DEMYSTIFYING THE CHINESE ECONOMY

THURSDAY, MAY 3, 2012
WASHINGTON, D.C.

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Transcript by Federal News Service
Washington, D.C.

URI DADUSH: OK. Well, Good afternoon, ladies and gentlemen. Welcome to our Carnegie Endowment to discuss "Demystifying the Chinese Economy," a book by Justin Lin, to my right, who is chief economist of the World Bank and he's also known for being my former boss – (laughter) – and friend. Justin will present, discuss his book briefly, for about 10 minutes. And this will be followed by our discussants, Nick Lardy of the Peterson Institute, to my right, and Vikram Nehru, who recently joined the Carnegie Endowment from the World Bank, and is the director for our Southeast Asia program.

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Just a word about our presenters, because you have the bios; you know who they are. So just very briefly I wanted to say that Justin Lin is one of the world's leading experts on development. If you read his book you will find there an enormous amount of information about the Chinese economy and knowledge that can only be developed through ongoing practice of the art of development policy. And that I what you will feel in the book and that is what you learn from Justin when you listen to him and when you work closely with him.

He has, of course, published very, very widely. I see here that he's written 23 books. I have to look every time because the number of books grows and grows. (Laughter.) And when I left the World Bank three years ago, it was less than 23 as I recall, now it's –

JUSTIN LIN: Eighteen.

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MR. DADUSH: – 18, sorry. So now it's 23. And Nick Lardy, of course, is known to as one of the leading experts on China in the world, long history in this area. Before the Peterson Institute he was at Brookings and at the University of Washington, at Yale University School of Management. He's also written widely, of course, on China.

And my friend Vikram, to the left, was chief economist of the East Asia Region of the World Bank and also was director of economic policy, among other very senior positions that he held at the World Bank. Vikram was the lead author of the recently published report on China done jointly by the World Bank and Institutes appointed by the Chinese – by the Chinese government, which proposed a far-ranging set of reforms to China.

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So we have quite a – quite a panel here today. And let me ask Justin to begin. And to say again, 10 minutes – no more than 10 minutes, because we want to keep – we want to have a conversation about it. And then – and then five minutes each to the discussants then we'll open I up. Please, Justin.

MR. LIN: OK, thank you very much for this opportunity to share with you some of my understanding about the Chinese economy. We know that China started to reform. It began on 1978, beginning of 1979. And in the past 33 years, and especially in the first 25 years, most people thought Chinese economy was going to collapse anytime soon. But in spite of all those expectations, China continued to grow dynamically, on the average 9.9 percent per year for the past 32 years.

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And it's a record in human history. And so for me, today I'd like to, you know, share a few points. How come it was possible for China to grow at this rate for such a long time after the reform in 1979? Then I also want to share with you briefly how come it was impossible for China to achieve similar rate of growth before the reform in '79. And if reform was the main reason for China to have such performance, how come other country in a transition – in a reform, they could not have a similar rate of growth? And equally important is that how much longer China can maintain such a high growth rate.

Regarding how come it was possible for China to have such a high rate of growth, my answer actually is very simple: We know that for any country to have a sustained growth, the most important driving force is a continuation of technological innovation. That's for every country. But for a developing country, there's something called the advantage of – (inaudible). High-income country on the global technology frontier, for technological innovation they need to invent the technologies. For a developing country, innovation can be (absorption ?) imitation.

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And if a developing country know how to tap into that potential, they can maintain 7 (percent), 8 (percent), 9 percent growth rate. And in effect, there were 13 economies in the world, after the Second World War, tap into the potential, achieve 7 percent and more growth rate continuously for 25 or more years. And China became one of those 13, after the reform started in 1979. So the answer is simple: an advantage of – (inaudible).

But an advantage of – (inaudible) – has been there for century. How come China did not benefit from the growth rate before the reform in '79? Again, it was because the government policy before '79 was trying to be too ambitious. And like in the 1950s, China wanted to overtake United Kingdom in 10 years. China wanted to catch up the U.S. in 15 years.

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So that means that, you know, after the establishment of the People's Republic in 1949, and immediately when China started a five-year plan in 1953, China wanted to develop the most modern industry at that time. And China wanted to develop most modern industry at that time, so that China cannot – could not benefit from the advantage of – (inaudible). Not only so. Those kind of – (inaudible) – industries was so capital intensive it was against China's competitive advantages. Firms in those kind of sectors were not viable in an open, competitive market.

And as to establish them China needed to protect them, give them all kind of subsidies for the investment and for the continuous operation. And – but not only did China not benefit from the advantage of – (inaudible) – but also were hurt by all those kind of distortion, very inefficient resource allocation, the repression of the incentive. Only after 1979 China started to change its strategies, started to develop the light manufacturing labor-intensive sectors, and to (employ ?) incentive in every culture – in the industrial sectors. And those kind of change in the strategies allowed China to start to benefit from the advantage of – (inaudible).

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But this is a simple story for the success of China, we know that other country in a transition in the 1980s, 1990s, no matter if it's a socialist country or Northern America or in Africa. We know that in post-World War II almost every country followed similar strategies, wanted to build up the commanding height, wanted to, you know, be modern country immediately, right? So they all had those kind of heavy industry-oriented strategy, had a similar distortions, like China started to go to transition in 1979. And how come other country did not benefit from the transition like China? Again, it was transition strategies, because most other country followed the Washington consensus. They observed the distortion. And certainly, for economists, it's very easy to build a model to show as long as you have those kind of distortion, you have those kind of intervention, your economic is going to be very inefficient.

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And so the otherwise to privatize – (inaudible) – sectors, to remove all your distortions and to liberalize your economies. But this kind of approach (negated ?) those kind of distortions were introduced as a second-best arrangement to protect a non-viable firm in these priority sectors. If the government remove all those distortion immediately, all them are going to go bankrupt. And if all of them go bankrupt, you're going to have 30 percent, 40 percent unemployment in the cities.

And if the government really implements that, you are going to have social, political instabilities. (Inaudible) – your political instability so that you can have growth. And for (three ?) of that, in effect, most countries follow the Washington consensus. After officially they removed those kind of distortion, they reintroduce all kind of disguised subsidies and protection to the old firm in the name of protection job and so on. And those kind of disguised distortion and subsidies were even less efficient than the old distortion – (inaudible). Another reason why other transition economy did not perform well.

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Then how come China could do well? Well, China is a very pragmatic country. So China adopt a certain kind of – (inaudible) – approach. On the one hand, continued to provide transitory protection and subsidies to all sectors, but – (inaudible) – at the entry to the labor-intensive new sectors. And this kind of strategy, on the one hand, preserved the stability, but on the other hand promoted dynamic economic growth. And it was dynamic economic growth, it also created a condition for the Chinese government to do reforms in all the sectors. So that the reason why that China could perform so well and in contrast to the poor performance in other transitional reforming economy.

