Transcript of the Interview with Michael Pettis

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Michael Pettis
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Industry: Academic

Michael Pettis is a Senior Associate at the Carnegie Endowment for International Peace and a finance professor at Peking University’s Guanghua School of Management, where he specializes in Chinese financial markets. He has taught, from 2002 to 2004, at Tsinghua University's School of Economics and Management and, from 1992 to 2001, at Columbia University's Graduate School of Business. Pettis has worked on Wall Street in trading, capital markets, and corporate finance since 1987, when he joined the Sovereign Debt trading team at Manufacturers Hanover (now JP Morgan). Most recently, from 1996 to 2001, Pettis worked at Bear Stearns, where he was Managing Director-Principal heading the Latin American Capital Markets and the Liability Management groups. He has also worked as a partner in a merchant banking boutique that specialized in securitizing Latin American assets and at Credit Suisse First Boston, where he headed the emerging markets trading team. Besides trading and capital markets, Pettis has been involved in sovereign advisory work, including for the Mexican government on the privatization of its banking system, the Republic of Macedonia on the restructuring of its international bank debt, and the South Korean Ministry of Finance on the restructuring of the country’s commercial bank debt. Pettis is a member of the Institute of Latin American Studies Advisory Board at Columbia University as well as the Dean's Advisory Board at the School of Public and International Affairs. He received an MBA in Finance in 1984 and an MIA in Development Economics in 1981, both from Columbia University.
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Transcript

Interviewee: Michael Pettis
Interviewer: John Delury
Date: April 21-23, 2009
Place: Beijing (China)
John's intro on explaining archive for a hundred year's hence; introduce yourself

MP:

00:50: Um, I started my career um after you know the various graduate degrees and stuff uh working on Wall Street in, in the Latin American markets, at the tail end of the big crisis of the 1980's. And um, I was born in Spain, I lived many years in Peru, and had a strong, sort of, not Latin background, but great deal of interest in Latin America, and that was always the area I wanted to go into. So I spent most of my career, about 15 years on Wall Street, focusing first on Latin America, and then on developing countries. And my background was always in bond trading or in capital markets. Um, at the same time beginning in, in 1992, uh, Columbia business school, first Columbia business school, and then later the school of international affairs, asked me if I would uh, uh, come and teach on Latin American finance and eventually emerging markets. And I taught courses on finance, I taught courses on something that interests me a great deal, which is the history of capital flows to developing countries. So my career was sort of a mixture of Wall Street and academia, um, focusing just generally on financial flows and developing countries.

02:01: Um, then in uh, in in 2001, I decided to take a one week holiday and come to Asia. I’d done some work in Asia but not a whole lot. I had advised the Korean government on the restructuring of its debt after the 1997 crisis, and I’d done some work in the Philippines, ah, but that was about it. And so um, in typical Wall Street fashion as, as China became more and more important, and as uh, as a so-called expert on developing countries, I did the Wall Street thing, I figured I’d go to China for a week and then come back and declare myself an expert on China. Um, and so I came here on the holiday in Beijing and Shanghai, and I was just so blown away, by the, just the excitement, the sense of change, the real feeling that, that stuff was happening here. Um, when I started as a freshman in Columbia, I remembered I’d grown up all over the world and after one week in New York, that’s it, I know where I’m going to live for the rest of my life, I’m never leaving New York. But after a week here in Beijing it’s like, there’s, there’s so much going on, it’s such a historically important process, and this is probably the only chance in my life ever to participate in something so big. So on the flight home, literally it was a very difficult flight, because it was like, so what am i going to do about this? And I decided that i would move out to China. And I thought perhaps coming out here as an investment banker, but the trouble with being an investment banker is you work so hard that you don’t really get a chance to learn all the kinds of things you wanted, you want to know about. So I thought since I’d been teaching at Columbia that maybe there was some way I could, I’m not a formal professor, I don’t have a PhD, but I thought I could use 9 years at Columbia to scam my way into a Chinese university.

03:40: And it turned out we had just hired a kid ah, from Chicago Business School who was one of the ten most wanted after the Tiananmen, after the June Fourth affair. And he was the first one put in jail, and I believe it was Clinton who got him out of jail. And he came to the States, went to business school, and we had hired him. And um, so when I got back I took him aside and said, "Don't tell anybody but I'm thinking of quitting and going to
China. And I’m wondering if there’s any chance in hell that I could ever be a professor in a Chinese university." And I thought that would be a very difficult process. And he said, "Oh don’t worry, I will get you a job in the best university in China." And this was in March and true to his word by May Qinghua University, which is, which was his school, had made me an offer to go there for two and a half years to teach. Um, two years to teach. And my plan was to go to China for two years, learn as much as I could about China, um, and then uh, and then come back to New York, return to Wall Street, and... do whatever. At the end of my two years of Qinghua, I thought, OK I want to spend one more year here, and so I asked for an extension of the contract, and they were kind enough to say yes. And at the end of that, I, I kept hearing the two most famous universities, the top universities in China are Qinghua, and the cross the street rival, Peking University.

