



C A R N E G I E E N D O W M E N T  
*for International Peace*

**CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE**

**“CHINA: THINGS GET UGLY”**

**SPEAKER:**

**JONATHAN ANDERSON,  
CHIEF ECONOMIST FOR ASIA UBS**

**COMMENTATOR:**

**ALBERT KEIDEL,  
SENIOR ASSOCIATE,  
THE CARNEGIE ENDOWMENT**

**FRIDAY, JULY 1, 2005**

*Transcript by:  
Federal News Service  
Washington, D.C.*

ALBERT KEIDEL: When I arrived to live in Beijing in 1997, Jonathan had already been there for a few years. I would turn on the TV to watch Chinese-language economic talk shows, and Jonathan would be on them talking about the slump in the economy or trade issues. He was already at that point a fixture in the China analytical scene.

He then moved from being the bureau chief for the IMF in Beijing to Moscow where he also was their resident representative and then back to Hong Kong first for Goldman Sachs, where Fred Hu worked with him, and now at UBS where he's the chief economist for Asia. Those of you that receive his regular emails open them very quickly because of the way that they cut right through a lot of nonsense to what's happening in various Chinese dimensions in the economy and financial sector.

And so when he gave us his title, "Things Get Ugly" – I thought, you know, that's a lot of hype.

JONATHAN ANDERSON: That is a lot of hype. (Laughter.)

MR. KEIDEL: But things are of course sort of drifting in the U.S.-China relationship; things are challenging for the Chinese economy itself, and how ugly they are is something we can talk about. I have some ideas also.

Jonathan's going to speak for about 30 minutes, maybe 40 max. I then have some questions and back and forth that we will engage in for another 10 minutes or so and then we'll open it up to questions from the floor. We'll have hand-held microphones. So without any further ado from me, let's give a warm welcome to Jon Anderson, who has been on a road show for a couple of weeks now and is tired but refreshed by your smiling faces.

(Applause.)

MR. ANDERSON: Thank you very much. Thank you, Bert – thanks very much. I don't think it is a surprise to see so many people out at a China-related event. Obviously China is very much in the news these days. I do apologize in advance for those of you who have been sucked into this event by that overly sexy title. I'll explain exactly what I mean by that later on.

There are some ways that the economic situation is getting a bit uglier, and we'll go through that in a bit. I first want to say thanks to Bert and to Carnegie for bringing me out, and also a recognition that the collective wisdom on China in this room is much greater than my own. I would recognize Bert himself. I see Pieter Bottelier, former head of the World Bank Office. Nick Lardy is somewhere lurking about. There he is. These are people who have worked on China much longer than I have and have much greater wisdom, so I look forward to hearing from you all as well. And those of you I've missed in the room – Minxin as well – obviously we'll hopefully have a good and engaging discussion.

What I would like to do, though, is to set the stage in three ways. I would like to begin by insulting some of your intelligence by going through a short history of the last 10, 15 years on China just to make sure we're all on the same page on the economy, understand where things are coming from, what's going on right now.

The second phase of my remarks would be to explain what on earth I mean by this title. Why are things getting ugly, what's happening now in the economy, where do we think things are going forward? And finally, I'd like to take a few minutes to do what I usually do in China presentations, which is to try and deflate a few of the longer-term myths about China and perhaps inject a note of reality into some of the wild scenarios that you hear about the Chinese growth situation and about where it's going.

But let me begin by taking us back to the early '90s. Again, many of you know this story much better than I do, but if you recall, after Tiananmen, after the volatility in the Chinese political economic situation in the late '80s, early 1990s. China embarked on a very radical experiment. Deng Xiaoping, in the early '90s, went to the south, discovered a maelstrom of economic activity. Guangdong was already in a sharp upturn. You had Hong Kong companies who were investing heavily, who were throwing money into their neighbors up to the north. The Chinese leadership saw this and decided that this was a good thing; this was the way for the economy to develop going forward, and so a message was sent out that China should get rich and China should get rich as fast as possible.

And in these years, from 1991 roughly to 1995, China embarked on what was surely one of the great bubbles of not only Chinese history, not only Asian history, but probably one of the great bubbles of post-war history. Those outside of China can be forgiven for having missed it because it really was a domestic Chinese experience, but there were years when investment skyrocketed at rates of 30, 40 percent year on year. Money growth, credit creation, banks who were barely banks at all simply throwing money at anything that moved without any oversight from regulatory authorities. Asset markets went up by hundreds of percent in terms of property, in terms of equities. This was a time when things were completely out of control. The economy of course skyrocketed. We had growth that was in the mid-teens on any reasonable basis in terms of measurement.

Unfortunately, things ended rather badly. At some point the Central Bank decided to become a central bank. The authorities decided that this was all too much too fast. Inflation was running out of control at 25-plus percent. Again, the economy was just – it was an orgy of lending and speculative activity, and you started to get some tightening. The authorities tried to bring a note of realism, bring this economy down to what they like to think was soft landing.

It didn't quite work out that way. After four years of very, very aggressive activity, China went into what, by all accounts was a much harder landing than the official numbers would show. Official GDP data at that time would have given you 7, 8

percent GDP growth. Our best guess, looking back from our vantage point now, would be something more in perhaps the 2 to 3 percent range, which for China, again, was a virtual recession. You had profits collapsing; you had overinvestment and inventories building up in nearly every sector after, again, four years of wild, rampant, out-of-control investment. You had 25 (million), 30 million people who lost their jobs over the ensuing four or five years. China, between 1996 and the early 2000s literally put a working population the size of Korea's workforce out of work in China. You shut down tens of thousands of loss-making state-owned enterprises. Things did get ugly for China at home.

These were bad years. And the only reason you did not have an outright recession in China would be because of two things: number one, exports were fairly buoyant coming into '98 and particularly 1999-2000. And the second was that China embarked on a very large-scale project of fiscal stimulus. The deficit went from nearly zero to 3, 4 percent of GDP – probably much larger on a quasi-fiscal basis. China was putting in roads, putting in communications, putting in schools, building whatever they could, as a matter of fact, to try and prop up growth in the economy.

This brought us to the 1999-2000-2001 years, and these were the recovery years in China. The recovery was driven, as I mentioned, by fiscal expenditure – China, again, starting to put in as much as they could lever output on the ground, but also you had two very propitiously timed consumer measures, which actually are the story that you want to look at when gauging where China has been in the past five years. China did two things. Number one, they liberalized the housing market and they created mortgage markets. So from virtually zero, suddenly Chinese were owning their homes, suddenly people were upgrading. They started to relocate homes away from central business districts to create suburban housing developments. So you had this enormous housing demand which was created, and sure enough, housing investment as a share of GDP rose from 1, 2 percent at the trough to perhaps 6, 7 percent of GDP at the very height. This was an enormous driver for the economy.

The other, which went alongside the suburbanization of China, also with the road creation, was autos. Suddenly Chinese were buying cars, and Chinese consumers were buying sedans in droves. You created, again, housing finance; you created auto finance. As people moved out to the suburbs they wanted to buy vehicles. And these were the initial gist of the current Chinese upturn we've seen in the past few years. It was driven both by infrastructure spending, by exports, but also by very, very strong consumer spending – people taking their savings, leveraging up, trading up, buying autos and homes.

