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THE FUTURE OF STATE CAPITALISM IN CHINA

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P R O C E E D I N G S

MR. DOLLAR: Gentlemen, I'm David Dollar from the John L. Thornton Center here at Brookings Institution. We're very excited to have Dr. Xu Xiaonian. He doesn't need much introduction, but let me just say a few words.

He's Professor of Economics and Finance at the China Europe International Business School in Shanghai. I think of him as a -- maybe it's not fair to call him an outspoken critic, but I would call him an outspoken thinker, worrying about issues of state capitalism in China. The title of his presentation is slightly different than what we advertised. It's "State or Crony Capitalism?"

Dr. Xu has worked for a number of major international investment banks. He has a Ph.D. in Economics from UC Davis. Also studied at Renmin University in Beijing, taught previously at Amherst College. Long, impressive research record. He's spoken here previously at Brookings a few years ago. We're very happy to welcome him back to tell us about State or Crony Capitalism.

I've asked him to speak for about 40 minutes. That's a little bit flexible, but we've got the chairs here so then we can then move into question and answer and discussion mode.

Dr. Xu?

MR. XU: Thank you, David. It's my great pleasure to come back at Brookings and to do this presentation. Originally, the title was "State Capitalism and Its Future." And later on I thought about this and thought, oh, wait a minute. Is China really going on the road of state capitalism? Maybe not. So maybe somewhere in-between state capitalism and crony capitalism. It depends on the outcome of the ongoing power struggle. I will touch upon that in the later part of my presentation.

Forty minutes. David limited my time to 40 minutes. I probably need a

little more. A little more, because I'm going to cover the history of China's economic reform in the past three decades, and so 40 minutes for three decades is tough. That's tough. But I'll try. I will try my best.

So, what I'm going to do is -- well, if the audience knows the content or the material pretty well, I'll just quickly mention it and then shift to the next points.

So looking at these bullet points, I would like to clarify. I would like to clarify the misunderstanding in China's research, the research of the Chinese economy. We often call the past few decades as the era of reforms, but actually, I would like to divide the past three decades into two phases -- phase one and phase two. Phase one, I call it the era of Adam Smith or the era of Deng Xiaoping. And phase two is the era of Keynes, or the era of somebody, I don't know.

These two phases, the nature of economic reforms and the nature of economic growth are fundamentally different. Fundamentally different. If we don't see that turning point or the reversal in China's growth model, it will be hard for us to understand why one's miracle, economic miracle now is becoming miserable with the risks, with the possibility of meltdown ahead. So it is really critical to see the change in the late 1990s in China's economic growth model.

There is a very popular misperception or misconception about China's success. When we compare China with Russia, with India, with other emerging market economies, what we did, this and that, and oftentimes, people cited a large government as a key factor for China's success. That is counterfactual. And it is a misconception.

Over phase one, the Chinese government was actually becoming smaller, not larger. I have some data to show that. And only in phase two, a big government is coming back, changed the nature of economic growth.

So if you don't have disagreement -- well, I'm sure you do, but if you

have no problems seeing these points, I will jump to the next one.

So here is what I mean by two phases of China's economic growth in the past 30 years. You can take the mid-1990s or late 1990s as the turning point. And before that, the government was shrinking over phase one, so roughly speaking, (inaudible). In phase one, roughly from '78, when Mr. Deng Xiaoping started (inaudible) and all the way down to around '93 or '94, that's phase one. That's what I call phase one. Well, actually, we had smaller and a smaller government. This is (inaudible) as a percentage of GDP. And after the mid-1990s or late 1990s, it's been coming back. And these two sets of data are not compatible. Not compatible after the mid-1990s fiscal reform. And this set of data doesn't include so-called government funds. So the size of the government is actually bigger than what the numbers indicate. So you can put another line above, about 5 to 6 percentage of GDP above this line. That gives you a more accurate measure of how large the government is today. So last year, in 2013, total government revenue as a percentage of GDP is about 40, almost the same as in the years of central planning.

So this U-shaped or V-shaped bottom represents the turning point of China's economic growth model. So I want it to be wide the last 30 years this way, and how this was, as Adam Smith's growth or Deng Xiaoping's growth, and phase two is Keynesian growth. Keynesian growth meaning driven by government spending, by expansionary model policies. Adam Smith growth, meaning the growth from gains (inaudible). So the nature of the growth is fundamentally different.

So this number, I use it against the theory about China's success. China's success is due to a large government? No. In fact, the government was smaller and smaller over phase one.

And another theory about the success of China's economic growth is

investment. Large government invested a lot in infrastructure. Again, that is not true for phase one. It is true only for phase two.

So infrastructure investment did not show a very significant driving force for China's growth in phase one. Again, here, mid-1990s -- before mid-1990s, this is mileage of highways and mileage of railway. You can see the growth is mild, moderate, mild. So not so much the economy benefitted from the government provision of infrastructure. Quite the opposite. Only over phase two, look at the mileage of highway and the railway.

So infrastructure in China's economic growth didn't play such a significant role as some people believed; rather, they used as a policy instrument to stimulate short-term growth instead of to facilitate long-term growth.

Well, then the question is what drives China's economic growth over phase one? Over phase one, as I said, Adam Smith type of growth is gained from efficiency. We can identify sources of gain efficiency as the following: reallocation of resources. Reallocate resources from low efficiency sectors to high efficiency sectors, namely two reallocations. One is from the state sector to the private sector. The amount of resources didn't change. The same amount of resources, but you use them in different places. When you shift resources out of the inefficient state sector into efficient private sector, you have a productivity gain. You have an efficiency gain. That's one of the sources of growth. And the second reallocation is, of course, from agricultural sector to urban comers and industrial industries. That's a second reallocation of resources.

And also, the change from central planning to private economy to market-based economy, that changed incentives. Incentives for people to work hard. The incentives for entrepreneurs to innovate. And the source of growth, number three, coordination mechanism switched from planning to price, to market price. Information

incorporated and disseminated by prices faster and more accurately than bureaucratic hierarchy. This is a point made a long time ago by Nobel Prize winner Hayek. Why the market economy is more efficient than central planning? It's not because the central planners are dumb or they're planning methodology is backwards. No, nothing about that. It is a very different incentive scheme, market provided, as compared to the incentives under central planning.

So I identify three sources of growth. Of course, you can find more than three points, but I consider the three as the most important in explanation of China's success in phase one.

So phase one is a case for the Washington consensus. I think in a 2009 conference, co-organized with Caixin. I also mention the Washington consensus. People look at me. 2009, yeah, think about 2009. When some guy from Beijing talking about a Washington consensus, yeah, people probably thought of me as, oh, who is this guy? Is this guy out-of-date? And today, I want to mention Washington consensus again for transition of economies and for emerging market economies. So China's success in phase one, I think is a case for Washington consensus.

