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# TREMORS IN THE CHINESE ECONOMY: DEBATING THE ROAD AHEAD

Washington, D.C.
Wednesday, February 10, 2016

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**Introduction:**

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P R O C E E D I N G S

MR. LI: Good morning. Happy Chinese New Year. It turned out to be a very beautiful day. My name is Cheng Li. I'm the director of the John L. Thornton China Center here at Brookings. We are so honored to have you all here today for a very timely discussion on the Chinese economy, which is facing some very real problems. Almost every day, you can find a headline article about this subject with a wide range of concerns and fears about what will happen next.

Many Chinese public intellectuals have begun to wonder whether their government has a clear plan and effective measures for the future. The Chinese leadership also acknowledges the tremendous risks, economic and socio-political, that it must navigate. The previous export-led and the investment-driven economic model has come to an end, but the new consumption-driven and innovation-led model is not moving quickly enough to meet public expectations.

Labor costs are rising. Real estate is bubbling. The environment is deteriorating, and the stock market looks like the world's most expensive roller coaster (Laughter). Now, this pessimistic view, though valid, must be balanced by competing perspectives. Otherwise, we may indulge too much in the drama of the moment and fail to see the big picture and identify some great opportunities.

Environmental problems will reallocate investment to new areas, such as improving air and water quality and provide better access to health care. The rise of Chinese wages and household income can help drive consumption. And we should not dismiss important attributors of the Chinese economy, or the strength of the Chinese economy, such as a dynamic middle class, still one of the most important economic forces in today's world.

And China's state of the art infrastructure in transportation, robust human capital, remarkable catch-up in size and technology and a vibrant entrepreneurship, especially in creating new business models. The fact that the outside world has been so worried about China's economy now, also reminds us not only of China's serious problem, but also, of its recent historic re-rise or re-emergence as the second largest economy in the world.

A more balanced assessment is needed in academic, policy and the business communities. Now, we are so delighted to have three very well respected economists here to present their expert insights and different perspectives. You already have their bios, so let me just very quickly introduce them, very briefly.

First, Steve Roach, in the middle, from Yale, is one of the most articulate public intellectuals on the subject of China's economy. Known for his optimistic views, Steve and I have had many informal debates about China's future. But each time, it seems that he has won, I have lost, since he has correctly predicted outcomes.

For instance, a few years ago, I believe that the Bo Xilai scandal would be a major blow to the Chinese Communist party, but instead, Xi Jinping has saved the party and regained public confidence by cracking down on corruption, just as Steve predicted. So, thank you, Steve, for being here, and for painstakingly challenging our conventional wisdom all these years.

Next, we are very pleased to welcome Brad Setser, a senior fellow at the Council on Foreign Relations. Brad is a leading voice on emerging market economies. I have followed his work for a long time, although this is the first time we've met, I believe. His critical thinking and assessment of the Chinese economy has always kept me on my toes. I'm thrilled today to welcome him not only to Brookings, but also back to the think tank world after four years' service at the Treasury Department.

Last, but certainly not least, is my colleague and a close friend, Eswar Prasad, who will moderate today's event. Eswar holds the New Century Chair in International Trade and Economics at Brookings. He is also a professor of economics at Cornell University. As a leading economist in the world, his opinions are highly valued wherever he goes. Just a few days ago, Eswar published a fantastic report on China's efforts to expand the international use of its currency, renminbi.

We have brought printed copies, I think, that you can pick up outside for all guests of today's event, but it is also available online. You can download it very easily from Brookings' website. Please also note that a video of today's event will be available on the Brookings Web site in the next few days.

Now, today's event will take the form of an unstructured dialogue, but the issues that emerge, I hope, will become part of a serious intellectual debate about the road ahead for China. On that note, I turn the conversation over to Eswar, and look forward to an enriching conversation. Thank you very much.

MR. PRASAD: Thank you, Cheng, for that introduction, and welcome to all of you. We have a wealth of education as well as private sector and government expertise, so, I'm sure that within the next hour and a half, we will have China all sorted out. We have a lot of ground to cover, but let's start with the short-term.

Now, the Chinese government tells us that the economy in 2015 grew at close to 7 percent, something in the range of 6.9 percent. There is some degree of skepticism about whether this number actually bears any relation to reality, and whatever the case for 2015, that is an interesting issue about what lies ahead in the next year or so.

Many international organizations have started downgrading their forecast for Chinese growth for 2016, the government still has a target somewhere in the range of 6 1/2 to 7 percent, and they seem very insistent on still maintaining the notion of a growth target, even though the Chinese government, including its top leaders, have been talking about shifting the emphasis away from headline GDP growth towards what is behind that growth.

The IMF now has a forecast of about 6.3 percent for growth this year. The World Bank has it at about 6.7 percent. So Steve, what is the reality and what do you see as lying ahead for the Chinese economy over the next year? And then, we'll turn to the longer term as we go ahead.

MR. ROACH: Well, thanks, Eswar and Cheng. Thank you for your kind words. In terms of the economy, as long as I can remember, at least you know, and that becomes more and more of a challenge as I move through life, you know, there's always been skepticism about the official numbers and whether or not the government is you know, coming clean on the Chinese economy.

And of course, as financial markets, especially the equity market unwinds in China, the skepticism deepens, and the confidence becomes stronger that the government is not really disclosing the full extent of the problems in the economy. Number one, as a financial market practitioner for many decades, and I realize in this era of Senator Sanders, you know, it's not something you want to really talk proudly of (Laughter). But I am very proud of my career on Wall Street over those years.

You know, I've learned to be very skeptical of making the leap of faith between the turmoil in financial markets and what that means for the real economy. You know, if I had you know, a dollar for every financial market collapse that did not get reflected in the real economy, you know, I'd be sitting even more comfortably than I am today.

Number two, you know, I think the Chinese economy is performing much, much better than your average market participant would want to conclude right now. And you know, whether the number is 6.9 percent or 5.9 percent, you know, I don't think any of us are able to say that with any precision, probably including Chinese government statisticians themselves. The acid test, though, of whether or not the economy is performing in a satisfactory way or not, I think is job growth, unemployment and its connection to social stability or instability.

