INCREASING MARKET ACCESS FOR U.S. FINANCIAL FIRMS IN CHINA: UPDATE ON PROGRESS OF THE STRATEGIC & ECONOMIC DIALOGUE

HEARING

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL MONETARY POLICY AND TRADE

OF THE

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INCREASING MARKET ACCESS FOR U.S. FINANCIAL FIRMS IN CHINA: UPDATE ON PROGRESS OF THE STRATEGIC & ECONOMIC DIALOGUE

Wednesday, May 16, 2012

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON INTERNATIONAL
MONETARY POLICY AND TRADE,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 1:45 p.m., in room 2128, Rayburn House Office Building, Hon. Gary G. Miller [chairman of the subcommittee] presiding.

Members present: Representatives Miller of California, Dold, Manzullo, Huizenga; McCarthy of New York, Carson, and Scott.

Also present: Representatives Hayworth and Green.

Chairman MILLER OF CALIFORNIA. Without objection, all Members' opening statements will be made a part of the record. I ask unanimous consent that Ms. Hayworth of New York and Mr. Green of Texas be allowed to sit with the members of the Subcommittee on International Monetary Policy and Trade for the purposes of delivering an opening statement, hearing testimony, and questioning the witnesses.

Without objection, it is so ordered.

We are going to limit the opening statements to 10 minutes per side.

I yield myself as much time as I may consume.

Today's hearing is entitled, "Increasing Market Access for U.S. Financial Firms in China: Update on Progress of the Strategic & Economic Dialogue." This hearing follows the fourth meeting of the U.S.-China Strategic and Economic Dialogue—we will call it S&ED—which was held at the beginning of the month in Beijing. We want to receive an update on progress made at this meeting.

The week after the meeting in China the Federal Reserve voted to approve the application of three Chinese firms to operate as banks in the United States. We are here to discuss today what is happening on the other side of the coin. How is the Administration fighting for our U.S. financial firms who are seeking to do business in China? What has the Administration been able to accomplish to level the playing field to ensure fair access to U.S. companies? That is a huge issue for us.

We have a very open market in the United States. As long as investments don't threaten national security, we welcome investment, because we know it creates jobs. To create jobs for U.S. companies, it is also critical that we understand the many issues that continue to create barriers to financial services in China, which have to be resolved through this debate.

China continues to impose restrictions on foreign financial institutions with regard to market access, licensing, type of corporate ownership, branching, third party auto liability, and permitted products and services. There are also numerous examples of discriminatory treatment by Chinese regulators. While China might be meeting the letter of the WTO obligations, U.S. firms have complained that China is not meeting the spirit of those obligations. It is heartening to hear about the progress made at the recent S&ED on some of these fronts, but I want to make sure the Administration understands that China needs to communicate and be held open and held responsible for that communication.

Today, we want to hear more about the actions the United States is taking and needs to take to support U.S. financial firms which seek to do business in China. I am pleased that the United States and China continue to come together to discuss issues of mutual importance to our countries and to global economies. The U.S.-China economic relationship is one of the most important bilateral economic relationships in the world, and how this relationship evolves will be critical in determining the growth and stability of global economies in the 21st Century. I fully believe that both countries will benefit if we continue to encourage open communication, mutual respect, and equal access.

While progress to help China to modernize its financial systems is critical for China to be able to develop its economy and create opportunities for its people, it is also competitiveness for U.S. companies. China is now America's third largest export market. Fair and competitive access to China's fast-growing middle-class and business sector represents an enormous opportunity for American manufacturers and service providers.

Better access by U.S. companies to a Chinese market, especially for financial services, would create millions of jobs here at home. By helping to provide the financial products and services that China's citizens need and businesses need to save, invest, insure against risk, and consume at higher levels, U.S. financial institutions can play a role in China's developing an economy that is less dependent on exports and more dependent on their own consumption in the future. This is beneficial for the U.S. economy and good for global growth and stability.

While progress is being made, it is really being made slowly, and I know the Administration agrees with that.

The American market is open. If you are an American company and you want to invest in China, but the investment you take is excluded from the catalogue, then you are just basically out of luck. This is not equal access and this is not a level playing field. This is what the S&ED is all about. We need to create a level playing field in China for American companies. It is in America's interest to do this, and it is in China's interest to work with us on this issue. Equal access and free markets will benefit both China and the United States, and make both countries stronger. It is time for economic uncertainty to end. The two largest economies in the world simply do not have a choice. We must engage in productive dialogue, we must deepen our relationship, and we must find ways to get both economies growing again at a healthy level.

I will yield back the balance of my time, and yield to Ranking Member McCarthy.

Mrs. MCCARTHY OF NEW YORK. Thank you, Mr. Chairman. Thank you for having this hearing. And welcome to all of you.

As the United States continues to recover and rebuild our economy, we must focus our efforts on markets that provide a solid foundation for growth and sustained global competitiveness. China's is the fastest growing major economy and the third largest export market for American companies looking to grow and create local jobs by selling goods and services abroad. That is why the U.S.-China bilateral economic relationship is so important.

As two of the largest trading nations and economies, it is vital to maintain a global trading system. This system should enable U.S. companies and workers to compete on a level playing field. The U.S.-China Strategic and Economic Dialogue provides a forum to encourage the Chinese to increase market access through economic and overall reforms as a means to expand growth opportunities for American businesses and local job creation through the sale of goods and services to Chinese markets.

The financial services industry is one of the most important industries in the United States. Prior to the fourth Strategic and Economic Dialogue held earlier this month, I joined several of my committee colleagues in sending a bipartisan letter to the President encouraging a robust discussion on reform and modernization of China's undeveloped financial sector that imposes severe restrictions on foreign financial firms, including U.S. firms.

I want to thank the Under Secretary for being here today, and I look forward to your detailed update on the progress achieved during the recent dialogue meetings, especially in the area of financial sector reform and market access.

As China begins to move towards a more balanced economic model that relies more on internal consumer demand, America's policy regarding China should ensure that China acts as a responsible stakeholder in the economy. This should include ways to ensure that trade with China is fair and profitable for American businesses and its workers, open market access for U.S. companies, and the elimination of discriminatory treatment of foreign investors.

I would like to thank all of the witnesses for being here today, and I look forward to hearing your views on areas of improvement still necessary for China market access as well as how progress made thus far will help American businesses and workers.

Thank you, and I yield back the balance of my time.

Chairman MILLER OF CALIFORNIA. I yield the balance of our time to Vice Chairman Dold.

Mr. DOLD. Thank you, Mr. Chairman, and certainly Secretary Brainard, I am so happy to have you here today. I appreciate you taking the time to be here.

Today, when capital is so mobile internationally and global markets are so interrelated, an open and efficient financial industry is a necessary component of any stable and growing modern economy. And while there is no question that China's growth has been remarkable over the past 20 years, my colleagues and I have real concerns about the Chinese financial sector.

Today, U.S. firms face meaningful market access barriers that significantly limit the efficient flow of private foreign capital into the Chinese economy.

For example, the Chinese financial sector restricts the kinds of services that U.S. firms can provide, the corporate structure U.S. firms can utilize, and the licenses that U.S. firms can obtain. Additionally, the Chinese Government caps foreign investment on Chinese financial institutions at 20 percent, which has had the effect of keeping foreign ownership in the Chinese banking industry to below 2 percent.

In addition to these severe equity ownership limitations, U.S. firms are also subject to discriminatory supervision and regulatory requirements which I think are inconsistent with WTO standards. But recent reports indicate the Chinese Government is willing to work with the United States to create a highly developed Chinese financial sector that can function in an advanced global economy.

As we help move China towards that highly developed financial sector, we must keep in mind some of the necessary components that I believe are important.

First, a highly developed financial sector must operate under a fair and predictable legal system that is consistent with international legal standards, including intellectual property protection, contract enforcement, and impartial regulations and proceedings.

Second, markets must obtain open and transparent and driven by market forces instead of political considerations.

Finally, the financial services industry must be supported by government policy that encourages both domestic and foreign investment on an equal basis. When we have a level playing field for financial services in China, I am confident that U.S. firms will perform very well there, to the benefit of both the United States and China, and our respective economies, consumers, employees, and investors.

Secretary Brainard, thank you so much for your time.

Mr. Chairman, I yield back the balance of my time.

Chairman MILLER OF CALIFORNIA. Thank you.

It is my honor to introduce the witness on our first panel. The Honorable Lael Brainard is the U.S. Department of the Treasury's Under Secretary for International Affairs. She has been very helpful over the years, very cooperative, and she has really benefited this committee tremendously by her time, and I want to thank her for that. She served as the Deputy National Economic Adviser and Deputy Assistant to the President of the National Economic Council during the Clinton Administration, addressing challenges such as the Asian financial crisis and China's access to the World Trade Organization. Secretary Brainard was Vice President and Founding Director of the Global Economy and Development Program at the Brookings Institution, and was an associate professor of applied economics at MIT.

Secretary Brainard, thank you for being here. We always appreciate your appearance. It is really helpful. Without objection, your written statement will be made a part of the record. You are recognized for a 5-minute summary of your testimony.

STATEMENT OF THE HONORABLE LAEL BRAINARD, UNDER SECRETARY FOR INTERNATIONAL AFFAIRS, U.S. DEPARTMENT OF THE TREASURY

Ms. BRAINARD. Thank you, Chairman Miller, Ranking Member McCarthy, and members of the subcommittee. It is a pleasure as always to be with you here today.

Before I turn to China, let me just take this opportunity to thank you for the very important work you and the committee undertook on laying the groundwork for the reauthorization of EX–IM, which we think is going to be extraordinarily important for helping America's workers and exporters to compete on a level playing field.

With respect to China, no other country presents as many opportunities and challenges. We have been working to achieve a more balanced economic relationship with China, a relationship in which U.S. companies and workers benefit more from the opportunities China presents.

Since early 2009, U.S. exports of goods to China have almost doubled, and last year we exported around $130 billion of goods and services supporting well over 600,000 jobs here at home.

China's exchange rate has appreciated by 13 percent against the dollar in real terms over a similar time period, and we have seen a large reduction in China's current account surplus, from 9 percent to under 3 percent today.

As you noted, we are just returning from the fourth Strategic and Economic Dialogue in Beijing. We made important progress but, of course, many challenges remain. We made progress on leveling the playing field. China confirmed its intention to participate in negotiations for new rules on official export financing with the United States and other major exporters with the goal of reaching agreement over the next 2 years.

As one of the world's largest, perhaps the world's largest providers of export financing, China's export credit program has been a longstanding competitive impediment. U.S. exports must not be undercut by subsidized foreign government financing.

We also made progress on rebalancing global demand, which is critical if we are to sustain strong and sustainable growth.

As we reorient our growth strategy here at home to focus on exports and competitiveness, with European demand expected to be weak for some time, sustaining growth will necessarily require stronger domestic consumption in China. That will mean more demand for U.S. goods and services, more exports for U.S. companies, and more jobs here at home.

Fortunately, China has ample capacity for boosting domestic consumption. At the Strategic and Economic Dialogue, China pledged to reduce tariffs on consumer goods imports by the end of the year, and to reduce the high tax burden on services industries, which will both promote consumption and opportunities for our competitive services providers.

And we made progress on securing a more open and market-based financial system, which is central to our other objectives with China.

China's financial sector remains dominated by government-owned banks and subject to extensive government controls. Chinese households get low returns on their savings, and they have very few savings, investment, and insurance products, forcing them to save more, consume less, and with few opportunities to ensure against life's risks.

With controls that keep deposit rates and interest rates artificially low, China relies on limiting the quantity of loans to control inflation, so banks ration credit to favor politically connected state-owned enterprises. Thus, we continue pressing on financial opening. We have made some progress. Moving to a market-determined exchange rate is a key part of both changing China's pattern of growth and reforming its financial system.

In April, China widened the daily R&B trading ban and is diminishing intervention. If it is implemented in a way that fully reflects market forces, this could contribute to rebalancing China's pattern of growth and reforming its financial system.

We secured new financial sector commitments that improve market access, boost consumption, reduce the unfair competitive advantage of state-owned enterprises, and begin to loosen the chokehold that state-owned banks have on China's financial sector.

China announced it will move beyond its WTO commitments in securities to permit foreign investors to take up to 49 percent equity stakes in joint ventures and to allow securities joint ventures to expand business activities more quickly. China also committed to allow U.S. and other foreign investors to establish and hold up to 49 percent stakes in joint venture futures brokerages.

On auto financing, our companies will now be able to issue local bonds to fund their operations, helping our auto producers in the world's largest automobile market.

China amended regulations to allow foreign insurers to sell mandatory auto liability insurance, opening a large and growing market to our producers. And China committed to applying credit taxation and regulatory policies on a nondiscriminatory basis across state-owned enterprises and other enterprises, and going forward, it will increase dividend payments by listed state-owned enterprises to be commensurate with publicly listed firms.

These are tangible, significant gains that will benefit the United States.

Going forward, we are committed to continuing to work closely with Congress and with domestic stakeholders to make sure that our relationship with China is more balanced and yields greater benefits for our workers and for the American people.

Thank you.

[The prepared statement of Under Secretary Brainard can be found on page 34 of the appendix.]

Chairman MILLER OF CALIFORNIA. Thank you very much.

I recently sent you a letter about American bond holders in China and their inability to collect, and hopefully you will have an opportunity to respond to that at your convenience in the future.

I guess the big concern I have is that three Chinese government-controlled corporations have become bank holding companies—to become bank holding companies in the United States was approved and the acquisition is going to be up to 80 percent of the voting share of the bank of East Asia (USA), National Association. This is the first time we have really had this kind of an approval in the past. How do we make sure that American investors and businesses have the same opportunity in China?

Ms. BRAINARD. We are working very hard to persuade China to move beyond the commitments it made in the WTO and to provide greater market access in key financial services sectors. We were pleased by the move they made, the very substantial move they made beyond their WTO commitments in the securities areas to allow joint ventures to move up to 49 percent equity shares.

In the banking sector, as you say, currently we actually have—our firms have a large number of branches, affiliates, and subsidiaries operating in China, but under the WTO commitment China made, they are restricted to a minority shareholding. And so, we have raised these issues with China in the past, and we will continue working. As they work on reforming their financial sector, we are going to press very hard and use the leverage that we have to ensure they do so in a way that gives our firms the same kind of access and opportunities in their markets that we generally offer across foreign countries to be afforded national treatment in the U.S. market.

Chairman MILLER OF CALIFORNIA. This country believes in free trade and open markets, and we have, I believe, demonstrated that to China over the years. But they use discriminatory regulations and lack of transparency in the process when American companies apply to do business in China. I guess my concern is that they continually make gestures of how they are going to accomplish certain things, but they never seem to accomplish them in a reasonable span of time, if they are accomplished at all.

How can you better hold their feet to the fire on this issue, because we understand that doing business creates jobs, and the more business we do in China, the more jobs it creates here? But we don't want to have the reality occur where it is just a one-sided event where they are coming here and we are not going there.

Ms. BRAINARD. Yes, I fully share the priority that you place on making sure that China moves forward to provide better access and then follows through on its commitments. Where China has made WTO commitments, we obviously use the WTO dispute settlement to the greatest extent possible. We have taken six cases, we have had a number of very important successes, and we are building on those successes.

