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P R O C E E D I N G S

MR. DERVIŞ: Good morning, everybody. And thanks for joining us on Friday morning. We have a really wonderful Panel on China, which, for the world economy, obviously, is one of the most important topics.

Markus Rodlauer -- I'm not going to introduce them in detail, the information is in the handouts; but Markus Rodlauer is the Deputy Head of the Asia Department. He just came back from China, from the Article IV Consultations, and so he will give us an overview, with a PowerPoint, on the latest IMF perspective, and his personal perspective on the Chinese economy.

And then we have two of the world's top China economists, China experts, David Dollar and Nicholas Lardy. Nicholas was, for a long time, at Brookings, now he's at Peterson. David was at The World Bank for a long time, and now he's with us at Brookings, and they will give their views, their perspectives, and then we'll try to have a discussion which I'll try to moderate and make as interactive as possible.

Welcome also to the new Saul/Zilkha Room. I hope you've seen improvement; although the shape of the room is still not ideal, but that we couldn't change.

Just let me make, perhaps, two or three points. One is that everybody knows, I mean, China is now, with the U.S., the largest economy in the world, on market prices, PPP, where at market prices it still has some ways to go. At PPP it's roughly equal, but in any case over the next decade, I think under any reasonable growth projection, we will have China and the U.S., kind of, more or less equal weight in the world economy.

Now the interesting thing I think that many have already pointed out of

course, is that that's, historically, a very new situation in the following -- in many ways, perhaps, but in the following sense, that a country where the per capita income, is still pretty low. Depending on which PPP you believe between, you know, one-fourth and one-fifth of the U.S.; so not a very poor country anymore, but barely a middle income country, if you take per capita income. And yet, it is one of the two largest and most powerful economies in the world.

In the old days, in the old -- in most of history, the two things went together, high per capita income, and strength and weight in the world economy went together, and here we have a somewhat different situation. Other countries less so, of course, because they are much smaller than China, still, India and so on, are heading in the same direction, but there's a lot more time. So I think this is an -- this is always something one has to keep in mind, and when I was at the UNDP, you know, in my visits, it was very clear to me that that was a very special situation.

The second point I'd like to make, is that when the Asian crisis hit, and China was not of course really affected by the -- in a major way by the Asian crisis, but it was affected because all the region was affected, but itself was not in crisis. It was a blip really, for the world economy as a whole, and for the advanced countries. It was a huge crisis in Asia, but there was no world crisis that came with it.

You know, some banks had trouble and, you know, overall it was still a very localized regional crisis in Asia. This has now changed. Clearly if there's a major crisis in Asia, or even just in China, and of course if there's a crisis in China, there will be a crisis in Asia, you know, it will become a world crisis, reflecting the importance of trade, investment flows, and financial flows in the weight of China now.

So, for the first time, there really is a true two-way dependence between

the advanced economies and China and its neighborhood, and I think that also is very new. There's also a very strong link with the developing countries, as you know our program is global economy and development, and the links between China and developing countries are extremely important. So these are, maybe, it's just some part on the global context.

Finally, and you can, of course, not be very surprised by this, there is great disagreement among economists, otherwise we wouldn't be economists. Subramanian, who, you know, wrote this book about two years ago, and your colleague from Peterson, who was also a Non-Resident at Brookings, sees China in 2030 as the dominant economy in the world; very optimistic about its growth rate. Most of you interested in China, I'm sure have read parts, or all of the book. That's one view. One extreme view, probably.

And then you take somebody Danny Roderick, whom I had an opportunity to have a long chat with over the weekend, at the Institute for Advanced Studies in Princeton, who takes a much more pessimistic view. Not just of the Chinese growth rate, but in general, of emerging market growth and convergence. He hasn't ventured a particular number, but something close to half of what Subramanian thinks about, is probably where Danny comes out, and he points out that the manufacturing sector, you know, is already declining in proportion of GDP.

He views the tremendous catch up, technological catch-up opportunities that were there in the past, as having been largely for -- or are largely exhausted. And we have a very, very different view. So that always makes it interesting. I think the presentation will be squarely on China, and not on China and the world, but perhaps in the discussions we can draw some of the impact, you know, that -- the way we see China

evolve, will have on the rest of the world economy.

With that I turn it over to Markus, with great pleasure, whom I worked with. How many years ago, twenty-five? Something like that.

MR. RODLAUER: About that.

MR. DERVIŞ: All right.

MR. RODLAUER: Thank you. Thank you very much, Kemal. And thanks to Brookings for inviting us here. Also to David and Nick for joining us on the Panel, and to you all for your interest in China, and for coming here this morning.

At the outset I'd like to, of course, state the obvious. Our work on China is a team effort. I'm just here to represent the team which is really led by Steve Barnett, who is all the way at the end there. I got him to put on a jacket, and I have failed to put -- get him to put on a tie, again, but anyway, here we have -- Carol is up here and in the front seat. Some others are, I think, somewhere in the audience.

I'd like to touch, today, my remarks on three points. First, on the outlook -- and again, what Kemal said, of course is true at the IMF too, frankly, our views are very different when you talk about all the people involved in China, from Research to SPR, to other people, to analysts in the Fund, we have a wide divergence of views, and just yesterday, we had a meeting among departments to talk about very recent developments. And, again, a very broad spectrum of views, that in the end, converges and it does reflect, what I'm saying today, reflects also not just you have a default, which was in May, June, but also our view on recent -- most recent development.

So obviously the economy is slowing, we don't see a hard-landing risk, and even though it it's slowing it's a good slowdown. And therefore we would like to say, don't get nervous, don't lose your nerve. Continue with reforms, but don't over-stimulate.

The second point on risks. Well, even though they are starting to be addressed they are still rising. Vulnerabilities now have been on the rise for a number of years, we have been talking about this again, and again. You need to find new sources of growth. You need to contain risks. As the years go on, the tradeoffs become sharper, and starker, and here we are again, at the talk -- it looks still manageable, but it becomes more urgent now to really contain them.

And then third; where are on reforms? Well, we have a good plan. Out there we have made some progress on implementing, but the heavy lifting really still is out there, and at the very end, if I still have time, I will throw up one or two slides on the global impact of what's going on in China, so that we have a bit of perspective on where that -- how good or bad is it for the world, what's happening in China.

Obviously China has seen remarkable growth over the last decade. It has decelerated now from double digits in the 2000s to a 7 to 8 percent range. I think the green bars that you see here, is one of the really good aspects of what's happening recently. That is the contribution to growth that comes from the external sector, from their exports, which is very high of course, in the 2000, very large current account surpluses. So, the external rebalancing towards a much slower current account deficit, actually negative contribution to growth from the external sector.

That's a success story, but less so, domestically, obviously. You see investment which is the red bars, gross capital formation are still very high, it came down a little bit in the last two years, but slightly below the contribution of consumption. But last year, again, investment became the largest driver of growth; so domestic rebalancing, clearly a very long way to go.

More recently, growth continued to slow into the third quarter, somewhat

surprisingly. We were all surprised that after quite some momentum from last year into this year, there was, again, a slowdown earlier this year. Now I would like to say, importantly, much of the slowdown, really in our view, was policy-induced. It is a reflection of the authority's efforts to contain the risks in the shadow banking to bring that into better control; to address the over-investment and over-indebtedness of local governments, to change the incentives there for the officials to be more careful.

