Xiaoping era, he can afford to wait or postpone. But now the society starts to change. This is what I argue, that within three years or around that period he needs to carry out some other reform. Basically, the innovation-driven economy requires political openness. So that's the reason that he should do it very, very quickly. But it will be suicidal for him to do that now in terms of broad, fundamental, political reform because he needs to have the support from his team and he needs to carry out some capital first. So that's the things I talk about. So in a way, I think your statement has some truism, but also we should not overlook what people believe reform is all about.

MR. POLLACK: In the back of the room, please.

MR. LIEBERTHAL: Ken Lieberthal, Brookings.

Very interesting set of presentations.

I've heard increasingly in China, especially since this past spring, reference to the potential importance of both the U.S. China BIT and conclusion of a Trans-Pacific Partnership, TPP agreement, as points of leverage to promote reform within China. It seems to me that's the general consensus as this has come up on this panel.

My question to you is since we're meeting in Washington,

each of these issues has a U.S. congressional component to it, as I understand it. Each of these agreements in somewhat different forms will have to get congressional approval in order to become effective. And I guess my question is whether you have any sense as we look to 2014 whether we are likely to run into enormous stumbling blocks on Capitol Hill over either or both of these agreements, or if we do, what are the implications of that, both for reform in China and for the U.S. relationship with China? Thank you.

MR. POLLACK: Erica, do you want to have a crack at that?

MS. DOWNS: Sure. I guess on the question that you had asked about TPP and BIT and potential congressional stumbling blocks, I was actually having a conversation about that with someone else who has been looking at the issue of China and a BIT and a TPP closely, and one of the comments that this individual made, which I'll relay here, is that first of all, it's going to be a while before China -- if China were to sign onto the TPP, it's going to be a while. It's going to be after the current, you know, sort of 12 countries conclude in agreement. And the observation of this individual was that obviously this would have to get congressional approval, and in his view, you know, Congress probably wasn't going to say, okay, China can just sort of sign on to what the other 12 countries

have agreed; that there's likely going to have to be something else in there in order for, you know, Congress to approve it. And one of the things might be -- and a lot of this is going to depend. Again, this gets back to the issue of teeth and how strong, for example, a competitive neutrality agreement is there. But in order for Congress to agree to having China join the TPP, are we going to have to see China sort of reiterating or making more pledges to open up sectors of the economy wider to foreign investment, and I keep harping on this because this really is one of the big objections that a lot of people have here in the United States. Every time a Chinese company wants to buy a high profile asset here, you inevitably have someone that comes up and says maybe we should conditionally block this because of a lack of reciprocity. And so my sense is that there's going to be -- something else is going to have to be in there in order for Congress to approve.

MR. DOLLAR: I would just add that the investment chapter, I think, is a key component of the TPP and one of the most difficult. So I like the idea of the U.S. and China first trying to negotiate a bilateral investment treaty, because obviously that's going to look a lot like the investment chapter of TPP. That will be difficult enough, but at least it's just kind of carving out one set of issues. If the two sides can negotiate

something successfully which will take time, then that will really be a very important historic moment. If Congress somehow turned that down, that would be a very powerful statement about where globalization is going and what's happening in the large relationships. So I would like to think that when we get to that moment, that different stakeholders in the United States and Congress would understand the importance of kind of cementing China's participation in the global system, and then that could become a very good step toward a TPP, which will add even more difficult things and take longer.

MR. POLLACK: If I could just say, Ken's question suggests that we should anticipate greatly heightened political salience to these questions of trade and investment. They have been there back and forth in various contexts, but over time, particularly under circumstances where the United States is trying to affect ideally continuing economic recovery with China at the same time, for many of the reasons that several of us have noted on the panel already, China's incentives to become more intentionally engaged, it creates a space -- political and economic -- that could either suggest the possibility for intelligent outcomes, but also raise the possibility for some very, very unpleasant, highly politicized outcomes as well. So that is something to be continued.

Let's proceed ahead quickly. Here, and then here.

MR. JONES: Bill Jones, Executive Intelligence Review.

I have a question on the pace of reforms here. When I hear the world "bold reforms," I think shock therapy, and I know it's not exactly the same thing but there is a lot of similarities here.

The question is that China is entering a financial system which in itself is in pretty sad shape. The countries in Europe, of course, are under the gun now. They've lost their sovereignty and they're forced to impose austerity policies here in the United States. The fact that we're talking about this debt ceiling is largely because the accumulated debt by the government is largely due to the fact that we bailed out Wall Street, and people are working to try and put controls on Wall Street here, including going back to Glass-Steagall, which is being discussed in Congress. The Chinese obviously see this as well, and therefore, I think they're less inclined to go too quickly with regard to this because the dangers, as Mr. Dollar pointed out, are indeed in the reform itself. If it's opened up too much you're going to have a lot of the hot money coming into China, driving up inflation, and the government thereby, by introducing these reforms, relinquishes a large degree of its control over what happens, and that really can spin out of control. So I think reform is

necessary. Everybody is in agreement with that, but if the pace is too quick, I think it represents very grave dangers for China, and I think the Chinese leadership is aware of that.

