

**CARNEGIE ENDOWMENT  
FOR INTERNATIONAL PEACE**

**REFRAMING CHINA POLICY DEBATE 2: CHINA'S ECONOMY**

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JESSICA MATHEWS: I wanted to say good morning to all of you on this rainy morning in Washington. My name is Jessica Mathews, president of the Carnegie Endowment for International Peace, and it's my great pleasure to welcome you to the second in the Carnegie debate series, reframing China policy. I want to extend a special welcome to our television viewers in several countries this morning. We are very pleased to have you with us.

The first debate in this series focused on the political sustainability of the Chinese Communist Party. This debate addresses the equally critical question of the sustainability of China's high-speed economic growth. Our next debate – I hope you will all write down the date, February 6<sup>th</sup>, 2007 – will examine China's military modernization, and its implications for the United States and for the West.

Before introducing our panel for today, I want to extend my deep appreciation to Jon Stivers, Speaker-Designate Nancy Pelosi's chief of staff, who was helpful to us in organizing this morning. Thank you John, and to your staff as well. I want to also thank and extend my appreciation to the GE Foundation, and to Michael Gadbaw, which has provided really important financial support for this series.

Understanding the rise of China and responding appropriately is one of the most serious challenges that faces U.S. foreign policy and Western foreign policy generally now and for decades to come. China's economy could eclipse that of the U.S. before the middle of the century, which might lead to a reordering of the global trade and investment system, and redistribution of global power in very fundamental ways, or it might slow dramatically, for one of several reasons, with equally profound consequences.

The China program of the Carnegie Endowment addresses this issue and the political, social, security, and multilateral aspects of China's transformation. We work here in Washington and in China through our joint program with the China Reform Forum in Beijing, and through half a dozen research partnerships with a variety of groups on the mainland. Together with our research center in Moscow and the Middle East, our growing presence in China reflects our initiative to transform ourselves from a foreign policy think tank to the first truly international think tank.

Now I want to turn to those we have come to listen to and to learn from this morning. We are really honored to welcome Dr. Wing Woo, professor of economics at the University of California at Davis, and director of the East Asia program in the Center for Globalization and Sustainable Development at Columbia University. Dr. Woo has served as a special advisor to the United States Treasury, a consultant for the Chinese Ministry of Finance, and currently advises the prime minister of Malaysia on development strategies.

Debating with him is Professor Barry Naughton, Sokwanlok chair of Chinese International Affairs at the University of California at San Diego. We are an all-California panel this morning. His most recent book, "The Chinese Economy," is the most comprehensive study of the Chinese economy in English, and like his other work, this one is certain to be influential in China as well. We are really proud and grateful to both of them.

Our debate is going to be moderated this morning by Carnegie senior associate, Dr. Albert Keidel. Before joining the endowment, Bert served as deputy director of the East Asian Office at the U.S. Treasury, and before that, a senior economist in the World Bank office in Beijing. I want to thank Bert on all of our behalves for his hard work in putting this debate together. I want to thank you all for joining us. We will have time for vigorous interaction with those of us in the audience, and now I would like to turn it over to Bert.

ALBERT KEIDEL: Thank you, Jessica. And let me add my warm welcome to all of you this morning. First of all, let's go over the ground rules. Professors Woo and Naughton will each take 8 to 10 minutes for opening statements on our proposition this morning. The proposition of course is that without significantly accelerated reforms and major policy actions, China's rapid growth will unravel before China's economy overtakes the United States. Professor Woo will argue the "for" position in this proposition and Professor Naughton will argue against this proposition. Professor Woo will then have 5 minutes for rebuttal. Professor Naughton then will have his 5 minutes.

On your seats, you'll find index cards on which you can write your own questions for the debaters. During the rebuttal, please pass those to the outside aisle, and our junior fellows will collect them. We will then have about 30 minutes in which I can pose your questions to the two debaters. The debate will end with some final statements. Professor Naughton will give his final statement followed by Professor Woo.

Now let's just turn to the debate. China's economy currently is growing at over 10%, and it has averaged 10% growth for at least 15 years. Simple calculations show that even if it slows to, say, 7% by the middle of the century, and even if the United States grows at 3 -3.5%, which is somewhat faster than it has grown over the last 10 years, China's economy will still become larger than the U.S. economy by 2050 easily, and possibly by 2040. This raises implications immediately for issues such as energy prices, global climate change, world trading systems, and of course the military force projection, including possibly space-base platforms.

So if it became apparent that China's economy will overtake the U.S., all of these, and other issues, will come to the fore. Upcoming debates in our Carnegie debate series will focus on these other issues in some detail. Today we are asking the question, what would it take for China to succeed in generating that kind of growth trajectory? Professor Woo will argue that it will take significantly accelerated reforms. Wing, the floor is yours.

WING THYE WOO: I'm very happy to be here this morning, although I must say I was even happier when I was first invited because I thought here I will have the forum to win friends and influence people – (laughter) – until I realized it was a different Carnegie.

And I am very happy to be here to be speaking in support of the motion that without new major reforms, China's growth will unravel before it catches up with the U.S. The implication is, of course, a potentially alarmist one, which is that China's growth will decline substantially if these major reforms are not implemented. I have some hesitation in delivering this potentially alarmist view, even though I thoroughly believe in it. I hesitate because I realize that in this town, crying wolf has built more reputations than destroyed them, and I do not want to be accused of building a reputation on the basis of crying wolf.

But the crying of wolf really was sounded within China itself. On October 11<sup>th</sup>, when the sixth plenum of the 16<sup>th</sup> party Central Committee ended, they passed a resolution calling for the establishment of a harmonious society by 2020. What is a harmonious society? Four characteristics: a democratic society under the rule of law; number two, society based on equality and justice; number three, a vigorous, stable, and orderly society; number four, a society that lives in harmony with nature.