The anticorruption drive that we all know about has had its impact on demand. And also the pollution control, you know, shutting down some steel mills and so on, I think all of this has had an impact on growth. And I think in that sense it's a reform-induced, a good slowdown, so to speak. And also we see the correction that has started and is going on in the real estate sector, of which we will talk more later; is a necessary correction, and in that sense is a good correction that is happening.

So, the slowdown is largely for good reasons, and in response, the authorities have taken measures, that they call "targeted stimulus" we are very happy that it is not a broad-based stimulus, as it used to be in the past. Very carefully, so far, in terms of not overdoing it, not returning to very large -- giving out credit, and restarting the whole investment machinery. So I think these are the really, quite good aspects of where we are.

The very recent high-frequency indicators that came out in July-August suggest a further slowdown this quarter, in Q3. You'll see that at the end of the chart here, where we have real GDP quarterly, and we have the value-added in industry. Growth, which is really the value that it attracts most closely, historically, the GDP is down in July-August, and we have, sort of, two scenarios in a way that looks at what might come out in the third quarter.

Our central scenario is part of our forecast for his year is that, third quarter growth of GDP will be around 7.2, down from 7.5 in the second. And then the Choice Indicators are that there will be a bit of a rebound in the fourth quarter, so our current expectation on the baseline, the blue extension here, is that growth will be 7.2 in the third, and 7.4 for the whole year. It might be slightly weaker if the real estate downturn is a bit more intense, then we might have slower growth in the third quarter, and the annual growth may be a shade below what I just said, 7.4.

But the main point really, in our view, is not that it's, you know, is it 7.4 or 7.3 or 7.5, or even 7.2; is there a hard-landing in the near term? Here our judgment remains that a hard landing is unlikely in the near term. If you look at from the big-picture consumption, it's holding up well. Retail sales are still in the double-digits annual growth. Even fixed assets investment is still well into the double-digit growth there; and from a year-on-year basis; so consumption investment and exports are still relatively strong.

Credit, although it has slowed down, it's not in this chart, but credit growth still is way faster than GDP growth, and equally important China has important policy buffers that they can use, in order to stem a sharper slowdown, were that to occur. And I'll come back to that in a second.

So, in a nutshell, projection for 2014 around 7.4, maybe a little lower, but for now we haven’t changed our forecast. Then for next year, one has to remember that growth in China, of course, is highly policy-dependent. It really depends on what the authorities want to do.

Our focus for next year has therefore, which is 7.1, continued a moderate slowdown. That has an important element of a policy recommendation. What would we actually recommend that the leadership set itself as a growth target for next year when

they get together in December for their Annual Work Conference?

And here we, again, want to say that China is now modernizing in a way that perhaps it's time not to have a specific point target for GDP anymore. You know, maybe it's better to focus on policies, and decide for the leadership, what's the minimum that we want to achieve, in order to maintain social and political stability, and economics to the financial stability, and then see what's the top, that we don't want to overheat the economy anymore.

And in a way, to find a range of what might be acceptable, and within -- accept the outcome within that range. And for next year, in order to continue to adjust and allow the economy to moderately slow down, and reduce all those risks, of which we will talk in a second, our recommendation is to set a target range of 6.5 to 7 percent for growth next year.

Let's move on to my second point on the -- and look at the risks in this economy, here, real estate of course jumps out at all of us at this point. It has been a key driver or growth, it's now about 16 percent of GDP is real estate itself, including upstream and downstream linkages, it accounts about a third of GDP.

And the important point to make also is -- that maybe goes back a bit to what Kemal said at the beginning -- there no really one real estate market in China. We have two charts here on the left, which is the big cities, the four big cities, and we look, clearly there's a boom there in terms of demand, there's a huge excess demand. Prices are above benchmarks, above fundamentals, as they by the way, are in London and Tokyo, and other big cities.

So you have one side there, and you have on the other side smaller cities on the right side where the supply, the oversupply of floor space compared to

underlying demand, and clearly there is substantial overbuilding and an oversupply in the Tier 3 cities. For example, on the red chart you have unsold floor space now which is very high in terms of month of floor space sales, you have a very large excess demand that will -- excess supply that will take a long time to work off.

And, you know, in response to Kemal's point, to think of China's economy as one economy is perhaps a fallacy. You know, we have nearly advanced economy in the southeast, in some of those cities, when you go there you see it. It doesn't look very different from one of our advanced cities, but then you have of course very different areas of economies in the rest of China.

So the bottom line here is that clearly a correction in the real estate sector is needed, it is underway, and it is important to allow this correction to happen, while at the same time avoiding a disorderly adjustment.

By this orderly adjustment I mean a very sharp correction that starts to feed on itself, and because many strands of the domestic economy really runs with the real estate sector. Local governments are heavily connected it, banks and shadow banking are heavily connected to it, so you’ve got to be careful not to allow -- not to allow a free fall in the real estate.

And for that, really the government does have policy tools available and they are using them. For example, purchase restrictions in the smaller cities, which artificially have restrained demand, have been loosened; mortgage lending support, social housing, infrastructure, investment and so on. So they are using these targeted measures to support a real estate sector, and so far we can see that there is effect of those measures. In the more recent months we have seen some signs of stabilization, for example, declining floor space and new starts of housing.

So our assessment is, there is a correction underway, it is perhaps a bit sharper than we had expected initially, but it is manageable. We can talk more about alternative scenarios if the correction were deeper, what the impact might on GDP, and so forth.

The second point on risks, credit of course; credit has been growing very fast. The left chart, which is perhaps our most favored chart in terms of illustrating the risks, shows you a total -- social financing, all the credit in the economy, both from the banking side and from the so-called shadow banking side. Bank for the blue bars, shadow banking is the pink bars -- the red bars on the left side, all this has increased over the last five years by about 80 percent of GDP.

Half of that increase has been in shadow banking which, in size, has more than tripled over this period of time, and clearly the international experience which is plotted on the right side, shows that such kind credit growth, generally tends to create high risks of crisis, or at least a sharp slowdown in growth after that period. Here you have plotted all the countries that have had this kind of credit growth. Very high credit growth.

On the left axis you have credit to GDP ratio increase in five years. It goes from 10 percent to 20, and we are up in the 80 percent range for China. And then you see the change of GDP in the subsequent years, after this period of very rapid credit growth. And you can see that most of those countries -- most of the countries that have this kind of credit growth, subsequently do experience a very large decline of GDP.

The question then is of course China. Might China be different? What's the point of -- of the points that are here on the right, so but clearly this is a huge expansion of credit risks that has been created here. We should at the same time not

forget the positives of shadow banking, particularly, the red bars. It has created a new market-based finance in the economy; it has created access to credit, to many enterprises and firms that haven't had access before.

In terms of risks, much of the shadow banking is also implicitly backed by large banks and by the governments, so perhaps that will contain the risks, but clearly the problems, of course, dominate this regulatory arbitrage away from supervision. It is very rapid credit growth, and there's a huge amount of moral hazards in the system, because implicitly many of these credits are guaranteed by the government, and therefore are not properly priced.

