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PARTICIPANTS:

PANEL 1: NEW DYNAMICS IN CHINA'S STATE-SOCIETY RELATIONS

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PANEL 2: A TURNING POINT IN CHINA'S DEVELOPMENT

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## P R O C E E D I N G S

MR. LIEBERTHAL: I'm Ken Lieberthal, the Director of the John L. Thornton China Center at Brookings. We are convening for what has become an annual event, a joint Brookings-Caixin Media Conference on the economic developments in China. We've sometimes added the United States to this. This year we are focusing especially on the Chinese side, but looking at the coming five years or so with two panels this afternoon. The first is on new dynamics in China's state-society relations.

Before I introduce the panelists, I want to introduce the head of Caixin Media, Hu Shuli, who is enormously well known in China and abroad. She has gotten a list of awards, most of which say "one of the top 100 most important thinkers in the world" or "one of the top 10 thinkers in Asia" and so forth. So Shuli, we're delighted to have you here. She will be moderating our second panel, but I just wanted to introduce her at the start of our program.

For our first panel, we have three speakers. I will introduce all of them now so I don't keep interrupting as each one finishes. When all three are done, we'll then have a substantial amount of time for Q&A from the audience. When we turn to Q&A from the audience, we'll have roving mics. So I'll ask you to please identify yourself by name and affiliation and then feel free to direct a question to a particular speaker or to the panel as a whole.

Our first speaker is Ambassador Zhou Wenzhong. Ambassador Zhou's last foreign ministry posting was as Ambassador to the United States. He now is the head of the Boao Forum in China. He is also vice president of the China-U.S. People's Friendship Association. He had a long and distinguished foreign ministry career,

diplomatic career, at times serving as ambassador to Australia, and early in his career as Ambassador to Barbados and to Antigua and Barbuda. I've never heard of Barbuda, but anyway -- forgive my ignorance -- but anyway, really a pleasure to have you here, Mr. Ambassador.

Our second speaker will be Vikram Nehru who is now a senior associate in the Asia Program at the Carnegie Endowment. He spent 30 years at the World Bank where he had a variety of positions. His research overall has focused on economic, political, and strategic security issues involving Asia.

And then our third speaker is professor of finance at the Yale School of Management, Professor Chen Zhiwu. He spent a good part of his career focused on overall financial theory and global financial issues, but in the last decade or so has especially focused on issues in China. When I see the number of people that follow his postings in China and his writings in China, it is staggering. It makes a Western scholar like me drool. So he has become a very well known figure there and is a well known scholar of international finance overall.

Let me step down and ask our speakers to come up one after the other. Each will speak for about 15 minutes, and then we'll have the panel up here and welcome questions from the audience. Ambassador Zhou?

AMB. ZHOU: Thank you, Ken. I would like to thank Brookings and also Caixin for their kind invitation. It's very nice to be back and to see so many old friends.

Today's theme of this forum is state and society. As you know, as far as the state is concerned in China, the most important event in the last some 40 years or even longer is the reform, the beginning of the reform program. So I think when we try to discuss the relationship between the state and the society, we need to take a close look

at the future and the prospects of the reform program of the state. So I would like to start by presenting to you my views with regard to the reform program and also China's ambitions for modernization.

And I think two words -- you hear two words very often when we discuss this subject. One is the middle-income trap and the other is the high wall before China. So the question is China has joined the ranks of the middle-income countries. Will China be trapped in that middle-income trap? That's a question we hear very often, a question put to us. At Boao Forum there is an actual panel discussing that subject. So my view is this. In 2010 the per capita GDP of China has reached 7,864 international dollars based on the 1990 international dollar. That has surpassed the per capita GDP of most of the Latin American countries of 4,000 international dollars when those countries fall into that middle-income trap. And also that has surpassed the 6,000 international dollars per capita GDP for most of the East European countries and the former Soviet Union when they fell into that trap. And judging by the trend of growth of China's economy, I think in three to five years time the per capita GDP in China will probably reach 11,000 international dollars based on the figure for the 1990 international dollar. So that is to say in three to five years time, in per capita terms China's GDP will be more than those who have successfully climbed over that high wall. So this sort of forecast holds water. So I think probably China will not be trapped by that middle-income trap in the context of current growth of China's economy provided that growth rate will continue.

So the challenge is after China's over that high wall, what would happen? And I think the main challenges, of course, are as follows: That China needs to effectively resolve the problems it will be confronted with in terms of all kinds of structures. And secondly, whether or not China will be successfully transformed in its

growth pattern that is so far based on low cost, driven by low cost? And will China be successful in changing that into one based on innovation? That is to say, the growth would come from innovation-based development.

As far as this is concerned, there are pros and cons. And the pros are as follows: Unlike Latin American countries, China started as opening to the outside and started its export-oriented development strategy much earlier when its per capita GDP was still at a very low level. So that made it different from most of the Latin American countries. And unlike most of the East European countries, China started its reform of marketization also very early when its GDP was still at a very low level. So what we have seen happening in China is the industrialization going hand in hand with marketization. So that is also the difference between China and most of the East European countries and the former Soviet Union. Besides, as you know, China is a big country with a very large population, and it has very large market potentials.

So the conclusion is probably China will be able to climb that high wall. But then after that, judging from what happened to those who successfully caught up with the more advanced countries, the rate of growth will drop after China is over that high wall. So that will be the largest challenge to China and the window of opportunity, as some scholars predict, would be between 2015 and 2017. For instance, in 2016 if the per capita GDP is based on 1990 figure, it would be 11,608 international dollars. So if what happened to those who successfully -- as compared with those which successfully caught up with more advanced countries, the growth rate probably would sort of come down by as many as 3 percent. So that is to say the forecast is during the '12 five-year plan will be 9.7 percent and during the '13 five-year plan will be 6.5 percent. Of course, this is just a point of view. So that will be the most serious challenge. So once China is

over that high wall, will China be successful in changing the development model to one that is based on innovation and efficiency and equality of the economy?

So what to do? I think the first is to continue to carry out the industrialization, urbanization, and modernization. So I hope China's economy, society, population grows, and other structures will be effectively transformed so it will become a major force in China's sustainable development.

In 2011 China's urban population ratio reached over 50 percent. So this means that there will be billions of new population entering the cities in the future. According to statistics, this will jumpstart domestic consumption and investment needs. So we can see that in China's future urbanization process that our country will become the world's biggest manufacturing base as well as the largest consumer market in the world.

Secondly I think what we should do is to work hard to improve people's livelihoods. And during the process of economic development and transition, programs sprung up all over China to support and help the poor, ensure that the middle- and lower-income class will have sufficient living conditions, health care for all, as well as large-scale social programs to help out the poor. So the reform to the social welfare system and government structure was sped up. This was not only meant to decrease the gap between the rich and the poor, but also meant to equally distribute the benefits brought by economic reform to all social groups so that each individual will acquire equal benefits during the process of development. At the same time the social risk brought by fast economic growth will be reduced. The numbers of people with large incomes will be increased and domestic consumption will be triggered.

Certainly we need to look at the deepening of reform in terms of structural innovation and management improvement. China has experienced three decades of reform and opening up, and we can conclude that up until now we have changed all that can be changed and opened all that can be opened. Things that have remained the same are the issues that have deeper structural problems so that changes cannot be easily pushed forward and implemented. Due to this reason, the Chinese government brought forth new reform goals so that structural and managerial innovations can further deepen the reform in fiscal policy, taxation, finance, price, income distribution, government management structure, as well as state-owned enterprises. So through the reforms in China's core economic structure and in management, we can create a more transparent, fair, predictable, market environment and a legal environment so that a mature and stable market and legal framework can be sustained.

So I will stop here for now. Thank you.

MR. NEHRU: May I also extend my thanks to Brookings and to Caixin Media for inviting me to this event.

The topic, "New Dynamics in China's State-Society Relations," I made the mistake of taking the subject heading very seriously, and I actually applied my mind to it because I thought to myself, what a topical topic given what's going on in China today. One can't help thinking about when one thinks of state-society relations, one can't help but think about the events surrounding the Bo Xilai case and now the Chen Guangcheng case. And these events have sort of raised to the surface concerns that I know many hold in China and have for a very long time about a range of factors -- things like corruption, inequality, absence of the rule of law, lack of accountability, seemingly the part of the state contrasting with the seeming lack of institutions protecting individual

rights. And there is now media speculation about these events triggering perhaps political and constitutional changes.

So many of these issues that seem to have been raised by these two events also apply in my view very centrally to the key economic challenges facing China. And I believe that there are just two key challenges. The first is how does China maintain a relatively rapid pace of growth? And the second is how does China ensure that it improves the quality of growth? This is nothing new. This is something that the Chinese have been discussing for quite a long time. The key point I want to make here is that trying to achieve the first is very difficult. Trying to achieve both is going to be very difficult indeed. And both will require a significant change in state-society relations.

Now let me start by making the point that there's a sort of general belief that growth in China is going to slow. As Ambassador Zhou just pointed out, one of the projections that he had showed that between the '12 and '13 five-year plan there would be a decline in greater growth. And the reason for the decline in greater growth is rising capital labor ratios. As more capita per unit labor increases, the marginal productivity of capital will decline. The fact that China has already penetrated export markets to a great extent, and the fact that many industries in China are already approaching the global technology frontier. But in addition to these three factors, the supply of savings is also expected to diminish in China primarily because of an aging society; but also because as the Chinese government introduces social reforms, the incentives to save amongst households will also decline. So not only will capital labor ratios decline and the amount that each unit of capital can provide towards growth will decline, but the amount of capital available is also expected to decline.



Now the combination of these two points about capital, both the availability as well as the use of capital, means that in order to maintain the same pace of growth or at least to ensure a relatively rapid pace of growth requires China to become more efficient. To be more efficient, it needs to either become more innovative or become innovative and allocate free sources more efficiently and ensure that it has a system which allows for the churning of capital, the Schumpeterian creative destruction of capital. In many countries this process has been a very, very important driver of growth.

But adding to the growth question are two other objectives which the Chinese have and which they very clearly enunciated in their '11 and '12 five-year plan and that is improving the environment. After all, the environment, the physical environment, in China has degraded enormously. And second, to reduce the inequalities that currently prevail because inequalities have been rising rather dramatically.

Now the allocation of resources towards the environment and the allocation of resources to reduce inequalities by providing greater access to social services are not income generating necessarily. They have low financial rates of return even though they have very high social rates of return. They're very valuable to society, but they don't necessarily generate growth. So for that reason, too, one would expect that if China seriously attacked the quality of growth issue, it would mean the GDP growth -- as it's traditionally measured, not in the welfare sense but in the output sense -- would also be expected to decline.

So what are the recommendations that people have come across? And Ambassador Zhou just put several recommendations to you. There are recommendations that are included in the '11 and '12 five-year plan. There are recommendations that have come out from a range of academics within China and

outside China. And if I were to summarize them, I would say that there were about six. The first is that China needs enterprise, output, and factory market reforms. China needs to develop an innovative society. China needs to address its environmental problems by developing a pattern of green growth. China has to attack its social -- has to introduce social reforms in large part to try and reduce the inequalities that currently prevail. And in order to do all of those above, China has to reform its fiscal system. And finally China has to ensure it has lasting, good relations with the rest of the world -- six different elements to a possible future strategy for China, and this in order to have rapid, sustainable, growth. And by sustainable I mean socially, environmentally, and globally sustainable growth.

