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"China's Financial System and Monetary Policies:
The Impact on U.S. Exchange Rates, Capital Markets, and Interests Rates"

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Co-chairmen Wortzel and Mulloy, members of the Commission, thank you for the opportunity to participate in this important hearing on China's accession into the WTO and the implications for American financial services firms and the broader U.S. economy. I'd like to begin by thanking all of you for your service as members of this Commission. The work you do reporting to and advising the Congress on the economic relationship between the United States and China, and its implications for our national security, is of vital and growing importance.

I am here as Senior Vice President of the Financial Services Forum, a financial and economic policy organization comprised of the chief executives of 20 of the largest financial institutions with operations in the United States. Charles Prince, CEO of Citigroup, is the Forum's current Chairman, and Former Commerce Secretary Don Evans is the Forum's chief executive.

The 20 member CEOs of the Financial Services Forum meet twice a year, our most recent meeting occurring this past April. At that meeting, for the first time, we conducted a survey of our members regarding their 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 asked 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 were 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 rated growth in China as the single most important source of growth of the global economy, with an average rating of 4.5.

Mr. Chairman, 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. Since 1980, more than 400 million Chinese have been lifted out of poverty, and over the last four years the United States and China have accounted for half of global economic growth. How this critical relationship is managed is sure to be one of the most important factors determining the growth and stability of global economy in the 21st century.

China's WTO Obligations in Financial Services

As this Committee is aware, under the terms of its December 2001 WTO accession, China committed to implement a set of sweeping reforms that required the lowering of barriers to trade in virtually every sector of its economy, as well as national treatment and improved market access. With regard to the financial sector, China's commitments fall principally into the category of progressively increased market access for foreign banks, insurers, and other financial services firms. The phase-in period for many of these commitments has already been completed, while in other areas, particularly banking, such obligations must be met by December 11th of this year, which will mark the five-year point since China's accession.

Banking:

Prior to China's WTO accession, foreign banks were not permitted to engage in local currency business with Chinese clients, and the establishment of foreign banks was severely restricted geographically. As part of the WTO agreement, China agreed to:

- allow foreign banks, immediately upon accession, to conduct foreign currency business without restriction and, in certain cities, local currency business with foreign individuals and foreign-invested enterprises,

- allow foreign banks to conduct local currency business with Chinese enterprises beginning two years after accession, and with Chinese individuals after five years, and,

- grant foreign banks national treatment, and remove any remaining geographic or client restrictions, by December 11, 2006.

Insurance:

Prior to accession, China allowed selected foreign insurers to operate in China on a limited basis in only two cities. As part of its WTO commitments, China agreed to:

- allow foreign life insurers to hold up to 50 percent ownership in a joint venture upon accession;

- allow foreign property, casualty, and other non-life insurers to establish as a branch or joint-venture with up to 51 percent equity share upon accession, and to establish wholly foreign-owned subsidiaries with two years of accession;

- phase out over three years all existing geographic restrictions on all types of insurance activities;

- allow foreign insurers engaged in large-scale commercial risk, marine, aviation, or transport risk activities, as well as reinsurance, to participate in joint ventures with foreign equity share of 50 percent upon accession, 51 percent after three years, and to establish wholly foreign-owned subsidiaries after five years.

Securities and Other Financial Services:

- Foreign firms may establish securities operations in China by way of joint-ventures in which foreign ownership is limited to 33 percent. Such joint-ventures are permitted to underwrite domestic company shares (A), foreign currency shares (B) and Hong Kong registered shares (H), as well as corporate and government debt, and to trade in all these securities, except A shares.

- Foreign firms may also establish asset management operations by way of joint-ventures in which foreign ownership is limited to 49 percent.

As to whether China is fulfilling its financial sectors WTO obligations, the answer is basically yes, although there have been a number of procedural and regulatory issues that have frustrated foreign financial institutions as they have sought to take full advantage of China's market access commitments.