Let me recall the three major points of the Washington consensus. Number one is prioritization. Number two is the liberalization and the deregulation. And number three is stable macroeconomic policies.

So what China did? China did all the three things in phase one -- prioritized the state sector, and liberalized prices, and deregulated the markets. And in phase one, the government didn't talk a lot about physical quality and monetary policy. As a matter of fact, they were not even aware of the Keynesianism or they didn't even know they could use a fiscal policy and a monetary policy to stimulate short-term growth. They didn't even know that. Keynesianism was a relatively new word, new terminology

introduced in China only after the late 1990s.

So I'm not saying the Chinese leadership under Mr. Deng intentionally goes with the Washington consensus, but you call it an accident, coincidence, whatever. China's success as far as I can see, can be explained by the Washington consensus.

The consensus is not incorrect, but the consensus is incomplete. It is incomplete. These three points -- the privatization, the liberalization, the deregulation, stable macroeconomic policy environments are not sufficient to guarantee success. That's the point I would like to stress. You need something more than these three points.

The market cannot work well without institutional support. Without institutional support. The institutions in the western countries, we are all familiar with, so familiar with, we tend to take it as granted, as assumed. But many of the institutions that worked as a foundation for the market economy do not exist even today in China. So many economic problems we encountered can be traced back to the lack of institutional support.

The most important institutions for market economy is property rights, by which I mean, of course, private property rights, not state property rights but private property rights. Important institution is the rule of law. Checks and balances on the government among many others. Again, the three, as far as I can see, are the most important for a market economy to operate efficiently.

A large and powerful government is more a curse than a blessing for the institutions required by a market economy. This point relates to the later discussion about what's going on in Beijing today. We see the trend of recentralization of political power, and people argued for that recentralization of power as you need a powerful government to push forward reforms. I take that but at a very important footnote. The footnote is a powerful government is more a threat than a blessing for private property

rights for the rule of law and for checks and balances on the government itself.

Is that okay? Is this fine with you?

Usually I can tell in my classroom, yeah, my students' acceptance or dispute against my view but today I don't see any signs of agree or disagree. I don't know. Anyway, we have time after this for discussions.

So Mr. Deng Xiaoping. We often said Mr. Deng Xiaoping is the architect of China's new economy. Actually, he is not an architect or the architect of China's economic reforms. He didn't design anything. He didn't design anything. As an architect, we would imagine he planned this and that, laid out a roadmap for China to go. Well, in fact, he didn't do any of this. And I worked for the state council under Deng's leadership. I didn't get the chance, of course, to talk to him face-to-face, but I felt at the time the style of his leadership is not hands-on. It's not as today's leadership designed every detail and perfect planning, sophisticated policies, and monetary implementation. All of this, today's working style of the leadership reminds me of the olden days under central planning. It's not a style you frequently see in a market economy.

So where are we going? Are we going in the direction of Mr. Deng? No, I don't think so. At least I doubt. At least I doubt. And Mr. Deng didn't design every reform. Quite the opposite. Yeah, quite the opposite. He allowed people to participate in economic organization and institutional innovations.

The family responsibility system wasn't designed by Mr. Deng but invented by peasants in Anhui Province. The township and village enterprises are not designed by Mr. Deng but created by people at grassroots. And the private companies are not designed by Mr. Deng but set up by private entrepreneurs. That is not to deny the contribution of Mr. Deng to China's economic development. No. He played a critical role in China's economic reforms, but not by designing but by allowing, by enabling

people to do this and that.

So you compare Mr. Deng's with today's Chinese leaders, you can see a huge difference between them. A huge difference between them. And Mr. Deng's attitude is kind of humble, it's kind of "I don't know what to do. You guys figure it out. You try whatever is the best. White or black cat. Whatever will catch the mice is the best."

And he just to prove it. If it is indeed enhanced productivity, okay, good, do it. Then he issued a policy. And applies that policy to all nation. That's what he did. And not today's government officials, particularly the high ranking officials. They went here and there to get instructions about how to develop your regional economy. I would like to ask them how much do you know about the local economy? Are you really in the position to issue orders or to issue directives and to tell people what to do? Come on. We don't need you to tell us what to do. We know what we can do and what we should do. We know. What we need you to do is to give us the permission. Or, you don't prohibit, okay, like Internet financing innovations. You don't stop it under the name of regulation, under the name of maintaining market order. This is what we did. This is what we need. Just like Deng Xiaoping. Enable the people. Empower the people. Not empower government agencies. Not empower NDRC. And I think for China's next stage of reform we need to dismantle NDRC. Okay? NDRC is the biggest obstacle on the way of China's future reforms.

So the two phases, over and over again I stressed the importance over the distinction between phase one and phase two.

All right. So that's about my story on phase one. And things changed. Things changed in the middle of the 1990s or late 1990s. A gradual (inaudible) of growth model took place in the late 1990s. Why? Okay, there are several reasons for the

change in China's growth model. There are several reasons. And reason number one is two financial crises. One, as you all know, is in 1997, Asian Financial Crisis and the second one was in this country in 2008 as a catalyst for the change of growth model in China. So that's one reason.

When the economy was hit by external crisis, external demand weakened. That slowed down China's economic growth. And I mentioned a minute later there is growth rigidity in the Chinese economy. When the growth slowed down, the government has to do something, has to do something to promote growth for political considerations, not purely economics. Of course, it is economics, but not purely economics.

So the two crises, the two crises pushed China into the other direction, into Keynesian direction, away from the direction of Adam Smith or away from the direction of Mr. Deng.

The second reason for that change, reform dividends started running out. Reform dividends started running out. We have done little on the front of factor markets, on the front of state sector reform after 1993 or 1994. Almost no reforms. Almost no reforms. And why almost no reforms? Again, there are several reasons. One is limited by cognitive limitation of the leadership. The leadership didn't realize without factor market, growth market only cannot carry China into the next stage of economic development.

So looking backwards into the mid- or late 1990s, what we should have done is factor market reform, including land reform, capital market reform, and continuation of the state -- the reform of the state sector. But we didn't do that. We didn't do that.

Now, why we didn't do that? The leadership then thought with the

growth market, that's enough. That's sufficient for China to move on. It turned out, no, it is far from being sufficient if you only have the growth market but without factor market.

And secondly, the lack of political courage after Deng. You push forward more deeper reforms. Of course, it is the stabilizing force for the economy, and only the kind of leadership Mr. Deng has can afford the instability of the economy and even the society.