In other areas, such as the securities equity holding that I mentioned earlier, where China's WTO commitments do not go far enough, we have been using our bilateral engagement to press China to move beyond its WTO commitments and to make greater access available. And in cases where they make a commitment, we use the machinery of the Strategic and Economic Dialogue, the very frequent opportunities for very deep engagement that it affords to push forward for actual implementation of those commitments.

So if you look in the area of, for instance, indigenous innovation, where President Hu made a very important commitment to President Obama to dismantle the set of policies that they were going to put in place that would have favored Chinese innovators over U.S. innovators, we used the machinery of the Strategic and Economic Dialogue across the Administration to ensure that regulations were actually rescinded that would have applied not just at the central government level but all the way down to the provincial level.

Similarly, in the case of third party auto liability insurance, we got a commitment from China that it would move to open its markets to U.S. providers. We have now followed through and have seen that they have issued this regulation, and we will continue to press them as our firms apply for licenses.

And so in each area, we need to be very vigilant and work together with you here as well as with domestic stakeholders to ensure that when commitments are made, there is follow-through, and in areas where we feel that commitments are inadequate, we continue pushing for more market opening as we have now seen in the securities area.

Chairman MILLER OF CALIFORNIA. My concern is, and I am going to close with this, in many cases you have made commitments which is dealing in good faith, and they have made comments. And enforcing comments can be very difficult.

My time is up, so I yield to the ranking member.

Mrs. MCCARTHY OF NEW YORK. Thank you, Mr. Chairman. I agree with you and, as I said in my opening statement, the Strategic and Economic Dialogue has been a formula that does allow us to encourage China to adopt various reforms, but it is not a binding forum, which we had talked about or you had talked about.

So you mentioned a little bit about how the Administration will continue to encourage and urge China to follow through on the commitments they made during the recent dialogue, but as you press ahead, we have seen them not live up to those particular agreements, and I find that as we are trying to get our financial markets especially into China the risks that our companies might take by going in, setting up, and then getting pulled back on, and they are left there.

China car insurance—as you have said, they have passed the legislation that everybody, it is mandatory to buy insurance, car insurance. The last time I was in China, I think 30 percent of people, middle-income families were now buying cars. How are we going to be able to protect our business people if they go in there on this venture, and was there any discussions of timing for implementing these commitments when they were agreed upon?

Ms. BRAINARD. Generally, we try to be as specific as we possibly can, and as you know, we negotiate a joint document coming out of each Strategic and Economic Dialogue with the Chinese which we then use as a document for tracking actual implementation of outcomes. So, we have a pretty precise mechanism, and we go through quite regularly with our Chinese counterparts as well as soliciting input from U.S. stakeholders to work through on each commitment whether they are on time in implementing the commitments they have made to us.

And, again, in some areas we really have seen explicit follow-through on commitments—not across-the-board, and we share very much the sense of frustration that China needs to move forward. But we have used to a very great extent all the mechanisms that we have available to us. We used Section 421 to provide relief to our tire producers. Again, we have taken six enforcement cases in the WTO. We have had some very important strategic successes on those cases that go beyond the specific matter at hand to really try to drive systemic change in the Chinese economy more broadly.

And we will continue to use trade remedies, for instance, to protect our industries where we think Chinese companies are not playing by the rules.

So, as you know, the President talked in the State of the Union and has put forward in his budget a proposal to create an interagency trade enforcement center, which would bring together staff from across the interagency so that we can be very proactive in finding areas where our firms are not getting the access that they deserve and then following through with the tools that we have.

So we are going to use all of those mechanisms and the Strategic and Economic Dialogue has been useful in that context. Again, we have had a set of commitments negotiated and then timelines that we have been trying to follow through on, and we will use the WTO when we can, we will use our domestic remedies where we must, and we will use these bilateral negotiations through the S&ED wherever possible to get follow-through.

Mrs. MCCARTHY OF NEW YORK. Just out of curiosity, are other nations also having dialogue with the Chinese as far as bringing their products in? Are we going to have competition also with, say, Germany, the U.K., France?

Ms. BRAINARD. China has, as we do, a number of major economic dialogues on a bilateral basis with other major economies. I would say that we have made more progress through the Strategic and Economic Dialogue with China than we have seen in some of the other, in all of the other dialogues that China has held, and I think that speaks in part to the very substantial engagement and priority that the entire Administration has placed on breaking down these barriers, leveling the playing field, achieving rebalancing, and opening up the financial sector.

So when I look across the set of engagements China is having, and we of course examine them very closely because we want to build on progress wherever it has been made, I would say that the U.S. discussions with China under the S&ED have made much more concrete progress again in areas like market access for securities firms, like indigenous innovation, intellectual property, things that matter to American companies and American workers.

Mrs. MCCARTHY OF NEW YORK. I yield back.

Chairman MILLER OF CALIFORNIA. Vice Chairman Dold is recognized for 5 minutes.

Mr. DOLD. Thank you, Mr. Chairman.

Secretary Brainard, thank you so much for being here.

In 2009, the United States exported approximately $15.7 billion in services to China, a surplus of about $7½ billion. In my view, I think that sales should be higher, but access to the Chinese service markets remain severely constrained. China imposes foreign equity limitations in many key sectors, including banking, insurance, rail, express delivery, and telecom, just to name a few. Chinese investment restrictions have a significant effect on services companies which often requires a local presence in order to do business. Other Chinese regulatory barriers, including limitations on licenses, a lack of transparency, discriminatory or overly burden-some regulatory requirements, and other restrictions, also prevent service companies from gaining market share.

What is this Administration doing to create new opportunities for U.S. service companies that wish to export to China and continue to expand the trade surplus and services?

Ms. BRAINARD. As you say, China has numerous restrictions in its services sector. I should say that China, for the size of its economy, has a services sector that really is not in keeping with its being the second largest economy and with its aspiration to be a major center for high-value production. So that it is not just restrictions on foreign participation of services but in fact services sectors have traditionally received much less favorable treatment in Chinese domestic policies as well.

We are beginning to see a shift and a recognition that as China rebalances its economy, it needs a much more robust services sector, and we are trying to use that shift in thinking among China's policymakers to make inroads on services access, which, as you say, we agree this is an area of major competitive advantage for U.S. producers. It is an area of major potential export expansion. We have seen very strong export expansion, but we think it still is well short of potential, and it is an area where China's commitment under the WTO reflected a much earlier stage of development in terms of the kinds of services sector they should have.

So we have raised issues associated with equity on ownership restrictions, market presence restrictions, and investment restrictions. We have raised those in the Strategic and Economic Dialogue. I know that Commerce and USTR raise these issues in their JCCT, and we also made this a major focus of the investment forum that we held earlier this year with China, pushing in particular on the restrictions in their foreign direct investment catalogue in many of these sectors.

We are starting to see some changes. They moved some services sectors out from their restricted into the encouraged sector. We are seeing them shift their taxation system so that they will, we hope, start to reduce the burdens on the services sector, and we are going to push industry by industry, whether it be auto liability insurance, life insurance, express delivery, across-the-board as you—of the services you mentioned.

Mr. DOLD. I appreciate that. If I can, I am going to move from the services sector over to financial and even manufacturing. The Tenth District of Illinois, which I represent, is actually one of the largest manufacturing districts in the Nation, and I had an opportunity to talk with someone yesterday who was doing a significant amount of business with China and actually was competing also with Chinese companies. Honestly, the thing he told me was that he can't even compete now with the Chinese companies because of, in essence, the backing that the Chinese Government is giving to their companies. So, the same thing is going to happen with the financial institutions that have the explicit backing of the government as the state-operated enterprises, and therefore their cost of capital is going to be significantly lower, putting the United States businesses and manufacturers at a tremendous disadvantage.

The gentleman I was talking to, again manufacturing in the Tenth District in Illinois, was talking about how he can't even compete with the Chinese companies. His costs of raw goods were going to be greater than what the Chinese companies were going to be able to put out.

What is this Administration—what are you seeing in terms of leveling the playing field? How are we able to try to level the playing field so that American workers can not only manufacture here but can compete effectively with China?

Ms. BRAINARD. We spent a great deal of time at the Strategic and Economic Dialogue putting high priority on the competitive advantage that we think state-owned enterprises in China unfairly enjoy and pressing for very specific changes for China to dismantle the set of preferences that we think unfairly benefit their state-owned enterprises. This is an area where previously we had seen almost no willingness to discuss and certainly no willingness to put any commitments into a public document.

For the first time, China did say that it would move forward to ensure that credit policies, regulatory policies, and broader sets of policies would be applied on a nondiscriminatory basis across state-owned and other enterprises. That is a very important commitment but now we are going to need to work to find ways of seeing through implementation on very specific fronts.

The preferential credit terms is a very particular set of problems that are closely intertwined with the set of restrictions in the financial sector more generally. You have caps on deposit rates which lead to lower interest rates, and then they have to ration credit because they are worried about inflation and generally we believe, we think that we see a pattern whereby state-owned banks ration that credit on a favorable basis to state-owned enterprises. So they are starving their own private enterprises and they are also unfairly advantaging our companies, which is what matters to us. We think that system has to go, and we are pushing really hard on it.

For the first time, China said that they would ensure that state-owned enterprises pay dividends at a level that is comparable to publicly listed companies. If they actually move forward on that, that is a huge change, and we believe that if they make that funding available, it will also help to strengthen domestic consumption and contribute to rebalancing.

I think this is an area that is going to take a lot of effort to start to disentangle. So I don't want to suggest that we feel like we are done, quite the contrary; this is the beginning. But it is an area of very high priority for us for the reasons you said.

Chairman MILLER OF CALIFORNIA. Thank you.

Mr. Scott, you are recognized for 5 minutes.

Mr. SCOTT. Thank you, Mr. Chairman. We understand that China may have been much less amenable to arguments about opening up their financial sector to U.S. firms during the financial crisis that we have had. But they seem to have come around on that because they have been impressed with the resilience of our financial system and also have seemed interested in some of the reforms that we have subsequently put into place, Dodd-Frank, Wall Street reforms, some of the other things we have done.

What is your view on China's willingness to engage with the United States and with different segments of our financial sector during and since our financial crisis?

Ms. BRAINARD. I think your characterization is very much consistent with our experience, which is that when I first started in this job, which was in the early days of responding to the financial crisis, China was really most interested in whether we had the capacity to really fix our problems, reform our system, try to retain the innovation and dynamism that comes with the U.S. financial system is really the hallmark of it, while putting in place reforms that would fundamentally strengthen safety and soundness, and we have seen that they have responded, and I think this is true more generally of our foreign partners, in response to the very strong reforms we put in place with Dodd-Frank, the very strong increases in capital that we forced our firms to take on, we have seen a much more sort of heightened interest again in having our financial services firms participate in the financial market opening that China's reformers are pushing forward.

At the same time, China's regulators also moved to put in place some of the same safeguards that we put in place, so they increased capital buffers in their banking system at the same time, and they are moving in a lot of consistent areas to come forward with a set of regulations that are in many respects convergent with some of the things we did in Dodd-Frank. So, I think it has been positive for our financial services firms as they seek to expand their participation in China's market.

Mr. SCOTT. Let me ask you something else. China is the second largest economy in the world. Is that a safe assumption?

Ms. BRAINARD. Yes.

Mr. SCOTT. And we are the first, we are the number one economy in the world. Is that a safe assumption?

Ms. BRAINARD. Yes.

Mr. SCOTT. And China has nearly a trillion or over a trillion dollars of our debt. They purchased it. Is that a safe assumption, too?

Ms. BRAINARD. I don't know the exact numbers.

Mr. SCOTT. It hovers around a trillion. But they are our largest investors. So it just seems to me with all of this infrastructure in place, I find it difficult to see why China has such restrictive policies in place that make it difficult for our firms to set up operations in China.

How do you assess that? We are number one, number two in the economies. They have invested in our debt. But yet, we have this other thing here.

Ms. BRAINARD. I think the relationship between China and the United States is fairly extensive in both directions. So our firms have much greater foreign direct investment into China, for instance, particularly in areas in which we are very competitive than Chinese firms have had in the U.S. market, and they are only now starting to increase their investments.

While it is true that China's WTO commitments have restrictions so that, for instance, in the banking sector, our investors are limited to minority shareholdings, nonetheless, we have a much larger number of branches and subsidiaries from U.S. banks operating in China than China does in the United States. So moving forward, I think there is enormous opportunity for the number one and number two economies in the world to greatly expand opportunities for our workers and our businesses. But we do want to make sure that when that expansion takes place, it does so in a more balanced way.

Mr. SCOTT. My final point that I wanted to get out, is there any differentiation, are there more restrictions on American companies based upon what kind of companies they are, whether they are financial services companies or they are manufacturing companies or they are distribution companies, electronic companies, computers? Is there any differentiation where the restrictions are greater or less depending upon the nature of the American firm's businesses?

Ms. BRAINARD. China has differential commitments on equity ownership, for instance, permitted by all foreign investors, including U.S. foreign investors by sector. So they have, for instance, a foreign direct investment catalogue. This is an approach that is just very different from the one we have here. We think our approach is a much better approach, which is a general presumption in favor of openness as long as those investments are consistent with national security. So we are going to continue to push for a broad opening of foreign direct investment, and we have seen some progress but not near enough to have a fully balanced relationship.

Mr. SCOTT. Thank you very much.

Chairman MILLER OF CALIFORNIA. Mr. Manzullo, you are recognized for 5 minutes.

Mr. MANZULLO. Thank you.

I noted in your testimony, on the last page, it says, "China committed to submit a revised comprehensive offer this year to join the WTO Agreement on Government Procurement that is responsive to the requests of the U.S. and other GPA parties."

Do you really expect that we will get a document that the United States will agree to from the Chinese?

Ms. BRAINARD. I do expect them to submit an offer because they have committed to do so. We have been very frustrated, as I am sure you have, that China committed to come into the Government Procurement Agreement 2 years ago, and they have yet to submit an offer that we think provides commiserate access into its government procurement market to that provided by other large economies. Now, in this area, of course, countries don't automatically get benefits. So, for instance, as you know, here in the United States, our "Buy American" policies apply to countries that are not full members in the Government Procurement Agreement.

Mr. MANZULLO. I understand. China has a lousy record of intellectual property protections. They still continue to manipulate the currency even though it has appreciated 13 percent in the last couple of years. But I think Americans would be aghast to know that if a State or municipality or the Federal Government, especially the latter, is opening up this bidding process to the Chinese when their record of IP protection is becoming worse.

Ms. BRAINARD. So, again, I think on the Government Procurement Agreement we are going to continue pressing hard for China to come into that agreement with an offer that is commensurate to what we have—

Mr. MANZULLO. I understand.

Ms. BRAINARD. —demanded from other countries. And until they do, they simply won't have access to those parts of our procurement market that are governed by "Buy American." And that is a very important, I think, consideration for them that I hope will persuade them to move forward with an offer.

Mr. MANZULLO. Look at where we are with minerals and holding that hostage. I just don't think Americans are ready, nor is China ready, when you have somebody actively bidding to do a public works project or a major purchase that they are ready to have the Chinese come in with a government that is still far from open, with a continuous violation of ethics and business.

