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PRESENTS

THE FUTURE OF POLITICAL REFORM IN CHINA

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CHINA'S POLITICAL DEVELOPMENT SINCE 1979

SESSION CHAIR: DR. BATES GILL,
CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES

PROFESSOR JOSEPH FEWSMITH, BOSTON UNIVERSITY
“ELITE CHANGES AND PROSPECTS FOR REFORM”

DR. MINXIN PEI,
CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE
“IS CHINA'S TRANSITION TRAPPED?”

PROFESSOR YASHENG HUANG,
MASSACHUSETTS INSTITUTE OF TECHNOLOGY
SLOAN SCHOOL OF MANAGEMENT
“THE ECONOMIC CONSEQUENCES OF LAGGING POLITICAL REFORM”

*Transcript by:
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BATES GILL: Well, good morning. I want to draw everyone's attention to our next panel and move forward. I'm Bates Gill. I hold the Freeman Chair in China Studies at the Center for Strategic and International Studies. I want to thank Jessica, Minxin, and Minxin's staff for all the hard work they've done in drawing together this excellent set of discussions. Clearly the turnout for today is an expression of just how important and timely the many questions we're going to discuss today are.

I'm increasingly of the mind that our future relationship with China – or to put it another way, the China that we will see in 10 years and we'll be living with in 10 years, will be defined far more by what happens inside the borders of China rather than sort of how China externalizes itself. And I think here in Washington we need to recalibrate how we understand our relationship with China. We do a lot of work on how China externalizes itself -- rising Chinese power, proliferation, relations with Taiwan – all of which are extremely important. However, we can do a lot more to understand what's going on inside China and how it impacts our interests here in the United States. So I congratulate the Carnegie Endowment and Minxin and others who are working so hard on these very important questions.

Let me turn immediately then to our speakers. I think we'll simply proceed in the order that they're listed in your program. We're all very privileged to have this excellent panel before us to discuss questions of political reform, the impact of economic development on political reform in China.

Let me first turn the floor over, then, to a person well known to all of us, Joe Fewsmith, professor at Boston University, widely well known for all the work he's done on political development and elite politics in China.

Joe, please.

JOSEPH FEWSMITH: Thank you very much, Bates. It's a terrific privilege to be here this morning, and I can't believe there are so many people coming out to listen to a discussion on domestic politics in China. But I just want to say before I launch into my remarks that I really agree with Bates' comment, and I have for years. As an old, sometimes historian, I just have always thought that the domestic processes of China have driven modern Chinese history, and that certainly is not going to stop. So I just want to second that comment with vigor.

In any case, I think that when one steps back and looks at the last 20 years of reform, the process looks fairly incremental and relatively smooth, and yet, when one looks more closely, one sees that it has always been a discontinuous, conflictual, and rather jerky process. The tremors that one feels reverberating through the political system are caused by the grinding of the underlying tectonic plates of political and social

change. Some times these tremors are rather small and go by unnoticed in the outside world, and sometimes they are very large indeed, as was the case with Tiananmen.

I mention this discontinuous, conflictual character of reform because I think perhaps we are entering a period in which the underlying political and social tectonic plates are beginning to shift once again. This comes after a period of relative quiescence. I think in the 1990s, several things converged to bring about a situation that was basically stable in both political and social terms.

First, in the 1990s, at the political level, the notion of new authoritarianism, bolstered by nationalism, took hold. The bold experiments and the big debates of the 1980s were over. People began to focus more on problems and less on isms. That's not to say, of course, that there wasn't a lot of reform in the 1990s – I think there was – but it was implemented incrementally and largely from the top down -- and largely not, I should say, in the political realm.

Second, at the intellectual level, the bubble of democratic idealism that had existed in the 1980s burst as people came to understand that reform could only be a very long and difficult process. The collapse of socialism in Eastern Europe and the breakup of the former Soviet Union actually made people in China feel pretty good about their own progress. They thought that they were smart; they'd avoided the big problems, dodged the bullets. Political reform didn't seem so important as economic reform at the time. And of course nationalism, fears of globalization, and dare I say in this city that there was some inept policy coming out of Washington, which made the United States less attractive as a model for China.

Finally, there was the development of an economic elite that was quite dependent on the goodwill – and frequently a bit more than the goodwill – of the political elite. And that meant that economic growth did not generate political dissent. Indeed, in the 1990s one had this convergence of political, intellectual, and economic capital; all converged around upholding the status quo. The fact that so many were left out of this process may well have driven such elites closer together. Fear can be a very strong adhesive.

So by the end of the 1990s, it seemed that China had settled into a long-term period of relative stability: An elite that found that corruption allowed all – at least all of their -- boats to rise together, and a public that had little voice and could mount only localized protest. Falun Gong, of course, was the exception, which is why it was suppressed with such vigor.