So, overall point is that a slowdown of the social financing growth is very rapid credit growth is needed and is warranted, and we have indeed seen it over the past year. Here, you see the last two years, that the black line is the total social financing, the growth, it is on a declining trend in recent quarters and months; in response to measures by the government to restrain shadow banking. And I think that is positive and needs to be sustained.

Third point of risk, and I probably have to move faster and faster as we go on. Local governments I think that is nothing new, we have seen this in last year's study -- in last year's report already, that there is an issue of local government debts, which are much higher than what the official numbers of government deficits, and government public sector debts show.

On the left side you hear -- we have an illustration of that. The red lines they are negative, it's the deficit of the on-budget central government, and whatever is in the budget of the local government spending. And that is very contained, almost near zero, small deficits between 1 and 2 percent of GDP. However, if you add to that, all the

spending that goes on, off-budget, by the local governments out there, and is being financed mostly by debt; the debt financing is the green bar, you get deficits in the range of 8 to 10 -- 7 to 10 percent annually, of GDP.

And if you add even the stuff that's being financed by land sales, which are not debt-creating, but are still the kind of deficits to get, even higher deficits. This is adding to debt every year, and as a result you see the debt numbers on the right side, which the official debt is very nicely contained, around 20 percent of GDP, not a big issue.

But if you add in all these liabilities that have been accumulated in the local governments you get to various different measures of debt. The highest measure is if you include all of it, it's the blue bar, and it goes through 2019 in terms of a projection, but if you look at 2013, it's a little over 50 percent of GDP.

Now that includes all the contingent liabilities of local governments. Now some of that may be commercial and may not have to be included, so if you take some of this commercial stuff out as the national audit that was done in last October does you get to the green point, it's a little bit lower, of course, but the point of this chart really is, it's much higher, and it's on a rising trend. This is a baseline projection, if things continue as unchanged; it will go up from 50 to 60 and perhaps even higher into the danger zone. But we are not there yet, that's clearly something that needs to be watched.

And putting all this together into the macro picture, what does this rapid credit, this local government spending, this real estate boom, what has this created in terms of macro imbalances? The familiar charts of very high investment on the left-hand side. The green bar is investment -- the green line is investment as a percent of GDP, it's nearly 50 percent now, it's gone continuously up every year, because investment is being

done to sustain demand, it's creating new capacity, and then you need to invest even more to keep the machinery going.

That, on the right-hand side, if you compare this to growth, we have seen this ever-rising investment, as a percent of GDP, again, nearly 46 percent of GDP now -- annual GDP is investment. At the same time we have had growth declining from the middle digits now to 7, 8 percent; meaning of course that all this investment that they are doing is creating less and less growth. The iCore, the so-called investment efficiency indicator, depends on how you are investing and how output you are get out from out of that, the investment over GDP growth is continuously going up and creating less and less efficient investment.

That's the basic point about rebalancing. In China you need to start rebalance -- you need to rebalance it from investment away to more productivity. And if you also compare this investment by international metrics, China clearly is an outlier there. You've seen this chart before probably, here, on the left-hand side, China compared to all the other advanced and emerging market economies as a percent of GDP, investment is way up there, compared to the others.

And even to the economies that are the sort of, few of the fast-growing takeoff economies, let's say, Germany in its earlier years; Korea, Japan, the red line of China, again, is starting to be a clear outlier.

SPEAKER: Any sort of comparison to iCores?

MR. RODLAUER: I could do that, but I don't have it now.

SPEAKER: But off the top of your head, I mean, higher than?

MR. RODLAUER: I'm sure they are at this point, I'm sure they are. I'm sure they are, because investment, David has studied this more carefully. I think it must

have been Korea that reached 35, maybe 38 percent, and they were still growing at 7 or 8 percent at that point in time.

So a rebalancing is needed, a slowdown of investment is needed, and therefore we are, I wouldn't say happy, but I think we are reassured that, in fact, investment growth has started to come down. If you look at the trend here of total fixed asset investment, the black line, since 2012, it is on a declining trend, perhaps not fast enough, and the infrastructure on the -- the green bars also, somehow, are starting to decline. But again, clearly more and continued rebalancing and slowing of investment is warranted.

Where does this leave us all, together in our risk assessment for China? On the left-hand side you'll see the policy buffers, or what leads us to the conclusion that it is still manageable. Well, government debt overall is still relatively low it's, you know, somewhere between 40, 50 percent of GDP, depending on what you think about the contingent liabilities, how many of those will come back to the government, and therefore which are out there.

There is still, on the other side there's very public sector assets in there, including international reserves, we all know that. Huge state assets which can be mobilized to support the debt service if needed. All of this is domestic savings. There's very low external debt as a result of this huge current concept, because there really is very little foreign debt. It's starting to change now, as the capital account is opening and more and more firms are going outside to finance themselves, but so far still the external, the situation is very, very safe.

And overall, one needs to recognize that this is an economy where the government really is present everywhere. It's a problem in many ways, but in this sense

it's an asset because there is -- the government is in control of the economy. It's amazing how, you know, state-owned banks are still managing much of the economy. You don't need to worry about having to nationalize banks, passing laws to intervene; all of this is pretty much under control.

And as I have said, adjustment has started, but you know, so therefore in the near term we don't see a lot -- a high probability of crisis, or a sharp slowdown even, but the risks are rising, as we have said before, that is three or four big risk factors out there.

These vulnerabilities also need to be -- recognize they are very closely interlinked. You know, as I've said; many of these risks actually go through the real estate sector, and you can imagine a scenario later on where credit suddenly is dropping sharply and confidence is being withdrawn. The real estate investment completely dries up, local governments get no more revenues from real estate, they can't invest anymore, and so forth, it could turn to a negative, a nasty situation if the government loses -- were to lose control over it.

And so without reforms, without changing this whole growth model, there will be growing risks over the medium term, and therefore we really continue to emphasize, it is crucial to keep your nerve and continue reforming, and continue to address the risks, and don't return to over-stimulating the economy just for the sake of sustaining growth.

So, third point of my presentation, where are we on reforms? Where is this agenda now going? We have a comprehensive plan as we all know in the blueprint that came out of the Third Reform Plenum; it is going in the right direction. It touches on all the important reforms in the economic sphere. On the financial side, I have listed

them here, towards more balanced, a more sustainable growth, and also at the same time address the vulnerabilities.

On the fiscal side, on the exchange rate, the flexibility side, opening capital account carefully, and most importantly I would say on the structural side, to introduce through, and more competition everywhere in the economy, open up new sources of growth in the services sector, allow foreign companies to come in and provide true competition, domestic competition, and therefore get new productivity growth.

It's not just about rebalancing from investment to consumption, now the true challenge is to change the investment from a state-led infrastructure investment model to one where we have more productive investment into the new spheres of growth, produce stuff that you don't have to export, but it then can be consumed domestically, and therefore also will generate household incomes and will be much more inclusive and hopefully, also more environment friendly.

So it's a good agenda that's been there. Now, as will be expected from a blueprint of this size, and of this reach and scope, it can only be a general direction of reforms. One wouldn't expect specific commitments to actual measures. And in China, because it's such a highly decentralized economy, and that's one of the -- and this is one of the challenges also, is you don't -- you can't really have centralized implementation of reform.

You can have centralized direction and guidelines, but in the end, much of the implementation specifics have to be on the local level in the provinces, because the economy is so diverse, and so decentralized. So you have some progress on all these fronts, I've listed them here, but we -- you know I won't go, of course, through all of this, but in many areas, that real heavy lifting, really, is still out there.