Lo and behold, we found that many sectors which had looked moribund a few years before suddenly were making money hand over fist. This was the steel sector, this was aluminum, this was cement, this was construction machinery and equipment. Suddenly these activities looked very, very profitable, and sure enough, China erupted into another spasm of overheating, bubble-like activity beginning in 2002, going into 2003 and 2004. Again, it was driven primarily by the housing, the auto markets but it

soon spread to investment into the things that fed into construction, fed into autos. So it was steel, it was cement. You had property, which erupted, again, into a very, very strong bubble.

I remember in 2002, 2003, friends of mine I hadn't seen for a decade suddenly came out of the woodwork to try and rope me into developer activities. The story went, I've got a couple hundred thousand; you give a couple hundred thousand and my cousin the bank manager is going to give us a couple million and we're going to go build 20-story residential housing in Shanghai. So it wasn't just strong capitalized state-owned enterprises who were in the game. Anyone who was anyone was out there trying to hustle for a bank loan. You were using your connections – the local mayors, the governor's office – and it all started to look very speculative very quickly.

And sure enough, from the outside world perspective, these are the years when China suddenly, from literally out of the blue, became one of the largest global purchasers of steel, of cement, of crude oil, of basic materials, minerals, mining goods in general, and for the last few years China has been the marginal driver of many of these markets.

From October 2002 on, as a private sell-side economist, my phone hasn't stopped ringing. It's been commodity analysts, it's been steel analysts, it's been consumer analysts. Suddenly China is buying everything under the sun, and the peak import growth was 45 up to 50 percent year on year both in value and volume terms in many of these activities.

So suddenly China of course is everyone's friend. Growth at home reaches a level of about 12 percent. And I should note that you don't want to use official GDP numbers when gauging the pace of Chinese growth. They will lead you astray historically; they will lead you astray now. China has much more volatility than the official numbers would tell you, and at the top of the cycle growth was, by any measure and by all accounts, extremely strong.

So here China is cruising along. You've got banks which are lending again at 25 percent year on year. You have investment as a share of GDP over 40 percent, which is going up enormously. You've got bubbles starting to pick up in the property markets; people are putting plant and equipment on the ground like it's going out of style, and the rest of the world is along for the ride. Suddenly the rest of Asia, which was still reeling from the tech downturn in exports – very, very low – is now exporting at a pace of 30, 35 percent year on year again, and if you look at where Taiwan and where Japan and where Korea were getting those sorts of export numbers, it's all coming from China. Japan's sharp domestic upturn, as a matter of fact, was primarily driven by investment in things like steel and things like construction equipment, things like cement, most of which are, again, going out the door to China.

This takes us up to about 2003, 2004. In the middle of '03 China begins to wake up. The government begins to wake up a situation which is actually starting to look very,

very speculative. You've got banks, again, who are lending not 11, 12, 13 percent as they normally would but 25 percent year on year. You have lending to small, undercapitalized developers which is rising at hundreds of percent per year. Shanghai property is starting to go up at a pace of 35, 45, 50 percent per year in the high-end luxury property areas. You've got too much investment visibly coming into steel and autos. Every global automaker in the known universe, as a matter of fact, is starting to announce plants, put them on the ground in China.

Their reaction of course is to try and cool things down. Remember, this is a China that just came out of a massive bubble, has just gone through a very sharp downturn, has just had to fire 25, 30 million workers at home, and now it looks like it's all starting again. So within a space of 12 months actually – the reaction time was very quick – China jumps on the situation, starts restricting investments in overheated areas, starts telling these banks they can't lend to property developers anymore. Fairly quickly the property situation cools down and you've got most of the small, undercapitalized players who are forced to make an exit because they can't get their financing. You have new projects in steel, autos, others, some of which are cancelled outright. Most new approvals now are getting kicked back by the Chinese government. They're not letting them through. And sure enough, bank lending starts to slow and all of this starts to come off.

However, as usual in China, it's been a little bit too little and a little bit too late. You have had two or three years of very strong growth, and China again is facing pressures in parts of its economy, and in particular if you look at the auto sector, if you look at the steel sector, if you look at some other heavy industrial sectors in China, we once again see signs that demand is coming off a bit more rapidly than you might like, supply is coming in much strongly that you would like because of the excess capacity that we've seen over the past few years.

The good news is this is not a collapse in China. China is not going to go down to 2, 3 percent growth, at least not by my accounts, going forward. The reason is they did stop it before it got completely out of hand. China, the last few years, was not the same sort of bubble you had in 1991 to 1995. So you still have very strong exports. You have consumption incomes which are rising very rapidly still in parts of the population. If you look at the services sector, if you look at the light manufacturing sector, things haven't quite been as overheated and over-invested as one might imagine. However, from the perspective of the rest of the world, China is now starting to look ugly. And I'm going to highlight three areas where China is starting to look less of a friend and more as a – less of a consumer and more as a competitor, to use the words of one my colleagues, in the global economy.

Number one, everything that China was buying from the rest of the known universe has slowed down an awful lot. China used to be the world's biggest buyer of steel outside of the U.S. Now China is actually starting to sell steel back to the rest of the world. Steel imports are starting to fall 20, 25 percent year on year. Steel exports are rising at a very rapid clip. China, which was buying cement, buying finished fertilizers,

buying machinery and equipment from its neighbors in Asia, those order books have pretty much dried up, and actually China again is starting to sell back to the rest of the world in these areas. It's not a reflection of China that's collapsing but it's a reflection of a China that is significantly now over-invested and over-supplied in these particular areas and slowing down on the demand side.

China, which used to be propping up oil prices, which used to be buying iron ore and mining goods at a very rapid clip, is still a net buyer, but these numbers have slowed down quite significantly. In fact, they were flat-lining in the first four months of the year – could come back on again. But China, broadly speaking – which was the main driver of Asian growth over the last few years; China, which was the “great white hope” for U.S. growth in fact for turning around the U.S. current account deficit, Chinese purchases of U.S. goods, suddenly all of that is off the cards. China is no longer a large buyer of things that come from outside of its borders.

Second, the trade surplus, which looked to be going into deficit 12 months ago, has now rocketed into surplus. Again, from a U.S. perspective, Chinese growth, 12, 13 percent year a year, should have been an enormous boon to the U.S. economy. We should have seen the current account deficit being moderated by Asian purchases, by Chinese purchases. None of that really happened. Chinese trade dipped into deficit very, very mildly for a brief period of time and is now running at surplus levels never before seen. So, far from China helping to ameliorate global imbalances in the world economy, China is actually starting to exacerbate them. Exports are still running 25, 30 percent year on year. Imports are, again, rolling off fairly significantly.

On the RMB front, we've been looking for a move out of China for a number of years. They've been talking about a move on the currency for a number of years. They have their own reasons to move and not to move the currency – and I'll talk about these a bit more in a minute – but China is now seen as being rather intransigent on the currency, and the longer China waits, I think the hotter things are going to get. I'll come to that in a second. But, again, this is an area where I do think things could get fairly ugly fairly quickly in U.S.-China relations, given what we see happening on the trade front.

Finally, of course, Chinese companies which have loads of money, which is now seeing its reserves grow at \$20 (billion), \$25 billion a month, is suddenly starting to buy companies abroad. The Unocal transaction, the bid we saw in the last few weeks, was simply the latest in a very rapidly growing round of acquisitions by Chinese companies.

