HEARING ON CHINA'S QUEST FOR CAPITAL: MOTIVATIONS, METHODS, AND IMPLICATIONS

HEARING

BEFORE THE

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

ONE HUNDRED SIXTEENTH CONGRESS
SECOND SESSION

THURSDAY, JANUARY 23, 2020

Printed for use of the
United States-China Economic and Security Review Commission
Available via the World Wide Web: www.uscc.gov

UNITED STATES-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

WASHINGTON: 2020

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

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CHINA’S QUEST FOR CAPITAL: MOTIVATIONS, METHODS, AND IMPLICATIONS

THURSDAY, JANUARY 23, 2019

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

Washington, DC

The Commission met in Room 419 of Dirksen Senate Office Building, Washington, DC at 9:15 a.m., Chairman Robin Cleveland and Commissioner Michael Wessel (Hearing Co-Chairs) presiding.

OPENING STATEMENT OF CHAIRMAN CLEVELAND HEARING CO-CHAIR

CHAIRMAN CLEVELAND: Good morning, and welcome to the first hearing of the U.S.-China Economic and Security Review Commission's 2020 reporting cycle. Today's hearing will examine the -- today's hearing will examine the internal and external dynamics of China's financial system and the risks as well as opportunities of China's growing global integration poses to U.S. institutional and individual investors.

I want to welcome our witnesses and thank them for participation in an extremely complicated hearing. I also want to start by thanking the staffers that supported this. I always try to remind myself at the end of the day, but this was a complex hearing with multiple witnesses, very, very different points of view.

So I really appreciate Nargiza, Virgil, and Kaj's support of our learning effort. And I also want to thank Leslie, who I -- is she here? She's not here. It's her last time helping manage this hearing. She has been a fantastic Congressional Affairs Coordinator, and we will miss her as she goes home to the great state of Texas.

So with stage one of the trade deal inked, China has committed to greater access to its banking, asset management, credit, and financial markets. At the same time, China's securities are being included in global indices. This expansion in access raises reasonable concerns about the transparency, stability, regulation, and real value associated with China's market access and lending instruments.

To fuel growth over the past decade, China's banking sector has grown from $9 trillion to a staggering $39 trillion, and 8.2 to 21 percent of which is estimated by Moody's to be held in shadow lending instruments. Meanwhile, China's debt-to-GDP ratio exceeds 260 percent. The speed, scope, and lack of transparency regarding this increase are troubling as China seeks closer integration with U.S. and global financial markets.

Despite a four-fold expansion over the past decade, China's financial system is marked by weaknesses, inefficiencies, and a lack of transparency, which challenge an accurate understanding of capital requirements, debt levels pricing, and treatment of bank balance sheets, volume of non-performing assets, and general operations.

High savings rates historically have reduced concerns about excess debt, however, in the last several years the flow of credit has far exceeded deposits. Beijing seemed to recognize the risks of excessive corporate debt, but abandoned de-leveraging as growth slowed. A renewed surge in shadow banking practices add challenges for small and medium enterprises in raising capital.

Adding to the cost in terms of borrowing, SOEs are adding stress to the system by not paying their small and medium corporate suppliers. Data from the People's Bank of China suggest that in the second quarter of 2019, the value of outstanding commercial acceptance bills, essentially IOUs, reached $1.7 trillion.

Backstopping this entire opaque banking and credit system is China's foreign exchange reserves, which experiences its own problems. In the space of just a few years, nearly 25 percent of the reserves were wiped out in an all-out campaign to shore up the RMB, an undertaking which cost nearly one trillion.

In 2019 Commission witnesses suggested within that remaining three trillion in the reserves, a lack of transparency may be hiding between $500 billion and $700 billion of loans to domestic banks, for which Beijing only holds promissory notes.

There's no doubt China's reserves have served multiple policy agendas, from subsidizing RMB rates and major banks as they take on regional enterprises' non-performing loans, and underwriting Belt and Road Projects. Again, a lack of transparency calls into question the strength and sustainability of this resource.

As China's economy struggles with the legacy of the fastest debt buildup in history, Beijing seeks to attract U.S. and other foreign investors to ensure growth and the sustainability of the CCP's model of authoritarian capitalism.

The challenge for our witnesses, as well as investors, is to better understand what drives the demand for capital and the tools used to raise it, and whether the U.S. regulatory and legal governance system have kept pace with this new troubling reality.

Are we looking at a rational model that delivers consistent value and yield for investors? Although there seems to be attractive yield, I have a nagging feeling that there should be a buyer beware label on all of these enterprises. Five years from now will we be looking at situation where we are more fully sunk into China's financial system and grappling with a massive toxic debt crisis?

I'm hopeful our witnesses today will inform our understanding of the debt, equity, and investment picture, particularly the impact of global indices on financial market stability, which will help inform the risks to American investors, which my colleague, Commissioner Wessel will address.

**PREPARED STATEMENT OF CHAIRMAN CLEVELAND
HEARING CO-CHAIR**

Good morning, and welcome to the first hearing of the U.S.-China Economic and Security Review Commission's 2020 reporting cycle. Today's hearing will examine the internal and external dynamics of China's financial system, and the risks as well as opportunities China's growing global integration poses to U.S. institutional and individual investors. I want to welcome our witnesses and thank them for their participation.

With stage one of a trade deal inked last week, China has committed to greater access to its banking, asset management, credit and financial markets. At the same time, Chinese securities are being included on global indices. This expansion and access raises reasonable concerns about the transparency, stability, regulation as well as the real value associated with China's markets, assets and lending instruments.

To fuel growth, over the past decade China's banking sector has grown from $9 trillion to a staggering $39 trillion, 8.2 to 21.4 percent of which is estimated by Moody's to be held in shadow lending instruments. Meanwhile, China's debt to GDP ratio exceeded 260% in the second quarter of 2019. The speed, scope and lack of transparency regarding this increase are especially troubling as China seeks closer integration with the US and global financial markets.

Despite a fourfold expansion over the past decade, China's financial system is marked by weaknesses, inefficiencies, and a lack of transparency which challenge an accurate understanding of capital requirements, debt levels, pricing and treatment of bank balance sheets, volume of non-performing assets and general operations. High savings rates historically have reduced concerns about excess debt. However, in the last several years, the flow of credit has far exceeded deposits. Beijing seemed to recognize the risks of excessive corporate debt, but abandoned deleveraging as growth slowed. A renewed surge in shadow banking practices add to the challenges small and medium enterprises face in raising capital. Adding to the costs and terms of borrowing, SOEs are adding to stress in the system by not paying their small and medium corporate suppliers: Data from the People's Bank of China suggests that in the second quarter of 2019, the value of outstanding commercial acceptance bills, essentially IOUs, reached $1.7 trillion.

Financial markets in China are opening at a particularly challenging point in time. Are we on the verge of a prudent period of well supervised credit expansion which could fuel global growth, or are we being drawn in to a swamp of toxic debt, ponzi schemes with no possible legal or financial recourse? Americans investors are not accustomed to China's ongoing practices of random suspension of trading, artificial limits on IPO valuation and interference in corporate operations and practice to serve Communist Party objectives. Although yields seem attractive, there is a nagging feeling that there should be a buyer beware label on the stock connect platforms and Chinese debt and equity sales.

Backstopping the opaque banking and credit sector is China's foreign exchange reserve which suffers its own problems. In the space of just a few years, nearly 25% of the reserves were wiped out in an all-out campaign to shore up the RMB, an undertaking which cost nearly $1 trillion. In 2019, witnesses suggested to the Commission that the lack of transparency may be hiding between $500 billion and $700 billion worth of loans to domestic banks, for which Beijing only holds promissory notes. There is no doubt, Chinas reserves have served multiple policy agendas from subsidizing rates and major banks as they take on regional enterprises non-performing loans to shoring up the RMB and underwriting Belt and Road projects. Again, lack of transparency calls into question the strength and viability of this resource.

As China's economy struggles with the legacy of the fastest debt buildup in history, Beijing seeks to attract U.S. and other foreign investors to ensure growth and the sustainability of the CCP's model. The challenge for our witnesses as well as investors is to better understand what drives the demand for capital and the tools used to raise it especially on US exchanges. Are we looking at a rational model that delivers consistent value and yield? Or five years from now will we be more fully sunk into China's financial system and grappling with a massive toxic debt crisis. I am hopeful our witnesses today will inform our understanding of the debt, equity and investment picture, particularly the impact of global indices on financial market stability. That, in turn, will help inform risk to American investors which my colleague, Commissioner Wessel, will address.

OPENING STATEMENT OF COMMISSIONER WESSEL
HEARING CO-CHAIR

COMMISSIONER WESSEL: Thank you, Chairman Cleveland. Good morning, everyone. And also want to give my thanks to the staff for their great work. And Leslie, who is out at the moment, she's out again, to thank her for all of her work for the Commission.

From a traditional point of view, Beijing has taken a range of steps to tap into new sources of capital to manage an economic slowdown, weather trade frictions with the United States, and bolster its balance of payments. But we also need to understand that China is seeking capital to support Made in China 2025, mil-civ fusion, and a wide range of other policies designed to enhance China's national and economic security interests.

We cannot view China's capital needs and acquisition strategies through a myopic lens, but must assess them and their impact on U.S. interests as part of a more comprehensive outlook.

In 2001, China became a member of the World Trade Organization after a lengthy negotiation. Today, most analysts recognize the flaws in the original accession agreement and the limited enforcement of its terms. Yet, despite the immensely consequential nature of China's expanded role in international financial markets, we are not treating that entry with anywhere the same scrutiny.

In my view, this is a very serious mistake. Indeed, we are allowing Chinese companies to skirt many basic international financial norms in order to placate Beijing so that our financial services firms can earn fee income and investors can achieve higher but riskier returns.

The global economy's exposure to the unique risks in China's financial system is rising. Today's hearing is part of the Commission's ongoing effort to bring that exposure and risks into sharper relief. In 2017 the Commission assessed how Chinese audit regulators' refusal to cooperate with their U.S. counterparts exposes U.S. investors to fraudulent activities of U.S.-listed Chinese firms.

And in 2019, the Commission analyzed how this reluctance, together with other regulatory and oversight gaps, can erode the integrity of U.S. financial markets. The Chinese government's strategic opening of its financial system in recent years has enhanced foreign investors' ability to buy Chinese stocks and bonds. Major global securities index providers are taking bold steps towards including Chinese stocks and bonds in their indexes.

These steps are projected to lead to some $405 billion in new capital flows over the next two to three years alone, including retirement assets of federal government employees and members of the military. In short, China's integration into global financial markets is accelerating and U.S. investors' linkages with China are deepening.

To what extent does China's financial opening and push to elevate its profile in global financial markets reflect an effort to recruit foreigners in paying off domestic debt? Are U.S. stock and bond investments funding Chinese entities or activities that run counter to U.S. economic national security interests? Can we limit this while still preserving opportunities for U.S. investors?

And just as China's entry into the WTO was promoted by multinational firms seeking to access China's market and also use as an export platform to serve our market here, we are seeing U.S. financial firms promoting access to China for their products and services.

The parallels are significant. This potentially will create a new point of leverage for China to influence U.S. policy through those seeking to curry favor with the CCP leadership.

For the average citizen, we need to have an answer for Samuel L. Jackson's -- two to three years from now when he asks what's in your wallet. They deserve to know.

To our distinguished witnesses, thank you for joining us to discuss these important questions. I look forward, as we all do, from hearing from you.

Before we begin, I'd like to remind you that the testimonies and transcript from today's hearing will be posted on our website, www.uscc.gov. Also, please mark your calendars for the Commission's upcoming hearing on Chinese Military Power Projection and Influence, which will take place on February 20. I got it, thank you.

PREPARED STATEMENT OF COMMISSIONER WESSEL
HEARING CO-CHAIR

Thank you, Chairman Cleveland, and good morning everyone. I want to thank our witnesses for joining us today, and for the thought and consideration that they have given their testimonies.

From a traditional point of view, Beijing is taking a range of steps to tap into new sources of capital to manage an economic slowdown, weather trade frictions with the United States, and bolster its balance of payments. But we also need to understand that China is seeking capital to support Made in China 2025, military-civil fusion and a wide range of other policies designed to enhance China's national and economic security interests. We cannot view China's capital needs and acquisition strategies through a myopic lens but must assess them, and their impact on U.S. interests, as part of a more comprehensive outlook.

In 2001, China became a member of the World Trade Organization after a lengthy negotiation. Today, most analysts recognize the flaws in the original accession agreement and the limited enforcement of its terms. Yet, despite the immensely consequential nature of China's expanded role in international financial markets, we are not treating that entry with anywhere near the same scrutiny. In my view, this is a very serious mistake. Indeed, we are allowing Chinese companies to skirt many basic international financial norms in order to placate Beijing so that our financial services firms can earn fee income and investors can achieve higher, but riskier returns.

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The Chinese government's strategic opening of its financial system in recent years has enhanced foreign investors' ability to buy Chinese stocks and bonds. Major global securities index providers are taking bold steps towards including Chinese stocks and bonds in their indexes. These steps are projected to lead to some $405 billion in new capital flows to China over the next two to three years, including retirement assets of federal government employees and members of the U.S. military.

In short, China's integration into global financial markets is accelerating, and U.S. investors' linkages with China are deepening. To what extent does China's financial opening and push to elevate its profile in global financial markets reflect an effort to recruit foreigners in paying off domestic debt? Are U.S. stock and bond investments funding Chinese entities or activities that run counter to U.S. economic and national security interests? Can we limit this while still preserving opportunities for U.S. investors?

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For the average citizen, we need to have an answer for Samuel L. Jackson two to three years from now when he asks: “What’s in your wallet?” They deserve to know.

To our distinguished witnesses, thank you for joining us to discuss these important questions. I look forward to hearing from each of you.

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ADMINISTRATION PANEL INTRODUCTION BY COMMISSIONER WESSEL

Turning to our first panel. Our first panel today will discuss how the U.S. Department of Commerce views China's deepening integration with global financial markets and the implications for U.S. investors and U.S. national security interests.

Ms. Nazak Nikakhtar, I hope I pronounced that correctly, is the Assistant Secretary for Industry and Analysis at the U.S. Department of Commerce, where she serves as the Department's primary liaison with U.S. industry and trade associations and the Department's lead on the Committee on Foreign Investment in the United States, CFIUS.

During her previous tenure at the ITA, Ms. Nikakhtar worked at ITA's China Nonmarket Economy Office. In that position, she led numerous complex antidumping cases, advised on legal and regulatory matters related to the enforcement of U.S. trade laws, and participated in bilateral negotiations on trade issues between the United States and China.

We deeply appreciate your coming before us today. Please begin, you have seven minutes, roughly, and then we'll open it up to questions. Thank you.

OPENING STATEMENT OF NAZAK NIKAKHTAR, ASSISTANT SECRETARY FOR INDUSTRY AND ANALYSIS, U.S. DEPARTMENT OF COMMERCE, INTERNATIONAL TRADE ADMINISTRATION

ASSISTANT SECRETARY NIKAKHTAR: Vice Chair and Hearing Co-Chair Robin Cleveland and Commissioner and Hearing Co-Chair Michael Wessel, thank you for the opportunity to speak today about the extent to which China's access to U.S. and global capital markets poses risks for U.S. economic, foreign policy, and national security interests.

I'd like to offer perspectives from my vantage point at the Department of Commerce's International Trade Administration, where my office examines trade policies and their effects on industry competitiveness and national security through our sector expertise and role as Commerce's lead in the CFIUS process.

Today, China is the world's second largest economy and the world's leading exporter. Chinese companies have been intensive users of U.S. capital markets, and from 2013 to 2019, Chinese companies have raised over $48 billion through 119 new listings in the United States. This is more than the total raised by companies from any country except for the United States.

As of September 2019, there were 172 Chinese companies listed on the three largest U.S. exchanges, the NASDAQ, the New York Stock Exchange, and the New York Stock Exchange American, with a total market capitalization of more than one trillion.

The 2018 National Defense Strategy identifies China as a strategic competitor and states that China's predatory economic practices are a central part of its global strategic ambitions. A key pillar of the Chinese communist ambition is the government's emphasis on civil-military integration.

This doctrine subordinates the civilian economy to the deeds of the Chinese national security apparatus, and mandates that the Chinese government or military may direct any civilian sector entity, indeed any corporate commercial entity, to act on behalf of the Chinese government or military.

Further, Chinese economic practices, as enshrined in the One Belt, One Road Initiative, encourage the expansion of the country's geopolitical reach. It's also reported that the Chinese government is implementing this year a nationwide social corporate credit rating system for corporations to detect misconduct and noncompliance with state and local law.

The corporate credit system has implications for companies operating in China with respect to sensitive data, surveillance, and proprietary technical information. Companies, including multinationals, could be required to transfer internal data to the Chinese government.

Failing to score well by non-compliance with Chinese government policies or demands may subject companies to a myriad of sanctions, essentially life or death for the company. These facts underscore the Chinese government's efforts to dominate the global economy through data and technological hegemony, as explicitly stated in its Made in China 2025 plan.

Key to this effort is its ability to grow corporate champions through access to global capital markets. The New York Stock Exchange and NASDAQ exchange as market capitalization. It counts for over 40 percent of the world's stock market capitalization. Companies, especially emerging growth companies, choose to list in the U.S. capital markets for several reasons.

Some want greater access to deeper pools of capital. Others seek the seal of approval that is achieved by listing in U.S. exchanges with higher disclosure and regulatory requirements, which may enhance a company's reputation in its own markets.

The use of dual class shares in the United States is also attractive to companies as a separate class of stock offers its holders the ability to maintain control of their growing companies. In the case of China, this may allow individuals or entities connected with the Chinese government to maintain significant control of certain companies in which they have a pre-existing vested interest.

In my written testimony, I explained that these features have drawn companies, Chinese companies, to the U.S. exchanges over the years. Today, however, some of the corporate governance and regulatory frameworks of the U.S. exchanges are being adopted by competing exchanges.

For example, in 2018 the Hong Kong Exchange debuted new regulations allowing companies to use a weighted voting share structure. These regulations are also allowing listing of certain technology companies that do not have a history of profitability to list on the exchanges.

Recent IPO activity reflects these changes, and in 2018, Hong Kong Exchange topped the New York Stock Exchange in both the number and value of new IPOs. Chinese exchanges are also trying to attract these listings.

In 2018, China debuted its NASDAQ-style technology board on the Shanghai Stock Exchange. It's called the STAR Market for short, which allows the listing of companies with weighted voting rights and without having to show profitability. It outperformed other regional exchanges, including those in Hong Kong, Japan, and Australia.

China's quest for capital continues to grow. Shanghai's exchanges, after the New York Stock Exchange and NASDAQ and the Tokyo Exchange, the fourth largest exchange in the world. And the Shenzhen Exchange is number eight. Together with Hong Kong at number five, this represents a significant source of capital for new Chinese companies.

Today, Chinese companies are growing in prominence in the race for capital. According to the Hurun Global Unicorn List, at the end of June 2019, China had 206 unicorns, start-ups valued at over a billion dollars, compared with 203 in the United States.

Many of these unicorns in China represent technologies and key emerging sectors that may threaten to undermine the United States, both in terms of economic competitiveness and national security.

Artificial intelligence, for example, is one of the largest sectors for the Chinese in the Unicorn listing. Chinese doctrine has stressed AI as a lynchpin of future economic and military power. And of course, AI technology is driving China's social and corporate credit systems.

Here it should be noted that when U.S. individuals and institutional investors invest in Chinese firms, they may not be aware that they are funding companies involved in activities that are contrary to U.S. interests, including companies that appear on the Commerce Department's Entity List, a list of foreign entities subject to significant U.S. trade restrictions due to national security or foreign policy concerns.

In sum, China's growth into international capital markets is expanding, and its implications for U.S. economic and national security is great.

It is in this context that we need to reexamine our policies to determine how to prioritize our interests to preserve our nation's economic strength and national security, both today and equally as important, tomorrow. I look forward to answering your questions on this important topic. Thank you.

PREPARED STATEMENT OF NAZAK NIKAKHTAR, ASSISTANT SECRETARY FOR INDUSTRY AND ANALYSIS, U.S. DEPARTMENT OF COMMERCE, INTERNATIONAL TRADE ADMINISTRATION

January 23, 2020

Statement of Nazak Nikakhtar

Assistant Secretary, International Trade Administration, U.S. Department of Commerce

Testimony Before the United States China Economic and Security Review Commission

China's Quest for Capital: Motivations, Methods, and Implications

Vice Chair and Hearing Co-Chair Robin Cleveland, Commissioner and Hearing Co-Chair Michael Wessel, thank you for the opportunity to speak today about the extent to which China's access to U.S. and global capital markets poses risks for U.S. economic, foreign policy, and national security interests.

The International Trade Administration, with its professionals in Washington, across the United States and around the world, is responsible for strengthening the competitiveness of U.S. industry in the United States and global marketplace, increasing investments in America, monitoring compliance with U.S. trade agreements, and enforcing U.S. trade laws.

At Industry and Analysis (I&A), we are, in particular, responsible for developing and implementing international trade and investment strategies for a range of industries from the manufacturing sector to the financial services sector, including industries that are critical to U.S. economic and national security. I&A also leads the Commerce Department's participation in the Committee on Foreign Investment in the United States (CFIUS), a Committee that reviews specific foreign investments in the United States for their impact on U.S. national security.

Today, China is the world's second largest economy and the world's leading exporter. Chinese companies have been intensive users of U.S. capital markets and, from 2013 to the end of 2019, Chinese companies have raised over $48 billion through 119 new listings in the United States. This is more than the total raised by companies from any country, except for the United States.

Further, according to the U.S. China Economic and Security Review Commission, as of September 2019, there were 172 Chinese companies listed on the three largest U.S. exchanges, NASDAQ, the New York Stock Exchange (NYSE), and the NYSE American, with a total market capitalization of more than $1 trillion. In 2018, Chinese initial public offerings (IPOs) raised more than $9.4 billion on U.S. exchanges – or 51 percent of all cross-border listings in the United States – compared to an aggregate value of $60 billion for all IPOs. Similarly, in 2019, Chinese companies raised $3.8 billion – or 42 percent of all cross-border listings in the United States – compared to an aggregate value of $53.9 billion for all IPOs. As shown by these statistics, Chinese companies have a continuing interest in raising capital on U.S. markets even as Chinese capital markets mature.

But why, if China is now the world's second largest economy, do its companies continue to seek access to U.S. capital markets? And to what extent – if any – are these investments intersecting with U.S. economic, foreign policy, and national security interests?

The 2018 National Defense Strategy identifies China as a "strategic competitor," and states that China's "predatory" economic practices are a central part of its global strategic ambitions.[1] A key pillar of the Chinese Communist Party's ambition is the government's emphasis on civil-military integration. This doctrine subordinates the civilian economy to the needs of the Chinese national security apparatus and was formally adopted by the Central Military Commission in December 2015. In essence, this doctrine mandates that the Chinese government or military may direct any civilian sector entity – indeed any commercial corporate entity – to act on behalf of the Chinese government or military. The doctrine has no jurisdictional limits, which means that Chinese businesses operating abroad are also subject to this requirement.

Further, China's economic practices, as enshrined in the One Belt, One Road initiative, encourage the expansion of the country's geopolitical reach globally. Under this initiative, Chinese firms are acquiring stakes in critical industry and supporting infrastructure in many countries, such as key transportation ports in Greece, railways in Ethiopia, and massive steel plants in Indonesia and India. These investments, as noted in the 2017 National Security Strategy, can serve as "persuasion" for nations to follow Beijing's directions.

It is also reported that the Chinese government is implementing this year a nationwide social credit rating system for all corporations to detect misconduct and non-compliance with state and local law. The corporate credit system has implications for companies operating in China with respect to sensitive personal data, surveillance, and proprietary technical information. Companies – including multinationals – could be required to transfer internal data to the Chinese government as part of their obligations. The European Chamber reports this credit rating system as potentially amounting to "life or death" for companies operating in China. Failing to score well, by non-compliance with Chinese government policies or demands, may subject companies to a myriad of sanctions, including higher taxes or permit difficulties, or a blacklisting which could mean financial ruin for that entity.

The foregoing facts demonstrate the Chinese government's efforts to dominate the global economy through data and technological hegemony, as explicitly stated in its Made in China 2025 plan. Key to this effort is its ability to grow corporate champions through access to capital markets. In this context, we need to understand how China has accessed capital markets in the past and how it will participate in the global securities markets in the future.

The NYSE and NASDAQ exchanges' market capitalization accounts for over 40 percent of the world's stock market capitalization. Companies, especially emerging growth companies, choose to list in U.S. capital markets for several reasons. Some companies want greater access to deeper pools of capital. Other companies seek the seal of approval that is achieved by listing in U.S. exchanges with higher disclosure and regulatory requirements, which may enhance a company's

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[1] *U.S. Department of Defense,* "Summary of the 2018 National Defense Strategy of the United States," https://dod.defense.gov/Portals/1/Documents/pubs/2018-National-Defense-Strategy-Summary.pdf. Accessed 22, January 2020.

reputation in its home markets. The use of dual class shares in the United States is also attractive to companies as a separate class of stock offers its holders the ability to maintain control of their growing companies. In the case of China, this may also allow individuals or entities connected to the Chinese government to maintain significant control of certain companies in which they have a pre-existing vested interest.

For many years, the United States offered faster approval of new IPOs than either Hong Kong or the mainland, and U.S. exchanges also allowed emerging but not yet profitable companies to list. These reasons help explain the three distinct waves of IPOs by Chinese companies.

First was the state-owned enterprises (SOEs), who came in heavily around the time that China entered the World Trade Organization (WTO). They came to raise large amounts of capital and to import corporate governance principles that would make them behave more like for-profit companies.

The second wave included over 500 Chinese companies that entered the U.S. market through reverse mergers. A reverse merger was a cheap and quick way to list a company by essentially merging a foreign company into an already-listed shell in the United States. Unfortunately, many of these reverse mergers had issues with investor protections, particularly with auditing obligations and visibility into the Chinese parent company, and in 2011 the exchanges eliminated the advantage of reverse mergers.

The third wave, which we are discussing today, includes many emerging and technology companies such as Alibaba. Some of the largest and best-known Chinese companies have sought access to U.S. exchanges. Although Hong Kong has traditionally been the venue of choice for Chinese-based companies, U.S. exchanges provide unmatched access to capital, liquidity, and credibility. U.S. exchanges permit weighted voting rights, and the ability to list without having shown profitability. These differences allowed owners in the United States to both list years before showing their profits and to maintain their control after listing.

Some of the corporate governance and regulatory frameworks of U.S. exchanges are being adopted by competing exchanges. Over the last few years, foreign exchanges have competed for listings and, in April 2018, the Hong Kong exchange debuted new regulations allowing companies to list using a weighted-voting share structure. These regulations also allow listing of certain technology companies that do not have a history of profitability. Recent IPO activity reflects these changes; in 2018 Hong Kong's exchange topped the NYSE in both the number and value of new IPOs.

Chinese exchanges are also trying to attract these listings. In November 2018, President Xi announced plans for a NASDAQ-style technology board on the Shanghai Stock Exchange. The new science and technology innovation board – the STAR Market – would allow the listing of companies with weighted voting rights and without having shown profitability. China's STAR Market debuted in the second quarter of 2019 and outperformed other regional exchanges including those in Hong Kong, Australia, and Japan. Of course, the broadening and deepening of Chinese capital markets fuel the growth and expansion of a Chinese ecosystem to fund businesses and facilitate joint ventures between international and Chinese companies that not only compete directly against American firms but may ultimately threaten U.S. national security interests. China's growing securities market, moreover, signals their lowering dependence on foreign markets.

Another indicator of China's desire for a growing share of the global capital markets is the Hong Kong Exchange's failed bid for the London Stock Exchange (LSE). Hong Kong is a Special Administrative Region of China, and in 2019 the Hong Kong Exchange touted its proposed $40 billion acquisition of the LSE as a perfect fit for London to ensure its global prominence post-Brexit. The LSE, however, rejected the deal due to its concern about the Hong Kong Exchange's "unusual board structure and relationship with the Hong Kong government." Government and party influence on the board reduced investor confidence in the exchange's independence.

China's quest for outside capital continues to grow and, as Chinese companies look to other exchanges to fulfill their growing capital needs, it is unclear whether the United States will be as clear a first choice as it was 20, 10 or even five years ago. Reforms to exchanges in Hong Kong and on the mainland have made those exchanges attractive to countries wishing to expedite their companies' growth.

According to the World Federation of Exchange, Shanghai's exchange is, after the NYSE, NASDAQ and the Tokyo exchange, the 4th largest exchange in the world and the Shenzhen exchange is number eight. Together with Hong Kong, at number five, this represents a significant source of capital for new Chinese companies.

Without question, today Chinese companies are growing in prominence as players in the race for capital. According to Hurun Global Unicorn List, at the end of June 2019, China had 206 unicorns – startups valued over $1 billion – compared with 203 for the United States.

Many of these unicorns in China represent technologies in key emerging sectors that may threaten to undermine the United States both in terms of economic competitiveness and national security. Artificial intelligence, for example, is one of the largest sectors in the listing. Chinese doctrine has stressed AI as a lynchpin of future economic and military power, and of course it is the technology driving China's social and corporate credit systems. China has 15 of the 40 unicorns in this critical sector while the United States has 20. It is also important to note that all of these Chinese unicorns – like all Chinese companies – are subject to a patchwork of national security-oriented laws that allow Chinese security and intelligence services to effectively leverage Chinese firms for espionage and other purposes. For example, per Article Seven of China's 2017 National Intelligence Law, private Chinese companies are compelled to cooperate in "state intelligence work." Furthermore, these laws require data to be housed inside China, as well as require random inspections and black-box security audits.

Here, it should be noted that when U.S. individual and institutional investors invest in Chinese firms, they may not be aware that they are funding companies involved in activities that are contrary to U.S. interests, including companies that appear on the Commerce Department's Entity List – a list of foreign entities subject to significant U.S. trade restrictions due to national security or foreign policy concerns.

Investment in Chinese firms also underscores the importance of audit quality and transparency, but there have been difficulties in achieving these goals with respect to China. The Public Accounting Oversight Board (PCAOB) has noted that it is "prevented from inspecting the U.S.-related audit work and practices of PCAOB-registered firms in . . . China, and, to the extent their audit clients have operations in mainland China, Hong Kong."[2] This means that investors often do not get a true picture of these companies' financial health, and of course bear the resulting risks associated with the lack of disclosure and difficulty in pursuing legal recourse.

In short, China's growth in the international capital markets is expanding and this has significant implications for U.S. economic and national security. It is in this context that we need to reexamine our policies to determine how to prioritize our interests to preserve our nations' economic strength and national security for both today and tomorrow. I look forward to answering your questions on this important topic.

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[2] *Public Company Accounting Oversight Board*, "Public Companies that are Audit Clients of PCAOB-Registered Firms from Non-U.S. Jurisdiction where the PCAOB is Denied Access to Conduct Inspections," https://pcaobus.org/International/Inspections/Pages/IssuerClientsWithoutAccess.aspx. Accessed 22 January 2020.

ADMINISTRATION PANEL QUESTION AND ANSWER

COMMISSIONER WESSEL: Thank you very much for your prepared and your oral testimony. I'll begin with the first question. In October, I believe it was, the Department added 28 new entities to the Entities List, as you refer to, which is broader, a substantial addition to the list that already existed.

And in cross-referencing this against MSCI, a major international index, a significant benchmark of companies that drives billions, if not hundreds of billions, of dollars of investment, those companies are on the MSCI list and are therefore receiving investments from the Thrift Savings Plan under its I Fund and pension funds, mutual funds, many of the funds that would also be covered by the PBGC. And therefore U.S. taxpayer funds are potentially at risk.

What policy concerns do you have about this conflict between our national security interests and the indexes or the investments that are driving those investments, the indexes themselves? Isn't this essentially providing material support to many of those companies on the Entities List?

ASSISTANT SECRETARY NIKAKHTAR: Thank you for that question. So with regard to the Entity List, the criteria for a company being included on the Entity is a -- is that the U.S. government has to have reasonable cause to believe that the entity has been involved in or poses a significant risk of becoming involved in activities that are contrary to U.S. foreign policy or national security interests.

And to your point, the Secretary of Navy in October of 2019 stated that with respect to the Thrift Savings Plan, American Naval forces should not be put in a position to unwittingly, quote, underwrite the threats of China and Russia -- underwrite, I'm sorry, the threats that China and Russia pose to their lives.

So with respect to the Entity List, in October the Commerce Department came out with an addition to its Entity List of companies that were involved in human rights abuses with, in the Xinjiang Uyghur Autonomous Region and aid to the region's public security bureau.

