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Transcript

CHINA'S UNBALANCED GROWTH: VICE OR VIRTUE?

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URI DADUSH: Good morning. Good morning everybody and thank you very much for being with us this morning. My name is Uri Dadush. I'm standing in for Doug. There are some problems with the Metro this morning and so Myron might manage to make it, but Doug is still struggling out there. So as soon as he comes in, I get to have my free breakfast – (laughter) – and he – and he – (chuckles) – he will take over.

This is actually a wonderful subject, "China's unbalanced growth, vice or virtue?" And we are going to – I'm sure – have a very lively discussion around that question with Yukon Huang, my former colleague at the World Bank and now my current colleague at the Carnegie Endowment in the Asia Program.

Also, Michael Pettis, who is a senior associate, also, with the Carnegie Endowment based in Beijing and he is there on that screen. And of course, Myron Brilliant, senior vice president for international affairs, U.S. Chamber of Commerce. I'm not going to go into the details of the vitae because you have them and I also want to have as much time as possible for this vital topic. So let me ask Yukon to kick it off and then we go on to Michael and then Myron. Thanks.

YUKON HUANG: Thank you very much, Uri. Let me start off by apologizing for using slides. This presentation is more visual than normal. Anyone who's interested in China realizes very quickly that it is different. And I would say that its defining feature is its scale, its economic geography, and its location of people and activities.

And this economic geography – this spatial dimension essentially defines China's development strategy and our understanding of these features actually helps one understand the course of future policies and changes.

Let me begin by pointing out something which is kind of odd. What did Deng Xiaoping and the Nobel Prize Winner Paul Krugman have in common? Now, Paul Krugman, as you know, is the noted columnist of The New York Times. He writes frequently about everything, including China.

And some others realize he won the 2008 Nobel Prize in economic geography. He won this prize on the basis of a paper he published in 1979, which defined a location determined the pattern of trade and growth.

Coincidentally, Deng Xiaoping launched, in 1979, his strategy for developing China, which moved China from a strategy of balanced growth to unbalanced growth. And ironically, Mr. Krugman is a major critic of China's policy, although China is probably the best example of the validity of Paul Krugman's views. Let me show you exactly what Paul Krugman had in mind.

Essentially, new economic geography says there are three factors which shape growth: density, distance, and divisions. We call this the "three Ds of development." Density means that you concentrate activity, in China's case, along the coast to realize economies of scale and specialization. Distance means that you improve transport to facilitate movement of goods and people. And divisions mean you break down the barriers between provinces and with the global economy to improve connectivity between markets.

Essentially what Deng Xiaoping did for three decades was to work on density, distance and divisions to transform China into one of the most competitive export-oriented countries in the world. And he began by, first of all, saying let's put our incentives or our books along the coast. He started by creating what I call special export processing zones– special zones along the coast in 1980, basically centered around Fujian and Guangdong province.

And then along the 14 coastal cities and in the three deltas, Shanghai, Fujian, Guangdong province here, and border cities along the western and northern portions and then along the Yangtze River. Now, there's one thing very different in the case of China. Its special incentives are solely oriented toward trade and production. Most people give special incentives in what I would call the backward regions to try to bring back what I would call the poorest areas. In China's case, incentives are always focused on trade and production.

The second thing he did was very unusual. If you go back to 1980, the budget is split about equally between money for the coastal areas and for the inland areas. Deng Xiaoping deliberately changed that mix so that two-thirds of the money went to the coast; one-third went to the inland regions. Only now is this balance starting to become equalized.

So put your incentives along the coast. Put your money along the coast. And most of this money was for transport. This is the location of the density of roads in China back in 1978. It's very odd. It's actually essentially equal. And then you start to concentrate only in the three growth areas along the coast. And then you start developing the coast and then you start moving inland.

Right now, what China's doing is actually filling in the gap. But more or less, you begin by concentrating along the coast. So put your money, put your transport, and put your incentives along the coast. And of course, the people follow. And you essentially, you have a herd of 50 million migrant workers going from everywhere to the coastal areas here. So you move your people.

These people essentially moved on their own accord. It wasn't like the government actually encouraged it. It just flowed. So you have money, people, incentives, infrastructure, all along the coast. And what do you get? You get a completely different location of activity. All your globalized industries centered along the coast in China, extraordinary concentration, extraordinary specialization.

Your resource-based industries and domestic-oriented industries, they're all over the place, which is what you'd expect. Now, if you look at an industrial map of China 30 years ago compared to today, you'll see there's a whole total switchover in terms of where industries are located from what I would call a balanced – spatially balanced to a spatially concentrated, specialized location.

And this allowed China to get economies of scale that no other country has been able to achieve and frankly because no other country can go through this process of concentrated resources, people, in one particular area.

Now, this is a graph that only economists like, but let me spend a little bit of time on this. This is a plot of the rates of return to revenues of enterprises, depending upon where they're located. If you go back to 1978, what you see is when Deng Xiaoping began concentrating resources along the coast, the rates of return of enterprises along the coast, which are these plus signs are much, much higher than those which are in the western region, which are the triangles. And the Xs are the central.

And there's extraordinarily wide dispersion. So rates of return of companies vary enormously depending upon where they are located. Now, what is extraordinary in China is the convergence over time. Their location is beginning to become – it doesn't matter. This is the consequence of what I call the internal competition in China.

Now, not only has this concentration – this variance in terms of rates of return narrowed, it still reigns extraordinarily high. So this is a diagram of what I call the efficiency of competition in China, the competition across borders, across provinces, forces returns to equalize depending and regardless of where location is.

You're getting into a situation where it is becoming relatively neutral in terms of location and activities. Now, how does this translate to GDP growth? You go back to China in 1970 – 1980 – '79, actually. Here it is, going very slowly, but the growth rate between the coastal areas, which is this line here and the inland regions, the central provinces and the western provinces, they're more or less the same.

You've got balanced growth or very low growth. Then you start concentrating your resources along the coast and you see that the coast is beginning to pull away. This is the Tiananmen years. That's why the growth collapsed. But what you see is that this unbalanced growth process leads to an extraordinarily wide – first of all – divergence between coastal growth rates and the inland growth rates.

This red line is the all-China average. This is the central and western; this is the coast. It hits the peak in the early '90s, where the coastal regions growing about twice as fast as the inland regions. Now, this is what's really extraordinary. It's starting to converge. And if I extrapolate this line for the last two years, what you find is that the inland regions are now growing faster than the coastal regions.

So this is what I call extraordinary movement from balanced, to unbalanced, to balanced. The future pattern is going to be more like this and the issue will be whether the coastal region will suddenly start to grow significantly slower than the inland regions over time. But this is what I call extraordinarily effective concentration growth strategy of unbalanced to balanced growth.

Now, what is the current debate in China? The debate is whether China's growth should be more balanced. Should China continue to rely on investment-led, export-oriented growth strategy? Can consumption play a greater role? Should China reduce its trade surplus to resolve the problem of global trade imbalances? Will appreciating the renminbi solve the problem? Can the threat of increasing coastal-inland and urban-rural income disparities be reversed?

Now, let me just spend a few minute son each of these three questions and each of them is very, very complicated. But where I want to focus in is a little bit more on what are the nuances of the debate and where do I feel that the debate – where the coverage doesn't actually capture the reality of what's going on in China against this kind of presentation I just made.

The first point I'd like to make is everyone realizes that consumption is growing much slower than investment. This is the growth rate of investment. This is the growth rate of consumption. And the debate, of course, is the share of consumption relative to income is very, very low. The share investment to GDP is very, very high.

So the first question of unbalanced growth is can you increase the share of consumption? Can you reduce the share of investment? But before we begin with that question, I would just like to raise the point against the background, why do you want to do this? If this strategy led to this rapid growth, what's so wrong with this? And let me come back to that because it's not an easy question to answer.

But the second point I want to make is if you want to increase consumption in China, from the Chinese perspective, the first thing you will note is that the growth of consumption, first of all, is relatively high. It's eight or 9 percent a year, the highest in the world, annually. And the second thing you realize is it's very, very steady. You can't actually influence consumption too much because it's essentially related to household income.

So it's not something that jerks up and down. But investment is very erratic, and it's erratic for a couple reasons. One is the major stimulus program here jumps up. And here, it's coming down from the major stimulus program, the Asian financial crisis. So aside from what I call the countercyclical boost that the government gives to stimulating the economy through investment, it creates a tremendous amount of what I'll call variation investment so that what I would call the long-term stability of investment is a different issue.

Now, the big question is, is this going to come down? Should it come down or not? But what I want to point out is it's very hard, actually, to change the pace of consumption, but it is a lot easier to change the pace of investment.

Now, the first point I'd like to make is the sudden increase – this jump up in investment in China is really to increase savings in corporate profits. The enterprises are making a bundle. And what's unique in China is China's corporations don't pay dividends. And since most of the big companies making money are owned by the government, it means that the government doesn't get anything from these corporations.

