Well, maybe we should get started. My name is Yukon Huang. I'm a senior associate at the Carnegie Endowment Asia Program. And first, let me thank all of you for trudging down here on such a cold day. This is going to be what I call a very complicated discussion today.

Let me start by noticing how much times have changed. Go back to 2010. China grew by 10.3 percent. That was good news. China accounted for half of global demand in the midst of the financial crisis. So everyone thought that was actually a very good thing. China grew last year at the rate of 7.7 percent. If you pick up the newspaper today, many articles will say that the good news would be if China's growth rate actually declined rather than rose. So what is different today? And what is different today is that China has a massive debt problem, and for many people, dealing with that debt problem to reestablish sustainable growth means that you have to compromise on the growth objective and that good news would be that growth this coming year and next would actually be lower; lower by how much, we don't know, but lower, and that higher growth actually would be bad news.

Now, the complicated factor is China's Third Plenum. This came out in the fall. And as many people have noticed, it potentially is transformative. If it is actually implemented, it can actually change the nature of China's economy over the coming decade and next. So what I want to do today is to talk about the Third Plenum and look at its implications for growth and debt and the future growth path of China over the remainder of this decade.

Now, the Third Plenum is a very complicated document. If you look at the decision note, it's ten pages. It's 16 sections. It's 60 issues. How does one digest something so complicated? And I'm going to try. I'm going to say to you it is as easy as one, two, three. And my talk about the Third Plenum is to categorize that it is one, two, three. The Third Plenum is about changing the way the economy has governed the governing structure of China, and it consists of one principle, two groups, three themes and two tools. And the principle is that the market will be decisive, and to make sure it works there will be two leading groups: one dealing with security, one dealing with the economy. And you're dealing with three major themes: to unify the urban rule area, to restructure the state enterprises and to realign the relationships between Beijing and the provinces. And to do that, you have to revamp the fiscal system and you have to rationalize the financial system.

So let me go through the Third Plenum, one, two, three, plus two tools. The first one is the principle. The market will be decisive in setting key prices, allocating resources while the government's role is to complement the market. But this principle requires sound institutions in competitive markets. This is not the case yet in China, especially for what I would call the three key factors of production: capital, land and labor. Until you get sound institutions, competitive markets, these three prices remain or will remain distorted. And the big challenge in China is how do I get to that point. But people think when they – about the market being decisive and setting prices, they're thinking about
outputs, commodities, energy, the cost of food or manufactured goods. That's not the issue. It's capital, land and labor.

Two groups: dealing with security and the economy. Why these two groups? And the first is dealing with security, and they create a National Security Commission. And the second is dealing with the economy, a leading group to deal with economic reform. And many people think that security, the immediate perception was they must be talking about foreign security, the South China Seas, the relationships with the neighbors, nuclear issues. Not really. It's domestic. Now, why is it domestic? It's because of the rise in mass protests, 160,000 incidents of mass protests a year increasing exponentially, the costs of dealing with mass protests, mass incidents in China now exceeds the military budget. The world is worried about the military budget, but they need to realize that actually China spends more in dealing with domestic security than it does with the external security, and this is, of course, a big issue for the party.

The economy: if you survey Chinese – excuse me – they will say that they're much better off than their parents, the highest in the world. That's a Pew survey. Now, some people will say the Chinese are always optimistic. They always come out with positive statements. But if you actually look at this question, this – in this Pew survey, five, six, seven, eight years ago China was actually not at the top. It was actually in the middle. So the same question's getting different responses. Nonetheless, many or most Chinese feel that their lives are better than they were, but many are still very unhappy because of inequality and the nature of the growth process. Security, growth, the two leading groups, and the fact that Xi Jinping is the head of the two indicates how important it is in China.

Now, there will be, actually – now it's just coming out about whether Xi Jinping being the head of both groups is actually a good thing or a bad thing, because if you think about it, it's kind of strange. He's already head of the country. Why does he need to be head of these two groups? What is the significance of him actually becoming head of these two committees? And that's, again, a very complicated issue which still needs to be developed.

The first cross-cutting theme: you need a better-managed organization process to promote productivity and an urban rule equity. Now, China is in the midst of a very rapid urbanization process. That's this red line. This blue line is what urbanization would have been in China if they had not controlled the location of people. And people cannot move easily in China. So traditionally, China's been under-urbanized, but it's rapidly catching up. And this is the trajectory. A better managed urbanization process will maintain the speed but do it much more efficiently. And we will see later that that is part of the story as to how China can grow faster in the coming decade, or at least be able to maintain the growth rate that it currently has in a more efficient way.

But the big controversy in China will be where do those people go. And if you look at the Third Plenum documents, it talks about the fact small cities, secondary cities, open them up; let people come. Large cities be a little bit careful but strictly limit the size of
the mega cities. And my point here is that I actually don't agree with that view. China's mega cities, the Beijing, Tianjin, Shanghai, Wuhan and Shenzhen, Dongguan, Zhenjiang, Shantou; the mega cities of 10, 15, 20 million, I think they need to continue to grow. Now people think that's crazy. You have cities which are 20 million. How can they be bigger? Won't they be more polluted? Won't there be traffic congestion?

Well, the reality is, people forget. This is a country with 1.3 billion people. It has substantially less arable land than the U.S. China's mega cities need to be bigger. And if they were bigger, they'd actually be less polluted, less congested, more efficient. And if China's going to be a high-income country, the high-valued service jobs are going to be in these big cities. So big tension the coming years is where will these people go and can they go to the big cities where productivity is the highest, and can China reap what I would call the productivity gains needed to become, in some ways, a more equitable society? That's the first thing.

The second is the role of SOEs, the role of the state. China has been very successful because it has allowed competitive pressures to drive the economy. This makes it different from the Former Soviet Union and Eastern Europe. It makes it different from India. Where do these competitive pressures come from? First, globalization: China competes with the rest of the world. That competition with the rest of the world is very, very strong. The second competitive pressure is regional competition between the provinces. Each of the 25, the 30 provinces and major cities, they compete with each other.

Now, if you look at the Indian economy, they neither compete globally, nor do the major states in India compete with each other in the same extent that China does. So China may have weak institutions. They may have lots of inefficiencies and problems, but the power of competition keeps China going on a relatively efficient growth path, which is not true in many other developing countries. But where China fails is the competition between state enterprises and private enterprises, which are weak. And this is the agenda for the coming decade or more, to maintain the competition between or to increase the competition between the state and private enterprises.

Now, why is this becoming so important? This is the rate of return or profitability between state enterprises and private firms. And this is private companies, the black line, the red line, our state enterprises, the gray line is the average. Now, many people don't realize it, actually, but state enterprises, the profitability, the efficiency, the return actually was increasing as fast or even faster than private enterprises for the last 10 or 15, 20 years until the global financial crisis. And by this point here, around 2007 and 2008, the difference in returns between private enterprises and state enterprises had narrowed to only 1-1/2 percent, which is insignificant, and it's particularly insignificant because the state enterprises are concentrated in activities which inherently have a low rate of return: the heavy industries, the utilities. So for all intents and purposes, by 2007, the performance of state enterprises and private enterprises were actually roughly the same, despite a common perception that the state must be much more inefficient or must have a lower rate of return.
But something happened. Something happened during the crisis, and you can see that returns to the state enterprises almost collapsed. The private enterprises took a little dip but then continued. And the state enterprises have not actually caught up. They've actually not rebounded, and the gap today is six or seven percentage points. It's enormous. It used to be 1, 1-1/2. It's four times as much. The reliance, the pushing out of funds during the fiscal stimulus in 2008 fundamentally changed the financial performance and relationship between state enterprises and private enterprises, and this is going to be a huge challenge in the coming years if China wants to get back to a sustainable growth path. So this is the second theme.

