As prepared for delivery

The Third Bund International Financial Summit
remarks of
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Shanghai, China
July 12, 2015

Thank you for the opportunity to join you today.

This is a time of economic transformation in China, within a global economic environment that is in flux.

So when I received the invitation from the Fosun Group, Yabuli China Entrepreneurs Forum, and the Zhejiang Chamber of Commerce, I was especially intrigued. Because I believe that the success of China's private sector is fundamental both to China's reforms and the health of the world economy.

Given the Bund's special place in China's economic history—and I hope in its future—this location, and this conference, offers a symbolic center for examining China's challenges of innovation, entrepreneurialism, and inclusive growth.

Today, I will discuss four topics:

- First, the role of China's private sector;
- Second, the vital connection of China's private sector to the country's agenda for reform;
- Third, lessons of innovation that may assist China and its private sector; and
- Fourth, international links between China's reforms and private sector on the one hand, and the American and global economies.

<u>The Role of China's Private Sector</u>

Last year, Dr. Nicholas Lardy of the Peterson Institute of International Economics published a book titled "<u>Markets over Mao</u>" and subtitled "The Rise of Private Business in China."

Dr. Lardy has been studying China's economy for three decades. He knows how to interpret the data. Here are some of Dr. Lardy's key conclusions about China's private sector:

- Private firms now produce about two-thirds of China's output.
- Private firms have been the major engine of China's economic growth, the sole source of increasing employment, and the major contributor to China's global trade.
- Almost all growth in China's urban and rural employment since 1978 came from the private sector.
- Private Chinese firms earn substantially more on assets than state-owned firms.
- And the access of private firms to bank credit has improved so much that on average new bank lending to private firms in 2010-12 was two-thirds more than lending to state firms.

Dr. Lardy's findings also have significant implications for China's state sector:

- The profit share of non-financial firms supervised by SASAC, the State-owned Assets & Supervision Commission, peaked in 2006-07 and has fallen sharply since then.
- The SASAC firms' return on assets declined since the middle of the last decade, and the returns are now far below those firms' cost of capital.
- And the absolute numbers of employment in state firms has fallen for over a decade, and now represents only 13 percent of urban employment.

Taken together, the changes in China's economy paint the following picture:

Where the barriers to entry to privately-registered and privately-controlled companies are relatively low, private businesses have largely displaced state companies. Therefore, China has benefited from a surge of private entrepreneurs in construction, retailing, wholesaling, catering, and most manufacturing and mining sectors.

But where private Chinese firms encounter barriers because of natural monopolies, capital requirements, and government regulations, the positions of state-owned enterprises have eroded only slightly. Private businesses have made much less headway in sectors such as electrical power, oil and gas extraction, tobacco manufacturing, finance, transportation, basic telecom, education, health, movies, broadcasting, culture, and sport.

Since 1978, state firms' share of the industrial sector has dropped by two-thirds. Today, about three-quarters of China's investment in manufacturing is made by the private sector.

As the Third Plenum of the 18th Party Congress recognized, China's service sector now offers the greatest opportunities to boost China's domestic demand, productivity, urbanization, creation of higher-wage jobs, and environmental quality.

To achieve these gains, the Third Party Plenum signaled that the state was prepared to reduce its role in sectors that are not natural monopolies. That is an opportunity for all of you.

China's Private Sector & the National Reform Agenda

Consideration of the Third Party Plenum brings me to my second topic: the connection of China's private sector to the country's agenda for reform.

When I was President of the World Bank, we launched a study titled "China 2030" with the Development Research Center of China's State Council. Our aim was to survey global development experience so as to make recommendations on how China could build a "modern, harmonious, and creative high-income society" by 2030. We released the China 2030 report in 2012; many of its findings seemed to contribute to the conclusions of the Third Party Plenum the next year.

Our report recognized China's amazing economic performance over three decades: growth averaged 10 percent a year, and over 500 million people overcame poverty. These results are truly historic; no other economy has grown as fast for as long.

The China 2030 Report identified China's considerable strengths as it faces the next stage of economic transformation. One important resource is the rise of a business and entrepreneurial culture. That means all of you are a tremendous asset for China.

Yet our report also explained that China's growth was bound to slow as population growth fell and investment rates declined. To sustain growth, China has to increase what economists term Total Factor Productivity, or TFP. In effect, TFP measures the contribution to output of everything other than labor and capital: innovation; managerial skill; organization; and even good fortune!

Indeed, global history prompted a warning about what some economists have called "the middle income trap." This obstacle refers to the tendency of many economies to falter once their populations reach middle income levels because of failures to increase productivity. Of the 101 economies that the World Bank categorized as middle income in 1960, by 2008, almost 50 years later, only 12 had achieved high income status—and one was Greece!