For example, on the fiscal side, we have this huge challenge of reordering local government finances, by giving them the right kind of revenues, through their own taxation, by reordering their spending responsibilities. Maybe moving some back to the center, changing the sharing agreements of taxes with the center, allowing them to borrow but in a very controlled way.

So all of this is beginning but the true throw of the dice really is still out there. We have a new budget law, for example, that was just recently passed, I think it's a huge progress; the medium-term budget framework, the ideas of local government borrowing in a controlled way, more transparency. But again, it doesn't really address, yet, the truly politically hard issue which is to reorder local government finances, given more or less revenues, and given more or less spending in the right way.

More urgent exchange rate reform, we know that needs to totally change among the framework from one that has been basically anchored on the exchange rate. Direct credit controls, and fixed interest rates. To monitor the framework, now that it's a modern advanced economy framework that guides the economy with flexible interest rates, and open capital account and the flexibility of floating exchange rates; so all of these tasks are still out there, and will need to be -- will need to continue to be attacked.

And here, just a few points to make -- to illustrate the challenge really here, which is, these reforms are technically complex, they are interlinked, so you really worry about the phasing and make sure that you don't advance too fast on one, before you attack the other. It will be a mistake to give more latitude to enterprises and banks at a time when you haven't addressed the moral hazard problem. The budget constraints, I think we have seen this in many other transition economies that this will be a mistake.

As I have said, there can only be central guidance, but the

implementation has to be locally, and you need to be very careful to balance adjustment, which we need. And the need for a sort of a minimum near-term growth momentum without which, social and economic, and possibly even financial stability would be truly undermined.

So, some key questions for us out there. What can we really expect on fiscal and SOE reforms? That is, again, still the big political vested interest questions out there that needs to be addressed. How much tolerance is there for lower growth in the near term? I will get to this in a second. The cost of some of these reforms will be lower growth, because we have slower credit expansion, you have less investment, you can't rebalance all the way so quickly, so you have to allow somewhat low growth, and I think we'll see it in the coming months and year, how much tolerance there truly is for that tradeoff.

If there was stimulus need, let's say, if there is sharper correction in the real estate sector. If for some reason the economy and private sector confidence gets more weak, what do you do in order to sustain the economy? How do you stimulate? Do you go back and just do the easiest thing; by easy, that's the ones that can be done clearly, is to invest again? Do you ask the local governments to pull out more roads, and more airports, and more trains? Or do you try to really try to really stimulate the budget, as we would have preferred that you do the really more on-budget, fiscal stimulus, that also then would support reform? Would support household incomes, would support consumption; maybe through tax credits, or something like that.

So the shape of the stimulus, if it's needed, is a key question, and the big one in the room of course, is how to tackle the moral hazards, and the implicit guarantees in the economy, when you have all the -- most of the fixed income instruments still,

basically, backed by government guarantee. How do you slowly move out of that, create true default risk and make investors more careful and more discerning about the bets they make? That is, again, a very difficult challenge.

Two charts at the end, to illustrate this one, and the impact on the global economy. Here, you know, how does this -- we try to model even though it's very difficult to model these reforms and to do this in a quantitative way, but our team, I think, has made the point here quite well, that you have a central scenario where the baseline, as we say, the red dots, where, well, slow implementation of reform, all of this is supposed to be done by 2020. Sometimes, you know, in the next six to seven years, these reforms will be done.

But kind of back-loaded, and the result of that, you get a growth path that is slowly declining because productivity doesn't really pick up. And you may be successful to keep the soft landing, but the risk there really is that you sort of usher in a period of low growth, and maybe not Japan type but -- and the risks of a disorderly adjustment of course become bigger and bigger.

What's the alternative? To reform faster upfront, to be more aggressive in your credit -- in your financial and in your enterprise reforms; t that would have a somewhat of a near-term cost to growth, so that's the black line, where you have a little bit less growth. You have more tolerance for slow growth in the medium term, but the payoffs in terms of productivity growth in the medium term are significant.

Even in the model which doesn't fully capture all the dynamics, you get larger growth and higher income, and especially more household incomes, and more consumption, and therefore much higher welfare in the larger population, a more inclusive type, and therefore a sustainable type of growth.

If you don't reform, if you continue to pump investment and credit and just try to sustain, you may be able to sustain higher growth for a few months -- for a few years, the blue line, but you will eventually go into a scenario where you have a sharp slowdown, and sort of fan chart opening up a risk of a real calamity, of a financial crisis that then looks back into real activity, and the risks of a really sharp financial crisis and adjustment becomes larger and larger.

So that brings me to my final chart, what is the impact of all of this on the world? This is a complicated chart even though it is Steve's and my preferred chart, I would say. It sort of tries to model, what's the impact of a 1-percentage-point change of growth in China? And let's say we look at lower growth in China by 1 percentage point in China, instead of 7 let's say we have 6. The black dots; that models the various countries and what is the impact on these countries of lower growth?

And clearly, of course, it's a very significant impact. It depends on how dependent countries are on expert in investment goods like Japan and Korea in the middle, or Germany even, to China, because if you have lower investments, of course lower exports, lower growth. You have a significant impact on commodity prices, commodity markets, so that will also impact growth negatively.

So, on average, the black dotted line, for 1 percentage point lower growth in China, is about 0.1 less global growth, with larger impacts on select economies. Conversely, if you are successful in China and over the medium term, create higher growth in China than otherwise. Of course you have positive impacts on the countries and, again, depending on their export structures and on their linkages to China, the blue bars, and you get higher global growth, the red line.

So it's very important, I think even globally of course, that China is

successful in its reforms, that the impact of a somewhat slower growth path now, for the world to accept that China has to slow down moderately. Let's all not all get nervous immediately if China goes from 7.5 to 7.3 o 7.2 in a moderate, controlled way. I think that's good for the world, because if it is reformed and used, if it buys us the reforms for the future, it is good for the world. Thank you very much.

MR. DERVIŞ: Thank you, Markus. (Applause)

MR. DERVIŞ: (audio skip) -- give his reactions, his views may be, like, seven minutes or so, then we'll turn to David, and then we'll see how it goes. I may add a few questions, and then we'll turn to Markus again, and then maybe have some back and forth, but also go to the audience of course. So, Nick?

MR. LARDY: Okay. Thank you, Kemal. Maybe I'll start with a couple of comments just to get things going. I think the first comment that I'd like to make, takes off from what Markus said about China in recent years, has had more and investment but slower and slower and slower growth. And I have an explanation for that, which really requires one to disaggregate the economy based on ownership, and looking critically at what is the return on assets of state companies versus private companies.

And the performance of state companies, state-owned companies, since the middle of the last decade has deteriorated dramatically. Their return on assets has come down, down, down. They are now earning about half the cost of capital, and on the other hand in this period, private companies' return on assets has gone up.

So I think if you disaggregate the economy, part of the answer, and maybe a large part of the answer to why more and more investment is leading to less and less growth, is that the state sector has become less and less efficient in the use of

resources, particularly in the use of capital, after our return on assets is just, you know, profits divided into assets.