So from the rest of the world's perspective it certainly looks as if China is no longer helping growth. China actually looks a bit unfriendly to growth. It's now a negative contributor to growth in the rest of the world – still growing very rapidly at home, which raises the specter that most of the growth is being propped up at the expense of the rest of us by a sharply undervalued currency; not only that but they're taking this money and they're starting to buy up assets abroad, and buy up assets in extremely sensitive and strategic areas in many cases. So thus the title of the presentation, “China: Things Get Ugly.” They're not necessarily getting ugly at home. We're not looking for a

China which is going to collapse, and I would actually say that China is very likely to go for a soft landing – I'll say a bit about that as well – but a China which is no longer turning such a smiling, friendly face to the rest of the world on the economic front.

Let me say a bit more now about a few of these points. I'm going to start with the currency because that certainly is the topic du jour. You have now any number of measures sitting in the U.S. Congress aimed at either forcing Chinese to make a move or penalizing them if they don't. In October it's very likely that U.S. Treasurer Snow could or would label China as a currency manipulator from the administration side, which of course opens a Pandora's Box of measures which could look very, very similar to what we saw in Japan in the '80s and the '90s – structural impediments, intransigence, currency manipulation. These are very serious charges that are leveled at the Chinese side.

Let me say a few things from the economic point of view on the currency, and then I'll talk a bit about the politics as well. I want to ask three questions on the currency. First of all, is the Renminbi undervalued? The short answer would be, who knows? And I say that quite honestly. If we define undervaluation in very near terms – i.e. lots of pressure on the currency to appreciate, lots of reserve accumulation because the authorities are maintaining a fixed exchange rate in the face of strong current account, capital account inflows, then of course the Chinese currency is undervalued. In a near-term sense, there is enormous pressure on the currency to appreciate and it's not only coming from the speculative inflows, it's not only coming from FDI, but it's now coming from a trade balance, which is running about 10 billion a month.

In a longer-term sense, as my economics colleagues in the room will attest, it's devilishly difficult even to agree on what we mean by undervaluation, much less whether China is undervalued or not. I'll give you a couple of arguments. China has a closed capital account. If China ever decides to open its capital accounts significantly so that Chinese depositors and household and corporate depositors in the system could leave the banks and go abroad, you would almost certainly see a strong outflow of portfolio assets from China, which would probably send the currency to depreciate, not appreciate.

So one of the reasons that the Chinese currency is under appreciation pressure is simply the fact that people are allowed in, money is allowed in; it's not really allowed out, and that gives you a one-way flow, which obviously skews your view on the currency. However, on the other hand, it's very unlikely in the next five or even 10 years that China will undertake a significant capital account liberalization. I don't think China is going to be foolish enough to open the doors for its depositors to flee the banking system before they're completely fixed the banks, and therefore in the near- and medium-term sense, we do have to look at a China which is going to be behaving basically like it is today.

My guess would be, yes, that China should be appreciating over the medium term. Structurally, the current account in China has always been positive and it's never been higher than it is at the present time. You've always had net inflows of medium- and

long-term capital. The basic balance, if you will, in China has been structurally positive for many, many years, which is normally looked at as a sign by emerging market practitioners of a structurally undervalued currency.

So, yes, I think there is a case that China should be more appreciated – would be better off, in fact, being more appreciated, but I don't think the charge of undervaluation is unfair. I do think the charge of 30 percent undervaluation is unfair. If you were to let the Renminbi go tomorrow, it would likely move by 25, 30 percent because those are the current pressures that are coming in. But remember, half of those pressures on the currency are coming from speculative capital flows, which could easily turn around tomorrow. In fact, if you were to move the currency by that amount you would almost definitely see capital leaving the system, taking their profits and taking their money offshore.

The sorts of numbers we usually come up with when looking at longer-term valuation estimates are perhaps 10 to 15 percent. That would be the amount of structural undervaluation in the currency. This is not a big number. I mean, let me be very frank. If China were to move the currency by 10, 15 percent tomorrow, the impact on the U.S. economy in particular I think would be almost zero. This would make Chinese goods marginally more expensive to U.S. consumers. This would make imports decently more cheaper in China, would fuel some greater purchases on the import side, but most of those purchase would be very likely to come from China's neighbors, who are the main suppliers of the Chinese economy, rather than its more distant trading partners, the U.S. and Europe.

I don't think there is a – I don't think the U.S. has a dog in this race in terms of the Renminbi, but it has become a big political sticking point. But, again, I think the main beneficiaries of a Renminbi appreciation would not be the U.S. economy, it would be the Indonesias, the Turkeys, the Mexicos and the Indias of the world in particular.

The second point is, should the Chinese really move? It is one thing to say the currency is undervalued; it's another thing to say that China should actually be taking aggressive action to try to bring the currency up, down, et cetera. To my mind, I don't think a repeg or a revaluation is the way to go. China's problem is not that its currency is too cheap; China's problem is that its currency is fixed. The biggest problems you see in emerging markets today – and most emerging market crises you have seen in the last 15 years have all been tied to fixed exchange rates – countries holding on desperately to a fixed-currency regime too long in the face of policies that have been going in different directions that have made that currency unsustainable.

China is not there yet, but there is a very good chance that in a few years down the road we could be seeing a China which is in a position that perhaps Argentina or perhaps the Asian crisis economies were in. There are no guarantees, but there are a lot of worries on the part of most international economists that a fixed exchange rate simply is no good for China. We would like to see China more flexible. In the near term that would certainly mean China appreciating.

So my starting point is that, yes, I do think China is much better off with a more flexible currency. In the long run I think it helps them take pressure off the domestic economy from external imbalances, and I think the Chinese broadly agree with this, which brings me to the third question, will the Chinese move? What are we going to see over the next three months and what are we going to see over the next 12 months?

I'm going to give the arguments first, why not move? If you're the Chinese senior leadership with a vague understanding of international economics, the view from the ground is very simple. China has had a fixed exchange rate for as long as anyone can remember, and it's particularly – as long as you've been undergoing strong market reforms this has provided a great element of stability for the economy, it's provided us with growth. We're not hurting anyone else; all we're doing is selling cheap goods out to the rest of the world. We've been a great buyer from the rest of the world; why on earth should we play with this now? We have a fragile economy. It's an economy that's slowing down. The export sector in particular has very low margins. We've got farmers who are just starting to get on their feet again with rising incomes and rising food prices. If we mess with the currency, all sorts of bad things are going to happen to us. Export margins are going to collapse, imports are going to become cheaper so food prices go down, farm incomes all of a sudden collapse on the downside, and lo and behold, as we discovered over the past few years, this closed capital account is not as closed as we thought, so if we start playing with the currency, suddenly we're going to be hit with speculative flows in every which direction. So why on earth would we want to be changing its currency?

