SECTION 3: CHINA'S FINANCIAL SYSTEM AND MONETARY POLICIES AND THEIR EFFECTS ON THE UNITED STATES

The Commission shall investigate and report on—

"REGIONAL ECONOMIC AND SECURITY IMPACTS—The triangular economic and security relationship among the United States, [Taiwan], and the People's Republic of China (including the military modernization and force deployments of the People's Republic of China aimed at [Taiwan]), the national budget of the People's Republic of China, and the fiscal strength of the People's Republic of China in relation to internal instability in the People's Republic of China and the likelihood of the externalization of problems arising from such internal instability."

"FREEDOM OF EXPRESSION—The implications of restrictions on speech and access to information in the People's Republic of China for its relations with the United States in the areas of economic and security policy."

Key Findings

- China's financial system is an increasingly important element in Beijing's development strategy and its program to preserve internal stability. China's banks serve the nation's development strategy in several key ways. The banks, which are predominantly state-owned or state-controlled themselves, often are called on to make loans to other state-owned enterprises without attention to creditworthiness, collateral, or other typical lending requirements of banks operating in real market-driven economies. Instead, Chinese banks often are expected to grant low interest loans, carry large amounts of defaulted loans on their books, or forgive such debts held by government-owned companies. In a centrally planned economy such as China's, these loans are a device for subsidizing various activities and specific industries that China's power structure favors. The ultimate goal is to preserve

internal stability and strengthen the control of the Chinese Communist Party.

- Serious and potentially crippling problems threaten the financial system in China and render it vulnerable to excessive volatility and collapse. These problems include a large number of defaulted bank loans, an underdeveloped stock and bond market, an immature insurance system, poor accounting practices, and excessive government ownership and control over the economy, including a refusal to let the currency be governed by market forces. China cannot fully develop a free-market system until these problems are substantially resolved.
- A financial crisis in China would harm its economy, decrease China's purchase of U.S. exports, and reduce China's ability to fund U.S. borrowing, particularly to cover the U.S. budget deficit. An economic crisis in China has the potential to raise U.S. interest rates, thereby placing major additional costs on U.S. businesses and individual consumers and producing dislocation in the U.S. economy. It also could exacerbate Chinese domestic political tensions in an unpredictable fashion. This is why the condition of China's financial system is of concern to the United States.
- The Chinese government's deliberate undervaluation of the renminbi makes U.S. products more expensive to Chinese consumers who therefore purchase fewer of them. Conversely, China's undervalued currency also makes Chinese products cheaper in the United States, and therefore U.S. consumers purchase more of them. The combination is a major contributor to the record-high and still-growing U.S. trade deficit. The undervalued Chinese currency harms American competitiveness and is also a factor encouraging the relocation of U.S. manufacturing overseas while discouraging investments in U.S. exporting industries.
- There has been so little independent regulation of accounting procedures in China that the health of the entire securities and insurance sectors remains questionable. Chinese officials remain highly reluctant to allow independent and objective assessments of the financial system by foreign auditors and credit rating agencies.
- The ownership of U.S. Treasury securities, government agency bonds, and corporate bonds cannot be easily tracked. Foreign holders of U.S. Treasury securities, including foreign central banks, need not disclose their ownership and are not required to do so either by the United States or by international agencies. The lack of accurate data makes it difficult to predict the effect of a sell-off by any one country of dollar-denominated assets.

Overview

China's financial system is in its most critical transition period, facing a December 11, 2006, deadline to adhere to its extensive World Trade Organization (WTO) commitments to liberalize its financial sector. With some notable exceptions, China appears to have made a good faith effort to comply with its WTO obligations in the banking sector. But creating a strong and sound banking, in-

surance, and securities sector—from a patchwork of highly-protected, inefficient, state-owned enterprises—is an enormous task. China's banks are filled with IOUs from delinquent borrowers, many of them government-owned or -controlled and unlikely ever to completely repay the loans. Meanwhile, the assets that served as collateral for many loans have failed to hold their value. Bank loans continue to be made for political rather than financial reasons.