The corporations keep this money. And since they keep this money, they don't know what to do with it. They either spend it or invest it, wisely or unwisely. In many countries, maybe 30 percent of your retained earnings are paid out in dividends. In China, it's two or 3 percent. So what is the easiest fix to the problem?

The easiest fix is to get a dividend policy that channels money from corporations to the government, directly or indirectly to households. But this is really different – this is really difficult. The government's passed a law trying to do this. And even if they do this, it's only going to be maybe four or five or 6 percent, maybe 10 percent at most. So there's a problem.

There's also political resistance to pulling the money away from corporations. There's something – what I call state capture, which on account of corporate influence makes the government unwilling to take money away from the corporations. This is the key fact. If you really want to bring down or change the composition of investment or the level of investment, you've got to somehow change this dividend policy. There's no other measure that's as important.

Now, the reallocation resource of the government would change the composition investment, but what you will change is that if this money flows into the government, it's more likely to go to what I would call social infrastructure and less likely to go to what I call industrial capacity expansion, which is what P-4 worried about.

Let me return to the final point. Stimulating private household consumption is a longer term option; it depends a lot on the rise of the middle class and the shift of location of activity. I won't get into this discussion. A lot of people are focusing on the rise of the middle class in China and how much it's going to actually change the pattern of consumption and the pattern of activity in China.

Well, there's a big problem. The way that the income distribution of China is shaped means that the middle class in China is in some sense much smaller than it should be for this kind of a country and its income level. Therefore, its boost to consumption is not as great as you would expect. Now, how do you change this?

Well, fundamentally, the change is they have re-allocate it. And that is not a trivial, short-term matter, but that's the spatial dimension. It's not going to happen unless these people move. But I also would like to point out that why is it that China is so reluctant to give up this investment-led strategy?

Well, here is China over the last couple decades. This investment-led strategy has elevated China in terms of labor productivity to a class by itself. Extraordinary high labor productivity compared to everybody else in the world. And this explains why China's extraordinarily competitive and why even today, despite all the problems, the global recession, despite rising wages production, exports still boom.

It's living off of a productivity increase which is extraordinarily strong and sharp. And frankly, it'll take many, many years before it becomes what I would call comparable to the levels in other countries.

Now, how important is currency evaluation in this strategy of trying to balance growth prospects in China? Well, basically, I don't think this focus on the currency is very helpful. It actually shifts the focus from something which is I don't think really important in the China context and diverge it from other things which I think is more important.

From a Chinese perspective, there is recognition that they have to moderate their trade surpluses. They realize that it's got to be part of the solution to global imbalances. But from their perspective, they're saying let us focus on China increasing its imports and this can occur through improved consumption but improved consumption or higher consumption is very difficult.

But you can do it through investment, through soft – what I call social infrastructure. And that is a more palatable message than asking China to curb its exports through currency appreciation, which has an income-depressing effect for China. So they see a boost in imports through an increase in investment as a win-win strategy because it increases global demand, China's demand, and helps the external imbalances.

The currency appreciation focusing on repressing exports is a global demand-depressing effect which they do not see as a win-win. Secondly, they see something has to happen on the capital account. Money is flowing into China. It creates pressure to appreciate the exchange rate. It leads to inflationary pressures.

But the quick fix here is China's really got to start liberalizing the capital account, but it's got to begin by liberalizing outflows rather than worrying about or liberalizing inflows. And if it liberalizes outflows, money will pour out of China.

Now, why will it pour out of China? Because all of this repression – of not allowing Chinese households and firms to easily move their money out – if you allow them to do so, they will diversify their portfolios and a ton of money will go out even though perceived rates of return in China are relatively high. And that outflow, actually, will reduce this pressure on currency appreciation.

So a win-win kind of solution focuses more on focusing on capital outflows, focusing on imports increasing in China to resolve currency – resolving the trade imbalances rather than the exchange rate, per se.

Now, the trade imbalance is actually beginning to resolve itself, even if you don't change the exchange rate. Now, economists will argue if you have a trade imbalance you can do two things. Either you change the exchange rate, appreciate it – nominal appreciation – but if you don't, you'll have inflation.

And when those prices rise, it basically changes your real exchange rate and solves the so-called trade imbalance by itself. And that's what you see in China. That's what you read about in terms of its inflationary pressures. It's actually impacting upon the real exchange rate. Now, is this all negative in China?

I would just like to point out is that this inflation in China is not actually all negative. And the reason that it's not all negative is because it's regionally or spatially differentiated. It's higher along the coast than the inland. And the consequence is something that you read about, which everyone applauds: factories starting to move inland and starting to find cheaper workers inland. And this is part of the rebalancing effect.

So personally, I find this kind of differentiated inflationary consequence not bad, actually. It solves the trade imbalance problems, and it starts to address what I call the internal spatial imbalance, which is a big issue in China. And one of the reasons it's a big issue is, unlike other countries where you might have 50 or 60 percent of your people on the coast or activities on the coast, only one-third of China's population is along the coast. One-third is in the central. One-third is in the west.

A China of 20 or 30 years from now will have the gravity of economic activity in the central provinces, not along the coast because as it becomes more domestically oriented it needs to serve the domestic market. The logical place to serve that domestic market is the central provinces.

So places like Chongqing, Wuhan, Changsha – they're going to grow in relative importance vis-à-vis the coastal and the inland – relative importance. But China does need a more flexible exchange rate for monetary management. So I think that is an important issue. But the last part I'd like to focus a little bit upon is this rising inequality.

This really is causing problems in China and keeps the leadership from sleeping very peacefully at night. This is the Gini coefficient. A Gini coefficient is a measure of your overall inequality. It's getting close to 0.50. And it's steadily been rising over the last several decades. So China's income inequality is increasing.

But what I'd like to point out is that the Gini coefficient in China of close to 0.50 is essentially the same as the United States. It's the same as in Singapore. It's the same as in Malaysia. It's actually lower than where it is in Latin America.

So what I call the national measure of inequality in China shows inequality increasing dramatically, but it's a level which is not significantly different than other, what I would call regions and successful countries. What is different in China is the ratio of urban-to-rural, which is close to three. That is the highest in the world.

There's something really strange in China when you're urban-to-rural income ratio is three and your coastal province income ratio to inland is exceptionally high. So the inequality in China is very much a spatial issue. It's not the normal thing that you read about in other countries. It's the inequality between urban-rural areas. It's the inequality between the coastal and regional areas.

So the real question is how do you address this kind of a spatial factor? Well, the first thing I'd point out is that China's fiscal system is incapable of redistributing across provinces for a whole bunch of political reasons. So you can't tax Shanghai, Beijing, Guangdong a lot and send it to the other provinces easily. China's fiscal system is just not able to do this.

The biases for the past imbalanced growth need to be moderated. And we saw what all of those biases are. They need to be dealt with. You really have to solve it; however, by the location of activity between the coastal-inland areas, the only real solution in China is migration and urbanization. People have to move.

Those of you who understand China, the problem with moving in China is the hukou system, the residency rights. It's not easy to get the right to live in Beijing or Guangdong province if you move from another province or if you move from rural areas. You don't get the social services. You don't get the housing. You can't move.

As long as that's the case, the urban-rural income differential will remain large. The coastal-inland regional income differential will be large. Your ability to influence consumption – to have an increase in the middle class cannot be achieved. This global imbalance problem everyone's stuck with here – you can't fundamentally resolve this until frankly, you change the hukuo system.

You get this great irony. You go from this global trade imbalance to this – to the policy lever and the policy lever is the hukuo – the movement of people. That's fundamental, but changing the hukou system is a very complicated subject by itself, so let me skip that.

Now, if you get it right – (laughter) – if you get it right, you're going to have balanced growth, but only over decades. Consumption will rebound upwards. Investment will no longer go zooming up; it'll start to modify. This is the path of urbanization in China if you eliminate the hukuo system. It's going to be a country with 70 percent urban rather than 45 percent.

The quicker you do this, the sooner most of China's problems and the global imbalance problems will be resolved. And if you can do that, your rural-urban income ratios will fall dramatically rather than continue to spiral upwards. So very quickly, here is what I would call the answers to the four major questions that people are debating.

Will growth be driven by exports, investment or consumption? Well, the balance will be restored, but only gradually. Wages and consumption will rise as the share of income, enterprise, and investment decline. Trade surpluses in China will not disappear. They will moderate, but they will remain substantial for a long time.

Will growth slow down? Lower investment rates and trade surpluses point to slower growth, but if China can increase productivity, decline will be modest with more sustainable outcomes. Now, what do I mean by productivity increases? They've actually exhausted much of the productivity increases in what I would call the normal form.

The major remaining productivity increase available to China is moving people from rural areas to urban areas, where their productivity doubles. So what China has to also realize is that movement actually is the great factor that will maintain growth rates in the coming decade if they let the people move.