But the common theme running across all of these areas of possible reform is really one common thread in my view and that is the changing role of the state, a new relationship between state and society, and I want to illustrate this with just three points. The first is the need for greater even-handedness -- and I'll come to this in a second. The second is a need for greater transparency. And the third is the need for more equality of access and opportunity.

Now what do I mean by the need for greater even-handedness? I mean two things: The first is the need for greater even-handedness between the private and the public sectors, and the second is the need for greater even-handedness in the relationship between private and public goods. With respect to the private and the public sectors, I think there's a lot of evidence now to show that state enterprises in China have a very privileged position in the economy. State enterprise leaders have close connections with senior leaders in the government. Many state enterprises in many sectors, especially in the strategic and pillar industries as they're termed in China, are

protected to a large extent from competition either formally or informally. State enterprises have privileged access to finance, whereas private enterprises find it very difficult to get access to finance. And for state banks there has been a history of periodic refinancing efforts by the Huijin Corporation, which is the domestic arm of the China Investment Corporation.

But there's also recognition that if state enterprises are given this privileged position, there's also recognition that state enterprises are not necessarily going to be the drivers of innovation in China. Already we see very rapid growth in the private sector. We see very rapid growth in the total factory productivity growth in the private sector, which is a measure of efficiency, and a large amount of the innovation that is coming out of China is being driven by the private sector.

So if there's something that needs to happen in this area of even-handedness, it means that there should be greater competition between the private and the public sectors, that there should be greater ease of entry into areas where the public sector currently, where the state enterprises currently are protected from competition. And that's not enough. It's also important that state enterprises have harder budget constraints. By that I mean that they don't necessarily have access to finance quite often in the financial sector in order to rollover debts which they have to pay. So in other words even if they make losses, currently the arrangements are that they would be covered one way or the other, usually through the financial sector. But if budget constraints are hardened, then state enterprises will be forced to improve efficiency when they compete with the private sector.

Now to do this, it means the government has to take a very different role in society. It means it no longer should be a direct participant in the production process.

It means it has to step back. It has to create the rules for competition. It has to ensure that the playing field is level. And that is a very sharp distinction from the kinds of actions that it currently takes, and the question is, is the government, is the state, ready to do that?

The same would apply with even-handedness between the public goods and private goods. There's recognition that there has not been enough emphasis placed on the delivery of public goods in China. And again, many of those actions will actually this time require more government action, greater implementation, and better implementation of existing rules, a better designing of those rules. For example, in the environmental sector, many of the laws are in place, many of the rules are in place. The issue is, is the government prepared to apply them even-handedly between the private and the public sectors and actually make the tough decisions necessary in order to arrive at its environmental goals?

The next item that I want to talk about is the need for greater transparency, and I'm using this in a very economic sense, not in a political sense. Take the example of the repression of the financial sector. The repression of the financial sector in China has been brought about largely through lower interest rates, which essentially have taxed household savings. Now, this indirect form of taxation of household savings has been remarkably successful in a sense because it's allowed the financial sector, largely through state banks, to finance enormous levels of investment. This has been actually a success story in many ways in China. But it has also meant an under-delivery of public goods because the financial sector normally doesn't finance public goods. It tends to finance goods from which it can earn a high financial rate of return and, therefore, it's meant an under-delivery of public goods.

Now the role of the financial sector clearly has to change. I talked about the need for greater efficiency, and the financial sector has to play a very important role in improving the allocation of capital in the system. It has to play a very important role in ensuring that the state enterprises have a hardening budget constraint. And, willy nilly, if the authorities are keen, that the Renminbi is internationalized, it is very important that the financial sector becomes much more market driven.

At the same time, the fiscal policy, China's fiscal policy, has to become much more important for four reasons. The first is that the financial sector can no longer take on many of the quasi fiscal policies that it was asked to take on in the past if it is to be more market driven. Secondly, there are going to be much greater claims on the budget if state enterprises are to be covered for their losses and they can't go to the financial sector, they're going to have to go to the fiscal system. The third, China needs a fiscal system that allows the country to absorb shocks to the system -- domestic shocks, external shocks of various kinds. And lastly, but more importantly, it's the fiscal system that's going to have to deliver the incremental resources for the environmental and social agenda.

Now for all these reasons it means that if the fiscal system is going to have to deliver these resources, the government is going to have to raise the revenue from somewhere. Those indirect, hidden, taxes in the financial sector are going to have to become direct taxes of corporations and individuals either in the form of consumption taxes, income taxes, or corporate taxes. And as soon as you have direct taxes in a system, it forces then the government to explain what those resources are going to be used for. It forces transparency on governments, especially in countries like China where there's a rising middle class, demanding a greater accountability on the part of

government. A fiscal system which is required to take on these additional requirements, these additional responsibilities, is going to also be asked to become more transparent, to publish their accounts, to explain where these resources are going to, and that will significantly alter the current way the fiscal policy is practiced and will change the way that state and society relate to one another.

And the last point that I want to talk about is the need for greater equality of access and opportunity. I just mentioned the growth of the middle class. And normally when you have a rising middle class in any country, a middle class usually is more educated, has greater knowledge of its rights and responsibilities, has a greater understanding of what it wants, and demands a much higher level and a much higher quality of public services from the government, and this is true of China today.

I think there have been quite a few surveys in China which have shown that there's a lot of distrust and a lot of dissatisfaction with two specific aspects of government. The first is the justice system and the second is the delivery of services. And in both it is because there is a huge inequality in access, inequality in access to the justice system and inequality in access to service delivery. The reason for this inequality in access to service delivery is because there's a huge inequality in the availability of fiscal resources, of government resources, across the country, large spending disparities between local governments across China, and, of course, now there is a greater demand for better services and, therefore, a greater desire by the public to participate in some of the decisions that local governments are making.

So given these three, to my mind the forces that have been unleashed in China, many of the reforms that have been considered in China, many of China's recent events, all point to a very rapidly changing state of relations between the state and

society. The government has a choice, the choice of whether it wants reforms that will make it have indirect as opposed to direct control of the economy, whether it wants to increase the empowerment of the private sector and of households, whether it wants to increase the accountability of government and the accessibility of services including access to justice institutions, whether it is willing to allow increased scrutiny of the government and of its own actions. These are difficult and uncomfortable questions. To my mind, of course, the choice is clear as to what needs to be done. The real question is what is in the minds of the Chinese leaders? Thank you very much.

MR. CHEN: First I want to thank the Brookings Institution and also Caixin Media, especially when I heard that Shuli, my long-time friend, spent almost 48 hours in order to get from Hong Kong to Washington. She's always energetic, but today she is going to appear tired and it's really understandable.

So I want to stress three points, using my 15 minutes or so. The first point is -- in terms of the state and society relations in China, the first point is the size of the state or the government in China is historically unprecedented. It's very big in both absolute terms and also in relative terms.

And then my second point -- if it's okay I will just use my printout -- so the second point I want to stress is the state is still rising, it's still growing pretty fast. I don't see real efforts or even a real possibility for this trend to be reversed unless political reforms, fundamental political reforms, really take place. So that's my second point I want to stress.

Then my third point is that, in fact, the state being too big. It's really the root cause for the economic growth model that everyone has been talking about, which is too dependent on investment and too dependent on export. So in order to change this,

clearly then again we need to see more fundamental reforms. Otherwise personally I don't expect the very nature of investment-driven growth is hard to change.

And then related to this also with the state being too big is also the root cause for the lack or the difficulty of legal development. So what do I have to substantiate my three points I just mentioned? First, in historical terms how big is today's state in China? Why do I say it is unprecedentedly large? Of course, many of us know that the Chinese state has been pretty large, larger than in Ancient Greece or Ancient Rome, or probably goes back to at least the Qin state, about 2,500 years ago. But actually even though the Qin state and then the different dynasty imperial course may have been always pretty big, but they're not as big in relative terms or absolute terms as today's state. Why do I say that? Well, according to estimates by historians, back in 1766 our high-growth period in the 18th century, the imperial government's total tax revenue was roughly 49 million taels of silver. So that translates into roughly the total annual income of 2 million Beijing residents. So in other words, back in the middle of the 18th century, it would just take 2 million residents income to support the whole imperial government's revenue.

Of course, in those years on average the fiscal surplus by the Imperial Court was between 5 million to 10 million taels of silver. It's almost like 10 to 20 percent surplus. Of course, that would make the Obama Administration very envious. But they did not really spend that much money. So 2 million residents income was roughly equal to the total government expenditure or revenue during the middle of the 18th century. But today, according to the official numbers, if I just use the within budget tax revenue for 2010, the total tax revenue for 2010 without including land sale proceeds and SOE income and so on, it was roughly equal to the disposable income of 430 million urban



residents. So 430 million urban residents versus 2 million urban residents back in the middle of the 18th century. That's why you see in relative terms, it's really much bigger.

If I were to use the peasants' per capita income for 2010 within budget, the tax revenue would be equal to the total income of 1.45 billion peasants income for the year 2010. Of course, there were not so many peasants in China, so that makes it even much bigger. Okay, so that's the first point. In historical terms, it's the biggest government within today in China over the last 2,500 years.

The second point is it is still growing very fast. I could give you a lot of different numbers, but let me try to make it less confusing for you. Over the last 16 years, from 1995 to the end of 2010, the total tax revenue -- again using the budgetary terms not including the other off-budget, off-balance sheet income sources for the local government and the central government -- over the 16 year period after adjusting for inflation, the total tax revenue and other government revenues increased on a cumulative basis by 9.2 times. So that's very large growth. Of course, many of us would like to invest in private equity deals, right? We always look for gains of multiple times -- 9 times, 5 times. The Chinese state has done pretty well over the last 16 years -- 9.2 times cumulative growth.

But in contrast, for urban residents the cumulated growth after adjusting for inflation over the same 16 year period was 2.6 times and for peasants 1.8 times. So you can see who's getting an increasingly larger share of the Chinese GDP even without taking into account the SOEs and so on. So clearly the size of the state has been expanding over the last 16 years very fast. Of course, you wonder why there have not been real results in terms of containing or limiting the growth of the state. Well, that takes us back to the balance of power among the different branches because after this point,

the executive branch pretty much is free to introduce new taxes or increase existing tax rates without having to go through real public hearings at the National People's Congress or the standing committee or the different subcommittees. No public hearings have been really called for. Of course, the Chairman of the National People's Congress would like to emphasize the separation of power. It's absolutely not what we want to adopt from the West. Don't talk about the three branches of government checking on each other. That's too Western. We cannot do that.

Let me also give you another set of numbers just to see. Yes, the tax revenue has been increasing. But hey, maybe the tax revenue has been spent on the right things, not just on the government itself. So in order to give you some idea about the actual administrative power or apparatus and how that has been changing in monetary or financial terms, back in 1955 the administrative expenditure by the government at all levels in China was roughly equal to 7 percent of the total fiscal expenditure by the government in China. So 7 percent of the government expenses or budget was going into the operations and administration by the various agencies, ministries, and so on.

In 2008 and 2009 this relative number increased to 22.5 percent, so almost like one-quarter of the government expenditure was just to support the administrative expenses. If you like more numbers, back in the Qing Dynasty, roughly speaking for every employee on the government's payroll in China in the 18th century, it would take roughly 250 to 300 citizens so that the ratio between government employees to the population was 1:250 to 300. So today there are many estimates. I think they give an estimate of 1:26. It's pretty reliable because many different scholars have come up with assessments. So the ratio between the government employees and the population

is 1:26, so it has come down -- or it has increased from 1:250 to now 1:26, so there is a 10 times relative increase. Today's ratio for China is about 4 times as big as for India. So roughly speaking in India today, the ratio is 1:100 between official employees and the Indian population.