The other two legs of the financial system—securities and the system of property, casualty, and life insurance—may be even worse off and therefore contribute to the overall instability of the financial system. Here, too, decisions have been made for non-financial reasons. Equity investments of some insurance companies have been directed to the shares of certain companies with strong government connections, but low or non-existent profits. Another avenue of safe investments relied upon by Western insurance companies—the corporate bond market—is in its infancy in China. Forced instead to rely on low-yielding Chinese bank deposits rather than higher-yielding, private domestic and foreign equities or bonds, Chinese insurance companies apparently have built up insufficient reserves to cover their future liabilities.

The equity ownership rights of individuals in China—and of foreign investors—have been heavily restricted. Chinese citizens have been mostly limited to low-interest-bearing bank accounts. Shares of stock on Chinese exchanges are therefore thinly traded and subject to large price swings. This further discourages such investments by Chinese citizens. Even as China's economy has grown at a near-10 percent rate, the value of publicly traded companies in mainland China generally has been falling, although prices have been on the rise this year.

U.S. investors have also been discouraged from using the Shanghai and Shenzhen stock exchanges. Even foreign financial giants such as Goldman Sachs, Morgan Stanley, and Citigroup have had to go through extensive licensing procedures and approval processes just to invest in Chinese companies. And such investments may be very risky still. There is little transparency in the Chinese mainland stock exchanges or in the companies themselves.

China's financial markets are due for some substantial changes, however. China's WTO accession agreement requires that it open up its financial system to more outside scrutiny and investment, with the phase-in of the new changes to be completed by December 11, 2006. If China complies with its looming deadline, the nation's financial system will experience a liberalization whose scope and speed have seldom been seen before. Only two precedents exist: after the collapse of the Soviet empire, Russia and some of the Central European, former Communist bloc countries underwent a rapid change. Russia's system quickly became a free-for-all and devolved into criminality. Central Europe, whose pre-World War II system was capitalistic, fared much better.

Unfortunately, at the time this report is being finalized, Chinese authorities announced that the opening of Chinese securities firms to partial foreign ownership may be delayed for a year past the December 2006 deadline. This is in contrast to the willingness of authorities in Beijing to allow up to 25 percent foreign ownership of

Chinese banks, and their pledges to allow foreign banks to establish branch offices in China.

The Banks Must Climb Out of a Deep Hole

Of all the changes in the financial system contemplated by the WTO agreement, the Chinese government is most enthusiastic about implementing those relating to banking. Beijing realizes the country must have a stronger banking system to take the economy to the next step in the process of globalization. To help accomplish that, China has already privatized a significant part of its banking sector and has, in some cases, beaten its deadlines for allowing foreign investment in the sector.

Until now, China's banks have been the primary vehicle for financing business investment, and while the securities industry undergoes modernization, banks likely will retain their importance. China's banks have enjoyed a near monopoly on the impressive savings of the private and public sectors—estimated to be as high as 50 percent of GDP. Clearly, a shortage of savings and deposits is not China's banking problem. With a foreign currency reserve of about $1 trillion, the People's Bank of China has the ability to throw the banks a stout lifeline.

Indeed, China has already spent heavily to bail out its banking system, primarily through government purchases of bad loans. A low estimate puts the cost so far at $60 billion since 1998.[116] Another estimate using similar methodology estimates the cost at $95 billion.[117] According to Michael Petit, managing director of Standard and Poor's corporate and government ratings in Asia, the Chinese government may have already spent or committed $400 billion to create a solvent banking system. Still, he says, problem loans represent an additional $500 billion to $650 billion.[118] [119]

A large number of the bad loans originated with the practice of state-owned banks lending almost exclusively to state-owned businesses. Dr. Kellee Tsai, a political scientist at Johns Hopkins University and authority on the Chinese banking system, noted that the government-owned banks were originally established as a reform measure in the 1980s because in prior years, money had flowed directly from the government treasury into the state-owned businesses. "So all the employees within the state banking system were afraid to lend to private entrepreneurs because they thought, 'Well, if they don't repay, I could lose my job; it would be disastrous.' And they weren't trained to evaluate clients according to standard market ways of evaluating creditworthiness. They weren't looking at their credit history and collateral."[120]

