

# TECHONOMY

TECHONOMY 2012 • NOVEMBER 11 – 13 • TUCSON, AZ

## Making Sense of a Changing China

### Speakers:

David Kirkpatrick, Techonomy  
Robert D. Hormats, U.S. Under Secretary of State  
Zachary Karabell, River Twice Research  
Gary Rieschel, Qiming Venture Partners

### Video:

<http://techonomy.com/2012/11/techonomy-2012-making-sense-of-a-changing-china/>

**Kirkpatrick:** Next panel please come up. We're doing something different with this next panel, which is we're not going to have a moderator. I'm going to introduce the panelists. I'll sort of hover in the periphery. Two of these guys have moderated for us. The other one is obviously an imminent thinker and quite un-shy.

Let me just quickly introduce them. Bob Hormats you met yesterday, Under Secretary of State. But the thing I want—I wanted to mention a number of things about Bob. He goes to China all the time. He was economic advisor to Henry Kissinger in the Nixon Administration when, you know, we first really opened up to China. So he's been thinking about the Chinese economy as long as anybody in the U.S. government and he is really sharp on this subject.

Now, Zachary, one of the many books he's written is called "Superfusion" about the merging of the U.S. and Chinese economies. It's a quite brilliant book, and I think an important one.

Finally, Gary Rieschel, who is a good friend of Techonomy's and of ours, lives in Shanghai. He's the leading U.S. venture capitalist in China. He's been a VC for his whole adult life, I guess, and basically, I don't know—isn't that true? That's true. Okay, no, it's not true. Forget it. He's been a VC for a long time in the U.S. and for how many years in Shanghai now?

**Rieschel:** Eight years.

**Kirkpatrick:** He's been living in Shanghai for eight years. He's got a very a good sense of what's happening there.

I think China is probably the most techonomic country. I wonder what that means in relation to us. I frankly don't feel quite as optimistic as the U.S. competitiveness panel just was, which is probably why I asked all those dire questions—we asked those dire questions that they all disagree with.

But in any case, how do you guys feel about where the U.S.-China relationship is going and how should we think about China? So, you know, anybody say anything.

**Karabell:** So I'm going to kick it off by pre-designation. Someone had to go first and I drew the short straw.

Just to highlight a few things: We all are aware of the fact that we just came out of an election, and as has been true pretty much in every election since 1992—when then-candidate Bill Clinton excoriated then-President George Bush for coddling Chinese dictators in the wake of Tiananmen Square and claimed that the first thing he would do once he entered office should he win the election was label China a currency manipulator, which he then promptly did not do; to John Kerry assailing then-President George Bush, similar, but different, for enabling Benedict Arnold CEOs to outsource jobs to China; to this current election cycle where you had yet another round of the challenger to the presidency assailing the administration's soft sense on China, it does seem somewhat inevitable that in American politics right now and until this China-U.S. relationship shifts dramatically, either until one or the other of those two either descends hugely or accelerates widely, that that's going to be part of it.

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All parties will come together to fulminate against the pernicious influence of China in the domestic economy during a campaign season, and then once that campaign season is done, policy will turn toward the much more nitty-gritty difficult and in many ways more mature relationship of working out what is one of the most closely intertwined economic relationships the planet has ever seen. I think you'd probably have to go back to Great Britain and the United States prior to World War II to find two economic systems that were more or at least equally intertwined. I mean, there are probably others that you could think of, Scandinavian countries, the Hanseatic League, I don't know how relevant those historical analogies are to our present day.

And that this is not, at least in my view, a relationship that is anything other than both symbiotic and intensifying largely in spite of the desire of either populace for it to do so. I think popular attitudes, as we all know, remain highly contested both in China and the U.S. Chinese popular opinion tends to view the United States as wanting to keep China down or prevent it from emerging. And we know the various currents within American public opinion about China as the proximate cause of the decline of U.S. manufacturing, even though, as we know, U.S. manufacturing has been declining as a share of the workforce since the mid-1970s when outsourcing began to Taiwan and Hong Kong and then to Mexico and also the role of technology. I mean, the flip side of all these great technologies has been you can have a manufacturing renaissance in the United States today, but the factory employs 500 people whereas 30 years ago it employed 5,000.