And so, I think there's a lot of ways to triangulate on the macro performance of the economy, and you know, urban job growth I think is the best and most reliable indication. It's averaged 11 million new urban jobs per year over the last three years, which is about a million per year faster than the government's targeting. And urban job growth has held up fine, even though the economy, the overall GDP growth has slowed, and I actually had that as question on my midterm exam for the China class I teach at Yale.

I said, you know, how can GDP growth slow and job growth come in above target? And you know, these students, who I have brainwashed for years, they all knew the answer. And the answer is, the shift to labor intensive services, where services in China generate about 30 percent more jobs per unit of output. So, it's quite possible to actually have slowing job growth -- excuse me, slowing GDP growth, firm job growth and the economy, you know, goes through what I believe are the early stages of a powerful, structural transformation. I think that transformative process in China, where the mix of the GDP is far more important than the overall GDP is really the key to the puzzle.

And the economy is progressing with obviously, a lot of challenges and problems along the way, and we can go through all of those, but the bottom line on China is the transformation is intact. The economy is not on the brink of a hard landing. The financial markets are not performing well. There are issues in the equity market. There are issues in the currency market. There are issues with debt.

But don't underestimate the resilience and the capacity of the real side of the Chinese economy to perform much, much better than you know, these rocket scientists in the West will tell you.

MR. PRASAD: So Brad, from your perch in the government, I know we live in a time where Bernie Sanders disses the private sector, and Ted Cruz disses the government government area of public service, but from your perch in government, you are very closely watching the Chinese economy. What is your reaction to what Steve said? And also, what do you see as the prognosis for the year ahead?

MR. SETSER: Well, I don't know that having a perch in the government provides you with greater insight than having a perch on Wall Street. I am, I guess, neither in the Wall Street, China is about to crash, get short as much as you fan, as fast as you can, camp, nor am I in the nothing to worry about, all is fine camp.

I think there were reasons to start to worry about China's economic performance, starting in the first quarter of last year, when real import growth came in, in Q1 of '15 at a very negative print, so, down ballpark 5 to 10 percent. That told me that you should be paying attention to the underlying dynamics of growth, and that there was reason for some level of concern. I think there was also reason for some level of concern when the PMIs started turning quite negative in the middle of last year. So, I think there is a basis for having some worry.

But what I think happened, without having any great deal of false certainty, is that I -- what I know happened is that the property sector was overbuilt, and there was a significant downturn in property investment, and that downturn in property investment in an economy where property and associated sectors was a very important source of growth going back, provided a negative impetus; probably a much more pronounced negative impetus to imports and to the broader economy, but it did provide a negative impetus, and that that was creating pressure on the manufacturing sector; steel, cement, et cetera, et cetera.

And in that context, there were signs of a slowdown in manufacturing investment. I think the Chinese policymakers then, responded by loosening some of the policy restraints that had been introduced, allowing a higher level of infrastructure investment, allowing faster credit growth to certain parts of the economy, despite all the rebalancing talk. And at the margins, I don't think doing enough, allowing a slightly looser fiscal stance.

So, I kind of view the Chinese economy right now as a race between the stimulative policy support coming from the Chinese authorities, and the drag emanating out of the property sector. I think the available evidence suggests, contrary to the kind of Wall Street pessimism driven very heavily by movements in the currency, that the policy stimulus started to have some impact in the latter half of last year, and going forward -- now, even though I think that, I kind of would not put my money that growth is exactly seven. I would put my money that it was maybe a little bit lower.

And I kind of view the year going forward as a test of the strength and efficacy of the policy stimulus, which should, if it all works well, support consumption, sustains robust consumption growth, sustain strong service growth, sustain strong growth, and the drags that continue to emanate out of the property contraction. And I would bet that the -- maybe I'm being too optimistic, that the policy support wins out. But I have a tiny bit of concern that the drags from property to manufacturing may hit real wages and real consumption, and take away the one bright spot in the Chinese economy right now.

MR. PRASAD: So, you buy into the view that a lot of the high frequency indicators in the market tends to focus on things like the PMI, electricity consumption, freight volumes and so on, do affect the manufacturing sector, but the services sector growth is strong enough to make up for what is happening with the manufacturing sector and with property investment?

MR. SETSER: I don't think it is strong enough to make up. I think it is strong enough to provide ongoing forward momentum at a pace somewhat lower than 7 percent, but not to fully make up. And I don't think it can fully make up without policy support from the central government and the government's fiscal balance sheet.

MR. PRASAD: Brad has just made the transition from government to the think tank world, so he still uses phrases like ongoing forward momentum. But within a couple of months, that will change to something more direct (Laughter).

MR. SETSER: I thought that was pretty direct (Laughter). Ongoing forward momentum.

MR. PRASAD: Steve, in terms of this policy space, Brad has made the point that some of the policy stimulus is already in the works, but there are consents, at the same time, that monetary policy in particular, isn't getting as much traction as it used to be getting, now that we have higher levels of debt, and so on.

How much space do you think the government really has right now, in terms of monetary, fiscal, other instruments to boost growth, if in fact, growth were to slow down over the next year?

MR. ROACH: Well, Eswar, let me ask you this. Can you find any central bank in the world right now that is getting traction from monetary policy? Anywhere?

MR. PRASAD: Yeah.

MR. ROACH: I mean, you know, the Fed? You know? The ECB has led the charge in going to negative policy rates. That's working brilliantly. It's so working so well that the BOJ decided to follow it, and that's not exactly -- it's premature to say whether or not that's working.

But I just want to go back to the point that Brad raised on the property market, because this is sort of a common view on China that you know, there is a big overbuild, and now it's unwinding, especially in the second and third tier cities. And I think there is definitely some validity to that. But you know, does property really occur in a vacuum in China? I would argue that the property market-led investment in China is a pillar to the structural rebalancing story that really rests on urbanization.

The urban share of the Chinese population in 1980, when the miracle began, was less than 20 percent. Last year, it was 56.1 percent, on its way to probably 65 to 70 percent in the 2025, 2030 timeframe. That will require, you know, probably another 300 million rural citizens to move to urban areas. And you know, do the math. I mean, that will keep the investment GDP ratio quite high for the foreseeable future, and will require a lot of additional property market construction to occur over the next 10 to 15 years.

Brad is correct that there has been some short-term, I think, overbuilding along that trajectory of urbanization, and so now, you know, going above the trend for several years, you could certainly see some below trend investment to absorb the overhang. But the longer term, I think conclusion on China is, they're not backing away from urbanization, and they're not going to back away from the infrastructure and their property requirements of that urbanization.