That picture, I think, remains largely valid, but I find it increasingly challenged from a number of different angles. One is succession politics. There are those who argue that the transition from the Jiang Zemin leadership to the Hu Jintao leadership has been a smooth and more or less institutionalized process. I beg to differ. I still see a very incomplete transition accompanied by a considerable amount of political conflict. After intense bargaining, you'll recall, last year Jiang Zemin was able to expand the size of the Politburo Standing Committee, presumably because he had so many friends that seven

standing committee members was just not enough, so he had to find a couple more seats. And indeed, that committee is dominated by a number of close allies of his. And then, of course, he retained a chairmanship of the very powerful central military commission for himself, thus dividing control of the party from control of the military. This need not lead to conflict and difficulty, but I think that the potential is always there as long as that situation exists.

Looking back a year later, It seems to me that this awkward situation is still no closer to an institutionally stable solution. It appears that when Jiang Zemin decides to step down as head of the Central Military Commission, perhaps next year if he decides to abide by the precedent Deng Xiaoping staying around for two years in that position, that Hu Jintao will move up to replace Jiang Zemin but that Jiang Zemin's close associate, Zeng Qinghong, will move up to replace Hu Jintao. If that scenario comes to pass, I think that it significantly weakens Hu Jintao's position as leader of China. Zeng Qinghong would hold concurrently powerful positions in the party, the state, and the military: head of the secretariat, vice president of the country, and vice chair of the CMC. He would be the only lower-level person that I can think of to combine these positions other than Hu Jintao himself. In other words, these are the jobs that you give to the successor.

Now, whether or not Zeng Qinghong would be the successor remains of course an open question. It may be that Zeng and Hu will be able to compromise and work things out. Indeed, you look at their abilities, talents, resources, and they seem to complement each other rather well. Nevertheless, history does not suggest that there is a lot of basis for such collective leadership. Indeed, even in institutionalized democratic settings, presidents and prime ministers try very hard to establish themselves as being in charge. I just don't think collective leadership is going to work out in China. So I suggest that this would be an unstable situation and one that might have – might have -- serious ramifications for both domestic and foreign policy.

Part of this process of generational change is the desire, indeed the necessity of the new leadership to set out new themes and concerns that distinguish them from their predecessors. In the case of the Hu Jintao-Wen Jiabao leadership, there has been a conspicuous emphasis on concern for the common person, people that were left behind in the 1990s. Many people point to the East Coast emphasis of Jiang Zemin and Zeng Qinghong on the one hand and the more interior emphasis of the Hu Jintao-Wen Jiabao leadership. It's like going from Herbert Hoover to Franklin Delanor Roosevelt. While one can see this as a healthy corrective for a policy that favored the wealthy and did so for too long, it could also generate conflict, as resources are fought over and as more cases such as the Zhou Zhengyi, the land developer in Shanghai, are brought to the fore and exposed.

There is clearly a populist aspect of the Hu Jintao-Wen Jiabao leadership in reaching out to the common people. That was clear as early as December 2002 when Hu Jintao went to Xibaipo to emphasize the "good" aspects of the Chinese revolution,

namely plain living and hard struggle. It continued right through last month when Hu Jintao gave a very long speech at the 110th anniversary of Mao Zedong's birth.

The SARS crisis took this populism in new directions. I have to confess, I was initially quite skeptical that the SARS crisis would have any affect at all on the governance of China. After all, the SARS crisis itself was contained really through the old tools, by mobilizing the old party system, getting the old local danweis (work units), the neighborhood party committees, and so forth, to go into action and isolate this disease.

I was also discouraged at the time when, within five days of when the minister of Health, Zhang Wenkang, and the mayor, Meng Xuenong, were fired, and the government called for more openness, the propaganda department had a meeting that elaborated a new line that repackaged the whole SARS case. Now it was not covering up, it was openness, but it was also a "people's war" against SARS. And, again, this is a very populist theme, and I think that is going to have some ramifications for China's governance in the coming years.

But , as you look at this SARS crisis, there were some longer-term effects that have begun to challenge the 1990s conservative consensus that I described a moment ago. One of the terms that gained currency at the time was the term *zhiqingquan* -- the right to know -- that people have a right to know especially those things that affect their own direct, personal interests. Another was a slogan that "people's interest is higher than anything else." And of course the doctor who exposed the SARS crisis, Jiang Yanyong, really became a national folk hero. And I think this has had an impact on China over the last year.

The most famous case is that of Sun Zhigang, the person who was arrested as a vagrant, taken into detention and then beaten to death. This case came to public attention with three Ph.D. students in law wrote about the case and how it violated Chinese law and then posted the letter on the Internet.

There has been a long debate about whether or not the Internet will lead to political change. And I think many people have been very skeptical about it. But what the Sun Zhigang case suggests is that issues that are legitimate within the terms of the PRC laws and rhetoric but have not been implemented in practice can be brought to public attention and stimulate positive political change. And I think that there have been a number of cases since then that suggest a continuing dynamic of this sort, including the recent case in which a wealthy woman in Harbin ran over and killed a peasant for scratching her BMW. Interestingly enough, these cases -- the Sun Zhigang case, the BMW case, and others -- have issues of class conflict in them.