I heard a joke that a new factory was going to open in Mississippi. It was going to employ one man and a dog. The dog's job was to prevent the man from messing up the machines and the man's job was to take care of the dog.

[LAUGHTER]

So, you know, this is a very different world. China becomes an axis of concern.

Just a couple of points on this, though. In spite of China actually slowing down in its rate of growth this year, to whatever figure it's going to be, and whether or not that figure is notional or accurate, a deceleration of the rate of China's growth is not, as both media and investors seem to treat it, the absence of growth.

So, in nobody's mathematical universe does a shift from let's call it 11 or 12 percent growth to 7 or 8 percent growth constitute contraction. Only in a particular short-term media and investing lens does 7 percent growth constitute contraction. It is definitely a lower pace of growth.

But as Gary and I were talking about, China growing at 7 percent, if it even is that low this year, will add more to global output than China growing 11 or 12 percent did five years ago because the sheer size of the economy has grown larger, which means it's pulling everything from resources like iron ore to coal to its consumer market, which is chronically underemphasized as an emergent phenomenon and largely because the way in which we measure it is complicated and the ratio between China consumption and investment on the part of the government is as well.

And I guess the final point on this is that the relationship between the United States and China has never been, at least in my view, asymmetric the way trade figures make it look. So Americans tend to focus largely on this trade deficit with China, which continues to expand.

But two points on this. One, America's imports from China were about \$320 billion in 2007 and are on pace to be about \$470 billion this year. America's exports to China were about \$60 billion in 2007 and are on pace to be about \$120 billion this year. So as a market for U.S.-produced goods, China is the fastest and largest growing market in the world. Bar none.

And that even that import side, a vast proportion of that import side is American companies sourcing goods on China and essentially re-exporting them to the United States. Now, we count those as imports, but if Nike makes a billion dollars of shoes in China and sells 300 or 400 or 500 million of those in the U.S., if Apple makes the iPad and iPhones in Foxconn factories and then pays Foxconn \$20 per unit and sells those at retail for \$500 in the U.S., the way those things are valued creates an optic of a trade relationship that is negatively impacting U.S. GDP, and as Erik Brynjolfsson showed, that's a statistical artifact, but it

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doesn't necessarily represent where value is flowing in these ways. And I think this is a much more complicated system that demands our understanding that we have chronically failed to understand.

**Hormats:** Let me make a few observations. One of the things is we have had an election, but the Chinese are undergoing their version of change, which is not the same as ours, but is very important to understand. And that is they are replacing a large portion of their leadership. It's not just the President and the prime minister who are going to change, but there are vast numbers of changes taking place throughout the Chinese political system.

The Chinese have term limits and they have age limits. So at a certain level, age level or term level, you give up your job through a process that's very well organized and orchestrated to another younger generation of Chinese. So there's leadership change going on in China.

The other thing that's very important and I think one can analyze what they are going to do. But I think this notion of in effect term limits and age limits is a very important way of ensuring a wave of new leadership takes place from time to time.

Very interestingly, though, they are looking at economic growth in a very different way. They are not just looking at the aggregate numbers, whether it's 6 percent, 7 percent, 8 percent. They need a very robust rate of growth, but there is going to be, as Zachary's pointed out, a robust rate of growth even if it's a little bit slower than the past.

But the big difference is the quality of growth. They are now focusing—and if you read every—the Communist Party—the 18th Communist Party Conference was just now taking place, the tradition is the president of China, who is also the head of the Communist Party of China, gives a speech where he talks about what has happened and what the new set of policy objectives will be. One of them is not just the growth rate, which is the double China's growth between 2010 and 2020, but also double GDP per capita. First time they have talked about that.

Second, what's even more interesting is the notion of a harmonious society, harmonious growth. And that is it's not just the aggregate amount of growth, because we know there's a lot of growth in the two big Pearl River, Yangtze River delta areas and certain parts of Eastern China. They are now emphasizing growth in the middle part of China, Western China. They are emphasizing a Social Security system which lower income people will have opportunity to access and to take advantage of.

So basically, what's happening is that they are not only focused on growth, but they are focused on the distribution of growth and building up what they call a harmonious society.

Three, they are focusing on corruption. The biggest single focus of President Hu Jintao's speech was on corruption and the damaging effect it has and could have if it continues on the Communist party and in China in general. Very, very bold, important statements.

