

# Whither China?\*

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I'd like to say how pleased I am to be here in Seoul in general, and in this group in particular. I've known Dr. SaKong for many years now, and consider him an old friend. He spent a year in Washington at the Institute for international Economics, which I'm associated on a part time basis, and so I'm delighted to be here with you.

I do not know how it is in Seoul, although I can imagine from how it is in the United States, in Washington, New York, Boston, and in London, Paris, and Berlin: China is on everyone's mind these days. It is in many ways a remarkable story, the last few decades, and people are wondering what the next few decades are going to look like. I notice that recently, at least in the United States, China is increasingly paired with India, and the two are treated as non-identical twins. I will comment only briefly on India, the focus of my remarks will be on China. What I'm going to do for concreteness is focus on the year 2025, two decades from now. It's far enough away so that small changes from year to year that accumulate can mark significant changes between now and then, and yet not so far away as to be outside our horizon. I daresay most people in this room can remember twenty years ago, and by the same token, you can project twenty years forward. Fifty years is beyond my imagination.

We begin by sketching what China's economy will look like in 2025, two decades from now. It is desirable to do this quantitatively, both to indicate the practical possibilities open to China and to demythologize statements that suggest large magnitudes – “the next economic superpower”—without specifying what they are. Of course, no one really knows what China will look like in two decades, and indeed a range of outcomes is possible. In its recently released “Global Scenarios to 2025” the Royal Dutch/Shell (oil) Company allows China's growth to vary from 6.7 to 8.4 percent a year, depending on the nature of the external (world) economic and political environment. As we shall see, others would allow the possibility of even lower growth rates. For sake of concreteness, I will build here upon the 2025 projections of the US Department of Energy, yielding a growth in dollar terms of 7.2 percent a year. They will not necessarily be correct, but

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they represent an internally consistent projection that is reasonably optimistic about China's growth, and ties that growth to projections of energy demand, an important source of interaction between China and the rest of the world, both in economic and in environmental terms. We can then address the implications of this growth, and take excursions from the baseline projection.

<Table 1>

	<b>GDP</b> (trillion, 2005 dollars)		<b>Population</b> (millions)	
	<b>2000</b>	<b>2025</b>	<b>2000</b>	<b>2025</b>
<b>China</b>	1.30	7.40	1275	1445
<b>Japan</b>	5.09	7.61	127	120
<b>USA</b>	10.87	21.90	276	350

<Table 1> presents the projected GDP and population of China, Japan, and the USA in 2025, compared with 2000. GDP is reported in US dollars of 2005 (adjusted from 1997 in the original source). We need to allow for some real appreciation of the Chinese currency (rmb) relative to the dollar over the next two decades. I allow, somewhat arbitrarily, one percent a year. (The yen appreciated 0.8 percent a year against the dollar over the period 1950-1975, although all this appreciation was concentrated in the period 1971-1975.) This would bring China's GDP in 2025, measured in dollars, to \$8 trillion, exceeding Japan's projected GDP in that year (it would be larger if the appreciation of the rmb is greater than one percent a year), and amounting to about ten percent of gross world product. It would be one-third the projected size of the US economy in that year. What people forget when talking about the future of China is that the United States is also growing during this period of time. And so, the US economy will be substantially larger than it is now. China will be 8.4 trillion, and the US economy will be 22 trillion measured in 2005 dollars, during this period of time. China's population will have grown to 1.4 billion, while Japan's population will have declined to 120 million. The USA will have grown to 350 million, all figures drawn from medium projections by the US Census Bureau.

Several observations can be made about these projections. First, they assume that China will grow at 7.2 percent a year over the period, in dollar terms. This is only slightly lower than its 7.4 percent annual growth rate over the period 1980-1998 as calculated by the economic historian

Angus Maddison, but considerably below the 9.9 percent official growth figures, and below actual growth in the past few years. The drop is partly due to a significant drop in the growth rate of the population, to 0.5 percent a year, and an even sharper drop in the growth of the potential labor force, as children born under the one-child policy reach adulthood. In other words, China will be doing well, meeting its official aspiration of quadrupling GDP when measured in dollars (although not quite when measured in rmb). Japan is assumed to grow at 1.7 percent a year, despite its drop in population and even sharper drop in labor force; the USA is assumed to grow at 3.0 percent – lower than in recent years – with population growing at 0.8 percent a year, also lower than in recent years when immigration is included, as it should be.