04:59: And I thought it might be fun to go, and teach at Peking University for a little bit. And so I went and met with them and they made me an offer and that’s basically little over seven years ago. Um, I just discussed with them extending my contract for another two years, and probably at the end of two years I’ll extend it again. Um, I’m finding it very, very hard to leave China, it’s just been such an exciting place to be.

JD:

05:23: Um maybe maybe one place we, we can go, just from what you said there, when you talked about you were sort of immediately aware this was a historically important process, unpack that a little bit. What, what here is of, kind of historic importance?

MP:

05:37: Well China was clearly making that transition from being a country that was pretty marginal to the world economically, politically, and everything else, to becoming one of the central countries. Now I, I’ve never really bought this, the, some of the China hype about, in 10 years, 15 years, China will be the world’s largest economy, the world’s sole superpower, that’s all nonsense I think. And I guess the people watching a hundred years later will know if I’m right or wrong, um, but China has some really really significant problems. But there is no question that uh, when I came to China, it represented maybe 3 to 4 per cent of world GDP, and to me there was no question that it would end up, unless you had a small probability event of a, some kind of political break-up, that it was going to be, if not the largest, probably the second-largest economy in the world. Um, that it also represented, people talk about the rise of China and the assumption is that there is ah... comparative decline in US relative power.

06:35: I’m not sure I agree with that either, but what I do see, is, partly for demographic reasons, and partly for other reasons, Europe and Japan are in very serious trouble, and their economies are contracting as a share of the world very quickly. And it just seemed to me that this rise in China and this contraction in Europe and Japan meant that (cough) when you think about the 20th century, almost everything, culture, science, politics, war, sort of revolved around the US-Europe axis. And it just seemed to me that the 21st century it was going to revolve around a US-China axis. And that’s just a major transformation, and
it just seemed like something that uh, that would have, ah, very important historical impacts (cough). Um, a co-professor at Columbia by the name of Dan Rosen who specialized in China, when he heard I was coming out here, he told me something that I thought was very interesting, he said, "In the next ten years, more history will be made in China than anywhere else in the world." And I think that was a pretty smart statement, and that's really what drew me to China, that sense of massive historical change.

07:39: And then of course being able to teach at Qinghua and Peking University, which I later realized were um, dominated Chinese business, and political, and financial, and cultural life the way, you know, there's no equivalent in the US. Um, that meant that not only could I watch this whole story unfold, but by teaching the kids at these two schools, um, I could actually play a role by teaching students who were going to end up running the country, running the show. And since these are some of the smartest kids in the world, but at the same time, one of the worst educational systems in the world, especially for very bright kids, um, bringing a much more American style, and American universities probably don't do a great job of educating the bottom half or even the bottom two-thirds, but American, American universities are absolutely brilliant at, at, you know, the sort of elite students, the top 5% or whatever. And bringing those kinds of techniques to a place like Qingua or Peking University, would have a big impact on the students, and it would really help them in their future careers. So it was a chance to get involved in a very direct way, and not just watch an important historical transformation taking place.

JD:

08:52: Um, our, our project is you know, we're calling this phenomenon the boom (mm hm), um and we're mostly describing it as a 30 year you know (right) somewhere between 9 and 10 per cent annual GDP growth since 78. Um, what's your you know you picked up being here watching closely since around 2000-2001, but obviously you have a working picture of the bigger, say 30 year spectrum. Um and what even preceded that. How do you, how do you first of all define that 30 year boom? I mean, is that accurate? And how do you account for it? What's your working explanation?

MP:

09:32: Um, well before coming here, one of the, one of the simple but very effective little tricks that I have is to really study financial history and economic history. You learn so much about um, uh, about financial processes in general but around specific countries by looking at their financial history and their economic history. And it's a very cheap way of getting a reputation of being good at predicting, because all you have to do is say, basically, the range of things that happened last time around are going to be the same range of things that happen this time around. Um, so in that, in that sense, the last 30 years are certainly a unique period, but another way of looking at it is that the 30 years before that were a unique period that interrupted um, uh, quite a lot of growth. Because China was growing quite well during much of the 20th century, uh, I believe for the first 30 years of the last century Chinese manufacturing output was expanding by around 10% a year. So there was
some pretty significant growth, but certainly from, from let’s say, the Anti-Japanese War until 1978, China was in a relatively stagnant period.

10:39: Um, and then from 78 onwards something changed. Now, one of the things that’s very interesting, you don’t want to overstate demographics, but, it’s very interesting that from basically the early 50s until 1975 until the mid-1970s, China had a real demographic problem. And that is that the share of the population that works, that is between the ages, let’s say we can use between the ages of 18 and 65 as as proxy, was contracting quite rapidly. Um, and in a lot of countries we’ve seen, when this dependency ratio we call it, when it deteriorates there is economic stagnation. And there was something very close, I wouldn’t call it stagnation, but there was very weak growth in China during that period.

