

CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE

**THE SHAPE OF CHINA'S FUTURE
GROWTH**

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ALBERT KEIDEL: Well, good morning, everybody on this slow traffic day. On behalf of Jessica Mathews, the president of Carnegie Endowment for International Peace, and Doug Paal, the vice president for studies and director of the China program, welcome. We have a very interesting program this morning. The Olympics are over, and we are faced with a number of dimensions of questions about China's future economy. Did the Olympics matter? Is it going to join the global slowdown the way many other Asian and European economies seem to be? And more long term – is China really going to be able to translate some of this jargon-sounding structural shift – scientific development and harmony – into some tangible economic policies?

And we are going to focus on that last question initially this morning with some evidence from South China. And we are very fortunate to have the government economist from the Hong Kong autonomous region, KC Kwok, who has just arrived this weekend from Hong Kong for a visit in the United States, and who, over his career, has been involved in the Hong Kong economy intimately and also in the mainland economy in his position as government economist – chief economist, in a sense, of the Hong Kong government because as the flyer has mentioned, South China, and particularly the province of Guangdong, is preparing reforms that seem to be presaging or piloting a number of the reforms that have been promised for the mainland.

If you remember, about this time last year, the party congress changed the constitution of China to include scientific development in its organizational description of China's goals and purposes. And that sounds kind of abstract. What does it mean? But it is a shift from growth as the preeminent purpose of the Chinese economy and economic policy. And there is a literature behind the development of this concept of scientific development, which implies – if you go back and look at it over several years in its preparation, broadening the goals of the government. Growth is still a major goal and a necessary goal, particularly if jobs are created, but focusing on social needs, focusing on environmental needs, and a number of other problems that might seem to potentially thwart the continued successful expansion of the Chinese economy.

Scientific development is then confirmed this year when the new cabinet was appointed in March – the National People's Congress appointing a new government cabinet. And we now – the focus has been so intently on the Olympics until now. Will it come off? Will the pollution be a problem? What other issues might cloud the Chinese experience? Now that that is behind us, I think it is really appropriate to turn to the more important issue, at least in my mind, of where is China's economy likely to go in coming decades? And will it strangle itself on the various problems and issues that seem to be coming up?

If you look at the detailed biography of KC's, you will see that he is really an excellent person to give us an intelligent and informed view of just what kind of policy changes in a practical sense will be coming. And so I am going to turn it over to KC. He will speak for 20 minutes to half an hour and whatever. And we will then move to a question-and-answer period, which is often even more illuminating. So KC, thank you very much and welcome.

(Applause.)

KC KWOK: Thank you very much, Bert, for that very good introduction. You have almost said all the things I want and need to say from a very high-level perspective. But anyway, good morning, first of all, everybody. Actually, when I was planning my presentation, I had very little idea as to your background and your area of interest, and so forth. So what I have done with a very short

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PowerPoint outline is to give you a very high-level summary of some of the things I see happening in China.

The conceptual and the theoretical strategy – the outline of the Chinese leadership's thinking has been very well summarized by Bert just now. But what I will do, first of all, is to give you a very quick overview of these key issues, supplementing them with some examples I see happening on the ground. And then, I will see what follow-up areas you are more interested in during the Q&A session.

Bert just now mentioned China's economic slowdown and the Olympics, and so on. And bearing in mind that the whole world – almost the whole world is now slowing down, the natural question, of course, is to ask where is the Chinese economy heading. Well, it is a big coincidental that China's economic slowdown happens after – or during the Olympics. But I think when people talk about post-Olympics China and how far the Olympics will affect the Chinese economy, I think rationally it is just a non-issue.

The Olympics may be a big event in Beijing, but in the size of China, Beijing's economy is roughly 3 percent of China's GDP. So no matter how much investment you are talking about pumping into Beijing for the Olympics and so on and so forth, it is going to a tiny international scale. So one quick – draw analogies from Greece and Sydney and whatnots, but I think rationally, the impact of the Olympics on China is just negligible. It may have some psychological impact here and there, but that is a different issue.

But in any case, the bigger picture is that from a macro cyclical perspective, China's economy is, indeed, slowing down. I will turn it around and say China's economy – or the Chinese leadership wants the Chinese economy to slow down. The economy has been accelerating for the past five years or so to a speed of close to 12 percent year on year. It was around 10 percent, and then it was 11 percent, and then it is 11-and-a-half, and so on. And clearly, inflationary pressure is building up here and there.

Property prices are exaggerated. The stock market is in a bubble. Producer prices are rising fast. Bottlenecks are happening in the Chinese terminology – so-called – the oil, the transportation, the electricity, and supply of materials. There are bottlenecks appearing here and there. So the Chinese leadership actually was trying to engineer a slowdown, except that they want a gradual slowdown in the economy. And then, superimposed on this is the global slowdown leading to depression on the Chinese exporters. Like it or not, the series of measures that China has introduced in the past in areas like pollution control, tightening standards on labor – I mean, with the introduction to labor law, reducing export tax rebate, and all these policies in the past.

Somehow, they happen at the same time, so that at a time when global demand is slowing, the domestic price pressures are also putting a lot of pressure on the Chinese exporters. So you put everything together, you see the Chinese economy gradually slowing down in the last six months, nine months, and so on. But so far, I think this is actually quite healthy. What the Chinese government is worried about is that they don't want to see this slowing-down process from getting overboard, particularly given the fact that the rest of the world is still in a very uncertain state. And that is also the reason why recently the Chinese authorities have shifted their emphasis from what they call – (in Chinese) – or preventing overheating, preventing inflation to what they call – (in

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Chinese) – which means controlling inflation on the one hand, but trying to cushion and provide some support to economic growth at the same time.

So there is obviously a gradual shift in the strategy because the economy – while it is still a bit overheating, a bit tight – but the trends, it is slowing. So you don't want the slow down to gather too much momentum. So there is a gradual shift in macroeconomic strategy. So China's economy, in a sense, from a macro cyclical point of view is in a turning point. The slowdown is already happening. And I think China would be very happy if the economy slows down to, say, 9 percent growth year on year.

They still have some way to go before that. But if you look at the detailed numbers, the slowdown in China so far is actually not very significant. Consumer spending has been maintained at a reasonably high level. Retail sales are still growing at over 20 percent year on year in nominal terms. If you take away probably around 7 percent inflation, you are still talking about retail sales growth at the real terms of roughly 14 percent or 15 percent, which I wouldn't say is slow.

Investment numbers are still growing at between 28 – 29 percent on average in the first six, seven months of this year. I wouldn't say that is slow. Of course, you take away the price effect; the real increases would be somewhat slower. But still, I wouldn't say this is a very significant slowdown. The export surplus is still substantial. It is slowing down slowly. You look at last year. Net exports account for roughly – I can't remember the exact numbers, but it is roughly 2.5 percent, 2.8 percent of GDP. So even if net exports slows down suddenly to zero, you take away 2.5 percent, maybe 2.8 percent from GDP, you still get from 11-point-something, you still get 9 percent GDP growth.

So the domestic consumer spending, the domestic investment spending – so long as this could be sustained at a reasonable level – will have to cushion the Chinese economy from the slowdown in the rest of the world. And indeed, I don't think you should count on China's net export surplus to slow down suddenly from 200-something billion last year to suddenly zero. This is not going to happen. In the first half of this year, I think there is a bit of a slowdown. But you are still talking about 100 – I can't remember the exact number, I'm sorry – but it is 120 billion or somewhere around that number for the first half of this year.

So the slowdown is coming gradually. It is a turning point in terms of the macro cycle. But I don't think it is right to, you know, talk about China's going into a recession or anything like that. Of course, a lot will also depend on development in the rest of the world. So the Chinese authorities are still taking a very cautious stand and stand ready to give more stimulus to the economy if needed. The good news is that after a prolonged period of rapid growth, after the taxation reforms in the past, the Chinese fiscal position is now in a rather strong state. The central government, the local government, and so on have much better fiscal positions, so that if they really want to pour more money into the economy, they are in a position – they are in a better position to do that.

So much for the macro cycle. As Bert mentioned today, I think I want to put more emphasis on the medium-term structural issues. On the medium-term perspective, I think this is also a very important turning point in Chinese economic development. I won't go through the details because these are probably – the points given in this slide are probably very familiar to you. But there is an increasing realization – or I will put it this way. Three years ago, five years ago, the

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central government – you talked to decision-makers, you talked to the think tanks in Beijing, they could talk with you in these terms. You go to the local governments, you go to the provinces, you go to the major cities, you don't feel that these government officials talk in these terms.

But today, you go to the provincial governments, you go to the city governments; they are also talking with you in these terms, which is a sign to me that the message is now cascading downwards to the local level. Five years ago, you go to talk to any major provincial or city officials, they would still talk with you about attracting – we want more foreign direct investment. We want more industries for the better developed places. We want more heavy industries. We want more chemical industries. We want – what do you call – (in Chinese) – you know, heavy industries and chemical industries because they believe that these are the pillars of a modern economy.