Another area that is challenging the conservative consensus of the 1990s is the notion of inter-party democracy, which is really a response to local-level party cadres who abuse power and are highly corrupt and provoke social violence on a local level. The center would like to have local cadres who are both responsive to the center and

acceptable, perhaps even responsive, to the local people. But to quote Mencius, “You can’t have them both” (bu ke jian de).

Thus, the party has moved gingerly to experiment with electoral mechanisms, not only at the village level but increasingly at the township level. These are rarely direct public elections, but involve some sort of “democratic appraisal” vote that can then be ratified (though sometimes rejected) by the local party committee. But the more responsive local cadres are to the local people, the less responsive they are to the higher levels. So the party organization finds itself vexed by this dilemma.

I just want to cite one example, that of Baicheng Municipality in Jilin Province up in the northeast, which has gone quite far in this direction. Baicheng has adopted what’s called the three-ballot system – (sanpiao zhi). The first vote in the cadre-promotion system is a democratic recommendation ballot in which the “masses” vote. The second vote is called a democratic evaluation ballot. A cadre proposed for promotion must secure at least 50 percent of the vote on each of these two votes or else he or she cannot enter the process of investigation, discussion, solicitation of views, and decision by the party committee. The final vote then, the third ballot, is by the party committee, either the standing committee or the full committee, and is apparently conducted by secret ballot. So now cadres can abstain from voting or even vote negatively, whereas before it was a show of hands. And of course they went with whatever the leader wanted before. This system has been extended from deputy heads of county bureaus to full heads and from the number of candidates being equal to the number of positions to the number of people being greater than the number of positions.

However, this sort of democratizing pull appears to be too much for the Organization Department of the Chinese Communist Party. In a recent article, Li Jingtian, the deputy director of the Organization Department wrote:

For instance, democratic recommendation, democratic opinion, and democratic evaluation are effective ways of expanding democracy and implementing the principle of public recognition. But in carrying it out, some places have simply chosen people according to votes.” [A terrible idea, of course. (Laughter.)] “Some cadres fear losing votes so they do not uphold principles and try to please everyone. Some cadres are not honest and unscrupulously pull ballots” (*lapiao*). [I think this is called campaigning. (Laughter.)] “To solve such problems, fundamentally speaking, we need to rely on deepening the reform of the cadre system, strengthening the coordinated building of the system, and gradually form a strict structural system.

In other words, they’re interested in party reform, but in ways that centralize the system and do not lead to democratization.

Let me suggest that the tension between places like Baicheng and the Organization Department of the CCP are of a kin with the problem we see in the

provinces as more and more party secretaries take up posts as head of the provincial people's congresses. The reason they do so is to prevent the sort of oversight or expression of opinion that might really be effective and produce political reform.

In the 1980s, there was a call to separate the party from the government. This created a problem of having two centers of power, and this approach was rejected in the wake of Tiananmen. In recent years, the idea has been to "root the party in the government." That is why political reform has taken the form of inner-party democracy. But rooting the party in the government undermines the organizational competence (professionalism) of government. So the very effort to reform the party and particularly the state are undermined by the approach taken.

Nevertheless, the pressures to reform are real, and since the system does not allow reforms that threaten the party's hold on power, there will inevitably be conflict. And because the elite situation at the top of the system is murky, this conflict could be serious.

Thank you.

MR. GILL: Thanks very much, Joe. Let's give him a round – (applause) – yes, indeed. That was excellent – excellent way to kick off our discussions today. I take it from your remarks that while you see some encouraging signs – and you've given us some interesting examples – you do see a kind of coming confrontation with the conservative consensus and the democratization inside the society.

I think that leads us directly then to our next set of remarks from Minxin Pei. Minxin is familiar of course to all of us. We thank him again for the organization of today's meeting and look very much forward to his remarks which I think are going to give us a taste of the book that's soon to come from him on China's trapped transition.

Let's turn the floor over to you, Minxin, and thanks again for staying within the 10 or 15 minute time limit. Thank you.

MINXIN PEI: Thank you very much. My remarks will echo in many ways what Joe has just said. China today appears to be stuck in what I would call a neoauthoritarian trap – that is, you have an authoritarian government engaged in very rapid economic growth while maintaining one-party rule. The conventional wisdom is as long as economic growth continues, the one-party system will be maintained. My remarks today will try to illustrate why that kind of conventional wisdom needs to be questioned.

First, there is no doubt in my mind that when historians reflect upon the '90s, they will probably conclude that the '90s will be remembered as the decade of economic dynamism – unprecedented economic dynamism in China. But it will also be remembered as a decade of political stagnation and a decade in which crony capitalism began to emerge and showed signs of self-destructiveness.