China doesn't do rural urban migration the way that India does, and that is, you know, just bring them into the city, create this urban squalor with no construction and no infrastructure. China has a totally different model to do it, and they couple rural urban migration and the urbanization with services development, because if you look at you know, the long history of urbanization, the biggest source of job creation that comes in newly urbanized areas is in building the services that are required for new and expanded cities.

And China is in the early stages of services-led economic growth. It's very powerful right now. Services in China are growing, you know, 8 1/4, 8 1/2 percent year on year, versus manufacturing and construction at around 6 percent. But there's a long way to go in that area.

And the final thing -- well, no, I never say the final thing (Laughter), but another aspect of the story that really gets missed is, all of this fixation on these excessively high levels of the investment share of GDP. You know, what's the number? You know, 45 percent, 50 percent? No country -- this is you know, worse than Japan. No country has ever sustained investment to GDP ratios of that magnitude without, you know, imploding.

Well, let's just back up and remember that we're supposedly economists. And investments to flow. And it's a means toward the end, which is a stock. And you know, if you're looking at economic growth over a long period of time, what you should care about the most as an economist is the stock of capital relative to labor. Capital labor ratios drive productivity, which is ultimately, the essence of long-term economic growth.

And the stock of capital relative to labor in China is still abysmally low, because there was no stock in the aftermath of the Cultural Revolution. So, they've had to, you know, move up the ladder in building the stock of capital relative to labor to drive productivity for the economy as a whole, and they've got a long way to go in that regard.

And so, I think you can look at urbanization, services-led, high investment ratios for years to come, and I think the government is focusing its policies on those types of issues, rather than this counter-cyclical panic of expanding the fiscal space to make sure we hit you know, the six point whatever percent growth target. That's not what China is doing right now, and I think you need to look at policy from that perspective as opposed to you know, the lens that is emphasized so much in, you know, more western policy circles.

MR. PRASAD: So Brad, Steve has given us a nice segue into the long run. He points out that some things are going in the right direction; that the services sector is accounting for more of GDP growth; now accounts for more than 50 percent of GDP. If you think about investment, Steve argues that there is a lot more room for China to invest, if it were to do it the right way.

And then, if you look at this rebalancing effort, you know, there are many indicators suggesting that there is progress, you know, if you look at the contribution of overall consumption to GDP growth. That is greater than 50 percent now. If you look at the household saving rate, it's been declining in the last couple of years.

All of this suggests that the rebalancing is going in the right direction. Do you share this reasonably sanguine view about the longer term, although I know that Steve has a lot of views about what needs to be done, to make sure that this is all in the bag. But are things in your view, going in the right direction?

MR. SETSER: There are a lot of different questions there. I broadly agree with Steven's arguments about the long run, that China needs more capital, China needs a bigger, not smaller stock of high quality and low quality apartments in urban areas, as the number of migrants you know, increases. And although within that general story, I'm a little bit less positive about how China has handled migration, because I am struck by the fact that many of the existing migrants don't have full access to public services in urban areas, and there still seems to me to be important constraints that limit the provision of services, public services, healthcare, access to schools for your children where you live in public areas.

MR. ROACH: But they're working on that right now. I mean, the whole -- one of the major reforms reiterated in late October, is this Hukou Reform that will make those benefits much more portable for migrant workers.

MR. SETSER: And I think that needs to go further, faster.

MR. ROACH: Okay.

MR. SETSER: I think indicators like public spending on healthcare as a share of GDP suggests that there is significant public sector investments that are needed to support the long-term transition of China to a more service driven, more urban economy. And I think in some sense, the Social Security safety net remains a little bit weaker than it should be. And I think that access to high quality education for your children where you live, while going in the right direction, is starting from a really low level.

And so, my vision for a healthy Chinese economy includes a world where there are enough public schools, enough spending on public schools, so that more or less, everyone can send their children to school where they live and work. And I don't think China is quite there yet. So, I think that's kind of -- but in the general sense of, China is still a relatively poor economy with a relatively low level of capital, and therefore, there are ongoing opportunities for a relatively -- to sustain a relatively high level of investment, I broadly agree.

I am less sanguine about the success of the rebalancing than some are. I am struck by the fact that the savings rate, national savings rate and the last available data is from 2014, so it's a little bit lagged, and it's probably come down, is still close to 50 percent -- around 48 percent of GDP. And that strikes me as still too high.

And that unless there are more aggressive policies put in place to lower the savings rate, I worry that the fall in investment, which is clearly happening somewhat, will impart a bigger negative impulse on the economy than the rise in consumption. And my sense is, that is what happened in 2015, and without the policy support, we would have had a somewhat more negative outcome.

So, I am not convinced that we should be confident, because services are growing relatively well, because consumption is now more than 50 percent of GDP growth, which it should be. You know? It should be 70 percent. I will be confident when I am convinced that there is a very significant fall in the national savings rate underway, so that China can transition to an economy with investment between 35 and 45 percent of GDP, probably closer to 40 than 35 ballparky (sic), and savings falls from 50 to around that. Otherwise, I worry about the cyclical drags associated with the transition.

MR. PRASAD: So, I think those are good points. The household savings rate has gone down, but thanks to the rise in corporate savings, and to some extent government savings, the national savings rate has in fact, gone up a tiny bit, and stays very high.

So, Steve, Brad is not as sanguine, if I interpreted your sanguineness correctly. But clearly, there is a lot left to be done. What do you see as the biggest policy challenges for the government at this stage, to get the economy moving in the right direction? In the third plenum, we heard a lot from the government about what needed to be done, but not a great deal has been done. If you were to prioritize what the government should be focusing on to get this rebalancing in the right direction, what would you say to them?

MR. ROACH: Well, actually, you know, what have I said to them? What I've said to them is the following: You know, identify the goals. They've done that, and the goal is to shift the model from you know, basically a producer approach to a consumer approach.

One of the key things they should be focused on in doing that, and I break them down into three building blocks, and we've talked about it, but let's just sort of formalize that. More jobs, and that's a services focus. Higher real wages, and that's an urbanization focus, because urban workers make three times their counterpart in the countryside. And then, to Brad's point, and he's hit the nail right on the head, you can generate more labor income by jobs and real wages, but it'll be saved and not spent, if people don't have a better sense of security about the future with respect to benefits like retirement, healthcare, and the portability of those benefits for 270 million migrant workers.