We had a hearing before my Asia Subcommittee on what China did to Fellowes Shredder. It was absolutely outrageous how they literally stole $185 million worth of intellectual property, forced out their partner, closed the operations, but then opened it up with 100 percent Chinese ownership.

But let me ask you a question. Last week, the Fed approved the Commercial Bank of China purchasing the Bank of East Asia's U.S. banking subsidiary, the Bank of China's application to expand its U.S. operations to Chicago, the application by the Agricultural Bank of China to establish a branch in New York. Can the Chinese purchase 100 percent of a company in the United States or of a bank and operate here? Is that correct.

Ms. BRAINARD. In terms of our market access commitments, as you know, the U.S. provides for international treatment and does not have equity ownership restrictions.

Mr. MANZULLO. So the answer is yes?

Ms. BRAINARD. However, companies' foreign financial institutions do need to undergo a process of—

Mr. MANZULLO. I understand. What I am saying is, we don't have anything mutual going on here. American companies can't buy or have 100 percent of a business ownership in a Chinese company or actual ownership but the Chinese are allowed that in the United States. Isn't that correct?

Ms. BRAINARD. Under the WTO commitments, China came in with a WTO commitment which at the time was more commensurate with—

Mr. MANZULLO. The answer is yes, isn't it?

Ms. BRAINARD. Which is much—which does not allow a controlling shareholding, whereas yes, we do here in the United States.

Mr. MANZULLO. So we offer the Chinese more than what they are offering us?

Ms. BRAINARD. And we are trying very hard to get them to move forward on—

Mr. MANZULLO. I understand that. My question is, why didn't the Federal Reserve, if possible, take that opportunity or the government take the opportunity to say, I think it is time to talk about the same access to Chinese financial or operating U.S. operations if China can operate in the United States? We allow them to do that but they don't allow us to do that. Is there a problem there? Something intrinsically wrong?

Ms. BRAINARD. The Federal Reserve has an independent regulatory proceeding which is designed to ensure that prudential requirements are met. The Administration has ongoing discussions with China about market access, and we fully agree with you that China should provide access that is commensurate with the access that we provide to them. So we agree with you very much that it should be commensurate.

Mr. MANZULLO. If I may, please, it is my time.

Why didn't we take that opportunity? I am looking at the testimony of the panel that will follow you, from Rob Nichols.

Chairman MILLER OF CALIFORNIA. The gentleman's time has expired. You need to wrap it up. We have votes coming in, and I have two more Members with questions. I have tried to be generous, but we have votes coming, and I have two more Members I have to let go through the process.

The gentleman from Michigan, Mr. Huizenga, is recognized for 5 minutes.

Mr. HUIZENGA. Thank you, Mr. Chairman, and with that, actually, I am willing to grant some time to my friend from Illinois. I will give him some of my time, and let him pursue that line of questioning, because I am interested in that as well.

Mr. MANZULLO. The question was, why didn't the Administration at the time that these applications were pending with the Fed for these three purchases tell the Chinese Government that now is the time for you to give us 100 percent ownership opportunities just as we give to the Chinese? Why didn't the Administration do something at that point?

Ms. BRAINARD. I will just say that the Administration has consistently raised with our Chinese interlocutors—

Mr. MANZULLO. That doesn't answer the question.

Ms. BRAINARD. —the ownership restrictions, and we saw some progress on market access in the securities sector which we think is important progress, but we are going to continue to push.

Mr. MANZULLO. But why didn't they take the opportunity at that point to demand market access?

Ms. BRAINARD. We do take every opportunity to demand market access, and we saw, again, a very important step forward by China, a step forward that will expand meaningfully our market access in the securities area, and we will push for China to move beyond its WTO commitments in the banking area as well. We agree with you, it is important they provide access commensurate to the access we provide into our market.

Mr. HUIZENGA. Reclaiming my time, I appreciate you pursuing that line of questioning, because I think the frustration that I have had, and probably you are hearing here, is it seems that we take two or three steps forward, China will take one step forward, and we declare it a tie, somehow that we have made equal progress as we are moving along, and that I think is sort of the concern and the frustration that I have. And I apologize, I came in a little late, but I was curious—and we are hearing the vote bell go off right now. But with this approval going in, what impact do we really see this happening on our domestic banks as well? I am sure you are quickly covering some territory that you may have touched on already, but how are we seeing what these Chinese banks coming in may do to our own banks?

Ms. BRAINARD. Again, these are—this is a regulatory process that is undertaken by the Fed on an independent basis and it is on the basis of prudential requirements. As you know, we already have extensive market access into our banking sector for foreign companies, and generally speaking, we believe we have a more competitive, more vibrant, more dynamic financial services sector as a result of having an open financial services sector. We think China should undertake the same policies, that it would be only fair for us and very beneficial for the dynamism of their economy.

Mr. HUIZENGA. But it seems to me that would be a little different having Deutsche Bank here or somebody else that we have a—or a Canadian bank, TD Bank, which is huge down here, those are countries that we have parity on whether it is trade or any of the—patent protection and all of these other things that have been addressed in various treaties where they have stepped up and actually done that. That is the concern you are probably hearing, is aren't we again putting ourselves at a competitive disadvantage when we say well, they have made positive steps forward but haven't crossed the finish line, yet we somehow say the race is done and so therefore we are going to grant this.

Ms. BRAINARD. Let me just be very clear. We don't think there is anybody who should be saying the race is done. We are working very hard because we think that it is important to our workers and to our businesses that the relationship with China be more fair, be more balanced, and that we need to see greater market access into the Chinese market. So, we are using the tools that we have. We are very aggressive in taking WTO cases. We have been quite successful so far. We used Section 421 for the first time ever. The Bush Administration had not used this tool at all. It is a very important tool and we have been very aggressive on using trade remedies as well.

So, we completely agree that this relationship is one that needs to be more balanced. That is why the President has put forward in his budget a proposal to create a trade enforcement center that would bring together resources across the interagency that would allow us to be more effective in bringing cases on behalf of our companies. We very much agree with you, and you know we made some progress at the Strategic and Economic Dialogue, but by no means are we satisfied with that and we are going to go right back at it, and we look forward to working with you and your constituents to make sure that we are aware of all of the areas where we need to keep pushing.

Mr. HUIZENGA. Mr. Chairman, my time has expired. I know we have a vote as well. So thank you.

Chairman MILLER OF CALIFORNIA. I think the Under Secretary is hearing from this committee that we understand the United States is making commitments and the Chinese are making comments. And that is of great concern.

Do you have time for one more questioner?

Ms. BRAINARD. Sure.

Chairman MILLER OF CALIFORNIA. I yield to the gentlelady from New York, Ms. Hayworth, for 5 minutes.

Dr. HAYWORTH. Thank you, Mr. Chairman, and Under Secretary Brainard, it is a pleasure to see you again. As you are aware, I believe we sent a letter, I worked with our chairman, Chairman Bachus, and with Ranking Member McCarthy, to encourage greater access to the financial markets by our U.S. institutions, and I note that you made some progress in the Strategic and Economic Dialogue. I wonder if you could comment briefly and specifically on issues like licensing, the forum in which our institutions might join Chinese markets, product services, and of course discriminatory practices, we are going to address those, by the Chinese Government. And more fundamentally, what kind of leverage can we bring to bear, particularly given that we are in rather large debt to China at this point?

Ms. BRAINARD. As you say, we made some important progress in financial services opening, and frankly, these are commitments that our companies, and indeed the United States, had been seeking for many years. It predated the Administration. So, it was good to see China move forward. Again, there are a whole host of areas where we need to see much greater progress. So while we welcome these steps, we are going to continue pushing very hard for broader access in financial services across-the-board. We have seen some progress on mandatory third party auto liability insurance. We have seen some important progress on futures brokers, on securities. But we need to see more progress in other insurance sectors, on the banking sector, and I think we can continue pushing hard.

We have leverage with China. We are the largest market in the world. We have some of the most innovative dynamic companies in the world. As Chinese authorities look to transform their economy, I think we all tend to forget here that China is facing incredible challenges. They are facing a very steep demographic cliff. Wages are rising very fast. Costs are rising very fast. They have maxed out on resource-intensive, very heavy investment, export-oriented policies and need to have a domestic consumer that is going to sustain their growth.

We have leverage. They want what we have. They want an environment that produces innovation, they want a dynamic private sector, they want an economy that channels capital to companies on the basis of their good ideas and good management, not on the basis of rationing by state-owned banks. So, we do actually have leverage. And we are seeking to use, where necessary and where we can, dispute settlement at the WTO and leverage in that form, but we also have a lot of leverage by virtue of the strength of our private sector and the depth of our engagement. And so, we are trying to use all of those things to make progress, again recognizing the huge interest here and we should not be satisfied. We have a lot of work ahead of us.

Dr. HAYWORTH. I appreciate your comments and your dedication to this task, Secretary. No question.

We just passed a bill through the House for—CSPA to help our institutions to fight the challenging battle against hacking by those who seek to harm our institutions or our country. And unfortunately, of course, much of the challenge seems to come from China. Is there any—are we addressing on an official level China's policies toward—I realize this would be a delicate subject—but toward industrial espionage, if you will, all the ways in which our fundamental code of ethics, if you will, is different seemingly from theirs?

Ms. BRAINARD. Yes. I share very much the priority that you put on the cybersecurity issue. We do see this area of cybersecurity as a major risk to the competitiveness of our companies and their ability to compete on a level playing field internationally.

It is an area which has been included in the Strategic and Economic Dialogue. The State Department has taken the lead in conversations on cybersecurity, so I would suggest that they could give you more information there, but it is a priority for the Administration, and the State Department has held discussions on this topic in the context of the S&ED.

Dr. HAYWORTH. Thank you, Madam Secretary. And I yield back, Mr. Chairman. Thank you.

Chairman MILLER OF CALIFORNIA. Thank you. I want to thank Madam Secretary for her testimony. You have always been very candid and thorough in your thoughts.

The Chair notes that some Members may have additional questions for this witness, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for Members to submit written questions to this witness and to place her responses in the record.

Madam Secretary, I have a letter I would like to give to you on Chinese bonds that I sent to Secretary Geithner on April 6th. I thank you for your time.

I would encourage all the Members to come back for the second panel.

The subcommittee is in recess.

[recess]

Chairman MILLER OF CALIFORNIA. The hearing is called back to order.

I would like to introduce our second panel.

First, the Honorable Rob Nichols has been chairman of the Engage China Coalition since its creation in 2006. He is also the president and CEO of the Financial Services Forum, a nonpartisan financial and economic policy organization comprised of CEOs of 20 of the largest and most diversified financial services institutions doing business in the United States.

Before joining the Forum, Mr. Nichols served as the Assistant Secretary of Public Affairs at the U.S. Treasury. He also held positions in the House, Senate, and White House. Mr. Nichols was recognized as one of the most effective trade association leaders in Washington, D.C., in 2009, 2010, and 2011.

Welcome.

Second, Mr. David Strongin is managing director of international policy at the Securities Industry and Financial Markets Association, SIFMA, which brings together the shared interests of more than 650 security firms, banks, and asset managers. Mr. Strongin is SIFMA's expert in U.S.-China policy.

Third, the Honorable Clay Lowery is vice president of Rock Creek Global Advisors. He previously served as the Assistant Secretary of International Affairs at the U.S. Treasury Department, where he was involved in the first Strategic and Economic Dialogue with China headed by former Secretary of the Treasury Henry Paulson.

Mr. Lowery has chaired the Committee on Foreign Investment in the United States, CFIUS, and served as the Financial Deputy to the G-20, G-7, International Monetary Fund, and Financial Stability Forum. At various times, Mr. Lowery has been appointed to be the U.S. representative on the board of the World Bank, the African Development Bank, the European Bank for Reconstruction and Development, and the Inter-American Development Bank.

After his government service, Mr. Lowery was vice president of international government affairs with Cisco Systems and the managing director of Glover Park Group.

It is good to have you here today.

Finally, Mr. Nicholas R. Lardy is the Anthony M. Solomon senior fellow at the Peterson Institute for International Economics. Mr. Lardy joined the Peterson Institute from the Brookings Institution where he was the senior fellow in the Foreign Policy Studies Program and served as the interim director of Foreign Policy Studies.

Before Brookings, he served at the University of Washington, where he was the director of the Henry M. Jackson School of International Studies from 1991 to 1995. He was also the Frederick Frank Adjunct Professor of International Trade and Finance at the Yale University School of Management. Mr. Lardy is an expert in Asia, especially in Chinese economy.

I want to thank you all for being here today.

I would like to recognize the witnesses in order, for 5 minutes each.

Mr. Nichols, you are recognized for 5 minutes.

STATEMENT OF THE HONORABLE ROBERT S. NICHOLS, CHAIRMAN, ENGAGE CHINA COALITION

Mr. NICHOLS. Thank you, Chairman Miller and Ranking Member McCarthy, for the opportunity to participate in this very important hearing regarding the need to expand access to China's financial sector for U.S. institutions.

Today's hearing is both timely, given the recent round of the Strategic and Economic Dialogue in Beijing, and it is enormously important. China's economic emergence and the impact of its integration into the global economy are unprecedented in the history of the world's economy with profound implications for U.S. economic growth and job creation.

Today, I would like to use my appearance to help connect the dots and shed light on why a more consumption-based Chinese economy is very much in the interests of the United States, how a more active Chinese consumer will dramatically expand demand for U.S.-made products and services, and, finally, what role a more modern and sophisticated financial sector plays towards the acceleration of a more consumption-based Chinese economy. So I am really going to focus on jobs today.

As you all know, China's economy has grown at an annual rate of nearly 10 percent over the last 2 decades. It was the world's seventh-largest economy in 1999. It recently surpassed Japan to become the world's second-largest economy. Since China joined the WTO in 2001, our exports to China have increased more than sixfold, growing 7 times the pace of U.S. exports to the rest of the world. China is now America's third-largest export market and the largest market for U.S. products outside of North America.

According to a recent article in the Washington Post, exports to China from almost every U.S. State and congressional district have grown exponentially in recent years. So clearly, fair and competitive access to China's fast-growing middle-class and business sector represents an enormous commercial opportunity for American manufacturers, service providers, farmers, and our ranchers.

So let me give you a quick sense of what an expanding China can mean for U.S. economic growth and job creation.

Last year, for example, our exports to Japan totaled about $66 billion. Our exports to China were about $104 billion. China's population, of course, is about 10 times the size of Japan's population, so about 130 million people in Japan, about 1.3 billion in China.

If China's citizens were eventually—not overnight but eventually—able to consume American-made goods and services at the same rate as her neighbor, Japan, U.S. exports to China could, over time, grow to $660 billion. That is 7 times what America exported to China last year and an amount equivalent to nearly 5 percent of U.S. GDP and nearly twice what we imported from China last year, potentially turning a $300 billion trade deficit into a $300 billion surplus.

More importantly, if we apply the Commerce Department's metric that there are 5,000 new American jobs for every $1 billion in additional exports—that is a Commerce Department figure—increasing exports to China $660 billion a year would amount to somewhere in the vicinity of 2.8 million new jobs here. That won't happen overnight, but with the right reforms and with the right access to their markets, it will happen over time.