So not enough political courage to push forward the factor market reforms. The concern concentrated, focused on the stability, economic as well as social stability.

And number three, why since the mid-1990s are there so few reforms? Vested interests. Vested interest formed and blocked reform initiatives. So, of course, as this is a political economy, it's an issue of political economy, it's not pure economics. As an economist, I feel so helpless these days because the issue is way beyond my reach as an economist. I have to work with a political scientist. I have to work with a sociologist. I have to figure out what's going on and what the problem is. So as I recognize, some of you are college graduate students. If you study economics, my advice is economics today is not enough for China. You have to go for political science, sociology, even culture study. Economic study is not good enough.

So when the growth has slowed down and the authorities are so anxious, they try to push the economy back on track, on a high growth track. Why do they have to push it back? I know Mr. Obama campaigned for a second term. What year, last year, right? And he won. He may be the first president who won the second term when the unemployment rate is so high. Is he the first one? The unemployment rate last year was six-point something, a little below 7 percent. According to the economic model, we can predict Mr. Obama would lose, but he won.

So economists in this country use the unemployment rate as the most important indicator to predict the outcome of a general election, but it failed last year. Why do you use the unemployment rate to predict the outcome of the election? Political legitimacy. Again, it's an issue of political economy.

The Chinese political system, as rigid as it has been in the past 2,000 years, the political rigidity leads to growth rigidity. Leads to growth rigidity. Every government, the last government we remember, and the bottom line -- the premier said the bottom line is 8 percent. And for this government, the bottom line, what is the bottom line? 7.5 percent. Why every government has a bottom line? And economic growth is like your kids. Your kids are growing up. You ask your kid to grow 10 millimeters every year and if your kids fail to do that, what do you do? What do you do? Do you promote growth? By what? By medication?

So why does government target growth? Why does government target growth? Mr. Obama never targeted growth, even though employment or unemployment is a very important indicator for them, index for them. And the Chinese government is so eager to maintain a certain level of growth because of the political rigidity. The political rigidity stems from performance-based legitimacy. Performance-based legitimacy.

The issue of legitimacy is a notion in political science. Legitimacy put in simple words is why you? Why you are the president of the United States of America? Why you? Not me. Of course, I am not a U.S. citizen. Not eligible. But why not you in the audience? Why? You don't have any votes.

So the source of legitimacy. The source of legitimacy, number one, votes. You voted for me. Come on. Right? And the source number two for legitimacy is charisma. This is not economics. I'm sorry. I'm going out of my field. The second source of legitimacy is charisma. Why Mao Zedong was the chairman of People's

Republic of China? Because Mao Zedong won the civil war and drove Chiang Kai-shek to Taiwan. Why me? Mao would have said, "Because I defeated Chiang Kai-shek." It's that simple. Can you do that? Why Napoleon was emperor? Why? Very simple. I defeated all the European powers that tried to kill the new republic of France. So charisma is the second source of legitimacy.

Other than these two, performance. Performance. Why you? You are in power for 60 years. Why you? Should I get a chance? You have to prove yourself. You prove yourself by what? By performance. By performance. So that is why the government tries everything they can to maintain a certain level of growth.

When the genuine growth engine lost steam, how can you promote growth? Keynesian policies, fiscal policies, and monetary policies. So convenient instrument for government to stimulate growth.

So the first fiscal stimulus introduced in 1998 or 1997 by Premier Zhu Rongji, and since then the fiscal monetary stimulus became a routine operation of the government. After the 1998-1999 stimulus, 10 years later, during the Asian financial crisis, we did the 4 trillion stimulus in 2009. It was crazy. It was crazy. When the stimulus program was announced, I wrote an article to criticize right away. Right away. And, of course, my article didn't get any chance to be published. I sent it to a newspaper, leading newspapers. All got rejected. And I asked them, why did you reject my paper? And they said, Professor Xu, we all love your article but now we have instruction from the top. No discussion about 4 trillion program. No discussion. Period.

So that's not the end of government-driven growth. In 2012, it's what we called 4 trillion version 2.0. If you look at long growth, if you look at the funds raised by the whole society, it's called *quanshehuirongzi*. In 2012, the second peak. The second peak. And still that's not the end of the fiscal and monetary policy. This year, right, this

year, we have many stimulus. Many stimulus. This is all in Chinese. I cannot translate. I cannot translate. It's called *wenzongqiangciji*, *qiangzongwenciji*. Only those who understand Chinese can see the art of Chinese language. How do you translate it?

Premier Wen, in Chinese, meaning what? Meaning moderate, warm. What else? Soft. Right, right, right. Premier soft. Rolled out -- rolled out stimulus that is very strong. That is very strong. Strong is the middle name of the current premier. Not a middle name. Last name. Last character. Last character. So in English it is moderate premier for strong stimulus. And now the strong premier for moderate stimulus.

So why every premier, every government wants to stimulate growth, yeah, legitimacy issue in the background. Legitimacy issue in the background. Not only the legitimacy of the government, but also the legitimacy of the top officials themselves. You got this job not by your track record. Right? We all know how the premier was picked in China. It was not elected; it was picked by somebody. Or by somebodies.

So why you? And everyone has to prove himself or herself. How could I possibly prove myself, my track record? Look at the GDP of growth. Look at the GDP of growth. So I call it double legitimacy issues. Not only the legitimacy of the government, but also the legitimacy of the government officials. So we fall into a kind of growth rigidity because of the political rigidity. In a democracy, the prime minister or premier will say, "Who cares?" GDP growth is 3 percent or -2 percent. Who cares? It's not my fault. This is a free market. The free market runs as a result. We got -2 percent economic contraction actually. That's not my fault. That's the fault of Wall Street in 2008.

So I don't worry about my job, but the top officials in China do. If the performance of the economy is disappointing, well, his job may be in danger.

So when the government, when the visible hand -- when a visible hand of government is coming back, we see a reverse. We see a reversal of China's growth

model. Resource allocation turned around back into the state sector. Back into the state sector. The SOE, once a cancer, now a pillar industry of the economy. It's a crown prince as called by the former head of SASAC, the state asset management committee, absorbed so many resources and it received preferential policies and it monopolized certain markets.

So when you have resource allocation reversed, economic efficiency got killed. And the incentives, the incentives, why we prefer market for government intervention? Because we believe the market provides the right incentive for people to work hard and provide the right incentives for people who are entrepreneurs to innovate. But when government intervention prevails, it provides intervention for rent seeking. It provides incentives, I'm sorry, it provides incentives for corruption. Not for innovation but for corruption.