Second, however, China remains a relatively poor country, with GDP per capita only about one-twelfth that of Japan and the USA; the gap will be considerably lower in terms of purchasing power parity, more on which below. But Chinese will be five times richer than they were in 2000, and all Chinese under the age of fifty will have grown up in a period of rapid economic growth and increasing prosperity.

Third, the dynamics of population change is quite different in the three countries. America's population continues to grow, albeit at a somewhat slower rate. The number of 20-24 year-olds, the group that is just leaving its education and entering the labor force, will grow by 0.6 percent a year to 2025. The same age group in Japan, in sharp contrast, is expected to decline at 1.4 percent a year, so that by 2025 this age group will be only 70 percent as large as it was in 2000. China is in between, with the 20-24 year-old group declining at 0.7 percent a year, down 16 percent from 2000. All three countries have aging populations due to increased longevity, but it is most rapid in Japan because of low natality. China will experience a significant drop in total population after 2035.

It's worth noting as a digression, but it's relevant to these comparisons, that the United States is unique among the rich countries of the world, in its demographics. We've seen a crash of natality in all the rich countries of the world, and including many middle-income countries, like Korea. Korea has had a very sharp drop in natality, Eastern Europe, as well as Western Europe, and China, the only really poor country included in this group, partly due to the one child policy that was introduced in 1979, but partly due to other changes that are taking place in China. And the United States, while there has come decline in the birth rate in the United States, it has not been nearly as dramatic as other rich countries, and of course the United States is continually refreshed

by immigration, and the immigration tends to be concentrated in young adults; so just this group that is the most flexible in the labor force. So the United States stands in marked contrast to other rich countries, but including in this category, China.

A fourth observation is that China will be only about one-third the size of the USA in terms of economic output, but roughly equal to the size of the USA in 1988. If it chooses, China will thus have considerable scope for internationally relevant policies, whether in military expenditure or in foreign aid, provided sufficient tax revenues can be raised. (In 1988 Americans paid in taxes 29 percent of their GDP, compared with 19 percent in China in 2003.)

One sometimes sees much larger numbers, even suggestions that China's economy could be larger than that of the United States by 2025. These presentations compare GDPs using so-called purchasing-power parity conversion rates, rather than market exchange rates. Purchasing power parity (ppp) is necessary when comparing standards of living between countries, since an important part of a family's expenditures is on locally produced goods and especially labor services, and these are much cheaper in poor countries, reflecting lower overall productivity. In terms of ppp, China's GDP in 2002 was 4.6 times what it was at market exchange rates, and already 70 percent larger than Japan's economy, whereas at market exchange rates Japan's GDP was 3.5 times that of China. There are however two serious problems with using ppp-based GDP for these comparisons.

The first is conceptual. China is tied to the world economy at market prices mediated by market exchange rates, not ppp. All trade in goods and services and foreign investment takes place at market exchange rates, and even local goods and services are linked to traded goods by the opportunity cost of land, labor, and capital – factors that could earn more in the trade sector will move there, as circumstances permit. China is not a market economy in every respect, but prices are largely determined freely, influenced by the prices of traded goods. These days some argue that the rmb is “under-valued,” and suggest that it should be appreciated by as much as 25 percent. Such an adjustment, should it occur, would close only a small portion of the large difference between the existing exchange rate and the so-called ppp rate. As noted above, an allowance for appreciation by one percent a year, 28 percent over 25 years, has been assumed in the projection used here.

The second problem is practical. China's ppp exchange rate is based on fragile US-China price comparisons made in the mid-1980s for roughly 300 goods and services, some of which involved heroic assumptions to make them comparable. Moreover, the necessarily arbitrary choice of weights to add up these goods or services makes a large difference to the final result, by a factor of three.

For geo-political or geo-economic purposes, market exchange rates, perhaps smoothed over several years, provide the relevant basis for comparing market economies. The choice makes a big difference: China's economy is already 70 percent larger than Japan's when calculated at ppp; but only slightly more than one quarter of Japan at market exchange rates. China's ability to trade or invest abroad is determined by market exchange rates, not by ppp. China demonstrated the importance of market exchange rates even in the military arena when it purchased military aircraft and ships from Russia, presumably at Russia's export prices, despite a known strong preference for producing military equipment at home. In effect, China indicated that it could not produce comparable weapons at competitive cost domestically.