This is a total break with everything up to last year, where economic reconstruction was number one – i.e., a prosperous society was the goal. But now we don't even hear it mentioned. A prosperous society – and yet, with an open mind, these are objectives listed by what the government wishes to do – a prosperous society is number nine, and qualified by the expression, as long as the fruits are shared all around. And the shared all around is actually repetition because it was objective number two. So there has been a downplaying of economic construction as the number one priority of China.

Why the change? I think the mental image you should have is of a car speeding on the road to capitalism – thank god, not the road to socialism – at around 90 miles per hour overtaking the other auto vehicles. Now, if an accident were to happen, it could be one of the following scenarios, roughly described: One, the right front tire rode off because it was loosely connected, or the steering wheel was loose and it came off. Basically, it's like the backing system failed, and hence they crunch the economy into a production collapse, or fiscal spending was over-expansionary, created deficits, and hence inflation, and the government lost control of the process.

On the other hand, a crash could also occur because the way in which the car is driven makes the people sick inside, and they wish to argue about the direction – (laughter) – in which the car should be taken because there are forks in the road. It's not a straight road; there are paths to be taken. And this infighting in the car could very well be the reason for the crash. And remember, the social tensions, the fighting that was caused, is by the effect that the car is heading toward a direction and people are fighting over the speed and the way to go.

The third is the car could simply run out of gas. That would be the environmental collapse that we talk about. In my paper that you will get, I emphasize the last two of these points: the social disharmony that would wreck the growth and the environmental collapse that might happen. It is not that I do not think that the banking system is sour or in need of reform, nor do I think that the fiscal picture is as good as it looks; I think there are a lot of traditional economic difficulties like the large amount of unemployment.

Well, one thing for sure to substantiate the point that this high economic growth has generated greater social unrest is the fact that in 1994, there were 10,000 mass social incidents involving 730,000 people. And just later to '04, there were 74,000 compared to 10,000 such mass incidents, involving 3.7 million people, compared to 730,000 people ten years earlier. What were they so unhappy about?

One, inequality has grown in China. The gap between the rural and coastal provinces has continued to widen – the rural-urban gap has widened. But it is not just the widening of the gap itself. What is more important is that the poverty situation is not improving; the poverty rate has been stuck at 11% since 1998. And more than that, they are doing more of the same. Expansion of the economy is going, but yet it's not filtering down. But in fact the latest look suggest there might be a filtering up that is occurring.

The World Bank just announced a study that shows that in this period of 10% growth per year or more, the income of the poorest 10 % has fallen by 2.5% between 2001 and 2003. The World Bank's findings support the earlier finding I had, which shows that the average income of the poorest had fallen from 78 cents a day to 62 cents a day between 1998 and 2002. So we're talking about the possible impoverishment of the poor and disadvantage.

Then we must realize the environment situation is extremely serious. China has the dirtiest air in the world. Of the 20 dirtiest cities in the world, China has 16 of them, some in the top few. And the governance of society has not kept up. The government has not been responsive to the problems, and hence there are issues of corruption, which the government has been slow to act on. More importantly, there has been a change in social expectations of the people regarding the government, largely because of the rising income – once people have more than just food and clothes, they aspire to other things.

More importantly, just as China has learned how to reform by looking at the rest of the world, it has learned to aspire for the better things in life by looking outside of China. This leadership is fully cognizant of the democratic developments that have occurred in Eastern Europe and in East Asia, and certainly in Taiwan and Hong Kong.

So it is not surprising that since the legitimacy of this government rests on its ability to improve life and generate high growth, the two questions that the Party now faces are, number one, democracy, rule of law, and stable income distribution, an indivisible package that will sustain growth; number two, can the Party lead

democratization and emerge afterwards as number one? I think the new harmonious program clearly suggest that the Party think yes, that it could.

But this is a very risky undertaking. Number one, the problems are serious. The usual one, you know – banking, but what is even more important? We are talking about new problems which have real precedence elsewhere. For example, on the environmental front, we in the U.S. are not even sure about the Kyoto protocol and the suggested solution to it. And here the Chinese have to come up with new ways to solve these environmental problems which the world has not been able to achieve. And second, the reforms themselves created losers inevitably, and the question is will the losers be able to form a paralyzing coalition to stop these needed changes from occurring.

And I think the important thing is we hope that it does because without a harmonious China, there will be no harmonious world. A failed society, like North Korea, Afghanistan, and Somalia, can be a source of great disruption to the U.S. So it is as much for ourselves that we hope that China succeeds in overhauling not only its economic system, but its entire social economic institutions, that are needed.

What is really important to realize, to give an example of the complexity, is the question of if China is running out of water. All projections show that it will run out of water within the next 20 years. Without water, you cannot grow. So now China is building three canals to answer this issue, but the problem is, that it may well be unable to solve it – actually because there is now convincing scientific evidence that the black carbon emitted by China is causing a pattern change, which causes less rain in China, which means building the canals would not solve the water problem. I have been told to stop, and I shall – thank you. (Applause.)

MR. KEIDEL: Thank you very much, Wing. Barry, it's your turn.

BARRY J. NAUGHTON: Hey, thank you. It's a great pleasure to be here – get a relief from the sunshine out in California. (Laughter.)

You know, Wing said that he was an alarmist. So I have got to admit I am a little bit confused here because I didn't hear that much in that initial remark that was alarming. Wing told us that China was going to run out of water. I think I'm going to come down with the opinion that China is not going to run out of water. And let's think about what the fundamental things are that underlie China's economic growth.

I heard two things from Wing that I disagree with very much. Number one, he said that China needs a dramatically different set of policies in order to keep growth growing. And number two, he said the Chinese Communist Party recognizes this and was going to deliver the policies. At least I think that is what he said. At least he said that, at the most recent plenum, they published a document that indicated a commitment to a whole new range of democratization and environmentally friendly growth.

So let me structure my remarks in these ways. First, Wing, I don't think the Chinese Communist Party is going to deliver the things that you think they're going to deliver. The Chinese Communist Party has a long history of spinning nice-sounding rhetoric out, and I think they are very familiar with that; they are doing that in this case. And I think if you're looking for the harmonious society to solve all of China's problems, you are looking in the wrong place.