Now, for that remarkable transformation to occur, clearly, many things need to happen inside of China—I will be the first to acknowledge that—to change their culture from one more towards consumption and less saving. There needs to be infrastructure changes, cultural changes, societal changes. But first among equals is her citizens need the tools found in developed nations to save, to invest, and to insure against risk; and those are the tools that are offered in an open financial services sector.

So by providing the financial products and services that China's citizens and businesses need to save, invest, and insure against risk, raise standards of living, and consume at higher levels, foreign institutions will help China develop an economy that is less dependent on exports, more consumption-driven, and therefore an enormous and important and expanding market for American-made products and services.

I look forward to answering your questions. Thank you for hosting this important hearing, which I, frankly, think is about jobs in America.

[The prepared statement of Mr. Nichols can be found on page 47 of the appendix.]

Chairman MILLER OF CALIFORNIA. That was very timely. I am impressed.

Mr. Strongin, you are recognized for 5 minutes.

STATEMENT OF DAVID STRONGIN, MANAGING DIRECTOR, THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION (SIFMA)

Mr. STRONGIN. Thank you.

Chairman Miller, Ranking Member McCarthy, I thank you for the opportunity to testify today on behalf of the Securities Industry and Financial Markets Association on the importance of improved market access for financial services firms in China.

I would also like to take this opportunity to reiterate our support for the Strategic and Economic Dialogue and the efforts of Treasury Secretary Geithner, Under Secretary Brainard, and the rest of the Administration.

With the conclusion of the most recent S&ED, this hearing is especially timely and provides us with the opportunity to assess the progress made and the need for continued reform in China.

My testimony will cover three areas: priorities that are necessary to allow U.S. firms to compete on a level playing field; the significance of the commitments made at the S&ED; and the growth of China's financial services firms and their implication for a level playing field.

Despite progress at the most recent S&ED in raising ownership share and for securing joint ventures, full market access and national treatment for financial service firms in China remains an industry priority.

We have identified five key interconnected priorities: first, permit 100 percent ownership and the right to establish in a corporate form of choice; two, allow the same scope of business; three, further develop the Qualified Foreign Institutional Investor Program; four, improve the bond market; and, five, promote regulatory transparency.

This year's S&ED yielded commitments from which further progress must be made. This includes some of the things Secretary Brainard discussed:

One, raising ownership on security joint ventures from 33 to 49 percent. This is a notable development, but we believe a roadmap toward full ownership should be developed and implemented as quickly as possible.

Two, reducing the seasoning period from 5 years to 2 years. This will provide U.S. joint ventures with expanded access for different activities in China. However, the length of the season period of 2 years remains. We believe that is a significant obstacle, and there are also a number of opaque requirements that restrict access for U.S. firms in China related to this.

We also believe while increasing the qualified foreign institutional investor quota at $80 billion again is a step forward, we need those quotas to be eliminated and allow free investment.

We believe that it is essential that these commitments are implemented expeditiously and that this committee is well placed to ensure these obligations are met.

The S&ED remains the primary forum in which to discuss financial services' issues on a bilateral basis. Ongoing engagement and continued dialogue is vital for pushing forward with further reform of China's markets.

SIFMA has consistently urged both the Bush and Obama Administrations to engage in results-oriented discussions that lead to the reduction and elimination of these barriers. Despite these commitments, more work needs to be done to ensure U.S. financial services firms are able to operate on a level playing field, and monitoring implementation of China's S&ED commitments will be critical.

While the United States continues to advocate for improved market access and the reduction of regulatory barriers, China has increased its global profile considerably. Chinese regulatory authorities are now full participants in the G-20, the Financial Stability Board, and the International Organization of Securities Commissions. As China becomes a more active participant in these institutions, it is imperative they reduce restrictions and eliminate discriminatory barriers in order to meet these global commitments and responsibilities.

We look forward to working with the committee, Congress, and the Administration to further expand the industry's access to China. We believe the committee has a central role in helping ensure the rapid implementation of China's S&ED commitments while at the same time pursuing a level playing field for U.S. firms.

Finally, to ensure these goals are met, we offer two recommendations: first, that an annual report from Treasury to Congress is provided demonstrating China's implementation of commitments agreed to at each S&ED; and second, increasing the frequency of the economic portion of the Dialogue to perhaps twice a year, as was done during the original S&ED.

I very much appreciate the committee's interest in this issue and the opportunity to testify today. Thank you very much.

[The prepared statement of Mr. Strongin can be found on page 55 of the appendix.]

Chairman MILLER OF CALIFORNIA. Thank you.

Mr. Lowery, you are recognized for 5 minutes.

STATEMENT OF THE HONORABLE CLAY LOWERY, VICE PRESIDENT, ROCK CREEK GLOBAL ADVISORS LLC

Mr. LOWERY. Chairman Miller, Ranking Member McCarthy, thank you very much for the opportunity to testify today on increasing market access for U.S. financial firms in China.

I think Mr. Nichols covered the jobs issue very well, and Mr. Strongin covered some of the specific areas, and Mr. Lardy, I know, is a complete expert on China. So I figured my area that I could help you with is what is it like to be in a government position doing financial liberalization negotiations with China, no longer being in that position.

In my experience working with Chinese financial officials, China makes changes when it believes it is in China's interests. This probably does not come as much of a surprise to you, and I don't mean to diminish the impact of external pressure, but that pressure is mitigated by China's size, its unprecedented speed of economic growth over the last 30 years, and its ability to attract investors from around the world. That is why financial liberalization should be thought of as more than just increasing market access for U.S. companies. It is also about rebalancing China's internal economy.

For a few years, various observers have noted that China's export-led, production-heavy growth model could not last forever. Two major questions were asked: one, when is the turning point at which China needs to transform its economy; and two, can China actually accomplish this transformation?

With regard to the first question, the timing of this hearing is excellent. China appears to be on the verge of significant changes. The leadership is scheduled to change in China over the next 10 months or so; and these leaders will be the ones responsible for taking China through what I believe is an even more important transition, the vital changes to its economy that are going to be made necessary by the long-term unsustainability of its current economic model.

You have heard from Under Secretary Brainard and others on this rebalancing of its internal economy, but the challenges in China cannot be underestimated. Entrenched interests, whether they are state-owned enterprises or captured regulatory agencies, there is just inertia; and, frankly, pure politics will fight for the status quo.

While the jury is out whether China can make this transition, the last 30 years suggests that China at times does use external pressure to advance internal reforms. Therefore, I see the S&ED and the negotiation of a Bilateral Investment Treaty as opportunities for the United States to provide input and maybe even influence the way China addresses these challenges.

The difference between when I was working on these issues a few years ago and today is that U.S. officials and observers are not the only ones emphasizing that China is bumping up against the limits of its existing growth model. As your letter and many members of this committee's letter to President Obama points out, Chinese leadership and respected international organizations like the World Bank have joined the chorus, and perhaps most importantly we are actually starting to see some of that transformational change.

In many ways, financial sector development is the key to this transition. The current system is influenced heavily by the state, capital markets are woefully underdeveloped, and households suffer from a form of financial repression due to interest rate caps on deposits. This system leaves small- and medium-sized enterprises with little access to capital, stifles consumption, and leads to a banking system with growing nonperforming loans. As is well-recognized and mentioned earlier, financial sector development depends on various factors, but a key one is opening the market to global competition.

I want to conclude my testimony by respectfully suggesting areas where Congress can play a role. Mr. Strongin suggested a couple. Let me add one. This committee should bring the same intensity and oversight of pushing for strong deliverables at the S&ED and in the Bilateral Investment Treaty negotiations that Members of Congress have shown on the exchange rate issue. Putting pressure on the Executive Branch to continue to work with the financial services industry to push for market access, to work with China to regulate in a fair and transparent manner, and to assist China in building out its capital markets are all good steps that should be taken.

If China breaks the rules, then by all means hold them accountable and enforce the rules. But we also should be open to working with China, engaging in vigorous but productive discussion with them, and finding solutions that are clearly in the interests of both of our countries.

Thank you very much. I will be happy to answer any questions.

[The prepared statement of Mr. Lowery can be found on page 42 of the appendix.]

Chairman MILLER OF CALIFORNIA. Thank you very much.

Mr. Lardy, you are recognized for 5 minutes.

STATEMENT OF NICHOLAS LARDY, ANTHONY M. SOLOMON SENIOR FELLOW, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. LARDY. Chairman Miller and Ranking Member McCarthy, thank you very much for inviting me to participate in this hearing today.

I believe that the Strategic and Economic Dialogue has made some progress in addressing issues in the bilateral economic relationship. These range from the big picture, like China's commitment in principle to rebalance the sources of its economic growth away from investment and exports towards domestic consumption demand, to small points like concrete steps, concrete commitments on more specific issues, for example, increased access for U.S. financial firms.

I would say further that since China joined the WTO, it has partially liberalized its financial services industry, but I think U.S. and other foreign firms have been disappointed that they have not been able to expand their activities in China more rapidly. I attribute this to three factors, and I would be happy to expand on that in the question period.

First, I think in the bilateral negotiations that we entered into with China in the 1990s, we did not press very hard for market opening in financial services. All these ownership caps that are in place today were agreed to in that bilateral negotiation, and the Chinese by and large have found it relatively easy to live up to their commitments because they were not very demanding, and now we are in the position of having to kind of renegotiate.

So my second point would be, in this renegotiation, I think both the U.S. and the Chinese side negotiators are very constrained in their ability to make reciprocal concessions in order to get further market-opening measures in the U.S.-China Strategic and Economic Dialogue or in other bilateral fora.

Third, I would say that the U.S. argument, which I think is increasingly heard and has an element of truth to it, this argument that China would benefit from further unilateral opening of its market to U.S. and other foreign financial services firms, quite frankly is just far less compelling today than it was prior to the onset of the global financial crisis in the United States.

Let me just expand on one or two of these points.

First, with respect to what concessions each side can make, U.S. negotiators, I think, are very constrained. China's number one request is to have a relaxation on controls of exports of U.S. high-technology products to China, and negotiators can't relax these standards unilaterally.

Congressional action is required to move this forward, and I am sure Members of Congress would be quite upset if they read in the newspapers that the Executive Branch had decided to unilaterally liberalize this regime along the lines that might ultimately be appropriate.

So what commitment did we make in the most recent S&ED? The United States commits to give full consideration to China's request that it be treated fairly as the United States reforms its export control system. Commitment to give the other side top priority involves no concrete commitment on the part of the United States to do anything at any specific time.

The Chinese have the same problem. They are talking about rebalancing their economy in ways that would be very beneficial to us, but they have been talking about it for years. But vested interests within China, I think, have stalled the very important financial and fiscal reforms that are necessary to undertake this rebalancing.

For example, market-oriented interest rate liberalization, which Secretary Geithner has correctly said would increase household income, reduce their need to save, and thus lead to substantially more private consumption expenditure. This has been on the agenda for years, but no progress has been made on this since 2004 because basically the vested interests that have blocked this and other reforms, even when them are being promoted by the top Chinese leadership.

So my view is when each side is very constrained in what concessions it can offer to the other, it is not surprising that the incremental steps are indeed very incremental. Moving insurance from 33 to 49 percent is important, but I wouldn't classify it as a breakthrough; and it is very hard to see how we are going to get breakthroughs, given the limitations that I have outlined today.

[The prepared statement of Mr. Lardy can be found on page 38 of the appendix.]

Chairman MILLER OF CALIFORNIA. Thank you very much.

I look back to the late 1960s when we were looking at Germany selling cheap cars we thought of in the United States, and everything you bought said, "Made in Japan" on it. Kids today don't know that. You thought Japan was going to control it forever. Then wages started increasing, the cost of living started increasing, and the Japanese people started to see what was available in the West and started wanting it. Now today, you see very few products that say, "Made in Japan" on them anymore.

Do you see that same trend occurring in China? Any one of you?

Mr. LARDY. I would say it is a long way off. China is starting at a level of per capita income and then obviously wage levels that are far, far below the level that Japan had in the 1960s when we were very worried about Japanese imports. So I think it is a process that will take effect over a long period of time, but I think we are very far from reaching the kind of turning point that you alluded to that we experienced with respect to Japan.

Chairman MILLER OF CALIFORNIA. My concern is as I look at a restrictiveness in financial markets paper that OECD put out in a 2010 update with zero percent being the best and 10 percent being most restrictive—China was about 6.1; Russia was about 5.4; Mexico was about 4.3; the United States was about four-tenths of one percent; and surprisingly, Japan was zero percent.

But at these types of numbers, how can the pace of that growth be accelerated through financial services reform of the markets when, as you said, you talked about the Chinese just talking, and my comment to the Under Secretary was that they make comments, and we make commitments? How do you see that changing in the near future, unless we change the way we are dealing with them?

Mr. NICHOLS. I will start, Mr. Chairman.

I would say that how it can change over time is there is a huge group of folks in China who do not have access to the global financial services marketplace, the things that you would find in other developed nations. So we need to continue to stay both at the table bilaterally, multilaterally, and then, most importantly, to underscore to them that it is in their best interests to change the economy, their economy, from one of manufacturing to export into one based on domestic demand and consumption. Ultimately, that is how we will get them there.

I would say, just as a general observation, we are not satisfied. We are not satisfied. We have plenty of concerns. There is more to do. Has there been some incremental progress? Absolutely. Is it positive? Absolutely. But we are not satisfied. There is much more to do to get them to open their markets.

But as that huge, what I call silent, majority of her citizenry does begin to participate in the global marketplace, it will I think, as I indicated earlier, be a huge export opportunity for our manufacturers and our ranchers and our farmers, but we just need to continue to point out why they need to do that.

Mr. STRONGIN. I also wouldn't discount the importance of continued outside pressure. So I think the S&ED, this committee, and even the China-U.S. commitment to restart BIT negotiations all provide us with both pressure and some leverage, not all the leverage we would like to have, but I think we have to sort of see what is in our toolbox and use whatever is appropriate.

Mr. LOWERY. The only other thing I would add is, if you took that same index 25 years ago, China probably would have scored a perfect 10. And then if you took it probably 5 or 6 years ago, they probably would have been about an 8. So I think the point is that they are making progress. It is not nearly at the pace, as Rob said, that we would like.

But I think that with outside pressure, with potentially internal reform being driven more by Chinese citizens than by Americans thinking that they want to do this, there are possibilities that we can make even more and more progress. But I agree with the premise that we need to keep the pressure on them.

Chairman MILLER OF CALIFORNIA. Do you believe the S&ED meetings are being fruitful? Are they benefiting this country? Are they moving in the right direction?

Mr. STRONGIN. I think from the securities industry perspective, they have been helpful. They have moved the ball forward. Not nearly enough. We are talking about going from 33 percent ownership in China to having U.S. firms now being able to own 49 percent. It still does not give them strategic control. That movement from 49 to 51 is in a sense much greater than from 33 to 49. So, I think it is helping the margins, but there is a lot left to do.

Chairman MILLER OF CALIFORNIA. I think the American people are having a real problem right now. Our markets are tough over here. We are getting out of a recession. Too many people are out of work. And they are looking at China as taking their jobs through fixed currencies.

And then, when you hear on the news that the Administration, the Federal Reserve is talking about allowing more groups to come over here in banking industries when our companies are restricted from going over there and doing the same thing, that is a tough pill to swallow for the American people.