The private sector has a vital role to play in China's future reforms. Private sector competition boosts productivity and the pace of innovation. Private sector entrepreneurs put capital to best use and employ workers most effectively. If the private sector is open to global competition, it will also be the transmission channel for new ideas, technologies, ways of doing business, people, and even cross-investment.

The theme of this conference—from Manhattan to the Bund—fits well with this reform imperative. And the Fosun Group's value investment approach—drawing from Warren Buffett's model—offers an excellent example of the adaptation of China's financial and investment markets to the next stage of the country's economic transformation.

Moreover, much of China's service sector seems ripe for private sector entrepreneurs if the government reduces regulatory and other barriers to entry.

A study by the Asian Development Bank points out that the share of China's economy and employment represented by the services sector is substantially below that predicted in a comparison of 12 Asian economies.

The share of the service sector in China's economy expanded during the first two decades of reform, but the growth of services has slowed over the past 10 years for four reasons: first, the undervalued Renminbi raised the profitability of exports, which were primarily manufactured goods; second, the Peoples Bank of China's (PBOC) low interest rate policy, which began in 2004, helped capital intensive industries, further favoring manufacturing; third, the abandonment of full cost pricing for energy and fuels in 2003 also subsidized manufacturing; and fourth, government policies restricted the entry of private entrepreneurs into services businesses.

This pro-manufacturing policy mix was similar to that of Korea during the 1990s, before the Asian financial crisis triggered Korea's belated move to liberalize the service sector.

If China's leaders recognize the need to shift from the policies of the last decade and appreciate the lessons from other Asian development experiences—as seems to be the case—there should be private sector opportunities in service sectors such as IT, leasing and business services, and of course finance—and perhaps also in activities such as education, health, science, water conservation, and even the provision of public services.

Lessons of Innovation

Having recognized the strong performance of China's private sector—and its potential role in China's economic transformation—I would like to turn to a third topic: Lessons of Innovation that may assist China's entrepreneurs.

In 1776, the year my country declared its independence from the British Empire, Adam Smith, a Scotsman, wrote The Wealth of Nations. Smith explained that national wealth did not arise from mercantilist restraints on trade intended to build surpluses; wealth originates instead from a legal order of property and exchange that encourages the rational pursuit of self-interest through open, competitive markets.

Adam Smith viewed private business people as producing things of value in order to achieve their own gain. Yet in the pursuit of self-interest, business people are led by an "invisible hand" to benefit society as a whole by producing goods and services that others value.

Yet private sector competition is disruptive, and therefore leads some governments to shrink from its achievement because of the consequences.

Early in the 20th Century, Joseph Schumpeter, an Austrian economist who later taught in the United States, explained that entrepreneurialism leads to a "creative destruction." Capitalism, according to Schumpeter, is not just a system that administers existing structures, but one that "creates and destroys them."

Schumpeter believed that entrepreneurship is a fundamental driver of growth and development. Entrepreneurship transforms low-income societies with subsistence self-employment and low productivity into new businesses, wage employment, better jobs, and improved living standards.

According to Schumpeter, the innovation of entrepreneurs extends beyond invention: Entrepreneurs have to figure out how to use inventions—through new products, means of production, and even forms of organizations. That is what all of you are discussing and doing.

More recently, Professor Robert Schiller of Yale summarized the fundamental basis for innovation and entrepreneurialism: "Capitalism is culture. To sustain it, laws and institutions are important, but the most fundamental role is played by the basic human spirit of independence and initiative."

In his recent book, The Innovators, Walter Isaacson explains "how a group of hackers, geniuses, and geeks created the digital revolution." Isaacson's book is about entrepreneurialism at the technological frontier, a special category of creativity. It is a tale of innovation in different forms: physical devices, computers, transistors and related processes—programming, software, and networks. This spirit of enterprise extended to innovation in services, organizational structure, corporate culture, and management.

Isaacson suggests that the "great innovations of the digital age sprang from an interplay of creative individuals… with teams that knew how to implement their ideas." The creativity arises from a collaborative process and is the result of ideas that flow from many sources. According to Isaacson, "rugged individualism and the desire to form associations [are] compatible, even complementary…."

He explains that successful innovation in the digital age requires at least three components: "a great idea; the engineering talent to execute it; and the business savvy… to turn [the idea] into a successful product."

Yet some entrepreneur must still push ahead. As Bill Gates explained, "An innovator is probably a fanatic, somebody who loves what they do, works day and night, may ignore normal things to some degree and therefore be viewed as a bit imbalanced."

Entrepreneurial innovators may also conceive of totally new markets instead of chasing old ones. That is what Texas Instruments did in the 1960's when it produced and marketed the small pocket radio.