But I think on another level, it really doesn't matter as much as some people might think it does. In other words, the Chinese Communist Party is going to react to economic opportunities and challenges in the same way that they have over the last 25 years. China is not going to get the kind of steerage of the economy that Wing thinks the recent plenum says they are going to deliver, but it's not going to need it either because powerful economic forces have been set in motion that are not going to be disrupted by policy from the center, whether it's misguided or well-intentioned.

Let me just say for a second, there is one part of Wing's presentation that I very much agreed with, when he likened to the metaphorical part. And again, maybe it's because we're both from California where people are addicted to automobile metaphors, you know. He said the Chinese economy is like a speeding car. That is exactly right. If we look at the Chinese economy today, the reason why China is growing so fast is because the pace at which inputs are going into the production process is incredibly rapid.

You know, an economist looks at the economy sort of through the lens of a production function. How fast are the inputs, capital, labor, human capital, technology increasing, and then how productively are those things used, how productively are they put together.

The astonishing thing about the Chinese economy is how rapid the increase rate and all of these inputs is. The growth of the labor force is extremely fast. Why? Because of the one-child policy started 25 to 40 years ago that has reduced the number of dependents. We are in this demographic dividend period where there is a very large labor force, a very young labor force growing very rapidly.

We are also at the point where structural transformation of the economy is occurring – rural to urban migration. The urban labor force in China is growing right now at over 4% per year. Wow, all of those people need to be equipped with education, they need to be equipped with physical capital. That is exactly what is happening. Right now the number of people graduating from college in China in the last five years has tripled. A program to spread universal primary school education is just getting started, but it is well underway and has spread to about a third of the provinces. So the human capital inputs are also zooming up.

What about physical capital? I think you probably know about this. China has the highest investment rate we have ever seen of any large economy in the world ever in history, so that labor, human capital, physical capital, and urban labor are all growing more rapidly than we have ever seen before.

Every one of these processes is familiar to economists. It's not rocket science; we have seen all of these things before. There is just one thing that is different. We have never seen all of these things put together at the same time so fast and on such a large scale. What that means is between now and about 2015, China is going to continue to grow very, very rapidly. What the Communist Party says or does isn't going to matter that much. All they have to do is not obstruct it and take care of a few really critical problems when those problems arise.

2015 – China will surpass Japan. For the U.S., that means China is going to become the predominant power in Asia. The U.S. is still at that point – much larger economy, much more important country overall. But after 2015, something is going to happen, China's growth will moderate somewhat. All of those demographic factors, labor force factors, they turn around. Labor force growth starts to drop very quickly. Rural to urban migration will have drawn lots of the people out of the countryside, so it will slow down in relative terms.

So China's growth will slow down after 2015, but you know what, it is still going to be robust, it is still going to be impressive, and it's still going to be a lot faster than the United States. So there will be a slowdown. There will be difficulties in adjusting to that, but you'll still see continued growth. By about 2035, I think about a decade before when Bert predicts, China will be on par with the U.S., and we will face a whole series of foreign policy adjustment processes as we struggle with defining what the relationship is between these two approximately-the-same-size economies.

Now, why do I think that the Chinese Communist Party is not going to be the main player in all of this? Simply because when we look back – it's not because I think the Chinese Communist Party is quasi-democratic or super well-intentioned or anything like that – but when we look back over the last 25 years, we see a very consistent pattern, and that is when problems in China get really, really dramatic so that policymakers are forced to address them, then they do. When the Chinese government is pushed hard enough so that they have no choice but to tackle the problem, then their record of tackling that problem is extremely good.

The very initiation of the reform process in China fits into this pattern. They didn't really want to reform, they didn't know where they were going, but they were faced with such a fundamental challenge in terms of growth that they felt they had to start to allow the emergence of independent economic forces.

But a crucial turning point came in 1994 when the Chinese government, faced with a disintegrating fiscal situation, faced with a real crisis of effectiveness of the state, adopted a new taxation system, faced a situation where government revenues had been declining for almost 20 years, thoroughly reformed their fiscal system, got their house in order, turned around their budgetary system and have had increasing budgetary revenues as a share of GDP for more than a decade since.

It's that kind of response, challenge, and self-interested but effective response that really defines Chinese economic policy. We have seen it again just in the last couple of years in an absolutely critical way, which is with regard to the financial system of China. You know, for years, people have been talking about how desperate the condition of Chinese financial institutions are. Nick Lardy, who couldn't be here today, in 1998 wrote a brilliant book that really just revealed the depths of the financial problem. And he predicted crisis. He predicted problems.

Now, 10 years later, China has dodged the bullet. For now at least, the financial system is good enough that we have just seen these remarkable public offerings where \$10 billion, \$20 billion total was raised in international capital markets by people who wanted to invest in the Chinese financial institutions. Now, does that mean that Nick Lardy was wrong in his analysis and his assessment of the Chinese financial system? Absolutely not. Time has shown that every one of prescriptions was right.

The difference is that in response to those problems, in response to those criticisms, the Chinese government did the minimum that it had to. On the basis of its fiscal reconstruction, it threw money at the problem. It cost them a fortune – \$350 billion went into this financial system. They didn't do it because they wanted to; they did it because they had no choice.

Wing pointed out that we have this tremendous water crisis. It's true, and we also have a government that is being forced to put billions of dollars into new projects. Wing mentioned the water in the Yellow River ran dry 10 times in the 20 years up to 1998. That is true. What he didn't mention is that in the 7 years since 1999, it hasn't happened once because the Chinese government has been forced to put so many resources, time, effort, and money into managing the Yellow River.

So my point is, yes, the Chinese economy is like a speeding car. And that speed, the distance that is covered is real, it has come a long way, and it's got a lot of momentum. China's economy is going to face some serious short-run problems when it has to downshift and slow down that speeding car. There will be some disruptions, absolutely, but the point is, with that kind of ingenuity, entrepreneurship and growth of inputs, the economy will recover from that disruption and continue to move forward regardless of whether the Chinese Community Party meets and declares that they have got a harmonious society or not.