The last question: How long China can maintain this kind of high growth rate? Well, my answer is also very simple. It depends on how large is the advantage of – (inaudible). And how can we measure the advantage of backwardness or to measure your technological level with the highest income countries? And the U.S. can be the representative of the highest income countries. And in 2008 there was – the data I have for comparison. In 2008 the per capita income in China was 21 percent of U.S. per capita income measured by purchasing power parity. It's that simple. And I think that is the good – the best measurement for the – (inaudible) – of development and for the (technological ?) certification for the whole economy.

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It was similar to Japan in 1951, Taiwan in 1975, Korea in 1977. Their economy were all 21 percent of the U.S. economy in terms of per capita income in those three years. For Japan, you know, 1951 to 1971 the average annual grow rate was 9.2 percent. For Taiwan, the average annual growth rate from '75 to '95 was 8.3 percent. For Korea, from '77 to '97 the average annual growth rate was 7.6 percent. We know that East Asian economies were the group of economies ever to tap into that growth potential advantage of backwardness. The East Asian economy was – those economy I described – (inaudible).

And since the reform in '79, the mainland part of China followed similar strategies as Japan, Korea, Taiwan. So will this growth potential allow Japan, Korea and Taiwan to maintain 20 years of about 8 percent growth rate? I'm quite confident the potential is (there ?) for China to maintain another 20 years of around 8 percent growth. So let me stop here.

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MR. DADUSH: Fantastic. Justin, thank you also for staying within the time. So if I understand – (laughter) – again the – before I turn to Nick for some comment, your point is that China's growth is fundamentally – was – the success of China is fundamentally due to the fact that it adopted a dual-track approach –

MR. LIN: After the reform.

MR. DADUSH: -- after the reforms – once it embarked on the reforms, where it sort of maintained the protection of some of the basic industries, the commanding (hides ?) and changed that relatively gradually so as not to have chaos –

MR. LIN: Yeah.

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MR. DADUSH: -- but at the same time opened up the market for a lot of the new industries which are – and the labor intensive industries, whether they were new or old, in a way – that reflected China's underlying comparative advantage –

MR. LIN: Right.

MR. DADUSH: -- and that that dual-track approach and the fact that it was taking advantage of backwardness is what explains its growth. And also as you look to the future, you said China is today not too distant from where Taiwan, Korea –

MR. LIN: Right.

MR. DADUSH: – and Japan were many years ago and therefore is capable of growth at a very high rate for 20 years to come.

Nick, do you – what is your reaction, both to the book or to the main points that Justin made?

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NICHOLAS R. LARDY: Let me talk a little bit about the book. Given that he only had 10 minutes, he really couldn't cover. And I'd just like to give you a sense of the range of issues that the book covers. It is very broad-gauged. I think it really is a book in three parts.

First is a very comprehensive analysis of why China last its early economic lead over the West. I mean, most of us are familiar with the idea that certainly through the early part of the Ming Dynasty China was the richest, most developed, most technologically advanced, the most urbanized country on the globe and that once the Industrial Revolution got started in England and then spread to other countries, that China fell behind. Its GDP didn't fall in absolute terms, but it was rough, you know, with some fluctuations. But basically the long-term trend was relatively flat in terms of per capita GDP so that China lost its early lead. And there's a very insightful analysis of the factors that may be responsible for that. Lots of hypotheses have been generated over the years, and I think it's a very good survey and brings some new ideas to the debate as well.

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The second part of the book is really the planned economy period. Justin, again, didn't have time to comment on that very much in his remarks, but kind of looking at what happened after the formation of the People's Republic in 1949, the planning system that began in the – in the early – about '51, '52, '53, more '53 on – the first five-year plan, and he talks about the shortcomings of that. And then the other part of the book is really about the reform era, as he indicated, is the period over the last 30 years.

And as Uri said, it does really reflect Justin's very strong development economics orientation. The basic idea is that the planning period up until '78 for the most part, with some exceptions, followed what he calls the CAD strategy that is a comparative advantage-defying strategy, the emphasis on heavy industrialization, as Justin just mentioned, the desire to catch up rapidly that was fairly pronounced in a number of countries over – in the post-war period.

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This kind of a development strategy is characterized by artificially depressed interest rates and overvalued currency, low wages, suppressed prices for raw materials and intermediates so that certain parts of the industrial sector will be very highly profitable and the state then confiscates those profits and uses them – and allocates them through the planning mechanism to generate a very high level of investment, given the level of per capita income. It's a resource mobilization strategy that's state-driven, and the resources are allocated predominately to heavy industry. And obviously that strategy works in certain respects – certain superficial respects, but it turns out not to be viable in the long run for reasons that the book explains very well.

I think the argument of the book is that since the late '70s China's been on – in a CAF strategy, that is a comparative advantage following strategy that's more market-oriented, relies on market-determined prices, market-determined resource allocation for the most part and is more consistent with China's comparative advantage and allows China to achieve the very high rates of economic growth, as he said at the beginning, and much more emphasis on light industry, much more open to the global economy, lots of labor-intensive exports exploiting China's comparative advantage in abundant labor, relatively low wages. And a period of growth that has been very rapid has been accompanied by an increase over time in the capital-labor ratio, but that leads China to gradually move up the ladder, but it is one in which the pace of that is market determined rather than predominately planned determined.

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He does – the book is mostly about the history. It has in the closing chapter some very interesting discussion, however, of the challenges going forward – distortions in the financial structure gets some attention, distortions in resource prices and administrative distortions, the monopoly role of state-owned companies in a number of critical sectors. And he suggests ways that these distortions might be overcome.

I guess if I – since I have to say something critical, I would say if the book – if the book didn't have this huge historical sweep, it might have been able to – which I'm not recommending that that should have been done or maybe the book were longer – it would be interesting to hear and maybe shed some light on this in terms of his own views right now on why – given the fact that we've had very successful reforms for 30 years, why haven't we been able to break down the remaining price distortions? He alluded briefly to the dual-track pricing system that evolved. It allowed a mechanism for moving forward without bankrupting all the existing enterprises at the beginning.

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But here we are 30 – we're really closely to 35 years later and some of these price distortions still exist. Most prices have been liberalized. But as he properly points out, certain prices have not, particularly their energy and a certain number of other prices that are still controlled by the government. And also I think the government has not been very successful in dealing with the monopolies. And obviously there are some monopolies that are natural monopolies that might require one set of policy approaches and there are other monopolies in China, sectors that are monopolized that is largely a result of government policy. And again, the question is why haven't – why haven't some of these issues been successfully addressed, given the rapid economic growth and the – and so forth.

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The only other thing I would say is, given the broad range of topics that are discussed, that we're painting with a very broad brush. It's – in many areas where you talk about financial reform, for example, it's a very broad brush, so there's not a lot of detail. And I think the book actually grew out – originally out of a – out of a course that Justin taught for many years at Beijing University at the China Center for Economic Research. And I wondered if that's why he had 13 chapters. You must have 13 – (laughter) – 13 weeks in your semester.

MR. LIN: Chapters – (inaudible).

MR. LARDY: So that – I enjoyed the book very much and am glad to have an opportunity to participate in this discussion.