Indeed, one theme of the digital age is recognizing how technology can make devices personal.

Another theme is the need to be alert to how synergies between industries can create symbiotic opportunities: for example, together computers and microchips produced a dramatic fall in the price of pocket calculators, creating a new market; similarly, a half century earlier, the decline in oil prices created the opportunity to invent a whole new sector: the auto industry.

So how might this experience with innovation and entrepreneurialism contribute to China's economic transformation?

To start, the more sectors that China opens to private sector competition, the greater the likelihood China will unleash its innovative potential. Competition requires ease of entry—and necessitates processes for exit. Competition involves risk—and acceptance of failure.

The open competition should not be just for Chinese businesses. As Deng Xiaoping recognized, foreign firms bring know-how, organizational experience, and access to international markets and ideas—as well as make investments and create good jobs.

International business can also speed adjustment processes, including in interior provinces. When high tech multinationals have invested in Chinese cities—including inland metropolises such as Chengdu and Xian—they have supported industrial upgrades, encouraged spillover benefits to local Chinese businesses, and enhanced cities' reputations as science and technology hubs.

To ease the social dislocation of this creative economic destruction, China needs to help people adjust. Effective social policies can assist people to receive education and training, new jobs, finance, quality social services, and portable social security that is linked to individuals, not jobs or factories. Indeed, just as Chinese businesses have learned from the experiences—and mistakes—of companies in developed economies, China's government can create an effective and efficient social safety net that avoids costly problems now burdening many developed economies.

The World Bank-DRC China 2030 Report also recommended that the Chinese government's role in innovation should shift to match China's higher stage of development. Instead of targeted attempts to create specific technologies, China should develop institutions and an enabling environment that supports innovation throughout a competitive market economy.

For example, China should encourage quality tertiary education that helps students look beyond the rigid boundaries of separate academic streams. Schooling should stress learning competencies, not just meeting qualifications.

Intellectual property needs to be protected through laws and enforcement.

Countrywide research networks could be supported by research consortia drawing on firms from interior and coastal cities, as well as multinationals.

And new, growing businesses will need risk capital provided through financial innovation, including early stage funding, angel investors, venture capital, private equity, corporate equity and bond markets, and commercial banking.

There are many opportunities for China to integrate technological innovation and entrepreneurial business in ways that advance development.

For example, China's rapid urbanization offers opportunities to unite the infrastructure of intelligent cities, energy-saving buildings, low carbon and large-scale public transport, institutes that support innovation, a new industrial base of science and technology workers from heterogeneous fields, and firms that invest in R&D, digital networks, and online services.

An aging China will benefit from innovation in health care: extending from basic research in bio medicine, to the use of ICT in health care management, and on to new systems and institutions for health care finance and management.

Green technologies and renewable energy sources offer opportunities, too.

This is an exciting time to be an innovator and entrepreneur in China.

<u>International Linkages</u>

These fascinating prospects bring me to my fourth and final topic: the international linkages between China's private sector and the American and global economies.

Over 30 years, spurred by Deng Xiaoping's belief that China needs to open to the world, both China's government and businesses have looked outward for ideas, experience, investment, and markets. Then Chinese officials and entrepreneurs adapted these inputs with "Chinese characteristics."

Former Premier Zhu Rongji used China's accession to the WTO to import rules and competition, making China into a manufacturing powerhouse.

Alibaba's innovation combines business and technology elements from Amazon, Google, and PayPal. Alibaba transacts 80 percent of China's online commerce and expects to surpass Wal-Mart in sales this year. Jack Ma recently told the Economic Club of New York that, "Alibaba was founded in China, but created for the world." Mr. Ma went on to explain that, "We want to connect small business in the West with the largest, fastest-growing market in the East."

China's foreign direct investment is increasing, too, including in the United States and the European Union, and Chinese private investors and businesses are leading the way.

According to the Rhodium Group, Chinese firms completed $12 billion worth of deals in the United States in 2014, topping the $10 billion mark for the second year. The number of Chinese acquisitions in the United States reached an all-time high of 92, three times as many as in 2012. Chinese private firms accounted for 81 percent of the value and 76 percent of the transactions.

Chinese FDI seems to be seeking technologies, market know-how, managerial and process capabilities, and brands. There is also an increasing interest in foreign real estate. The primary sectors of interest in the United States in recent years have been food and agriculture, ICT, pharma and biotech, and entertainment. The energy sector was also of interest in past years, and although it fell off in 2014, the recent drop in oil prices may revive private sector deals.

The lessening of governmental restrictions on outbound investment by Chinese financial firms is opening the way for more foreign acquisitions by Chinese insurance firms, private equity, and financial conglomerates. Fosun is a leader in these activities. Chinese small and middle market deals, both globally and in the United States, are catching up with mega-mergers.