Those are very strong arguments and very potent arguments in China. The arguments for moving the currency are much less understood, much more nuanced, and really only apply to people who understand international economics very well. The arguments for moving the currency are, again, that, A, in the long run China is better off with flexibility. And again, that's not a point that's well understood by the masses. And, B, that China is facing external imbalances now. Two years ago China was buying \$5 billion a month in FX reserves; 12 months ago China was buying \$13 (billion), \$14 billion a month in FX reserves; today China is buying \$15 billion a month in FX reserves, and no end in sight, which means that eventually you do run into problems. This money could flow back into domestic liquidity. In technical terms, the possibility for sterilization, for putting up a wall between the external inflows in your domestic economy starts to break down. You could be running into trouble in terms of monetary management.

So, yes, there are very good arguments to move the currency. I think that on balance, China is thinking about it. You definitely have scenarios on the table. My guess is it's a coin toss. I think there is perhaps a 50 percent chance of seeing a move in the next six to 12 months, and an equal 50 percent chance of seeing them sit on their hands and not do anything for the next few years. But I will say this: if the Chinese do go, it's not going to be 10 or 20 percent. It's not the numbers that most of us are looking for in the U.S. The favorite scenario, as I understand from talking to the technical people and

the authorities, would be a gradual move from a U.S. dollar peg to a trade-weighted peg, so move away from the dollar at the margins, and perhaps a very small upfront jump – 1, 2, 3 percent – but with an eye to providing greater flexibility over time.

Again, you may wake up July 15<sup>th</sup> and you discover on the front page of the Wall Street Journal that China has adjusted the currency. It simply is not going to be very exciting, and it is not going to be very big. I think 5 percent on the outside is something that I could see if the Chinese wanted to give a sop to the U.S., but anything that has a double-digit percentage behind it I think looks very scary from the viewpoint of the Chinese authorities.

So here we sit. The currency is seen as an enormous issue in the U.S. In China it's seen as not a very big issue, and an issue that's still a bit fuzzy and vague in people's minds. From the U.S. point of view, China is aggressively and cynically manipulating the currency in order to keep that trade balance going, in order to steal growth from the rest of the world. From the Chinese point of view, you've got an economy over here with a per capita income of \$35,000 picking on a small, poor, fragile economy that has a per capita income of \$1,400 per head. They don't think the U.S. is very serious. And I think this is a potential problem. We've got the Schumer bill coming up, you've got Hunter-Ryan, and you've got a host of other areas. The Treasury itself may be acting. If you speak to the Chinese, they don't see the arguments, and they can't believe the U.S. is going to actually do it because all that China has been doing has been keeping its currency stable, as it promised it would do for the last seven years, and it's a very poor and fragile place. And we shouldn't be going and beating them about the head. I think that's a disconnect in views which is likely to come to a head over the next six, 12 months, and I'll say more about that in a bit during questions and answers as well.

One more word on the external side, which is the FDI front. As most of you know, CNOOC, a Chinese oil company, has now made a bid for a U.S. oil company, Unocal, with oil and gas assets. And this is one of a long stream of announcements we've had. This has hit closest to home for the U.S. because it's the first time of course we've seen China bidding very aggressively for assets that are considered strategic in the U.S. What on earth does this mean and where is this going? Let me make a couple of points on this.

First of all, from a macro point of view, China has a great incentive to see companies go out and buy things, and it's not because they want to go out and buy things from the Americans; it's because they've got a problem on reserves. China has reserves that, again, are growing at \$25 billion a month. This year China is going to buy 250 (billion), 300 billion of reserves that it doesn't want. China does not want their reserves to go to a trillion (dollars). They would be happy if reserve growth stopped yesterday. This is a big problem for them. It means that they have a big trade surplus, it means that they have a big capital account surplus, speculative flows, putting pressure on the domestic monetary side. They've got to borrow all this liquidity back from banks when it comes rushing in. They're unhappy about it, and they've been trying to take measures to get money to go out the door to offset. There are only two ways you get money to go

back out the door in China. You can open up the capital accounts and let all the depositors flee the banking system and go to Citibank or HSBC. That's not going to happen because that would kill the domestic banking system.

So what do they do? They go to companies and they say, well, FDI is the solution to the problem. The government today is very actively encouraging Chinese companies to make acquisitions abroad, precisely because they want to generate capital outflows and precisely because they want to take the pressure off of their reserve growth. So now you've got Chinese companies all in Asia, Latin America, Egypt, Middle East, Africa, and of course the U.S. and Canada. And that's where it's coming from. It's a macro policy aimed at trying to counter imbalances in the economy. And companies have a lot of money now. Profits have never been higher in China than they were in the last few years.

The second issue pushing companies out the door is a very specific one, which is energy. Ten years ago China was virtually self-sufficient in minerals and fuels and agriculture. Today things look very different. Over the last 10 years China has seen a radical change in its dependency on crude oil – 40, 45 percent of its energy needs are now imported from abroad; 25, 30 percent of its mineral needs are imported from abroad. Agriculture is still fairly self-sufficient but believe me, within five years, 10, 15 percent of its agricultural needs over the next decade could start to be imported from abroad. China is virtually running out of everything it can pull out of the ground, has very poor resource base, and is scared to death of what this means going forward. They're growing at a very fast pace. They have 1.3 billion people that need to be housed, clothed and fed, and they've got nothing at home to do it with. So of course you can just do what the U.S. does, which is to depend on spot markets for your import needs, but in Asia that's never really been a favored policy.

You remember Japan going out and locking up long-term supply contracts. In China they want to take it one step further. They're not even that interested in long-term supply; they would rather own the resources. They're scared of the rest of the world, they don't know where they're going to be in 20 years' time in Japan relations and U.S. relations; they just like to have some equity stakes. And sure enough, energy companies are on an acquisitions binge now, and it's not just macro; China is specifically going to energy companies and telling them you need to get out the door and you need to buy whatever you can find in resources, in minerals and materials, in oil, gas. Unocal is a perfect match for them. Most of Unocal's assets are Asian oil and gas fields. It's next door. It's not that they want U.S. assets; they want assets that are close to them that they can use if necessary to fuel their own economic needs in a pinch. This is the beginning of a large iceberg, by the way. The Chinese external imbalances are not going away. The macro situation is not turning around. And Chinese dependency on imported stuff is not going away either.

So if I look at the ways in which China is interacting – rising trade surplus, falling imports, currency that's increasingly becoming a sticking point, Chinese acquisition strategy, which is now starting to raise hackles in the rest of the world – none of these

things is going to go away, and I think in the next 12 months things are simply going to become exacerbated, which is, again, why the title of this presentation. It happens to be close to the title of a piece I wrote in the Far East Economic Review entitled “The End of the China Love Affair,” but it is that; it is the end of the China love affair as far as the next 12 to 24 months are concerned.

My time is quickly running out but let me take another five, 10 minutes and quickly go off to the medium term and the long term now to try and take a look at the long-term outlook for China, and I’m going to couch this in terms of myths about how China interacts with the rest of the world, and I’ve made a list of six or seven that I’ll run through very quickly.

Myth number one: China is headed for collapse; profits are running out, China is massively over-invested in its economy, we’re going to go through another painful spiral-down, China is going to be growing at 2, 3 percent and we are going to see all of the instability that rises on the back of it – simply not true. China has a long list of growth drivers at home, among which are long-term housing demand, infrastructure, roads, farmers who are starting to see rising food prices and food prices that are going to be rising fairly sustainably, exports – China is still the premier exporter of goods to the rest of the world, and it isn’t because China’s currency necessarily is cheap. This is a strong structural element of the Chinese growth. What we’re seeing is really an overheating issue in a host of heavy industrial sectors, which are going to be causing China and the rest of the world pain for the next 12 to 24 months, but in the long run, China will regain its rightful place in the world as a large net buyer of capital-intensive, tech-intensive goods from the U.S. from the rest of the world. It’s not going to be pretty in the next four to six quarters but I think life will get better in the five-to-10-year horizon.