I think the battery's out on this thing. [Laughter] Can someone help me here, Alex? This – if I could do it manually on the machine now.

**Audience Question:** Excuse me. While we're waiting, you said this was all about pushing out of fiscal resources.

No, no. What happened here – and frankly, the analysis of this has not been firmly done – you had this $600 billion stimulus program that came out in 2008 or 2009. A large chunk of it went to the state enterprise or the state sector. Production capacity increased dramatically. They have a huge stock of excess capacity. They've gone into areas or done area things which I would say didn't make a lot of sense. So the liabilities and the problems with that have stayed with the state enterprises, but it's not affected the private enterprises as much. The financial position of the private enterprises in China are reasonably strong. But the financial position in many state enterprises, in particularly sectors, have deteriorated dramatically.

But there's another thing that's actually happening. In both sectors they've become what I would call running up to the limits of potential of how they can expand and grow after 10 or 15, 20 years. So the next generation of actions has to be that state enterprises can move into areas of the private sectors formerly dominated. And this is, I think, one of the big issues that the Third Plenum decisions is getting into.

Third, cross-cutting theme; very little attention to this theme, but it's actually the most important one. This will determine the way this country operates. It's the relationship between Beijing and the provinces. And this is unique. This actually explains how China functions. You have a regionally decentralized administrative structure. It's designed to support economic and political objectives. Beijing sets the objectives and targets for each of the provinces. It appointments and rotates local officials to achieve national objectives.

Their performance, their regional performance shapes promotion prospects. So someone like Xi Jinping goes to Fujian. He goes to Shanghai. He goes to various provinces. He does well and becomes the president. The next potential successor is now in Guangdong. He used to be in Inner Mongolia. If they do well, they're assessed. They get promoted. And what are they assessed on? Economic targets political. Now the economic targets
are easier: grow, invest, trade, do various things. And there are known policy instruments: prices, incentives, whatever, credit.

The provinces are encouraged to experiment, and they do because they want to achieve better. And the success is easy to measure and reward. And there's a feedback loop between Beijing and the provinces which is relatively efficient. And this helps drive the economy. And since your senior officials, the party secretary, the governors, the major mayors, they all don't come from the province. They come from outside the province. They get – they're in for three or four or five years. If they do well, they leave. It has fundamentally a structure you don't see it in any other country.

The political objectives are more abstract: maintain peace, security, stability, keep the people happy. How do you do that? The uncertain policy instruments, you don't really know how to do that. But stability is paramount. The key thing in China is maintain security, maintain stability. So Beijing exercises what I would call conditionally autonomy vis-à-vis the regions. You out there, the party secretaries, the mayors, the local officials, I'm going to watch you try to achieve these objectives, but if you don't do it well, I'm going to do something. And the normal way that officials at the local level respond is what I would call a combination of concession with repression.

Now, remember: there's 160,000 incidents of mass incidents a year. "Mass incident" is defined as two or three or four, five people protesting or more in some way. It could be trivial; it could be serious. How do you deal with this? And most of the time the local officials deal with it with a mix of concession – what's your problem? Let me solve it. You have a wage complaint; let me raise the wages. Your land has been grabbed; let me sort it out. But you don't want to encourage this. So every time you have a concession, you also have a repression. Somebody goes to jail. Somebody gets punished. Mix of concession with repression, and the last thing you want is that the issue is escalated to Beijing. And it happens through the petitioning system. If the people come, that's a problem for the center. And this insulates and protects the center.

Now, this system has worked extremely well for three decades. It's managed very good economic growth. It's managed to contain and maintain relative political stability, but it's under stress. It's under stress because on the economic targets growth investment for the sake of growth and investment is no longer acceptable. You have environmental issues. You have equity issues. You have sustainability issues. So these targets are being modified, and they are being put out in a different way and people are going to be assessed differently. But whether you can achieve it or not is not clear. So this is a new system.

And the politics of the system is changing. This has not been able to contain the incidence of mass arrests. The costs have increased dramatically. The pressures are going higher. And most importantly, the senior leadership in Beijing are increasingly being drawn into incidents at the local level that are potentially have risks to the state, and they have increased. And whether it's a Bo Xilai affair or it's in Guangzhou and Shandong, or a village in Guangdong which wants more representation, the center is
being drawn in. And how this relationship between Beijing and the localities is handled will actually determine the governing structure of China in the future.

Instruments, the budget: if you go through the Third Plenum decision, what you will notice is enormous amount of attention on the budget. And I mention that because when you go through the financial pages of the newspapers, very little on the budget. This all about banks and the financial sector. But the Third Plenum gets it right. It realizes that the major problem in China is the budget, and the budget is extremely small, relatively speaking. Here is an economy, a country, state-owned, land, major resources; everything is owned by the state. The government provides a range of social services which exceeds normal. They have to do everything. They have to basically respond to everything, much more than a market-driven economy, yet China's budget as a share of GDP is very low, much lower than OEC economies and much lower even than middle income – upper middle income economies, and the expenditures on social programs is very, very low, relatively speaking, to the size of the economy.

And because the budget is lower than normal, for a country that you'd expect the budget to be higher than normal, you have a big problem. And the big problem is that you fund everything through the banks. So the banks are actually your budget instrument, and that should be the way it is, but that's the problem. But you can't solve the banking problem unless you solve the budget problem. Now, why can’t you solve the budget problem fairly easily? And you cannot because the structure of the budget is messed up. The taxing power is centralized largely at the Beijing central levels. The local levels have relatively less taxing power or sources of revenue.

But the expenditures, who spends the money, is largely at the local level, the county level, the prefecture, the provincial. The center doesn't really have much expenditure responsibilities, this is the expenditure responsibilities. But the center collects most of the money. So you have a very funny system. Those who actually spend the money don't get the money. Those who get the money don't spend the money. And you have to fundamentally restructure the fiscal system who collects the revenues and who's responsible for services. And you have to do this for a budget which is actually too small. So this is a major problem that’s going to take the rest of this decade to resolve.

Trouble with – oh, got it. Now, this is the guts of part of the debt problem in China, the local government debt problem. You read about it in the paper. The local governments are in debt. They're building all sorts of things that aren't needed. They're developing land in the rural areas. This is driving the farmers off. This is – lead to ghost towns in cities. So what has been happening in China? And if we understand this diagram, we understand the nature of the debt problem in China.

Here's a local government. This local government doesn't have enough tax revenues, as we just indicated, doesn't get enough money. It has to provide social services. Where is it going to get it? What they've been doing is creating what is known as China as local investment companies, local government financing vehicles. And they give these vehicles some money, and they give them land. And this vehicle can function because it
becomes a company, a corporation. Whereas the government can't borrow, this vehicle can borrow. So it borrows money from banks by giving them collateral that the government's given them and gets money. It borrows from financial intermediaries, gets the money and gives them shares in bonds. And then it builds transport, energy, water and housing spends a lot of money. But critical to this relationship is land. If you don't have land, you don't have collateral.

So what has been happening over the last ten years? Land speculation, land sales, land development. And that's the only means because you don't have the taxing authority or powers that you normally have. You don't have property taxes. Your income taxes are almost nil. Your sales taxes are already so high that people are evading it. So the only means of getting money if you're a local government is through land sales. And it become excessive. And then the land prices go up to the sky. They go through the roof and you have a property bubble. And these entities, what are they building? What are they financing? Infrastructure, housing, water supplies; very little revenues. They don't pay off immediately. How can they service their debt? They cannot. So you hear about local government debt build up to very sizeable portions. This is the fiscal problem.