MR. DADUSH: Great. Thank you. So before we come back to you, Justin, Vikram, your reactions?

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VIKRAM NEHRU: Well, thank you, Uri. And first of all, let me wish Justin fare thee well. Justin is leaving Washington as a – in about a month, is going back to Beijing. I know the World Bank will feel his absence. When I was doing the China 2030 report, I can tell you that Justin was a tremendous support. And in my many interactions with President Zoellick where Justin was present at every time, I could tell that President Zoellick really valued Justin's ideas and Justin's thoughts. So I know that he will miss your absence, too.

I was going to talk about the book, but Nick has stolen my thunder on that. So let me just quickly tell you what I found the most valuable part of the book. I – the entire book is really interesting reading. But to my mind, the most valuable part of this book was the description of the reform process. This was really an insider's view of that description. You know, it's – it was really captivating to learn how the household responsibility system began in Xiaogang village, what the desperation of the villagers was at the time, how the local council saw the value of what they were trying to do, because they were actually flouting the law at the time; they were taking a big risk. And they – the local council saw this, recognized its value because of the increased production, decided to spread it and support it. And finally, thanks to the fact that in China there was a lot of, at that time, competition between local governments who are trying to expand output, this spread like wildfire across China – a fascinating glimpse of what was going on within the country.

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So when I – when I read it, I thought to myself, you know, actually the – there were too really big parts to China's success, two core parts to China's success. And while none of those policy reform initiatives were drawn from Western economic thinking, actually there are two branches of theory which support it and support it very strongly.

The first is of course the Ricardian Theory, where Justin talks about the dual-track approach. The Ricardian view is that provided you get marginal cost equal to marginal revenue, you can achieve efficiency. It's the marginal price that's important. And even though a large part of the economy may still be controlled, may still be supported by controlled prices, provided marginal revenue equals the marginal cost, you can get a substantial increase in production to improve the incentives. So Ricardian economies certainly would very strongly support what happened in Chinese agriculture.

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The second dimension, of course, is what happened in Chinese industry. And I would argue, as Yukon Huang has done, a colleague of ours at Carnegie, that the theory developed by the economics of geography proposed by Paul Krugman definitely supported what happened in China. I'm not suggesting that this where the ideas were drawn from. Certainly not. But it is remarkable that after Deng Xiaoping's tour of the south, there was the idea of expanding industrial production, increasing liberalization for these labor intensive industries in the south, particularly on the coast. And it very quickly spread along the Chinese coast.

Not only was this – was this focused on the coast, but substantial resources were injected by the government into this area in the form of infrastructure and other sorts of – other sorts of resources. So ironically, resources were pumped into an area of China which was already relatively well-off compared to the rest of China.

And this was not a spreading of resources to equate – to increase the marginal returns of capital. But the implication was that coastal China benefited very substantially from economies of scale, from agglomeration economies and from urbanization economies, as a result of which was a very rapid decline in the unit cost of production and a very substantial and quick improvement in China's competitiveness in international markets. So this was a very interesting application of the – sort of the Krugman idea on agglomeration economies and the economics of geography.

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Now if – I – like Nick, I feel I need to make sort of a few observations as to what I felt were – where the book could have gone further. The first is – actually it's interesting; it's the title, right? "Demystifying the Chinese Economy." And I thought to myself, would we have a book entitled "Demystifying the Indian Economy" – (laughter) – or "Demystifying the American Economy"? And the answer is probably not, right? The reason is there's such a dearth of information, actual data and inside information on what is happening in China. It is a very opaque decision-making system.

When I worked on China 2030, as Uri said, I had colleagues from think tanks on the other side. And to them, I realized, substantial parts of the Chinese economy were like black boxes. They were not able to get information from inside ministries as to what actually was happening. So it would be – it would be useful if China were to become more transparent so it wouldn't have to be periodically demystified for the rest of us. (Laughter.) And one of the interesting things is, I did a – I did a word search on Justin's document, and the word "transparency" or "transparent" didn't crop up once. I think this is an important issue and something that could be emphasized.

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The second is that I felt that the book was very strong on the past, as Nick has pointed out – very good explanation of the past rather than the present or the future. And I guess that would have meant a substantial increase in the size of the book, which none of us would have necessarily wanted. But also I suspect it was because this is a – this is a compilation of Justin's lectures.

But it was also a focus on the what – what happened – rather than on the why and a little bit of the how. Especially when we talk about the future – when Justin is talking about the future, he does – he does point out what needs to be done. And he – I think he has sort of five big points, but those points are to improve the financial sector, to do this, to do – what needs to be done. But the big question is how. As Nick seems to have suggested, there are many lingering distortions in the economy which have not been removed. And there is a reason why they've not been removed. I would argue that there are substantial vested interests now in China that could be blocking reforms. And the big challenge in China, like in many other countries, is how do you go about bringing these deep reforms?

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And this really takes me to my last point. My last point is taken from this very recent book by Acemoglu and Robinson on "Why Nations Fail." We were talking about it just before this discussion. And in that book, the question that Acemoglu and Robinson ask is, you know, why do some countries make the right decisions? We know China made several decisions which turned out to be very successful. But why did it happen? How did it happen? What were the processes that took place inside the Communist Party, inside the decision-making structures that made it happen?

And the sort of – the conclusion of the "Why Nations Fail" book is really something like, you know, politics trumps. Ultimately it's about politics. But the political aspects of the Chinese economy – and I would have loved for that to have been demystified, but the political dimensions were not discussed in this book. (Scattered laughter.) And I missed that. Let me stop there.

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MR. DADUSH: OK. Well, thank you very much. I was tempted to say – to think and to say, when Vikram was speaking, that just because policies are more transparent in India and the United States, it doesn't mean they're any better at the end of the day. But certainly they may be easier to interpret.

So Justin, do you have any response to the discussants?

MR. LIN: Yeah, I'd like to respond to you.

MR. DADUSH: Yeah.

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MR. LIN: I think those comments are very good – and thank you for reading my book so carefully. (Laughter.) Yeah. And I hope you will also read my book very carefully. (Laughter.) The first one, how come I do not go to very details about certain areas, because I need to give some scope for you to write books. (Laughter.) Actually Nick was right. You know, the book was based on my lecture notes, and I taught this course for 15 years. At the beginning, it was a semester system with 18 weeks. And so if you took out exam week and so on, and the first week or introduction, I had – I had 15 lectures.

But later on, because it was influenced by the American system – (laughter) – the semester was shrinked (ph) to 15 weeks. So I could only have 13 lectures. And it was 13 lectures because I like the student to understand the history. I like student to understand the origin and to have a framework. And even I do not give all the details, but with a framework it's very easy to understand what would be desirable, what would be necessary for the futures, and also to have a good enough grasp how we come about to the current situation. That's one thing.