Second myth: China is headed for a financial crisis. We look at Chinese banks – one of the biggest disaster scenarios that you hear bandied about in the press is that, again, Chinese banks are going to collapse very soon. You’re going to see the financial system implode, and it is game over for the Chinese economy. The dirty little secret in China – which is not quite a secret anymore – is that China has been spending tens and hundreds of billions of U.S. dollars to fix the banks as fast as it can. And it’s fixing the banks as fast as it can, writing off any bad loan it can find, precisely because it wants to sell those banks to you and me. Three or four years ago, Chinese large four state banks and most of the second-tier banks were completely off limits to foreign investors. The financial system was the last bastion of the socialist economy in China. Remember, he who controls the financial system controls the reigns of power. This was a statement that goes back to Lenin.

Today things look very different. China has been busy selling off shares in its second- and third-tier banks, finding strategic investors as fast as it can. It now wants to get the big four out the door as well. It’s no longer very concerned about holding onto the reigns of financial allocation. What it really wants to do is to prevent exactly the sort of financial disruptions and crisis that it nearly got 10 years ago at the end of the last round. The strategy is clean them up, put as much money in as you need to, sell them out

the door. Most of the fund managers that I talked to within 12 months are going to be faced with a choice of buying shares of China Construction Bank, the Bank of China, and The Industrial and Commercial Bank of China. All of these are going to be floated to you and me. China will maintain its majority state shareholdership in the near term, but I can easily imagine a strategy in 10 years' time where China will be a small minority shareholder in the financial system as a whole, and that's a very different place than we were, again, five, 10 years ago.

So, again, Chinese banks are not great institutions. Some of them are still technically insolvent. But we're not looking at an illiquidity situation; we're certainly not looking at a situation where Chinese banks go under, for the simple reason that there's an awful lot of liquidity and money in China that can be used to bail them out if and when anything comes down the horizon.

Myth number three: Social tensions are tearing apart the Chinese economy and polity. You hear a lot of stories about this – farmers in revolt, uprisings, in the villages, major demonstrations in the cities, unpaid wages, unpaid pensions. From where I sit, again, things are exactly the opposite. Seven, eight years ago China looked like a disaster scenario. You had very large unemployment, you had just shut down tens of thousands of companies, people in these one-company towns in the north, the rustbelts had 60, 70 percent unemployment. Aggregate unemployment in China, if you had measured it correctly, probably would have been 18, 20 percent in those years on the urban side. After five years of very, very buoyant growth now those numbers have come down very, very rapidly. Unemployment today in China in the urban areas is probably closer to 8, 9 percent – still decently high, mostly skewed up to the northern part but no longer in the strong double digits. China has been creating jobs much faster than workers are coming into the workforce over this last part of – this upturn and this overheating cycle.

If you look at the rural sector, what we find is that things look phenomenally buoyant. For the last two years the biggest story in China has been rising food prices because demand is skyrocketing for foodstuffs – meat, milk, the diet is moving very rapidly to high-caloric intake. China's agricultural and arable land is eroding. A lot of that is going out to urbanization, to mechanization and industrialization. So suddenly Chinese farmers have rising incomes and incomes that are rising very sharply. In the manufacturing sector the big buzzword now is labor shortage. It sounds silly to talk about labor shortage in an economy with 800 million rural peasants, but the fact is that China is running out of young men and women to man the factories and the construction sites. If you look at Chinese export manufacturing, it is only 18- to 25-year-olds, and mostly women who are employed, and the One China policy means that this demographic is now fading.

So if you look in the rural sector, for the first time in 10 years, rural income is rising, food prices rising. There are children who are working in the factories and in construction who are for the first time seeing rising wages. And this is something that's going to continue over the next 10 years. As long as I don't see China collapsing I think the next decade is going to be much better in terms of decreasing rural-urban income

gaps, decreasing urban-urban income gaps that we saw in the last 10 years when it was simply a rapid explosion in gaps in equality in China.

Myth number four: Pensions are breaking the bank in China. Remember, the one-child policy that was instituted in China 20 years ago pretty much guarantees that China is the only economy with a per capita income of under \$15,000 a head which is now going through a population crisis. Korea is going through a population downturn. Japan is going through a population downturn. Europe is going through a population downturn. All of these economies are extremely wealthy. China is the only economy with a per-capita income of 1 (thousand) to \$2,000 per head which is facing exactly what the OECD is facing now. Within 15 years the workforce in China will have peaked; within 25 years, the population in China will have peaked, and if you look at dependency ratios from three retirees – or three workers for a retiree today, those numbers are going to be flipped on their head in 20, 30 years' time.

And no one knows how China is going to foot the pension bill for all of these workers, but I will tell you two things: number one, it isn't happening yet. The big turnaround comes in 10, 15 years down the road. That's when the dependency ratios start to rise or fall depending on how you describe them, but the workers per retiree start to fall. That is when the big numbers start hitting home. It isn't going to be a story for the next five or 10 years. Down the road no one knows if they'll have the money to meet it, but also no one knows what the implicit pension liability is going to be. The simple fact of life in China is there is no promises to anyone. It's promised that – China has promised that they're going to pay their fair share -- they really haven't promised you what they are going to pay. And if you get down the road and it turns out that they don't have enough money to pay you 2,000 renminbi ahead, they could pay you 1,300. We are not looking for an explosion necessarily. So we'll see how things play out in 10 years, but it's not something that I lose sleep around in the near-term horizon.

Myth number five, China is too cheap, and this goes back to the renminbi question. China is too cheap and it's hurting us, i.e., the U.S. consumer, U.S. jobs, U.S. manufacturing at the end of the day. And here let me make two points. One, again, there is a case certainly that the renminbi is too cheap. I don't think the renminbi is massively undervalued but, again, 10, 15 percent is there.

But you ask yourself the question, does it really matter for U.S. jobs and U.S. workers if Chinese wages are \$100 a month or \$115 a month. Is that going to bring the jobs, particularly in light manufacturing, back into the U.S. economy? I doubt it. What it would do of course is provide a greater incentive for places like India and Indonesia, others, to start eroding at China's margins and gaining manufacturing employment. And that would probably be the case.

But this brings me to the second point, which is, if you look at wages in India, they are now three-times less than they are in China. You know, you can hire an Indian manufacturing worker for \$30, \$40 U.S. a month. In China, the marginal bid is already above \$100. If you go to Indonesia, virtually the same is true. Vietnam is around the

corner. Again, very disciplined cheap work force. Yet, the money continues to pour into China. We don't see a big light-manufacturing boom in India and Indonesia yet.

What is going on? It is very simple. If you poll foreign investors who are in China, there is a long list of reasons why they are there and low wages are about number 13 or 14 on the list. The top 10 are stability, proximity to suppliers, infrastructure, maybe perhaps preferences that are given in terms of land and taxes. It is the – again, the educational level of the workforce, discipline in the workforce. You know, there are long list of reasons why people want to be in China besides the domestic market. These are areas where the rest of Asia is not yet competing on a fully level basis.