Today you go to visit – in some places, you hear the government officials beginning to talk about a chain of industries. They are no longer focusing on what they used to call – (in Chinese) – the fist industries, industries that will help you to punch beyond your weight. In the past, they emphasized, I want to be a chemical producer or whatnot. They talk about strategic industries. And then, they gradually improve, and they say – they realize that we need a chain of industries. We need a supply chain. We need a production chain. So we want an agglomeration of different industries that could reinforce each other's competitiveness.

So they started to think about chains of industries gathering together and having those kinds of strings. Today, you go to these places, you talk to these government officials, you will find that they talk very literally about all these things. They are now talking about in their terminology what is called rationalization of industrial structure. They want a better economic structure, a better industrial structure. And then if you talk with them further, what they really mean is I want to have more of an emphasis on services because they now realize that manufacturing and services are not two totally different categories of activities.

A strong services capacity will help to enhance the competitiveness of your manufacturing industries. Ten years ago, a lot of Chinese knew that. I produce a polo shirt. I don't know – one dollar or whatever. That polo shirt sells in the U.S. for – I don't know what the price is – 70 U.S. dollars? Much more. The Chinese companies know that I manufacture all this stuff; I earn a very tiny margin. The big money goes to all these brands and advertising and trading and whatnot.

So more and more, the Chinese government officials – not only at the central level, but also at the local level, they are talking in those terms. And they know they are going to attract investments and promote developments in a totally different way. So I think there is more and more realization that all these factors listed here: low cost, export-led, investment-led, emphasis, da, da, da, da. But the Chinese economy has gone a long way on these factors and developed to where it is today.

But many of these factors have probably run their course or are about to run their course, so they need a new paradigm. They need new ways of looking at how to develop the economy going forward. Of course, from another perspective, the imbalances in the economy are increasing – urban-rural, east-west, haves-have-nots, you know, all these social issues that Bert mentioned just now. The imbalance between investment and consumption, between external and internal, and more and more, you talk to the academics, the think tanks. They are now looking at the dominance of the public sector versus the private sector, even though the private sector is growing very fast.

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I will talk a little bit more about this point, which is also very interesting, later on – and environmental degradation and so on. And therefore – well, I highlight here some of the changes that the Chinese are talking about, particularly in the last two years. Well, first of all, the title here is Changing the Mode of Economic Development. If you pay attention to the Chinese terminologies – in the past, they emphasized changing the mode of economic growth – (in Chinese). That was what they usually said in the past – changing the mode of economic growth. And in recent years, they have changed. It is very subtle, but if you talk to a Chinese guy and say, changing the mode of economic growth, they will laugh at you quietly because they know this guy doesn't really understand what is going on. He is just changing the word from growth to development. But it means a huge difference in terms of what is really underneath.

They have also changed in a very subtle way with fast growth – (in Chinese). You develop your economy in a fast and good quality way. Now they reversed the order – good quality and fast. Good quality comes first. We must develop the economy in the right way, in a good quality way. And then, we talk about fast growth. The emphasis is now different. All these are very subtle changes in terminology, in wording, in the order, in the sequence, and so on. And you find these in party documents, in government documents. But these changes actually are very important to Chinese government officials. They pay a lot of attention to these kinds of things.

So rather than relying on low cost as a competitive edge, they now put a lot of emphasis on – (in Chinese) – innovative capability, whatever that means. It could be scientific innovation. It could be design. It could be better ways of servicing your customers. But you just can't rely on low cost. China could no longer be just a low-cost competitor. They realized that. Of course, it took some time. Instead of emphasizing manufacturing, they are now talking about improving economic structure. Instead of just talking about attracting investments into China, they are now thinking about going out.

Our Chinese companies need to invest in the rest of the world. In the past, money is attracted to invest in China. Now China has a lot of money. They want to see how to invest the money. In the past, they attract a lot of people to come to China to work. They still do. But they are also thinking of how to encourage more Chinese people to go out and see the world. And you talk to some of these Chinese companies that are expanding globally. The critical challenge they are facing is they don't have a Chinese management that has the capability to deal with the rest of the world.

This is the major challenge to many Chinese companies who are developing their international connections. So going out is now a very big subject, but they encountered some problems in the past, some failures in the past. The central government is still very cautious in terms of all this control, so they want to do it slowly step by step. They are now, of course, encouraging, first of all, the resource companies to go out, buy coal mines and iron ores, and whatnots. The banks are gradually expanding faster. The trading companies, of course, the shipping companies, of course. But then, I think these things will gradually come.

In the past – (in Chinese) – economic growth is everything. Now the emphasis is very different – harmony and society. And initially when – (in Chinese) – someone said harmony is society, very few people in China know what he wants. With the introduction of the labor law, I think people now start to understand what that potentially could mean. The labor law effectively is

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– I don't know very much about the U.S. labor law. But the businessmen complain that the labor law in China is as socialist as the labor – (laughter) – labor laws in some European countries. Is that a good thing? I'm not here to give you the judgment. Your judgment is as good as mine.

But the labor law is effectively a very socialist labor law. And there are a lot of changes here and there. For example, in the past, you probably know a lot about the so-called – (in Chinese) – the kind of –

MR. KEIDEL: Household –

MR. KWOK: Household registration system. If you are an urban guy, you have registration in an urban setting. You are entitled to certain benefits – Social Security, education, medical, health, so on, and so forth. If you are a rural guy, too bad; you go back to the rural part to get whatever benefit, and typically that means no benefits. So in the past, there were a lot of rural people going to the cities working in the factories. And these people don't have any urban rights – any support from the urban governments because these people belong – their account belongs to where they come from. And if they bring the children to the cities, their children would not be entitled to free education in the cities.

So it is a big problem. But starting with some cities, particularly as Bert mentioned earlier on, in Guangdong, in some cities in Guangdong, in some cultural cities, the government – the central government is now saying very soon the city governments will have to look after all these immigrant workers. They will have the choice to become an urban resident. And you have to look after all these people's benefits and their family members as if they were urban residents. So they are putting a lot more emphasis on how to improve the Social Security system, education and medical benefits, and so on.

The governments are now a lot more conscious. They are a social service provider. You may take it for granted that the government should do this and that, but this is not – this has not been the case in many cities in China. The government does not have the concept that – public housing, for example. I don't know the housing situation in the U.S. in detail. In Hong Kong, a large number of people live in what we call public housing – public renter housing, or what you call home ownership housing – you know, cheap housing provided by the government to the people who could not afford the private market.

In China, there is very little of this. Now they are thinking about this. Many city governments are now instructed that sooner or later, you have to provide all this. In Hong Kong, for example, we have received many delegations from Guangjiao, from Dongguan, from Shenzhen – you know, all these cities. They send delegations of people to Hong Kong. They want to know how you guys provide all these services. Of course, they also go to places like Singapore and so on, but it is obvious from all these visits that they are very eager to learn these things.

I list here some of the ongoing reforms. The Chinese reform is still a very big project. The Chinese authorities like to say that China today is still a half-planned, half-market economy. And it is. A lot of administrative reform needs to happen because right now the government is still controlling too many things. The government still, for example – many state-owned enterprises still have their CEOs and senior management appointed by the relevant government agencies. So these guys run these state-owned enterprises. They appear to be a business executive, but deep down,

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they hardly know that – I am a government – I am a bureaucrat; I am a party member. My affiliation, my duty is to help the government, the party to run this organization. So most of the time, I run it on commercial terms; but from time to time, I have to listen to orders from my masters.

These guys may have stock options. They appear to have stock options in the annual report. But behind the scene, they may have already signed a contract or a deal with the relevant authorities that they may not be able to pocket all the difference in their own pocket. They may have to share it in some way and so forth. Obviously, this is not very satisfactory. And they are now gradually step by step trying to do this. Fiscal and taxation reform – more than half of China's taxes today come from VAT. And the VAT in China today is largely a production-based VAT. It is not a consumption-based VAT.

It was very effective. It helped to reverse the fiscal position of China. It was introduced in the days of – (in Chinese). It has been very effective for a long time. But more and more, there are calls in China that the VAT should be reformed. And experimental schemes have already been introduced here and there. Last year, the Chinese government reformed the property tax rate. Foreign companies operating in China will have their tax rate gradually equalized with the local companies. It means for some companies a higher profit tax rate; for some companies, a lower profit tax rate. This is now being gradually implemented across the country. It means a lot of work for the accountants and lawyers and so on. So some companies – the – (inaudible) – of their profits may increase or decrease because of all these changes in profit tax.

And right now the next big subject on the screen for Chinese fiscal taxation reform is reform of the VAT system. They may also change the income tax by raising the threshold at which people start to pay income taxes, but a bigger subject for the residents is what you do for the nationals of China rather than for foreign investors.

Financial market, of course, is a very important subject – an exceedingly important subject. Financial market development has lagged behind economic development in China for many, many years. I will talk a little bit more about that later on. SOE reform – further reform of the SOE. They have already done the big things. Many smaller SOEs have been turned over to the private sector. Many of them have been closed. The bigger SOEs are now much stronger organizations. But still, the government's influence is very obvious. In banking, for example, ICBC is now the world's biggest bank – even before the financial crisis in the U.S. The market capitalization of ICBC was bigger than Citi, was bigger than Bank of America, and so on – even before the American financial crisis.