Can you reduce income inequalities? Yes. As growth centers move inland, if differential regional price inflation exists, wages will rise. But this is a long-term process and you basically have to allow people to move. Now, is appreciation of the renminbi in the interest of the United States and China? A major revaluation is not in the interest of the United States, but greater flexibility is in the interest of China.

And there are other ways, actually, as I've indicated, to moderate these Chinese external surpluses, which I would call – more of a win-win approach rather than a win-lose approach, which is what I think the media tends to exaggerate or focus upon. Let me stop there. Thank you. (Applause.)

DOUGLAS PAAL: Thank you, Yukon. You're going to have to change all of American teachings and combine geography and economics together – (laughter) – as a consequence of what you've discovered in China. I owe you all an apology for being late. It's kind of living a metaphor of America's urban decline – (laughter) – Metro was down and the escalator's down so I'm out of breath.

But I'd like to turn now, quickly, to Michael Pettis, who has been waiting for us in Beijing at the Carnegie Endowment's – we're the world's global think tank and we have an office in Beijing and Michael is professor at the Guanghua School at Peking University and a very popular blogger, too. If you don't know his blog, look it up when you get home. But Michael, I'll turn it over to you for your perspective. Thank you.

MICHAEL PETTIS: Thanks very much, Doug and greetings from freezing Beijing. (Laughter.) I agree. I want to pick up one of the things that Yukon said and – briefly about the currency because I think Yukon is absolutely right. All of this focus on the currency can be a little bit misguided.

It's not because the currency doesn't matter. The currency matters a great deal as part of the imbalances. But it's one of several important factors and probably not the most important factor that matters. I would want to frame this a little bit differently. And one thing, I guess, is that I think it's dangerous to conflate rapid growth with unbalanced growth. And what I would argue is that beginning in the reforms in 1978, China had a decade or so of very rapid growth and growth that I wouldn't really consider unbalanced growth.

It's really only in the last decade, perhaps following the Asian crisis in 1997 that we begin to see significant imbalances within the economy, especially the imbalance that matters most according to Premier Wen and a number of other people and certainly something that I would agree with, which is the consumption imbalance.

Now, before the Asian crisis or before the year 2000, China did indeed grow very, very rapidly and it was very much an investment-driven growth. But it wasn't an unbalanced growth. If you look at the household income share of GDP or if you look at the – (inaudible, audio interference) – share of GDP, it was lower than many other countries, but it was not unprecedented. It was not out of control.

It was sort of typical, maybe a bit – a little bit lower than some of the other Asian countries that followed a similar growth model. But things changed dramatically sometime in the last decade. And I think there were a number of things that might have affected that change.

First of all, China devalued the currency – I want to say it was in 1993, perhaps 1994, significant devaluation of the currency. And that became part of what later on became the significant imbalanced growth within China. But during that period, if you look, for example, at interest rates, interest rates were low but not exceptionally low. In real terms, they were quite reasonable.

More interestingly, wage growth was a little bit slower than productivity growth, but not a whole lot slower. And I'm going to come back to those three things, the currency, interest rates and wages because I think they're key to understanding the – the unbalanced growth in China. It's really only in the last decade that we start seeing a number of issues that really lead to the imbalances.

First off, although the big devaluation took place 16, 17 years ago; during that period, productivity in China grew much faster than that of its trading partners. One could argue that the currency got progressively more undervalued over that period. More importantly, in the last decade, we saw the gap between wage growth and productivity growth grow significantly.

And then finally, over the last decade, we've seen extremely low interest rates in a very severely financially repressed system. And I think that matters because it's those factors, primarily, that explain the unbalanced growth in China. Why? Because I think of all of those things as basically very, very heavy taxes on household income, taxes which were used to subsidize growth in other areas.

How are they taxes? Well, clearly an undervalued currency is a sort of a consumption tax or an import tax, the proceeds of which are used to subsidize manufacturers in the tradable goods sector. (Inaudible, audio interference) – if the workers' share of growth is constant, you would expect wage growth to keep pace with productivity growth.

And the big split between the two in the last decade, you can again think of as a sort of tax – a tax on wages that was used to subsidize employers. Finally, very, very low interest rates have been a huge tax. I calculate at least five to six percent of GDP every year in the past decade, all in household savers, were the net savers within the system, which acts as a pretty significant subsidy to the banks and to net borrowers, who are the real estate developers, SOEs, local provincial governments, et cetera.

And it's really this that's at the root of the imbalance because with all of these very significant taxes on household income, it's not a surprise that household income grew more slowly than GDP. And household consumption, which has grown quite quickly, has grown around seven, eight, or nine percent per year in the past decade still, nonetheless, grew much more slowly than GDP.

It kept pace with the growth in household income, but not with the growth in GDP and that's the heart of the imbalance. Because total production – GDP is a measure of total production – grew significantly faster than household income and with it, household consumption, household consumption declined as a share of GDP.

So whereas in the 1990s, it was low but not unprecedented; it was within the pack of Asian countries, by 2005, it was the lowest number ever seen. It was around 40 percent of GDP. At that time, Beijing got very nervous about the imbalance and said it's very important that we raise household income as a share of GDP.

And there was a lot of optimism that they'd be able to do it, a few of us, very pessimistic, said they're not going to be able to do it because it requires a significant change in the growth model. Even, I think, the pessimists were surprised by what happened because in fact, household consumption continued to decline. Last year, it was officially 35.6 percent of GDP, I think a number that's not even on most economists' maps.

And it may be that it was even lower. There's a lot of hidden income in China which accrues mostly to the wealthy. And some surveys have suggested that consumption is an even lower share of GDP. So the – the question then that Yukon asks is, so what? What's so bad about unbalanced growth?

Certainly, even during the past decade, unbalanced growth has been very good for China in the sense that it's generated very, very rapid GDP growth and even though that growth was imbalanced, that is, household income and consumption growth lagged it significantly, nonetheless, they grew very, very quickly – both household income and household consumption in the past decade has grown from six percent to nine percent a year, depending on which years you look at.

And by any standard, that's very rapid growth in household income. So what is the problem with unbalanced growth? The problem with unbalanced growth is that it relies too heavily on the other two factors in the economy. If it's not household consumption that's driving rapid growth, then we're pretty much left with a rising trade surplus or increased investment.

And we've seen both – a significant increase in the trade surplus until 2007, 2008. This year, it started increasing very rapidly again. And of course, significant increase or very, very high levels of investment, China entered the crisis with, I believe, the highest investment rate maybe ever recorded. And it responded to the crisis with a significant increase in the investment rate.

So why is that problem? Why not just keep building the trade surplus and keep building investment? Keep increasing investment to generate the spectacular growth in household income? The problem is that you run into constraints in both cases. The constraint with the trade surplus is pretty obvious, I think.

A rising trade surplus requires that the rest of the world is able to absorb the augurs of it, which is a rising trade deficit. And I would argue that the two big deficit entities, the United States and trade-deficit, peripheral Europe, in one case, wants to bring the deficit down, that is, in the case of the United States. And in the other case, the case of peripheral Europe, has no choice to bring the deficit down very, very quickly because their ability to finance the deficit is collapsing.

So the trade deficit is not likely to provide a major source of growth for China over the next few years. So that leaves us with investment. And in fact, in 2009, we saw a massive increase in investment, precisely because the trade – the trade surplus came down so quickly and the impact of the contraction in the trade surplus on China was dramatic.

Growth rates probably dropped from around 12 percent in the first quarter of 2008 to maybe zero, some people even argue negative growth rates in the first quarter of 2009 before shooting up to again 11, 12 percent in the first quarter of 2010. In the first case, they came down because of the rapid reduction in the trade surplus. In the second case, they expanded because of the rapid increase in investment.

But there's a growing sense in China that we have reached the point – some of us would argue many, many years ago, but certainly, I think there is a widespread consensus within Beijing policymaking circles, not in the provinces and not at the SOEs, but within Beijing, that we've reached the point where investment – increased investment is being misallocated.

Now, those who are pessimistic like me think we reached that point many years ago. Those who are less pessimistic think we're in the process of reaching that point. But either way, the response is that you can't keep jacking up investment because as you do so, it becomes – it results in increasing nonperforming loans and increasing debt levels for the government.

I'm running a little bit out of time, so I will – I will discuss a little bit what I think is going to happen next year. I think it's pretty clear that growth rates next year are going to be very high. The rumors for the last couple of months is that new lending next year is going to be in the six (trillion dollar) to $7 trillion range.

That's been the rumors for several months. We never really believed them; we thought they would be higher.

There was a recent report that came out that suggested new lending would be 7.5 trillion(dollars), even that I think is low. I suspect new lending is going to be officially set closer to 8 trillion(dollars).

To give you some context: Last year new lending was around 9.6 trillion(dollars) and this year the quota was 7.5 trillion(dollars) but the quota has been breached. New lending is going to be around 8 trillion(dollars) and so much was taken off the balance sheets that I suspect that total new lending on and off balance sheets probably matched last year and for that reason I don't think that we're going to see a significant reduction in new lending next year.