And, again – so it's not a problem with the currency per se. Moving the renminbi is not going to change that dynamic. It will speed the process by which those advantages peter out, but that is about all we can say at the present.

Myth number – where are we – number six. Cheap capital or free capital dooms China to boom-bust cycles going forward. The myth says that one of the reasons that China is eating everyone else's lunch is that banks give away free money, interest rates are laughably low, and this is why China is suddenly appearing on the scene as a big exporter of capital in terms of steel, machinery, even automobile. The first Chinese automobile is probably going to roll into the U.S. in a couple of years time and cost seven (thousand dollars), \$8,000. That is going to be a big shock to a lot of people here. And the myth says that this is all because China is providing cynical manipulative subsidies on its – on lending.

At let me say two things. First, interest rates are not outrageously low in China. The lending rate in China is 6, 6.5 percent today. In real terms, given that core inflation is roughly zero in China, it is also 6, 6.5 percent today. And I have to say, by Asian standards, that is actually a pretty high real interest rate. If you look at where Japan and Korea, Taiwan, Thailand, Singapore, most of the Asian tigers were in their 9-10-percent-GDP-growth phase when they were eating everyone's lunch and building out their export basket. Real interest rates were a good a bit lower on average.

There is a view among investors in the U.S. that if you take the nominal growth rate, which in China is 10, 11, 12 percent, that is where interest rates should be. In the U.S. that tends to work. If you take 3 percent, 3.5 percent U.S. growth, take 1, 2 percent inflation, long yields in the U.S. should be 4.5, 5, 5.5 percent. And on average, that is where they usually end up being. That mathematics has never applied in Asia. I don't see interest rates as drastically low in China. Interest rates should be rising over time, and guess what, they are rising over time. I don't think that is the problem.

The real problem in China is very, very simple in my view. You have state banks who are lending to state companies. It is not that the price of capital is too low; it's that no one ever thought about repaying it in the first place. You have, again, civil servants in the state banks who are lending to the local governor who comes in with their brother-in-law, who is going to start a steel factory. The bank knows that this is an overheated area,

that margins are falling. Can it say no? Well, no. It has an awfully hard time saying no. Why? Because it is all in-house, it's one part of the state lending to the other. This has been the story for the last 10, 20 years.

And this is where China always gets itself into trouble, what I call the new white elephant syndrome. Every time you get into a bubble, everybody wants to jump on it, and they are all your cousins and neighbors and colleagues in the party. This cycle will be broken going forward. Whether broken slowly or quickly I don't know, but it is going to be broken as they privatize the banking system. The easy way out is very simple: get the state – get the banks out of state hands. And this is now official policy in China. This is what they are doing now, and it's going to take them 10 years, but they are going to privatize, they are going to try and privatize most of the state banks.

Finally, the last myth, and one that I think strikes closer to our hearts at home, is that an emerging China is not only a communist state, but also poses a dire threat to free markets and to democratic ideals abroad. And this is a very touchy point because China is emerging as a radically growing force in the world economy, in the regional economies. We read about the military buildup in the Chinese economy. We see China in foreign policy just starting to flex its muscles alongside its economic might.

But let me say this. As I look upon China I see two things. Number one, in an economic sense, there is virtually hardly a shred of communist ideology left in the system. And even socialist economic ideology is rapidly fading. When Milton Freedman comes to China, he sees an economy that is as capitalistic as any that he has visited in the last 25 years.

And you can see this on the ground. China still has vestiges of the state financial system, you have vestiges of the SOE sector, but it's no secret that China is selling most of this off as fast as possible. It has already broken up all of the monopolies; nowhere in China will you find even what you find in other emerging markets, which are monopolized energy sector, monopolize steel sector, a monopolized electricity sector, transportation where you have one big sink hole which is sucking resources out of the rest of the economy.

The central government has an almost laser-like focus on making their companies profitable, on promoting governance. And if you look at China compared to what you even saw in Japan, Taiwan, Korea – remember, in the high-development days of the Asian tigers, it was “Japan Inc.”, it was “Taiwan Inc.”, it was “Korea Inc”. The received wisdom was that they wouldn't let you invest in their economy, all they wanted to do was sell back out the door.

Even today the first foreign investors are still struggling with trying to make acquisitions in key sensitive areas in Japan, 30, 40 years after the beginning of their sharp rise. Meanwhile, China has the world's largest stock of FDI in the economy. Most U.S. companies now have a presence and are making very large profits in China. China has

flung open its door to import markets, flung open its doors to foreign investors, flung open its doors to domestic investment.

The one thing you see in China today which you never saw in Japan, in Korea, in Taiwan, is the utter lack of *chaebols*. The story in North Asia was always very cozy small groups who have interests all across the economy, very strongly motivated by the state, cozy relationship with banks. In China, you don't see massive conglomerates with cross holdings. Instead what you see is increasing competition in every sector.

The ideals that China is now exporting to the rest of the world in an economic space are very close to the ideals that we have at home: competition, markets, equities, better access to finance, governance. These are now the watchwords – better legal system. It's far from perfect, where you're decades away from reaching the sort of legal infrastructure and commercial infrastructure that we have in the U.S., but that is where it's going.

On the political side – and again, I'm not a political scientist, and I apologize for sticking my nose where it doesn't belong, but I will also say this. If you look at the Asian development process over the last 30 years, you have a strong history, particularly in North Asia, of what I call, again, the Japan-Inc., the Korean-Inc. model, which is no democracy until you get a car in every garage, put very simply.

Japan was a one-party state through most of its sharp upturn. Korea was a one-party state until the mid-late-'80s. Taiwan was a one-party state until the mid-'90s. Singapore is a one-party state today. This is Asian business as usual. This is the tradeoff you make. You keep an authoritarian regime at home, which delivers the growth goods until you reach a per capita income of \$15,000 per head, and then once you have got a car in every garage, all of the sudden you start liberalizing, and everybody develops a taste for democracy. It's a middle-class good. That is how Asian societies and economies have traditionally viewed the situation.

And as I see China developing, that is pretty much where I see it going. Again, the Chinese Communist Party is no longer communist. It is barely socialist as we speak today. What the Chinese Communist Party is, though, is a party that is extremely committed to keeping the reins of power and taking – and maintaining a one-party state by all means necessary, in part because they are desperately afraid of giving up the reins and in part because the only role models they have in the developing world have taught them that going to multi-party democracy too early is a disaster.

And that is pretty much how I see things playing out in China. If you look at the ground in China, what you're seeing is a rapidly developing rule of law, accountability on the local level. These are the tradeoffs you make in China in order to keep the populous from focusing on national issues.

I think it's safe to say that within China today, in Beijing, or in any major city, what people care about, deeply and violently care about, is not who runs the nation – I

don't think peasants and people in Nanchang care whether it's Hu Jintao or Wen Jiabao or anyone else from the show. What they care about is this: they have just got their first mortgage, they have just traded up on their apartment to a bigger place that they have put their hard-earned savings down to buy.