These positive trends are, however, at risk of being overshadowed by rising dangers.

As China developed, it created interests that argue that China's markets should be protected against foreign intrusions. As you know, the theme of China separating itself from the rest of the world—as a Middle Kingdom between heaven and earth—resonates through history. There is also an old Chinese conception that

China's relations with others should be defined as tributary ties, not as exchanges among trading partners. And some Chinese interests will simply argue that China's market is now big and wealthy enough that it should be reserved for Chinese actors.

This protectionism has a special appeal for some companies in innovative sectors where the requirements and purchasing patterns are still fluid. They may push for unique Chinese standards and restrictive procurement rules that block foreign competition.

This path of protectionism would cut China off from new ideas, external research, and opportunities to adapt foreign technologies. The trend in global R&D, in contrast, is similar to other areas of economic activity: increased specialization; more extensive exchange of ideas and know-how; and frequent exchanges of research personnel. Open exchange requires mutual trust—including through efficient patenting and enforcement—especially in cutting edge sectors such as biotech, nanotech, software, and multimedia.

Long-standing frustrations with China's weak enforcement of IPR are now combining with red-hot worries about Chinese commercial cyber-espionage to create pressure for retaliation.

Cybersecurity incidents are destroying confidence in the benefits of China's international connectivity.
Our governments need to reach understandings about cybersecurity behavior, especially concerning commercial espionage, which the United States does not conduct.

I also believe China and the United States should expand and adapt international rules and institutions to encourage Sino-American and global economic and business connections.

These rules can support China's reforms and the expanding role of China's private sector.

I was the U.S. Trade Representative in 2001, when we completed China's accession to the WTO. At that time, a senior Chinese negotiator explained to me that the WTO requirements would assist private business in China. The WTO, for example, requires that member states offer "national treatment" to foreign companies. The requirement of national treatment simply means that while any country is free to establish its own domestic rules, those rules must be applied equally to foreigners. The private Chinese companies argued that if foreign businesses had to be treated like China's state firms, China's private businesses would have a good case for equal treatment with state firms, too!

Today, China is negotiating Bilateral Investment Treaties—or BITs—with the United States and the EU. Those BITs include basic protections for investors. Those rules would support the internal reforms that China's government is now pursuing.

Similarly, countries are now negotiating in the WTO to liberalize global services markets. If China committed to opening its services market in order to join those WTO negotiations, it could accomplish multiple purposes: help establish global rules; clarify China's rules for private sector competition; invite foreign competition that would strengthen Chinese markets and benefit consumers; and open possibilities for Chinese service sector firms to expand around the world.

Working with the IMF, the United States could also encourage China to complete reforms to open China's capital account. These reforms could enable the Renminbi to become a global reserve currency, included in the IMF's Special Drawing Rights, or SDRs.

The United States should also be open to Chinese initiatives to strengthen the international economic system to the mutual benefit of both countries. For example, the Chinese proposal for an Asian Infrastructure Investment Bank could serve a useful purpose. I have suggested specific steps that would support the AIIB while strengthening its capacities to foster good economic governance, fight corruption, encourage competitive and open procurement, and incorporate environmental safeguards.

Conclusion

Shanghai, as epitomized by the Bund, is one of the world's great financial and trading centers. Many of you contributed to the achievement of that preeminence.

Yet as historians know, Shanghai's fortunes, like those of other hubs of international commerce and capital, depend on the prospects of the national economy it serves and the global economy with which it connects.

I believe that private business entrepreneurs and innovators—all of you—are the creators of opportunity, higher incomes, and better living standards. You help unlock the potential of societies and individuals. I have seen the amazing benefits of technological and entrepreneurial change in my own country. And I believe China, like the United States, enjoys a dynamism that can move the world.

China now faces a generation of challenging structural reforms. The old growth model of the past 30 years produced incredible results, but is no longer suited for this era. The new growth model will need to draw on your enterprise, in fresh ways, with new businesses, in open markets. I believe it can. I hope it will.

This changing China will also need to navigate its course in an evolving world economy. Change creates uncertainties—opportunities and fears.

Ten years ago, when I served as U.S. Deputy Secretary of State, I urged China to become a "responsible stakeholder" in the world's economic, security, and political systems. Those systems—which the United States had help build after the Great Depression of the 1930s and the devastation of World War II—created the conditions of security, growth, trade, and investment that enabled the hard work of the Chinese people to produce epic results. China has a continuing stake in the success and adaption of that international system.

I hope that private sector groups such as this one—and your businesses—will contribute to building a better, more innovative, and more resilient international order, too.

"From Manhattan to the Bund" is a good place to start. Now the network needs to grow.

Thank you for inviting me to offer some ideas on how we might grow together.