Why that is the case? Because modernization theory, particularly democracy theory, would tell us that economic growth will lead to democratic opening. I will say this theory is correct but only for the long run. But when you look at the effects of economic growth and modernization in the short term on democratization or regime change, these effects can be very, very negative for several reasons.

First of all, in a transition economy, especially for a closed economy that's being opened up, political power all of a sudden becomes much more valuable because political power can now allocate economic resources. And that makes the government in charge of political power much less willing to give up or even allow political reform. There's no coincidence that in the 1980s, political reform actually proceeded much faster. All the major political reforms that we talk about today in China – strengthening the legislature, strengthening the legal system, allowing civil society to grow, and experimenting with village elections they all began in the 1980s. In the 1990s you basically saw a dramatic slowdown if not stagnation on the political front. And so, if you understand why that occurred in the period of rapid economic growth, I think this perspective will help you to understand the thinking of the ruling elites.

The second negative effect from rising economic prosperity is that it really takes pressure off the ruling elites to reform. We have to remember that the Communist Party began reform in the late 1970s because it was forced to. There was this tremendous pressure within the regime and also within Chinese society as a result of the disasters of the Cultural Revolution.. But once you have rising prosperity, the pressure of change can actually decrease.

The third negative impact is that rising economic prosperity also allows the government to have more resources to co-opt potential challenges to its power. So the 1990s you saw a dramatic change in Chinese society. That is, those elites, especially the liberal intelligentsia that were unalterably opposed to the government in the 1980s became very silent. A large part of them joined the ruling coalition.

But how do we understand the emergence of crony capitalism and runaway corruption in China in the 1990s? I offer another theoretical explanation. That is, although things appear to be going well for the government, in the hearts and minds of the members of the ruling elites they understand that there is an expiration date on their power. It's hard to know scientifically – over the past three years while writing a book on China, I have been collecting anecdotal evidence to show whether there was indeed this psychology among the ruling elites. And here I cite two very interesting examples involving high-level cadres in China..

One was the head of the tax bureau in Hubei Province. His name is Li Zheng He was recently executed. He took \$6 million in bribes. And the other was the executive vice governor of Hubei Province – both were very senior cadres. There were two things they did that stuck in my mind. First,, the tax bureau chief made a confession after he was arrested. . And this is what he said in his confession. He said, “After the dissolution of the former Soviet Union, we saw that the former ruling elites, in order to make a

living, became security guards or even sold pancakes.” I don’t know whether it’s true or not. (Chuckles.) Our Russian experts please let me know. “I mistakenly concluded that once power is lost, everything will be lost for us. So the best thing for me to do is while I still have power I must seize the moment to make economic preparations.” This is one person. And there is another. This is the executive vice governor. He said, “Once I retire I must engage in real economic activities. I must build buildings. To do these things I need tens of millions of Chinese yuan. I must start collecting them now.”

So that’s this mentality. And then at the same time China’s ruling elites are very uncertain about their future. So what these two particular individuals did, they consulted fortunetellers about their chances for promotion. The tax bureau chief consulted a fortuneteller and was told that he would become a provincial governor within a few years. So in a moment of joy he gave the fortuneteller 8,000 yuan, which is a lucky number in Chinese. (Laughter.) As for the executive vice governor, he also consulted a fortuneteller and he was told that quickly he would be the governor, the party secretary, and then work at the State Council, China’s cabinet. It’s really disturbing to see the very top elites having no faith in the political process and but believing in the predictions of a fortuneteller. This kind of psychology is very destructive because it encourages massive looting of the state. The symptom of the looting of the state is crony capitalism and runaway corruption..

In also the ‘90s we had a constellation of factors that contributed to this political stagnation: the 1989 setback for the democracy movement, the high pressure put on the Chinese society by its government, and then the reaction to the collapse of the former Soviet Union, as well as rising nationalism. Joe mentioned some of these. But I think this period is coming to an end in China, for several reasons.

First of all, the memories of the post-Soviet chaos are fading in China. The chaos in the former Soviet bloc in the early ‘90s was the defining frame of reference for the people in China. They are afraid of the risks, instability, and uncertainty associated with regime transition. Today they are concerned not by the history of turmoil in the former Soviet Union.. But they are deeply unsatisfied by the hidden costs of the growth of the ‘90s in China: runaway corruption, environmental degradation, rising inequality. We know all about these problems. What’s interesting is that among those who supported the policies of the ‘90s, they are beginning to reexamine the strategy of putting economic growth above everything else.

And I cite the example of Mr. Wu Jinglian, who is China’s most influential liberal economist. In the 1990s he was the key player in designing reform packages. What’s his focus now? The rule of law. Because in many of his public speeches he said that, “A market economy will be impossible in China without the rule of law.” So there’s this much deeper understanding among those discerning elites that political change will be needed.