In short, yesterday's reform became today's problem. Official Chinese estimates show that nearly 80 percent of the bad loans on the books of Chinese banks are attributable to "conflicts of interest where local governments were the owners of some of the banks and financed unnecessary projects."[121] Standard and Poor's estimates the proportion of loans in default at the end of 2005 was between 20 percent and 25 percent.[122] To some observers, this high level of problem and defaulted loans shows that state control over the banking system is still extensive. "Everybody assumes that China wants to be capitalist and that socialism with Chinese characteristics is really code for capitalism, but it's not," Gordon Chang, au-

thor of the book, *The Coming Collapse of China,* told the Commission.[123]

Now, China hopes to tap Western management expertise by allowing partial foreign ownership and participation in its giant banks. The thinking: Western banks will make lending a more rational process without the cronyism and favoritism of the past, and this will improve the performance of the Chinese banks.

But some experts fear that China may not be offering the Western banks enough incentive—a sufficiently large ownership stake—to attract their involvement and enable them to introduce necessary reforms. No single foreign bank can own more than 20 percent of a Chinese bank and total foreign ownership cannot exceed 25 percent. This will be the case even after full implementation of China's WTO commitments. So far, the ownership levels have been too low to allow foreign banks to force reforms and old hands at China's banks have resisted. Chinese banks, for example, have created new positions for loan and risk officers, but they have staffed these new positions with the same employees using the same analytical tools. Under those officers, Chinese banks have amassed non-performing loans which are now equal to 7.5 percent to 9 percent of total bank deposits according to official figures, but may be as high as 25 percent according to Standard and Poor's.[124] (The People's Bank of China reported that total deposits in Chinese banks in December 2004 amounted to 24 trillion renminbi [about $3 trillion].)[125] If Standard and Poor's high estimate is correct, non-performing loans could amount to $750 billion.

China also must prepare for the day when its GDP growth rate dips below nine percent, possibly pushing up the number of defaulted and problem loans, which are now on the decline. As more state-owned enterprises are forced to adopt market-driven business practices, more of them will either fail or reveal their profits to have been illusory. Banks will have to be strong enough to write down those loans and still remain solvent. And as the Chinese securities market grows, banks will lose their monopoly on the depositors who are offered so few alternative opportunities to grow their money in China. But so far, China has not faced up to the challenges posed by the many bad loans held by its banks. In September, the central government decided to exempt more than 2,000 of its worst performing state-owned enterprises from the new bankruptcy law passed only the month before, demonstrating a questionable commitment to dealing with the problem.[126]

To its credit, China has managed to establish a regulatory regime for banking, headed by a central bank modeled on the U.S. Federal Reserve Bank. The People's Bank of China sets short term interest rates and bank reserve requirements, and manages the foreign currency reserves. In spite of this effort, implementation falls short.

The formal banking system is failing entrepreneurs. If China is to move to a free market economy, Chinese entrepreneurs must be able to finance their ventures. This will require a banking system that meets their needs, which they currently do not have. As late as mid-2006, only one percent of the loans from state-owned banks had gone to Chinese entrepreneurs, according to Dr. Tsai. Instead, small businesses rely on a scattered, unregulated, and informal

lending system estimated by the People's Bank of China to account for $118 billion or seven percent of GDP.[127] The default rate in this informal system is far lower than it is among the large banks. In the informal system, "Assets will be confiscated, fingers will be taken . . . kids will be kidnapped—you name it," Tsai told the Commission. "They have very low [non-performing loan] rates." The size of this informal banking sector is yet another symptom of the inadequacy of the formal banking sector.

The health of Chinese banks is a concern for the United States for several reasons. Their weak state makes the entire Chinese financial system vulnerable in a crisis. A Chinese banking crisis could even imperil the entire Chinese economy, whose growth has accounted for about a quarter of global growth in recent years. Given China's size, the impact of a financial and economic collapse could be global and severe.

In a crisis, as domestic demand dried up, China's export sector would be even more important to the overall economy and could receive even more government support. The financial and political turmoil in China in the spring of 1989, for example, had no effect on China's export sector, which "just continued to hum along as if it were in a separate country."[128] An economic crisis in China would also cut into U.S. exports there, particularly of such capital goods as commercial aircraft, currently among the top U.S. exports to China. Yet the U.S. trade deficit with China might also accelerate since the Chinese export sector would stay strong.