And that means they're going to have to improve their legal system and enforcement of the legal system. And not just at the center, but he specifically pointed out this had to be done at provincial level and city level for reasons that you will know when you read the paper about recent events in China. So this whole corruption issue is very important.

The last point—we can go into the details—is don't look at China as some people do. And I think this is a very sophisticated audience so it probably doesn't do this, but many do. The power—the growth in China is not just in Beijing and Shanghai. The regions, the provinces have enormous influence. A lot of the growth taking place, they have cities springing up—2, 3, 4, 5, 10 million people all over China. And the government—it's not a government that runs in a central way anymore. A lot of power is in the hands of provincial authorities. Provincial banking systems play a very substantial role in regional structures.

If the government says something, it doesn't necessarily mean that the provincial leaders are going to accept that. In fact, provincial leaders have minds of their own. And promotion in China is in part determined by how well your province does in creating growth.

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So there's a lot going on in rural China and regional and Central Western China, all of which are very important in understanding China.

And the last point is that you have a lot of pressure for greater participation in the governance process. Now, don't equate participation with Jeffersonian democracy. But more and more there's an understanding that provincial leaders, city leaders, and other leaders have to listen to people.

There are numerous protests over environmental issues, over corruption, over poor governance. And they are trying to do these little experiments in different parts of China, and they call them experiments, on greater participation in the system and how you emphasize what one might call democracy with Chinese characteristics. It's not the term they use exactly, but it's something similar. And that is people—it's not voting at the booths for who's going to run China, but it is greater consultation with the people, which is a step in the direction of political reform. Modest, but positive.

**Rieschel:** So I think those are great points that both Zachary and Robert made. So I think today we're taking the positive view. So to stay in that vein, I think one of the things to realize, a couple of ways to think about China, is that, as Zachary mentioned, the scale of China now, you really don't need to think about it in terms of percentage growth. You just need to think about in terms of aggregate addition or addition every year to GDP.

And so China over this year, 2012 through 2015, kind of worst case adds 1 1/2 to 2 times Indonesia's GDP to its industrial base. So when you think about it as an investor, you kind of look at Greenfield, if you can invest today and in four to five years later have California, India, or a couple of Indonesias, that's still a relatively attractive growth opportunity. In fact, pretty much larger than the rest of the world's growth combined. And I think that's very significant.

The second thing to realize is that in China, along the lines of these experiments, one of the grand experiments that China did 25 years ago was Shenzhen. So it's important to realize when they talk about doing experiments, sometimes they are small and sometimes they actually change the entire economic structure of the country, which obviously Shenzhen and the special economic zones managed to do.

So that is something that that society still retains a very, very great capability to do. And I think that is one of the saving graces of China. They play with property taxes. There are seven different entirely different property tax schemes between Shanghai, Chongqing, Beijing and so on. There's a Social Security tax scheme that they implemented.

And two things to think about. One, Beijing said everyone in 2012—2011, 2012 has to pay the Social Security tax, including all the foreigners. Shanghai said, you know, we don't really like that. So Shanghai just refused to implement it. Interesting, right?

So from a country where you think about this autocratic government structure, you have to realize that everything in China is now in negotiation. You have constituencies that in 1978, when Deng Xiaoping liberalized the country, liberalized the economy, those constituencies were relatively small. And when Beijing said do something, pretty much everyone in the country would have done that.

So we're very close to the people at Baosteel. Yeah, it's a 30, \$50 billion company, give or take a few billion dollars. And when you talk to them, they laugh, they say, well, Beijing or NDRC will say, you need to do this and we say, we'll get back to you. That would not have been the case even 10, 15 years ago.

So these are really fundamental changes in China and China is struggling with this. It's a time where the insecurities—you know, we talk about the strengths of China, but one slight insight into the insecurities, for the last week and a half and two weeks in Beijing, they forced the taxi drivers to take the handles off the windows so people could not roll down the windows driving by Tiananmen Square and throw ping-pong balls with seditious messages in front of the palace.

What kind of economy --

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**Karabell:** Is that really what they do? They throw ping-pong balls?