But you have to bear in mind that ICBC is a protected bank in the sense that the lending rates are set by the government. The deposit rates are set by the government. And over the years, because the government needs to help the banks write off the bad debts, they have widened the interest margin. The interest margin between deposit rates and lending rates is exceedingly high in China. It helps the banks to earn a lot of money. But it means that a lot of customers are paying for the costs. The decision-makers at the top level clearly understand these kinds of issues. So they are still pushing a lot of – well, of course, you have the stock market, the factor market, and all these things.

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There are a lot of areas where the financial markets in China are not up to standard. But as the economy continues to develop, and if you are an economist, you know very well that efficient allocation of financial resources is exceedingly important. Otherwise, misallocation of resources, mispricing of risks are disastrous things in the longer-term development of the economy. And right now there is a lot of mispricing of risks, of assets, and there is a lot of misallocation of financial resources because you don't have a very efficient stock market. You don't have a very efficient banking system. So this inefficient allocation and mispricing of various resources is a huge problem. So long term – this is a big issue.

And then, of course, factor markets – labor movement is still restricted in some way. Land is not allocated in a very efficient way, financial resources, so on, and so forth. And then, of course, for environmental improvements, apart from doing all sorts of things at the top level, at the end of the day, you must have the right incentive system for people at the working level to take measures to improve the environment, which means, for example, oil should not be – petrol should not be so heavily subsidized. You must have the necessary systems in place to make sure that the bad guys are punished; the good guys are rewarded. So instead of just thinking about how to address the environment, you must have all these incentive systems in place. These are all the key areas where the government is already addressing. Of course, they have to do things one step at a time.

I mentioned earlier about financial market development. Specifically, I use this slide to highlight the importance of this to Hong Kong. China today has a very unique situation. It was one country, two systems. One country, two financial systems. The Hong Kong system is very open, very liberal, very efficient, very modern. The internal system is still a rather socialist one. How are you going to continue to develop the country and try to take advantage of one country, two financial systems to allow a better development – a faster development of the financial system?

Hong Kong, therefore, sees a unique opportunity to help China to do this. But at the same time, China is also very worried that if we gradually open up our system, and Hong Kong being so open, financial market contagion – if anything wrong happens in the outside world, it could be brought into China through Hong Kong, so financial stability and managing financial risks and contagion are also subjects on many Chinese decision-makers' minds. So there are huge opportunities, but also there are various issues that we have to be very careful about. But this – well, if you are interested, we could talk further about this.

I mentioned earlier about the dominance of the public sector. More and more, the thinkers, the academics, the think tanks in China, some of the smart people in China, they are now beginning to question a lot about why we have all these imbalances in China. Why does investment keep on growing so fast, and yet, consumer spending is not growing fast enough? Why do you have, you know, all these misallocation of resources problems? Why do you have over-investments and major investment cycles and so on? When you think more, a very large proportion of the fruits of Chinese economic progress is captured by the public sector one way or the other.

In many major sectors, the SOEs dominate – in banking, in infrastructure, in aviation, in almost all the major industrial or services sectors. The retail industry is very open. The light industrial manufacturing is very open. But when it comes to heavy industries, it is the SOEs. All the major services industries are still dominated by SOEs. So when the Chinese economy developed a very large part of the benefit goes to the SOEs; the SOEs, of course, at the end, go back to the government. And then, the rising share of government revenue and GDP. Thanks to Jurong Ji (ph)

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in the 1990s – Jurong Ji was able to reverse the decline – a very common chart economists use is the percent share of government revenue in GDP.

That decline continues to, I think, around 11 percent or so by the early 1990s, so total government revenue is only 11 percent of GDP back in the early 1990s. Jurong Ji introduced a series of reforms in the taxation system. That number has now gone back up – I don't know what the latest number. It is, again, close to 30 percent. So the government – you look at the government revenue, it grew yearly in recent years every year by over 30 percent year on year – total government revenue grew by more than 30 percent year on year at a time when the economy in nominal terms is probably growing at 15 to 20 percent, depending on the inflation.

And then, of course, as the Chinese economy grows, there are a lot of increases in asset values, in land values, in property, in other assets. And most of these assets, again, of course, are in the hands of the government. So much so that more and more local governments now realize that a major source of my revenue comes from land sales. Actually, it is not actually sales because it is actually a land lease. In China, China is still run by the Communist Party, and under the Communist doctrine, all means of production are owned by the state. So land could not be sold, but we could lease it for 75 years or whatnot. But a lot of these assets are still held either in the hands of the local government or in the hands of the state-owned enterprises.

So a very large part of the economic growth – the fruits of economic development go to puppet hands. And of course it means that the bureaucrats, the company executives will decide how to spend the money. And typically, they want to invest instead of giving the money to the hands of the consumer, who wants to spend on totally different things. So why doesn't the services sector in China develop very well? Because the consumers don't have the money to spend. It is driven more from the supply side. Companies will say I want to develop a bus service. I want to develop a train service. I want to provide this and that. It is driven by the supply side and not so much by the demand side.

So if you want to change a lot of imbalances in China, you have to address this imbalance. How to do that, of course, is another very tricky subject. Regional development – I don't want to say very much. I think most people know this. But there are different regions. But from Beijing's angle, I think Beijing feels that, all right, the Yangtze River Delta is up and running. The Pearl River Delta is up and running. Well, of course, there are still various things we need to do. But then, we need to diversify economic development in China – so the Bohai (ph) region centering around Beijing and Tianjin and the areas around it. The northeast – the three provinces in the northeast, Heilongjiang, and Jilin, and Liaoning. And then the – this used to be all industrially based in China. A lot of agriculture, a lot of heavy industries that needed to be revitalized.

Developing the West was raised in Jiang Zemin's time. It comes and goes. It is still there, but not many people talk about it these days. But at the end of the day, the development tends to focus in a number of cities like Guangzhou, like Chongqing, like some of the key cities here and there. In recent years, many people talk about rise of the middle, but I don't think a lot is happening. And with the improvement in the relationship between Taiwan and the mainland, there are talks about developing a Taiwan Strait across the economic region. Taiwan, up until now, is not particularly interested in it. So Fujian is trying to develop what they call the Western part of the Taiwan Strait economic region. (Laughter.)

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You know, they come up with an interesting concept that the Yangtze River Delta is there. The Pearl River Delta is there. It is like a dumbbell; the middle is in Fujian. So we developed Fujian, and we can link the two parts up. And bearing in mind also the fact that many of you may realize that China right now is investing heavily in railways, particularly high-speed railways. You are going to have a high-speed rail going all the way from the Pearl River Delta Region through Fujian Province into the Yangtze River Delta Region linking to Hangzhou and Shanghai.

And then another high-speed rail will go from Guangdong all the way to Beijing through the middle of China. And that is also the reason why Hong Kong is now trying to build a high-speed rail from – linking – (inaudible) – to Shenzhen, and then to Guangzhou. When this high-speed rail is built, it will take us only 50 minutes – less than an hour to go from – (inaudible) – to Guangzhou City. Today it takes us about two hours, sometimes slightly more than two hours to go from Hong Ham (ph) to Guangzhou. In the future, it will be less than an hour.

Of course, in the medium term, apart from all these reforms and so on, the key economic drivers in China are still very strong. On the demand side, there is the continuous improvement in living standards in the mainland and increasing consumer spending both in terms of quantity and quality. You go to talk to some of the people in China. You go to see cities in China, you can feel it physically. You see how people are spending money on housing, on cars, on furniture, and all these things. Urbanization is still going on at a rapid rate. Of course, in growth terms, it is slowing down because it is already happening on such a large scale. But still, you look at the broad numbers – still around 60 percent of the people in China are living in what are called rural areas – 60 percent of the population.

So you keep lowering this 60 percent and move them into cities. Effectively you need to fill a lot of cities, a lot of urban areas to house these people. And you just go to visit some of these housing states in China, and you look at what is happening inside. You see some of these families. You will be amazed by the amount of spending. It is nothing new. American homes are a major driver of the U.S. economy for a very, very long time. It is just that these kinds of things are happening in China only in recent years.

China has already got a lot of investments. A lot more investments, of course, are needed. After heavy investments in highways, China has already got a reasonable highway network in place. Now China is spending a lot of money on upgrading the railways and in building high-speed rails. And then, more and more cities are investing in subways. The city infrastructure still has a lot to do in terms of gas supply and so forth. So there will continue to be a lot of investment.

Industrial upgrading is another important – from the supply side, while China has already done a lot, you need to further liberalize the economy. You need to further restructure the economy. You need to further reform the government. All this will improve efficiency, and therefore, enhance economic efficiency and economic growth. All these things happen in a specific way between Hong Kong and Guangdong. Guangdong used to be the pioneer in China's economic reform 30 years ago, 20 years ago. Guangdong, particularly, the special economic zone of Shenzhen was the pioneer. They liberalized much faster than other parts of China. Late last year, the new party secretary, Mr. Wong came to Guangdong after looking at what is happening in Guangdong, he held a very high-level party conference in Guangdong.