(Applause.)

MR. KEIDEL: Thank you, Barry, and Wing. We now enter the rebuttal phase. And I remind you, please now take cards that are on your chairs and write you questions. This side, pass them here to the south. This side, pass them here to the north, and our junior fellows will collect them.

MR. WOO: Well, I would like to express a puzzle and three points about the puzzle that I'm going to present to you.

The motion that I am arguing in favor of is without new major reforms, growth, will unravel. The negative of that statement is either with new major reforms growth will unravel or without major new reforms growth will continue, and yet we do not hear Barry arguing that. I would like to believe of course that my persuasiveness brought him around to my position.

So yes, we agree that with the same reforms, growth will continue. So what could be the difference? The difference would be the differences in optimism because Barry tells us, don't you worry about a thing; they will do what is required to put the car on track on the road.

The question is here there are three points. The first is a general methodological point. How good is the past in predicting the future? Could past variables predict the future? Or should we look to project future conditions to project the future? If we use the past to predict the future, we cannot predict turning points. We cannot predict those collapses in such a short time. We could not have believed that Japan would be number one followed by 10, 12 years of economic stagnation.

So, hence, I am less optimistic largely because the past problems were problems that could open your eyes and learn from the outside. Opening to trade, special economic zones, that's what Southeast Asia's been doing. Now we are talking about qualitatively new problems. How do we reduce inequality, or how to solve the environmental problems?

The second point, which makes me less optimistic after listening to Barry, is that we all remember that I have imperfect information and most of you have imperfect information about what the situation in China is, and most likely in my case, highly specialized in the field of economics. But let's listen to people who have the best information overall, the Communist Party. It is the one that is saying, look; that could be a good price down the road. For a leadership to predict disaster is not a terrible thing. Jimmy Carter told us in 1976 that there was a malaise America. And Ronald Reagan says, it's morning in America, and we know what happened. For a leadership that's unable to project a confident future that he can lead, it's not a reassuring sign.

The last thing I will use is the example that Barry talks about particularly. I think it is not a good one to support his hypothesis. He brings up the banks, why hasn't there been a bank panic? Nick Lardy shows that these were hollow banks, bankrupt. And Barry's response was, the government fixed it. The reality is the government hasn't fixed it; the problems remain and will reappear. What prevented the crisis from happening was not because of fixing it, but because the people knew that the government was solvent and was capable of building up the banks. And as long as the government is capable of building up the banks, there's no need to panic. But the trouble is, my research shows, this is the last time the state could afford to bail out the banks. The next crisis that happens, it would have to do more than list minority shares of the banks, it would have to list most of it, or just sell and sell it even cheaper.

So in short, I would say that the past is not a good prediction of the future, and the people who have the best information of what's happening are the people who appear to be the most alarmed. And that's the message here.

(Applause.)

MR. KEIDEL: Barry, your five minutes.

MR. NAUGHTON: Well, the problem is the people with the best information, people who may or may not have the best information, don't have the right incentives to tell you the truth. (Scattered laughter) – the Chinese Communist Party may or may not have the best information, but actually, you know, people in power have a very big ability to deceive themselves when they want to. So the Chinese Communist Party has very strong incentives to convince you that their role is essential. And if their role isn't essential, then they're going to do everything they can to convince you that their role is essential because that's the only justification they have for holding on to power.

Wing, I don't think you even actually got it right, what they said in the most recent plenum. You talk about democracy and the rule of law, but I read that communiqué very carefully, and it never uses those words. What it says is, we need to progressively perfect the system of socialist democratic legality. That's a big difference, because they don't use those words the way we use those words.

The Chinese Communist Party doesn't commit itself to democracy and hasn't committed itself to sharing power. It has committed itself to a kind of paternalistic role in solving the income distribution and corruption problems that it itself created. So I think if you're relying on that as evidence that this is what China needs, I think it's really misguided. I mean, we really do disagree about that. So, you know, the question is – I guess I still didn't hear what the dramatically accelerated reforms are that we need to have in the opinion of Professor Woo. I'm still waiting; I'd still love to hear it.

I think policy everywhere constantly changes. It constantly adapts. That's got to be true of China as well. There will be crises; there are risks. But the point is, a level of adaptation that's similar to what we've seen for the last 20 years is going to see us through just fine. So I'm an optimist. I think China's growth will be sustained through a period where it reaches the kind of overall heft of the United States.

(Applause.)

MR. KEIDEL: Thank you both very much. We're now at the question period, and I have a number of excellent questions here. We have really one mike at that podium and only one mike here. What I'm going to do – it's been suggested I go to the podium, but I think I'm going to stay because we have to pass the mike back and forth between these two, unless we can bring one of these mikes down. And so I'm going to jump right into the questions, and I will be the mike keeper, the gatekeeper.

The first question is a great one for an economist – (chuckles) -- it's technical. "Is this growth real? You cited 10 percent, but there were huge figures for bail out, which if you take the bailing out of the banks into account, China's growth was brought to 6 percent. So what does an economist say about the huge costs that the Chinese government has incurred in subsidizing its system, and this claim that there has been real growth?"

I'll turn to Barry first, and then to Woo.

MR. NAUGHTON: That's a great question. I mean, I think there definitely should be a growth discount factor. The improvement in the well-being of the Chinese population is somewhat less than the growth figures would lead us to believe because, yeah, there is creation of goods and services which don't add to well-being at the full price at which they are accounted for in the GDP statistics. So that is right.

On the other hand, we talk about 350 billion. That is a lot of money. Some of it is funny money; some of it is real resources. That is a third of GDP at the end of the 1990, stretched over 10 years. So that is a couple percent of GDP, of which only a relatively small amount should be subtracted from GDP. So it's a little bit less than the official numbers show, but it is still very healthy, real growth, and it's something we see in just about every indicator.

MR. KEIDEL: Wing, do you want to comment on that?

MR. WOO: Well, I regret to say that up to around 2002, you should pick up 1.5 percentage points from accelerated growth. But so far it's still 8.5%, which is very real. The thing is, you look at all of this wastage, like the state-owned banks are losing money, so you think of wastage that should be reduced. That was what has been asked.