**Rieschel:** That was the reason. They said we don't want people throwing messages. Paper airplanes perhaps or ping-pong—

**Kirkpatrick:** They do it very well.

**Rieschel:** You have to look at this and say, guys, get a grip. I mean, you have to realize this is a country—it's a huge teenager. It is incredibly powerful. It is very proud of itself. And sometimes it has absolutely no clue in terms of what to do. And it doesn't like to be lectured to.

So I think one thing, if you look at the U.S.-China relationship, one thing to contemplate is big brother-little brother, big brother-big sister. I mean, you need to start to accept that China is going to be a major player on the stage. China is going to have a huge impact on innovation.

The vast majority of the companies that we're investing in now, they are all being commercialized in China. We're taking technology from the U.S., a lot of clean technology, a lot of healthcare technology is being developed here, but it's being commercialized in China. And it will wind up being the China product that will go around the world, particularly to the other developing markets.

So I think that what we just—how do you capture China in 25 minutes? So it's a little bit of an interesting task. But I'll stop there and we can kind of play off each other.

**Karabell:** I have a question for Bob. Two, in your experience in a long public and diplomatic career, has there been a relationship that at least at the level of how governments are interacting that has actually been better managed? For all the friction, right, there's been remarkably few actual crises, other than the spy plane going down in 2001.

**Hormats:** It's been I think remarkably managed. I think that's right. We have various groups. We have the strategic and economic dialogue with Secretary Clinton and Secretary Geithner. We have another group where you have the trade representative, Ron Kirk, and the Secretary of Commerce. There are groups after groups. What we did—if you look at Europe after World War II, we had a network of contacts with Europe that sprung up over the course of 20 or 30 years. We have done this with China over the course of five or six years to build this network of cooperation and collaboration with the Chinese on a wide range of issues, financial issues, environmental issues, foreign policy issues.

And there are clearly major differences of opinion, intellectual property protection, protection of trade secrets, advantages given to state enterprises, currency issues, although they have diminished a little bit in intensity at least. But there are a whole range of things where we work closely with the Chinese. And I think that is really one of the very important parts of it.

And the other thing that I think is very important is that we have—if we do it right, we can look—and I think the point that Gary made was about not lecturing to them. This I think is very important. This—we cannot lecture to the Chinese and get anywhere. They don't like to be lectured to.

But there are many areas, if you look at the 12 Five-Year Plan, which is now in the process of being implemented, and you look at the report 2020 which was done by a branch of the NDRC, which is sort of their big planning group and the World Bank, there are many elements where what the Chinese want for themselves is helpful to the relationship between China and the United States.

A few examples. One, we want them to be less export dependent, more dependent on domestic demand. They want to do the same thing. We want them to have better environmental policies because they are big polluters. They want to do the same thing. Not easy to do, but quite do-able. They want their companies to be able to invest abroad as part of their going out strategy, what they call their going out strategy. We would like to have Chinese investment that creates jobs in the United

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States. But if they want to be accepted as market-oriented companies, they have to reduce the degree to which their competitive capability is distorted by excessive subsidies in China or excessive advantages that they are given.

They have come to realize that many of the subsidies that the government gives state enterprises are wasteful subsidies, so there's an active debate in China about that issue. And on intellectual property, in general, many Chinese companies are innovating. And they want protection for their intellectual property. So our hope and expectation is as the government of China is forced by their own citizens to protect intellectual property developed in China, they will be more rigorous and disciplined about protecting American intellectual property.

**Karabell:** I actually had a question for you on this. Again, I know I am not the moderator, but I am sitting in the middle and I just moderated, so—and nature abhors a vacuum.

By the way, the only country in the world that dislikes being lectured to more than China is the United States.

**Hormats:** Right, we don't want that either.

**Karabell:** Absolutely. So when I was managing a China investment fund, it was almost entirely about U.S. companies investing in China. Why is there not now more focus, particularly as a huge capital base that China is building up, about sort of facilitating and helping and encouraging outward Chinese investment in the United States? And why is not the United States making more of an effort to woo that capital and then regulate it? Meaning, why are we doing the classic keep your friends close and your enemies closer?

**Hormats:** We want their capital. We want their investment. We're going out, well, Shanghai—the Shanghai chamber. Exactly, Bob is doing a fabulous job.