A larger China of course has implications for the world economy. Demand for food, energy, and other resources will be much higher. By the same token, the supply of manufactures and other goods and services will be much higher. Of special interest to Japan, indeed to the world, will be China's demand for energy, especially coal (with its tendency to pollute) and oil (with its limited domestic supply). On the Department of Energy projection, China's total demand for energy will grow at 4 percent a year to 2025, as opposed to 1.3 percent in the United States and 0.7 percent in Japan. These projected growth rates allow for continued increases in energy efficiency, but no major breakthroughs during the next two decades. By 2025 China will be consuming 14 million barrels of oil a day, over twice Japan's consumption, and over half that in the United States. Coal consumption, mainly to generate electricity, will more than double to 2.8 billion tons, with important implications for air pollution, absent drastic improvements in the way coal is consumed, and for emissions of carbon dioxide, an important greenhouse gas. These figures imply that energy efficiency in China remains much lower than in the USA and especially than in Japan, despite significant improvement. China will have great demand for infrastructure of all kinds – power, transport, housing, and urban services as the country becomes much more urbanized.

With a further quadrupling of China's GDP, the composition of both output and demand will change significantly, the share agriculture in output and employment will continue to decline, and

that of manufacturing and services, especially, will rise. Manufacturing will move into more technologically sophisticated products, as large numbers of trained engineers enter the labor force. One of the many remarkable features of China in recent years is a quadrupling of college students over the last decade. I cannot address, and indeed I'm puzzled about, the quality of the new graduates; how one can expand the system of higher education as rapidly as, in fact, the Chinese have expanded it, and at the same time maintain quality is something we would all like to know about. Part of the answer may be that they have not maintained quality. We won't know until a few years time, as these graduates come into the labor force and are absorbed.

Exports of manufactured goods will continue to rise, although at a slower rate as Chinese products encounter increasing market resistance, and as poorer countries compete with increasing success at producing at the low skill end, of labor-intensive products. There will be more intensive competition in the US market, indeed in most markets, from Chinese products that require much labor and assembly, for example household appliances, and maybe even automobiles. This competition will meet some selective resistance, but in the end, I think, be accepted.

By 2025 China's imports will amount to perhaps \$1.5 trillion, far greater than Japan's but less than half of US imports and markedly less than imports by the European Union. Thus China will be a major market for the products of many countries, roughly on the scale of the United States at present.

China's transition period for full compliance with WTO rules and the terms of China's WTO accession will expire at the end of 2006. Compliance is not likely to be complete by then, however, since many commitments run strongly against well-established Chinese practices, and Beijing is unable to control the entire country except on a few issues of the highest priority. But compliance will gradually take hold in the coming decades, and by 2025 China is likely to be much more transparent and rule-bound, at least in the arena of commercial activity, than it is now. Foreign businessmen will play a significant role in that transformation, and not incidentally will provide an important source of information to the central government, independent of official channels, on what is happening around the country.

The age-old problem of the Imperial Court in Beijing, including the current imperial court, the public bureau of the communist party, has been how accurate information from the provinces,

because officials have been known to lie in their own interest. In your country as in mine, the press, as much as I dislike the press, plays an extremely important role as a source of information, or misinformation but anyway, to senior officials. For their own reasons, the Chinese are reluctant to encourage a truly free press, but they will find, at least in the commercial arena, in foreign businessmen who complain when the rules are not obeyed, a source of information as to what's actually happening out there in the countryside, and will be able to discipline provincial and city officials if they are deviating too grossly from the rules.

By 2025 completion of the Doha Round of trade negotiations, at least if Japan can make some serious concessions in agriculture, will have been in the distant past and the ten-year transition period following completion of multilateral trade negotiations will have concluded, so the trading world of 2025 will be governed by the outcome of the Doha Round, even though a post-Doha round of trade negotiations may have been launched. If the aspirations of APEC of several years ago are realized (the target date was 2020), world trade would be completely free of tariffs and other restrictions on imports. The discriminatory features of the preferential trading arrangements, which are currently proliferating rapidly, as we were discussing at our table the negotiations between the United States and Korea over the Free Trade Agreement, although I prefer to call them preferential trading arrangements, would have been obliterated, or at least greatly attenuated, by such a development.

China has played a conservative, low-key role in international economic organizations, and that is likely to continue because the evolving status quo has served China's interests well. As noted, China will provide a huge domestic market for imports, giving the rest of the world a great interest in China's trade policy and practices.