The answer is no. It's just a transfer payment. The reason why the banks are not getting the money back is because there is no incentive for the people to return the money. The government would make good. Basically you borrow; you invest in something that is high earning, and you embezzle the funds. So it is real growth. We're talking about transfer payments on that front. It's not that they are investing in things that are useless, so growth is high. But the question is, would they continue under this kind of regime that allows this embezzlement that occurs.

The corruption is taken as the cause of the inequality, is taken as the reason for environmental degradation. This is what generates the social tension. We have an economic system that generates and allows this kind of embezzlement of assets all around.

MR. KEIDEL: Thank you, both. We have got a question here that is sort of split.

“East Asian economies have grown very rapidly in the past, and faced the same challenges that China now faces. Why can’t China do the same? And what is the significance of India’s emergence on the potential for China’s growth and its place in the economic world?” I’m going to turn to you, Wing, first.

MR. WOO: In the case of East Asia, the thing that is clear is that Taiwan can produce all of the pollution it want and the next typhoon that comes blows it all offshore. But we have, the case of China, the same amount of pollution per-capita produced in the hay days of Taiwan. That is not sustainable, and the world will not allow it to happen.

Right now China can afford not to be – the Kyoto protocol is pretty relaxed on China as a developing country. But once China overtakes the U.S. in being the world’s biggest emitter of CO<sub>2</sub>, let’s see if the world would still put up with that behavior. The rise of India, here it comes to a point that this puts tremendous stress on the international system, not just one giant but two giants. The solution is therefore the world’s stage has two new heavyweights on it, and that is less elbow room. We have to enlarge the global stage, which means we have to move to some mentality of greater shared global governance.

For enlightened self-interest, it is the U.S. who should draw China and India in as partners, number one. Number two, not only should we enlarge the stage to accommodate the larger number of players, but also strengthen the foundations holding up the stage. International institutions have to be strengthened and reorganized, new ones introduced and old ones, with their past purposes, shut down across this town. We are talking about changing the roles of international financial institutions, and we have got to strengthen and give them new functions. That is what the rise of India means too.

MR. KEIDEL: Southeast Asia – East Asia and India.

MR. NAUGHTON: Let me start with India. I mean, the contrast is so striking in so many ways, right. China and India seem so similar in so many respects, but their trajectories are so different, with China being so focused, having the highest share manufacturing of any economy, India having an unusually high share of services and not very successful in terms of manufacturing. So there are tremendous sort of potential synergies, and the fact that the two countries are close as they are means that their growth basically will tend to stimulate each other.

It also provides a kind of perspective on the parts of Chinese growth that lead me to conclude that Chinese growth is fairly sustainable. In some respects, China has done a much better job of spreading broad-based education and health services than India has done. Sure, there are definitely problems in China; environmental and health problems are serious, but when you look at the solidity of the base in terms of human capital, China is a lot better off than India. Of course India has democracy, and China doesn’t.

But as China reaches this higher level of development, which I think we are already seeing in the way that the discourse changes among the people, between the

people and the government, there are more and more demands on the government to provide a more open economy, to provide a more open society, to provide better property rights, and I think that is what is going to really drive the next stage of China's growth.

MR. KEIDEL: Wing, do you have any response to that about comparing India and China?

MR. WOO: I think that India will grow if it undertakes new, major reforms – (laughter) – that China has already embarked on. And should we be surprised that India started it in 1991, when the Chinese navy starts appearing in the Indian Ocean? Being poor is a national security threat. And, India has changed tremendously, largely because of that possibility.

And we have now, basically, amended the nuclear proliferation treaty because we need to think about how India could be a partner of the United States. So we are talking about shared governance, but let's do it in a rational and systematic way that will ensure a harmonious world.

MR. KEIDEL: Here are two questions that are related. One is historical, and the other about the future. Do the catastrophes of the Great Leap Forward and the massive famine of 1958-61 teach us anything about the irrelevance of Communist Party policy in terms of economics? And, given these past disasters, what is the specific mechanism that will ensure systemic failure, Professor Woo? The accumulation of adverse factors is not enough. What would cause the tipping point? Woo, I'll go to you first.

MR. WOO: I presume partly because of the experience of Japan. I believe that enlightened self-interest normally prevails. Even if the party's definition of democracy is not the same as in the U.S. Constitution or the Russian Constitution, the point is that the social expectations in China have changed. If the outcome – and I predict that the outcome will be closer to the definition in the U.S. Constitution or the Taiwanese Constitution than what some people think the Chinese have in mind. The definition may be firm, but the outcome, I predict, will be the same as what we are thinking of given the changes in social attitudes within China. They are the same changes in social attitude that require any Chinese government to live in harmony with nature.

MR. KEIDEL: What's the tipping point, the relevance of the Great Leap famine?

MR. NAUGHTON: Actually, I'll take the question about the relevance of the Great Leap famine as being a very pointed criticism of something I said probably in a little too flip fashion in my remarks. Namely, I said, what the Chinese Communist Party does didn't matter. And I should be rebuked for that, because obviously it could matter. And the Chinese Communist Party can do things that would be very disruptive to the economy, to people's lives – could shape the economic edifice – if their policy making is bad enough. So I shouldn't have said that what they do doesn't matter because obviously they showed in the Great Leap Forward, it could matter a lot.

I should have said, given their political incentives, given their desire to protect their own position, to protect their power, to protect the tremendous financial resources that they and their families now control because of the corruption that Wing has talked about – because of that, the Chinese Communist Party is now basically a status quo power that represents the wealthy and powerful. Yeah, they want to put a nice face on things, but their fundamental incentives are to protect vested interests and keep the economy growing so that they can have more resources to play with.

MR. KEIDEL: Thank you.

Just one historical comparison question: Dr. Woo has argued that economics problems the Chinese face have been easier than those that are coming. And this calls to mind the experience of Latin America that seemed to be doing quite well, but then entered a period of significant difficulty. Do you see, Professor Naughton, any learning points or teaching points or lessons that might come from this Latin American experience?"