11:24: Beginning around 19-, about the mid 1970s, the dependency ratio began very rapidly improving. Um, largely because of the one-child policy. Um, the, the dependence, or the old and the young, and when you eliminate the young the working population is a much bigger share of the total population, so the dependency ratio in China, and I’m speaking off the top of my head, but it improved from roughly 50% in the mid-70s to somewhere in the low 70s in the next 3 or 4 years its peaks out. Um after that it begins deteriorating very dramatically and one thing about the improvement in the dependency ratio it means that while the overall population may have been growing by around half a percent a year, the working population was actually growing at something like 2% a year, at a much much faster rate. And I think we shouldn’t underestimate the impact of that tremendous improvement in demographics. And if I’m right, then the next 30 to 40 years we’re going to see a great slowdown in growth, because that demographic sweet spot is reversing, and we’re now going to see the working population contract much faster than the total population, which, will be a little, stable to slightly down.

12:34: Um, that was very important, um, but other things happened there too, and I, I sort of divide um, the... 30 years of growth into broadly speaking three periods, and we’re at the end of the third, and we’re now going to enter into the fourth period, a much more difficult period. And those periods are. In, in the 1980s when the first spurt of growth, um, much of the growth was really achieved by unwinding economic policies that were quite frankly idiotic. Um, a lot of the stagnation that took place, took place because of very poor economic policies, and very poor economic planning. Um, so that even simple things, like in the 1980s, it no longer, of after 1978, it no longer marked you as a criminal to sell stuff in the street. Now decriminalizing market activity has a huge impact on the underlying economy. Other things that happened was that a small portion of the collectivized land was turned over to households, and they were able to keep everything they grew on that land, above some quota that they had to give to the government. Before that of course everything that you grew was given to the government, and, and a portion of it was given back to you. So there were all sorts of problems with that, but among other things, there was no incentive to really increase productivity, because if you did, what you gave to the government would simply increase by exactly that amount.

13:56: Once, uh... peasants households were able to retain a portion of what they grew, not surprisingly productivity nearly doubled, and nearly doubled for all of it even though what
was given over to the peasants was probably less than 5% of the land. Um, so things like that had a huge impact on growth. And the healthiest period of Chinese growth was really in the 1980s, where you really did see an elimination of a whole series of rules that constrained economic growth, and productivity shot up. In the 1990s, beginning in the early 90s, things changed, um, and suddenly productivity growth slowed down a lot. At the same time you’re sort of seeing a reversal of many of the market reforms, and much more focus on, sort of a state-led industrial expansion, um, and for me much of that growth really occurred as a consequence of mass, massive fiscal expansion. And the fiscal expansion didn’t take place the way fiscal expansion normally does, it took place by uh, banks being forced to make what should have been grants by the government but were called loans.

15:04: And most of those loans were non-collectible. So um, there was, not most of them but a significant amount, so there was lending into whole ar-, whole series of areas that were policy-driven. And basically when you pump money, when you pump fiscal deficits into any part of the economy, that part of the economy grows very quickly. What was bad about that period is that all the growth took place in, in, in manufacturing, in heavy-industry, in capital-intensive sectors, and a lot of the entrepreneurialism that we saw in the 1980s sort of withered away. In the 1980s the informal banking sector was treated with far more respect, and it’s a much, much better functioning part of the system, but it’s not controlled by the government. Um, in the 1990s you started seeing a tax on the informal banking sector and a much more of a sense of corralling resources into state-led sectors. So China still grew very rapidly but it did so at the expense of a mass of, uh, massive expansion in the fiscal deficit, indirectly. So it didn’t show up as government debt, it showed up as bad loans in the banking system, which are ultimately government debt.

16:08: The World Bank estimates that the cost of cleaning up the debt, the banking system was around 55% of GDP, so (cough) you can sort of argue that the fiscal expansion drew debt levels from 0 to maybe 70 or 80 per cent and that’s a significant expansion in government debt. Fortunately China was growing very very quickly so it could grow out of that problem. By the time it cleaned up the banking mess in the early 2000, in the early decade of the century, um, the uh, they were able to leave much of that problem behind them. And that really was where the third stage of growth occurred. And the third stage of growth occurred really as part of this massive global bubble, and China played a key role in that bubble. After the 97 crisis it’s very interesting that a number of indicators changed dramatically.

16:59: First of all American household savings collapsed to levels it had never before reached in history. The US trade deficit expanded to levels that it had never reached before, I think the highest the trade deficit had been in the 20th century was around 3 and half per cent of GDP. By, and, it was normally less than 1%, so it had declined, after the 1980s it had declined back down to around 1% of GDP, and then beginning in 97-98-99 it started expanding again to the point where it reached um, 7% or more of GDP by 2007. Um, and this, this was very very important for a bunch of reasons. China had a uh, monetary regime; it has a currency regime. Basically it has no monetary policy. It sets the level of the currency, um, so, the Chinese, as well as a number of Asians after the 97 crisis,
were so scarred by the impact of the crisis that they decided to build defenses against its ever happening again.