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The key message he put forward was 30 years have passed. This is the thirty-year anniversary of China's economic reform. I think China is going to make it a big thing in December because 30 years ago in December, the party made a decision to reform. And it was a significant event. And what the party secretary of Guangdong says is it is time that we redo the situation. We stop, we look forward, we liberalize our minds again, and we try to become the pioneer of China's next stage of economic reform again. This is the mission he set for his government. And ever since then, they have been trying to think about what they should do.

But from Guangdong's perspective, they know that they must change. A lot of the low-cost export-oriented industries are in Guangdong. And therefore, they are also facing the crunch of this change, so they are forced to change. Guangdong also realized that we have Hong Kong at our front door and we should leverage the capabilities of Hong Kong to link Guangdong up with the rest of the world. We should leverage Hong Kong's trading and financial services capability. Hong Kong is a highly services-oriented organization. We need the services. We could provide the back office operations for a lot of the front-end services – activities in Hong Kong.

Hong Kong is also a city with a very efficient urban administration. Hong Kong is a city that makes things work – and I daresay, in many ways, much more efficient than American cities. So there are a lot of things that we could leverage on Hong Kong. On the other hand, from Hong Kong's perspective, Guangdong, of course, is the immediate hinterland of Hong Kong. Guangdong is the conduit between Hong Kong and the rest of China. So if we could build up a much closer relationship between Hong Kong and Guangdong, there is a lot of synergy. And because of that, we have developed lately a range of policies with the approval from Beijing that China would allow Hong Kong and Guangdong to liberalize the restrictions on investment, on the flow of resources, on the flow of companies, and so on, and so forth between Hong Kong and Guangdong before those reforms would apply to other provinces in China.

So on top of SEAPA (ph), which allows Hong Kong companies to enter China first before other companies from the rest of the world – effectively it is like the North American Free Trade Agreement allowing American companies better access to Mexico and Canada or vice versa. SEAPA allows Hong Kong and mainland companies more preferential access to each other. Of course, this is a large reform – Hong Kong into China. On top of SEAPA, between Hong Kong and the rest of China, we have now closer economic integration arrangements being put in place. So hopefully, this will generate a lot of – 30 years ago, it was a lot of Hong Kong investors that brought about the changes in Guangdong, and then those changes spread to the rest of China.

Now it is up to the new – all these new arrangements to see how the new services capabilities of Hong Kong could lead to all the changes in Guangdong that would also spread gradually to the rest of China. I think I have spoken a lot more than I am supposed to. But I think I had better stop here. Thank you.

(Applause.)

MR. KEIDEL: Thank you very much, KC, for that sweeping review of changes coming in China, and at the end, a picture of how Hong Kong and Guangdong can preview the changes coming more nationwide. I think we are going to move into a discussion and question period. We have microphones. I will occasionally – rather than leading off with a long list of questions and comments – open to the floor. But I will interject my interest and questions as time goes forward.

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But let's see what the audience is most interested in right away. If you will raise your hand, I will identify you, and please then identify yourself and stand. Thank you. Yes, in the back.

Q: Eric McVadon, the Institute for Foreign Policy Analysis. Thank you for the presentation. I noticed on your list of regional development that development of the West was fifth of eight. I wonder if that is meant to imply priority. I thought the party was sort of afraid of the repercussions of not succeeding with development of the West.

MR. KWOK: I think the reality is the West of China is just too big. It was – when – (in Chinese) – this was raised back in, I think, the late '80s and early 1990s – sorry, in the early 1990s, there was some enthusiasm about the subject. But after a number of years, more and more investors find that – what do we really mean by the West? The West is so big – you know, Xinjiang, and Ningxia, and Tibet, and Sichuan, and all these places. They are so big. You must have a focus. So gradually, I think the reality is that – of course, there are some big investments like the railway linking Tibet with Xinjiang and so on, but at the end, a lot of this so-called investing in the West and developing the West means you must be more focused.

So development then gradually tends to be focused in certain cities or perhaps specific regions rather than in whole West. And therefore, in official terminology, these days – I think you still hear this from time to time, but you don't hear a lot. And then there is a lot more development in other regions and more concrete developments in other regions. So in terms of the order of priority, in terms of importance, and so on, I think that developing the West is now given much less emphasis. You still have – (in Chinese) – somewhere in Beijing's hierarchy. But I don't think a lot is happening.

But at the same time, China has also instituted a system where the government requests all the major provinces and major cities to develop sister cities and sister whatever, so that the responsibility goes down to individual cities and provinces; so rich Guangdong will have to take care of a number of places and regions and cities in the poorer parts of China. And this happens very clearly in the Sichuan earthquake. After the Sichuan earthquake, the central government basically asked all the provinces in China to share the responsibility of helping the cities and places in the affected areas because of the earthquake.

MR. KEIDEL: And Sichuan is officially part of the West when they have these regions. Huge problem. Yes, over here.

Q: (Inaudible, off mike) – Resources for the Future. Could you please discuss the implications of the rapidly increasing shortage of water in China and the spread of the desert across the North?

MR. KWOK: Well, frankly, I don't know enough to answer your question apart from the comment that I think the problem is well-known. How to solve that, of course, is a much bigger issue. Perhaps what I can add is from an economic perspective. There is an argument that if water is a scarce commodity in China, then perhaps it is not a very good idea to be self-sufficient in food. Using so much water for agriculture may not be a very economic use of the water. If China is willing to let go its food security policy, China could have imported a lot more agricultural products from Canada and the U.S. And China could conserve the water for other better use.

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So if you think out of the box, then you have solutions like this. But of course, giving up food security is not something you should expect the Chinese authorities to adopt in the near future. China still believes that food securities are of utmost importance. And on that – [53:00] – going back to some of our earlier discussions about commodity prices and so on, China today is generally rather self-sufficient in terms of food. So while China has an impact on the rest of the world in terms of coal, and metal, and so on, the impact of China on the world's food prices is actually quite small. But the water problem is a big issue.

MR. KEIDEL: And you are right, though, to say if I could just add that it is a problem in North China only. It is not a problem in the densely populated South China. And on the North China plain, which is the wheat belt for China, it is felt rather severely. And so the point about self-sufficiency and grain – sort of the grain security policy of – [53:47] – is really something that also keeps prices down for farmers who are required to continue to plant grain. And grain is sort of embodied in water in many ways. So that is a very important and useful – [54:01] – but one that is not likely to come.

The economist in me, and I'm sure in KC, as well, says that also a scarce product should have a higher price. But then that affects the costs of many industries. And you have the competition between the urban residents, the farmers, and the industrial uses of water in the north. And if they can successfully, over a long period of time, raise the price of water in the north, you would see shifts of water – heavily water-using industries out of that region and also conservation in water use.

But it is interesting also that looking internationally, water supply and water quality problems are ones that respond well to development – as a country gets richer under per capita terms given public pressure to improve supplies and quality. Almost universally around the world, it is something that governments turn to. So I think we can expect this is not something that China is going to be left sitting on its hands about.

I saw that hand shoot up first in the bright blue shirt. And then we will go back.

Q: Bill Stroher (ph) from the Center for American Progress. Thank you very much for that excellent presentation. I was interested in what you were talking about in terms of raising living standards, yet China's personal savings rate remains very high. Could you talk in a bit more detail about some of the reforms that are taking place to create social safety nets – health care, Social Security, the labor rights that you mentioned, and so on?

MR. KWOK: Well, very broadly in the last – I can't remember exactly how long, but for the last 10 years or 15 years, China dismantled the cradle to the grave system because in the past, a lot of these benefits go with your affiliation – university, the university ought to get everything from cradle to grave. You belong to a hospital, you belong to a factory, you belong to a government union – you know, it is the responsibility of all those things. But once you have the state-owned enterprise reform, once you ask all these entities to stand on their own, obviously, you find that many of them are not able to provide all these benefits.

Actually some of these companies go bankrupt and they just don't have money to pay for any of these things anymore. And yet, at the same time, the government hasn't developed all these provisions coming out of the government – either the national government or the federal

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government or the local governments. There is no such thing. So increasingly, citizens in China complain that you go to the hospital, you have to pay and you have to pay for each and every step. You want to have registration, you pay for registration. You want to see the doctor, you pay for the doctor. You want to have an injection, you pay for the injection. These things happen.

China suddenly swings to an extremely market-based economy, even in terms of education, in terms of all these things. And clearly, the people are not happy. But at a time when they couldn't do anything – the only thing you could do is save more money. You had better look after yourself. You save more. And therefore, the savings rate in China is high. Of course, there is also a very long cultural tradition there, too. So that has been happening for 10, 15 years.

Now they are trying to – the Chinese authorities have come to the point that they are in much better financial shape. They have the resources. And there are more and more people in China questioning why you pump so much money in investing in roads and railways, why don't you pump some of the money into these services? So more and more, there is a demand from the population in the media, by the think tanks, by the academics, and so on asking the government to provide more and more of these kinds of services.