MR. NAUGHTON: Yeah. It's not going to happen. I would disagree completely with Professor Woo's perspective on that, if that's a fair representation of Professor Woo's views. I would say the problems China faced 25 years ago were far more serious than the problems China faces today. Now, their problems are at a higher level. They're more complex, they're more difficult in some sense, but the capabilities in Chinese society to address these problems are double order of magnitude greater. So, development is occurring.

The one Chinese communist slogan that I really like and that I think really tells the truth is Deng Xiaoping's comment, development is the only hard truth. Deng Xiaoping at a certain point said, all of our policies have to be subordinated to the need to develop, to bring up educational standards, to bring up learning and have a more sophisticated economy. He was right. And the most impressive thing about China is that real development has occurred, and that means the capabilities to handle these problems are greater now than they were a decade ago or two decades ago.

The situation in Latin America was the opposite. The import-substituting industrialization created a kind of Potemkin façade of development that wasn't fully reflected in the actual level of social development.

MR. KEIDEL: Wing, do you want to say anything about Latin America?

MR. WOO: Yes. Well, give me a chance to cry for Argentina, too. (Laughter.) I think that the economic problems of 25 years ago are less serious than – no, less difficult than the kind of economic problems of the future. What were more difficult were the political problems of 25 years ago, compared to those of the present.

25 years ago, you had a group of people who believed that, as official Party documents say, the end objective of the economy was a birdcage economy, i.e., the bird

is the economy and the cage is the plan to keep the bird from flying away. And what we do is we swing the cage to create the illusion of more space, so that the bird will be happy and sing. Of course, after the collapse of Soviet Union, we all know the leadership realizes that the birdcage economy was a bird-brained idea. (Laughter.)

Basically, the political difficulties were much more severe. The economic solutions were quite clear: open your eyes and look at the rise of Southeast Asia and East Asia. What did they do? And we do the same. How did Jiang Zemin come to leadership? He was the person who led the team who visited the special economic zones all over developing Asia. And he came back, and he did it. And it succeeded. Surprised? No. Marketization – they looked at it.

But the important point about Latin America is the following: they had the policies to start an industrial base, but they did not switch policies so that the industries faced external competition and incentives to innovate and to learn more from abroad. And, they did not switch from depending on physical capital investment industries to emphasizing human capital accumulation, so that it allows it to flow to where the market system says it should flow. So it was the inability to switch policy, that's the failure in Latin America. All of East Asia started off with import substitution policies, but they switched gears. That's the difference.

MR. NAUGHTON: I very much agree with that analysis. We share that.

MR. KEIDEL: This is a question that actually tries to round up some of this political discussion we've had about democracy.

There seems to be an inconsistency, Barry as you just pointed out, between the Communist Party having little to do with sustaining rapid growth, that it will happen, and saying that leadership could respond and that this response is a key factor. And the necessity for democracy as a component of that capability is something that is implicit, Professor Woo, in what you're saying. And there seems to be, in a number of these questions here, a question to focus in on what kinds of democratic changes, and what kinds of roles for the government that it would enable, are really necessary, regardless of what they seem to be saying that they will do. Have you had or heard conversations with top leaders that would give some indication about why they may think democracy of the type that we would consider democracy is necessary? Or is it really just a palliative phraseology?

MR. WOO: In October this year, the Brookings Board of Trustees visited China and met Prime Minister Wen Jiabao. He went at great lengths to talk about how important democracy was as a means of mediating social conflicts and of improving public administration as a feedback loop. He went on to say, we have now at the village level, county level, the prefectural level, the city level and the province level. He was smart, in that he did not give a timetable. But we could see what the progression is.

If such a survey were taken today in China, I think it would receive endorsement all around on this movement to a higher level of democracy. My prediction, however, is that over time, people's expectations will rise, and will require the level of democratization to reach up to the national level. My question is, would the Party be pragmatic enough to accelerate the pace of democratization that Wen Jiabao talks about up to the national level. It will either lead the way, or be pushed out of the way. I think that the pushing out of the way, if it occurs, is what would disrupt economic growth in China, severely.

MR. NAUGHTON: What was the last part?

MR. WOO: If they are being pushed out of way, the social unrest would disrupt growth.

MR. NAUGHTON: Wing, you need to listen a little bit more carefully to the words that these leaders use. When Wen Jiabao says he supports democratic oversight and democratic participation, et cetera, et cetera, all these words are in the communiqué. They're always strung together. Indeed, they hope to have them at all levels. That doesn't mean that they are willing to allow power to be contested. So far, power acceptance – tightly controlled experiments – power has never been contested above the village level. And the village level in China is not part of the government. There's very clear policy about this, and there's a Communist Party which imposes discipline on its members, including the Premier Wen Jiabao, and he's not going to change this fundamental policy because he sits down with the Board of Governors at the Brookings Institution. So, you really need to listen. They have not committed to this kind of democratization.

Will they in the future? Maybe. Because they might be forced to. Will it be because they institute a harmonious society? No. It will be because powerful interest groups have arisen which contend with the Communist Party, and inside the Communist Party. And as those interest groups advocate their interests, you know, there will be a choice. Yeah, the choice will be, do we have social conflict or do we set up a rule-based truce that will allow us to continue to prosper, so we don't have to fight and kill each other. I share with you the optimism that they'll get to that truce, and that truce will ultimately evolve into democracy. But I think we have looking at how that's going to happen.

MR. KEIDEL: Well, if I could just press you a bit, because there are additional questions about social unrest and the Chinese way of dealing with that, and there seems to be in things that you're saying that come out in the questions that the democracy or the widening gaps between the rich and the poor will lead to problems that they can't face. So this idea that democracy is necessary, I wonder if you could say what kinds of changes might be needed soon or in the medium term to make democracy capable of solving these problems.