The new lending numbers are going to be very high if we're expecting growth rates of 9 percent. But after that is the big question of what happens next. We're starting to see an increasing sense, increasing worry within Beijing that growth rates are going to slow down significantly when the new leadership comes into place and I think that's right, I think that's correct and I think that's necessary for the rebalancing.

And my guess is that growth rates over the next decade may be as low as 3(percent) or 4 percent. I know that's a very minority view but to me this whole issue of rebalancing is going to be extremely difficult because so much wasted investment has already occurred. So with that I will leave it and pass it back to Doug and perhaps we can discuss more of this during the question and answer session.

MR. PAAL: Thank you, Michael. That's a terrific and different look at the same problem that's – in balance and growth. I have to just amplify one point you were making. You just said, the new leadership will come in and reduce and I think it reifies the point you were making just before that which is when you have an impending new leadership one thing you get is a tremendous growth in credit to keep everybody well-lubricated in the system running up to the party Congress – (laughter) – and we can count on that. Those of you who bet stocks – (laughter) – you can count on a run up there, too.

But we now are privileged to have with us a guy who's been in the frontlines of the conflict and cooperation between American business, U.S. government and China's leadership for, really, two decades, now, isn't it Myron? And I remember working closely with him even when I was in the government so many years ago and I don't think we can ask for someone to do a better job of representing where the issues that have just been raised by you and, kind of, Michael bump against the policy constraints and desires of the United States. I ask you to speak, Michael, thank you – Myron.

MYRON BRILLIANT: Well, first of all, Michael, it's as cold here as it is in Beijing – (laughter) – so we're not getting any relief in Washington. Secondly, I think we can all agree that in Washington there is not a lot we can agree on – (laughter) – so I would just say if there is anything we can breathe on is one that Doug, you've been a longstanding servant in support of this relationship and I applaud you and Carnegie and the work you do and thank you for agreeing to have this forum and inviting me to participate.

The second thing I think we can agree on and Doug you talked about it and so did I earlier. We have a failed Metro system – (laughter). If we have a failed Metro system that does speak volumes to our nation's challenges and why there is some insecurity in our country and why there's some insecurity closer to home in Washington, D.C.

And the third thing is this obsession with the U.S.-China relationship and this Faust economy in some ways between is China's growth, a virtue or a vice for the U.S.-China relationship. Is it a vice or virtue for the world-trade system and the world-economic and financial system? And I'll touch upon that today because I think we're – they are (strains ?) in the relationship and by China's rise which is inevitable and we've all seen that train coming and there are opportunities still, though, for cooperation and growth in our relationship as well.

So you know, the press likes to paint people as either pro-China or anti-China and I recall that a few years ago some magazine, the Washingtonian magazine, put me in the pro-China camp. I wonder if I would still be in that – (laughter) –after this presentation today? Because I think we have to look ourselves in the mirror and ask ourselves, what are we doing to improve our own competitive posture? But we also need to take note of the challenges that China presents as it grows and look at that.

So my presentation – which I tend to be somewhat short because I think there's a lot of interesting people in this audience who will ask a lot of questions and Doug will moderate it – a good discussion. We'll try to sort of go between the "I'm either all for China or I'm all against China." So let me try to address some of the issues that I think that we're very concerned about and focused on from a business standpoint.

I will say that before I get into them, and part of the way to get into them is to know that over the last two days I went through The New York Times and the Wall Street Journal. I don't know if any of you ever do this and just kind of glance – you know, I know I was going to talk about China today and I just kind of glanced through the newspapers and I'll put aside the North Korea issue and the geopolitical issues that were discussed in the papers and just give you a rundown of the kinds of issues that were discussed just in the last two days in the newspapers and I tell you, 15 years ago this would not have happened.

Okay so what was discussed? Briefly, obviously, the U.S.-China JCCT recently concluded commercial talks. The caption is really, U.S. wins concessions. That in itself is pointed. U.S. wins the WTO fight on tires, got a lot of coverage in The Times, Wall Street Journal and other newspapers. China passes Japan in RMB, which was not discussed by the – although it was alluded to by the great presentations by the two academics and economists – but that is significant in many ways.

Okay, China is now heading to be the number two investment country investing in RMB, well behind the United States but moving at a much faster ratio – profound implications there. China pushes ahead in alternative energy. We all know that China has about half the wind market and is moving quickly in other areas like solar. China expanding in offshore trading on the RMB, what does that mean for the future of the international financial system?

Russia and China are looking to trade in something other than dollars. That would be significant if that was the way China approached bilateral relationships. Premier Wen Jiabao was off to India. Now, we know that's a tense relationship but what is that? That's a trade mission to advance commercial ties between the two largest emerging markets in the world.

Rare-earth report by the Department of Energy commenting on China's rare-earth export strategy or lack of in terms of exporting raw materials. What does it mean to the United States? Does it fuel fears here that we will see us lose – or China will dominate clean technology? Currency was also referenced in a number of these articles, currency manipulation, and the lack of appreciation of the currency.

My point is, you can see in these articles, one, an obsession about China that did not exist to the same degree 15 years go; two, a sense of inevitability about the rise of China and, three, the sense that it's going to impact our own competitiveness in the United States and that as China moves ahead with India or Russia or as it moves ahead to convert its RMB or as it moves ahead in any of these areas we must be losing something here in the United States and that's the way the media is reporting it.

So guess what? Americans are taking notice and so when the Wall Street Journal or other publications poll Americans about trade or our engagement around the world, guess what? The numbers are going down. They're going down, they're not going up. People are thinking, well, engagement around the world is a bad thing and that's, of course, something I would argue against but I would also say the China piece of that comes out.

So whether you're having a conversation in Washington, in which we talk about China all the time, or whether it's around the country China looms large in all of our minds. Now, just a couple quick facts: We all know, in this room because most of you have spent a lot of time in this relationship and think about it, that China is actually our fastest growing market. In fact, it's the fastest growing market in American history and it provides, obviously, a lot of opportunities for our farmers, our manufactures, our service providers.

We have millions of jobs tied to trade with China both from exports into China as well as imports. In fact, U.S. exports will have grown at what, twenty-nine percent, or so, since 2000? The same decade our exports to China grew by 350 percent. Now, that's not something generally well-understood in the public. It doesn't mean the relationship is balanced – the trade deficit is going up. But it does that our relationship is increasingly integrated and it does mean that not everything has to be viewed in terms of conflict. That challenge does not have to translate to conflict or confrontation.

And so we have to look at what the meaning is of all these dialogues. This week the JCCT – I actually would argue that there were some important issues discussed, some important concessions, if you want to use that word, or compromises, or accommodations, or whatever word you want to use that were made to advance the U.S.-China relationship. Now, clearly, and Ira is here in the audience and Hank and others who have worked in the government, and Doug.

We now need to hold the Chinese accountable to those kinds of commitments that were made, whether it was in clean technology or Internet piracy or software legalization or any of the issues that were discussed – or selling beef into the American market which is still an issue to be –

MR. PAAL: Chinese market.

MR. BRILLIANT: True. Well, if they want to sell it here too they could – (laughter) – because we need to open up our market, but yes, the Chinese market – or chicken, for example, which was also discussed. We've got to hold them accountable and the dialogues are intended to provide a forum for resolving disputes in the commercial agenda or area but, clearly, accountability is important and that is on both sides.

I would say that one of the reasons if the JCCT surpasses our expectations – and I would argue it did, in many respects – is because the Hu Jintao's visit is around the corner and the Chinese are no dummies when it comes to these things. So the Chinese providing some deliverables ahead of the Hu Jintao visit, a visit they are managing very carefully in terms of their presence here.

They are not unaware of the sensitivities; the fact that we're still recovering from our financial crisis, that unemployment is still hovering around 10 percent, and that trade deficit has expanded is not lost on the Chinese. They are students of the political system here and so the JCCT probably was benefited from that reality, and I think that's important to recognize. At the same time I think it was important to recognize that the House of Representatives passed legislation that many of us thought was inappropriate, not without cause but inappropriate in the terms of the way it was directed against the RMB.

I think that the Senate did not move and I think that is an indication that while we should not take for granted that the Congress won't move on legislation when it comes to China, at least, I think, for the time being we recognize here, in our political system, that there's a risk of going too far in how the Congress acts or even how the administration acts when it comes to dealing with the Chinese.

Now, just a brief comment on the G-20. In some ways the G-20 was a failure on the part of China and the United States when it comes to the economic-imbalance issues. Because yes, I would agree that currency is not the only issue in our relationship, but it is an issue in our relationship and I would say that it's not about having a 40-percent target but it is about moving China to a market-based currency regime.

I think rather than have a currency war between China and the United States we need to think of multilateral solutions. I don't think the numerical-target approach was the right way, but to look at an approach in a multilateral framework, I think China and the United States have vested interests to work together on those kinds of issues. I think that G-20 process did not manage to really deal with the global-imbalance issue. It sort of put it down the road and so we'll have to come back to that in some context.