So, the safety net is really the missing piece in the puzzle. So, when I grade, you know, the Chinese rebalancing, you know, I give them, you know, great grades for the first two building blocks, but you know, I don't even give them a passing grade on the third one, which is the safety net. And that's why this rebalancing gets clogged, because they're sort of re-engineering the structure, but they're not really getting at the incentives that can change behavioral norms, because they haven't really done the heavy lifting on the safety net. And you know, I'm a broken record when it comes to being critical in that piece of the rebalancing challenge.

I draw comfort, though, in what they did last October, with the fifth plenum of the Central Committee of the 18th Party Congress, where they actually did give us a preview of what to expect of the new five-year plan that will be enacted in March of this year. And they did make a number of concrete proposals in number one, consolidating rural and urban Social Security systems, consolidating the critical care piece of healthcare, and the Hukou reform that I alluded to earlier.

These seemed like much stronger commitments to address the issues that Brad just mentioned. And also, you know, by making significant proposed changes in the One Child Family Planning Policy, these get at a lot of the behavioral issues that I think are hobbling this conversion to more income, more labor income into discretionary consumption.

If there's one area, you know, sort of intellectually where I'm most critical of sort of the Chinese strategy and policy, is they view everything as sort of a big engineering problem, and they're great at solving engineering problems. I mean, you know, look at the roads, the dams, the bridges, whatever. You know? You name it, they can do it.

But they're not -- they don't, I think, at this point, know how to make the leap from solving an engineering problem into getting at the mindset, the DNA of consumers as behavioral animals. And I think you've got your finger on it. The safety net is really the issue.

And so, you can make all the proposals in the world in terms of addressing the safety net, but do you have you know, in place, the governance that will allow you to implement quickly these policies that will alter behavioral norms? And this enters into a whole rich array of issues about, you know, you can even bring anti-corruption in there. You know, will people have confidence in institutions, if the institutions are corrupt?

And I happen to believe that Xi Jinping and Juan Cochon actually think a lot about the need to build more robust -- well, to instill greater confidence in robust institutions by addressing the corruption issue. And that's part of the puzzle, as well. But I'm hopeful, but I take your point. I mean, it's a big and it's a fair criticism, but you've got to put it in the context of a bigger framework, and thinking of it along those lines is more helpful.

MR. PRASAD: Steve has given us some good things to think about. I think that commitments, at least in words, are certainly there in the third plenum and the fifth plenum documents. The government says it wants to move towards a more market oriented system. They have made progress in certain areas. The Hukou Reform, the one child policy. A lot remains to be done, as both of you seem to agree, on the safety net and so on.

But over the last year, one of the striking things has been the number of policy missteps we've seen, especially on the stock market and the currency market, which has raised questions about whether, despite their best intentions, the government really knows what it is doing. What is your sense, Brad, about whether the policymaking apparatus and the leaders in China are up to the task that lies ahead of them?

MR. SETSER: Well, I'm a little bit less optimistic that they've identified the necessary set of reforms going forward. I find the social safety net reform still far too modest. And I think in order to successfully provide public services like education and health to a migrant population that will increasingly become an urban population with rights to a broader set of services, you also need to reform the fiscal relationship between the center and local governments.

And I haven't yet seen -- maybe I've just missed it -- a real articulation of how local governments will be able to raise revenues, whether from a grant from the center, or from a set of taxes which provide dedicated sources of funding, sufficient to finance the level of public sector services. And by that, I mean healthcare where doctors are paid enough that you don't have to bribe them to actually be paid to receive care; where doctors are paid enough that they fear losing their job in the public hospital if they are caught accepting bribes, which implies, you know, realistic, higher, more expensive salaries. So, I think there's still significant gaps in the authorities' plans going forward.

The execution over the past year, as you identified, wasn't great. You know, blowing the stock market bubble, talking up stocks was not the wisest decision. Equating the strength of the stock market with the strength of the China dream was clearly not a smart policy move. And then, I think the difficulties of carrying out an exchange rate reform in the current context were wildly underestimated.

MR. PRASAD: So, that brings me to my pet topic, the currency and the capital accounts. Steve, what's going on? The PBOC is clearly a very -- well, I won't say clearly, but in general, seen as a fairly competent institution. Again, they seem to have the right intentions in mind.

What do you think they're trying to accomplish with the currency, and what do you see as the reasonable exit strategy for them from this corner that they've painted themselves into with large capital outflows, very large reserve losses over half a trillion last year? What can they do to get out of this mess?

MR. ROACH: Well, first of all, I'd like to recommend as an answer to that, and there's a new book that has just come out about -- published by the Brookings Institution that you wrote (Laughter), that I think probably has you know, a much richer and more in-depth answer than I'm about to try to give you. So I mean, you're on the pro on this, Eswar, so we should really turn that question back to you (Laughter). But --

MR. PRASAD: You've done this to me in the past (Laughter).

MR. ROACH: Yeah. But you know, I would just say a couple of things, without really getting into you know, the specifics of you know, the sequencing of the currency reforms that you really you know, have done an excellent job in laying out over a long period of time, including in this book.

And that is, just you know, keep in mind, again, the basic goals of China, at this point, strategically. And I would really underscore two of them. One,stability. And two, you know, this structural rebalancing.

Number one, I mean, to me, modern China made its entrée into the world of international finance in the depth of the Asian financial crisis in '97, '98, and it saw firsthand what could happen to you know, brilliant, fast growing you know, miracle economies that didn't have foreign exchange reserves; they were running current account deficits, and that had excessive exposure to short-term capital influence, and it watched every one of those economies from Thailand to Korea, you know, get destroyed, and made up its mind at that point to build the largest reservoir of foreign exchange reserves in the history of the world, and it went from a hundred -- you know, China had 140 billion of foreign exchange reserves in '97 and '98, and it you know, basically sort of top ticked at four trillion, now down to you know, a measly 3 1/4 trillion, which is still about you know, 20 some odd times what existed back then.

China was so focused on creating a stable cushion of foreign exchange reserves to prevent it from ever experiencing what it saw in Asia back in the late '90s, that it will never allow it to go back to that period of earlier vulnerability. And if that involves dealing with capital flight in a way that closes the capital account temporarily, as much as I know you would abhor that, they would do that, first. That's number one.