I'll give you some examples. College graduates rushed to join the Civil Service. The number one choice on college students' wish list when they graduate now is Civil Service. Number two -- what is number two? Guess. SOEs. Not finishing institutions but state-owned financial institutions. That's number two. So you also fell in that trap; right? You want to join the public sector; right? For what? For what? For stability? For job security?

I asked Peking University graduate students. I said, "Why do you guys all want to be a civil servant?" And one student told me as a civil servant you get a lot of respect and you've got job security. And I said, "Okay, don't fool me around. I know the true reason. I know the true reason."

For example, civil servants working at *maliezhuzhuanbianyiju*. What is that? A government bureau in charge of translation of Marx and Lenin's works. That job is also respectful. It's also quite secure. Why are you guys not interested? Why? You

are interested in jobs where? Taxation bureau. And customs. Why? Why? So many opportunities to get great income. So many opportunities for deals, under-the-table deals. So many opportunities for being corrupt.

Actually, I wrote an article. I wrote an article about this. I said this is disastrous for the society. If everyone wants to get the job for rent-seeking purposes and no one cares about how to create wealth, how to create value for society, where do we get economic growth? Where?

So the incentives, the government intervention in the economy in particular, when a government resolves checks and balances involved so deeply and broadly in the economy, the outcome, the result will know it. It is corruption. It is a distortion of incentive for the society. Entrepreneurs are more interested in overseas investment and innovation, as you all know.

I was visiting Stanford University. People complained so much about housing prices in the Bay Area. Housing prices surged in the past 12 or so months, and the local residents even cannot afford nice houses. Why? Very strong demand from China. Very strong demand from China pushes up the property prices in the Bay Area. I think also in New York City. Not so much in Washington. Not so much. Because no one likes politicians. So they stay away.

The incentive scheme changed. Changed from that in phase one. In phase one, young people, college graduates were encouraged to create their own business. Now, civil servants. And businessmen interested in dining and wining rather than research and development. So the incentive system changed. And even the incentive for low income people no longer working hard, but for low income people and groups, they look at somebody like Mr. Bo. They liked Mr. Bo so much it surprised me. It surprised me. When I wrote my web blog on a regular basis, every day I received

criticism from I don't know who. And I click in. The guy sent me a critical note and put Mr. Bo's portrait on his web blog as his label.

So what do they want? What do they want? The people at the grassroots level, what do they want? They want another cultural revolution. Another cultural revolution to redistribute wealth. So even incentives for low income people now is quite different from 50 years ago. From 50 years ago. And for the government, we have seen replanning, reregulation, reintervention. How many plans have we seen, industrial policies under Premier Deng? More than 10. I didn't count but my impression was more than 10. The NDRC grew into the most powerful ministry. And industrial policies, of course, have disastrous consequences, such as high speed rail and solar power industry. Overcapacity and corruption everywhere.

So how does the government maintain?

Am I running out of time? I need to wrap up pretty -- okay. Another 10 minutes. Thank you for the generosity.

So how does the government promote growth? You cannot rely indefinitely; right? You cannot rely forever on fiscal spending or on monetary policy because the government will run out of resources pretty soon, and if you keep pumping money into the economy, you will create inflation. So instead -- still, they are using fiscal policy and monetary policy to stimulate growth. But in addition to that, they raise money from sales of land. From manipulating the factor market. From manipulating the factor market. The deal you all know. The government acquires land at a price much lower than market value from farmers, from urban residents, and auctioned land doubled 10 times the cost in the marketplace for commercial development. In this way, the government raises a lot of money and they invest it in public works. And, of course, a big chunk of the money fell into their own pockets. No surprise.

So the government dominated growth strategy. The consequence is the distortion in incentives, the distortion in income distribution, the unsustainability of the growth is obvious. It is obvious. And when we talk about today's China's structural problem, oftentimes people point to the investment consumption gap. The investment consumption gap. But that investment consumption gap is just a natural result of this growth strategy.

Let's look at this chart. The blue line on top is the consumption GDP ratio, and the red line at the bottom is investment GDP ratio. Again, from here -- again, from here, about the mid-1990s or late 1990s, the gap enlarged. Well, on my chart it's narrow. On my chart it's narrow but actually what I mean is enlarged in the sense capital accumulation went up at a pace much faster than the persons in power of households. Capital accumulation, capital formation went up at a much faster pace than consumption, than domestic person power.

So as the gap here narrowed, what problem we will see in the economy? What problem we will see? Overcapacity. Overcapacity.

Before the mid-1990s, the gap, by and large, constant, were narrowed somewhat, but in the past 50 years--investment outpaced -- investment outpaced the consumption. So that's what I think is the biggest structure issue of the Chinese economy.

But this is the only phenomenon. Behind this phenomenon is the growth pattern, the growth driven by the government. It is an inevitable outcome. This is the inevitable outcome because the government wants more money to spend. Where do you get more money? You squeeze the household. You squeeze people. So taxes, effective taxes raised. Also, funds raised from selling land at the cost of farmers and urban residents. Of course, that is a cost for consumers.

So income distribution in the past 50 years worsened. Look at this set of numbers at the bottom, down there. This is the income share of three sectors -- government, enterprises, and households. In 1993, the government income accounted for 17 percent of China's GDP, and in 2007, it was 26 percent. So a 9 percentage point increase. And today, I think government income as a percentage of GDP stands at somewhere near 40 percent, even higher than 2007. And the income share of enterprises, not much changed -- 20 percent to 22 percent. The biggest loser is the households. Their income share dropped from 63 percent to 52 percent. So, no wonder consumption is down so much. Consumption is down so much because their income is down so much.

And this growth is not going to sustain. This kind of growth is not going to sustain. Government-dominated, investment-driven growth is not going to sustain. Why is it not going to sustain? Look at this chart. Look at this chart. You cannot rely on investment forever to drive GDP growth. Impossible. Why is it impossible? Technically, you can see very clear. This is the investment GDP ratio. China's investment GDP ratio, again, a difference over these two phases are noticeable. The investment GDP growth ratio over phase one, not much changed. Not much changed. Over phase two, it surged. Over phase two it surged. We have to invest more and large in a larger share of GDP in order to keep growth. In order to keep growth.

Now, my question for students here, can we go along this line forever? Can we? Why not? Why not? Because there is an upper limit. The upper limit is what? The theoretical limit is what? It is 100 percent of GDP. What do we mean by investment GDP ratio 100 percent? What do we mean? No consumption. You don't eat. You don't drink. You do nothing. Every renminbi of GDP invested.

So technically, there's a limit. This upward trend cannot go forever.

