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# U.S. INTERESTS IN THE REFORM OF CHINA'S FINANCIAL SERVICES SECTOR

## HEARING

BEFORE THE

## COMMITTEE ON FINANCIAL SERVICES
## U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

JUNE 6, 2007

Printed for the use of the Committee on Financial Services

**Serial No. 110–35**

U.S. GOVERNMENT PRINTING OFFICE

37–551 PDF WASHINGTON : 2007

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

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# U.S. INTERESTS IN THE REFORM OF CHINA'S FINANCIAL SERVICES SECTOR

**Wednesday, June 6, 2007**

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
*Washington, D.C.*

The committee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Present: Representatives Frank, Waters, Velazquez, Watt, Moore of Kansas, Clay, McCarthy, Scott, Green, Cleaver, Sires, Ellison, Klein, Wilson, Donnelly; Bachus, Baker, Pryce, Castle, Gillmor, Manzullo, Capito, Garrett, Neugebauer, Davis of Kentucky, and Roskam.

The CHAIRMAN. The hearing will come to order. This hearing of the Committee on Financial Services is called pursuant to our jurisdiction over trade and financial services, and we deal with the very important subject of the ability of the American financial services industry to do business in China. I, along with many others, have talked about the unhappiness among a lot of Americans at what seems to them to be an uneven deal that they are getting, in which there is a great deal of growth and they do not participate and then there is also this concern that many have in America about an increasing problem in the trade balance perception that the world's rules are not as fair as they should be. Now, I am aware of the fact that in the world in general nothing is ever fair in the eyes of many people.

We have a very interesting physical phenomenon that I have noted in my years on this committee: namely, we have within the country, but also internationally, in the economic field something that you would have thought defied logic and maybe gravity and that is a constantly declining playing field. People often talk about how the playing field is not level, and in all the years in which I have heard people talk about an unlevel playing field, I have never heard anyone who was at the top. It is a playing field which always slants against individuals.

So apparently it is, as I said, just as we have an economic constantly downward sloping curves in some functions, we have a constantly downward sloping playing field. But just because people often unfairly invoke something doesn't mean they are always wrong. And it does seem to me that the playing field between the United States and China in terms of openness of each one's economy to the other is, in fact, unlevel.

The Chinese currently benefit enormously from the openness of the American economy and from the prosperity of Americans. It is not entirely one-sided—obviously Americans get some benefit from this as well—but the American economy, it seems to me, is far more open to those areas of Chinese economic activity where they have the advantage than the reverse. And that in areas where Americans have an expertise and an ability to compete that exceeds that of the Chinese, they have been much less willing to allow that to operate than they are to take advantage of it when it goes the other way.

A one-sided invocation of the principal of openness and of free trade is not only in my judgment flawed intellectually but it is deeply flawed politically. The Chinese should understand that until and unless they do a better job of practicing in China what they preach within the United States, namely, openness in terms of your economy even when another economy might outperform you, they will continue to run into resistance.

I have joined with some others on the Ways and Means Committee and the Energy and Commerce Committee in our concern about China currency. I know we will hear today assertions that these things are linked, that part of the problem that the Chinese talk about when they say they cannot fully allow economic activity by our financial sector is in part a self-inflicted wound because of the manipulation of their currency. But there will be the concerns about the currency, and there will be other concerns. There are, of course, geopolitical concerns that are not directly relevant here.

But the Chinese should understand that until there is more openness to American financial services activity, until there is a serious effort in China to protect intellectual property—not the jurisdiction of this committee but relevant—the notion that a society as controlled as China where you can in fact regulate the number of children and censor the Internet—which we were told was supposed to be uncensorable—but you cannot stop people from massively pirating other people's intellectual property, does not sense.

And we are told, "Well, do not be protectionist and do not be restrictionist," and those are legitimate debates to have elsewhere. Today, we are arguing, I believe, to the Chinese that if they wish to maintain the kind of political support they will need in America for them to be able to continue to enjoy the advantages of the American economy, there is going to have to be a great deal more reciprocity than there has been to date.

I will now recognize the gentleman from Louisiana, Mr. Baker.

Mr. BAKER. I thank the chairman. And by way of explanation, Mr. Bachus is on his way to the hearing this morning. I am advised that for reasons beyond his control, he was unfortunately detained, but he will participate and will arrive soon.

In his absence, I merely wish to observe that this is not a simplistic policy matter which can be readily resolved by simple actions of the Congress with a single bill being adopted, at least I hope that is not the remedy that is ultimately suggested. China abandoned its decade-long policy of pegging the yuan to the dollar in July of 2005.

Since that period of time, I am advised that the actual increase has been limited to about 8 percent against the dollar. Principally,

because the dollar is weakened, the trade weighted exchange weight really has not budged significantly. In real trade-weighted terms, it is about 10 percent cheaper today than at the dollar's peak valuation in 2002.

This should be noted in the context of this conversation about what appears to be a government-driven market advantage to U.S. interests. I am the first to acknowledge that China's trade surplus with America increased $233 billion just last year. This is by no means insignificant, accounting for almost 30 percent of our total deficit. The total current account surplus reached an estimated $250 billion or 9 percent of GDP. We are still in the first 4 months of 2007, the current year, the trade surplus jumped by 88 percent compared with the same period in 2006.

However, not all economists are of the same mindset as to how we should address or respond to these factual observations. There are some who feel that it is inappropriate to be arguing from a U.S. perspective for a great appreciation in Chinese currency. It is even difficult to establish and agree on what the correct value might actually be. I only bring these points up at the outset to establish that we should be intellectually cautious as we move forward in this matter and understand all the moving parts.

This is a country of a billion people with enormous assets, which is awakening to the principles of a free-market system, and once fully acclimated to U.S. principles of competitiveness, I suspect they will be more than competent in competing in the international marketplace. One does not have to go back far to recognize you picked up an item, a pair of glasses, and somewhere on it was stamped, "Made in Japan," or "Made in Indonesia," or "Made in Korea," or "Made in Taiwan." Now, they are all basically the suppliers to China, who is becoming the aggregating manufacturer. If they were to somehow mysteriously disappear, does anyone think those prior labels would not resurface in the American economy? So let us understand before we act. It may be a big challenge, but I think we owe it to ourselves. I yield back.

The CHAIRMAN. Now, we have been joined by the ranking member, and I recognize him for 5 minutes.

Mr. BACHUS. Mr. Chairman, I apologize to the committee for being late. I was greeted this morning by a police officer at the door telling me that there was a suspected pipe bomb in front of my residence between 3rd and 4th on Maryland so I did just now get a police escort over here. That was nice. They blew it up and it was harmless. I did not get close enough to it. I am going to submit my statement for the record, I do not want to delay the hearing any more.

And we have a very prestigious group of witnesses. We are all—our focus I think, many Americans, we are focused on China and trade by China, and we all have a bit of mixed emotions. We are happy that they are successful and that they are a capitalist system, or not capitalist system, it is actually I am not sure what it is, but transition from communism to a more open market has really brought a lot of prosperity to China. It has brought a lot of benefits to America. With those benefits are some negative consequences. I have great faith in Treasury Secretary Paulson and his negotiations, but anyone who has been to China—I have been

to China five times—knows that the Chinese have a different perspective than we do. We tend to think of tomorrow or next week; they tend to think of 3 years from now or 10 years from now or 20 years from now.

So, even though we agree that we are going to do something, our timelines are quite different. I do believe it is essential that we maintain good relations with China. It is good for Americans, and it is good for the Chinese. And I sincerely believe the Chinese feel the same way. We are two countries that are very dependent on each other, and I think going forward the one thing my opening statement talks about is we made a financial—we had a similar situation with Japan, where we had a large trade deficit, and one thing we were able to offer them was financial services; it is an area in which we excel.

We made a financial services agreement with Japan, which has been very beneficial to both countries, and I have advocated for the last 2 years that the United States and China sign a financial services agreement similar to what we did with Japan. It would really help China address a lot of its demographic and economic problems. It would be very beneficial for the Chinese citizens. It would be of great benefit to them, and it would also help us address our trade deficit.

But with that, I will yield back and I look forward to hearing from the witnesses.

The CHAIRMAN. Before recognizing the gentleman from New Jersey, I ask unanimous consent to insert into the record at this point a statement from Mr. Paul Stevens, president and CEO of the Investment Company Institute. If there is no objection, that will be made a part of the record.

The gentleman from New Jersey, Mr. Garrett, is recognized for 2 minutes.

Mr. GARRETT. Thank you, Mr. Chairman, and thank you everyone for your testimony today on China and the financial services sector.

I would just like to briefly comment for a moment about the other side of the Taiwan Straits, that is Taiwan and how it fares regarding issues that we will discuss here today. To begin with, let me applaud the democratic Taiwan's accomplishments and willingness to improve access to the U.S. financial markets, banking, and insurance industries. But, in contrast, I think it is important for us here today to highlight the necessity and feasibility for China to reform its financial services and access to international financial service providers.

We often applaud Taiwan's efforts in having transformed itself into a democracy, and we urge China to emulate Taiwan politically, but I equally and strongly believe that Taiwan can serve as a successful economic model for China as well. According to a report done by Nicholas Lardy and Daniel Rosen of the Institute for International Economics, "Taiwan has reformed its financial sector significantly in recent years, in some respects, more quickly than required as documented in the 2003 National Trade Estimate Report from the USTR."

One of the U.S. insurance representatives even pointed out that Taiwan not only accepted the model schedule for insurance put

forth by the United States for WTO accession, but also was the first to embrace extended commitments under the schedule, including regulatory procedures for approval as well. I have co-sponsored a resolution that calls for a U.S.-Taiwan free trade agreement and through such an agreement, I believe that we can further harmonize the trade policies of these countries that would benefit both the United States and businesses in Asia. So I would just be curious from the panel here when you give your testimony and the questions later on your thoughts on this comparison and when we discuss these issues today and to hear from you whether you think that China can learn or look to the economic model and the actions that Taiwan has taken in the past.

And with that, I yield back.

The CHAIRMAN. If there are no further statements, we will proceed to the witnesses, and I appreciate this very knowledgeable panel being available. We are going to begin with Don Evans, the former Secretary of Commerce. He was, I am told, the 34th Secretary of Commerce, and he has now come before us as the chief executive officer of the Financial Services Forum. We have worked on a number of issues. I will report to him now, since I like to give good news, that the conversations we have had with our colleagues in the Senate lead me to think that we are going to have a CFIUS bill on the President's desk before we break for the 4th of July, and I think that is an accomplishment, a bipartisan one on behalf of this committee and a bicameral one that we will all be looking forward to. And that is just one of a number of issues on which we have worked with Mr. Evans. So, please, Mr. Secretary, you are recognized for 5 minutes. All of your statements will be put into the record.

Mr. Secretary?

**STATEMENT OF THE HONORABLE DONALD L. EVANS, CHIEF EXECUTIVE OFFICER, THE FINANCIAL SERVICES FORUM**

Mr. EVANS. Mr. Chairman, thank you for your leadership on CFIUS very much. It is bipartisan and bicameral but terrific leadership. Thank you for that.

The CHAIRMAN. I got a grievance from the appropriate union about the gentleman from Missouri working on a classification.

Mr. EVANS. I do not know, but I am surely not going to sit in the chair of Congressman Boren, I can tell you that.

Chairman Frank, Ranking Member Bachus, and other distinguished members, I am delighted to be here. Thank you for the opportunity to participate in this important hearing and for your public service.

I will focus my brief opening comments on how increased market access for U.S. financial services firms in China's capital markets will benefit America and American workers. A more efficient financial sector in China is a prerequisite to successfully addressing issues that have complicated the U.S./China economic relationship, chief among them, further currency reform and the trade imbalance.

Regarding the currency, most China observers agree that an immediate shift to a fully market determined one is very difficult given that Chinese banks, securities firms, and other businesses

lack the expertise to develop and trade financial instruments used to hedge the risks associated with greater currency volatility. Chinese authorities are also concerned that a rapid appreciation in the yuan would disrupt the current pace of economic growth and job creation, which could impact the U.S. and global economies as well.

A more open and modern financial sector is the answer to both concerns. Sophisticated derivative products and hedging techniques provided by foreign financial services firms would enable China to deal with greater currency volatility and more sophisticated capital markets would enhance the ability of the Chinese economy to weather economic shocks. For these reasons, China should pursue more rapid appreciation of the yuan by opening its financial sector to greater foreign participation.

Turning to the trade deficit, helping China move toward a more services-based, consumer-driven economy, a major economic goal of China's leadership, will help to integrate more than $1 billion Chinese consumers into the global economy, creating vast new markets for American products and services. This is the most powerful remedy to the U.S./China trade imbalance. This will not happen overnight, but the long-term benefits for U.S. businesses and workers are astounding.

Chinese households save as much as half of their income as compared to single digit savings in the United States and Europe. The pronounced propensity to save is related to the declining role of the State and the fact that most Chinese depend on private savings for health care, retirement, and education of their children, and the economic consequences of accidents or unforeseen events. Access to financial products and services that we take for granted: personal loans; credit cards; mortgages; 401(k)'s; pensions; and insurance products will reduce the need for precautionary savings and facilitate consumption. As China's consumers, a fifth of the world's population, participate in the global marketplace, new markets will open for American products and services.

Mr. Chairman, the fastest way for China to develop the modern financial system it needs to achieve more sustainable economic growth allow for a more flexible currency and increased consumer consumption is to import it by opening its financial sector to greater participation by foreign financial services firms. If you care about the currency issue, or if you care about the trade deficit, you care about expanded access for financial services in China. By providing the financial products and services that China's citizens and businesses need to save, invest, insure against risks, and consume at higher levels, foreign financial institutions, including the United States providers, would help China develop an economy that is less dependent on exports, more consumption driven, and, therefore expanding markets for American products and services, and a powerful engine for creating good 21st century jobs for American workers.

Thank you very much for the opportunity to appear at this hearing, Mr. Chairman.

[The prepared statement of Mr. Evans can be found on page 83 of the appendix.]

The CHAIRMAN. Thank you, Mr. Evans, and I appreciate your encountering the difficulty. I am told we have the glitch cleared up

now so we will go to our next witness, and here we are, sorry, Mr. Norman Sorensen, who is the president of Principal International, Incorporated.

Mr. Sorensen, please go ahead.

**STATEMENT OF NORMAN R. SORENSEN, PRESIDENT, PRINCIPAL INTERNATIONAL, INC.**

Mr. SORENSEN. Thank you, Mr. Chairman, Ranking Member Bachus, and members of the committee for the opportunity to testify today. I am Norman Sorensen, president of Principal International, Inc., which is a subsidiary of Principal Financial Group based in Des Moines, Iowa. I testify before you in my current role as chairman of the International Committee of ACLI, the American Council of Life Insurers, and in my capacity as the president of Principal International.

ACLI is a unified voice for the United States life insurance, reinsurance, and pension retirement security industry—373 member companies are present in every major global market including China. Principal Financial Group is the Nation's 401(k) leader and provider of retirement benefits and assists asset management in the United States and abroad. We are in 11 countries, including China, where we have one of the most successful and well-recognized asset management companies, the China Construction Bank, a Principal asset management company.

With the recently concluded second session of the U.S./China Strategic Economic Dialogue, the SED, I am here to underscore the importance to our industry of continued engagement with China on economic and broader financial services issues and to seek your continued support as we address the remaining challenges. In our industry, China pledged in the SED II, just concluded: One, to complete the review of branch to subsidiary license conversion applications by August and to institute a policy of completing all future license applications within 60 days; two, to have by the time of the third session, which is December in Beijing, a streamlined licensing regime for financial services firms seeking to provide enterprise annuity services in place; and, three, to expand the qualified domestic institutional investor and qualified foreign institutional investor programs broadly.

We view these commitments as meaningful, important, and part of a longer term process which our industry and the Administration has been working vigorously to advance and which Congress has been supporting all along.

The SED provides us an opportunity to heighten the level of focus and attention in two critical areas: One, the need for China to redouble efforts to comply with its WTO commitments on insurance, re-insurance, and pension products; and, two, the need for China to hasten financial reform, supported by greater liberalization of financial services markets, including removing equity limits on foreign financial services firms and establishing a one-stop shop which can approve licenses for providing enterprise pension annuities, which is a new Chinese program.

China is the world's 11th largest insurance market by total premium volume, the 8th by life insurance, with almost $70 billion in total premiums in 2006, including $50 billion in life insurance,

nearly a threefold increase since 2001. Foreign insurance companies, ACLI members and U.S. companies among them, have a 4 percent share of that market with roughly $3.5 billion in annual premiums. That is growing at about 40 percent per annum.

Although ranked in the top 10 globally, China's life insurance market is underpenetrated, with only 40 percent of households having life insurance. As Mr. Evans had indicated before, the financial services area at the consumer level is still in the early stages of development. The Chinese spend only about $35 per annum on insurance, far below developed markets. As China's middle class grows, especially in the lower and middle class, it will rank among the world's largest middle class and largest life insurance markets by 2020. The demographics already indicate that.

To address the pension gap, which is very important, Chinese regulators started in the spring of 2005 to establish an enterprise annuity pension system similar to our 401(k)—they basically copied our plans. Conservatively, our estimates indicate that within 10 years, the assets under management for this program should be close to $100 billion. Within 25 years, they should reach $1 trillion. While a number of foreign firms have been licensed to provide trustee management and services for pension assets, no American firm has yet been licensed to underwrite pension products directly.

We remain committed to ongoing engagement and dialogue with our Chinese counterparts and have confidence in the process started by the SED, as well as other ongoing bilateral discussions, such as the JCCT and multi-lateral discussions in Geneva under the WTO. We welcome all efforts to help the industry address and resolve longstanding issues of concern, including approval concurrent as opposed to consecutive branching for insurance companies, for example, and recognition of global experience and assets for insurers seeking asset management licenses in China, all of which were discussed most recently during the SED. In particular, I am interested in approval of pension licenses under the new Enterprise Annuity Pension System, which is going to be huge in China.

Principal Financial Group and ACLI welcome the creation of the Enterprise Annuity System, and China's decision in the SED to streamline the application process for financial institutions. This afternoon I will be meeting with Ambassador Holmer and Secretary Paulson's staff to continue the process of detailing what these commitments actually mean and pushing forward to produce solid results before the SED Session III in December in Beijing. Clarifying the regulatory framework to authorize single provider plans under a single license is extremely important, both to the principal and to the ACLI members.

Finally, progress in these areas has the potential to greatly increase American participation in China's efforts to improve its social safety net, as Mr. Evans indicated earlier, and grow its financial service industry assets. Given our experience in this area, management of most of those assets should come to American companies. We believe that working constructively to resolve the issues noted above and taking additional bold steps, such as removing equity caps and significantly expanding foreign participation in China's Enterprise Annuity System, would represent a fortuitous win/

win for the United States and China, one which we should all work to expand.

Thank you very much.

[The prepared statement of Mr. Sorensen can be found on page 110 of the appendix.]

The CHAIRMAN. Thank you, Mr. Sorensen. Next, we are going to hear from Michael Decker, who is the senior managing director of the Securities Industry and Financial Markets Association, an organization which frequently gives the committee the benefit of its advice and counsel and it is an organization that we very much enjoy working with.

Mr. Decker?

**STATEMENT OF MICHAEL DECKER, SENIOR MANAGING DIRECTOR, RESEARCH AND PUBLIC POLICY, THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION**

Mr. DECKER. Good morning, Chairman Frank, and thank you for the opportunity to be here. We appreciate your support and that of your colleagues in expanding trade and financial services. One of the most important things China can do to ensure long-term economic stability and growth is to build their financial markets. The Chinese recognize this and in many ways they are working hard to build efficient and robust markets that will serve the needs of investors and companies who need capital. One of the best ways to build their markets is to open participation and financial services to companies from outside China, including the United States. In the area of securities, China has made some progress in removing barriers against non-Chinese securities firms but there is a long way to go to make the China securities markets truly open.

Attracting non-Chinese companies to the Chinese markets would bring many benefits to both China and to firms from the United States and elsewhere who want to participate in China's growth. For China, opening their markets would bring capital, expertise, innovation, experience, and efficiency. For securities firms in the United States and elsewhere, better access to the Chinese markets would bring the opportunity to help build the financial system from its very early stages and would represent an unprecedented commercial opportunity with major implications for the competitiveness and growth of this vital sector.

Despite these promises, China has been reluctant to take several key steps to reap the benefits of a more open market. Working directly and through the Treasury Department, we at SIFMA have urged China to make several key policy changes to make the Chinese markets more accessible for non-Chinese securities firms. These include lifting the effective moratorium on the approval of new joint ventures between Chinese and non-Chinese securities firms. China announced at the recent SED meeting that they will lift the moratorium later this year but they did not specify precisely when.

Permitting foreign securities firms to own 100 percent of their local operations in China and to organize themselves in whatever corporate form is best. Currently non-Chinese securities firms can only participate in the local market through minority positions and

joint ventures with Chinese companies or by acquiring stakes in local firms.

Expanding the types of securities activities that foreign firms can engage in. Currently, joint ventures involving foreign securities firms can underwrite and trade certain securities but are prohibited from trading in the large and liquid A shares market. China announced recently that they will expand the permitted activities for foreign securities firms, including in brokerage, proprietary, trading, and fund management. We welcome this development but, again, China has said only that they will announce such an expansion prior to the SED III planned for this December.

Expanding the qualified foreign institutional investors program. The QFII program permits certain foreign institutional investors to invest in the A shares market and was a major step forward in opening the Chinese markets. But China can go even further by lifting certain restrictions on QFII's that limit the programs attractiveness. During the just completed SED meeting, China agreed to raise the QFII limit from $10 billion to $30 billion.

And finalizing the implementation of the Qualified Domestic Institutional Investor Program. The QDII Program permits Chinese banks to pool funds from local investors to invest outside China. In addition, we have urged China to amend its process of developing and implementing domestic market regulations to be more transparent and fair. We have also recommended changes to China's interim derivatives rules, which have prevented securities firms from creating and distributing derivative products.

Finally, SIFMA is actively engaged with China on helping to build the capital markets infrastructure there. For example, last year, our affiliate, the Asia Securities Industry and Financial Markets Association based in Hong Kong, entered into a partnership with China Bond, the clearing and settlement facility in China, to improve China's trade processing system. We have also been communicating with China's securities regulator on crafting a regulatory plan for the local corporate bond market, and we have been conducting training sessions for Chinese regulators and others on the re-purchase agreement market. We believe these initiatives go hand-in-hand with opening access to the Chinese markets. After all, the more robust and efficient the Chinese capital markets, the more opportunity there will be for both Chinese and non-Chinese firms to compete.

The Treasury Department has been very responsive to the interest of U.S. firms in opening access to the Chinese financial services industry. We thank Treasury for its efforts in engaging China on these important issues. We are hopeful that a continued dialogue among U.S. and Chinese governments and Chinese and foreign financial services firms will result in continued progress on opening the Chinese markets to all who wish to compete there.

Thank you again, Chairman Frank, for inviting us to participate in this important hearing, and I look forward to the committee's questions.

[The prepared statement of Mr. Decker can be found on page 64 of the appendix.]

The CHAIRMAN. Thank you. Next we have Dr. Eswar Prasad. He is the senior professor of trade policy at Cornell University, and he was formerly the head of the IMF's China Division. Thank you.

Dr. Prasad, please proceed.

**STATEMENT OF ESWAR S. PRASAD, TOLANI SENIOR PROFESSOR OF TRADE POLICY AT CORNELL UNIVERSITY, AND FORMER HEAD OF THE IMF'S CHINA DIVISION**

Mr. PRASAD. Thank you, Mr. Chairman. The process of broader financial liberalization in China is important to the United States for two reasons. One is that it has implications for China's balanced economic development, which is clearly of interest to the United States for a variety of reasons, and the second is that the pace and manner in which this financial liberalization is conducted will obviously have important repercussions on the bilateral economic relationship between China and the United States.

So let's start by thinking about what the financial system in China looks like. In China, essentially the state-owned banking system remains dominant at this stage. Deposits in the banking system in fact amount to almost double GDP. And despite all that you have heard about the stock market in recent months, the stock market capitalization in total is only about 60 percent of GDP. The corporate bond market remains very small, and many of the other segments of the financial markets remain very small, so the banks are really the key game in town.

Now, the Chinese have essentially taken the approach of trying to reform the state-owned banking system and there are a couple of important issues here. One is that traditionally the state banks had a process of directed lending, which essentially meant that a lot of money was funneled to state enterprises, which are financially unviable, and the legacy of those non-performing loans is now coming home to roost.

Capital controls have played a very important role in protecting the domestic banking system from external competition by restricting the entry of foreign banks until recently and by making it harder to take capital out of the country, and both of these dimensions are important. This lack of competition for the banking system has limited financial innovations and kept the risks of the financial system heavily concentrated among banks.

In recent years, the government has moved aggressively to rid the legacy problems of the banking system, and if you think about the magnitude of problems that the Chinese authorities are facing, they are really quite staggering. Non-performing loans in the banking system a few years ago were estimated to be about 50 percent of GDP. State-owned shares—shares in state-owned companies—were largely non-traded, which meant that even though you had a functioning stock market, the capitalizations that you saw in the stock market were not really valid representations of the value of those companies. So that again was a transition problem that the government is dealing with.

The implication of all this is that banking sector weaknesses have contributed to the very unbalanced pattern of economic development in recent years, which means that investment has been the primary driver of growth, accounting in fact for almost 40 percent

of GDP and more than half of GDP growth in recent years. The investment boom has raised fears of a resurgence in non-performing loans if the economy were to slow down and there are also risks of asset-priced bubbles and a future deflation in the economy.

So the problems are really staggering and the Chinese recognize that foreign participation in the financial system is essential or at least a very important catalyst in terms of moving forward and yet they have not moved forward in terms of what seems to be in their own interest.

And there are three possible reasons for this: One, the concern about the preparedness of local financial firms to deal with foreign competition; two, whether they have their own regulatory and administrative capacities to deal with the increasing sophistication of financial instruments; and three, cross-border penetration of domestic financial firms which will be exacerbated at one level if foreign financial firms enter. They are also a little concerned that lifting the restrictions in cross-border capital flows, which they believe will inevitably happen with the larger foreign presence in the domestic financial markets, could cause them to lose control of their capital in-flows and out-flows, and given the managed exchange rate system that they are trying to sustain, could cause problems.

And in each of these I think there is a very clear agenda through which the United States could contribute to this process. One is to emphasize that in terms of domestic financial market development, the entry of foreign firms may in fact have a very beneficial effect in terms of efficiency, in terms of improving the quality of financial instruments and corporate governance that domestic firms can put forward, and basically by bringing in expertise that would push forward financial reforms.

In terms of administrative and regulatory capacities, again, I feel that the United States has a very real opportunity to be able to cooperate with the Chinese and to take care of their concerns on that front in order that they would feel more comfortable about opening up to foreign financial firms. Finally, I think there has to be a recognition that openness to capital in-flows, and equally to out-flows, plays a very important role in terms of domestic financial market development.

And here again the Chinese are open in a philosophical sense, but I think guiding them through the expertise that the United States has to offer is going to be very important. And, arguably, I think in terms of this bilateral economic dialogue, tools such as the Strategic Economic Dialogue do have a very important role to play in terms of creating channels through which this expertise can be pushed forward and also in terms of indicating to the Chinese how importantly linked the variety of reforms are, the financial market reforms, the exchange rate flexibility, which the United States has been pushing for, and a much broader set of comprehensive reforms, which I think are going to be important for the United States and for China in terms of a balanced economic relationship.

Thank you.

[The prepared statement of Mr. Prasad can be found on page 103 of the appendix.]

The CHAIRMAN. Thank you very much. Now, we will hear from Grant D. Aldonas, the holder of the William A. Scholl Chair in

International Business at the Center for Strategic and International Studies.

Mr. Aldonas?

**STATEMENT OF GRANT D. ALDONAS, WILLIAM M. SCHOLL CHAIR IN INTERNATIONAL BUSINESS, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES**

Mr. ALDONAS. Thank you, Mr. Chairman, and I want to thank the committee for holding this hearing. I happen to think that this is the key issue in our bilateral relationship with China. The points that I want to highlight complement what the other members of the panel have said. The first thing is the tremendous stake that we have in the outcome of the reform process in China, not only because of the market access it would provide American firms, but reform of the capital markets in China are absolutely critical to eliminating the underlying distortions in the Chinese economy that become trade problems and generate the pressure for protection and isolating the United States economy, a policy that would hurt both us and China as a part of the process. So we have a tremendous stake in the outcome in terms of what it drives in the way of change on the ground in China.

The second thing is that broader economic policy goals in China, the choices they are making, are what is going to drive reform. I do not have any expectation that the WTO is going to deliver anything in terms of new market commitments in short order given that the Doha Round talks are stalled. And the final point I want to emphasize as I go through my remarks is that the time is ripe for reform. If you look at the economic situation worldwide today, and the economic situation in China, there will be no more benign and no better economic environment for China to undertake the fundamental reforms that they need to undertake in their own interest than it is now.

With that, let me just turn to our stake in the process. First, obviously, we have a tremendous commercial stake, as you have heard from the other witnesses in terms of the export of financial services. We are tremendously competitive in that arena and it is something that our firms still remain hobbled despite the WTO commitments of China in terms of their market access into the Chinese market.

But the second factor I think is actually more important, the stake we have in the outcome is ending a series of lax credit practices that have driven additions to capacity in the Chinese market that when the economic activity turns down in China, they spill over in international markets, they are imported to the United States, and we face dislocation as a result of those lax lending practices. Disciplines inside the Chinese capital markets would do a lot to eliminate the distortions that metastasize into trade problems and that you all see as trade friction from your constituents.

We have a stake in the success of the reforms also because China now represents one of the main engines in the international economy, any sharp reversal in China's fortunes would have negative consequences for the world, for China, and for the United States. We are tightly interwoven now with the Chinese economy in ways that I think are fundamental. That means we need to take great

care but it is also why we should be driving the process of capital markets reform in China.

Despite its impressive record of growth, China has very serious economic vulnerabilities. They have a two-speed economy with a growing disparity between high economic growth along the coast and those portions of the economy that are deeply integrated in world markets, slow growth in China's interior provinces where most of China's population still lives, a heavily distorted mix of economic activity that really results from the lax credit practices that I mentioned, the lack of discipline in China's financial markets and undue reliance on export demand is the main driver of economic growth rather than a more balanced approach that relies on domestic demand and that of course has generated a significant backlash from China's trading partners.

And I have to say it is not just a phenomenon in the United States. It is interesting that India now surpasses the United States as the largest filer of anti-dumping actions. The target of all those anti-dumping actions are China. This is not just a phenomena where you are seeing a protectionist drift in the United States as a result of China's export-driven growth; you are seeing that worldwide at this point.

The last thing is that there is a tremendous demographic challenge China is facing as a result of the one child policy. It is growing old before it grows rich. That means that there is an awful lot that they need out of the private sector to create a social safety net that does not currently exist. That creates phenomenal opportunities for U.S. firms if the Chinese policymakers are wise enough to let the American firms in to help grapple with those problems.

The last thing is the tremendous economic adjustment that my colleague alluded to that has to go on in the Chinese economy if you are trying to draw 700 million more people out of poverty and into productive employment somewhere in the Chinese economy.

Well, given the stake that we have in the outcome of the reform process, it is entirely reasonable to ask where are we in the reform process. And at this juncture, I have to say that China did undertake significant liberalizations in its WTO commitments and has lived up to those commitments. They exceed commitments that any other developing country has made. Now, on the other hand, if in fact the goal of China's accession process was to encourage a more efficient allocation of capital and resources throughout the Chinese economy, in this instance the WTO commitments fell far short of that goal. There are simply too many restrictions on market access for U.S. companies to have the profound and powerful impact they could for all the reasons I stated earlier.

Well, at that point, I want to turn just to where we are in terms of the world economy. We are seeing the strongest growth that we have seen in 3 decades. We have growth at about 5 percent. China's growth is likely to exceed double digits for more than a decade now. It will do so again this year. It has savings that are at least half of its current GDP. It has an enormous foreign exchange surplus. When you add all that together, in China's context and in the world's context, there will never be a better moment actually to undertake the reforms.

The savings, the foreign exchange surplus all serve as a buffer against the risks that they will face when they undertake these reforms but there is simply no better time. The pressures inside the Chinese economy are such that things will only get worse on each of the challenges that I mentioned over time. If they want to solve this problem, the easiest way to do it frankly is to import a financial services market from the United States.

Thank you very much.

[The prepared statement of Mr. Aldonas can be found on page 50 of the appendix.]

The CHAIRMAN. Thank you. Let me begin, and I understand this is a matter of some delicacy, particularly for those who represent institutions, companies that might want to be doing business, but I would like to ask all the panelists, assuming that it is a desirable goal for the restrictions that China imposes to be relaxed, are there things the U.S. Government should be doing that it is not now doing or that it is not now doing with sufficient vigor to advance that? What should our posture be in our negotiations and are there things we could do more than we are now doing? Let me start with Dr. Prasad and Mr. Aldonas, who have less at stake in terms of any pending applications, but the others can think about how to soft-peddle whatever they want to say while they are talking. So we will start with either one of you.