Number two, their goal of rebalancing from the producer to the consumer -- they don't want a recurrence. You know, the markets are saying, oh, the Chinese are going to devalue by a minimum of 10 percent, maybe 20, maybe 40. That's totally inconsistent with the fact that a consumer economy needs a strong, and not a weak currency. And if they were to go to, you know, a strategy of currency devaluation, to shore up the export economy, you know, the old economy they're trying to move away from right now, to do that in a weak, global demand environment, when they're -- they have much less in the way of external support to address currency devaluation, would take a much, much larger devaluation than otherwise might be the case.

So number one, they're not going to do it, from the standpoint of trying to support an old model that they're moving away from. And number two, they're not going to go back into a point of vulnerability that really formed their core international financial strategy back in the late 1990s.

Having said all that, yeah, they definitely failed to communicate a good transition to this more market-based strategy that they're trying to adopt, one that we in the West have been pushing them to do for years and years. They didn't manage it well, and you know, they didn't manage the stock market well, and they're not good at these things. But you know, they'll probably get it better next time.

MR. PRASAD: So Brad (Laughter) -- one hopes, this time. So Brad, what we are facing is a 20 percent loss of reserves since the high point of 3.993 trillion back in June of 2014. They didn't quite hit 4 trillion. We've seen by some estimates by private sector, and less nearly a trillion dollars worth of capital outflows last year.

De facto, the capital account has become quite open, partly because of policy measures, you know, like the Kill the (Inaudible), the mutual fund connect, the stock connect. So, at this point, has the horse left the barn, and our capital outflow is something they're going to find very difficult to control? And second, what do you see as the exit strategy from this currency depreciation capital outflow dilemma they are facing?

MR. SETSER: So, one thing I do not worry about is uncontrollable portfolio outflows, simply because the portfolio flow, so buying stocks, buying bonds portion of the financial account, while it has been liberalized, it has been liberalized in a very small and a very controlled way. There is not a big stock of foreign portfolio claims on China, and there isn't a real capacity for portfolio claims to run, nor for Chinese investors to suddenly, although it's you know, arguably, a little late to be buying U.S. treasury bonds at 1.75, you know, there's a limit to the capacity of Chinese residents to engage in that kind of portfolio diversification.

Where there is potential for substantial pressure is through the interconnection between the liberalization associated with the internationalization of the renminbi, the creation of the C&H market and bank flows. So, if you look at where there's been a lot of volatility in flows, it has come through the banking system and through invoicing of trade.

I think it is, like Steve suggests, what has been opened can be closed. And that can reduce some of the outflow pressure. So, on the bigger question, which is kind of, has China lost the capacity to manage its currency effectively because of the powerful impetus or difficulties created by capital outflows, I think the answer is still no.

I actually think China had more than four trillion of reserves at the peak. China had a little bit -- like a hundred billion slotted aside in something called other foreign assets, which showed up on the Central Bank's balance sheet, which was a legacy of forcing the banks to hold required reserves in foreign currency. So, I actually think the fall in reserves has been even bigger, and I have no doubt that the private sector analysts have basically gotten the scale of the financial outflow over the past year right.

I think part of the scale is associated with what I think was a policy mistake, which was allowing a very rapid buildup of short-term cross-border claims on China between 2012 and 2014, which created a lot of money that had gone in, that could go out very quickly. And then, I think a very large share of --

MR. ROACH: Do you put that at like a trillion as per the BIS?

MR. SETSER: Yeah. I think the BIS data matches relatively well with the Chinese data.

MR. ROACH: All right.

MR. SETSER: And again, it's come down 300 billion since the peak. I think there's another three, four hundred billion to go, potentially. But it's finite. It is manageable. What came in can go out, and China will still have somewhere north of 2.5 trillion in reserves, which to my mind, is an adequate amount.

So, what else has happened? And I think this is relatively clear, if you look at the details of the data and the reserve loss. If you go back to the second quarter of 2015, the currency was broadly stable against the dollar. You know, at that time, the dollar was very elevated relative to the other G3 currencies. The strengthening of both the dollar and the renminbi was not helping China sustain momentum in its economy. But there was no evidence of uncontrolled outflows. Actually, in the second quarter of last year, China was ever so slightly adding to its reserves.

The third quarter in the devaluation or reform created expectations that there would be a further devaluation, and that induced those who had already borrowed in dollars to want to repay their dollar loans, and it induced companies that had gotten very good at arbitraging cross-border flows to profit from short-term currency movements, to want to hold more of their savings in dollars.

China responded by limiting further currency moves in the month of October and pressure on the currency fell. Then, for whatever reason, China, partially because of the concerns about the Fed tightening cycle, maybe because there was some desire to support the export sector, taking all of Steve's points that that's the wrong way to go aside, there was further movement in November, and much more in December, and then, a lot of movement in the first week of January.

And that reignited expectations that there would be a further depreciation. And once again, you saw measures of capital outflows spike. So, I think realistically, it will be very hard for China to have a controlled depreciation, along the lines that China had a controlled appreciation against the dollar from 2005 to mid 2008, and again, in 2010 and 2011.

The expectation that a small move signals a desire for a big move creates, with some openness on the -- to bank flows, very strong outflow pressure. I do not think that having failed to transition to a more flexible exchange rate from a position of strength, China will be able to successfully transition to a more flexible exchange rate from a position of weakness.

So, I think the realistic option is either sort of a disorderly exit, which I agree with Steve, would be bad for the world; would not help China with its long-term rebalancing goals, or a period of renewed commitment to stability reinforced by some slowdown on the financial account liberalization. So, I know we kind of disagree just a tad there.

MR. ROACH: (Laughter) Seriously, I mean, can I ask you, on the basis of your, you know, just huge wisdom in this area, how you would respond in the very questions that you posed to us, in terms of (Laughter) the sort of capital -- especially on the capital account, as it were, and whether -- and I know you would say you would advise -- well, I don't want to put words in your mouth, so let me just ask you how realistic it might be to expect China to begin to operate in a way that would withstand the pressure of capital flight by backing off on some -- and possibly, even temporarily unwinding some of the liberalization they've put in place recently to open the capital account?