Financial reforms: enormous agenda here. You need to promote competition between banks, between state banks and state banks, between state banks and private banks. But your banks are too large and they're too dominant. You need to strengthen capital markets, equity markets, bond markets, very, very small in China. You need to eliminate the bias favoring state banks and borrows, and you have to improve the regulatory system. And you have to have a capital market. Capital markets will allow the formation of more flexible but not necessarily higher interest rates.

Now, most of the time, when you pick up the financial pages, it's talking about the banking sector needs to reform, but it's talking about interest rates. And practically every article will say that interest rates in China are too low. And this leads to all sorts of problems. But the reality is, interest rates in China are actually too high. They're not too low. The problem in China are the banks are too dominant. Compared to any other country, the size of the banks, the deposits in the banks, the lending in the banks, the credit flows of the banks in China way exceed norms. And we now know why; it's because the budget it is too small. If the budget were actually sensibly sized, the banks in China would not be playing such a dominant role, and much of the financial stress you see in China would actually be contained.

But many people then, however, focus more on the interest rates. These are one-year deposit rates. I live in China a portion of the year. I have a bank account at the Bank of China. I have a bank account in the Bank of America down the street. I put all my money in the Bank of China in Beijing. I get 3-1/4, and my money is essentially insured 100 percent because it's a state bank, totally government guaranteed. And then when I put my money in China, I get it in renminbi, and the renminbi is appreciating. So why
would I put my money in the Bank of America, which pays me 0.05 percent, insures me to $100,000.00 or plus. The dollar is diminishing in value. And if you look at it, China's interest rates, deposit rates, lending rates have been free, but deposit rates are controlled; China's deposit rates are quite high, and they're even quite high after you account for inflation.

And then if you take exchange rates into consideration, it's really high. No wonder, therefore, that more and more money is moving into China because of high interest rates. Yet, if you pick up the newspaper, every article will say interest rates in China are too low; they need to go up. And then they argue that if you liberalize rates or if you sort of like free up rates, they will go up. And they will. And they will go because China's financial system is distorted and repressed. But supposed China fully liberalized. They let money flow wherever it wants to flow. And people all of a sudden are allowed to move money in or out. You will then see that China's interest rates will actually fall. Because China is connected to the global financial markets, it makes no sense for savings rates in China to be over three percent and savings rates in every other financial center being less than half a percent, especially when exchange rates to interest rates are played.

Another major issue that needs to be addressed, but no so obvious, China invests a lot; 47 percent of GDP. It's gone up enormous amounts. But not many people realize that the increase in investment rates, the share of investment to GDP is very much geographically located. It's all occurring in the interior. This is the investment – regional investment share of GDP of the western provinces. This is of the coast. And if you look, the surge in investment over the last decade, all of it was in the interior. It's not along the Shanghais, Beijings, Guangdongs, but the press makes you think it's that way. After all, those are the major trade centers, the industrial centers. But it's largely in places like Xinjiang, Guangzhou, Shanghai, Zoucheng.

Is this a problem? It is a problem. It is a problem because the rates of return, the investment efficiency, as measured by the ICOR – now the ICOR is the Incremental Capital-Output Ratio – high is bad, low is good in terms of return to investment. The ICOR for the western provinces are fundamentally higher than along the coast. So you invest more and more in the interior, but you're getting lower returns. Now, the interior as a consequence is starting to grow faster. It's growing faster than the coast. No wonder more and more investment is going to the interior. But the returns to investment in the interior are much, much lower. So when you look at China overall, you see a declining efficiency of investment, but you have to realize it's very much a regional or spatial issue as opposed to the efficiency of the country as a whole. This is a major issue the government has to decide. A policy designed to promote more equitable distribution of income between the coast and the interior also has a very negative impact in terms of lowering rates of return for the country as a whole.

And you can see the consequence. Roads can have a high or low return. Here is a major highway in Jinjiang. There's no traffic. They want four lane – four or five-lane divided highways, but there's very little traffic. Here is a road outside of Beijing, 60 miles outside of Beijing, total concentrated mess here. This has a very high rate of return if you
can build more road and solve it. This has a very low rate of return. And as you push out more and more infrastructure in areas where there's no demand, you get a low rate of return.

Will the Third Plenum reformance change perceptions about China's unbalanced growth? The standard concept of China is consumes too little, invests too much. And you can see it in the historical decline and consumption as a share of GDP and the rise in investments as a share of GDP, and it really zooms up during the stimulus program. Investment zooms up, and consumption declines.

If China implements the Third Plenum reforms, will you see a more balanced growth process in China, because if you pick up newspapers, 90 percent of them will say the major problem in China is its unbalanced growth. Consumption share is too low. Investment share is too high. And the answer is no. If you look at the decision note, there is no mention at all about imbalances or unbalanced growth. It actually gets it right. It says that our goal is to have the proper relationship between consumption, investment and trade. It doesn't actually say that this is too high or this is too low because – I have a problem again – because urbanization doesn't work, because urbanization, if it is done well, actually leads to more unbalanced growth. So China continues to become more urbanized. You will see that as a natural consequence of the process that this consumption, that this consumption share of GDP will actually stay low. Can you – is there any way you can just change the start, or change the next one here? I think you can go back a second. Okay, go there. Next one, yeah.

You'll see that China's growth path designing its declining consumption of share of GDP, which has been happening for 20, 30 years, is essentially the same as Japan, Korea, Taiwan, Singapore. They all have this declining consumption as a share of GDP, and then it flattens out. Now, the interesting thing, when it flattens out, the so-called balance period, let's note a few things. That balance period stays relatively level for decades. It's not like it bounces back up, become balanced and you get balanced significantly. You don't, actually. It changes very little, which it flattens out. China is just starting to enter the balance phase, but it hasn't really quite reached it. Next slide.

So why does urbanization cause unbalanced growth? You have a farmer, let's say in the far West. So he's produces his rice worth 10,000 renminbi. He spends $100,000.00 for seeds and fertilizer, and he nips $9,000.00. He consumes $7,000.00. He saves $2,000.00. This is a typical farmer, actually. It's actually the typical numbers for a farmer. He now moves to Guangdong. He works for Apple producing iPods. Apple pays him 30,000 renminbi three times, and that's the urban rural income differential. Urban income's a three times rule. They bring in parts and components and they produce an iPod with a value add of $60,000.00. So wages here are half of the value added. And of this $30,000.00, this farmer now consumes $15,000.00, 50 percent, which is the norm, and he saves $15,000.00.

Now, this farmer is deliriously happy. He used to consume $7,000.00 and he now consumes $15,000.00, more than twice. He used to save $2,000.00. He now saves
$15,000.00. But labor share output goes from 90 percent, 9,000 out of 10,000, to 50, 30,000 to now 60,000. Consumption as a share of GDP goes from 70 percent, seven out of ten, to 25, 15 out of 60. Now, here's an interesting phenomenon. This is what's been happening for three decades. A farmer leaves. His income triples. His consumption more than doubles. His savings goes up seven-fold. The company makes a fortune. The country grows at ten percent a year, but consumption as a share of GDP falls. And after you have 250 million migrant workers moving from rural to urban areas, you have the steady decline and consumptions of share of GDP.