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And secondly, about demystifying, it – you know, your comments for 20 years ago about there was no data – that was right. But today is not a data issue. The data is available. Just the framework to understand the data. The data has been there. But because of this kind of – (inaudible) – dual economies, the data is very hard to understand. So very often, when you present the data to the people outside China – or even within China, they use a – (inaudible) – theory as a framework to understand the data. They often say the data was wrong, the data was manipulated. But in effect, if you have a better understanding of the structure of the Chinese economy, then you understand actually the date was right – reflect the facts. In effect I have a chapter on that. Right.

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So I think that now it's not a data issue. For understanding China it's a framework issue. It's a theoretical issue. You cannot use the theory simply transparent from what you learn in Chicago or at Yale and wanted to use that to understand China. If you want to use that, you will say the data has some problem. But if you – (inaudible) – my book, its approach you understand. Then you find enough data for you to have a very good grasp about what's happening in China. That's the first point.

The second point regarding, you know, political economy issue. I discuss a little bit in my book. I don't think the political captures is the whole story, because for the political leaders, no matter in which country, always have some degree of freedom, some discretionary power. And at the success of – (inaudible) – countries – (inaudible) – the political leaders can utilize that degree of freedom to shape the direction and the restructure – (inaudible).

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Today you can say, well, some industrialist or financial sectors – they are so powerful, they have the – they – so they capture everything. But 30 years ago, collective farming sectors and industrial sector – have industrial sectors, like at the time in the cabinet the industrial sectors were represented by eight ministers. They were very powerful. But how come China – (inaudible)? Because Deng Xiaoping used a degree of freedom to start some kind of changes. And a succeeds (ph) – success breeds success.

(Today ?) I can understand. The top leadership in China still have that degree of freedom. And they are also wanting to do things, but they do things – they need to, you know, depends on – (inaudible) – in a way it depends on the domestic situation and the global situation. And the direction of the reform has been very clear, because if you – if you read the 11th Five-Year Plan, 12th Five-Year Plan, you see all the direction of reform has been discussed. But the implementation of that reform depends on the global economic situation and the domestic economic situation.

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So I think that the answer – I do not really think that political capture, because – (inaudible) – equilibrium – (inaudible). And that give me the hope. China can do those kind of changes. Other country like in India – in the past we often say that you have the Hindu equilibrium. And there has been the equilibrium for thousand – for 3,000 years. But how come in the 1990s you can start to have those kind of reform because the political leader use that – (inaudible) – freedom to introduce some critical policy changes. And that kind of policy changes change the essential structure.

And so with that, I have – (inaudible). Not only China can carry out the reform. African country, Latin American country can carry out the reform. And we cannot, you know – I don't think that we are a (state ?) of the political capture. We are a state of the equilibrium of political economy.

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MR. DADUSH: Thanks very much, Justin. That message was, as I interpret it, can-do. We can do. Yes. (Laughter.)

MR. LIN: Right, yeah.

MR. DADUSH: Which I think is a good message in this city, for example. (Laughter.) The – let me ask – I have the advantage of not being an expert on the Chinese economy, so of asking simple questions hopefully that will appeal to the audience. So one of the things that still remains a mystery that needs to be demystified is this consumption rate in China. So 36 percent of GDP is consumption in China – the lowest, as far as I know, in the world – anyway, of any case that I am familiar. And I'd like to get the panel's sense of why the Chinese consumption rate is so low, and is it likely to change?

I don't know if you want to start, Justin, or you – yeah. Yeah. Yeah.

[00:46:46]

MR. LIN: Oh, I'd be happy, because – (inaudible) – in my book. You know, the consumption as a percentage of GDP in the 1990s was about 60 percent. And as you observe, now dropped down to about 35 (percent), 36 percent. There are many hypotheses for that. One of the common hypotheses was because China did not have the social security system. And the household need to save for their retirement, for their health, for their children's education. And so the common recommendation in the media or in the academic circle you can read here, is that China need to do those kind of reform.

And I agree. China need to do those kind of reform. But those kind of reform cannot change this kind of pattern because if China's – if there's more, you know, social security system, and if the government provide more, you know, housing or education or health, individual household may not to – may not have to save as much. But the government need to save more. So it's a balance. I don't think that it's going to change this kind of pattern.

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So we need – really need to understand what are the rules of this kind of decline in the household consumption, and also increase in the saving rate in China. In effect, household saving in China – high, 20 percent as a percentage of GDP. That is the same level as in India. What different – what differ China – what distinguish China from other country was corporate saving rate. In China – (off mic). It is another 20 percent or more –

MR. DADUSH: Of GDP.

MR. LIN: – yeah, the GDP.

And how can the corporate saving rate in China is so high? It related to the dual track of China's reform. The government retains certain kind of protection to the old industrial sectors, large industrial sectors. And the distortion is – you know, Nick just mentioned including the financial sectors. And the government, you know, have a, you know, overconcentration of financial resources in the banking sectors as a way to provide low interest rate to the corporate sectors is a way of protection and subsidies.

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And also in the resources sectors – the resources are owned by the state. But the levies on the resources is close to zero. And that's a way also to, you know, subsidize the resources (firm ?). And then some monopoly in the service sectors. Those are the – you know, the company in those kind of sectors, they enjoy extremely high corporate profit. And because they enjoy high corporate profit, so the corporate saving rate is so high.

So I think that, you know, to address the issue of law of consumption as a percent of GDP, we need to carry out for the reform, to remove those kind of distortion. And I think that is the way to change the picture.

MR. DADUSH: Good. Any – do you guys want to add – Nick or Vikram – on this?

[00:50:07]

MR. LARDY: Well, I'll just add a couple of things. I think I, by and large, agree with what Justin said. I would argue that, you know, from roughly the middle part of the last decade, financial repression actually increased in China. Interest rates went down. Household income was depressed as result of that. Households started save more. That further depressed consumption. Lending rates came down dramatically in real terms as well, as most of the borrowing is being done, at that time, by the corporate sector. And that contributes to the high profitability in the corporate sector. And the tax system didn't capture very much of that.

I think I might disagree a little bit about the social safety net because obviously the government will have to spend more to provide the services if the individuals might save less, but it depends a lot on how that's financed. And if you took more profits – if high-profit corporate sectors were required to pay dividends to the state at a much higher level, low-income households might be big net beneficiaries, high-income households might not be. And I think – so I think there is some leverage on – in improving the social safety net in terms of rebalancing the economy.

[00:51:26]

Also I would mention the exchange rate became increasingly undervalued after 2003. And that contributed to a big increase also in corporate profits in the manufacturing sector. And that's where the profits and the high savings has been generated. So it's not just low raw material prices or low royalty payments on natural resources, but it's also the exchange rate, the underpricing of capital, all of which serve to increase the returns to capital, and the labor share of income went down. So all those things need to be addressed to get back on track.

MR. LIN: Can I respond to this? I agree to some extent. You know, if you have this – a much better social provision and so on. The government need to spend more. The government also need to save more. So I think that effect on the commerce consumption as a percent of GDP, I would say very small, because you can look into Singaporean situation. Singapore also – Singapore has one of the best social safety net. But as – the saving rate in Singapore is also one of highest in the world.