MR. PRASAD: Always remember the adage: Don't ask a question unless you have an answer ready for it already (Laughter), because it might come back to you.

At the moment, I think it's hard to imagine how China gets out of this without restricting capital flows. But my concern, which actually is a different version of the concern that both of you have expressed about what might happen if you had a small currency devaluation, how that might lead to anticipations of further currency devaluation trigger outflows, I think is similar to the issue of capital outflows.

China's capital account has become very open in de facto terms, partly for policy reasons, and partly for the reasons you mentioned. Right now, there is a lot of cross-border trade. You do have Chinese financial institutions and corporations operating on both sides of the border. So, I think when the incentives are strong enough, the capital account has become a lot more porous.

Now, China has, in fact, started tightening up administrative restrictions on some of these flows, and not really re-imposing capital controls, but I think tightening up on where it hasn't really officially let go yet. But my concern is that trying to put in place capital controls of some form or the other could have two negative effects.

One is a very negative signaling effect, as we've seen in many other countries, once you start off with capital controls. For instance, Thailand did with its equity outflows about five years ago. That leads to a wave of panic that there are more capital flow measures coming in, and that can exacerbate the short-term problem.

The second issue is that if you look at what's been accomplished in China, the reform front over the last year, and we talked about this to some extent, much of the reform has been focused on the financial sector rather than the real side of the economy. And this certainly poses some risks, if you have very unbalanced reforms in the financial sector, reforms moving forward. But the institutional reforms, such as corporate governance, auditing and accounting, standards not moving forward, and the real side reforms don't catch up. But I think the PBOC, the People's Bank of China, has opportunistically taken the window of opportunity they had that was given by the notion of the R&D getting into their (Inaudible) basket, to push forward those reforms.

Now, certainly, the classical answer to the right sequencing is get your exchange rate flexible, fix your financial system, then move forward on the capital account.

I don't think China has the luxury of doing that, and so I think the PBOC has taken this opportunistic approach, which I know that both of you share the view that this is very fraught with risks, and I do, to some extent, agree with that view. But I think that if you have a more open capital account, it impels a certain set of reforms in the economy, especially because the financial system, the banks in particular, do face more competition.

So, this can potentially end very badly. But I think that if we had not had the capital account opening, we would be left right now with very little having been done over the last year, in terms of any reforms. And I think putting in place capital account controls right now would roll back not just the financial market reforms, but affect the momentum on virtually over other market-oriented reform.

So, I take your point that this is a risky strategy, but I don't see an easy alternative out there right now. So, I think this is the conundrum that they put themselves into, but this is, I think, another good segue into thinking about what could go wrong. And so far, I failed miserably my role as a moderator of generating the debate between the two of you.

So, let's give it a go now. What do you think can go wrong in these cases? We've talked about one possibility, that a very open capital account with other reforms not catching up can lead to things going south. But we hear about lots of other potential problems of the banking system, the notion that there is a lot of debt out there, and they can see (Inaudible) the growth strategy DP numbers approaching three times GDP.

We don't see many of the market oriented reforms going forward. Do you see any scenario where over the next year, it's not just that growth slows down, but you have a cataclysmic event of some sort?

MR. ROACH: You know, when I was at Morgan Stanley, I was really good at coming up with cataclysmic events largely for the U.S.

MR. SETSER: (Laughter) Which largely came true (Laughter).

MR. ROACH: And most of them didn't actually work out, sadly. (Laughter) Pretty close to the mark. And you know, I'm not in the doomsday scenario, but you're asking me to sort of concoct one. And you know, I think you know, you've described the one that would be at the top of my list. And that is that China, because of the issues that we have just finished discussing, does sort of get caught up in a vortex of a classic, sort of credibility currency crisis, despite, you know, this extraordinarily large cushion of reserves.

And you know, I think that that's the mistake that investors are playing right now. And that is, conjuring up this sort of -- you know, emerging market currency crisis model that they've seen all too many times before, and sticking China into that box. I don't think that's going to happen. But I take Brad's point, which is really very, very important, and that is, to do currency reforms at a time when, you know, the economy is transitioning to a slower growth rate and you're unwinding, you know, just a horrific stock market bubble, I mean, timing is everything.

And so, in retrospect, to inject the currency reforms into that swirl of events probably was the wrong thing to do at the -- or maybe the right thing to do at the wrong time. And so, that feeds the -- you know, the capital flight and the sort of classic, sort of powerful forces that we've seen at play in earlier crises. And that to me, is something to worry about, and I think the government needs to be much more forceful and much more direct in its communication strategy, whether it's respect to the currency, its commitment to growth, and putting those fears to rest.

And I think if there's one area I would really urge the Chinese government to step up to the plate on, and that is in communicating its commitment to stable economic and financial outcomes at this point in time. It needs to do that. You know, the markets are basically closed, and this week um, I was actually there over the weekend.

And you know, I won't tell you that I get a sense that that is what -- you know, how they're going to come out of the holiday. But they're very mindful of the need to do a better job in improving their communication policy.

MR. PRASAD: What about the debt, especially the notion that the high level of corporate debt, about 125 percent of GDP could unravel messily.

MR. ROACH: Do you want me to comment or do you want Brad?

MR. PRASAD: Yes, and then I'll turn to Brad.

MR. ROACH: That's just a bunch of hot air. I'm sorry. I mean, there's some really smart, well known observers who want to put China into the sort of debt bomb, you know, Japan type scenario. To me, the bulk of the debt is -- it's you know, property. There's local government issues. But it boils down to a state owned enterprise leverage issue. And you know, state owned enterprise is the first word of state, so it's more of a hidden fiscal issue that China has ample capacity to address.

And there are consequences of unwinding the post crisis debt binge, and a lot of that is playing out right now. But is this a, you know, a debt bomb that's about to explode? Absolutely not.

MR. PRASAD: Okay, I'll be turning to the audience in minute, but first, let me ask Brad, what could go wrong?

MR. SETSER: There are sort of three risks that are foremost in my mind. One, I think has been implicit in everything I've said to date, which is that the market liberalizing reforms either stall, which would be bad, or they go ahead, but they are not matched by reforms to strengthen the social safety net. And as a result, the market liberalizing reforms on their own fail to provide the impetus to consumer demand that I think is needed.