And state firms now are under 5 percent, and I think any reasonable estimate of the cost of capital in China is something in the neighborhood of 7 or maybe 8 percent. And I don't think -- I heard you mentioned the word ownership specifically, and the larger Article IV report, doesn't say very much about ownership as well.

This gets to the whole question, or related question of whether or not it's inevitable to have slower growth as reform gets going. I think if reform is focused on reallocating resources from the state sector to the private sector there's a possibility you could increase growth. After the private sector, at least in the manufacturing sector, the industrial sector as a whole, has return on assets, it's almost three times that of private -- of state companies.

So if you change the financial system and other aspects that Markus has touched on in his report, you could be reallocating resources to a sector that's going to contribute three times more into value added. So, it's kind of appealing to say, well, the price of getting reform is, you know, slower growth today in order to have faster growth tomorrow. But I'd like to see a careful analysis which does look more at the question of ownership, and maybe overemphasizes the price one has to pay upfront in terms of growth.

And I think it's very important from a policy point of view. If this is a real possibility, I don't think the IMF advice to the government should be you are going to have a pay a price for the reform, you are going to grow much slower for a while, than you otherwise would. Maybe that will turn out to be true, and it's aggregated analysis, but kind of the raw numbers make me think that maybe that's a bit overstated.

Now, the second comment that I'd like to make is really to play devil's advocate with the risks. The question is, are risks manageable? And Markus was saying, yes, and quite frankly I tend to agree with that for many of the reasons that he mentioned. But if you go into the report in some detail, it's really quite striking that much of the analysis, particularly when you get to the corporate sector, is based on a very peculiar set of data.

That is its data for a listed company, so the big macro picture is, you know, debt to GDP has gone up by the staggeringly large amount, maybe 80 percentage points of GDP, but that makes -- in box two, there's a long analysis of this leverage question at the corporate level, showing that debt to equity leverage in state firms is only about 100 percent, and for private firms only 50 percent, and privates are going down.

Yet, if you look at the aggregate data, the leverage ratio for state companies is 160 percent as compared to the 100 percent. And for private firms it's about 120 percent versus the 50 percent in the report. The whole analysis is based on a universe of listed companies; there are only 2,000 listed companies. There are millions of companies in China, and I am of the view that the 2,000 firms that are listed are not a random sample and the leverage in general, is substantially higher than the -- this whole analysis about the degree of leverage.

I could go on about some of the details, but I'll spare you, but I guess the question is, how do you square this kind of big increase in credit at the aggregate level, but when you start looking at the micro picture of the firms, you actually are showing a picture that actually understating the risks? So I'm giving two contradictory comments. I mean, it's the first one is, maybe reform could increase growth, but the second comment is how do we know without underestimating the risks associated with this big build-up of

credit, over the last five years?

MR. DERVIŞ: Thank you. David?

MR. DOLLAR: Thank you very much. So let me add three quick points. So I enjoyed the report and the presentation very much and, you know, I largely agree with the IMF analysis.

The first point I want to make is, you know, their Article IV Report, you know, shows that there is some modest progress with rebalancing in a number of different ways. You know, in two out of three, of the most recent years, consumption grew a little bit faster than investment, and the service sector share of the economy has been increasing, and the secondary share of the economy is gradually decreasing.

All of that's consistent with the rebalancing, but when you dig a little bit deeper, it struck me as very interesting that that shift in the services industry mix in the economy, completely depends on price changes, and what's happened in recent years is there's deflation for industry and then there's moderate inflation for services, and that's shifting their shares in the economy. But if you look at real growth rates, they haven't changed.

You know, for quite a few years in a row now, the real growth of industry and the real growth of services are about the same. So I just want to make the point that this seems strange, that we are getting the price changes you'd want with this internal adjustment, but the real economies doesn't seem to be responding to that. So put that out there as a puzzle. You know, it's possible that there's enough local government interference, even with private firms, encouraging continuing investment in steel mills, even though there's a lot of excess capacity. You know, so I just -- I find that interesting and somewhat worrisome.

It leads to my second point, you know, I basically agree with the IMF assessment that moving more quickly on reforms, you know, is a good way to try to reduce the risks and sustain growth in the long-term. There are risks in the reform, these are big, complicated reforms, you know, liberalizing interest rates, opening the capital account, you know, frankly this is quite risky, so I sympathize that the officials want to move slowly.

The one area where I lack sympathy is it continues to be the case that China's service sectors are relatively closed and uncompetitive, you know, the modern service sectors are largely closed to foreign investment, with very few exceptions, and there doesn't really seem to be much private investment in the modern service sectors as well. So this strikes me as an obvious are of reform, where they could be opening up some new opportunities for efficient investment, areas where there has been under-investment, and it links to my first point.

You know, why isn't there more shift of resources, into the service sectors, so that their expansion is real, and not just based on price changes? So among the various reforms, you know, that one strikes me as something where the government really could move ahead.

And then the third point I want to make is, I think the IMF gets it right that, you know, probably the government is going to be moving very cautiously, it's going to be reforming slowly. Many of us are always going to be encouraging the government to move faster. So looking ahead, I see they are very much walking on a knife edge, where it may be that this gradual reform brings about a transformation of the economy to make their growth more sustainable in the long-term, but it's also, you know, quite -- the probabilities are building up, but the reform is not fast enough to prevent some kind of

sharp slowdown.

And Kemal started this by saying there are a lot of different views among economists so I think tracing out these different scenarios is reasonable. I don't see how anybody can predict, you know, which way things are actually going to go, other than discussing the probabilities, so it's going to be very interesting to see if their reform, in fact, is rapid enough to bring about this transformation. And I agree with that last bit of analysis, that it has a very significant effect on the world, whether or not China gets this right, or in fact it doesn't reform fast enough, and we get a very sharp slowdown sometime. You know, more likely a few years out than in the near term, but it's certainly, there's a possibility there.

MR. DERVIŞ: All right. Well, these were, I think excellent comments and questions, let me add I think two or three. Markus, one question which is related to this, you know, we were focused on the iCore, but in a sense, a better measure of overall performance of productivity would be total factor productivity, okay.

Because I mean, there could be a scenario, I'm not saying that's the scenario, but presumably, as labor coming from the lower productivity sectors, from agriculture and so on slows down, the labor input slows down, you know, to maintain the same growth rate, you would need more capital, let's say, okay.

So any information on actually how total factor productivity has behaved over the last five years or so, I think would round up the analysis. And would allow us to say with more confidence, you know, what's an efficiency problem and what isn't an efficiency problem. So that's my first point.

The second point, I wanted to ask you, is on the -- since I'm so interested on the spillovers, on the model where you -- you know, you model the impact of a

slowdown and an acceleration on the world economy. Is that model basically based on trade linkages, on net exports? Or, is it kind of more than that? I mean, in terms of net exports, if it's strictly a net export story, you know, one can have an economy that grows very fast or very slowly, but nothing changes in terms of its net exports to the world, and the impact on the world is very little. Okay.

China now has this -- has a current account that is very moderate, may even go further down, and in the old sense of just the trade linkages, you know, the net trade linkages, one could argue that the linkages have actually decreased a lot. On the other hand, if it's a more involved model with, you know, the whole value chains entering the economy, the trade viewed as trade and value-added, and total factor productivity, effects of foreign investment and trade, then the net trade, you know, is not -- is only a very small part of the story. And the impact of growth in China has other channels, than just the net trades. So I wanted to ask that second question as well.