MR. POLLACK: That's more a comment than a question.

MR. LI: Very quickly to answer, I think Chinese don't like the concept of shock therapy, which they believe only leads to shock but not so much therapy.

Your question is a legitimate one. It's extremely dangerous that we pursue financial reform. Because of this, they established the Shanghai free trade zone, which is a three-year experiment, which could be duplicated, should be promoted if it's successful, but this is the way they can do it. Of course, you can be cynical how to control the financial flow, capital flow, it's not really by region, but still they want to monitor it very, very closely, step by step. If it's successful, then they can expand it to some other areas. And this really reflects their mindset. It should be bold, but it should also be gradual, and the hope can control, can monitor.

MR. POLLACK: I must say, Cheng and I both were in Shanghai and we had some briefings and presentations on the zone. I'm not sure if I understand it much better now than I did before because you really got a sense that it is not in any sense fully formed. A lot of the

discussion is as much about what gets excluded as opposed to what gets included. At the same time, the fundamental question, if this process were to take off is how do you restrict it to, again, this tiny little area of Pudong. You know, so all of these are questions that I didn't detect, and Cheng, I don't know if you feel otherwise. I didn't see clarity from the discussions that we heard but maybe I missed part of the --

MR. LI: I'm a little bit more optimistic about that. I think there are some important things because the real estate in the zone, increased within three weeks 50 percent. I wish I could make some decision. And all the stock related with Shanghai free trade zone, you know, stops at the peak because each day we are at peak. And constantly. This is a very important signal from how Chinese consumers, how Chinese companies look at that. I hope that what can raise the issues is fundamentally important. China is already second to the largest economy in the world, and the failure or success of China's ongoing economic reform have profound implications for the United States. I think people on Capitol Hill should monitor this very, very carefully. I think we should take advantage of China's further openness, but also avoid making some serious mistakes.

MR. POLLACK: On the other hand, Cheng, I'm not

surprised that a lot of that Chinese money that, if you will, that hot money is floating into an expectation that it's a good place to park your money for the moment. So we'll see.

Yes, right here there was a question.

QUESTIONER: Good morning. I'm Jo, poli sci major senior of American University.

I have a question regarding the reform. Since CCP hasn't really balanced the urgency of economic growth and political reform very well, but at the same time the (inaudible) intention within China seem to be increased in recent years, so I'm just curious if there will be a decisive moment to give a very hard approach to the political reform, and if there will be, then what that might come from. So will it probably come from like the massive protest or the pressure of business, or even like Xi's own willingness to change. Thanks.

MR. POLLACK: Anyone want to take a crack at that?
Cheng?

MR. LI: Well, it's a very difficult question. We do not know. There are so many contentious issues -- food safety, environmental protection, ethnic tensions, social safety, urban relocation, rural land issues. Name it. A long list. We know that there are 500 group protests

per day. Certainly, if you are a leader you will be very, very nervous. But the thing is that's exactly the pressure for the leadership. They're precisely made to have a sense of urgency. But my view is ultimately it will be similar, either because of a success or because of failure, there will be some fundamental change on the political front. The timeframe is not 20 years down the road or 30 years down the road, but a relatively short window of opportunities.

MR. POLLACK: There's a prediction.

MR. DOLLAR: I would just add that I think implicit in a lot of our discussion is there are economic measures China could pursue to accelerate this transformation to a model based more on innovation, productivity, and some of those have political implications. But I agree with Cheng that looking further down the road, you can't really have an innovative society without freedom of the press and more openness. So I think China as a country and as a society is going to face the fundamental choice, not immediately but within a few years about are they going to implement the kind of broad-based reforms that would allow China to really move to high income. No one has really moved to high income without a more open society than China has.

MR. POLLACK: Yes. There's a question right -- the

gentleman with his left hand up. Yes.

MR. SUNG: Wen Ti Sung, visiting fellow at East-West Center.

When Xi Jinping first came to power last year, there was some perception that he was kind of like the man for all factions in a way. Military liked him because he had experience in the CMC; (inaudible) liked him because he was a princeling; and the liberals might like him as well because his dad was a renowned liberal and he had a good friendship with Hu Deping, the former liberal leader Hu Yao Bung. So I was wondering to what extent is the perception of Xi Jinping as a man for all factions still true today or was it ever true? And if it's no longer true, what will be the implication for Xi's political consolidation within the party and for the prospect for legitimate political reforms? Thank you.

MR. POLLACK: Cheng, is he the man for all seasons?