There's a limit capped on China's growth potential. That is 100 percent of GDP. Practically, what is the limit? Nobody knows. Nobody knows. But now it is already 50 percent. Can you imagine even higher? Can you imagine even higher? Every \$10 value created in a country in the U.S., \$5 invested. \$5 invested. And \$15 taken away by the government -- I'm sorry, I messed it up. For every \$100 GDP we produced, \$50 invested, and \$15 taken away by the government, and \$35 left for consumption. Can you imagine this growth model is sustainable? Of course not. Of course not.

Let's compare China's growth pattern with the U.S. The U.S. investment GDP ratio is the bottom line, it's a green line. What's the difference between China in the U.S.? The U.S. is decreasing, increasing, stable? It's a horizontal line. But the fundamental difference is not the absolute level. The fundamental difference is what? It's the shape of the curves. If you have a horizontal line that means what? You can go along the horizontal line indefinitely. Long term you can go. And China's upward sloping line you cannot go along that line forever. Okay? Sooner or later, the blue line -- what will happen to the blue line? Way before reaching 100 percent, you will turn down. Now, once it turns down, what will happen to the economy? Look at Japan, the red line. The red line is Japan.

Japanese investment peaked in early 1970s. We all know what happened to the Chinese economic growth. Down. Stagnate with investment. With investment. So this is an economic theory developed by Professor Robert Solo of MIT. Sustainable growth can come only from what? Not from increasing use of resources but from what? From technology improvement that will enhance productivity. Have you studied that? Does it sound familiar? Did you pass your exam?

So government-driven, government-dominated, investment-driven growth is not going to be sustainable, that's for sure. That's for sure. The question is

when? When the interruption of growth? When the end of growth will come? We will see. And my sense is pretty soon. Even though I cannot predict when, but pretty soon. We are seeing that in the first quarter of this year.

So the way out. The solutions you offer, the solutions that I offer here, this is my wish list. This is my wish list. Of course, it's not on the 18th party Congress. I didn't get a chance to submit my policy proposal. Market-based industrial consolidation. Our industry is plagued by overcapacity everywhere. Capacity utilization estimated in a range of 50 to 60 percent. In this country, capacity utilization is more than 80 percent, but in China, it's about 50 to 60 percent.

So industry consolidation and restructure is so urgent. So urgent. With the overcapacity here, enterprises cannot -- they are not to invest more. And as prices keep falling, more and more enterprises will encounter difficulties, may even go bust.

And more important than industry consolidation is structural reform, not policy reflate. I'm very disappointed in the past three months of visiting Stanford University what I heard. Not so much about structural reform but all about policies. All about policies, not reforms. So the structural reforms on my wish list shrink as they sector through prioritization. Across the board, tax reduction, fiscal reforms followed by land reform, deregulation and domestic opening up, judicial reform, independent and transparent protection of property rights to restore confidence. To restore confidence. Right now confidence is so weak. We need to do something to reestablish confidence.

And what you should do is to empower the people and incentivize the private sector. It's not to empower government officials, not to incentivize the government agencies. And the people told me the current leadership is doing that, but my question is self-reform, is that a credible commitment? I'm not sure. I'm not sure.

If we look at the business models, very popular business models, we

can't imagine how difficult today in China to introduce new reform measures. The business models, I think some of you might be familiar with, in particular, those who can read Chinese media.

In the public project, in the process of bidding for a public project, let's say the contract is worth 10 million renminbi, and 10 companies submitted their bidding and for sure one company won the contract. The other nine lost. Actually, some of my students are among the nine losers. They told me the true story. This is a true story.

The winning company doesn't know anything about construction of public works. It doesn't know anything. It doesn't have the engineers. It doesn't have the working teams. It has nothing. Well, what the winning company did was to subcontract the public work to other companies at a value of 8 billion. So where does the 2 billion go? Where does the 2 billion go? Even more, subcontract. Subcontract. So when the construction company eventually got a contract, the money wasn't enough to cover the cost, so what the construction company did? Why did so many roads and bridges in China collapse? Why?

Mr. Zhu Rongji -- what year? I don't remember what year the Yangtze River flooded. So Zhu Rongji flew to that place, Jiujiang, to review the construction work. What he discovered, in place of steel, people put bamboo in there. For what? For cost savings. For cost savings. And Mr. Zhu Rongji was so mad. Was so mad. And dirty words, four letter words out of his mouth.

But this is a reality. This is a reality. Why the local governments are so passionate about public works? Why? They built this and they built that. So many bridges, so many highways. So many skyscrapers in a downtown office city. Why? In addition to their economic performance, under their jurisdiction, but also private benefits.

For SOEs, we know, it is revealed in a recent anti campaign, anti-

corruption campaign, it is revealed that some SOEs capital expenditure, CAPEX was designated to certain companies. It is a black box. The CEO has to write, can sign a paper, and spend billions of dollars on a project with certain partners. The partners are often appointed partners, and a mysterious pre-IPO investment. This is also a story my student told me.

My student went public, listed in the stock market, and a couple weeks before the public listing, he received a call. Somebody asked him, "Hey, we heard our company is going public." He said, "Yes." "Can we buy some shares?" "Who are you? Why should I sell shares to you?" "Well, if you let us become an investor before the IPO, I guarantee all green lights for your public listing."

So this is why PE investment funds are so popular in China. Very popular. The big ones, you can always find some big figures behind the big PE investment funds.

This story is not to leave you with the impression about how corrupt the society is today, but to let you think how difficult further reforms are. How difficult further reforms are. And in an effort of the current leadership for tiger hunting, *dalaohu*, tiger hunting is not a good translation. Can't you have a better one? *Dalaohu*. Yeah. The biggest tiger we talk about for so long, and yet we don't know if this tiger will be hunted or not.

So why is it so difficult? Why is it so difficult? The vested interest is so powerful. The vested interest is so powerful. I, myself, fully support the anti-campaign effort by the central government, but my doubt is not on their intention but on the possibility to succeed.

So I think I do need to wrap up.

It comes to a conclusion. The conclusion is actually no conclusion.

College professors always do that. Their job is not to offer you a conclusion but to make you think. That's our job. Not give you a conclusion.

So there are two possibilities for China looking forward, looking ahead. Looking forward there are two possibilities. One is state capitalism. One is state capitalism. The government is so powerful, they control economic activities. They control the society. They control the politics. They control everything. Is that what we want? Let's imagine if the leadership, the current leadership wins the battle of anti-campaign with recentralized power, the Chinese economy, we will see more central planning. We will see more government intervention. That makes me think maybe state capitalism. But examples of state capitalism -- Germany and Japan before World War II. Is that what we really want? We have to ask ourselves.

And Germany and Japan before World War II, as compared to the United States and Great Britain, they were also market economies. They were also market economies, but what was missing? Rule of law. Rule of law. And what was missing in those two countries? Constitutional democracy. And respect for individual rights and individual freedom. So that's the nature of state capitalism. That's the nature of state capitalism.