Meanwhile, unemployment in the state-owned sector could be expected to grow with potentially devastating consequences for the population.[129] The social safety net is highly porous. National unemployment benefits do not exist, only about 15 percent of the population is covered by any type of pension, and many of those pensions are underfunded.

Other Problems in the Financial Sector

The other two legs of the financial system stool—stock and bond brokerages and the insurance industry—are in even worse shape than the banks. In theory, the nation's stock exchanges should be facilitating the transition from a state-owned economy to a private, market-based system. But whenever the government hints it is going to sell its holdings in a particular firm, investors try to sell first to avoid the price drop that results from putting up so many shares for sale so quickly. This has been creating volatility and diminishing confidence in the market.

There are structural reasons for the difficulties in the exchanges as well. Unlike the banking system, securities dealers are not welcoming competing, foreign companies to help in the transition. In fact, in September, Chinese regulators announced a one-year suspension of partial sales of brokerages to foreign investors.[130] Even before this suspension, foreigners were limited to joint ventures and ownership was capped at 33 percent.[131] (Among its WTO commitments China pledged to fulfill by December 11, is to increase to 49 percent the proportion of a joint venture a foreign securities company can own.) Thus far, of the $24 billion that foreign investors have expended in buying into financial services companies in

China since 2001, only $600 million has been spent in buying shares of securities firms.[132]

The insular nature of the securities system also makes it vulnerable to rapid price swings and loss of public confidence. It also reduces the effect of regulations. After all, as many as three-quarters of all private financial transactions may be occurring outside the formal financial system, according to one estimate.[133]

In the past few years, China has established a foreign currency market, a commercial paper market, a corporate bond market, and the "back offices" and trading systems to implement them. This infrastructure gives China the potential to continue to liberalize its financial system. Perhaps most important for the United States in the short term, this infrastructure would allow China eventually to adopt a more flexible exchange rate regime. Nevertheless, Beijing has decided not to relax its tight control over the value of the renminbi relative to the dollar.

China has only slightly loosened the controls on its insurance companies to allow them to invest abroad. Without such investment, insurance firms cannot be certain of steady returns that help them to cover their losses and to keep premiums affordable. Domestic stock markets have not proved to be a reliable vehicle for the Chinese insurance companies to hedge their risks.

Foreign insurers face discrimination. They are required to apply for licenses serially while Chinese insurers can apply concurrently. That is, foreign insurers must await approval of one application before applying for another.[134] This is apparently intended to slow the entry of foreign and U.S. firms into the fast-growing Chinese insurance market. It is a clear violation of WTO rules on "national treatment." Insurers are engaged in what they call a "dialogue" with Chinese regulators and say they are making progress on this issue.

Information Flow Is Increasingly Restricted

A free flow of information is essential to the efficient functioning of markets. Information flowing from consumers to producers is what allows the capitalist system to avoid the production bottlenecks and the waste that plague planned economies. But China refuses to recognize this principle and has been enacting ever-larger barriers to the free flow of information.

Chinese regulators have sought to prevent independent credit rating agencies such as Standard & Poor's, Moody's, and Fitch from establishing operations in China. The work of such credit rating agencies is essential. They evaluate the underlying risk of bond issuers and therefore impose discipline on the borrowing companies that know that drops in their ratings will lead to higher borrowing costs. This helps keep the system honest and understandable and avoid nasty surprises.

But Chinese authorities want to limit foreign credit rating agencies to a minority stake in joint ventures, which would reduce their independence and credibility. Even worse, regulators want to use their licensing authority to control the hiring of credit analysts and their various activities. Trying to control the flow of any negative news would render the credit rating system useless and make it extremely difficult for all investors to make informed choices. A com-

promised credit rating agency system, by obfuscating potential problems, increases the chance a small event will turn into a financial crisis, with cascading effects both within and outside China.