Let me talk just briefly about the link between macroeconomic policies and industrial policies. And look, I've said some things here already. I want to be clear that there are, what we would see in the business community, four, what I call core-priority issues. I think the administration, very much, has taken them to heart and is moving on them, and not only in the JCCT context but also obviously in the upcoming visit of Hu Jintao.

One is clearly currency and global imbalances, and we have to continue to talk about it. Not just because of the political strains here but because of the impact. If we don't change the equation where we're saving more and China is importing more, that is not only political suicide, but that is going to risk the financial system around the world and I think we have to work together. Germany is a part of that too, and Germany needs to be brought into that conversation as well.

Second: IP protection and enforcement. Here China has actually made some strides. They are not going to get nearly as much credit as they deserve because the results are not there, but they have made some strides. There's a new campaign underway in Beijing, but it's going to continue to be a top priority for the U.S. business community and it's an area where CEOs – whether it's Ballmer from Microsoft or Immelt from GE or others – are speaking more openly about it.

It used to be that they would hide behind the U.S. government, the U.S. Chamber, the U.S.-China Business Council. Now the CEOs are going out and talking about it publicly. So it's indicative of a larger concern because clearly, we don't produce the shoes and the t-shirts anymore; what we produce is innovation.

We drive innovation and while India and China and Brazil and others are – and Europe are, certainly, competitors in that front, we still have an edge and we don't want to lose that edge. And while we may have very definitive views about IP, we have to also recognize that those views are not always shared by others. That's a challenge and that's a priority area.

So is government procurement, because the procurement market in China is so significant in size we don't want to be cut out of it. We wanted to be treated in the same way that Chinese actors are treated, and that is increasingly a challenge in the Chinese market. Industrial and government policies in China are directed to create state actors and winners and that can be a challenge in terms of providing a level playing field.

And in that vein, the fourth one is discriminatory indigenous innovation and industrial policies. So these are our issues that are very significant at the macro and micro level discussed, not only, in the JCCT but also in many other dialogues. I think we should comment a little bit on the 12th five-year plan because I think this is a critical plan for China's determination whether it's going to transition to a market economy. Is it going to be driven more by domestic demand? What does it really mean?

Now, I'm not going to go through it in great detail because of time but let me just highlight a few areas where I think we should all be taking notice and we should be thinking. First of all, what are they going to do about state-owned enterprises and dividends? Many of you know may know that the State Council has decided to raise the dividend-payout ratios of SOEs owned by the central government.

Now, this is a significant departure and move on the part of China and if it moves in the way that they're talking, it will have profound impacts on the service sector and the social-safety net. I think we need to watch what it means in terms of income-distribution reform in China and I think we need to understand what it will mean in terms of opportunities for consumers – will it increase the wealth or benefits that consumers have? It will certainly not help large SOEs, but it could help the consumers in China which, again, will lead to more consumption hopefully from foreign imports.

So what they do about state-owned enterprises, with respect to the dividends, is the second one. The second area that was incorporated in the 12th five-year plan is the building of a service economy. Again, this could be a positive development for foreign investors who are looking to participate more aggressively in the service market.

What are they going to do about land prices? What are they going to do about electricity? What are they going to about value-added tax reform? What are they going to do about consumption tax and business taxes? What are they going to do about encouraging private-sector development in service areas like health-care, tourism, utilities, culture, entertainment, and logistics? So that's another critical component that I think we need to watch.

I've already commented on the currency-exchange issue. We can more into detail. I will note that the currency gains in November and October were pretty minimal. In September we had an almost 2-percent appreciation but we've had very little since. So we do need to continue to make the point it's not about hitting a numerical target, but it is about driving a market-currency exchange rate that allows China's development to move in the right direction and allow China to participate in the global financial system in a different way than it is currently.

I have to comment, Doug, in passing because I know – I've spent some time here – that we have to look at how we can encourage China to scale back subsidies and other industrial policies that distort what I call competition and provide obvious advantages to state monopolies. And there's a lot here to discuss on that front. We in our own country have taken a large step to move out of our investments in companies like GM and Citigroup and others. And you know, that is not the model of a market system.

We want to make sure that as we engage the Chinese, that we encourage them to reform their state subsidy practices. That doesn't mean eliminate state-owned enterprises, but it does mean to provide a more level playing field not just for foreign investors but for the development of private enterprise in the Chinese system. There'll be different views on that front, but if we're going to challenge ourselves to resist protectionist measures, we have to be honest with the Chinese that they have to do some things on that front as well.

I'll end there because there's a lot to cover. But hopefully that facilitates the conversation.

MR. PAAL: Thank you, Myron. You've sketched out the landscape very helpfully on the policy front. Ladies and gentlemen, we are in a very consequential period of history, as our speakers have indicated, of looking largely from the commercial and economic perspective. Twenty-two years ago this week, probably one of the most consequential days in history occurred when Deng Xiaoping called in the American ambassador and said he wanted to normalize relations – and did it in a few hours, stood up and walked across the hall and addressed the party meeting then taking place in the Great Hall of the People and launched the revolution in China's economics and society that we've seen since then.

This month, before the end of January, we will have not just the Joint Commission on Commerce and Trade and last week's Defense Consultation Talks. We now also have the deputy secretary of State and some others in China trying to shape the upcoming visit of Hu Jintao – of his agenda – and try to get to some point where the U.S. and China can take a more common position in dealing with the greatest threat to peace and security in the East Asian area, which is currently North Korea's behavior.

Between now and then, we will also have a visit by Secretary Gates to China, which will be, I think, an extremely important event because no one speaks cleaner than Bob Gates – and the Chinese, I think, could use some plain speaking on some of these issues. So we are in a very interesting time. And we've got a very interesting audience here today – people who'd know a lot about this subject.

Please, when you are called on to ask a question, please wait for the microphone. Michael is far away and he needs to rely on the technology to hear you. Identify yourself and then ask a brief question, please. Starting up front.

Q: Thank you. Dan Neumann with the U.S.-China Commission. A question for, I guess, this half of the panel is the –

MR. PAAL: Which is this half?

Q: The Myron-Doug half – (laughter) – is on – is on the pending 301 petition. We're due to see a response from the administration possibly before President Hu lands in China. You talked about subsidies at the end of your presentation, Myron. Do you think that a WTO case might come out of that? And what might that do to the upcoming presidential visit?

And then for the economists on the panel, I was just curious to hear a little bit more about the hutong (sic) system that you touched on briefly. Do you think China will attempt to tackle this in the next five-year plan or in the – in the decade ahead? And if so, do you see this leading to more urbanization in the east, or do you see this spurring those, what are now migrant workers, to stay home and the factories to continue to move to them? Thank you.

MR. BRILLIANT: I'm going to be brief on this. Look, I'm not going to endorse or oppose here today what the U.S.T.R. might do in conjunction with other parts of the government on the WTO case. I will say that it's appropriate to scratch our heads and look at every opportunity to address subsidization of the state sectors in China. And frankly, you know, the Chinese need to reform their system for their own good. But it does create a distortion in the marketplace. And it's not just about market share in China. It's also about competition abroad – increasingly. What does it really mean in terms of our market share in China? Now, increasingly, it also has ramifications for our market share around the world.

And so we're very aware of the issues. We're very concerned about the direction of China's subsidy practices linked into their broader industrial policies. We recognize the competition it means for us.

MR. PAAL: Yukon or Michael, do you want to take that on?

MR. HUANG: Alright, just a quick thing about the hukou system essentially is the right to stay in a place. You go from inland province – you go to Beijing. If you don't have hukou and you brought your family with you, your kids can't go to local schools. They have to pay fees.

You don't have access to normal housing. You have no preferential or neutral treatment in terms of getting jobs. So you're very – well, you're very disadvantaged.

The other major problem is you're reluctant to move because your land is back in the rural areas. You have value in that land but you can't sell that land – you can't sell the rights to farm that land. So if you move to the city, you move nothing. That keeps families and workers in place. That's obviously an extraordinarily inefficient process.

My own feeling is if you didn't have the hukou system, China would be probably be at this point 60-(percent), 70-percent – 60-, probably, percent urban rather than 45 percent. And then if it increases to be 70 percent – a China which is 70-percent urbanized is a China which is much more consumption-oriented, much more service-oriented, much more inclined structurally to contribute to what are called the global-imbalance problem – a country which would grow actually much more rapidly without the need for export surpluses.

So it's, to me, a fundamental issue in terms of how you address what I call U.S. concerns and Chinese concerns. Now they on paper said they're being more flexible on the hukou. But the reality is each city can apply it differently and people are reluctant to move. Even if you gave people the residency rights, people will still not leave rural areas because they got their land holdings back there, and they can't monetize it. So it's like if you want to move from California to Nevada, but you can't sell your home in California – you're not going to move to Nevada.

So that has to be solved too. But if you solve that, this is the biggest factor that what I would say changes the structure and location of people in China in a way which I would call – is compatible with global interests.