And then over the years, China has also gradually built up welfare contributions from the workers. So if you run a company in China, you know that the wage is one thing, but then you add onto that the insurance, the retirement benefit, the medical benefit, the housing benefit, all these other so-called funds. You contribute – when you employ a worker, you pay him or her maybe 1,000 renminbi, but then on top of that 1,000 renminbi, you probably pay around 400 renminbi into all sorts of funds. The funds supposedly should pay for the retirement, the medical, the insurance of the workers. But in reality, in many cases, the funds go to a central fund. The central fund becomes – is it called a pay-as-you-go system?

MR. KEIDEL: Yeah.

MR. KWOK: The government can use the fund to pay for the current retirees, the current whatever while promising these contributors that you will enjoy those benefits when you retire. So this is stop-gap measure. This is what is happening. Of course, if you are a worker, you cannot do very much about it. You continue, but the companies are contributing. Sometimes the employees are contributing. But this is slowly – but over time, a lot of these funds are becoming bigger and bigger in size. And the government's fiscal position, as I mentioned earlier on, is improving.

So they are now in a better position to gradually improve that. But in the process, of course, there are other problems. And from time to time, you hear all those scandals – some Shanghai government official being prosecuted or whatnot, it is very often related to the fact that – because these big sums of money in all these funds are in place, very often you have corrupt officials putting their hands in this piggy bank, getting the money out, investing in stocks, and what next – lose the money and these kinds of – so managing the process is also a very tricky subject.

MR. KEIDEL: I think also it is recognized that this problem of pay as you go for payments that are meant to ensure some kind of fund is a worldwide problem – certainly a problem here in the United States. But it is exacerbated in China because the level of benefits expected by the urban registered people is quite high. And the rural population, as you mentioned, is not included at all. And the current reforms, therefore, have to sort of downscale the benefits that are promised and

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delay the date or the year – the age of retirement. At the same time, to try to extend it to include the rural population to some extent. So it is a daunting challenge and one that many countries, including the United States, are facing. But it is a real issue.

I am going to go in the order in which I saw them. This gentleman on the right way in the back next to Doug, and then I have got one here and then one there.

Q: Jod Dahir (ph) and I am a documentary filmmaker. I am interested in research and development in China. Here I am really interested in product innovation. So that China moves from – you mentioned polo shirts – for being an export platform for polo shirts is something more sophisticated where I can capture more of the value added.

MR. KWOK: You look at the industrial structure, the product structure of Chinese exports and so on; you have seen actually a dramatic change in China's product mix. We used to believe that exports from China are all these low-end garments and toys and electronic products, and so on. You look at the actual product breakdown of China today, you will see that some of the categories of products that – well, put it this way. The kind of IBM – it is no longer IBM now; it is the – (inaudible) – computer these days – the kind of Samsung electronics you buy, the sort of Panasonic electrical products you buy. The chances are these have Korean labels and Japanese labels – they may be made in China.

China is also exporting more and more – all kinds of equipment to the developing countries. So while China continues to export a lot of consumer products to places like the U.S. – you go Wal-Mart, you still have a lot of products made in China. But you look at the rapidly growing industries in China; many of these are actually electronic products, electrical appliances. China is still beginning to export some cars largely made by the Japanese in Southern China. It is tiny at this stage, but sooner or later, I think it will grow.

So more and more, the product mix of China is actually changing – actually changing quite fast. We keep talking about China at a turning point. I think in this aspect, you are also going to see China at a turning point. Five years from now, 10 years from now, I think you will be amazed by the sort of product mix you see coming out of China not necessarily by Chinese enterprises. It could come from a lot of these foreign investors. And more and more, the Chinese enterprises will also be able to churn out this kind of stuff. So this is happening.

But going back to research and development, being able to produce a laptop is different from investing in the technology of producing either the Pentium chip or whatever production technology. I think China is still rather early in that process. But you have to bear in mind that every year China is turning out a few million university graduates. And these people are learning very fast. They are still young, but they learn very fast. So five years, again, 10 years from now, I think you will see a very different research capability in China.

MR. KEIDEL: Doug, did you want –

Q: I'm Doug Paal from the Carnegie Endowment. Thank you, KC, for a really broad and solid presentation. I would like to push you a little bit to talk about issues of concern to here. What are the implications broadly for the linkage between the U.S. and China – or the delinking of the two economies? What about the impact on the dollar, the renminbi relationship, and the various

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financial transactions that take place between the U.S. and China? We had Fannie Mae and Freddie Mac over the weekend. And a lot of the excitement that led to that change seems to have been stimulated by the Bank of China unloading Fannie Mae securities. Can I push you a little bit to talk about where what you have described has meaning for the U.S.-China relationship?

MR. KWOK: Well, I am not so sure what area you really want to address, but if you are talking about the financial side first, obviously, China has a big stake in the state of the U.S. financial system, the U.S. dollar, and it's a big holder of all these U.S. treasuries, and so on. I don't think China is in a position to get away from all these issues, particularly given the fact that China doesn't want its currency to appreciate so quickly. At a time when you have a trade surplus, you still need to buy a lot of U.S. dollars. And you need to invest those U.S. dollars in something. So while individual institutions may be able to get rid of some of these securities, I think for China as a whole, it is not easy for China to get away from this.

So China has to play ball with this global financial architecture, the global financial issues, and so on. So you look at what the Chinese leaders say in the recent past. They keep saying that the U.S. has to be responsible – you know, the U.S. has to be responsible for its currencies, for its interest rates, for its financial systems, and so on. But at this stage, of course, China is not there to tell the rest of the world what the world should do. I think China still wants to keep a very low profile in that perspective. But obviously, I could imagine that looking at the world – what is happening around the world right now in terms of the financial market stress, in terms of currencies, and in terms of markets, and so on, I wouldn't be surprised that China may be thinking about some strategic moves. Should it behave like the – (inaudible)? How far should China go in those directions?

Of course, they need to bear in mind the political dimension after the events they experienced in the last few years. They want to buy oil companies – (inaudible) – they want to do this – you know, the political noises, and the U.S. is not particularly friendly. You know, you have to be sensitive about these things. But if you are talking about the much bigger U.S. and China dimension, I think it is – well, this is too big for me to address.

MR. KEIDEL: Well, there is, I think, implicit in this the interesting question about the degree to which China's economy really is linked to the U.S. And therefore, does it feel responsible in its financial dealings to support the U.S. financial system rather than divesting? And those are hard areas to get some hard statistics on. Can you give us any sense about what you think China's mood is or what it has been doing recently?

MR. KWOK: The popular media in China, of course, is asking the authorities how could you keep buying a sinking dollar? How could you keep buying assets in all these troubled agencies and so forth? But from a macro – of course, China doesn't publish its breakdown of foreign reserves, and so on.

And you have to bear in mind that most foreign currency assets are held by the public sector. I don't know. In the U.S., not many people have foreign currency accounts is my guess. But still, the U.S. corporate sector has a lot of overseas investments. But in China, both the corporate sector and the private sector, as a whole, have relatively little overseas assets – some here and there, but in general, little. The largest among the foreign assets are held by the public sector in the form of foreign currency reserves and in some foreign currency assets of some major SOEs, but

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still rather limited. You look at the balance sheet of the mainland Chinese banks; the external dimension is still rather small.

So while China holds a lot of foreign currency reserves, you have to bear this in mind that the private sector actually holds rather less. So net-net, while China's official sector is a very large external creditor, China, as a whole, is actually not. So it is – the key issue is how to manage the public sector-held foreign currency assets. But as I said earlier on, given the economic reality that the government doesn't want the – the currency is managed, I think, as the U.S. dollar. And the government doesn't want the currency to appreciate so fast with the U.S. dollar. So effectively, it means that if you have net external surpluses, you must absorb that inflow. It means that you have to hold more and more foreign currencies, and most of them will be in U.S. dollars.

You could try to diversify your currency, but once you sell a substantial amount of U.S. dollars and buy Euros, you are going to affect the relative exchange rates. And then you also need to manage your own exchange rate against the U.S. dollar. That will be a very difficult task. You cannot get a consistent answer in terms of diversifying your foreign currency mix, as well as maintaining the fixed parity or relatively stable parity against the U.S. dollars. It is difficult. So that is also the reason why the PBOC keeps talking about letting foreign currency assets get out of China – what they called – (in Chinese). It is like a flood. You cannot keep all the water. You must allow the water to get out.

MR. KEIDEL: Drainage.

MR. KWOK: Drain the water out. And that is also the reason why they want to liberalize the foreign exchange control. Let the companies invest outside of China. Let the individuals get more foreign currencies out of China. The PBOC wants to do that. But from the supervisory angle, the authorities are still worried. Do you really want to do that so quickly? Is it going to lead to money laundering? Is it going to lead to corrupt officials taking the opportunity to get the money out of China? There are all sorts of worries like this. So it will take time.

MR. KEIDEL: (Inaudible, off mike.)