Mr. PRASAD. Well, I am leaving for China tomorrow morning so I guess I should be a little careful what I say.

[Laughter]

Mr. PRASAD. I think one very important thing the United States has to do is to put issues such as exchange rate flexibility in a broader context. Now in a sense, discussions of financial services liberalization and exchange rate flexibility have almost been moving on parallel tracks, and I think the authorities' desire to move forward in financial sector reform, which has been alluded to, they really care about it, should be turned around to advantage in some sense because ultimately these things are linked in the following way.

You cannot really move forward financial sector reform, especially banking reform, unless you have independent monetary policy and can guide credit through the interest rate, and you cannot guide credit through the interest rate unless you have an independent monetary policy, which you cannot do if you do not have a flexible exchange rate. So I think actually making these connections and showing how capital account liberalization and exchange rate flexibility are important for domestic financial reform and how these have to move in tandem is very important.

The CHAIRMAN. That is very important. I notice you make this point on page six, and Mr. Morris on my staff underlined it for me. We have had people say, "Well, the Chinese cannot do anything about their currency and about really freeing the currency from the constraints until they have reformed their financial system." And, as I understand what you are saying, it is almost the other way around, that in fact as long as they are artificially depressing their currency, the banking system will to some extent have to be a servant of that policy and will be accommodating that policy rather

than being able to serve a more independent function. Is that an accurate—

Mr. PRASAD. That is exactly right. There is some misconception that exchange rate flexibility necessarily implies the full opening of the capital account to both in-flows and out-flows and that is not the case. They have a relatively restricted capital account now, which they are opening—

The CHAIRMAN. In fact, what you are saying is that as long as you have this very manipulated currency, that is an obstacle to the financial openness because you have an added goal for the financial system, which is to meet the needs of this currency depression.

Mr. PRASAD. Manipulated currency is not quite the term I would use but it is true that they need a more flexible currency. But the focus really is not so much on the level of the currency, which is where the debate in the United States tends to focus on, but about allowing the currency to move up or down, and it could very well move down, if they did allow the capital account to be open and if they allowed some of the domestic savings to go out of the economy.

The CHAIRMAN. Well in fairness, I think, to those of us in America who have been arguing that, I do not know who said that they should arbitrarily be raising the level. The argument has been to let it float freely and there is a sense that it would go up. But I agree nobody is insisting that they artificially peg it high.

Mr. ALDONAS. Mr. Chairman?

The CHAIRMAN. Yes, Mr. Aldonas?

Mr. ALDONAS. I have to say that I am agnostic about a lot of the debate about the currency peg, I really—

The CHAIRMAN. I am glad to meet a member of the Bush Administration who acknowledges being agnostic in any respect. I appreciate that.

[Laughter]

Mr. ALDONAS. The distortions in the Chinese economy are such, and the conditions under which people talk about revaluation are such, that I do not think we can honestly say what the value of the reminbi would be. Having said that, the Chinese have the argument precisely wrong: maintaining the peg does not help them with the reform process or address the economic challenge that they have. In fact, reforming the currency is an absolutely essential step to encouraging the reforms, to driving change inside their own economy.

The old line is that, "The dentist who pulls your tooth slowly does not do you any favors," and in this instance, by maintaining the peg, in effect what they are doing is pulling the tooth slowly on the reforms that have to happen in the Chinese economy. So when they say that we are worried about our economic vulnerabilities, my own reaction is your economic vulnerabilities are going to grow unless you resolve the peg. But that is, again, without regard to the arguments that are made about whether it is fair or unfair.

The CHAIRMAN. Well, again, there are people here who are assuming it would go up, but I do not know of anybody who has said, "Raise the level of your currency." The argument is to let it float, assuming that is where it will go.

Mr. Sorensen, you had something?

Mr. SORENSEN. Mr. Chairman, you asked a very specific question, which is what can the U.S. Government—

The CHAIRMAN. I know, general questions make me nuts.

Mr. SORENSEN. What can the U.S. Government do that it is not doing today? I would suggest that Congress and your committee, Mr. Chairman, can play a tremendously powerful role in supporting the SED dialogue, not only in supporting it but insisting that the deliverables that the Chinese are beginning to commit to are in fact delivered. If you add your weight to the process, the SED and Secretary Paulson and the Administration—

The CHAIRMAN. "SED" stands for what, now?

Mr. SORENSEN. The Strategic Economic Dialogue—

The CHAIRMAN. Thank you.

Mr. SORENSEN.—that Secretary Paulson has been undertaking with Madam Wu Yi. Times are changing very fast in China. I am there every 2 months. I am going there again next month. And I can see the positive winds, as Mr. Aldonas is saying, of change. But if Congress can support the SED and insist on the deliverables very, very actively and very insistently, I think the Chinese will get the sense that we are a united front, and it is not just the Administration that is pushing these reforms.

The CHAIRMAN. Thank you. Mr. Bachus?

Mr. BACHUS. Thank you, Mr. Chairman. Mr. Aldonas, you said that China will grow—their economy will grow by 10 or 12 percent for the next 10 years, that is the assumption that is pretty much universal but is that in fact true? They are a first-class manufacturer but their financial markets, their ability to invest capital efficiently and effectively is not first-class or even second-class, it is very third-rate. And I say that—I think they realize they have a long way to go. And you talked about the demographic challenges and that they have to reform their financial markets and their financial services if the middle class, if the 700, I think billion, Chinese participate with the other 300 or 400 billion. But if they do not do that, are all these assumptions people are making, they cannot keep growing at 10 percent if they do not do exactly what we are saying they need to do, can they?

Mr. ALDONAS. Thank you, Congressman. I should clarify, what I said was they have been growing for a decade at double digits. I do not actually expect that on the trajectory they are on, with the relative capital inefficiency that is built into the Chinese system, that they can maintain that level of growth. And even the growth that exists is so weighted towards certain activities, like construction and a variety of other things, it is not actually providing a lot of value to the average Chinese citizen.

The best measure of that is that a McKinsey study showed that in the 1990's, as there were great productivity gains that cost about $3.30 of investment to produce a one dollar of GDP growth. Since 2001, that number has become $4.90 for every dollar of GDP growth. What that means is at a time when you would expect most economies are becoming relatively more capital-efficient, they have become less capital-efficient. And that is not the trajectory you want to be on if in fact you are moving toward a society where you are going to have fewer workers, many more retirees, and many more social problems to deal with.

Mr. BACHUS. Anybody else? Secretary Evans?

Mr. EVANS. Yes, I would just—when I first went to China back in 2001, there was a lot of concern among economists as to whether or not we were going to see a hard landing or a soft landing in China because of the dramatic growth that people had seen the previous 10 years or so. Here we are some 6 or 7 years later and we are continuing to see this double-digit kind of growth. I think more and more economists are starting to get comfortable that China is doing a relatively effective job of managing the ongoing growth and structuring itself for long-term economic growth.

But what they do need to do is they do need to turn it into a consumption-based economy. Right now, it is an industrial-driven, export-based economy, and they know that to really continue this kind of pace of 10 percent growth, they have to become more like America where two-thirds of the GDP is driven by consumption, and you cannot get there when 1 million Chinese own credit cards and 500 million of them own cell phones. You have to have the financial tools in place for the citizens of the country to begin to become consumers. And we have articulated some of that already, but I think that just really puts a hard focus on what they need to do, and I think they know they need to do it.

And I am going to follow-up on what the chairman asked a little bit earlier too. What else can we do? I really think, in my experience dealing with the Chinese, they are really starting to understand the important role that Congress plays in the process. I do not think they understood that 5 or 6 years ago. I think within the last year or so they are starting to get the picture and starting to get the message. What I would say is if this committee could go, or members could go, and I am sure, as you said, you have already been over there 5 times, if I go over there and look them in the eye and tell them, "This is what we expect," and they are very open, they are receptive. I am over there once a year at least, talking to all the regulators. But for them to hear from you in their country, I think, is a powerful statement. They are starting to understand the important role that this body will play in the ongoing economic relationship between our two countries.

Mr. BACHUS. Yes, Mr. Sorensen?

Mr. SORENSEN. Congressman, one of the things that has been mentioned here is a social safety net. We are in the pension business, Principal Financial Group, that is what we do, we are in China with that objective. China just established basically the first ever social safety net. It is the enterprise annuity system, which is like our 401(k). We should be thankful that they copied our system and did not emulate the European systems, which, as you know, are upside down and almost insolvent.

As they establish this social safety net by allowing Chinese households to save for retirement, the Chinese capital markets will grow like ours did in the United States. The potential for U.S. companies to participate in that market is immense. It can grow very, very quickly and it will. So I think that Congress and your committee should, in my opinion, consider supporting that process very, very strongly because over the past 40 years since the 401(k) was created, 25 or 30 years ago, the capital markets have benefitted enormously from that. As people understand that they do

have their retirement nest egg relatively growing and secured, they consume more freely and they are less precautionary, putting less money under the mattress, so to speak.

Mr. BACHUS. Most Americans do not realize that they save a lot of money, well, there is no social security, there is no pension, there is no Medicaid, there is Medicare, there is no social net. Now, one thing they need to do, and if they do it they are even going to be more efficient, is to not model themselves after some of the things that we have done. Our social security system is not the most efficient in the world.

But they basically can put it in the bank and draw 2 percent interest or they can put in the stock market and they do not know what they are investing in and it is going to turn out very badly for them in many cases. They are going to lose a lot of money. And it is going to be a real political problem for the country. If their leaders do not allow their people to efficiently and effectively invest their money, I think you are going to see 300 or 400 million Chinese—I think I said billion before and I should have said million, but you are going to see—I think you are going to see the Chinese people demand that their government allow them to—

Mr. SORENSEN. Precisely, Congressman, we know the exact number. There are 165 million Chinese over the age of 65. We do this every year. By 2020, which is very, very close by, the population is aging so quickly, they will have 320 million Chinese over the age of 65 and most of those people will not have retirement funds to retire on. This is why the government has established this enterprise annuity system and other systems, which need to be established in that area.

Mr. BACHUS. Thank you.

The CHAIRMAN. The gentlewoman from California?

Ms. WATERS. Thank you very much, Mr. Chairman. I appreciate this hearing. We need to do more hearings and have more discussions about China because China is emerging as not only a very, very powerful country but there are many concerns that are circulating and being discussed about China. It is very hard for me to even talk about what is happening in the financial services community when in fact we have so many other issues with China.

First of all, we have never resolved our concerns about human rights issues. The Congressional Black Caucus is leading a fight about their relationship with Darfur and trying to encourage them to use their power in the U.N. to help us end genocide there, which they do not appear to be willing to do. I cannot even begin to talk about intellectual property concerns that we all must have about them. They produce more fake and phony goods than I guess any other country on earth.

We have to be concerned about the bilateral trade surplus, the currency manipulation, where do we begin? There are those, and I suppose in an article that was just given to me from the Economist about China-bashing, those of us who have some of the concerns I have alluded to just do not understand that we should not be concerned about the currency manipulation and other kinds of actions. I guess they think it will all work itself out. But all I can say is that my hat is off to Secretary Paulson for meeting and having the dialogue, and I suppose that will continue. But they make

his job very hard because of all of these other issues to which I have alluded.

I guess my only question to the panel is, are they aware that we do not like our pets killed by contaminated pet food? Are they aware that there are real concerns about their continued support of the government in Sudan, the killing of so many people? Are they aware of all these other issues that we have? Anybody can answer that.

Mr. DECKER. I cannot speak to all the important issues that you have raised, Congresswoman, but I can tell you with regard to financial services there are many influential people in China that recognize the weaknesses in their own financial system and recognize that a corporate lending system that is based too heavily on bank lending and inefficient allocation of credit is a two-legged or one-legged stool that is just waiting to topple. And there are a number of influential people in China who are internally pushing reforms and trying to build alternatives to the existing capital system to better be able to serve both investors and users of capital. They are worried, I think in part, with regard to opening their markets to foreign firms. They are worried in part that U.S. and European and Japanese firms will come in and dominate the local market and crowd out the local firms with expertise and capital and other benefits that they bring to the market.

Ms. WATERS. I suppose I should ask you, should we continue to have a policy that will allow China to buy up as many firms and whatever they want to buy in the United States, and invest as much money as they want to, while we still have limits imposed by them on our ability to be involved in their financial services sectors? As I look at what has just been given to me, those limits include a 49 percent ownership cap on fund management joint ventures, a 20 percent ownership cap on single investors in the banking sector, and perhaps most crucially, a 33 percent cap on ownership of securities joint ventures. Thus, should we continue to be as liberal as we are, given all of those restraints?

Mr. DECKER. Yes, they are worried about big foreign firms coming in and dominating, but when you look at some other emerging market countries, like India, Brazil, Russia, Mexico, Korea, and Taiwan, they all allow 100 percent ownership of financial services firms and there is still plenty of room for local firms to be able to compete. If you look at the U.S. market, there are over 5,000 registered broker-dealers in the United States; they are not all Goldman Sachs.

Ms. WATERS. So what do we have to do to convince them?

Mr. DECKER. I think we are confident that the SED process is going to result in meaningful change. We have seen some incremental benefits from that process already. And I agree with what Mr. Sorensen said a few minutes ago, that ensuring the message to the Chinese that the entire U.S. Government, both sides of the aisle and both branches, are fully behind the points the Treasury has been making, I think, will go far.

Ms. WATERS. Thank you very much.

The CHAIRMAN. If the gentlewoman would yield me just 30 seconds because I was negligent and should have said what she said. And you are right, we should let the Chinese know what we think

and we are for economic encouragement but the Darfur issue is one of the most deeply felt in America. If the Chinese continue to be an obstacle to an international effort to relieve the people of Darfur from this genocide, they will pay a significant price in America. And all of the rational calculations about economic self-interest could come crashing down if we were go to the U.N., if there were to be a Chinese veto of a resolution, so the Chinese, if you want them to understand what Congress thinks, to understand that Congress is reflecting the views of the American people who care very deeply about this Darfur situation, and they put a great deal at risk if they continue to be an obstacle to a resolution. I thank the gentlewoman for reminding us of this issue.

The gentleman from Louisiana?

Mr. BAKER. I thank the chairman. I wish to return to the initial economic focus that is a cause for concern. Not in this body at least, but on the Senate side in prior sessions, there have been suggestions as a result of the view that there is under-valuation of the yuan, that certain economic congressionally-driven sanctions, a 20 percent tariff for example, should be imposed in order to re-balance the international equities. I find that to be somewhat short-sighted in the consequences of that in a global economic view.

Mr. Secretary, I want to just make a few observations, some of which are based on the article that was previously mentioned in The Economist and some of which is U.S. Treasury and Federal Reserve data and get your learned opinion about whether these are consistent with your overall view of our China imbalance. It is pointed out in that article that since 2004, almost the entirety of the trade surplus occurred in heavy industrials and equipment.

In the build-up internally in China, in an enormous explosion of economic activity, there were internal assets built up until 2004 when the Chinese government began to tighten policy a bit while continued investment continued in metals equipment, creating substantial excess capacity, much of which found its way to the United States, so that much of the imbalance can be attributed to that specific economic abnormality in the Chinese market.

Secondly, that excluding food, their internal inflation rate has been less than 1 percent and that has been brought on by extraordinary excess liquidity. Others have referenced the personal savings rate, which is abnormally high within China, that surplus of funds has driven abnormally low interest rates, which is now causing households not to invest in bank product but to speculate in the markets, which only further fuels the potential for an economic overheating.

The conclusion of those observations is to get China back on a solid monetary platform, letting its currency rise is really—value to the dollar—is really to its own economic best interest going forward. But any action that is viewed, excluding the human rights issues previously mentioned, any economic adverse action by this Congress comes at our own significant peril. I go to now the Treasury data as of May 7th and in looking at debt held, U.S. Treasuries by Mainland China, they are second only to Japan, and making the top 20 list now for the first time is the City of Hong Kong, which held only $11 billion a year ago, and is at $110 billion now, as of this report, demonstrating a $100 billion growth just in Hong Kong

and a similar $100 billion growth in Mainland China, now exceeding over $800 billion.

Then when you look at the portfolio that is constructed by this $800 billion investment, it is principally a long-term debt, which goes directly to the stability of our interest rates and our housing markets. So if we were to see as a result of congressional actions precipitous increases or tariffs or actions resulting in a currency readjustment, it could have consequential and significant adverse impact on one of the big concerns of many on this committee, the dream of homeownership, and having our own rates precipitously climb as our ability to market our securities in international markets becomes impaired.

In other words, sure, we need to get these folks to open their doors and let smart people in and help them build their pension plans, their governmental services, move to consumer-oriented commerce, but all the while we need to make sure we are viewed as being helpful partners in this process because they are enormously invested in our economic stability at this time.

Mr. EVANS. Well, Congressman, I think you have hit on a very important point. First, let me say who I am one that is on the side of they need to move at a quicker pace toward a market exchange for their currency. They need to pick up the pace. They are not getting there quickly enough, and they need to do it in their own self-interest. They need to get their system structured in a way to where they can use monetary policy tools in an effective way, which they are really not able to do now because they have to worry about administratively controlling their currency.

So I am one who falls on the side of, let's pick up the pace of moving toward a free market exchange of their currency. But when we start moving down the path, and moving toward protectionist kinds of policies or isolationist kinds of policies or trying to push it too quickly, you are exactly right, we might find in our economy—we can say right now, guess what, this economy in America is strong. It is very strong, we have a 4.5 percent unemployment rate, it is showing great strength, the global economy is strong, the China economy is stable and growing.

So when you start moving things around too quickly, then does it create some instability in the system in their own economy that winds up kind of spilling over into our economy, as you suggest. If all of a sudden the currency goes up too quickly, well, guess what, they do not need to buy as many dollars and so guess what, our interest rates go up. And guess what, maybe it also means inflation starts to creep up in this country.

And my experience in Commerce was that all the times we tried to use some of our tools, which I support, but would tell you that when we put anti-dumping kind of tariffs in countries here and there on their products, their product would come from someplace else. And so the idea that if we try and shut off China, well it is going to come from Thailand or Malaysia or Vietnam or somewhere else.

And so I think we have to be very careful in how we deal with the issue. And I would go back to I think the most important issue to focus on for them is open up your financial services industry. All of us—to me, sometimes we put the yuan out there as a kind of

quick fix, silver bullet, solve all the problems, we are losing jobs here and there, that will stop that, I do not think so. And I really think the focus really needs to be laser-focused on open up your financial services industry. Thank you.

Mr. ALDONAS. Congressman?

The CHAIRMAN. I am afraid the time has expired for the gentleman, I am sorry. The gentlewoman from New York?

Ms. VELAZQUEZ. Thank you, Mr. Chairman. Mr. Aldonas, in your written testimony, you discuss some of the risks inherent to China's liberalization of its financial markets. Could you please comment on how these risks could affect U.S. firms?

Mr. ALDONAS. What you worry most about is that there is something catastrophic that comes about in China's capital markets. You are seeing an asset bubble. Alan Greenspan has referred to that—some discontinuity on the financial side that drives Chinese growth down and American companies with it. It is what I was referring to earlier, Congresswoman. I was saying that we have a very large stake in China's success. It is one of the main engines of growth in the world economy from which we benefit and we participate in.

And China's absence from that would have negative effects on the U.S. economy as well as U.S. firms, both those invested in China and those invested in the United States. So what you worry about is that discontinuity. But the tonic, and the reason why the hearing is so important, the tonic is capital market reform.

The more that you see the liberalization of China's capital markets, the more that you see U.S. firms with the discipline of their credit practices operating in a Chinese market, the less risk there is of that catastrophic sort of boiling down of the Chinese economy. And so one of the great reasons to try and ensure that our firms are on the ground doing what they do best is to make sure that it is a buffer against that sort of problem.

Ms. VELAZQUEZ. Thank you. Mr. Aldonas, many have expressed concerns that enactment of reforms that strengthen the review process for the Committee on Foreign Investment in the United States could result in similar changes in other countries that will have the effect of deterring the ability of U.S. firms to enter overseas markets. Do you believe that CFIUS reform could indirectly impact the ability of U.S. financial services firms to enter foreign markets in China?

Mr. ALDONAS. I cannot say that specifically but certainly the issue of Dubai ports, the issue of China National Overseas Oil, an offshore oil company investing—trying to invest in the United States, have generated—and the response in Congress and the Administration, have created a backlash against U.S. investment in the form of similar sorts of procedures that have been introduced abroad. China is certainly looking at it. Russia has already introduced one.

You see this mirror-image legislation going on. The problem is that the process in these other countries is nowhere near as transparent as what would go on in the United States, the opportunities to state your case in front of the Treasury Department, to get a reasoned judgment does not always exist. And so that is a much

greater barrier than the CFIUS review process that you are grappling with here in the Congress but that is the risk.

Ms. VELAZQUEZ. Thank you. Mr. Evans, in 2004, during a Senate Finance Committee hearing, then-U.S. Trade Representative Robert Zolak stated that he did not support pursuing a World Trade Organization dispute settlement case against China over concerns of currency manipulation in part because it could be difficult to prove that China is in violation of WTO laws. In your opinion, would this argument change if reforms were instituted that increased the ability of U.S. financial firms to participate in the Chinese financial system?

Mr. EVANS. Ask the question again, Congresswoman, I am sorry, the very last part?

Ms. VELAZQUEZ. Can a case for currency manipulation be made without the reforms to the financial systems that have been discussed today?

Mr. EVANS. I am not that familiar with the facts of it. I would say this though, you raise a very important point about China being a member of the WTO and it is very important to use that and all the tools available to us through that rule-based system to do exactly what the chairman pointed to earlier and that is a level playing field. So I am not the expert on whether or not we would have what the position should be with respect to taking that case to WTO, but I would tell you we ought to use the WTO every time we can if we think it helps level the playing field with our economy and the China economy.

Ms. VELAZQUEZ. Mr. Aldonas?

Mr. ALDONAS. Just by way of background, I spent most of my life working in the international trade arena and teaching WTO law at Georgetown University and at least on the basis of the petition the United States faced, I would say that, no, that was not a case you could make under WTO law. It remains to be seen whether you could craft a case that you could actually pursue under Section 301.

But the important thing is what would that lead to? It would lead to the potential for retaliation in the form of tariff sanctions or withdrawal of other trade benefits. The important thing to focus on is what needs to change that has a negative impact on our economy, and those are the distortions in the Chinese economy, not the currency peg.

There is nothing about changing the currency peg or necessarily about slapping a 27 percent tariff on Chinese goods that will do anything to end the practice of non-performing loans that are in fact at zero cost of capital, that favor capital-intensive investment, that lead to this burst in manufacturing that Congressman Baker referred to and that metastasize into trade problems when those imports come to our shores. The answer to that is financial market reform.

Ms. VELAZQUEZ. Yes, thank you very much.

The CHAIRMAN. The gentleman from Illinois.

Mr. ROSKAM. Thank you, Mr. Chairman. As I have been listening to the testimony, one of the things that occurs to me is the different foundations upon which these two economies that we are talking about are actually premised. Our economy and our economic growth and success is based on the premise that the indi-

vidual matters and that freedom is a glorious thing and private property rights are to be upheld, free markets and free people and you know the sound bite but it actually works.

We are trying to translate that or we are casting that, sort of with hopeful eyes, upon a system that really does not share that premise. And so the question is now, as we are having this discussion about the financial marketplace and the maturity of it, as you look forward 10 or 20 years, what is it that animates your hope that the Chinese will see this in a self-interested point of view and how do we shake off the things that they have done in the past that do not give us that hope?

And here is what I mean by that, let's take the conversation that we have had as a country over the past several years about the manufacturing sector. We have talked a lot about it. I represent a district that I have characterized before, the west and northwest suburbs of Chicago, that feels really conflicted in some ways about China, in some ways, great opportunities, in some ways, a lot of pain.

But if you look at what the Chinese have done in the past, they have manipulated currency; I think there is a consensus there. They, as Ms. Waters mentioned earlier, abused intellectual property rights and so forth. So what is it that animates the hope that they are going to do the right thing as it relates to the financial marketplace and that we will not be having this same conversation in 6 or 7 years about the financial markets being abused by the Chinese the way that we have been having that conversation about our manufacturing folks feeling abused. Do you have some insight on that?

And also maybe just commenting on the premise that the Chinese—I think it was an earlier witness, but basically laying out the notion that the Chinese Government is very patient, very control-oriented, casting a long view and do they get eclipsed at the end of the day, do the Chinese officials get eclipsed and does freedom come raining down in China because of the economic growth and they have to translate that into political freedom? I would just be interested in your observations on that.

Mr. PRASAD. How the politics will play off is very difficult to predict, Congressman, but I think a case can be made that in terms of pure economic self-interest, the Chinese are very concerned about what is happening with the financial sector because, as Mr. Aldonas said, there is a two-speed economy in China right now and there are implications of that for social stability.

In addition, if China continues to grow at 10 to 12 percent as it has been for the last 2 years, but does it in this very inefficient way, in a manner that the benefits do not reach down to the households, then again I think social stability becomes a very important issue. So I think in terms of the narrow question about whether financial services that are formed, and liberalization more broadly, is something that the Chinese care deeply about. They care about it deeply.

Now, why they care about it, whether it is for the perpetuation of the existing political system or to lead to something bigger or different is a little hard to tell. But I think on the narrow question, especially as it affects the interest of the United States, is whether

in terms of the economic dimension, China is doing the right thing. And I think we can guide them towards doing the right thing, which will be ultimately in the best interest of the United States as well.

Mr. ALDONAS. If I could, Congressman, they are communists and they want to stay in power, and it has dawned on them that the only way they can stay in power is by meeting the rising expectations of the people. They understand that further liberalization is essential to meet those rising expectations, but they have no experience with how far and how deep that freedom has to run to actually meet those expectations. And so they hedge in terms of their liberalizations, thinking that maybe one part more will make a difference. They just do not realize you really need to blow the whole thing open. It goes to your point about operating off of very different premises.

The interesting thing looked at is China's trade policy is not that different than during the Imperial Age, they granted a silk concession to Marco Polo in Shanghai, what does that sound like to the financial services firms? You get the life insurance thing in Qiang Jo but nowhere else, right? It is not that different. They really lack the experience with the ultimate freedom it would require, but that is one of the reasons why I think we have to articulate why this works in their interest.

And then if I could, I have a little story I have to tell about traveling in China where we were very close to the Straits of Taiwan. We were in a cab in one of those causeways that go out on the street, and I am with a friend of mine who speaks Chinese. And we go by a sign on the Chinese side that says, "One Party, Two Systems," right, and it is so large you can see it in Taiwan. And I noticed there is a sign on the closest Taiwanese island so I asked my friend to ask the cab driver what that says, and in much more colorful language, what the cab driver said was the sign in Taiwan says, "Get Bent."

Well, that is a story about the cab driver's freedom, not the story about Taiwan, right. There are these indicia that what we are seeing evolving in China is a very different society and it is one that frankly the folks in Beijing do not control, and I think it scares them to death. But they need to understand that the only way they are going to achieve their ultimate goal, even under the best of circumstances, is to blow that freedom through their system.

The CHAIRMAN. The gentleman from North Carolina.

Mr. WATT. Thank you, Mr. Chairman. We were trying to figure out what "get bent" meant, but I think we figured it out.

The CHAIRMAN. You could check with the Vice President.

Mr. WATT. Say it again?

The CHAIRMAN. Check with Vice President Cheney.

Mr. WATT. Oh, okay. All right.

Well, that's the third interpretation of it, but anyway. As Members of Congress, it seems to me that we approach this on two different levels. And there's going to be a question at the end of this, so you can be assured of that.

One is the micro level that we experience in our own congressional districts. At that level, obviously being from North Carolina I've seen my textiles decimated, my furniture in the process of

being decimated. In exchange for that decimation, I've seen people argue when I walk into Wal-Mart and Target, lower prices for my consumers.

I've seen my constituent corporation, Bank of America, become a small part owner of a bank in China. For the life of me I can't figure out why anybody would want to own a bank if you have 50 percent nonperforming loans. But you know, I chalked that up, they understand, there's a reason for them to be there. And so I chalk that up as a positive.

On the macro basis up here, everybody in the room, Republicans, Democrats, everybody on the panel has agreed that this transition, transformation is not taking place as quickly as they would like. I heard the chairman's first question, what should the Administration be doing that it's not doing, which I never heard a real good satisfactory answer to other than let's keep doing the same things we've been doing, keeping the pressure on.

And somebody mentioned that there was a role for Congress here, but I'm still not clear what that is. So my question is, given these micro impacts in our congressional districts and the macro imperative of quicker change, what is the role of Congress here? What should we be doing as a financial services committee other than sending shots over the bow like we're doing today at this hearing, assume the Chinese financial services elite will read what we've done here, and maybe the government personnel will read what we've done here, maybe they'll hear the message that we've sent to them over and over again through the Congressional Black Caucus that if they don't do something to humanize their response in the Sudan it's not at all a foregone conclusion that there won't be a growing momentum toward a boycott of the Olympics that are about to take place in China.

I reminded the Ambassador myself that it was black folks who stood with their fists on the winning podium in the middle of our own transition, so this notion that the Olympics is sports and politics is politics is something that we never have quite bought into.

My ultimate question here, and maybe whoever mentioned the possibility of congressional involvement can really answer this, what should we be doing other than sending these shots over the bow as Congress now, as this Financial Services Committee? If somebody can, respond to that in the time that I have left.

Mr. Sorensen seems like a willing participant here.

Mr. SORENSEN. Thank you, Congressman. Very well put, a specific question, which I like to delve into. I yield to my colleagues here who are probably above my pay scale on this but my sense of things is very simple.

Congress can and should work very, very closely and aggressively and insistently with the Administration's efforts to open up the financial services area. Congress in my opinion with respect to the chairman and everyone on the committee has probably not worked as hard with the Administration in constant communication and constant insistence in this work.

The devil is in the details unfortunately. For example, the commitments to open up the insurance section in the branch two subsidiary, the commitments to open up in the securities sector, the

commitments to open up in the banking. Those are commitments. They have to be delivered.

So on a very specific basis over the next 6 to 9 months as the new—the strategic economic dialogue third session gets going and started, and the dialogues with China, those are very specific items in which the committee could work with the Administration, directly with Secretary Paulson or all of his staff at that level.

And then the second thing is to become acquainted a bit more with the actual issues on the ground in China. If we agree that the opening of the financial sector could yield to lots of household aspirations and investments that will eventually free up the currency to the levels where it should be, if that premise is correct then the second premise is, "Let's get it done faster."

I don't think the Chinese understand, as Mr. Evans had earlier said, that the Congress has such a tremendous interest and such an influence. And the congressional process is not very well understood in China because there is no such thing there.

Mr. ALDONAS. Congressman, you know, it's the old trade negotiator in me, but things work best when there is unity in Congress behind a set of negotiating objectives and a very clear message about what the outcome is going to be if those results aren't met.

And again it's probably my instinct as a trade negotiator to say I think what you really ought to do is add an authorization to the President to negotiate. It doesn't have to be trade promotion authority, but an authorization to negotiate on these issues, and then say with the outcome is going to be. We're not going to pull the trigger on 27 percent tariffs in response to a pegged currency if we actually see the underlying reforms that would eliminate many of the distortions.

I recall working on textiles and working on furniture when I was at the Commerce Department. And I'll tell you, when I looked at that problem economically a lot of the unfair competition I saw wasn't from a pegged currency. What I saw was this problem in the financial markets that created a zero cost of capital for Chinese firms.

It wasn't labor costs. This just blew a hole through an industry because it favored those manufacturing interests that now have productive capacity that isn't going to go away until there are reforms in the capital market sector. But what I would want to do is rather than focusing on the peg, identify those items that are critical for American companies to open the market for this committee in the financial services arena, and then lay out what the outcome is if those instances aren't met, give the President the authority and tell him to get after it.

The CHAIRMAN. The gentleman from Texas.

Mr. NEUGEBAUER. Thank you, Mr. Chairman, and I would like to welcome my fellow Texan and neighbor to the south, Mr. Evans. It's good to have you here.

As I was listening to this testimony, and by the way, Mr. Chairman, I think this has been a great panel and great discussion—we know that China has been basically financing their industrial revolution through their banking system and that they have these high savings rates, and what we want them to do is to open up new opportunities in the financial markets in their own country.

I guess the question I have is, is the reluctance of the Chinese to do that because, well, this is the mechanism where if we force all this money to either go to the banks—this is where we have control over that money, this is how we can finance our infrastructure and our industrial agenda. If we open up other investment opportunities to the Chinese people, say, 401(k)s or just other financial vehicles, is there a concern on the Chinese people then that takes the control out of how that money is invested and does that money leave their country or does it stay and continue to be reinvested in their country?

For example, if American companies come in there and they start collecting money from Chinese people, where does the money go and is that a concern of theirs? And I think secondly, if we introduce those new financial vehicles and the ability to borrow and to do some of those other kinds of things in that, does that begin to take some of that money out from under the mattress because maybe they don't trust the bank?