You have unbalanced growth. Nothing wrong with this, yet everybody writes and says unbalanced growth in China is bad, that consumption is repressed. How can consumption be repressed if its consumption more than doubles? Why is he better off if he's able to save seven times as much as he used to be? And why is the company any worse off? They get this good labor. They paid in three ties. But they're very productive, and they reinvest and invest, and China grows at ten percent a year. This process has not stopped. It's going to continue under the Third Plenum, which means that unbalanced growth in China will actually continue or even get worse, and you will pick up many articles where people are saying, "Are they rebalancing now? Is it going to happen now?" And the answer will be, "If they are successful." If they do it well, no, it won't. And it shouldn't.

And there are many articles which say China's growth must be more consumption driven. How can growth be more consumption driven when it's already growing more rapidly than any country in the world? Consumption in China in real terms, real terms is growing at eight percent a year, 11 percent nominally, nominal terms, building in prices. Think about the U.S. Here, we're wrestling with weather consumption will increase at one or two percent a year in real terms. Consumption in China's growing eight percent, four times. Yet people will write say China needs a more consumption driven growth process. It just doesn't make any sense. But that's what you'll read. But what can the Third Plenum Reform really do to change the nature of China's economy, and that is it needs more urbanization, and it needs to increase the share of services in the economy.

Now, I want to look at Japan, Korea, doesn't work. [Laughter] Japan, Korea and Taiwan. They are the path that China's on. This is their urbanization lines here in their critical development period. What you see is a very rapid urbanization, which then levels off. And they all level off. Japan here, Korea and Taiwan later, as you would expect. When this line levels off, growth becomes more balanced. That consumption, investment, share flattens out more. Here is China's urbanization line, way down here. It's got a far ways to go. You will not see balanced growth in China until this line starts to level off. Now, why is it that urbanization, when it levels off, you start to get more balanced growth? It's the service sector, the growth of the service sector and when it starts to reach its maximum, because services is more consumption oriented. Services does not require as much investment. Services generates high-valued ways jobs.

But China's services, as with its urbanization, is really too low and has been repressed for decades. So the critical issue in the Third Plenum also: can urbanization increase rapidly
enough? Can they reduce the restrictions and regulations which prevent services? Can they get to a path which looks more like this? And if they do, China's economy will become more balanced, but sensibly so.

Next: debt. This is what markets are fixated on. China's overall debt as a share of GDP soared with the stimulus and continues to increase. So many people are predicting, or some people predict a crisis, but many people say to deal with this debt you have to basically slow down the economy. You have to cut off the credit supplies. Let's look at the composition of this debt. Household loans, consumer loans, the property bubble, the residential thing. Three years ago, when you pick up the paper, everybody said, "Financial crisis in China because of the property bubble, the housing bubble. Prices are too high." And they all felt that way because they had the memory of the UI states in mind. The crisis here was housing driven.

But the housing bubble, the consumer bubble, the household debt issue is not really an issue in China. Then you have the central government, the government debt, this little line here, this little 22, the shaded area here, not an issue. Central government debt in China, very, very small GDP, much smaller than other countries is not the problem that you see in Japan or Europe. Local government financing vehicles, that has jumped up. But as the share of the total debt, despite all those borrowings and infrastructure buildings and everything we've build about, it's actually a very small percentage of GDP. It's also not the source of the debt problem in China. This increase in debt in China is in the corporate sector.

So if there's a vulnerability, if there's a financial problem in China, it's going to be in the corporate sector. And there are people starting to write about it's not local governments, it's not the central government, it's not household, it's not the property bubble; it's the corporate debt. It's very, very large. And then because it's very, very large and because it increased so rapidly, China's going to have to collapse or will collapse, as in Malaysia or Thailand or Korea or Japan 20 years ago.

But there is a difference here, actually. This corporate debt – go back. This corporate debt is not the same kind of corporate debt that we know in the West, and the first reason is a very large chunk of this are state enterprises, maybe 60 or 70. And some of these are state utilities, the railway corporation, the power sector, the heavy industries. Some are what I would call more normal kinds of industrial enterprises. But their liabilities, their risks are not what I would call normal corporate risks. They are essentially the risk of the government. So much of the corporate risk debt in China needs to be looked at as a state debt risk and not a so-called "corporate risk debt."

Let me go further. Next. A lot of ____ talk about shadow banking. Now shadow banking is essentially defined as loans which do not go through the banks. They go through other corporations. They're equity financing. They're bonds. They're sort of like, companies would use banks as conduits and pay them a fee. Shadow banking consists of all these colors, and they become large, and they only emerged in the last four or five years. So many other articles will say, well, the risk is going to occur because of
shadow banking. Normal bank loans, this dark blue, the normal kinds of bank issues, they've actually declined as a share of GDP. So the financial crisis in China is not a crisis of what I call normal banking form. It's a crisis if there's a crisis in terms of the growth in shadow lending, which actually don't use the banks, or they use the banks as an intermediary.

Now, the word "shadow banking" immediately generates a view of problems, risks. China shadow banking is an issue because we know very little, and we also realize that risks are greater in this economy than other economies because people don't quite know what's going on. It's not very transparent. But shadow banking exists everywhere. And shadow banking dominates the lending in the United States. It's the lending that goes through corporates, financial houses, the insurance companies, private equity funds, everything else. Shadow banking as a share of GDP in China is only one-quarter that in terms of the size of the economy as it is in the West.

Now, it doesn't mean that there isn't a risk. It means that the emergence of shadow banking is actually an indication of what I would call a breakout of financial and diversified products in China that is now, has been existing in the West for a long time, but it's riskier because people know much less about it. But its size, actually, is actually quite small relative to the size of the economy. So this is going to be an interesting question, but the nature of the risks are also not fully appreciated or understood. Next.

China's debt problem is high, high because of the corporate increase, but largely state. But China's debt as a share of GDP is much lower than developed countries, but much higher than developing. And this is very difficult to evaluate. Is China's – do you see China as a developed country or do you see it as a developing? Clearly, on per capita income terms, it's a developing. But in terms of many other structures, it's more like a developed. This also makes it very difficult to assess risks in China. Next.

If you look at the analysis of all the major investment banks and financial centers, the general conclusion is rapid debt rises a serious but manageable concern. And the reason why it's manageable is it's largely domestic. They don't borrow externally a lot. It's backed by enormous reserves. It's $3.8 trillion, enormous amount of household deposits, one of the highest in the world in relationship to lending. And it's supported by trade surpluses. If you look at all the other countries which had financial crisis and had a real problem, they don't have any of these characteristics. They're running trade deficits. They're borrowing a lot of overseas. They didn't have a lot of household deposits. The local level government debt is a problem. It's increased dramatically. It has to be curtailed. It needs to be dealt with. But it's also, in terms of size, actually not a big issue.

Shadow banking is a risk factor. Very little known. Needs to be better regulated. It has to be contained. These things are all problems that need to be managed put probably aren't manageable. But to make it manageable, you have to grow at seven or eight percent a year for the future because if you don't, then the interest burden, the problems become very hard to deal with these issues. So the tricky issue is can you do it? Can you achieve seven to eight percent reforms? Can the Third Plenum do this? Next.
And here's the issue here. When you put out money in the system, when you lend a lot in China, in the past you got a lot of growth. This is the growth impact of credit, the ratio of credit divided by real GDP, and low is good. When China pushed out money in the past, expanded liquidity, expanded loans, it got a fairly big bang in terms of GDP. Last three, four, five years, it pushes out credit. The growth impact is not very substantial. So here's the problem: more and more lending, more and more debt, leads to less GDP growth in the past. So one thing basically is, less need to put out credit, but you have to deal with this because you're not getting the major impact. So big question is: why? Why is it that the pushing out of money in China in the last three, four, five years has not led to an increase in output that occurred in the previous decades? And I'm going to come to this because this real – is I think a really interesting question in China which hasn't actually been fully understood. Next.