All the above assumes China stays on its current growth path, which in turn assumes continued peace and prosperity in the world, so trade can continue to grow unimpeded. Even so, China's internal requirements remain formidable. It must grow the private and township sectors enough to compensate for declining employment in the state-enterprise sector. To close many loss-making enterprises it must create a social safety net (unemployment compensation, pensions, health care) for urban employees. It must deal with rapid growth in demand for water, waste disposal, and new housing in urban areas. It must greatly improve agricultural productivity, partly through large and more efficient irrigation projects, partly through improved seeds and techniques of farming. And it must address the widening regional inequalities of growth and

income, in part through significant investments in infrastructure within and to the central and western parts of the country.

A team at the RAND Corporation, responding to a request by the US Defense Department, produced in 2003 a study of various adverse scenarios, along with estimates of their negative impact on Chinese growth over the period 2005-2015. The possible adversities cover a socially disruptive increase in unemployment, increased corruption, a major epidemic (focused on AIDS, written before SARS), failure to solve the emerging shortage of water in northern China, a major disruption in world oil supplies, a domestic financial crisis, a sharp decline in inward foreign direct investment, and a military conflict over Taiwan or elsewhere. Others are imaginable, for example a severe world recession or a significant reversion to protectionism in Europe and the USA, neither of which is likely but both are possible. Each scenario has an adverse impact on China's growth ranging from 0.3 to 2.2 percent a year on the assumptions made in the study, lowering China's GDP by 3 to 24 percent by 2015 from an unspecified base line.

Continued rapid growth in China requires peace and prosperity in the rest of the world. China thrives on a benign international environment, and China's current leaders understand that well. Legitimacy of the Chinese Communist Party (CCP) depends on delivering economic prosperity at home, as does the "peaceful rise" of China in the society of nations. But China will have at least two sets of new leaders by 2025. If the leaders of 2025 are around 60 years in age, they will have been born around 1965 and reached college age in the radically changed environment of 1985. Their parents will have been the victims, or in a few cases the perpetrators, of the Cultural Revolution.

Political evolution in China is likely to proceed slowly. Current leaders and their likely successors will remain preoccupied with maintaining political and social stability, and the political monopoly of the (admittedly much transformed) Communist Party. They see opening up to free discourse, e.g. through a truly free press and contested elections, as potentially unleashing destabilizing forces. Yet increased "democratization" is part of their program. They are likely to experiment with a variety of techniques for holding officials more accountable to the local populace, and some of this may involve carefully constrained and monitored elections, as in many villages today. If these experiments are successful, they may be gradually extended in scope. The notional model is likely to be Singapore, where the forms of western democracy have been



introduced, but where in fact a single paternalistic party has governed, with wide public acceptance, for forty years.

Latent nationalism in China is very high, and indeed is fostered by the educational system. Not only are Chinese taught that Taiwan (and the South China Sea) have been part of China for centuries, regardless of the views of the 23 million people who live there, but they are raised to believe that China suffered terrible humiliations and indignities at the hands of Europeans and Japanese (with Americans thrown in for good measure) for century ending in 1949, when “China stood up.” These are reflected in middle school textbooks, which still today distort history through selective omissions (e.g. Chinese students are not told that North Korea invaded South Korea in June 1950, starting the Korean War which China later joined in defense of North Korea) and tendentious, colorful, adjectives (one is the Chinese never had “meetings” with the British in the 19<sup>th</sup> century, they only had “humiliating meetings”). This pattern runs through the Chinese texts: selective omission of, what I think, are critical facts in comprehending a historical event, and colorful adjectives. This is not educational policy of the 60s or 70s, this is policy for the early 21<sup>st</sup> century, and I think foreigners need to ask what is going on here. This could be just a disconnect in Chinese policy; anyone who knows anything about government knows that disconnects happen, especially when multiple ministries are involved. Or it could involve Chinese authorities deliberately playing a different hand at home than they are playing internationally.

One could imagine scenarios under which internal obstacles slow Chinese growth and violate high expectations of the Chinese public, leading to domestic unrest threatening the CCP regime. Contemporary leaders may then trump up external factors, perhaps even provoking them, to arouse the latent nationalism in order to rally support for the regime to stand up to the external “threats” or “indignities.” Japan and/or the United States are the most likely targets of such, but it could also involve Russia, depending on how that country and polity evolve in the coming decades, or even India. Russia and Japan are seen as traditional adversaries; problems with the USA arise over Taiwan and general American influence in the western Pacific. Such a turn of events would likely damage further China’s economic prospects, since foreign investment and even foreign markets would be put at risk. Sensible leaders will thus be very cautious about unleashing Chinese nationalism; but that is no guarantee that it will not occur. Germany in 1914 and Argentina in 1982, to name only two, took on external “adversaries” in ways clearly not in each country’s economic interests.