18:00: And the 97 crisis was largely a currency mismatch crisis. In other words, countries had currency obligations, dollar obligations that far exceeded their dollar assets. And as long as they could continue refinancing those obligations there was no problem. But as the trade deficit started to grow and as central bank reserves started to contract, people became nervous, and they started taking money out of the country, and they stopped renewing loans, etc. So eventually the, uh, central banks were unable to defend the currency, the currency collapsed, and when the currency collapses, anybody with dollar debt, external debt, and that, that included many of the biggest borrowers in these countries saw their debt levels shoot up. And that led to the whole crisis of 97-98. And so China, like other countries in Asia, decided that the way to deal with that is to engineer trade surpluses and build reserves. But their, their plan was too successful.

18:56: Um, and it was successful for a bunch of reasons. Um, one reason could've been, um, the uh, 9/11. The United States, in reaction to 9/11 and in concern that it might cause a, a freezing of the economy, flooded the markets with liquidity. Another thing that may have been, that had, that may have had a very serious impact was the Iraq war. Historically, unpopular wars, like the Viet Nam war, and the Iraq war, tend not to be funded by taxes, they tend to be funded by monetary expansion. And it’s interesting during the 1960s we had a monetary boom and again in the last decade we had a monetary boom. I think those are not coincidental, um. But, this combination of events, uh, the US Fed flooding the market with liquidity in response to 9/11, and then a response to the Iraq war, um, China, and other Asian countries determined to build up reserves by pegging the currency and holding the value of the currency and engaging in other industrial policies aimed at constraining consumption and boosting production, um, caught the whole world in this cycle. Um, in this, which almost got out of control, in fact it did get out of control, in which you had, if we simplify the world into two countries, China and the United States, which is a reasonable simplification, um, Chinese monetary policy was massively expansionary (phone rings), uh, and it was expansionary towards uh, boosting um, production. Can I interrupt...

20:45: So if you look at the two systems. In China, you had trade surpluses, and the way the monetary system works in China, it basically doesn't have a monetary policy, it has a currency regime, which means that the central bank of China has to buy all the net inflows of dollars. When they buy those net inflows, they have to pay for it, and they pay for it by creating currency. Now the Chinese financial system consists mostly of the banking system. So as the central bank created currency it all was deposited into the banking system. The banking system has never really learned how to make consumer-based loans, or loans to the service sector; everything has been channelled into the prod-, into investment, into manufacturing investment or infrastructure investment. So as all of this money was channelled into manufacturing, Chinese production grew, much faster than Chinese consumption. Now the problem is that the trade surplus is the excess of production over consumption, and as production was growing faster than consumption, that meant the trade surplus was growing, (knocking on the door, door opening) but the
trade surplus represented money coming into the country, which, which the central bank had to monetize. So the central bank was caught up in this circular process where rising trade surpluses meant more money coming in, more money coming in was channelled even more into manufacturers, who created more production, who created rising trade surpluses. So China was caught in this loop (motions hand in a loop, then gesticulates for expansion), where money, money expansion was out of control. And then it was all going towards uh, increasing production. Can I interrupt...

22:20: ...This loop of out of control monetary expansion leading to out of control growth in production. Now, somebody has to consume that stuff. And on the other side of it we had the United States, which had its own loop, and that is, that as this huge trade deficit was recycled back into the American securities market, that created a massive expansion of liquidity in the US. And when you have massive expansion of liquidity, the financial system has to accommodate and it does so by increasing credit (other background murmuring), so whereas in China they were increasing credit to the manufacturing sector, in the US they were increasing credit to the ah, consumer sector. Um, which was a marriage, it seemed, made in heaven (other background voices quite audible), because the Chinese were producing way too much, Americans were...

23:16: So China was producing way too much, and its monetary system was pumping production up, America was consuming way too much, and its monetary system was pumping consumption up, so everything was fine. Chinese overproduced, Americans overconsumed, great. The problem with that is that both systems depended on an infinite capacity to borrow on the part of American households. Because debt levels were getting higher and higher and higher. And at some point, unless you believed that American households could borrow forever, that would have to stop. And um, as balance sheets became more and more unstable, it took a smaller and smaller shock to set the whole thing in crisis. And the shock turned out to be the sub-prime crisis in 2007. Which caused, for reasons that are much too complicated to explain here, but which I’m sure in a hundred years will have been written about a thousand times, it caused a massive collapse in the ah, in the credit sector in the United States. Suddenly ah, American households can no longer consume, because their ability to borrow to consume has been constrained.