And secondly, I think the change will be unavoidable and the stagnation in the ‘90s will not last because of the self-destructive logic of crony capitalism. Crony

capitalism is based on the same logic that brings companies like Enron and MCI to collapse; that is, the cashing-out by the insiders. The best analogy is a bank run: those insiders who know the bank is tottering will first try to get their own money out. This then triggers a rapidly escalating crisis. People like the two individuals I mentioned just now – and multiply that by several million times, then you have a frightening picture, because the corruption within the regime will ultimately have a huge economic impact on China's economic growth, and when that happens I think that the current model – economic opening under authoritarian rule -- will not be sustained.

But in closing I will say that I do see some hopes, as Joe did, and I will cite just four small stories.

One story, is about some residents in Hanzhou whose houses were being razed to make way for urban redevelopment. To attract public attention they put on doctors' uniforms and took to the streets. They were holding the Chinese constitution in hands. They were disseminating the spirit of the Chinese constitution and protesting that their constitutional rights were being violated.

In another instance, peasants whose land was being requisitioned by the government to make way for economic projects went to the local government to show government officials central government documents that would give them a say in the process of land requisition.

And the third instance is that in prefecture government Hubei Province, a local official, very reform-minded, had a terrific idea. He forced many party members to give up their positions temporarily and sent them to Shenzhen to work as day laborers so that they could understand something about a market economy. And what these officials found is that if they put their party affiliations on their resumes, they would not get a job. (Laughter.) So they were forced to hide the fact they were party members. This is, again, a very revealing lesson.

And finally, peasants in one county in Hunan Province formed their own association to defend their rights.

So this means that after a decade of economic growth but political stagnation, pressure from below may be building up, and hopefully the recent signs of political opening at the top will be combined with bottom-up pressure and create a new political era in China, and perhaps political reform in China will have a future.

Thank you.

(Applause.)

MR. GILL: Thank you very much, Minxin. Thanks for those excellent remarks, and we appreciate you staying well within the bounds of our time limit so we can have a

good discussion following up. I think, just to sum up your remarks then, again, much like Joe's, I think pointing to an uncertainty going forward, but with at least some smatterings of hopeful signs here and there.

We want to turn now our attention to a slightly different subject but still quite relevant. Coming to as associate professor at the MIT Sloan School, we're very pleased to have Huang Yasheng here with us. His recently finished book on "Selling China" focused on the issue of foreign direct investment in China, and he is very well positioned to talk to us about how or whether economic issues will be affected by the problems of lagging political reform in China.

Thank you, Professor Huang.

YASHENG HUANG: Thank you, Bates. And thank you, Minxin, for organizing the conference as well as for conceptualizing these strategic issues confronting the Chinese government and economy and society in the next 10 years.

Let me echo one comment that Minxin made about the fact that there are Chinese thinkers and policymakers who supported the 1990s strategy and now they have second thoughts. I can tell you from my own personal experience that this is absolutely true. In July of this year, a former colleague of mine at Harvard Business School and I co-authored a piece on India and China comparison that was published in the Foreign Policy magazine of the Carnegie Endowment in which we made the point that the neglect of the domestic private sector in China is going to have negative long-term economic implications more than many people have realized.

I've been making that point since late 1990s. When I was making that point in the late 1990s to the Chinese managers and Chinese officials, they typically had two reactions. One was that they would say Xiao Huang – Little Huang. It's a very kind way of putting you down. (Laughter.) But I accepted that. And they will say, with a quizzical look on their faces, have you been away from China for too long? (Laughter.) And you may not understand some of these things. What's very interesting is that this time around their reactions are decidedly different. In India they are all crazy about the article, which is understandable because nobody has said anything good about the country for so long – (laughter) – but in China it was published recently on the official website of the Chinese government. It was actually reprinted on several local government official websites.

I have talked to a number of central and local government officials about this article. What I was very, very impressed by was the fact that these people came to me to have a discussion and not to rebut the argument, and they may tell me that, we disagree with some portions of the analysis, but let us find out how you reached the conclusion that you did. It is an extremely productive attitude, as far as I can tell,

So there's a sea change in the mentality on the part of some key people in China, who, by the way, are merely catching up with what is going on in the reality. It is not so

much a reflection of forward thinking as much as a candid and pragmatic approach toward what is going on in the reality.

Let me come back to the big picture, which has to do with the economic consequences of lagging political reforms.

The first comment I want to make is that there is no denying that the Chinese economic performance has been extremely impressive, and I don't want to repeat the statistics and the familiar stories: very high growth every year – 200 million people were lifted above the absolute poverty. But here I would disagree a little bit with Minxin's observation about 1990s. In my own view, the 1980s economic performance was far more impressive than the economic performance in the 1990s in the following sense:

One is that you get about the same economic growth rate in the 1980s as well as in the 1990s. The difference is that in the 1980s the economic performance was much more broad-based. First it began in the countryside. The 200 million people being lifted above the absolute poverty, a lot of these people were lifted in the 1980s. In 1990s you actually begin to see greater income disparity. You begin to see sort of Latin American phenomenon, which is that the urban metropolis areas develop extremely fast, but the countryside is kind of left behind. For China, the true economic prosperity has to include the Chinese countryside, by definition because China is still a rural society.