A few examples are iFlytek, Zhejiang Dahua, and Hikvision Technology. Those companies are on the Entity List. They're also all listed in MSCI's indices, which the TSP tracks for federal government workers' retirements.

But I also want to add that it's not just the Entity List that could potentially be an issue. You have a range of other companies that are also listed on major indices, including MSCI, which is the world's largest and most prominent. They're basically engaging in activities that are contrary to U.S. national security interests.

I'll give you a few examples. AviChina Industry and Technology produces aircraft and missiles for the People's Liberation Army. China Mobile, it's owned by the Chinese government, it was blocked by FCC this year from providing international services in the United States. China Unicom and China Telecom, Senators Schumer and Cotton had asked the FCC to review approvals in the -- approvals in early 2000 that allowed the company into the United States.

Aluminum Corporation of China, that's listed on the New York Stock Exchange. It's a state-backed holding company. It's contributing significantly. It's the third largest primary aluminum producer in the world, and the second largest alumina producer in the world, that's smelted for aluminum. And it is driving a massive overcapacity in an industry that the United States government has deemed to be critical to national security.

And China's race -- which brings me to the final company that I want to give an example of, is Cinco Solar, which is the world's largest solar panel manufacturer. And the solar industry is doing the same thing.

In China's quest for dominance in advanced energy, an energy storage system, it's running a massive oversupply and overcapacity in solar panels and solar modules. And Cinco Solar is also operating within a subsidiary in the United States. And again, it's listed on the New York Stock Exchange.

And I'll actually add two side points too. Our involvement in the Belt and Road Initiative, China's, is significant. You have U.S. banks that have issued bonds for countries and beneficiaries of the Belt and Road Initiative. And U.S.-listed companies participating in China's One Belt, One Road projects through government contracts.

COMMISSIONER WESSEL: Thank you. Commissioner Wortzel.

COMMISSIONER WORTZEL: I'm going depart a little bit from your excellent testimony, if I can. The Communist Party of China recently strengthened the role of Party members and Party committees and organizations in all PRC companies. Last week I think was the announcement.

How can we structure legislation that requires that the U.S. consider that corporate boards, in the interests of companies from China, are no longer commercial, really, they are acting as instruments of the Communist Party of China?

ASSISTANT SECRETARY NIKAKHTAR: I'm sorry, do you mean how do we structure legislation that takes that into account?

COMMISSIONER WORTZEL: Yes, thank you.

ASSISTANT SECRETARY NIKAKHTAR: So I'll start with noting that with the Chinese government it's sort of explicitly stated, as you noted, that it strengthened the corporate boards' involvement with linkages to the Chinese Communist Party.

There's also a study that was, has been done by a journalist in connection with Harvard University that basically looks through what is deemed to be independent corporate commercial entities, which one could argue that maybe none of the corporate commercial entities are truly independent with respect to the civil-military integration and the other aspects that we've talked about.

But kind of traces these companies back through layers, and often hidden layers. And then you have the individuals, key controlling individuals, that are linked back to the Chinese government.

I think first and foremost, before we get to the legislation, I think the U.S. government, including the Administration and Congress, needs to really think about and assess where are we as a country with respect to the threat in China. Because I think we've just sort of, as the U.S. government as a whole has kind of just woken up to this threat.

I think we've gone through a period of engagement, and we've seen, which was fair to do. And I think over time we've seen that engagement hasn't worked. So now we're in the so-what period, right. And we're pulling these levers.

But I think first and foremost, we need to come together as a nation and really be on the same page as to the threat that China poses. And once we get to that point, then we can think about meaningful legislation on how to deal with this threat.

COMMISSIONER WESSEL: Commissioner Fiedler.

COMMISSIONER FIEDLER: In your testimony you make reference to the 2017 national intelligence law that China passed, basically obligating all Chinese companies to act on behalf of the national security apparatus of China. How -- you are the CFIUS lead for Commerce, right? How has this changed CFIUS deliberations?

It seems to me that before, I mean, it's a voluntary process in the initial stages, right? And then if they don't voluntarily comply, we can act and dissolve whatever corporate action they took. That now the universe seems more total, more total.

There's less discerning of, I mean less ability to discern whether someone's a threat if everyone has to, every Chinese company has to act on behalf of the Chinese security apparatus.

So how has that affected the CFIUS process, the short question?

ASSISTANT SECRETARY NIKAKHTAR: That is sort of the big question that we're trying to deal with through the CFIUS process. So there is, there are a number of -- the CFIUS group is made up of a number of different agencies.

And I think to the earlier point, we're slowly waking up to the China threat, but I think different agencies from different points of views. Which is fair, because that's why you have a number of agencies through the CFIUS process has sort of different perspectives.

I think the way that the Commerce Department is approaching it, and certainly USTR, we're the lead China negotiators here, are kind of viewing the China threat as a, through this context of the civil-military integration strategy, the 2017 national intelligence law, the social-corporate credit system.

All of these ways that the Chinese government is using ways to control what seems to be sort of independently, independent corporate entity.

Which comes to the fact which I think is the issue that you're raising in your question is when those Chinese companies invest in the United States, it is now the Chinese government investing in the United States, right. That's a question that we are, at least the Commerce Department is trying to socialize at the CFIUS table. And I think different agencies have different points of view on that.

But if you kind of take the Chinese government law de jure the way it just stands, that is a logical reading. And so do we want the Chinese Communist Party in our supply chain? Do we want it to participate in the U.S. government under the safe harbor of a CFIUS-cleared review? That is a question where I think we're all trying to come to terms with.

With respect to the point of, you know, we can dissolve a transaction after the CFIUS review, I'll also note that we're seeing a number of transactions which come in, which we've pulled into the CFIUS process. But by the time the review happens, all the damage is done. All the technology has flown to the company.

Or by the time -- or, I should also say there's instances where we've cleared transactions in the past, and we watched what's happened over time, and the Chinese government, or I should say the Chinese ownership of a U.S. company, has stifled innovation. They've basically dissolved the company itself, laid off all the workers. Which is another way to stifle innovation in the United States.

So I talked about a lot of things in response to the question, but the overarching view is that we're seeing non-competitive practices through Chinese investments, through the CFIUS process with, in terms from the supply chain.

Traditionally we've looked at this through tech transfer, but also through the supply chain perspective, and also through the effort to stifle innovation and repress growth in the United States.

COMMISSIONER FIEDLER: Thank you. Let me just make one comment and ask you to comment on it. The national security law that, or national intelligence law that they passed to me, state ownership is clear in many instances. We talk, how we talk about China and private companies, independent companies, state-owned companies now seems to be completely muddied.

If a, by law in China, a, quote unquote, private company must be subordinate to the national security apparatus of China, how can we call them private? So the muddied -- and I would guess that there are all kinds of nuances in that world of the Chinese intelligence community asking companies to do stuff on their behalf.

So it makes this a very difficult process. And very difficult to talk about if we use our current lexicon, and I don't know what the replacement lexicon is.

ASSISTANT SECRETARY NIKAKHTAR: May I quickly --

COMMISSIONER FIEDLER: Yes, please.

ASSISTANT SECRETARY NIKAKHTAR: Add that to. Part of the CFIUS process also is mitigation strategies. And so even when different agencies may kind of view the threat in the same way that other agencies do or not, then the question is can you mitigate this threat. And the big existential question we're all having right now is who do you actually trust in terms of mitigation.

When you're trying to do a mitigation agreement with Germany, for example, it's fundamentally different that you're doing a mitigation strategy with a Communist Party that is not, that doesn't have benign interests, right.

And so not all agencies kind of view this threat in the same way, but that is the existential question that we're all dealing with now is that is the Chinese Communist Party to be trusted in these mitigation strategies.

COMMISSIONER FIEDLER: Thank you.

COMMISSIONER WESSEL: Chairman Cleveland.

CHAIRMAN CLEVELAND: It's a perfect lead. Madam Secretary, I'm interested, you have a really deep historical perspective on trade issues. And you mentioned that we went from a period of cheerful engagement to questioning engagement to, now we're in the so-what period.

And it feels to me that we are often playing a game of catch-up in terms of the Chinese are very clear, they lay out what their strategy is, and somehow we seem surprised when they execute it.

I'm interested, in the context of defining threats and how we think about the relationship in corporate social, their construct in terms of responsibility of corporations to disclose, to, as you said, transfer technology and IP, is the new corporate social credit system a way of subverting the agreement that we've just reached in terms of protections of IP and transfer of technology?

Is this kind of the leapfrog way to gain access in a way that the Chinese say but this is our law? Just like they won't disclose audits, this is national security information?

So I'm interested in how you place the corporate social credit, the CSC, it's a tongue twister, how you see the CSC in the context of the recently inked deal, and how the Chinese will use it to subvert rules and regulation and expectations.

ASSISTANT SECRETARY NIKAKHTAR: I've been thinking about the same question for a long time. I'll start with the historical context. Back almost 20 years ago, I used to be at the JCCT and then it became the SED, Strategic Economic Dialog, with China.

And the commitments that China had made in terms of the WTO, in terms of trade it just basically had never adhered to. And that's pretty much well known, and that's why we're here where we are now.

So with respect to the corporate credit system and then these new, this new China deal, they're both being implemented this year, right, and they're both kind of being implemented on the same track. Time will tell, but also history tells us a lot.

I will say that it's interesting that in the China deal, China states that confidential data would be protected, protection would be, protection of disclosure will be guarded by the government. But it also says, you know, companies won't be pressured to transfer their technology.

And so when you have, when you dangle, which is what China has done for many, many years now, dollars in front of a corporation and the promise to great access to the great Chinese market, knowing full well that you're going to be out of business five, ten years from now when they copy your corporate governance system and your IP and basically take over your market share and bankrupt your business.

Until that point, the lure, and the, what's glittering before the companies is just too hard to resist. And the Chinese know that, they've taken advantage of that, I think system, for quite a long time.

So again, time will tell, but it's also interesting that when they have provisions like no tech transfer by pressure, you can still use the corporate credit system as, when companies fully understand that there are repercussions. It doesn't have to be explicit pressure, but just knowing that there's repercussions if you don't play ball, I think that's completely telling.

But I will tell you that in terms of the government, for us to really have our finger on the pulse of how extensive this is in terms of pressure or non-pressure or whatever what want to call it, it's really hard.

Because companies are very reluctant to kind of publically say what they've experienced, the kind of pressure or non-pressure they've experienced for fear of either retaliation or stock market prices plunging or anything like that.

And so what we're able to kind of gather is anecdotal information. Because companies -- so it'll really be incumbent on companies to kind of quietly tell us how China is implementing its agreement.

But I will say that the agreement does have enforcement measures in terms of tariffs, so that if companies do tell us how they're being impacted and we see that China is not adhering to the terms of the agreement, we do have the ability. Now, whether we are going to take on that ability in years to come depending on who is running the government I think is a question that nobody has the answer to right now.

CHAIRMAN CLEVELAND: Thank you.

COMMISSIONER WESSEL: Senator Goodwin.

COMMISSIONER GOODWIN: Thank you, Mr. Chair, and thank you, Madam Secretary, for your time today. I was really intrigued by your use of the phrase fundamentally different, because I don't think that is incorporated into our conversation enough and effectively conveyed to policymakers around the country and investors.

In response to Commissioner Wortzel's question, you were talking about the need to assess the risk and assess exposure that investors may have in investing in these companies. And I think as part of that assessment it is important to also assess how those risks are fundamentally different from risk in investing in other emerging markets.

So it's not simply that we may be investing in a market, in helping it grow on a macro level and that inures to their benefit. But instead, whether we are investing in specific initiative, perhaps unwittingly, as the Secretary of the Navy observed, that run counter to U.S. foreign policy and national security objectives.

How do we determine whether those are fundamentally different from risks posed by investments in other emerging markets, and how do we effectively convey the difference in those risks to policymakers, not just here in DC, but around the country? Including, you know, various state investment boards, pension systems, and the like.

And on a related note, this may be a little bit outside your purview, but do we have a sense as to how many state pension boards and investment funds may be investing and tied through these indices, and as a result, funding some of the entities on your Entity List?

ASSISTANT SECRETARY NIKAKHTAR: So the second question, we're starting to tally that information up right now in my office, just so we have a good understanding of it. But I think was your, your earlier question went to how are kind of defining China's practices as being fundamentally different than other countries.

COMMISSIONER GOODWIN: Well, sure, but we will have a witness on a later panel that, without characterizing his testimony or putting words in his mouth, at least offers the suggestion that we have faced these sorts of risks before, we're facing them now, and investing in certain emerging markets we are confronted with political risk, human rights concerns, and perhaps investments in entities that run counter to our interests.

What makes these investments in China different?

ASSISTANT SECRETARY NIKAKHTAR: So as the National Defense Strategy kind of, as I mentioned, points out, China's a strategic competitor. And it's used predatory practices I think in a scale that we've never seen before. China's just, the size and scale of the Chinese economy gives it so much power that we've seen -- we haven't seen in any other country before.

And China knows quite well how to exercise this power, right. Massive overcapacity, wiping out industries. It's not just in terms -- well, I should say it's not just in terms of competitive interest.

When you've got massive SOE funding and all of the strategic ways the Chinese have been acting in terms of not just competing on a level playing field in the global market space, but using its sheer power and size to wipe out competitors entirely.

I will give you sort of the race in next generation is 5G, right, and 5G dominance, which was really going to be the next big industrial revolution. And China is not only throwing a lot of money in terms of the infrastructure, but it's also working on a plan B, which is the optical fiber cables, right.

With massive, massive overcapacity, oversupply in the global markets, driving down the business -- driving down prices, I should say. And wiping businesses out, where you're seeing companies that are starting to exit the market, knowing full well that if you control the optical fiber cables, you control who can connect to them, and you can control 5G.

So if it doesn't win the 5G race in sheer just output in terms of the equipment and the technology, it controls the optical fiber cable. You compound that with one to three million people in internment camps, it's unlike how we've strategically competed against Japan before. And it's much like, you know, almost in terms of sort of the World War II, that kind of mentality or the Cold War mentality.

It's, again, I want to underscore the size of it makes it quite unique. China's view, I think a lot of people in the government would argue, is a unipolar view of the world where, and the fact that it has made its country a surveillance state I think is the fear that it's not going to be just competition with a competitor, it's going to be competition with a country that is intent on dominating the rest of the world in very, very scary ways. And has the power to do so, again, because of its size.

COMMISSIONER WESSEL: Thank you. This is, as I think Chairman Cleveland said, a very complex set of issues. So we're all trying to feel through it.

I think the underlying securities law indicates that investors, you know, deserve to know the risks of what they're investing in. But it does not preclude investments in those risky assets, that's up to the investor.

But here we seem to have some clear and direct challenges to U.S. policy. So again, we talked about the Entities List issue. The PCAOB has been negotiating with the SEC for I believe it's 12 years now to try and get access to audit papers, which, again, is a fundamental part of the information that should be available to investors.

Yet, rather than requiring that China comply for those assets, those companies that have not been properly audited or questionably audited, we are allowing U.S. investors to invest because the government is taking no active role. What kind of policy challenges do you see here?

Again, going back to the WTO, we negotiated a set of rules, China didn't comply. Here we have a set of rules, but we're not requiring them to comply in the first place, and we seem to be looking the other way. Sixty percent of China's exports emanate from foreign-invested enterprises.

The President has made clear that reducing the trade deficit and stopping outsourcing is an important objective, yet these investment flows would seem to be again Entities List, audits, trade deficit, seem to be running pretty counter to U.S. national interests and national strategies. How do we square that, you know, what do we do about it? Do we need new tools?

ASSISTANT SECRETARY NIKAKHTAR: So I think fundamentally with respect to the new global trading regime, our tools that we're using were developed decades ago. And we're dealing with sort of a new country and a new threat on a massive scale that we've never encountered before.

So I think the first question that the U.S. government needs to ask itself, and certainly we in my office have been posing this question to the National Security Council, etc., is that do we, do our tools that we have actually work and fit all the circumstances that we're dealing with?

But then there's just tools that we don't, there's areas where we just don't have tools for, with respect to SOE funding, with respect, just sheer global overcapacity. You know, price, global price depression in terms of noncompetitive levels that other industries or other markets can't compete with. So I think that's the first question.

With respect to the PCAOB, I think there's about 222 Chinese companies, which is I think all or virtually all of the listed companies on the U.S. exchanges, that are able to undergo through this independent audit. I think on one hand you would have people tell you, well, the independent, or the reviews that the exchanges with, before listing these companies should be sufficient.

But I think that undermines the entire argument through the Sarbanes-Oxley of why you, we set up the PCAOB to begin with, right. And Chinese companies have, had a historical use of irregular structures to do business in the United States, questionable accounting practices, lack of transparency.

I used to audit Chinese companies 20 years ago when I was at the Department of Commerce. There's four or five financial statements, they give their government in many instances false financial statements. They give the U.S. government false financial statements. And we've seen this over and over again.

So I think that is the reason why the PCAOB was set up, and it certainly is the reason why. But I think going to the earlier point, the U.S. government really needs to think about where we are as a nation in terms of addressing these threats, and do we want to have a cohesive view? Because right now our views are very disjointed from one agency to another.

It's part of the evolutionary process as we're trying to understand these threats. People will eventually come to the same page. But I also want to underscore that time is of the essence. Our technological leadership with respect to China I would say, judging from semiconductors, which is sort of the crown jewel here, four to five years.

And unless we and the government get on the same page, and as a nation I should say, get on the same page, and Congress, including Congress, as to what this threat are -- what this threat is and how we need to act, I'm afraid time will be, we will lose time and we might be in a position where we can't dig ourselves out of.

COMMISSIONER WESSEL: That's optimistic, thank you. Commissioner Fiedler.

COMMISSIONER LEWIS: Thank you. Thank you for your presentation today. I want to focus not so much on the risks to American investors, but how the money is used.

What is in the national interest or why shouldn't the United States bar Chinese companies from raising money in the United State unless we know that the use of that money will only be for commercial purposes, and not for anything to do with the Uyghurs or with the protestors in Hong Kong, or in other things that are contrary to U.S. national interests?

Why should we allow such money to be raised in the United States when we don't know how that money is going to be used?

ASSISTANT SECRETARY NIKAKHTAR: Well, that's an excellent question. And so there is that component. There's two distinct components I think to this argument. One is are we worried about how our money is going to be used to fuel all of these either predatory things that the Chinese government is doing, or the human rights abuses.

I think the second question is the integrity of the investments that the United States are making. In companies, in a government where macroeconomic data skews the way that you can actually assess the fundamentals of investing, you have general corporate governance concerns with respect to the Chinese government's reach into the companies --

COMMISSIONER LEWIS: That's looking at it from the opposite side. I'm talking about if we can't determine how that money's to be used, why should we allow that money to be raised at all?

ASSISTANT SECRETARY NIKAKHTAR: Well, I think we are starting to consider how that money is abused. And I think the first part of the exercise is to look at the investments that are made. And the point that we talked about a little bit earlier is the companies that have been identified by the U.S. government of engaging in practices that are contrary to national security and foreign policy interests.

Those are listed companies, so we know that the money that the U.S. government is investing in those companies is being used in some way, shape, or form to fuel and funnel -- and facilitate those activities that we feel are contrary to our national security interests. So we have a good amount of evidence there.

And then we have -- we're studying in terms of other companies that may not make it on a government -- on the U.S. government's banned list within an affirmative finding that something's going on, but anecdotally we know that the company is using U.S. individuals' money to fuel behavior that facilitates the People's Liberation Army, for example.

COMMISSIONER LEWIS: What would be the downside of the United States just barring Chinese companies from raising money in the United States? What's the downside?

ASSISTANT SECRETARY NIKAKHTAR: Well, I think publicly there's been comments that this could be disastrous, but when you actually look at the U.S. -- the Chinese companies listed on the U.S. exchanges, we're looking at about -- or I'm sorry, you're looking at in terms of the Chinese companies, yeah, listed on the U.S. exchanges.

That's just a portion. That's $375 billion over the market, full market cap in the United States of $35 trillion. So that is less, far, far less than one percent.

And so I would say that if you just look at the data and the statistics, the impact is very minimal. But I would also say that money just doesn't disappear. If you bar investment in these companies, the money is going to end up being invested elsewhere.

So there's a substitution effect here, which means that the investments won't amount to zero. But also, even if they did, it's less than one percent of the total market cap in the United States.

COMMISSIONER WESSEL: Thank you. Commissioner Fiedler.

COMMISSIONER FIEDLER: I want to go back to your comments on, I mean, basically you were saying if I oversimplify that the regulatory system is outdated vis-a-vis dealing with China.

I would also, and you, you're talking about sort of agreement among all of us on what the threat is, which goes to the, you could have a perfectly good regulatory system and lack the will to use it. You made some reference to that in terms of successive or succeeding administrations.

The, our role in advising Congress seems to me to be start an examination of the regulatory, the key elements of the regulatory system that are inadequate in dealing with the threat. You brought up predatory pricing and predatory practices, which to me goes to the speed with which we're able to respond. So in other words, the industry is totally destroyed by the time we have any, you know, we respond.

And I'd like to make one also observation that I think that my colleagues have made in terms of investment. We always make these out -- sophisticated investors are sort of exempt from certain kinds of rules. And I'm getting old, so I remember the financial crisis.

There seemed to me to be only three or four short sellers that benefitted from the crisis and saw it coming. So I think there were only three or four sophisticated investors. All the so-called sophisticated investors lost money and everybody else's money, ordinary people's money.

So I'm not so impressed with sophisticated, the sophisticated investment community or banking community, because the country suffered greatly and continues to suffer from it.

So how is it that we -- the government process is difficult to get everybody together. What can the Congress do to prompt that examination of the regulatory system, the key elements, not every regulation, but the key elements of the regulatory system to address a China threat?

ASSISTANT SECRETARY NIKAKHTAR: So in economics we say that the most efficient form of government is a benevolent dictator.

And so falling a little bit short of that, I think that the way that the Chinese government, the Chinese Communist Party runs the government is way more efficient than a democratic system because you have different points of views. And built in that you have certain inefficiencies. Which I think underscores the importance of the China Commission.

What you're able to do is put together an assessment of where we are now, and potentially policy recommendations. But I really, really, from my vantage point in terms of my role and responsibilities in the administration, my, one of the things, the most important things that we need to look at, and that I'm trying to sort of build out the analysis is where we just don't have tools.

And I think what the Commission can also do is look at how China is behaving in the global marketplace. And it has so many different tactics to sort of, in terms of its strategic competition. What are all of those tactics? Where do we have tools that effectively deal with them and where we don't.

And I would actually say just from my study of China over the course of the last 20 years, there may be areas that we just don't have the tools. Or it may be areas, like you said, that we're just playing catch up in a whack-a-mole game.

And if that is the assessment that we ultimately come down to as a country, what's next? Where do we need to go and what do we need to do? And we certainly need to do it expeditiously. But again, I think the Commission has a key role to play, and I'm grateful for it, is that it can help build out the set of facts as to where our tools fall short.

And I really haven't seen the U.S. -- a really good, comprehensive study of this that enumerates all of the tactics that China uses and then matching it up with where we can act, where we can't, what tools we have, where we develop new tools, or where no tool will be good enough.

COMMISSIONER FIEDLER: Thank you very much.

COMMISSIONER WESSEL: Commissioner Cleveland.

CHAIRMAN CLEVELAND: You may have answered the first part of my question, which was you have used the term predatory practices a couple of times this morning. And I'm curious whether or not there is a common understanding across the government, the U.S. government, of what a predatory practice is, in terms of whether it's through CFIUS or the interagency process.

You've talked about overcapacity and subsidizing SOEs, but I wonder about things like not allowing zombie companies to default. I mean, how are we thinking about that fundamental term of predatory practices, how are defining it?

ASSISTANT SECRETARY NIKAKHTAR: One way to actually -- so the predatory practices are -- the way it's commonly understood is that the practices that are meant to essentially not compete with your competitors, but basically wipe them out, using any means and all means possible.

Now, the international trading rules, certainly the vast body of rules at the WTO, may not address everything like overcapacity, but at least they set out fundamental principles of how we're supposed to behave and when we compete. And when you look at the spirit of those rules, and then the tactics that the Chinese Communist Party is using to participate, then you can see when they fall outside the norms of fair competition.

When you have intellectual property misappropriation, when you have theft, when you have massive -- I mean, I think one anecdote I heard in terms of steel overcapacity, steel of course strategic sector, important, vastly important to national security. But when you have overcapacity, they can build the steel bridge to the moon I think nine times and back, that's not competitive, that's not normal.

When you're seeing China's acquisition of mines around the world to restrict access, advanced energy storage is a big one.

And now that you see that the Chinese government has somehow worked, we're still trying to get to the facts of this, with the Indonesian government to export a lot of nickel to China and then restrict exports to the rest of the world, which is what is needed for advanced energy storage, that's basically falls outside the rules and the norms as enshrined in the international agreements.

And that's where you start seeing the definition or what is evolving into the definition of predatory practices.

CHAIRMAN CLEVELAND: Thank you. Again, in trying to think ahead, we have all been talking about China and the government, China, Inc., at a national level, and one of the concerns that I have is at the provincial and local level, we are seeing far more aggressive lending and bond issuance and engagement in global financial markets.

I'm wondering if Commerce or anybody else is looking at provincial and local level engagement, which to some degree is independent of Beijing in terms of their operations and activities as they look to raise capital.

ASSISTANT SECRETARY NIKAKHTAR: That's something that we haven't traditionally looked to. But right now as we're taking, undertaking the from sector to sector reviews of Chinese behavior, we're certainly looking at all levels of the government.

And I should actually mention that in my prior tenure at the U.S. government, when we were looking at government compelling corporate behavior or directing corporate behavior, we certainly looked at it from all levels of the government. And the Chinese government is quite complex and it does have different pockets of control.

And so we've always been looking at it, but in terms of sort of trade competitiveness overall, it's something that we're just starting to look to in my office right now.

CHAIRMAN CLEVELAND: Yeah, I think my concern is that it's hard to argue when a local government is offering a bond that has a four percent yield in the current Treasury's market that isn't something worth considering the risks and the transparency behind that bond issuance are troubling.

And I'm not sure it's aligned with what Beijing wants to do, and I think we have to have a multidimensional approach to assessing risk as they are engaging in it. So thank you.

ASSISTANT SECRETARY NIKAKHTAR: Absolutely.

COMMISSIONER WESSEL: Our time has expired. I want to thank you for your testimony. As we have talked in the past on a lot of different subjects, I want to thank you for the work that you and your staff do to try and look at these issues, expand our analytical base to dive deeper into what's happening and the challenges we face.

And I hope not only that we can follow up on this hearing, but work with you and your people over the coming weeks as we seek to identify and confront these challenges. So thank you.

ASSISTANT SECRETARY NIKAKHTAR: Thank you very much.

COMMISSIONER WESSEL: We will stand adjourned for ten minutes.

(Whereupon, the above-entitled matter went off the record at 10:19 a.m. and resumed at 10:31 a.m.)

PANEL I INTRODUCTION BY CHAIRMAN CLEVELAND

CHAIRMAN CLEVELAND: So the next panel will focus on the overall structure of China's financial system and identify how the system allocates capital to different actors in the economy as well as address the emergence of risks in China's banking sector, financial sector.

We will begin with Dinny McMahon, author of China's Great Wall of Debt: Shadow Banks, Ghost Cities, Massive Loans, and the End of the Chinese Miracle.

From 2015 to 2020, Mr. McMahon was a fellow at MacroPolo, where he spearheaded a research program on China's efforts to clean up the financial system. Mr. McMahon was previously a financial journalist in China, including six years in Beijing with the Wall Street Journal.

He will provide testimony on Beijing's strategies for dealing with systemic financial risks including bank capital shortfalls and orderly disposal of non-performing loans.

We will then hear from Leland Miller, the Chief Executive Officer of China's Beige Book -- if I slowed down I'd speak better -- a China-focused economic research firm and aggregator of the world's largest proprietary data set on the Chinese economy.

Mr. Miller will discuss China's informal finance sector, shadow banking, and the resurgence of off-balance bank sheets lending to private companies in 2019.

We will then hear from Zhiguo He, Fuji Bank and Heller Professor of Finance at University of Chicago's Booth School of Business. Dr. He's comprehensive study of China's bond markets and interbank market will be published in the handbook of China's financial system by Princeton in 2020.

He will provide testimony on the structural characteristics of China's banking system and bond markets as well as local government debt and bond issuances.

We really appreciate your testimony, I am eager to hear it. I will remind you to try to keep your remarks to seven minutes because we will have lots of questions.

So Mr. McMahon, will you begin, please?

OPENING STATEMENT OF DINNY MCMAHON, AUTHOR, CHINA'S GREAT WALL OF DEBT: SHADOW BANKS, GHOST CITIES, MASSIVE LOANS, AND THE END OF THE CHINESE MIRACLE

MR. MCMAHON: Thank you for the invitation to speak here today.

As Chairman Cleveland just said, I'm focusing my prepared comments on how China is dealing with non-performing loans, which is perhaps the key factor that will determine banks' capital needs in the near future.

The process of making provisions against bad loans and ultimately writing them off directly erodes bank capital.

Until recently that wasn't a significant driver of the banks' capital needs but starting in 2016, banks have accelerated their disposal of bad loans.

Beijing is in the midst of a sustained, albeit slow-moving, clean-up of its financial system, one that is growing increasingly complex and one that will require decisions from Beijing as to who bears the burden of recapitalization.

In my comments I'll aim to outline the approach that Beijing has pursued in cleaning up the banks over the past few years, how, given the State felt compelled to intervene in 5 of China's 50 largest banks in 2019, that that approach may be reaching the limit of its effectiveness, and overall what this means for China's banks' capital needs.

China has been engaged in cleaning up banks' bad loans for about the last four years. Between 2016 and the end of 2019, Chinese banks disposed of 6.4 trillion yuan worth of non-performing loans.

That's almost $1 trillion but represents only about 4.7 percent of the total volume of bank loans outstanding in China's banking system at the end of 2019. Of course, it's difficult to say just how significant that is.

At the moment China's official non-performing loan ratio is less than 2 percent, which is very healthy by international standards but no one really, inside or outside of China, actually believes. It really sort of massively understates reality.

But of course, coming up a fair representation of what the actual number is is also incredibly difficult. In recent years I've heard estimates ranging anywhere between 4 percent and 20 percent, which really just goes to underscore how little we know about the true level of distress in China's banking system.

However, there is plenty of indications that Beijing is currently ramping up its efforts to clean up the banking system, which suggests that we are only really at the early stages of this clean-up process.

Certainly it's easy to look at this artificially low bad loan data and assume that China's authorities are in denial about the extent of the problem. But the decision to understate bad loan data has some strategic value.

Now, what I mean by that is that it gives Beijing the freedom to deal with bad loans in its own way and at its own pace.

So, for example, if Beijing decided to acknowledge overnight a significantly higher non-performing loan level, the international rules that govern the capitalization of banks would require that China's banks immediately raise huge amounts of capital all at once, which would inevitably be at fire sale prices.

Secondly, companies that were in arrears but had previously enjoyed banks' forbearance would be forced into bankruptcy. And the secondary market for bad loans would be hit by a glut of new supply, forcing down prices and reducing the value that banks could extract from them.

So, Beijing's slow-paced clean-up is designed to minimize any of this sort of economic disruption and also to try and minimize the degree to which the State needs to intervene directly to recapitalize the banks.

And it's about doing that by reducing the amount of capital that banks need to raise in any given year. So for example, this slow-moving clean-up has allowed the banks to sell bad loans for more than would otherwise have been possible.

That's been a major focus of the central government over the last few years as it's built up the financial infrastructure necessary to help banks dispose of their loans, things such as a proliferation of provincial asset management companies, also allowing banks to securitize their bad loans by encouraging debt-for-equity swaps.

And perhaps most importantly, it has streamlined the legal system such that it is much easier for banks to sell the collateral that has been posted as collateral for delinquent loans.

Moreover, by gradually recognizing and disposing of bad loans slowly over time, it's allowed banks to replenish capital from profits generated over multiple years, which would not be possible if all the bad loans were recognized in one hit.

And when retained earnings hasn't been enough to meet capital needs, the banks have raised capital from IPOs, from private placements and bond issuance, albeit at a pace that hasn't overwhelmed the market's ability to absorb them.

However, this approach is becoming less sustainable. As the Chinese economy slows further, the volume of bad loans will mount and banks will need to dispose of them more quickly in order to keep their level under control.

Also, the value banks have been able to extract from bad loans has been declining since the beginning of 2018, when a bubble in the secondary non-performing loan market popped, bringing down prices precipitously.