How big is this 22.5 percent government administrative expenditure as a percentage of the total fiscal expenditure in China when compared to other countries? Russia's ratio as of 2007 was 20.6 percent, so that's pretty high. For the U.S. back in 2007 about 11.2 percent of the government's budget went into administrative costs and so on. The lowest I think is actually Norway, so it spends about 9 percent of the government's budget on administrative costs. And for China in comparison, even though administrative costs took up 22.5 percent of the government expenditure, roughly 15 percent of the fiscal budget went to health care, social security, and unemployment benefits. So in that sense the actual expenditure on items, things, programs related to real people's lives, is actually lower than the administrative cost amount.

So in short you can see the state in China is not really shrinking. It's still expanding at a very fast pace. And this cannot be reversed or changed unless, as Premier Wen Jiabao put it, unless political reforms really take place and unless the National People's Congress and other people's congresses at the local levels really do what they are supposed to do according to the Chinese Constitution, that is to provide real checks and balances on taxation power.

Of course, I'm making such comments without really taking into account what the SOEs take in the national income and also the SOEs' percentage as a total percentage of the popular productive wealth in China. So let me not go there because of time.

My last point is so why do I say that the state being too big is really at the root cause of the investment-driven and export-oriented growth model? This is something I tried to stress last time when I came to Brookings almost a year ago. So let me just simply say that when it is the government that decides how to spend money, how to make investments, they generally have a tendency to prefer physical structures, infrastructure projects and big industrial projects, because those projects are very tangible. So for performance evaluation -- so as an economist, we always talk about performance evaluation and asymmetric information -- when you put the money into buildings and industrial projects, then right away you have results. Your performance will be so visible. You don't have to really do that much to convince your boss that you have done a good job.

But on the other hand, if it is up to the private sector, to society, to decide how to spend money and what to spend money on, then they don't necessarily have to show to other people that they have done a good job. So then they tend to spend more on health care services and consumer products. So this is why when we say in China the service sector has such a tough time to grow. Well, it's not surprising. When the government controls most of the spending power and makes the spending decisions, investment decisions, not surprisingly they want to focus more on the more tangible things rather than on services such as education and health care that are not so tangible. In fact, there are a lot of statistics that can show this.

Then lastly, just quickly, let me spend one minute. I've done some studies on the connection, on the relation between SOE share in an economy, in a society, and the rule of law development. Not surprisingly, if I use the SOE share in total national investment back in 1980 as a basis and divide roughly 65 countries into three

groups, then clearly those countries whose economy is dominated by SOEs have much lower rule of law ratings than the countries in the other two groups. Of course, we can get into the reasoning as to why this is the case, but believe me I've spent many years doing research on this topic. The conclusion to me is so convincing that when the SOEs' share in a national economy is too big, then that presents a lot of challenges to private enterprises and to citizens in terms of how much they can protect and enjoy their own individual rights, including various civil rights.

So I should stop here. Thank you.

MR. LIEBERTHAL: Is this microphone on now? Thank you very much. We want to open this up to the audience in just a moment. I just want to ask one question before we do it to get this started.

This is on the changing dynamics, the new dynamics, in China's state-society relations. All of you ended up talking more about the state than about society. There are huge changes going on in Chinese society obviously, and one of the most dramatic of these is in social media, the advent of Weibos and so forth. So just an enormously greater amount of information available to society and the expression of opinions from society to the state. So the pressure is on for reform of the state.

And as I understood the three presentations, what you had in common here was essentially saying that without political reform, the economic objectives stipulated in the '12 five-year plan are not really fully achievable because the current incentives in the political system are built around the game plan to date, the model to date, and that model now needs to be changed. That's been recognized at the top, but the question is whether you can change the incentives within the political system in ways

that are necessary in order to fully achieve the goals of the '12 five-year plan, the more innovative, et cetera, type of economy.

So I guess my question is what is your expectation about changes within the political system necessary to achieve the economic objectives? You've each stated them in somewhat different terms, but I think they all revolve around, in part, that core issue. Do you see any dynamics here that suggest that we should be optimistic about that or should we be looking more to ways in which developments within the state are likely to constrain the changes in the economy that all of us have pointed to?

I'd be happy to have anyone take that up.

AMB. ZHOU: I am from the very beginning of the reform program, and we realized we need both political restructuring and economic restructuring. But we also believe that we need to combine all these things. That is to say, we need to combine political restructuring and economic restructuring. And we need to combine democracy and also the reform of the legal system, put emphasis on institutionalize and legalize of the democracy. And we also believe we need to combine the political restructuring with improving the livelihood of the people and protecting the citizen rights of the people. And we also believe we need to combine putting in place a system of democracy at the grassroots level and administering the country by law. So I think we understand all these things.

On the other hand, I think we really need to have this in mind. China is a very big country with a very large population and many of them are still illiterate, and development is very uneven in different regions. So both the economic restructuring and the political restructuring have to be a very long process. And so that's why we have

come up with the idea of having some places to undertake the pilot program. So I think people here, friends here, are very familiar with that practice.

So I think as we have already reached a certain point in terms of economic growth, and we have reached a certain point of the reform of political restructuring, I think we -- there are a number of decisions we'll have to make with regard to the future -- with a plan for the future sort of execution and enforcement of this strategy.

MR. LIEBERTHAL: Thank you. Any other comments?

MR. CHEN: I think maybe I was sounding a little bit too pessimistic because part of me -- I personally hope that real fundamental reforms can take place as the Premier has mentioned so many times over the last two years. But on the other hand, there are a lot of new dynamics definitely, especially the two-term limit for each president and also age-based retirement for different levels of officials, have created this unintended consequence that you have so many still able and energetic retired officials whose personal safety and whose children and other family members' safety are not necessarily so ensured.

So I think there is now this growth trend for there to be more consensus, that a rules-based system supported by checks and balances will become the common consensus among the different factions, especially next year there will be three presidents living at the same time and all being supported by his own political base. So from my experience when you have a two-person game, it's different from when you have a three-person game. So the three-person game dynamics can create different challenges depending on their matter or issue being addressed.

Of course, at the same time Weibos is one of the real gifts that has really made many people, like myself, able to express our opinions even though I'm not as popular as Shuli. So you're going to get a real joy out of her remarks in a moment.

MR. NEHRU: You can never ask a World Banker about political reform. He will always find it very difficult to answer that question.

I think the real question in my mind is what are the obstacles to reform? And is political reform a necessary condition for economic reforms to take place? I must admit that I cannot, probably not that is to say, that many of the points that I made about greater transparency, greater ability to treat private and state enterprise in the same way, increase competition, greater entry, these are not -- they don't require political reform necessarily.

Why are there obstacles to reform? I do believe now that China after one generation of reforms -- exactly from 1970 and onwards -- has created a very large set of vested interests which would be threatened by reforms. And these vested interests have very close connections between the government, the Party, and the state enterprise system or the state banking system. And the challenges -- can the government deal with those vested interests in a way that they don't become an obstacle to reform, but without necessarily having fundamental political reforms?

Having said that, of course, if there are greater moves towards democracy, and politically one could welcome that personally provided they had done it in a way they do not destabilize society.

MR. CHEN: Can I just add a point? I think many economists like to say that you can have real competition whether you have state-owned enterprises in an industry or in an economy or not. I think logically you cannot have real market-based



competition whether you have SOEs in the economy or in any industry. The very fact that the shareholders behind SOEs are the state, and the shareholders behind a private enterprise are private citizens who don't have enforcement power or legislative power to change the rules. So I just don't see the logical foundation expressed in many of the economists' remarks at all. You can have SOEs or private enterprises. Don't worry because as long as they all compete in the same place, as long as the market disciplines are being -- the rules, the principles relied on to determine resource allocation and entry to an industry and so on. But the problem is as long as you have SOEs, then you don't have a real basis for fair competition.

MR. LIEBERTHAL: I will say my own sense is one of the biggest problems here is in the specific career incentives for local territorial leaders and the difficulty of altering those, and they now have a tremendous capacity to intervene in the actual allocation of capital and a whole array of things in how their local economy functions. But anyway, it's a tough issue.

I want to remind you, please, wait for the roving mic and say who you are and then feel free to direct a question at one panelist or at all of them. This gentleman over here with the beard.

SPEAKER: My name is Arnold Zietland and I teach in Guangzhou. And basically I want to ask a variation of your question, which is simply do any of you have suggestions on how you convince the leadership that the Communist Party can keep control and still reform the economy?

AMB. ZHOU: I think the part of the political restructuring is to separate a party and the state. I think looking back we have come a long way in the enforcement of that strategy. China is a multiparty state with the Communist Party being the leading

party, and there are a number of parties which are participating in the running of the country. There is always room for improvement, but I think we have to do this step by step.

So I think, if I understand your question correctly, you are asking whether the Party could maintain its control while running the country. Actually I think the actual situation is sort of like this. The country is being run at different levels by the National People's Congress, by the local authorities, and of course, at the national level is run by the National People's Congress and also the State Council. So the Party makes recommendations to the State Council, and policy needs to be debated at the National People's Congress. And unless it is adopted at the National People's Congress, sometimes I think the policy can't be implemented. So maybe there is still room for improvement, but I think that's a path we'll continue to travel.

MR. CHEN: Actually, I don't think the party has to worry about losing control after conducting reforms. That's why Premier Wen Jiabao has been calling for political reforms. You think that he would not have thought all of this out with his advisors before he called for political reforms?

MR. LIEBERTHAL: Actually it's a measure of our lack of full understanding of China that some would argue that the Party can't maintain control if it institutes major reforms. Others would argue the Party can only maintain control if it institutes major reforms. So you can kind of see the tension here. Yes, sir?

SPEAKER: Thank you very much. I'm Randall Doyle. I teach at Central Michigan University, East Asian History and Modern China. I think what hasn't been spoken here, which needs to be addressed, is the Bo Xilai situation which is having some serious reverberations and will. It's the most serious situation politically in China since

1989 in Tiananmen. And as you well know, it took a number of years for Deng Xiaoping to get the momentum back with the southern tour and everything. Now with this situation happening, reforms and all this other stuff you're talking about will not take place until there's some kind of political stability.

And also another thing is that the Chinese ruling families, the Immortals or whatever they're called, were basically untouchable. Now Mr. Chen, what happens, as you brought up, if the political situation becomes triangular with Jiang Zemin, Hu Jintao, Xi Jinping, how is reform going to take place in a country where basically if productivity starts to go down and panic starts to break out in the leadership and this fractionalization takes place, what do you think is going to happen? This is very serious because the country can't move forward until there's some consistent leadership in the upper ranks of the party.

MR. CHEN: Of course, Ambassador Zhou can speak much more about this than I can, but I would say this time it's very different from 1989. So back in 1989, it was more the right, the reform side that had been put in this defensive position. So the left, the antireform, factions were gaining more momentum as a result of the 1989 events. But this time it's the left that is losing momentum. They are more on the defense now. They have to make sure their house is in some uniformity or has some place to stand. So this time is the reform side, I would say, that is gaining more momentum.

And then also the very fact that all three of them will be alive and healthy at the same time, they will realize that at the end of the day in order to make sure that their own future, their relatives and securities, will be more ensured, the rule of law is the way to go. So I'm much more optimistic than you sounded on this point.