MR. BRILLIANT: Can I just ask both of you a question? Can I jump in here for a second? Look, we all know wages are rising in China. We also know the costs of commodities are rising. Now, we just went through a very difficult debate on health care. We're not finished, but we went through a very difficult debate because of the impact of the health-care costs in our own system.

What do you see, both of you, in terms of health care and the social-safety net costs in the system? And how does that impact consumers and their ability to buy – are the Chinese going to subsidize that system in ways that takes this cost out? Or are they going to pass that on to the consumers? And what does that mean for us in terms of China's own growth?

MR. PETTIS: I think there's a lot of misunderstanding about the role of the social-safety net in China and the use of that as an explanation for the very high savings rate. China doesn't have an especially bad social-safety net given the level of household income in China. It's better than some, worse than others. What really matters is not so much the lack of a social-safety net but the deterioration in the social-safety net, because that represented a massive transfer from the household sector to the corporate sector.

In other words, 20 years ago, you were working to take care of your parents, medical bills, your kids' school bills, your unemployment benefits, et cetera. And now they don't. Now, you're on your own. And to me, this is part of what I was discussing earlier: this transfer of income from the household sector to the corporate and government sector which is at the root of the imbalance.

So when we talk about repairing the social-safety net, to me, repairing the social-safety net, in and of itself, doesn't do anything to consumption in China. It may have a small insurance effect. What really matters is who pays for the repair of the social-safety net. And if it's paid for through borrowing or through taxes – and borrowing is an extreme; it's a hidden form of taxation on the household sector – then it doesn't really do any good because you take money, you put it in medical treatment or in a pension system, or whatever, in building the social-safety net which increases household income, and so increases consumption.

But if the cost of that is then taken from the household sector, you're basically taking money out of one pocket and putting it into the other. So I think the real key is not whether or not there is a social-safety net, the real key is, how is it funded? And there, it doesn't seem to me that there is anything very optimistic to say about that.

MR. HUANG: Just a couple comments. I agree with Michael that the emphasis in terms of improving the social-welfare system as an approach to increase consumption is not likely to have a major impact. And in fact, recent studies have shown something which is counterintuitive: that the improvement of the pension system – in particular, increasing the access to the pension system in China instead of increasing consumption as people expected because you're more secure – is actually leading to decreased consumption. And the reason it has lead to decreased consumption is because as you start paying in your contributions to the pension system for future retirement, people don't have faith, in fact, that they're going to get it back in 20, 30 years.

So they're actually increasing their savings to compensate for the fact that they have to pay into welfare system. It's like the Social Security debate in the United States – you maybe think the Social Security system is going to be here in the future, and you have to pay Social Security taxes. You'd probably have to say, I have to increase my savings because Social Security just won't be able to cover my needs. So the improvement in the social-welfare system is not increasing the consumption as much as people had hoped for.

The second point I'd like to make is that joining the formal social-welfare system is having a negative impact in terms of generation of formal jobs in China because of the cost structures. There's a very interesting paper I just saw which looked at growth and manufacturing jobs in China and the United States over the last five years. Guess which country is showing growth and which country is showing a decline? It's the exact opposite. As a matter of fact, job growth in China is declining and manufacturing job growth in the U.S. is increasing – counterintuitive. So it's a great – (inaudible) – because that's the huge debate out there, that we're losing jobs to China. So let me just leave it there.

MR. PAAL: And another question?

Q: I'm Sheldon Ray, Morgan Stanley Smith Barney. I'm often asked about the Chinese real-estate bubble with housing costs. And my response is usually that because of the lack of leverage like we have here, and other cultural issues possibly, that hypothetically if there were a 30-percent drop in real estate in an area in the mainland, the default rate would be negligible. I wonder if you agree with that. And also, what are the risks in real estate and commercial developments?

MR. PETTIS: (Chuckles.) I see everybody looking this way. (Laughter.) I think –

MR. BRILLIANT: You're the one living in Beijing.

MR. PETTIS: I think it's a mistake – it's a mistake to look at a real-estate crisis in China or a banking crisis in China as occurring the same way that it would in the U.S. If we were to see a significant reduction in real-estate prices – first of all, there's a lot more leverage out there than the numbers suggest. And there are lots of reasons for that, but don't trust the numbers on leverage – it's probably fairly significant.

But more importantly, if we were to see a drop in real-estate prices, you'd want to look at the real-estate developers and how they respond to a drop in real-estate prices. If we were to see a liquidation of real estate, that would be very painful and very brutal but it would take real estate and bring it back into the market. At some point, it becomes – it becomes meaningful to rent or to buy real estate because the prices are low enough.

What I'm really worried about is a very different sort of scenario where basically if we see a significant reduction in real-estate prices, the large real-estate development companies – especially those associated with local and provincial leaders – rather than liquidate real estate, simply take them off the market. And they're able to do that as long as they have access to cheap and unlimited amounts of funding, which they generally do – unlimited up to a point.

So what I worry about is not whether there will be a collapse in real-estate prices leading to a massive increase in defaults and problems in the banking system. What I worry about is something quite different, and that is that if we see a significant reduction in real-estate prices, we're going to see the amount of capital that was misallocated significantly increase because all of this real estate is simply taken off the market and there are no attempts to mark it down. And the real-estate development companies that have taken them off the market continue financing themselves at very low interest rates.

You're going to hear me talk a lot about interest rates. Victor Shih sent me – Victor Shih is a professor at Northwestern, very smart guy – who sent me a presentation in which he was trying to figure out how much room does the government have to raise interest rates. And what both he and I have been worrying about in the last couple of years – and his numbers are pretty ugly – is that there is so much government debt out there. In fact, one of the areas that we don't really think about is simply the PBOC – the PBOC has about $2.6 trillion of debt, local currency debt, funding $2.6 trillion of external assets. And everyone thinks that's a good thing. That's not a good thing because if you raise interest rates, the PBOC runs a huge negative carry.

If you add all the other bits and pieces of debt that are out there, including potential non-performing loans, it becomes very difficult in China to raise interest rates. And the one area where I would disagree with Yukon, I think, is he argued that raising dividends may be the single-most important reform in the rebalancing process. And I would argue no, I think raising interest rates is the single-most important reform in the rebalancing process. In fact, a 1-percent increase in interest rates is equivalent to 100-percent dividend payment by the SOEs. And I think we would all agree that interest rates are at least 600, 700 basis points too low.

That to me is the key problem in China. And that's why I worry about a banking crisis: because of the impact on interest rates.

MR. HUANG: Let me just make two observations about their real-estate market. One thing that's very strange in China is the real-estate market can change dramatically from quarter to quarter. And so, there's something illiquid and there's something very abnormal. So you can have a situation where prices of real estate goes up by 10 percent in one quarter, and the next quarter it goes downwards or flat. You can have a situation where whole blocks of commercial buildings are empty, and then six months later they're fully rented out.

And it shows there's a lot of speculation going on and a lot of hedging going on so it's very difficult to get a grip on the true nature of the market.

Now, the second point I would make is as long as you have this issue of potential appreciation of the renminbi, then money will pour into China – and the easiest way to park it is in real estate because even the stock market is dubious. So you park it in real estate on the hopes that renminbi will appreciate. As long as that pressure is there, you're constantly going to have this issue of buying real estate in China – is it an asset? Is it a bubble?

Now, the other point I would make is, I was mentioning – to me, a large part of the solution in China is you have to actually allow firms and households to basically say, you could move your money out of China. Because a large number of these apartments in China are not rented, they're just totally empty. And Chinese investors are somewhat unique. In the United States, you wouldn't buy a whole bunch of apartments and just leave it empty on the hope of it going up. In China, you do. And you do it for a variety of reasons.

But one of the reasons you do it is because the alternatives are very limited. Suppose you say to yourself, well, gee, why do I have this apartment building in Beijing – and it's empty? Why didn't I buy it in London or New York or Malaysia and rent it out? Well, if it were a lot easier, people would start doing this and this thing would resolve itself a little bit.

Let me go back to Michael's comment about interest-rate distortions and dividend distortions. I agree fully with Michael about what causes the imbalance and what causes the distortions. It's what I would call the inappropriate pricing of capital or of labor. It talks about ways it's being depressed, and interest rates are too low. And that leads to these distortions in terms of excessive investment. I don't focus on that because I don't see that changing. This is part of the growth model of East Asia. And although interest rates are repressed at 4 or 5 or 6-percent lending, they're actually not extraordinarily low compared to interest rates elsewhere because everywhere, they're globally depressed.

Nor do I see the government actually using this as an instrument for influencing investment because if they raised interest rates, they would figure out a different way of subsidizing the firms. The real question in China is not interest rates – or even dividends. The real question in China is, can the government accept the fact that they don't have to grow at 10 percent a year to achieve its goals? Because if it is fixated on 10 percent, it will do everything under its power to maintain this, including distortions. But if it agrees that 8 percent is good or possible to generate the jobs and create the kind of living standards that they hoped for, most of these distortions would probably go. But as long as you have this fixation on this growth target, they'll stay.