And a really interesting question is: money's been flowing out. It's been invested, but it doesn't lead to growth. And the answer is, there are two definitions of investment. Economists have two definitions of investment and one is fixed-asset investment. One is gross fixed capital formation. Now, you out there probably think, "What's the difference? They sound the same to me. Their investment is investment. This includes the value of land and property transfers, but nothing real. This takes it out. So this is what I call real capital formation in the economy. And they used to be essentially the same, the growth path. But they diverted in the last three, four, five years. Public investment growing much faster and much higher than fixed capital formation.

Now, fixed capital formation is the concept that shows up in GDP accounts. That's growth. So the money that's been pushed out into China shows – and pushes up investment, but it doesn't generate the same bang for the buck in terms of gross capital formation. And the answer is price of land. The price of real assets has zoomed. And then the interesting question is: is this good or bad? I have an apartment in Beijing, bought it in 2006. The value has increased five-fold. Now, if I had to go out there and get some credit to finance it, I show up as a huge credit or a huge debt. Is this a problem? Well, it isn't a problem if my apartment at five-fold stays five-fold.

Now, here is the issue in China. For 2-1/2 decades, when you didn't have a private property market, the value of land and real assets was unknown and hidden. Now that you have a private property market and land is being traded, the value of land and real resources in China is not becoming realized by the market. And the big question is: the over-realized or appropriately realized? Suppose it's appropriately realized, that land in China and Beijing in major centers should be the price it is, that all this credit, all this money that's flowed out there, no problem. It's just realizing the intrinsic value of resources in China, which were repressed for decades. And then you're on what I call a more normal path. But supposed it's a bubble out there, that all this money out there and all the prices of land are overstated and sometimes it's going to adjust, it's going to come down. Then you have a problem.
But really what's happening in China, money is going out. It's spending on land. Remember all that local governments? Remember all the property? It's being spent in land and buying land, developing land, transfer of resources. And in some ways, it's actually what I would call the deepening of the financial system or the money in the economy rather than what I call a distortion. The distortion was in the past. It was all repressed. It is now becoming revealed. It's like discovering a hidden Mona Lisa in your attic. Before, no value to anyone. You find this Mona Lisa. You put it up for auction. Somebody paid $60 million for it. This is not, by the way, real investment. Nothing's changed. It's always been there, right? But now it's been realized. So the bank gives you a loan for $60 million. As long as that Mona Lisa's worth $60 million is not a problem. What doesn't show up is GDP. And this is happening throughout China. And it's going to be interesting because what it needs is going to be hard to say.

Now, productivity, this is the productivity increase in China. This is the increase in public investment, or excuse me, increase in fixed asset investment. Most people don't realize this because there are tons of articles out there which say productivity is declining. Return to capital is declining. Efficiency of capital investment is low. Most people don't realize that the productivity return to capital was actually increasing all the way up to the global financial crisis, and not declining; it was actually increasing despite ever-rising investment levels. And then it collapsed during the global financial crisis and stayed down. So the problem, the return to capital, the efficiency issue is largely a global financial crisis issue, but not necessarily a structural. Next.

[Inaudible comment] Can the Third Plenum Reforms increase productivity and growth? Yes. Shift more resources to the private sector, more efficient urbanization process, restructure the regional investment strategies, less for the interior, more for the coast. You do these three things, and you can add one to two percentage points to China's underlying growth. Its underlying growth is what it's actually intrinsically growing at now without stimulation, and that's 6-1/2 percent. That's why the growth rate is constantly sort of like inching down or seems to be falling, because it's still being propped up by excessive liquidity. Its real growth, if you strip at all that, is 6-1/2 percent. But if China can introduce these reforms, it can add anywhere from one to two over the next several years. And that's why I think that growth this year and next year will be 7-1/2 percent, and two years or three years down the line it'll be eight. That's assuming that they implement the Third Plenum Reforms.

I've talked too much. Sorry about all this. Let me stop here and take questions. Okay. Yes?

Audience Question: And to your comments on respite rates, on interest rates, it's particularly interesting that the received wisdom that we've received is that there's a repressed financial system so ____ liberalization and nominal interest rates would rise, putting in jeopardy the provincial investment units and also the state-owned enterprises. Can I draw you more on –

Okay, let's look at –
[Crosstalk]

Audience Question: Obviously you don't agree with that.

No, I don't. Look, the issue is, what do we think a true equilibrium interest rate is? What is a real market-driven interest rate, right? You liberalize interest rate controls in China right today, and that's the only thing you do. You just free up the deposit rate. Lending rates are already free. Deposit rates are not. Deposit rates will rise. That will happen. It will rise because the system's all screwed up. It's a repressed system. State banks have easy claim to household deposits because they have all these guarantees. They got all these things. Private banks do not. They have a hard time getting deposits. They will bid up deposit rates in a repressed system. So the pressure will be for it to go up.

Now, let's talk about a fully liberalized unrepressed system. The literature shows that, in their financial repression, when you liberalize it, rates go up, but then they go down, in a fully liberalized system. You open it up to the outside world. You let money flow back and forth, okay? Everybody in the world will start moving the money to China. I get 3-1/2 percent there. It'll be flooded with money. Why should I put and get it in the West and get 0.1 percent? Now, what will companies do? Suppose your big state Chinese companies with good credit. Right now, if you're borrowing in China you pay seven, eight or nine percent. I pay six or seven percent for a mortgage loan in China. I pay three to four here. Why don't I get my mortgage money here? Lending rates are much lower in the West than they are in China.

You have this arbitrage, and it's already happening. Chinese companies with international branches are borrowing overseas because they can get money at three, four, five percent. Why should they pay seven, eight or nine? Companies which can get into China in some ways to get 3-1/2 percent, they're already starting to do it. That's why you see reserves at 3.8 trillion now. They're coming in because interest rates are so much higher in China. If you have a fully liberalized system, you allow capital to move everywhere and you change the structure of the banks, China's interest rates will fall; they have to be. You can't have one economy with interest rates of three to four or five percent to savers and the whole rest of the world it's less than half, less than 0.5? It doesn't make any sense.

Audience Question: Of course, that would have to go ____ assume the liberalization of the foreign exchange.

Correct. But it's what I'm talking about a true equilibrium market rate. If like sort of like truly liberalized and have it equilibrium market driven, China's rates would have to fall. And look at it this way: China saves 52 percent of GDP, invests 47, 48 percent. It saves more than it invests. It's very strange. Invests an enormous amount, but it saves even more. What do we know about interest rates in a true theoretical, hypothetical sense in terms of equalizing savings and investments? If savings exceeds investment, interest rates will fall because in every other country it's the opposite; they invest more than they
save. \textit{[Laughter]} But China saves more than it invests. And it will fall until it equilibrates.

So it's true. If I just liberalize one rate and keep all the distortions, all the restrictions, all the biases in the system, rates are repressed. It will be just like a distressed bank out there in Washington. If I – if they're under heavy pressures, having problems, and they need money, they'll go out and bid higher for savers. They'll go bankrupt eventually, but they'll do that because otherwise they have no choice; they can't compete. In a repressed system, you have all these kinds of distortions. Okay? Yes, Peter?

\textit{Audience Question: [Inaudible comment]} First a comment – oh, excuse me. A comment on the question. First, a comment. I agree with almost everything you said. You have offered significant insights into the question of the capital markets, label markets, lend markets. I'd like to single out one that is the frequently focused on question of China's low consumption rate. You are completely 100 percent right. It's unfortunate that there is so much misunderstanding of that issue, including amongst some of your own colleagues at Carnegie. Now my question: on the corporate debt, that is what they need to focus on. Now, you tried to convince us that we don't have to worry too much because a very large part of this huge corporate debt outstanding is, in fact, government debt, government corporation, railways and so on. You estimated, if I understood you correctly, 50 to 70 percent. Well, that still leaves you 30 to 50 percent non-state of a huge amount. Is that a risk? How much of that part of the corporate debt is purely private and property related, as I believe a large part is? If it is, indeed, property related, how vulnerable is the whole system to a sharp decline in property prices? Thank you.