MR. LIEBERTHAL: From my perspective I'm only seeing questions from the right, not from the left. We're trying to achieve balance here. If we could get a microphone over there, please?

SPEAKER: Am I on the right or on the left, Ken?

MR. LIEBERTHAL: You're to my left always, Hank.

SPEAKER: That's fine, thanks, I think so. Hank Levine with the Albright Stonebridge Group. I was interested in and Professor Chen referred several times to comments by Premier Wen Jiabao, and it strikes me that over the last six months or so we have seen increased comments, both by the Premier as well as others on specific economic reform initiatives, related primarily I think to the financial system. But I'd be interested in the view of the panel. As we're talking about then the outlook for economic reform, what do you think these recent experiments and announcements indicate for the prospects for revived economic reform over the coming year, two, three, five years, whether again it's before the new leadership team takes over or indeed in the years after they take over? Are we seeing -- are these the initial real concrete expressions of a serious renewed drive toward economic reform? Thank you.

MR. LIEBERTHAL: I don't know, Vikram, you kind of spoke about this.

MR. NEHRU: I think it was addressed more to you, Professor Chen.

MR. CHEN: Okay, thank you. I think the window financial zone experiment that was announced recently and also the stated 7.5 percent target growth rate for GDP for this year and the coming years, both to me are results of the reform side winning the policy argument. That's why earlier I was saying that maybe this Bo Xilai, this whole episode, is only helping the reform side because the other side would probably want to push for faster growth regardless of the quality or the structure of growth.

But it is the more critical thinkers' side that has called for more balanced, higher quality, growth. Why is 10 percent growth always the best thing? So from my conversations with some officials on the reform, they would really like to see slower growth, but make sure that the long-term cost of growth is under control so that the future generations of leaders and people in China have a better opportunity set. I may sound too abstract.

MR. LIEBERTHAL: We have time for one last question back here, please.

SPEAKER: Donald Burns, Ranchi University. I'd like to follow up on that last comment. Each of the speakers has done a fine job of describing their view of the future. Most of those descriptions were in the context of GDP as a measure of growth and a measure of somehow goodness. In some people's points of view, that is not a measure that we ought to be using anymore, that that's sort of 20th century if you will.

I'd like to have your views on how you think if there's any movement towards viewing growth and the betterment of society in terms other than GDP. For example, the experiment that was used three or four years ago in Shanghai and other places where they talked about a green GDP, people were talking about a goal of a moderately well-off society. In all of your comments, you seem to be suggesting that there should be continued growth into the foreseeable future, if it's not 10 percent, then 7.5 percent and so on. And yet I don't understand how all of that is sustainable and whether or not it's really desirable.

MR. LIEBERTHAL: Okay, so the question is whether we should keep looking at rapid GDP growth as really the key measure or a major measure of success.

Why don't we go down the line and get a brief comment from each of you, and then I'm afraid we'll have to draw this to a close. Professor Chen?

AMB. ZHOU: I think GDP is, too, very important for China. We have these for Shanghai, Beijing, Guangzhou, maybe five of them, which have already had very high per capita GDP, more than 10,000. But we also have places where the level of GDP is still very low. So without GDP being the material base for more social progress, for the social security net, it's very hard for us to discuss other standards, other measurements, of happiness. So that's why I think we still need to -- I still remember when Wen Jiabao was interviewed by Wallace.

MR. LIEBERTHAL: Yeah, Mike Wallace.

AMB. ZHOU: Yes, Mike Wallace. And he made a statement that was to be rich is glorious. That's the first time I heard something like this. So I think in his mind, for us, for most of the people in China, the number one priority at that time was to become rich, become better off. But maybe we have already reached that point, so we need to pay more attention to other things.

MR. NEHRU: Well, four very quick points: First, the '12 five-year plan and the '11 five-year plan already had many more indicators than GDP as targets. So there were environmental indicators, social indicators, and I think in all the government wanted to monitor about I think 17 to 20 indicators and therein lies the rub. The second point is that there is no one comprehensive indicator of welfare that we have yet. The third point is that there is a commission, which was headed by Joe Stiglitz and a couple of others called Beyond GDP, which President Sarkozy had asked, had commissioned, to try and come up with a measure which brings together measures of welfare which go beyond just the utility that one derives from income.

And lastly what's really encouraging about what's happening in China is that there are now quite a few, not terribly many, but a few local governments that are using measures which go beyond GDP in assessing the performance of local government officials. And one of the problems has been that the competition between local government officials, which has been based on GDP, has led to a hell-for-leather quest for growth. And this change in the performance measurement, the key performance indicators, the KPIs of local governments, is significant and hopefully will go beyond these few local governments to change actual behavior on the part of local leaders.

MR. CHEN: I would say it's good to have more indicators, but in China you can have many indicators but as long as any indicator becomes inconvenient, you're not going to see the new readings for these indicators. But on the other hand, we are agreed that the Chinese society has gone through, has experienced so many fundamental changes. One way to look at this is to compare the lifestyle, the way of life and values of the 60-something generation to those of the 40- or 30-something generation and now to those in their teens and 20s. So from one generation to the next, the change in the way of life is so dramatic, especially when compared to similar indicators in how they have changed for the American society.

I know this sounds very abstract. One place to look for such changes is marriage as an institution and the family, especially in ways I've noticed with the Weibos and other technologies available, extramarital affairs, divorce rates, have really skyrocketed. So how is that going to change the values and sense of personal security for every Chinese citizen? There will be very, very fundamental changes. I don't know how our children's and their children's lives would be affected, but it's not pretty. So I

have to say, it's not going to be that pleasant. So that's why I enjoy the work by my colleagues at Yale who study social and anthropological issues focused on China.

MR. LIEBERTHAL: Thank you for introducing a new quality-of-life indicator that I never thought of before. The next panel, which will begin after about a 10 minute break, will focus more on the dynamics of economic reform itself. So this has keyed that up very well, but also added a lot on its own. And I hope you'll join me in thanking our three panelists for their presentations.

MS. HU: Welcome to the second session of our conference today, our turning point in China's development.

I think recently China's economy has been certainly overlooked by international watchers. Compared to Europe's economic turmoil and actions and dissolving of the governments, China seems stable. A slowdown is obvious in the first quarter. Current account surplus is reduced significantly, and inflation is increasing but well within control. Of course, changes in China's economy pale in comparison with the political drama at home.

What has been described as China's biggest risk? The real estate bubble hasn't had its day of reckoning. Although the giant bubble remains, Chinese government is pushing hard for social housing and the domestic demand remains stable. Overall, macroeconomic policy has protected growth but avoided another big stimulus package.

But behind the seemingly stable façade, there are reasons for deep concern and reasons for excitement, too. We are indeed at a turning point. Some policies with long-term impacts are brief. Just to name a few: the Wenzhou financial pilot program, the expansion of RMB trading band, and the increasing costs for liberalization



of interest rates.

Look beyond the border. There are external demand shocks and competition increase still to the rising labor cost. China's economic development in the past three decades was primarily driven by economic reforms that open up policy, globalization, and the demographic dividends today. The effect of the last two factors is getting weaker.

China needs more reforms to protect growth. In that sense, the country's economy is at a crossroad. We are privileged to have a distinguished group sharing with us their perspectives from both industry and academia. They are Dr. Wang Tao, China chief economist at UBS Securities; Barry Naughton, professor of Chinese economy and So Kwanick chair of Chinese international affairs at the University of California, San Diego; and Zhang Lanlan, the managing director of CICC US Securities, Inc. They're going to talk one-by-one and I will start a discussion later.

Thank you. (Applause)

MS. WANG: Thank you, Shuli, and good afternoon. I'd like to thank Brookings and Caixin for inviting me here to share my view and also, actually, give me a chance to listen to the distinguished speakers and also the audience.

In the first panel, we talked a lot about the turning point and about the challenges in China, both politically, socially, and also economically. It's okay, I can talk without the --

MS. WANG: So, normally being an economist at an investment bank, normally I talk about turning points for investors. So, it's this quarter, next quarter, which doesn't matter, of course.

I think the first panel already talked a lot about the challenges, and I think

the turning point that we're talking about is really the challenges that Shuli and Vikram already mentioned, which is to -- in an environment where external demand is probably going to stay weak for a long time and China is facing demographic changes, and in an environment where we have relied very much on investment for growth, how to sustain growth in the long-term, in the next 5 to 10 years. And also, how to make that growth shared by the wider populace to improve sort of the social equality and to make that development -- I would like to use the word "development" rather than "growth" -- more sustainable. So, it's not just about GDP at 9 or 7 percent, but also socially and politically make things more sustainable.

On the economic front, before I go there I probably just want to say two points up front the two points I wanted to share. One thing is that as an economist, I tend to think the economy is more important than politics, so please forgive me. And I do not hope for a wise and powerful politician to somehow see the greatness of change in the next 5, 10 years and miraculously change things. I believe we need to change the economic incentives and the incentive structure in the economy to frame the political powers. So, I think actually economic reform is more critical for political reform that is necessary, rather than political reform has to happen first because it's very hard to ask politicians to basically give away their power voluntarily. We must use economic forces, whether it's price signals or incentive systems or taxation systems to change their behavior and change the government's behavior. So, this is point number one.

Number two is about the priorities of reform. What are the key important things? What are the things to break through? Normally, people talk about the financial sector reform as very important and being an economist in the financial sector, you can imagine how many times I hear that. However, I've also been an economist who worked

in the IMF and for a long time in the IMF it's mostly fiscal. IMF is short for It's Mostly Fiscal, because a lot of the structural reforms must start with fiscal. (Laughter)

Just imagine in the U.S. You have the Fed, okay? It can print money, but how difficult is it to do fiscal consolidation. But important structural reforms are in the fiscal. It's not about the Fed printing money, isn't it? So that's the same with China. A lot of fiscal reform and public finance reform has to happen, and so that's -- I probably exaggerated a bit -- but there's also other reforms, including the state-owned enterprise reform as well as factor price and market reform.

So a question -- I think the second point is that it's much more important to actually get right these structural imbalances in the structural root cost in the domestic economy before we open up to subject all the forces -- all the imbalances to greater volatility in the financial world. So, that's the two points.

I agree very much with Vikram in the first panel about, you know, what are the key issues that are underlying some of these structural problems and sustainability in China. It is about the role of the state. It's really, I think, in the next stage when we talk about reform, we must re-think what the state, what the government should do and what they should do less or not do.

I don't think it's really about the size of the state, I think it's really about the role of the state. So, we all know, I think, that the Chinese government has very strong power not only in directly participating in the economic activity and production, but has a very strong hand in allocating resources in terms of energy and mineral resources, land resources, and capital.

When the government does the allocation, sometimes it can be very effective, actually. It can generate spectacular growth, and we had very strong growth for

30 years. To some extent, one has to acknowledge the efficiency of the ability of the government to mobilize savings and channel that into investment, and that has generated very rapid growth.

However, at certain points that becomes stifling for further development, and that path cannot continue because the state is not always efficient in allocating resources in the best place. And so, going forward for that to change we think that the market has to play a bigger role. The government, of course, made some progress but some key prices are still under the government's control. So as a result, the government rations and directly uses administrative measures to allocate the resources. So, I think an important reform is price reform. To let the energy and resource prices reflect the scarcity in China, and to let the market forces play a bigger role in pricing capital as well.