Could you kind of just—I think that may be the premise of what the dynamics in China are doing. Now Mr. Decker, do you want to start, lead off on that?

Mr. DECKER. Sure. I think that concern may have been in place in the past. I think it's less so now. I think that many in China want to build a more robust, more efficient capital market so that companies that need capital don't have only one source through bank lending. They have other sources. They can issue bonds, they can issue stock.

We're contacted regularly by people in China who want advice and help and technical support in how to build a bond market or how to improve the efficiency of the stock market, how to build a clearance and settlement system, issues like that.

The hurdle is that they recognize the need to build an internal market; they're much less willing to open a more robust market up to non-Chinese companies to come in and compete.

Mr. PRASAD. To make one point, they are very concerned about broad financial market reform, but again the order that they are thinking about things may be a little complicated because the banking system again is very dominant and households have a tremendous amount of deposits in the banking system. So their concern is that allowing more financial opportunities for households to put money in places other than banks or to take money out of the country could have a negative impact on the banking system.

So their approach is, let's fix the banking system and then move forward, but the problem is that it's very difficult to fix the banking system unless it has competition, unless there are incentives to improve its efficiency, including importing expertise from abroad.

And the other point I'd like to make is that in terms of their opening, there is a serious concern that they have about their regulatory and supervisory capability because in the past it was the case that this was not an issue. The government told banks who to lend to and the government was going to step in and take care of things.

If the banks need to run as commercial institutions, they don't have the expertise yet. This is why U.S. firms could help them. But even though one might argue that U.S. firms are paragons of vir-

tue, there is a concern among the Chinese that they have a difficult enough prudential problem on their hands. If foreign firms enter with their expertise, do they have the expertise to be able to regulate them effectively?

And this is where I think in terms of the dialogue and in terms of the expertise that the United States can transfer to them, not just through the private financial sector but also in terms of regulational supervision the United States could make a difference.

Mr. NEUGEBAUER. Mr. Aldonas.

Mr. ALDONAS. It's about political power. Ultimately they're concerned that market-based reforms would siphon capital away that is going to be lent to underperforming state-owned enterprises that will result in the displacement of workers. They'll face social unrest.

They don't want to change the capital controls because that siphons money out of the state-owned banks that fund the state-owned enterprises that would lead to job displacements and social unrest. So what they need to be convinced is that there is actually far more to gain from eliminating these things than the risk that flows from those state-owned enterprises.

Now the problem is right now bank lending goes about 75 percent to those state-owned enterprises. It's only about 27 percent roughly to private enterprises, and they're horribly inefficient, so it's a dead weight. The problem is growing, not declining as a practical matter, and so it's a tax they're imposing both on themselves and as their society ages.

That's where you have to point to the risk because if you're really trying to persuade them, look, all right, you want to stay in power, you want to avoid that longer term problem. You know, in politics it's much easier to deal with the short term than the longer term, and I think that's what they're facing, frankly. But it's about the politics as far as I'm concerned.

Mr. NEUGEBAUER. My friend, Mr. Evans.

Mr. EVANS. Well, Congressman, my view is that China is amazed at our economy, and they've been moving into a free market economy for about the last 25 years. We've been in it for a couple hundred years, and it takes time to get these systems in place.

And look at what they've recently done to their banking system. They just separated out the People's Bank of China that now can be the one body that acts as their federal reserve, that conducts monetary policy.

My experience over there is that the leadership understands they need to continue to move away from administrative kinds of controls toward market-based forces. And the debate gets to be the pace of that and how fast does that happen.

But it seems like—my judgment anyway is that they are continuing to try to move—their intention is to move toward more market-based reform. And they have the Central Banking Regulatory Commission now in place that they didn't have a few years ago, the China Insurance Regulatory Commission, the China Securities Regulatory Commission. All of these regulatory bodies are being put in place, so my judgment is that they're trying to continue to move toward market-based economy.

Mr. NEUGEBAUER. Mr. Sorensen.

Mr. SORENSEN. Very briefly, Congressman, in the interest of your time, I'll give you a specific example.

We are partners with the same bank that Bank of America actually bought a 9.9 percent share of for about $4 billion. Their investment has tripled in value. Their $4 billion investment has become about $12 billion because of the stock market increase in China. That was a good play on the part of Bank of America, and a good play on the part of Principal Financial Group and our asset management company.

The specific reason is that the Chinese regulator insisted on an American partner for the bank in asset management. They did not allow the bank, China Construction Bank, our partner in joint venture, to enter the asset management field without an American company as an equity partner. The same happened to the other three pilot banks.

So it is by sector. There is some reluctance, but the regulators actually know that without a foreign technical partner, an equity partner that owns part of the business, that bank or that institution will not do as well.

Mr. NEUGEBAUER. Thank you.

The CHAIRMAN. Let me just ask unanimous consent, if I could, to follow up on that.

Is that a danger then that that's—they got B of A to come in for 9.9 percent to get that technical expertise, so is there a danger then that they'll let us in enough to help them but not enough to really benefit and profit? I mean that's a kind of very limited role and it could be an exploitative one. And that seems to me to be a great danger that they need the expertise, so they buy all the expertise for a very small piece of the equity, and that's trouble.

Mr. SORENSEN. Sir, with great respect, I would argue the opposite. China gets it. The regulators and the government get it. They understand that they will soon be a market economy. And soon to them means 15 to 20 years. They will be absolutely freely interchangeable in the markets within 20 years, in fact probably earlier than that because they need their companies to be global companies.

So this bank, China Construction Bank that has a partner, a 10 percent partner in Bank of America, whose investment, by the way as I said, just tripled in value in the last year-and-a-half, that 9 percent does not need to stay at 9 percent.

The bank will have and probably does have—

The CHAIRMAN. But isn't the policy the other way around, they get the expertise, it doesn't need to expand? If they buy the expertise and they earn, they're smart people and you say they get it. It just seems to me they did get it; they buy the expertise and if they have that then there's no need to expand.

The other thing I would have to say is that we're dealing with Americans who have current needs and concerns. 15 to 20 years is a long time and it's a long time to expect people on our side that we represent to continue to forebear.

But to go back to the specific point, I don't see how there is any necessity for them, having bought all the expertise—they didn't buy 10 percent of the expertise. They get 100 percent of the expertise for 10 percent of the equity, and if they learn and know—be-

cause we run into this in the technological area. There isn't anything automatic that says they will then have to open up more. Maybe they get the expertise and say, "No, we don't need you as much."

Mr. SORENSEN. There is obviously that possibility, and of course that depends on business relationships. I don't know the terms of the agreement that this specific equity purchase entailed. There are a number of other requirements from Bank of America to enter the credit card business. I believe that they have over 500—this is the information that I have from my partners who have shared this—actual Bank of America technical experts putting in a credit card system that is partly owned by Bank of America and the China Construction Bank, whose profits actually are revenue split with Bank of America.

The CHAIRMAN. In what proportion?

Mr. SORENSEN. I'm sorry?

The CHAIRMAN. In what proportion, 90/10?

Mr. SORENSEN. I really don't know, but I know that the intent of Bank of America, in that particular situation was not only to own equity in the bank, but to actually create a credit card business—

The CHAIRMAN. For the Chinese owner who may then not need them in the future.

Mr. SORENSEN. Well, I would say for both, for both, sir.

The CHAIRMAN. At 90/10?

Mr. SORENSEN. Well, maybe not necessarily at 90/10.

The CHAIRMAN. You're right. I don't want to exaggerate it, at 90.1 to 9.9.

The gentlewoman from New York.

Mrs. MALONEY. I thank you. A fascinating—I'm sorry I missed the testimony, but I was on the Floor mainly because we on the Education Committee have been trying to push science, math, and engineering for our young students, which fits into the global economy that we're facing. So we finally got something that we've been trying to do for 5 years now.

I had the privilege of being over in China with the Education Committee last year. I'm not going to say that my knowledge on the financial services issues is as sharp as some of the others, but the questions that were brought up I have a curiosity about.

Meeting some of the younger communist leaders who mostly have gone to school here, they are looking to the future. And then dealing with the older ministers who have been there for a long time, you can see they're concerned about moving forward too fast. And with us here, you know, we're a fast moving country; we want to go, go, go, go, go.

Understanding the culture is something that the United States has not done a good job with; we need to work on understanding the cultures of different countries. Are we pushing them too fast?

They know they have to change their finance service outlook, but one of the questions that was just answered—Bank of America, does the money come back here to America or does it stay in China? When you were talking about that the profits, where does that money go?

Mr. SORENSEN. From my understanding of the capital market system—and by the way, I'm not an economist, so I'm not an expert in this area, China Construction Bank is a publicly traded company. It is 51 percent owned by the government, however 49 percent of the shares are actually in the public hands; 10 percent of those shares are Bank of America's, so any dividends that the China Construction Bank pays do come back to America from those shares.

Mrs. MALONEY. They do come back. And I guess the other question that I had—Mr. Evans, we talked about being protectionists and everything else and yet, with the conversations that we've heard, China is doing the same thing. They're afraid of discourse because their laborers will be laid off. So we're fighting the same thing here. That's what a lot of Members of Congress are dealing with as far as our people losing jobs.

And again, I do believe over the last 20 years we have not done the right thing on retraining workers for the future. You know, everyone keeps talking about that even with some of the trade deals that we're looking at now with Peru. Where is the educational force coming in, not for a job that's going to last for 2 years, but where are the jobs going to come from that will be there in the future? And that's where the businesspeople in my opinion should have a voice in this because the more people that are laid off in this country, which I understand is going to happen, it has always happened—but we have not been prepared for it. In the past it has been a slow movement.

Now we're seeing it with the automobile industry. It is something that is happening. You know, we're losing that. And we're going to be seeing—you know, you wonder why we're going to have Korean cars, Chinese cars. I toured their plants. They're way ahead of us on the technology, the forms. So I can understand why the Chinese are afraid of their people losing jobs in discourse. We have that going on here.

So until we start settling some of our own problems here in this country, how do you expect us as Members of Congress, who all know global economy is there, how do you expect us to handle that when we should be protecting our people too? It's all part of the global economy, but you can't tell that to a lot of people who are being laid off. I mean that's just my common sense talking.

Mr. EVANS. Yes, I think you raise the central issue. What do we do to make all Americans ready for globalization, ready for this rapidly changing economy that we all find ourselves in now? I think it's important to put it in perspective. Remember that in 1975 we had about 30 free market economies in the world and about 400 million workers. Now we have 135 free market economies in the world and over 2 billion workers that we're competing with. We have to train our people, educate our people, and get our people ready for this rapidly changing global economy that we are in today.

And I would be one who would be a very strong advocate for increasing the support for training programs and education programs and supporting people who are in transition from one job to another job. It used to be you'd go to work for a company and that was your career at that one company. Now you may have 4 or 5

different careers, not to mention 10 or 15 different jobs. And we ought to make sure people understand that's the economy we live in today, so as American workers you'd better have yourself ready and trained and have the skills to compete in this rapidly changing economy.

And I think as you said, I think the private sector has a very important role to play there. I think government has a very important role to play there.

Mrs. MALONEY. I'm not concerned about the younger workers; I'm talking about the workers who are 55 years old. You know, yes, you can retrain them, but they're being retrained for a job where they're not making as much money. That has a lifelong effect on them because that deals with their pension. That deals with social security. That deals with their healthcare benefits.

I mean we, as the Federal Government, in my opinion, know that we're going forward. We will go forward, but we still have to do a better job of taking care of people who are going to be disrupted by this economy that is changing rapidly.

The CHAIRMAN. I'm afraid we have to move on. Mr. Manzullo.

Mr. MANZULLO. Thank you very much for coming. I recall reading an article by Bob Vestine years ago that when financial services—and I'm wondering why he's not on the panel, but—

The CHAIRMAN. If the gentleman would yield, in part because the Republicans didn't suggest him.

Mr. MANZULLO. Yes. That's okay. I'm sure we'll have lots of hearings, a lot more hearings on this. Anyway, the article talked about manufacturing will follow—manufacturing exports into underdeveloped countries will follow the development of financial services because you have to find a way to buy the stuff and pay for it, etc. And I've always believed that to this date, the more penetration we have into China's financial services, the greater opportunities we'll have to sell U.S.-manufactured items there.

Some people disagree with that, but I think what happens is that the maturity of the financial markets really is a forced springboard into economic maturity. The Chinese have—to them, "soon" could be 5,000 years. That is the length of recorded history.

Secretary Evans, the last time you were here the press said that I gave you a very difficult time. I didn't think that I had, and I just want to let you know that I think you're doing a great job over there as you did in Congress. And Under Secretary Aldonas, you came to Rockford and held one of the manufacturing seminars that improved everything.

The problem that we have, and I agree with everything that everybody says, it's a very scholarly presentation, and it makes a lot of sense. The problem is, I think, joined by what Chairman Frank said, and that is, how long are the American people going to have to wait for this?

I believe that it could be sooner than 15 or 20 years and you cannot have the hemorrhaging that's going on, but I know that what you're saying is factual based on two things. I mean your word would be enough, but when I was in Shanghai, I ran into Mr. Shang He, who was the president of the Shanghai stock exchange. He's 30 years old. And I said, "Mr. Shang He, how is it somebody

your age is the president of the stock exchange?" And he said, "Anybody over my age does not know what a stock exchange is."

And when I was in Macao, there was this incredible festival going on and there were balloons and clowns and I had no idea what it was. It was an insurance festival. I mean people were just excited that all of the vendors were selling insurance. And I said, "Why are the Chinese excited?"

It was like an outdoor circus or a carnival. People were excited, and lined up, and getting balloons and pins—Made in America—and everything. And the issue there, the issue with the fact is that there is no real social security system. The Asians do invest a fourth to a third of their money for retirement.

So I mean no one can say that what you gentlemen are stating is without factual basis. I've seen it for myself, and you really have to be there to see what's going on in the country.

My question is this. And Grant, if you want to take a stab at it, and Don, and anybody else, what will it take to go from an undeveloped to a developed state? What incentive do the Chinese need? And the third thing is that now they have a very aggressive federal government that is slapping countervailing duties on glossy paper, which is the first time that's been done in a non-market economy.

Madame Wu Yi has gone wild over that. She's extremely excited. That caught her attention. What do we need to get this thing moving?

Secretary Evans, maybe you could take a stab at that, because I feel I owe that to you after what that newspaper article said.

Mr. EVANS. No, I thank you, Rob. Look, I think we're doing what we should be doing and just I would pick up the volume probably a little bit. As I said earlier, Congressman, I think this committee has a vital role to play, a critical role to play. And if we should be heard, you make the absolute point that, you know, they're starting to understand countervailing duty tariff.

Where did that come from? Well, that came from a trade law that was passed by Congress. That's where it came from. And so Congress plays a critical role in this whole process. The Administration has set out, under Secretary Paulson's leadership, the strategic economic dialogue, which has enhanced the engagement, increased the engagement with China, and I just think that Congress must play a big role in that engagement.

It comes from doing what you did, going over there and seeing them and sitting down and talking to them. You know—in terms of I'm not here to propose any specific policy. Here is my belief of how this works. My belief is that when you conduct commerce or trade with somebody, you have to communicate with them. You talk to them. When you talk to them, you begin to understand them better, and they understand you better, and then you develop respect for one another. Once you develop the respect, all of a sudden you have some friendships and partnerships, and so I think that's what it's about. I think it is about continuing to enhance the communication between our two countries, so they clearly understand where we're coming from, and we get them to respect that view, as we should respect their own views.

But I don't have any silver bullet, other than just keeping the pressure on through dialogue and I think it's perfectly appropriate

obviously that Congress is talking about different kinds of legislation. I think it's perfectly appropriate that the Administration continues to enforce the trade laws, like anti-dumping, on glossy paper, or taking them to the WTO.

The CHAIRMAN. Briefly, Mr. Aldonas.

Mr. ALDONAS. It's a wonderful question, Congressman, and I'd make one concrete suggestion just to add what the Secretary said. We deem them to be a non-market economy under the dumping laws. Why not go to them and say, we're more than happy to call you market economy, but you have to have a function in capital market before we can do that.

And what we want to have is complete liberalization in the financial market. Put it on the table. See if they bite. You know, the reality is if these people have full access to their market, you will find it will be a market economy. It will drive change.

But why not go ahead and sit down and have that conversation rather than shooting at it? And Congress can lead on that score. Congress can put that issue out there as a possibility so that the Chinese know there's a successful outcome as well as a potentially negative outcome.

The CHAIRMAN. I'm going to recognize the gentleman from Georgia. I'm going to take 30 seconds of his time just to say, Mr. Secretary, I was delighted to hear you say, and I'm serious, that there's a rule for the private sector but also for government in responding to the important social concerns of the gentleman from New York, retraining, education, yes.

The problem we have is this. There has been for a decade or more a relentless and unfortunately successful assault on the revenues of government, and the fact is that neither the Federal Government nor most state governments today have the money to do this important job training. I've heard from Chairman Bernanke and Chairman Greenspan. Education is the way you deal with diminishing inequality. The fact is that in America today, the way we finance higher education reinforces inequality. It does not diminish it.

And so I welcome that, but you know it's important to recognize the role of government. It's unimportant to make sure that government has the revenues to do that and until we have that, the situation will get worse and worse.

I thank the gentleman from Georgia and I recognize him.

Mr. SCOTT. Thank you, Mr. Chairman. I find this to be a very, very interesting and provocative hearing. China presents a dilemma for us, in effect. It's sort of like a yin and a yang. It's like a threat and a big one, but it's also an opportunity and a big one. And we have here a growing private capitalistic economy: globalization, and yet at the same time it's tied within the secretive constraints of communism. And I think within—that gives this tug and pull that we're faced with here, particularly in the area of currency reform, in which all of our manufacturers are saying that they need to raise their currency and value.

At the same time all of this is going on, we're in debt to China for nearly $400 billion. At the same time, our trade deficits are huge. And at the same time, there is this reluctance to increase the level of foreign ownership in Chinese banks and other financial in-

stitutions. So, one of the first questions I'd like to kind of get at in all of this is, could you give me an assessment of something that we haven't mentioned. We're dealing with a communist country still, are we not?

And could you tell us in your own opinion, very quickly, because I have a series of other questions I wanted to ask, of what significance is this now. What role does China being a communist country play in particularly the issue that we're facing today, trying to get market-determined currency exchange rates, trying to get the currency reform, trying to do the issues we do. What problematic situations are we faced with with, that being within the constraints of this still being a communist country?

Mr. DECKER. I'll take a shot at it. Well, I think one of the most significant effects we see with regard to the process, the policymaking process in China is the relatively closed and opaque process that they have in place for rulemaking and for regulation. It's difficult for firms doing business in China to understand always what rules apply and how they apply, how they'll be enforced.

When rule changes come about, it's not always possible. The process is not often interactive. Those being regulated don't really have a chance to make their views known to the regulators. There's not always sufficient time, once regulations are put in place, for firms to comply, to change their processes in order to comply. And one of the points we've tried to make through the SED, and independently in talking with China is that the regulatory process there needs to change.

It needs to become more transparent. It needs to become more open. It needs to be the same kind of opportunities we have here, to file comment letters with regulators when new regulations are proposed or to have sufficient time to implement regulations or to know that enforcement of regulations will be uniform and fair. Those same kinds of processes need to be in place.

Mr. SCOTT. You don't see the fact that they are still a communist country being problematic here?

Mr. ALDONAS. I think that the regulatory process stems in part from the broader system of government that's relatively closed and undemocratic.

Mr. SCOTT. Particularly, would that be in terms of their managed control of the yen as currency?

Mr. ALDONAS. I think the desire to control the currency value and the other kinds of currency-related issues that we've talked to probably stem from a different motivation than trying to keep the regulatory process relatively closed.

Mr. SCOTT. Do you see the influence of communism in the near future being lowered? Are we looking at a crystal ball ahead as we move forward with China becoming more open in terms of its markets, in terms of capitalism, in terms of all of the trade issues, all of the interplay and the globalization? Do we see communism then being marginal as something the old guise about to be had now and maybe in the next 10 to 15 years, communism will be a thing of the past in China?

Mr. ALDONAS. Congressman, first of all, you're right. It just builds in a very conservative, from their perspective about any kind of change that moves in the direction of a market. We have a tend-

ency to think about this as a monolith, but it's not. There's politics in China and there is a backlash against liberalization going on in China right now.

Mr. SCOTT. My time is up. But Mr. Chairman, I'd like to just ask one more question.

The CHAIRMAN. I took a minute of your time.

Mr. SCOTT. Thank you, sir. And while Secretary Paulson has stated his support for continuing dialogue with China and how it has allowed this country, our country, to achieve certain results, Mr. Secretary has also expressed disappointment that China has refused to make changes to its foreign ownership rules, especially in its financial services sector. I'd like to know your thoughts on ownership caps and furthermore do you believe that domestic Chinese interest groups have something to do with or a strong influence on blocking more extensive change?

Mr. PRASAD. As in any other country, there are interest groups that would prefer to keep things a little bit protected. But I think the Chinese authorities, and this is where the communist role that you brought up becomes very important, because it is true that there are issues about lack of accountability, lack of transparency, which is referred to. But there is also a strength in the sense of the communist party derives its legitimacy from economic development. And therefore they can focus on that, tamping down some of the short-term pressures that arise in the process of transition to a market economy.

Again, with respect to the question that Chairman Frank had asked earlier about whether ownership should be opened up completely, I think the Chinese are fearful at the moment that opening up their financial system completely to foreign ownership could in fact lead to the domestic financial institutions, including the banks, essentially becoming non-competitive. So they're taking it in stages, and I would like to echo the optimism of the other panelists, that they are taking this in a stage-by-stage process, and I do see this moving forward, once they feel that the domestic finances—

The CHAIRMAN. You say they're afraid to open up because their people wouldn't be competitive. What do we say to American manufacturers who have been put out of business by the Chinese because they weren't competitive? Why does it become legitimate to say, we can't let you in because you'll be too good at it? Why is that a one-way ocean?

Mr. PRASAD. Other than legitimizing this, I think in terms of economic welfare, I think there is a consensus that opening up, either in terms of the financial services or trade, is ultimately beneficial to the economy.

The CHAIRMAN. Except you've just accepted, or not accepted but put forward the Chinese reason for not doing it. And remember, again, not everybody benefits equally from this. But you've just come to the heart of it. We are talking about—you can't expect the Chinese to allow our banks to go in there. They would out-compete the Chinese banks. But why is that not an argument for restriction against Chinese coming in and putting Americans out of business. And, I mean, to tell Americans well, you shouldn't worry about it, but they're allowed to, they're not happy.

Mr. PRASAD. In a sense I think those restrictions hurt the country that impose the restrictions, and in the Chinese case, if they do not move fast, I think it will affect—

The CHAIRMAN. Well, Dr. Prasad, let me say this. Now you say that because I brought it up, but I think if you go back and look at the transcript, you sounded much more sympathetic to that earlier. And it was oh, the Chinese don't want to open up because then their people will be at a disadvantage. And yet when I raised it, you say well, it's not in their interest. But they think it is and they're acting that way, and you have this fundamental contradiction, gentlemen, that you have to deal with.

And then, I mean I know you did not explicitly say it was okay, but you said this is why they do it. What is it, to comprende, to pardonne; to understand is to accept and to pardon. And there is this theme, and you've heard this from some of my colleagues. It is a one-way ocean to some extent, and that is causing problems. Mr. Decker?

Mr. DECKER. I just want to respond by saying that some of the biggest financial services firms in this country are predominantly owned or headquartered outside the United States, companies like Credit Suisse, UBS, and Nomura.

The CHAIRMAN. Deutsche Bank, yes.

Mr. DECKER. And of the 8 or so emerging markets countries with the biggest potential for growth and financial services, 6 of them allow 100 percent ownership of financial services firms by foreigners.

The CHAIRMAN. China and who else?

Mr. DECKER. China and Malaysia are the only two that don't.

The CHAIRMAN. So that does not seem, I accept what you say, that does not bolster the case for letting the Chinese off the hook. The gentleman from Georgia?

Mr. SCOTT. I want to conclude on this point. We're trying to find out—my follow-up was is there anybody who can give us any level of foreign ownership in Chinese banks or financial institutions? You know, I said earlier that China to me has really been the big elephant in the room for a long time, but we're going to have to deal with this. It's the biggest market.

There are all kinds of problems going on over there in terms of their pollution, their environment, and their population. I mean, they're just—so we have to deal with it. The area that concerns me so much is the fact that this not allowing participation and ownership in getting involved with their financial institutions, we are an open area, yet we borrow $400 million, $400 billion a year from Chinese banks and their financial institutions. Just the interest alone on paying that is more than we put in to take care of our veterans. And yet this participation is only one way, and the most critical area of financial services rests within the banks and the financial institutions that—they're closed to us.

So, I just wanted to, in conclusion, see if anybody had any information in terms of what is the current level of foreign participation in the Chinese banks or their foreign service, and specifically American—

The CHAIRMAN. Let me do this, because I think these are useful figures. We would ask you to please respond to that in writing, but

could we maybe get an "off the top of your head" estimate now. But if we could get that in writing that would be very helpful, and we'll leave the record open.

Mr. EVANS. Yes, Congressman, you articulate that very well, so keep it up. The numbers as I understand it are 25 percent total ownership, 20 percent by anyone from any one country, I think it is.

The CHAIRMAN. Any one investor?

Mr. EVANS. Any one investor. So, it's 25 percent total and 20 percent any one investor. The investor can't own more than 20.

The CHAIRMAN. The gentleman from Missouri. Oh, I'm sorry. Mr. Sorensen, go ahead.

Mr. SORENSEN. That would be in the banking sector.

The CHAIRMAN. Yes.

Mr. SORENSEN. Insurance is up to 50 percent, and that is due to the commitments that China made to the WTO. We have not been able to get them over that 50 percent range yet. In the enterprise annuities area, which is my specific area, which is just being born now, no particular percentages has yet been set up, because it is too new an industry, and we are pushing to have at least the same as the insurance industry, which is 50 percent.

The CHAIRMAN. Thank you. Mr. Cleaver?

Mr. CLEAVER. Thank you, Mr. Chairman. My concerns are a bit different than those that have been expressed, which were very enlightening. You are very enlightening. Thank you so much for being here. Doctor, perhaps my question should be directed to you. The Chinese began construction on a new coal-fired plant every week, one a week. Each coal-fired plant emits about 10,200 tons of nitrogen oxide, NOx. That equals to about 500 late-model cars.

And in addition to that, they are essentially saying to the EU and to other 21st century companies, which I hope we join eventually, that "yes, we are carbonizing the atmosphere. Yes, we are damaging the earth. But you did it for years, and now that we have our opportunity, now that we're into the industrial age, you're saying we need to stop." Our effort now is to stop.

Now does not this create problems, particularly when the 27 nations of the EU are already putting in place a carbon trading system and the European nations and almost all the nations in the world except the United States, Australia, China, and India are already trying to deal with this problem?

But in a global economy when you have the EU and the companies there, and by the way there are American companies that are in Europe, like shale, that are also far ahead of the U.S. Government in dealing with this issue of climate change. But when you have China in bold disregard to the environment, trying to do business with Europe and the United States, does not this create some major problems for all of us down the road?

I mean, I'm not suggesting that, you know, setting up a cap and trade system or the other things that we need to do, will by any means create economic problems for us. But at least we're going to be moving toward new technologies, and if China is and India—but let's deal with China now, is still going back doing what we did in the 1920's and 1930's, and refusing to even make any modest changes, aren't we headed for some major economic problems?

Mr. PRASAD. This is normal. But let me make two observations based on what I have heard from the Chinese authorities. One is that they are concerned, as you are, about the implications for the rest of the world. They are very concerned about implications with China itself, because again, when you go on the streets in Beijing, the effects of the pollution and the smog are very visible. So I think ultimately the pressure will come from within. But the problem is whether the accountability systems are there in place so they can actually control what individual enterprise system, especially the state-owned enterprises, which in principle are under the government's control.

So I think ultimately the move towards market economy will, I hope—and this is more a hope than anything specific, that it will include aspects of environmental concern. But the government, I can tell you, is very seriously concerned about it. But again, the legitimacy of the government derives from a variety of things, including economic development, so they are facing this very difficult balance, which is what ends up coming out in the sort of statements that you referred to.

Because, ultimately, the legitimacy does come from being able to deliver economic development to the people. So when the issue of the environment starts becoming something that the people demand, it's very difficult to tell.

Mr. CLEAVER. So, with Europe and as I said, I hope that the United States can join the 21st century during our lifetime, that we will also admit that there is a climate change. But as we're moving toward trying to establish new technologies, it appears that China is not trying to move at all. I mean, I realize that with some of the government sponsored companies, that does create a challenge, but there's going to eventually be even greater resentment. We have a resentment here, because of the balance of trade-in and a number of other issues. But there will be even greater resentment when we begin to alter economically how we produce goods and services and the Chinese are simply, you know, just building coal-fired plants, which is very inexpensive to operate, and we're using all kinds of new technologies.

It seems to me that I'm saying we, I'm hoping that we'll join, but the problems that I foresee is the balance of trade increases, the imbalance rather of trade increases that we are going to import many, many more cheaply produced products into the United States, because the Chinese are not spending any money trying to clean up the environment, and the Europeans are already looking at what's going on over there and over here, for that matter.

Hopefully, something will happen this week in the G8 meeting. I don't think so, but the concern I have is we don't have time. I mean, time is not on our side in terms of the environment. You know, it's not like we can fix this in 2020. I mean, it's not on our time. Most of the scientists are saying that we need to move today in order to put in place whatever controls that are needed, you know, in the next 2 or 3 years. And I could go on. I don't want to start preaching, but Mr. Sorensen?

Mr. SORENSEN. Just a quick comment, Congressman, in the interest of your time. One of our partners in our joint venture with China Construction Bank is a minority partner, with a smaller

stake than as a Chinese partner. It was Huadian Power Generation. It's a very large, I think the third largest power generation company in China. They have two things: one, they are building a number of coal plants, yes. They're also building nuclear plants. The concern that they have is that they don't have access to enough technology from the United States to actually reduce their carbon emissions, so there has been a lot of intensive dialogue. I sat at the head table with Mrs. Hu Yi and Mr. Dave Johnson, the Administrator of the EPA, whose counterpart was on the other side of the table, the Chinese counterpart.

They are extremely worried. In fact, one of the things they're actually discussing is that during the Olympics in July 2008, most industry in Beijing will have to shut down because they will not be able to, for the 2 or 3 weeks, deal with all of the pollution and will obviously wish to put a better face on the environment, because Beijing is becoming extremely polluted.

So there's a lot of worry about their own environment, which transcends, basically, their economic concern about not having enough energy. So they're between a rock and a hard place on this and there's a huge concern. There's a huge opportunity for American technology in basically the sequestration or capture of these carbon emissions, for technology companies in the United States to actually provide this and sell it to the Chinese as best as we can.

Mr. CLEAVER. They're refusing any kind of cap and trade system, the Chinese have so far. They're saying no. We have 103 nuclear plants here in the United States and we have some major problems, because as you know there's no way of storing the waste.

The CHAIRMAN. We do. I mean, it's not our jurisdiction, so if you gentlemen could just wrap up, we could.

Mr. CLEAVER. Thank you.

The CHAIRMAN. I thank the panel. I have one last question. Why are there two names for the Chinese currency and is either one the preferable one to use?

Mr. PRASAD. The reminbi is the name of the currency. It literally means the people's money. The yuan is the unit of accounts. It's sort of like pound sterling. You know, the sterling is the currency, but you say 10 pounds for something. So you would say that something costs a yuan or it is 8 yuan to the dollar.

The CHAIRMAN. The reminbi is like the sterling and the yuan is like the pound.

Mr. SORENSEN. Well, on the actual currency, the actual term is printed.

The CHAIRMAN. What does it say?

Mr. SORENSEN. Reminbi yuan, both.

The CHAIRMAN. Oh, it says both?

Mr. SORENSEN. Yes.

The CHAIRMAN. All right. Now, I know. Thank you. And I really appreciate this. I have been talking to staff members here, and I think we will probably take some further action. It does seem to me that frankly a resolution of the House might make some sense as a contribution to the dialogue, and so you've suggested it. Congress ought to speak out on this.

And I would just say this: From the employment standpoint, we don't expect this to be a major source of American's going over to

work there, but there is enormous concern about the balance of trade in that huge deficit and our ability to earn a lot more in China, if they would have reduced these restrictions, is a very important one. And I think you might see that in a resolution.

Thank you, very much.

[Whereupon, at 12:27 p.m., the hearing was adjourned.]

# A P P E N D I X

June 6, 2007

**STATEMENT OF RANKING MEMBER SPENCER BACHUS**
**HOUSE FINANCIAL SERVICES COMMITTEE**
**"U.S. INTERESTS IN REFORM OF CHINA'S FINANCIAL SERVICES SECTOR"**
**WEDNESDAY, JUNE 6, 2006**

Mr. Chairman, this is as important a hearing as we have had in this Committee this year, and I commend you for scheduling it. When it comes to the issue of U.S. access to China's financial services sector, the stakes could not be higher – for both countries.