Let's suppose that 40 percent of the corporate debt is private. There have been – at least I've seen three or four, detailed studies of the profitability returns and cash positions of private companies, listed companies. All those studies basically show that their proper rates and positions are relatively strong. It goes back to that diagram where I showed you the rates of return on assets of private and state. The private ones are pretty strong. Now, most of the studies have a problem. They can't get into the smaller unlisted companies in the private sector of which there may be vulnerabilities. But I see no particular reason that those smaller unlisted companies are financially vulnerable. Partly the reason is, they don't get much debt. \textit{[Laughter]} They have to depend upon internal surpluses and savings. They don't borrow from the system. Likewise, when there's a debt problem, they're not the same indebted because they've never had.

Now, among the state ones, what we don't know is the distribution of that debt. Is it all the steel sector, the cement, the railways? And the answer is, a large chunk of it is, but not all of it is, okay? We also don't know how much of that corporate debt actually isn't corporate. It's actually local government financing vehicle debt because every local government financing vehicle has to become a corporation, and China's death statistics are a little bit messy. Now, other people are now beginning to realize that shadow banking and the way the central government has been classifying this debt, that there is a significant amount of that which is double-counting. How much, we don't know.
So some of our colleagues in the IMF are actually going to get into this question. How much that debt actually there is actually double counting and is really much lower? So in a nutshell, private sector – micro details don't reveal significant risks, state sector differentiated risk. But there is a risk there. A certain amount of this kind of debt out there is going to go bankrupt, and the question is, it's largely going to be a state problem. So what will happen in the end is that the government's share of debt and GDP's going to rise significantly. Now, there are studies out there which show that increase to be anywhere from two percent to ten percent of GDP. And so like possible maximum burden that has to be taken over the next ten years. And I think that is a problem, but it's not a collapse problem. It's a hemorrhaging problem. It's a phasing. It's a management that's very, very messy.

Where is a good example of China's risks? It's not Thailand or Malaysia or Japan. It's actually the Former Soviet Union because the Former Soviet Union, the debt was internal. It was largely government. You couldn't find it. It collapsed. It collapsed in '92. It collapsed because despite growth ten percent of the year, investment ratios of 45 to 46, it turned out that much of the production of the Former Soviet Union was nonviable. It was not competitive. It couldn't actually exist. China is actually saved because most of its production – most, not all – is pretty efficient or market competitive. That differentiates it from the Former Soviet Union. But like the Former Soviet Union, its debt, the contingent liabilities, the hidden responsibilities are not so transparent. So there is a risk out there of unknown nature.

Audience Question: Thank you very much. Vikram here from Carnegie. Thank you very much for this excellent presentation, Yukon. I'm glad you raised the point about double-counting of debt because when you put up that debt slide, you take these local government financing vehicles. They borrow money and they lend money. So their debt is actually, which are the liabilities, account to balance by their assets. And so the debts of the corporates are partly because of lending from the local government financing vehicles. So there is definitely double-counting when it comes to the NGFBs versus corporate debt. And there, it doesn't completely alter your story, but there is definitely double-counting, and I suspect there's double-counting elsewhere in that slide as well. My question to you is: I don't understand this point about an underlying growth rate of 6-1/2 percent. Could you elaborate a little bit more on that, please? Thank you.

Sure. Okay. China's growing 7.7. It's been coming down from 10.3, 9.2, 7.8, 7.7, and it still has pressure. It seems to be still going down. So for many people, the question is: is it artificially being propped up? If you didn't prop it up, what would be its intrinsic growth rate? What's its sort of like potential, commensurate with productivity and demand and what's going on? And my own back-of-the-envelope calculation, that roughly is about 6-1/2, that about one percentage point or more of GDP is still left over visages of past stimulus. It's the continuing expenditures and investment of local governments and corporations, which shouldn't occur, but they do because they don't want to stop production, et cetera, et cetera, and that's why I go down to 6-1/2. That's why I still think there's pressure on the growth rate to come down, and every couple of
months the government sticks – does something to try to push it up there. So I still think it has room to go.

Look at it a different way: what's the intrinsic growth rate of the economy if I break it down to components? It's essentially the growth of consumption, the growth of investment and the trade surplus. Consumption is about half of GDP. Consumption was increasing by 8-1/2 percent a year for a long time. It's come down to about 7-1/2 intrinsically, the growth of households’ consumption, the growth of government consumption. Investment is close to 50 percent of GDP. It was growing about 10, 11, 12 percent a year for decades. It's coming down. It's coming down closer to seven or eight. It's probably going to come down a bit more to five to six.

Suppose that trade is neutral. China does not generate either a trade surplus or a deficit. Essentially, growth is the growth rate of consumption and investment. One thing is growing around eight; the other one's growing around six or lower, and it's coming down. If they're growing at eight consumption, six investment at seven percent. If it comes down a little bit lower than I think it is, you're getting down to 6-1/2 or maybe even six. Now, I personally feel that the intrinsic growth rate in China right now, if you didn't do anything, is like seven percent consumption and six percent investment. That's seven – each is 50/50 at 6-1/2 percent.

Now, can it come down to three or four or five? Suppose investment collapses. You get zero growth in investment. But consumption continues at seven or eight percent. The economy will grow three to four. But of course consumption won't grow three to four. The economy collapses because households will change their behavior. So that's not to me a viable scenario. But could it go down to five or six slowly or hemorrhaging if the government doesn't do anything? And the answer is, it could. So I would not be surprised if growth hit five or six with no reforms. But suppose you start reforming. Suppose more money goes to private enterprises. More money is available to the coast areas rather than the interior. You urbanize and allow Chinese migrant workers the rights to buy land, housing in the cities, access to social services. I had a slide which showed you that migrants save half their income. They're making pretty large salaries in these cities, but they save half. Normal Chinese save a quarter of their income because they had to spend it on housing, education, schools, boom, boom, boom. Migrants cannot.

Suppose you allow migrants the same rights and privileges as ordinary Chinese, and they actually saved only a quarter of their income and not 50 percent? Growth would go up by one percentage point of GDP, one percent, a whole one percent just by that. [Laughter] You add that to the efficiency and these other factors, you get potential growth of one or two percent fairly easily. Now when I say fairly easily, none of this requires money. Hard stuff is when you have to spend a huge amount of money to get some growth. Easy stuff is if you liberalize and allow forces to spend or do something efficiently and it actually doesn't require anymore money. And the answer is, in China, many of the reforms don't require a lot of money, yet they generate growth. So a mix of sort of like growth enhancing reforms doesn’t have a huge credit need. You could
actually grow fairly well, but they're not easy to do. They're politically sensitive. It's really up to the government to figure out whether they can really handle this. Yes?

Audience Question: That's why I wanted to get into following-up on your last point is that a lot of what you've suggested requires the government opening up like letting in more migrants, et cetera, et cetera. But all the indications to – at least to an outsider like myself – is they're trying to open up the economy. But they're making very clear that there is going to be no opening up on the political side. And I know you're a, not a political scientist. You're an economist, and this has been a fabulous presentation. But do you want to venture out, a little out of your comfort zone to get into that aspect of it?