Moreover, the extent to which banks can replenish their capital from profits alone is diminishing as profit growth slows with the economy. It now appears that we have entered into a new phase of this clean-up.

Following the State's intervention in five banks last year, it's become clear that the pace of clean-up has been insufficient to keep financial risks under control.

It seems that the authorities are still experimenting with how to effectively deal with bank distress but we can nonetheless take a couple of lessons away from last year's interventions.

First is that Beijing has a wide range of financial resources that it can mobilize such as other banks, insurance companies, pension funds, state firms, and even the foreign exchange reserves that it can mobilize without resorting to the Ministry of Finance's balance sheet to recapitalize banks.

Secondly, it appears that Beijing will only commit to intervening in China's biggest banks and below a certain level, local authorities will be expected to step in and prop up local financial institutions.

Now, that poses a real challenge to local governments because while China's largest banks seem to be in relatively good shape, the smallest banks as a group aren't.

And while none of them are systemically important, recapitalizing them will only worsen the burden on local governments, many of which are already fiscally overstretched.

Finally, to reflect briefly on what this means to the U.S., it's worth noting that last time China cleaned up its banking system, foreign investment played a huge role in recapitalizing banks. That's unlikely this time.

Recent moves by Beijing to relax foreign ownership controls over Chinese financial institutions potentially opens the door to foreign banks to play a role, but really only for small banks.

I'll leave my comments there, thank you.

PREPARED STATEMENT OF DINNY MCMAHON, AUTHOR, CHINA'S GREAT WALL OF DEBT: SHADOW BANKS, GHOST CITIES, MASSIVE LOANS, AND THE END OF THE CHINESE MIRACLE

Testimony before the U.S.-China Economic and Security Review Commission
Hearing on "China's Quest for Capital: Motivations, Methods, and Implications"

Dinny McMahon
Author of "China's Great Wall of Debt: Shadow Banks, Ghost Cities, Massive Loans, and the End of the Chinese Miracle."

January 23, 2020

In the years following the Global Financial Crisis, China pursued a credit expansion unprecedented in its size and speed. Not all of the debt was well spent, resulting in a build-up of industrial overcapacity, empty housing, and underutilized infrastructure. China's financial system is now dealing with the fallout of that waste and excess.

Since 2016, China's banks have accelerated their disposal of nonperforming loans (NPLs). Nonetheless, the pace of disposals has remained slow and measured, a deliberate decision on Beijing's part to minimize economic disruption by spreading out the cost of resolving bad loans over an extended period of time. The approach hasn't been without merit. Banks have been able to accelerate the pace of NPL disposal while relying primarily on retained earnings to replenish capital eroded by write-offs. To the extent that banks have needed to sell bonds and equity to augment their capital, the market has proven up to task of absorbing the demand.

However, China may have already reached the limitations of that approach. In 2019, the government intervened directly to prop up five of China's 50 biggest banks. It's feasible to think there will be further interventions in the years ahead. The chairman of China's sovereign wealth fund recently said as much, noting that as the economy slows, the failure of financial institutions will become "a fact of life".[1] Certainly, it seems likely that the banking sectors' need for new capital will accelerate in the years ahead.

This paper will not seek to estimate just how much additional capital China's banks will need. Official data understates the extent of China's NPL problem, and the stock of NPLs is likely to swell as the economy slows further, complicating any calculations. Rather, this paper will attempt to outline the factors that will determine how large the banks' capital needs will be. Specifically, there are four aspects worth our consideration:

1. The degree to which debtors are able to repay their loans, either by having the burden of their outstanding debt reduced, or by drawing upon new funding sources with which to pay down their loans.
2. The degree to which banks are able to extract value from their NPLs, thereby reducing the amount of bad loans they need to write off.
3. The degree to which banks' profit growth is sufficient to meet capital needs without banks needing to sell bonds and equity.
4. The degree to which the state feels it is necessary to intervene directly in struggling banks, and the means by which the state intervenes.

It's worth noting that banks' loan growth also places demands on their capital. Despite having launched a 'deleveraging' campaign in 2016, the Chinese economy continues to rely on the rapid accumulation of debt in order to deliver politically acceptable levels of growth. That means China cannot deleverage at a macro level in the near term. But as long as lending expands, banks will need more capital. Banks' loan growth is further

[1] Sun Yu, "China sovereign wealth fund head signals more financial failures," *Financial Times*, September 20, 2019, https://www.ft.com/content/29e133dc-db73-11e9-8f9b-77216ebe1f17.

fueled by government efforts to repatriate shadow banking loans back onto the banks' books. To the extent that such repatriation continues to swell bank loans, banks will need more capital.

That said, we will focus here solely on the challenges posed by distressed debt. This paper will look at how Beijing is trying to clean up the financial system; the ways actors in the economy have attempted to mitigate NPL formation; how the state has tried to minimize the need for banks to raise fresh capital; the limitations of the current approach; and what we can expect from future government intervention in the banks.

China's Bank Clean-Up Strategy

According to Chinese government statistics, at the end of September 2019, only 1.86% of Chinese bank loans were nonperforming. It is widely accepted—both inside of China, and out—that the figure significantly understates reality. However, estimates of the actual level vary wildly. Further complicating efforts to arrive at a figure is that the degree of distress among various tiers of banks differ significantly. A researcher at Tsinghua University's National Finance Research Center[2] recently estimated that the NPL ratio for large state-owned commercial bank is between 5% and 8%,[3] joint stock banks between 8% and 12%, city commercial banks between 10% and 15%, and rural financial institutions between 20% and 30%. While I have no way of independently verifying whether those figures are a fair estimate, they nonetheless reflect the consensus on how distress varies between bank types.

It would be easy to mistake obfuscation of the data for denial of the problem, and believe that Beijing's failure to provide a fair and transparent accounting of the banks' NPLs reflects an unwillingness to deal with the issue. However, since 2016, Beijing has been pursuing a concerted—albeit moderately paced—cleanup of the banking system. Between 2016 and the end of the September 2019, Chinese banks disposed of 5.8 trillion yuan ($828.6 billion) worth of nonperforming loans, equivalent to about 4.6% of the total volume of outstanding loans at the end of the period.

The decision to understate the NPL data is strategic. It gives Beijing the freedom to deal with bad loans in its own way and at its own pace. If Beijing were to acknowledge a significantly higher NPL ratio, then the banks would have to immediately raise huge amounts of capital, all at once, and at fire sale prices. Companies would be forced into bankruptcy as delinquent borrowers who had previously enjoyed the banks' forbearance, are foreclosed upon. And the secondary market for bad loans would be hit by a glut of new supply, forcing down prices and reducing the value banks could extract from them.

Pursuing a slow-paced cleanup has allowed Beijing to minimize the disruption to the broader economy, and to reduce the cost to the central government. It allows banks to make write-offs from profits generated over multiple years, thereby reducing the need to raise fresh capital from the market. Moreover, banks can gradually drip nonperforming loans into the secondary market rather than dumping them en masse on disinterested investors. And by having banks exercise forbearance on delinquent loans, it gives the authorities time to find ways to help overstretched borrowers repay their debts.

China is able to take such an approach because its financial system functions differently from those in market economies. Market economies demand that banks offer an accurate accounting of their asset quality in order to ensure that they're adequately capitalized, which is necessary to ensure that the market retains faith in the banks. In China, the state stands behind the country's banks. That ensures that the market retains faith in the banks even if they're not sufficiently capitalized. As long as authorities ensure those banks have sufficient

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[2] Yang Xiaohai, "**如何化解不良资产"堰塞湖"**," (How to Resolve the "Railings Dam" of NPLs) *FT Chinese*, October 8, 2019, http://big5.ftchinese.com/story/001084431?adchannelID=&full=y&archive.

[3] The designation "large state-owned commercial banks" refers to ICBC, CCB, BOC, ABS, BoCOM, China Postal Savings Bank.

liquidity to meet their obligations, they can trundle along with higher delinquency levels than would be regarded safe in a market economy.

The approach is not without risk. While gradualism helps to avoid the trauma that would accompany a more sudden adjustment, the trade-off is that banks must tolerate a higher level of NPLs for a longer period of time. That leaves the banks more vulnerable to economic shocks, which has the potential to lead to far greater economic disruption down the line. So far Beijing has been able to manage those risks by ensuring that banks have sufficient liquidity.

But the measured approach Beijing has pursued thus far only works if the banks are able to dispose of bad loans faster than new ones are created. We have no way of knowing whether the banks have been able to maintain that balance over the past few years. However, it seems clear that in the coming years the balance will become far more difficult to maintain, requiring greater NPL disposals, greater capital raising, and more direct intervention on the part of government to support individual banks.

Mitigating the Creation of New NPLs

The first step toward managing banks' NPL burden is to mitigate the creation of NPLs in the first place, by ensuring borrowers have the resources to repay their loans. There have been a couple of efforts to this effect over the last few years, but they have been short-lived in their effectiveness. The following section will look at those efforts, as well as their limitations and potential for the future.

1. Inflation

One way to make it easier for struggling firms to repay their loans is to reduce the real cost of borrowing. That occurred in 2017 and early 2018 when producer prices surged, the result of Beijing's success in closing factories to deal with industrial overcapacity. The price of industrial commodities rose, reducing the relative cost of debt, and making it easier for firms to service their obligations. However, the Producer Price Index (PPI) has since plunged, even turning negative, which has exacerbated firms' debt repayment burden by pushing up the real cost of borrowing. While industrial overcapacity remains a problem in many industries, Beijing is increasingly concerned by unemployment, which likely lessens the political will to aggressively shut down more factories in the interests of boosting prices.

Alternatively, Beijing could just reduce interest rates. Despite the occasional five basis point cut to benchmark rates in 2019, the central bank has been reluctant to make more meaningful cuts, perhaps for fear of reigniting speculative investment in real estate. For similar reasons, Beijing is reluctant to resort to the type of pump priming stimulus it has fallen back on repeatedly over the past decade. Injecting more credit into the economy would boost profits for some firms, making it easier for them to manage their debt. However, it will create new bad loans, and when the stimulus has run its course, the economy will be no better off.

2. Asset Sales

For years, economists have argued that China's local debt problems are manageable if only local authorities were allowed to divest their huge asset holdings: land, forests, mining resources, and equity in companies. Land sales have long been central to local authorities' ability to borrow and repay loans, but with land sales sluggish in many parts of the country, land no longer seems sufficient to pay down the debt. A potentially important resource for local government—and state firms as well—to manage their loans is equity in companies they own. Nationwide, local governments own about 100,000 firms, with assets worth trillions of dollars.

Xi Jinping opened the door to the sale of state-owned equity when he launched mixed-ownership reform in 2013. At the time, he heralded mixed-ownership—which refers to the diversification of ownership of state firms—as a way to lift the efficiency and effectiveness of the state sector by diversifying ownership.

Governments would reduce their equity in state firms by selling their shares to other state firms, pension funds, and private equity investors, as well as private and foreign companies, in the hope that a greater range of shareholders would unleash companies' entrepreneurial spirits.

However, soon after, Beijing seemed to go cold on mixed-ownership reform, in part due to the enthusiasm of provincial governments, who saw it not as a way of boosting efficiency, but as a new channel through which they could raise capital. That said, mixed-ownership reform has bubbled along ever since, and even gained momentum in recent years, with local governments and state firms divesting equity they hold in non-core businesses. Regardless of mixed-ownership reforms' original intent, it has become a tool for the state sector to manage debt and capital needs.

Sadly, there is no aggregate data measuring the scale of funds raised through the sale of equity of state firms, or its impact on local government and state firm debt levels. While this could become a meaningful way for China to manage state-sector debt in the years ahead, for the time being it currently appears to be a marginal tool as best.

3. Delayed Payments

Throughout 2018, and at least the first half of 2019, one way that large companies were able to pay down their debt—or at least limit their accumulation of new debt—was by delaying payments to their suppliers. Private companies—the weakest political constituency in the economy—were most effected and had little scope to push back against large customers who insisted on paying later and later for goods and services bought on credit. The issue broke through into the public domain late in 2018 when Premier Li Keqiang called for an end to the practice.

"Government departments and state firms all must resolutely stop falling behind in making payments owed to private companies," the premier said at a State Council meeting in November that year.[4] "For government to do so violates the basic responsibility of the 'people's government serving the people.'"

The practice gained momentum for a number of reasons. The contraction in shadow banking that began in early 2018, meant that many firms—and local governments in particular—no longer had sufficient access to credit, and so they hoarded resources by pushing their financial stress onto their suppliers. Moreover, the slowing economy has forced firms in certain industries—notably construction—to consolidate. Consequently, many private companies—including multinationals—have found themselves dependent on a smaller pool of major customers who are able to use their concentrated market power to delay payment. However, there are limits to the extent that delaying payments can help reduce the NPL burden, with small firms likely already at the limit of stress they can absorb from their major customers.

4. Monetary Solutions

According to Bloomberg,[5] at a State Council meeting in 2019, the National Development and Reform Commission suggested that the People's Bank of China (PBOC) inject liquidity into the financial system for the express purpose of having banks use it to buy stakes in companies. Those companies could then use the capital injection to pay down their loans. According to the story, Premier Li Keqiang shot down the proposal. However, the suggestion wasn't outlandish. In fact, the PBOC had already done something similar the previous

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[4] "李克强：抓紧解决政府部门和国有企业拖欠民营企业账款问题" ("Li Keqiang: Grasp and Resolve the Problem of Arrears Owed by Government Departments and State Firms to Private Companies"), State Council, November 10, 2018, http://www.gov.cn/guowuyuan/2018-11/10/content_5339135.htm.

[5] "Inside the PBOC's Struggle to Balance China's Growth and Debt," *Bloomberg*, November 19, 2019, https://www.bloomberg.com/amp/news/articles/2019-11-19/inside-the-pboc-s-struggle-to-balance-china-s-growth-and-debt?__twitter_impression=true.

year. In mid-2018, the PBOC demanded that the liquidity released to large banks from a reserve requirement cut be used to fund debt-to-equity swaps, whereby loans to large, struggling firms were converted into shares in the companies, to be held by banks and other investors.

The ability to relieve pressure on debtors by changing the characteristics of their loans is one of the tools authorities can deploy to manage the debt burden. In addition to converting debt into equity, it can also convert debt into other types of debt with longer maturities and lower interest rates. That was part of the rationale behind permitting local government to issue bonds, which allowed local authorities to exchange bank and shadow banking loans for a cheaper source of funding that wouldn't need to be repaid as quickly. For many local governments, however, their debt burden is so heavy that swapping their debt into bonds has proven to be an insufficient solution.

An alternative could be for Beijing to mobilize the policy banks to warehouse local government loans. In mid-March, Bloomberg reported that China Development Bank (CDB) was set to play a role in helping ease the financial burden on overly indebted local governments.[6] Specifically, it reported that CDB was "leading an effort" to swap implicit short-term debts accrued by Xiangtan city in Hunan for 15-20 year loans. It also reported that CDB was talking to officials from Zhenjiang in Jiangsu, about making the city a test case for replacing existing debt with cheaper long-term CDB loans. The involvement of CDB and the other policy banks in resolving local government debt is a development worth watching. If the government uses the policy banks to monetize the loans (by having the PBOC fund the policy banks), it could lower interest rates on the policy bank loans below market rates on bonds. And by offering ultra-long maturities, the debt might ultimately be inflated away over time. As yet China hasn't taken this approach.

Maximizing the Value of NPLs

The need for Beijing to come up with a way to constrain the creation of NPLs is particularly important given that some loans are too politically sensitive to allow to default. However, contrary to what many observers assume, that doesn't apply to all loans made to state entities. Beijing has proven willing to allow loans to state firms to default, and for banks to pursue repayment in the courts. It has even allowed one major state-owned firm—Guangxi Nonferrous Metals Group—to pass through bankruptcy and into court-ordered liquidation. The firm was broken up and its assets sold at auction to an assortment of state- and private-sector buyers. However, that has so far proven the exception rather than the rule. State firms that can't repay their debts typically call upon other firms in their corporate group to repay their debt. In other cases, their debt has been dealt with via debt-to-equity swaps, or a white knight has appeared to take over the debt.

But for local governments in particular, the volume of debt is so large that none of these solutions seem feasible. Asset sales, or the shifting of the debt from commercial lenders to the state, loom as potential courses of action. In the meantime, loans that can't be written off will be a drain on bank resources—even if the banks' decline to officially recognize them as NPLs.

That said, there are still plenty of bad loans that banks are free to dispose of. Banks have two options when it comes to managing bad loans. They can write them off—which requires new capital to make up the capital that is eroded in the write-off process—or they can dispose of them in a way the allows the bank to recoup some value. The more that banks can earn from their disposal of NPLs, they less they need to write-off—and the less fresh capital they need to raise.

[6] "China Development Bank Leads Debt Fix in Another City," *Bloomberg*, March 17, 2019, https://www.bloomberg.com/news/articles/2019-03-18/china-development-bank-is-said-to-lead-debt-fix-in-another-city.

In order to maximize both the volume of disposals and the value that the banks can extract from their NPLs, Beijing has developed an ecosystem of financial institutions to help banks dispose of their NPLs. It has promoted a market-oriented approach, championing competition and transparency as key to lifting NPL prices. But it has also reserved a role for the state in dealing with potentially sensitive assets.

The main conduit for NPL disposals has been **asset management companies (AMCs)**, otherwise known as 'bad banks.' AMCs are a fixture of banking crises around the world. They're usually deployed so that a specific bank or group of banks are able to spin-off large volumes of NPLs quickly and efficiently, and are typically wound down once they've resolved or disposed of those NPLs. Seldom are there more than one or two—or at most a small handful—in operation in an economy at any given time.

Somewhat unusually, China has about 60 AMCs. Together they share the exclusive right to acquire from banks portfolios of three or more NPLs. Four of them—a group that was set up in 1999 to deal with an earlier banking crisis—are permitted to acquire NPLs nationwide. The remaining AMCs—the first of which gained regulatory approval in 2014—are allowed only to acquire NPLs solely from the single province in which they are licensed to operate. Most provinces have at least two local AMCs, and some have three. The AMCs are expected to operate on a commercial basis. And while they can hold on to the NPLs they acquire, they typically aim to sell them onward to third parties—Chinese entrepreneurs, dedicated distressed debt investors (both Chinese and foreign), and other firms. I estimate that in 2018, the banks sold about 500 billion yuan worth of NPLs to the AMCs.

Debt-to-equity swaps are the second most important NPL resolution channel. Debt-to-equity swaps are primarily used for dealing with the debt problems of large, state-owned firms, and particularly those that claim some strategic importance. Debt-to-equity swaps are not a cure-all, offering firms—and banks—only temporary relief. Debt-to-equity swap agreements are routinely signed on the understanding that the indebted company will buy back its equity after a few years. Nonetheless, they are a way of rapidly reducing NPLs. According to the State Council, China's banks conducted 228 billion yuan worth of debt-to-equity swaps in 2018.[7]

Since 2016, banks have also been able to package bad loans into **asset backed securities (ABS)**, which have mainly been used to dispose of loans to households and individuals. And finally, banks and AMCs post loans directly on Taobao, JD.com, and other online auction websites in order to market bad loans directly the public. The banks sold about 15 billion yuan of NPL ABS in 2018. There is no data on the volume of NPLs sold via auction, but banks raised 10.9 billion yuan from selling NPLs on Taobao alone in 2018.

Crucially, China's legal system has been broadly supportive of the NPL resolution process. They have been willing to freeze assets posted as collateral against loans, transfer rights to that collateral to investors who have acquired NPLs, and then auction those assets in a fair and transparent way, usually on Alibaba's Taobao platform. NPL investors, AMCs, and the banks themselves, use this process for extracting value from NPLs.

This supporting infrastructure has helped banks claw back significant value from their bad loans, and reduce the volume of bad loans they needed to write-off. According to the China Banking and Insurance Regulatory Commission, China's banks disposed of 1.9 trillion yuan worth of NPLs in 2018. Of that, 988 billion yuan was

[7] Huang Tianlei, "Tracking China's Debt-to-Equity Swap Program: "Great Cry and Little Wool"," Peterson Institute of International Economics, June 24, 2019, https://www.piie.com/blogs/china-economic-watch/tracking-chinas-debt-equity-swap-program-great-cry-and-little-wool?utm_source=feedburner&utm_medium=email&utm_campaign=Feed%3A+ChinaEconomicWatch+%28PIIE+China+Economic+Watch%29?utm_source=feedburner&utm_medium=email&utm_campaign=Feed%3A+ChinaEconomicWatch+%28PIIE+China+Economic+Watch%29.

written off.[8] For the most part, the banking system has been able to sustain such levels of write-offs by replenishing their capital with retained earnings. However, that's been supplemented with equity and bond sales, at levels that haven't overwhelmed the market.

Traditionally IPOs have been limited to the biggest and best-managed Chinese banks, but in the four years from 2016 to 2019, there have been 29 initial public offerings by Chinese banks on the Shanghai, Shenzhen, and Hong Kong stock exchanges as smaller banks have been allowed to list. During that period, the number of publicly traded Chinese banks doubled from 25 to 50 (some of the IPOs during the period were by banks that were already publicly traded, but engaged in a secondary listing on another exchange). At least another 15 banks are currently waiting for approval to list. Meanwhile, bank issuance of tier two capital bonds has been rising aggressively since 2014. And the authorities have introduced perpetual bonds as a new tool for banks to replenish their capital.

Most fundraising, however, is difficult to track. Small, non-listed banks raise capital by selling equity in private placements and in auctions on financial asset exchanges. However, there's sufficient evidence to suggest that such sales have surged in recent years, and in 2019 in particular. Non-publicly traded banks with more than 200 shares must apply to the China Securities Regulatory Commission for approval if they want to issue new equity. In 2019, 46 banks made such applications, up from 26 in 2018, and only 3 in 2017.

Government Intervention in the Banks

In summary, over the past few years Beijing has attempted to cleanup China's financial system at a moderate pace. That has allowed banks to maximize the value they've been able to extract from bad loans, and so minimize the volume of bad loans needing to be written off. The elevated level of write-offs has required banks to replenish their capital, but the additional capital raising hasn't stretched the resources of China's financial markets. If Beijing could sustain this process for another decade, it could conceivably clean up the excess and distress in the financial system without undue disruption to the economy and with the authorities being required to mobilize the bare minimum of their own financial resources.

However, the approach is becoming less sustainable. As the economy slows, banks will need to dispose of bad loans more quickly. Moreover, the value banks have been able to extract from bad loans has been declining since the beginning of 2018 when a bubble in the secondary NPL market popped, bringing prices down precipitously. Hence banks, unable to sell NPLs for as much as they used to, will not only need to dispose of more NPLs, they'll also have to write-off a higher portion of those bad loans, putting pressure on bank capital. But the extent to which banks can replenish their capital from profits is diminishing as profit growth slows with the economy.

Where possible, Beijing will continue to rely on market mechanisms to recapitalize the banks, that is IPOs, private placements, and bond sales. However, government intervention is also likely to become more regular. That became clear in 2019 when five of China's 50 biggest banks received some kind of state support. That support took a number of different forms, reflecting the different circumstances of each bank. But it also signals that Beijing is still formulating a response to the issue of bank distress. The various types of state intervention over the past year offer interesting insight into what we can expect from Beijing as it works toward ensuring financial stability. The following section will look at the way the state has recently intervened in China's banks.

Receivership

[8] Guan Lidan, "银保监会发布数据：去年银行业处置不良资产近 2 万亿，风险总体可控," ("CBIRC Data Announcement: Last Year Banks Disposed of Almost 2 Trillion Yuan Worth of NPLs, The Risk is Under Control"), *Sohu*, January 11, 2019, http://www.sohu.com/a/288247855_100001551.

Baoshang Bank, a city commercial bank based in Inner Mongolia, was taken into receivership by the central bank and banking regulator in May. It's still unclear why Baoshang was singled out for special treatment—at the time, the authorities said it was due to "severe credit risk" without giving details—but it seems likely related to its chief shareholder. Baoshang was 89% controlled by Tomorrow Group, the investment vehicle of Xiao Jianhua, a politically connected billionaire who was abducted by Chinese security forces from the Hong Kong Four Seasons in 2017 and renditioned back to mainland China.

So far, the takeover hasn't involved the state injecting capital into Baoshang. That said, the bank has only been able to meet its obligations to creditors with the help of the PBOC's Deposit Insurance Fund, China's version of the US Federal Deposit Insurance Corporation (FDIC). The PBOC has been collecting dues to finance the Fund since 2015, but Baoshang is the first bank it has intervened in.

The fund has guaranteed Baoshang's obligations to deposit-holders and bondholders, albeit within limits. The Bank of Gansu recently disclosed that the Fund guaranteed 90.7% of the 1.45 billion yuan the provincial lender had deposited at Baoshang, forcing the Bank of Gansu to recognize losses on the remainder. This is the first time that banks have been forced to take a haircut on funds lent to another Chinese bank, and is a blow to the long-held assumption that all banks are implicitly—and entirely—backed by the state.

The financial authorities have said that receivership will last for a year, during which time, the actual running of the bank is the responsibility of a trustee, China Construction Bank. (In the US, that role would fall to the FDIC, but China's Deposit Insurance Fund currently neither has the staff nor expertise to do so). It seems fair to assume that at the end of the receivership period, the authorities will seek a buyer for the bank.

Forcing banks to take a haircut on their exposure to Baoshang has introduced a new element of risk into China's financial system, and raises the prospect that more banks will require state intervention in the further. Banks are now more cautious when lending to small banks, wary that their loans aren't entirely safe. That has raised the cost of borrowing for some banks, and raised the prospect that their funding may not be as secure as they'd previously assumed.

Bailout

Hengfeng Bank is the smallest of China's 12 joint stock banks. The management of Hengfeng—which was previously known as Evergrowing Bank—came under a cloud in May 2016 when a number of Chinese media outlets reported whistleblower accusations of fraud among the bank's senior management. In December, a former chairman of the bank was sentenced to death for financial crimes he committed while at the bank.

According to local media reports, the Shandong government had wanted to restructure Hengfeng Bank back in 2017. The bank eventually came under the management of the China Banking and Insurance Regulatory Commission (CBIRC) in March 2018, when the former party secretary of the Shandong banking regulator took over first as the bank's interim secretary, then as chairman. Other regulatory officials also took on senior roles at the bank.

In December, Caixin reported that the bank would raise 100 billion yuan by selling 100 billion shares, swamping the 11.2 billion shares that were outstanding at the end of 2016 (the last period for which we have data), and giving the new shareholders all but total control.[9] Central Huijin Investment, the subsidiary of China's sovereign wealth fund that holds the central government's bank shareholdings, will acquire 60 billion shares, not only bailing out the bank, but effectively nationalizing it. An asset management firm controlled by

[9] Liang Hong, Wu Hongyuran and Denise Jia, "China's Hengfeng Bank Gets $14.21 Billion Bailout," *Caixin*, December 19, 2019, https://www.caixinglobal.com/2019-12-19/chinas-hengfeng-bank-gets-1421-billion-bailout-101495712.html.

the Shandong provincial government will acquire 36 billion shares, and the remainder will be acquired by an assortment of other investors.

Whereas market economies typically use tax revenues to bail out financial institutions, when Beijing intervenes, it typically avoids using Ministry of Finance resources. Rather, intervention typically involves mobilizing state resources that don't appear on the government's ledger.

When in 2016, Beijing recapitalized Great Wall and China Orient—two of the four national asset management companies—it used the National Social Security Fund (NSSF). And in 2015, China Development Bank and China Export-Import Bank were recapitalized by the State Administration of Foreign Exchange (SAFE), using China's foreign exchange reserves. SAFE was also used to recapitalize ICBC, China Construction Bank, and Bank of China in the mid-2000s. It's likely that such state-controlled pots of money will be called upon again to recapitalize banks in the future. That said, given the decline in foreign exchange reserves from their peak in 2015, and the strict capital controls currently in place to prevent their further decline, Beijing might be reluctant to turn to SAFE again.

Restoring Market Confidence

The two other banks to receive significant media attention for receiving government support are the Bank of Jinzhou and Harbin Bank. Both are Hong Kong-listed city commercial banks from China's northeastern rustbelt provinces—Bank of Jinzhou is based in Liaoning, and Harbin Bank is from neighboring Heilongjiang.

In July, Industrial and Commercial Bank of China (ICBC), along with Cinda and Great Wall—two of China's four national AMCs—acquired a combined 18% in the Bank of Jinzhou from existing shareholders. Then in November, two state firms owned by the Heilongjiang provincial government acquired a combined 26% stake in Harbin Bank, similarly buying existing shares. While both banks are publicly traded in Hong Kong, the new investors acquired non-listed domestic shares. In neither case were the banks bailed out. The money spent acquiring shares didn't replenish the banks' capital, but rather went to existing shareholders. Soon after the acquisitions, both banks announced that they would raise fresh capital by selling new shares to the public.

These interventions seem aimed at bolstering confidence in the banks, by signaling that they have entered into a closer relationship with the state. In the case of the Bank of Jinzhou, the change in shareholders also resulted in a change in leadership—ICBC has supplied the bank with a new president and three other senior officials—signaling that the bank is now under the explicit guardianship of China's biggest bank.

Beijing may have assessed that the Bank of Jinzhou's primary problem was liquidity, and not capital. The bank ran into trouble soon after Baoshang was taken into receivership, when it found it difficult to borrow sufficiently from the interbank market. It appears that ICBC is being used as a means of permanently restoring market confidence in the Bank of Jinzhou—by sharing its credibility with the Liaoning bank—while also being made responsible for overhauling the way the bank is managed.

It's also worth noting that the Beijing thought it necessary to mobilize centrally controlled institutions to intervene in Bank of Jinzhou, but not Harbin Bank. Upon first glance that appears to be a fairly arbitrary decision given that, for all their other similarities, the two banks are also comparable in size. The Bank of Jinzhou is China's 30th biggest bank by assets. Harbin Banks comes in at around 35. However, the decision might be informed by Beijing's approach to dealing with global systemic risk guidelines.

Under Basel III guidelines, countries are expected to designate certain banks as being systemically important to domestic economies. China is yet to decide which banks qualify, but it recently said that the group will be drawn from the 30 biggest banks. So even though not all banks in that group will ultimately be considered systemically important, Beijing may have decided that they nonetheless warrant special oversight—and assistance—from the central government. Notably, Hengfeng Bank falls within the 30, ranking as China's 20th largest bank. Baoshang Bank, however, is China's 36th largest.

Capital Solutions for Small Banks

The intervention to get the least attention involves the Bank of Jilin, a non-listed city commercial bank that ranks as China's 44th largest bank. In June, the bank announced that it would raise fresh capital by issuing new shares equivalent to 30% of the enlarged share base, in a private placement. It lined up the Jilin Province Finance Department, the Liaoyuan City Finance Bureau, the Baishan City Finance Bureau, as well as nine other investors. The bank had been having some trouble—its total assets declined in 2018—and it certainly appears that the mobilization of local government resources was a rescue.

In very few cases do banks sell shares directly to the government, as in Bank of Jilin's case. However, over the past year, local government entities—and in particular local government financing vehicles (LGFVs) and other local banks—have routinely been mobilized to acquire new shares being issued by non-listed banks. Particularly in cases where the banks have high NPL ratios, it seems likely that there may be no other potential buyers available.

However, the involvement of the state investors might be driven by other considerations as well. Over the past year there has been a glut of bank stocks put up for sale. According to Financial News, the PBOC's official newspaper, in the first nine months of 2019, there were almost 2000 judicial auctions involving banks stocks, up from 990 in 2018, and 630 in 2017. Judicial auctions occur when bank stocks have been posted as collateral against a loan, but the borrower subsequently defaults. The courts then auction the stocks, usually on Alibaba's Taobao platform. With so many banks' shares available for sale, banks needing to raise capital might find it easier to line up state buyers, rather than run the risk of there being insufficient commercial demand.

If any section of the Chinese financial system needs a sustainable solution to their capital shortfall, it's China's small banks—city commercial banks, rural commercial banks, and other rural financial institutions. Small banks were responsible for about 11.3% of write-offs in 2018, despite accounting for more than 30% of all bank assets. According to the CBIRC, all of China's banks wrote off 988 billion yuan worth of NPLs in 2018, up 35.5% from 729 billion yuan in 2017. But once the Big Five and joint stock banks are stripped out, the remaining banks wrote off only 111.8 billion yuan worth of NPLs that year, down 37% from 177.3 billion yuan in 2017.