Another possibility is crony capitalism. Examples of crony capitalism are Latin America and some Southeast Asia countries today. They also have market economies, but no rule of law, and a superficial democracy, not genuine democracy but what I call a superficial democracy. Corruption widely spread to every corner of society as we have seen in Indonesia under Suharto and the Philippines under Marcos.

And for crony capitalism, the future is economic stagnation, inequality, instability, and middle income trap. So which category will China fall in? I hope neither, but the likelihood, I don't know. It depends. It's up to our future research to offer some

answers.

Let me stop here. I have taken too much time. Thank you so much for your patience.

(Applause)

MR. DOLLAR: We can just use this microphone if it's on. If this is on. Think about your questions. I'm going to start with one. But just one.

Professor Xu, thank you very much. Very stimulating. A little bit -- quite sobering.

I tend to agree with his analysis about the unsustainability of the growth model and there are a lot of possibilities, but within a reasonable timeframe, it's possible growth will slow down very dramatically.

MR. XU: Yes.

MR. DOLLAR: So my question is, if growth slows down below 4 percent, will the leadership then turn to some of the things on your list? Will there be political movement towards greater political participation? How do you see things playing out if the growth slows down quite quickly?

MR. XU: First of all, I think the growth may be already around 4 percent. Maybe around 4 percent. Because the Keqiang index, some research institute in China calculated the Keqiang index suggests the growth is already in the range of 4 percent. I don't know how the census bureau reported 7.4 percent for the first quarter. So already pretty serious situation there.

The central government didn't do a lot. I understand why they didn't do a lot, because the constraints, the fiscal constraints and monetary constraints didn't allow them to do a lot. If the economic situation deteriorated further, what they could do, still

two possibilities. One is the state capitalism. Like what the Chongqing authority did. The government would get even more powerful. Even get more powerful. Redistribution of wealth to maintain social stability, and on the other hand, the government raised a lot more money to invest. And part of the money comes from confiscation of private wealth. So what happened in Chongqing, I think it's a mid-Asia model of state capitalism.

And another way is what I hope is going for the reforms on my wish list. I think China's economic growth potential has not been exhausted. We have much room to grow, but we need to break up the straightjacket on the Chinese economy. We need to break up the constraints on the creativity of the Chinese people and Chinese entrepreneurs. And that straight jacket is government regulation. It's government intervention. And also planning.

MR. DOLLAR: Questions? This woman here.

Do we have a microphone? Yeah.

And just please briefly introduce yourselves.

SPEAKER: Thank you, Dr. Xu. I'm a master's student at Johns Hopkins SAIS and also graduated from Renmin *daixue*.

MR. XU: Okay. Alumni, yes.

SPEAKER: So you've mentioned about China's factor reform in the late '90s, and in the recent third plenary, the Chinese government emphasized the market roads and resources allocation. And the Shanghai Free Trade Zone, they put forward an idea called negative list.

MR. XU: Right.

SPEAKER: So I was wondering, what's your opinion about how China could conduct the market factor reforms?

Thank you.

MR. XU: Good question.

I think Shanghai Free Trade Zone is a perfect example to share how difficult today for further reforms. The Free Trade Zone is set, a project of the premier himself. But, the ministries and the regulators told him -- this is a rumor. I'm not a reporter, so I don't know if it is true. No, we cannot do this. We cannot open that. The stability of the financial system, we don't want any eternal disturbance. So, sorry, Mr. Premier, we cannot do that. And the premier is so unhappy, put it this way, and even said, pounding the table. But still, we don't see much progress in Shanghai Free Trade Zone. We don't see much.

The vested interest everywhere, and with their representatives sitting in government offices. So what do you do? What do you do?

MR. DOLLAR: So what would you do? In terms of reforming the factor markets? Capital, land, labor; what would you do?

MR. XU: Okay. Let us study the case of Deng Xiaoping. Deng Xiaoping didn't do any free trade zone or special economic zone in Shenzhen and Zhuhai. Deng Xiaoping didn't tell people what to do and just would draw a line here. And within this line, within the Shenzhen area, whatever you want to do. Go ahead. You don't know how the market economy operates. You go to your next door neighbor. You go to Hong Kong and study Hong Kong and come back. This is how the special economic zone prospered.

What I would do, I would say, okay, guys, from today on, whatever you want to do. Go ahead. As long as it improves productivity, as long as it enhanced efficiency of resource allocation, again, white cat or black cat, I don't care, go ahead. Without mass participation, the point I want to make is today China is in a great transition from a traditional society into a modern society, and this transition cannot be completed

by a few small number of elites. It is a mass participation. So study the history of modernization of England. Study the history of modernization of Germany and Japan. Top-down approach maybe is needed, but bottom-up at this stage, from my point of view, is even more important than top design. Bottom-up enables the people, empowers the people. Without any law, legal, forbidden or prohibited, you can do. And let me know the result. If the result is good, all right. I will approve it. I will approve it. And I will issue a policy and apply that policy to our nation. That's like what Mr. Deng did.

MR. DOLLAR: That woman in the back, the purplish red shirt.

MS. NA: Hi, my name is Na Hu. I'm a first-year MBA student from George Washington University. I have two questions today.

The first question is according to the World Bank report issued earlier today, China will overtake the United States as the largest economy by the end of 2014, which is five years earlier than the previous estimation. So what do you think what kind of signal this report sends out? What kind of strategy does China need to adopt for their future development?

MR. DOLLAR: Can I just add a footnote? This is in purchasing power parity terms.

MR. XU: Yeah, purchasing power parity terms.

MR. DOLLAR: With the new PPP estimates, China overtakes the U.S. this year.

MR. XU: Okay. We can take over the U.S. at any time. Any time as the State Statistical Bureau wishes. No problem. No problem.

I don't care about we are number one or number two. Number two is already big enough. Number two is already big enough. What I care is are our people happy? Is their standard of living improving or not? That's what I care. Our productivity

can compete with top U.S. companies in the international markets or not? Can we have Googles, Microsoft, companies like that coming up more and more and take the place of Google in the world market? That's what I care. That's what I care. The size itself doesn't matter as an economics professor. What I care is efficiency. It's not size. Economics is not about size; it's about efficiency.

So our company, are Chinese companies competitive enough in the world? That's what I care.

MS. NA: Just a very short second question.

So you're talking about one way out is to shrink the state-owned sector through privatization. So I wonder how do we evolve cooperation and fairness during this process? And who really has the rights to own the previous state-owned properties?