The testimony to the Commission of representatives from Standard and Poor's, one of the major credit rating agencies, was instructive. The company has been active in China since 1991, evaluating the credit-worthiness of Chinese government debt and its issuance of U.S.-denominated sovereign debt by the central government. The company has maintained an office in Beijing since 2005, but is allowed to issue ratings on Chinese companies only from its Hong Kong office.[135] This is in marked contrast to such other Asia-Pacific nations as Japan, Singapore, and Australia, which understand and support the market function of independent ratings agencies. Further hampering the establishment of an independent ratings system are the competition and confusion among four regulatory bodies that claim jurisdiction over rating agencies operating in China.

In addition to restrictions on rating agencies, China has moved aggressively to limit dissemination of news and financial information by foreign news media. In September, China's government issued strict curbs on the dissemination of news in China. In particular, international financial information companies such as Reuters Group PLC and Bloomberg LP are prohibited from selling their information and financial news directly to Chinese customers such as banks and brokerages.[136]

The new restriction, issued by China's official Xinhua news agency, seems designed to accomplish two goals: the first of these is to bring foreign news agencies under the control of Chinese government authorities, a continuation of China's efforts to limit independent dissemination of news within China, particularly news that points up government mismanagement, civil unrest, and man-made and natural disasters. The new restriction makes it illegal to distribute articles that "undermine China's national unity, sovereignty, and territorial integrity" and that "endanger China's national security, reputation and interests." The restrictions also are intended to persuade foreign news media to avoid politically sensitive subjects such as corruption of government officials, and the activities of civil rights associations and leaders on behalf of the Chinese people when their interests conflict with those of the government.

China Manipulates its Currency to Gain a Trade Advantage

China's policies on trade and investment depend directly on the government's strict control of the value of the renminbi.[137] Rather than allow the nation's currency to seek its own value in the international currency markets, the People's Bank of China dictates the value of the renminbi and allows only small fluctuations. The central bank requires that dollars entering the country be traded for renminbi at a rate of about 8 renminbi to one dollar. By artificially setting the renminbi at a value that most economists believe amounts to a 15 percent to 40 percent discount against the dollar, China provides its exporters with an equivalent price discount.[138] This practice violates both the letter and the spirit of the rules of the WTO and the International Monetary Fund, which prohibit the

manipulation of currency values in order to secure a trade advantage.

This practice harms U.S. companies in a variety of ways and distorts the trading relationship between the United States and China. The policy attracts foreign investment to manufacturing in China by automatically discounting the purchase price of Chinese land, machinery, construction costs, and manufacturing inputs. The exercise also puts competing U.S.-based manufacturers at a disadvantage by making their exported products more expensive to Chinese consumers. American small and medium-size enterprises are particularly disadvantaged by having to compete for U.S. market share with Chinese exporters who enjoy the subsidy of an artificially undervalued renminbi. Smaller U.S. companies often don't have the cash, credit, experience, or willingness to shift large amounts of capital abroad. So many of the smaller U.S.-based manufacturers find themselves competing for American customers with the large multinational corporations now producing at a discounted rate in China.

This practice is "export-led growth with a vengeance," according to C. Fred Bergsten, president of the Institute for International Economics.[139] China's surplus, according to Bergsten, "is an off-budget job and development subsidy which enables them to under-price their products in world markets, and thereby enables them to export some of their unemployment to the rest of the world."

This emphasis on export earnings puts Chinese citizens—although not the companies—at a disadvantage. The standard of living of Chinese citizens is below what it would be if Chinese firms produced goods for domestic consumption.[140] Additionally, because the Chinese government has been dismantling the social safety net previously provided by state-owned and state-controlled companies, Chinese workers must now save money for their retirement and health care; pension plans and health insurance cover less than 20 percent of the population. Expanded government programs in such areas as education and health care could allow Chinese workers to save less of their income and to consume more, leading to more domestic-led GDP growth. Instead, government and business savings, as well as household savings, have been on the rise.