I think the second risk is implicit in the fact that the shadow part of China's financial system expanded significantly, and you can imagine that if expectations that while these are really kind of linked to various state financial institutions, although not technically on the balance sheet, and a lot of their loans are to local government financial vehicles, not technically loans, but their credit exposure is to local government financing vehicles or entities that have provincial SOE type characteristics.

So, there's some expectation that there won't be big losses born by the people who have invested in parts of the shadow financial sector. If that expectation of an implicit limit to losses somehow gets pulled away, and there is a run out of the liability side of the shadow financial sector, which would have some parallels to our crisis, you could imagine how that could lead to a disruptive event.

And then, the third risk is whether by accident or by design, there is a disorderly exit from a managed currency against the dollar that leads to a very large depreciation. I'm not sure that would be great for China. It would be clearly great for China's export sector. I am quite confident at a point in time when no part of the G3 is generating very much demand, it would be bad for the world.

MR. PRASAD: There you have it. We have time for some questions. I have many more in my mind, but I'm sure you have a few as well, so let me turn to you know, if -- can you start here, please? Please identify yourself, and please ask questions rather than have comments. So, very brief. Over there, the gentleman in a turban.

SPEAKER: Thank you. (Inaudible) Kumar, just a very short comment. Those are extremely valuable, insightful comments. I really appreciate. My question concerns the banking sector.

You know, you talked about you know, maybe problems, you know, corporate indebtedness being high, maybe you know, problems in the local government. But you know, we get estimates in the market. I am in the market on the buy side, that a large proportion of the mid-tier banks have MPRs. which may exceed 20 to 30 to percent. And these are estimates done by some serious people.

That is tied up or in people's perceptions very much with the discussion we've had on the currency and on the results. First of all, the notion that this 3.3 trillion is available for intervention; I mean, that, frankly, very few people believe that. You know, the liquid reserves which are actually available is probably a trillion short of that.

But even that, would it be politically acceptable for PBOC to lose another trillion in reserves if capital flows continue? But the way it ties up with the banking sector is that as they've done in the past, there is a notion that the banking sector is in serious trouble, and you will need FX results to recapitalize them.

So, the notion that somehow, you know, you have this huge pile of reserves which could be used to deal with this trilemma, that is sort of in question. So, value very much your observations on that.

MR. PRASAD: Okay, that's an important set of issues. First, how bad are things in the banking system, really? Does China really have enough liquid reserves? And if you start counting up what they may need to do in terms of re-capitalizing the banking system, will that run out very quickly? Steve?

MR. ROACH: I appreciate the seriousness of your concern, but I have to say, I find myself losing patience with the idea that smart people -- everybody knows the number should be this or that; that there really isn't 3.3 trillion of liquid reserves. It's got to be at least a trillion below that; that NPLs and smaller banks are 20 percent.

I've looked at all those numbers, as well, with all due respect, and I am not nearly as convinced as you seem to be in asking the question, that these are actually credible, defensible estimates. So, I would urge you, while I realize that there's a lot of strongly held convictions as to the unreliability of data, whether it's you know, the financial numbers that you cite or the growth rate in the real economy, to really kick the tires on these alternative estimates that you hear.

Having said all that, you know, I think the published NPL ratios by the CBRC are ridiculously low and stable, and you know, in a declining economy where there are some -- or declining economic growth trajectory, where there clearly are dislocations, you can expect credit quality to deteriorate. And I think there are signs of deterioration that are evident in many of the loans, especially as the property -- the near-term property market excesses are unwound.

Again, I go back to the point I made earlier, that vacancy rates in property markets that are judged as the grist of NPLs in the west, in a Chinese system where these vacancy rates will begin to rise as real urban migration continues, need to be viewed very differently. So, we evaluate NPLs on more of a short-term basis than Chinese financial institutions would in a longer term basis in that context.

I think the biggest problem for the Chinese banking system is a structural one, and that is that the large banks are policy banks, still, no matter what they'll tell you today. And so, their experience in making risk adjusted lending decisions is that of a fiscal authority as opposed to a well trained credit risk officer. And as much as the Chinese have built up risk monitoring systems in these large banks, they have done not nearly as much to change the culture of a credit allocation at the lending officer level, and that's a generational thing that will take a lot further to go.

Do I think there's a banking crisis in the offing? No, I don't. If I'm wrong, I think that you know, this economy with still, its vast reservoir of internal savings and ample fiscal space has the wherewithal to address it as they have done with earlier banking crises in their system in the last, oh, 15 years.

MR. SETSER: Can I jump in --

MR. PRASAD: Yes, of course.

MR. SETSER: -- and play on this?

The U.S., in 2008 and 2009, had no reserves to speak of. We of course, have access to swap lines from the ECB and the Bank of Japan. We could get access through those swap lines to foreign currency liquidity, though at the time, we were supplying foreign currency liquidity through the swap lines to the Europeans and to the Japanese and to some others.

We nonetheless were completely capable of re-capitalizing our banking system without using one iota of reserves. Re-capitalizing a banking system takes fiscal resources. In our system, it required the passage of legislation. In China's system, I don't think that's a real constraint. That's just a question of political will.

It requires writing a check, and the government has the capacity, if it so desires, to write a check. Even if the NPLs are 20 percent in some segment of the banks, that doesn't mean the losses are 20 percent. There's some recovery. That doesn't mean there's no capital. So, the actual check that the fiscal authorities will need to write is a fraction of that. And that check need not be written touching the reserves.

I think China did the world a disservice by using its reserves to recapitalize its banks the previous go round, because that created the false perception that recapitalization requires the use of reserves. It doesn't.

What requires the use of reserves is an uncontrolled run out of deposits into foreign assets. And I think there are other policy tools available to limit that risk. Moreover, we haven't discussed this, in addition to having at least two trillion of liquid reserves, I would say probably a little bit more than two trillion of liquid reserves, China's economy is now running a goods trade surplus of $600 billion. That was when oil was ballpark 50 to 60. Oil ain't 50 to 60.

The goods surplus unambiguously will go up. The current account surplus is somewhat smaller, 300. I think my true estimate is actually probably a little bit bigger. It will also go up. So, there is an ongoing capacity to finance a relatively high level of capital flight, not uncontrolled capital flight, or let's take the capital flight issue off the table, portfolio diversification.