Q: Thank you. My name is Beverly Hong-Fincher, the – (inaudible, chuckles). I would like to ask you if you could give us – I am from UDC. I would like to ask you to give us some examples of the – (in Chinese) – you know, the fist industries. That is one. And then secondly, I wonder in your agenda here in Washington if you have an appointment to see our mayor, Adrian Fenty. You mentioned that Hong Kong government is efficient. And having lived in Hong Kong for several years, I know how efficient it is. But in education, you definitely can help us – this city. Our mayor is very interested in education reform. So I – please, make an appointment to see our mayor.

(Laughter.)

MR. KWOK: Well, I am not so sure your mayor wants to see me.

(Laughter.)

Q: He wants to see you. I'm sure!

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MR. KWOK: Well, Hong Kong also has a lot of educational issues, but that is a different subject. Going back to – (in Chinese) – you know, the fist industries. In the past – of course, it evolves over time. In more recent years, I think you talk to many local governments. They would tend to say I want car-making, I want steel, I want petrochemicals, you know, all these kinds of things because they are seen to be the strongest industries. And then, of course, they also want – well, when you really think about it, what is really a car-making industry – car assembly. You are not really talking about the core technologies right now at this stage.

Interestingly, you find some places in Guangdong – recently, I saw a piece of news. I can't remember exactly which city it was. But a city says I want to become a key electronic publication center. So you could send through electronic means, whatever, publication materials. You could edit in the offices here. You could send it electronically to print it somewhere. You could manage a very electronic, globalized publication system using the city as the key base.

So you are starting to see cities come up with such ideas. You have seen cities who say that I want to be a major back office processing center for the insurance industry. So as I said earlier on, more and more local governments are getting away from the mindset of manufacturing, manufacturing, manufacturing. They are now a lot more into these kinds of services related to – you know – all sorts of things. So the concept of – (in Chinese) – is gradually changing in China. As I said earlier on, you don't hear local government officials talking in those terms so much if you visit the different places in China these days.

MR. KEIDEL: Yes, this gentleman was next.

Q: My name is Robert Herstein. I would be interested in how you see the future with regard to the role of the state in the economy both with regard to state-owned enterprises, potential privatization, and with regard to regulatory and administrative guidance on the development of industries.

MR. KWOK: The direction is clear. It is more liberalization. It is a matter of the extent, which I think from the Chinese government's perspective, they want a limited extent because they still see the need to have some kind of ownership and control over all these strategically important sectors. But I think they wouldn't mind liberalizing them further to allow more market forces into these industries. So the direction is clear, but I don't think you should expect too much from the perspective of the government. So this is going to be the sort of things you can expect. The voices from the media, from the think tanks, from the academics, of course, is to ask the government to do more. But what I am trying to say is that in a more practical perspective, given the mindset of the Chinese authorities, you shouldn't expect too much.

Q: Could you add and answer this question? What might be the role of the planning commission going forward – the National Development Reform Commission – it has had such a hand in the economy. How is that going to weaken or change or –

MR. KWOK: The broad direction is not to have very detailed plans. You should more and more have strategic directional guidance rather than plans. So in recent years, they have already changed the term of the national planning from – (in Chinese) – to – (in Chinese). So instead of plan, they are talking what is – (in Chinese) – guidance plan or something like that. It is no longer a plan. It is a – (in Chinese) – guideline or something.

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So what they are now trying to do is – first, let me give you an example. This is very illustrative. Instead of assessing provincial and city governments' officials' performance by, say, GDP growth, they have now changed this criteria. I want higher per capita GDP growth. I don't want just GDP growth. I want higher per capita GDP growth. It is a totally different thing. You want to raise per capita GDP growth, you had better raise productivity. You don't just want to bring more workers from the countryside and keep pumping more workers into low-end industries. That is generating more pollution. That will not add to per capita GDP growth.

And by changing things like this – and they are also requesting governments to achieve a gradual improvement in energy consumption per dollar of GDP. Okay, you can grow your economy. You want to grow, have industries, fine, you go ahead. But you had better deliver at the end of the day a gradual improvement in energy consumption per dollar of GDP. So instead of specifying what you should do and what you should not do, they are specifying criteria like this, so that the governments will have to juggle within these big criteria. And then, of course, you will guide them to do the right things. So this is the direction where things are going.

MR. KEIDEL: Yes, I saw in the middle here in the seersucker suit.

Q: Elliott Feldman of Baker and Hostetler. I want to ask you three very specific questions. One, which I heard the word only once this morning – coal, which would appear to be at the heart of the climate and environmental problem, and China has an abundance of it. And what are the disincentives about using it? Second, the Guangdong-Hong Kong relationship, is it not driven in significant measure by Hong Kong's being the recipient of pollution from Guangdong, so that an economic integration is very much in Hong Kong's interest to clean up the pollution problem?

Lastly, the United States has undertaken a series of – the Department of Commerce has undertaken a series now – 12 cases against China on alleged subsidies. These are, in general, an attack on the whole Chinese planning system, the economic system. They are all underwritten by an assumption that wherever the state is acting, it is a subsidy. If a state-owned enterprise is involved, it is a subsidy. It doesn't matter what the mandate of the state-owned enterprise is. This is salt on the whole scheme of the Chinese economy. How do you see it in comparison to the other policies of the United States that come out of the Treasury Department, for example?

MR. KWOK: Well, again, I am not so sure whether I know enough in all these big subjects to answer your questions. But in coal, the reality is very clear. China doesn't have a lot of oil. Coal is the dominant sort of energy for China. And I don't see this pattern changing for many years. China is aggressively building a lot more hydroelectricity. But I think they account for – I don't know – less than 3 percent of the country's energy, probably less than 1 percent of the country's energy. China is aggressively developing nuclear energy, but again, it accounts for a tiny percent of the country's energy. I don't know what the accepted proportion between coal and oil is. I think it is probably – ignoring all the other energy, just between coal and oil, I think the percentage is probably 70/30. As I said, I don't know the exact numbers. But this is the rough order of dimension.

And the problem for coal, of course, in China is that there is a lot of dirty coal. There is a lot of coal in remote areas. And coal technology has yet to be developed further, so all these will take time. And at a time when the economy is still growing so fast, there is – well, China, of course,

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will try to do its best here and there. They have closed down a lot of dangerous mines. They have introduced more and more environmental control and incentive systems in place and so on. But the macro picture is unless China is able to introduce a lot better coal technology, the problem is not going to go away any time soon. So I think there is a huge opportunity for these kinds of technology companies to cooperate with China.

How to address the greenhouse gas issue, of course, is an even more complex issue. It goes back to all these global negotiations about carbon and how to deal with it. Who has a bigger responsibility? How to deal with the trading, so on, and so forth, and you get into even more complex subjects. So this is the broad situation.

Guangdong-Hong Kong pollution – actually if you go to Hong Kong in the last six months, you will be amazed that the sky is crystal clear. We had a few days of bad air, but it is largely because of the typhoons. When the typhoon is about to come, somehow the air pressure is low, it gets trapped – particles get trapped and you have one or two days of bad air. Otherwise, the air is crystal clear most of the days. The real test comes when winter comes whether all this wind blowing from the north will carry polluted air to Hong Kong. So let's wait and see.

MR. KEIDEL: Could I just interject – isn't it also because there were some Olympic equestrian events in Hong Kong, and so there was an issue of air quality, as well, there? And there may have been Olympic-related policies that – but is that – that is over, so that doesn't matter anymore?

MR. KWOK: In any case, the Olympic policies affect mainly Beijing, not other places.

MR. KEIDEL: So there wasn't an effort to clean up the air in Hong Kong for some of these –

MR. KWOK: Hong Kong has been investing a lot in efforts – Olympics, no. We don't have a lot –

MR. KEIDEL: Because there were some Olympic events in Hong Kong.

MR. KWOK: Yes, but we don't stop cars. We don't – (laughter) –

MR. KEIDEL: No Guangdong manufacturing, which is a major source –

MR. KWOK: The Guangdong situation is a lot more related to the long-term issues that I mentioned earlier on like the labor laws, the environmental standards, you know, all the pressure on the export industries and polluting industries, the inefficient industries.

In the last year or so – I don't have the actual number, but – and the governments don't have the actual number, but the talks are that more than 20,000 small-scale industries have closed in the last year or so. So you have a lot of polluting industries closing down in Guangdong Province. And I think this certainly will contribute to the situation.

Subsidy – what can I say – it is a very tricky subject. I think from China's perspective, obviously, the policy is gradually to ask these state-owned enterprises to stand on their own. But

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China still has a lot of administered policies and prizes and whatnots. So it is not easy to get to the bottom of whether – for example, oil prices are still administered in China. You could always argue that well, because the oil prices are – at the retail level is too low, then obviously, the transportation companies get a subsidy from the losses of the upper-stream oil companies. The interest rates in China are administered.

Do corporations get a subsidy from those industries or are they actually penalized by those interest rates? And if they are penalized by those interest rates, are the state banks being subsidized by these kinds of government policies? It is complex, but of course, blatant subsidy I wouldn't say is totally gone. But it is largely not the government's policy. I wouldn't rule out the possibility that some local governments may produce some schemes that could be seen to be a subsidy that would distort competition. But providing preferential treatment to attract investors – it is so common. It is not just in China; it is everywhere.