Just recently, Treasury Secretary Paulson, Chinese officials and U.S. and Chinese business leaders – including some at the witness table today – concluded the second meeting of the Strategic Economic Dialogue (SED) here last month. Participants made solid progress in a number of important areas.

Unfortunately, last month's session did little to address the underlying causes of the growing trade imbalance between our countries: China's unwillingness to embrace market reforms and currency liberalization. So, as we move forward, we need to acknowledge that a dialogue, though important, simply isn't enough.

Our trade deficit with China has reached historic levels, ballooning from $83 billion in 2000 to over $200 billion in 2006.

This is both emblematic of and one of the main contributors to the overall U. S. current account deficit, now totaling nearly seven percent of the U. S. gross domestic product. Tangible results to address this deficit are needed in a relatively short timeframe.

At the end of the 20th Century, the United States faced similar challenges related to the decade-long surge in Japanese exports and subsequent capital investment in many U. S. companies. Then-Treasury Secretary Rubin's decision to negotiate a financial services agreement with Japan in 1995 now offers us a blueprint for a concrete, measurable step that would allow for market conditions to determine exchange rates and drive the structural changes necessary within China to create domestic growth led by consumer demand.

In my opinion, the quickest way for China to strengthen its own domestic financial markets is to bring in foreign financial service experts with the advanced talents, technology, and know-how it would take China decades to develop on its own.

By providing the world-class financial products and services that China's citizens and businesses need to save, invest, insure against risk, and consume at higher levels, U.S. financial firms can help activate the Chinese consumer and entrepreneur, better mobilize China's vast savings, create and protect wealth, and provide the operational means for greater currency flexibility.

The result would be what every U.S. manufacturer and service provider wants -- an unleashed Asian tiger hungry for American products.

That is why, Mr. Chairman, I have called upon the U.S. and China to complete negotiations for a Financial Services Agreement by the end of this year. Such an agreement would establish commitments to allow complete market access in the banking, securities and insurance sectors, ensuring a level of non-discriminatory regulation necessary to allow U.S. financial firms to transform China's financial sector into a modern success story.

Two centuries ago, Napoleon is said to have likened China to a sleeping giant who, once awakened, would "astonish the world." That the giant is now awake is obvious. Now we need to determine how and on what terms we want to engage it. With America's clear leadership in the global financial services marketplace facing energetic competition from Europe and Asia, tapping into the Chinese financial services market offers us remarkable opportunities we cannot afford to ignore.

Chairman Frank, thanks again for convening this important hearing. Let me conclude by thanking our witnesses for being here today.

U.S. Congresswoman
Ginny Brown-Waite
*Representing Citrus, Hernando, Lake, Levy, Marion, Pasco, Polk, and Sumter Counties*

Committee on Financial Services
Hearing, "U.S. Interests in the Reform of China's Financial Services Sector"
June 6, 2007
**Statement for the Record**

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Thank you Mr. Chairman for holding this hearing today. And thank you to all of the witnesses before us.

While trade relations with China have improved over the years, I still have several concerns over their policies, particularly their disinterest in providing greater currency flexibility. Since 2005, Chinese officials have promised an adjustable Yuan exchange rate, yet the only step they took was to devalue the Yuan a mere 2.1%. Today the Yuan still enjoys an 8.11 exchange rate with the dollar – a suppressed measure that requires competing East Asian economies to follow suit. It is obvious the United States will continue to wait for China to make good on a promise made years ago.

Keeping the Yuan artificially low places a seriously unfair competitive advantage on Chinese exports over American imports. Chinese leaders hide behind the excuse of a developing country and spin tales of economic chaos should they abandon their currency policy. This self-serving practice by the Chinese only adds to the lop-sided trade deficit America holds against China - $233 billion in 2006 - and is bad for American auto, textile, technology, and other manufacturing markets.

China is America's 2nd largest trading partner; the 2nd largest source of imports; and the 4th largest export market. It is high time our President steps up to the plate and puts the pressure needed on China to force them to make good on promises made over two years ago. American exporters cannot afford to be patient any longer.

I look forward to hearing what our witnesses have to say on China's trade policies, and thank the Chairman again for holding this hearing.

**Written Statement of Grant D. Aldonas[1]**
**Before the Committee on Financial Services, U.S. House of Representatives**
**"U.S. Interests in the Reform of China's Financial Services Sector"**
**Wednesday, June 6, 2007, 10:00 a.m.**
**Room 2128 Rayburn House Office Building.**

## Introduction

Chairman Frank, Ranking Member Bachus, and Members of the Committee, I want to thank you for holding this hearing on reforms under way in China's financial services sector and for offering me the opportunity to appear before you. From the perspective of one who has been involved in our economic relationship with China for over 25 years since my early days as a Foreign Service Officer in the State Department, there is no single more important topic – for what it says about China's role in the world economy, for what it portends for our bilateral trade and investment relationship, and for what it means in terms of China's progress toward a market economy and, ultimately a freer society. I intend to touch on each of those topics as a part of my testimony before the Committee.

I want to start by outlining where China's capital markets stand today. I will identify the reforms that are needed for China's capital markets to perform the essential functions of providing liquidity to China's economic system, steering capital to its most efficient use, valuing assets properly, broadening the vehicles available for Chinese savers and other investors to participate in and contribute to China's economic success, and the ability of China's financial markets to serve as a useful economic policy tool.

From there, I think it is important to put China's reform efforts in a broader economic context, domestically and internationally. After that, I will discuss the potential vulnerabilities inherent in China's liberalization, the pace of China's reform efforts, the constructive role that U.S. firms could play as a part of those efforts, and the prospects for U.S. financial services firms in China in the future.

## Needed Reforms in China's Financial Markets

Reform of China's financial sector is critical to China's ability to confront the broader economic challenges it faces. China's capital markets do not currently provide the liquidity for the smaller enterprises that are needed for a shift in its pattern of production and consumption. Failing to address the needed reforms will ensure a

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[1] William M. Scholl Chair in International Business, Center for Strategic and International Studies; Founder and Managing Director, Split Rock International; Under Secretary of Commerce for International Trade (2001-2005); Chief International Trade Counsel, Committee on Finance, U.S. Senate (1997-2001); Partner, Miller & Chevalier (1986-1997); Director, Latin American and Caribbean Affairs, Office of the United States Trade Representative (1984-1985); Foreign Service Officer, Department of State (1980-1984); University of Minnesota Law School (J.D., 1979); University of Minnesota (B.A. in International Relations – concentration in Economic Development, 1975).

continuation the current export-led growth strategy that has caused such friction in the trading system, particularly in with the United States, China's most important export market.

In the absence of serious reform and an opening of the Chinese financial system to firms with sound credit practices and healthier balance sheets, China will continue its current pattern of capital inefficiency. The Chinese capital markets should be steering capital to its most efficient use, given that China remains desperately short of capital for longer term investments despite the obvious excess liquidity in the system currently.

China also needs reform in its financial sector to ensure that assets are properly valued. Whether stocks or real estate or a variety of other speculative investments, China now faces something of an asset bubble without the means to unwind those investments should the market turn down at some point soon.

China also needs reform of its financial sector to ensure that there is a broader range of savings and investment vehicles available to Chinese savers and other investors. Such vehicles create opportunities for a much greater share of Chinese society to participate in and contribute to China's economic success. Access to those vehicles would encourage a much more broadly-shared prosperity than is currently the case throughout China, with all that implies for social and political stability within Chinese society.

China needs financial market reform in order to ensure that its economic policy decisions have some traction in the economy. Currently, the inefficiency of China's capital market prevents Chinese economic leaders from exercising any control over the provision of credit, the quantity or velocity of money, or any other factor without using fairly blunt means of control, generally involving direct controls on the quantity of money in circulation rather than its price, as is the case in most modern economies.

The costs of these weaknesses in China's financial system are manifold, which leads to policies like the current peg of the reminbi to the dollar, which has its own significant negative effects. While much of the debate over China's currency peg here in the United States focuses on the impact on our bilateral trade, in China the peg is viewed as a necessary means to ease adjustment in the financial sector and a means to an end – maintaining export-led growth, which the Chinese believe is necessary until reforms in the financial sector can foster the more balanced growth they need.

That argument is, of course, almost precisely backwards in terms of what China most needs to ensure greater capital efficiency and to regain control over its monetary policy so that it can be used to foster more balance economic growth and a more broadly-shared prosperity. A floating exchange rate would lead to more efficient use of capital throughout the Chinese system, which would facilitate adjustment, rather than retard it. In addition, it would allow the Chinese central bank to concentrate on domestic economic management and improving the banking sector, rather than spending most of its time

worrying about sterilizing dollar inflows and figuring out how to recycle its foreign exchange surplus.

In that sense, the currency peg and all that it implies about the focus and pace of China's economic reforms offer a counterpoint to the undoubted economic success China has enjoyed since embarking on its bath to liberalization nearly 30 years ago.

**Broader Economic Context of China's Efforts at Financial Sector Reform**

For all of the concerns that its financial sector raises, the pace of China's economic growth remains impressive. It surged in the first quarter of this year to 11.1 percent.[2] The World Bank recently raised its prediction for growth in China's gross domestic product ("GDP") this year above 10 percent. Should China meet that prediction, as I expect it will, it will mark over a decade of near double-digit economic growth.

The benefits of growth have offered real prosperity to a broader range of China's people. Urban per capita disposable income has risen 127% over the past 10 years; rural per capita net income has grown as well, although not nearly as fast (approximately 72% over the same period). China's domestic savings amount to $1.113 trillion or roughly half the size of China's economy of $2.512 trillion measured.[3]

China's international position is probably well known to the Members of the Committee. It has a large and growing current account surplus, both globally ($250 billion in 2006 or roughly 9 percent of GDP) and bilaterally with the United States ($233 billion over the same time period)[4]. In the first four months of 2007, China's current account surplus jumped by 88 percent over the same time period in 2006.[5] That current account surplus has translated into foreign exchange reserves estimated at $1.2 trillion.[6]

What those reserves, on top of the continued strong economic performance, suggest is that now is the optimal time for China to undertake the needed reforms of its financial markets.

The same holds true of the international economic environment. China's growth has paralleled strong economic performance worldwide. The International Monetary Fund, in its most recent report on the state of the world economy highlighted the fact that the world economy is growing faster than at any time in the past three decades.[7] The IMF also sees less risk in the current economic environment than it has in some time – risk that has declined even over the last 6 months.[8]

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[2] *The Economist*, May 19, 2007, at 75.
[3] Measured on a current exchange rate basis. *CIA World Factbook (2006)*.
[4] Id. at 73.
[5] Id.
[6] Id. at 74.
[7] *IMF World Economic Outlook (2007)*.
[8] Id.

While the U.S. economy has slowed, we will still see considerable economic growth this year of 2.6 percent, which, while not dramatic, is reasonable for this stage of the business cycle. In the meantime, growth has improved in a number of other major industrialized countries, Japan (2.2 percent growth in 2006; expected growth of 2.3 percent in 2007 according to the World Bank) and Germany (2.2 percent growth in 2006; 2.3 percent expected in 2007).

The current global economic growth is much more broadly shared than you might expect. In 2005, for the first time ever, the developing world accounted for more than 50 percent of the world's GDP. Those countries contributed considerably more than 50 percent of world GDP growth. China and India combined represented only 25 percent of the developing world's contribution to world GDP growth that year.

In other words, economic growth today is much more widespread and the international economic environment more benign than it has been in many years. That offers a stronger buffer against any potential global fallout from China's efforts at reform and financial market reform. Again, the time would appear ripe for China to undertake the needed reforms in its financial sector.

**Potential Vulnerabilities in China's Liberalization of its Financial Markets**

China's impressive record of economic growth tends to obscure some serious economic vulnerabilities. Chinese officials often cite those potential vulnerabilities as reasons to delay reform. But, the reality is that any reform entails economic change and some risk and the one thing that can safely be said about each of the vulnerabilities discussed below is that they will only get worse if left unaddressed.

The first and most important Chinese economic vulnerability is the disparity between the high economic growth along China's coast in those portions of the Chinese economy that are already deeply integrated into the global economy and the slow growth in China's interior provinces where most of China's population still lives. In China, those who are fortunate enough to live and work in the coastal provinces that are most involved in China's engagement with the global economy have both the income to afford and access to most of the material benefits of life in a global economy. Individuals have much greater freedom to determine with whom they will work and to bargain freely with their employers for the value of their labor.

By contrast, life farther west in China almost belongs to another time in China, one in which peasants engage in near subsistence farming and what employment exists in local factories is still subject to significant oversight, if not control, by local party officials. Recent years have been marred by a growing number of protests, at times violent, by peasants who are seeing their real income decline while much of the rest of the country prospers.

China's capital markets and financial sector do little to allow alleviate the conditions in which the vast majority of Chinese workers live. Chinese firms do not help those living in poverty to convert what assets they have to capital in order to create a better life for themselves. Furthermore, the statutorily regulated rate of return on interest rates paid on savings in state-owned banks offers little in the way of return or reward for savings and investment. To that extent, the lack of a functioning capital market and a financial sector in which banks and other financial service providers are competing for customers is contributing to the growing friction between those living on the land and local officials.

The risk of reform, which would involve a considerable restructuring of the banking sector and the potential collapse of state-owned banks weakened by the burden of non-performing loans and the continuing demands to provide credit for politically-motivated investments, could have a ripple effect through the countryside that would exacerbate the continuing friction there. But, the far greater risk comes from failing to undertake the reforms in ways that would help address the needs of Chinese citizens in the western provinces. Done with the goal of serving the bottom of the economy as well as the top, financial sector reforms could do a great deal to alleviate the strains in Chinese society that flow from China's two-speed economy.

The second vulnerability flows from the mix of economic activity in China, which has been heavily distorted by the failure of the financial sector to discipline investment practices (i.e., ensure that investments are made for market-driven reasons, rather than political motives). Easy credit available to state-owned firms or recently "privatized" firms in which the government still holds a significant stake and still influences management decisions has led to a boom in certain investments in heavy industry. When combined with the relative laxity with which Chinese state-owned banks demand repayment from such firms, the system overall has produced considerably greater investment in certain capital-intensive industries than might otherwise have been warranted if credit practices were such that they accurately gauged the risk and likely return of the proposed investments.

In steel, for example, China has added over 100 million tons of new steel capacity (a sum equal to or larger than the entire installed capacity in the United States) over the past few years. The same sorts of credit practices have kept antiquated production in place, rather than forcing it out of business. As significant as that seems, it is even starker against the backdrop of the steel industry globally, where consolidation is still taking place and where there is still considerable excess capacity. What that means is that much of China's investment in steel was unnecessary. Chinese manufacturers could easily have purchased steel at low prices on world markets and the capital invested in steel could have gone to meet other needs within China.

Financial sector reforms that tighten credit practices will inevitably confront well-entrenched economic interests that are likely to prefer the current state of affairs. That will generate considerable conflict between the central government and its provincial

counterparts, which are frequently complicit in pressuring the state-owned banks for easy terms for pet industrial projects at the provincial level.

That said, it is also true that the problem of easy credit and politically-motivated lending tends to compound the politically difficult reforms that the Chinese face just like interest compounds on unpaid debts. As difficult as it may seem now, this festering problem will only get worse as time goes on and the needed adjustment will be far more dramatic if the current state of affairs proceeds unchecked.

The third vulnerability in China's economy flows from its heavy dependence on export demand as the main driver of its economic growth. Although there has been a recent increase in consumer demand, much of China's growth continues to depend on exports. To the extent that lax lending practices make credit available for export-driven industries, it is not surprising that they continue to add capacity and drive world market prices for many commodities.

The problem, of course, is that China's heavy dependence on export-led growth, particularly when focused on a limited number of markets like the United States and Japan, makes China's overall economic health heavily dependent on continued economic growth and rising import demand in those target markets. A sharp decline in the U.S. market, for example, would have a serious rebound effect on China's own growth prospects. A general slowdown globally would magnify that problem.

This is what leads to the absurd situation in which China is lending money to the largest and most highly developed economy in the world – the United States – in order to continue its purchases of Chinese goods and services. That is a far more serious economic problem from China's perspective than it is from ours.

Consider what China's export-led strategy means in the context of China's development. China is a labor-rich, capital scarce country that still has a very considerable distance to go in terms of alleviating basic poverty for nearly 700 million of its citizens, much less offering hope of real prosperity. To raise those people out of poverty, China badly needs capital investment in the interior to raise productivity, which will generate higher incomes for individual Chinese currently living in abject conditions.

But, rather than employing its capital in the Chinese economy to meet the needs of those citizens, it is lending the money at extraordinarily low rates of return (relative to the return the same investment could garner if invested on global markets) to the United States government in the form of China's purchases of our Treasury notes. Rather than employing its capital at home, China is lending to the most capital rich nation on Earth.

It is precisely this situation which has led to China's creation of an agency to manage its foreign reserves and to an initial investment of $3 billion in The Blackstone Group ("Blackstone"). The investment in Blackstone represents an effort to gain a greater return on the foreign reserves China holds and, in that respect, represents a step

forward in terms of its approach, but not one that is calculated to lead to capital investments where it is needed most, in China's western provinces.

Reform of China's financial sector is absolutely essential to encouraging a shift towards domestic demand. Until Chinese businesses have vehicles that allow them to finance expansion, they will continue to save in order to acquire the needed capital assets for expansion. Until Chinese consumers feel that they have a number of different financial vehicles to hedge different kinds of risk, they are likely to continue saving at extraordinarily high rates since those savings are the only hedge they have against catastrophic illness or the loss of a job.

China's reliance on export-led growth generates the fourth serious vulnerability. China's reliance on exports to fuel growth translates into an extraordinary current account surplus. Critics of trade with China regularly point to China's bilateral trade surplus with the United States as reason for retaliation, which led to the introduction of nearly 30 bills urging retaliation against China in the 109th Congress and the introduction of another dozen such bills in the first five months of the 110th Congress.

Without addressing the merits of each bill or the merits of the underlying complaints that motivated them, the obvious point is that China's heavy reliance on export-led growth stimulates a backlash from competing industries and workers in importing countries for protection. That risk is as serious for China today as I have seen it for any country in nearly 30 years of working in U.S. trade policy.

The phenomenon is not limited to the United States alone. Europe has introduced significant quantitative limitations on Chinese textile exports and is contemplating similar restraints on imports of Chinese shoes. India has become the largest user of antidumping actions – surpassing even the United States – and most Indian antidumping actions are directed against China.

While I disagree with the intense focus on and proposed solutions for our bilateral trade deficit with China, there is undeniably merit to the concerns that distortions in China's economy have serious effects on the U.S. economy.[9] But, in point of fact, most

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[9] Economists frequently suggest that we should be indifferent to subsidies or other market distortions in foreign countries that have the effect of increasing production or enhancing the competitiveness of a country's exports. But, in such instances, the effect is to stimulate investment in the subsidizing country that would not otherwise exist under market conditions. In the economists' jargon, such subsidies or other market distortions imply that the subsidizing country is not operating at its pareto optimal state. With an economy as open as that of the United States, with multiple avenues for the transmission of the price effects that such subsides or distortions engender, that implies that the United States (or any similar importing country) will see its investment pattern shifted in reciprocal ways that leave it short of its own most efficient (i.e., pareto optimal) state. That holds true even if exchange rates adjust to account for the effect of subsidies (although I am skeptical that exchange rates adjust to such influences given the much more significant impact that real interest rate differentials have on such movements). If exchange rates were to adjust, they would similarly affect the mix of investment in the United States or another importing country in ways that were suboptimal. In other words, there is a cost to both the exporting and importing countries when one country tries to gain advantage or simply distorts its own investment pattern through an inadequately functioning capital market, as is the case in China today.

of the serious distortions flow from the lack of a functioning capital market that adequately prices risk and steers capital toward its most efficient use. In other words, financial sector reform is the key to resolving many of the underlying problems that create serious tensions in bilateral trade relations between the United States and China.

In fact, rather than exacerbating the vulnerability that might flow from a protectionist backlash against China's export-driven economic growth, financial sector reforms would eliminate many of the underlying distortions that give rise to legitimate complaints regarding the economic effects of China's economic policies, including its regulation of the financial sector.

**Pace of China's Reform Efforts**

Since the onset of general economic reform in 1979, China's financial sector has gone through what are generally regarded as four relatively distinct phases of reform. The first phase, from 1979 to 1986, involved the breakup of the single bank system in favor of a banking system in which the People's Bank of China ("PBC") served as the central bank. The Industrial and Commercial Bank was created to handle urban commercial banking, joining other specialized institutions such as the China Construction Bank (construction), the Bank of China (international trade and foreign exchange transactions), and the Agricultural Bank of China (rural lending).

The second phase of reform, from 1987 to 1991, saw a decrease in administratively governed speculation among institutions and significant growth in non-bank financial intermediaries. The second phase also saw the establishment of the first state-owned insurance companies and the rudiments of a capital market in the form of a secondary market trading in government securities.

The third phase of reform, from 1992 to 1996, brought further diversification. Shanghai and Shenzhen saw the creation of stock exchanges. An inter-bank market developed. Some interest-rate flexibility was introduced. Life and non-life insurance licenses were granted on a limited basis to foreign firms, with significant limitations compared to similar licenses offered to domestic insurers.

The fourth phase of reform, from 1997 to 2001, attention shifted to the portfolios of China's banks and governance issues in the wake of the Asian financial crisis. At the same time, China launched a series of reforms that were designed to prepare the way for China's accession to the World Trade Organization ("WTO"). This brought a host of changes from restructuring the PBC to clarifying the roles of the China's insurance and securities regulatory agencies to the creation of new classes of financial instruments needed to implement specific WTO obligations, such as the opening of automobile financing to parallel the increased market access for foreign-manufactured automobiles.

Just prior to WTO accession, roughly 200 foreign banks operated in China. They largely served the needs of enterprises established by foreign investment. The were subject to restrictions on location, products offered, and investment oppotunties. They

were also subject to vastly different tax and regulatory regimes, which tended to limit the interaction between domestic and foreign banks in the Chinese market, as well as competition and technological spillover to the Chinese market for financial services generally.

**Relevance of China's WTO Commitments on Financial Services**

China's accession to the WTO marked a significant step forward in terms of both liberalization and restructuring, with one driving the other. China agreed to a variety of market openings[10] –

- **Banking:** China allowed foreign banks to begin foreign currency operations upon accession and phased in local currency operations over the next 5 years. Foreign banks began offering local currency services to Chinese enterprises 2 years into the phase-in period; local currency services to all Chinese were to be opened at the end of the 5-year period. China opened 4 cities to foreign banks upon accession and opened an additional 4 there after. China also agreed to lift all discriminatory non-prudential measures restricting foreign ownership of banks and their branches.

- **Securities:** China agreed to allow foreign securities dealers engage directing in B share business immediately upon accession. China agreed to allow investment banks to establish join ventures with foreign ownership not exceeding 33 percent 3 years flowing accession. Such ventures were to be allowed to engage directly in underwriting domestic securities (B and H shares, government and corporate debt). China allowed representatives of foreign securities companies to become special members of Chinese stock exchanges.

- **Fund Management:** China agreed to allow the establishment of joint venture fund management companies upon it s accession to the WTO, with foreign ownership not to exceed 33 percent. The foreign ownership limitation was to be raised to 49 percent after three years.

- **Insurance:** China agreed to phase out all geographic restrictions within 3 years of accession. It allowed foreign life insurance companies to provide individual (non-group) policies at that time. The policies they could write were to be expanded to include health insurance, group insurance, pension insurance and annuities for Chinese and foreign customers 2 years after accession. China opened its reinsurance market upon accession without restriction. Foreign life insurers were allowed to hold 50 percent ownership in joint ventures and were allowed to choose their own joint venture partners. For non-life insurance, China allowed branching or 51 percent ownership upon accession and wholly-owned subsidiaries 2 years after its entry into the WTO. China agreed to grant licenses soley on the

[10] The discussion of China's commitments on financial services is drawn from a very helpful survey of its accession to the WTO done by the World Bank. See *China and the WTO: Accession, Policy Reform, and Poverty Reduction Strategies 181-190 (2004).*

basis of prudential criteria with no economic needs test or quantitative limits on the number of licenses.

What should be immediately evident from that summary is that China did agree to a significant liberalization of its financial sector as part of the accession process. The changes wrought by accession were bound to redistribute the flow of funds within the Chinese system through a series of different intermediaries. Those shifts were bound to bring new pressures to bear on the Chinese banks, which ran high cost operations and had limited flexibility in lending practices due to the political pressures brought to bear on them to lend to specific projects regardless of credit risk. The Chinese banks faced this new competition in a relatively weak state, with portfolios of non-performing loans conservatively estimated at 30 percent or more.

What should also be apparent is that the accession process would continue to allow significant restrictions on the operations of foreign financial service providers, both in terms of their ownership interest, the products they could offer and their geographic reach. The accession commitments, while considerably stronger than any previously agreed to by a developing country, were simply too limited in too many ways to contribute to a fundamental restructuring of the Chinese financial sector.

To the extent that one of the goals of China's accession process was to encourage a much more efficient allocation of capital and resources throughout the Chinese economy, the commitments undoubtedly made an impact – one that will continue to grow over time as improved banking practices and other business processes filter through the Chinese system due to increased competition. But, it is safe to say that the broader access offered to foreign financial service providers did not have and will not have the impact it might have or could have with a much broader opening of China's market.

**Broader Economic Policy Goals Will Require China to Reach Beyond its WTO Commitments**

In the current round of multilateral trade negotiations under the WTO, China has essentially adopted the position that it "paid at the office." China views the commitments it made as part of the accession process as sufficient for the Doha round as well. That rejection of further liberalization applies to financial services as well as agriculture, manufacturing and other service sectors.

Whether China could ultimately sustain that stance in the face of the rest of the WTO membership's willingness to undertake considerably greater liberalization remains to be seen. The Doha process has ground to a halt over agriculture and little has been done in the way of preparatory work on services that would allow U.S. firms to see the outlines of what a Doha round agreement would mean for them in China or elsewhere.

The reality in China, however, is that its broader economic policy goals is likely to force the pace of financial sector reform even without a Doha round agreement. There is nothing in the current system that will allow the government to exercise greater

influence inflation and economic growth within the Chinese economy, encourage the broader provision of financial services that would ease many of the adjustment pressures it faces in its two-speed economy, or help in providing a social safety net by providing financial products that would allow Chinese citizens to diversify types of risk and hedge accordingly.

The health care sector offers an interesting example. China's leaders recognize that they will need private health care companies to provide much of the needed expansion of medical services if China is to improve its social safety net. Toward that end, they have recently announced significant reforms in the health care sector. Those reforms will no be effective in reaching a much broader swath of the Chinese people without considerable expansion of the health insurance sector and a diversification of the products they offer.

The same holds true with China's pension system. China is in the long-term process of shifting from an entirely state-owned and operated retirement system to one that depends heavily on the market to create different investment vehicles to allow individual Chinese to provide for their own retirement. That shift simply is not possible without a significant expansion of the Chinese life insurance market.

China's "go west" campaign, which is designed to foster greater economic development in China's interior provinces has been largely financed by the government itself. That effort has largely focused on infrastructure. As needed as such infrastructure is, real self-sustaining economic growth and a broader, more-evenly shared prosperity will not follow if the financial sector does not provide greater liquidity for smaller enterprises and options for individual Chinese to convert what capital they have in the form of land or other assets to working capital.

China's efforts to renovate its industrial north have been entirely financed by state-owned banks backed by government financial support. That entire process of eliminating outmoded industrial production in favor of more modern production processes, as well as creating new industries and jobs for displace workers, would be more easily accomplished with a financial sector that was experienced in the process of breaking up bankrupt companies, getting the most value for their assets, or stripping costs out of production processes and putting the companies back on their feet in a healthier form. That is what a well-functioning financial market can do better than any government lending program.

What all of China's economic challenges ultimately requires is a far broader opening of China's financial services sector to competition that will drive down costs and increase the availability to credit and other financial services to a much broader range of Chinese enterprises and individuals. The point is that China needs to open its financial markets not simply due to WTO commitments, but due to the needs of its rapidly growing economy and the rising expectations of its citizens.

What is surprising in that context is that the Chinese do not make virtue out of necessity and use the potential opening they know they have to undertake to their advantage in the Doha Round. Further commitments to financial sector liberalization in the context of the round would go a long way to permitting China to obtain what it most wants and needs out of the round, which is not just greater assurance of market access for its exports to the United States and other developed country markets, but commitments from its fellow developing countries, where the instinct toward protectionism is far stronger than it is in the United States or other industrialized states.

**Role for U.S. Firms in Reform**

As the foregoing suggests, there is an extraordinary role for U.S. financial services firms to play in the process of financial sector reform in China. While we do not often think of the financial sector's role as one of facilitating change, that is in fact what it does best. In the process of accurately valuing assets, extending credit, allowing businesses and individuals to mitigate risk, and creating new savings and investment vehicles that allow a broader spectrum of society to participate in economic success, the financial sector also provides the all important grease that eases the transition from one economic state to another.

American financial firms have what China needs. China has proved hungry for U.S. technology in manufacturing throughout the nearly 30-year old process of economic reform launched by Deng Xiaopeng in 1979. What has been missing to date has been an equal interest in the financial innovations that American firms bring that would help China face its most pressing economic problems.

Perhaps most importantly, opening the Chinese financial sector fully to the U.S. financial services industry would also be an extraordinary tonic for U.S.-Chinese bilateral trade relations, although not for the reasons many expect. That opening does not imply a trade off between our financial sector's export interests and the continuing fight import-competing industries face from Chinese manufactured goods in our home market. Rather, opening the Chinese financial market would prove instrumental in ensuring that the competition in the manufacturing sector was fair.

As noted above, China's state-owned banks face continuing pressure to provide credit at favorable terms to pet industrial projects at the provincial level. Those loans often go unpaid, which is precisely the reason for China's ongoing non-performing loan problem. But, what that also means is that the Chinese manufacturers that benefit from such credit practices face a near zero cost of capital. Indeed, the provision of credit on those terms favors heavy investment in capital intensive industries (read manufacturing).

Those practices ultimately have a far more pernicious impact on the competition faced by U.S. manufacturers than does a pegged exchange rate or other Chinese practices that form a part of a more mercantilist approach to trade. In the absence of bad credit practices, that production capacity would not exist and would not depress prices globally, regardless of the rate at which China pegged its currency to the dollar.

The involvement of U.S. financial firms would help in two significant respects. The first is with respect to the Chinese banks themselves and their recurring non-performing loan problems. The best analogy I can think of in a U.S. context is the savings and loan crisis of the 1980s. When savings and loans went under, what was needed was a significant opening of the market to other credit providers with stronger balance sheets that could take over the troubled savings and loans, sort out the bad non-performing assets from the good, and continue the functions of providing credit to the local market.

The same situation prevails in China today. Chinese banks and the Chinese banking system would benefit significantly from the entry of much stronger U.S. banks with sturdier balance sheets to help clean up the system while continuing to provide much needed liquidity to the Chinese economy.

The entry of American firms would also help reduce the trade frictions we face by squeezing bad lending practices out of the market. Chinese banks that persisted in the bad lending and credit practices of the past would rapidly find themselves competing with much stronger banks and would have to respond by cleaning up their processes or facing bankruptcy or a takeover.

What that would do is end the contribution that those same credit practices make to current trade frictions with China. The process of adding industrial capacity regardless of the actual demand for its output and expecting export markets to provide an outlet for the production when it exceeds Chinese needs would come to a grinding halt.

Moreover, the overall capital efficiency of the Chinese economy would rise. That would steer credit to worthier investments and allow the system to serve a much broader range of Chinese enterprise and citizens that it currently does. That is what the Chinese should be focused intently on in light of the economic challenges they face.

**Prospects for U.S. Companies Going Forward**

As I indicated earlier, the broader economic reforms under way in China are likely to create significant new opportunities for American financial service providers. In several respects, there is a significant and healthy intersection of interests between what China needs most and what American financial firms can provide. Indeed, China needs exactly what American firms are the best in the world at – financial innovation.

Let me take just one example – health insurance. China's proposed health care sector reforms have only just begun. They point toward a mixes system of state-provided care and a far larger role for private health care providers.

Within that system, China faces a growing challenge in its aging society. Due to the one-child policy, Chinese society is aging before it grows rich. In that sense, the real health care needs will rise due to the age of the population, just as they have here in the

United States and as they have in Japan and Germany, which face similar demographic challenges. Costs will rise as well simply because health care in the later stages of life is more complicated.

What the one-child policy also implies is that there is less of a family network to fall back on as an insurance policy against a catastrophic injury or health care crisis. Caring for aging parents will be costly enough, but could spell financial disaster for a single child trying to create his or her own economic future in China's highly competitive market.

What that means is a much broader need for financial mechanisms to hedge the risk of injury or disabling disease. It also means the much broader need for the business processes and technologies that reduce the cost of providing care. The challenges China faces will mean a much broader need for administering a system of mixed government and private care in terms of record-keeping and other management functions. And, perhaps most importantly, it will mean a much broader need for techniques of cost management to control the rising cost of health care in an aging society.