MR. RODLAUER: Thank you so much. These were great points, and let me just briefly summarize. My views on this ownership question that Nick certainly, has raised, we have limited our analysis of the state-owned enterprise reform agenda, to what we understand it is. We did not radically change in the ownership structure for the large, big state-owned enterprises, we understand their strategy is to gradually increase the pressure on the state sector, to move them to a position where they are truly competing on a level playing field with the private sector.

It means removing the cheap credit that they are getting, removing the low wages that they are paying to their employees, removing the few capital gains that they delivered to the budget in terms of the offers to the budget. Removing their protection from entry, gradually, and then people hold on to the few big strategic

enterprises but let the others go.

Now, that is a strategy that, in theory, can succeed and we can see some movements toward it, but as Nick says, the ownership question, really, in the end comes in when you think of a small local community where you have the three actors, basically. It's the owner of the large bank, it's the owner of the large enterprise, and it's the (inaudible), now can you really in the current system of where you don't have really different decision-making and ownership, can you really have the private sector and competition, be the one independent force that makes decisions?

Or, as long as you have this nexus of joint ownership, will you always end up -- end up being (inaudible). So I think that's one question, we certainly have in the long run but, you know, we don't see them moving to.

Now, in terms of how much you could get from a much more aggressive removal of this current whole mechanism. I'm a bit, frankly, a comment, by my experience in working on a lot of other transition economies in the time when Kemal and I used to work together in the '90s. And you know, in the sense we were all, we were all probably too optimistic thinking that by just removing the state from all of this, and leading to the private sector, you can immediately create huge (inaudible) growth.

Now I have to admit that China may well be different, because China's experience of course, has been Xi Jinping reforms opening up huge boost of growth; a second wave of reforms; again, (inaudible) backing the state-owned enterprises and opening up to the WKO a huge push of growth. So maybe there is something there in China and certainly in the areas of underserviced sectors like health care, you could see tremendous growth potential if you were to allow two private enterprises to flourish there, or education, and so on.

So I think that that -- there is a potential of very rapid gains of growth, if there was a political (inaudible) that's my balanced view even though the experience in transition economies has been different.

Now in terms of the listed companies only -- yeah, it's true that the -- unfortunately the credit and the leverage analysis has to rely on the unlisted companies, because that's only where they are available. But to my understanding it's that, in fact, there is a large body of data available for enterprises outside the listed companies through 2008 to 2009, and at least until that point in time, much of the -- you know, the picture has been very -- probably similar, not qualitatively different in the listed and unlisted company.

So that remain -- that leaves the puzzle out there, why is over leverage and credit so much larger than what we see in the listed companies? I don't have an immediate answer, other than perhaps, thinking that of course the economy has become financially much more complex.

The credit chains have become much larger, so maybe the actual credit that you are measuring, as such has gone up. And while the final leverage in the enterprises have -- public and private, is not high as the aggregate total growth created and listed out. That's a hypothesis that we really haven't tested. Unfortunately there is no corporate data for outside (inaudible) recent years.

Absolutely no difference with David's view that, why is it that the economy is so much more productive and profitable in the private sector, and much less profitable in the public sector, and why doesn't investment respond to that -- to these pricings?

Once again I think it's, in a way, a reflection of the way the economy is

being run, that the state, you know, for better or for worse, still, is very dominant in making investment decisions (inaudible) local level.

To Kemal's point on factor productivity; absolutely, is well taken. Unfortunately, I didn't bring the chart, in fact, did exactly that analysis, where we not just look at the very rough iCore, but a deeper analysis of what has been factor productivity is and what might this model of different growth models require and bring as factor productivity.

Just in terms of summary, when you look -- and I think the charts are in the report, either this year or last year, in terms of historic analysis, you clearly see a major decline of total factor productivity, which means that the efficiency of investment, capital and labor. Other than just increasing the volume of labor and capital that you put into the economy; then you know whatever else comes from factor of productivity that has declined from factor of productivity gains of 5, 5.5 to 5.6 percent in the decade before the last five years. And in the last five years, the average productivity factor has been actually -- almost collapsed to something like (inaudible) annually.

And then we try to model what might you actually get out from these reforms that we were proposing to be able to -- what might be the productivity gain out of that. And you can get some mileage out of the -- as I said, China is not one economy; there are different provinces that have very different structures of the economies, but also different legal and governance regimes.

For example, on the registration system for household, it's the famous Hukou system. Some provinces are more liberal than others. You have different degrees of contestability in the services sector, where some provinces are more open to service sector investments, and others are more closed. And if we -- if we look at these

provinces and try to extract somehow; what are the productivity gains that we might get from moving nationally to a more open system of service sectors; or to a more liberal system of reform of the Hukou system?

Our model clearly shows that at least from these two or three reforms alone, you already get about 2 percentage points of higher TFP growth going forward, so you could jump back from something like 2.5 to 4.5 through these reforms. But clearly TFP, you know, is important analysis, and it does, absolutely, support the kind of reforms, and the growth dividends you might get from that.

In terms of the spillovers model, you are right, that this would need to be a more dynamic analysis, you'll think at this point it's limited towards trade, and the growth trade, it does not -- it's not based on value-added growth, and it does not include the potential changes of the supply chains and what rebalances -- what rebalancing would mean in (inaudible) challenge for countries.

Then of course if China rebalances from investment to consumption growth, exports have to rebalance from investment goods to consumer goods, so that in itself will be a challenge, which I think is modeled by that, but then it raised the question of access to consumer markets in China, which probably is much easier for investment in raw materials than it will be for consumer goods.

And so there is dynamic challenges that go beyond the pure -- the trade effects, which have not been modeled in the (inaudible), actually might dampen somewhat, or might alter the conclusions of how much individual countries will benefit from a rebalancing in China.

MR. DERVIŞ: But, it's a very difficult, to be sure.

MR. RODLAUER: Right.

MR. DERVIŞ: I mean, it's a very complex analysis, but I just wanted to know what the model was actually doing. Let me, before opening, again, and also if you just want to come in for one, you know, (inaudible) quickly, but on total factor productivity (inaudible) 5 percent is fantastic, you know, in historical world terms. 2.5 percent is actually pretty good. I mean, for those of you who've read Robert Gordon's work on the U.S., and he says, you know, the U.S. will be lucky to have 0.5 percent TFP growth in the next decade.

He may be wrong, but you know. So 2.5 -- and that doesn't contradict at all Markus' statement that the reforms would be good in taking the 2.5 that we have up to 5 again. Okay. But I think, as an international economist, you know, 2.5 percent TFP is good and particularly it contrasts with other histories, of countries over-investing to the point that it generated negative TFP.

The Soviet Union when it was investing 45, 50 percent was actually having negative TFP, another country which I happen to, at The World Bank, follow closely, which was investing 50 percent of GDP was Algeria, and it had consistently negative TFP. So the fact that with all of this investment, China still has positive TFP one could argue that the investment rate, you know, in itself, while there may be even better performances hasn’t yet become the destructive of value added. In other words, the golden rule hasn’t been exceeded. You know, investment is still adding something to growth. Anyway, any quick -- Yeah?