In 2002, for example, the People's Bank of China (PBOC) issued working capital requirements and other prudential rules for foreign banks that far exceeded international norms, was slow to act on foreign banks' applications, and allowed foreign banks to open only one branch every 12 months. Similar problems have been experienced by foreign insurance companies, such as the approval of new branches on a strictly sequential basis rather than a concurrent basis. In addition, in December of 2005 the China Securities Regulatory Commission (CSRC) imposed a moratorium on foreign investments in Chinese securities firms. While the moratorium may not be a technical violation of China's WTO commitments, it is clearly a step in the wrong direction.

Since its creation in April of 2003, the China Banking Regulatory Commission (CBRC) has eliminated many of the PBOC's more onerous requirements on foreign banks. However, just last week, the CBRC circulated a draft announcement that would require foreign banks to incorporate their local operations in China in order to engage in yuan-denominated business with Chinese individuals by the end of the year, as required under China's WTO commitments. Local incorporation would be expensive for foreign banks, who currently run their Chinese branches from overseas headquarters. Local incorporation would require separate capitalization and would likely entail significant legal and tax implications.

It's important to acknowledge such problems and to work toward their swift resolution. And, indeed, the Treasury and Commerce departments, along with the U.S. Trade Representative's office, are actively working with their Chinese counterparts through the Financial Sector Working Group, the Joint Commission on Commerce and Trade, and the China Enforcement Task Force to extend foreign access to China's financial markets and to pursue financial regulation that is more transparent, predictable, and in keeping with international norms. The Forum commends these important efforts.

At the same time, such difficulties must be considered with the understanding of just what the Chinese undertook in joining the WTO and what they have achieved in a very short period of time. Following 15 years of negotiations, China agreed to extensive, far-reaching,

often very complex commitments, at all levels of government. Fulfilling these commitments has required nothing short of a wholesale institutional transformation of China's financial system and the relationship between government and major industries – a transformation that is painful, stressful, expensive, and that has no comparison in American history.

It should also be pointed out that China has achieved progress beyond what was negotiated as part of its WTO commitments. For example, China opened several cities ahead of schedule for foreign banks' domestic currency business. It has also taken important steps to liberalize the financial sector and to 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;

- Meaningful steps have been taken to get state banks out of the business of 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 CBRC was established in April of 2003 to oversee all banks and financial institutions in China, investigate illegal banking operations, and punish violations of law; and,

- Interbank, equity, and foreign exchange markets have been established and important progress made in the use of indirect means of monetary policy.

The Financial Services Forum applauds this progress to open and modernize the Chinese financial system – and urges continued progress. Indeed, despite the achievements to date, 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 alarmingly high;

- Banks are undercapitalized and lending practices, risk management techniques, and internal controls remain inadequate;

- Prudential supervision and regulation of the financial sector still lags behind international best practices; and,

- At present, investment by foreign financial institutions in Chinese banks is limited to 20 percent ownership stakes, with total foreign investment limited to 25 percent. Despite the clear benefits that foreign know-how and expertise would bring to China, foreign financial institutions currently control less than 2 percent of the assets of the Chinese banking system.

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

- the critical importance of an open commercial banking system, capital markets, and insurance products to promoting the consumption-led economic growth that China's leaders seek;
- the clear benefits to China of increased market access for U.S. financial services firms – namely the importation of world-class know-how, technology, and best practices.
- the importance of financial and regulatory transparency; and,
- the implementation of global standards regarding corporate governance.

Opportunities in China that Would Benefit the U.S. Economy

Without question, continued reform of China's financial sector is in the interest of American financial services providers and the U.S. economy more broadly. American financial institutions – along with American manufactures, farmers, and other service providers – naturally perceive China's fast-growing middle class and new businesses as potential consumers of U.S. products and services. Opportunities of particular interest to U.S. financial services firms would include China's expanding credit card market, auto financing, mortgage lending, corporate lending, and investment banking.

More fundamentally, continue progress toward the modernization of China's financial sector is in the interest of the United States because a stronger, more sophisticated, and more resilient financial system is a prerequisite to China's continued development – and its ability to extend westward the prosperity experienced principally in the East.