**Rieschel:** Yeah, Bob has been instrumental in the Shanghai chamber and I've been on the board of this small and medium-size enterprise advisory group. It was one of the first ones in the world where it's really there to support small and medium-size enterprise doing market access to China. And then another part of it is to help Chinese companies identify targets and identify investments in the United States.

In fact, the day I get back, there's a panel—a keynote. I got ambushed into a keynote. But they are talking about Chinese direct investment in California. So all the states, some of the cities. I think there's hundreds of initiatives to the point of being confusing sometimes to actually try to attract capital from China into the United States.

I think one of the things about China, though, on the panel about U.S. competitiveness that was just here, they talked a lot about the university system and innovation. One of the things that there's a huge concern about is China threat to innovation in the United States. And that's something that if you are the U.S. you probably should take some comfort.

One of the things that we have done in our world is we invest in start-ups. And when we poll our partners, out of 70 projects and thousands of deals we have looked at over seven years, maybe three in healthcare and clean tech people would say would really be innovative in terms of native Chinese development. Because there are some fundamental weaknesses in trust and in terms of the peer review process that in Chinese universities, that the U.S. university has been able to take advantage of for a very long time.

So I think that in some way again it's a very complex organization, kind of complex entity. But what it can do is it can commercialize its scale now in a way that very few other countries in the world can actually implement. And one example, we have a start-up company called Xiaomi. They make a handset. The founder Lei Jun's goal is to create Apple of China. That seems silly. Right? How is he going to do that?

They sold \$1.2 billion of phones in 18 months, fastest company in world history to a billion dollars in sales profitable. It's his own design, uses an Android operating system. And the last batch of phones—I think it's 250,000 phones sold in seven minutes

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and 50 seconds, because what they did is they implemented a strategy of never going through a channel. Everything is direct. Everything is online. Directly to the consumer.

So it's one of these places where if you have a great idea, it is the place to commercialize technology I think in the world today.

**Kirkpatrick:** But you don't see innovation emerging from there that is really a global scale major game changer?

**Rieschel:** Slowly. It will come. But what we're seeing now are teams—and I think this is a global phenomenon. All right. Teams in the United States of Chinese, ethnic Chinese maybe from mainland China, they are developing the first phase of a product here. But when they look at the process of commercializing or the cost of commercializing in the United States, compared to commercializing in China, they are going to be inclined and they are moving to commercialize more in China. Because then what happens is once it's commercialized in China --

**Kirkpatrick:** You're saying companies from anywhere are going to take that attitude?

**Rieschel:** Companies from anywhere.

**Kirkpatrick:** Yeah.

**Rieschel:** But a lot of groups here are doing that in particular. Where we're seeing that quite a big is in healthcare. The China SFDA now is almost at the same level.

**Kirkpatrick:** What is SFDA?

**Rieschel:** The Food and Drug Administration. A drug approved for use in China is accepted by virtually every country Africa, most countries in Europe. Even the U.S. FDA is now almost at peer level. So you commercialize in China, you suddenly have a global product. That was absolutely not the case five years ago.

**Kirkpatrick:** That's fascinating. Can we have take one or two audience questions and then wrap? Are there people who have a—over here. Linda, take the mic.

**Abraham:** Linda Abraham from comScore. And we do digital measurement of consumer trends around the world. And my first experience in China was about five years ago. And I guess my question has to do with, how do companies—putting aside Apple and Google and companies that have huge names and huge legal teams. We went there. Basically we were looking for either a partner or a potential acquisition. And walked into one company and kind of said, oh, hi, come on in, we love you. We know everything you do. We admire you. Please sit down. Let us show you our product.

And it was exactly our product. And they said, have some tea. And then, would you like to buy us? And believe it or not, we actually went down that path and started those conversations. That was a whole crazy process. And we were just about to sign the deal and they called and said, oh, by the way, someone else bought us, but we would still like you to buy us at the same price and same terms.

It was just like sort of as a company that, you know, started as a start-up and growing, who obviously our customers really want us to be in China and be bigger in China than we are. How do kind of growing companies think about that? If you don't have the resources of larger companies. I mean are there—particularly in the venture capital space, are there, you know, pieces of advice? Do you have to be of a certain size before you even bother?

And, of course, so how do you think about it? And at what point does it even make sense to begin to have those conversations? Because we're trying to develop the whole rest of the world. As big as China is, there's a limited amount of time and energy you can put into it. And there's so much conflicting information about how to approach it. Love to hear your perspective on that.