The fourth of Deng Xiaoping's Four Modernizations was to modernize the People's Liberation Army (PLA). Anomalously, the PLA is still an instrument of the Communist Party, and it reports mainly to the CCP. In the early 1980s the PLA was huge in manpower, archaic in equipment, doctrine, and training. China has greatly reduced its size (although it remains the largest military in the world in terms of manpower), and plans further reductions. It has acquired more modern weaponry from Russia, especially for the navy and air force, although with technology of the 1970s that weaponry is still well behind the frontier of modern weaponry. The primary task of the PLA is still to preserve internal stability, although that assignment lies formally now with the People's Armed Police, not with the PLA. The PLA, like militaries around the world, has been a close student of recent military conflicts in the Middle East, Iraq, and Kosovo. It recognizes a need to change its structure and doctrine in order to be able to fight a "high tech war," but remains a long distance from achieving the transformation. Presumably by 2025 it will have done so.

China in recent years has settled its numerous border disputes with all of its many neighbors, including even the dispute with India, although that has not been given wide publicity or official recognition, but I'm told that the deal has been worked out, it's just that neither country has been willing yet to put it in front of its parliament. It still has unresolved territorial disputes at sea with Japan to the east and with several Southeast Asian countries in the South China Sea, although it has proposed in the latter case to exploit potential undersea resources cooperatively without formally resolving the territorial disputes. Its strategic aim is to control the seas around China, especially the Strait of Taiwan. Its military aim is to be able to act quickly if necessary to a provocation by Taiwan, and to keep the US Seventh Fleet and other forces at bay with threats from missiles and submarines. None of this is surprising. Military modernization is thus on the agenda, and the PLA commands a growing defense budget, but one has the impression it is not the top priority of the current leaders and that it is being pursued diligently but without a sense of urgency.

As China grows, its dependence on imported materials will also grow. China has ample coal and is rich in some other minerals, but in general China is not a resource-rich country and it has already become dependent on imports of iron ore to feed its voracious demand for steel, of copper, and especially of oil, where domestic exploration has so far produced only disappointing results. China is also a large absorber of foreign technology, and so far has demonstrated only limited

capacity to generate new indigenous technology. That may change with the large increase in college graduates, including engineers, combined with greater incentives and fewer inhibitions to think creatively than has characterized China in the past – another major challenge to the Chinese leaders.

Growing dependence on critical imported materials, including food and feed grains, creates new vulnerabilities for China. The clearest and most notable concerns oil. On the US Department of Energy's baseline projection, China will consume 14 mbd of oil in 2025, up 4.0 percent a year from the 4.8 mbd consumed in 2000. China was a small net exporter of oil in the early 1990s; by 2025 it will import over nearly 11 mbd. China also desires to increase its consumption of natural gas, including liquefied natural gas (LNG), for environmental reasons – to replace coal in the home and workplace, and even to generate electricity in places close to the coast (or gas pipelines) and far from coalmines.

Chinese leaders are of course aware of this growing dependence and vulnerabilities it creates, both to physical and to market disruption. China has aggressively pursued oil exploration around the world, with a strong emphasis where possible on equity oil. China is engaged with Iran and Sudan, and has had discussions with Russia, Venezuela, Canada, and elsewhere. China's oil firms have invested in Canadian tar sands, and are building a pipeline to the Pacific coast. It has expressed an intention to build a pipeline from Kazakhstan, and an interest in building one from Russia, to mitigate its growing dependence on oil imported by sea, and plans to create a strategic stockpile of oil.

At the end of the day, then, practical considerations of high dependence on imports of critical materials, especially but not only oil, combined with a navy of limited capacity and no naval tradition since the 15<sup>th</sup> century, are likely to shape Chinese behavior in the international arena in a peaceful and even strongly cooperative spirit. Concretely, China has the same interest as Korea and the United States in a stable Persian Gulf region, from which most of the world's incremental oil must come over the next 20 years.