A secondary effect of China's policy of currency manipulation is the huge and growing trade surplus accruing between China and the rest of the world. China now enjoys the largest current account surplus in the world, a position held by Japan until 2006.[141] That surplus has helped push Chinese foreign exchange reserves beyond $900 billion and on a path to break the $1 trillion mark this year. If China were to allow its currency to move toward a market-driven level, many economists expect that the growing imbalances would decline. If the dollar and other currencies decline in relation to the renminbi, investing in China would become more expensive for foreigners, as would the purchase by foreigners of Chinese raw materials, parts, machinery, and other inputs. This would lead to less foreign investment in China relative to other destinations. After a period of adjustment, it is reasonable to assume that China's trade surplus—and the trade deficit of the United States—would decline, although few economists have undertaken the empirical research necessary to quantify the dollar estimate of this decline.[142]

The U.S. Treasury Department has argued that it would be in China's interest to allow the value of the renminbi to be set by market forces rather than central government fiat. China has begun to acknowledge that its projected 11 percent GDP growth rate this year is not sustainable and has taken some steps to cool the economy. For example, Chinese authorities have issued tighter banking regulations in an effort to reduce speculation in commercial and industrial real estate. Authorities are increasingly concerned that too few people in China receive benefits from an export-led boom dominated by foreign multinationals. The already-substantial economic inequality is increasing between the coastal, urban elite and the rural dwellers who make up 45 percent of China's population. Because of China's export-oriented industrial policy, of which the renminbi valuation policy is a key part, many in China cannot consume the very products that their factories are producing. Meanwhile, cheaper imported goods are kept out of the market by the policy of keeping the renminbi at such a low value. In spite of these and other arguments that favor allowing the renminbi to reach a more market-oriented value, Chinese economic officials have said they prefer to emphasize stability.[143]

Possible Effects on the Overall U.S. Economy

The United States will run a current account deficit of over $800 billion, or approximately seven percent of GDP, in 2006. This is historically an extremely high level that no other country has ever been able to sustain for any significant period. The danger is that the U.S. economy could suffer a precipitous decline if the ability of the United States to borrow ever greater amounts should end abruptly. Interest rates and inflation might suddenly soar as the dollar fell and the stock market crashed.[144]

For now, however, the effect on the U.S. economy of the huge purchases of U.S. Treasury, government agency, and corporate bonds by China and other East Asian countries was summed up this way by Dr. Bergsten; "It's great to live on those credit cards, as long as nobody calls in the balances." Another witness, University of Maryland economist Peter Morici, added up the consequences to the U.S. economy, some of which are beneficial in the short term, but all worrisome over the long term: currently, interest rates are lower than they would be without China's purchases of U.S. debt instruments. The rate of growth is therefore higher in some sectors, said Morici, but employment and wages in the United States are lower than they would be otherwise.[145] Francis E. Warnock, an economist at the University of Virginia, said in written testimony submitted to the Commission that it is reasonable to assume that interest rates in the United States are up to one-and-a-half percentage points lower than they otherwise would be without the lending from China.[146]

In one sense, economists are still feeling their way through the discussions of these huge imbalances and the potential for rapid shifts in the value of the dollar. The size of today's trade imbalance is nearly unprecedented; large amounts of currency are sent across the globe nearly instantaneously, thanks to computerized trading. This new, virtual, paperless trading floor complicates America's ability to track and manage certain aspects of its finances. For ex-

ample, little is known about the amount of Chinese investments in U.S. bonds because U.S. statistical agencies don't require bond holders or bond issuers to disclose such information. Furthermore, many bonds are held on behalf of investors by third parties, often in tax havens such as the Cayman Islands. This much is known, however: Chinese investors primarily engage in portfolio investments and not in direct investing, such as the outright purchase of U.S. companies, factories, or commercial real estate.[147]

While some U.S. officials cite a precipitous sell-off of the dollar as one of their biggest worries, most experts believe this is an unlikely scenario. One reason: this would cause the People's Bank of China's bond portfolio to collapse in value as well. It is far more likely that China's central bank, along with other Asian central banks, will diversify its holdings away from the dollar rather than rush them to market. As long as such a shift occurs slowly, U.S. capital markets will adapt with only a minimal impact on the real economy. Regardless, the United States would be able to better predict potential problems resulting from the movement of foreign capital invested in the U.S. economy if there were tracking systems better suited to monitor how individual countries invest in the United States.