[00:52:36]

OK. And then regarding the exchange rate issue, I think it is – you know, depends on what kind of model you are using. When you say that China undervalues exchange rate, in general I think you use Balassa-Samuelson's theory as a reference, because the tradable sector in China expanded so fast, productivity increased so much, and if you use the Balassa-Samuelson theory as a reference, then you can say China undervalued its real exchange rate.

However, Balassa-Samuelson theory assumed that you have a unified nation or labor markets. But China is still a dual economy with a lot of, you know, surplus labor in the traditional sectors. In this process, we can build a model to show that Balassa-Samuelson did not work. And in this process, even the productivity increased very rapidly – expand very rapidly in the tradable sectors. It's a way to sort the surplus labor from the traditional sectors to the modern sectors.

[00:53:38]

And in this process wage rate will not increase much. And if the government – you know, so those kind of exchange rate, if you base it on the revised Balassa-Samuelson theory, the exchange rates in China was very close to equilibrium. And if China's government artificially appreciate the nominal exchange rate, it will slow down the absorption of the surplus labor from the rural areas to the modern sectors.

And as a result, the income of the surplus labor will be replaced and the consumption will be possibly replaced. So it is from this point of view I don't think that that can contribute to – you know, if you change the exchange rate, in effect, it will reduce consumption instead of increasing consumption.

MR. DADUSH: OK, Vikram, your turn, so long as you don't speak about the Balassa-Samuelson effect. (Laughter.)

MR. NEHRU: Well, let me just make three quick points. First, it's important to know that consumption growth has been very high, in fact one of the highest in the world, even though the share of GDP is low because – the share of consumption of GDP is low. GDP growth is so high that the consumption growth rate has been very high.

[00:54:49]

Secondly, the share of labor – the share of wages as national income has declined. And the wages as national income has declined in large part, in my view, because of structural change in the economy away from agriculture, where the share of wages tends to be high, towards manufacturing where the share of wages tends to be low and the share of capital tends to be high. So even if nothing else happened, even if there were no distortions with the financial system, you would expect that the share of household consumption of GDP would decline simply because the share of wages had declined.

And lastly, I just want to emphasize Justin's last point. I find it very frustrating when I – when I listen to or read stuff in the press here about how important it is for China to raise consumption, to raise the consumption share. And this has led to many policy interventions in China which – you know, to subsidize cars and to subsidize refrigerators and white goods and so forth.

[00:55:45]

I think the right emphasis is to attack the distortions in the economy. The decision whether to save or to invest is up to individuals, households and corporations. The important point is that there shouldn't be policy distortions that move them in one direction or the other. And I agree with Justin, it's very interesting. If you look at the share of savings in Korea and in Japan, even after the introduction of several social benefit schemes, even after the removal of many distortions, the share of savings remained relatively high.

They're not beginning to come down in Korea. They came down earlier in Japan. But the remained rather high for a significant amount of time, which suggests that if you believe in the precautionary desire to save, that that precautionary sense remains for a long time because people still don't believe that the government is going to continue to provide their social benefits, as people grow old. Perhaps that's the reason.

[00:56:43]

MR. DADUSH: At some point I want to come back to the panel to ask a question about inequality in China, because inequality is a very, very important issue in the United States at the moment, and I'd like to get a sense of what's happening – which I know inequality has been widening in China – and how that is playing out and how that will play out. But rather than go to that directly, I will come back to that.

I'd like to ask the audience if they have any questions or comments. If you do, please begin by introducing yourself and try and keep it short because we don't have actually a lot of time. We've only got about another half-hour or so. So I'm going to start here at the – at the front over here. We're going to take two or three because there's a lot of hands up. Yeah.

[00:57:36]

Q: Hello. I'm Bill Bran (sp). I work for the government here and I teach some at GW. You made a pretty interesting comment at the beginning about sort of pushing back on the Washington consensus and saying that China's model was sort of better, I guess, is what you said. What I'm – what I'm interested in your – in your analysis is if you look at East Asia, there's another country there that I would argue has done an even better job than China – I would say a far better job than China – and that's South Korea, over the same period.

Especially your last comment that – something like China is still 20 years behind Korea. Well, in 1960, I think South Korea was probably behind China. So South Korea's done a remarkably good job also in East Asia, I think with probably much less distortions, certainly far less inequality than China. Of course, it's a much smaller country. But it's followed a much more Washington-oriented – maybe not exactly opening up, but it's certainly opened up its own capital markets to its own people so that savings were rewarded very strongly in South Korea, in a way that even today savings are not rewarded in China.

[00:59:00]

So I'm wondering, how are you looking at this Washington consensus? To me, that's your strongest statement and most provocative statement that you've made here. And I'd be interested in your analysis of other countries like South Korea.

MR. DADUSH: Good. Yes, the gentleman from the IMF. Yeah.

Q: I'm Karan Singh (sp). I work at the IMF now, but I worked for nearly three decades in India watching China from the Indian borders. A simple question, seeking some demystification here: What could be the reasons for China holding such high reserves? And does China think that holding such high reserves could be a cause of concern for the international monetary system? Thank you.

MR. DADUSH: The lady there – the lady – the – yeah.

Q: Thank you very much, Professor Lin. My name is Luca (sp). I'm a student from John Hopkins School of International Studies. And I'm actually very lucky, I sit in one of your classes – (speaks foreign language) – when I was back in Peking University. So actually, I went through your lectures, which – (laughter) – is, like, sort of like the main content of this book.

[01:00:12]

My question is mainly about interest rate liberalization in China which is explicitly outlined the 12th five-year plan. And very interested in your opinion about the timing of the complete interest rate liberalization in China. And do you think right now that the necessary institutions, legal framework supervisory framework, as well as banking managements is sufficient to conduct a complete – gradual, but complete interest liberalization. If not, why? And also, like, what do you think will be the best sequence and other preconditions for such a liberalization? Thank you.

MR. DADUSH: OK. So we'll come back to you then, Justin, and perhaps Nick and Vikram if you want to chip in. Yes, go ahead please.

MR. LIN: I think that regarding the first one, the experience of Korea, we know that Korea did not following Washington consensus because Korea have a very proactive government interventions in its development process. So in a way, Korea follow more of the structuralism proposed by Latin Americans countries. And the Washington consensus was a reaction to the structuralism, right? So I think your description of Korea following the Washington consensus was not a fact.

[01:01:45]

And Korea did not carry out as much intervention as Latin American countries. You know, in my (March ?) lecture I tried to understand that – 2007. It was because if you wanted to have those kind of structuralist intervention, you needed to subsidize the sectors heavily. And in Korean and other East Asian economies, they're resources-poor economies. In general, unless you are a very resources-rich economy or you are large economies, otherwise it's very hard for the government to mobilize a lot of resources to protect the priority sectors.

And so that's the reason why, although in the 1950s, 1960s, 1970s, other East Asian economies were influenced by this structuralism – those kind of interventionist – those kind of attempt to build in the –(inaudible). But because their government did not have the resources to subsidize the target sector heavily, and so without much subsidies, the sector developed, well, would have to be more consistent with their competitive advantages. So that's my response to your question.