Moreover, the local governments that are currently being called upon to provide the resources to recapitalize them are themselves financially overstretched. Local governments have long relied on land sales to repay loans borrowed to fund public works, but land sales are declining in some places. Meanwhile, tax cuts introduced at the beginning of 2019 to stimulate the economy are squeezing tax revenues, and much of what gets allocated by the central government to lower levels of government is earmarked, leaving local authorities with little in the way of discretionary funds with which to pay down their debt burden. The need to recapitalize local banks is a responsibility that will further stretch local resources.

Conclusion

It's difficult to determine how much capital China's banks will need to raise to deal with its bad loan problems. However, it seems that, despite Beijing's efforts to clean up the system over the past few years, the demands on the banks in the years ahead will likely grow. The stress will not be felt equally among banks. China's largest banks are in relatively good shape, and may be called upon to help deal with distress at smaller banks. The greatest challenge will be to recapitalize the small banks, and rural financial institutions in particular. While no single rural bank poses a systemic risk, as a group their stability presents a significant challenge.

As banks deal with the NPL burden, it will be important to watch for innovative solutions from Beijing. Will the authorities monetize local government debt, and if so, how? Will asset sales by state firms and local governments accelerate as a means of paying down debt? Or will Beijing baulk at the prospect of state assets being sold too cheaply? It is early days in the process of China's debt cleanup, and we should expect that Beijing will experiment with new, creative approaches to reduce the potential capital burden on the banks.

Recommendations

During China's last banking system cleanup at the beginning of the century, foreign investment played an important role in the recapitalization of China's major financial institutions. US and European banks took strategic stakes in China's biggest banks prior to them listing in Hong Kong, lending credibility to the stock offerings. China's most important financial institutions aren't likely the need help this time round, but there could be scope for China's smaller banks to reach out for assistance. Certainly, recent moves by Beijing to relax foreign ownership controls over Chinese financial institutions potentially opens to door to foreign banks to play a role—at the margin—in the recapitalization process.

However, there will likely be little scope for US investment to play a meaningful role in China's recapitalization of its financial system. Moreover, the absence of such investment will not matter to China, which will strive to recapitalize its banks internally. Hence, there is little need for the US to formulate a policy position on whether it should seek to play a role in China's bank clean up, and if so, how. More significant for US policymakers is that the process of cleaning up China's financial system will be a further drag on the Chinese economy.

Globally, China's economic ascent is shrouded in an aura of inevitability. Access to China's markets are deemed essential not simply because of the size of those market today, but for what it's assumed they'll be in the near future. In reality, the challenges of cleaning up China financial system—paired with efforts to fundamentally overhaul the way the economy grows—means that China's economy is entering an adjustment period where growth slows further. The adjustment may only last a few years, but it may also last indefinitely. Regardless of its length, it will not only constrain China's ability to distribute financial resources around the world, it will also challenge the narrative of China's inevitability.

In the US, the default assumption is that China's rise is inexorable and that the US must plan for how to counter it. However, the US should also make contingencies for how to make the most of a period in which China is less economically assertive globally. Certainly, the US shouldn't try to exacerbate China's financial challenges. But much as China was emboldened by the US subprime crisis, the US should use a period of relative Chinese economic weakness rebuild relationships with countries that have felt that China's economic inevitability made it necessary to align their interests with China.

OPENING STATEMENT OF LELAND MILLER, CEO, CHINA BEIGE BOOK

CHAIRMAN CLEVELAND: Mr. Miller?

MR. MILLER: Madam Chairman, Commissioner Wessel, Members of the Commission, thank you for the opportunity to testify this morning.

China's financial system is notoriously opaque and outside observers have long found it a challenge to report accurately on current conditions.

Yet within the financial system there is a particularly opaque segment that even Chinese officials may have a tenuous grip on, shadow finance.

In China this sector was born largely out of necessity, as a conventional banking system by its very structure makes it difficult for lenders to price risk.

And therefore, a disproportionate share of lending has always been directed to safer, often more politically connected firms.

While the term shadow banking may bring to mind Ponzi schemes or toxic financial instruments, much of the shadow sector in China came to be simply to allow large chunks of the economy to remain capitalized. But this has not occurred without great controversy.

By their own telling, officials in China have been engaged in a bruising, multi-year campaign to either eliminate much of this lending or else bring it out of the shadows, making it more transparent, subject to more oversight, and in the process taming some of its excesses.

Most experts agree that a shadow crackdown over the past few years has indeed occurred, but is Chinese policy still focused so intently on taming these risks, or have other priorities now superseded that goal?

More pointedly, as the slowdown in China's economy accelerates and its trading relationship with the United States comes under greater strain, is shadow financing in China poised to make a comeback?

Our data suggests the answer is yes. In fact, it is already happening. From 2016 to 2018, there's little question that shadow finance saw a major crackdown in China. Certain categories of shadow finance such as online peer-to-peer lending appear to have been largely wiped out.

Other categories such as wealth management products saw regulations implemented to make them more standardized and transparent. Our data, too, showed a notable drop in the proportion of bankers who reported selling both WMPs and trust products over this period.

In addition, companies reported to us an overall pullback in non-bank usage as a share of overall borrowing. Yet these results saw an important shift in 2019.

While bankers in our survey continued to report that sales of shadow products were decelerating, corporates reported a surprising reversal in non-bank usage, and not merely to previous levels, but to the highest share of overall borrowing that we've tracked in eight years.

A critical driver of this jump was borrowing from state-owned, non-bank intermediaries, indicating that Beijing may not be as oblivious to the shift in posture as the government narrative suggests.

Now, why this shift happened is just as important and the answer to that is the severe weakness of the Chinese economy in the fourth quarter of 2018.

That quarter, thousands of Chinese companies in our survey reported the worst national results in three years.

Growth weakened across virtually every headline metric we track including on-quarter declines in each of our eight geographic regions and in every major sector.

Faced with faltering growth, plummeting sentiment, and sharp weakness in investment in hiring, as well as a rapid deterioration of the U.S.-China trading relationship which resulted that September in an additional $200 billion in U.S. tariffs on China, a decision appears to have been made in Beijing to reprioritize short term growth and materially ease credit conditions across certain segments of the economy.

While the idea of a credit-fueled recovery is, of course, nothing new for China, the breadth and intensity of what we saw in the corporate sector in the first quarter of 2019 was exceptional, even by typical Chinese standards.

Corporate borrowing shot up, rejection rates plummeted, credit standards fell, and credit access broadened, with traditionally disadvantaged borrowers the clearest beneficiaries.

In a remarkable reversal, private firm borrowing surged past that of state firms in Q1 while SMEs saw lending temporarily jump past larger companies.

By spring 2019, as Chinese state media continued to trumpet the need for proactive policy support, it became clear that this substantially looser credit access for corporates was not a one-quarter aberration.

In fact, Q2 is in certain critical ways an escalation. While corporate borrowing fell a notch and bank lending showed some signs of retrenchment, the crucial development in Q2 was a resurgence of shadow finance to help fill the vacuum.

In the second quarter of 2019, Chinese companies reported the highest shares of shadow borrowing as a share of overall borrowing and the sharpest on-quarter jump in shadow usage in our survey history.

This de facto stimulus was still not enough to jumpstart the economy but it did help Beijing arrest what would have likely been a substantial second quarter fall.

The third quarter saw a continuation of this robust credit provision, yet with far lesser impact. Despite the fact that company borrowing, shadow bank usage, and bond sales all remained at or near record highs, our third-quarter corporate sector results were the weakest of 2019. It is thus notable that as the year progressed, even these high levels of credit support to corporates were not just failing to accelerate the economy; by Q3 they were not even enough to keep it stable.

Entering 2020, China Beige Book data showed no sign of retrenchment of either overall credit provision or shadow finance specifically.

In the fourth quarter of 2019, overall corporate borrowing rose yet again, hitting a level not seen since 2012, and bond sales notched another record high.

Over the past three quarters, the second through fourth quarters of 2019, companies reported the highest share of shadow bank usage to overall borrowing in the history of our survey.

Even so, the Chinese economy's fourth-quarter performance barely improved over a weak Q3. This suggests that rather than being at the tail end of this corporate easing trend, Beijing has likely just begun it.

I would like to conclude with a single but I think critical recommendation. China's the second largest economy in the world behind only the United States, and the single largest U.S. trading partner. How the Chinese economy fares obviously has enormous implications for both America and the world.

Yet due to the limits of publicly available economic data on China, including well-documented problems related to the country's official data, U.S. policymakers often have very little idea of how China's economy is actually performing.

Congress could rectify that severe shortcoming through the creation of a China economic data coordination center.

Such a center would be mandated to: one, collect and synthesize all existing public and private sources of China economic data; two, commission independent research and data tracking to fill holes in the informational infrastructure; and three, provide analysis and data to Congress and the Executive on all China economy or finance-related issues.

Such a center is sorely needed and long overdue. It would play an invaluable role in identifying and plugging U.S. government information gaps on China while ensuring that Congress and the White House are always fully informed of key economic dynamics in China that may have important implications for bilateral, regional, or even global stability.

Thank you.

PREPARED STATEMENT OF LELAND MILLER, CEO, CHINA BEIGE BOOK

“China’s Quest for Capital: Motivations, Methods, and Implications”

January 23, 2020

Leland R. Miller

Chief Executive Officer, China Beige Book International

Testimony before the U.S.-China Economic and Security Review Commission

CHINA BEIGE BOOK

STATEMENT BY LELAND R. MILLER
CHIEF EXECUTIVE OFFICER
CHINA BEIGE BOOK INTERNATIONAL

I. EXECUTIVE SUMMARY

China's financial system, like its economy, is notoriously opaque, and outside observers have long found it a challenge to report accurately on current conditions. Much of this is blamed on issues relating to the reliability of Chinese official data, which over the past two decades has spawned volumes of literature questioning its timeliness, methodologies, collection architecture, and potential susceptibility to smoothing or political manipulation.[1]

Yet within the financial system there is a *particularly opaque* segment that even Chinese officialdom may have a tenuous grip on: shadow finance. In China this sector was borne largely out of necessity, as the conventional banking system by its very structure makes it difficult for lenders to price risk,[2] and therefore a disproportionate share of lending has always been directed to "safer," often more politically-connected, firms—i.e., large and state-owned enterprises. While the terms "shadow banking" or "shadow finance" often bring to mind Ponzi schemes or toxic financial instruments, much of the shadow sector in China came to be simply to allow large chunks of the economy to remain capitalized.

But this has not occurred without great controversy—and concern. By their own telling, officials in China have been engaged in a bruising, multi-year campaign to either eliminate much of this lending or else bring it "out of the shadows"[3]—making it more transparent, subject to more oversight, and in the process taming some of its excesses. Most experts agree that a shadow crackdown over the past few years has indeed occurred. But is Chinese policy still focused so intently on taming these risks, or have other priorities now superseded that goal? More pointedly, as the slowdown in China's economy accelerates, and its trading relationship with the United States comes under greater strain, is shadow financing in China poised to make a comeback?

Our data suggest the answer is yes.[4] In fact, it is already happening.

While many areas of the Chinese financial system merit the close attention of policymakers, this statement will focus primarily on recent developments in the Chinese credit environment, with particular attention paid to the crucial issue of shadow finance. The statement will explore the evolution of Chinese economic policy from 2016 to the present, the role of shadow finance within that framework, and finally, the reasons we believe the sector has returned to prominence over the past year.

II. METHODOLOGICAL CONSIDERATIONS

a. Shadow Banking Defined

The People's Bank of China (PBOC) defines shadow banking as "credit intermediation involving entities and activities outside the regular banking system, with the functions of liquidity and credit transformation, which could potentially cause systemic risks or regulatory arbitrage."[5] The Bank of International Settlements (BIS) has adopted a similar definition, namely "all financial instruments that fulfil functions of credit intermediation typically performed by banks (such as liquidity, maturity, and credit risk transformation), but reduce the burden of, or bypass, banking regulation."[6] The common thread is recognition that the term encapsulates not just the activities of non-bank entities but also "credit intermediation activities performed by banks themselves that lower or circumvent regulatory requirements."[7]

This discussion will utilize the BIS definition spelled out above. However, to alleviate potential confusion over the bank/non-bank divide within the shadow banking universe, the more inclusive term "shadow finance" will be used instead.

b. Difficulties Inherent in Tracking Shadow Finance in China

While it is not the purpose of this statement to assess the reliability of Chinese official data or highlight the potential shortcomings of government data methodologies, two points are worth noting in the context of tracking China's shadow finance activities.

First, tracking shadow finance accurately over time is a difficult endeavor under even the most auspicious circumstances. Shadow finance derives its name from its opacity and corresponding lack of visibility to regulators; as such, the ability of regulators or other officials to effectively track evolving trends within the shadow finance universe is often limited. Moreover, financial innovators, in any system, are often highly incentivized to minimize reporting and/or evade regulation when possible, be it to minimize transaction costs or maintain lower barriers to execution. This in turn creates incentives to underreport, misreport, or simply rename financial vehicles or instruments in order to stay ahead of regulatory oversight.[8]

This is to suggest that chunks of shadow finance may at times, or at all times, go unreported through official channels. As recent Bank of International Settlements research has noted, "A key characteristic of China's shadow banking is that banks hide loans within alternative accounting categories."[9]

Second are problems intrinsic to Chinese economic data. As with all official economic figures in China, there may be various degrees of pressure on officials not to announce certain economic trends if and when they conflict with the political narrative of the Chinese Communist Party (CCP). There are ample reasons to believe this may be the case with shadow finance now, considering the overwhelming support in recent years from the Party's senior-most leadership for a crackdown on shadow banking—including from General Secretary Xi Jinping himself.[10] This may now make it politically difficult for government agencies to acknowledge a near-term resurgence.[11]

III. BACKGROUND

a. China's Shadow Finance Pullback: 2016-18

There is considerable academic debate over whether (or to what degree) China actually undertook "deleveraging" over the past several years[12], as it has claimed. However, there is relatively little question that shadow finance specifically saw a major crackdown and regulatory rethink over that same period.[13] Certain categories of shadow finance, such as unregulated peer-to-peer (P2P) lending, appear to have been largely wiped out.[14] Other categories, such as wealth management products (WMPs), saw specific regulations implemented to make them more standardized and transparent.[15] Our data, too, showed a notable drop in the proportion of bankers who reported selling WMPs as well as trust products over this period. In addition, companies reported to us an overall pullback in non-bank usage as a share of overall borrowing from 2016-18.

Chart 1: Banker Reports of Sales of Wealth Management Products

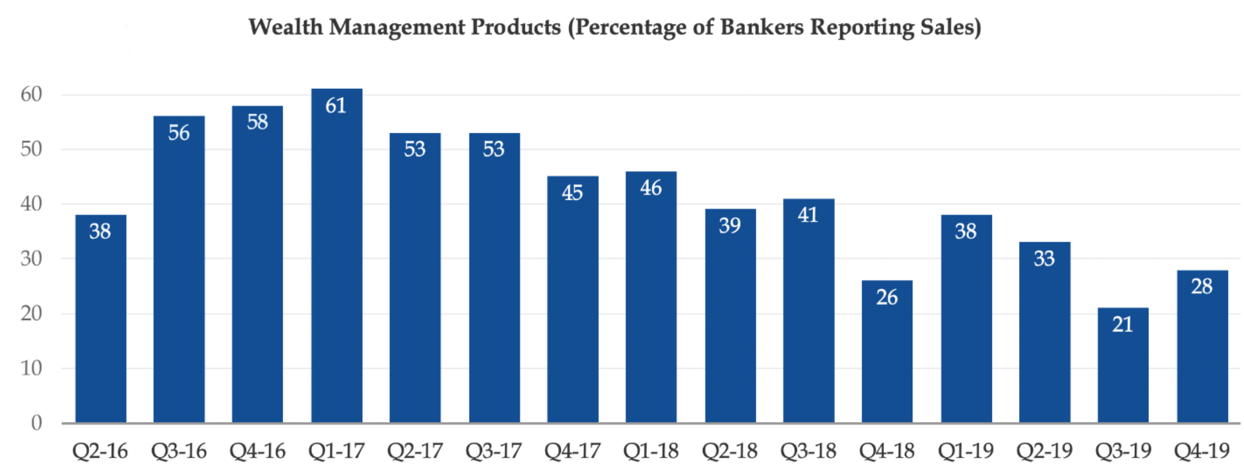
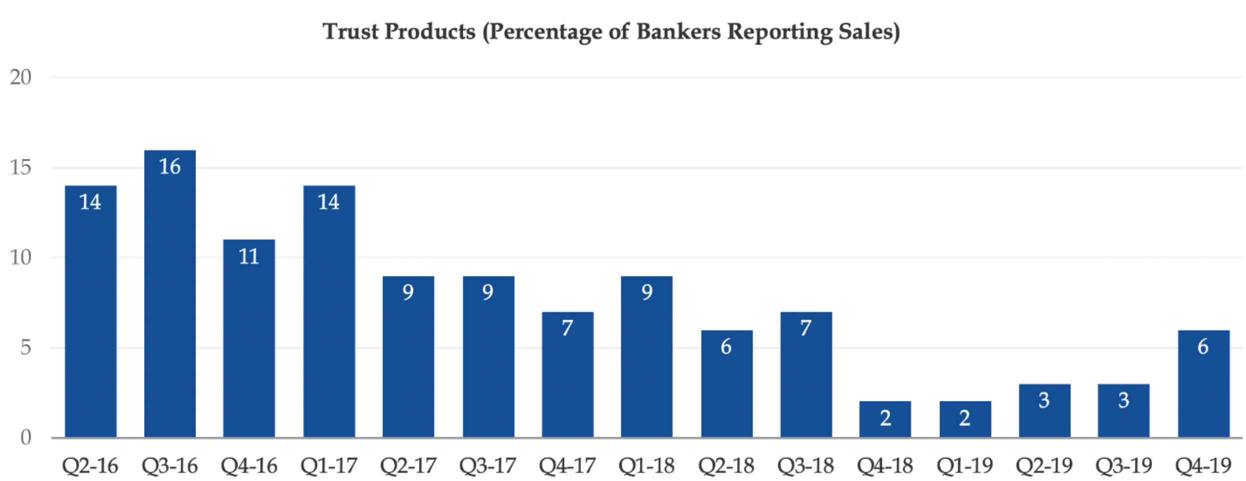
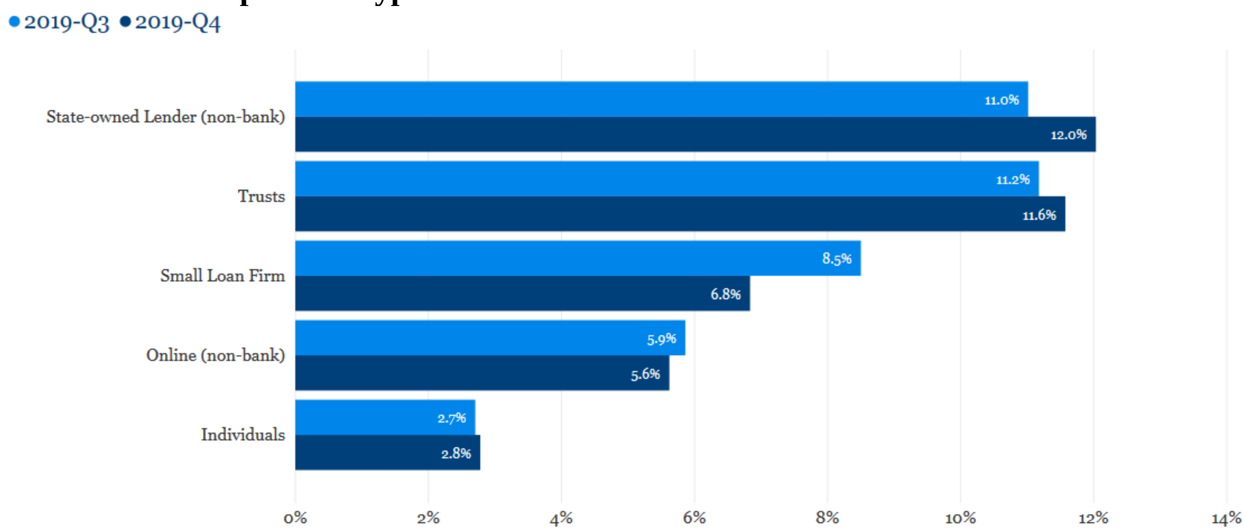


Chart 2: Banker Reports of Sales of Trust Products



Yet certain of these results shifted materially in 2019. While bankers in our survey continued to report that sales of WMPs and trust products were decelerating, corporates reported a surprising reversal in non-bank usage—and not merely to previous levels, but to the highest share of overall borrowing that we've tracked in eight years. The most prominent driver of this jump: borrowing from "state-owned non-bank" intermediaries—indicating that Beijing may not be as oblivious to this shift in posture as official credit data suggest.

Chart 3: Firm Reports of Types of Shadow Lenders Accessed



The story behind these 2019 developments in shadow finance, and the larger credit story that undergirds it, are explored in more detail below.

IV. CREDIT CONDITIONS IN CHINA 2018-19: WHAT PRIVATE DATA SAY

a. Late 2018 Economic Weakness Portended 2019's Shadow Finance Comeback

A key inflection point for Chinese economic policy was the fourth quarter of 2018. That quarter Chinese companies in our survey reported the worst national results in three years.[16] Growth weakened across virtually every headline metric we track, including on-quarter declines in each of our eight geographic regions and in every major sector. The performance was nearly as bad when viewed on-year.

Until these gloomy Q4 results came in, Chinese economic policy appeared stuck in an unusual state of limbo, with the central government sending conflicting signals[17] over how aggressively it was willing to support its now increasingly faltering economy. These circumstances were exacerbated by a major escalation in the U.S.-China trade war in September, when President Trump announced tariffs on $200 billion worth of Chinese imports on top of the $50 billion worth that had already been implemented earlier that year.[18] The president additionally threatened to place tariffs on the remaining $267 billion worth of imports if his actions were met with Chinese retaliation.[19]

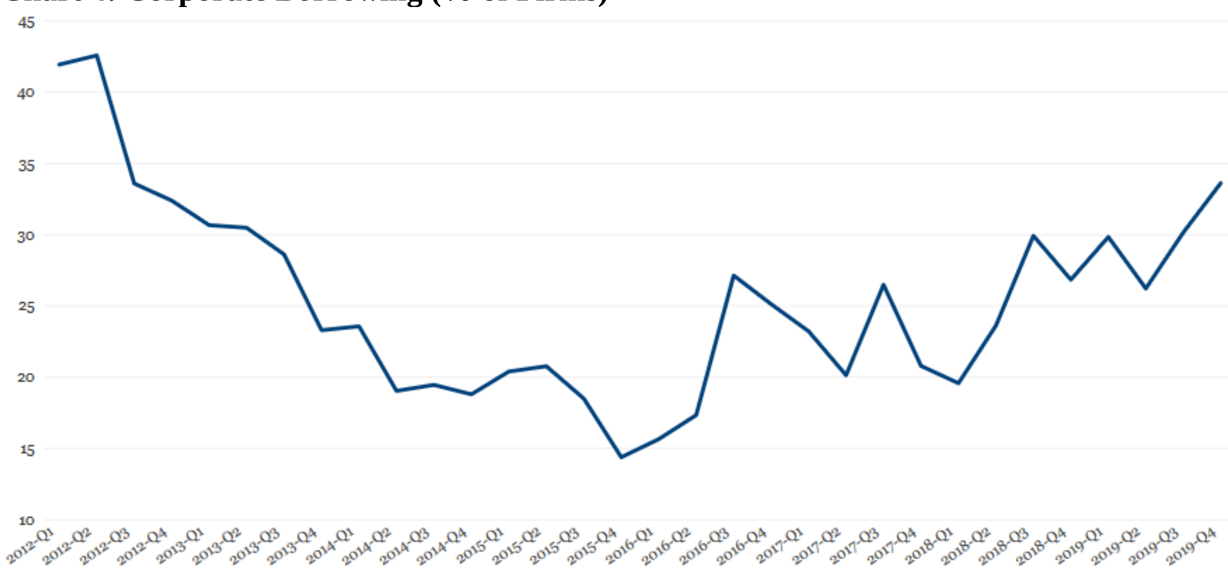
Amid this rapid deterioration of the U.S.-China trading relationship, and faced with faltering Q4 growth, plummeting sentiment,[20] and sharp weakness in investment and hiring,[21] a decision appears to have been made in Beijing to reprioritize short term growth and materially ease credit conditions across certain parts of the economy. While this looser corporate credit policy would look very different from the infrastructure-heavy stimulus programs of 2016 (discussed further in Section V), it represented a clear policy pivot—marking an end to any even notional commitment to deleveraging, and setting the stage for a reemergence of shadow finance the following year.

b. 2019: Anatomy of a Credit Surge

In the wake of fourth quarter 2018's worrisome results, our first quarter 2019 data saw "an unmistakable economic recovery,"[22] highlighted by a marked surge in borrowing reported by Chinese corporates. The idea of a credit-fueled recovery is of course nothing new for China. However, the breadth and intensity of this new wave of credit support proved exceptional even by typical Chinese standards:

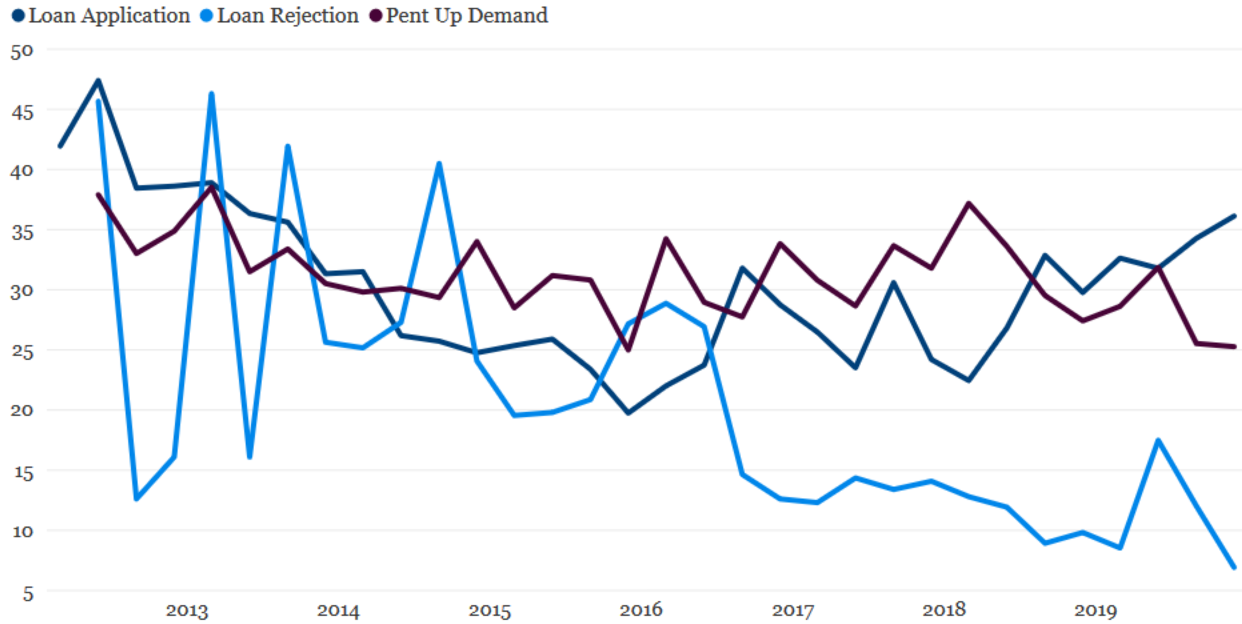
1) **Corporate Borrowing Jumped.** In the first quarter of 2019 corporate borrowing notched a six-year high in China Beige Book data, hitting a level not seen since the PBOC's response to the country's mid-2013 credit panic.

Chart 4: Corporate Borrowing (% of Firms)



2) **Credit Standards Fell.** Loan applications surged to a six-year high in Q1-19, while loan rejection levels slid to what at the time was an all-time low.

Chart 5: Loan Application & Rejection Rates & Pent Up Demand



3) **Credit Access Broadened.** Most notably, *traditionally disadvantaged borrowers* were the clearest beneficiaries of these newly eased conditions. Publicly, Beijing has long lamented that private firms, and especially small and medium sized enterprises (SMEs), receive far inferior credit access than their state and large firm counterparts.[23] This trend reversed in Q1, at least for the short term: private firm borrowing outpaced that of state-owned enterprises (SOEs) in Q1—and continued to outpace it throughout all of 2019—while SMEs saw lending temporarily jump past larger companies.