Those are precisely the roles that American health insurance companies play in the American economy. The changes under way in Chinese society and the Chinese economy are creating a demand for the sorts of innovations that American health insurers have used successfully in the United States to expand coverage, reduce administrative costs, and encourage broader cost reductions elsewhere in the health care sector. A much broader opening of China's health insurance market – one that actively recruits American firms to help solve the challenges China faces – is what China should pursue as part of its broader effort to reform its health care system.

There are many other opportunities that Chinese needs create for American firms, but suffice it to say that the potential is vast because the needs are so great. What is needed is the vision and the political will on the Chinese side to allow American firms to help meet those needs.

# WRITTEN STATEMENT OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION

## TESTIMONY BEFORE THE

## HOUSE COMMITTEE ON FINANCIAL SERVICES

## "U.S. INTERESTS IN REFORM OF CHINA'S FINANCIAL SERVICES SECTOR"

## JUNE 6, 2007

New York • Washington • London • Hong Kong
120 Broadway, 35th Floor • New York, NY 10271-0080 • P: 212.608.1500 • F: 212.968.0703 • www.SIFMA.org

***Statement of Michael Decker***
***Senior Managing Director, Research and Public Policy***

***Before the Committee on Financial Services***
***United States House of Representatives***

***Hearing on U.S. Interests in Reform of***
***China's Financial Services Sector***

***June 6, 2007***

Mr. Chairman, and Members of the Committee:

The Securities Industry and Financial Markets Association[1] is pleased to submit this testimony on China's capital markets and the benefits for U.S. financial services firms and both the U.S. and Chinese economies of opening China's financial markets. Our testimony will focus on the goals and objectives of the U.S. securities industry in our growing relationship with China's economy. As such, this testimony delves into some key issues related to China's capital markets. This hearing is especially timely and provides us with an opportunity to outline progress made to date on expanding opportunities in China for non-Chinese financial services firms as well as areas for continued attention.

SIFMA has long supported more open, fair and transparent markets, and has strongly advocated liberalization in U.S. multilateral and bilateral trade in financial services. The economic benefits of financial services sector liberalization reverberate throughout the world in the form of higher growth and greater opportunities. Financial services liberalization leads to new entrants, innovative products and services, and capital markets with greater depth and efficiency.

In the global economy, openness and fairness are essential to ensuring that markets operate efficiently so that capital can move seamlessly across borders and investors can easily and quickly buy and sell securities anywhere, while businesses can access capital at the lowest cost. The international financial system has been a major contributing factor in the marked increase in living standards of those countries that participate in it.

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[1] The Securities Industry and Financial Markets Association ("SIFMA") brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

China's WTO accession commitments for financial services, and more specifically for the securities industry, demonstrated a reluctance to open this sector fully to foreign competition. China's reluctance to open its securities markets fully to foreign investment has stymied the interest of foreign securities firms, and has slowed the pace of reforms in China's capital markets. Since China's accession to the WTO, nearly $24 billion has been committed to China's financial services sector, and according to SIFMA estimates less than $600 million of this total has found its way to China's securities firms. We believe China should improve and accelerate its financial sector reform so that it will have the financial tools necessary to sustain and improve the quality of its economic growth.

We also wish to take this opportunity to commend the U.S. Treasury Department for its continuing work and active engagement in seeking open and fair markets for securities firms in China. Through the formation of the U.S.-China Strategic Economic Dialogue ("SED"), and the establishment of a Treasury Financial Attaché in Beijing, Treasury has put in place the framework for continued and active advocacy on behalf of the U.S. financial services sector.

### Expanding Business Opportunities for U.S. Financial Services Firms

Many of SIFMA's leading member-firms have identified China as the largest single emerging market opportunity in the next few decades, with some measures indicating that China will be the world's largest economy within the next 40 years.[2] To achieve this, China will need an enormous supply of capital and a market that can efficiently allocate savings. Analysts predict that over the next five years China will need to invest more than $1.5 trillion in improvements to physical infrastructure. Moreover, as China's economy continues to move from planned to market-based, decisions on capital allocation will become increasingly complex, and it will be ever more important to have efficient capital markets to ensure capital is allocated to where it is needed and will be used most efficiently.

At the same time, China will accelerate its ambitious reform program even while its nascent pension system begins to address the needs of a huge and rapidly aging population. In 2005, 7.6 percent of China's population was over 65; by 2025 that number is projected to reach roughly 14 percent. The country's infrastructure, privatization, and social welfare demands will require an increasingly more efficient and sophisticated deployment of capital.

To meet these demands, China will need to modernize its capital markets more rapidly. Currently, banks intermediate nearly three-quarters of all capital in the Chinese economy. For China to meet its financing needs, increase the products and services available to investors, provide companies with new funding options, and enhance financial stability it will need to transition to a financial system less dependent on bank lending and more

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[2] Goldman Sachs' Global Economics Weekly, Issue 03/34, 1st October 2003.

focused on capital markets financing. China's first modern stock market only opened in 1990. Between 1998 and 2000, market capitalization more than doubled from $231 billion to $581 billion; by the end of 2006, market capitalization rose to more than $917 billion. In less than two decades China's stock market stands as the largest in the emerging market world.[3] However, the need for China to further develop its capital markets is illustrated when compared to other developing markets. A McKinsey & Company study found that in 2005, equity market capitalization, excluding non-tradable, state-owned shares, was 17 percent of GDP. This is the smallest market capitalization to GDP ratio in emerging Asia, where the ratio averages 70 percent.[4]

The government of the Peoples Republic of China (PRC) has acknowledged the need to reform the securities industry and has stated that it wants foreign investors and foreign firms to participate. China's domestic capital markets will benefit from the entry of U.S. securities firms and their technology, capital, innovation and best practices. As local firms prepare for this increased competition, they will adopt new technologies and improve the quality of products and services they offer. More competitive and efficient capital markets will also improve the allocation of capital to borrowers and users, facilitate the hedging and diversifying of risk, and assist the exchange of goods and services.
Importantly, increased competition will create incentives and opportunities for niche players to enter the market and provide financial services on a regional basis, offer expertise in specific product areas, and produce new and innovative products that respond to consumer demands for risk management and retirement products, for example.

As China's capital markets develop, Chinese firms will be able to raise more capital at lower costs to grow their businesses and create more products, services, and jobs. Since financial markets are inextricably linked to increased investment and economic growth, it is estimated that financial sector reforms could boost China's GDP annually by up to $321 billion.[5] To put that number in perspective, as of 2005, only 20 countries have total GDP that exceeds $321 billion.[6]

China's private and public sectors alone cannot mobilize the massive financial resources, advice and expertise that are necessary to sustain its economic growth. Much of the infrastructure development will, by necessity, be funded through foreign sources, and this opportunity has generated substantial interest by the U.S. securities industry. Indeed, despite difficulties entering and operating in China, numerous U.S. securities firms have established offices in China and have participated in China's international securities offerings.

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[3] However, according to McKinsey Global Institute, once these figures are adjusted for nontradable shares, China's stock market capitalization as a percent of GDP is among the world's smallest, about 17 percent. Corporate debt issuance lags too, with issuance equal to about only 1 percent of GDP. "How Financial System Reform Could Benefit China," 2006 Special Edition: Serving the New Chinese Consumer, *The McKinsey Quarterly.*
[4] Similarly, corporate bond issues by non-financial companies amounted to between 2 and 3 percent of GDP, compared with a typical 50 percent in other emerging Asian markets.
[5] Putting China's Capital to Work: The Value of Financial System Reform, May 2006, McKinsey & Company.
[6] World Bank, World Development Indicators database, World Bank, 23 April 2007.

## U.S.-China Strategic Economic Dialogue

SIFMA is an enthusiastic supporter of the Strategic Economic Dialogue (SED) and we commend Treasury Secretary Paulson, Ambassador Holmer, their Treasury colleagues, and the Administration, for this important undertaking. Our view is that the SED has the potential to play a key role in advancing the US-China economic relationship. The SED provides a forum where—with a single, unified voice—the Administration can underscore the importance to China of an open, fair and transparent market for financial services. Consequently, SIFMA has urged the Administration to engage in a results-oriented discussion that leads to the reduction and elimination of barriers that continue to obstruct global financial services firms in China. Eliminating burdensome barriers to entry will benefit the economies of both nations. While we detail our agenda for reform below, we believe there are a number of steps the Chinese should take in the short-term that will help it to reach its stated economic goals and reinforce the political sustainability of the SED.

First, China should lift the de facto moratorium on foreign securities firm joint ventures that has been in place since December 2005. Importantly, removal of the moratorium will bring China back into compliance with its WTO commitments. We are pleased that during the May 22-23, 2007 SED meeting, China took a critical first step towards this goal by lifting the moratorium imposed on foreign investment in Chinese securities firms. It is important to note, however, that the moratorium is to be lifted sometime in the second half of 2007, rather than by a specific date.

Second, China should put in place a precise and transparent roadmap, on an agreed to timetable, that would result in providing foreign securities firms with the right to own 100 percent of a PRC financial services firm and the ability to engage in a full range of securities activities. No progress was made on this issue during the recent SED.[7]

## China's WTO Commitments For Foreign Securities Firms

China's 2001 World Trade Organization (WTO) entry commitments in the securities and asset management sectors marked the country's first step toward liberalizing its capital markets. The commitments permit foreign firms to participate in the securities sector only through joint ventures (JVs) in which foreign ownership is capped at 33 percent—although as more fully described below the scope of securities activities in which these joint ventures can participate is limited. China's WTO commitments also limit foreign participation in China's asset management sector to ownership of no more than 49 percent of domestic fund management firms.

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[7] That being said, Tu Guangshao, vice chairman of the China Securities Regulatory Commission, was quoted by state media as saying China will raise the ceiling for foreign investment banks' stake holdings in domestic brokerages and joint ventures before the year-end. Reuters, Shanghai, Wednesday, May 30, 2007.

These WTO commitments make no provision for further increases in foreign ownership in either securities or asset management firms. Instead, the commitments suggest that without a change in policy, foreign investors will remain minority shareholders in local securities firms for the foreseeable future. Indeed, China remains as one of the few markets of interest to the securities industry where majority ownership is not permitted.

China's WTO commitments in the securities sector also limit these minority owned JVs to underwriting the A shares of Chinese corporations, and to underwriting and trading government and corporate debt, B shares and H shares. The fundamental ability to trade in A shares was not conferred on these minority JVs. (A shares are Renminbi (RMB)-denominated shares limited to domestic investors, foreign financial firms with qualified foreign institutional investor (QFII) status, and foreign strategic investors. B shares are foreign-currency denominated shares listed on PRC exchanges and are open to both domestic and foreign investors. H shares are shares of PRC companies listed in Hong Kong.).
Though foreign industry involvement can improve many aspects of the securities industry, we would urge China to move forward in two distinct, but reinforcing, areas to modernize and strengthen its capital markets. First, improvements in market access would improve the ability of foreign securities firms to compete in a fair manner with local firms. Second, steps in market reform would better regulate the industry and increase transparency.

However, there remain significant market access barriers. SIFMA strongly urges China to make the following additional commitments, in the context of the ongoing WTO financial services discussions, in other trade forums, or government-to-government discussions:

**1) Permit Full Ownership and the Right to Choose Corporate Form**

China should put in place a precise and transparent roadmap, on an agreed to timetable, that would result in providing foreign securities firms with the right to own 100 percent of a PRC financial services firm, including the ability to engage in a full range of securities activities, including underwriting, secondary trading of government and corporate debt and all classes of equity, hybrid mortgage products, derivatives trading, and asset management. We do note, however, that one of the results of the recent SED was that the Chinese will announce before the next SED meeting that foreign securities firms will be permitted to expand their operations in China to include brokerage, propriety trading and fund management.

The right to enter a market and establish a wholly owned presence in a form of the firm's own choosing is relatively common in today's global markets. Currently, foreign investors can enter China's securities markets in two ways: by establishing a new JV with a Chinese partner or by taking a stake in an existing brokerage, the path that a number of foreign securities firms have chosen. Because in most cases the negotiations that result in a JV or a foreign stake are opaque, however, potential entrants have little available in the way of guidance on how to arrange such JVs. Similarly, foreign asset management firms should be permitted to manage money for Chinese investors, both retail and institutional, as

well as to sell internationally diversified mutual funds to individuals through qualified local distributors.

**2) Liberalization of Qualified Foreign Institutional Investors (QFII) Standards**

China's decision to permit foreign investment in A shares through QFIIs beginning in 2003 was a landmark step in the development and liberalization of China's capital markets. More recently, PRC authorities have taken steps to increase the number of QFIIs and the amount invested by QFIIs.[8] Nevertheless, a few QFII requirements are onerous and have substantially limited the utility of the program, as well as the number of investors that can take advantage of it.

Along with the QFII program, China has recently taken steps to allow certain large foreign investors to purchase shares in domestic companies. These new rules will allow foreign investors to buy stock in Chinese companies that have completed the share-reform program (exchange of nontradable shares to common A shares). Foreign investors that meet certain government standards can buy existing shares or purchase new shares that might be issued. But requirements that an investor purchase at least 10 percent of the company, and hold the stake for at least three years, could limit the desirability of the program.

China would make its securities markets more attractive to investment through the liberalization of QFII restrictions. Such progressive liberalization, done in consultation with foreign and domestic capital markets participants, would almost certainly result in greater foreign investment in China's securities markets, deepen and broaden trading in those markets, and increase capital availability to Chinese issuers.

**3) Implement a QDII program**

China is in the process of launching its long-awaited qualified domestic institutional investor (QDII) program to promote Chinese investment in foreign stocks and bonds. The People's Bank of China (PBOC) announced the launch of the program in April 2006, and the PBOC, the China Banking Regulatory Commission, and the State Administration of Foreign Exchange released interim measures that permit qualified commercial banks to pool RMB from domestic institutions and individuals and convert them into foreign exchange for investment overseas in fixed-income securities. Other implementation rules will eventually expand the program to qualified mainland insurance companies, fund management firms, and securities brokerages to convert RMB into foreign currency, raise funds in RMB or foreign currency, and invest in overseas securities. Such a program

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[8] China will raise the quota for Qualified Foreign Institutional Investors from $10 billion to $30 billion, SED Financial Sector Reform Fact Sheet, May 23, 2007.

will further liberalize China's capital accounts. It may also help familiarize Chinese domestic investors with international corporate and brokerage practices and give them access to top-quality research under conditions that would respect officials' concerns about currency flows. China recently lifted restrictions prohibiting Chinese banks from buying foreign equities, and will allow banks to invest up to 50 percent of the QDII funds in overseas stocks. Previously, QDII banks were restricted to buying bonds, money-market products and fixed-income derivatives.[9]

**4) Promote Regulatory Transparency**

A transparent industry is generally one in which the public and industry participants have the opportunity to be involved in the rulemaking process, access information about proposed rules, question and understand the rationale behind draft rules, and have sufficient opportunity to review and comment on them. Transparent and fair regulatory systems play an integral role in the development of deep, liquid capital markets that attract participants, increase efficiency, and spur economic growth and job creation. The absence of transparency in the implementation of laws and regulations can seriously impede the ability of firms to compete fairly and often distorts the market. Though China's securities regulator, the China Securities Regulatory Commission (CSRC), has improved its policies on prior consultation and has presented many proposed regulations for public comment, much progress is still needed. Short comment periods are insufficient to review complex new regulations, particularly those intended to affect foreign firms whose ability to comment is hampered by distance and language.

SIFMA has published a paper (attached as an Appendix) that serves as a blueprint for a transparent regulatory regime. The paper underscores the key guiding principles of fair and transparent regulations as follows: 1) rules, regulations and licensing requirements should be considered and imposed, and regulatory actions should be taken, only for the purpose of achieving legitimate public policy objectives that are expressly identified; 2) regulation should be enforced in a fair and non-discriminatory manner; 3) regulations should be clear and understandable; 4) all regulations should be publicly available at all times; and 5) regulators should issue and make available to the public final regulatory actions and the basis for those actions.

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[9] QDII's will still be prohibited from, "...no investment in commodities-based derivative products, hedge funds and debt securities with credit ratings below BBB as assigned by an international credit rating agency." Notice of the Adjustments to the Offshore Investment Scope of Overseas Wealth Management Business of Commercial Banks on behalf of Their Clients (promulgated on May 10, 2007), http://www.cbrc.gov.cn/english/home/jsp/docView.jsp?docID=20070511425E7E3A4547640AFFE563AD79AEB000.

**5) Liberalize Derivatives Regulation**

> Interim derivative rules, which took effect in March 2004, have prohibited securities firms from creating and distributing derivative products. The inability of securities firms to engage in these activities hampers the development of these markets. Foreign firms hope that China's newly revised Securities Law will lead the State Council to formulate measures on the issuance and trading of derivatives.

Continued liberalization of China's capital markets has clear benefits for China and the global economy. Long-established U.S. policy seeks to promote economic growth through open financial services markets. Global economic integration facilitates the importation of capital and intermediate goods that may not be available in a country's home market at comparable cost. Similarly, global markets improve the efficient allocation of resources. Countries gain better access to financing, and the suppliers of capital—institutional investors or individual savers—receive better returns on their investments.

The most reliable and expedient way for China to meet its massive capital demand is to access the larger pools of capital available in the global markets. Foreign securities firms can contribute to the development of China's financial markets by sharing their expertise on the infrastructure needed to effectively serve a sophisticated and globally oriented client base. Foreign players can also provide new financial products and services that meet the changing needs of Chinese investors, demonstrate the benefits of high corporate governance standards, and consult on legal issues that must be addressed to help domestic equity and capital markets flourish. Ultimately, the modernization of China's financial system, especially its capital markets, will benefit both China and the world.

Finally, open, fair markets help to increase living standards. We look forward to working with the Congress and the Administration to further expand the U.S. securities industry's access to China through the use of bilateral and multilateral trade forums. A coordinated U.S. government effort, including all relevant agencies, will be critical in helping U.S. securities firms to gain full access to these crucial markets.

We appreciate the opportunity to present this statement today and we look forward to working constructively with this committee on issues related to the global financial markets in the future.

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# PROMOTING FAIR AND TRANSPARENT REGULATION

## DISCUSSION PAPER

### I. Setting The Foundation for Open and Fair Securities Markets

Deep and liquid capital markets are the essential building blocks of today's economy, supplying the funds for economic growth and job creation. The firms that participate in the markets price risk, allocate capital, provide investors with advice and investment opportunities, and supply the liquidity needed to make markets work efficiently.

Just as capital markets underpin economic growth and job creation, transparent and fair regulatory systems are essential to the development of deep and liquid capital markets. A system of regulation that is transparent to market participants instills the confidence needed to attract both the suppliers and users of capital to make the best use of the markets.

Governments, regulators and the international financial institutions have undertaken substantial projects designed to improve the quality of the financial systems world-wide. Attention is now focused on building fair and transparent regulatory systems – grounded in the principles of market integrity and investor protection – to oversee those markets. Consistent with those goals and the principles of prudential regulation, discriminatory practices and considerations, such as the nationality of individuals or the place of origin of firms, should not be permitted to influence regulatory policies or actions.

This paper is based on the assumption that a country's relevant laws should promote fair and transparent regulation. The principles outlined in this paper are not intended to prevent a regulator from taking measures for prudential or legitimate public policy reasons recognized under the World Trade Organization, including protecting investors, ensuring that markets are fair, efficient and transparent, and reducing systemic risk.

A consensus view, supporting the development of active, sound and efficient markets based upon established principles for capital market regulation, is rapidly emerging. In September 1998, the International Organization of Securities Commissions (IOSCO) issued a paper entitled "The Objectives and Principles of Securities Regulation" that urged the adoption by all regulators of processes and regulations that are:

- consistently applied;
- comprehensible;
- transparent to the public; and
- fair and equitable.

The International Monetary Fund ("IMF") is developing a broad-based "Code on Good Practices and Transparency in Monetary and Financial Policies" that complements IOSCO's work.

The securities industry, which today operates on a global basis, supports the IMF and IOSCO efforts to establish principles of fair and transparent regulation. The securities industry strongly believes that by making regulation and the operation of regulators accessible and transparent and by treating foreign and domestic licensed market participants fairly and equitably, governments, regulators and international financial institutions will promote the best markets for investors throughout the world.

Building on the emerging regulatory consensus, this paper provides the views of the securities industry on fundamental regulatory principles and practices that will provide a fair and level playing field for market participants. It also sets the foundation for building strong and vibrant markets worldwide. Moreover, we strongly believe that the principles promoting fair and transparent markets are broadly applicable to all financial services firms participating in the global capital markets. In this regard, we are actively seeking the support of financial services firms worldwide in promoting these principles.

## II. Guiding Principles of Fair and Transparent Regulation

A. *Rules, regulations and licensing requirements should be considered and imposed, and regulatory actions should be taken, only for the purpose of achieving legitimate public policy objectives that are expressly identified, including, for example, investor protection, maintaining fair, efficient, and transparent markets, and reducing systemic risk.*

B. *Regulation should be enforced in a fair and non-discriminatory manner.*

1. *Regulations and regulators*[1] *should not discriminate among licensed market participants on the basis of the nationality or jurisdiction of establishment of the shareholders of a market participant or the jurisdiction of establishment of any entity that owns or controls the equity or indebtedness of a market participant.*

2. *The relationship between a regulator and a licensed market participant should be governed by the standards set forth in relevant rules and regulations, and should not be subject to political or other extraneous or improper considerations.*

3. *The introduction of new securities products and services by firms should be governed by the standards set forth in relevant rules and regulations*

C. *Regulations should be clear and understandable.* Clear and understandable regulations and rulings provide market participants with the predictability and necessary knowledge to comply with regulations. Opaque or ambiguous regulations and rulings create uncertainty among investors and licensed market participants.

D. *All regulations should be publicly available at all times.* All regulations should be made, and at all times remain, publicly available, including requirements to obtain, renew or retain authorization to supply a service. Disciplinary actions should not be taken based on violations of regulatory standards that were not in effect at the time the relevant activity took place.

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[1] The term "regulator" is intended to cover all bodies that are authorized pursuant to law to play a role in the licensing and supervision of the activities of financial services firms, as well as the bodies that formulate rules, regulations and policies relating to such firms. Where the legislature or authorized regulator delegates its authority to a non-governmental entity such as a self-regulatory organization or trade association, the term is intended to encompass such an entity.

E. *Regulators should issue and make available to the public final regulatory actions and the basis for those actions, in order to enhance public understanding thereof.*

## III. Rulemaking and Implementation

A. *The rulemaking process*

1. *Regulators should utilize open and public processes for consultation with the public on proposals for new regulations and changes to existing regulations.* A reasonable period for public comment should be provided. Any hearings at which formal promulgation or adoption of new regulations or changes to existing regulations are considered, if open to a member of the public, should be open to all members of the public. Regulators should not take arbitrary regulatory action against those who participate in the consultation process.

2. *In considering whether rules, regulations, licensing requirements or actions are necessary or appropriate, regulators should also consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation.*

B. *Communicating and implementing new rules*

1. *New rules and regulations that provide advice for market participants should be made available to them and the public in a timely and efficient manner.* Such changes should be made available, in writing, by electronic media or other means of distribution so that all market participants have reasonable access to such material.

2. *Market participants should be given a reasonable period of time to implement new regulations.* The effective date of a new regulation should provide a reasonable period for market participants to take the steps needed to implement the new regulation under the circumstances.

C. *Interpretations of rules*

1. *Regulators should establish a mechanism to respond to inquiries on rules and regulations from market participants.* The titles and official addresses of the relevant regulatory offices should be provided.

2. *Interpretations and the grants or denials of regulatory relief or exemptions should be made available to the public.* Such interpretations, relief or exemptions should generally apply or should be applied upon proper request, to substantially similar licensed market participants and new products. Under limited circumstances it may be appropriate to delay the publication of individual grants of relief for reasonable periods of time to address legitimate competitive concerns.

## IV. Licensing and New Product Procedures

A. *Procedures for licenses and introduction of new securities products and services.*

1. *Criteria governing licensing of firms and the introduction of new securities products and services by firms should be in writing and accessible, and should be the basis on which decisions are made.* All regulations and related explanatory materials governing the consideration and issuance of licenses to firms and the introduction of new securities products and services by firms should be reduced to writing and made publicly available to potential applicants upon request. No licensee should be denied a license, and no new securities product or service should be prohibited, on the basis of any factor not identified in such written regulations or explanations.

2. *The introduction of new securities products and services by firms should be governed by the standards set forth in relevant rules and regulations.* Where particular requirements are established in connection with the introduction of a product or service, such requirements should govern the introduction of complying products and services. In order to promote flexibility and efficiency in the capital markets, such standards and requirements should

enable firms, to the maximum possible degree consistent with principles of prudence and investor protection, to introduce complying new products and services on the basis of sound internal procedures for compliance without additional regulatory review.

3. *Information supplied by applicants as part of an application process should be treated confidentially. Such information should be disclosed only in accordance with existing rules permitting public disclosures, such as those that may be triggered by the granting of a license or product approval.*

4. *Regulators should promptly review all applications by firms for licenses and required product or service approvals and should inform the applicant of any deficiencies.* No application for a license or approval that provides all information required pursuant to regulation and is made in good faith by an applicant that meets required criteria should be refused review and action by the relevant regulator. Action on all applications received should be taken within a reasonable period. Licenses should enter into force immediately upon being granted, in accordance with the terms and conditions specified therein.

5. *Where an examination is required for the licensing of an individual, regulators should schedule such examinations at reasonably frequent intervals.* Examinations should be open to all eligible applicants, including foreign and foreign-qualified applicants.

6. *Fees charged in connection with licenses and the introduction of new securities products and services should be fair and reasonable and not act to prohibit or otherwise unreasonably limit licensing requests or the introduction of new product and services.*

B. *Licensing of entities and their employees*

1. *An applicant's competence and ability to supply the service should be the criteria used for licensing entities and employees.* The terms and conditions for granting licenses should be made explicit, including education, experience, examinations and ethics. Procedures and criteria should not unfairly distinguish between domestic and foreign applicants. In addition, there should be no quantitative limits on the number of licenses to be granted to a particular class of market participants who are otherwise qualified.

2. *When imposing licensing requirements, regulators should endeavor to give consideration to comparable testing or other procedures confirming the qualifications of an applicant that already have been completed in another jurisdiction.* The ability of qualified and experienced market professionals to provide services in a foreign jurisdiction may be promoted where testing or other procedures used in the professional's home jurisdiction may satisfy all or part of the foreign jurisdication's licensing requirements.

C. *Denials of licenses and product and service approvals*

1. *When denying an application for a license or a required securities product or service approval, regulators should, upon request, provide an explanation for that action.* Any total or partial denial of any application for a license or a required new product or service approval should, upon request, be accompanied by a written statement of explanation from the relevant regulator detailing the reasons for the denial, including the particular requirements of the regulations governing the issuance of such license or required approval that were not satisfied. Applicants should be given the opportunity to resubmit applications or to file additional or supplementary materials in support of their applications.

2. *Applicants should be afforded meaningful access to administrative or judicial appeal of a denial of a license or a required product or service approval (or failure to act on an application).*

3. *An appeal of a denial of a license or a required product or service approval should be decided within a reasonable time period after the appeal is filed.* An applicant's decision to pursue an appeal (whether formal or informal) should not prejudice its existing licensed operations.

## V. Implementation of Regulatory Standards

A. *Inspections, audits, investigations and regulatory enforcement proceedings*[2]

1. *All inspections, audits, investigations and regulatory enforcement proceedings should be conducted pursuant to established regulatory and judicial standards and should not arbitrarily discriminate based on improper or other extraneous criteria like nationality.*

2. *All inspections, audits, and investigations should be conducted in a manner that does not impinge on the rights of licensed market participants and their directors, officers and employees.*

2. *A regulatory authority*[3] *should not publicly disclose the fact that it is conducting an enforcement related inspection, audit or investigation of a particular entity until a determination has been made by the regulatory authority to take remedial or other enforcement-related action, unless otherwise subject to a legally enforceable demand unless made in connection with a generally applicable disclosure requirement imposed on the entity.* The inspection, audit or investigation should be conducted at all times with due attention to the privacy and confidentiality concerns of all affected parties, including licensed market participants, their directors, officers, employees, and clients.

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[2] The term "regulatory enforcement proceedings" means administrative or judicial action authorized by the relevant regulatory authority and is intended to cover civil, administrative or criminal proceedings that involve a financial services firm and/or its employees based on their financial services activities.

[3] The term "regulatory authority" is intended to cover all regulatory bodies involved in the inspection, auditing, investigation or prosecution of the activities of financial services firms. Depending on the system, the term may encompass criminal and judicial authorities as well as non-governmental entities such as self-regulatory organizations.

B. *Regulatory proceedings to impose a sanction*

1. Notice and opportunity to be heard

a. *Notice of applicable law and regulation.* A regulatory proceeding to impose a sanction should only be instituted based on the violation of laws or regulations that were in effect at the time that the relevant activity occurred and where the subject of the proceeding had timely notice of them.

b. *Notice of determination to take action.* Licensed market participants should be notified in a timely manner both when: 1) a determination has been made to hold a regulatory proceeding concerning the conduct of that participant; and 2) a decision in, or on the status of, that proceeding has been made.

c. *Opportunity to be heard.* Except in situations where emergency temporary relief is necessary, in all regulatory proceedings, licensed market participants should be given a reasonable opportunity to be heard and to submit, on the record, position papers and other documentary evidence.

2. Representation by counsel and access to evidence

a. *Right to legal counsel.* The subjects of a regulatory proceeding should have the right to have legal counsel of their choice represent them in all meetings with, and interviews by, regulatory authorities. A regulatory authority should not suggest or imply that the attendance of counsel will in any manner alter the character of the proceedings being conducted, the level of supervisory review to be undertaken, or the manner in which the regulatory authority carries out its functions.

b. *Access to evidence.* The subjects of a regulatory proceeding should, upon request, be permitted reasonable access to all documents and records that are relevant to the subject matter involved in the pending regulatory action. Documents and records

to which access is denied based on privileges generally recognized in such proceedings should not be admissible in evidence in such regulatory proceeding.

c. *Burden of proof.* The burden of proof to demonstrate that a licensed market participant has not conducted its business in accordance with the relevant law and regulation should rest with the regulatory authorities.

3. Sanctions and Appeals

a. *Sanctions.* Sanctions by a regulatory authority should be imposed in a fair and nondiscriminatory manner based on the relevant facts and with an effort to treat similarly situated persons and entities in a similar manner. The basis for any decision to impose sanctions by a regulatory authority should be explained in a writing that is made available to the subjects of the proceeding.

b. *Appeals.* The subjects of a regulatory proceeding should have available to them a forum for appealing the decisions rendered and sanctions imposed. The body considering a particular level of appeal should be separate from that which made the decision or imposed the sanction that forms the basis of the appeal. Appeals to a regulatory authority should be decided in a timely manner and appeal determinations should be explained in a writing that is made available to the subjects of the proceeding.

For information and/or comments contact:

David Strongin, 212/618-0513 – dstrongin@sia.com

Statement of the Honorable Donald L. Evans
Chief Executive Officer
The Financial Services Forum

Testimony Before the
House Financial Services Committee
June 6, 2007

**Introduction**

Chairman Frank, and Ranking Member Bachus, thank you for the opportunity to participate in this important hearing regarding U.S. interests in reform and modernization of China's financial services sector.

I am here as Chief Executive Officer of the Financial Services Forum. The Forum is an association comprising the chief executive officers of 20 of the largest and most diversified financial institutions with business operations in the United States. The Forum works to promote policies that enhance savings and investment and that ensure an open, competitive, and sound global financial services marketplace. As a group, the Forum's member institutions employ more than 1.5 million people and hold combined assets of more than $12 trillion.

**Importance of China to the U.S. and Global Economies**

The 20 member CEOs of the Financial Services Forum meet twice a year, our most recent meeting occurring this past April. At each meeting, we conduct a survey regarding our members outlook on the U.S. and global economies. The answers we collected are of special value because, as the CEOs of 20 of the world's largest financial institutions, our members enjoy a unique vantage point on the U.S. and global economies.

As part of the survey, we ask our CEOs to rate a number of factors, including technological innovation, improved education, freer and more open trade, and growth in a number of regions around the world, to reflect their likely contribution to global economic growth over the next decade. The CEOs are asked to assign a number between 1 and 5 to each rated factor, with "1" being "not important" and "5" being "the most important." Our CEOs have consistently rated growth in China as the single most important source of growth for the global economy, assigning a rating of 4.7 out of 5 in our most recent survey.

The rate of China's expansion and the impact of its integration into the global trading system are unprecedented in the history of the world's economy – with profound implications for U.S. economic growth and job creation. Since China's joined the World Trade Organization (WTO) in December of 2001, trade between the United States and China has nearly tripled, exports to China have grown at five times the pace of U.S. exports to the rest of the world, and China has risen from our 9$^{th}$ largest export market to our 4$^{th}$ largest. How this critical relationship is managed is sure to be one of the most important factors determining the growth and stability of the global economy in the 21$^{st}$ century.