MR. LARDY: I want to make one comment on what Markus said about the state still dominates investment in China. Again, I think this aggregation is very important. If we look at -- I mean it ties in with what he said that I very much agree with about the importance of competition in terms of driving efficiency. If we look at the

manufacturing sector today, which is still producing about a third of GDP, state companies are responsible for only 10 percent of investment, 10 percent.

Private indigenous Chinese companies are responsible for about three-quarters. And most of the rest of investment in manufacturing is being undertaken by foreign invested companies, most of which I think should reasonably bind as private companies. The vast majority of investment by foreign companies in China today is by wholly -- wholly foreign-owned firms and they are privately owned.

So in the manufacturing sector, there has been a very dramatic shrinkage in the role of the state in investment, but here I want to reinforce what he said, in services that's not so true. The share of investment by the state and services is four times higher than it is in manufacturing. So except for retail and restaurants, and what I would call traditional service -- components of the service sector, the state is very dominant, particularly in the modern services; such as financial services, or telecommunications and other things that are very important to modern economic growth.

So it's maybe not quite as state-dominated, and that's why I tend to think that if we -- if China really follows through on its commitment to eliminate all the natural monopolies, we'll have a very substantial increase in private investment, in services, and the productivity difference as measured by return on assets, and services between state and private is roughly 2 to 1. In other words, private service providers are roughly twice as productive as state ones, so again, if you can do that reallocation of investment resources, away from state toward the private sector it will have a very positive effect on economic growth.

MR. DERVIŞ: David, any quick?

MR. DOLLAR: Just kind of picking up on Nick's point, a lot of the

measured productivity growth in manufacturing, you know, has come from the relative shift of resources out of state sector and into the private sector, but you know I agree with Nick that's gone about as far as it can in the sense that manufacturing is overwhelmingly private. So it's a plausible hypothesis, you know, that China needs that kind of process and services in order to sustain these TFP growth rates which he thinks sound okay.

MR. DERVIŞ: All right. Well, we'll open it to a few questions. Yes. The lady here first, I will take, and then you, and then and then -- we'll take three questions. Yes? Please identify yourself.

MS. LEE: Thank you very much. My name is Sue Lynn Lee, I'm an Economist from Marubeni, Japanese company, and I was following the CSIS, my question is about the reform. I think maybe everyone agree that reform is a key factor, a factor of (inaudible). How far or how good China can go? But the question is; what kind of role can or should the United States play on pushing this kind of reform in China? Thank you.

MR. DERVIŞ: Thank you. Yes, the gentleman here?

MR. EHRLICH: I would like to push you a little bit on --

MR. DERVIŞ: Identification?

MR. EHRLICH: Sorry. Judd Ehrlich, Documentary Filmmaker. I would like to push you a little bit on interest rate reform, interest rate liberalization. We've heard so much how this is important for financial sectored growth and development, but we've also heard about the debt loads, and the SOEs, the debt loads in the local governments, and also perhaps that the leverage ratios are much higher than published.

So what strategy can the government follow to achieve a market-based solution for active and passive interest rates in the face this huge debt load, without

causing a crisis on all three of those sectors?

MR. DERVIŞ: Yes, the lady behind; identification? Yes?

SPEAKER: My name is Lee Yung. I just wonder what specific strategy that you have in order for reform? By reform I mean, increase the wellbeing of humankind, whether in the Chinese, in the Mainland China, or in the world. If you just say reform in a rhetoric sense, you really want to follow the misleading of capitalism, or for the globalization, or liberalization, then that will be far away from reform. And then GDP is not really a term to measure the productivity, it can be also measured -- or forget to measure these services. So I wonder if you can have specific -- address these types of issues.

MR. DERVIŞ: Thank you. I think we can take one or two more questions before we -- Yes?

MR. ELLIOT: It's Doug Elliot from Brookings. I was interested in your views on the shadow banking sector. It seems to me that this is simplistic, but one way to divide it is between a substantial amount, which is really bank-lending in disguise. A form of regulatory arbitrage that they would be doing if it weren't for the various limitations they faced.

And some portion of it, is qualitatively different, and it's getting money to small and medium-sized enterprises, private firms, et cetera, that have more trouble getting money from the formal sector. I was just wondering your view as to how much -- if that's a useful characterization as to how much comes from each of those flows, do you think?

MR. DERVIŞ: There's, a lady in the back there. Oh, no, sorry; the gentleman there? The lady is with the --

MR. CASEY: I'm Bill Casey -- Is there a lady back there who still has her hand -- if not, I'll ask my question. Bill Casey, with *The Wall Street Journal.* I'm just wondering if someone could comment on the impact of the personalities in the leadership. We talked a lot about policy and the reform policy, but a lot of that depends on the policymakers.

And we've had a number of reports of the prospect of one of the key backers of the financial reform program, Zhou Xiaochuan, possibly stepping down. If there's a change at that level there's no longer that voice for interest rate reform, exchange rate changes; what impact would you think that would have -- might have on the growth pattern? Thank you.

MR. DERVIŞ: Okay. So what I suggest, we give the privilege to Markus, out guest, of course, to answer whatever he likes to answer. And then, if you can -- want to add some things, but first Markus, and not necessarily every question, but you know.

MR. RODLAUER: Sure. Yeah, absolutely. Thank you very much. I think China's partners can play a huge part in anchoring reforms, especially the United States. It will be very helpful, and I'm thinking here particularly of the bilateral (inaudible), the agenda for doing that, particularly in terms of commitments (inaudible) sectors and allowing through competition (inaudible), this was the WTO in the early 2000s, to be (inaudible) domestic reform in China. And then that's an (inaudible) extremely helpful, but then (inaudible).

On the interest rate reform, I think our view is quite clear that a lot of it has already happened, you know, lending rates are basically (inaudible), much of the lending is going on -- half of the lending is going on outside the official sector, a truly liberal for interest rates? Now, of course official interest rates are still somewhat

contained because the deposit rates are low, but overall, we do believe conditions are right for the next step for deposit rate for liberalization.

Now that means, not that you can do it overnight, because you have to put this by two other important measures. One is deposit -- I think we need a transparent, clear system to resolve banks if they get into trouble. And I think it can only be a gradual move forward perhaps for the next several years, where you start liberalizing certain segments of the deposit rates, and would go gradually into full reform.

Why am I saying this? Because as I've also said, the more hazards -- problem and the budget constraints still is out there, and again, what we've seen in other transitions (inaudible) usually give latitude to liberalized banks, for example, to (inaudible) aggressively for deposits, without the real investment discipline, potential failure, and the clear resolution process, that could be unhealthy. But, overall I don't think the debt load is such, it should be a constraint on going the next step on the (inaudible).

Your question on the wellbeing and on the true impact on the population of this reform, I think is very well taken. My understanding of that is that the reform understands this -- the reform agenda understands this very well, because it's precisely the point of getting away from a very narrow growth model that basically collects savings and resources from everybody. Starting with the savers, to enterprise employees, puts all this back into concrete and steel and polluting, investment, and creates growth that way.

Moving to a growth model that is much more inclusive and environmentally sustainable, because you are basing it on a much more broad-based productivity increase (inaudible) out there, services that provide much more employment, higher incomes for the wage earners, changed incentives for local government officials,

who no longer will be geared solely towards creating GDP.