[Laughter]

Can you go back to that slide with the central local? Okay. This one here, I wrote an article for it. It's in the SICE Journal. It's also in the Foreign Affairs, because I was struck by this question as an economist: why is economic liberalization in China proceeding relatively fast and well and doing very well, but the political liberalization in China was essentially stagnant? The basic structures of what's going on in this country hadn't changed. I'm not a political scientist. So I was looking at it as an economic issue. And what I realized was that these actual these links are interlinked. For China, the political targets of stability required what I would call tight controls, stabilities, repression and concession and conditional autonomy in order to get the maximum growth product out of China to allow you – to allow China to experiment, to grow, to do it, handle it with ease. And this has been the – this is the China model.

Now the question has – now is: can you maintain this objective here while leaving this relatively constrained or repressed or controlled? And if you read my article, you'll see in there I don't think so. And I look at it as an economic issue. When the numbers of mass incidence in repression or acts increase so dramatically, the economic costs are enormous. So it's got to change, but it's going to change, but it's going to change starting at the local levels. People are, I think, making a mistake because they look for this change at the very top. They try and look at it in the standing committee. They're trying to see the actions of the senior leadership. I think it's going to be the relationship between Beijing and the localities because China cannot afford to have a complicated large economy moving forward and trying to micromanage or handle it from the top down, as it has been in the past.

So liberalization, political liberalization, in my view, first of all, is going to occur over the local level. And the relationship between the senior leaders in Beijing and the local officials, and the question will be how do you deal with this issue. So I do think there's pressure on the system, and I think there's a couple of things you're going to have to – that will happen. You don't want protest. You don't want appeals to Beijing. That's too risky for the center. That means you're going to have to basically say – allow local officials to deal with these issues more. You have to give them the flexibility because if they can handle it, it will not lead to a protest. It will not be escalating up, and that's what's been happening.
So you're going to have to see signs in terms of what I would call greater autonomy between the people and the local representatives in some way. You're going to have to see changes in the court system so that – don't have protests. Take it to the courts. But people don't take it to courts now, of course, because they don't see the courts as an unbiased neutral player. But pressures in the system, if it works, has to force these kinds of changes at the local level. And then if it forces a change at the local level, suppose the village head, who is now dually elected by the villagers, and they want him to do something and he can't do it, so the protest is getting serious, and he now goes to his boss up at the higher level and says, "I have a problem. I got protests. I got people. They want me to change something, but I can't do it because of this or that. Can you help me? Can you change it? Can you do it, because if you don't, it's going to get escalated to you and it becomes your problem, because if I don't satisfy it they're going to kick me out."

That, to me, is the nature of the change in China that's going to occur. But I'm not a political scientist, and I can't tell you the speed, but I see it coming at the local levels. And you can start seeing it at the local levels in certain ways. The people who manage or control incidents of mass protest at the local level have changed. They're no longer the security apparatus. It's become the party officials of a different form. It's actually mirrored at the top.

Why is Xi Jinping head of the security group? That group in the past would have been headed by the standing committee member dealing with security and discipline. It isn't. It's now being dealt with by the senior most party officials. That is happening at the local levels too because there is a recognition that that political liberalization security stability issue needs a broader view of its implications for everybody. Now whether that leads to what I would call a process of evolution, I don't know. But this is why I think this is actually the most important change in the Third Plenum, because if you read it carefully, you'll see indications that this is what has to change in China. Next question. Back there, in the…

**Audience Question:** Hi. I'm Dan Morrow with the Center for Global Development. Thank you, Yukon. Very interesting. In the third component for increasing growth going forward, it was restructured or regional investment strategies. And I take that to mean shifting money back toward the coast away from the interior and the West where it has been less productive. But my understanding is that the increase in investment in the interior and the West was driven by the political imperative. And why will that political imperative become weaker? I mean is it feasible to actually, from a political perspective, have that restructuring of the investment strategy?

If it's a political issue, if you go back and look at the surge in investment, it begins around 1999. And you go back and look what happened in 1999. Develop the West. So China sent massive investment into the 12 defined far western provinces: infrastructure, environmental, services and reform, everything, dramatic shift, and then develop the northeast, then the center rising; all these regional programs. Now, what they did was basically say that if we have to push out money – or if you have to do something, the
system makes it easier to spend money in the interior than it does along the coast because they could justify against these rule development or these regional development programs.

Now, initially, these had what I would call a good impact. They built needed infrastructure. They focus on environmental preservation. They restructured state enterprises. They had a long-term payoff. But this has continued. And then during the global financial crisis, a large chunk of the money went to the same kinds of areas and programs, and I would say that was overkill. Now, you look at GDP accounts, you see some very positive things. The far west is growing faster than the coast. The center's growing faster than the coast. China's regional inequities are moderating. But this is a huge heavy cost. How can you do it there for – how can you achieve the same objectives at lower cost? And the answer is, you can, and you can by focusing on social service and environmental investments in the interior and not trying to increase production. You can focus on not trying to build five-lane highways but smaller highways that actually serve people a bit more. And you can – if you can educate and help the people more, the ultimate solution is, frankly, they leave. They go to areas where there are more jobs.

One of the things you see in China is that a disproportionate amount of so-called "directed investment" goes to small or medium-sized cities as opposed to the mega cities. Therefore, if I have to spend money, I -- easier for me to get approval to spend it on a smaller city because the rules say it's fine, and secondly, the government wants people to move to these places. But the reality is people don't move to these small towns. They can't find jobs. They want to go to the mega cities. So we have kind of funny problems. You put your money in areas where you think you'd like to develop. They're backward they're -- they have problems, but they have low productivity. They don't generate jobs. You waste money. You're better off letting them leave. It'd be like the United States. Do we develop West Virginia by investing in West Virginia -- roads, highways, industries, or do we develop West Virginia by educating everybody in West Virginia and telling them to leave West Virginia?

[Laughter]

In the United States you can never get away with it. What governor in West Virginia will say, "My platform is I will educate all of you and you will leave, and those who return will have bigger farms, bigger lands, nice ecotourism, and they'll be well off. And those who leave will be better off." Now, ideally, an economist would say, "That's a great model." But politically it's untenable in the U.S. No governor is going to say like Detroit, "I'm going to say Detroit by basically closing it down and you all leave." I'm going to save Detroit by more investment, tracking more people, and boom, boom. That's what we have to do.

Now, China actually has it a little bit easier because its governors and state party congress people don't stay there forever. Yes, so there is a political issue, but it has some potentially policy implications which could actually improve the situation. Any more? Madam, and then here and then there.
Audience Question: Hi. Thank you for the wonderful presentation. I learned a lot, actually. And I'm just curious to know your opinions on the planned establishment of 12 more free trade zones of Shanghai, and do you think it's going to incentivize China to grow more rapidly? And do you think the interest rates liberalization could be realized only within those free trade zones?

Very good question. Free trade zone in Shanghai focused on financial services and not so much geared toward trade, production and commodities. The free trade zone concept for Shanghai is an excellent idea. But its success will be reflected in the fact that it doesn't exist. Okay? What do I mean by that? Suppose you say in Shanghai, well, Shanghai money can move freely in and out easier than elsewhere. In Shanghai, services will be less restricted. I can show all the American movies I want. [Laughter] Unrealistic, of course. You don't expect everybody in the country to go to Shanghai to go to a movie. And if I can send out $100 million from a Shanghai bank easily, not too hard for me to move my money to Shanghai and send it out.