In spite of vigorous programs to build up nuclear energy, hydro power, LNG, and even wind power in inner Mongolia, Chinese demand for electricity is growing so rapidly that China expected to build in the next two decades more coal-fired power plants than United States and Europe put together. So while the share of coal is going down, the absolute level of consumption

is expected to rise significantly. Anyone interested in either acid rain, as Korea might well be, or global climate change, has a tremendous interest in the character of these plants. China is where the action is, not in Europe, not in Japan, not in the United States on global climate change. Once these plants are built, they will last for half a century. It's much easier to build in the capacity to capture sequester Carbon dioxide, the greenhouse gas, than it is to retrofit these power plants to do that. So I see a natural area of cooperation especially between the United States and China, the US providing the technology and the funding with some help from other rich countries, and China providing the experimental field, so to speak, just because it's building so many power plants. We do not know yet which technique will be the most effective technically and the economic. A lot of work has been done in the laboratory, very little in the field when it comes to carbon sequestration. This seems to be high on the agenda of potential cooperation.

An alternative scenario is possible but implausible. Like Germany before 1914 and in 1941 (with the invasion of the Soviet Union), and Japan in the 1930s, China's sense of vulnerability regarding critical materials might lead to an aggressive policy of gaining control over such materials. In China's case, that points mainly to East Siberia, lightly populated and defended by Russia; or to acquisition through sponsored political coups in southeast Asia, leading to governments that are in effect satellites of Beijing – although absent significant new discoveries the latter course would not by itself assure sufficient oil for China's needs. In the long run, China might attempt to build a blue water navy (and collateral air support) capable of challenging the US Navy, not only in the western Pacific but also in the Indian Ocean, as Japan did with brief but transitory success in the 1930s. But that would require the expenditure of tens of billions of dollars, and require several decades of construction and naval training to build a modern navy.

China is more likely to consider these less attractive alternatives; the more hostile is the political environment in which it must operate. Those who see China as a "threat" and act accordingly may well be making a self-fulfilling prophecy. Thank you very much.

### Questions & Answers

[Q] This question is regarding North Korea and China. I am concerned with the possibility that North Korea is absorbed into China, through China's political and economic influence. What should Korea do about this possibility?

[A] I'm not sure of the exact implication of the words "absorbed into" mean in this question, but if it means that North Korea would effectively become part of China, I have to say that this is the first I've heard of this suggestion. First I should say, as I don't have to tell this group, that this is a highly charged political issue these days, especially with the missile waiting to be tested in North Korea, and the North Korean claim to have several nuclear weapons, and there are many people closer to this issue, and more conversant with the details than I am, but I will give my impression, which is informed with conversations with many Chinese on this question, although it is not necessarily the official view in China. China, concretely, I mean think-tankers in China, (serious people who worry about defense policy, and the shape of the world, and where China is going in it), is as seriously baffled and as troubled by the existing regime in North Korea as the rest of the world is. To be absolutely candid, they don't know how to deal with it. China is the major material supporter, as you probably know, of North Korea, especially in the area of energy, but also in the area of food, along with other people, supporting the North Korean regime.

The basic Chinese view, this is me interpreting what I've heard, is to preserve the status quo ante, the pre-nuclear north Korea, not because they like it, but because they dislike all of the alternatives even more. They are troubled by them. Either they don't like the outcomes, or they're troubled by the uncertainty of the dynamics of getting from here to there. So the course of least resistance for the Chinese authority is, "Let's just keep the regime alive, and continue the status quo, and maybe something will happen later that will improve things."

Of course a nuclearized North Korea is not a continuation of the status quo ante. That's why China are tremendously concerned about the possibility of a nuclear test. As you've probably read, they've also demonstrated their concern, although North Korea as a country has every right to test rockets, the Chinese have indicated their very strong concern about rocket testing because they know that that will increase anxiety levels enormously in Japan and especially in the United States, if the test is a successful one, which I incidentally doubt that it will be, if they test at all. The puzzling question to everyone, as far as I know, is why North Korea has chosen this moment to roll their rocket out and fuel it in a test, is part of the high-stakes game that North Korea has historically played of trying to maintain enough attention in the rest of the world to gain the kind of dialog and support that it wants. But I've heard no suggestion anywhere, and in my own understanding of China it makes no sense for China to absorb North Korea regime into China. As I guess I don't have to tell this group, there's already a significant minority of Koreans in China

in what I still call Manchuria, in the three Northeastern provinces of China, and China is actually uncomfortable with minorities, they have an official status with minorities, but the Han think of them self a homogenous, culturally homogeneous, not linguistically, group, and the last they want is another 20 million destitute North Koreans in their economy.

[Q] Regarding Taiwan, What is the likelihood of Taiwan remaining independent? Do you see any possibility of having a multi party system?