MR. WOO: Here we have a leadership that has talked reform, even louder, but yet we see the closing of Internet portals, the shut down of reformist newspapers, and a tightening of the flow of information in general. So yes, we do see seemingly less democratic behavior than one would have expected from the rhetoric. However, I think the important point is what will we see after November 2007 when the present leadership is truly ensconced in power? The important point is the following: Barry makes it a strong point – which I agree. That’s why I say major new reforms are required, that the barriers are very difficult ones, especially political barriers, because a functioning democracy requires a free press and an independent judiciary. And what will happen to a Party that’s used to monopoly rule for 50 years? Unless enlightened self-interest prevails, the outcome could very well be like August 1991 when the empire struck back in the Soviet Union - the Party split. So, if there is no greater democratization, social unrest, there’s a strong possibility if the Party does not rise to the occasion, the party’s over.

MR. NAUGHTON: I guess I’m still unclear, Wing, what you think the policies are that need to be adopted. And do you think there is a chance that China’s growth will unravel? Because that’s the case you’re defending.

MR. WOO: I’m not defending, I’m proposing that unless the reforms – especially democratic reforms and policies that, from what the rule of law and the policies that stabilize the income distribution. Now, what kind of steps are there? On the political side, definitely the first two steps: there has to be greater press freedom and greater independence for the judiciary together with the extension of elections beyond the village level.

On the economic front, they are more difficult, largely because we are talking about problems whose solutions are difficult. Just like regional inequality. The Appalachians were poor 50 years ago, and they are poor today. The regional imbalances reflect a lot of geographical barriers, which policy finds hard to address. For example, they will think more outside of the box. Rural education: remove school fees; give them free books. That’s not enough. You’ve got to go further than that. You’ve got to give them a free lunch so that the poor families can tell their kid, instead of working at home, you go to school. There is one less mouth to feed. We are talking about new, innovative policies that are not part of the traditional package.

And we are also talking about – why is the rule of law particularly important? Largely because a country that does not obey its own laws, will not be a country that would obey international laws. And the rest of the world will not put up with it. So, one of the big things that China has to do in order to maintain its accessibility to the world markets, is to improve its own internal rule of law so that it could obey the international law. Example: intellectual property rights. Unless China respects intellectual property rights within its own borders, the rest of the world it is violating international laws like that. And the world could react with crippling economic retaliation which China should avoid.

MR. KEIDEL: We'll come back to that in our next question, but Barry on your question to him.

MR. NAUGHTON: Well, I guess what I hear Wing saying is there's a million things that need to happen. I agree with that. As China develops, there's a whole range of policies that need to be adopted. There are areas where we see slower progress. There are areas where we see faster progress. My point is, if we look at where we are today, are we in a situation where problems are building up and if we don't do something that's dramatically more effective than what we've just been doing, then we're in big trouble? That's what I thought Wing was going to argue, but maybe he's not.

And I'm arguing the negative. I'm saying no. When you look at the current situation, what's happening is that at least on the economic front, the lag effect of policies that have already been adopted is positive: The changes that have already been set in motion, the kind of corporate restructurings that have already been adopted, the financial reforms that have already been adopted. Of course, much more needs to be done, but the point is that the follow through, the lag effect of policies over the last 5 or 10 years is still positive, working in our favor. And we should understand that that's what's going on in China.

MR. KEIDEL: There are several questions on international economics, so let's got to those.

"Secretary Paulson of the Treasury, as everybody knows, is going to China in two weeks, exactly, with a large delegation including Chairman Bernanke. What is the risk of a trade war? What is the role of the exchange rate issue in preventing this kind of trade war? And what can we expect from the Chinese side to this new initiative to have Cabinet-level meeting at this level?" Barry, why don't you go first?

MR. NAUGHTON: I might surprise Wing a little bit here. I think that the short-run risks, or sort of the medium-term risks here are actually pretty substantial. The problem with driving a speeding car and slowing down is – the problem, rather, not of driving the car, but the problem with that metaphor is it's pretty easy to slow a speeding car if you want to, where it's a lot more difficult to slow an economy that's so dependent on a very high investment rate. The thing that I worry about the most in the short-run is that China reaches some kind of cyclical turning point that causes a bust in certain segments of the Chinese economy – let's say something like steel, where huge expansion of capacity has occurred recently. Trying to shift it from being a big importer to being a big exporter.

Now, this economy – it's dynamic, it's robust, but it's not super stable. And they're going to be some bumps in the road. What I worry about is sort of a short-run recession that leads steel makers and others to dump product on the world market. If that coincides with a negative – with a less prosperous phase in the world economy in particular, we could have a huge breakdown in the commitment to free trade. We could have a very rapid increase of protectionist policies. There could be some very serious

short-run bumps in the road, and they could look very big when we're staring them in the face. So, consultation mechanisms are certainly absolutely essential. And I think we would like very much to see a more rapid appreciation of the renminbi. It got almost six percent appreciation so far, that's something. But there's a lot more that could be done in policy, so it's one thing to look at the long run and another thing to think of the short-run difficulties.

MR. WOO: I certainly think that the short-run difficulties are tremendously immense, too. In a fast speeding car, a bump on the road is enough to derail domestic politics. So, I'm saying that the difficulties are not just long run only. I'm emphasizing the short run as well. Let us talk about the question of the possibility of the trade war.

What we have is a turning point in world history where it is not just China that is re-integrating to the world after the end of the Cold War. We see the re-integration of the Soviet bloc in its entirety, and we see the re-integration of India from its isolationist economic policy. The result is the world labor force has doubled. The world labor force that's participating in international division of labor has doubled. And the implication from theory is that real wages cannot rise, and in fact, could well fall. In fact, if you look in the United States, which is the strongest lobby group for free trade? The economics profession. That is one of the two propositions that two-thirds of economists believe. Free trade is good for you and me; and a floating exchange rate is better than a fixed exchange. These are the only two statements that receives more than 70% of the votes in the economics profession.

We learn that free trade is good for you and me from the mathematicalization, by Paul Samuelson, of something called a Heckscher-Ohlin model. A few years ago, four years ago, Samuelson wrote another article in which he changed a tiny assumption, and which basically allowed learning by the poorer country. And, voila, what's the result? The result is free trade is good for a developing country, but not good for a developed country.