But that brings me to the second part about the state, because I actually do not believe simply liberalizing interest rates is going to do the trick. We all understand the importance of financial repression in China, which actually played a big role, as I said, in generating very fast growth and investment. The reason that I think that interest re-liberalization probably is not the simple answer is that we also must reform the micro-entities in the economy, the state-owned enterprises, the local governments who are direct participants in the economy. They probably are not very sensitive to interest rates because they do not have hard budget constraints.

We also must continue to reform the governance of the banks and the risk control system, risk management system. I do not believe they have successfully made a big change in the way they are running after their IPO restructuring. Of course they have gone a long way, but just look at 2009 in the crisis. How did that 10 trillion RMB of new loans get out if they had really good risk controls?

So before we do that, I think interest rate liberalization when the entities in this have not been reformed could actually generate a lot of risk and probably credit bubble followed by financial crisis as well. So I think the SOE reform is something that we must go forward and we must tackle, and we cannot say let's just have the prices free and everything will be fine.

The reason I also say that -- here is where my visual aid comes in. I just use an example of a fact that probably everybody knows, which is in China everybody knows that consumption as a share of GDP is very low, investment as a share of GDP is very high. A common myth is that because the Chinese save a lot because of our culture, because of our lack of social safety net, but I here point to you one other fact, which is that household income as a share of GDP has also not increased. That's declined, and household consumption and household income actually go hand-in-hand.

So, what is the cause of that? Why is China's saving rate is so high that China's investment -- most of the increase in savings in the last 15 years is actually the corporate and government savings, not so much as household savings. The reason they are doing that is really in the model of growth, which is that China has gone through a rapid heavy industrialization. As you know, heavy industries are very capital-intensive, so we didn't really -- you know, another myth is that we grew because we had a lot of cheap labor, we manipulated the exchange rate and just exported our way to growth. The truth is that we relied a lot on capital-intensive heavy industries, and you know the increment of growth comes from there.

As the input in the production function comes a lot from capital, you can understand that the returns also go to capital and less to labor, and hence that income in household as a share of GDP declines. So when China talks about the income

distribution it is this income distribution. It's the income distribution between labor, household, and corporate and capital that matters the most. It's not about the rich and poor. I think that belittles the structural issues that China faces.

I'm not saying that's not an issue. The incoming equality between the rich people is also an issue. But in terms of the structural change, it's also here.

So even though interest -- profit margins have remained relatively stable but profit as a share of GDP just goes up because we put a lot of capital in the economy. Okay? So to change that, here comes the questions I talked about that we must do SOE reform. One important thing, of course, is that we must remove and reduce some of the subsidies on energy, on land, on resources to industry at the expense of services and household. This is the number one.

Number two is that the state-owned enterprises don't pay dividend to the state shareholder, okay? So, they have free capital at their disposal. We talk a lot about these state-owned enterprises borrow a lot from the banks. They do, but they actually have free capital as well because the opportunity costs of the capital, of retained earnings are not redistributed to the household sector or the government is free. So, that makes them investing in capital-intensive industries. That cycle must be broken. So, that will go a long way to help actually make the savings rate come down. Therefore, the supply of capital also comes down. So under those circumstances, interest rate liberalizations have a better chance of reflecting true market signals.

Finally, I think I would just -- I'm probably running my time a bit. About the public finance reform, which I promised. I said it's mostly about fiscal. An important reason that I believe local governments are so obsessed about growth in addition to their measured -- about their GDP performance is that in China, the taxation system is such

that most local revenue, most government revenue comes from so-called indirect tax, from production, VIT tax, which is tax at the production gate, at the factory gate, at the production site; business tax and corporate profit tax. Personal income tax almost amounts to nothing, very little, right? Less than 5 percent of the population actually pays income tax.

So, local governments who want to build infrastructure or social services or grow their GDP who want fiscal revenue, what do they do? They want investment, they want industry. They would sell their land very expensively to the commercial sector and households, but they will build industrial parks for free to invite manufacturing investment, and that whole incentive structure binds them towards industry. So, we must change the fiscal and taxation system so local governments are more interested in providing public service, attracting people to live there, rather than attracting businesses to plunder resources and just print GDP.

And so, another probably structural issue that many of you are familiar with is about -- is the social issues in the rapid urbanization in China. We have 200+ million so-called migrant workers in China who work and live in cities but do not have access to urban public service, and there is a lot of call for hukou reform, the household registration system. But I think the essence of that hukou is access to public service.

Here when we talk about inequality of access to opportunities and to social services, including education and hospitals, healthcare, and public security, this is basically -- and the greatest inequality, because we have a second-class population there that exists but are ignored by urban governments, right?

Some of you may know that recently the Chinese government announced that we were going to do hukou reform. People get very excited. But if you

actually look at the local government, what they are doing in Beijing, in Shanghai. They're trying to close down the schools, they're trying to close down the migrant schools to chase away the people there.

Why? Because they don't get any tax revenue from those people. Their fiscal resources are allocated according to hukou people. They have no incentive whatsoever to attract those people to live there. The only way they see them is cheap resources. So, public finance reform to shape how local governments get their resources and spend their money can help address the core issue of making this urbanization actually a true urbanization rather than urbanization of land and property.

So, I will just stop here. Thank you very much. (Applause)

MR. NAUGHTON: So, thank you. It's an enormous pleasure to be able to follow four really interesting talks that hit on many important aspects of China's economy and society today. It gives me the opportunity to sort of weave around some of the things that have been said and try and connect it, in particular, add a little integument to the very contemporary situation.

So, the way I'd like to try and do this is argue that there are essentially three different turning points that are going on right now in China. In other words, we can think of turning points in the Chinese economy, but when we use that terminology we're very quickly talking about three different phenomenon that happen on three different time levels.

So first of all, we're right now in the middle of a short-run macroeconomic turning point, as essentially orthodox macroeconomic policy starts to affect the way the economy functions and the growth rate. There is second a medium not un-policy but a medium-run policy turning point, because we're facing a leadership transition and that



introduces uncertainty and new possibilities into the policy framework. And third, of course, there's a very, very fundamental long-run shift in the Chinese growth model, but more importantly in the underlying factor endowments that China faces as it develops its route to the future.

And so, we should be very careful because there are symptoms of each one of these turning points that are evident to us right now and yet no one of them is really clearly under way. No one of them is clearly consolidated and happening yet, and yet we can clearly see that each of them is on the horizon, is beginning to have an impact in the way in which the Chinese economy functions.

So, look. The first one, the macroeconomic turning point. Obviously I think most everybody knows the Chinese economy is slowing a little bit, but we should also recognize that the current slowdown is very much the intentional result of policy, of very orthodox policy, in a sense. Right? Tightening monetary policy in an effort to deflate bubbles that basically date back to the Chinese response to the global financial crisis at the beginning of 2009. Of course, these bubbles needed to be deflated, so the growth slowdown should essentially be seen as a good thing because it indicates the first steps towards a healthier macroeconomic environment.

But as we look at this process, we start to see right away there are many different kinds of bubbles. There's a housing bubble, there has been a housing bubble that the Chinese government has attracted a lot of attention to and a lot of very specific tailored policy measures to try and control the housing bubble. There is a local government infrastructure, and in fact a national government infrastructure bubble that, again, got completely out of hand during the course of 2009 and 2010. And there's also a high tech industry bubble that I'll talk about a little bit more in a second.

So, as Hu Shuli mentioned, there's an ongoing attempt to grapple with these bubbles. First, before we look at them a little bit more carefully, let's just say how does it look so far? What we see so far is, it looks pretty good in the sense that growth has slowed as an effort has been made to tackle these bubbles, but growth hasn't slowed so much that it looks like we're heading for a hard landing. In other words, so far we seem to be in a sustainable growth slowdown, and here's the manufacturing and non-manufacturing PMIs that give a sense of the robustness of demand. It's clearly slowed, and yet at the same time it hasn't -- doesn't seem to be nearing any kind of cliff.

And you know, the reason for this is, essentially, a relatively steady disinflationary policy being run by the People's Bank of China. So we've got a little bit of disinflation. That's good. We still have significant inflation. The CPI bounced up from 3.1 to 3.6 percent in March, so it's certainly not over, but the central bank seems to have reclaimed an authority that it lost during 2009 to set macro policy and monetary policy and to drive that policy in the direction of a more consistent and stable economic policy.

But the issue is far from over, right? Because there is still an enormous volume of resources tied up in all these different kinds of bubbles. There's an enormous volume of uncompleted housing construction, there's an enormous volume of uncompleted infrastructure investment, and the government has just begun to address these issues. So for instance, when we look at the so-called local government funding platforms, the regulatory authorities have tried to start separating them into five different categories, essentially triage, right? Which are the ones that can be salvaged, which are ones that have to declare bankruptcy.

But when we look at overall growth, as I say the pattern is growth declining. Quarter to quarter, growth rate in the first quarter of 2012 is about 7

percent -- I mean, year over year it's 8.1, but quarter to quarter it's a little slower than that. But what we really -- you know, so the question is, if these bubbles are being burst and if growth is slowing, does that mean that the economy is now reorienting towards a different basis for growth?

And the answer I think we have to say is, not yet. Right? It's not there yet. If we look at -- if we ask the question whether fixed investment growth has slowed below overall GDP growth, the answer is, no it hasn't, not yet. So, that raises a puzzle, right? If housing growth investment is down, which it is, if infrastructure investment is down -- in fact, infrastructure investment actually dropped in the first quarter of 2012 compared to the first quarter of 2011. So, what is it that's powering continued rapid investment growth and, to a certain extent, stabilizing the growth of the economy?

Well to some extent, it's that third bubble. It's the high tech industry bubble, which continues to be a very high focus of Chinese government priority. So while these older, if we may, forms of investment bubble in housing and infrastructure have dropped, investment in machinery, electronics, specialized machinery, all these kinds of sectors are still experiencing investment growth rates in the 20 to 30 and sometimes above growth rate.

So, there's a third bubble that's going on: government-sponsored investment in high-tech industries and especially these so-called strategic emerging industries, and I would argue that this is not a particularly healthy form of industrial development. It's not very likely to lead to an extremely innovative society, so it's a bubble that will also need to be burst and which will create problems down the line.

Now, let's look at the second phase of this, the medium-term. Of course political transitions inevitably bring uncertainty. And boy, we see extra uncertainty today,

especially because of Bo Xilai. And still, it's necessary to point out that the transition -- I mean, the real reason why this transition introduces so many interesting new features is that it is a very much a rule-driven transition, despite Bo Xilai. As Chen Zhiwu mentioned, the fact of having term limits, age limits, these whole series of rules are creating new dynamics in the way that leaders are selected and come to power.

Now, it's natural, of course, we focus on the top leadership, Xi Jinping. Of course, that's the most important. But notice that lots of changes in economic policy over the last six months can be closely related to the rule-driven turnover of economic bureaucrats. For instance, the new head of the China Securities Regulatory Commission, Guo Shuqing, known to be a strong reformer, has already introduced several important measures that tend to push forward the development of capital markets. On the other hand, the new head of the China Bank Regulatory Commission perhaps less hawkish, less concerned with strict financial criteria than the outgoing head. In each of these sectors, we see important changes in policy driven by the turnover that is, in turn, forced by term limits and age limits.

And at the top, that means we see lots of forced change coming. In particular, we outsiders tend to look at the role of Wang Qishan, who is currently a vice premier. Exactly what role will he play in the next administration? Or Zhou Xiaochuan, who is the head of the Central Bank, which means he has ministerial rank, which means he must retire when he's 65. If that rule is applied to him, he has to retire the beginning of 2013, but if he's promoted to something like a vice premier then he wouldn't necessarily have to step down at that point. Since he's a key person in both the policy and the underlying intellectual design of reforms, that's certainly an important thing to watch.