24:18: And that means China has to adjust. And at this point in time, we’re only starting to become aware of the amount of adjustment that China has to make. It’s something that I’d been arguing for years, that the adjustment would be very difficult for China. At the time, I think most people thought the argument was crazy, China seemed immune from the crisis. I argued that China would be worse hit than other countries. And I think we’re now starting to shift, so we’re now going into the fourth phase. So we’ve had, the first phase of the, the easy reforms, the second phase of massive fiscal expansion, the third phase, the bubble, the out of control monetary growth, and now, that, that period is ended, and we’re now entering into the phase in which China has to make an adjustment from being an export-led economy to a domestic economy. This is a necessary and important adjustment; China must make it. But what I think many people don’t realize is that historically, countries that make that adjustment do so very slowly and under conditions of great difficulty.
25:20: There’s a lot of very excited talk about in the next year, in the next two years, Chinese consumption will rise to make up for the decline in US consumption. But if that happens it will be... an historically unique event. The United States, when it shifted from being export-oriented to domestic market-oriented, took place after, took place quite a long time ago, after the Bank of England’s seven, 1797 crisis, which began a very difficult period for the United States, the Napoleonic Wars, the US quasi-war with France. And basically the export industry got killed and the US began reorienting itself towards domestic markets. Japan has gone through that process also. After the, after the 1990 crash, the Japanese development model, which was also export-oriented, shifted towards more of a domestic market-oriented, and as of 2009, we still haven’t the end of that shift. Japan has gone through 20 very difficult years trying to reduce its reliance on export-orientation. And my guess is that we are now going to see China go through one or two decades of much slower growth, which in addition to the demographic contraction, means that the growth rates of China are probably going to be much much lower than people expect. And for the viewers a hundred years from now, the, the hype about China is as crazy as the hype about Japan was in the 1980s. And even very smart people are projecting 30, 40 year growth rates of 8-9-10% a year, uh, which is lunacy, it won't happen. Um, growth rates are going to slow down significantly, partly because of the demographic problem, partly because the transition is always very, very difficult, um and we’re, we’re out of those, out of the games that worked in the past.

JD:

27:11: Um, I, I understand a good deal of you know, within each phase, especially as you get to the later phase, but I was curious if you could go back, especially to that first transition, sort of what accounts for it? You know um what accounts for the shift from one to two? From two to three? To three to four? But maybe especially that, that first one. Is this, and may-, I don't know if it gets us into the political economy, you know more the, the political side of it, and...

MP:

27:38: Edited

JD:

29:42: Um, when we, when we talk about the boom, I get, especially because of how much of your analysis is looking at monetary expansion and, and um, sort of excessive um um, liquidity, you know, how do you separate what in this boom is real growth, and how much is to some extent illusory? Um, you know what, and, and, and here drawing maybe on your personal experiences too, in terms of, in the lives of, of, Chine-, the lived economy of China (Right), what’s the, what’s the picture here of you know...
30:22: Well there’s, there’s, you know, my views is constrained because I live in Beijing and I go to Shanghai a lot, and they’re, they’re clearly a completely different China from the inside China. I do travel a lot around China, and when you travel around China, you realize that it is an extremely poor country. Um, but having said that, there’s clearly been a huge improvement in the living standards, in a whole variety of measures, um, other measures there’s been deterioration, most obviously the environment, but generally speaking, the quality of Chinese lives, and... sort of economic prosperity has been pretty dramatic and pretty general. Now, this is a controversial statement but, booms are not necessarily, or bubbles, are not necessarily bad. They’re very destructive and they create a lot of unhappiness when they burst, and a lot of happiness when they happen, and they’re often compared to cocaine parties, it’s great fun until it’s over. Um, but there’s also some good that does come out of bubbles, it seems to me, in that historically each of these big globalization bubbles has coincided with a stage of the industrial revolution...

(Interruption by people passing through; cut to new clip, MP giving sports tap to random passing Chinese)

MP:

31:34: Um, uh, each of the the, these big globalization cycles of the last, certainly of the last 200 years, has coincided with a stage of the industrial revolution and most recently the 1990s in the last decade, the Internet, the computer and information systems revolution. And I think that’s not a coincidence, because I think when you have this, massive monetary expansion, um, you also get a huge increase in risk appetite. Among traders, we call it "stretching for yield"; investors go into riskier and riskier securities, riskier and riskier investments, and risky could be lending to a developing country that has no chance in hell of repaying it, or it could also mean going into high technology, which is very very risky. And in my opinion, industrial revolutions are really created not by scientific innovations, but by the sudden rapid commercial application of scientific innovations. After all, the Internet wasn’t invented in the 90s, it was invented in the 60s, and personal computers were invented in the 70s, but the revolution didn’t occur until basically the 1990s. And I think that has to do with the fact that when you have this, this huge increase in risk appetite and the willingness for investors to invest in riskier and riskier ventures including high technology, suddenly you see a massive expansion of technology. Whether it was railroads in the 1860s or radios and washing machines and electricity in the 1920s or the Internet, or the Internet now. So there are many good things that come out of these things, um but it is a very destructive process.