Be that through steel and pollution, but now a much more comprehensive way of judging progress and success that, you know, measures growth and wellbeing based on a number of indicators, including environmental sustainability, including inclusiveness, but we think that the growth agenda and the reform agenda in fact, does provide the necessary elements to make growth a lot more inclusive and more sustainable, not just narrowly focused on GDP. And this is the question.

On the shadow banking, I think, you know, your characteristic between, you know, what's good and bad about it, is in a way it appeals to me, but I think it's still overly simplistic. One cannot just say that all the shadow banking that goes -- that's connected to the banks, it's bank having a disguise is bad, and the rest, it goes out in through the trust and so on. That they are not connected to the banking system, it's all good, because it provides --

I think that it's -- it's too -- there's an element of truth into that, but I think it's more complex, and I don't want to go into (inaudible) we have. We have some analysis in our reports, but I don't know whether you guys (inaudible).

MR. DERVIŞ: (Inaudible), anything you want to add?

MR. DOLLAR: Well, I'd like to add on two of the others, if that's okay?

MR. DERVIŞ: Mm-hmm.

MR. DOLLAR: So on the first question about role of the U.S., so my own personal view, it's not really helpful for the U.S. to be loudly criticizing China, and urging China to do this and that. On the other hand, I agree with Markus, if the U.S. can create positive incentives for China. Now he mentioned the bilateral investment treaty, if we had some -- if we could negotiate such a treaty, it would require China to open up, you know,

most of those closed sectors, except what's on a small (inaudible) negative list would require opening of the capital account over time.

It will be very important -- it could be a very important anchor for many of the reforms that we are discussing. And then beyond that, you know, the United States is involved in negotiating the transpacific partnership, you know. And if you follow the press that the probabilities for that seem to go up and down every, but I remain optimistic that we will successfully implement a transpacific partnership, which is a new, more open, high quality trade agreement.

China is not one of the initial negotiators, but looking further down the road, we should be welcoming of China, meeting the standards and joining PPP. So I think external agreements in which the U.S. plays a leading role, can be an important anchor for China's reform. But the kind of sitting back and harping loudly, I don't think has been particularly helpful.

And I just want to echo what Markus said, in response to this lady's question. It's very refreshing to read an IMF report that talks about reforms, you know, liberalizing the Hukou systems so farmers can move to cities with their family; urging the government to spend more on health and education, so that those -- the children of those families get benefits. Pointing out the environmental benefits of this kind of transition; so it's really a very people-friendly agenda; so this is a nice case, where what's probably good for the Chinese economy in the medium term, is very clearly a people-friendly agenda.

MR. DERVIŞ: Let me -- oh, sorry. Go ahead.

MR. LARDY: I would like to respond to the question about personalities. I am very skeptical of this view that Xi Jinping is seeking to replace Zhou Xiaochuan

because he "wants his own people in high positions," and that he has been unable to get the kind of more massive increase in credit that he wants.

I think this is flawed at several levels. If Xi Jinping and Zhou Xiaochuan did not have a very big overlap in their views, they never would have given the dispensation that they gave him to be reappointed as Central Bank Governor in the first place. And secondly, if Xi Jinping wants a more expansionary monetary policy, all he has to do is pick up the phone.

The Central Bank is not really independent, and this idea that the only thing that stands between the continued moderation of credit growth, that Markus pointed, is badly needed and a wave of liquidity flowing over the system, is that Zhou Xiaochuan has his finger in the dike, or something like that, I think is misleading.

Secondly, the speculation, and this is all speculation, that he's going to be replaced, the speculation that the successor will be Guo Shuqing, I hope it's correct if Governor Zhou does step down for whatever reason. But Guo Shuqing is cut from the same cloth, he is the same kind of reformer, I think. On most issues he and Zhou Xiaochuan would see eye to eye. He was a very vigorous regulator when he was at the Securities Commission, (inaudible) a very strong record going back decades. So that part of the story also doesn't -- the whole thing doesn't really hang together.

Maybe Governor Zhou is, say, tired and wants to retire, and Guo Shuqing is going to take his place, that conceivably could happen, but this idea that there is a big power struggle at the very top of the system over monetary policy, I don't think is credible.

MR. DERVIŞ: We will have to close, let me ask -- take the privilege of the Chair, for a more general question to Markus, and I think might be interesting. Not to

go into details but, you know, in the dialogue with China, it's at the same time with dialogue on the world economy, China has done extremely well, but is facing these problems we talked about, there's quite a bit of consensus, in which direction to go.

But in terms of the overall, particularly macro management model, I mean, if I was Chinese I would look at the U.S., and I would say, well, recovery is on its way but, Larry Summers is talking of secular stagnation. Roger Gordon is saying the U.S. will be lucky if it grows close to 1 percent with TFP at 0.5. I look closer to Japan, interesting experiments and efforts, but far from successful yet. You know, last year seemed more likely to be; now it seems to be petering out.

And the place that's close to my heart, the Euro Zone, you know, is probably going to grow at a rate of less than 1 percent this year, and maybe something like that next year. So these are the advance countries. (Inaudible) model, I mean, there's Canada, Australia and so on.

So in terms of, you know, I mean, and I think the report, I mean, I haven't got the report, but I think the IMF's overall language is very appropriate. I mean, are they also kind of saying to you; well, look, we may -- we have to reform, but the whole world, macroeconomic system seems to be in a quandary, and we should all put our heads together and see how we can achieve the additional 2 percentage point of growth that the finance ministers of the G20 agreed on in (inaudible) Australia.

So it's not as if there was this very well-functioning world economy and then, you know, giving advice to China, it's more like everybody has some pretty tough problems. Would you agree?

MR. RODLAUER: I fully agree. And China is very clear even though they are not as vocal as others are that (a) global growth is extremely important, not just

for growth in China, but for reforms in China. (Inaudible) whenever we speak to our counterparts at the senior levels particularly, (inaudible) is the Managing Director, and the Deputy Managing Director, the first question that comes, how much is growth going to be next year? And if there's another downward revision, you can see how it hurts.

Not just because of the impact of China, but because it undermines the reform (inaudible), but going on, and pressing ahead because it has impact. (Inaudible). The second point is that they have their views about the adverse impact of the -- complicating impacts of the very deep-rooted conditions in the global economy, those have not very high and immediate direct impacts on the Chinese economy, because of capital controls, but they do view this, as a (inaudible) flood, that is not helpful for emerging (inaudible).

Now that, of course, needs to realize that (inaudible) factual is not attractive to them either, and they realize that this is the second best, because that's the one thing that needs to be done. And I think they go back to sort of (inaudible). It's really a (inaudible) of the financial crisis that happened (inaudible) before. It is not helpful for them (inaudible), but I think there is overall consensus, but there is no big questioning of the model if you want to -- if that was your question.

MR. DERVIŞ: The big model.

MR. RODLAUER: I think that there's no real debate about the basic macroeconomic jobs, the basic conclusions you have when you are facing increasing risks that you have to address them; and the basic truth, whether you call it Washington consensus, or macroeconomics, or structural economics; that you need to implement structural reforms to generate new growth.

MR. DERVIŞ: All right. Well, please me in thanking our great Panel;

(applause) Markus, of course Nick, and David. And I hope we can do this again, in a year and see what happens.

MR. RODLAUER: See what happens.

MR. DERVIŞ: Thanks a lot.

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