MR. KEIDEL: I would also add that – I mean, the more general picture is that both U.S. leaders and Chinese leaders need to treat their own populations as their constituents because a great deal of this is coming from special interest pressures, particularly here in Washington. And there are also special interest pressures growing in China, of which Secretary Paulson, for example, is aware and needs to be aware.

But the U.S. is really pushing the double standard because in the WTO, it has insisted that China be treated as a non-market economy. And it does that so that when it wants to protect its own interests from a surge in Chinese products, it is allowed to use third country prices as the standard. But you make a country a non-market economy because you agree that there is no way to rely on its own pricing system as a guide to what its goods should be costing because of all the interlocking subsidies. So you can't go and criticize them for their subsidies and use this as a basis, which is a market economy basis for protection – if you have designated them as a non-market economy.

But the U.S., in recent years, has tried to do both, obviously, because it has these constituencies demanding action. And you can't just say, oh, well, that is just politics; it doesn't work. China also needs to be aware of those constituencies. And what often happens is when it looks like it is going to go to the WTO, it gets withdrawn or stopped because eventually we know two, three years down the line, this is going to be thrown out. And so there is real politics and special interests on both sides here. And the assault on China's system, I would say is not necessarily that. It is really an effort here domestically to come up with steps that you can take with countervailing duties.

And I first testified before Congress 25 years ago on countervailing duty legislation. And the conclusion was that it didn't matter whether there were subsidies or payments under a bridge or anywhere – that if it is a non-market economy, you just can't use those subsidies as a basis for protection. But it is a complex area. The U.S. is legally not justified in taking these actions. There may be a few exceptions in WTO regulations. But by and large, it is a huge political stage to process here in Washington. But it has to be managed as that.

Yes, in the back, that hand that went up there.

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Q: Hi, I am David Blair from the National Defense University. I have a philosophical question. The consensus among China economy experts seems to be that China is going to continue to grow at rapid growth rates for the next 20 years or so, enough so to raise Chinese living standards significantly – maybe not all the way to first world standards, but significantly. Is there any reasonable scenario that could prove that consensus wrong? I am not talking about a catastrophe of some sort – a war or revolution. But is there a reasonable sequence of economic events that would lead you to think that scenario might not happen?

MR. KWOK: I would look at it from either a cyclical angle or a structural angle. By cyclical, I mean – well, there is always a possibility that China would suffer a 1929-style U.S. economic problem. When will that happen? How will that happen? Of course, you can have many different permutations. But I wouldn't rule out the possibility that – like many other developing countries, like many other countries that grow so rapidly in certain phases of development, there will be a time and then suddenly a crunch. It may be like a 1929 U.S.; it may be like a 1997-98 Southeast Asia.

So there is a possibility that at some point in time, there may be such a crunch. But whether that crunch will really lead the country into a totally different direction will, of course, be another very complex subject. Whether you will really turn all those cycles totally, so much that it could not reverse itself. That is – I don't know how to philosophically address that.

And the other – what I call the structural perspective is going back to issues like water shortages, for example, or global warming. These are longer-term structural issues that may suddenly make the whole economic development a totally different ballgame. Whether they will be very substantial bottlenecks or optical in that perspective – we may be thinking about water today. We may be thinking about global warming today. Ten years from now, we may be talking about something else. What those things could be – again, I have no idea. But there are potential limitations to China's growth like this.

It goes to a bigger philosophical issue of whether the earth could allow so many percent – a much higher percentage of the people living on this planet to enjoy such a high level of living standards consuming so many resources at such a high rate. Is the earth going to be able to sustain this? If not, what will be the new situation? It is not just China. It is India coming up. It is so many other people, too. So how will the world cope with – you know, the world, for the last 200 years – it is a situation when you have the industrial revolution, when you have rapid technological progress, surges in living standards for a relatively small number of people.

But that would be a different situation if a substantial percent of the population living on this planet is going to go through the same process. It will be a different ballgame. What that is, I don't know.

MR. KEIDEL: Could you extend your answer to say – I know about a year or so ago, the financial debates within China were should we liberalize our financial system much more rapidly. And the decision was we think this would jeopardize the success of our long-term growth because of the impact on infrastructure finance, for example. So is that something that then could – once you get financial liberalization, if it is too rapid, then you are subject to the kinds of crises that you are talking about.

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MR. KWOK: Well, financial services liberalization, of course, is a very sensitive subject in China. If anything, I think if you talk to the Chinese thinkers and decision-makers, and so on, they believe that the 1997-98 financial crisis in Asia is because of the fact that these developing countries liberalized their financial sectors too early before they had built the foundation. Well, to a certain extent, I think the financial crisis facing the U.S. right now is that liberalization moves a lot faster than the ability to regulate it or the ability – well, it is a big subject. You know, or the participants got greed – goes too fast ahead. The ability to restrain your greed is lacking or whatever.

Financial market liberalization is a very sensitive subject. I can imagine that the Chinese authorities will do it very cautiously, one step at a time. But then at the same time, the other side of it is that if you don't move fast, you are also creating more bottlenecks. And you could also be storing up more problems for the future. So it is a very tricky situation.

MR. KEIDEL: It is a very interesting question, for example, if you look at East Asia, you have got these countries that stay with high growth from \$1,000 to \$10,000 per capita – just brushes up against nine – eight, nine, 10 percent. You try to do that with Latin America, say, Brazil. It starts off well, and then it just collapses. And you see inequality levels rising very fast and corruption levels just enormously destructive. What are the chances that we are seeing influences of just money and raw corruption coming into the Chinese economy that could lead to kind of a Latin American collapse?

MR. KWOK: I don't think the situation in China is that bad. Of course, you hear news about corruption in China from time to time. There are officials in China who are corrupt. But on the bigger scale, I think this news is an exaggeration of the reality. I mean, the image people have about the corruption in China is, to a certain extent, colored by the way the media reports these things. You talk to the mainland Chinese people, you know, the ordinary people. They know well we have corruption here and there. But in general, I think they think the country is moving ahead. Things are okay. And the social sentiment, the popular attitude towards the government, towards the way things are developing – in general, I think, is still very positive.

One characteristic development in China these days is a lot of comments being posted on the Internet. The Internet is now a very powerful engine in China. You could have a lot of people criticizing government policies – specific government policies on the Internet. So much so that a lot of governments feel that they are, to a certain extent, quote, unquote, “supervised” by the Internet. (Laughter.) I don't think you should underestimate the power of these kinds of sentiments in China. Of course, from time to time, the government steps in and erases some of those comments. (Laughter.) They are too sensitive.

But you go to any major city in China, you go to see the city government main building. Chances are you are going to see a lot of people sitting there demonstrating today – almost every major city. In the past, these guys will be swept away very quickly by the police. But today, they can't. They cannot do that because they know that if you do that, you are going to create even more trouble. You just have to treat these guys well, give them lunchboxes, and whatever. (Laughter.) You try to persuade them – what are you problems? Let's sort it out, da, da, da, da.

MR. KEIDEL: I'm following up – still on this question because it is one – there has been quite a bit of writing for the *FT*, even in the *Washington Post* saying that China's growth is really not healthy, not healthy for the world and not healthy for China. And they say that, for example, with

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less than 40 percent of GDP going to household consumption, this explains the explosion, as they describe it, in social unrest, and that this is a real threat to the stability of Chinese economic progress. And so you have just touched on that. I mean, lunchboxes help, but is social unrest and all of the inequality that is also reported statistically something that threatens to get out of control that could really lead to tumultuous change of an unproductive sort?

MR. KWOK: Well, social disruptions happen from time to time. And in China – and given the large number of people in China, the large geography, and so many cities, and so many lower-level government officials who are not very – these people are not very sophisticated people – I'll put it that way. So there are problems here and there. But it is just a personal feeling. You go around China. You talk to people. People grumble from time to time here and there. And in the countryside, in the less developed parts of China, I think the people's grumbles are even more serious because the government officials in those places typically are bad guys. They are not very sophisticated, not very well-educated. They tend to squeeze more from the people. They tend to cheat, so on, and so forth.

But are these people going to be able to overturn the government, create so much trouble, and so on? I am not so sure. Typically, in China, the government will face a big problem when these things happen in big cities. If you are – you know, Tiananmen Square in 1989, you have very big uncertainty. But typically these days, you go to the major cities, most people in major cities don't want disturbances. They want – my life is improving. Don't stop it. There are people who joke that in the past, the Communist Party is in the alliance of the proletariat, the workers, the farmers. Today the Communist Party is the alliance of the capitalists, of the intellectuals, and all these people who are benefiting from economic progress.

Of course, this is – you pass your own judgment as to how far this is true. But it does illustrate that to a lot of people, continued development of the country is in interest of the vast majority. But still, when it comes to specific issues – in recent years, a lot of these grumbles come from local governments getting land away from the people without adequate compensation. This is the major source of a lot of complaints. And you could imagine that because you are talking about so much money involved. Land suddenly becomes a very valuable commodity. And yet, land title was non-existent in China for so many years because the system was just not there.