33:07: And from that point of view we need to see what happens over the next 5 or 10 years to see how the, the total impact of this recent credit bubble will have on, on Chinese lives, on, on the average income of Chinese. Um, because so far we’ve been through the fun part and now we’re going to have to go through the tough part and see. I’m not suggesting that it is all going to be like the 1930s for the United States, although that’s not totally out of the realm of possibility. Um, but I am suggesting that we’re going to see growth slow down
and we may see greater disparities in... wealth and things like that. And so that has to be part of the overall package. But I would be very surprised if looking back from the year 2020, let’s say, that we hadn’t seen over thing 20 year period, the 30 year period, the 50 year period, a huge improvement in the standards of livings in China and a huge improvement in ah per capita income.

JD:

34:04: What’s your sense of the role of human capital in China’s you know development? And, and here again, I think it would be interesting to draw on in the most recent phase, in the last 8 years of the boom, when you’ve been here, (Right) working closely with students, you know in terms of the thinking about development, the thinking about economics about, (cell phone rings) the increasing sophistication or not, I mean what’s your sense of, at different stages, of this 30 year evolution, the role that that’s played. Both at an elite level and maybe at a broader base level.

MP:

34:38: Um well you know, just the brute, raw facts are that as per capita income rises, um, people are able to focus on a whole variety of different things. They’re able to get more education, and, you know instead of worrying about simply extracting food from the ground, you’re now living in cities, and getting involved in lots of other things. So human capital is definitely developed, but not nearly as quickly I think as many of us believed. Um, I think um, uh, you know my experiences for example in hiring are two very very different levels. On the one hand as a former investment banker I spend a lot of time talking to the big investment banks about hiring my students, those are the most prestigious jobs for elite students at elite universities. And the investments banks feel that it’s very very important to hire Chinese students because they want to be major players in the Chinese markets and of course you want locals to drive that, but at the same time there’s a great frustration, um. My students are probably among the smartest, if not the smartest in the world on average. Um, the Chinese university system, to get into an elite university, is brutally competitive.

35:46: Now it has big problems with it. If you’re in the least bit imaginative, you will almost certainly be dropped out of the system or go to a second-rate school. Qinghua University, it’s a common joke there is that Albert Einstein could never qualify to get into Qinghua University, and that’s absolutely correct. To get in, you have to basically memorize for four or five years of school to take this one exam in which all the answers are very clear. There is one correct answer and everything else is incorrect, and there’s no discussion about that. So on the one hand the universities draw students who are the world’s greatest at taking exams and of course there’s a correlation between your ability to take exams and your intelligence, but it’s not a perfect correlation. So one of the problems in the university system is that A, we tend to lose our most imaginative and creative kids, they simply are not capable of following the um, the... required courses. Secondly, we also drive a lot of that creativity out of them, um, in Chinese schools you do not succeed because you are cleverer than the teacher, you succeed because you’ve memorized everything. And that has a very
very big impact on, on the way you think going forward. Um, so when the investment banks hire, they all say the same things. They say these kids are very smart, and very hard-working, and the moment you throw them the least bit unexpected, they're completely floored, they don't know how to handle it. An American kid would, you know, would actually be better at doing something he doesn't know how to do, sort of figuring out is part of the process in the States, and here it's just very very difficult.

37:26: Um, I also hire on a different level, because I own a music label, and we hire a bunch of people in order to sort develop the music scene here in China. And that's also been quite difficult because we try to work as a small partnership, as a start-up where everybody contributes, and everybody sort of pushes in the same direction, and it's often been very very difficult because many of the people who work with us, many of the Chinese who work with us, are much more comfortable in a very hierarchical situation where there's clearly a boss, the boss clearly tells you what to do, and you get it done, certainly you get it done while he's standing around. Um and we're trying to break that mold, and um you know, sort of like everyone needs to, you know, basically our argument here is, we don't know what we're doing, this is a very new business (cough), the CD business is in the process of collapsing, everyone is looking to figure out you know, how to create and grow a music business, particularly something that focuses on much more difficult, much more challenging, much more underground music. Um, so, nobody knows, no one can tell you what to do, you're just going to have to figure it out. And that's very difficult message to ah, pass around here. It's ah, it takes a lot of work, and we've had, often had problems with that. So I would say that um, the educational system here prepares Chinese very well for the transition from a, um, agricultural society to a early industrial society, factory worker society, a society where the roles and jobs are clearly defined. But going forward I think it's going to be very difficult to make the next transition, because the educational system here just doesn't, it doesn't really encourage that type of thinking, and... you know, sort of cultural norms and a number of other things reinforce that. It's not a tremendously creative society, it's not a society that puts a great deal of value on developing creativity and creating, developing, you know, the ability to think outside the box.