What is your opinion? Some of you were in government before, but now you are representing the private sector. Something has to change. And if Congress standing up to the Administration or whomever and saying this is unacceptable, we believe in a fair and open marketplace—yet if you look at Germany and Japan today and China, they are still benefiting from trade agreements that were post-World War II because they were such a downward economy we were trying to help them get out. But some of those agreements are still in place today that they benefit from. What would your response be to the American people?

Mr. NICHOLS. Mr. Chairman, I will start on that on this issue of the Fed licenses.

Again, my initial position is we are not satisfied. This playing field is not level, and that is not good. That said, we, the United States, should lead by example. We have an open capital market. That is the right message to send to emerging markets. So I don't think that we should move backwards.

That said, again, it is not a level playing field, so I am not happy about that at all. But I think it is important for the United States to lead by example and send the right message to these other emerging economies around the world about the right direction to go.

Now, also, actually there is some positive aspect here that the reason the Fed—among the reasons the Fed granted these branch licenses that have been pending for some time there is because the home country supervision in China has improved, and it is starting to come into global norm. So, that is actually good, too. That is a good thing you can point to.

So, acknowledging the playing field is not level, the fact that their home country supervision has improved up to some global norms, and the Fed has been sending teams over there to inspect, to talk to the regulators, to look at the way they are supervising and making sure they are doing it in a modern, efficient way, that is actually a good thing. All that being said, we are not level. We are not where we need to be.

Chairman MILLER OF CALIFORNIA. I agree, and I think we need to aggressively encourage them to do the right thing.

I yield 5 minutes to the ranking member, Mrs. McCarthy.

Mrs. MCCARTHY OF NEW YORK. Thank you.

Listening to all of you, and I think certainly the chairman and I at this point agree with everything that you are saying. We know that the markets are going to be opening down the road.

The one thing I guess that just keeps going through my head is how are you going to market your products? Because China, the people of China, do not trust us. That was taught to them from their government: Do not talk to Americans.

Now, they are trying to change that. I had about 44 Chinese—I will call them students, but they were probably middle management from the banks from China—over here at Georgetown for 6 months learning our ways. But it is the people, when you go outside of the inner cities, who don't have the education yet, how are you going to sell your products? Why would they trust Americans to give them car insurance or life insurance or get into our banks versus their own?

And this is really scary, because it is in the back of my mind. Supposing we are doing well, there and supposing people in China are buying your products and we are doing very well financially, and then China—because this is the way they were brought up—flips it and says, "Get out." What do we do? How do we protect ourselves? How do you protect yourselves on the business issue going in?

But that is the natural mistrust I would tend to think that certainly the Chinese people have been brought up with, and certainly the American people have been brought up with. Even though I have been to China—and I need to go back there again because it has been 10 years—those things to bother me when I think about it. And when I think about what is going on in the world, North Korea, what is going on in the Asian Sea. These are things that we are involved in.

Anybody?

Mr. LARDY. Let me just briefly make one comment, and that is we should recognize that American and other foreign firms have invested about 1.6 trillion U.S. dollars in China. There haven't been any expropriations that I have been aware of.

And the other thing that is quite interesting is, even though the business environment could always be improved and we could come up with a long list of things to do, very, very few companies ever disinvest. They would like to have the regulation be more transparent. They would like this, that, and the other thing. But the environment is not so bad that very many firms are disinvesting. Only a handful of foreign firms have ever disinvested from their operations in China, and the money continues to go in there.

So I think the chance of expropriation, if you look at the footprint that foreign firms have in China, they are not going to be removed. They are producing almost 25 percent of the manufactured goods produced in China. They are producing about 30 percent, 40 percent of the exports. They are fully integrated into the Chinese economy in many respects, and the Chinese would be shooting themselves in the foot to push foreigners out.

Mrs. McCARTHY OF NEW YORK. I agree, if they were shooting themselves in the foot, but I believe it was Mr. Nichols who said that China is only going to do what is good for them. I believe that was—I am sorry, Mr. Lowery—that they will only do what is good for them. And when things come to the point of where it would be very good for them to be more involved, to take over, they are just not mature enough yet. I guess that is my question.

Mr. LOWERY. I guess my argument would be that I do think China will do what is in China's interest, and I think a lot of people in China are recognizing that it is more and more in their interest to allow this type of investment or to allow the type of trade flows that we have seen. So if you look at just statistically the stock of trade from the United States to China is still not that big for as big an economy as it is, but the flow is quite good, which suggests that there are more and more Chinese who are liking American products and services.

The second point which I wanted to make which is related to the discussion you and Mr. Lardy were having, this is why one of the good things we saw at a recent S&ED was an agreement to move forward on trying to get a Bilateral Investment Treaty (BIT).

A Bilateral Investment Treaty does a few things.

First, it basically helps provide market access, the way we do Bilateral Investment Treaties.

Second, it provides protection for our companies against the type of issues you are talking about. It is a hard negotiation.

Third, it provides a service, which is basically finding out where China is on some of these issues and actually having a real negotiation which becomes a binding legal agreement.

I think that those are all very positive things.

I think you raise some very good points. But we are chipping away at it, again, as I think all of us have said, although probably not at the pace we would like.

Mr. STRONGIN. I would just like to support Mr. Lowery point. I think as businesses are in there and investors, legal certainty, predictability become incredibly important, particularly as you have longer-term investments. And I think what Clay was pointing out, that is why the BIT is critically important, to move forward on that. And also it is why we have in some cases the WTO, right, where we could actually take WTO, we could take them to dispute settlement.

It is the problem with the S&ED that they are commitments of a sort, but they are not binding commitments. So that is somewhat problematic, not only getting the Chinese to live up to those commitments, but then they aren't what they call bound, so the Chinese could pull back. So we do have to find a mechanism where, once we achieve what they give us within the S&ED, they can't claw it back as you are suggesting.

Mrs. McCARTHY OF NEW YORK. My time is up. Sorry. I have one more question.

Chairman MILLER OF CALIFORNIA. Mr. Carson, you are recognized for 5 minutes.

Mr. CARSON. Thank you, Mr. Chairman.

Unlike the Federal Reserve, China's Central Bank often uses reserve requirements as a means of expanding or even contracting the money supply. According to CRS, China's Central Bank increased the reserve requirement ratio 6 times in 2010 and another 6 times in the first half of 2011. As of last June, China's reserve requirement stood at around 21.5 percent. To what extent is this high capital reserve requirement a barrier to entry for U.S. firms that seek access to China's banking sector? And that is for anyone.

Mr. LARDY. Maybe I can start on that.

I don't think of it as a barrier. It is a restriction or a requirement that applies to all banks, foreign and domestic, so it doesn't tilt the regulatory environment in favor of domestic banks. The fact that they rely so heavily on the required reserve ratio reflects the fact that they do not have market-determined interest rates for the most part, so their Central Bank does not rely on adjustments in interest rates to control the flow of credit but rather these quantitative restrictions like the requirement to put 21.5 percent of your deposits into the Central Bank.

So it is a very quantity-oriented control mechanism, rather than a price-oriented control mechanism. They have talked about moving towards more of a price-oriented mechanism, but, quite frankly, I think they are still a long way from being able to do that.

Mr. STRONGIN. I would just add a parenthetical that I think when you talk about restrictions in financial services, it is key to focus, though, I think on the ownership restrictions. I sound like a broken record, but I think whether you go through insurance, banking, securities, or other types of financial products, it always starts foremost with the inability to run your business the way you want to run it.

I just wanted to add that.

Mr. LARDY. Can I just make a footnote to that?

I think that is certainly true in securities and asset management and insurance, but it is a little bit less clear in banking. Because there are hundreds of foreign banks that are running their own businesses in China, either as subsidiaries or as branch banks. They run their business. They can offer whatever range of products they are licensed for. They don't have to worry about talking their partner into doing something.

And I don't think, quite frankly, very many foreign banks want to buy into existing Chinese banks. So I don't think the ownership cap—remember, the banks that have had ownership in China have been disinvesting in recent years for a number of reasons.

So I don't think there is a big demand on the part of financial services for banks to come in and buy up 50 percent or have a transaction similar to the transaction that ICBC created with the U.S. branches of Bank of East Asia. I think banking businesses are trying to build up their domestic networks, and some of them have been quite successful. HSBC, for example, operates more than 100 branches in China. It is trying to develop the retail business. Over time, they are expanding their footprint. And they do control all of those businesses. They don't have a foreign partner.

So I would say in that respect, banking is a little bit different from securities and insurance.

Mr. NICHOLS. One observation, too, just building on that.

What we are seeking ultimately is an entirely open capital market there, for banking, for securities, for insurance. The Chinese leadership says they would like, for example, to have Shanghai be a global financial sector. And one thing that we have reminded them is you are not going to be able to have a global financial center with a closed capital market that is punitive toward either insurance, banking, or securities firms. So our end goal is an entire open capital market like here in the United States.

Mr. CARSON. Thank you, gentleman.

Thank you, Mr. Chairman. I yield back.

Chairman MILLER OF CALIFORNIA. Did the ranking member have one question she wanted to ask that I cut her off on? I would be happy to yield for that question.

Mrs. MCCARTHY OF NEW YORK. To very honest with you, I would ask a favor from each of you. I am sure you have briefing papers, and if you could give a briefing paper that would be not on your level, but maybe on my level, so that I could start reading and finding out and then ask follow-up questions to all of you in the future.

Thank you. That is all.

Chairman MILLER OF CALIFORNIA. Thank you.

The Chair notes that some Members may have additional questions for this panel, that they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for Members to submit questions to these witnesses and to place their responses in the record.

I want to thank you all for your time, for your talent, and for your expertise. Your information was very beneficial, and this is something I think we need to stay on top of and monitor and make sure the Administration is moving our economy in the right direction with the Chinese economy.

This hearing is adjourned.

[Whereupon, at 4:07 p.m., the hearing was adjourned.]

A P P E N D I X

May 16, 2012

Embargoed Until Delivery

Under Secretary for International Affairs Lael Brainard

Written Testimony before the House Financial Services Subcommittee on International Monetary Policy and Trade

"Increasing Market Access for U.S. Financial Firms in China: Update on Progress of the Strategic & Economic Dialogue"

May 16, 2012

Chairman Miller, Ranking Member McCarthy, members of the Subcommittee, thank you for the opportunity to speak with you today about our economic and financial relationship with China.

No other country presents as many opportunities and challenges as China. China is, and will likely remain, the fastest growing major economy. This Administration has worked to achieve a more balanced economic relationship with China, one in which U.S. workers and companies benefit more from the opportunities China presents.

Since early 2009, U.S. exports of goods to China have almost doubled, growing much faster than our exports to the rest of the world. In 2011 alone, the United States exported around $130 billion in goods and services to China, supporting well over 600,000 jobs here at home. China's exchange rate has appreciated by 13 percent against the dollar in real terms over the past two years. And we have seen a large reduction in China's current account surplus – from 9 percent the year before President Obama took office to under 3 percent today.

The Strategic & Economic Dialogue (S&ED) has been central to our efforts by providing a platform where the Administration engages on an ongoing basis with Chinese authorities to make progress on the economic, trade, and financial issues that matter most to Congress and American workers and businesses. We have just returned from the fourth S&ED in Beijing. While many challenges remain, we made important progress.

We secured commitments that will expand market access and help level the playing field for U.S. companies in China. And China agreed to take concrete steps to shift away from exports and relying more heavily on its own domestic consumption for growth.

On export credits China confirmed its intention to participate in negotiations for new rules on official export financing with the United States and other major exporters. The first meeting will take place this summer, with the goal of reaching agreement on a set of rules by 2014. China is one of the world's largest providers of export financing, and its export credit program has been a longstanding competitive impediment. It is critical that competitive U.S. exports are not undercut by subsidized foreign government financing.

Stronger consumption in China means more demand for U.S. goods and services, which in turn means more export opportunities for U.S. companies and more jobs here at home.

Rebalancing global demand is critical if we are to sustain strong and sustainable growth. As the United States reorients its growth strategy to focus on exports and competitiveness, and with European demand expected to be weak for some time, sustaining growth will require stronger demand from surplus emerging economies.

Chinese leaders made clear at the S&ED that they understand China will not be able to sustain its growth unless it shifts fundamentally its growth strategy. Wages are rising, labor migration from the countryside is slowing, and China's overall labor force will soon peak as its population rapidly ages. Relying on ever-higher amounts of fixed investment is depleting China's resources, damaging its environment, and producing increasingly lower returns. And weak IPR protection and enforcement constrain China's ability to move up the value-added chain through innovation.

Fortunately, China has ample capacity for growth driven more by domestic consumption and less by overinvestment in resource intensive and export industries. But achieving this shift will require important policy changes.

To strengthen consumption, at the S&ED China pledged to reduce tariffs on consumer goods imports by the end of the year, and reduce the high tax burden on services industries.

A more open and market-based financial system is also central to achieving more balanced Chinese growth and a more level playing field. For that reason, we had a focus at this S&ED on pushing for liberalization of China's financial system.

China's financial sector, which remains dominated by government-owned banks and subject to extensive government controls on the price and quantity of credit, generates massive distortions that filter through the whole economy. That is a problem for China, and for us.

Bank deposit rates are kept low. Chinese households get little return on their savings, often not even enough to keep up with inflation. There are also very few saving, investment, and insurance products available to help households manage their money efficiently, and their ability to invest overseas remains restricted. That means they have to save more – and consume less – of their income to insure against life's risks, prepare for retirement, and pay for education.

With interest rates artificially low, China relies on limiting the quantity of loans to control inflation. As a result, with demand for loans often exceeding supply, banks ration credit. This benefits large, politically connected SOEs and local governments, while starving China's private sector and entrepreneurs of funds. It also results in overinvestment and overcapacity in favored industries.

Moving to a market-determined exchange rate has to be a key part of both changing China's pattern of growth and opening its financial system. In April, Chinese authorities announced the widening of the daily RMB trading band in the context of diminished intervention. If implemented in a way that enables the exchange rate to reflect fully market forces, this would help promote rebalancing and financial reform.

We secured new financial sector commitments that will reduce market access barriers, help Chinese households save and invest more effectively, reduce the unfair competitive advantage of SOEs, and begin to loosen the chokehold that state-owned banks have on China's financial sector. China announced it intends to permit foreign investors to take up to 49 percent equity stakes in domestic securities joint ventures, moving beyond its WTO commitment of 33 percent. And China will also shorten the waiting period for securities joint ventures to expand into brokerage, fund management, and trading activities that are essential to building competitive securities businesses. China also agreed to allow U.S. and other foreign investors to establish joint venture brokerages to trade commodity and financial futures and hold up to 49 percent of the equity in those joint ventures.

Our auto financing companies will be able to issue local bonds to finance their operations – a plus for our auto producers in the world's largest market for automobiles, as well as for China's consumers. Furthermore, China amended its regulations to allow U.S. and other foreign insurance companies to sell mandatory auto liability insurance, opening access into a large and rapidly growing market, as well as an entry point to sell other insurance products to Chinese citizens. Finally, China will increase the amount that foreign investors can invest in China's stock and bond markets under its Qualified Foreign Institutional Investor Program (QFII) from $30 to $80 billion, creating opportunities for US pension funds and money managers.