Chart 6: Corporate Borrowing: SOEs vs Private Companies (% of Firms)

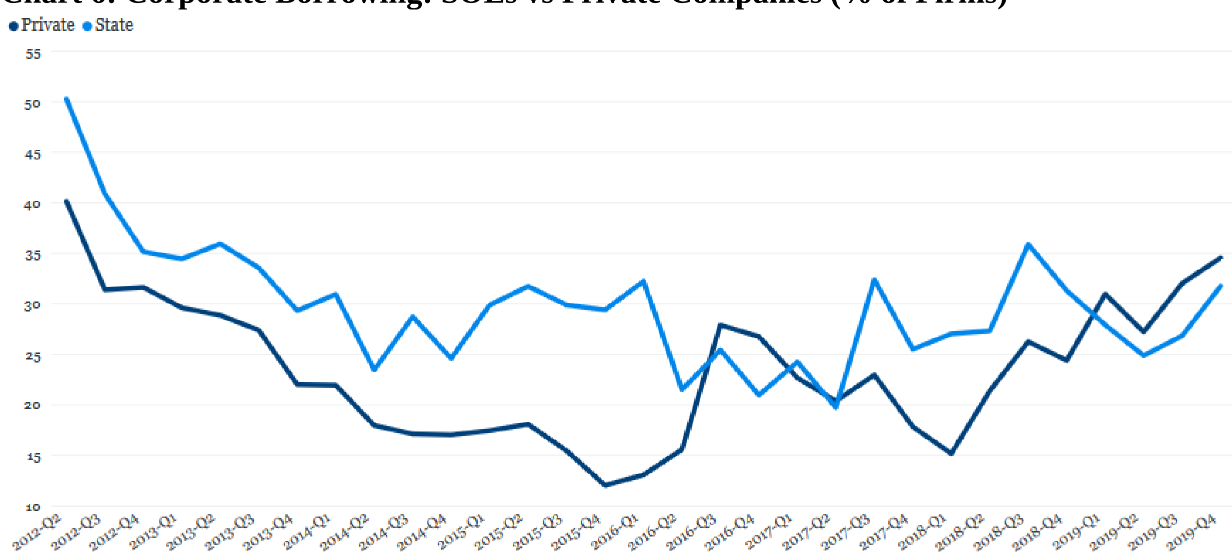
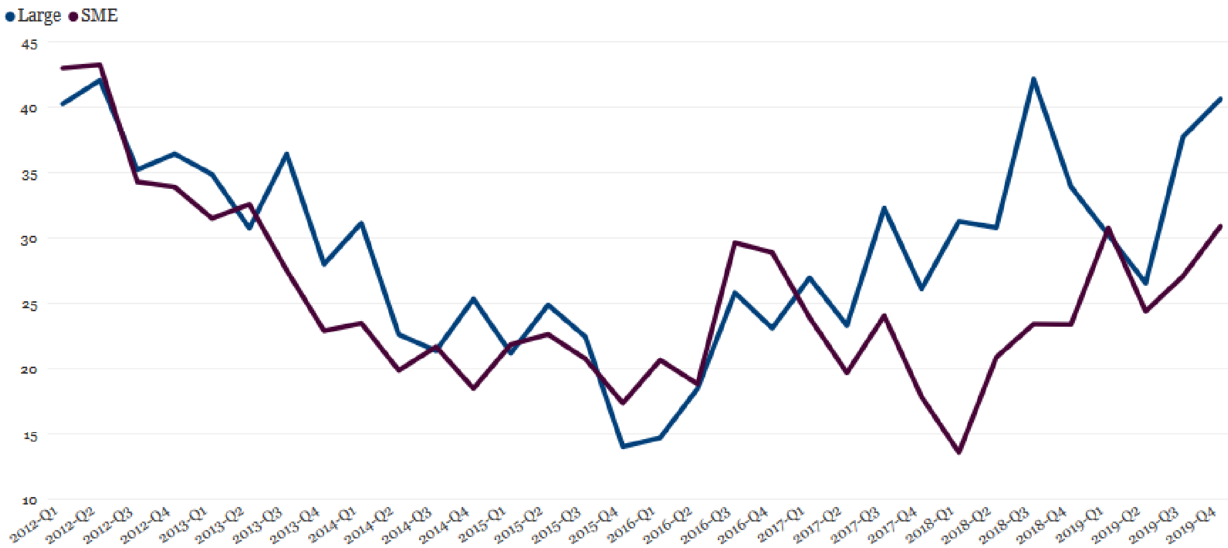
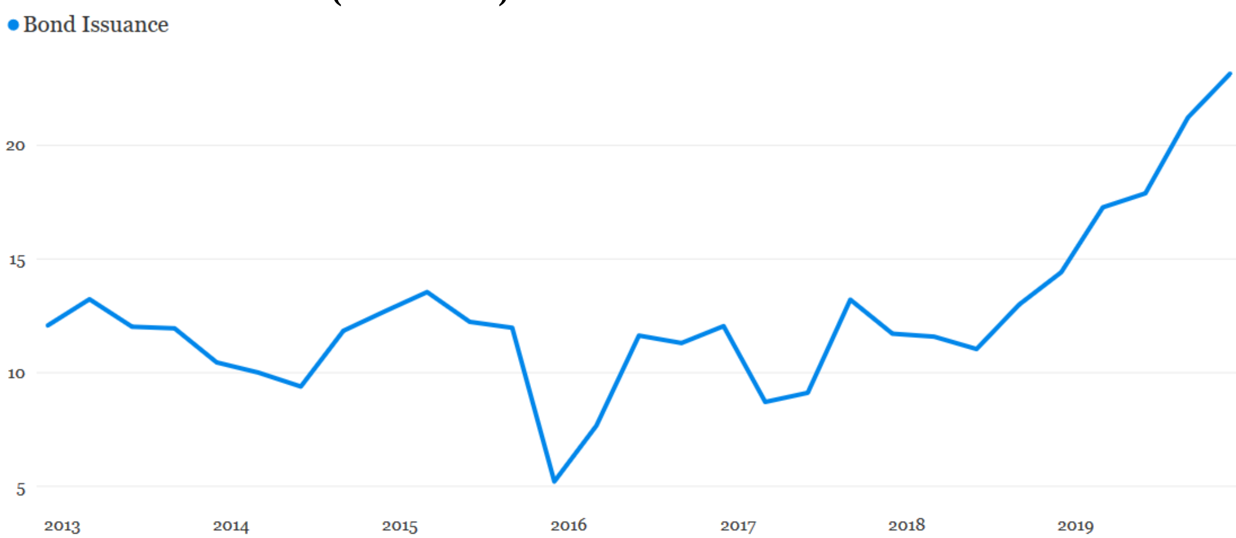


Chart 7: Corporate Borrowing: Large Firms vs SMEs (% of Firms)



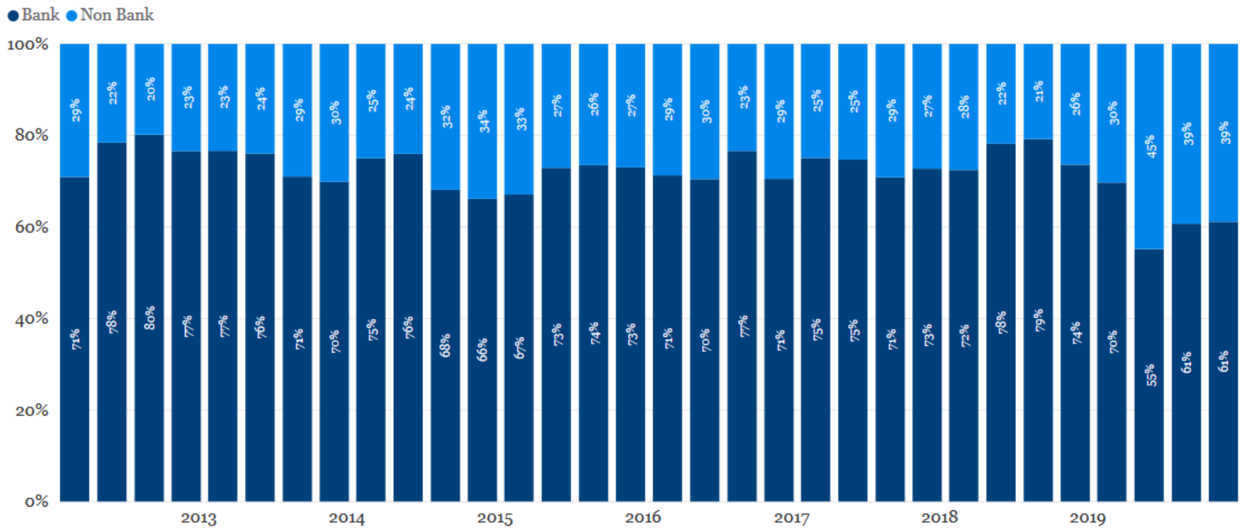
4) **Bond Issuance Surged in Tandem.** Bond issuance also continued to rocket upward, rising in Q1-19 for the third of what would ultimately be six (and counting) consecutive quarters of rising sales.

Chart 8: Bond Issuance (% of Firms)



By spring 2019, as Chinese state media continued to trumpet the need for proactive policy support,[24] it became clear that this substantially looser credit access for corporates was not a one-quarter aberration. In fact, the second quarter of 2019 was in certain critical ways an escalation. While corporate borrowing fell a notch, and bank lending showed some signs of retrenchment, **the crucial development was a resurgence of shadow finance to help fill the vacuum.** In Q2 2019 Chinese companies reported the highest share of shadow borrowing as a share of overall borrowing, and the sharpest on-quarter jump in shadow usage, in our survey history.[25] This de facto stimulus was still not enough to jumpstart the economy, but it did help Beijing arrest what would've likely been a substantial second-quarter fall.[26]

Chart 9: Bank vs Non-Bank Borrowing (% of All Loans)



The third quarter saw a continuation of this robust credit provision, yet with far less impact. Despite the fact that company borrowing, shadow bank usage, and bond sales all remained at or near record highs, our third quarter corporate sector results were the weakest of 2019.[27] Nationally, growth in revenue, profits, output, sales volumes, and hiring all slowed from the previous quarter, as did both domestic and export orders, indicating weakness in future demand. It is thus notable that as the year progressed, even these high levels of credit support to corporates were not just failing to grow the economy, by Q3 they were not even enough to keep it stable.

c. Into 2020: Where China's Credit Environment Is Now

Entering 2020, China Beige Book data show no sign of retrenchment of either overall credit provision or shadow finance specifically. In Q4-19 overall corporate borrowing rose yet again, hitting a level not seen since 2012, and bond sales notched another record high. Over the past three quarters—the second through fourth quarters of 2019—companies reported the three highest shares of shadow bank usage to overall borrowing in the history of our survey. Even so, the economy's fourth quarter performance barely improved over a weak Q3 (though the improvement was much more noticeable over a year ago).

Meanwhile, lenders overall do not seem to be getting much pickier, perhaps because resistance to higher risk lending in the banking sector is being compensated by a pickup in non-bank lending. Loan applications in Q4 remained at multi-year highs, even as loan rejections slid to a new low.

Moreover, other evidence also suggests that credit provision has been much more vigorous than Beijing has publicly admitted: "Pent up demand"—our metric highlighting those firms that report wishing to access capital but chose not to apply—is currently at its lowest level in four years. (See Chart 5 above.)

V. A TALE OF TWO STIMULI: 2016 vs 2019

a. 2016 Stimulus

There are at least two key reasons why this view of robust 2019 corporate credit support is not consensus amongst observers of the Chinese economy. The first is that the vast majority of China watchers rely on official government credit data, so if Beijing is not acknowledging a trend publicly, and in real time, then these observers have no way of recognizing that anything interesting may be happening beneath the surface.

The second is that the 2019 policy stimulus described above, though fairly characterized as "aggressive credit easing," was of a fundamentally different nature than the much heavier-hitting Chinese stimulus of 2016.

In 2016, following a panic in Chinese markets during the first few months of that year, the government responded in overwhelming fashion via its traditional policy lever of heavy infrastructure spending. As 2016 carried on, this became increasingly evident in our data: our construction indicators[28] shot upward, followed soon after by remarkable rallies in both the manufacturing and commodities sectors.[29] As has often been the default, Beijing's response to economic weakness in 2016 was to try to build its way out of the problem.

b. 2019 & Beyond

This was clearly not the case in 2019. In fact, far from seeing a pickup in infrastructure spending our data at year-end 2019 show the transport construction sector suffering from several quarters of sharp weakness, and the commodities sector mired in a Q4 correction.

On the other hand, credit support directly to corporates continues apace, and at record levels. This is a reflection, perhaps, of Beijing's evolving policy goals. In the past, Party leadership repeatedly proved itself willing to trade a jump in risky debt for a short-term surge in growth. Today's priorities may be more modest. Rather than try to stimulate itself out of every crisis, Beijing appears focused on simply keeping struggling firms afloat. This won't solve China's structural problems, nor fully arrest the slowdown of its economy. But it may buy time, pushing off a more serious downturn until the government feels better prepared to address the shortcomings of its financial system.

VI. KEY POLICY RECOMMENDATION

a. Establish a China Data Coordination Center Inside the US Treasury Department

China is the second largest economy in the world, behind only the United States, and the largest U.S. trading partner. How the Chinese economy fares obviously has enormous implications for both America and the world. Yet due to the limits of publicly available economic data on China, including well-documented problems related to the country's "official" data, U.S. policymakers often have very little idea of how China's economy is actually performing.

This makes it a severe oversight that there is no single entity tasked by Congress to monitor the Chinese economy from the data perspective and track it comprehensively from the ground up, utilizing all available public and private data sources.

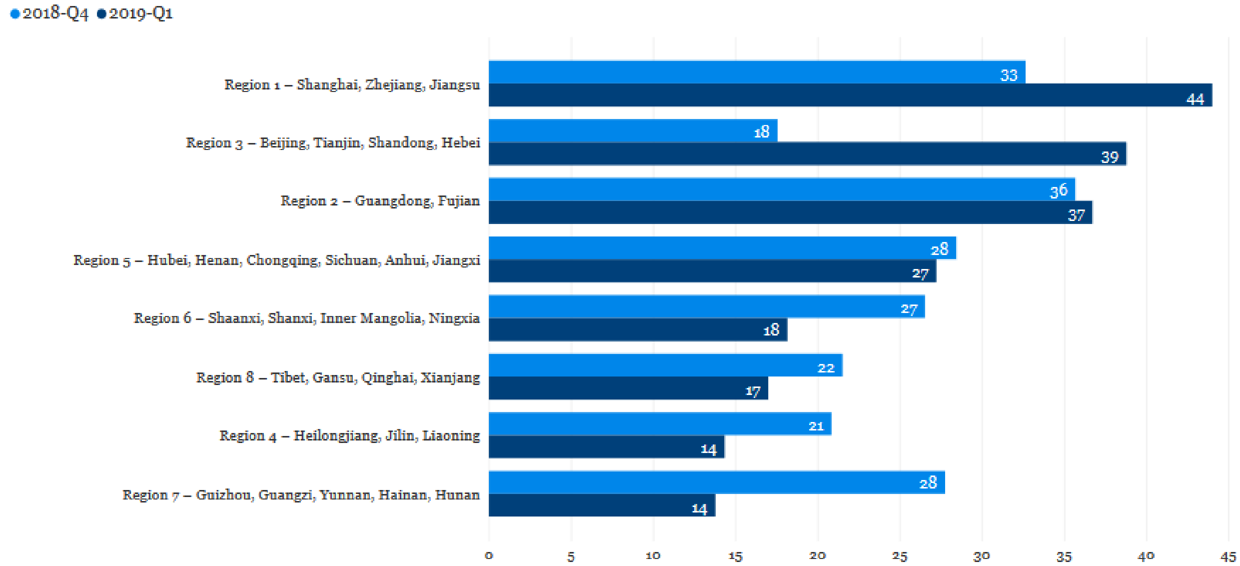
Congress could rectify that shortcoming through the creation of a China Economic Data Coordination Center (CEDCC). Such a Center would be mandated to 1) collect and synthesize all existing sources of China economic data; 2) commission independent research and data tracking to fill holes in the informational infrastructure; and 3) provide analysis and data to Congress and the Executive on all China economy or finance-related issues.

In my view locating the Center inside the Treasury Department makes the most sense simply because analyzing and tracking China's financial system—the foundation of any understanding of the broader economy—will require a team with a sophisticated finance skillset. But there are certainly reasonable arguments to house such a data coordination center elsewhere: The Commerce Department has the most experience collecting and utilizing data. The State Department has the most obvious portfolio to subsume it into. And the traditional coordination role of the National Economic Council makes it a sensible candidate as well.

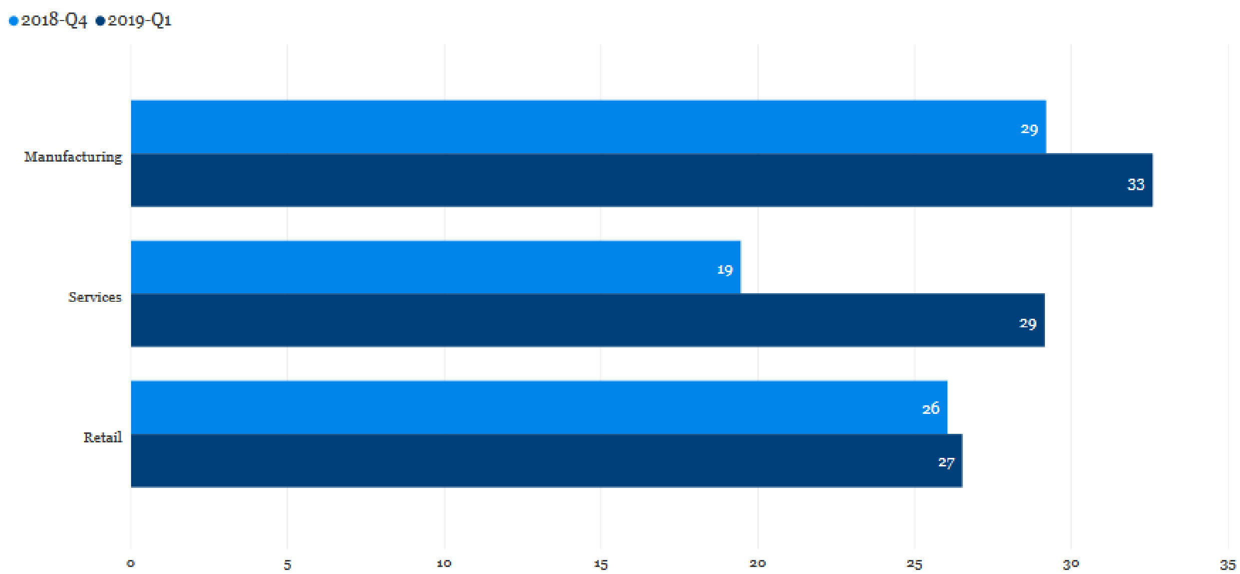
Yet wherever such a Center might be housed, it is sorely needed. A CEDCC would play an invaluable role in identifying and plugging USG information gaps on China, while ensuring that Congress and the White House are always fully informed of key economic dynamics in China that may have important implications for bilateral, regional, or even global stability.

APPENDIX: SUPPLEMENTARY CBB CREDIT CHARTS

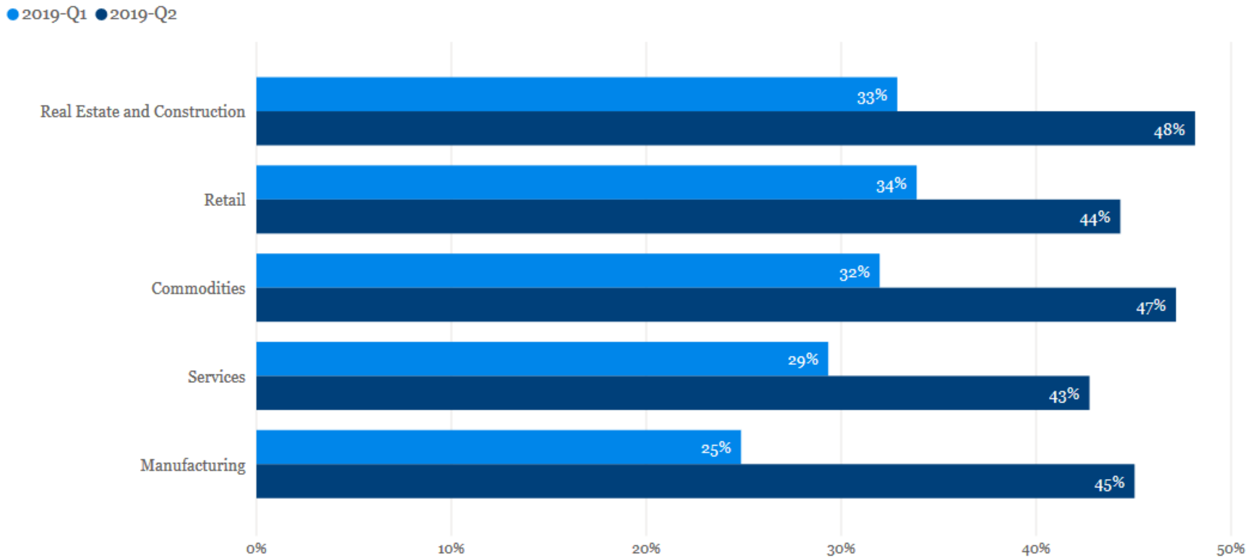
1. Chart 10: Corporate Borrowing by Region (% of Firms)



2. Chart 11: Corporate Borrowing by Sector (% of Firms)



3. Chart 12: Proportion of Loans from Non-Bank Lenders by Sector



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[4] China Beige Book is the world's only large-scale independent data focused exclusively on the Chinese economy. The platform tracks every key component of China's diverse economy—from growth dynamics to labor market and inflation trends to the formal and shadow credit environments. The nation-wide data collection tracks over 3,300 Chinese firms across key sectors, sub-sectors, regions, city tiers, firm size, firm ownership, as well as the crucial state/private divide. Data are released eight times a year. http://www.ChinaBeigeBook.com.

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OPENING STATEMENT OF ZHIGUO HE, FUJI BANK AND HELLER PROFESSOR OF FINANCE, UNIVERSITY OF CHICAGO BOOTH SCHOOL OF BUSINESS

CHAIRMAN CLEVELAND: Thank you, Mr. Miller. Dr. He?

DR. HE: Thank you for inviting me here today to participate in this hearing. My name is Zhiguo He, and I'm working at the University of Chicago Booth School of Business.

I plan to deliver my oral statement in three parts. The first part is about China's capital allocation and Beijing's policy tool in a higher level.

I have to say that thanks to rapid economic growth and financial market development in the past 30 years, China has developed a fairly sophisticated financial system.

Today in a reverse order of a market-driven mechanism, the major financing channels in China are bank loans, corporate bonds, shadow banking, that was mentioned in the previous two speeches, equity market, and venture capital. So, this is the whole range.

With a multifaceted financial market and a variety of financial intermediaries, Beijing has a rich set of policy tools to affect the working of China's financial market, and in turn, influence capital allocation.

Let me illustrate based on the recent policies that favor private sector. The background is that of deleveraging and a tightening of shadow banking regulations that I mentioned before.

Starting in 2016, it struck a significant blow to the economy which hurt the private sector in particular.

Now this is not what Beijing would like to see, to be honest, but all investors just prefer lending to SOEs just because it's safer, especially in bad times.

So to combat this, starting in mid-2018, Beijing has pushed the following. The first one is it lowers the entry barrier for private firms to issue equity as well as corporate bonds, and anecdotally, large state-owned banks have been encouraged to lend more aggressively to private sector.

The second, even if a regulator lowers the entry barrier for the private sector, private firms often face difficulties in selling their corporate bonds, especially given the defaults nowadays. So, that's a market force.

The government, therefore, set up some credit enhancing funds to help these private firms to issue bonds using some CDS-related products that are available in the market.

Third, in 2018, the sharp drop in the stock market has driven many private firms to stop pledge loans under water. In response, Beijing established a series of bail-out funds for listed private firms.

Much of these bail-out funds had detailed exit plans to mitigate the concern that the State advances and the private sector retreats.

In my written testimony, I also mention a very significant reform on LPR, that's the Loan Prime Rate reform, but given the time constraints I won't have time to cover that.

The second part of my testimony is on the recent bail-outs on regional banks. Since 2010, the unleashing of the financing demand propelled a rampant growth of financial innovations in China at a pace at which the regulators cannot keep up.

To me, China faces a fundamental tension in the past 20 years of underdeveloped financial markets with overdeveloped financial products.

This causes the unbalance of back growth somewhere which unfortunately will be burst sometimes and this time, it is in the Negotiable Certificate of Deposits market, or called NCD market.

Now, as a form of interbank borrowing and lending, NCD plays an important role of wholesale funding for Chinese financial institutions, like everywhere else.

Typical issuers of NCDs are small joint stock commercial bank and the city commercial banks while buyers are large state-owned banks and money market funds.

On May 24, 2019, the regulator announced to take over Baoshang Bank. Retail depositors were guaranteed with full repayment but institutional creditors could have lost up to 30 percent of their investment.

Shocked investors started to shy away from troubled city commercial banks including the other two banks, Bank of Jinzhou and Hengfeng Bank.

These two banks suffer serious corporate governance issues, I have to emphasize. For instance, controlling shareholders have used their banks as ATM machines to fund unprofitable pet projects related to themselves. So, they're just bad banks.

The Baoshang event triggered a rollover risk for these banks, which is a good thing, but because financial institutions in the interbank market are closely connected, a systemic risk could have emerged.

The PBOC, the Central Bank of China, therefore, decided to bail it out and restructure these banks. Through these decisions, the PBOC signals to the market that it reserves the full discretion on the timing as well as the place to intervene.

To me, these are all great moves. Going forward, the systemic risk unearthed by these bail-outs are unlikely to change the funding model of China's financial institutions in the interbank market because financial market development and reform is basically a one-way street, it doesn't always get it back.

The third part of my testimony is on local government bonds and the recent trend. This year, China has accelerated the issuance of pace of municipal bonds in response to the sluggish economy.

This is a countercyclical fiscal policy like the four trillion stimulus plan in 2009. But there are a lot of key differences.

Today, about 40 percent of issued municipal bonds are general bonds which help local governments finance broader spending as well as refinance the old debt in the previous round.

The rest of the municipal bonds are so-called special purpose bonds. They correspond to revenue bonds in the United States, whose repayment relies on projects.

In China, these infrastructure projects are land banks, shanty town renovation programs, medical care and nursing homes, environmental and ecological protection projects and toll roads, et cetera.

Special purpose bonds work quite differently this time compared to 2009, a decade ago. First, in 2009 local governments were encouraged to launch any quote, unquote, infrastructure projects without being monitored.

Second, in 2009 these projects were mostly funded by bank loans and the shadow banking activities. Special purpose bonds today are supposed to be a more transparent solution.

Now every local government needs to submit detailed project descriptions and after getting approval from regulators, they need to disclose these descriptions in the bond issuance prospectus. In recent months, Beijing has responded to the economic slowdown with various relaxation measures.

For instance, the application procedure of a special purpose bond is expedited and this is a trend I expect to see in the coming years. Thank you again and I'm happy to answer all these questions.

PREPARED STATEMENT OF ZHIGUO HE, FUJI BANK AND HELLER PROFESSOR OF FINANCE, UNIVERSITY OF CHICAGO BOOTH SCHOOL OF BUSINESS

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

HEARING ON "CHINA'S QUEST FOR CAPITAL: MOTIVATIONS, METHODS, AND IMPLICATIONS"

January 23, 2020

Assessing China's Capital Requirement and Systemic Challenges

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1. <u>How does Beijing govern capital allocation?</u>

   Thanks to rapid economic growth and relentless financial market reform in the past thirty years, China has developed a fairly sophisticated financial system. If "central government governing capital allocation" refers to allocation via various directives from the central government, as Beijing did before the 1980s, then I believe it is a quite misleading phrase.

   In today's China, capital allocations are achieved by different forms of financial intermediations in various financial markets. These financial intermediaries range from traditional commercial banks to modern Venture Capital funds, some of which are more market-driven than others. I will come back to the detailed channels of capital allocation in Q2.

   Regarding detailed asset allocations in China across different sectors, Table 1 gives two snapshots for 2010 and 2016 (RMB trillions, with percentages of total assets given in parentheses):

Year \ Sector	Household	Non-financial	Financial	Government
2016	177 (42%)	199 (47%)	2.9 (0.7%)	46 (10%)
2010	87 (40%)	93 (43%)	2.0 (0.9%)	35 (16%)

Table 1: Asset ownership across different sectors in China, 2010 versus 2016; Trillion RMB. Data source: Li, Yang, Xiaojing Zhang, and Xin Chang. 2015. China National Balance Sheet 2018). Beijing: China Social Science Press

   This table calculates net assets (i.e., equity, which is assets minus liabilities), which naturally gives a small size for the financial sector. Households control a relatively large fraction of assets in China, thanks to the soaring value of real estate over the past two decades. The relative importance of the non-financial sector has kept rising since 2010, while the government's ownership has been diminished. One important caveat, of course, is that the non-financial sector includes many strategically important state-owned enterprises (SOE), and they are mandated to fulfill government duties in some circumstances.

   I will explain the tools used by the central government to influence capital allocation in Q3.

2. <u>How do China's banks structure their loans to different actors in the Chinese economy, and what does that structuring reveal about their capital requirements?</u>

   <u>Financing Cost and Debt Maturity</u>

   Let me focus on interest rates and maturity, and their gaps between state-owned enterprises (SOE) and non state-owned enterprises (non-SOEs).

The data on corporate bonds are publically available, with detailed interest rate and bond maturity information. My analysis of bank loans is based on financial data of listed companies in China. Since we lack a trustworthy dataset that reports actual interest rate data on bank loans, I estimate interest rate by taking the ratio between interest expense and average outstanding interest-bearing debt each year. And, some companies voluntarily disclose their loan maturity information in their annual reports, which allows me to calculate the bank loan maturity for SOE and non-SOE firms.

Figure 1 shows the result. The top two panels are for bank loans, with the left (right) panel depicting the interest rate (loan maturity) since 2009. We observe that SOE firms have lower interest rates than their non-SOE peers, with an average wedge of 43 bps (0.43%). Loan maturity–wise, the overall maturity is about 2-3 years, and there is no significant difference between these two groups of firms–except in 2011 and 2012 during which SOEs borrowed longer-term than non-SOEs. The bottom two panels in Figure 1 are for corporate bonds. Again the SOE firms are paying lower interest rates, by about 99 bps, and borrow slightly longer-term.

The interest rate wedge reflected in the sample of listed companies tends to be downward biased, simply because only exceptional private companies are eligible to be listed. To address this potential bias, I further calculate the interest rate wedge based on the annual census of enterprises collected by the Chinese National Bureau of Statistics, which covers firms with sales over 5 million RMB (about 600,000 USD) in the manufacturing sector.[1] Most firms in this sample are non-listed, and according to my calculations, SOEs paid about 200 bps (2%) less than non-SOEs during 2005–2013. There is no loan maturity information for this sample.

Broadly, there are two major mechanisms behind the significantly positive interest rate wedge between non-SOE and SOEs. It is crucial to clarify the relative importance of these two forces in different contexts.

i. The first force is directly related to policy guidance of certain industries and sectors. For instance, Beijing has issued various rounds of industry policies that favor certain sectors (e.g., new energy vehicles) deemed to be strategically important for domestic development as well as international competition. On the other hand, the real estate sector is often disfavored, as local governments occasionally raise the minimum down payment requirement for the second home-purchase to curb over-heated housing market. In today's China, since most of these policy supports are through explicit subsidies (reported in formal financial statements), these policies have only limited impact on the interest rate that banks charge on their loans.

   Industrial policies form the backbone of China's economic growth, but will be distortive—at least in some dimensions—by their own nature. Before the 1990s, this was perhaps the only policy tool for Beijing to govern its capital allocation, and has been instrumental for China to develop its modern industrial sector. Recently, Beijing has realized the potential harm of industrial polices, and it is on the policy agenda to make them less distortive.

ii. The second force, which is an awkward by-product of how the market mechanism and (the belief of) government intervention interact, is more relevant in China. Banks, as well as other players including naïve retail investors and sophisticated fund managers, are way more willing

[1] Controlling for the industry makes the comparison across different ownership structures more informative, but the drawback of this dataset is the lower quality of financial information.

to lend to firms who are less likely to default. This is driven by a standard profit-seeking motive, the very essence of a market mechanism. Relative to non-SOEs, SOEs are less likely to default on their debts, either because they are less sensitive to aggregate economic shocks (as they are in a more advantageous industry), or because the local/central government will step in after bad performance for social stability reasons (e.g., employment). The latter "bail-out" reflects the same spirit of "too big to fail" in the US banking industry, just with a way larger scale in China.

Going forward, policymakers in Beijing will likely continue the industry policies mentioned in i), although in my opinion the subsidy scheme could be improved with more transparency and fairness. In contrast, policymakers in Beijing have been trying relentlessly to address the issue mentioned in ii), as China's future growth engine will likely come from private businesses. The tension reflected in ii) is deeply rooted in the intricate interaction between market and government, a topic that has recently drawn heated debate even among the western world. As a result, there is no silver bullet for China to solve this extremely challenging problem, especially given Beijing's stand on the role of government in its economic reform. A related discussion can be found in Q3.

New LPR Reform in August 2019

So far we have focused on the wedge of financing cost between SOEs and non-SOEs. An equally important issue that sits on Beijing's policy agenda concerns how to lower the financial cost of its real economy. And, because SOEs have been enjoying the preferential treatment due to reasons mentioned above, any reform that can successfully lower the real sector's financial cost will predominantly benefit the non-SOE firms.

The most recent new Loan Prime Rate (LPR) reform, implemented by People's Bank of China (PBOC, the central bank in China) is aimed to achieve this goal, with a potentially far-reaching impact on China's banking system in the next decade. The background of this reform is the PBOC's ambition to establish an effective monetary policy transmission mechanism, which has a profound effect on its agenda of interest rate liberalization, and ultimately, the modernization of the Chinese capital market.

Loan prime rates (LPR), widely used as an indicator of the borrowing cost of the real economy, are the interest rates that banks charge their most creditworthy customers. Before August 2019, Chinese banks set their interest rates based on the so-called "benchmark lending rate," which plays a similar role as loan prime rates in the United States.

The benchmark lending rate aggregates the quotations of the 10 largest commercial banks. The quotations are at the level of interest rate, and collected daily. Many influential academics and policymakers in China believe that these large commercial banks are colluding for better profits. As shown in Figure 2, the PBOC policy rate—medium-term lending facility (MLF), which is a funding facility that the PBOC extends to commercial lenders—was cut by 50 bps at the beginning of 2016, but the benchmark lending rate has remained constant since 2016

Beijing, which has been fighting against economic slowdown for several years, was deeply concerned about the clogged transmission of monetary policies. On August 2019, the PBOC announced that it would replace the benchmark lending rate with the new LPR.[2] Under the new regime, gradually LPR will be used as a benchmark to price new loans and existing floating rate loans (both industrial and home mortgage loans). I highlight several points regarding this reform:

i. Increasing the number of participating financial institutions that submit LPR quotations, from 10 to 18 entities. The additional 8 entities include smaller rural commercial banks, foreign commercial banks—Standard Chartered Bank (China) and Citibank (China), and nascent fintech-based lenders—WeBank (Tecent group) and MyBank (Alibaba group).

ii. Setting the loan prime rate on the 20th of every month, instead of daily. Presumably, less frequent quotation makes the quotation quality higher.

iii. Asking the participating banks to submit their quotations of the LPR rate in terms of its spread over the policy rate MLF, as opposed to the LPR itself.

To me, the most interesting reform is iii). As explained, the leading explanation for the sticky benchmark lending rate is collusion among participating banks. Beijing could take the non-market route to use its authority to investigate collusion, but it is difficult to identify "collusive behaviors" (n.b., the same problem exists in western financial market).

Instead, Beijing just changed the quotation from the loan rate itself to its spread over the MLF policy rate. This way, even if participating banks collude so that quoted spreads barely move, the loan rate—which is the policy rate MLF plus the average of quoted spreads—will go in tandem with the MLF policy rate. When the PBOC decides to cut the policy rate, this mechanism could help transmit its loosened monetary policy to the real sector in an effective way. The data from the past four months shown in Figure 2 seems to suggest that this reform indeed works to a large extent.

3. How do the central government's capital allocation practices impact different actors (e.g. banks, local governments, corporates) and their respective abilities to meet their financial needs?