JD:

39:29: How would you apply that, that, that analysis to the, at the high level, over the last couple of decades, the economic policy makers, you know, what's your sense of. Cuz I'm just thinking as you were talking you know, some of them came even out of the revolutionary generation (Right). Deng himself, I mean they have a wild trajectory from you know, from studying in France in the late teens, through the Long March, to you know (Right) experiments with radical Maoism (mm hmm), etc., so probably able to think outside the box in a way you know, not formally trained and constrained in that way, um but you know, when... Some people look at the China Boom and just see it as, God how did they pull this off. You know, I mean, how much credit do you give, do you give to there being some real sophistication at high levels of economic policy makers who have made good calls to navigate it, or is that not you know, not, what do you see?
MP:

40:22: Edited

42:01: Edited

43:33: Edited

JD:

44:45: Are you, quick there, are you hopeful, uh about the future, about the next generation of leaders? I mean you’ve describe, described all the constraints, at the same time,

MP:

Well if my students, if my students take over (cough), then I’m very very hopeful because they're really bright, um...

JD:

And the universities have brought people like you here you know...

MP:

45:04: Not so many, but what's maybe more interesting is that more and more elite Chinese students go abroad for at least a semester or a year, and I think that has a very very big impact on the way they think. And I’m hoping that it has a big impact on opening up the way uh, Chinese think about the economy. One thing that we still have in China, which as an American, it’s something that's understandable, because I think in the States we had this problem in the end of the 19th and the beginning of the 20th centuries. Was we're, China’s still like an adolescent, it’s, it's got the body of an adult, it’s big and it’s strong, but it still doesn't really, it doesn’t have the self-confidence yet. So I think some of that is just waiting our way through. For example, this is very important in the music scene. When I came to China the most interesting Chinese musicians, the coolest Chinese musicians, were the ones that did the best copy of cool American or cool English musicians. And I think, one of the reasons why people say me and a couple of other guys had such a huge impact in transforming the music scene was really quite simple. Because as foreigners, especially as a New Yorker who worked with many famous musicians, I had the credibility to come in and tell my Chinese musicians, that you guys are just as good or better as anything I've heard in New York or in London or in Berlin or in San Francisco. Um, and, you know, just go for it. And that had a really really big impact. There was that you know, first you build the confidence and suddenly they start thinking differently, and I think we’re still not there in a more general way in China.

46:38: I still think Chinese tend to over-respect anything that's foreign. Or the flip side of that and condemn anything that's foreign. I mean in China there's a real love-hate thing
going on. Um, and I think until they, until they develop the self-confidence to get beyond that, we're going to constantly veer between slavish imitation and equally slavish rejection. And I think that affects also the policy choices here.

JD:

47:04: Could you, I know you have a show so we'll wind down here but, since you brought up some of the music stuff, I think that would be interesting to comment on a bit about in more detail, sort of how you been involved in that, and the club and the label, and maybe trying to connect it, as you just have, but to the general discussion here of how is it a part of this bigger boom that's going on, or are they the critics of the boom, are artists leading the vanguard of attacking the commercialization that produce, or you know, the flow of money that in a way helped produce them, what's going on...

MP:

47:37: I think the best way to think about it is the United States in the 1960s. Um but before I explain why, let me give one other little anecdotal thing that sort of says something about the educational culture here. Um, every important musician that I've worked with, without exception, not a single one of them studied music in school. Um, I've known American composers who have come and taught at the leading music schools here in China, and almost to a man, they say the same thing. These, the people coming out of these schools are technically virtuous at a level that would impress Julliard, but they're never going to do anything. They, it's just, you know, the ability to create music has been squeezed out of them. And I think that's very telling, because you know, we have kids like Xu Wong (sp?) and, and I hope a hundred years from now everybody will know who I'm talking about, I think they will, um who's never studied music, he's an absolute genius at music. He just does wonderful, wonderful stuff, incredibly creative, and I think that's not a coincidence. Um, so that I thought was always a very illuminating thing about the music scene. The best musicians in China did not study music. If you studied music you're almost guaranteed to be technically very good and second-rate. Um, which is sort of a reflection on the whole educational system.

48:56: But let me go back to discuss this whole um, 60s comparison with the US. In the United States there was a major generation gap that occurred at the time. Americans who had grown up in the, in WWII or in the Great Depression, had a very very different view of the world that Americans who were born after the war and grew up in the prosperity. They tended to be much more anxious, much more constrained, much more determined that you study hard, you know, get a good job, you know, all, all the sort of things that were so heavily criticized by, by Kerouac and Ginsberg and the sort of the hippies of the 1960s. Um, in China there's something like that too. There is clearly a generation gap. Those who grew up, and that is the parents of most of my students, in the Cultural Revolution, have a completely different outlook on life. They're really frightened, they're really anxious, they really tell their kids, don't go to bars, don't waste your time reading books about philosophy or art or history, get a job, focus on studying hard, getting a good degree in something that'll lead to a good job, you know, every mother's dream is
that her son becomes an accountant, um and that's how you should live your life. And then the younger kids are just starting, like in the early 60s in the States, to say, is this it? This is all? Um, and so for example, the beatniks are very popular here, everyone's read Kerouac and Ginsberg, everyone among the cool kids. And it's spreading very rapidly, in the seven years that I've been here. Seven years ago I didn't know anybody who knew Kerouac; now it's hard for me to find a cool kid who hasn't read Kerouac. Um, the music scene is developing very very rapidly. And like in the 60s you know I imagine San Francisco in the 60s must've been like this. Basically all the people who felt they didn't fit into the American culture of the 1950s sort of gave up, and moved to enclaves in Greenwich Village or San Francisco and said, we're never going to be part of this culture, so we're just going to do our own thing. And they had no idea that five or ten years later, that, that thing which was never supposed to be part of the culture, suddenly becomes central to the culture. And my guess, my bet is that that's what's happening in China, that we're seeing this huge generational shift, and it's very hard to predict what the Chinese are going to be like, because you can't simply say, well, we're going to see incremental changes from the past. I think the shift that's taking place is culturally as important for China as what happened in the 1960s. And a lot of people in the States will say that there was an America before the 60s, and America after the 60s, and it would've been almost impossible in the 1950s to predict what America would look like in the 1970s. I suspect it's also as difficult to predict what China's going to look like, except to say that it's going to be very very different ten and twenty years from now. Um, in the sense that there will be this massive cultural shift, um, which will be a lot of fun and very exciting to watch.