We also worked to level the playing field with China's favored SOEs, which have benefited from preferential policies across a range of industries. At the S&ED, China committed to ensure credit provision, taxation incentives, and regulatory policies are applied on nondiscriminatory terms across enterprises of all types. China also announced it will encourage higher dividend payouts by all listed companies, including SOEs, and that the dividends paid by listed SOEs be in line with other publicly listed companies. During the years when China's imbalances ballooned, the high profits retained by state-owned enterprises were a major contributor to those imbalances, acting as a drag on consumption and a competitive impediment. As these savings are unlocked, it will both reduce a competitive advantage and potentially unlock a new source of funding to boost social spending.

Following its commitment from last year's S&ED, China issued measures instructing that departmental rules and administrative regulations should be posted for public comment on an official government website for a period of no less than thirty days, except under special circumstances. This will give interested parties, including U.S. firms, an opportunity to comment on rules and regulations that affect their business.

Working through USTR and USPTO, we also continued to press for robust protection and measurable enforcement of intellectual property rights in sectors such as software, and for strong enforcement against trade secret misappropriation. And we reinforced the importance of China honoring its commitments not to require technology transfer as a condition of market access. China also agreed to treat IPR owned or developed in other countries the same as IPR owned or developed in China, which will help to ensure that as China becomes a more innovative economy, its policies do not discriminate against U.S. firms. And China committed to submit a

revised comprehensive offer this year to join the WTO Agreement on Government Procurement (GPA) that is responsive to the requests of the United States and other GPA parties. Specifically, on investment, China committed to open up new sectors to foreign investment.
These are tangible, significant gains that will benefit the United States. But they are not enough. Going forward, the Administration is committed to working closely with Congress to foster a more balanced economic relationship with China that maximizes the benefits of this relationship for the American people.

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House Committee on Financial Services

Subcommittee on International Monetary Policy and Trade

Hearing on

Increasing Market Access for U.S. Financial Firms in China:

Update on Progress of the Strategic & Economic Dialogue

May 16, 2012

China has partially liberalized foreign access to its domestic financial services industry, including banking, insurance, securities, and asset management, since its accession to the World Trade Organization (WTO) in 2001. Nonetheless US and other foreign firms have been disappointed that they have not been able to expand their financial service business activities in China more rapidly. This disappointment in my judgment stems from three factors. First, in the bilateral negotiations for China's entry into the WTO the United States did not press very hard for market opening in financial services. China, by and large, has complied with its WTO commitments in banking, insurance, securities, and asset management but foreign firms have gained only a marginal presence in China's domestic financial services market. Second, both US and Chinese negotiators are constrained in their ability to make reciprocal concessions so further market opening measures flowing from the U.S.-China Strategic & Economic Dialogue and its predecessor, the U.S.-China Strategic Economic Dialogue, has been painfully slow. Third, the US argument that China would benefit from further unilateral opening of its market to US and other foreign financial services firms is far less compelling today than it was prior to 2008.

Banking

Prior to China's entry into the WTO, China's central bank limited the number of cities in which foreign banks could operate and severely restricted the ability of foreign banks to provide local currency services. Foreign branch banks were permitted to operate in China as early as 1981, shortly after economic reforms began. But these institutions effectively were limited to providing foreign currency banking services to foreign-invested companies, foreign embassies, and individual foreign citizens. In the late 1990s foreign banks operating in Pudong and in Shenzhen were allowed to conduct domestic currency business, but this liberalization was subject to a number of constraints. The result was that domestic currency lending by foreign banks at the end of 1999 accounted for only 0.07 percent of the volume of domestic currency credit extended by domestic Chinese financial institutions.[1]

Under the terms of China's entry into the WTO most of these restrictions were eased or eliminated. Geographic restrictions on where foreign banks can operate were lifted by 2005 as were numerical limits on the number of foreign banks operating in China. By 2006 foreign banks were subject to national treatment, meaning that they could offer the same range of domestic currency services to domestic firms and individuals as domestic banks.

As a result of China's implementation of its WTO commitments, the number of foreign banking institutions operating in China grew significantly from 177 in 1999, on the eve of China's entry into the WTO, to 387 institutions by the end of 2011.[2] But as, shown in table 1, the foreign bank share of the total assets of China's banking system, which was 1.5 percent in 1999, has grown extremely slowly, reaching only 2.0 percent by the end of 2011.

Table 1: Foreign Bank Presence in China

		Foreign Bank Assets	
	Number of Institutions	Amount	Percent of Total Banking System
Unit	Number	RMB Bn	Percent
1999	177	263	1.53
2000	191	285	1.70
2001	190	373	2.10
2002	180	324	1.50
2003	192	416	1.50
2004	188	582	1.84
2005	207	716	1.91
2006	224	928	2.11
2007	274	1,253	2.38
2008	311	1,345	2.16
2009	338	1,349	1.71
2010	360	1,742	1.85
2011	387	2,154	1.93

The limited role of foreign financial institutions in China is the result of several factors. First, most foreign banks operating in China have limited aspirations, focusing primarily on investment and corporate banking. Only a handful of foreign banks aspire to develop a substantial branch network that

[1] Nicholas R. Lardy, *Integrating China into the Global Economy* (Brookings Institution Press, 2002), p. 70

[2] The total at year-end 2011 includes 94 foreign branch banks and 37 locally incorporated banks with 245 branches.

would allow them to compete in the retail banking market. HSBC, for example, has opened about 110 branches and sub-branches. Bank of East Asia, its nearest foreign competitor, has more than 90 banking offices.

Second, regulatory changes initiated since China joined the WTO have increased the cost to foreign banks of providing domestic currency services. Originally, virtually all foreign banks operated in China as branches, meaning that there was no requirement for separate capital to support their operations in China. But beginning in 2006 China began to require foreign banks that wished to offer domestic currency services to incorporate as subsidiaries, meaning that the parent bank had to supply capital to the subsidiary to support its lending and other banking services. Requiring foreign banks to operate as subsidiaries rather than branches is a common practice in both emerging markets and in developed economies. But the new requirement increased the cost of doing business in China, thus reducing foreign bank profits.

Third, there are still a number of administrative hurdles to create a subsidiary bank in China. A bank must operate a representative office for three years before applying for a banking license. Once a license is granted and a subsidiary created, it must operate for three years before it can apply for a license to provide full domestic currency services, and the operation must have been profitable for two consecutive years. Nonetheless banks that are pursuing a retail strategy and seek to expand their geographic footprint have been able to open a significant number of branches. This group includes not only HSBC and Bank of East Asia but also Standard Chartered Bank, Hang Seng Bank, Citibank, and DBS Bank.

The fourth factor limiting the expansion of foreign banks in China is price controls. In banking the key prices are interest rates, and in China the central bank sets benchmark interest rates for both deposits and loans for a variety of tenors. While the central bank has increased the flexibility that banks have to set deposit and lending rates above and below these benchmark rates, there remains a fixed upper limit on deposit rates and a lower limit on lending rates. These limits restrict the ability of foreign banks to exercise their presumably better capability to assess the creditworthiness of potential borrowers. In a liberalized interest rate environment foreign banks presumably would be able to offer lower rates to better borrowers. This, in turn, would allow them to offer higher rates to depositors than their domestic competitors. Less efficient domestic banks would have to devote a larger share of their interest income to the writing off of non-performing loans made to poor credit risks and thus would not be able to offer competitive interest rates to depositors. Thus in a liberalized interest rate environment foreign banks would be able to attract a growing volume of deposits that they could use to fund an expanding loan portfolio and thereby increase their market share at the expense of domestic banks. But existing interest rate controls limit the ability of foreign banks to take advantage of their superior risk pricing ability and thus foreign banks have not been able to significantly expand their market share over the past decade.

Insurance

Prior to accession to the WTO, China also severely limited the access of foreign firms to the domestic insurance market. The first license to a foreign insurance company was granted in 1992 but it was only for a single line of business, life insurance, and limited to a single city, Shanghai. By the end of the decade China had licensed only a handful of foreign companies to sell a limited range of insurance products in only three cities. As a result, in 1999 foreign insurance companies accounted for less than two percent of all insurance company assets and only 1.3 percent of all insurance premium income.[3]

Under the terms of its accession to the WTO China was required to gradually phase out many of these restrictions. For example, all geographic restrictions on the operation of foreign insurance companies were lifted by 2005. However, China retained the right to limit foreign participation in the life insurance industry to joint ventures and caps the foreign ownership share at 50 percent. The China Insurance Regulatory Commission continues to subject new branch applications to a lengthy review process and refuses to consider multiple branch applications at the same time, limiting the ability of foreign firms to expand geographically within China.

Foreign insurance firms were able to grow their share of the life insurance market after China's accession to the WTO, reaching a peak of 8.9 percent in 2005. By 2010, however, this share had fallen to 5.6 percent, only slightly ahead of their share prior to China's WTO accession. The foreign share of the property and casualty market also rose slightly in the mid-2000s but by 2010 had fallen to 1.1 percent, strikingly below their share prior to China's entry into the WTO.[4] This presumably is because until February 2012 China has not allowed foreign firms to enter the Mandatory Third-Party Liability auto insurance business. Since China's car market has surpassed in size that of the United States, auto insurance now accounts for more than two-thirds of the property and casualty insurance market. Thus foreign firms were excluded from an increasingly important segment of the insurance market.

Securities and fund management

Prior to China's entry into the WTO, foreign participation in China's securities market was limited to a single joint venture in which an American firm held a 37.5 percent interest. China's WTO commitments opened the securities and fund management sectors to foreign firms only marginally. Most important participation in the Chinese market was restricted to the form of joint ventures, limited to 33 percent and 49 percent in the case of securities and fund management firms, respectively. The Chinese government, in the most recent Strategic & Economic Dialogue, agreed to raise the foreign ownership cap in securities firms to 49 percent, and more importantly, to reduce the waiting time before these firms can apply for licenses with a broader business scope. It remains to be seen whether these steps will be sufficient to erode the dominance of the securities market in China by indigenous firms.

[3] Nicholas R. Lardy, *Integrating China into the Global Economy*, p. 71.
[4] American Chamber of Commerce in China, *2011 White Paper*, p. 107.

Statement of the Honorable Clay Lowery
Vice President
Rock Creek Global Advisors LLC

Before the U.S. House Subcommittee on
International Monetary Policy and Trade
May 16, 2012

Chairman Miller, Ranking Member McCarthy, and Members of the Subcommittee, I thank you for the opportunity to testify on increasing market access for U.S. financial firms in China.

I am here as a Vice President of Rock Creek Global Advisors, a consulting firm that advises its clients on international economic and financial policy matters. I am also a former Assistant Secretary of International Affairs for the Treasury Department who was deeply involved in negotiating financial service liberalization and macroeconomic issues with China during the Strategic Economic Dialogue – SED -- headed by former Secretary of Treasury Hank Paulson.

It is an honor to share the table with Rob Nichols and David Strongin who represent some of our key financial institutions as well as Nicolas Lardy -- a genuine expert on China's economy. It is also an honor to follow Under Secretary Lael Brainard, who leads Treasury on these issues and many other important matters.

Given the expertise of these individuals, I thought my value to this subcommittee would be to address financial liberalization from the viewpoint of someone who led negotiations on the subject as a government official, but no longer represents the government.

In my experience working with Chinese financial officials, China makes changes when it believes it is in China's interest, which might come as little surprise. I do not mean to diminish the impact of external pressure, but that pressure is mitigated by China's size, the unprecedented speed of its economic growth over 30 years, and its ability to attract investors from around the world. I believe these factors embolden Chinese officials to act with a sense of pride and confidence that they know the correct pace of change, even when officials in Washington, London, Brasilia, and Tokyo think otherwise.

In my testimony, I will explain that the time is right to increase market access because it is what China wants. I will give examples of recent market opening measures and conclude by making a few suggestions of what Congress can do to help.

Time is Right

The time is right to further open China's market to foreign financial firms because such liberalization is an essential part of China's broader effort to rebalance its economy. I believe that rebalancing China's economy will prove beneficial to the people of China and more importantly, in my opinion, to the people of the United States.

For a few years, various observers have noted that China's export-led, resource-intensive, production-heavy growth model could not last forever. Two major questions were asked: one, when is the turning point at which China needs to transform its economy and two, can China accomplish the transformation given the unique challenges posed by rebalancing an economy of China's size.

With regard to the first question, the timing of this hearing is excellent -- and not just because it follows on the heels of the Strategic &Economic Dialogue. China appears to be on the verge of significant transformations. As we all know, China's leadership is scheduled to change over the next 10 months or so. The new leaders who will take charge after the political transition will be responsible for taking China through what I believe is an even more important transition: vital changes to its economy made necessary by the long-term unsustainability of the Chinese economic model and changes to the underlying fundamentals of China's place in the world economy.

If the time for transformation is now, what does that transformation require? And is it even possible? In short, rebalancing China's economy means moving toward one that is driven by consumption, implying an increase in household incomes, a stronger social safety net to avoid excess savings, a more market-oriented exchange rate to diversify the factors of production, and a more liberalized services sector -- particularly financial services to allow for more competition and greater capital productivity.

The challenges to such change are significant and cannot be underestimated: entrenched interests – whether state-owned enterprises that enjoy subsidies or even private-sector firms with strong political ties; companies that don't want to compete; potentially captured regulatory entities; or just pure politics and inertia at local levels—will work to maintain the status quo.

While the jury is out whether China can make this transition, the last 30 years suggests that China does sometime use external pressure to take liberalizing steps. Therefore, I see the S&ED as an opportunity for the United States to provide input and maybe even influence on these challenges. It has aspects of a trade negotiation but is more about creating a dialogue to make progress on macroeconomic, regulatory, and even social economic issues.

Making Progress but More To Do

The difference between 2007/08 when I was working on these issues in government and today is that U.S. officials and observers are not the only ones emphasizing that China is bumping up against the limits of its existing growth model and the importance of rebalancing its economy. As the letter from many members of this committee to President Obama points out, Chinese leadership and respected organizations like the World Bank have joined the chorus, and, perhaps most importantly, change is actually starting to happen.

In many ways, financial sector development is the key to China's transition to an economy in which capital is deployed more efficiently and risk is more appropriately priced, managed and diversified. The current system, however, is influenced heavily by the state, capital markets are woefully underdeveloped, and households suffer from a form of financial repression due to deposit rate caps. This leaves small and medium-sized enterprises with little access to capital, makes entrepreneurship and innovation too expensive, stifles consumption, and leads to a banking system with growing non performing loans and an insurance system with poor risk management techniques.

As is well recognized, financial sector development depends on various factors but a key one is opening the market to global competition. World-class financial institutions introduce diversity, enhance training, improve market practices, strengthen risk management, and enhance financial stability. And it is clear that U.S. firms are some of the best in the world to assist in all these areas.

Let me take a couple of examples of progress that is being made:

Chinese drivers are required by law to have auto insurance, but foreign insurance companies have only been allowed to write voluntary coverage. So despite having one of the largest auto insurance markets in the world, the penetration rate for foreign institutions in the non-life insurance market in China is almost *de minimis*. As wealth has grown in China, consumers have continued to buy more and more cars. However, lack of competition, poor risk management techniques, and cumbersome claims processes have left Chinese consumers vulnerable. In other words, it is becoming in China's interest to allow foreign companies that have decades of experience weathering volatile economic climates while maximizing consumer benefits and maintaining high levels of solvency to compete and offer their services.