[01:03:05]

The second one regarding this high reserve in China, we need to understand – the large reserve in China was effect only after 2005, and that globally the reserve in the developing countries started to expand in 2001 because in 2001 the global reserve was only 1 trillion (dollars). And by the time of 2007, the global reserve – holding by a non-reserve issuing country – increased to about 8 trillion (dollars). And so we need to understand, how can globally the reserve, owned by non-reserve issuing country, increase from 1 trillion (dollars) in 2001 to 8 trillion (dollars) in 2007? I think that that will be give you a much better insight how come reserve in China increased so much from 2005 to 2008.

And then regarding your financial sectors, I think that –

MR. DADUSH: But wait – wait. So what is – (laughter) –

MR. : So why?

MR. DADUSH: Why?

[01:04:19]

MR. LIN: You know, in China we have – some say that when the water rise, then the ship will rise with the waters. (Laughter.) OK?

MR. DADUSH: All right. This has nothing to do with liquidity creation in the United States. All right, go ahead. Yeah.

MR. LIN: And then coming to the issue of the financial sector reform. I think the most important reform in China is to change the overconcentration of financial structure in the banking systems by the four largest state banks as well as the equity market. China should develop more – some more medium-sized local banks. They can provide the liquidities, the services to small- and medium-sized firms in manufacturing sectors, service sectors and agriculture. And then liberalizing the interest rate will not help much, because if you liberalize the interest rate, certainly most large corporation need to pay more to the banking sectors. And then that will allow the banking sector to have a much larger profit. And it will not help much.

So I think more important is – for the financial sector reform is through changing the financial structure. And in effect I discuss a lot in the book.

[01:05:38]

MR. NEHRU: Can I –

MR. DADUSH: And Vikram – yeah, go ahead.

MR. LARDY: I'd just like to comment on this last question on the financial structure. I have a little bit different view. I think that interest rate liberalization – gradual interest rate liberalization is actually quite important. I think deposit rates would rise. That would help to support private consumption expenditure. Lending rates would go up. I mean, one of the themes of the closing chapter is the overinvestment in China, and I think it's in part because real lending rates have been quite low in the last – you know, since roughly the middle of the last decade, which has resulted in the investment share of GDP going to almost 50 percent, extraordinarily high. So capital is too cheap.

[01:06:24]

And if you want to have a more diversified financial sector, I think it's also important to have interest rate liberalization. Wen Jiabao made this criticism of the banks a few weeks ago and said that they need to be broken up. But I think what they really need is more competition. And the reason you don't have too much competition in the banking sector is we that have price controls; that is, the interest rates are fixed by the central bank. In particular there's a ceiling on deposit rates and a floor on lending rates. And that means it's very – it's difficult to erode the incumbent position of the large banks that have massive deposit-raising capability.

There has been some erosion, however. If you look at the Big Four banks – and the so-called state-owned banks are now so-called commercial banks – if you go back in the late 1990s, they had about 75 percent of the banking business, about 75 percent of assets. Today they're down to around between 40 (percent) and 45 percent. So their share has been cut in half, and there have been many, many new financial institutions and banks – community banks, local banks, rural banks – I mean, the Chinese now say there are – I can't remember the number – 3,800 different banks in China. Many of them of course are quite small.

[01:07:36]

But I think if you want to have a change in the structure, that it is important to have more flexible interest rate structures so there can be more competition, so the more successful banks will be able to expand and the – maybe some of the incumbent banks would have their position eroded. And I don't think interest rate liberalization implies that bank profitability would go up. You have more competition if you have liberalization; bank profits would come down.

MR. LIN: My view is that, you know, unless you break the monopoly, otherwise – (inaudible) – the prices will allow them to have a(n) even higher monopoly rate.

MR. LARDY: So the flexibility to go up in the lending rates now. I don't think there is a monopoly.

[01:08:17]

MR. LIN: Then if that is – (inaudible) – implement, that means already you liberalize the interest rate already, right? Because they can –

MR. LARDY: No, but the deposit rate has a ceiling. And the spread is fixed.

MR. NEHRU: Yeah.

MR. LARDY: So it's anticompetitive.

MR. LIN: But you know – because if you go to (Wenzhou ?) in order to study those kind of local, small banks, even under current situation they are so profitable already. So it's – the main trouble in China is entry. The entry is controlled. And if entry is removed – the entry control is removed, then the competition comes, and the interest rate, you know, certainly will need to be fluctuated. But currently, you know, it's allowed to increase the rate, but it's not – you're right, it's not allowed to raise the deposit rate.

[01:09:07]

MR. DADUSH: OK, I'm tempted to comment that no economic system has been created where banks are not creating trouble. (Laughter.)

Go ahead, yeah. Yeah, Vikram.

MR. NEHRU: No, I – actually I have some strong views on this. But I – it's been discussed enough. So I – perhaps we should move on.

MR. DADUSH: All right. Yes, the gentleman there in the middle, and then we'll go to the gentleman there at the back. Yeah, go ahead. Yeah.

[01:09:35]

Q: OK, thank you. Dong Huiyu with China Review News Agency. My question is for Professor Lin. Recently the World Bank's report caused a lot of debates in China. And do you think the World Bank's recommendation for Chinese economic reform in the next 30 years are good for Chinese economic substantial growth and social stability? How would you evaluate the (momentums ?) of economic reform right now in China? What should be the priorities of further economic reform in the near term and the middle term? Thank you.

MR. DADUSH: Well, that should be an easy question to answer. (Laughter.)

Yes, way at the back. The gentleman – yeah.

[01:10:26]

Q: Yes. Clem Miller, Wilmington Trust Investment Advisors. You alluded briefly to equity market reform. I'm wondering if you could expand on that. You know, sort of beyond the banks – equity markets, bond markets, currency markets – what kind of reforms are needed there?

MR. DADUSH: OK, we'll take one more. The lady here. Yeah.

Q: Yangyi Chan (ph) with Hong Kong Phoenix TV. Given the security – Strategy and Economic Dialogue will be held on May 3rd, I want to know that – according to U.S. and China Business Council, there are lots of foreign investors, they help the – Secretary Geithner could help raise some issue about to improve the climate for the – for foreign investors in China. So I want to know that will the experts foresee that any issue will be put on the table in this dialogue?

MR. DADUSH: All right. OK. Go on, Justin.

[01:11:25]

MR. LIN: About the China 2030s, Vikram can be a better person to answer because he is the task team's leaders of the report. And for me, I think a lot of the recommendation in the China 2030s have been discussed in China. And I think the most important value is that this report put all those recommendation in a consistent framework. And as I – you know, I referred to earlier in China about the direction of reform and the area of the reform, basically people have some ideas. But how to implement that depends on domestic economic situation and global economic situation.

When you have a global crisis, then it's harder to push domestic reform because in general those reform areas may reduce the job opportunity or something like that. And the government – (inaudible) – will be redundant unless you see some kind of very dynamic growth in the economy, otherwise you will not implement any reform which has some kind of (confessionary ?) implications, right?