Closing congenial remarks. On-camera release, with exceptions for the two indicated segments.

Michael Pettis Log

BOOMMichaelPettisMasterA.mov

21-23 April 2009

Bio Additional Information

Background in Latin America, minimal experience with Asia prior to China

Graduated from Columbia, went on to teach there

Formerly at Bear Stearns


Visited China in 2001, moved there to become instructor at Tsinghua then Beida, teaching on finance and economics (ongoing)

Runs music label and club in Beijing
Bio (pre-China):
http://www.milkeninstitute.org/events/events.taf?function=show&cat=allconf&EventID=gc01&SPID=457&level1=speakers&level2=bio

Blogs: http://piaohaoreport.sampa.com/china-financial-markets/blog/;
http://mpettis.com/

Article in Business Week:
http://www.businessweek.com/magazine/content/09_09/b4121050739249.htm?campaign_id=rss_null

Highlights and Connections (time stamps under other interviewee refer to their interview)

11:24: Dependency ratio

- Philip Pan:
  - 10:26: One-child policy as ideological “contradiction” that marked deeper state penetration into social life, even as other reforms reduced state interference
  - 13:34: Argues that impact of policy on economic growth very weak; less coercive methods would have sufficed

13:56: Characterization of economic policy shifts beginning in 1990s

- Trevor Houser:
  - 14:16: Biases in banking system dictate flow of investment
  - 15:52: Elaboration on structure of Chinese banking, “target savings effect”

- Susan Shirk:
  - 22:36: “Fruits of the boom” being monopolized
  - 24:06: “Symbiotic relationship”
  - 26:34: Concentration of benefits more notable since 2000

20:45: Succinct description of dynamics of cyclical Sino-US monetary expansion through overproduction/overconsumption relationship (has to be cut and edited due to interruptions in filming and background interference from other activity)
- Brad Setser:
  o 0:54 to 7:12 (on Setser Main 3.mov), on financial analysis covering growth of China’s foreign exchange reserves, export policy, currency management

- Trevor Houser:
  o 10:00: Energy-oriented perspective on growth during 2000s
  o 12:11: Incentive structure for Chinese manufacturing encouraged capital-intensive “prestige” projects

24:18: Cogent periodization scheme, emphasizing nature of "phase four"- introversion of economy to domestic orientation

27:38: Applies Yasheng Huang’s argument about significance of 1989 to draw interesting parallel drawn to late imperial Russia and Sergei Witte

35:46: Criticism of Chinese educational system

37:26: Social dynamics in employment contexts; difficult to foster greater creativity, initiative- break with hierarchical model

- Shaun Rein:
  o 19:44: On role of Tianjin; points to Internet as evidence of China being “extremely innovative”

40:22: Dismissive of current quality of leadership; argues that reform was simply case of “unwinding policy stupidities”

- Philip Pan:
  o 30:12: Transitions did not proceed as smoothly or successfully in other communist countries; China successfully managed dismantling/privatization of SOE sector
  o 32:32: “Piecemeal fashion” combined with “the effectiveness of the authoritarian system” to break iron rice bowl

- Susan Shirk:
  o 11:07: “Reciprocal accountability”- necessity of cultivating constituency in power apparatus that would support reforms
16:58: “Political challenge” primary- cannot institute reforms easily without addressing internal interest groups; points to reforms in other communist countries during 60s and 70s

45:04: China as "adolescent" still maturing in terms of confidence to engage with world

47:37: Anecdote about quality of music training as reflection of structural deficiency in educational system (technically brilliant but devoid of creativity)

48:56: Generation gap in China; contrast between Cultural Revolution and contemporary youth; popularity of Kerouac among "cool kids"

*The full-length video of this interview is available in the online repository of Rutgers University Libraries: http://rucore.libraries.rutgers.edu*