**Critical Importance of Financial Sector Reform in China**

Capital is the lifeblood of any economy's strength and well-being, enabling the investment, research, and risk-taking that fuels competition, innovation, productivity, and prosperity. As the institutional and technological infrastructure for the mobilization and allocation of investment capital, an effective and efficient sector financial system is essential to the health and productive vitality of any economy.

As a financial sector becomes more developed and sophisticated, capital formation becomes more effective, efficient, and diverse, broadening the availability of investment capital and lowering costs. A more developed and sophisticated financial sector also increases the means and expertise for mitigating risk – from derivatives instruments used by businesses to avoid price and interest rate risks, to insurance products that help mitigate the risk of accidents and natural disasters. Finally, the depth and flexibility of the financial sector is critical to the broader economy's resilience – its ability to weather, absorb, and move beyond the inevitable difficulties and adjustments experienced by any dynamic economy. For all these reasons, an effective, efficient, and sophisticated financial sector is the essential basis upon which the growth and vitality of all other sectors of the economy depend. It is the "force multiplier" for progress and development, amplifying and extending the underlying strengths of a growing economy.

Almost immediately after assuming leadership at the 16th Chinese Communist Party Congress in 2002, President Hu Jintao and Premier Wen Jiabao sought to distinguish themselves as the "putting-people-first administration." They also articulated the notion of a "scientific viewpoint of development," by which economic growth is to be balanced with social priorities such as a more equitable distribution of income, poverty reduction, education, improved medical care, and environmental protection.[1] Such adjustments were necessary, according to the new leadership, to establish a more sustainable course for China's long-term economic growth and to achieve a more "harmonious" – which is to say, a more equitable and stable – society.

These priorities became the framework of China's 11th Five-Year Plan[2], which broadens China's development policy beyond simply promoting rapid economic growth to include a clear emphasis on "common prosperity" – that is, an effort to extend westward the economic gains enjoyed principally in China's east coast urban areas. The Five-Year Plan seeks to address the twin problems of an economy perceived as being too dependent on external demand and the social consequences of the widening wealth gap by: 1) maintaining high rates of growth and job creation; 2) encouraging a structural shift from industry to services; 3) promoting the development of domestic consumer demand; 4) reducing poverty; and, 5) ensuring a more equitable distribution of opportunity and prosperity.

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[1] See Wen Jiabao, closing speech at the Specialized Research Course for Province-Level Cadres on Establishing and Implementing a Scientific Developmentalist Viewpoint," February 21, 2004.

[2] The Five-Year Plan, the 11th since 1953, was approved by the fifth plenary session of the 16th Communist Party Central Committee in October of 2005 and ratified by the National People's Congress this past spring.

Given the unique and critical role an effective and efficient financial sector plays in any economy, reform of China's financial sector is a *prerequisite* to China achieving its own economic goals. Financial sector reform is also a prerequisite to meaningfully addressing issues that have complicated the U.S.-China economic relationship, particularly greater currency flexibility and reducing trade imbalances.

Achieving China's Economic Priorities

- *Maintaining High Rates of Growth and Job Creation*: Maintaining exceptional rates of economic growth and job creation in China increasingly depends on an effective system for mobilizing investment capital. At present, China's weak banking system intermediates nearly 75 percent of the economy's total capital, compared to about half in other emerging economies and less than 20 percent in developed economies. Despite some improvements in recent years, Chinese banks' credit analysis, loan pricing, risk management, internal controls, and corporate governance practices remain inadequate. Meanwhile, China's equity and bond markets are among the smallest and least developed in the world. More fully developed capital markets would provide healthy competition to Chinese banks and facilitate the development and growth of alternative retail savings products such as mutual funds, pensions, and life insurance products. And by broadening the range of funding alternatives for emerging companies, more developed capital markets would greatly enhance the flexibility and, therefore, the stability of the Chinese economy.

- *Shifting from a Manufacturing-for-Export to a Services-Based Economy*: Facilitating China's desired transition to a more services-based economy will require that competitively priced capital and credit be channeled to the most promising emerging service businesses, and that the array of financial products and services emerging businesses require – loans, letters of credit, accounts management services, asset management, and insurance products – be made available.

- *Activating the Chinese Consumer*: Chinese households historically save as much as a third of their income, as compared to single-digit savings rates in the United States and Europe. This pronounced propensity to save is related to the declining role of the state and the fact that most Chinese depend on their families and private savings to pay for retirement, healthcare, and the economic consequences of accidents or disasters. Activating the Chinese consumer requires the availability of financial products and services – personal loans, credit cards, mortgages, pensions, insurance products, and insurance intermediary services – that will eliminate the need for such "precautionary savings" and facilitate consumption.

In sum, a more modern, open, and competitive financial system would greatly enhance the productive capacity and stability of the Chinese economy and facilitate the achievement of China's economic goals, as described in the 11th Five-Year Plan. Indeed, research conducted by

McKinsey indicates that genuine reform of its financial system would expand China's economic output by as much as 17 percent, or an additional $320 billion a year.[3]

Meaningfully Addressing Issues with the United States

A more effective and efficient financial sector in China is also a prerequisite to successfully addressing issues that have complicated the U.S.-China economic relationship, particularly further currency reform and meaningfully reducing the trade imbalance.

- *Market-determined exchange rate*: A Chinese authorities have repeatedly argued – reasoning generally acknowledged by most foreign analysts – that a more rapid shift to a market-determined yuan is not possible given the underdeveloped state of China's capital markets. More specifically, China's banks, securities firms, and other businesses lack the expertise to develop and trade derivatives and other structured instruments used to hedge the risk associated with greater currency volatility. Sophisticated derivative products and hedging techniques provided by foreign financial services firms would clearly diminish such concerns.

- *Reduction of trade deficit*: Reorienting the financial habits of China's population from precautionary savings to a better balance between savings and consumption – while progressively bringing more than a billion Chinese into the global economy – is the most powerful remedy to the U.S.-China trade imbalance. Last year, the United States exported to Japan goods and services worth $60 billion – approximately the same amount exported to China ($55 billion). But China's population of 1.3 billion is ten times Japan's population of 127 million. If U.S. exports are expressed in relation to population, the U.S. sold the equivalent of $472 worth of goods and services to every citizen of Japan last year, but only about $40 worth of goods and services to every Chinese citizen. If China's citizens were to eventually consume American-made goods and services at the same rate that Japan's citizens did last year, the United States would export more than $600 billion worth of goods and services to China, 11 times what America exported to China last year, an amount equivalent to 5 percent of America's GDP, and more than twice what we imported from China last year – replacing the trade deficit with a significant surplus.

**Status of Financial Sector Reform in China**

In addition to working to meet its WTO commitments, China has also taken important steps to liberalize its financial sector and improve financial regulation. For example:

- The financial sector has been transformed from a single-bank system to a more diversified system with a central bank at the helm.

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[3] See "Putting China's Capital to Work: The Value of Financial System Reform," by Diana Farrell, Susan Lund, and Fabrice Morin, The McKinsey Global Institute, May 2006.

- Meaningful steps have been taken to eliminate state-directed policy lending, and amendments to the Law on Commercial Banks and the Law on the Peoples Bank of China have laid the foundations for commercially viable lending.

- The China Banking Regulatory Commission (CBRC) was established in April of 2003 to oversee all banks in China, investigate illegal banking operations, and punish violations of law.

- Interbank, equity, and foreign exchange markets have been established and important progress made toward implementing monetary policy through market mechanisms rather than by government fiat.

Despite these achievements, China's financial sector still faces serious challenges:

- Non-commercial lending to state-owned enterprises continues, although on a diminishing scale.

- The stock of nonperforming loans on banks' balance sheets remains high.

- Banks are undercapitalized and lending practices, risk management techniques, new product development, internal controls, and corporate governance practices remain inadequate.

- Prudential supervision and regulation of the financial sector is opaque, applied inconsistently, and lags behind international best practices.

- China's equity and bond markets remain small and underdeveloped.

With these problems in mind, efforts to build on the progress achieved to date should focus on:

- The critical importance of open commercial banking, securities, insurance, pension, and asset management markets to promoting the consumption-led economic growth that China's leaders seek;

- The clear benefits to China of increased market access for foreign financial services firms – namely the introduction of world-class expertise, technology, and best practices – and the importance of removing remaining obstacles to greater access.

  Foreign investors in Chinese banks remain limited to 20 percent ownership stakes, with total foreign investment limited to 25 percent. The China Securities Regulatory Commission (CSRC) continues to limit foreign ownership of Chinese securities firms to 33 percent and foreign ownership of Chinese asset management companies to 49 percent. Worse, since December of 2005 has imposed a de facto moratorium on foreign investments in Chinese securities firms. The moratorium is inconsistent with the letter, and certainly the spirit, of China's WTO commitments. Foreign life

insurance companies remain limited to 50 percent ownership in joint ventures and all foreign insurers are limited to 25 percent equity ownership of existing domestic companies.

While these caps were agreed to in the course of WTO accession negotiations, the limitations are among the most restrictive of any large emerging market nation and stand in the way of a level playing field for financial service providers. Most importantly, they limit access to the products, services, know-how, and expertise that China needs to sustain high rates of economic growth, and that China's businesses and citizens need to save, invest, and create and protect wealth. For these reasons, the United States and other WTO members have urged China to relax these limitations.

China also continues to restrict access by foreign credit card companies. Banks in China are permitted to issue a credit card with a foreign logo only if the card is co-branded with the logo of China Union Pay (CUP), an entity created by the People's Bank of China (PBOC) and owned by participating Chinese banks. In addition, all yuan-denominated transactions must be processed through CUP's network, while the network of the foreign credit card company is used only to process foreign currency transactions.

- Non-discriminatory treatment with regard to licensing, corporate form, and permitted products and services.
- Non-discriminatory treatment with regard to regulation and supervision.
- Regulatory and procedural transparency.
- Attracting sophisticated institutional investors to China's capital markets through the expansion of the Qualified Foreign Institutional Investor (QFII) and Qualified Domestic Institutional Investor (QDII) programs.
- Priority issues from the Transitional Review Mechanism that remain unresolved.[4]

For a more detailed discussion of the U.S. financial services industry's priorities in China, please see the Appendix.

[4] China's WTO accession included the Transitional Review Mechanism (TRM) as a means for ongoing review of China's compliance with its obligations, and to provide those elements of the Chinese government supportive of further economic reform with information and evidence to urge full compliance with China's WTO commitments.

**The Importance of a Market-Determined Yuan**

With the importance and status of financial sector reform in China as a backdrop, let me focus for a few minutes on the importance of a market-determined Chinese yuan. In recent years the discussion in Washington regarding the U.S.-China economic relationship has focused in large part on China's currency policy. Many policymakers assert that an undervalued yuan makes cheap Chinese exports even cheaper, giving Chinese producers an unfair advantage over American companies and contributing to the U.S. trade deficit with China.

A market-determined yuan is important – for the United States and especially for China. Foreign exchange market intervention by the People's Bank of China – buying dollars with yuan – has boosted liquidity in China's economy, thwarting government efforts to scale back excessive bank lending and fixed investment. Speculative money flowing into China in anticipation of a revaluation is also undermining government objectives. Finally, allowing the yuan to more fully float according to market forces would free the PBOC to pursue monetary policies that advance China's macroeconomic goals. For these reasons – as well as the priority of a more fair and transparent trade relationship – U.S. policymakers should continue to press China to accelerate progress toward a market-determined yuan.

For years, the United States has worked with China toward achieving a yuan whose value is determined by market forces. Indeed, shortly after taking office, the Bush Administration committed to helping China develop the capital markets know-how and expertise necessary to end the yuan's peg to the dollar, providing massive technical assistance. And those efforts have begun to bear fruit. In July of 2005, China revalued its currency upward by 2 percent. Since mid-2006, the pace of appreciation has accelerated, averaging about 4.9 percent a month at an annualized rate, and quickening to around 5.4 percent in the first few months of 2007, as China has become more confident about the resilience of its economy. In total, the yuan has appreciated by about 8 percent since July of 2005.

This is important progress – but, clearly, much more progress is needed. Given the importance of a market-determined yuan to the economic objectives of both countries, the United States should continue to press China to redouble its reform efforts and accelerate movement toward a freely floating yuan.

But even as we continue to press China on the yuan, we should not allow the currency issue to overshadow the broader potential of the U.S.-China economic relationship. Indeed, it should be noted that the short term effect of a significant appreciation in the yuan would likely be to make the trade deficit *worse*. Because a higher-valued yuan would mean higher prices for imported Chinese goods, and because the process of finding cheaper alternatives to more expensive Chinese goods takes time, the trade deficit would likely get worse before getting better – a phenomenon economists call the J-curve effect.

Of far greater significance to the policy goals of maintaining strong U.S. economic growth and job creation is for China to achieve a more sustainable model of continued economic growth, and for its population of 1.3 billion – a fifth of the world's population – to begin consuming at higher levels. Both goals require reform of China's financial sector.

**Conclusion**

Mr. Chairman, the fastest way for China to develop the modern financial system it needs to achieve more sustainable economic growth, allow for a more flexible currency, and increase consumer consumption is to import it – that is, by opening its financial sector to greater participation by foreign financial services firms. Foreign institutions bring world-class expertise and best practices with regard to products and services, technology, credit analysis, risk management, internal controls, and corporate governance. In addition, the forces of competition brought by foreign institutions would accelerate the development of modern financial techniques and methodologies by China's financial institutions.

By providing the financial products and services that China's citizens and businesses need to save, invest, insure against risk, raise standards of living, and consume at higher levels, foreign financial institutions – including U.S. providers – would help China develop an economy that is less dependent on exports, more consumption-driven and, therefore, an enormously important and expanding market for American products and services. In doing so, U.S. financial services firms can help China become a more stable and responsible stakeholder in the global economy and trading system.

Thank you very much for the opportunity to appear at this important hearing.

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# Appendix

## U.S. Financial Industry Priorities in China

### Banking

Raise Current Investment Caps – Foreign investors in Chinese banks remain limited to 20 percent ownership stakes, with total foreign investment limited to 25 percent. Such caps are a significant obstacle to China's achievement of a more balanced, resilient, and stable economy. Creating the millions of new jobs that China will need each year requires maintaining exceptional rates of economic growth, which in turn will increasingly depend on an effective system for mobilizing and allocating investment capital. At present, China's weak banking system intermediates nearly 75 percent of the economy's total capital, compared to about half in other emerging economies and less than 20 percent in developed economies. Despite some improvements in recent years, Chinese banks' credit analysis, loan pricing, risk management, internal controls, and corporate governance practices remain inadequate.

The result is that investment capital continues to be misallocated, to the detriment of China's economy and people. State-owned enterprises, though contributing only a quarter of China's GDP, receive more than a third of bank credit and account for nearly all equity and bond issues. Private enterprises – the most productive of China's economy and the engine of future growth and job creation – account for only 27 percent of bank loan balances.

Greater access for foreign banking institutions bring world-class expertise and best practices with regard to products and services, technology, credit analysis, risk management, internal controls, and corporate governance. In addition, the competition brought by foreign institutions would accelerate the adoption of such techniques and methodologies by domestic financial institutions

Grant non-discriminatory treatment with regard to licensing, corporate form, regulation, and permitted products and services: While China imposes no explicit limits on the number of licenses provided to foreign banks and remaining geographic and customer restrictions were phased out as of December 2006, regulations continue to require three years of operation and two continuous years of profitability before foreign bank branches are permitted to carry out local currency business. China also imposes substantial asset and capital requirements. To establish a subsidiary in China, a foreign bank must have total assets of more than US$10 billion and the subsidiary must maintain minimum capital of 1 billion yuan (US$129.2 million); to establish a branch, foreign banks must have total assets of more than US$20 billion and each branch must maintain minimum operating capital of about $50 million. Such capitalization requirements have the effect of making subsidiaries significantly more economical than branches – limiting the extent to which foreign banks can penetrate the Chinese market.

The efficient deployment of the capital and other resources of foreign financial institutions in China requires the flexibility to determine which particular corporate reform – whether a wholly-owned subsidiary, branch, representative office, joint venture, or majority

equity investment in an existing Chinese company – is most appropriate economically and within the broader strategic parameters of the foreign institution. Restrictions on operational form can discourage foreign financial institutions from initiating business activities in China, despite finding the market attractive, which will not serve the interests of the Chinese consumer.

Chinese authorities have also been slow to act on foreign banks' applications and continue to permit foreign banks to open only one branch every 12 months. In addition, a portion of foreign banks' branch capital must be deposited in Chinese banks, and foreign banks remain subject to minimum interest rate rules when borrowing from Chinese banks. Most problematic, the 75 percent loan-to-deposit cap discriminates against foreign banks because their small number of branches – made worse by a slow approval process – limits foreign banks' deposit base.

Improve regulatory and procedural transparency: Related to the issue of non-discriminatory regulatory treatment, China must also continue to make progress regarding the critical issue of regulatory and supervisory transparency. Fair and transparent regulation plays an integral role in the development of deep and liquid capital markets that attract market participants, increase efficiency, and spur economic growth and job creation. Transparency generally means that the public and industry participants have the opportunity to participate in the rule-making process, to access information about proposed rules, to question and understand the rationale behind draft rules, to have sufficient opportunity to review and comment on proposed rules, and that final rules and regulations be clearly articulated and easily understood.

Unfortunately, regulatory ambiguity continues in China and administrative procedures and the rule-making process continue to be inconsistent and unnecessarily opaque. New regulatory guidelines are too often promulgated without notice or consultation with the industry. Even when industry consultation has been sought, the response period has often been insufficient. While China has agreed to publish the laws and regulations governing financial services as its WTO accession protocol requires, it has not committed to all of the essential elements of modern regulatory transparency, including advance notice of new rules or rule changes, public comment, and the right to judicial review.

## Securities

Greater Market Access

China's 2001 WTO accession commitments in the securities sector were an important first step towards liberalizing its capital markets. These commitments permit foreign securities firms to participate in the securities business in China – but only through minority-owned joint ventures with permitted ownership levels in such ventures capped at just 33 percent. China has made no further commitments in the securities sector for further increases in foreign ownership in the Doha Round. Moreover, China has a placed a *de facto* moratorium on securities firm joint ventures.

- Permit 100% ownership, and right to establish in corporate form of choice: China should lift the de facto moratorium on securities firm joint ventures. Foreign firms are unlikely to invest without the ability to control their investment, either through a wholly-owned entity or another ownership form of choice. Firms also should have the right to establish without geographical limitation.

- Permit same scope of business: Foreign minority-owned joint ventures are limited to underwriting the A shares of Chinese corporations, and to underwriting and trading government debt, corporate debt, B shares and H shares. The fundamental right to *trade* A shares, the most liquid domestic market, was not conferred on these foreign joint ventures, which compromises their underwriting business. Foreign entities are also restricted in many cases from trading renminbi and renminbi-linked products with foreign and domestic enterprises in China. Without the ability to trade renminbi, any progress otherwise made in expanding the permitted activities of foreign securities firms will be difficult to realize competitively.

Regulation

- Permit Derivatives Transactions: Subject to reasonable prudential requirements, foreign or domestic securities firms should be permitted directly to engage in the development and distribution of derivative products and services, without requiring a banking license.

- Change Assessment of Capitalization Requirements: Rather than establishing a capital requirement based upon a technical assessment of the risk of the business to be entered, China has promulgated a fixed minimum capital requirement of RMB 500 million ($U.S. 50 million) for securities and asset management firms wishing to participate in joint ventures permitted under China's WTO commitments. This dissuades smaller foreign entrants, reducing the overall attractiveness of the joint venture vehicle and discouraging foreign direct investment. A capital assessment system that took into account a firm's overall risk and consolidated capital would reward firms who invest in stronger risk management systems and shore up their balance sheets appropriately for their business mix.

- Promote Regulatory Transparency: Transparent and fair regulatory systems play an integral role in the development of deep, liquid capital markets that attract market participants, increase efficiency and spur economic growth and job creation. In general the practice of transparency means that the public and industry participants have the opportunity to participate in the rule-making process, to access information about proposed rules, to question and understand the rationale behind draft rules and sufficient opportunity to review and comment on them, and that the resultant rules and regulations be clearly stated and easily understood.

- Improve Qualified Foreign Institutional Investors (QFII) Program: Reforming the QFII program could encourage more investors for Chinese stock markets. Limits on the types (size) of investors, the length and size of quotas, and difficulties with remitting profit are key barriers to more participation.

- Support A Qualified Domestic Institutional Investor (QDII) Program: Implementing the QDII program would help familiarize Chinese domestic investors with international best corporate and broking practices and give them access to top quality research.

## Insurance and Insurance Brokerage

Ownership (#1 insurance issue)

- Ensure that foreign insurers are guaranteed the freedom to choose their desired form of juridical form of establishment (branch, subsidiary, or joint venture).

- Remove equity limitations on foreign life insurers - currently capped at 50%; allow equity ownership up to and including 100%.

- Provide national treatment for foreign invested insurers, allowing them to purchase or sell ownership stakes on commercial basis between joint venture contract partners, consistent with most favored nation principals.

Discussion Points:

- There is no statutory restriction that foreign life insurance companies be limited to 50% ownership, and the Government of China has discretionary power to authorize up to 100%.

- There are legitimate prudential reasons why Chinese insurance regulators could need to allow an equity increase by a foreign JV partner above 51% and up to 100% (such as financial difficulty of the Chinese partner) in the interests of policyholders and the stability of the Chinese insurance market.

- All parties in managing insurance companies should be committed to the financial vitality of the company and the best interests of policyholders. Both foreign and Chinese partners should have the right to purchase or sell their interests consistent with the interests of their stakeholders and the contractual terms of the joint venture.

- It is not in anyone's interest to require ongoing company ownership by partners who are no longer committed to the enterprise, and who are dedicating their resources to other businesses.

Branches, Subsidiaries

- Allow foreign insurers to submit multiple applications for branch approval, and if approved, grant them concurrently, which is consistent with branch approvals for domestic insurers.

- Approve existing non-life company applications for conversion of their branches to subsidiaries and ensure that future applications are considered and acted on in a transparent and timely fashion consistent with international norms and practices.

Discussion Points:

- Both of these issues have been raised in the JCCT, the JEC and the annual TRM.
- The Government of China is on record as agreeing with the US requests on both concurrent branching and conversion, and stating that their laws and regulations provide for such treatment.
- On conversion several U.S, companies have had applications pending for approaching two years, where as Chinese regulations promise decisions within sixty days.
- Achieving a commitment for resolution of these issues is necessary as the base elements of any outcome acceptable to industry, but represents low hanging fruit.

Enterprise Annuities (#1 pension issue)

- Establish "one stop shop," managed and coordinated within one government agency, which can approve licenses for providing EA related products/services in the market – master trust plan bundle; trustee; record keeper; asset manager and custodian.
- End the moratorium on EA licensing (last batch of licenses were awarded in August 2005) and allow applicants to submit EA related applications at will.
- Allow foreign equity ownership in EA related ventures up to (at least) 50%; and, participation up to 100% consistent with broader goals for financial services market access (see above).

Discussion Points:

- The enterprise annuity framework is already in place, and all relevant Chinese regulatory agencies (MOLSS, CBRC, CSRC and CIRC) are on record as supporting the increase in plan sponsors and participants.
- Current Chinese statute allows for bundled licensing for three of the four licensing elements (asset manager, trustee and record keeper) only requiring removal of the prohibition on licensing of "custodians" by insurers and asset managers.
- A public announcement that the Government of China will process applications bundling these three elements would allow the Government of China to proceed with an effective first step towards the "one stop license" within the scope of their current discretion.

- The Government of China recently announced the creation of an inter-agency committee to develop unified national tax incentive policies for both employer and employee contributions to EA.

- Adoption of best practices tax incentives for EA along with a simplified licensing process is the best way for the Government of China to build private savings in support of the social safety net.

Investment of Assets

- Credit global insurers' international operating experience and capital to fulfill current seasoning and asset threshold requirements (eight years in the market, ten billion RMB) for asset managers.

Discussion Points:

- Achieving a commitment for resolution of these issues is necessary as the base elements of any outcome acceptable to industry, but represents low hanging fruit. An announcement by Chinese leadership of an intention to credit global experience and capital would be a strong first step, but would need monitoring to guarantee CIRC implementation.

Political Risk Insurance

- Allow foreign insurers to underwrite political risk insurance in China and approve all outstanding applications to do so.

Discussion Points:

- Achieving a commitment for resolution of these issues is necessary as the base elements of any outcome acceptable to industry, but represents low hanging fruit.

Reinsurance

- Confirm that foreign reinsurance and insurance companies are allowed to conduct cross border reinsurance with Chinese direct insurers or re-insurers on the same basis as reinsurance companies admitted in China.

Discussion Points:

- Achieving a commitment for resolution of these issues is necessary as the base elements of any outcome acceptable to industry, but represents low hanging fruit.

## Insurance Background - Lexicon

**Acquired Rights**

Industry would like to confirm that foreign insurance companies operating in China at the time of WTO accession may continue to operate and expand their existing structure without modification of juridical form, under the conditions that existed, and pursuant to the approvals granted, prior to the recently issued regulations and implementing rules on administration of foreign insurance companies. This should include operations, financial structure, capital and mode of establishment. Similarly, non-life companies already established in China (whether as a branch or otherwise) should also be able to open additional branches and sub-branches, whether or not they re-establish as a subsidiary (see below).

**Equity Ownership**

Currently, foreign life insurance companies remain limited to 50 percent ownership in joint ventures and to 25 percent equity ownership of existing domestic companies. Consistent with rights enjoyed by domestic insurers and all other financial service institutions in China, foreign insurers should be allowed to invest up to 100% in their operations in China. Foreign non-life providers can own up to 100%. AIG, which owns 100% of its life and non-life operations, and a number of life companies (Manulife and Allianz among them) were allowed to grand-father arrangements held prior to WTO accession. ACLI is currently investigating reports that Allianz has been allowed to buy up from its original 51% stake to 100% - if so, this would unprecedented and potentially allow for further increases in equity caps among insurers.

**Branches, Subsidiaries, Capitalization Requirements**

Branch Approvals: Foreign insurers repeatedly report that they are told by CIRC (China Insurance Regulatory Commission) officials that multiple branch applications cannot be submitted at the same time, or if submitted will not be concurrently examined and approved. Overwhelming evidence exists that indicates domestically-invested insurance companies, even new companies, have been permitted to expand aggressively through multiple consecutive or virtually consecutive branch approvals. By contrast, it appears that no foreign-invested insurance companies have received consecutive branch approvals. China undertook in its WTO accession agreement to eliminate all geographic restriction on foreign-invested life, non-life, and brokers by December 11, 2004. As for national treatment, China did not include in its WTO accession schedule any limitations regarding its obligations on form of establishment in the insurance sector. China also made commitments to allow internal branching consistent with the phase out of geographic restrictions.

Senior officials at the China Insurance Regulatory Commission have recently confirmed to USTR their commitment to allow foreign companies to establish multiple concurrent branches. We are pleased with this decision, and would call on CIRC to confirm this intention in an administrative clarification to all CIRC staff.

Subsidiary Conversion: Despite CIRC's effective requirement that foreign-owned insurers convert their Chinese operations from branches to subsidiaries (notwithstanding China's WTO commitment to allow foreign general insurers to operate on either a branch or subsidiary basis), the regulator continues to delay approval of companies' applications for such conversion. This delay contravenes CIRC's own regulation (Baojian Fa 45, page 3, section 6) that requires its response to applications within two months. The delay - over sixteen months for some companies -- has created uncertainty and confusion in corporate planning as insurers eager to expand can only apply for permission to open new offices three months after the conversion process is approved. Those few companies that have been granted subsidiary conversion approvals effectively have an unfair advantage over all of US firms, none of which have received approval, because they are able to move ahead to expand their Chinese operations.

Capitalization Requirements: CIRC should confirm that the RMB 200 million capital requirement for initial establishment, whether as a subsidiary or a branch, includes the right to establish sub-branches without limitation on numbers, and without having to satisfy any additional capital requirements. The Chinese government has yet to provide its rationale for requiring additional capital of RMB 20 million for each additional branch, particularly given that any additional branches would still be backed by the full asset base of the admitted entity and have to comply with all CIRC solvency rules.

**Enterprise Annuities**

In the spring of 2005, Chinese regulators started establishing an enterprise annuity system as a second pillar individual account, defined contribution retirement program. Conservatively, industry observers estimate that within 10 years the assets under management for this program should be close to $100 billion. Within 25 years they should reach $1 trillion, which is how long it has taken the U.S. 401(k) system to reach its current $3 trillion in assets. Participating in this type of growth is paramount for firms in worldwide retirement benefits leadership positions.

"One Stop Shop": Industry welcomes China's interest in developing its EA system. However, rules and standards for the provision of EA services remain unclear and act as a significant deterrent to market access and full participation in the market. The regulations currently prevent one company from providing a comprehensive package of services (custodian, administration, asset management, and trustee). China should clarify the regulatory framework to authorize single provider plans under a single license, which would enable a "one stop shop" to improve cost effectiveness of the plans, particularly for small and medium enterprises in China. The EA pension system needs changes and this is precisely the right time to implement them. The system is in a nascent stage and changes would not unduly harm or competitively impact either domestic or foreign providers. In fact, the changes identified would help to grow the market substantially, increasing the participation of employers and employees, and decreasing the future pension debt burden on the Chinese government.

Tax Incentives: A number of provinces in China have issued policies that provide various levels of tax incentives for corporate EA contributions, while many others do not have such policies in place. On the employee side, there is no individual income tax incentive for EA contributions. We believe that tax incentives are necessary for promoting private pensions and are crucial to the healthy development of the pension market. Therefore, we recommend that the State Tax Bureau

and the Ministry of Finance enact unified national tax incentive policies for both employer and employee contributions to EA.

Foreign Participation Limit: Foreign participation in the enterprise annuity market should be encouraged in the interest of introducing tested professional pension management experiences from other mature pension markets in the world to the fledgling EA market in China. As pension is included in China's WTO commitments under the section covering life insurance, we believe that foreign equity ownership in all EA service provider entities should be allowed up to (at least) the same current limit as life insurance companies (50%). This limit however should represent a floor and not a ceiling, and as part of SED and in support of building momentum for the WTO's Doha Round Negotiations, the Principal, along with ACLI, call for the Government of China removing this limitation and allowing 100% ownership, as further expressed in the ACLI SED priorities letter provided to Secretary Paulson.

Master Trust Plan: The EA rules as they stand now do not allow master trust plans, hence all EA plans have to be set up as individual trusts. This makes small plans unattractive to service providers. There is a strong need on the part of medium and small size companies for such plans in order to enjoy good quality service at a lower cost. Current rules effectively shut the small companies out of the enterprise annuity market. We encourage the Ministry of Labor and Social Security (MOLSS) to work with various other Chinese regulators to allow EA service providers to offer master trusts such that the medium and small size market can also be covered.

Pension Asset Investment: EA rules stipulate that no more than 20% of EA assets can be direct equity investments and no more than 30% can be investments in equity-related investment. This significantly limits the potential for higher long term returns for pension assets. In addition, the kinds of investment options allowed for EA assets are rather limited, too. We believe that a higher percentage should be allowed in equities, and that EA service providers should be allowed a broader range of investment options. This will help ensure a higher long term return for pension assets while at the same time allowing for prudent diversification to control risks. In addition, there should be a timeline for allowing pension assets to be partially invested overseas to further diversify their risk. Adding to offshore investments is a formula that has worked well for other markets, namely Chile where 30% of the assets can be invested offshore and the expectation is within two years to increase that level to 60%. It is a natural evolution in an effort to further diversify and insulate the system from local country risks as evidenced by Mexico enhancing their offshore allocations in the last two years.

Pension Regulator: While MOLSS (Ministry of Labor and Social Security) is the main regulator for EA, a lot of collaboration is needed between MOLSS and the other financial service regulators such as China Securities Regulatory Commission (CSRC), China Banking Regulatory Commission (CBRC), and China Insurance Regulatory Commission (CIRC). Further, it requires a lot of work and manpower to set up and run a well-regulated private pension market in China and much more dedicated and focused resources are needed at the regulator level, without which the policy making and approval process would naturally be slow. We believe that it is vital to have a fully staffed centralized decision-making pension regulator with dedicated resources so as to ensure that the EA regulatory system remains sound and healthy.