I have been living on this piece of land. I have been cultivating this piece of land for generations. Now the government comes to me and says you do not have the right to this land. This land is the government's. Now I am going to move you somewhere else. Here is a few thousand dollars. Go. And you could imagine the dissatisfaction of these people.

MR. KEIDEL: Just to finally follow up on this, is there any indication in the change in strategy that you have described so well and so many of the dimensions for money that, say, the planning commission would allocate to physical infrastructure – moving in any really significant volume into the infrastructure of conflict resolution mechanisms whether it is courts, or whether it is administrative measures, or these letters of complaint that come up from all over the country that all just get lost or hardly replied to? It is so costly to deal with these conflicts and separate out what are the legitimate ones and what are the ones of people that had unrealistic expectations. Do you see any financial indication that they are going to move sums of money to really strengthen that whole capacity?

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MR. KWOK: Well, from a fiscal angle, certainly the government is thinking of how to rationalize the fiscal system. The reason why the local governments scrap land from the people is because this is a main source of revenue because they complain that the central government is taking away a big share of my tax. And yet, I have to provide all these things. I have to keep all my officials happy. So there is always a pressure on them to impose all sorts of unnecessary fees and charges on the people, grabbing land from the people, and so on.

If the central government is able to come up with a fairer way of distributing fiscal revenue and prohibit the local governments from doing certain things, then obviously, it would help in that perspective. The legal system, of course, is still in the developmental stage even though the legal system has been up and running for more than 20 years. 20 years is, of course, a very long time. I don't know how many years the U.S. legal system has developed itself. But the number of laws written, the number of lawyers trained, the number of judges being trained, and so on – it takes a long time. So 20-something years is just so short for China. It is impossible.

MR. KEIDEL: Yes, in the back there again.

Q: Hi, I'm Terrell Henry with the Freeman Chair in China Studies at CSIS. Thank you for sharing your expertise with us today. My question is beyond the labor contract law and the currency reevaluation, are there any other specific aspects of the financial and economic market reforms that are currently on the table or on the agenda that foreign businesses operating in China should be concerned about?

MR. KWOK: The labor law is already there. The detailed implementation guidelines are still being studied and could be changed from time to time. But still, it is there, and it has to be followed. The government realized that perhaps it has gone too far, but unfortunately, it is too late to turn back. The currency, of course, is the other thing. I mentioned earlier on about taxation reform. The profit tax rate has been changed. And this is being gradually implemented. The VAT system is likely to be reformed. This is probably the most important fiscal reform agenda in the next year or so. The VAT reform is going to – they have already started some experimental changes here and there before they launch the system countrywide.

What they are thinking of is turning the production-based VAT into a consumption-based VAT, so as to alleviate the VAT burden on the production enterprises. I think this is going to be – the details are not yet available. But you hear discussions about this subject from time to time. And I think this is likely to be the big issue.

MR. KEIDEL: Yes.

Q: I'm Neil Hughes. I am an author and previously worked with China for the World Bank. My question touches on this issue of disturbances. After the Sichuan earthquake, the Western press media was given enormous access to the area. And they reported that the victims who suffered most – let's say the parents who lost children – when they tried to organize and make an official – (inaudible, off mike) – to the government as far as some compensation, the government took very strong action – not to allow them to come together – (inaudible, off mike) – or in any way have a discussion about this.

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It was very tough action by the government and this was widely reported around the world. So how does that – (inaudible, off mike) – the suggestion that the government is allowing the public more voice to express their discontent?

MR. KWOK: Well, I don't know the specifics about the Sichuan protestors and so on, so I am not so sure whether I could pass a fair comment on that. But I think you have to understand that in China, particularly in the rural areas, things happen in a rather complex way. In the rural areas of China, the mindset of the people, the mindset of the police, they are all very different from what you could find in the U.S. And these people somehow, one way or the other, got their issues resolved in their own ways. So I wouldn't be surprised that if some people go to demonstrate, they are asked to go home by the police. And then behind the scenes, the local government officials will negotiate with these people and say, why not, let's do this and that. And somehow, they got issues sorted out. And if they couldn't get issues sorted out, these village people will go to the county-level government and ask for a review. And if the county government officials don't hear them – don't listen to them, they go to the provincial governments. They go to Beijing and so on.

These people suffer a lot. But are they going to create serious social and political problems for China? My gut feeling is no. It is too bad for these people. It is tough for these people. And somehow, the government will be criticized for the way they treat these people. But adding them all up, are they going to undermine the social stability in China? My feeling is no.

Q: But my point is just the reverse of that – that they won't undermine social stability. So why not let them have a voice and then it would make the government look a lot better – certainly, internationally, it would look a lot more open.

MR. KWOK: Well, they are already having a much bigger voice than in the past.

MR. KEIDEL: I might add also a question I have about the earthquake damage and claims that are based on who was responsible for it is waiting for better information. What share of the buildings that collapsed were schools? What share of them were schools that were built early on with less steel reinforcement? There is a lot of anecdotal information showing a school collapsed next to a modern office building that didn't collapse. But I don't know – I don't have the facts that would allow blame to be placed, for example, on corrupt officials for underfunding schools when they were funding commercial structures and when they were built, and what the standards of construction were.

Then perhaps, we can come out and say, yes, this was corruption, and these people clearly deserve compensation for their children's death at a very high level. But if it is a natural disaster that destroyed all buildings of a similar structure or something, then I need more detailed information. I don't have it yet. So it is, for me, a very tough thing to think about objectively. And I am not sure that that is the degree to which it is being handled in China. But there is – I am fascinated at social science about the gap between what individuals' expectations are and the ability of those to be promulgated with very sort of almost sloppy evidence that makes a good story in a newspaper. And really what are the causal factors here? I don't yet have the evidence. But that is a side comment.

Yes, sir? Right here.

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Q: (Inaudible)– from Agence France-Presse You touched briefly on the financial contagion. Being the key financial window for China, how is Hong Kong bracing for challenges, for example, in checking financial contagion into China, especially with the Hong Kong dollar being tied to the U.S. dollar?

MR. KWOK: Well, this is a very general question. I don't know the specific – without the specifics, I am not so sure how to address that. But in general, I think what Hong Kong has to be able to do is to maintain a very high level of supervisory and regulatory standards. And this is what Hong Kong should do. So if we make sure that the financial institutions in Hong Kong, the financial activities in Hong Kong are properly supervised and regulated, then you will have a lot less financial disruptions and you would be a lot less likely to recede into contagion. And this is exactly what Hong Kong has been trying to do for a very long time.

Well, partly due to the fact that not a lot of financial institutions in Hong Kong get involved in all those CTOs and SIVs and subprimes and whatnots. So the financial system in Hong Kong today is actually rather – well, we are not affected very much by the sort of problems that you are going through now. Individual institutions may suffer a bit of loss here and there. Insofar as the mainland institutions are concerned, the Bank of China has already said that it has held some of the subprime instruments and so forth. But on the whole, the damages are pretty small.

MR. KEIDEL: Can I clarify for myself that the contagion you are talking about – because it is – (inaudible) – the idea that sort of not allowing global contagion to sneak in through Hong Kong to damage China's economy – are we saying that balance sheets on the mainland that will become integrated with balance sheets in Hong Kong need to be safe from having those Hong Kong balance sheets become damaged by their participation in balance sheets that are substandard globally? Is that the vector of this contagion that you are talking about?

MR. KWOK: Well, I think when we think about this subject, we have to bear in mind that China's financial markets are gradually opening. And as that happens, more and more Chinese financial institutions are going to come to Hong Kong, expand their operations, and use Hong Kong as the base to grow the global business. A lot of banks – the major banks in China have already set up offices in Hong Kong and are using Hong Kong as the base to expand the global business.

And that is also the reason why the Bank of China in Hong Kong is holding a certain amount of subprime securities. The insurance companies in China have for a very long time got their insurance premiums invested locally. They buy government bonds. They buy local stocks. They invest in local assets. But from a macro angle, these insurance companies should gradually be given the opportunity to invest their funds globally, so as to share the – again, many of these insurance companies are thinking of setting up fund management companies in Hong Kong and using Hong Kong as the base to gradually diversify their investments.

So as these things happen – and also, of course, on the other side of the equation, foreign financial institutions coming to Hong Kong expand their operations not just in Hong Kong and Asia, but also into China. So as that happens, more and more and more – obviously, when destructions happen somewhere, this will affect the institutions in Hong Kong. That has a lot of linkages with China. So that is why I mentioned earlier, given the need to ensure financial stability,

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the regulatory and supervisory aspects are very important. If we do a good job, then we will reduce the risk of this financial contagion being transmitted into China.

MR. KEIDEL: That is great. If we have one very quick question, we have time for it. Otherwise, I think we will wrap up. Any hand going up?

Well, then, let me say thank you to KC for just an outstanding marathon of a presentation.

(Applause.)

I know he has a busy schedule here, in New York, in Florida. And we wish him well. And thank you all for coming, and we look forward to seeing you at our next China event. Thank you so much.

(END)