Paul Samuelson could be wrong, and I think he is wrong. I'm not sure, but the important thing is, he is reflecting the kind of social tensions in the United States caused by the inability of the real wage to rise, and of the structural adjustment that the U.S. working class is experiencing, even if there were no trade deficit. In other words, U. S. exports go up by the same amount as U.S. imports. There would still be a temporary rise in unemployment, largely because the goods we import are more labor intensive than the goods we export.

So there would have been a big adjustment in any case. And the fact that we have cut, in part, taxes and hence reduced the social safety nets to a soft shock of globalization has certainly reduced our resolve to protect the free trade system that is affecting us.

But let me get to the important point on the exchange rate. We have focused on the renminbi revaluation and the other thing is, China should be doing it. The question is, this focus on one instrument is wrong. If we do the favorite economics example of

everything else remains constant, if the RMB goes up, what that means is China's goods become more expensive so we will buy more from the rest of East Asia, Indonesia, Vietnam. The Korean contractors that are producing Nike shoes in China will move to Vietnam, move to Indonesia to produce that for them. What we need is a generalized appreciation of East Asian currencies, rather than just the appreciation of the RMB. Just the appreciation of the RMB will refuse the bilateral great advantage between U.S. and China. That will not reduce overall U.S. trade imbalance.

Second point is that it is not just China that has to act, it is also the United States. The United States could do better to get its fiscal house in order, and to restore the social safety nets that are required to bear the stress of structural adjustment in the labor markets.

MR. KEIDEL: Thank you. We just have a very little bit of time for the questions session, and your final statements will be short as a result, but I want to ask this question and I hope you'll answer it handily. And then we may have time for one more, but maybe not.

"You know, are we really talking about going back to the domestic situation that the question is, is democracy really going to help China solve its problems or not? Is it good or is it bad for economic growth? Autocracy, the question says, has been able to confront crisis at the expense of painful moves, and move quickly on a large scale. Democracies don't always do that very well, so are you saying that democracy can really solve these problems and is necessary to do the job?"

MR. WOO: It depends on how democracy comes. If democracy comes from the result of the Party being pushed aside, then we will see great unrest. It's like the following: social tensions were heated in the Soviet Union through authoritarian coercive measures. And after the coercive measures were removed, it received the renewal of historical ethnic antagonisms. Democracy will not solve everything, but it is a means, a time-tested means, of mediating conflicts among people with self-enlightened and like their interest. That we look also at the change of democracy in Korea and Taiwan, and we see that it was top-down led, and we do not see the same destruction.

Think of Suharto's Indonesia. The introduction of democracy had to come by pushing the old man aside. And, Indonesia unraveled.

MR. NAUGHTON: I don't think that democracy will necessarily make China's economic policy better, but it will make Chinese life better. China is the big outlier. It's the only successful country that's still an autocracy, and I think it's increasingly a source of shame that will drive policy and change in China.

MR. KEIDEL: All right. We're almost to the top of the hour, so I think we have to cut questions to this. I'm sorry. I would like now to turn to each of our debaters for their final statements. We don't have five minutes for each of you. We have perhaps two minutes for each of you, so if you could tell us what you think.

MR. NAUGHTON: Then I won't stand up. The crucial thing, I think, both Wing and I see that flexibility and adaptation is necessary. The differences: I see China as a society that's achieving that ability to adapt. It's becoming more responsive, in which the growth of capabilities is feeding into the ability to be effective in the economic realm

There are going to be some bumps in the road. One thing we have learned is that when there are shocks to the system, when there are recessions, when there are political crises, that's when the system emerges stronger afterwards. So the message for U.S. policymakers is, let's get ready for a different kind of partnership with China, because it's going to happen. China's going to be a power.

MR. WOO: Well, I do not want to leave the impression that I am all in praise of the harmonious society program, the very things that I am. There is something critically wrong with the harmonious society program that is unfitting for an emerging powerful country like China. The program makes no mention of its role in the world, largely because without a harmonious world, there can be no harmonious society within China. And China can do a lot to affect the harmony of the world.

Specifically, let's tackle the economics front. It should be much more active in fighting for the preservation of the multilateral free trade system that has brought so much prosperity to the world and to itself. And what it means is, it has to work with the U.S. on trade issues. For example, China has to go by its commitments to the WTO accession agreements it signed. And it should, rightly, accelerate the implementation of those agreements to increase imports, to reduce the bilateral trade deficits that we see. So, China's defense of the global trading system is important. China's more active role in promoting global environmental protection is equally important, and China shall have a bigger voice in the global war against terrorism. And I think it should be part of the national society program.

When we talk about the rise of China, many people inevitably talk about the rise of Germany, Japan and the Soviet Union and the negative adjustments that occurred. But let us not forget that the most important country that rose in the 20<sup>th</sup> century was not Japan, Germany or the Soviet Union, but the United States. And, I argue, it was a positive force through development of the world, and at the minimum, it helped save the world from fascism.

And what has happened after September 11th, is that we have an insecure mentality. And insecure people do not make rational decisions. Look at the invasion of Iraq. Look at the possible collapse of the Doha round. So, we have to pull ourselves together and reach out and work with China to enlarge the global stage and strengthen the foundations of the global stage.

MR. KEIDEL: Join me first in thanking our two debaters.

(Applause.)

MR. KEIDEL: This concludes our debate today. Thank you all for coming and participating. I want you to be sure to visit our website, [carnegieendowment.org](http://carnegieendowment.org), and you can click on the debate series, you can see video of the past debate, and a video of this debate will be on our website next week. We want to again give special thanks to the GE Foundation for making this whole debate series possible, and we want to express our thanks to Speaker Elect Pelosi for helping us, and her office, for making this room available. And thanks to the Carnegie staff. We'll see you at our next debate, February 6th, on Chinese military modernization. Thanks again, and have a good weekend.

(Applause.)

(END)