Lo and behold they move into that apartment. They discover that it has been manufactured with shoddy materials. The developers reneged on all of its promises, and it's because he's in bed with the local mayor, and they want redress at the local level. They want to know that they can sue the mayor. They want to know that they can get recourse from the government. They want a legal system that protects their rights and makes them feel empowered.

And by and large, the story of the last 10 years has been to gradually give them this. We're not there yet; it's going to be a long slog. But they have – this is where you see progress being made in leaps and bounds. And this is the deal with the devil in China: we will give you the legal rights, we will give you empowerments in most of your affairs as long as you don't stick your neck into politics. And that is pretty much what I expect to see over the next 15, 20 years.

The only thing that I see, in the near term, coming in the way of a continued unbroken rule of the party would simply be a collapse in the economy. If you see Chinese growth tumbling down, unemployment, that is when you want to be worried about what happens with the government. As long as the growth is being delivered in its 8, 9 percent, this is not a government that is going to topple tomorrow.

China is going to be with us for a while, for better or for worse, for richer or for poorer. It is a growing part of the world economy and it's going to be an interesting next 10 years, I will say that. I have well overstepped my bounds, so let me stop and say thank you very much for your time.

(Applause.)

MR. KEIDEL: Jon, in true Washington fashion, has preempted most of my questions. I'm going to raise a few and then turn it over to you because I think we have a lot to chew on. But I need to go after this question of how ugly it has turned from how lovely it once was.

I have got three questions, Jon. You said China is turning ugly now because it used to be everybody's darling. But isn't that sort of darling image of China as the buyer questionable – when in fact it wasn't so darling because they were seen as pushing up prices of every material that anybody else wanted to buy?

And when I looked at it statistically, whether it was cement or oil, China's role in the surge in world markets was really secondary and tertiary compared to the recovery of the U.S., European, and Japanese economies in 2003 and 2004. In cement, it was things like the closing of a big plant in Florida and a U.S. construction boom.

So is there really such a big change? Aren't we amplifying China's role as a demand source earlier and now bemoaning it too excessively as someone that is sucking the blood of the world economy. (Scattered laughter.)

MR. ANDERSON: Probably and I think obviously so. China has not been the biggest single demander of these goods, but if you look at the growth gradient that you saw in crude oil purchases and cement and steel and many of these other areas, China had the single biggest uptake.

If you look at the first derivative of what was going on, the increments in barrels per day being added to the world economy, the increments in tons of cement, the increments in tons of steel, most of our commodity people finger China as the key marginal player that gave the extra \$20-a-barrel up if you will.

That might be overstating it but from a lot of commodity trader's minds and our commodity analysts as well, it is all China now. These people come spend an inordinate amount of time kicking the tires in rural China trying to figure out what is going on in steel capacity and so forth perhaps because the U.S. has been much more understood. I think coming up the learning curve on China has been much harder than coming up the learning curve in U.S. steel demand.

My sense is at the end of the day it is overstated, but I think the perception is there that it has all been China and now China is going to turn it all the other way.

MR. KEIDEL: Well, I think it is perception to a significant degree. I was just talking with some of the major copper players. They looked at it very carefully and discovered that even the copper that China was buying was largely going into exports back to the U.S. market. So it has a lot more to do with the final market, which is U.S., Europe, and Japan, than it does with China itself as a juggernaut disturbing the equilibrium of these world commodity markets. And I just want to throw that out.

Second, on the financial sector, I love your myth that it is going to collapse any time soon. But I'm really curious that you would think the Chinese would privatize it that quickly, because it seems to me that what they have is the Asian model of using deposit-taking institutions that are not banks to support infrastructure that is the lubrication for private-sector development.

And so I don't think they want to break that model in five or even 10 years, but that they will set up the forms that look like a private sector. You said they would be happy to lose control or sell away control of the "big four" [banks] that quickly. How do you see that working? What makes you think it will happen so fast?

MR. ANDERSON: Well, I don't think it's going to happen tomorrow. Right now China is in love with the PetroChina model. And the PetroChina model runs as follows. PetroChina was a big, poorly run state-owned oil conglomerate back five, 10

years ago. At this point, in the late-'90s, China was trying to come to grips with what on earth they are going to do with all of these state enterprises, especially the big ones. The small ones they have been selling off and gradually been bought up by the insiders and so forth.

And even – of the tens of thousands of state-owned enterprises on the book today, I would guess that most of them have been pseudo privatized by their own managers. But you are left with these behemoths, like PetroChina. And they have tried managing it by putting state-owned managers in there and putting an independent state board of directors, but it is all civil servants, it's all in-house, and you get regulatory capture pretty quickly in these areas.

What they decided to do with PetroChina – one of the first big state-owned enterprises to go out the door, is list it abroad. They were going to take 25, 30 percent of it and sell it to the Hong Kong and New York investor. And it was a daring move at the time, the first time it had been tried with one of these big companies. But lo and behold, it turned out to be magic. Just utter the word listing, and all of the sudden you have got investment banks and the HR people and the auditors descending on the company. They smell commissions in the air. You utter the words, and suddenly you have got people tearing apart the company and putting it back together and stripping out the pension assets and rationalizing these structures, and strip the good company out of the bad company, putting all of the bad stuff in the parent company, and suddenly you have got this nice clean entity that you can list abroad.

And suddenly PetroChina is one of the best performing, best governed, most transparent companies in China, despite the fact that it's about 70 percent state owned. The rest of it is listed abroad and foreign shareholders are doing their jobs. And China has a long line of these things waiting to go out the door, and so they want to do the right thing, and so they continue to make PetroChina the flagship.

And it turns out to have been the best decision they ever made. They are in love with the idea of the private markets and outside ownership exercising some control and restraint. And sure enough this is exactly what they want to do with the banks now. They don't want to sell 70 or 100 percent of it. They want to sell 35 percent of it – 10 percent to our bank and then another 25 out to you all as retail investors, precisely because they want to get that oversight, that transparency to avoid the next round of scandals.

Now, the banking system is a much more touchy issue than PetroChina because this is of course the reins of fueling the economy. But if you look over the 10-year horizon, we have gone – 10 years ago there was literally big arguments between hardcore communists and reformers in the state about whether you could privatize state enterprises at all. China is now selling off up to, 30, 40, 50 percent shares in these companies. You put that forward 10 years and let's see how it goes, but in 2015 we could easily be talking about selling off another big packet of state shares and making these minority holdings, for example.

MR. KEIDEL: And China will then be a \$3,000 per-capita –

MR. ANDERSON: Or five.

MR. KEIDEL: Or five, yes. Finally, I wanted to ask you, because this is really your expertise, on the domestic economy, how healthy is it right now? I mean, we have seen official growth rates stabilized. The growth rates, which I think are better measure from the expenditure side, show it dropped a half a percentage point [from 2003 to 2004] or maybe a percentage point. But you have seen imports really slump, so when you talk about domestic demand, it is clearly a lot weaker. And the numbers don't seem all that good anyway. I mean, the GDP deflator, which is the broad measure of GDP inflation, was six percent last year.

And yet you implied or said that the core inflation is zero. And so it seems to me that there are things happening domestically that put a lot of pressure, for example, on social unrest potentially if they slow down, if they forced farmers to go back to planting more grain, which they had relaxed—and which I think was one of the startups to the current boom, which was built on rural demand, as you mentioned. But how do you take the current numbers? It seems to me the inflation numbers are probably underreported. The growth numbers are now a little murky, and could we be seeing a slow down because there is such an impression that investment is due to a lot to foreign funds coming in and even to bank lending, when in fact it has really been retained earnings that keep the economy going.