And another aspect about 1980s was that China achieved the same economic growth rate in the 1980s with lower level of corruption, with lower level of income inequality, with almost zero non-performing loans, and this is according to Zhou Xiaochuan, who is now the president of the Chinese Central Bank. Almost all the non-performing loans were created in the 1990s. So the costs have not been explicit now; the costs of 1990s are going to show up by some point. The Chinese government has recapitalized the banking system twice in the last five years, and I think it is going to take 10 to 15 years to gradually grow all of the mistakes that were made on the economic side in the 1990s.

Another big difference between the 1980s and 1990s was that in the 1980s, China pursued a development strategy that emphasized internal reforms. At the same time they gradually opened up to the world economy. In the 1990s, the reform emphasis was on external reforms, more as a substitute for internal reform rather than as a complement to internal reforms. The current leadership – that's why I'm cautiously optimistic -- the current leadership is again going back, to some extent, to the strategy pursued in 1980s, with more emphasis on domestic private sector, with constitutional measures to address the lack of property rights security on the part of the domestic private sector.

And let me just make one very brief point about the domestic private sector, and this has to do with how Chinese private entrepreneurs are often portrayed by both Chinese and Western media. On Chinese soap opera on TV, private entrepreneur always bribes a Chinese government official. (Laughter.) The other portrayal, which is extremely consistent with the Chinese soap opera portrayal, is by Western media, which

is that domestic private firms are all corrupt, they bribe Chinese government officials, they violate laws all the time. One fundamental thing that is missing in this portrayal is the fact that in the 1990s, for many years, the business environment for domestic private entrepreneurs was extremely difficult. Essentially, if you were a domestic private entrepreneur you had a choice. The choice was between not doing anything, because if you follow the rules and regulations, you couldn't really start a business. Or you pay the taxes according to the law; then that means that you don't have any profits left, so why doing it in the first place? And the other choice is to bribe. So if you're in that extremely difficult business environment, that's what you have to do. And that business environment picture is very often missing in the portrayal of the Chinese domestic private sector.

And here let me give you some – Minxin cautioned me not to give any statistic, but let me just give you – (laughter) – just very few numbers, and they are from World Bank survey of domestic private firms across 80 countries in 2000. According to the survey, in 2000 the Chinese – the financing of constraint – credit constraint facing the domestic private entrepreneurs among these 80 countries is ranked 76. The countries that have been worse compared with China are Moldova, Ukraine, and another transitioning economy, Kyrgyzstan, and then I think Haiti. And then there's another question about property rights security, and China has done as well as Haiti in that category. So these are not subjective judgements; they are hard numbers.

China, arguably, has done extremely well on the hard infrastructure – building roads, building airports -- maybe more airports than they should – more airports, highways, and things like that. But in terms of soft infrastructure – protecting the property rights of domestic private entrepreneurs, organizing your finance in a way that is efficient and promoting of indigenous private sector growth, China has been lagging behind. And that has to do with a political choice, with a grand political choice, which has to do with the consideration that as a one-party system, as Communist Party system, do you encourage the growth and the development of the domestic private sector, which may, sometime down the road, demand power sharing. For the last 25 years, this question has not been resolved, and I think for another ten years or another 15 years, this has to be at the forefront of the policy and strategy issues confronting the Chinese leaders.

And on that, let me conclude by saying I'm cautiously optimistic by observing what Hu Jintao and Wen Jiabao have done. They have a much more pragmatic approach. They are going back to the 1980s, which to me was the golden period of Chinese economic development. They have revised the constitution. There are legal scholars sitting in this room who may disagree with me, but I think the constitutional revision is a big deal, is a very important milestone in the following sense. One is that it has the potential of providing legal recourse to address the massive level and the amount of property rights violations occurring every day in China; the things that we don't hear about. Usually the Western media will cover what's going on with multinational corporations, but they don't know what everyday business constraints that the average domestic private entrepreneur has to face in China.

The second significant aspect of the constitutional revision is that it provides a benchmark for the domestic private entrepreneurs to say to the Chinese officials that you have done something wrong. Even though the court doesn't have the full power to address the violations, at least we know that the violations have occurred. And recent research has shown that the private entrepreneurs are more willing now than before to take the issues to the court. My book, Selling China shows that the recent economic performance, the impressive part of the Chinese economic performance in recent years has been largely engineered by the domestic -- investments by the domestic private sector. And in the long run, I think this is the only way to go. And also, in the long run, it is the growth of the domestic private sector that is going to raise demands for political transparency, accountability.