MR. LI: Well, he is a man of contraction I would say. What he describes is absolutely right. I can give you a long list of contradictions. But very quickly, based on my unscientific observation, I think he's still very popular in the public among the middle class. People are hopeful that they will make -- under his leadership there will be change. Change is on the way. At the same time, during the past year,

liberal intellectuals have become increasingly critical of some of the things I mentioned about Seven Nos or the so-called document deny. And that's a very important group in China, liberal intellectuals. In many ways, they represent the good side, right side of history. Of course, whether you like it or not, but because they are also quite influential. So I think the next challenge for Xi Jinping should really be concern about how to make some good -- not only just economic policy but also social political legal reforms. But this is not, again, I said it probably would be difficult for him to do that now, but in the near future, to try to make this group less critical I think is very, very important. I think ultimately, it's the judgment of who wants to be on the right side of history. I still do not have the answer at the moment, but I hope that with all these policies, he has scored well in certain areas, but not well in some other areas. But on balance, I think particularly all the promises of the Third Plenum, I think it's encouraging. And people said -- I love that quote by Sir Francis Bacon. He said, "Hope is a good breakfast but a poor supper." It's breakfast time for him.

MR. POLLACK: What I hear, of course, this is almost the Clinton doctrine. By that I mean Bill Clinton, because I believe he was the first one to talk about being on the right side of history. Now, there's a very presumptive, dare I say, American conception here, but it does raise

fundamental questions about how we see the directions of change and capacities within a society, what has to be encouraged if societies are to be variable over the longer run. Interesting.

We have time for perhaps --

MR. DOLLAR: There's a lady over here you probably can't see.

MS. POLLACK: I could not see you. Okay.

MS. HUMP-FINCHER: It's Beverly Hump-Fincher.

No one has mentioned terrorism here at this platform, so I would like to know whether it will be on the agenda of the Third Plenum.

MR. LI: No. There are so many issues that deal with -- but again, potentially, if some of the incidents are terrorist-related, they will be in the spotlight. We do not know. But of course, at the moment, China faces so many other challenges. So if you can improve the economy, if then you can deal with some other sensitive issues, this is their mindset. So it will not be on the top of the agenda for anti-terrorism.

MR. POLLACK: Let's see. There's a question here, and I think we're going to have to draw this to a close very, very soon, but so you may get the last question here.

MS. PING: Li Ping from China Radio International.

I recently met an official from China who said that the importance of the upcoming Third Plenum session is comparable to the importance of the Third Plenum session of the 11th Party Congress in 1978. So what would you comment on this observation? And what is the historical significance of this Third Plenum session if people look back at it say 30 or 50 years from now? Thank you.

MR. POLLACK: That's a perfect question to summarize all of our discussions. And I'm going to let each of our speakers have a chance to comment on it. Do you think that this characterization of the significance of the plenum is warranted relative to --

MR. DOLLAR: Why don't I start so that others can disagree.

I personally feel that that characterization is a bit of an exaggeration because back in 1978, you really were talking about the beginning of a total transformation of the system from a planned economy, you know, toward to market economy, and even though it's a long journey, that's a fundamental shift from socialism to capitalism. Whatever you want to call it, you've started down the road of shifting to capitalism. So I feel like that was very fundamental. And there were a lot of specific measures, maybe not in the plenum document but within a few months there were a lot of specific measures that have been rolled out.

I feel like the current situation is different. We all agree that there are important reforms that they need to pursue in order to continue down this path of making a more market-oriented economy and then eventually it's going to require political reform. So I think it's very significant, but I don't think it's quite as momentous.

And then the challenges also are somewhat different. If I could write the plenum document myself, I'm not sure that I could write something that really captured everything that needs to be done at this stage just because the economy is much more complex. The needs are much more complex. So I feel like it is quite a different situation.

MR. LI: Our program has a question mark.

MR. POLLACK: I think I put the question mark there.

MR. LI: Good. And I think only time can tell the answer to that question.

But let me add a few things. I do notice top leaders, Xi Jinping and Li Keqiang said something in line with this kind of a promise. Xi said recently at the APEC meeting is that Rambo will appear after the storm. Li Keqiang said the next phase -- the upgraded version of China's economic reform will be far more colorful, interesting.

But I just want to add one thing. China experienced an

economic miracle after Deng Xiaoping drastically changed China's direction. So it should drastically change China's direction. So if the first miracle is economic reform, I think the second miracle should be political reform by nature.

MR. POLLACK: Erica, do you want to --

MS. DOWNS: Sure. I largely agree with what my colleagues said. I sort of have interpreted the comparison, you know, largely to signal that China has some big choices, some tough choices ahead, and depending on what choices are made and how they're made and when they're made, you know, we could see a very different China.

MR. POLLACK: Well, I think the issues today, this is almost a snapshot, if you will, but we are anticipating obviously developments that will be potentially very, very consequential. We've avoided the guessing game but we've identified inevitabilities in one sense or another that as China's leaders confront a very, very different set of challenges, I mean, again, the comment on whether or not a political reform process is truly the next revolution, if you will, that's something that bears our collective consideration, and I'm sure we will all be waiting, and maybe even the Thornton Center will have future events where we will comment on it.

Thank you all for being here today.

(Applause)

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