And so, the risk to the remaining 3.2 trillion of reserves is almost entirely the risk that there is an uncontrolled run out of domestic deposits or domestic deposit-like liabilities, and correctly managed, the financial sector can be recapitalized without triggering that run. And in that way, China is fundamentally different than the Asia crisis countries of the 1990s.

MR. PRASAD: Okay. Let's take a couple of questions. Yes?

MR. ROACH: A great point.

MR. SONG: Thank you. My name is John Song. I am a journalist from Shanghai. My question is about TPP. We know it was officially endorsed a few years back, and I want to know, does China really need to worry about this issue? And what is the real kind of impact of this TPP upon China's economy and its trade relationship with other kind of countries in the region? And should China try its level best to be a member of the TPP in the future? Thank you very much.

MR. CRONIN: Thank you. I'm Richard Cronin from the Stimson Center. And my question is whether there is actually a subtext to this very interesting erudite discussion; that is, about China can manage a stable decline to a longer-term lower level of growth. In other words, is this just a current crisis to get through, and then things go back, or is this part of a long-term transition to a much lower growth level? Thank you.

MR. PRASAD: Okay, let's talk TPP and then briefly turn to the issue. What do you both of you think is a reasonable and sustainable growth rate for China, beyond the next couple of years?

MR. ROACH: Well again, you know, my point is that you know, the growth rate is not the goal. The goal is sustainable growth and development, and the Chinese have made the decision. It's on the table, thatthey're moving away from the producer model that was driven and underpinned by hyper growth in investment and exports, to a more sustainable model that draws increasing support from slower growing private consumption and services.

And provided they manage the transition well, we've addressed what they're doing and what's missing, the answer is slower growth. And you know, you look at their long-term forecast put out by the DRC, the internal think tank of the state council, I mean, they give you the trajectory. And they're going to you know, put out a new five year plan next month, and it will be crystal clear that you know, at least over the 2016 - 2020 period, you know, their objective will be a half a point, maybe a point below what they did, you know, in the last five years.

Big deal. I mean, you know, our markets in the West, all we seem to care about is GDP. Look at the mix of the GDP. If the mix is moving in a way that pushes them further down the road toward a more balanced economy along the lines that we've discussed, then get used to it. I mean, the Chinese have these words, you know, new normal and whatever.

I'm a little frustrated, you know-the Chinese know what they want to do, but you know, a lot of this gets lost in translation. They don't know how to articulate it all that well, either. But slower growth provided it's supported by this constructive shift in the mix of growth is exactly what the doctor ordered.

MR. PRASAD: But are you willing to put on a number on it, Steve? I know you said lower, but what is lower? Is 5 to 6 percent sustainable? Is it going to be 2 to 3 percent?

MR. ROACH: Two to three is out of the question. Of course, there are experts who will tell you that that's exactly what the economy is doing right now. And I would say the same thing to those experts that I said to the -- with all due respect, to the gentleman who asked the first question. You know, you'd better check those guys out, too.

I think you know, they're on a transition, Eswar, to you know, probably over the next 10 to

15 years and down to you know, a 5 percent long-term sustainable growth trajectory. That's nothing new there. Again, that's what the government has been laying out for us for a number of years in their own internal and external strategy documents.

MR. PRASAD: Brad, what does your crystal ball tell you?

MR. SETSER: There are many topics where I feel like I have confidence in my crystal ball. There are many topics where I feel that the other two experts on the stage have better crystal balls than I. The long-term pace of Chinese growth is one where if I had to come up with an answer to that question, I would go talk to or read the latest thing that Eswar has written, and try to pretend like his insights were my own.

My guess is, China can grow over the long run at 4 to 5 percent, not 2 to 3. I agree with Steven that the composition of that growth is very important. I certainly would worry if it is 5 percent growth, 2 percent coming from net exports. And obviously, going forward, a higher fraction of the growth needs to come from consumption, but I am not an expert on growth accounting nor long-term growth forecast.

I'll quickly try to answer the TPP question. You know, I watched the outcome of the New Hampshire primary last night. Both parties, primaries were won by candidates who are not exactly enthusiastic about TPP. And my guess is that adding China to TPP would not increase political support for TPP in the United States. I personally don't see how China could join TPP until the currency issue is in some deep sense, sorted out.

So, I find it a little bit of an academic discussion and question, given the current political realities. I think TPP would, at the margin, obviously favor textile -- not textiles -- that should be precise--apparel, clothing and other labor intensive manufacturers from Vietnam relative to China. However, to my mind, China's competitive advantage is increasingly shifting towards mechanical engineering and a deeper electronic supply chain.

That is not to say that those sectors, the traditional low wage sectors aren't still important to China, but they're not kind of central or as central as they used to be. And I also don't think that the advantage that Vietnam would gain is nearly as consequential as some of the other things that are going on in the global economy.

So, if you look at where Chinese exports are really falling right now, they are really falling to Brazil and to the commodity exporting countries, because the commodity exporting countries have lost purchasing power. There's been a tremendous fall in their capacity to afford imports, tied in some sense to China's own slowdown and the composition of China's slowdown.

So, I think China increasingly has a big country problem; that China can't export as much as it would like, unless China also imports. Brazil cannot afford to buy China's manufactures, if the price of iron, ore and soybeans is really low. So, when thinking about China's trade going forward, I would put more emphasis on the demand impetus that China is providing to the world and how that impacts the rest of the world's capacity to afford Chinese goods, than on the details of the tariff regime governing specific product categories.

MR. PRASAD: All right. These two very distinguished and (Inaudible) gentlemen have given us, I think, a lot to think about. I, for one stand rather reassured at the end of this discussion, because I think both Stephen and Brad count as among the finest parsers of Chinese data, which is a great challenge in itself, and I think both of them have been very good in terms of discerning developments and trends in the future of about the Chinese economy, and indeed, about the global economy as a whole.

But as they've pointed out, I think there are still many roadblocks out there to China's balanced development, many potential potholes that could make all of this come apart. But I think you've given us a lot to chew over. Thank you very much, gentlemen. Cheng, do you have anything to add?

(No response heard)

MR. PRASAD: No. In that case, let me just thank all of you for coming, and Cheng Li and the Thornton Center for putting this event together, and most importantly, of course, to Brad Setser and Steve Roach for joining us and sharing their views with us. Thank you very much, gentlemen. (Applause)

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