**Investment of Assets**

Overseas Utilization of Insurance Foreign Exchange Funds: CIRC's *Provisional Measures on the Administration of the Overseas Utilization of Insurance Foreign Exchange Funds* establish a qualifying threshold (total assets of RMB 10 billion) for companies to be able to invest their foreign exchange capital in overseas funds or equities. ACLI members would like to know the prudential justification for this requirement. Industry is concerned that even though this limitation applies to both domestic and foreign providers, only the largest insurers, i.e., mostly domestic companies, will have the necessary assets to qualify. Many foreign-invested insurers invariably will not qualify unless CIRC recognizes the assets of the parent foreign company when determining the asset level of a foreign-invested company. To rectify this concern, CIRC should ccredit global insurers international operating experience and capital in fulfillment of current seasoning and asset threshold requirements (eight years in the market, ten billion RMB) for asset managers;

Insurance Asset Management Restrictions: Under Article 8 of CIRC's *Interim Regulations for Insurance Assets Management Companies*, only providers that have held licenses for more than eight years are permitted to apply to establish an insurance asset management company. Although China previously stated that this limitation applies to both domestic and foreign providers, it effectively excludes all foreign companies entering the market since China's WTO accession in 2001. Industry would like CIRC to provide its prudential reasons for this restriction. To rectify this concern, CIRC should ccredit global insurers international operating experience and capital in fulfillment of current seasoning and asset threshold requirements (eight years in the market, ten billion RMB) for asset managers;

Investment Channels: From an investment perspective, excessive and often discriminatory capitalization requirements continue to act as constraints on foreign insurers' ability to compete with local established insurers on a fair and equitable basis. In December 2005, CIRC's Draft Insurance Fund Management Regulation enforces outsourcing of the asset management (on-balance and off-balance sheet funds) of small and medium insurance companies to an Insurance Asset Management Company (IAMC). The draft regulation stated that an insurance company that does not own an IAMC, must outsource all its investments in equities, corporate bonds and mutual funds to an IAMC or any professional investment institution (no specific definition was given).

An IAMC is a subsidiary company to be set up by insurance companies that have total assets of at least RMB10B. Currently there are nine approved IAMCs that are all formed by large domestic companies. CIRC's official rationale for the policy is that an IAMC has better internal controls and investment capabilities for improving insurers' risk management and returns. However, the proposal has met with objections from both insurers and media. Both domestic and foreign insurers do not want to outsource their investment function, which is a core business element, to their competitors. There are concerns regarding potential disclosure of investment asset portfolio information to competitors and also, most important of all, potential conflicts exist for the IAMC to allocate assets to its parent insurance company's portfolio or those of competing insurance companies. If the proposal is implemented, all small and medium-sized companies that are not able to set up their own IAMC will lose the right to manage their own assets to their competitors' IAMC. Many small and medium-sized insurers viewed this initiative as a policy favoring large domestic insurers.

In June 2006, CIRC started to implement this initiative by indicating to insurers that in order to invest in direct equities, they would have to outsource equity investments to an IAMC, and CIRC would not consider any direct equity investment applications filed by them. Meanwhile, many insurers are already preparing to apply to manage their equity investments directly. CIRC also stated that it considered most small and medium-sized companies incapable of direct equity investment because of their lack of research capabilities, the fact that there was no separation between investment departments and finance departments and absence of a third-party custodian to protect asset misappropriation risk. In fact, all of the foreign insurers' parent companies have long histories of direct equity investment overseas. They could support and invest in research and systems capabilities, and install international-standard risk management systems for direct equity investment in their China operations. Enforcing outsourcing would add uncertainty and undermine insurers' commitment on spending resources to prepare for direct equity investment, which is important to insurers' portfolio diversification and future business opportunities in pension or asset management.

Enforced outsourcing of direct equity investment is seen as the first step in CIRC's initiative to have all assets outsourced. It is possible that the Chinese regulator will impose different kinds of restrictions (such as asset-based requirements) to push small and medium-sized insurance companies to outsource their fixed income investments and other future new investments (e.g., overseas investment, infrastructure investments, securitized assets investments) to large local insurers' IAMC. To any insurance company, investment capability and control are core strategic business areas to be controlled by the insurer itself. CIRC has long cited that, overseas, many small insurers outsource their investments for the sake of economies of scale. However, this would obviously not be the case for joint venture insurers in China who have strong support from their foreign parent companies. A self-controlled investment function is critical to operating an insurance business. The less robust internal control and investment capabilities in local insurers, along with the repeated scandals in their investment functions, are of obvious concern to joint venture insurers.

**Political Risk Insurance Product Approval**

American non-life insurance companies have been unable to gain China Insurance Regulatory Commission (CIRC) approval to provide political risk insurance (PRI) coverage for Chinese companies. One U.S. carrier has been waiting to receive CIRC approval for its PRI product for roughly 18 months.

China Export and Credit Insurance Corporation (Sinosure), is wholly owned by the Chinese government. Currently Sinosure is the only insurer allowed to offer political risk insurance in China for non-domestic exposures. It would appear that CIRC has been delaying the approval of foreign insurers PRI products because they have been told to protect Sinosure's monopoly, even though the market badly needs the additional capacity and expertise that American companies (some of whom are global market leaders in PRI) would bring. CIRC and the Ministry of Finance (MOF) jointly administer Sinosure, with MOF the stronger and more important of the two organizations in the Chinese Government. Although CIRC does not report to MOF, it can ill afford to upset MOF as the ministry provides financial resources to CIRC.

If American companies gain approval to underwrite political risk in China, Chinese investors could access enhanced, highly sophisticated risk management practices. Numerous Chinese companies have expressed a deep interest in access to new risk transfer options. China Ex-Im Bank and China Development Bank have indicated that they are not satisfied with Sinosure's service and limited capacity.

**Reinsurance**

Senior officials at the China Insurance Regulatory Commission have recently confirmed to USTR their commitment to allow foreign reinsurance and insurance companies to conduct cross border reinsurance with Chinese direct insurers or reinsurers on the same basis as reinsurance companies admitted in China. Industry applauds this action, and would call on CIRC to confirm this intention in an administrative clarification to all CIRC officials. This clarification should state that China will suspend implementation of the 2005 Regulations on Administration of Reinsurance Business, as the regulation discriminates against foreign reinsurance companies by requiring right of first refusal for 50% of each primary company's reinsurance program with domestically admitted re-insurers. CIRC should also clarify that for purposes of these measures a 100% owned insurance operation may cede to a parent or affiliate insurance company.

U.S. HOUSE OF REPRESENTATIVES: COMMITTEE ON FINANCIAL SERVICES

HEARING ON "U.S. INTERESTS IN THE REFORM OF CHINA'S FINANCIAL SECTOR"

JUNE 6, 2007

**Financial Sector Liberalization in China**

Eswar S. Prasad
Nandlal P. Tolani Senior Professor of Trade Policy
Cornell University

## I. Introduction

Chairman Frank and honorable members of the House Committee on Financial Services, thank you for the opportunity to share with you my views on the state of financial sector reforms and liberalization in China.

The process of financial liberalization in China is important for two reasons. One is that it has implications for China's balanced economic development, which is obviously of interest to the U.S. The second is that the pace and manner in which this liberalization is conducted will have repercussions on the bilateral economic relationship between China and the U.S. Hence, this hearing, which follows closely on the heels of the Strategic Economic Dialogue (SED) meetings, is indeed timely.

On the narrow issue of whether China is meeting its WTO accession commitments in terms of opening-up its financial services sector to foreign participation, my assessment is that, by and large, China is indeed hewing to the letter of the law. The practical reality, however, is that there are still significant administrative burdens on foreign firms that wish to enter China, but these are hardly insurmountable and vary considerably in intensity across different segments of the financial sector.

It is important to place the opening-up of the financial sector in the context of the broader agenda for reform of this sector. The Chinese authorities fully recognize that it is in China's own interest to open up the financial sector in a manner that goes beyond WTO commitments. Many of their policy statements and actions—such as the prominent role they ascribed more than two years ago to foreign strategic investors in improving corporate governance in domestic banks—bear testimony to this.

The Chinese authorities have serious concerns, however, about the preparedness of local financial firms to deal with foreign competition and about their own regulatory and administrative capacities to handle an influx of foreign financial firms. They are also concerned about precipitously lifting restrictions on cross-border capital flows, which they believe will inevitably happen with a larger foreign presence in domestic financial markets. These concerns have made them cautious and it is useful to keep this perspective in mind while discussing how they may be persuaded to push harder on certain aspects of financial sector liberalization that are in their own long-term interest and are also congruent with U.S. interests.

## II. Key Features of the Chinese Financial System and Their Consequences[1]

The state-owned banking system remains dominant in the Chinese financial system. Deposits in the banking system amount to more than 160 percent of GDP. By contrast, the total capitalization of the Shanghai and Shenzhen stock exchanges amounts to about 60 percent of GDP and the capitalization of the corporate bond market is equivalent to only around 1 percent of GDP. Of the total financing raised by the domestic nonfinancial sector in the first quarter of 2007, 98 percent was in the form of bank loans, 2 percent was from equities and virtually nothing was from issuance of corporate bonds.

Capital controls have played an important role in protecting the banking system from external competition by restricting the entry of foreign banks until recently and by making it harder to take capital out of the country. In conjunction with the limited development of debt and equity markets, this means that the state-owned banking system is effectively the only official game in town, for both borrowers and savers. The lack of competition has limited financial innovations and kept the risks of the financial system heavily concentrated among banks.

It is important to keep in perspective the size of the banking system and why it is so crucial to the effective functioning of the economy. Gross domestic savings in the economy amount to about 50 percent of GDP (of which about half is accounted for by households). This annual gross savings figure of over $1 trillion dwarfs net FDI inflows, which have averaged about $60 billion in recent years. Thus, no matter how large the beneficial spillover effects of FDI, reliance on foreign capital inflows will not obviate the problems of a moribund domestic financial system. The size of domestic financial flows being intermediated through the banking system also points to the urgent need to reform banks in order to prevent further misallocation of resources on a massive scale.

Until the late 1980s, lending operations of state-run banks were largely determined by the government. Most bank financing, under directives from the government, went to state enterprises—many of them financially unviable and held together by cheap capital and handouts from the state—creating a legacy of a large stock of nonperforming loans.

The government has moved aggressively to rid the banks of these legacy problems as a first step towards banking reforms. They have focused on the four large state-owned commercial banks, which together account for about two-thirds of total banking system assets. They have already eliminated a large swath of nonperforming loans from the books of three of these banks, recapitalized them, and given them permission to undertake IPOs and list in foreign equity markets. Reform of the last of these four large banks—the Agricultural Bank of China—remains a daunting challenge and is likely to be taken up in tandem with other rural financial sector reforms (this would encompass other smaller institutions such as rural credit cooperatives).

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[1] Many of the figures in this section are taken from the *China Financial Stability Report 2006* and the *Monetary Policy Report* for the first quarter of 2007. Both documents are from the People's Bank of China and are posted at www.pbc.gov.cn/english

Despite the honorable intentions of the authorities, however, the legacy of the era of directed lending lives on in some ways--Chinese banks have still not developed risk-assessment expertise or been given the right incentives to lend based purely on commercial considerations. Thus, lending to state sector enterprises remains far more attractive to banks than lending to the private sector, and this tilt towards lending to state enterprises has been exacerbated by the quantity constraints imposed on banks' credit expansion in recent years.

Corporate governance reforms in these banks have also stalled. To make headway on some of these problems, the government has sought to attract foreign strategic investors to take minority ownership stakes in these banks and thereby push them to undertake reforms to nudge them towards international best practices. But there is still a long way to go in getting domestic banks on a sound footing as robust commercially-oriented financial institutions.

Banking sector weaknesses have contributed to the unbalanced pattern of economic growth, with investment and exports being the key drivers of growth in recent years. The lack of financial market development has played a key role in restraining private consumption growth. The uncertainties engendered by the transition to a market economy, the limited availability of instruments to borrow against future income to finance purchases (major durable goods, housing etc.), and the lack of international portfolio diversification opportunities have all contributed to high household savings.

Financial system repression and controls on outflows of capital have together meant that there are few alternatives to funneling these savings into deposits in the state-owned banking system. Households willingly hold bank deposits despite the weaknesses of the banking system because of implicit deposit insurance provided by the government. This provides abundant liquidity for banks to expand credit which, because of the distorted incentives faced by lenders, largely finances investment by state enterprises. State enterprises that do make profits were, until very recently, not required to pay dividends, encouraging them to plow retained earnings back into investment. Thus, the investment boom in recent years has been fueled by cheap credit and overoptimistic expectations of future demand growth in sectors that are doing well at present.

In the last few years, investment has accounted for more than half of nominal GDP growth; the level of investment now amounts to about 40 percent of GDP. While factor accumulation is a time-honored path to higher growth for developing countries, whether such a high level of savings intermediated mainly through an inefficient banking system can produce long-lasting welfare gains is dubious. The costs of these inefficiencies are probably ultimately borne by depositors, in terms of low real returns on their savings, or through the financing of fiscal transfers to firms and financial institutions.

The investment boom has also raised fears of a resurgence of nonperforming loans if the economy, or even the few sectors that have accounted for much of the recent rise in investment growth, should falter. Indeed, higher inflation is not the only risk on the horizon—there are also risks of asset price bubbles and of future deflation resulting from a buildup of excess capacity if investment growth is not restrained.

The authorities are keenly aware of these problems and have made financial sector reforms a core priority. How does opening up of the financial sector to foreign participation fit into the reform agenda and how much progress has been made on that front?

### III. Opening-Up of the Financial Sector: Progress and Challenges

The major WTO accession commitment concerning the financial sector was in terms of opening up the banking system to foreign entry by the beginning of 2007. That commitment has been met in principle, although foreign bank entry remains restricted in some ways. There has also been progress in other areas of financial sector liberalization.

Foreign ownership stakes in the large domestic banks are still limited to 25 percent (20 percent for any single investor). Locally incorporated subsidiaries of foreign banks can now offer a wide range of commercial banking services to retail customers, including taking RMB deposits and making RMB loans, issuing debit and credit cards etc. Setting up a subsidiary bank requires a minimum paid-in capital of $130 million (RMB 1 billion), a requirement on par with that for domestic banks. Similarly, subsidiary banks need to keep their loan to deposit ratio below 75 percent and no single borrower must account for more than 10 percent of a bank's total loan portfolio.

Most such requirements are no different from those imposed on domestic banks but they pose some transitional challenges for foreign-owned subsidiary banks since earlier restrictions on their operations have limited their deposit base and their loan-to-deposit ratios are much higher than the threshold. The government has, however, given foreign banks a couple of years to meet all these requirements. Branches of foreign banks (that do not incorporate locally) are on a tighter leash and face many restrictions on their ability to raise deposits and make loans.

Qualified foreign institutional investors are now allowed to invest directly in renminbi-denominated assets and the quota has recently been raised from $10 billion to $30 billion. This is a ceiling, however, and it remains to be seen how the approval process works. At the recently concluded SED, the Chinese agreed to permit foreign firms to set up new securities firms as joint ventures, although foreign firms are still proscribed from setting up wholly-owned subsidiaries. A number of foreign insurance companies have been authorized to carry out business in the domestic insurance market, and easing of licensing requirements for insurance companies has been promised in time for the next round of the SED.

In short, there has been progress in many dimensions of financial sector opening, although some of this progress seems grudging and restricted in many ways.

What accounts for the slow progress in opening up the financial system to foreign participants? One of the key issues is that regulatory and supervisory capacity remains limited. The authorities seem to recognize that a delicate balance will need to be struck between picking up the pace of reforms and not getting too far ahead of institutional

constraints. Continued interest rate liberalization, for instance, is important for the banking system to function efficiently. But an all-out sprint towards full liberalization without adequate regulatory and supervisory mechanisms in place could create perverse incentives that could decrease financial system stability.

Financial system regulation in China is carried out by three major bodies—the China Banking Regulatory Commission (CBRC), the China Securities Regulatory Commission (CSRC) and the China Insurance Regulatory Commission (CIRC). The People's Bank of China (PBC) is also involved as it has responsibility for overall financial stability.

These regulatory bodies are facing difficult challenges as the complexity of financial transactions and instruments increases. Furthermore, as financial firms diversify into different realms of business, it becomes increasingly important to monitor cross-sector and cross-market risks. As both domestic and foreign financial firms increase their presence across national borders, cross-border risks will also start becoming important. The level of expertise in the regulatory bodies and the degree of coordination among them in dealing with these risks need to be upgraded to deal with these challenges. Indeed, this is one area in which further cooperation between the U.S. and China could benefit both countries—the U.S. could enhance its transfer of regulatory and supervisory knowledge to China and thereby set in place the conditions for the authorities to become more confident in opening up to foreign firms.

There is also considerable internal opposition to allowing foreign participation in the financial sector, both from entrenched interests such as existing firms and from policymakers who fear job losses and financial market disruptions if domestic financial intermediaries are not given more time to prepare for increased competition.

For all of these reasons, opening up of the financial sector must be placed in the context of broader economic reforms. It is important, for political economy reasons, that calls for such opening not be seen as being promoted by foreign governments for the sole purpose of benefiting foreign financial firms. Indeed, the case for opening-up can be made quite effectively just in terms of promoting the development of the Chinese economy. This will also help to illustrate the fact—which often gets lost in the midst of heated polemics—that the interests of China and the U.S. are closely aligned even in spheres where there would seem to be a direct conflict of economic interest.

## IV. The Place of Financial Sector Reform in the Overall Reform Agenda

Financial sector reforms are an essential requirement for macroeconomic and financial stability and, therefore, for sustained and balanced growth. In turn, to be effective, financial sector reforms require a conducive macroeconomic and institutional environment. Rather than seeing reforms or opening-up of the financial sector reforms as isolated policy goals, the importance of simultaneous and complementary reforms in

several dimensions needs to be recognized by Chinese policymakers and to be emphasized by U.S. policymakers as part of the bilateral policy dialogue.[2]

A more independent monetary policy is a key requirement for macroeconomic and financial stability, particularly as the economy becomes more market-oriented and complex, and as its rising integration into the global economy makes it more vulnerable to macroeconomic shocks from abroad. A more flexible exchange rate is a prerequisite for being able to direct monetary policy instruments such as the interest rate to meet domestic objectives rather than be constrained by the exchange rate objective. For instance, in present circumstances, giving the PBC room to raise interest rates by freeing it from having to target the exchange rate would help rein in credit to enterprises and deter reckless investment, reducing the risk of a boom-bust cycle.

On the flip side, the lack of effective macroeconomic management could generate risks via the financial sector. In the absence of room for maneuver on interest rates, liquidity flows into the economy could result in asset price bubbles, including in the real estate and stock markets. These markets could become vulnerable to sudden and unpredictable shifts in investor sentiment, which could send them tumbling at the slightest provocation, with broader ripple effects throughout the economy. Moreover, forcing the nominal exchange rate to remain stable has contributed to a rising trade surplus and large capital inflows over the last few years, leading to a gusher of liquidity pouring into the domestic banking system and making the monetary authorities' job of controlling the magnitude and quality of credit expansion much harder. Clearly, exchange rate policy has important implications for financial stability.

The argument that the financial system needs to be fully modernized before allowing currency flexibility has it backwards. Indeed, durable banking reforms are likely to be stymied if the PBC's ability to manage interest rates is constrained by the exchange rate objective. The PBC then has to revert to its old practice of telling state banks how much to lend and to whom, which hardly gives banks the right incentives to assess and price risk carefully in their loan portfolios. This makes financial reforms even more complicated than they already are.[3]

For developing the domestic financial sector, opening up of the capital account—to inflows as well as to outflows—could also serve as an important catalyst. Inflows—including in the form of direct foreign participation in financial intermediation activities—can bring in technical expertise on developing new financial instruments, creating and managing risk assessment systems, and improving corporate governance. Indeed, the approach of using foreign strategic investors, including U.S. banks, to improve the efficiency of domestic banks is a strategy the Chinese authorities see as playing a useful role in their overall reform effort.

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[2] Eswar Prasad and Raghuram Rajan, 2006, "Modernizing China's Growth Paradigm," *American Economic Review*, Vol. 96, No. 2, pp. 331-36.

[3] "Exchange Rate Flexibility in China: Why it Really Matters and How to Make Progress" Eswar Prasad's testimony at the Senate Finance Committee hearing on "Risks and Reform: The Role of Currency in the US-China Relationship" March 28, 2007. Posted at http://prasad.aem.cornell.edu

Opening up to capital outflows should also be encouraged. Allowing outflows would help increase efficiency by creating competition for the domestic banking system and limiting the captive source of funds (bank deposits) that now keeps domestic banks flush with liquidity. Some progress has already been made on this front by raising the caps on the amounts of money that individuals and institutional investors can take out of the country.

It is not enough, however, to permit Chinese residents to take financial capital out of the country; they also need access to instruments for investing abroad. There is likely to be a strong pent-up demand for retail products that give Chinese households the ability to diversify into a broad range of foreign assets. The authorities may be concerned about opening up the floodgates to outflows while the domestic banking system is in poor shape. But there are ways to allow outflows in a controlled manner--for instance, closed-end mutual funds that could be run by foreign financial services firms and that would allow for international portfolio diversification by domestic investors. An approach of this sort would have the added benefit of stimulating development of securities markets.[4]

In summary, opening-up of the financial sector could have important benefits for domestic financial market development. Thus, the narrow interests of the Chinese authorities as well as those of U.S. and other foreign financial firms that are seeking to enter China are in fact much closer than is generally recognized. In order to extract the full benefits, however, it will be important to see this process as part of a much broader set of reforms that should proceed in tandem, including moving towards a more independent monetary policy regime and a more open capital account. Political economy considerations must also be given their due, and the bilateral dialogue through forums such as the SED may therefore be important in bringing to the fore these common interests.

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[4] For a specific proposal along these lines, see "Reserve Relief" by Eswar Prasad and Raghuram Rajan in *Wall Street Journal Asia*, February 26, 2007. The proposal is discussed in more detail in IMF Policy Discussion Paper PDP/05/7 by the same authors.

# TESTIMONY OF NORMAN R. SORENSEN

**ON BEHALF OF**

## The American Council of Life Insurers

**BEFORE A HEARING OF THE**

## UNITED STATES HOUSE OF REPRESENTATIVES COMMITTEE ON FINANCIAL SERVICES

**ON**

## U.S. Interests in Reform of China's Financial Services Sector

**June 6, 2007**

*American Council of Life Insurers*
*101 Constitution Avenue, NW, Washington, DC 20001-2133*
*www.acli.com*

Thank you, Chairman Frank, Ranking Member Bachus, and members of the Committee, for the opportunity to testify today on U.S. Interests in Reform of China's Financial Services Sector.

I am Norman Sorensen, President and CEO of Principal International, Inc. a wholly owned subsidiary of the Principal Financial Group. I testify before you in my current role as Chairman of the International Committee of the American Council of Life Insurers, and in my capacity as the President of Principal International.

The American Council of Life Insurers (ACLI) is a unified voice for the United States life insurance and reinsurance, pension and retirement security industries. Its nearly 373 member companies account for more than 93 percent of total industry assets and life insurance premiums in the United States and are the leading providers of financial and retirement security products covering individual and group markets. Member companies are present in every major market globally, including key emerging markets. ACLI member companies are represented and invested throughout China's major cities and provinces.

The Principal Financial Group is an Iowa-based financial services company focused on retirement benefits and asset management, both here in the United States and overseas. As the nation's 401(k) leader we have a particular interest in providing long term savings for employers, employees, and individuals which will benefit them during their retirement years.[1] A focus on pension products has served us well as we have accumulated over $250 billion in assets under management from 16 million customers, serviced by our 15,100 employees (9,396 staff in Iowa) in 11 countries, including in China where we established an asset management company – the China Construction Bank (CCB) Principal Asset Management Co. – in 2005.

Our venture is becoming another success story in our family of companies and a testimonial to the promise of China's market. Our partner – CCB – is the third largest bank in China and was ranked 11th out of the top 1,000 global banks by The Banker Magazine with respect to capital adequacy. As of June 30, 2006, the bank has 14,250 bank branches, 300,000 employees and over US$667 billion in total assets. We rolled out four mutual funds since November of 2005 with the most recent retail mutual fund accumulating US$1.25billion (RMB 10 billion) in subscriptions in a single day. The joint venture has also earned awards for most innovative fund and also awards for sales distribution excellence. The Principal has integrated some of its own staff and processes into the fund company in an effort to develop worldwide best practices within the Chinese asset management industry. We have become one of the major asset management players in China (20 out of 60), but there is much yet to achieve, and we hope that regulatory changes in China will make that possible.

This is my fourth opportunity since 2000 to provide testimony to both U.S. Senate and House committees in support of our growing economic relationship with China. I provided testimony on May 11th, 2000 before the Committee on Banking and Financial Services of the U.S. House of Representatives on the subject of granting Permanent Normal Trade Relationship (PNTR) status to China, which culminated in China being allowed to join the World Trade Organization. I was further honored to be able to provide testimony on May 17th, 2005 before the Sub-committee on Trade of the Committee on Ways and Means of the U.S. House of Representatives on the subject of liberalization of financial services trade with China, and opening China's financial markets to U.S.

[1] The Principal ranks number one in plans among companies that provide both administrative and investment services – 2006 Spectrem Group analysis of fully-bundled 401(k) providers.

companies. Most recently, I appeared before the Senate Finance Committee on March 27, 2007 to provide testimony on opportunities and challenges in the U.S.-China Economic Relationship, with emphasis on China's burgeoning enterprise annuity and pension system.

Engagement with China

With the recently concluded second session of the U.S.-China Strategic Economic Dialogue (SED) on May 23 as backdrop, I am here once again to underscore the importance to our industry of continued purposeful, sustained, and constructive engagement with China on economic and broader financial services issues, to highlight progress in our industry, and to seek your continued support as we address remaining challenges.

At the outset, I want to make clear that our industry views outcomes of the recently concluded second session of the U.S.-China Strategic Economic Dialogue as solid and meaningful steps in a longer term process. The SED is an ongoing process of dialogue that offers an unprecedented opportunity to pursue a frank exchange on the most important financial and broader economic issues facing both countries. This second session is also only the second time in the history of normalized relations that both countries have marshaled in one venue such a high powered group of economic leaders from both countries, including six U.S. cabinet level agencies, and more than a dozen Chinese ministries and commissions. No effort of this sort can resolve all issues in one or two sessions nor should we expect it to. Progress during this session in the area of insurance and other areas germane to our industry was evident, including:

- The China Insurance Regulatory Commission (CIRC) has pledged to complete its review of outstanding branch-to-subsidiary license conversion applications by August 1, 2007 and to institute a policy of completing all future license applications within 60 days of their filing;
- China has also agreed to have by the time of the third SED a streamlined licensing process for financial services firms seeking to provide enterprise annuity services; and,
- China's announcement to expand the Qualified Domestic Institutional Investor and Qualified Foreign Institutional Investor programs, which facilitate China's integration with international capital markets.

We will be working vigorously during the next few months and in the lead up to the next session of the SED to ensure that China's commitments in insurance result in meaningful outcomes for our industry, including licensing procedures to support these and other areas of greatest concern to our members. Expansion of the QDII and QFII programs will encourage China's greater participation in capital markets and open up broader avenues for asset investment, a critical link for fund management and related companies.

ACLI works regularly with the Office of the United States Trade Representative and the U.S. Departments of Commerce and Treasury to advance these and a wide variety of other industry interests and to engage Chinese counterparts regularly on China's commitments on insurance in its WTO Protocol of Accession. We appreciate the support we received throughout the entire SED process of consultations and look forward to working together constructively with the Administration and Congress to forge ahead with our ambitious agenda in China for the third session of the SED in December 2007 and beyond.

The SED provided our industry an opportunity to heighten the level of focus and attention on two fronts: one, the need for China to redouble efforts to comply with its WTO commitments on

insurance, reinsurance, and pension products; and two, the importance for China's reform agenda and our industry to hasten liberalization of financial services markets, including removing equity limits in key industries and, in our industry, establish a "one stop shop," managed and coordinated within one government agency, which can approve licenses for providing enterprise annuity/pension related products/services in the market. On this latter objective, we will be working in the SED process through December to make licensing of enterprise annuities for U.S. companies much easier so that our industry can participate more fully in China's retirement and securities market and offer the products, services and expertise that China needs.

China's Insurance and Pension Markets

ACLI has over 30 U.S. and global member companies with operations or representative offices in China. China is considered underserved but rapidly developing, both in terms of business model (distribution, products) and in terms of regulation and tax policy, because of the vast population, high savings, sustained growth rates, and demographics (rapidly aging population).

China is the world's 11th largest insurance market by total premium volume (8th by life insurance), up from 16th in 2000, with premium volumes of almost $68 billion in 2006 - life premiums accounted for the lion's share at $48 billion, a near threefold increase since 2001. Although ranked in the top ten globally, China's life market is under-penetrated -- 38% of households have life insurance and spend on average $35 yearly, accounting for 2.5% of GDP (far below developed countries). As China's burgeoning middle class grows (already considered to be the world's largest), incomes grow, and consumptions patterns change, average yearly per capita expenditures on life insurance will surge – predictions are that China will rank among the world's largest life insurance markets by 2020. As of 2006, the total number of insurers in China had increased to 83 - 35 were non-life insurance companies, 43 were life companies, five were professional reinsurers. Of the total number, 41 were foreign insurers.

In the area of life insurance, China's WTO commitments phased in over five years (2001-2006), enabled our members and other foreign life insurers to choose their partners, invest up to 50% in an equity joint venture, expand geographically throughout China, and enjoy the possibility of underwriting individual, group, health, and pension/annuity policies. Twenty-two life joint ventures and one wholly owned entity account for approximately 6% of the total life market - market shares approach 10% and higher in the cities of Shanghai, Beijing, Guangzhou, and Shenzhen.

The current trajectory of China's insurance market contrasts sharply with its earlier history. From 1949 to 1988, the People's Insurance Company of China (PICC) was the sole insurance provider in China. From 1988 to 1996, 18 new shareholder owned insurance companies were established, including 9 domestic companies and 9 foreign insurance companies, including AIG which was the first foreign insurer to establish a branch. Foreign life companies could not pick their partners until after China's accession to the WTO in 2001. Most insurers concentrated their businesses in Shanghai and Guangzhou. The People's Bank of China (PBOC) was China's sole insurance regulator until the CIRC was established in 1998. The United States has been regulating insurance at the state level for more than 150 years.

While China has come a long way in opening up its life insurance market over this period, China is only beginning to appreciate the critical role that enterprise annuities needs to play in providing retirement security to Chinese households. Up until last year, there was no formal supplementary

retirement savings program in China despite the fact that it began dismantling its "cradle to grave" social safety net beginning in the 1980s. Pensions are largely unfunded, under-funded or non-existent for scores of citizens.

To address the pension gap, Chinese regulators started in the spring of 2005 to establish an enterprise annuity system - the Enterprise Annuity Pension System (EA) - as a second pillar individual account, defined contribution retirement program (similar to our 401(k)). Conservatively, our estimates indicate that within 10 years the assets under management for this program should be close to $100 billion. Within 25 years they should reach $1 trillion, which is how long it has taken the U.S. 401(k) system to reach its current $3 trillion in assets. While a number of foreign firms have been licensed to provide custodial, trustee, management, and related services for pension assets, no American firm has been licensed to underwrite pension products directly.

Participating in the type of growth noted above is paramount for firms in worldwide life insurance and retirement benefits leadership positions. It is equally important for China's economic leadership, regulators and industry to view our greater involvement and participation as win-win for the economy, consumers, and capital markets generally. Circumstances in play, which were highlighted consistently throughout the SED, make this imperative - China's high savings (40%) are driven by the need to provide for family security in the absence of an adequate social safety net, especially retirement benefits. China's "aging" society heightens the need to save, however existing return on savings (as low as 2.5%) undercut the full potential of saving assets. Accelerating the growth of private consumption (i.e., decreasing precautionary savings) requires the strengthening of the social security system, the introduction of better, higher yield products, and capital markets more generally.

ACLI's Record of Engagement With China – An Industry Leader

Clearly, our industry desires much greater participation in China's phenomenal growth and China needs to accelerate its reform agenda – ACLI has worked vigorously through the SED and in other venues for a number of years to support these goals.

We have been the principal industry driver of four U.S.-China government-to-government insurance dialogues since 2002, established under the Joint Committee on Commerce and Trade (JCCT). In addition to the main government interlocutors – USTR and China's Insurance Regulatory Commission – ACLI, the American Insurance Association, the National Association of Insurance Commissioners, the American Chamber of Commerce in China, the Insurance Association of China, and representatives of major insurers from both countries participated in these deliberations. These efforts resulted in 2003 in a dramatic reduction in paid-in-capital – from $180 million to $60 million – required to qualify for and sustain an insurance venture in China. They also enabled our industry to re-focus attention on areas where we believe China has fallen short in its WTO commitments.

Governor Keating, ACLI President and CEO, traveled to China in the latter part of 2006 and in the beginning of 2007 to provide impetus and support for the SED, build coalitions with our Chinese counterparts, and reach out to a broad group of Chinese economic and financial officials. Our visit in

January of 2007, in which I also participated, included meetings with an unprecedented number of Ministers, Vice Ministers, and other senior officials representing all of China's economic and financial services agencies. We have concluded an MOU with China's largest industry group the Insurance Association of China, a first in our industry.