A number of private entrepreneurs told me that they don't mind paying taxes, what they do mind is the fact that once they pay taxes, all they see is this huge government building built in front of them, and we have to go inside the building to go to every office to get a permit and to get the licenses. They don't like that. They don't mind paying the taxes but they may demand more disclosure from the officials, they demand more transparency. And so I'm hopeful that this is going to be the way that China is going to go.

Thank you.

MR. GILL: Great, thank you very much. (Applause.)

Thanks very much, Yasheng.

We have about 10 minutes I think we can devote to some questions and answers.

One theme that I heard coming through all three presentations, but which was not explicitly addressed -- and maybe we can draw some more commentary from our experts -- is something that Lorne Craner also brought up.

I mean, they're talking the talk in Beijing. A lot of sophisticated people, even the uppermost leaders seem to recognize the need to move down this path of some greater opening and addressing the many questions of rule of law, transparency, corporate governance, accountability, et cetera, et cetera. But as Minxin and others have so ably demonstrated, it's a much different question getting these things to work at local and municipal levels where corruption remains endemic. And that's where the real fight on these issues is going to have to be fought out. And I wonder if that just lends an even greater cautionary note to the cautious optimism that we've heard from all of our speakers.

Let me ask the audience to please indicate their interest in raising an issue or a question, and when they do, to identify themselves and maybe even direct their question to a particular speaker.

This person right here, please. Yes. Yes, sir, you. Thank you.

Q: Thank you. Robert Price (sp), Department of Energy. I wanted to ask Professor Huang a question. Again, following up on your issue about not creating the finance infrastructure, do you see in the next five years or so the (center ?) allowing and creating the regulatory framework to allow municipal and provincial bond markets? Thank you.

YASHENG HUANG: Well, let me address the premise of the question. I don't see the problems in the Chinese financial system as a purely regulatory issue. And it is not a financing choice issue between direct financing and indirect financing, between bank financing and corporate bonds and stock. The issue, I think to be consistent with the theme of this conference, is a political issue: Do you use your financial system to support socialist enterprises, state-owned enterprises, or do you use your financial system to support capitalist, private enterprises? And there are small-scale, very efficient banks in China, they are located in Zhejiang province, and they have developed over the last 20 years, 15 years, very sophisticated way of monitoring risks, assessing the creditworthiness of their customers. If you allow the banking system to allocate financial resources according to the efficiency and profitability of the project, then these bankers are going to develop their expertise themselves.

And I was very struck when I was talking to the Chinese bankers in the late 1990s about this issue. They constantly emphasized -- these are not so much Chinese bankers, but these are officials in charge of the financial sector -- they constantly emphasize the fact that the reason why we have bad loans is because we don't have very good banking managers. And then I was -- as a business school professor I would say, "Why don't you organize some training sessions to train your banking managers?" And when I talk about the kind of cost that they will have to pay to come to America to do that, they say, "Oh, no, no, no. We don't want to pay that kind of cost."

But these same banks have spent over \$100 million building fantastic, fanciful buildings in Beijing. If you go to Beijing today, the most beautiful buildings are built by these banks which, in terms of their profitability, are either negative or among one of the lowest in the world. And many of these banks are insolvent in the technical sense.

So it has to do with its political choice. And the current leadership -- and I should give credit to -- some credit to the previous leadership -- they began to relax the financing restrictions in 1999. They abolished the lending quota in 1999, and they allowed certain bank branches in some parts of the country to lend to the private firms. So to me, I see this as a more important issue, rather than a choice between financing mechanism; it's really the function of a financial system.

If you have a good financial system, not only do you have healthier economic growth, you will have lower level of corruption. You would also -- very interestingly, you would also have lower level of social inequality. Remember the fact that many of

the private entrepreneurs come from extremely modest backgrounds. They are from the countryside; they start from scratch. If you have a good financial system that can support these people, you actually bridge the gap between the rich and the poor.

The bond market -- let me just say a few words about that. I think that's a very tough -- that's a very tough thing not only for China, but just technically, it's a very tough financing vehicle for many, many developing countries because there you would require a very sophisticated regulatory infrastructure in place because it's somewhat at arm's length. The advantage of banking system is that the bankers themselves will monitor the use of the finance and they will get involved in the management of the enterprises.

MR. GILL: Thanks very much, Yasheng.

We have a questioner over here, please.

Q: Justin Finnegan (sp). Professor Fewsmith, I just wanted to know if you could comment on the fact that Jiang Zemin wasn't present during the rocket launch in October and what that meant with the Hu-Jiang relationship?

MR. FEWSMITH: I don't even think that it means anything, actually. He did meet with General Myers, chairman of the Joint Chief of Staff, and so I think he has not gone into hiding at all. So I wouldn't read too much into that. (Laughter.)

MR. GILL: We have a question here at the front that I had missed earlier.