And so I just wonder if this is the picture you have – because it doesn't seem to me to be just international – it gets a little ugly domestically for China potentially.

MR. ANDERSON: Yes, agreed. You're reining me back to reality now. I think I got ahead of myself in some of the excitement of the hour. Yeah, core downstream inflation now, as best we can measure it, is still pretty flattish. If you look at the pricing on consumer goods, retail sale, we are not seeing a lot of inflation in the system. What we are seeing, though, is an enormous, 8, 9, 10 percent inflation in upstream areas—in raw materials prices, wages are going up, which means that there are pricing pressures coming into the system.

China is probably a zero- or low-inflation economy on consumer prices today, but I agree, I think that within 12, 18, 24 months you are going to see higher price pressures. Downstream produce has been propping up margins simply because of consolidations and high volumes. If you have a sector which is going from 20, 30 percent capacity utilization eight years ago, 75, 80 percent today, your marginal-per-unit margins are dropping like a stone but your capital margins are rising enormously.

So far you have been able to avoid pricing through these input prices because your volumes are rising 30 percent year-on-year on sale. That story is going to go away fairly quickly. And so if you look at my forward-looking forecast, I do think that you are

going to see inflation of 2, 3 percent over the next one, two years. And it's not going to be seven or eight. And the reason it is not going to be seven or eight is because of course the economy is slowing up, which brings me to the second point.

On the expenditure side of the equation, we have actually seen growth coming back up pretty sharply in the last two quarters because of this rising trade balance. If you look the production side, some of the domestic indicators, we actually see the economy coming off the other way. My guess is that aggregate growth in China is now 9, 9.5 percent, perhaps a little higher. Domestic demand is already slowing to 7.5, 8. So a lot of that aggregate growth is net exports.

So at home, if you took out the drop in imports and the export growth that you have, things would look worse. The trouble is I'm not sure how fast that turns around. And if you particularly look at the export side – let's look at three sectors in the Chinese economy. You have got the export sector, you have got consumption, and then you have got investment-heavy industry. Exports are still growing 25, 30 percent year on year and they probably will for the next couple of years especially with the textile quotas being lifted gradually over time. That is a big market share gain and that is going to keep light manufacturing coming along pretty easily.

Consumption, we have had a nice big period of rising incomes particularly in the low-end parts of the population. And, again, we don't see anything coming to kill the consumption story in the next one to two years. The big worry is how fast investment is coming off and how fast margins are coming off in things like autos and steel and heavy industry. If you see growth weakening and if you see mini disasters happening in China, that is where it's going to be. It's going to be in the heavy-industrial sectors where all the investment went.

The one consolation I take is that is not where most of the incomes are earned in China. These are not big employers in the Chinese economy. They are intensive in capital. So banks could take a hit off of that. Consumers would probably do okay in that scenario even if things are worse than I expected in machinery for example, as long as the biggest employers in China, which are the exports and the consumption-oriented areas such as retail, travel, tourism, are going on along as planned. Jobs will continue to be created, incomes will rise, and that does create a self-feeding mechanism. Unless we see an outright collapse in heavy industry, I'm still very optimistic on where we end up in Chinese growth.

MR. KEIDEL: Well, I turn it over to the audience after this follow up. My favorite myth is that China has export-led growth. I would like to hear your reaction to that idea. But we are seeing here a counter-cyclical move in Chinese growth to what is happening in the U.S. And the rest of Asia always – when the U.S. is booming, you'll see Singapore, Malaysia, Indonesia, Korea all pick up because the exports to the United States are such an important part of their growth picture.

China, in the late-'90s slumped its growth just during the boom in the whole U.S. economy, and then it really took off during our recession. And finally now we're seeing the U.S. economy recovering well over 3 percent and China is having some growth bumps again.

So to bring this home to the Washington crowd, the fact that imports are slumping as their economy goes counter-cyclically with ours, is this is a sign that the exchange rate is really undervalued, and can we take this surge in [net] exports over the next few quarters as proof that they really need to do something immediately [with the exchange rate] or suffer the consequences?

And is what you're saying about the really rapid expansion in capacity – which what any economist would say – that this growth in productivity is a clear reason over the medium to revalue your currency as your productivity gains rapidly? Is this what is happening? Or can we say that [the net export surge] is more than just a price advantage that the exchange rate brings? [Can we say that] what is happening now are structural changes, counter-cyclical moves, and we need to look further?

I think Secretary Snow said that if trends continue, China may be found to be manipulating its currency, and that was interpreted by the FT and others as deadlines for China to fix its currency, when in fact he was really saying if these trade trends continue, then the proof will be easier to find that China's currency probably is undervalued. So how do you come out on that mix of items, given the counter-cyclical nature of China's growth with that of the U.S.?

MR. ANDERSON: Yes, those are great questions. Let me just pick up on two elements of that. Number one, it is a big myth that China growth is export-led. Exports are a big employer in China, but if you look at the sheer size of the economy, it's very hard to argue. Let me give you a couple of examples.

If you look at trade on a growth basis, export-to-GDP ratio, China looks a lot like Taiwan. Here is an economy with 22 million people; here is an economy with 1.3 billion people. Taiwan's export-to-GDP ratio is 55 percent; China's is coming up on 40 now. So despite its enormous size, China looks a lot like a tiny export-oriented Asian economy.

If you look at it on a net basis, though, remember, the value-added share of those exports is probably 15, 20 percent in China. In terms of GDP on a value-added basis, Taiwan by our measures is still four or five times higher. China is still very export oriented but nowhere near what you would see in the rest of the economy.

And that brings to mind the anecdote you brought in – in 2001 the tech bubble collapses. U.S. demand collapses. All of Asia goes spinning into an export downturn. Exports slow by 40 percentage points, right, in China as well as everyone else. China went from 35 percent year-on-year export growth to zero export growth in the space of 12, 13 months.

What happened to the Chinese – what happened to the other Asian economies in that environment? GDP growth went from seven to two. What happened to the Chinese GDP growth? It went from eight to nine. It actually accelerated and it accelerated because it was going – it was in the middle of a sharp domestic pickup, but it does give you a strong sense that it is really not exports that drive the cycle.

The other point, which I think is much more interesting – it still is the trade balance and the export trends. What you have now is China, which has strong outsourcing growth and strong growth in textiles and toys, but overlaid with that – remember, you have collapsing imports in steel and materials and machinery, and rising exports of steel, material, and machinery.

That is not a sign that suddenly the currency is a lot more undervalued than it used to be; it is a sign that suddenly China has an awful lot of excess capacity in this stuff. It is a cyclical issue. Two years from now you are not going to see China exporting machinery and you will see China starting to import machinery again very heavily as long as demand holds up in the economy because they have stopped a lot of new investment there. But as far as Treasury Secretary Snow is concerned, these trade trends are going to continue. For the next four quarters it is going to look like this. You have got a sharply widening balance. I don't see much turnaround coming, so again I think it's going to get a little uglier over the next 12 months, albeit misinterpreted so.