In April of this year, I co-chaired the ACLI-Beijing University Roundtable Forum on "Livelihood Protection and Harmonious Society: Perspectives from Insurance, Social Security and Economic Reform," held at Beijing University's Center for Insurance and Social Security Research. The event, which included representatives of all of China's key insurance and pension related regulatory bodies, including the CIRC's Chairman Wu Dingfu, industry leaders, American and foreign insurers, and leading academics, was unparalleled in scope, focus and attendance. ACLI supported this event through its non-profit foundation and will continue to work with Beijing University and other partners in China to offer additional programs that support global best practices regulation.

Finally, ACLI has been a strong supporter of inclusion of technical assistance on pension regulation and policy between the U.S. Department of Labor and China's Ministry of Labor and Social Security, which we believe has the potential to significantly broaden government-to-government work in the area of enterprise annuities, other defined contribution programs, and tax reform.

Our Agenda on Life Insurance and Pensions – the Glass is Half Full

We remain committed to ongoing engagement and dialogue with our Chinese counterparts and have confidence that the process started by the SED, ongoing bilateral discussions in the U.S.-China Joint Commission on Commerce and Trade (JCCT), multilateral discussions in Geneva under the WTO related TRM process, and other efforts can help our industry address and resolve longstanding issues of concern to our members. These include:

- Approval of concurrent as opposed to consecutive branching for foreign invested insurers;
- Approval of foreign non-life insurers to convert branches to subsidiaries – full rectification pending China's SED II pledge to review all existing applications by August 1;
- Approval of new products, such as political risk insurance;
- Credit for global operational experience and assets for seasoning requirements for insurers seeking asset management licenses;

The SED also provided the impetus to focus attention on two areas where we believe China can make progress in support of its broader economic reforms and the development of our industry. These include:

- Removal of equity limits on ownership in the financial services sector; and,
- Establishing a "one stop shop" for the review and approval of pension licenses under its Enterprise Annuity system.

**Branch Approvals** Foreign insurers repeatedly report that they are told by CIRC officials that multiple branch applications cannot be submitted at the same time, or if submitted will not be concurrently examined and approved. Overwhelming evidence exists that indicates domestically invested insurance companies, even new companies, have been permitted to expand aggressively

through multiple consecutive or virtually consecutive branch approvals. By contrast, it appears that no foreign-invested insurance companies have received consecutive branch approvals. China undertook in its WTO accession agreement to eliminate all geographic restriction on foreign invested life, non-life, and brokers by December 11, 2004. As for national treatment, China did not include in its WTO accession schedule any limitations regarding its obligations on form of establishment in the insurance sector. China also made commitments to allow internal branching consistent with the phase out of geographic restrictions.

Senior officials at the China Insurance Regulatory Commission have recently confirmed to USTR their commitment to allow foreign companies to establish multiple concurrent branches. We are pleased with this decision, and would call on CIRC to confirm this intention in an administrative clarification to all CIRC staff.

**Subsidiary Conversion** We appreciate CIRC commitment to act on existing applications from insurers to convert their Chinese operations from branches to subsidiaries and to act on all other applications within sixty days. The delay - over sixteen months for some companies -- has created uncertainty and confusion in corporate planning as insurers eager to expand can only apply for permission to open new offices three months after the conversion process is approved. Those few foreign companies (Japanese) that have been granted subsidiary conversion approvals effectively have an unfair advantage over U.S. firms, none of which have received approval, because they are unable to move ahead to expand their Chinese operations.

CIRC should also confirm that the RMB 200 million capital requirement for initial establishment, whether as a subsidiary or a branch, includes the right to establish sub-branches without limitation on numbers, and without having to satisfy any additional capital requirements. The Chinese government has yet to provide its rationale for requiring additional capital of RMB 20 million for each additional branch, particularly given that any additional branches would still be backed by the full asset base of the admitted entity and have to comply with all CIRC solvency rules.

**Political Risk Insurance** American non-life insurance companies have been unable to gain CIRC approval to provide political risk insurance (PRI) coverage for Chinese companies. One U.S. carrier has been waiting to receive CIRC approval for its PRI product for roughly 18 months. China Export and Credit Insurance Corporation (Sinosure), is wholly owned by the Chinese government. Currently Sinosure is the only insurer allowed to offer political risk insurance in China for non-domestic exposures. If American companies gain approval to underwrite political risk in China, Chinese investors could access enhanced, highly sophisticated risk management practices.

Numerous Chinese companies have expressed a deep interest in access to new risk transfer options. China Ex-Im Bank and China Development Bank have indicated that they are not satisfied with Sinosure's service and limited capacity.

Investment of Assets

*Overseas Utilization of Insurance Foreign Exchange Funds.* Existing regulations establish a qualifying threshold (total assets of RMB 10 billion) for companies to be able to invest their foreign exchange capital in overseas funds or equities. ACLI members would like to know the prudential justification for this requirement. Industry is concerned that even though this limitation applies to both domestic and foreign providers, only the largest insurers, i.e., mostly domestic companies, will

have the necessary assets to qualify. Many foreign-invested insurers invariably will not qualify unless CIRC recognizes the assets of the parent foreign company when determining the asset level of a foreign-invested company. To rectify this concern, CIRC should credit global insurer's international operating experience and capital in fulfillment of current seasoning and asset threshold requirements (eight years in the market, ten billion RMB) for asset managers.

*Insurance Asset Management Restrictions.* Existing regulations indicate that only providers that have held licenses for more than eight years are permitted to apply to establish an insurance asset management company. Although China previously stated that this limitation applies to both domestic and foreign providers, it effectively excludes all foreign companies entering the market since China's WTO accession in 2001. Industry would like CIRC to provide its prudential reasons for this restriction. To rectify this concern, CIRC should ccredit global insurer's international operating experience and capital in fulfillment of current seasoning and asset threshold requirements (eight years in the market, ten billion RMB) for asset managers.

*Required Outsourcing.* From an investment perspective, excessive and often discriminatory capitalization requirements continue to act as constraints on foreign insurers' ability to compete with local established insurers on a fair and equitable basis. In December 2005, CIRC's Draft Insurance Fund Management Regulation enforces outsourcing of the asset management (on-balance and off-balance sheet funds) of small and medium insurance companies to an Insurance Asset Management Company (IAMC). The draft regulation stated that an insurance company that does not own an IAMC, must outsource all its investments in equities, corporate bonds and mutual funds to an IAMC or any professional investment institution (no specific definition was given).

Equity Ownership. Currently, foreign life insurance companies remain limited to 50 percent ownership in joint ventures and to 25 percent equity ownership of existing domestic companies. Consistent with rights enjoyed by domestic insurers and all other financial service institutions in China, foreign insurers should be allowed to invest up to 100% in their operations in China. Foreign non-life providers can own up to 100%.

Enterprise Annuities. The Principal Financial Group and ACLI welcome the creation of the Enterprise Annuity Pension system and China's decision in the SED to streamline the application process for financial institutions. The regulations currently prevent one company from providing a comprehensive package of services (custodian, administration, asset management, and trustee). We will be working vigorously in the SED process through December 2007 to clarify the regulatory framework to authorize single provider plans under a single license. This would enable a "one stop shop" to improve cost effectiveness of the plans, particularly for small and medium enterprises in China.

The EA pension system needs changes and additional momentum is needed to implement them. The system is in a nascent stage and changes would not unduly harm or competitively impact either domestic or foreign providers. In fact, the changes identified would help to grow the market substantially, increasing the participation of employers and employees, and decreasing the future pension debt burden on the Chinese government.

*Tax Incentives:* A number of provinces in China have issued policies that provide various levels of tax incentives for corporate EA contributions, while many others do not have such policies in place. On the employee side, there is no individual income tax incentive for EA contributions. We believe that tax incentives are necessary for promoting private pensions and are crucial to the healthy development of the pension market. Therefore, we recommend that the State Tax Bureau and the Ministry of Finance enact unified national tax incentive policies for both employer and employee contributions to EA.

*Foreign Participation Limit:* Foreign participation in the enterprise annuity market should be encouraged in the interest of introducing tested professional pension management experiences from other mature pension markets in the world to the fledgling EA market in China. As pension is included in China's WTO commitments under the section covering life insurance, we believe that foreign equity ownership in all EA service provider entities should be allowed up to (at least) the same current limit as life insurance companies (50%).

This limit however should represent a floor and not a ceiling, and as part of SED and in support of building momentum for the WTO's Doha Round Negotiations, the Principal, along with ACLI, call for the Government of China removing this limitation and allowing 100% ownership.

*Master Trust Plan*: The EA rules as they stand now do not allow master trust plans, hence all EA plans have to be set up as individual trusts. This makes small plans unattractive to service providers. There is a strong need on the part of medium and small size companies for such plans in order to enjoy good quality service at a lower cost. Current rules effectively shut the small companies out of the enterprise annuity market. We encourage the Ministry of Labor and Social Security (MOLSS) to work with various other Chinese regulators to allow EA service providers to offer master trusts such that the medium and small size market can also be covered.

*Pension Asset Investment*: EA rules stipulate that no more than 20% of EA assets can be direct equity investments and no more than 30% can be investments in equity-related investment. This significantly limits the potential for higher long term returns for pension assets. In addition, the kinds of investment options allowed for EA assets are rather limited, too. We believe that a higher percentage should be allowed in equities, and that EA service providers should be allowed a broader range of investment options. This will help ensure a higher long term return for pension assets while at the same time allowing for prudent diversification to control risks. In addition, there should be a timeline for allowing pension assets to be partially invested overseas to further diversify their risk. Adding to offshore investments is a formula that has worked well for other markets, namely Chile where 30% of the assets can be invested offshore and the expectation is within two years to increase that level to 60%. It is a natural evolution in an effort to further diversify and insulate the system from local country risks as evidenced by Mexico enhancing their offshore allocations in the last two years.

In a recent global retirement benefits study, Principal Financial Group found that only 15% of Chinese respondents have tried to figure out how much money they will need to have saved by the time they retire so that they can live comfortably in retirement. Perhaps this poor planning is because almost half expect financial support from their families when they retire and almost a quarter expect to live with their children or relatives. Another reason may be that Chinese households receive advice about financial and retirement planning from magazines and newspapers

(33%), television and radio (28%), or friends and relatives (17%), rather than banks (3%) or insurance or pension companies (2%) or other recognized sources of expertise.

*Pension Regulator:* While MOLSS (Ministry of Labor and Social Security) is the main regulator for EA, a lot of collaboration is needed between MOLSS and the other financial services regulators such as China Securities Regulatory Commission (CSRC), China Banking Regulatory Commission (CBRC), and the CIRC. Further, it requires a lot of work and manpower to set up and run a well-regulated private pension market in China and much more dedicated and focused resources are needed at the regulator level, without which the policy making and approval process would naturally be slow. We believe it is vital to have a fully staffed centralized decision-making pension regulator with dedicated resources so as to ensure that the EA regulatory system remains sound and healthy.

Conclusion

Taken together, progress in these areas has the potential to greatly increase American participation in China's effort to mend its social safety net and grow its financial service industry assets to new heights. Progress in this session in the SED is promising; much more remains to be done in the lead up to the third SED and beyond. The ACLI, The Principal and all other ACLI member companies, along with many other U.S. life insurance and financial services companies, see great promise in China's life insurance and retirement security markets. We believe that working constructively to resolve issues noted above and to take additional bold steps, such as removing equity caps and significantly expanding foreign participation in China's enterprise annuity system, represent a fortuitous win–win opportunity for the U.S. and China – one which we should all work to expand.

**STATEMENT OF PAUL SCHOTT STEVENS**
**PRESIDENT AND CEO**
**INVESTMENT COMPANY INSTITUTE**

**COMMITTEE ON FINANCIAL SERVICES**
**UNITED STATES HOUSE OF REPRESENTATIVES**

**U.S. INTERESTS IN REFORM OF CHINA'S FINANCIAL SERVICES SECTOR**

**JUNE 6, 2007**

Chairman Frank, Ranking Member Bachus, members of the Committee, the Investment Company Institute (ICI), the national association of U.S. investment companies, commends the Committee on Financial Services for holding this important hearing to examine U.S. interests in the reform of China's financial services sector.

ICI members include 8,781 open-end investment companies or "mutual funds," 665 closed-end funds, 428 exchange-traded funds, and 4 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately $10.917 trillion, representing 98 percent of all assets of US mutual funds. These funds serve approximately 93.9 million shareholders in more than 53.8 million households.

The ICI supports active engagement with China as the most constructive means of ensuring that our two nations effectively address common economic challenges. We commend Congressional leaders for taking the time to meet with the Chinese delegation during the recently completed meetings of the U.S.-China Strategic Economic Dialogue (SED). We also recognize the significant efforts of Secretary Paulson and Vice Premier Wu Yi to resolve the issues that have complicated the U.S.-China economic relationship. The recent SED meetings have resulted in important but incremental progress in opening China's financial services sector, and much more remains to be done.

The primary goals of ICI members with respect to China's financial services sector are related to the retirement challenges facing both the United States and China. First, Chinese financial markets need to be more accessible to American investors. Diversification plays a

significant role in retirement savings, and the opening of China's financial markets will create opportunities for American workers to participate in the benefits of China's growth through fund investments. Second, the opening of Chinese financial markets to increased foreign participation will improve the access of Chinese workers to the kinds of retirement savings vehicles that we have in the United States and will also improve the efficiency of those markets through increased competition and the introduction of global best practices.

Against that backdrop, three aspects of China's evolving financial services sector are specifically pertinent to the mutual fund industry that we represent: (1) raising the ceiling on foreign ownership of Chinese asset management firms; (2) liberalizing the rules on foreign portfolio investment in Chinese markets; and (3) liberalizing local portfolio content restrictions in China. I address them in turn below.

*Foreign Ownership.* The first priority, allowing foreign entities to own a majority, controlling interest in Chinese asset management firms, is a significant concern for us. As with other financial sectors, China currently restricts foreign ownership of asset management companies, which makes it difficult for foreign firms to run their businesses as they would prefer. Increased participation of U.S. asset managers in the Chinese market would help introduce world-class expertise and best practices with regard to products and services, risk management, internal controls, and corporate governance. In addition, the competition brought by foreign institutions would accelerate the adoption of such techniques and methodologies by domestic financial institutions.

*Foreign Portfolio Investment.* The second priority is liberalization of China's rules on portfolio investment in its markets by foreign investors, including U.S. mutual funds. At present, China severely restricts outside investments in its securities markets, and foreign investors that do receive the limited licenses and investment quotas have to contend with complex requirements and bureaucratic hurdles that may disproportionately affect regulated entities such as mutual funds. At the conclusion of the May SED meetings, the Chinese government agreed to raise the quota on foreign portfolio investment from $10 billion to $30 billion. This is an important harbinger, and we encourage the Chinese to continue to make their markets more accessible.

*Local Portfolio Content.* The third priority is a liberalization of domestic portfolio content restrictions for Chinese investors. China's restrictions on foreign investments by Chinese investors are quite stringent, despite some recent liberalization. If China were to further loosen restrictions, its domestic mutual funds, pension funds, and other institutions would be able to pursue portfolio diversification through international investment, which in turn would create advisory and management opportunities for U.S. asset managers.

There is a nascent and growing mutual fund industry in China. If permitted to grow, that industry could provide Chinese workers with more and better savings and investment options while providing them access to global asset management expertise, which will help the aging Chinese population prepare for retirement. We hope that Congress will work with us to pursue these priorities in reforming China's financial services sector to benefit U.S. investors and the U.S. asset management sector while also increasing options and opportunities for Chinese workers who are looking for better ways to save and invest.

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STEVAN PEARCE
2ND DISTRICT, NEW MEXICO

ASSISTANT MAJORITY WHIP

1607 LONGWORTH HOUSE OFFICE BUILDING
WASHINGTON, DC 20515
(202) 225-2365

www.house.gov/pearce

Congress of the United States
House of Representatives
Washington, DC 20515–3102

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June 21, 2007

**To:** The Honorable Donald L. Evans, Mr. Norman R. Sorensen, Mr. Michael Decker, Dr. Eswar Prasad, Mr. Grant D. Aldonas
**From:** Rep. Steve Pearce
**Re:** Follow-up question to Committee on Financial Services Full Committee Hearing – "U.S. Interests in Reform of China's Financial Services Sector" – June 6, 2007

Mr. Pearce submits the following questions to:

- The Honorable Donald L. Evans, Chief Executive Officer, The Financial Services Forum
- Mr. Norman R. Sorensen, President & CEO, Principal International, Inc., The American Council of Life Insurers
- Mr. Michael Decker, Senior Managing Director, Research and Public Policy, The Securities Industry and Financial Markets Association
- Dr. Eswar Prasad, Tolani Senior Professor of Trade Policy at Cornell University, and former head of the IMF's China Division
- Mr. Grant D. Aldonas, William M. Scholl Chair in International Business, Center for Strategic and International Studies

Gentlemen:

My constituents Ebby, Walter and Thomas Krebs, own a Christmas ornament manufacturing factory in Roswell, NM known as Christmas by Krebs. I recently received correspondence from these gentlemen regarding the impact the Chinese government's subsidization of imported products has had on their business and ability to compete. This has been an ongoing struggle for The Krebs and I am committed to finding solutions to this issue. Please see my constituents' correspondence below and respond to the highlighted questions. I appreciate your attention and look forward to hearing your response. Feel free to contact Tim Charters of my staff at 202-225-2365 with questions.

Sincerely,

Stevan Pearce

STEVAN PEARCE
Member of Congress

DISTRICT OFFICES:

400 NORTH TELSHOR
SUITE E
LAS CRUCES, NM 88011
(505) 522-2219

1717 WEST 2ND STREET
SUITE 100
ROSWELL, NM 88201
(505) 622-0055

1923 NORTH DAL PASO
HOBBS, NM 88240
(505) 392-8325

111 SCHOOL OF MINES ROAD
SOCORRO, NM 87801
(505) 838-7516

Dear Congressman Pearce:

Christmas by Krebs has been dramatically impacted by imports from China and this has cost a number of jobs in our Roswell factory and seriously affected our financial viability. While we are in favor of free and unrestricted trade, we are very concerned about the governmental support that our competitors receive.

China produces a very large range of glass Christmas ornaments, all of which benefit from the support that the Chinese government provides. The figures I am giving you below relate to the product that competes most directly with the items produced in Roswell and represents that largest portion of the market.

Export Rebates:
The Chinese governments, both local and national, provide payments to Chinese manufactures for product that they export. This can range from 9% to 13% in our market. This is a direct contribution to the bottom-line of these manufactures and allows them to sell product below even their subsidized production costs. The sole purpose of this support is to allow Chinese manufacturers an additional advantage over their global competitors. The Chinese government has been reducing these subsidies for a limited number of heavily polluting products, but they have not decreased for glass Christmas ornaments. **How do you recommend that the US government should respond to these subsidies, and is there any support available for a small manufacturer like us that is competing against these direct subsidies?**

Fixed Natural Gas Prices:
The Chinese government fixes the cost of natural gas at prices that are substantially below the global market prices. Natural Gas is the largest raw material cost for glass. The result of this is that our competitors production costs are 6% to 8% below what they would be if they paid global market prices. **What steps do you feel should be taken to remove the Chinese government from this market or is there a way to add duties to all glass products from China to adjust for this subsidy?**

Currency Intervention:
It is a given fact that the Chinese government intervenes massively in the currency markets to keep the Renminbi from appreciating versus the US Dollar. It has been widely reported in the press that this keeps their currency 20% to 40% below the appropriate market price. Since there are no imported components in the glass Christmas ornaments exported from China, this currency subsidy drastically affects the price from China. **What do you feel is the appropriate way for the US government to compensate US manufactures for this non-market competition? What steps can the US government take to offset this massive subsidy to China manufactured product?**

The three issues outlined above, Export Rebates, Natural Gas Prices, and Currency Intervention, have a dramatic impact on the price of glass Christmas ornaments from China. This allows our competitors to price their product 35% to 61% below what would be an honest market price. The result of this has been a large number of non-China glass

ornament manufacturers, one of which was the largest producer in the world based in North Carolina, going out of business in the past few years and a dramatic loss of sales and profitability for those that are still around. We have tried many ways to reduce our production costs to stay competitive with China manufacturers, but it is virtually impossible given the state support our competitors receive. All we ask is that we are allowed to compete with China manufacturers in a free and fair manner. **What steps do you recommend the US government take that will allow true free trade to occur?**

Sincerely,
Walter Krebs

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Walter Krebs
VP Finance
Christmas by Krebs
9150 N. Royal Ln.
Suite 110
Irving, TX 75063
(w) 972-929-2880
(c) 214-986-4828
(f) 972-929-2879

The Honorable Stevan Pearce
Assistant Majority Whip
1607 Longworth House Office Building
Washington, DC 20515

Dear Congressman Pearce,

On behalf of Secretary Donald Evans, chief executive of the Financial Services Forum, thank you for the opportunity to respond to the excellent and thoughtful questions submitted by your constituent, Walter Krebs. Mr. Krebs puts his finger on some of the most important issues regarding our nation's developing trade relationship with China.

There is no question that expanded trade has generated enormous economic gains for the U.S. economy and American families. According to a recent study that used four approaches to measuring those gains, expanded trade since World War II has boosted U.S. annual incomes by $1 trillion, or an average of $10,000 per American household. The same study found that removing remaining barriers to trade would raise U.S. incomes by an addition $4,000 to $12,000 annually.[1]

Expanded and freer trade with China, in particular, promises unprecedented gains for American producers, workers, and consumers. The integration of a fifth of the world's population into the global economy – not overnight, but over time – has enormous implications for U.S. economic growth and job creation. Since China's joined the World Trade Organization (WTO) in December of 2001, trade between the United States and China has nearly tripled, exports to China have grown at five times the pace of U.S. exports to the rest of the world, and China has risen from our 9th largest export market to our 4th largest. The emergence of China will not only be one of the great economic stories of the 21st century, but one of the most significant events in economic history.

Given the reality and inevitability of China's continued emergence, the task before Congress and other U.S. policymakers is to ensure that America participates constructively in China's development – and in ways that work for American producers, workers, and consumers. More specifically, U.S. policymakers and trade officials must, as Mr. Krebs points out, diligently work to ensure that trade with our major partners, including China, is fair and that the negotiated terms of free trade agreements are enforced.

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[1] Scott C. Bradford, Paul L. Grieco, and Gary C. Hufbauer, "The Payoff to America from Globalization," *The World Economy*, vol. 29, July 2006, pp. 893-916.

U.S. and international trade law provide authority and mechanisms outlining the procedures to be used to enforce trade agreements and resolve trade disputes. In many trade disputes, countries are able to reach a mutually acceptable resolution. When agreement cannot be reached and unfair trade practices continue, under the auspices of international law, countries may be allowed to retaliate or impose prohibitive duties on the imports from the country promulgating the unfair trade practice.

The Office of the U.S. Trade Representative (USTR) is the Executive branch agency responsible for developing and coordinating U.S. international trade, commodity, and direct investment policy, overseeing trade negotiations with other countries, and resolving disputes.[2] While we at the Financial Services Forum are not certain as to whether the two issues alleged by Mr. Krebs – export payments and the fixing of natural gas prices – violate China's obligations under the WTO, he can contact USTR to inquire.

Section 301 of the U.S. Trade Act is the principal statutory authority under which the United States may impose trade sanctions against foreign countries that maintain acts, policies and practices that violate, or deny U.S. rights or benefits under, trade agreements, or are unjustifiable, unreasonable or discriminatory and burden or restrict U.S. commerce. The section authorizes USTR to initiate an investigation of the trade practices of another country, either on its own initiative, or upon the request of a U.S. citizen. A list of investigations to date is available on USTR's website.

A Section 301 investigation may be commenced in one of two ways: 1) an interested party files a petition with USTR requesting an investigation of a particular practice of a foreign country (and USTR determines within 45 days that an investigation is appropriate); or, 2) USTR initiates an investigation itself. USTR must publish its determination to initiate an investigation (or reasons for not initiating in the case of a petition) in the *Federal Register*. Where USTR initiates an investigation based on a petition, it must provide an opportunity for the public to comment, hold a public hearing if requested, and must request consultations with the foreign government in question.

Where an investigation involves an alleged violation of a trade agreement – such as a World Trade Organization (WTO) agreement or North American Free Trade Agreement (NAFTA) – USTR must follow the dispute settlement provisions set out in that agreement. USTR must conclude its investigation and make (and publish in the *Federal Register*) a determination of whether the foreign practice is actionable under Section 301 within 18 months after initiation of an investigation involving a trade agreement that includes a dispute settlement mechanism, or 30 days after conclusion of dispute settlement procedures, whichever comes first (or 12 months after initiation of an investigation in all other cases).

Where USTR determines that a foreign government is violating or denying U.S. rights or benefits under a trade agreement, or its acts, policies, or practices are unjustifiable and burden or restrict U.S. commerce, Section 301 requires retaliation unless an exception applies. Unjustifiable acts, policies and practices are those that violate, or are inconsistent with, the international legal rights of the United States, including denial of national treatment or most-

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[2] See http://www.ustr.gov.

favored-nation (MFN) treatment to U.S. exports, the right of establishment to U.S. enterprises or protection of intellectual property rights.

The requirement for mandatory retaliation may be waived where: 1) a WTO dispute settlement panel has found that the act, policy or practice does not violate, or deny U.S. rights under, a trade agreement; 2) USTR finds that the foreign country is taking satisfactory measures to comply with a trade agreement; 3) the foreign country has agreed either to eliminate or phase out the act, policy or practice, or to a satisfactory solution; 4) the foreign country has agreed to provide the United States with compensatory trade benefits; 5) USTR finds "in extraordinary cases" that retaliatory action, would adversely impact the U.S. economy substantially disproportionate to benefits of such action; or, 6) the action would cause serious harm to the national security of the United States.

Where USTR determines that a particular act, policy, or practice of a foreign country is unreasonable or discriminatory and burdens or restricts U.S. commerce, it has discretion as to whether to take retaliatory action. An act, policy, or practice is considered to be unreasonable if it is unfair and inequitable, even if it does not violate the international legal rights of the United States. Practices considered unreasonable include: 1) denial of fair and equitable opportunities for the establishment of enterprises; 2) denial of adequate and effective protection of intellectual property rights, even if the foreign country is in compliance with the WTO Agreement on Trade-Related Aspects of Intellectual Property (TRIPS); 3) denial of fair and equitable market opportunities, including a foreign government's toleration of systematic anti-competitive activities by or among enterprises in the foreign country; 4) export targeting; and, 5) denial of worker rights.

In determining whether a foreign practice is unreasonable, reciprocal opportunities in the United States for foreign nationals and firms must be considered. Practices of a foreign country will not be treated as unreasonable if USTR determines that such practices are not inconsistent with the level of the country's economic development. Discriminatory practices include acts, policies, or practices that deny national or MFN treatment to U.S. goods, services or investment.

Where USTR makes an affirmative determination that an act, policy, or practice is actionable under Section 301, it may suspend or withdraw trade concessions, impose duties or other import restrictions, withdraw, limit or suspend benefits under the General System of Preferences, the Caribbean Basin Economic Recovery Act, or the Andean Trade Preference Act, and negotiate agreements to eliminate or phase out the act, policy, or practice or provide compensation for trade distortion.

Retaliatory action may be taken against any goods or economic sector on a non-discriminatory basis or solely against the foreign country involved and without regard to whether such goods or economic sector were involved in the act, policy, or practice that is the subject of the determination. The retaliatory action must be devised to affect goods and services of the foreign country in an amount equivalent in value to the burden or restriction imposed on U.S. commerce by the foreign country. Actions may be taken that are within the President's power with respect to trade in any goods or services, or with respect to any area of pertinent relations with the foreign country.

Where a determination is made to take retaliatory action, a damage estimate is prepared assessing the level of damage to U.S. industry resulting from the foreign act, policy or practice, and proposed retaliation list is developed and published in the *Federal Register*, inviting public comments. A public hearing is normally held on the proposed list. Based on the public comments, a final retaliation list is prepared, published and implemented.

USTR must implement the retaliatory action within 30 days of the determination, except in certain circumstances, including where substantial progress is being made in negotiations with the foreign country; or a delay is necessary or desirable to obtain U.S. rights or a satisfactory solution. Any action taken pursuant to Section 301 terminates automatically after 4 years unless the petitioner or other representative of the domestic industry requests continuation.

With regard to Mr. Krebs' question about the relative value of the yuan and its impact on the competitiveness of U.S. products, he is correct that the Chinese government actively intervenes in foreign exchange markets to manage the peg of the yuan to the dollar. As you know, in recent years the discussion in Washington regarding the U.S.-China economic relationship has focused in large part on China's currency policy. Many policymakers assert that the yuan is undervalued and that an undervalued yuan makes cheap Chinese exports even cheaper, giving Chinese producers an unfair advantage over American companies and contributing to the U.S. trade deficit with China.

A market-determined yuan is important – for the United States and especially for China. Foreign exchange market intervention by the People's Bank of China – buying dollars with yuan – has boosted liquidity in China's economy, thwarting government efforts to scale back excessive bank lending and fixed investment. Speculative money flowing into China in anticipation of a revaluation is also undermining government objectives. Finally, allowing the yuan to more fully float according to market forces would free the PBOC to pursue monetary policies that advance China's macroeconomic goals. For these reasons – as well as the priority of a more fair and transparent trade relationship – U.S. policymakers should continue to press China to accelerate progress toward a market-determined yuan.

For years, the United States has worked with China toward achieving a yuan whose value is determined by market forces. Indeed, shortly after taking office, the Bush Administration committed to helping China develop the capital markets know-how and expertise necessary to end the yuan's peg to the dollar, providing massive technical assistance. And those efforts have begun to bear fruit. In July of 2005, China revalued its currency upward by 2 percent. Since mid-2006, the pace of appreciation has accelerated, averaging about 4.9 percent a month at an annualized rate, and quickening to around 5.4 percent in the first few months of 2007, as China has become more confident about the resilience of its economy. In total, the yuan has appreciated by about 8 percent since July of 2005.

This is important progress – but, clearly, much more progress is needed. Given the importance of a market-determined yuan to the economic objectives of both countries, the United States should continue to press China to redouble its reform efforts and accelerate movement toward a freely floating yuan.

But even as we continue to press China on the yuan, we should not allow the currency issue to overshadow the broader potential of the U.S.-China economic relationship. Indeed, it should be noted that the short term effect of a significant appreciation in the yuan would likely be to make the trade deficit *worse*. Because a higher-valued yuan would mean higher prices for imported Chinese goods, and because the process of finding cheaper alternatives to more expensive Chinese goods takes time, the trade deficit would likely get worse before getting better – a phenomenon economists call the J-curve effect.

Of far greater significance, in our view, to the policy goals of maintaining strong U.S. economic growth and job creation is for China to achieve a more sustainable model of continued economic growth and for its population of 1.3 billion to begin consuming at higher levels. Both goals require reform and modernization of China's financial sector.

Chinese households historically save as much as a third of their income, as compared to single-digit savings rates in the United States and Europe. This pronounced propensity to save is related to the declining role of the state and the fact that most Chinese depend on their families and private savings to pay for retirement, healthcare, and the economic consequences of accidents or disasters. Activating the Chinese consumer requires the availability of financial products and services that Americans take for granted but that most Chinese currently don't enjoy access to – personal loans, credit cards, mortgages, pensions, retirement accounts, and home, life, and health insurance products – that will eliminate the need for "precautionary savings" and facilitate consumption.

A simple example demonstrates the potential impact of a more active Chinese consumer:

Last year, the United States exported to Japan goods and services worth $60 billion – approximately the same amount exported to China ($55 billion). But China's population of 1.3 billion is ten times Japan's population of 127 million. If U.S. exports are expressed in relation to population, the U.S. sold the equivalent of $472 worth of goods and services to every citizen of Japan last year, but only about $40 worth of goods and services to every Chinese citizen. If China's citizens were to eventually consume American-made goods and services at the same rate that Japan's citizens did last year, the United States would export more than $600 billion worth of goods and services to China, 11 times what America exported to China last year, an amount equivalent to 5 percent of America's GDP, and more than twice what we imported from China last year – replacing the trade deficit with a significant surplus.

The fastest way for China to acquire the modern financial system it needs to continue growing, enable a more flexible currency, and activate the Chinese consumer is to import it – that is, by opening its financial sector to greater participation by foreign financial services firms. Foreign institutions bring world-class expertise and best practices with regard to products and services, technology, credit analysis, risk management, internal controls, and corporate governance. In addition, the competition brought by foreign institutions would accelerate the adoption of such techniques and methodologies by domestic financial institutions.

By providing the financial products and services that Chinese citizens and businesses need to save, invest, insure against risk, create and protect wealth, and consume at higher levels, foreign financial institutions (including U.S. providers) would help create what every U.S. manufacturer and service provider wants – an unleashed Asian tiger hungry for U.S. products.

Congressman Pearce, we at the Financial Services Forum appreciate your interest in these important issues and look forward to working with you to ensure that the continued economic emergence of China works for all American producers, workers, and consumers.

Should you have any additional questions, please let us know.

Sincerely,

John R. Dearie
Senior Vice President for Policy
The Financial Services Forum