MR. XU: Privatization. Any privatization in the world is unfair, I can tell you. It is unfair by its nature. Privatization is unfair. But even more a problem, even a bigger problem is state ownership. I know no matter how unfair private ownership is, it is more fair than state ownership. So private ownership is an improvement over state ownership. In the process of privatization, of course it's unfair. You cannot find anything in the world 100 percent fair. If it is fair for republicans, it must be unfair for the democrats. If it is fair for the democrats, republicans must complain a lot. You can never find anything in the world you can name it as fair. I can only compare the two ownerships -- public and private. I will say in private ownership, resources are more efficiently used and therefore can create more value for the benefit of the people. That's all I can say.

MR. DOLLAR: Over there. I already passed the mic to my friend. Oh, sorry.

We can do both of you in succession. Yeah.

MR. REYNOLDS: Thanks. I'm Bruce Reynolds. I'm an old, retired

professor. I loved a lot of your thoughts today, and I look forward to emailing you about them maybe offline. And I wanted instead to invite you to comment on the news in today's New York Times that Chen Yizi had died at the age of 73 in L.A., and I wondered how you think we should remember him and what place you put for him.

MR. XU: Sorry, I haven't heard that story yet.

MR. DOLLAR: I'm sorry, who died?

MR. REYNOLDS: Chen Yizi died.

MR. XU: Right, right, right. He died today?

SPEAKER: He died two days ago.

MR. XU: Two days ago?

SPEAKER: I think it's four days ago.

MR. XU: Four days ago?

SPEAKER: He died.

MR. XU: Yeah, yeah, yeah. Okay.

He made his marks on China's economic reforms. I think we will remember him. Yeah, we will remember him.

Well, actually, I worked with him in China in drafting some of the reform plans. So his institute and himself made their marks on the history of China's economic reform. We will remember.

Other than that --

SPEAKER: It was a long time ago.

MR. XU: That was a long time ago. That was in the 1980s. The environment, the mentality was so different from today. So different. I miss that decade a lot. Yeah. I view that decade working for the government as one of the highlights of my career. I enjoyed it a lot. I enjoyed it a lot.

MR. YUKON: Yukon Huang at the Carnegie Endowment.

I enjoyed the discussion quite a bit. I think you're absolutely correct in noticing that there's a lot of rent seeking going on, a lot of distortions in the economy. Your principal thesis is that this is related to an increasing role for the state. My question really has to do with how do you measure this? Now, all the indicators we have show that the private sector share of the economy has been growing steadily for the last 20-30 years. So it's not like the state sector is actually getting larger; it's actually getting smaller.

If you go to your three factors of production -- land, labor, and capital, if you go back 15 years, there was no private property or land. Now it is, so the private sector's role in resources and land is greater today than it ever was. If you go back 15-20 years, workers are more or less staying where they were. They now move around, so you have two million migrant workers, and you have wages increasing at 12 percent a year, much higher than they were 10 or 15 years ago because of flexibility and mobility. So labor today is much more market-driven today than it was 15 years ago. And we realize that financial sector reforms are actually moving forward. Interest rates are much more flexible. They're moving up. Lending rates are decontrolled.

So my question is I can't figure out how you actually can measure the question that the state is actually getting more powerful. Now, you use revenues as a share of GDP as an indicator. China's revenues as a share of GDP is 30 percent formal revenues. You add 7 percent for other stuff. It's about 35-36. It's much lower than it is here in the U.S. Much lower than Europe. It's actually lower than most middle income countries. So the role of the state, as measured by the budget, is actually smaller than most other countries.

My question is how do you square this general question of the role of the

state? I do realize there is an issue here. The issue is that the role of the state in the economy somehow is becoming distortive or more distortive. But I actually think that the reason for that is because of the rising role and prominence of the private sector. It's created wealth and opportunities that did not exist 15 years ago. So the actual real problem is how do merge a fairly strong state with a rising private sector and able to address these distortions in rent seeking that you've mentioned?

MR. XU: Yes. It is a good and a tough question. It is very hard to measure the size of the government. I don't think that any quantitative measurement can actually give us some sense about the actual influence of the government in the economy. The revenue -- yet, the revenue GDP ratio now is even lower than some developed countries. But my point is, okay, maybe it makes more sense to compare the size of the state to the need of the economy. Then, to the past of the state. The current state. The question we should ask is not so much our government is bigger than before or smaller than before. Not this question. A more sensible question is to the need for China to move forward, our government is too big or too small? And my answer is for the need of the country to move forward, our government is way too big. It's way too powerful. In a sense, it doesn't provide effective protection of property rights but quite the opposite. It invades private property, and private property is so critical at this stage of China's economic development, and more important than ever because the economy is transforming from manufacturing into innovations. Into innovations.

And for innovations, I didn't have time to talk about innovations or David will get mad at me if I elaborate on that. For innovations, private property, intellectual property, the free markets, the market reward for risk-taking, all of that we see in Silicon Valley, bigger government would not offer anything for China to move on the road toward innovation rather than manufacturing. For manufacturing, that's okay. You use existing

technology. You copy the technology of the U.S. or Japan or wherever you can get. Now you have to create your own technology. So innovation is really the critical factor to sustain China's economic growth in the next stage. So from that point of view, I think our government is too large, too strong.

Did that make myself clear?

MR. DOLLAR: The gentleman way in the back to be fair to the back.

MR. XU: By the way, one more comment on the large government in Western countries. We do see a trend for Western government to become larger and larger. But I will say the government could spend more resources if the private property protected equally effective, equally effectively. In other words, the private rights and the power of the government should go hand by hand. Should go hand by hand. If your right hand is too powerful, your body will off-balance. It should go both ways. One hand is private rights; one hand is the power of the public sector. Otherwise, you cannot maintain balance. So I can understand why the U.S. government, even though I'm not for bigger government in this country, but the government can be bigger in this country because the legal system departure, respects, protects private property pretty well.

So we know Mr. Obama -- how much Mr. Obama is going to spend and how he's going to spend. We know. And we have a say and we have control over that. And in China, without checks and balances, do you want a bigger government? Just like in Japan and Germany before World War II, without checks and balances, you want a more powerful government? Think about it. Think about it.

MR. MULCAIRE: Hi. My name is Jack Mulcaire. I'm from the Center for the National Interests.

I just wanted to ask you about the fact that over the last few years China has been having record levels of gold imports, particularly through Hong Kong, but

they've opened it up to some other areas. And it's gone down a little bit lately, but still it's been really record billions of dollars of gold being imported into the country. So I'm wondering what might be the driving factors behind that?

MR. XU: I would say the most important driving factor is the lack of investment channels. People in China do not get many opportunities to invest their savings, and the yield and offer on their savings rate is minimal. It's less than 1 percent. So that's why an Internet company, Alibaba can attract so many depositors from the household sector.