MR. BRILLIANT: Can I just comment here? I'm going to leave the real-estate piece to you two but look in the United States, we have a fixation about job growth. Corporations are carrying $2 trillion in reserve and not investing in job growth. I don't care whether you call it GDP growth or what, but the bottom line is that China's had the same fixation. They have a lot of people that have to get jobs and they have a lot of transformational people who go in and out of cities, right? So they – they're targeting a GDP growth rate because it creates, for them, the platform to talk about job development.

And it's not dissimilar than here in the United States. You know, we're going to have a two, 2.5 percent GDP growth rate next year, okay? But we're not going to accompany it with job growth. But we're going to talk about job growth in this country as the number one priority.

So some of this doesn't really matter, it matters to economists. But what really matters at the end of the day to the Chinese government is how they create jobs in that country and how they create some stability in their system or maintain stability.

MR. PAAL: Please.

MR. PETTIS: Could I?

MR. PAAL: Oh, sure, go ahead Michael, we're going to –

MR. PETTIS: Let me address that a little bit because I think you're right. The issue is jobs, but there's – you know, Arthur Kroeber, who's an economist here in Beijing, a guy I disagree with a lot but a very, very smart guy did some numbers that I think are quite plausible.

And he argued that if China had the kind of growth rate that, say, other developed countries did or a growth model that other developed countries did, three to 4 percent growth would be more than enough to absorb all of the new entrance into the labor pool. And that seems to me like he's probably right. So why is China obsessed with 10 – nine, 10 percent growth rates?

Because the development model is so capital-intensive. So you will often hear people say that China's comparative advantage is cheap labor. And of course, that's simply not true. If China's comparative advantage was cheap labor, Chinese growth would be very, very labor-intensive. It's very capital-intensive. So what I would argue is that China doesn't need nine or 10 percent growth rates. If it had a more balanced growth and with a heavier reliance on the service sector, it could absorb unemployment.

It could absorb the new labor entrance at much, much lower rates of growth. The problem is it's very difficult to shift the growth model because for whatever reason – I'm not a political scientist – but I would argue that after 10 or 15 years of this political growth model, this specific growth model, entrenched interest in both the export sector and in the SOE sector, the export sector relies very heavily on the undervalued currency and the SOE sector relies brutally on very, very cheap financing.

It's very difficult to get them to agree to the necessary changes. But China doesn't need 10 percent to absorb unemployment. What it needs is a very different growth model.

Q: Thank you. I'm Elliot Feldman from Baker and Hostetler. Doug, this is a terrific panel.

MR. PAAL: Well, thank you.

Q: I've got a lot questions; I'm just going to ask a couple and if there's a pause on the answer – (laughter) – please, please come back to me. And Michael, I'm a trained political scientist and you just qualified. (Laughter.)

Myron, I was surprised by your answer to the question about the Section 301 petition, so I'm hoping maybe you'll elaborate a little bit? This is a petition brought by the unions, like the tire safeguard, no companies involved, no corporate interest. And it raises a profound question because there's a hypocrisy built in.

We've been heavily subsidizing not just the bailout companies and banks, we've been subsidizing the development of green technologies. And the Chinese have already complained about this, particularly with electric vehicles. So we've already got a Japanese case at the WTO decided against China with respect to these questions. Now, the United States piles on, but where is the corporate world on this question, given that this is a union petition? And given that it could open a lot of scabs with respect to American subsidies in the same areas?

Second question I want to squeeze in this time around. All this money is sloshing around in China. Some of it is being invested abroad, mostly for resources in Africa and Asia, very, very little in the United States. Will that change? Is there going to be an interest for the Chinese to invest in the best developing country in the world with a pretty good infrastructure – (laughter) – a great workforce? Is any of that money going to come here? (Laughter.)

MR. PAAL: You want to start out?

MR. BRILLIANT: Elliot, I'm aware that there's some friends of mine from the media in this room, so hence the words that I chose were, I think, appropriate in this context. Look, we have not been visible in our endorsement, right? So you can infer that either means we're silently supporting or silently opposed. (Laughter.)

MR. PAAL: Elliot, on the question of inward investment, I think this is the next big story in U.S.-China relations once we get past the current hiccups over who's an aggressor on the South China Sea. Every state and city in this country is trying to draw in investment and the Chinese are first and foremost on their minds.

We saw this past week, there's some news – Myron was ticking off news – something about an airfield in Missouri which was – I think it was a completely false story – misreported in some way, but even the small airfield in Missouri sees China as the future for transshipment of product into the heartland of America from the Chinese factory land.

This is going to be a big story – I think a lot of law firms are beefing up. I've been talking to quite a few law firms that are beefing up their CFIUS practice to help the Chinese navigate through the foreign investment rules here and try not to have the kind of snags that some others have hit along the way.

I think any Chinese corporation that wants to grow organically can see the virtue of acquisition in the U.S., even the market is back up American equity prices are still pretty low by Chinese standards. And the ability to acquire capacity is quite good here.

We do have to sort out some of the rules of the road. You can buy an American oil company, but you can't buy a Chinese oil company and that, in the end, is what triggered the end of the CNOOC effort in California. And this is something that's going to need some high policy attention as well. But I think that's the next big wave.

MR BRILLIANT: I have to comment on that because that wave has arrived and I see it in the way we deal with Chinese delegations today. I just had a delegation in town this week from China. And you know it used to be very predictable. The Chinese would come in with buying missions, Ira knows, Hank knows this from their days at the Department of Commerce.

The missions were very disorganized. They were all over the map. They might say agriculture, but they could be talking about manufactured goods. They had no idea what they were doing and we did our best to try to help them, whether it was the private sector like the Chamber or whether it was the Department of Commerce.

That changed – they got a little bit better. But now, they're coming in and talking about investment. The missions that we're talking about just – trade and commodities are now coming in and talking about investment. And they have worries about CFIUS – they're overblown worries, frankly, because there's a lot of investment you can make in our country that don't touch upon the CFIUS rules – a lot of investment.

But clearly, when Huawei comes to town and looks to make investments here, that does raise attention in Washington. We turned them down as a member of the U.S. Chamber of Commerce – (laughter) – but the point I would make is that you know, the Chinese are as baffled – more baffled than we are about investing there.

We can figure out how to invest in China. We've been doing it for a long time. We may run into challenges and we do in regulatory challenges and getting licensing and all that. But we know how to do it and we do it quite well. They're still struggling. The banks are looking at ways to come in. There are real estate firms now looking.

There are, obviously, state-owned enterprises with cash that want to make investments and make acquisitions here. And they are. This is a great opportunity for Elliot and others to cash in if they want to take advantage of the opportunity.

MR. PAAL: Nothing like having a federal legal system to navigate to – (laughter) – help out your businesses.

MR. : It's not easy.

MR. PAAL: There was a question in the back there? I see a blue tie; I don't see who it is.

Q: Hi. Doug Palmer with Reuters. I just had a question for Myron and it's about the currency issue which – anyway, I spend a lot of time writing about. I just wonder, what are you thoughts on what happened this year? I mean particularly after September when the House passed the bill and then there was like sort of talk about the Senate doing it. In the end, they never did. There was sort of an attempt this week, but it didn't – it fizzled out.

I mean do you think the administration weighed in behind the scenes and said, this is something we really don't want to have ahead of the summit? And then secondly, do you think it's going to continue to be a political issue in 2011? I mean would you expect them to try to restart the whole process or do you think it's kind of dead in the water now that the Republicans control the House?

MR. BRILLIANT: Doug, I always like your questions. Yes, the administration weighed in privately, as did others. But I think you also have to look at the fact that there's a lot on the docket, taxes being the number one priority for both the Senate and the House. But there are other issues that – I mean Reid had a whole list of issues he was trying to take up.

Some of them were sort of empty votes, but he had a whole list and this sort of wasn't a priority for Harry Reid. It might have been a Chuck Schumer focused priority, but it wasn't a Harry Reid priority. And so just be realistic about how this fit into a larger scale of issues that the Senate was trying to take up before they left for the holidays.

The reality is that these issues don't go away. They're going to continue to percolate to the surface. We're going to continue to have bumps in the road on the U.S.-China commercial relationship as we do in the broader geopolitical relationship. So I would not say the currency issue is dead. I think there are going to be periodic bumps.

And I just will point out to what happened during the campaign season. I think these numbers are accurate. They were something like – I may be wrong – 2,000 political ads that were run on trade and China. We, actually, if you want, we can show you videos of some of the ads that candidates ran in opposition to policies supporting engagement with China.

And so if you think it was bad in the midterms, what do you think it's going to be like in the 2012 presidential cycle when there's a lot more at stake? I think very much, though, it doesn't disappear. And I think interestingly, it's not just a Democratic issue. We used to think of it in terms of Democrats beating up on trade because their caucus beats up on trade and their stakeholders and unions, beat up on trade.