Now, in the last couple months the atmosphere has clearly improved. Why? Well, one reason is Xi Jinping has indicated an interest in deeper economic reforms. In the party suggestions for the 12th Five-Year Plan, there's a line in there that says we should carry out a top-level design, for deeper, broader economic reforms. And you know, the Communist Party is a hierarchical system with lots of face to face and person to person transmission of information. So when this document was sent down from the party center to the party committees at every level, the instruction that went along with it was, this line was inserted into the documents by Comrade Xi Jinping. So, there's a signal that the top leadership believes that -- or the incoming top leadership -- believes that more needs to be done in terms of moving forward with economic reform.

At the same time, the problems that economists have been warning about since 2009 are starting to come true, right? The bubbles that were created starting in 2009 that finance technocrats in particular warned about? Well, now the problems are sort of increasingly there for everyone to see. So, top leaders can also see, yes, we responded to the crisis in ways that were perhaps necessary but now we've got to face the facts and deal with some of the problems.

And of course, the fall of Bo Xilai opens up opportunities. Bo Xilai was a dangerous individual, in part because he was so smart and charismatic and he articulated a vision of economic and political -- I don't want to call it change, exactly, but it certainly was change that was inimical to what China really needs, right? It was exactly a package that led away from all of the necessary changes that had to be made in the economic and political system. So, his fall and more importantly his disgrace certainly opens up new space for better policy and more effective policy.

Can we be optimistic? Not yet. It's a little too early, right? We don't yet

see if there's going to be enough follow through to really create a turning point in economic policy, and we really won't see it until late 2013.

Now, these kinds of relatively short-run turning points, in my mind, pale beside the really important impact of long-run turning points. Of course there's lots of awareness that China's growth model has to change. Ambassador Zhou spoke about the fear of a middle-income trap. I agree with Professor Zhou that there probably isn't a middle-income trap that China has to fall into, but it's undeniable that Chinese growth rates will slow. It will slow whether policy is good or whether policy is bad, and the fundamental reason why the growth rate will slow is because the underlying endowment of labor and capital and, most importantly, skilled labor in China is changing.

You know, one way that people look at it is to talk about a labor surplus, whether China used to be a labor surplus economy and is leaving that status. And the answer is, yes, it clearly is. But the striking thing about China is, China's going to move out of this labor surplus status extraordinarily quickly because the normal process of economic growth is going to be reinforced with demographic factors and the rapid increase in education of young people, which means that shifts in endowments will be particularly fast. In other words, the decline in the supply of unskilled labor will be unusually rapid while the increase in the supply of skilled labor is going to be also extremely rapid.

So, here's just some quick information that shows that the overall labor force is going to plateau very, very quickly within the next couple years, but more important at exactly the same time that the overall labor force is going to plateau for essentially demographic reasons, the share of that labor force going into college or graduating from college is going to -- is continuing to explode. And, therefore, just as the

overall labor force plateaus, the skilled labor force continues to grow very quickly which means the unskilled labor force -- look at that -- is already declining by almost 40 million workers in this decade. And in the next decade, will decline by 70 million workers. So that means, China's export economy is going to change, it's going to change rapidly, right?

The wage pressure we're already seeing is going to continue. Again, this is not a turning point that's already happened. China's growth -- China's exports of labor-intensive manufactures continue to increase at double-digit rates in 2011, so the trade surplus hasn't gone away. But again, a third turning point that's on the horizon that faces the leadership.

So in conclusion, what do we face? Two choices. One quick argument that I want to make. Two choices. Will the new leadership headed by Xi Jinping really push for a revived economic reform agenda? The good news is, everybody's talking about it, everybody now recognizes for the first time that reform has gone backwards in the last four or five years, that at least we need to think about moving forward in the course of -- Vikram Nehru and the World Bank team did a superb job of pushing these issues on the agenda for China.

The second crucial choice for China is how will China opt to develop the skilled industrial sectors in which it has an increasing comparative advantage and which are needed to absorb the millions -- literally millions -- of new college-educated workers who are pouring into the labor force? I believe that the current approach is mistaken, it's going to have to be rethought, it's going to have to be redeveloped, it's going to have to be adapted in a way that opens up the economy to much more entrepreneurial, service-oriented, and creative activity than is the case in today's government-dominated

approach to high tech industry.

And then one final argument, and that is the fact that these three turning points are coinciding does create a window of opportunity for economic policymakers because it means that a policy of conservative monetary policy combined with liberalization, standard orthodox economics is something that we're very familiar with, that economists are very much aware of, will have better effects because it will simultaneously address all of these turning points and push them forward. Conservative monetary policy, more rapid liberalization could help China make its way through each of these turning points at the same time.

Thanks. (Applause)

MS. ZHANG: First, I would like to thank Brookings Institution and Caixin Media for inviting me here. My background was as industry analyst for my -- the time that I was with CIC--China International Capital Corporation. So instead of talking about the micro-level political reform and economic reform, I'd like to focus on where we see the industry reform can take place and how is that going to improve China's productivity.

Given what Ambassador Zhou just mentioned, that China is a developing country and it will take time for political and economic reform. So, is there anything we can do on the industry reform side that can actually improve the productivity? My background as a telecom analyst since a decade ago shows that actually that's possible.

If you'll look at what had happened to the China telecommunication industry since a decade ago, nobody would imagine that China could achieve what it is achieving now in the telecom industry. There was no foreign ownership in that sector, except there was a public ownership in the Hong Kong market for some of the major telecom operators there was no private sector involvement as well. But if you look at



where we are, we are one of the -- we're definitely the largest wireless and telecommunications market in the world and our operator, for example, like China Mobile becomes the largest operator in the world. They have -- by the market cap standard, and they have one of the strongest balance sheets, and sometimes it's getting too worrisome that China Mobile has, you know, about 300 billion RMB. In the listed company, probably another 300 billion RMB at the parent co. level.

And also, even if you look at the service level, the Chinese probably experience much better network coverage, much better job rates than even here in New York City. I think that's one of the things that some Chinese were complaining about when they travel in this part of the world. You have signals in the subway, you have signals in the lift.

So, how come China can achieve that but in the meantime we're facing new problems and concerns in that particular sector? For example, there are corruptions. For example, we're seeing the operators becoming a monopoly in the wireless sector, in the broadband sector. So reviewing, you know, what had happened in the last decade might be very helpful for us to understand how China going forward can reform some other service sectors. For example, the healthcare, for example, media sector. For example, the railway. You know, those are the sectors -- given the productivity that we have seen in the telecommunication sector, if that could be achieved in those sectors I would say in the short to medium term that China can continue its economic growth as well.

It doesn't mean that I don't believe in the necessity of political reform. It doesn't mean that I -- you know, we should have more reform on the ownership structure instead of having all the state-owned enterprises to dominate some very strategic

sectors. But if you look at what we did right for China telecommunication sectors for the reform, first of all we separate the regulatory function, the administrative function, from the corporate day to day functions in 1998. I think that's a very important step so that we have a true regulator, we have a true Chinese corporate.

And if you look at what we did right, secondly, even at that time I think there was a foresight that we cannot have a monopoly in that particular sector. So, the government actually tried every way to separate the companies into fixed lines and wireless, and also tried to support China Unicom to become the competitive carrier. So at the very beginning there was a mindset, even though that wasn't given to the private sectors but there was the mindset that we have to have competition in that sector.

And thirdly, I think it's very important not just because they went public in the Hong Kong market and then you have the international investment community to have the scrutiny on the operators, but I think very important through that listing process there is a set of benchmarks and KPIs that those state-owned enterprises will be measured, will be benchmarked, will be evaluated. And in fact, at a very early stage of the reform, there was a greater incentive plan there to encourage the Chinese operators, actually, to do better. There was a revenue-sharing plan at the management level, at the employee level.

So those were, I think, the right things that we did but there are also things that if there is a lesson that we have to learn, and I think there are also things that we missed. For example, at the very beginning we have a very strong regulator, and that was the Ministry of Postal Communications. But later on, it was change to the Ministry of Information Industry, and now it combined with all the industries -- for example, steel, automobile -- and becomes the Ministry of Industry and Information. So, what's the net

result of that? There was a lack of consistency in the regulation. There was a lack of adjustment to the market conditions, and as a result of that there was a lack of -- it was a result of a lack of staffing, lack of financial support. So, there is no figure or counterparty of the FCC in China right now. And the result is that those companies are becoming too big and they become such a monopoly in one particular sector.

And those subsectors are big. For example, China Mobile is controlling around 70 to 80 percent of the market in the wireless space, and then basically China Telecom and China Unicom are very strong players controlling similar if not higher market shares in the broadband space. So, you have this -- because there is a lack of antitrust law -- a procedure to put a control on those areas, then what we're seeing right now in the market -- there was complaining about, you know, a monopoly and not enough responding to the market and to the smaller operators.

And it's very interesting, actually, that at the beginning of the year there was one case. It was actually the first case that was brought to the NDRC and the court to go against China Telecom and China Unicom by two very small ISP providers in China. So, no consistency in the regulatory function and there was no antitrust. So as a result of that -- and also in combination with what is lacking, which is the optimum capital structure. Because government is the ultimate shareholder and if government does not go out to present or control or manage an optimum capital structure, the result is that there was way too much cash piling at the corporate level. And as Mr. Chen mentioned - - and also prior speakers mentioned -- that the efficiency or the return of those cash flows on the balance sheet was very low.

And what's getting even worse in that situation is that because there is so much cash, then there is corruption and almost China Mobile becomes the center of

many corruption cases and senior management -- quite a number of them if not three or four -- have already been put into custody. So, that's a side impact of having those piles of cash on the balance sheets. So, those are the problems that we have been seeing in this privatization or reforming of that one service industry.

So my conclusion is that I think there are a number of industries in China who are in a similar situation. If we can have the commitment to go push forward for the separation of regulatory functions from the operational units in stimulating competition, not between the private or state at this stage but at least among the state enterprises, there would be great potential of productivity achievement over there as well.

Thank you. (Applause)

SPEAKER: I've got too many questions, but I think I'm (inaudible) ask another. Yeah, anyway my question is about the income distribution because we all know that income distribution situation in China is really, really serious. I just heard that a new study about the GINI index is in the range of 2.6 already, and we know the next mark for making this -- for making the conflicts and social pressure is .4, but now we reached .6. What is the major ration measure that you recommend to resolve this problem?

(Laughter)

MR. NAUGHTON: Well, I think it's very, very difficult to address income distribution directly. So, I mean, I really -- I think I'm in Wang Tao's camp about how we can move forward. That it's a question of tearing down barriers that protect profitability in the corporate sector, allowing prices to rise for factors of production, including labor and land, and interest rates, and that if you -- that that's a good wedge to begin with, and that if we -- because that's a set of policies that not only move in the right direction in terms of income distribution because they tend to take away some of the privileges that the

wealthiest take advantage of, but they also move the economy in a direction of being more fair and more flexible.

I think I'd start with that, and then hope that in the longer-run -- improve Social Security, improved income tax systems would also take a step in the direction we'd like to go.

MS. HU: Wang Tao?

MS. WANG: I just want to add to that. I agree with that.

I think on China, one important thing about the income inequality is also inequality of opportunity, basically children going to school, access to higher education. I think things have actually deteriorated.

