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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.

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[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,

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[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.

[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.