So behind that gold rush, behind that gold rush are the narrow channels for ordinary Chinese people to invest their wealth. I would name that as the number one driving force.

MR. DOLLAR: This woman here.

MS. MARK: Hi. Anastasia Mark with the Progressive Policy Institute (BPI).

My question, we have spoken a lot about how political roadblocks are in the way of economic development, and I was wondering if you could speak a little bit towards education and how the Chinese education system is affecting economic development in China.

MR. XU: Oh, okay. We just talked about innovation. The Chinese school system does everything to kill innovation. So they put a lot of pressure for kids to memorize, not to think, or not to think creatively. So that education system, I feel so sorry for Chinese kids. They have no childhood. Mountains of homework and off-curriculum activities occupy. And a mother in the states now is a hero, right? A Chinese mother in the states.

MR. DOLLAR: Tiger mom. Yeah.

MR. XU: Tiger mom. Tiger mom. I don't want my wife to be a tiger mom. I want my daughter -- I have only one daughter. This is a state policy. I want my daughter to grow up happily and learn whatever interests her. So the school system of China, in terms of creativity, is a graveyard. If I were the minister of Education, I would reform, I would restructure the entire education system. And I would put creativity interest, natural development of kids' abilities as my priority. Maybe I was brainwashed in this country. Maybe. Who knows?

But look at Nobel Prize winners. Right? Look at the important inventions and innovations in the past half century. Any of them from China? Or even any of them from Japan? So that tells you something. That tells you something.

In the year of countries and people compete on innovation, the Asians have to think about their culture root. Our culture is very good in fostering the collective thinking, collective spirit to maintain sociability, but at a cost of creativity and innovations.

MR. DOLLAR: Pieter, you had your hand up. Do you still want the mic? Someone get the mike, please.

I think after this we'll just have one more question. Okay?

MR. BOTTELIER: Pieter Bottelier, Johns Hopkins University School for Advanced Studies here in town.

You seem to relate the origins of crony capitalism and big time corruption, especially through the stimulus programs that were first launched in '98 by Zhu Rongji, and then on a big scale after the global financial crisis in 2008. I was puzzled by the reference you made to an article you wrote that wasn't published, identifying or referring to the second stimulus program as crazy. What should China have done? And how truthful, how accurate is it to bring Keynes into the story? I mean, why do you cast such a negative perspective on the efforts by the Chinese government to protect the

economy against the effects of the Asian financial crisis in '97, the global financial crisis in 2008? Is something wrong with these programs or with Keynes? Is the whole idea of the government --

MR. XU: I think both. Yeah.

From my point of view, I think both. The government did wrong during the financial crisis, and from my point of view, Keynesian economics is wrong. Of course, I would have to offer a lecture for a semester to explain why I think Keynesian economics is wrong.

What the government did wrong during the Asian financial crisis and global financial crisis is for a country, the ability -- the ability to survive external shocks, not so much with something the government can do, but something the enterprises can do. If an enterprise cannot survive in the uncertain world, no matter how much protection the government provides, maybe the more protection the government provides the worse for the companies to gain the ability to survive in the unfair environment. It's like our kids. It's like our kids. Why American families kick out their kids when they are 18? Why you don't continue your support and protection of your kids? Why?

MR. DOLLAR: I'm still supporting mine. I'm a Keynesian.

MR. XU: You are a poor dad. You are a poor dad.

I told my students. I said, "You don't look at the government for protection; you look at yourself. You look at yourself. You make sure you have a healthy balance sheet. You make sure you have a very conservative business strategy so you can survive the downturns, that you can prosper during the upturns."

Business cycles, it's like our lives. We cannot get away from it. We have to face it. And stand on your own. Stand on your own. Try to do good business during a recess.

MR. DOLLAR: But let me push a little bit on that. In your own life, don't you save during the good time and then if you're thrown out of work, you know, you actually did save. Right? That's the individual's Keynesian equivalent. The alternative would be to say I have no income this quarter, and therefore, I have no consumption this quarter. But that's not going to work.

MR. XU: I save. It's not the government saves. It's I save my money and I spend money I saved in the past. It's not the government saved it for me. Actually, I pay so much tax every year, I didn't get any benefit from my government. I saved my own money and I spend it on rainy days. This is not Keynesian. This is Adam Smith. This is not Keynesian.

So I would say it's like the government's exchange rate policy. I told my students don't expect the government to keep the exchange rate forever for you. You have to figure out how you are going to survive when the Chinese yuan appreciate another 20 percent. A good company can survive another 20 percent of appreciation. A so-so company can never survive whatever the government is going to do. You are good or not. You don't look at the government. Look at yourself. Your business model is solid. Your business plan is conservative enough. Your balance sheet is healthy. That's how you survive the business cycles, not look for government help.

MR. DOLLAR: Okay. I'm afraid we have to go to the last question, so I'm going to pick this young man in the very farthest back who has his hand up. You, with the watch on your left hand.

SPEAKER: Hi, Professor Xu. I'm Meng Yang from the School of Public Policy, University of Maryland. And I have a question about the Washington consensus. We know the Washington consensus just made the developing countries, like Russia's economy, worse off in the 1990s. And how do you like the Chinese consensus? And do

you think the Washington consensus is a best way for the current situation with the China economy? Thanks.

MR. XU: Probably you were late, right?

SPEAKER: Yeah.

MR. XU: Yeah. That's what I figured. You were late.

As I said, the Washington consensus -- the Washington consensus is not incorrect, but the Washington consensus is incomplete. It is incomplete. Private ownership of private property rights, and the free market stable macroeconomic policies are the set of policies necessary, but not sufficient for transitional economies to succeed. For economic transition to succeed. They are necessary conditions but not sufficient.

Do I make it clear? Are you a student in China studying science or studying literature? *Wenkesheng*. I figured you are *wenkesheng*. (Laughter)

Necessary condition is not a sufficient condition. Sufficient condition is a lot more.

One more importance of the necessary condition is the institution. The institution to protect property rights. The institution to protect a free market against government intervention. So without that institution, the failure of economic transition in Russia is not a failure of the Washington consensus, but the failure of institutional buildup. There's no independent legal system to protect property rights. There's no concept or weak concept of rule of law. So that's why government officials and even policemen are so corrupt, as you know. So it's not the problem of the Washington consensus. If any problem for the Washington consensus, it's not enough for economic transition to succeed.

MR. DOLLAR: Thank you. So please join me in giving Professor Xu a big round of applause.

MR. XU: Thank you, David.

MR. DOLLAR: Thanks. Thank you very much.

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