[A] I think the view in Beijing strongly prefers the status quo in Taiwan. Their ultimate goal is a universal recognized "one China." The formula that they have used in Hong Kong and Macao, they've said, is applicable to Taiwan: One China, three or four systems. That's ok, as long as the sovereignty of China is recognized, including by the Taiwanese themselves. I think they have recognized that that is not on in the short run, and therefore strategic objective is to grow the economy, increase prosperity and wait for time to solve this problem. China will become sufficiently attractive as a market, and a place of investment and so forth that the Taiwanese will be so heavily engaged with China that any alternative of that engagement is inconceivable. They see the current president of Taiwan and his predecessor as loose cannons. They're not fond of either of them. They worry that the evolving ruckus, democracy, in Taiwan will result in an overt move towards independence, which they would regard as extremely provocative.

This is a sufficiently emotional issue throughout China that I think the government would be required to act by public opinion, but it does not want to have to act, because it knows that acting in an aggressive way particularly in a military way would jeopardize its objectives of growing the economy during the next couple of decades. So again, strong preference is for the status quo, an interest that is shared with the United States. President Bush, who initially sent some very pro-Taiwan signals, has now backed off into the traditional (for the last thirty years) diplomatic stance anything you guys, in Taiwan and Beijing, can work out between you is okay with us, as long as it doesn't involve military force. As you know, Bush leaned very hard on Taiwan not to modify their constitution, recently, in the direction of independence, even though the existing constitution of the Republic of China is actually quite anomalous now for the Taiwan today.

So again, China, in this sense, is a conservative power, and wants to maintain the status quo. In the last two decades, particularly since the mid-nineties, China has perused the policy of

intimidation of Taiwan, with the location of what now must be 600 missiles just across the straits, medium range missiles aimed at Taiwan.

I think there is recognition, among the think-tankers, again, that intimidation will not accomplish their ultimate objective, which is unification with Taiwan. So the new team has gone on a charm offensive, as they have indeed done in Southeast Asia, Latin America, and Africa. The charm offensive has taken the form of courting the leadership of the KMT, the opposition party in Taiwan, trying to isolate politically the current president and the Democratic Party. It remains to be seen whether it works, but it seems to me that that is a more promising strategy than just adding more missile bases across the straits.

[Q] China has relied very heavily on foreign capital. Some Chinese are concerned with what they call “ Latin-Americanization.” Is your assumption of 7.2 percent are based on a similar kind of foreign firm’ s contribution?

[A] As you know, China has perused a very different development strategy from either Japan or Korea, at their corresponding stage of development when China was poorer, and that is an open initiation, though not uncontrolled, to foreign firms to invest in China, initially for export in the special export zones. By initially I mean back in the early 1980s, and gradually over the years, the Chinese have extended both the special export zone privileges, and encouraged foreign investment for sale also in the Chinese domestic market.

If it wasn’t evident 20 years ago, it is certainly evident by now; China does not need the capital. The main reason for inviting this foreign investment is not a shortage capital; in fact Chinese savings are extraordinarily high. Rather it is the access to technology, the access to marketing channels, marketing know-how, and the access to modern management techniques, that are the incentive for foreign investment in China. One has to say that it has been smashingly successful. As was mentioned in the question, about 60% of Chinese exports are from what the Chinese call “foreign invested firms,” either foreign firms, or joint ventures with foreign firms. So that’s the quality control. The management techniques, and the marketing channels have worked very well.

Will this continue? I think my generic answer to that is “yes,” although the relative importance of foreign firms in China will decline as more domestic firms- created by a younger generation of people, sometimes western trained, usually influenced by firms in the West (I’m using the West

here in the generic sense, including Japan and Korea, in this regard, because the Korean firms have been one of the important group in China, and of course Taiwanese firms). I think their relative influence will decline, as more and more private Chinese firms become successful in China, and as state enterprises get sorted out better, there will be some very successful state enterprises. There already are a few; there will be more, some will drop by the wayside. So I expect that the role of foreign firms will continue, I think that it has been a success story from a Chinese point of view, and I don't see them stopping it, even though the relative importance of foreign firms may decline over time.

[Q] Chinese banks have a high rate of non-performing loans. Will China have a crisis like Korea had in the late 1990s?