Aggregate Financing to the Real Economy: Financing Channels in China

Released by PBOC since 2011, the Aggregate Financing to the Real Economy, which is also referred to as "Total Social Financing" in some other contexts, asks how China finances its real economic activities in a given period of time. As one of the most important economic statistics in China, the Aggregate Financing to the Real Economy offers a detailed breakdown of various financing forms, which is extremely informative about what drives economic growth in China. As a result, it has increasingly drawn attention from almost all market participants for gauging the near-term direction of domestic economic growth as well as any potential policy shifts from Beijing.

Figure 3 depicts the annual increment of the Aggregate Financing to the Real Economy starting in 2006, along with the real GDP growth in mainland China. The financing channels, in (reverse) order of "market-based rules," are:

i. Bank loans, an indirect finance channel, are still the dominant financing channel for China's economy. The big-four state-owned banks have experienced a steady retreat since

[2] The Loan Prime Rate was initially introduced in October 2013 in China. So the August 2019 new LPR reform is also being reported as a revamp of the old LPR scheme.

restructuring in the early 2000s,[3] and their total assets as a fraction of the banking sector dropped from 64% in 2002 to 35% in 2018. As I will mention later, regional and smaller (though, still state-owned) commercial banks have made a significant contribution to the recent growth of the Chinese economy.

ii. Corporate bonds, as a new form of direct financing instruments in China, have become increasingly important in the past decade. Most of them are issued and traded on China's so-called interbank market, a market that will be discussed in more detail in Q4. Admittedly, corporate bonds are still tightly linked to the banking system, but over time more and more non-bank financial institutions have participated in this market. The recent surge of corporate defaults, which breaks the "implicit guarantee," is a path-breaking step toward establishing a well-functioning risk-based pricing mechanism in China's corporate bond market.

iii. Shadow banking is crucial to understanding China's financial market development in the past decade.[4] It not only helps the financing of small and medium enterprises, but also aggressively engages in various regulatory arbitrage practices that channel funds toward real estate and local government financing vehicles (to be explained later). However, shadow banking activities slowed down in a dramatic way following regulatory tightening since mid-2017, and even shrank significantly recently; in Figure 3, shadow banking (indicated by the darkest shade) has a negative increment in 2018.

iv. Although the Chinese stock (equity) market has received widespread attention perhaps due to its notoriously high volatility, it played an almost negligible role in terms of capital allocation (about 2% of the Aggregate Financing in 2018). Facing mounting criticism for heavy reliance on debt, top policymakers in Beijing fully understood that equity financing is better for bringing about economic stability, structural balance, and even wealth equality in the long-run. However, with numerous scandals and hence a tarnished reputation, the Chinese stock market is far from a preferable savings vehicle for typical households in China.

    In the past few years, the Chinese stock market has undergone a series of reforms that aim to revert this trend. Among them, the creation of the STAR market (based on a market-oriented registration system) on the Shanghai Stock Exchange in June 2019 could be a milestone event, and revamp of the securities law in early 2020 will give regulators more teeth.

v. Another important financing channel, which is rather small in terms of magnitude, is venture capital and private placement funds. Not surprisingly, since these funds invest in promising high-tech industries, they represent perhaps the most vibrant market in China. I expect an accelerated growth of this market going forward, as the STAR market mentioned in iv) provides an organic exit channel for venture capital funds.

Detailed Funding Sources

[3] The big-four state-owned banks are Agriculture Bank of China, Bank of China, China Construction Bank, and Industrial and Commercial Bank of China.

[4] Shadow banking includes Trust loans, entrusted loans, and undiscounted banker's acceptance. Because of severe doubt-counting issues, wealth management products are never a part of the Aggregate Financing to the Real Economy (which is the correct treatment).

Today, each distinct actor can seek financing in China's multi-faceted markets by choosing one that fits—of course, subject to various regulatory restrictions and some broad policy guidance. To answer Q3 more directly,

i. Banks, especially large ones, are mainly funded by deposits (held by households). Some smaller and regional banks, especially those small joint-stock commercial banks and city commercial banks, fund themselves by selling a kind of short-term corporate bond in the interbank market. These short-term corporate bonds are purchased by other larger commercial banks or money market funds (see more details in Q4). In this way, large commercial banks and money market funds are funding these small regional banks.

ii. Local governments started selling "municipal bonds" in the interbank market; banks have been the major buyers of these bonds. Before 2015, local governments financed themselves by either bank loans or corporate bonds (so-called "municipal corporate bonds" or Chengtou bonds, which are different from "municipal bonds" after 2015), but via so-called local government financing vehicles (LGFVs). Municipal corporate bonds continued to exist even after 2015, and their major buyers are wealth management products or non-financial institutions like mutual funds or insurance companies.

iii. Corporations in China have lots of options. Listed companies can either do seasoned equity offerings in the stock market (subject to fairly strict eligibility criteria), or issue corporate bonds. Non-listed companies can issue corporate bonds.

iv. For households, their major borrowing needs are housing mortgage loans. Beijing has been imposing strong influence on the mortgage market, given the critical role of housing assets in China's capital market. The younger generation of households also has high demand for consumption loans, which are typically met by credit cards or the rising tech-driven consumer finance industry in recent years.

v. Let me add that Asset-Backed Securities (ABS), as a form of corporate bonds, have experienced dramatic growth in recent years thanks to the fast-growing fin-tech industry. The biggest seller in the ABS market is Ant Financial, which funds its consumer-credit loans and small-business loans by selling ABS to various institutional and retail investors.

<u>Beijing's Policy Tools for Influencing Capital Allocation</u>

Equipped with a multi-faceted financial market, a variety of financial intermediaries, and a fast growing list of financial products, the central government in China has a rich set of policy tools to affect the working of China's financial market, and consequently, to influence capital allocation. These policy tools include explicit subsidies to certain industries as mentioned in Q2, and in this section I will focus on the role of the market in Beijing's policy interventions today.

Let me illustrate this point using an event study on recent policies that favor private enterprises. Deleveraging and tightened shadow-banking regulations starting in 2016/17 struck a significant blow to the Chinese economy. The negative shock was especially damaging for private enterprises, for reasons that I have mentioned in Q2. To counter this, starting in mid-2018 the central government has pushed the following reforms:

i. The new LPR reform mentioned in Q2.

ii. From the angle of direct financing, Beijing asked regulators in the stock market (equity) and the interbank market (corporate bonds) to lower the entry barrier for private firms. Indirect financing–wise, large state-owned banks have, anecdotally, been encouraged to lend more aggressively to private enterprises—though, it is directly against their profit maximization objective. I therefore believe the policy push will be more effective on the side of direct financing (i.e, lowering the issuance barrier).

iii. In 2018, the sharp drop in the Chinese stock markets drove many private firms' stock-pledge loans underwater, and it could have been devastating if the fire-sale of pledged stocks had adversely affected the banking sector. Together with local governments, Beijing has set up a series of bail-out funds for listed private firms. Most of these bail-out funds had detailed exit plans, so to a large extent they mitigated the widely held concern that "the state advances and the private sector retreats."

iv. On the corporate bond side, even if the interbank market were to lower the entry barrier for private firms, they often face difficulty in selling their bonds, especially given the surging defaults of private firms nowadays. To address this issue, the central and local governments set up some "credit-enhancing" funds only to help private firms sell their corporate bonds. Thanks to the credit-enhancing products—in the same spirit of Credit Default Swaps contracts—that are already available in the market, the "credit-enhancing" funds just sell these financial products to bond investors.[5] For a similar policy intervention by PBOC in helping a troubled regional bank, see Q4.

v. Progressively, Beijing is destined to allow more private players to enter upper-stream industries, say energy, electricity, railways, telecommunications, and gas. Compared to the financial market interventions mentioned above, this seems to be a much "deeper" economic reform, potentially with profound impact on China's long-term growth.

4. <u>What does the recent spate of regional bank bailouts in the Chinese economy (e.g., Baoshang Bank, Bank of Jinzhou, Hengfeng Bank) reveal about the way capital is raised in China? How do the systemic risks unearthed by these bailouts impact the ability of banks to raise capital moving forward?</u>

Since China established its two stock exchanges in the early 1990s, the growth speed of the Chinese financial market has been second to none in the world. Since 2010, the financing demand unleashed in almost all sectors propelled an accelerated—and even rampant—growth of financial innovations, at a pace with which regulators cannot keep up.

For me, the running theme of China's financial market development in the past decade has been "underdeveloped financial markets with overdeveloped financial products." Here, "financial markets" refers to price discovery mechanisms, prompt regulations, legal standard and enforcement, complete and transparent trading rules, and many other institutional infrastructures that integrate all different market participants together.

This fundamental tension will certainly cause unbalanced growth somewhere, which, unfortunately, will burst sometimes. This is exactly what we are seeing with the recent turmoil in the Negotiable Certificate of Deposit (NCD) market and the three troubled regional banks in the

[5] Of course, these "credit-enhancing" funds charge a price significantly below the hypothetical market price (oftentimes, without charging any price). But this is a standard international practice.

summer of 2019. The underlying economic mechanism is almost identical to the wholesale funding turmoil preceding Lehman's collapse in the 2007/08 global financial crisis, and Beijing has learned a great lesson from this.

The NCD Market

As a money market instrument commonly used in the US market, an NCD is a certificate of fixed-term deposit issued by depository institutions in China's interbank market. As its investors are other banks or non-bank financial institutions, the NCD plays a role of wholesale funding together with liquidity management for financial institutions in China. The left panel in Figure 4 shows that the NCD market grew rapidly since its inception in December 2013. Its outstanding balance reached 9.8 trillion RMB at the end of 2018, thanks to its high credit quality (guaranteed by issuing banks), excellent secondary market liquidity, and reasonable premium over the risk-free benchmark offered by government bonds.

Typical issuers of NCDs are small joint-stock commercial banks (Hengfeng Bank) and city commercial banks (both Baoshang Bank and Bank of Jinzhou), while buyers of NCDs are large state-owned banks (e.g., the Big-Four) or their wealth management products, as large state-owned banks enjoy cheap funding sources either from retail deposits or various central bank facilities. Rural commercial banks, money market funds, and mutual funds (broadly defined to include asset management plans funded by wealth management products) have also been investing in NCDs for favorable returns.

The Baoshang Event and Restructuring of Bank of Jinzhou and Hengfeng Bank

On May 24, 2019, the PBOC and the CBIRC announced to take over Baoshang due to "severe credit risk." All retail depositors—and corporate deposits up to 50 million RMB—were guaranteed, thanks to the deposit insurance established in 2015. For interbank debts, which included NCD, creditors could have lost up to 30% of their principals.

The market was shocked by the radical action of the regulators. The NCD market was almost frozen for at least one week, contributing to the sharp drop of total NCD issuances in 2019 (the right panel in Figure 4). The PBOC then rolled out some other lending facilities which helped calm the NCD market, but market participants started to shun away from troubled city commercial banks, among them Bank of Jinzhou and Hengfeng Bank. (Many economists, including me, believe it is a great move for Beijing to awaken the NCD market to its risks.)

Bank of Jinzhou and Hengfeng Bank are typical regional small business lenders in China. They suffer serious corporate governance issues (i.e., controlling shareholders use of their banks as ATM machines to fund unprofitable pet projects related to themselves). Without the Baoshang event, likely these two banks could have continued to operate for a while. But now investors, seeing the potential risk, refused to buy their NCD. This triggered the rollover risk, greatly amplifying the initial fundamental risk. Because the interbank market is closely connected, a potential systemic risk could have emerged. Beijing at this point decided to bail out and restructure these two banks, by introducing various new strategic investors with fresh capital (other large banks, government related entities, and even foreign holding companies).[6] Again, I think it is the right move.

NCD Market Going Forward

To answer this question, let me first mention one particular thing that PBOC has done during this turmoil. In helping Bank of Jinzhou to issue its NCD, the PBOC provided an explicit guarantee—by selling Credit Risk Mitigation Warrants (CRMW), which are similar to Credit Default Swaps (CDS)—on June 10, 2019. This is the only case so far in which the central bank to step in the NCD market acting as the lender of last resort for troubled regional banks, although in January 2020 another smaller lender (Shanghai Huarui Bank) was reported to have failed in an attempt to seek help from PBOC.

Through these decisions, the PBOC told the market that it reserves full discretion on the timing as well as the place to intervene. It signaled to the market that it has the ability to stop the vicious liquidity cycle when it is necessary. Any responsible central bank faces a tough balance between maintaining market discipline and curtailing systemic risk, and the PBOC is no exception.

The turmoil in the NCD market emerged together with the recent surge of corporate bond defaults in China. This is not coincidence; financial markets merely reflect the slowdown of the Chinese economy as well as the unfavorable international environment. These default incidences naturally triggered a demand from market participants to hedge the credit risk, and going forward I expect a fast growing credit risk market (with products like CDS or CRMW) in China's corporate bond market.

The systemic risks unearthed by these bailouts are unlikely to change the funding model of China's financial institutions. Without any political regime shift, international experience tells us that market-based financial market development/reform is a one-way street. Led by the PBOC, one of the most market-driven government agencies in China, the interbank market today hosts a variety of financial institutions thanks to its sophisticated multi-layer structure. In many ways, China's interbank market resembles many modern interbank markets in developed countries, though there is still a long way to go to establish some genuine "price mechanisms" like those of its international peers.

More broadly, I believe that Beijing's recent effort to streamline and tighten regulations in the ever-complicated Chinese financial market is well justified. The recent surge in corporate bond defaults is a great opportunity for the Chinese financial market. Yes, it is painful in the short-run; but a transparent regulatory environment is paramount for building a healthy and sophisticated financial market in a modern financial system where market participants fully understand the risks and the consequences of their own decisions, including issuance, underwriting, trading, and investment.

5. In what ways does the structural imbalance in the fiscal transfer relationship between central and local governments inform local governments' capital raising needs?

[6] Why let Baoshang fail but bail out the other two during China's NCD market turmoil in 2019? The logic seems to be similar to the US experience of letting Lehman fail but bailing out AIG during the 2008 financial crisis. Size-wise, Baoshang is smaller (with an asset of 0.4 billion RMB in 2017) while Jinzhou and Hengfeng are bigger (0.8 billion RMB and 1.3 billion RMB, respectively). Another relevant factor is that Baoshang's effective controlling shareholder was Tomorrow Holding Group, a conglomerate that is currently under graft investigation.

1994 Tax Reform

The 1994 tax reform underlies the structural imbalance in the fiscal transfer relationship between central and local governments. In essence, the 1994 tax reform ensures the central government directly controlled half or more of those revenues, hoping stronger central oversight would help increase overall tax revenue. As an example, for the most important tax, value-added tax (VAT), the central government got 75% while the local got 25%. As importantly, the 1994 tax reform also banned local governments from borrowing (as explained later, this restriction was lifted in the 2014 tax reform).

The 1994 tax reform left local governments with significant operating deficits, as localities were assigned a minority of revenues but still a majority of expenditures. Here, expenditures include all sorts of public goods offerings (e.g., education and infrastructure). The left panel in Figure 5 shows local government revenue and expenditure as a fraction of the corresponding national level, starting in 1980. The noticeable structural break occurred in 1994; since then, local governments have always spent more than their revenues, and have run up even greater deficits in recent years. In principle, localities could balance their budgets by receiving transfers from Beijing. However, the transfer system worked poorly in practice, and localities felt immense pressure to raise extra revenues to cover the shortfalls.

Localities then turned to land. To get around the formal prohibition on local government borrowing, cities usually transferred land assets into special-purpose companies, so-called “local government financing vehicles” (LGFVs). Using the land as collateral, these local SOEs borrowed from banks and later repaid loans by selling the land, thanks to the housing reform and the skyrocketing land values that resulted during the early 2000s.

The 2009 Stimulus Plan and the 2014 Tax Reform

The fiscal imbalance between central and local governments and the unique land-based financing model were pushed to the center stage when Beijing rolled out its 2009 four-trillion RMB stimulus package in response to the 2007/08 global financial crisis. LGFVs borrowed aggressively from not only traditional banks but also shadow banking, especially after the credit tightening in mid-2010. Since then, the steadily rising local government debt has been increasingly alarming, and hence closely monitored by top policymakers in Beijing.

The tax reform in 2014 was Beijing’s major initiative to tackle the local government debt problem. I highlight four points below, with my own assessment of each reform effort.

i. LGFVs are banned from new borrowing. (Though, this policy faced fierce resistance from localities, and as a result was never seriously implemented. In fact, LGFVs’ borrowing has continued to grow in the past five years.)

ii. Introducing municipal bonds, including the general bonds and special-purpose bonds. These bonds are structured to replace banks loans, which were the major financing instrument of local governments since the 1994 tax reform. (See more detailed explanation in Q6.)

iii. Returning some responsibility (e.g., education, healthcare, and some social welfare programs) back to the central government. (This has been implemented.)

iv. Improving the accountability of local governments by establishing a better and more transparent reporting system. (Mixed reform outcomes so far, and hard to evaluate.)

6. What factors are pushing local governments to increase issuance of sub-sovereign and local bonds? What are local governments doing with the capital that is raised from this bond issuance?

Recently, China has accelerated the issuance pace of municipal bonds (general municipal bonds and special-purpose municipal bonds) in response to the sluggish economy. The right panel in Figure 5 plots the annual issuances of municipal bonds in the last two years. As a counter-cyclical fiscal policy, this is in the similar spirit as the four-trillion RMB stimulus plan in 2009 in the wake of global financial crisis in 2007/08. However, there are several key differences from the last stimulus plan, and these differences answer the questions raised above.

General Municipal Bonds and Bond Swap Program

In 2019, about 40% of issued municipal bonds were "general" bonds, which are supposed to help local governments finance broader government spending (and are formally backed by tax revenues).

As explained in Q5, LGFVs played a critical role in the 2009 stimulus program. As a major new policy stipulated in the fiscal reform of 2014, Beijing allowed local governments to sell "official" general municipal bonds to the financial market to repay the maturing MCB sold by LGFVs in years past. This explains a significant part (more than 80%) of issuance of general municipal bonds in the past two years.

Special-Purpose Municipal Bonds

The majority of municipal bonds are "special-purpose" bonds, which finance specific infrastructure-related projects. They accounted for about 60% of the municipal bonds issued by Chinese local governments in 2019.

Special-purpose bonds correspond to so-called "revenue bonds" in the United States, as the cash flows generated from the underlying projects will be used as the primary repayment sources. Special-purpose bonds have been vigorously promoted by Beijing in recent years to boost economic growth, and they have financed infrastructure-related projects, including land banks, shanty town renovation programs, medical care and nursing homes, environmental and ecological protection projects, toll road and metro construction, and even electricity/gas projects.[7] Here, "land banks" refer to the "primary land development" infrastructure projects on undeveloped rural lands, a necessary step before these lands are ready to be sold to real estate developers. Localities can also issue special-purpose bonds to refinance their maturing debts that funded some qualified infrastructure projects in the past. Figure 6 shows categories of projects that support the special-purpose bonds issued in 2019, based on their issuance prospectus.

Special-purpose bonds work quite differently in this round of stimulus compared to how they worked in 2009. First, in the 2009 stimulus plan, local governments were encouraged to launch any "infrastructure" projects without being monitored by state-level agencies. Consequently, some local governments invested heavily in some other non-infrastructure "business" projects (e.g., establishing some high-tech zones that host private businesses). Second, in 2009, these projects were mostly funded by bank loans, which were extended by all kinds of commercial banks

[7] For instance, in a detailed project by Zhejiang Province mentioned in China Daily dated 3/28/2019 that "proceeds from the sales will be used for land banks (300 million yuan) and shantytown renovations (1.1 billion yuan)." http://www.chinadaily.com.cn/a/201903/28/WS5c9c04cea3104842260b2f6c.html.

with their own corporate governance issues. Third, LGFVs borrowed heavily from shadow banking several years after the 2009 stimulus plan, due to mounting refinancing pressures.[8]

Special-purpose bonds are proposed as a solution, as they represent a transparent way to fund grand infrastructure plans, putting an end to the off–balance sheet borrowing by China's local governments. The Ministry of Finance and the National Development and Reform Commission are the two key regulatory and supervisory agencies who are responsible for special-purpose bonds. Particularly, the regulators set a quota each year, which gives the maximum total special-purpose bonds that Chinese local governments are allowed to issue. To apply for the permission to issue special-purpose bonds, every local government needs to submit detailed descriptions of the projects—e.g., the project budget and completion years, and then wait for approval from the National Development and Reform Commission. Finally, after approval, the interbank market requires local governments to disclose these detailed project descriptions in the corresponding bond issuance prospectuses.

In recent months, Beijing has responded to the economic slowdown with various relaxation measures, a trend that I expect to keep its momentum in the coming year. First, China has brought forward 1 trillion RMB ($142.07 billion) of the 2020 local government special-bonds quota to 2019. In the meantime, the National Development and Reform Commission expedited the application procedure for special-purpose bonds.[9]

7. <u>In addition to exchange rate management, in what ways do foreign exchange reserves act as a backstop for China's economy? How has Beijing deployed its reserves to solve economic problems and what are the challenges to doing so?</u>

<u>Foreign Reserve as a Backstop for China's Economy?</u>

Although foreign exchange reserves have played an instrumental role in shaping China's growth starting in the 1990's, today the phrase "foreign exchange reserves act as a backstop for China's economy" is misleading to a large extent.

In principal, China does not need to rely on foreign reserves for its economic growth, thanks to its vast size, increasingly balanced growth of industry sectors, moderate current account surplus, and most crucially, its tightly controlled capital account.

Let me elaborate on this point by citing a set of widely accepted IMF tests which assess the adequacy of a country's foreign exchange reserve. The tests look at four economic variables: (i) export income to reflect the potential external demand shock; (ii) broad money to capture potential residents' capital flight; (iii) short-term debt to reflect debt rollover risks; and, (iv) other liabilities to reflect other portfolio outflows.[10]

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[8] Chen, Zhuo, Zhiguo He, and Chun Liu, 2020, The Financing of Local Government in China: Stimulus Loan Wanes and Bank Loan Waxes, forthcoming in *Journal of Financial Economics*.

[9] According to a *Financial Times* article published on Nov 25, 2019, a local government financing entity in Jiangxi province in eastern China said that "All we need now is to fill out a few forms and within a few weeks the National Development and Reform Commission will give us the green light." https://www.ft.com/content/543a6d40-07b2-11ea-a984-fbbacad9e7dd

[10] Guidance Note on the Assessment of Reserve Adequacy and Related Considerations, IMF staff and completed on June 2, 2016. https://www.imf.org/external/np/pp/eng/2016/060316.pdf.

Because China has a fairly small amount of foreign-denominated external debt, the only test that China fails is ii), which requires a country to have foreign reserve that exceeds 20% of its money supply (say M2). For China, at the end of 2018, the ratio between its foreign reserves and its M2 is about 11%.

However, the same IMF paper emphasizes that the ratio of reserves to broad money only applies to countries with open capital accounts that have significant capital flight risks. With tightly controlled capital accounts, the capital flight risk is minimal—note, China has been very effective in dealing with capital flight risk in 2017.

<u>Why Is Foreign Reserve Still Important for China?</u>

Although not the "backstop" for the domestic economy, foreign reserve is still vital for Beijing in implementing its economic and financial policy at the international stage.

The first usage of foreign reserve, which is also perhaps the most direct one, is to repay USD-denominated loans or bonds if Chinese borrowing firms face difficulties in refinancing their debt. Another equally plausible situation is that these borrowing firms decide to pay back maturing USD-denominated debt, perhaps due to unfavorable expected exchange rate movement, just like what happened in 2016. At the end of 2018, outstanding foreign-currency denominated bonds (loan data are unavailable) amounted to about 848 billion USD, which was about only 27% of China's reserve (3.1 trillion USD). This is consistent with the fact that China—including both the public and private sectors—does not have heavy foreign-denominated borrowings.

Second, China's ample foreign reserve gives Beijing a fair amount of flexibility in pushing the One-Belt-One-Road Initiative. Foreign reserves allow China to not only invest directly in infrastructure projects in other central Asia countries, but also establish various market-oriented financial institutions that pursue the One-Belt-One-Road Initiative. A non-exclusive list of these entities include the Silk Road Fund, Asian Infrastructure and Investment Bank, and New Development Bank (formerly referred to as the BRICS Development Bank). Beijing has committed some non-trivial seed capital to these entities, hoping to attract capital injection from other partner countries. According to publically available information, the total capital commitment for these three entities from China are about 40 billion USD. This seems to be minuscule relative to China's foreign reserves, with the caveat that we lack reliable data on other One-Belt-One-Road initiative projects.

The above two roles served by China's foreign reserves are naturally linked to Beijing's ambition to internationalize the RMB. Internationalization of RMB requires China to open its domestic bond market, and USD-denominated Chinese corporate bonds help foreign investors get familiar with China's economic environment. For the One-Belt-One-Road Initiative, Beijing has been trying hard to sign the investment contracts in terms of RMB. Last—but perhaps the most important—China's ample foreign reserves help Beijing to manage a stable exchange rate of RMB against USD, which is the very backbone of the internationalization of RMB.

To sum up, I do not think that in today's China "foreign exchange reserves act as a backstop for China's economy." Nevertheless, it could be viewed that foreign exchange reserves act as a backstop for RMB internationalization.

8. Conclusion: How would China's management of its financial challenges in the wake of economic slowdown impact the United States or other world economies?

For the US and global economies, a potential severe recession in China will be quite damaging today, especially given the sluggish Euro-zone economy and heightened geo-political tension around the world. While slowdown is a sure thing to embrace, top policymakers in China have all the determination, together with various new tools thanks to its burgeoning financial market mentioned above, to prevent the China's economy from a complete collapse.

Can Beijing do it without reversing some past positive market and financial reform efforts, especially those that are essential for its long-term growth (e.g., deleveraging, cracking down shadow banking)? And are there other issues for which global investors will be affected by China's financial market reform? Here are the list of important points for these questions.

i. Almost all the current economic and financial challenges that Beijing is battling are about internal issues (except the US-China trade conflict, with a recent phase-one deal giving both sides a temporary relief). China's domestic economy, thanks to its vastness and sophistication, is on its own track. A free-falling economy is impossible, given the presence of a powerful central government that already puts financial systemic risk at the top of its watch-list.

ii. Nobody, not even the top policymakers in Beijing, is expecting China to grow like how it did in the past thirty years. It is a gigantic economy already, and the slogan of "New Normal" just means slower and better growth. And, it seems that Beijing has learned to adjust its policy-making style facing the new normal economic situation, as it relies on increasingly more market-driven tools when tackling its economic challenges. As mentioned in Q3, Beijing prefers to utilize the existing market infrastructure—admittedly still underdeveloped—to implement its policy goals. Equally interesting, in setting China's 14^{th} five-year plan, policymakers even debated whether it should include some pre-specified GDP target for the years to come.

iii. Another relevant issue is that of China's recent commitment to opening its domestic financial market to foreign financial investors/institutions.

    a. In my view, various connect programs that link Chinese exchanges with Hong Kong exchanges are the most exciting financial innovations in recent years. These allow both domestic and international investors to enjoy the benefit of diversification without changing the regime of closed capital accounts, a perfect example of reform gradualism of which Beijing has been quite proud.

    b. Foreign institutions now are allowed to set up sole-owned entities or joint ventures with control (above 50%) that operate in China's domestic financial industry (e.g., card clearing and payment, asset management, and distress debt businesses mentioned in the newly-signed first phase of US-China trade agreement). From China's perspective, many key managers in domestic big financial houses had extensive working experience in internationally renowned funds, and I think it is the right time to expose domestic financial institutions to foreign competition. From the perspective of international players, China's asset management industry is undergoing a complete revamp after the tightening of shadow-banking regulation, hence offering a great opportunity that it cannot afford to miss.

Appendix.

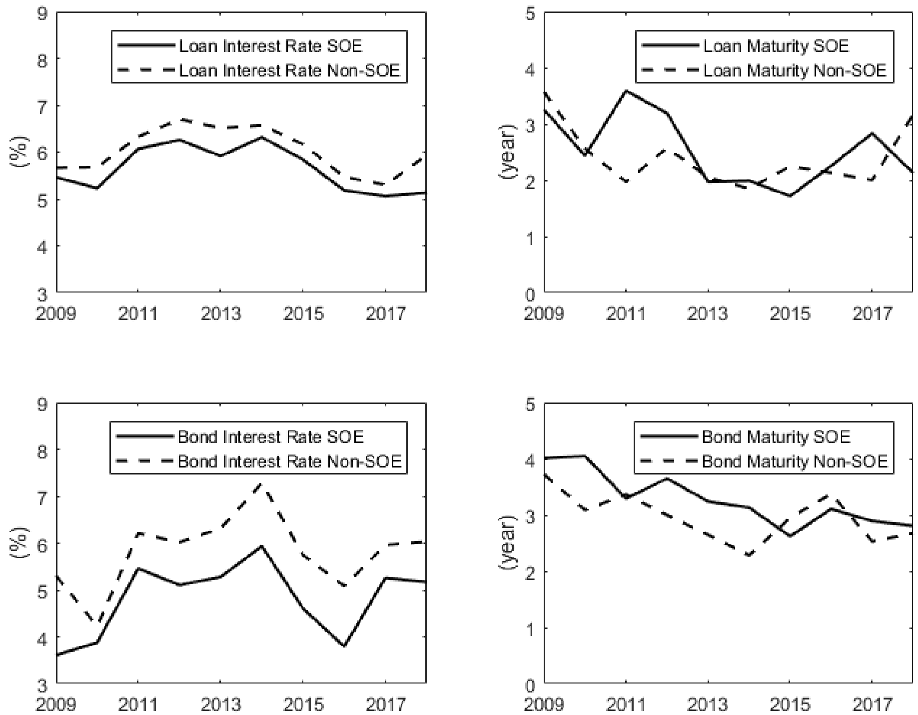

Figure 1. Interest rate and maturity for bank loans in Listed SOEs & Listed Non-SOEs (top two panels), and for corporate bonds in SOEs & Non-SOEs (bottom two panels). Data Source: CSMAR, WIND

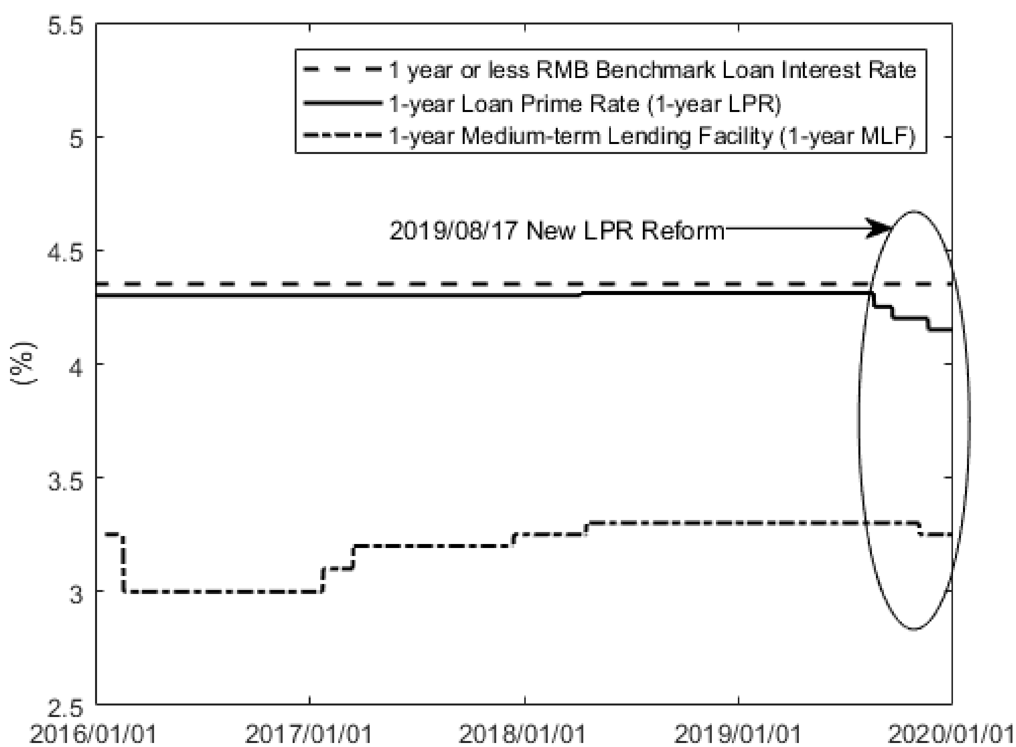

Figure 2. 1-year RMB Benchmark Loan Interest Rate, 1-year LPR and 1-year MLF in China. Data Source: WIND

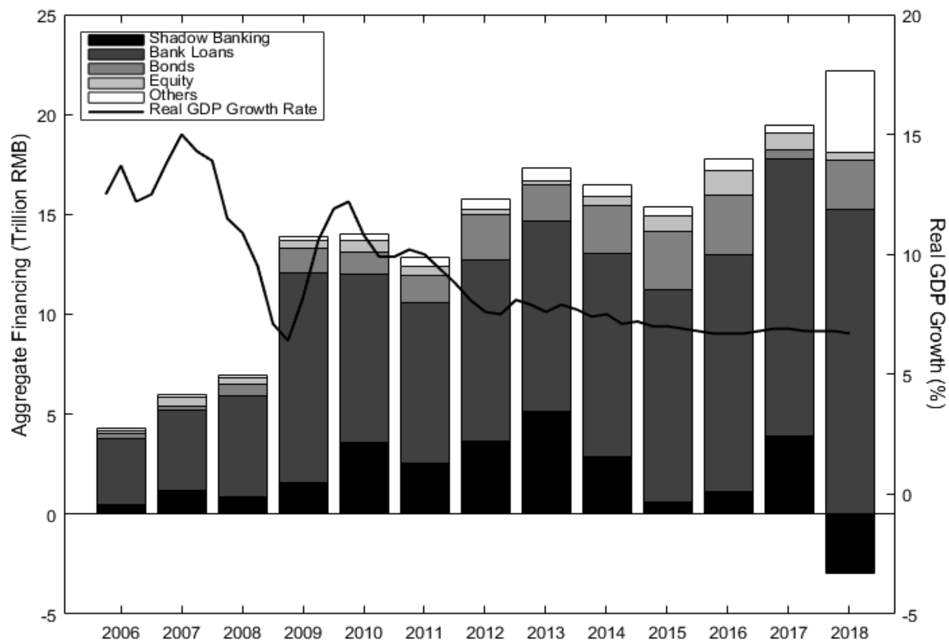

Figure 3. GDP Growth and Aggregate Financing to the Real Economy (Increment) in China. Data Source: WIND. “Others” in 2018 include financing from special-purpose municipal bonds and loan write-offs, both of which were not part of Aggregate Financing before 2018.