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**Kirkpatrick:** Gary, that's your question.

**Rieschel:** So I wish there was an easy answer to that question. So it's apocryphal, the stories that you hear about companies coming to China. Mark Anderson is here. Mark and I have talked a lot about the intellectual property theft issues. The biggest thing you have to realize when you go to China is you have to know what you want. They will help you decide what you want if you don't know. And that generally will end poorly.

[LAUGHTER]

For you. I'm serious. They are the best at making you feel—the Japanese are totally different. The Japanese go out of their way to make you feel you don't understand Japan. You will never understand Japan. And you should just give them what you have and then leave. The Chinese, you learn to say thank you in Chinese. They say, ah, your Chinese is so good. The outcome is the same, but they just take entirely different points of view on how to do this. So the key for any company going to China: Do the work to make sure you know what you want before you land there.

**Karabell:** It's also remarkably good life advice.

**Rieschel:** Yeah, I'm old. What can I tell you? But I think that's something few companies—they go on these tours. They go to China. But they really—they get in a hurry. Chinese aren't going to be in a hurry. And negotiating with someone who's not in a hurry when you're in a hurry, that's a bad thing.

**Kirkpatrick:** Wow, that was a good answer. Okay. Back here. And unfortunately, that's going to have to be our last one.

**Audience:** I'd like to hear your thoughts about the state of nuclear power in China and also about innovation. I mean it's really striking that for the AP1000, one of the leading reactors in the world, they have got a supply chain now where they are trying to build everything in China in a serious way.

There's a bunch of innovation. What I have trouble is figuring out how real it is and how plausible it is that it's going to accelerate.

**Karabell:** I think it's hard to know entirely because nuclear power from a state energy development level is not something that is being widely shared as to where the research turns into product. There's been a lot of talk for years about just how many reactors China has lined up. Particularly now with Japan pulling out, it becomes potentially the largest nuclear power market in the world. It's also the largest energy market for every other form of energy from hydro to coal, as you know quite well.

And there has been a lot of talk about internal innovations in commercializing next-generation nuclear technology, including things like pebble bed reactors that would have a far lower temperature point and then also lead to far less wastewater.

Where the spectrum is between those ideas becoming commercialized in China—and they are likely to end up being commercialized in China given the current regulatory framework globally, more likely anywhere else in the world I guess potentially with the exception of France, although I think that has changed.

I'm saying before you had a lot of that work being done. Now, if it's going to be done, it's going to be there. But I mean you might have some more insight. I don't know what the timetable is versus where these ideas are out there. I just know that they are out there. And if they are going to happen, they are likely to happen there.

**Hormats:** Yeah. I would think Zachary put it very well. The irony of China is that they are the biggest coal producer, but they are also putting more money into solar panels than anyone else. So it's an all-of-the-above strategy with large sums of money dedicated to this. And nuclear certainly is a very large part of it.

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The advantage of China is that the permitting process, which in this country is, shall we say, complicated, is not nearly so complicated in China. But it is not zero either because there are lots of parts of China. I mentioned earlier environmental issues are very important to the Chinese. There are more protests in China as a result of environmental issues in rural China or different parts of China along with shutting of factories, which is another factor. But the environmental protests are quite palpable in various parts of the country. And there are people who don't necessarily want nuclear reactors right near them. So whereas it's easier to get a permit to build a nuclear reactor in China, there are still inhibiting factors. But nonetheless, they have to go with the very robust nuclear program. What the pace is going to be, where they are going to be is worked out.

And the point we were all making earlier: you just can't go to a province and if you are in Beijing and say this reactor is going to be here. These provinces have a lot of influence in the way decisions are made. And this has to be a negotiation between the central government and the provincial authorities. So nuclear is certainly a major factor in China's energy future, but it is not as clear a picture and certainly is not as centrally directed as it might have been 10 years ago.

**Kirkpatrick:** Well, that was a panel that felt very authoritative. And I really thank the three of you for coming and doing it. So thank you, Gary, Zachary, Bob.

[APPLAUSE]

Thanks so much. Obviously, another one we could go on forever with, but in our magazine model, we get a couple of pages and then we want you to keep thinking about it and pursuing it elsewhere.