[A] They are now officially down to 8% of assets, that's a big drop. Street estimates come nowhere close to 8%, and put them as high 40% still, or generally in the 20s. There was a big surge of new lending in late 2003-2004 during this big boom in China, and those loans are relatively new loans, my guess is that many of those loans will end up being non-performing also. So the Chinese banking system, by Western accounting standards, is technically insolvent. Fortunately the Chinese public has not discovered that fact yet. Or if they have, they don't believe it. They believe, at least implicitly, by their behavior, as they continue to put their savings into the banking system, that at the end of the day, although these are now technically commercial firms, that the government will bail them out. My own view is that that is the correct judgment.

The government has already provided one major injection of re-capitalization, and more than one for a few of the large banks, we have not seen the last of that process yet, I think. Fortunately the Chinese fiscal situation is a relatively sound one, so they have fiscal scope for making periodic injections of capital into the banking system. The real problem is to change the behavior of the banks, so that the banks actually make genuine commercial lending decisions. This was about a year ago, we had (for China) extraordinary public statement by the new chairman of, I think, China Construction Bank (I'm not sure), but one of the big Chinese banks saying that the loan committee in this bank is the bank's Communist Party committee: that is completely unacceptable. It's unacceptable to have the party committee in the bank be the loan committee. They need to learn how to make commercial loans. And that involves a change in attitude, a change in their relationships with local governments, and training of a cadre of lending officers who actually know how to make commercial loans. This is a big challenge. The specialists in the



Chinese government and the People's Bank of China understand what's required. As so often in China, as indeed in many countries, everything is in implementation- in execution. I think this problem is probably deeper than the Chinese themselves want to acknowledge, in that it's closely related to the authority structure within the Communist Party. I'm not talking about the top leadership now, but the middle ranks, and the interactions between major (so called) commercial firms, including the banks, and the local officials- all of whom are members of the Communist party, and some of whom no doubt sit on the promotion committees of others.

I think this is a more issue for the future viability of the Chinese economy than any Chinese I've talked to have been willing to acknowledge, until now.

[Q] What's your comment on the current account imbalance between China and the US, China's financing of the US deficit? What is likely to be the impact on China-US relations, and the world economy?

[A] Let me just first say that I don't focus on bilateral imbalances at all. We've spend 50 years building a multilateral trading system and bilateral imbalances are all over the place in a multilateral system and are of no consequence in and of themselves. My Australian friends like to remind me that while China has a huge surplus with the US, Australia has a big surplus with China, and Australia runs a deficit with the US. That's exactly the kind of trilateral trade one would expect a multilateral trading system. So I focus on the overall imbalances. As Dr. SaKong has suggested, I have a somewhat unconventional view of the current admittedly novel and striking pattern of global imbalances, with which China is only a bit player. It is a player, but it is only a bit player.

And my view in a nutshell, I've written a whole paper on it, which he can make available to you, called "Understanding Global Imbalances." The gist of it is that the patterns of imbalances that we observe today are a natural consequence of what we call globalization in the financial markets, on the one hand, and the demographic developments, which I have already alluded to in Europe and Japan in particular, but coming down the road on China on the other hand: That countries with rapidly aging societies should be running excess savings, and they are. Japan has the largest single national surplus in the world. Germany is second, what I call augmented Germany, counting the Netherlands and Switzerland, two economies closely aligned with the German economy, has a very big surplus. The OPEC countries these days of course, have surpluses that

are a function of oil prices. And China comes in a poor third or fourth in that list of countries with imbalances in absolute size. This is the counterpart of the US deficit.

I think that given the demographics, and a notional globalized economy, it's very natural for aging societies to want to first put a lot of their savings abroad, because rates of return domestically in Japan and Germany are relatively low (real returns to capital). Secondly, if you are going to invest abroad, and you have a great interest in the security of your investments, I think the United States is a natural place to invest. It is a robust, vigorous economy; property rights are secure. It has lower returns, but much more secure returns than many emerging markets. If we didn't know that ahead of time, Argentina, Russia, and most recently Bolivia have reminded us how insecure private capital, particularly foreign private capital can be in emerging markets. I think the current pattern of imbalances is actually quite a stable one. I know there are lots of financial folks that are worried: "Will there be a collapse of the dollar?" and all that. And I'm not saying there won't be, because developments in financial markets are at least 50%, probably much more, psychological in character than economic. But what I'm saying is that there is nothing that I see in the economic fundamentals that suggests that the existing, admittedly novel, pattern of imbalances cannot exist for another decade or more. Eventually, of course, it will unwind, as Germans and Japanese age enough that they will want to cash in their overseas investments, and their consumption will rise relative to their incomes. But that will take a decade or more. So I actually see the current pattern of imbalances to be quite a stable one.