Starting a business, expanding an existing business, buying a home, sending a child to college – any productive or entrepreneurial activity – requires investment capital. Money and credit are the lifeblood of any economy. As the financial sector becomes more developed and sophisticated, capital formation becomes more effective and efficient, increasing the availability of investment capital and lowering costs.

A more developed and sophisticated financial sector also increases the means and expertise for mitigating risk – everything from derivatives for businesses to avoid price and interest rate risks, to insurance products to mitigate the risk of accidents and natural disasters. The depth and flexibility of the financial sector is also critical to the broader economy's resilience – its ability to weather, absorb, and move beyond the inevitable booms and busts of a dynamic economy. For these reasons, an effective and efficient financial sector is the essential basis upon which the growth and vitality of all other sectors depend. It is a "force multiplier" for progress and development, amplifying and extending the underlying strengths of a growing economy. Research conducted by McKinsey indicates that a more open and modern financial system would expand China's economic output by as much as 17 percent, or $320 billion a year.

A modern, more sophisticated financial system would also facilitate important aspects of U.S. trade and economic policy with China. For example, one reason why Chinese authorities have resisted further flexibility in the exchange rate is that China's banks, securities firms, and businesses enterprises lack the expertise to develop and trade derivatives and other structured instruments used to hedge the risk associated with great currency volatility. A more efficient financial system would also help to mobilize Chinese consumer consumption, a critical aspect of China's effort to restructure its economic growth and to address international trade imbalances.

Secretary Evans' Recent Trip to China

In this regard, I'd like to mention that Secretary Evans, the Forum's CEO, traveled to China just two months ago. The purpose of his trip was to engage China's political, business, and financial leaders on issues of China's economic development, financial sector reform, and market access for American companies.

As you might recall, Secretary Evans, along with then U.S. Trade Representative Robert Zoellick, co-chaired the highly successful meeting of the Joint Commission on Commerce and Trade (JCCT) in April of 2004 during which no fewer than seven potential disputes over China's WTO compliance were successfully resolved.

While in China, Secretary Evans met with a number of China's financial authorities including Liu Mingkang, the Chairman of the China Banking Regulatory Commission; Shang Fulin, Chairman Of China Securities Regulatory Commission; Li Yong, Vice Minister of Finance; Li Kemu, Vice Chairman of The China Insurance Regulatory Commission; Madam Hu Xiaolian, Vice Governor of The People's Bank of China; and Liao Xio Qi, Vice Minister of Commerce.

I am pleased to report that Secretary Evans came away from these meetings convinced that China's financial leaders are committed to further modernization of China's financial sector. China's financial authorities understand that it's in the best interest of the country's long-term growth, job creation, and general well-being of its citizens to move toward ever-greater reliance on market principles, a more flexible exchange rate, and increased foreign investment in Chinese financial institutions. This message is consistent with the announcement by the CBRC last September that current caps on foreign investment in Chinese banks were under review and will be gradually lifted, beginning later this year.

Conclusion

Mr. Chairman, China's membership in the WTO beginning in December of 2001 was the culmination of more than 25 years of political and economic engagement by the United States. Such cooperation has broadened and deepened the relationship between our two countries, to the benefit of both. Since 2001, trade between the United States and China has more than doubled from $121 billion to $285 billion, exports to China have grown at five time 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.

But our work to help China integrate into the global economy is not finished. Indeed, in a very real sense, the easy part is over. As China's transition period as a new member of the WTO comes to an end, U.S. trade policy should move beyond the monitoring of China's compliance with a discrete set of obligations to more proactively cooperating in an increasingly dynamic relationship, the aim of which should be to ensure that China participates fully and constructively as a mature and responsible stakeholder in a multilateral, global trading system. For the United Stated, this means a bilateral relationship that is more balanced, equitable, and durable.

As U.S. policymakers and trade negotiators adjust our priorities and methods to meet this new challenge, the advice and input of this Commission will be more important than ever.

Thank you very much for the opportunity to participate in today's hearing.