Now, I think we don't have just the Democrats beating up on the relationship. We have the Republicans in some quarters as well. So it's a far-left, far-right kind of challenge for us to navigate. And frankly, you know, it also touches on sensitivities about our competitiveness, where we stand today and how we're competing against China and the rest of the world. It doesn't go away in 2011 and I would expect it to percolate to the surface periodically.

MR. PAAL: Over here on the left side?

Q: Hi, I'm Ben Carliner from ESI. I have a question about the impact in China of the Feds' quantitative easing and the possibility of further monetary easing coming out of Europe. What is the impact going to be on the Chinese inflation rate, and by extension, on the balance sheets of the big Chinese banks in the PBOC?

MR. PAAL: Michael, do you think that's one for you? Did you hear it?

MR. PETTIS: Given all of my deep underlying pessimism about the difficulty of the adjustment for China, about the horrible process that Europe is going to go through in the next few years, it may be a little bit surprising to hear me say that I'm not really that worried about inflation in China.

I think we may be a little bit overexcited about inflation because one of the characteristics of a severely financially repressed system is that it combines very rapid monetary growth with very little inflation. I'm trying to figure out why. And I think to a certain extent, in a country like China, inflation is almost self-correcting, as you have rising rates of inflation, remember that one of the most important sources of income for the Chinese people is the income on their savings.

As interest rates fail to keep up with rising inflation, their income as a share of GDP is actually declining, and as their income as a share of GDP declines, consumption declines. Meanwhile, rising inflation without rising interest rates means that the cost of capital, which is maybe already negative for borrowers is declining even more. So you get this thing where inflation reduces consumption by reducing household income and then increases production by lowering the cost of capital even further. So after a few months, it starts working its way through.

We've seen an inflation scare in 2007, 2008, where inflation went all the way up to – if you believe the numbers – 7.8 percent. And then came down very, very rapidly. I don't think it's going to come down that rapidly, but I do think it's going to come down.

Nonetheless, QE2 has caused a huge amount of worry in China for a very different reason. Because in financially repressed systems, you tend not to have consumer-price inflation but you have asset-price inflation. And we're definitely seeing that in China.

In fact, I'm a bit of a financial historian, so one of the things that I like to keep track of is all of the things that you associate with financial bubbles – and I'll go through a quick list. Jade prices in China are at all-time historic highs. They've never been this high. Premium teas are at all-time historic high. Chinese art is at all-time historic highs. Calligraphy, collectibles, Chinese stamps have doubled in price in the last year – collectible stamps, et cetera.

To me, this is pretty strong evidence that we are in a liquidity-driven bubble. This wasn't caused by QE2 because this started well over a year ago. But QE2, I think, is going to increase asset bubbles within China. And already, if you look at the latest pronouncements by SAFE, which is the foreign exchange arm of the central bank, they're making tons of noises about hot-money inflows. They're very worried about the increase in hot-money inflows. So I think QE2 – (inaudible, audio break) – destabilizing to Chinese monetary policy but I don't think there's anything legitimately that China do about it. To the extent that the Fed believes – correctly, in my opinion, but grant you, with a certain amount of controversy -- the Fed believes that QE2 is necessary for the U.S. economy, then the rest of the world is simply going to have to live with it. And that means China, too.

MR. PAAL: Yes, sir. In the middle?

Q: Good morning. My name is Gil Sheinbaum (ph). Is this on?

MR. PAAL: Yes.

Q: I'm a retired Foreign Service officer. I spent 15 years in Asia but not in China on official business, but I've traveled extensively in China. I'm interested in – you've mentioned Bob Gates going to China soon. And there's also other reference to military. And this is not a question I would have originally brought here, but how does the expansion of the Chinese military establishment impact on its economy?

It obviously has the resources to pay for it all, just like it has the resources to pay for all those great highways around Beijing – six-rings and so on. But there's been a lot of concern, lately, starting with Dick Cheney, I think, as to the growth of the Chinese military and how that will impact on the United States. Are we threatened by China? Or should we not be? But then how does that impact on China, itself? The growth? Thank you.

MR. HUANG: Now, I'm not an expert on this. There are many more people in Carnegie who focus on the military aspect, but I want to just give you a slight economic perspective. First of all, from an economist's viewpoint, when we look at the military expenditures of course we don't know what the total value is because it's not all in the budget so one has a difficult time trying to say, is it excessively large? How fast is it growing?

But what you can see in the budget is that military expenditures are increasing in double-digit rates, 13(percent), 14(percent), 15 percent a year but it's increasing in the same rate as practically everything else so on paper it may be rapid, but a no more rapid increase in what I'd call other expenditures in China. Now, the second point is that one realizes that the military in China, in terms of the troops, their relative status or security or how people look at jobs is becoming more attractive. Many more people want to join the military. It just means to show that whatever is, life seems to be better in the military than it is in civilian life. Maybe it's even true in the United States now.

The third point I would make I think is often missed. About 10 years ago the government decided that the military should not be operating commercial enterprises to the same extent they used to, and they used to get a lot of money from operating restaurants and businesses. They were essentially forced to give this up. And they basically gave it up, and these were transferred to the banking system and they are operating it, but in essence they had to increase their funding from the budget, per se. In the sense of an economist I like this because it's more transparent.

So you actually find a significant increase in military expenditures through the budgetary process, which is looked at negatively in West, but from my own viewpoint actually is very good. It's actually a transparent process rather than buried in terms of indirect means of funding, but it also showed up in terms of what I call rapid growth of military expenditures in China, which people were saying this is a problem where as I say I'm not sure it's a problem because I really don't know the true level it's just becoming more transparent in the process.

MR. PAAL: Michael, I'd like to offer you a chance – if you don't want to speak that's fine.

MR. PETTIS: There are certain topics I don't touch. (Laughter.)

MR. PAAL: Let me just offer a thought on the consequence of the military developments in China. There's a wide-ranging debate going on in this country, in the national security community about how threatening or nonthreatening China's developments are. It's clear that China is developing capacities it did not have in the recent past.

China now has deployed fleets, submarines, they're building an aircraft carrier, and they've got a deployed flotilla in the Gulf of Aiden to work on antipiracy. This is the first time in 600 years that China has done something like this, so you have to notice that it's been a while. (Laughter.) On the other hand, I've not yet encountered a Pacific commander who feels that he's been stumped by the Chinese or he hasn't got the means to deal with whatever China has at this point in terms of capability. So somewhere in between those two pegs of the observation in that spectrum the truth may lay. Time for one final question, the back –

MR.   : (Off mic.)

MR. PAAL: In the back, in the orange.

Q: Gregory Ho from Radio Free Asia. This question is for Michael about QE2. Technically China has foreign-currency control. So technically how can this hot money can get into China? And the most difficult question is how can that hot money, with a certain good return, get out of China? So is there any secret tunnel which the Chinese government – (laughter) – acknowledges or actually they see it – well, in what time would you expect that those secret tunnels would be shut down and then all that hot money would be trapped inside China. Are there any possibilities of the risk for that hot money which gets into China? Thank you.

MR. PETTIS: Historically if you look at regimes with capital controls there are a couple of things that you notice about them. One is the longer you have capital controls in place the more porous they become, as businessmen, et cetera, find ways around them, and capital controls arguably have been in place in China since 1949.

Secondly, the greater your trading borders are that maintain capital control – and of course, China probably has the longest trading borders in the world. But the proof is in the pudding and it's pretty clear if you look at various proxies, there's no formal definition of hot money so, of course, there's no way of measuring it. But if you look at various proxies for hot money you can get a reasonably good sense of money flowing in and out of the country.

There have been periods like in late 2007 where hot-money inflows may have exceeded a hundred-billion dollars which is a big number by any standards. Some Chinese economists estimated even higher numbers. What we try to do is watch the PBOC. When they start acting like they are panicking about hot money then we assume there must be a hot-money problem and certainly in the last couple of months they have been acting like that.

MR. BRILLIANT: Can I just have a 10-second comment? You know, one of the things that has been lost because of the debate on currency and because of the financial crisis was the desire to accelerate China's movement to a capital market and to reduce capital controls, and things like that. We've lost that leverage in our discussions and, in fact, they've been sort of hijacked by the currency debate.

But there was, at one point, I would say around the turn of the – maybe 1999, 2000, 2001, 2002 a lot of discussion about capital-market reform, easing capital controls, convertibility issues and things like that. That's all slowed down because of the financial crisis, and here because of the preoccupation with currency which is unfortunate.

MR. PAAL: Ladies and gentlemen, I don't think you all stayed here because it's cold outside and you'd rather sit here and drink coffee. (Laughter.) I think we had a pretty interesting discussion. Michael, you've stayed up late but of course Michael runs the hottest night club and disco in China so he's just beginning his day – (laughter) – late at night.

MR. : (Off mic.)

MR. PAAL: And I want to thank him and Myron Brilliant and Yukon Huang for their excellent presentations. Thank you very much everybody. Please join me in – (applause).

(END)