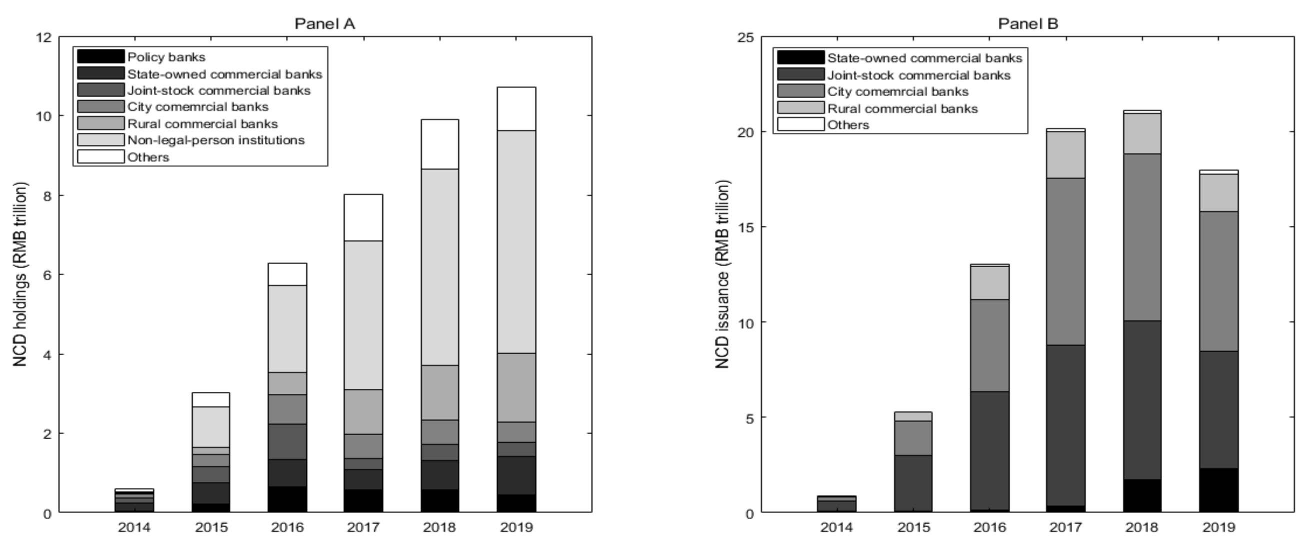

Figure 4 NCD Holdings by investor types and NCD Issuance by instituion types, from 2014-2019. Data Source: WIND.

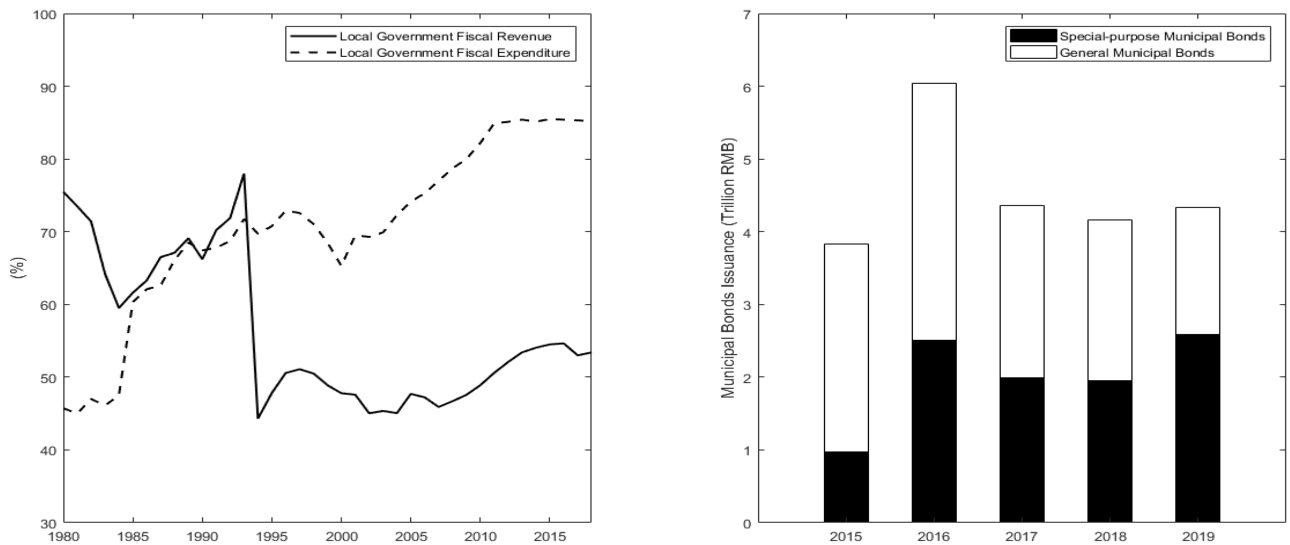

Figure 5. China's local government share of fiscal revenue & expenditure (left panel) since 1980, and municipal bonds issuance (right panel) since 2015. Data Source: WIND, RoyalFlush.

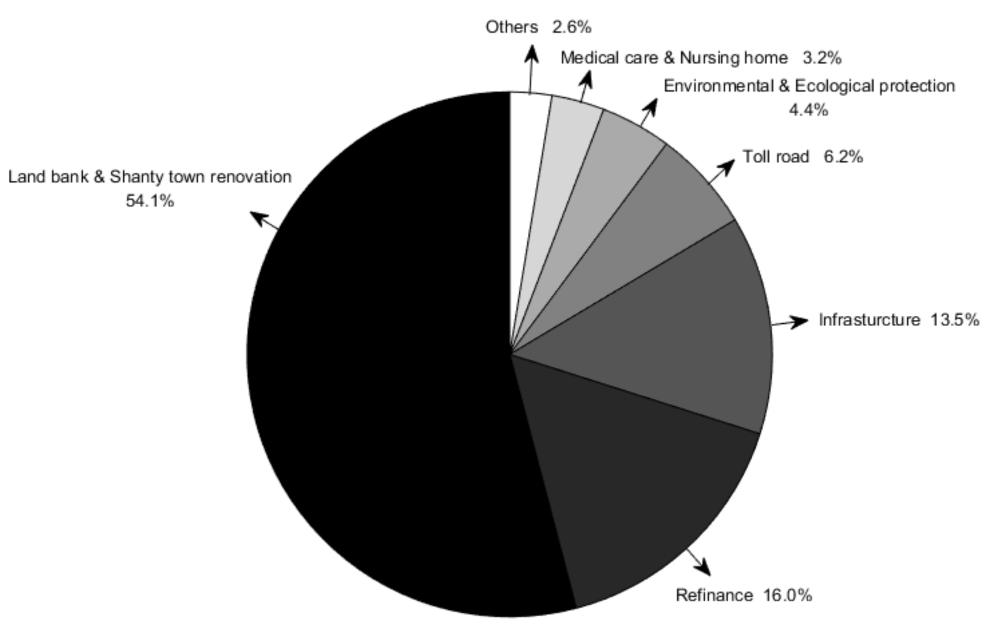

Figure 6. Categories of infrastructure projects that support special-purpose municipal bonds in 2019. Data Source: WIND and bond issuance prospectus.

PANEL I QUESTION AND ANSWER

CHAIRMAN CLEVELAND: Excellent testimony, thank you very much to all three of you. Commissioner Wessel?

COMMISSIONER WESSEL: Again, thank you all for testimony. This is one of our more complex topics and your testimony and that of the other panelists later on has really helped frame a lot of issues for us.

But I'm very troubled. It feels to me like this is almost a subprime crisis in China based on the acceleration of debt, the opacity of reporting, the cross-fertilization of products, wealth management products being cross-traded, et cetera, et cetera.

And as opposed to debates let's say five, seven years ago about China, hard landing, soft landing, what would its implications be for us, that was primarily in a traded goods sector.

Would China go through a hard landing such that their market for our exports would diminish?

Now we see a -- from what I can tell and, please, I'm looking for information from you -- dramatically expanded engagement by China financial instruments in the world economy.

One is the MSCI Bond Index, et cetera. So, as we had with the subprime crisis the dispersion of CMOs, collateralized mortgage obligations, et cetera, and the recent China deal, stage one, that appears to have an opening for the financial markets.

It feels to me that there's a subprime crisis and potentially we're opening ourselves up to more of that risk.

Can you, each of you talk to me about whether it is a crisis or it is reaching crisis proportions in terms of all of the various ratios, reserve requirements, all the things capitalization you know a lot more about than me.

And second, what is our exposure to the impact of that? Why don't we go down the row? Mr. McMahon?

I'm also talking too quickly.

MR. MCMAHON: Okay, to speak to the question as to the likelihood of the possibility of a financial crisis, China's financial system works in incredibly different ways to our own.

So, I actually think that given the existing levels of debt in China's economy, I'm not convinced that a free-market economy would have got to this point already. I think things would have broken well before now.

But the key difference the way I see it is this, it's a question of how do they maintain faith in the system.

So as I was saying before, China says its non-performing loan levels are significantly lower than what they are, which means that the banks are probably significantly undercapitalized.

But that matters less in the Chinese system. In the U.S. or any other market economy, you maintain certain levels of capital because each individual financial institution is independent.

The market's faith in that institution is based purely on the health of that institution, how well it's managed, how well it can cover its debts, how much capital that it has.

But in China that matters less. The faith of the public and the financial system in any given financial institution has little to do with the health of that institution itself.

It's purely based on the faith that the government will intervene if and when it's necessary to a degree that is required to ensure financial stability. And that is always how the system has worked.

Now, things are getting a little bit hairy at the moment because of what the PDOC did with Baoshang Bank in May.

Finally, other financial institutions were forced to take a haircut on their exposure to a bank that pretty much everyone in the system knew wasn't particularly well managed, knew was a little bit frail. And so that introduces risk that didn't exist before.

That said, I think given the nature of the government's intervention again in five banks last year, broadly speaking, there is this still underlying faith that the government will do whatever is necessary to ensure financial stability even as it tries to introduce a little bit of risk in the system.

Now, what that then means for international investors, it gets a little bit more complicated because I think ultimately it means that the overall stability of the financial system is -- we don't have to hugely worry about it, although it probably means that the ability of the financial system to provide the credit necessary to ensure the sort of levels of growth we've seen in the past are hugely compromised.

So, from a basic stability issue, we're not looking at a crisis environment as one that perhaps we experienced in the United States a decade ago.

COMMISSIONER WESSEL: Go ahead.

CHAIRMAN CLEVELAND: Can I ask, because it feels -- and we really are struggling because we're not the experts that you are -- it feels, Mr. McMahon, that you and Dr. He have a slightly different take on the Baoshang Bank bail-out and that you're saying that there is this underlying faith that the government will intervene to do whatever is necessary to ensure financial stability.

Dr. He, you said in your written testimony that you thought that this was the beginning of a new approach to, essentially, let --

DR. HE: Breaking the implicit guarantee.

CHAIRMAN CLEVELAND: Right. Could you two address what feels to me like a difference of opinion in terms of what's actually happening?

MR. MCMAHON: Certainly it is an attempt to break the implicit guarantee. I think the jury is still out as to just how committed the central bank is to this approach.

So for example, that's the approach that they took to Baoshang but six months later, the Sovereign Wealth Fund steps in and effectively bails out Evergrowing Bank for literally tens of billions of renminbi.

We saw with Zhilin Bank local governments step in and put as much capital as possible. I think Baoshang was an experiment, we might see it again but I think that if we do, the authorities are going to be very careful.

The point of this experiment is to try and get the banks to moderate their behavior in terms of how they treat risk.

Now, I think the moment that the PBOC feels that it's losing control of that experiment it will back away from it. So I don't necessarily think this is the beginning of a major change.

COMMISSIONER WESSEL: But Mr. Miller, with your data showing on shadow and all the things that that means rising, it feels to me like this is getting out of hand, that they have a cautionary tale with Baoshang to try and pull back on the reins. But at the same time there are more, if you will, horses running forward.

Again, is this going to get out of -- I know you can't say whether it's going to get out of control but it certainly feels like the velocity of this is increasing, velocity and volume, to levels that may not be controlled.

MR. MILLER: So, the goal of my remarks was principally to bring some transparency to what I think is not a very transparent situation, even for the Chinese.

I wasn't here to pass qualitative judgment on the rise of shadow finance on the one hand.

The more important idea here was that there's a belief by markets, by policymakers that the Chinese are single-mindedly committed to the crackdown on shadow finance and nothing can sway them from that inevitable course.

And what I would say is that's not true, that they have multiple priorities like anyone else and part of that's stability and part of that's maintaining growth, and those are wrapped in.

So, the idea that there's an ebb and flow to their shadow finance crackdown, their regulation, shouldn't surprise anyone. It's part of regulation development as they move forward.

COMMISSIONER WESSEL: Just as part of that, so what do you think the role of outside capital, U.S. capital since we're a U.S.-China commission, how important is outside capital to putting, not circuit breakers, but helping to reduce the velocity and volume of the potential problem?

MR. MILLER: I think outside capital is important in that it puts a strong incentive for the Chinese to make the system as safe as possible because there's a dire need to attract outside capital.

So, there may not be an easy way to track one pressure point versus another pressure point.

But in terms of the importance of foreign leverage, using foreign capital to be able to make the Chinese system safer, I think this is something the Chinese would like to do but I think the fact that foreign capital will only go into China if it looks like there are safeguards there, it's a very strong addition to the incentives for the Chinese to get this right.

COMMISSIONER TALENT: Mike, could we hear Dr. He, please?

COMMISSIONER WESSEL: Yes.

DR. HE: Thank you for the opportunity. As an academian that studied the U.S. financial crisis very extensively, I want to make two points.

One is it's so important to breaking the so-called implicit guarantee and Beijing is determined to do that. Now, where to break it? That's the key.

Clearly, we are already seeing that a corporate bonds market, which is bonds issued by manufacturing firms, real firms, it's breaking, okay.

The rising defaults is just at the level that I thought should be slowed up a little bit, even though I still think they could do it more, okay. It's just the speed is too fast.

The second point is that banks are very different, okay. They're not at a place, a good place, to breaking the implicit guarantee. And the way that they do it, the Baoshang Bank is an experiment, I totally agree with that, and there are some other reasons.

Baoshang Bank is relatively small and it's so aggressive when it's rising, so it's kind of to give the lesson to the people that you can't do too aggressive things for traditional banks.

And they also bailed out other banks that I mentioned, Jinzhou and Hengfeng, but I want to mention in early 2020, January 14th, when I write my testimony I saw on the news there's a very small Shanghai bank that operated in the Free Trade Zone, it's called Huarui Bank, requested help from the PBOC. PBOC said no.

So that's very important in the sense that they are very, very careful in making all these decisions and they understand that the banking system is something that is so fundamental, so critical to the working of China and the businesses, they have to be very careful in breaking the so-called implicit guarantee.

And to be honest, implicit guarantee is the biggest problem when I teach my financial class, China class to my MBA students. I told them that if you don't break the implicit guarantee, there's no market, no market force will come out.

CHAIRMAN CLEVELAND: So, we should view it as a measure of market forces. Senator Goodwin?

COMMISSIONER GOODWIN: Thank you and thank you gentlemen for your time this morning.

Dr. He, I want to talk a little bit about special purpose bonds, comparable I suppose, as you put it in your testimony, to our special revenue or revenue bonds here in the States.

As you testified, they offer perhaps a more transparent way to fund some of these grand infrastructure projects. But to be effectively transparent there's an important step in that process, which is the rating assigned by the credit rating agencies.

And as these bond markets open and these special purpose bonds grow in prevalence, are the rating agencies keeping up?

There have been reports the last couple of years that have compared ratings assigned by Chinese agencies to debt and bonds issued by issuers in China to comparable debt issued offshore that were rated by Moody's and Fitch and the offshore date was rated six or seven notches lower.

So, how confident are we in the ratings assigned by the rating agencies in China to ensure that the special revenue stream identified to provide debt service on these bonds will be sufficient?

DR. HE: So, let me answer this question. There is a little bit of misunderstanding of the way it works, of the special purpose bond.

It is backed by the projects but this is where China is taking gradualism reform. And actually, it is backed under certain circumstances.

If the project fails, it's still backed by Beijing, so that's part of the so-called municipal bonds. At this point, the way it's written is that it's backed fully by the authorities.

So, in a way, that's why there is no such rating on that and all these bonds were still bought by commercial banks with very low capital charges on that.

However, you get to a very important point about the rating system in China. It is so obvious that the ratings were inflated in China; however, the relative ranking of the rating is very informative.

So in a way, sometimes I joke around saying that when you get to Harvard, Harvard grades are always very good but it's a relative matter.

So, in a way, it does play a very important role in guiding the capital into the right place, as long as the ranking makes sense.

And I wish that more and more following S&P, Moody's, et cetera, gets into -- it's open now, at least according to the recent announcement -- that they get in and they compete with the local rating agencies.

I think that would be a great thing for the future.

COMMISSIONER GOODWIN: Are there requirements imposed on these local governments to issue these bonds in the sense that they have to be rated at a certain level?

And if so, would those requirements put some pressure on rating agencies if they are in fact rating them and assessing risk to perhaps downplay the risk and inflate the rating?

DR. HE: As far as I know now, the special purpose bonds were not subject to the rating requirements. That's what I'm saying.

COMMISSIONER GOODWIN: What about more general obligation bonds that the local governments may be --

DR. HE: These are even better, right? Usually, general bonds are unconditionally backed by the revenue so that's like subnational bonds.

And typically, in the United States it's a so-called -- it's not GO bond, it's the other bonds, it's called project revenue bonds.

That's specifically backed by certain projects, therefore, the people need to worry about whether the project is profitable or not.

In China, as of gradualism reform, it's basically saying they tried to resolve the issue of whether you're going to disclose it rather than assessing the risk at this point. That's the first step.

Before, we didn't even know who they are, now at least we know you need to describe it. But the risk is a secondary issue at this point.

CHAIRMAN CLEVELAND: That's so interesting. Commissioner Fiedler?

COMMISSIONER FIEDLER: I have a lot of questions but I don't have the time.

Just a quick factual question, how much of Sovereign Wealth Fund money, CIC, and SAFE assets are going to bank capitalization, recap? A lot of money, right?

MR. MCMAHON: So far not much.

So, the breakdown has been -- the last time that foreign exchange reserves were really meaningfully used for recapitalization was about 2005 to 2006 and that was for the big four banks.

Then in 2015, a subsidiary of SAFE provided $49 billion to recapitalize China Development Bank and another $49 billion to recapitalize China EXIM Bank.

Since then, there hasn't been much involvement until recently with Hengfeng Bank, when a subsidiary of CIC stepped in to recapitalize Hengfeng.

What we're not completely sure of yet is what the source of those funds are. Because usually, you would think subsidiary of the Sovereign Wealth Fund, they should be foreign currency denominated.

That said, it doesn't make a lot of sense to inject U.S. dollars to recapitalize a Shandong provincial bank.

So presumably, the Sovereign Wealth Fund or the subsidiary have some source of renminbi from somewhere else in the system. What that is, we're not particularly clear as yet.

COMMISSIONER FIEDLER: Thank you. Your initial testimony fascinated me about a rationalization, a logical rationalization, for the Chinese to be transparent, to be opaque, in dealing with the problem.

Now, we have a new agreement with China that U.S. financial companies are going in and if I oversimplified, allow me -- the bond markets in China are not pricing risk. Is that right?

And I don't mean the municipal bond market, I mean every bond market. There's no risk in what you described because the government's backing -- you said it's not rated.

And there is no risk if the government is backing it so people are willy-nilly putting their money in it. Now we have U.S. rating agencies going there.

You say there's no data, no really great data, and now we're going to have allegedly competent U.S. rating agencies telling U.S. rating bonds in China, using their reputation for rating in the United States based on opaque information in China.

And U.S. investors are going to say that's safe or the risk is priced properly in the bond. Now, the shadow banking system in the past -- am I wrong in thinking it sort of priced risk because those interest rates were really bordering on usurious.

Now, I don't know, you haven't described whether or not -- I think you did but you didn't conclude that they're not pricing risks. There's no market pricing of risk here, which makes it riskier as a market.

Am I wrong in understanding how the world works?

MR. MILLER: I would say that the major problem with the Chinese system is that there aren't mechanisms, in large part, to price risks. If you have interest rate corridors that you control things through, you have no way for the market to clear prices. There's no way to reflect true risk.

Shadow finance in some ways is a response to that but, yes, one of the major problems in this entire episode is that risk isn't priced in China because the market's not able to do so and because of what we've been talking about earlier which is this implicit government backstop from Beijing and possibly other levels all along the way.

So, it's very difficult to assess risk based on prices because prices aren't based on risk.

COMMISSIONER FIEDLER: And what he was describing, as the Chinese government responds to loosened credit, to me, we don't care whether they're credit worthy, so give them some money.

And that increases the risk, right. So I see if it's not priced, it certainly is higher than it is ostensibly pretending to be.

COMMISSIONER TALENT: Jeff, since we've been deviating a little bit from the regular order and you're going to crack down in a minute, help me a little bit.

Could I ask him to give me a 30-second definition of pricing risk? I vaguely know what it is. I'm just an old meat and potatoes Midwestern politician. So tell me, one of you, do you mind?

MR. MILLER: Essentially, having supply and demand dictate the price.

So instead of having the Chinese set a suppressed cost of capital, for instance, that capital would be broadly offered not just to a narrow corridor of firms or individuals, but that capital would reflect the differences, the credit spreads, between less risky and more risky.

I think one of the major problems with the Chinese system is that the state banks are such dominators of the financial system that because interest rates are suppressed and kept within a narrow range, if you're going to be loaning money out for, say, two percent or four percent, you'd much rather do it to a very safe SOE than you would a small, medium-sized enterprise or a private firm that may not be politically connected, that may not have government backstop.

So as a result, you're constantly -- most of these pricing mechanisms are based on a state entity, a state bank loaning money to a state-owned enterprise. There's no price discovery there.

COMMISSIONER TALENT: That helped a little.

DR. HE: Can I just clarify the price risk? In the market price if you are looking at different rating bonds, in China if you have an A, A-, it's really bad bonds already.

But again, I don't think it really matters in the sense that if everybody knows A- is bad bonds, they're just bad bonds. So, the rates spread over A, A- is very high, it's like 12 percent.

So if the base rate, let's say three percent or four percent, the market spread or the discount rate that you have to offer to the investors on these A, A- bonds is about 15 percent. So, it's like credit cards. It is in the way that it's priced in. Now, whether it's a reflection of, if daily new information comes in, I would say no, it's very stubborn. People just look at the ratings, they rely on ratings, and they price it.

Another factor that I really don't like in China is, in the sense that the Chinese financial market is underdeveloped, that a lot of times it's just based on quantity rather than the price.

So that's the two factors that I think going forward, bringing more defaults, et cetera, can try to address these questions.

CHAIRMAN CLEVELAND: Commissioner Wortzel?

COMMISSIONER WORTZEL: I want to try and deepen my own understanding of a couple of terms that now I think the three of you had used.

Mr. McMahon and Dr. He referred to an implicit guarantee; Mr. Miller called it a government backstop. I think it's the same thing.

It seems to me that as long as both the banking public, individual people that put money in a bank or invest, and companies have confidence in this implicit guarantee that the economy and even the social structure remains stable. That's the Communist Party's goal.

So I guess my question then is if funds that are flowing from the United States, either through individual investors or financial firms or banks, are helping the Communist Party of China make that implicit guarantee, why don't we just stop them from flowing?

What interest do we have in maintaining that implicit guarantee for the Communist Party?

MR. MCMAHON: I'll have a crack first. I'm not necessarily sure that the inward flow of foreign currency necessarily is essential to the implicit guarantee. I think what allows them to maintain that is their ability to print money in their own currency.

And this is where capital controls come in as well because they can print as much as they like to be able to help bail out a struggling bank, they can print as much as they like to -- let's say an investment product defaults and people are protesting on the street of some small city of China, they can provide the money to be able to fix that problem by paying people off.

And the money can't leave the country, which it might otherwise if there was porous capital controls, which it probably would given the sheer volume of money that has been created in China over the last decade.

Now, certainly there are real advantages to the Chinese government at the moment from having more foreign capital flow into the Chinese economy.

And that's because of structural changes in its trade position, which means that traditionally, it didn't have to worry about financial flows to supplement its holdings of foreign currency because the trade surplus could take care of that. Month on month on month, you just had U.S. dollars flowing into the Chinese economy because of its massive trade surplus.

And now things are getting a little -- are sort of turning against China's interest on that account, and so to supplemental that there is a need to bring in foreign currency through other measures in order to ensure that they have a sufficiently large foreign currency buffer.

I might leave it there.

DR. HE: I completely agree with the first statement about the fact that the implicit guarantee is about the domestic economy, the ability to tax, and obviously if there's no economic activity, then the taxes are useless.

So it's really the big economy help -- Beijing has the power to intervene in the market. I think it's necessary to keep the economy moving.

The second part is that I want to say that at this point it's negligible, of the foreign denominator, the capital into the bond market. I was -- as academia I was hoping it would be bigger because for foreign investors the interest rate differential is indeed quite big. So it's just profit maximizing activity.

MR. MILLER: I would agree with my co-panelists here. I think there's a very small sliver of foreign capital into domestic bond markets that are not -- so the implicit guarantee is not based on or reliant on that sliver of capital.

The other point I would simply make is that as we talk about pulling back implicit guarantees or government backstops or whatever we term it, there are severe repercussions for China in the world if this is done poorly, is one of the goals I think of the Commission, is to identify and uncover where these vulnerabilities are.

There is a desire by the Chinese government right now to create some ambiguity as this government backstop is pulled, perhaps the same way that we had done earlier with government-sponsored enterprises in the United States.

But I think that the idea that a government backstop could be pulled off quickly and in a definitive way could actually be very dangerous to financial flows and to the global economy.

CHAIRMAN CLEVELAND: Larry, did you want to?

COMMISSIONER WORTZEL: It seems to me that argument you're making structurally is very similar to the way the U.S. responded to the saving and loan crisis and the mortgage crisis. I mean if you don't have faith in your government, you don't have much faith in anything.

CHAIRMAN CLEVELAND: Commissioner Wessel, you had a --

COMMISSIONER WESSEL: Just a quick question because you stated that bond flows are not that great.

The inclusion in the MSCI Bond Index and some of the others, I think it's Bloomberg, I don't remember, what do you anticipate that will mean in terms of flows? I've heard numbers of 100 billion or more.

MR. MILLER: I've similarly heard those numbers; we don't do internal calculations about that so I think 100 billion is a number that sounds reasonable to me.

COMMISSIONER WESSEL: Are you able to track that, or will you be tracking that through the Beige Book?

MR. MILLER: We would not be. Our current focus is on evaluating the corporate sector in terms of asking about performance of the national economy, sectoral economy by region. So we have indirect ways of tracking trade flows but we don't track trade per se.

COMMISSIONER WESSEL: Thank you.

DR. HE: Let me add one thing. So my colleagues at University of Chicago have fantastic data on Morningstar, like the mutual funds, pension funds, all these things.

They have detailed bond holding data, and they'll keep updating. So I wish that they had it more recent. I would love to know how much the foreign investors are actually investing in China.

COMMISSIONER WESSEL: If you could have any of that sent to our staff afterwards that would be very helpful. Thanks.

CHAIRMAN CLEVELAND: I feel a little bit like a greyhound chasing a rabbit around a track in terms of I think I've almost got it and then it pulls away.

So following up on Commissioners' Wortzel and Wessel's comments about the feeling that this is like the CDO crisis that we faced, I'm curious about the role of the issues around non-performing loans and the role of asset management companies in terms of their -- I understand from your testimony, Mr. McMahon, that there are 60 of them and they have exclusive rights to acquire portfolios of NPLs.

But I'm curious about what these AMCs are, what their role is, how they become a surrogate or a proxy for this implicit guarantee, and are they part of the shadow banking system? I'm trying to understand.

They feel very important, and they feel like that rabbit running around the corner again, and I'm not quite getting it.

MR. MCMAHON: So AMCs are pretty much used, asset management companies are used pretty much in every country that's dealing with some sort of banking crisis or significant debt problems.

Now, originally there were four that were set up in China during the previous banking crisis, and the way they worked is that the big four Chinese banks have massive loans, they were disposed of by just moving them wholesale to these asset management corporations who have spent the next 20 years effectively trying to extract value out of them.

Now, originally those big four AMCs, all four of them are still owned by the Ministry of Finance, two are now listed in Hong Kong, they're still majority -- controlled by the government, majority controlled by the government, partially funded by the government. More recently, these days rather than --

CHAIRMAN CLEVELAND: Can you stop on that point? When they had to dispose of these assets, did they in some manner that provided value?

MR. MCMAHON: They disposed of them but because to start with they had to buy the loans at face value.

What I mean, you know, had a bad loan of $100, you may have at most been able to claw back $20 from that loan, but these AMCs were, initially at least, forced to buy them at $100.

So they were always up against it; they were never going to be commercially functional institutions. This was effectively a government subsidy to the banks.

Now, over time they were forced to operate more on a commercial basis, and then in 2014 the government approved the establishment of provincial asset management companies. So at the moment, every province has at least one, maybe two, sometimes three, of their own sort of captive institution to buy bad loans from the banks.

Now, the ownership of these things are far more varied. Some are owned by the provinces; some are owned by state-owned banks. I think about a dozen of them are actually privately controlled. Some are owned by other financial institutions. So there's a real range of ownership here, and what all of these AMCs are doing is they buy bad loans from the banks, ideally on a commercial basis, and then they extract value out of it.

Now, what that means is they can go after the collateral. So, so many of China's loans these days, particularly to the private sector, are backed by some asset, usually loans.

And so in some cases, given how China's property market has behaved over the last 20 years, if you buy, acquire a bad loan which is 5 years old and then you take the land that is backed by the loan, the value of the land, the collateral, could actually have some real value. You might actually be able to get a huge amount of money out of the loan.

CHAIRMAN CLEVELAND: Unless it's backing more than one loan?

MR. MCMAHON: Exactly, and certainly that complicates things with sort of the older loans as well. So that is sort of the process that's going on at the moment.

My understanding is that all of the AMCs are under a lot of regulatory, government pressure to dispose of the loans as quickly as possible when they acquire them. So in the past, as I kind of explained, the AMC spent 20 years trying to dispose of some of these loans. They were effectively warehouses for China's bad loans.

Ultimately, the way they got out of the problem is China's economy grew at ten percent a year for 20 years, which meant all of a sudden some of these companies, 15 years on from acquiring their bad loans, actually turned out to be quite profitable by the sheer fact that they'd stayed alive and had enjoyed China's economic boom.