And in the recent S&ED, we saw that China reiterated its commitment to lift its prohibitions on foreign competition in the mandatory auto insurance market. This should prove good for U.S. insurance firms, China's drivers and consumers of automobiles, and potentially U.S. automobile exporters. This step, however, is only one in greater market access in the insurance market – just as Rob and David have pointed out important but insufficient liberalization steps in the banking and securities industry areas.

Another important market access measure is the recent U.S.-China decision to resume negotiations of a Bilateral Investment Treaty (BIT). In essence, a BIT with China would provide U.S. companies with equal regulatory treatment as their local Chinese competitors, whether state-owned or private, and other foreign companies, both in terms of market access – the "establishment" of an investment -- and throughout the life of the investment. For China, the legal protections afforded by a BIT could help attract U.S. investors and address China's misperceptions that the U.S. does not welcome Chinese investment.

For the United States, enhancing the ability of American companies to invest in the Chinese market will create, not destroy, jobs in America. Academic research has repeatedly found that expansion abroad by affiliates of U.S. multinationals tends to support their American-parent jobs, not destroy them. This is especially true when companies establish affiliates to serve new customers—long the primary goal of many U.S. multinationals in China.

Suggestions for Congress

I wanted to conclude my testimony by respectfully suggesting areas for Congress to play a role.

This committee should bring the same intensity and oversight to pushing for strong deliverables at the S&ED and in BIT negotiations as Members of Congress have shown on exchange rate issues. Putting pressure on the Executive Branch to continue to work with the financial services industry to push for market access, to work with China to regulate in a fair and transparent manner, and to assist China on building out its capital markets.

If China breaks the rules, then by all means, this committee and the Administration should hold them accountable and enforce the rules. But we should also be open to working with China, engaging in vigorous, but productive, discussion with them and finding solutions that are clearly in the interest of both countries.

This hearing is taking place as our trade negotiators are in Dallas negotiating the Trans-Pacific Partnership (TPP) with 8 nations of the Asia-Pacific region. My view is that TPP is very positive for the U.S. – if successfully negotiated, it could provide greater market access for our firms, products and services, as well as new disciplines on state-owned enterprises. Moreover, it will truly help our competitiveness in the region, which I believe would place even more pressure on China to rebalance its economy and allow for greater market access.

As in the Korea Free Trade Agreement, financial service liberalization should be an area for the U.S. negotiators to emphasize – our firms are highly sophisticated, competitive, and can assist both directly and indirectly in creating jobs here. This is in our interest and it is the expertise and jurisdiction of this committee.

Let me finish by criticizing myself. When Secretary Paulson internally proposed the SED concept in 2006 as a way to create an ongoing process that could help both nations address long-term structural issues, while at the same time seek near-term results to build confidence on both sides, I admit that I was skeptical. He was the boss, of course, and I would do my best to execute. But Secretary Paulson was correct, having an S&ED provides an opportunity for the U.S. and China to have …what I (and I promise you, not Secretary Paulson) would euphemistically call a better chance at an "adult relationship," instead of being children in the sand box throwing sand at each other and not figuring out how to achieve common desires.

The S&ED process allows for the pursuit of a more mature and mutually beneficial relationship and Presidents Bush and Obama have demonstrated that the process is important to make progress—albeit slower than we would want—for opening market access for U.S. firms, improving China's overall economic balance, and eventually helping the United States by strengthening ties with an important export market.

Thank you and I'm happy to field any questions.

Statement of the Honorable Robert S. Nichols
Chairman
Engage China Coalition
and
President and Chief Executive Officer
The Financial Services Forum

Testimony Before the
International Monetary Policy and Trade Subcommittee
of the
House Financial Services Committee
May 16, 2012

Introduction

Chairman Miller, and Ranking Member McCarthy, thank you for the opportunity to participate in this important hearing regarding the need to expand access to China's financial sector for U.S. institutions.

I am here as the chairman of Engage China – a coalition of 12 financial services trade associations united in support of high-level engagement between the United States and China, with a particular emphasis on accelerated financial reform and modernization in China.

I also serve as President and Chief Executive Officer of the Financial Services Forum, a financial and economic policy group comprised of 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.

Today's hearing is both timely, given the recent round of the Strategic & Economic Dialogue in Beijing, and enormously important. The rate of China's economic emergence and the impact of its integration into the global economy are unprecedented in the history of the world's economy – with profound implications for U.S. economic growth and job creation.

Importance of Growing China to U.S. Growth and Job Creation

As you will recall, China's economy has grown at an annual rate of nearly 10 percent for more than two decades. The world's 7th largest economy in 1999, China recently surpassed Japan to become the world's 2nd largest economy.

Since China's joined the World Trade Organization (WTO) in December of 2001, U.S. exports to China have increased more than six-fold – growing at seven times the pace of U.S. exports to the rest of the world. China is now America's third largest export market, and the largest market for U.S. products outside of North America. According to a recent *Washington*

Post article, exports to China from almost every U.S. state and Congressional district have grown exponentially in recent years.[1] Clearly, fair and competitive access to China's fast-growing middle class and business sector represents an enormous commercial opportunity for American manufacturers, services providers, and farmers.

Let me give you a quick sense of what an expanding China can mean for U.S. economic growth and job creation. Last year, U.S. exports to Japan totaled $66 billion, while U.S. exports to China totaled $104 billion. But China's population is *ten times* Japan's. If China's citizens were to eventually consume American-made goods and services *at the same rate* as the Japanese do, U.S. exports to China would grow to about $700 billion annually.

That's seven times what America exported to China last year, an amount equivalent to nearly 5 percent of U.S. GDP and nearly twice what we imported from China last year – turning a $300 billion trade deficit into a $300 billion surplus.

Perhaps more importantly, if we apply the Commerce Department's metric of 5,000 new American jobs for every $1 billion in additional exports, increasing exports to China to $700 billion a year would create 3 million new American jobs. Now, that won't happen overnight. But we believe that with the right reforms in place, it will happen over time.

Critical Importance of Financial Sector Reform in China

In our view, one of the most fundamental and important reforms necessary for the United States to harness the job creation power of a rapidly growing China is modernization of China's underdeveloped financial system.

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 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.

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[1] "U.S. Exports to China Boom, Despite Trade Tensions," Keith B. Richburg, *The Washington Post*, March 11, 2012.

Unfortunately, the world's second largest and fastest growing economy is currently supported by one of the world's least developed and inefficient financial systems. Like a world-class athlete with cardiovascular disease, China runs an ever-mounting risk of catastrophic breakdown even as it continues to turn in robust economic growth performances.

China's financial sector challenges are many. For example:

- China's financial system is very bank-centric, with banks intermediating more than three-quarters of the economy's total capital, compared to about half in other emerging economies and less than 20 percent in developed economies.
- Meanwhile, China's equity and bond markets remain comparatively small and underdeveloped. 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.
- Non-commercial lending – or "policy lending" – to state-owned enterprises continues.
- As a result, the stock of nonperforming loans on banks' balance sheets remains high.
- China's 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 remains opaque, is applied inconsistently, and lags behind international best practices.

Simply stated, China's underdeveloped financial sector presents substantial risk to the continued growth and diversification of the Chinese economy – and, therefore, to the U.S. and global economies as well.[2]

China's Commitment to Financial Reform

In its 12th Five-Year Plan, approved by the National People's Congress last March, China's leadership acknowledged that its manufacturing-for-export economic model of the past three decades has left it vulnerable to slow-downs in external demand. China's leadership now wisely seeks a more balanced economic model that relies less on exports and more on internal demand – primarily, a more active Chinese consumer.

[2] See "Why Financial Reform is Crucial for China's Growth," Arthur R. Kroeber, The Brookings Institution, March 19, 2012

A more consumption-based Chinese economy is very much in the interest of the United States. As I noted earlier, a more active Chinese consumer will dramatically expand demand for U.S.-made products and services.

But accelerating the shift to a more consumption-based Chinese economy requires a more modern and sophisticated financial sector. Chinese households currently save as much as half 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 services, and retirement security products – that will eliminate the need for such "precautionary savings" and facilitate consumption.

This observation was recently confirmed by a report entitled "China 2030," jointly issued on February 27th by the World Bank and China's Development Research Center. The report emphasized that achieving China's macroeconomic goal requires a number of urgent reforms, including "commercializing the banking system, gradually allowing interest rates to be set by market forces, deepening the capital market, and developing the legal and supervisory infrastructure to ensure financial stability and build the credible foundations for the internationalization of China's financial sector."[3]

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.

Fortunately, China's leadership recognizes the connection between faster financial reform and a more consumption-based economy. In a March 5th speech opening the National People's Congress, Premier Wen Jiabao confirmed that China seeks more balanced and sustainable development, stating "we will move faster to set up a permanent mechanism for boosting consumption." Importantly, as part of the restructuring strategy, Wen also appeared to endorse further reform of China's financial system, stating: "We will improve both initial public offerings…and ensure better protection of return on investors' money and their rights and interests."[4]

The same day, Guo Shuqing, Chairman of the China Securities Regulatory Commission commented to reporters: "Market risk is concentrated in the banking system. Developing equity financing…can reduce the burden on the government, and open new investment channels to funds and wealthy citizens."

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[3] "New Push for Reform in China," Bob Davis, *The Wall Street Journal*, February 23, 2012.

[4] "China Premier Backs Blueprint for Financial Reform," Dinny McMahon, *The Wall Street Journal*, March 5, 2012.

On March 21st, Zhou Xiaochuan, Governor of the People's Bank of China, wrote in China Finance magazine: "Currently conditions for market-oriented interest rate liberalization are basically ripe. The People's Bank of China will actively push forward [with such reforms]."[5]

The fastest way for any developing economy to acquire the modern financial sector it needs is to import it – that is, to allow foreign financial institutions to establish in-country operations though the establishment of branches and subsidiaries, joint ventures with domestic institutions, and cross-border mergers and acquisitions. Foreign institutions bring to China world-class expertise and best practices with regard to products and services, credit analysis, risk management, internal controls, and corporate governance.

The U.S.-China Strategic & Economic Dialogue

To enhance the management of the growing bilateral relationship, President George W. Bush and President Hu Jintao established the U.S.-China Strategic Economic Dialogue (SED) in September of 2006. The SED -- led by then-Treasury Secretary Hank Paulson and Chinese Vice Premier Wang Qishan – created an unprecedented channel of communication between Cabinet-level U.S. and Chinese policymakers, and provided an overarching framework for the examination of long-term strategic issues, as well as coordination of ongoing bilateral policy discussions (e.g., the Joint Commission on Commerce and Trade, the Joint Economic Committee). A central focus of the SED was acceleration of financial reform in China.

Upon taking office, the Obama Administration renamed the Dialogue as the "Strategic & Economic Dialogue," broadening the talks to include other issues such as human rights, environmental issues, and diplomatic cooperation.

Limited but significant progress has been made by way of the Dialogue:

- China has agreed to allow qualified foreign companies to list on its stock exchanges by issuing shares or depository receipts;
- China has expanded its Qualified Foreign Institutional Investor (QFII) program and reduced the initial "lock-up period" for certain investors, creating new opportunities for foreign mutual funds and money managers to invest in China;
- China has agreed to allow non-deposit taking foreign financial institutions to provide consumer financing;
- China has agreed to ease qualifications for foreign banks to issue yuan-denominated subordinated bonds, which will allow foreign banks to raise capital in China;
- China has issued regulations specifying requirements to allow insurance companies -- including foreign-owned companies – to invest assets overseas; and,

[5] "Conditions Ripe for China Interest Rate Reform – Central bank Chief Zhou," Kevin Yao, *Reuters*, March 21, 2012.

- Since July of 2005, the yuan has appreciated against the U.S. dollar by more than 25 percent in nominal terms and almost 40 percent in real terms. China also recently announced that it would widen its trading band to allow market forces to play a greater role in setting the exchange rate.[6]

Additional progress was achieved at the most recent S&ED meetings in May:

- China now has amended its regulations to implement last year's S&ED commitment to allow U.S. and other foreign insurance companies to sell mandatory auto liability insurance in what is the world's largest market for automobiles.

- China committed that foreign and domestic auto financing companies – currently dependent on China's state-owned banks for funding – will be able to issue bonds regularly, including issuing securitized bonds. This will help boost the competitive edge in China of U.S. auto firms, which are global leaders in auto financing.

- China committed to increase the total dollar amount that foreigners can invest in China's stock and bond markets under its Qualified Foreign Institutional Investor (QFII) program from $30 to $80 billion. This will reduce restrictions on the free flow of capital and increase opportunities for U.S. pension and mutual funds and other investment management firms.

- China committed to allow foreign investors to take up to 49 percent equity stakes in domestic securities joint ventures, going beyond China's WTO commitment of 33 percent. China also agreed to shorten the waiting period ("seasoning period") for securities joint ventures to apply to expand into brokerage, fund management, and trading activities that are essential to building competitive securities businesses.

- China agreed to allow investors from the U.S. and other economies to establish joint venture brokerages to trade commodity and financial futures and hold up to 49 percent of the equity in those joint ventures; and,

- China reaffirmed its intention to promote more market-based interest rates, which will allow Chinese households to earn a higher return on their savings, supporting greater household consumption.

U.S. Institutions Still Confront Major Restrictions

Despite such important progress, U.S. financial institutions continue to face a number of substantial obstacles in China:

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[6] "The Outlook for China's Currency," Laura D'Andrea Tyson, *The New York Times*, May 6, 2011. Also see "China Bashing is Popular But Could Do More Harm Than Good," Editorial, *Bloomberg*, April 25, 2012.

- Investment by U.S. firms in Chinese financial institutions is limited to minority interests and is capped. For example, foreign investment in Chinese banks remains limited to 20 percent ownership stakes, with total foreign investment limited to 25 percent. Foreign ownership currently amounts to less than 2 percent of the Chinese banking system. According to Treasury Department data, as of December 2011, only eight U.S. banks were operating in China with a total of just 76 branches.

  Foreign-owned securities and asset management firms are limited to joint-ventures in which foreign ownership is capped at 49 percent. Meanwhile, foreign life insurance companies remain limited to 50 percent ownership in joint ventures and 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. More 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.

  Such investment caps also stand in stark contrast to last week's decision by the Federal Reserve to approve Industrial & Commercial Bank of China's acquisition of the Bank of East Asia's U.S. banking subsidiary,[7] the Bank of China's application to expand its U.S. operations to Chicago[8], and the application by Agricultural Bank of China Ltd. to establish a branch in New York.[9]

  As strong proponents of cross-border trade and investment, the U.S. financial services industry applauds the Fed's decision – but also calls on China to lift remaining restrictions to U.S. investment in China's financial system.

Other barriers to U.S. activity in China include:

- Non-prudential restrictions on licensing and corporate form;

- Arbitrary imitations of permitted products and services; and,

- Arbitrary and discriminatory regulatory treatment.