Q: Sheldon Ray , UBS. Concerning the advisory committee that just began in November to the Central Bank of China, consisting of, I think, Eddie George, Andrew Crockett, David Carse, maybe Andrew Sheng (sp), Gerry Corrigan, and the others, do you view that as fairly significant and would have a long-term positive impact, or more just window-dressing?

YASHENG HUANG: Definitely this is more significant than the last banking reforms in 1999, 2000. They are no longer thinking about the problem not just in terms of capitalization or recapitalization, but all the reforms they have launched to that point are really about the -- if you look at the balance sheet, are really about the liability side of the balance sheet, not about the asset side; about how you lend, how you monitor the use of the funds.

And this banking commission, I think for the first time, is beginning to think about reorganization of the banking system. But I think, you know, you have to work within certain political constraints. And to me, I think it's very encouraging that they set up this regulatory commission. But on the other hand, the bankers work within policy and political constraints. There are -- as I pointed out before, there are smaller Chinese banks that have done extremely well. So for me, the key lesson is to learn from those small Chinese banks why they have been doing very well, and to have -- I think one of

the reasons to set up that commission is to borrow the external credibility of these very prominent international financiers as a way to push forward reforms. Liu Mingkang, I think, is an extremely visionary reformer, and I think that the true significance of that commission is to provide the kind of advice with the authority and the credibility of these prominent international bankers.

But I think the lessons are very clear. You don't really need these bankers to say what the reform measures should be, you just need to talk to the Chinese bankers themselves. But having them does provide the kind of credibility that they previously didn't have.

MR. GILL: Thank you very much, Yasheng.

We have time for one more question. I'd turn it over to this person here. I'm sorry, we just are running out of time, unfortunately.

Q: Joan Nelson, the Woodrow Wilson Center, Smithsonian. Perhaps a question from a non-China specialist. To ground what's been being said about the domestic private business sector and its potential political importance, I wonder if we could have just a few words on the growth in that sector, some indicators including the proportion of employment as this has evolved, '80s, '90s.

MR. GILL: Okay, thanks very much.

Yasheng, Minxin or Joe -- anyone want to take that?

MR. : Do you have the numbers?

YASHENG HUANG: I have some numbers. (Laughter.)

MR. GILL: Minxin said no numbers!

YASHENG HUANG: There are two types of private firms in China. One is individual proprietorship, individual firms. These are the firms that can hire up to eight employees. And there are other -- there's another type of private firms which can hire more than eight employees. The number eight is actually very interesting, but that's for another meeting. (Laughter.)

In the 1980s, you'll find a lot of these individual, private proprietorships, and they created -- the numbers from the '80s are a little bit hazy now, a little bit blurry now. But let me cite the numbers in the 1990s, since 1997, 1998.

Now they hire about as many employees as the state sector. So we are talking about 90-100 million employment. That's the ballpark.

MR. GILL: Ninety million?

YASHENG HUANG: Ninety million. At a fraction of the financial resources that the state sector received. The state sector receives about 80 percent, 70 percent of the bank credits. The domestic private sector receives about -- less than 2 percent. So even from a political point of view -- and this is the point that I try to make with Chinese officials -- even from a political point of view, just political stability, not ideology, it is much more cost-effective to support the domestic private enterprises. You know, you give them one dollar, they create three jobs. If you gave one dollar to the state-owned enterprises, you also create three jobs, but they happen to be all three related to the manager's family. (Laughter.) The state sector has systematically destroyed around 20, 30 million jobs since the mid-1990s. This is probably a lower estimate.

So, as a Chinese leader, it's very clear which side you come down. And the current leadership, I think, is more willing to confront this stark economic reality. And the private sector has generated more tax revenue now than the state sector. Despite all the tax evasions that you hear about -- you know, Chinese economists often write about tax evasion on the part of the domestic private entrepreneurs. What they also miss -- and details really, really matter; you need to look at the details. The details are the following: The domestic private entrepreneurs evade personal income taxes, they don't evade corporate taxes. They cannot evade corporate taxes; they cannot evade value-added taxes because these are very difficult taxes to evade. Whereas the state-owned enterprises, they don't have to evade, they just don't have money to pay taxes. (Laughter.) Of course they don't evade personal income taxes, they do not generate much personal income. And if the private entrepreneurs pay all the personal income taxes, then the after-tax income will be reduced to zero. So why would he or she go into the business in the first place?

So just from the financing side, as well as from the expenditure side, this is a no-brainer; you support the domestic private enterprises. And the economies that have succeeded -- Taiwan, Hong Kong -- all have supported private entrepreneurs.

MR. GILL: Thank you very much, Yasheng.

And I want to thank our panelists. I think they've done an excellent job of presenting the many issues we had to talk about today. (Applause.)

If I'm not mistaken, we will reconvene in 10 minutes for our next panel.

Thank you all very much.

(End of 10:00 a.m. panel.)