[01:12:39]

And regarding the financial sector reform, China's a developing country. So certainly China will not have the (seminal ?) financial structure as in the high-income countries. And from what I see, the most important reform – you know, in my book and in other writing – it's most important of the entry of small and local financial institution, and especially small, local banks, because those are the financial institutions that could provide financial services to the agriculture households, to the small and medium-sized enterprises in manufacturing sectors and in service sectors.

And still today the employee – more than 60 percent, 70 percent of labor force in China. But because overconcentration of financial, you know, structure, they did not get the financial services. So those are the areas from my own understanding should be the priorities. And the bond market and so on – certainly we need to try. But that should not be the main focus of the financial sector reform at this stage.

And the third one – I did not follow, you know, day-to-day about what will be on the table of the dialogue and so on.

[01:13:56]

MR. DADUSH: OK, thank you.

Did you want to add something, Vikram? Or – yeah.

MR. NEHRU: Well, let me just say one – make one point about China 2030. And that is that, you know, during the discussions of this report, we discussed a huge range of areas. But there was just one common underlying theme. That theme is that there has to be a change in the role of government in China; not a change in the size, not an increase or decrease in the size of government, but a change in the role of government.

In certain areas the government needs to step back and be an indirect influencer of economic decisions through rules, regulations, laws, without being a direct participant in the market. But in other areas, the government has to be much more proactive in areas of delivery of public services, to improve the environment, to ensure that there is social security. And there we feel the government really has room to increase its activities in the economy. And this requires a shift in direction, not a change in the size or a retreat from the economy necessarily.

[01:15:11]

MR. DADUSH: Good. Yes, the lady here.

Q: Hi, my name is Lin Jones. I work for the U.S. International Trade Commission, but that has nothing to do with the U.S. government. So I just want to ask you a question that have not been touched upon during today's discussion, is about China's demographical changes. China is going through a rapid demographic change during – and there is a saying that China poverty – before China getting rich, China is getting older.

So I just wonder, you know, your project to the China were a continued growth at 8 percent for the next 20 years, have you taking into the consideration of the demographic change in the Chinese? And how – what kind of impact do you anticipate on the – China's economic growth? Thank you.

[01:16:10]

MR. DADUSH: Good. OK, well that'll – if there's any other question, because that's – then I'm going to close it to questions, because we're coming due. Yes, the gentleman there, and then the lady. Yes.

Q: Thank you. Jack Zhang, Eurasia Group.

MR. DADUSH: You need a mic.

Q: Thanks again. Jack Zhang, Eurasia Group. My question is about the global context of development. So you referenced Japan, Korea, Taiwan and their development. But it seems to me that they developed during a time when globalization was at a lower point – had less impact on development than China has. And they relied a lot more on indigenous innovation. Will that be the case for China, and can China develop those capacities to do indigenous innovation in order to sustain growth? Thank you.

[01:17:06]

MR. DADUSH: Yes.

Q: Yes. I'm Martha Holdridge (sp), a resident in China in the '70s, early '70s. I would like to ask whether you have done any environmental accounting and whether, if you have, you find that that could deter the rate of growth, because there's a lot of repair to be done.

MR. DADUSH: OK. Justin?

MR. LIN: OK. On the first one about the aging in China, and it's an issue has been discussed quite extensively in China. And I think that aging – you know, whether it's going to reduce the growth rate – the growth potential, I, you know, predict – I think not for several reason. The first one, the retirement age in China today is extremely young. You know, for the female, they retire at 55 or earlier. For the male, they retire at 60 or earlier. And I – if aging is an issue, it's possible to extend the retirement age, right, and to offset the reduction in the labor force. That's one thing.

[01:18:31]

And secondly, it's foreseeable. So China can also modify the family planning policies; allow, you know, some family to have two children instead of one. And in fact China already modified some of that. So that can, you know, also – (inaudible) – the reduction in the labor force in 15, 20 years from now.

And a third one, more important, that you can have the – you know, the substitution between quantity and qualities. So if you see that the labor supply is going to be reduce in the future, you can increase the investment in education. And you know that China expanded education investment very aggressively in the past few years. And it will continue to do that in the coming years. So if you take all those, you know, adjustment, I think that the aging will not be, you know, barrier for China to continue the dynamic economic growth.

[01:19:35]

The second one is that, you know, the environment for the growth of Japan, Korea and Taiwan. I think that as long as an economy can provide goods at a competitive cost, the market will always be there. Even you have a slowdown in the global economy, that means the consumer in high-income country or other country – they would love to have cheaper goods. So as long as you can provide goods at a competitive cost, you always have the market. And the question that – whether China can do that or not, and my recommendation is that it'd be – (inaudible) – your competitive advantages. And tap into the potential advantage of backwardness – you (will ?) be able to produce at a lower cost compared to others.

[01:20:24]

So you know, I think that that – you know, if you have a dynamic, growing global economy it's fine. But even in a global economy is slowing down, as long as you can follow your competitive advantages, you can, you know, grow – continue to grow. And regarding your statement that Japan, Korea and Taiwan, they did much more indigenous growth, that was only after, you know, they reached the high-income status. In the early stages, in effect, they imported a lot of technology. They license the technology. Japan was famous for licensing technology, right?

And only when they reach high-income status, their technologies – their industries were on the global technological frontiers. Then they started to increase much more in the R&D in the indigenous growth. And currently, for China, most industries still locate regional global technology frontier. China still has the potential to benefit from the advantage of backwardness. Certainly certain industries in China – many already hit the global technology frontiers. For that, if China wanted to maintain competitiveness in those kind of sectors, China need to increase its R&D in those kind of sectors.

[01:21:43]

And also, even a country wanted to – wants to benefit from the advantage of backwardness by, you know, importation of technology, you also need to do some kind of process innovation. And you can see, you know, China and other East Asian economy, they also engage a lot of – in the process innovation. So I think that – you know, I'm still confident that a possibility for China to upgrade their industry, to diversify industry's still huge. And those kind of upgrading – (inaudible) – that China has high saving rate, allow China to maintain rate and other growth in the coming decades.

The last one about it – and while I'm on the issue – well, you know, China is an economies – it's an economy with continental sense. So most people say, well, environment and climate change is externalities. But in China, all those kind of things need to be internalized. Because of that, Chinese government is very serious about the climate changes, about the environmental, you know, improvement and so on. So if you, you know, talk to those people in a group or discussion, they are very impressed by the unilateral action that the Chinese government, you know, have taken – has taken regarding the climate changes and environment.

[01:23:06]

MR. DADUSH: OK. Thank you very much. I'm going to draw it to a close. And – however, I'd like to ask the panel my question about inequality and then ask them to give any concluding remarks. So my question on inequality is how serious a problem is inequality in China today? And is there any comparison you want to draw to the United States, one way or another, in terms of the seriousness of the problem? And also, what, if anything, can be done about it? That's my question. I also ask you at the same time to make your – any concluding statement you have.