When I used to go to university we had almost half of the people coming from the countryside, very poor. Now you go to the top universities in China and very, very few are from the countryside. This is because they don't -- they already from the very beginning, you don't have access to the kind of school that will enable them to go to good universities. But also, job opportunities. I think sort of equal access to opportunity, that's a long-term solution for income inequality.

The second I think also on income tax reform. Right now the income tax is very much a salary tax that basically taxed the white-collar working class. There's no property tax, no wealth tax, no capital gains, no interest tax. No, you know, inheritance tax. Anything that the rich makes is not taxed at all so, you know, of course I have a personal incentive because I'm a working person who makes -- a lot of people probably pay half the tax of my district. So because only a few people pay, right? And most of my peers, actually, in Hong Kong. So, I think income tax reform is very important to put all the income there, every income together, and then significantly increase the threshold of

income tax.

And also, the breakdown -- sort of the privilege of access of certain groups of people to resources. A lot of the wealth was created because they have excess of land, of mines, that belong to the state but they don't pay any resource tax. So, these are how -- you know, it's not about people who are innovative and who have developed products. A lot of the time, I think the complaint about the inequality is this unfair access to resources.

MS. ZHANG: Yeah, I think in addition to that I think it's also very important to get our pricing of factors right, and in that process is actually you have a better chance to achieve income distribution results.

And also, I think it is also very important that there should be a re-thinking of relationships with the society from the Chinese corporate as well, and also the rich people. There will of course be excuses that, you know, because that area is pretty dark and disruptive so people are no longer making contributions to the charity work, but I think there should be a better way to show awareness to see this is a long-term sustainable approach.

MS. HU: Okay.

MR. NAUGHTON: Could I add one thing?

MS. HU: Yeah.

MR. NAUGHTON: You know, if we really are reaching this sort of turning point in labor availability, then we should expect to see inequality get a little bit better as the supply of unskilled labor starts to reduce a little bit. So, that makes me a little bit optimistic.

On the other hand, what I hear more and more from essentially middle-

class people who, you know, really are pretty well off and are certainly much better off than their parents, that they are much more concerned with the unfairness, that so many opportunities are taken by a relatively small group. So rather than it being, you know, the danger of the poor being angry, we really see middle-class resentment growing in China, I think.

MS. HU: Yeah, okay.

MR. HERREOD: Judd Herreod, documentary filmmaker.

Could I get Barry Naughton to elaborate a little bit more on why he feels that the -- I believe you called it the investment bubble in the high tech capital-intensive sector is the wrong way to go? Maybe you could talk a little bit more about innovation in that sector, how close are they to, say, fielding world-class products from that sector, and so forth?

MS. HU: Great, that's also my question.

MR. NAUGHTON: Well, of course it's a huge, huge topic and you know, China has remarkably creative scientists and engineers and it has some really wonderful startup companies. But what we're seeing in the last couple years is a lot of government money going top down, designated sectors, designated technologies. The strategic emerging industries cover 35 industrial sectors, and in each one of those sectors there is a plan that's been in process -- not an old-style, you know, centrally planned plan, but over the last couple of years drawing up has components of the 12th Five-Year Plan, a program of what kind of technologies are going to be supported, what regulatory policies will be used to support them, and sources of money.

And so, of course people respond to those incentives. They adapt their behavior and they say, this is where the money is, this is where the opportunity is. I will

adjust whatever I was doing to become eligible for these monies, to -- if I'm a local official, to set up a new industry. So I think a lot of energy, a lot of activity gets diverted into essentially -- in some cases, I mean, the extreme version is sort of fake innovation, but more than that just duplicate investment in technological paths that may or may not be successful.

So for instance, China has 8 or 10 large projects on plug-in battery cars. Okay, maybe, you know. But is that likely to succeed? How many will succeed, one, two? Right? So, there's just a lot of overinvestment in many sectors, and I think it's going to come back and hurt China while it disrupts the markets for these crucial products.

MS. HU: Okay, yeah.

SPEAKER: Hi, I'm Chen Qian. I teach finance at Johns Hopkins.

My question is actually to Hu Shuli. You know, I sometimes write for Caixin Media, so we are not strangers. This is not a staged question, I hope it's a hardball question.

So a lot of the audience of Caixin Media, they recently criticized Caixin for a lack of report on the recent very important incidents. (Laughter) And you know, a lot of my friends, online friends, they think Caixin could be pushing the political and economic reform by doing more investigative reporting.

So my question is, how do you position Caixin Media? Do you believe Caixin Media should be a pioneer in pushing all these, you know, reforms or just a fair, objective observer of these incidents? Thanks.

MS. HU: Thank you. Actually, it's not that relevant so I'll give a short answer.



Actually I think Caixin has been very active in the professional investigative reports, mainly in the business and finance industry. We are not that -- I think, yeah, in this cycle the Bo Xilai case understand the people are so curious and everybody wants to know the facts. We are working on something but it's hard. We haven't gotten the full picture of that, and right now we saw only piece by piece, more piece by piece, and we hope that we can get something which is really -- which is the whole story, because I think every -- we have got so many pieces. It's like as a blind man touching a big elephant. You all see different legs and never know what is a real elephant.

We feel that so far, and we are working, okay? Thank you. (Laughter)  
Okay.

SPEAKER: Hello, my name is Huang Yan from the finance world. I want to ask my previous colleagues about what's your view, Dr. Wang Tao's view, about the return on investment. Basically we all know current account equals saving money and investment. You mentioned a lot of the savings side. What's your view about the return on investment?

Secondly, what's your idea about -- you mentioned about the other political concerns and press concerns -- what's your view about cash motives, you know, to the investment side of cash motive savings in terms of -- you talk about a lot of stories of corporate levels. Some key questions, what's your view about return on investment?

MS. WANG: Return on investment. This being at the center of a lot of debate about whether China is a big investment bubble. You know, whether the returns on China's investment is diminishing.

I think the question, actually -- the answer is more subtle. Because if you

actually look at the returns, profit margins of the industrial sector, it's been very stable. So we haven't seen a lot of diminishing returns. It's not true, it's not like in the late-'90s where investment was just pouring into over-capacity sectors producing things that are not for sale. I think Chinese companies have been smarter and the economy has changed, so that's not happening.

On the other hand, how do you explain the fact that, you know, we have a lot of investment? Especially in the last few years, in the last three years, a lot of the investment that's government-mandated, government-supported actually went to infrastructure. So if you look at the ICOR, the incremental capital output ratio, it actually is increasing. However, I think a cautious point I would point out is that infrastructure -- we should not judge infrastructure by returns of sort of fare, tickets, fare, and so on and so forth because it has externality. It's supposed to generate productivity for the whole economy over a 20-, 30-year period. So it's a little too early to say those are completely unnecessary or unproductive. I tend to believe that China still has a lot of potential to make returns to this infrastructure investment.

But another part, of course, is in property and I would say for the next 10, 20 years we'll continue to build infrastructure but not generating returns via, you know, better productivity in the manufacturing sector and we would not be able to get those returns.

So, sorry. It's not a clear answer but basically I think that the fact that we do invest a lot means that returns are relatively low. But at the moment, you do not immediately see the diminishing returns, so there is still a case for more investment but the allocation of that investment to which sectors and, you know, the pace of growth is probably debatable.

SPEAKER: Hi, I'm Huining Cao. I'm a professor of finance in the Cheung Kong Graduate School of Business. I agree with the earlier analysis on the monopolies in China. You know, monopolies are kind of bad for innovation and also, like, greater inefficiency in the market.

So my question is, you know, a reason why there's so many monopolies in China is because they are actually controlled by many of the princelings of the old leaders, like *Guanerdai*. Especially as it's kind of a distribution of wealth more to the people who have connections.

If we only have to reform -- and as economists, we know that you have to satisfy the participation constraints or like the win-win kind of idea. That is, how do we make sure these principles or these people in power can also benefit from reform? That works very hard. I wonder -- you talked a lot about the antitrust law and the kind of more monopolies. How can that be initiated, given that these people who benefit from monopolies are actually in power?

MS. ZHANG: Well, yeah. For the industry, I just mentioned the telecommunications industry. It's actually not a result because it's owned by *Guanerdai* or -- you know, that was the key. But I think there is a broader-based lack of definition of what is antitrust in China. I think there is a lack of functional regulatory body that can dive into the research of antitrust, so that how is the impact of the, you know, innovation, going to -- I think there is a lack of understanding that, you know, if you encourage a long-term monopoly antitrust is actually a reduction of innovation and even an efficient allocation of resources.

And I think also because China's telecommunication industry is one of the first industries actually going through the industry reform, and eventually after a

decade we still start seeing a little regional intention, was to introduce competition. But the ending result because of the technology -- we didn't catch the technology trend because we were very reluctant to put a market share cap on the key industries. And then, it ends up with a monopoly situation in one or two major sectors.

I think this is actually a great opportunity for China to call for further reforms, and further than that I think at the legal system level there is a lack of definition of what is a monopoly. What kind of a market share will be defined as a monopoly? And I think that needs to be addressed.

MS. WANG: I just wanted to add a couple of things. I think they are actually -- so even if it's a princelings, *Guanerdai*, there are competing forces. Somebody is in the upstream, somebody is in the downstream. The downstream people will complain about the monopoly in the upstream, so I think natural forces in the economy will help.

The second thing is I think as the history of China's reforms have shown, that we are actually pretty good in developing around it. We started the economy with much of, you know -- the whole economy is state-owned, right? Instead of directly tackling the SOEs, the commanding highest industries, we let the rural sector, the FTI, the foreign sectors, and small businesses to flourish. And then gradually over time, SOE and the state as a share of GDP is much smaller. So I think that's also to allow private entrance into certain sectors. That's a way to gradually chip away at the monopoly as well.

MS. HU: Okay.

SPEAKER: Hi, I'm Felicia. I'm a junior at George High University, interning with U.S.-China Business Council. So, Professor, you talk about reforms in

China's capital markets, and Ms. Zhang also talked about there's obvious development in Chinese capital markets. And my question is, looking back at the financial crisis in 2009, one reason that China wasn't affected is that we don't have a larger range of financial products, we don't have the derivatives. And I was wondering if you could comment on what do you see of the development of financial products in China?

MR. NAUGHTON: You should take that.

MS. ZHANG: Yeah, I think we shouldn't let the financial crisis actually stifle the financial product innovation. I think China in terms of the financial market is way behind in terms of the products available in the market over there.

For one example, we have only cash equity in the equity business. There was lack of derivative and there was -- now we have futures, but there was also a shortage of mechanism in China. So, if we don't have those innovative financial products, the problem is that we -- the Asian market cannot find the fundamental value of that market easily because you only have one mechanism and one product.

So given that, I think we should not be discouraged, which is also CS or C, amazingly, was not encouraged when what happened when this part of the world introduced -- and they still decide to introduce -- future business -- the index future, and also I think most likely towards the end of the year there will be stock borrowing as well.

So, I think those are positive changes. But in the meantime, I think what is problematic in China is that we are not investing enough to build our regulatory functions. And for example, I mentioned about the telecommunications sector.

And another example. In many, many other sectors that we want to go for reform, but the problem is that probably over the last 20 years, the people will have the financial resources, who were having the education, decided to work for the private

sectors or decided to stay overseas. So there was obviously a regulatory function vacuum that was in China. We need to staff properly, we need to finance those functions properly in order to be able to have the regulatory body and to avoid the problems in the future.