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[7] The subsidiary has assets of $780 million and 13 branches in New York and California. ICBC, China's largest bank, already operates in the United States through a New York branch. Under the terms of the approval, ICBC, China Investment Corp. and Central Huijin Investment Ltd. will become bank holding companies. The Chinese government owns 70.7 percent of ICBC's shares. See "Fed Allows Three Chinese Banks to Expand in U.S.," Greg Robb, *MarketWatch*, May 9, 2012.

[8] The Bank of China, China's third largest bank, currently operates two branches in New York City and a limited branch in Los Angeles.

[9] Agbank, China's fourth largest bank, currently operates a representative office in New York City.

While China may be compliant with the letter of its WTO obligations, such restrictions and regulations – and the manner in which they are enforced – violate the spirit of China's WTO obligations by creating artificial and arbitrary barriers to greater foreign participation.

With these problems in mind, U.S. effort within the S&ED and other bilateral exchanges should focus on:

- the critical importance of open commercial banking, securities, insurance, pension, and asset management markets to promoting the services- and 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;

- non-discriminatory national treatment with regard to licensing, corporate form, and permitted products and services;

- non-discriminatory national treatment with regard to regulation and supervision;

- regulatory and procedural transparency; and,

- increasing institutional investors' participation in China's capital markets by further expanding the Qualified Foreign Institutional Investor (QFII) and Qualified Domestic Institutional Investor (QDII) programs.

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

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 open its financial sector to greater participation by foreign financial services firms.

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-made 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.

Statement for the Record
by
David Strongin
Managing Director
Securities Industry and Financial Markets Association

Before the
House Financial Services Subcommittee on
International Monetary Policy and Trade

Hearing on
"Increasing Market Access for U.S. Financial Firms in China: Update on Progress of the Strategic & Economic Dialogue"

May 16, 2012

Chairman Miller, Ranking Member McCarthy, and Members of the Subcommittee, I thank you for the opportunity to testify today on behalf of the Securities Industry and Financial Markets Association (SIFMA) on the importance of improved market access opportunities for financial services firms operating in China.[1] With the conclusion of the most recent Strategic and Economic Dialogue (S&ED), this hearing is especially timely and provides us with an opportunity to assess the progress made in recent years as well as areas that need continued attention and reform.

Our testimony will review the industry's priorities that we believe are necessary to allow our firms to compete on a level playing field, assess the significance of commitments made at the most recent S&EDs, and discuss the growth and global expansion of China's largest financial services firms and the implications for creating a level playing field.

We would also like to take this opportunity to reiterate our support for the S&ED and the efforts of Treasury Secretary Geithner, Under Secretary Brainard and their Treasury colleagues, Ambassador Locke, and the Administration. This year's S&ED yielded commitments from which to build from, including raising equity ownership on securities joint ventures from 33 percent to 49 percent, reducing the "seasoning period" from five years to two, increasing

[1] The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

Qualified Foreign Institutional Investor (QFII) quotas to $80 billion, and calling for renewed dialogue on a bilateral investment treaty (BIT).

We believe the S&ED remains the primary forum in which to discuss financial services issues on a bilateral basis and feel ongoing dialogue and engagement is vital for pushing forward further liberalization of China's financial markets.

SIFMA has long supported more open, fair and transparent markets, and liberalization of the national treatment of financial services in U.S. multilateral and bilateral trade forums. The economic benefits of financial services sector liberalization reverberate throughout the world in the form of higher growth, foreign investment and capital formation. Specifically, such 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.

Industry Priorities

Despite recent progress towards increasing ownership stakes in securities joint ventures, full market access and national treatment for financial services firms in China remains an industry priority. While U.S. firms operating in China continue to face equity ownership restrictions, Chinese securities firms seeking to operate in the United States are able to enter without restriction on a nondiscriminatory and national treatment basis if they meet regulatory requirements. U.S. firms seeking to enter China continue to face discriminatory entry criteria and do not receive national treatment.

SIFMA has identified five key and inter-connected industry priorities to help ensure a more level playing field for our members currently in China.

- *Permit 100% ownership and right to establish in corporate form of choice*
  Establishing and developing relationships are essential to providing financial services. While the U.S. is the global leader in the export of financial services, a business presence in the host country is often the best, or indeed the only, effective way for firms to provide their products and services competitively. Furthermore, given that most countries do not permit the cross-border provision of financial services and products, the right to establish takes on particular importance. The right to enter a market and establish a 100 percent owned presence in a firm's corporate form of choice is commonplace in today's global markets.

- *Allow 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. Additionally, 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.

- *Further develop QFII/QDII programs*
  Enacted in December of 2002, the Qualified Foreign Institutional Investor (QFII) Act permits qualified foreign institutional investors to invest in the securities of Chinese companies. Since the start of the Strategic & Economic Dialogue (SED) commitments, China has raised the quota for QFIIs from $10 billion to $80 billion and agreed to reduce the initial "lock-up" period for investments of certain QFIIs from one year to three months.[2] QFII requirements remain onerous with the effect of substantially limiting the utility of the program as well as the universe of investors that can take advantage of it.

  China's Qualified Domestic Institutional Investor (QDII) program, initiated in May of 2006, allows approved financial institutions in China to make overseas portfolio investments in foreign currencies, both for themselves and on behalf of clients. The program has been slow to gather momentum, due to limited knowledge of the program, a lack of understanding on the part of potential investors regarding overseas investing, and comparatively low returns associated with the original permitted investments.

- *Improve bond market depth/liquidity/efficiency*
  China is striving to expand its domestic bond and capital markets on a par with global leaders. Great strides and significant progress has been made toward the goals of modernization and the attainment of global best practices. However, China's advancement continues to be hindered by discriminatory rules and policies which disadvantage foreign banks, especially with respect to bond underwriting and derivatives trading. In addition, if China's sometimes opaque regulatory system is not reformed it will seriously impede the future development of the financial markets.

[2] Since the inception of the QFII program in 2002, China has raised the quota from $10 billion to $80 billion.

- *Promote regulatory transparency*
  Transparent and fair regulatory systems play 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. Lack of transparency in the implementation of laws and regulations can seriously impede the ability of securities firms to compete fairly. On the other hand, transparency instills the confidence needed to attract both the suppliers and users of capital to make the best use of the markets. Securities firms are often confronted with non-tariff barriers in the form of regulatory restrictions, and lack of transparency in the implementation and application of regulations. These barriers prevent access in much the same way as tariffs, but unlike tariffs, no quantitative mechanism exists to reduce them.

Recent S&ED Commitments and Results

We believe the S&ED plays a key role in advancing the U.S.-China economic relationship. The S&ED provides the best forum for constructive, high-level engagement on priority issues, including financial services market access. Since the SED was established in 2006, our priorities have not waivered. SIFMA has consistently urged both the Bush and Obama Administrations 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.

Timing is critical. While the U.S. continues to advocate for improved market access and the reduction of regulatory barriers, China has increased its global profile considerably. China's financial institutions are more globally active, and Chinese authorities are full participants in the G20, the Financial Stability Board, and the International Organization of Securities Commission's (IOSCO) Technical Committee. As China assumes a greater leadership role in international institutions, it necessitates a responsibility to reduce restrictions and eliminate discriminatory barriers in order to meet these global commitments and responsibilities. However, metrics developed by the World Bank and Organization for Economic Cooperation and Development (OECD) rank China as one of the most restrictive markets for financial services in the G20. Indeed, China's policies related to inward investment in financial services are more restrictive than other BRIC nations by a significant margin.

As we stated previously, this year's S&ED yielded commitments from China to allow our member companies an increased opportunity to conduct business in China on a more level playing field. We would like to briefly highlight the most notable outcomes from the dialogue.

- *Increased equity caps from 33 percent to 49 percent for securities JVs*
  The S&ED commitments allow non-Chinese financial services firms to hold up to a 49 percent equity stake in securities joint ventures. China also agreed to allow investors from the U.S. and other economies to establish joint venture brokerages

to trade commodity and financial futures and hold up to 49 percent of the equity in those joint ventures.

How this commitment is implemented is key. Despite this progress, we remain concerned that some incoming joint ventures will remain at a competitive disadvantage relative to existing participants. We are also concerned by the absence of or non-transparent actions taken by the China Securities Regulatory Commission (CSRC) in enforcement in this regard.

Importantly, the development of securities joint ventures will rely in part on the integrity of a rule of law. Until the current risks associated with a regulatory regime and/or existing dispute resolution systems are mitigated or remediated, the foreign parties may be at a disadvantage as compared to domestic participants.

Recommendation: China should put in place a precise and transparent roadmap, on an agreed upon timetable, that would result in providing foreign securities firms with the right to own 100 percent of a Chinese financial services firm and the ability to engage in a full range of securities activities.

- *Reduction of the "seasoning period" to 2 years*
  The Chinese agreed to allow qualified securities joint ventures which have been in on-going operation for no less than two years to apply to expand into brokerage, fund management, and trading activities that are essential to building competitive securities businesses. This period was reduced from five years.

  Recommendation: While we appreciate the reduction in the seasoning period, we believe it should be eliminated entirely. Continuing to tightly regulate the expansion and activity of joint ventures impedes the capability and operations of financial services institutions operating in China.

- *Increased QFII quotas*
  China agreed to increase the total quota for Qualified Foreign Institutional Investors (QFII) to $80 billion from $30 billion.[3]

  Recommendation: While we welcome this step, QFII quotas should be lifted completely to allow for the free flow of capital to and from Chinese capital markets. Continued, 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, adding to the depth and breadth

[3] This number reflects only the 2012 S&ED commitment to raise QFII quota restrictions.

of trading in those markets and result in increased capital available to Chinese issuers.

- *Commitment to continue BIT discussions*
  The United States and China commit to schedule a seventh and subsequent BIT negotiating round, and to intensify negotiations.

  Recommendation: Develop a high standard and commercially meaningful U.S.-China BIT which would improve access to China's market and reduce and eliminate measures that either discriminate against U.S. investors or deny them market access. A high standard BIT – one that SIFMA would strongly support – would guarantee, at a minimum, national treatment and "most favored nation" treatment, pre- and post-establishment of an investment, fair and equitable treatment, full protection and security, regulatory transparency, the free transfer of capital, protection against uncompensated expropriations, and availability of a rigorous and objective investor-state arbitration mechanism for enforcing those obligations.

A Level Playing Field

Despite the commitments made through the S&ED, more work needs to be done to ensure U.S. financial services firms are able to operate on a level playing field in China. While U.S. financial services firms operating face significant hurdles, Chinese financial institutions are expanding globally with operations in most major Western financial centers. Illustrative of this growth - four of the ten largest global financial institutions, including three of the top five, are headquartered in China.

Chinese financial services institutions are also expanding into the U.S. market. The Federal Reserve recently approved applications by three Chinese banks, most notably the Industrial & Commercial Bank of China (ICBC), to expand operations in the U.S. Last year, the Federal Reserve also approved a branch application from the Bank of Communications to establish operations in California.[4] It has also been widely reported that China's largest brokerage firm, CITIC Securities, is planning to enter the U.S. market.[5] As stated previously, Chinese firms seeking to do business face no restrictions on the size or scope of their operations and must only meet the prudential requirements established by U.S. regulators.

As China's largest financial institutions are developing a presence abroad, China is also working to develop platforms to allow it to better compete in the global financial markets. The Shanghai Stock Exchange Strategic Plan, introduced in 2010, aims to develop the Exchange into "one of

[4] U.S. Federal Reserve Announcement, April 8, 2011. http://1.usa.gov/wJegBr

[5] Wall Street Journal, *China's Citic Planning Push Into U.S. Market*, February 14, 2012. http://on.wsj.com/Ajejde

the most influential bourses in the world, boasting a mature stock market, an improved bond market, a highly developed fund market, an abundance of securities derivatives and an increasingly rational investor structure."[6] Without a more open financial system, China will be unable to attract sufficient foreign investment to achieve these goals.

Conclusion and Recommendations

The S&ED joint statements states that "China is committed to transforming its economic development pattern, improving the livelihood of its people and actively expanding domestic demand, with increasing consumption as a strategic priority in expanding domestic demand." 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.

Our member 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. Sophisticated financial institutions 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 the U.S. and global economies.

We look forward to working with the Committee, 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.

Consequently, we believe the Committee has a central role to ensure the timely implementation of China's current S&ED commitments while at the same time pursuing a level playing field for U.S. firms.

To ensure these goals are met, we offer two recommendations: first, an annual report to Congress demonstrating China's implementation of commitments agreed to at each S&ED; and second, increasing the frequency of the economic portion of the dialogue to twice per year as was done during the original SED.

We appreciate the Committee's interest in this issue and the opportunity to testify today.

Thank you.

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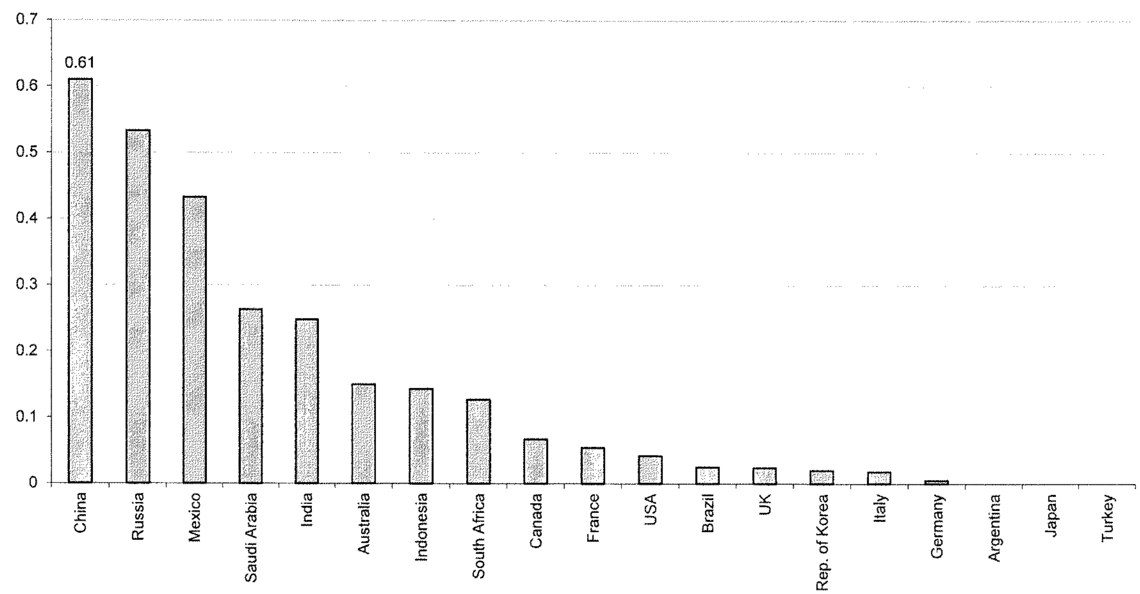
[6] Shanghai Stock Exchange, December 13, 2010, http://bit.ly/zs13AC, Accessed March 1, 2012.

Annex 1: Restrictiveness in Financial Markets



Note: Restrictiveness measures are taken from a recent study by the OECD (2010 Update) to identify the level of regulatory restrictions on foreign direct investment with 1 being a closed market and 0 being an open market. We present each nations aggregate score and its score in the financial sector (Banking and Insurance).