So why do I bother? Therefore, if you actually have the same kind of a model 12 more places, 20 more places, 100 more places, then I think this particular idea has done its job because essentially it's not Shanghai anymore. It's everywhere. You cannot have a physical zone trying to pilot transactions which have no physical space. So I think it's a great idea in the sense of saying, "How do I actually try to liberalize this," and then finding out, of course, that it's not restricted to a particular area. It's actually something you should do everywhere.

So start off in finding that out, then find out that you should be done everywhere, and then pretty soon there is no special zone in Shanghai. There's no special zone anywhere. So I think this is actually a good idea, but success will be measured differently. Next? Yes, ma'am.

Audience Question: Hi. Thank you. Shaiah from Chinese Embassy. Thank you for your kind presentation and the positive idea. But my question is about the service industry. We do know that the service industry share is not so high as that in developed countries. But from your point of view, how about that currently? What's the _____ that has affected the ____ ____ in China, and do you have any idea about that? We all talk about it _____ more industry service – service industry, but how can we develop that? What kind of service industry will make folks will be ______ said at this moment? And from the skills environment, do you have any suggest on that from your experience? Thanks.

Okay. Services in China are, relatively speaking, low. They're around 42 or 45 percent of GDP. They probably should be closer to 50 or higher. Why has it not been increasing very rapidly? One, as I said before: urbanization. Urbanization, although it's been increasing rapidly, it's repressed. It's 52 percent of the country is urban. It probably should be something like 58, 60 now. It's going up to may 70, 75. Now, why does urbanization have such a major implication for services? Because services flourish when
there are a lot of people. When you have a lot of people concentrated, they need services. But what China needs are high-valued services, the jobs that generate salaries at 10,000 renminbi a month, not the jobs which generate 3,000 or 4,000.

Now it turns out the high-valued services, the ones that generate jobs of that magnitude, they're basically in very large cities. Why is it the salaries in New York are twice as high as elsewhere? It's that concentration of high-value services which only occurs at high-density very large cities, like a London or a Tokyo or Paris, boom, boom, boom, a Hong Kong or Singapore. Now, part of the problem in China is that if you encourage only urbanization of small and medium cities, you get basically low valued services. That's okay when you're relatively poor. It's not okay when your income is upper middle and you're trying to go develop. So China has to realize that the so-called high-value jobs require much bigger cities. They require specialized cities.

Now, they then require usually much more innovation, much more risk-taking and therefore private players usually are able to break into the – what I call the higher valued services easier and better than the state. And that's why I think the Third Plenum talks about opening up services for investment, whether it's health, education, entertainment and financial. If you go to China today, you'll see there are many, many people, for example, who want to open hospitals, nursing homes, assisted living, China's aging. People have lots of money. They want to spend it on this thing. But most of these hospitals are under invested and inefficient. But you have to pass through also to regulations to open up and expand these kinds of hospitals that are controlled by the state. You eliminate that regulation, you're going to see enormous increase in health investment in China.

IT, mobile, software controlled by dominant Chinese companies. They're growing very, very rapidly. So people will say, "Why do I need to liberalize? It's growing very rapidly." The reality is, if you liberalize that sector, it'll grow even more rapidly, and it'll move into kinds of things which the state doesn't really want to get into because it can make so much money from what it's already doing. So you liberalize. A lot of the private comes in. You allow urbanization plays a role. Education is a trickier issue. China's graduating eight times as many college graduates as it did ten years ago. The salaries of college graduates have declined so that they're no longer any different from the salaries of high school students.

So many people think that college graduates are China's strength in the future, yet they have the same kind of problem we have in the United States; our college graduates here can't find jobs. And it's kind of ironic that both China and the United States have the same kind of a problem, that college graduates cannot find jobs. But the reason for that is quite different. You graduate from a high school in China, there are multiple people who want to hire you. You graduate from college in China, you're struggling to find a job. Part of it is the fact they've actually increased their education and room at the higher levels more rapidly than they should have. And secondly, the nature of those kinds of jobs haven't been increasing as rapidly as it should be. And the third is the state pays too much. State enterprises areas pay too much, and they're too secure, so no one wants to go
into these service kinds of activities or risk or start up their own things. But if you change that structure, then more and more college graduates will realize that the future lies in them creating or doing their own things rather than trying to find a job with a state enterprise. And then if they do, they'll create their own jobs and their own demand. So it has to be part of what I call a changing structure of the Chinese economy. Was there a question over here, there? Yes? Let's weigh in one more, and then we'll have to stop.

**Audience Question:** Thank you. My question is in regards to your second theme, making SOEs more competitive. Was there any language coming out of the Third Plenum about how you think China is going to invest that?

The first thing I would do is encourage to read Vikram Nehru's *Trial 23* Report, and there's a chapter there about SOEs and private enterprises. This is the 23rd report produced through the government talks about changing the ownership structure and the management structure of the state sector, separate ownership, operating functions and they were trying to get around some of these incentive problems that we just discussed. A second kind of question would be opening up or allowing private enterprises to operate in sectors which are currently totally monopolies for the SOEs. The third thing I think is probably to me more significant, that you get these state enterprises out of there. You allow bankruptcies and closures. You basically declare that there's no logic in SOEs in certain areas.

And then I think the fourth thing basically is you start taking away the surpluses of state enterprises and moving into the budget. SOEs perpetuate themselves because they don't pay dividends in the same form. They generate monopoly profits. They either are able to expand or they actually go into other areas which they shouldn't even be going into, and there's no logic in that. So take away their surpluses, a lot more competition, close and change the ownership operation structure of these SOEs. Those are the kinds of ideas that people are wrestling with. They're all politically sensitive and difficult, though. One last question; then we got to leave.

**Audience Question:** Thank you. This comes off your last remark. You've described what could and should be done, broadly speaking, but will it happen? Does the leadership share – have the insights, the determination, the ability to make these things happen, or will bureaucratic muddle inertia resistance from SOEs or others halt or prevent it?

I don't know the answer to that question. I don't think anyone does. I think – I was surprised by the nature of the Third Plenum decision note. I thought it was path breaking, comprehensive logic. For such a huge document, it's only ten page. I mean the 12 – five year plan is hundreds of pages, so this is very pithy. So you have 60 decisions, 16 sections; they're all in there. So I thought, compared to the summary statement which came out a week or two before, which was, what I thought, very poorly done, the decision was quite well done. So I think the other issue that's interesting is I think the president really wants to see himself in the same mold as a transformative leader like
Deng Xiaoping. And I think that's his model. He wants to be known as someone who changed the nature of China. And we know that leadership matters, so it's up to him.

Now, that he put himself in charge of these two committees, you can see it very positively. If things don't work, he's responsible, right? [Laughter] If you put somebody else in charge, he could say whatever. So that's a good sign. It's actually, however, potentially a bad sign because you don't usually put the head of the state in charge of these kinds of committees. You usually try to get somebody else. But I think what he's signaling is there's a problem. The problem is vested interest in politics are so severe that I have to get involved. Now he's signaling something which I think is kind of interesting. The structure of these two committees basically signify a change, and the change is the party dominates. The government is less important. For better or for worse, that to me is a very complicated interesting issue because he now thinks you cannot get reform through the government apparatus. The prime ministers, ministers, demi-prime ministers, whatever, too much vested interest, too many cones and cylinders. You have to get it through the party. That is certainly different from what's been happening in the last couple of decades.

Now, what that tells me is that he's committed, and he wants to do something. It doesn't answer your question: what will happen? But I think he also – and they have also realized this is a ten-year agenda. It's not a one-year agenda. I think that's sensible too. So I'm encouraged by certain signals, but I'm also like you; I don't know whether it's going to happen or not. But they've created a potential possibility for it to happen, and they recognize that these political issues are serious, okay? Thank you very much.

[End of Audio]