MS. HU: Okay.

MR. RAY: For Tao and Barry. Sheldon Ray, Morgan Stanley, Smith Barney. There were reports in March of copper import increases into China, 50 percent over the previous year and iron ore imports up over 5, 6 percent. Iron ore prices at like six-month highs. Is this like a post-New Year aberration or is the economy picking up a little more than people expect?

MR. NAUGHTON: You work for an investment bank, you should answer that question.

MS. WANG: So, I'll start with the iron ore. In terms of iron ore and the steel sector, basically our thesis -- I didn't talk about the short term. I agree with Barry that actually we have seen a turning point in China. The steel consumption is rising. We deducted by looking at steel production rising, inventory is dropping, steel prices are rising, so this is an obvious indication that actually some construction is returning. That probably includes some social housing construction, and in the private side it's probably stabilizing.

I talk a lot about property because 35 to 40 percent of steel in China is used in property, and it is the long products, which rebars and so on, for construction that is rising. It's not the sheet products.

And as you know, China produces half the iron ore and imports the other half. The other half happens to be the high-quality ones. And so, the inventories, you

know, have been reasonable. As demand starts to pick up, then people start to import more. So I believe this is true demand returning. And of course, we do have -- on the supply side we have monopoly or oligopoly so they can control the prices, so prices rise.

Copper is a much more complicated story because copper is highly speculative and so in the first quarter, not just March -- actually, imports went up 50 percent in volume year-on-year, and then at the same time in the bonded warehouses in Shanghai the copper inventory just went like that. Now currently, at historical levels. So, that does not seem to mean that under the line demand is going, but it's rather an inventory buildup, which could be speculative.

So I think, you know, for me if I just look at -- I'm not a copper analyst, I'm a macro person, but people ask me questions about the copper all the time. So, I look at that and I say, well, I can only conclude that even if underline demand in China picks up whether from construction or from power, and so on, I doubt that copper imports can go up much more because we already have such high inventory. So, I would be quite bearish on copper price at the moment.

MS. HU: In the back, yeah.

MR. HUANG: Ju Huang from the U.S. International Trade Commission. So, I have a question for Professor Barry Naughton. You mentioned China having three very important turning points, and talking about the structure change and the dominant structural changes. So, opportunity indicates two years ago, even very few people emerging from China to become a world factory, become a manufacturing center of the world. So, China is starting to export only -- become the lead exporter not only in labor-intensive products, but also technology and capital-intensive products -- or manufacture products. But because of the structural change having a fundamental impact on the

world economy, in the next decades or 20 years, as you mentioned, China's dominant structure will be dramatically shifted from unskilled labor to more and more skill-intensive.

So, what does that impact where -- impact on China's industry upgrading? And also, on the rest of the world? I think that's also going to have lasting impacts on the other parts of the world economy. I would really like to hear your opinion on this.

Another point is, I am talking about China's development of the civil sector. That's really important, but we have to understand the -- for example, the business sector is mostly for the many in the manufacturing sector. If you don't have a manufacture base, how can you develop the business for the manufacturing sector?

Secondly, if you use the official Chinese statistics, I have a question. Because you see, China's system is company-based. It's not an integration-based. So a lot of state-owned companies, they have -- when they replace the workers to a company, they do a lot of service sector stuff but it's still -- China's value agencies still collect them as industry sectors.

So in many people's view, China's service sector's share in GDP is underestimated. What is your opinion? Thank you.

MR. NAUGHTON: So, lots of great questions wrapped up in that. I think it is true that China's service sector is underestimated, and thank goodness because if it's really as low as the data say it would be an even more distorted economy.

But you know, China has a huge manufacturing sector, no matter how we look at it. The official data say that it's not only the largest share in the world but it's the largest share an economy has ever had. So, yes, there's probably some overstatement in that, but certainly there's plenty of manufacturing there, and so when we



think about the structural change, you know, what will be the impact on the global economy?

Well, I wish I knew, but clearly there is a sense in which it could be a highly positive driver of global growth, right? Because China is going to move out of many labor-intensive sectors and there are many, many economies ready and already thinking about gearing up on how to move into those sectors. So that could be highly positive.

It could also be positive for the U.S. because there's still -- U.S. and Germany and particular -- there's still a range of very sophisticated capital equipment that will have a larger market as China moves into the middle range of commodities, both for domestic demand and for exports. And of course, raw material suppliers would also welcome it.

So I mean, you know, it's possible to have a very, very optimistic story about what China's upgrading means for the global economy, and I hope we get there. I can't guarantee we will, but it could be very positive.

What do you think?

MS. HU: Okay, yeah.

Ms. TSI: This is Wei Tsi from the World Bank. I just want to ask Professor Naughton about how do you evaluate the Chinese young generation of labor force? Because everybody knows there is a high unemployment rate, and because of the expansion of the tertiary education in the '90s and also the single child policy. Actually, their reservational wage is pretty high and the kids don't really want to go to work if the wage is not high enough.

So how do you evaluate this labor force? And do you think they are

capable of transforming China into an innovative and skilled labor-intensive economy in the future? Thanks.

MR. NAUGHTON: That's well above my pay grade, as our president said before he reached the highest pay grade.

I mean, in the long-term do Chinese young people have the skills and adaptability to drive China to a much higher level of skill and capability? Of course they do. I mean, it's so obvious, right? They are so capable and so hungry, in many ways. So, of course. I'm very optimistic about what Chinese young people are capable of.

Now having said that, a lot of them -- you know, we've had a very, very rapid expansion of the educational system, so most people coming out with tertiary degrees have pretty mediocre educations at this point. I mean, obviously there are some great universities in China and some of them are moving towards the frontier, but the majority of these people are coming out with, you know, relatively low-quality education and they're going to need to supplement it by lots of on-the-job experience. They have to find work first, so there are a lot of challenges to overcome before we get there.

MR. MEYER: Kevin Meyer, (inaudible). Dr. Tao's belief that market resource allocation is favorable to state allocation and Dr. Zhang's talk about futures markets and derivatives and shorting the market makes me wonder whether you're advocating the introduction of American-style casino of capitalism to China. Is that position -- if you are -- philosophical, or are there metrics by which we can measure the success of resource allocation in an economy?

MS. WANG: It's not philosophical, to start with. I think that it's all relative. I think in the U.S. you have probably gone too far with your regulation without proper supervision, whereas in China I think we cannot actually look at the U.S. and say,

that's completely wrong, we should go back to our system. Which, unfortunately, I think, is the greatest lesson Chinese policymakers may have learned, and it's the wrong lesson, in my view. We are so far and still reforming the state control to say that, you know, we shouldn't repeat the U.S. We shouldn't, but we still are a long way from repeating the U.S.

I am a great believer that the state -- you know, the state should have some control, should have better supervision and regulation to sort of set up the framework where people have, you know, equal access and level playing field.

Right now, actually, in a lot of parts of China it is a casino, except it's a casino for the privileged few and not for, you know, the people who have autonomous desire to grow. It's the people who have the control of the resources. I think that -- so, for the U.S. case, you probably need better regulation, but in the Chinese case we need deregulation, still. We need the market to play a role, because right now their signal is not there. It's basically a government who decides -- who picks winners and who choose winners in industry. Barry gave the example of high tech. One year the government decided, we need to do green tech. 200 countries invest in solar power. In 2 years, the capacity increases by 500 times, okay? So, this is, you know, a casino with the state control and with the market not playing a role anymore.

So I think, you know, we are coming from another spectrum.

SPEAKER: Thank you. My name is (inaudible). I come from the University of Maryland. And I want to ask questions about China's young people, about their adaptability of the job market. Because I have noticed two states that last year the Chinese youth participated in the CFA test, and about the government officials entering tests. Both of these two tests, the numbers are at a historical high in the last years.

So, I wonder when there is a situation that the government upsets lots of Chinese youth to enter, and the financial market they provide high salaries, and salary packages for the youth. All of these young people, they want to find jobs in these two areas, and so what about the other job market areas? Because I have also noticed that there is a huge shortage in the industry, especially in the labor-intensive areas.

So, if no one else intends to force China's young people to participate in the other areas, I wonder if such trends will continue and if that will harm the future of China's economy?

Thank you.

MR. NAUGHTON: So, you're referring to the fact that more and more young people are taking the exam to get into the civil service? So, some 500,000 young people took it last year and then the other sector is the financial sector.

Because they are rational people, right? This is where the money is --

MS. WANG: This is where the money is --

MR. NAUGHTON: -- and the power is, and so I think in some sense it reflects well on Chinese young people but somewhat poorly on the Chinese system in the sense that you would hope there would be many more sectors that offer, you know, really high potential career returns.

And I think there are, and after all, 500,000 people apply for the government but only 2 percent make it. So, the other 495,000 are going somewhere else.

MS. WANG: Yeah, I think one thing is the reform of our education system. For example, that in universities the more students you get the more resources you get from the Ministry of Education, and so they don't care if the students actually find

jobs. So, there is a disconnect between what society, what business wants, and what the universities are producing. So, reform of that is necessary.

The second thing is that I think for business they have had a very good time just in tackling the surplus labor. They didn't have to provide training. They don't -- a lot of them don't even provide a working contract, right? Migrant workers work there for 10 months and then you go home. Next year, you reapply again. But as labor becomes shorter in supply, then businesses feel the incentive to provide a contract and on-the-job training, they see the benefits of retaining people.

You know, I have big hopes that we will be able to adapt on both sides because economic incentives are changing.

MS. HU: Anyone else? Okay.

MR. LI: Xue Li from SAIS. My questions go to Hu Shuli. You talked about the case of muckraking. Because, you know, consider about China's context to do the muckraking is very dangerous in China.

I just wonder, how do you deal with the law? Because there is the potential boundary for you to deal with these kind of radicals. How do you control these things? So as the case, like *jijinneimu*, when you decide to publish the book. What do you think about seeing the boundary and not outside the boundary?

Thank you.

MS. HU: Actually, boundaries are there in China but the thing is never think about the boundaries, otherwise you will do nothing. So, we just think where is the news and we cover the news.

In our case, we follow -- the more news and journalism in China.

(inaudible) is a powerful journalist in China. Thank you.

So, okay. Thank you very much. (Applause)

We have come to the end of the conference, and so on behalf of the Brookings Institute and Caixin, I would like to say our sincere thanks to all the speakers who gave the remarkable talks here and gave their frank and thoughtful interactive discussions with our audience. I also want to say thank you for all the audience for your attention and for interest about the topic we gave today, and also for your active discussions with our speakers. Thank you very much.

MR. LIEBERTHAL: First of all, I want to add with our thanks to Caixin Media for its wonderful cooperation on this, and especially to Hu Shuli. I want to mention that a good part of this will be available on our website, a transcript and perhaps all the slides or most of the slides. We still have to discuss with the various speakers. So, be sure to come to the website after a couple of days and you'll be able to get a good record of what you've just heard this afternoon.

Again, thank you all. Oh, and on Caixin's website you'll have, what, a video of this or a transcript?

MS. HU: Video and a transcript, and also reports.

MR. LIEBERTHAL: And small reports. So, all of us are famous in China now, okay? Probably in English and in Chinese, or Chinese voiceover?

MS. HU: First in Chinese, first. But the transcript will be in English at the same time. Afterwards, it will become Chinese, later.

MR. LIEBERTHAL: Okay. Bilingual on Caixin, monolingual on Brookings. And thank you all very much for coming. (Applause)

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