So I'll start with the discussants, if I may. Nick, do you want to – do you want to go first?

[01:23:59]

MR. LARDY: Well, let me say first of all, this is not an area I've worked on in any – in any depth at all. And second – my second comment would be, I think the data on income inequality are not as good as we'd like to them be. I mean, the government doesn't – well, we have some Gini coefficients that have been published over the years in a lot of World Bank publications. There's no official – occasionally government agencies put out a number, but I think there's some degree of uncertainty of exactly what the level of inequality is.

I think we know the stylized facts are that inequality declined very dramatically in the first seven or eight years of economic reform through the mid-'80s and it seems to have gotten steadily worse. My impression is that it is at least as bad as the United States, and possibly worse. But maybe Vikram has a better fix on that. And there are lots of problems. They have a tax system that relies entirely on indirect taxes. The total take of the personal income tax is now less than 1 percent of GDP, so the – taxing higher-income people – you know, having a differential income tax that might be redistributive is certainly not a policy option given the current structure of the tax system.

[01:25:18]

There is, I think, an increasing degree of redistribution in some expenditure policies. The building out of the social safety net I certainly think is benefiting more people at the lower income than at higher incomes. So I don't really have any recommendations on policy other than the rebalancing that we talked about earlier would help. I think faster growth of wages would help. Faster growth of the modern sector labor force, getting more people out of agriculture into the modern sector, would help the measures of income inequality that we look at.

MR. NEHRU: On inequality, I think all the evidence – and it's not just evidence on income inequality, but all the other evidence that we can get from house ownership and access to various services and so forth all point to rising inequality. And in fact, if you look at income inequality, it appears to have paused, but not the other measures of inequality. So it's not clear whether this is just a pause or whether it's an inflection point as a far as income inequality is concerned.

[01:26:20]

Now, whenever I sort of mention income inequality in China, I always use a phrase from my colleague Moises Naim in Carnegie. He says: Income inequality is like cholesterol. You have good cholesterol and bad cholesterol. (Laughter.) You have good inequality and bad inequality. Inequality that comes about because of differences in talent, ability, hard work clearly is the kind of inequality you want in order to maintain incentives for productivity growth. Also inequality that comes about as a result of structural change, as people move from low-productivity agriculture to high-productivity industry – the Kuznetsian effect, so to speak – is toward initial rising inequality before you ultimately get a decline in inequality. These are the sorts of inequalities that a country should – could – should try not to disturb.

[01:27:07]

However, having said that, a major contributing factor, in my view, to rising inequality in China is rising inequality of access to opportunities – opportunities for health, opportunities for education and opportunities for jobs and opportunities to get finance. These four areas are leading to a sort of a bifurcation, if you wish, between those in urban areas who have access or the high-incomes who have access to social services, good education, high-quality education who – and large firms which have access to finance, and people who are connected who have access to jobs.

The big inequality difference in China, unlike any other part of East Asia, incidentally, is rural-urban inequality. It is not intra-rural or intra-urban inequality. And increasingly, incidentally, the interior regions of China are now growing faster than the coastal regions in recent years. So some of the inter-regional inequality is beginning to decline, but rural-urban inequality continues to be high and continues to increase.

[01:28:11]

So the implications for government policy, in my view, are abundantly clear: that there must be increasing expenditure on providing services for health, education and social protection in rural areas and for migrant workers in urban areas who don't have access to such – to such services. It's a very clear result. The question in the minds of the government is how much.

How much do you finance? Because the government does not want to fall into the trap of high-income countries where you have an entitlement society which becomes fiscally unsustainable. So they want to provide a set of services which they can sustain over a long period of time, even during difficult times. And therefore, they want to be careful. And I think that that caution is well-warranted. Thank you.

MR. DADUSH: That's another way in which developing countries learn from advanced countries. They learn to avoid their mistakes. (Laughter.)

Justin, yeah.

[01:29:11]

MR. LIN: To me, inequality is the most serious issue in China. And I made that clearly in my books and also talk about that on many occasions. And I agree with Vikram: The, you know, inequality in the access to opportunities is serious, and therefore that the government need to improve the provision and so on in the public-goods areas. But also income inequalities in China is also very high. And according to the Gini coefficient, it's close to the Latin American situation.

And Nick mentioned that in the East Asian economies, like in Korea, Taiwan, Japan, during their rapid growing period time they achieve high growth and equities. And how can that – China follow the East Asian models after the reform? China achieved high growth, but the income disparity continued to widen. I think that related to the dual-track approach that China adopted. As I mentioned, China continue to provide certain kind of subsidy and protection to the priority sectors through the financial (depression ?), through the low levy to their resources and also some monopolies.

[01:30:39]

In a – in a financial sector, you know, only large corporation owned by state or by rich people, they have – get financial services. And because of financial repression, in effect, they were subsidized. And who subsidized them? Well, people put their money into the banking sectors that received low interest rate. And those people are relatively poor. And so in effect you are asking poor people to subsidize the large corporation owned by the rich people or the state. And so that's one of the source.

Secondly, you know, natural resources. In the past, low levy was designed to support the state-owned mining firms. But after, you know, '83, '84, the private sectors can also entering into the mining. And after 1990s, the prices of mining has been liberalized, but the levy did not increase. So those people who can get access to mining, they immediately become billionaire. So that's another source of income inequality. Then certainly, if you have monopoly, you have monopoly rent. And then those companies, they pay actually high salary to their workers, and other sorts of income inequalities.

[01:32:00]

So from what I see, if China wanted to achieve similar result of dynamic economic growth with equity, the way is to complete the reform, the transition from planned economy to a market economy by removing the remaining distortions. And I think that if China can do that, not only China can improve the income distribution, China can also continue to tap into the potential of 8 percent growth rate continuously for another 20 years.

MR. DADUSH: OK. Thank you very much. I think in this session we had a glimpse of the extraordinary complexity of this Chinese economy of 1.3 billion people, about four times the population of the United States, undergoing a transformation among the most rapid in history. By understanding it better, I think – and understanding some of the issues that policymakers are confronting, the enormously complex issues, I think we also have a better chance of – a better chance to manage this transition of this enormous economy that is bursting onto the scene in a way that hopefully minimizes international frictions.

[01:33:38]

It's very, very important for us to understand the internal workings of China for that reason, if for no other. And so this session has, I think, covered that very well. And we're enormously grateful to Justin Lin, who has brought his extraordinary experience and his wisdom and his balance to demystify the Chinese economy for us. It's also our opportunity to bid farewell to him and to say that this door will always be open to you. And you're still a young man; at least – (laughter) – at least you look like a young man. (Laughter.) And so I hope there'll be many more opportunities.

And Nick, again, thank you very much for joining us again in a Carnegie event. And I'm not going to thank Vikram because, you know, he's paid to do this here. (Laughter.) But thank you – (chuckles) – thank –

MR. : (Inaudible) – East Asian studies –

MR. DADUSH: Yeah, no. That's too. Thank you very much, all, for coming. Thank you. Good bye. (Applause.)

(END)