The sense at the moment now is that the AMCs can't be used as warehouses, or at least not at this point in the game. So they're under pressure to dispose of those bad loans as quickly as possible, certainly by selling them to third-party investors, so you do have some foreign and U.S. distressed debt investors active in China at the moment.

They're a small part of the picture. Certainly, there are Chinese distressed debt investors and entrepreneurs who are opportunistically buying bad loans. And then, of course, the AMCs are pursuing the collateral themselves.

CHAIRMAN CLEVELAND: Dr. He, do you -- anybody else have any comments?

DR. HE: The AMC setup and also the way they deal with the distressed assets is a very China characteristics. The first part is really that they have to set up a state-owned entity to take up the bad assets. Why?

Because these assets are state-owned assets and if you don't have the good pricing mechanism related to all these things, you just have bad consequences because some people might do some side-dealing, et cetera.

So in this way, they have to do it. And the hope is that after the economic boom or several years of operations, et cetera, the bad assets turns okay and at that time the private guys come in.

So I have a bunch of my friends who are doing the second round, and I think it's a very clever way of buying some time, you don't need to do the fire sale, like the U.S. here is fully market-driven, here's the right regulations, you need to do it right now, whatever the price.

In China, just looking at the whole thing and then let's do this slowly. So that's the way that it is, and AMC right now is such an important sector given the slowdown, given the bad assets, et cetera.

And I'm also very happy that we're seeing the first agreement between the U.S. and China, it's they write the distressed asset sector into the agreement. This is where, really, we need foreign investors to provide their expertise.

MR. MILLER: Just to quickly address the question about shadow finance there, any entity that's providing capital that's not a bank, that's lending but is not a bank, can technically be a shadow bank or part of the shadow finance world.

But the real implications for this is if you have a tranche of bad loans and these are securitized and they end up in other products. And so there's really several different levels here of analysis.

If the bad loans are put together, put in a non-transparent pot and end up as 30 percent of a wealth management product, then that creates a separate set of loans that are separate from the original entity.

CHAIRMAN CLEVELAND: Yes, that's helpful. Commissioner Lewis?

COMMISSIONER LEWIS: I have a specific question for Mr. Miller, then one general question for the panel. Your key recommendation is that a new agency be set up, CDCC.

Where would the opposition to that be? It seems so sensible that that occur. Why isn't it agreed to by those who would establish it?

MR. MILLER: That's a great question. It's been recommended before; I wish I could say that I invented the idea, but I haven't. It's been presented through various forums in the past.

I think one of the reasons is that, beyond any bureaucratic wars which I'm not aware of, is that there has generally been a belief that China economic data isn't good but it's good enough.

And this is one of the major problems with our study of the Chinese economy. For years and years and years, we've gone off official data, and there's been a backstop and belief that we can't get better and we shouldn't try to get better.

And while these things may be off by degrees, they're still directionally correct, and what I can tell you from having evaluated tens and tens and tens of thousands of companies inside the Chinese economy, sometimes even directionally things are not correct.

There are various reasons why the Chinese put out certain data. Some of them are quite good; some of them are absolutely terrible. But the idea of having a repository of experts and data sourcing within Congress' grasp, able to provide this information, I think would be very helpful for clarifying what is inherently a very, very opaque area.

COMMISSIONER LEWIS: Where does the opposition come from in our own government to this? Or from corporations?

MR. MILLER: I don't think any corporations are against it. I think probably it costs money. It probably wouldn't cost that much money, but any time any money would be allocated, then there's probably a question.

I think there may also be, or at least there used to be, the belief that there's only a couple data sets out there, the IMF, the World Bank, or the Bank of the International Settlements, already do this tough work. They do this work, they're part of the formula, they're part of the equation, but it's not enough anymore.

COMMISSIONER LEWIS: Thank you, and my basic question to everybody concerns the issuance of bonds by local governments in China. We're advised that the local governments have increased the issuance of bonds.

Why are they increasing them, and what do they do with the money when they get them? How are the bonds issued?

MR. MCMAHON: So I'd tell you the reason that there's been an acceleration is it's partly in response to the crackdown in shadow banking at the beginning of 2018. You saw a real contraction in shadow banking avenues, and local governments had always been heavily dependent on shadow banking channels in order to be able to raise money.

Now, at the same time, I think one of the ways that local governments have always paid down their debt is through land sales. Although at a national level, land sales were quite robust last year.

Certainly, in a lot of parts of the country it's getting harder to find people to keep buying local government land. And so certain local governments are certainly under stress to be able to pay off their debts.

So I think there is a sense that -- and then, of course, the last part of this equation as well is that starting at the beginning of last year, the central government did a whole lot of tax cuts, and they have affected local governments significantly as well.

So we have a situation where local governments no longer have access to their traditional funding conduits to fund things like infrastructure. Secondly, they are already under pressure to provide greater financial resources to social services, but the way that they fund those through taxation, they're not raising as much in taxes as they had previously.

So local governments are fundamentally under a lot of financial stress at the moment so that they should be turning to the only officially -- I guess the main officially sanctioned conduit through raising funds, which is through bond issuance.

I don't think it's a surprise that they should be turning to that and trying to ramp up issuance.

COMMISSIONER LEWIS: Are they issued in China or in the United States?

MR. MCMAHON: Most of them are domestic, but certainly some of the local government financing vehicles do issue foreign currency denominated bonds in Hong Kong I think, but I might defer to my co-panelists on that.

COMMISSIONER LEWIS: But not in the United States?

MR. MCMAHON: Not to my knowledge.

COMMISSIONER LEWIS: And do you know what they do with the money when they get it?

MR. MCMAHON: If it's a local government financing vehicle, which -- my understanding it's not the local governments themselves that issue foreign currency bonds but certainly local government financing vehicles.

It is usually for things like public works construction, so it's either infrastructure or utilities or some sort of comparable project.

CHAIRMAN CLEVELAND: Mr. Lewis, we have a couple other Commissioners who want to ask questions. Jim, did you still want to -- Senator Talent?

COMMISSIONER TALENT: Okay, so I've got two questions. The first is really for the record because we're going to do a report and we're going to have, I'm sure, a section on this. And as I read your testimonies, I think we have a disagreement. Mr. Miller seems to feel very strongly that shadow banking is coming back to some degree.

Dr. He, you didn't address it as extensively, but you had a figure in there that shows, no, the bottom's dropped out of shadow banking. So, I'd like you, and if you want to jump in, Mr. McMahon, address -- see if we can't come to some consensus, if one exists, what's actually happening with shadow banking.

And then the other question I'd just like you to address is, okay, if you were sitting on this side of the table, and we make recommendations to the people who are, and they struggle to understand this too. They have staff; we have staff, okay.

But we're talking about a system, a massive, huge economy that you said is very different, its banking system is really different from ours. They can't price risk.

At minimum we can't trust their data; however, it seems they actively misrepresent key data. They have huge numbers of non-performing loans in the system; we don't know where they are, and we don't know what they're going to do with it. We can't trust their company audits.

So if I'm still sitting on this side of the table, I'm saying to myself I don't care so much what the people who put $5 million with Goldman Sachs want to do.

If they want to take a flyer on this, fine, I don't want my constituents' index funds and pension funds getting invested in this system. We don't need to hunt for return that badly.

There are 100-plus other countries in the world you can invest the money in; I don't want it in this. And if I were in your position and somebody who was still in on this side of the table asked me that question, I don't think I could argue with them.

And I think it's Senator Rubio and Shaheen have basically -- they didn't say it but -- so tell me why that's wrong if you think it is wrong. Why shouldn't we recommend to the Congress, no, look, you can't -- maybe five years from now, not now.

We have fiduciary obligations to these people; you can't put the money into this. But do, please, address -- I took up too much time talking.

MR. MILLER: Sure, I'll start that because I think I'm -- the focus of the disagreement is right here.

I think the most important thing to make clear out front is we did see certain things reversed in 2019, but there are certain very high-profile areas of shadow finance which are continuing to decline.

We're seeing wealth management product sales continuing to go down, trust product sales continuing to go down, financing to local government vehicles, another issue which is very high profile, continue to be very low.

So a lot of the places where people have called anecdotally the foundations of shadow finance, we've seen them decline; we're seeing them in most cases continue to decline.

But we look at this very differently than official data in one key way. We're not guessing what's happening; we're asking thousands and thousands and thousands and thousands of firms, tens of thousands of firms over the course I'm talking about, who you're accessing capital from, how much are you paying for that capital, is it state or private, is it a bank or a non-bank.

And what we found is that there are these clear jumps in non-bank usage in 2019, and there's a very logical reason that this is happening.

The Chinese themselves have been very, very worried in their public remarks about sending credit to small, medium-sized enterprises, to private firms, to others that just cannot get credit in the Chinese system.

And while 2019, the very beginning of this, we saw the PBOC, and PBOC admitted this, they went to banks and they said you will loan more to SMEs, you will loan more to private firms. But that only lasts so long.

So what we've been seeing in the time since is a pullback to some degree on some of this bank lending but a state -- usually state-run, non-bank becoming a credit intermediary, where the funds would flow to this intermediary step, and then they would push credit where they think it needed to happen.

SMEs are very important in the Chinese system; private firms are very important in the Chinese system. So the idea that Beijing is just going to leave them alone to starve because of some broad issue with shadow finance, it begs credulity.

So I think what's happening here is that what people popularly think of as the big engines of shadow finance in China in most cases are seeing a decline, but, overall, the firms are saying that they are tapping credit from non-bank sources. And these sources are the intermediaries that are spreading credit in the system in a way that the government finds necessary at this time.

DR. HE: Let me clarify two things, and also some of them, obviously, you might disagree, and I might disagree.

First of all, the official statistics, whether it's totally wrong or not wrong, this is something that I found in many books about that.

And I'm on the side that roughly right in the following sense that have a greater example saying, you know what, we were there in the 1980s, I was starving as a kid. I was born in '77, but now when I go back, you know.

So you see this change. Either the number of growth was wrong, or we were not that poor. That's just not true. Okay. So this is the first one. Obviously, there are a lot of parts that you can't go into detail. This is the first thing.

The second thing is that I want to really clarify that Beijing has been pushing so much, and they made a lot of mistakes too, pushing so-called banking financing to market-based so-called direct financing.

Because direct financing is better, U.S. is based on direct financing. For example, VC, bonds, stock markets, et cetera. Banks, it's called intermediated financing, it's just so opaque, and we have problems.

So if I see data that I see more bond financing, I see a good sign, and I'm so happy that in the past ten years China developed a bond market.

So these are the two things. And the last point about the risk opportunity, that part, it's hard to see, there's an opportunity and a risk. So I don't want to mention that so much.

Usually, my friends who were kind of interested in China and they are able, they would have a better opportunity to talk to people like Mr. Miller, knowing the true data. They will spot something that is very good. So that's all I want to say.

COMMISSIONER TALENT: If I could just ask, so on the shadow banking issue --

DR. HE: Shadow banking, yes, so from what I see from the data that also all the friends that I've been, you know, interacted with, shadow banking really gets cracked down.

Now, I think when Mr. Miller was saying that there are a lot of other ways, non-bank financial institutions, there are certain ways, for instance, that they can structure certain products.

And even that thing, I didn't see the data, I feel like that's also cracking down. But if these mutual funds, non-bank financial institutions, are buying these bonds that are issued through the interbank market, I don't think that's shadow banking.

CHAIRMAN CLEVELAND: So it's definitional.

MR. MCMAHON: Just on the question of shadow banking, I'm assuming that the data in Dr. He's testimony was total social financing data, entrusted loans, entrustment loans. And it's right, that started contracting in 2018.

The thing to remember is that total social financing has always been an inadequate measure to capture all of shadow banking. And in some ways, it's always been a lagging indicator as well.

So when I was a journalist in Beijing covering this stuff, so often what I'd find is that the regulators would crack down on some sort of shadow banking and everything would be great, everybody would write about how the government has got the problem under control, but somehow what was going on in the economy didn't necessarily reflect those numbers.

And invariably, it would take anywhere between three quarters and a year for us to work out that actually there's been a new conduit of shadow banking that's been just building, and we just hadn't seen it until it's broken out into the open.

Now, certainly things are a little bit different now; the deleveraging campaign started in 2016, and the political dynamic has changed such that banks and the traditional shadow banks have been less enthusiastic about going against the spirit of what Beijing is being asked of them.

But the sort of shadow banking growth that Mr. Miller has been seeing doesn't seem to be that sort of fast and loose, wild west sort of shadow banking we saw in the past.

It seems to be state-owned entities, non-financial entities, lending to the private sector. Something very different seems to be going on than the traditional form of shadow banking that we saw in kind of the more wild west days.

And so I'm definitely inclined to think -- I mean certainly something has radically changed over the past 12 months, and I think we'll get more details as to exactly how this funding environment has changed in the months ahead.

Also sort of speaking to the second part of the question, which was what my recommendations would be, surely, we should just sort of cut off the spigot. And -- oh, sorry, I've spoken -- I'd like to share a personal experience. And so I spent 11 years living in China, and when I left I think the most stupid thing I did was not invest in wealth management products sold by China's banks.

Now, the reason I didn't was because I was covering these things for the paper, and I could see just how ridiculous they were. They were opaque; if you even bought one you had no idea exactly what you were investing in.

The banks said they were guaranteed, but were they or were they not? But the thing is, by the time I left, nothing had ever gone wrong, and everybody who had invested in them had sort of made out like bandits.

Now, clearly things have changed in recent years, and the picture that we've painted today is genuinely true. I mean the risks have been mounting; the government is having to deal with bank fragility issues.

Certainly, the system is more fragile, but at the same time, we have no sense of how long it's going to take to resolve these issues. Certainly, the government has potentially the ability to kind of really spin this out.

And so when it comes to making investment decisions, this is how financial institutions have always billed their ability. They are making decisions based on a whole lot of different criteria. What return can we get in the short term before things get worse? Are they seeing things that we aren't? Do they have a faith that at least in the short term they can get really good returns before things go pear-shaped?

And will even things go pear-shaped, or will it kind of be this sort of slow, gradual, drawn-out clean-up process that just results in slower growth and after a few years things return to normal? Or is it more like Japan?

Now the problem is we don't have a real sense of how this thing is going to shake out at the moment, and the way that our financial system is set up is that we leave the decisions of how to best make the most of those opportunities in the hands of professional investors, whether you think they are properly equipped to make those decisions or not.

CHAIRMAN CLEVELAND: Equipped was a really useful term. Commissioner Lee?

COMMISSIONER LEE: Thanks so much to the panelists, and I wanted to follow up on the policy recommendation of Mr. Miller about the creation of a China economic data coordination center.

And I guess this lack of reliable data, the lack of transparency, the asymmetry of information is an issue that comes up in pretty much every hearing that we've had. And we're always looking for what the right policy recommendation is, and sometimes it's very specific in terms of you must reveal this, that, or the other thing. And obviously, it's a key issue for the security and the integrity of U.S. investments.

But my question is, and I invite all the panelists to answer if you have thoughts on this, is it really feasible for a U.S. government agency, even if it were, let's say we get over the funding issues, to be able to provide, gather reliable and comprehensive data if the Chinese government is not cooperating?

So is the issue that we don't put the resources into collecting the data, or are there more fundamental issues?

MR. MILLER: I'll just make a few comments on that. I think it would be -- this is a difficult task; it's one of the reasons it hasn't been done, and I don't think that any U.S. government-backed effort to run the data would ever work.

But what I am familiar with living in this world is that there are a lot of people doing very interesting things inside the Chinese economy. Some people are doing deep dives on the auto sector; some people are looking at the manufacturing sector with a closer lens.

To my knowledge, we're the only people doing large-scale big data on the Chinese economy itself, but there are no shortages of different data inputs that create a larger picture.

And there's also not a very active forum for discussing this in order to inform policymakers.

I think we're very fortunate to have this environment where not only are there good questions being asked but the panelists ourselves can be disagreeing on what the dynamics of shadow finance are.

But had you not called this, there would not have been a singular place where this debate could be had, either through the data or through the individuals involved.

So there are absolutely problems with this; I don't want to play those down. The idea that the U.S. government will ever have transparency into what goes on in China is I think overly optimistic, but we can do better.

And I think right now the level of informational advisory to Congress, to the executive, is woefully low right now.

COMMISSIONER LEE: Thank you.

DR. HE: So, again, I think China also wants to do that, the data center. At this point, we don't have something like the Fed, which kind of comprehensively collecting a lot of relevant data and give very informed decisions.

The Beijing policymakers realize that, but it requires a lot of resources. It's just not something that you can do it quickly.

Having said that, clearly even if Beijing has done that, they will think about the security issues, all these things, as a first order.

COMMISSIONER LEE: I think it's a real question whether the Chinese government does want good data or do they want control over the data. It's two different issues.

DR. HE: So, clearly, for them to make informed decisions they would love to have data. Now, who has access, that's a different question.

MR. MCMAHON: Just to follow up very quickly, just to give you an idea of the types of data sources that are available at the moment if we wanted to put together something in parallel to official data, certainly surveys like Mr. Miller's, but also these days there are satellite surveys looking at -- which is able to track industrial production of China by taking photos from the sky.

A lot of big multinational corporations, not just America's but Japan's and Europeans', are very active in various sectors in China, and their disclosures in their own corporate earnings and -- sort of provide really interesting insights into what's going on in China.

And the other interesting thing is that although we kind of look at China's data and scratch our heads and shake our heads, there is actually a huge amount of publicly available information these days coming out of the Chinese economy. Because so many Chinese companies are issuing bonds, they have to publish earnings reports and prospectuses. So there is actually a huge amount of information out there.

Often, it's more reliable than the headline figure because the less that anyone's paying attention to a data-point, the less incentive there is to sort of manage it -- massage it. So there are a lot of data sources out there.

To come up with a holistic approach, to come up with something that gives a parallel interpretation of what's going on in the Chinese economy just really takes time to pick and choose.

DR. HE: Just one thing. In response to Mr. Lewis, the question about this bond -- what did they do with this money for the local governments, the data that I use is a public prospectus of bond issuance.

It's public, and I just read all these things, their plan, and group all these things together when I prepare my testimony.

I'm just telling you that there's a lot of data out there; it's not systemically linked together. So it requires people like Mr. Miller and corporations that do much better things, that they inform everybody.

COMMISSIONER LEE: Thank you very much.

CHAIRMAN CLEVELAND: Thank you. Could I ask one last question?

Do any of you have views on -- we had previous testimony on the fact that within the foreign exchange funds, there is this 7 to 900 billion in IOUs that are promissory notes, which would certainly compromise the understanding of the value of the foreign exchange fund. So you may not know, but we've had testimony on this before, so.

No? Okay. There has been reporting that the 3 trillion in the foreign currency reserves, in fact, around 700 billion has been lent out and there are promissory notes rather than actual dollar-denominated or yen-denominated treasuries.

DR. HE: There are some discussions on those things, especially the commitment to the Silk Road, One Belt, One Road.

I put it into my testimony a little bit. Based on the public information, these are the small, but I just do not --

COMMISSIONER TALENT: And we've been talking a little bit about whether their claims about their reserves are similar to our claims about the Social Security Trust Fund.

And their data is not real transparent about what's in the reserves, so we wondered if you guys knew?

MR. MILLER: I had heard about those IOUs. There has been discussion for a number of years about central bank swaps and how they affect the forex levels.

I don't know how to get good transparency on that, though, the one point I would make on the other side is that forex reserves are not necessarily the line item we should always be looking at when talking about what is holding up the Chinese system.

There is much more forex within the banking system, and one of the key elements of the Chinese system, it's a non-commercial financial system, and as a non-commercial financial system, it has the ability that Western financial systems don't have in terms of being able to swoosh capital from one side of it to the other.

This is one of the reasons why the idea of a repeat of 2008 was never likely in China in the same way because the Chinese can patch holes as the holes appear. The problem with that, of course, is that over time good money continually chases bad and you have stagnation.

But the fact that it's a non-commercial financial system means you have resources within the banking system that are not available in economies like ours.

CHAIRMAN CLEVELAND: An important point to end on. I hope you all will be willing to answer questions for the record because I have several more and I'm sure our colleagues do as well.

Really important and helpful testimony, and I appreciate the differences as well as the consensus on points of view. It really helps inform our work, so thank you very much. We will be in recess until 12:45. Thank you.

(Whereupon, the above-entitled matter went off the record at 12:02 p.m. and resumed at 12:46 p.m.)

PANEL II INTRODUCTION BY COMMISSIONER WESSEL

COMMISSIONER WESSEL: Thank you. We have a fantastic line up of experts assembled for our second panel which reviews the tools used by Chinese entities, particularly companies, to raise capital.

First, we'll hear from Carl Walter who will provide an overview of the financing environment facing different Chinese companies. Dr. Walter is an independent consultant and author of Red Capitalism: the Fragile Financial Foundations of China's Extraordinary Rise, one of the most authoritative studies of China's financial system.

Dr. Walter's ongoing research focuses on China's banking and fiscal systems, including the debt and capital markets which he plans to turn into another book.

Next, we'll hear from Gabriel Wildau, Senior Vice President at Teneo, and former Shanghai Bureau Chief for the Financial Times. Mr. Wildau will discuss the motivations for Chinese firms' stocks exchange listing decisions.

We will then hear from Brian McCarthy, Chief Strategist and founder of Macrolens, a macroeconomic advisory firm focused on China. Mr. McCarthy was previously chief strategist and portfolio manager at Emerging Sovereign Group where he managed the Nexus Fund, a China-focused macro hedge fund.

Mr. McCarthy will discuss domestic financing issues faced by Chinese companies as well as assess the risks associated with several index providers' inclusion of Chinese securities to U.S. investors.

Thank you all for the time and effort you put into your testimony. I'd like to remind you to keep your remarks to seven minutes so we'll have enough time for Q&A with the Commissioners.

Dr. Walter we'll begin with you.

OPENING STATEMENT OF CARL WALTER, INDEPENDENT CONSULTANT; AUTHOR, RED CAPITALISM: THE FRAGILE FINANCIAL FOUNDATION OF CHINA'S EXTRAORDINARY RISE

DR. WALTER: Thank you very much. It's an honor to be here again and share with you some of my comments.

As you will remember, I guess, from last time, I spent 20 years in China, mainly in Beijing, working in the financial sector in banks and securities firms, and living there with my family as well. We had a marvelous time in the '90s and the first decade of this century which I believe is China's golden age.

Today I want to talk a little bit about the financial system and how it deals with the Chinese, how they raise capital.

I'm now sitting on the Board of China Construction Bank, one of the largest banks in the world by any measure. And this is an issue that I can see quite clearly. But China's financial market is really a banking market. There is stock markets, there are bond markets. But basically, it remains a banking market.

The second thing is that China's financial system is still subordinate, I think, still a remnant of a planned economy, so that its lending activities, to a large extent, are constrained by what the government decides it wants to do.

And that is made very plain in still existing five-year plans and in the annual budget. This information is quite available publicly, so you can see the strategic policy direction of their government and therefore, of the banks.

But in addition to this kind of lending, the banks also have to survive. So they do a lot of retail lending. So there's a balance between this.

So the big SOEs, they're part of the government apparatus. They have access to any kinds of capital channel that exists, including overseas offerings. And I have a lot of comments about that later on.

The retail borrowers also have access to an awful lot of channels that you are used to seeing here in the United States where there's credit cards, home equity loans, loans, consumer loans, or mortgages.

The problem really is the middle ground which is the mid-sized private enterprises and the small and medium private enterprises. I distinguish between the two because there is something called a, I don't know how to call it, people's enterprise, a people's managed enterprise, which used to be a SOE but was given by local governments over to the private sector to run and operate. These are what drives the greater economy around Shanghai and, to a certain extent, in Guangdong.

The small and medium enterprises are really small. And whether it's the people's enterprise, or whether it's the small and medium-sized enterprise, it's extremely difficult in China to lend to these entities.

As someone commented this morning, there has been a policy press, given the larger GDP depression, to lend to these kind companies. But it's exceptionally hard to do so without losing money.

Banks are subject to fraud. Even though they try and take guarantees or take assets as collateral for lending to these kind of entities, nonetheless, if it's a people's enterprise, then it's supported by the local government, and the bank gets caught up in that. It's very hard to realize their loan value.

If it's a small and medium-size enterprise, then there's almost nothing there to recover. So they sell these loans out in packages to asset management companies, or other non-bank entities and move on. So my point is it's very difficult.

There are some banks that are trying to -- there's a thing called inclusive finance going on now. So it's a major policy of the central government by which is meant lending to small and medium-size enterprises.

Some banks have the technical capacity to screen the borrowers, using fin-tech means and access to government databases, and develop screens for the owners of these enterprises and then decide on a more or less retail, as opposed to a business basis, whether or not these are good borrowers or not.

So I think there is movement on that, although it is still quite different. The policy is there, but the lending is very difficult for the large banks. If you look at the city commercial banks lending to small, medium-size, or otherwise non-state sectors, I think, is not what is going on.

These 125, that I can count anyway, city commercial banks are really captives of local governments, and they lend to local government projects. Their balance sheets are not large nor are they strongly capitalized.

In short, I think, let me talk a bit about the bond markets. Because you've seen a lot of growth in the bond markets over the last ten years. But as I've shown in the book, the bond markets are not liquid. That means they do not trade.

Generally speaking, in the west when we have a bond market we're looking for valuation through market-based pricing. In China, there is no market-based pricing at issue. It's administrative, and during trading.

If you chart out all of this stuff, you'll see that it's really not traded at all, and the prices are not representative value. So I would rather think of the Chinese bond market, which is almost wholly government or state-owned enterprise oriented, as a disguised loan market.

And I think that maybe would help you understand that market a bit better.

I think those are my comments. Happy to take questions, and I'm pleased to be here. Thank you all.

PREPARED STATEMENT OF CARL WALTER, INDEPENDENT CONSULTANT; AUTHOR, RED CAPITALISM: THE FRAGILE FINANCIAL FOUNDATION OF CHINA'S EXTRAORDINARY RISE

Testimony before the US-China Economic and Security Review Commission

China's Quest for Capital: Motivations, Methods and Implications

January 23, 2020

Dr. Carl E. Walter

It is an honor to provide testimony to the Commission on China's financial system. My comments seek to address the kinds of questions raised by the Committee. I will be pleased to try to answer the questions the committee members may have. I note, however, that China's financial system has become exceptionally large and complex since 2009, so my answers seek mainly to draw an outline and this is difficult as well.

1. How does Beijing govern capital allocation? What are the government's priorities?

China is no longer a strictly planned economy but the central government remains in a position to control a significant amount of capital. At the planning level Beijing still compiles annual and five year plans that reflect the government's development priorities. In brief, these priorities come down to maintaining social stability by providing employment and, therefore, to protect the government's position. The National Budget is the financial expression of these plans and is put together by the central government based on a compilation of provincial budgets, adjusted and then passed by the National People's Congress.

This budget functions as the overall map of fiscal revenues and expenditures for that part of the economy managed by the State. Figure 1 shows the overall trends of these incomes and outflows for the post-1979 reform period. The collapse of fiscal income in the 1980s was associated with state enterprise reform and was corrected by the Budget Law of 1994. Since the outbreak of the global financial crisis in 2009 China's expenditures, as is well known, have exceeded fiscal revenues leading Beijing to borrow to fill the gap (see Figure 2). In other words, fiscal revenues have been insufficient to meet policy goals. Given this, private sector funding (not including multinational investments) is an afterthought except to the extent private companies are extensions of local governments.

Weak fiscal revenues have always been the case since the start of the reform era in 1979. In the 1980s Beijing was starved of fiscal revenues and borrowed heavily from its banks. After the near collapse of 1989 Beijing was able to push through in 1994 a new Budget Law that greatly strengthened Beijing's control over fiscal revenues, but at the expense of the provinces (see Figure 3). In response, the provinces actively developed a wide variety of so-called "extra-budgetary revenues" that Beijing then took over as funds, or adjuncts to the official national budget. The latest example of this is the sale by local governments of land use rights. The fiscal stimulus of 2009, therefore, was a godsend to local governments.

The point here is that the "government" is not a centralized one-piece entity operating in lock step. Nor is it a federal style arrangement like the US operating within a web of well-defined responsibility. Rather it is a Chinese arrangement of near equals where institutions are weak and laws ineffective. All decisions are political and maintaining a balance of personal and professional interests is the goal within the vague notions expressed by the Party Line. As a result, any market incentives for allocation of funds are replaced by individual considerations of career advancement. It takes a crisis to revel the system's true nature.

Since most senior officials hold local government positions at some time in their careers, "Beijing" is well aware that "local governments" are starved of revenues and burdened by required social expenditures (see Table 1). As a consequence, the central government cannot ignore the political needs of local governments, that is, party secretaries. It therefore creates through negotiation the leeway for them to "self fund" outside their budgets so long as they deliver what belongs to the "central government." These words "Beijing," "central" and "local" are used loosely to represent the central government or the provinces and are used only for convenience here.

As a consequence it is difficult to say that Beijing governs the allocation of capital especially "when the window is open," that is, when opportunity arises hard-pressed party secretaries throughout the system – local governments, ministries and state enterprises - take all the advantage they can. The 2009 stimulus was such an opportunity and all within the party no matter what position they were in sought to grab a piece. This explains the plethora of 100 story buildings, the empty skeletons of apartment complexes as well as the magnificent national bullet train network.

2. How do the government's capital allocation practices affect different economic actors, e.g., banks, local governments and corporates and their abilities to meet their financial needs?

As mentioned above, the consequence of the 1994 Budget Law was to nominally strengthen central government control over fiscal revenues. Fiscal transfers by Beijing to poorer provinces were the compromise that led to local government support of the Budget Law in 1994. Although strengthened central control led to increases in revenue, they have not been commensurate with political plans at the local level. These transfers, moreover, have made Beijing reliant on debt to fund its own expenditure plans (see Figure 2). This led to a gradual forcing down of social expenditures and capital investment onto SOEs and local governments (see Figures 4 and 5). Transfers have not been sufficient to make local government budgets whole. Local leaders are compelled to develop sources of revenue outside the budget since they were not allowed to legally raise taxes.

In 2007, when budgetary categories were revised, capital expenditures as a line item disappeared altogether (see Figure 5). These expenditures now rely on local governments to put together financing including "self-raised funds," 80 percent of all such investment prior to the fiscal stimulus of 2009. How did they achieve this? By skirting central government regulations. By involving "private" investors, local governments had no need to seek central approvals for projects. This explains why Public-Private Partnerships (PPP) are the structure of choice at the local level. Once a PPP is established banks are able to lend to it legally and "self-raised funds" come into existence.

Similarly, any state owned enterprise (SOE) owned or established (for example, Local Government Financing Vehicles) by a local government can borrow from banks or from large SOEs and the funds received can go to capital investments, no matter their maturity. This is why local governments all seek to have a financial institution under their control. As one local official explained to this author, "budgets are to eat, loans are to build."

In short, due to Beijing's budgetary arrangements and its inability to increase tax revenues, local governments were already extremely leveraged as a matter of practice long before the global financial crisis. The crisis forced Beijing to allow them to issue guidance funds[1], bonds, trust products and wealth management products (WMP) (see Figure 6). Now, of course, local governments are so leveraged, in my opinion, that their debt can never be repaid, only rolled forward.

The obverse of local debt is necessarily large state bank lending to SOEs and, through the interbank market, to smaller banks. The major state banks have always been indirectly exposed to local governments through lending to major state enterprises. Chinese regulations do not permit corporations to have a central treasury function. So if the principal corporate entity wishes to fund its subsidiary it goes through a bank to make an "entrusted loan."

As Table 2 shows after 2009 such loans increased significantly peaking in 2014 at 42 percent of total SOE funding. These funds go to subsidiaries that may become partners in local government PPP schemes. From an accounting viewpoint SOE subsidiaries only show up as investments and parent enterprise loans made to them are seen in the undifferentiated loan category. In other words you can't see where the money went by looking at SOE balance sheets.

Similarly at different times banker's acceptances (loans against a shipment of goods) and trust loans (loans arranged by trust companies and sold as investments) have played a large role in funding SOEs and, onward, to funding local government

[1] Since 2015 many local governments and central ministries have developed a new way around budgetary restrictions. They have created so-called "guidance funds" or so-called "private equity funds" financed by other state entities including especially banks that they alone invest

projects. All of these products are ways that banks work around regulatory limits on lending to single borrowers. The result is both ballooning bank and state enterprise balance sheets.

The major state banks also fund the rest of the financial system via the interbank market. This market is meant to provide short term funding for banks but during the past few years its function has changed and a huge collateralized interbank market has appeared ((see Table 3). This table shows the net lending (negative) or borrowing (position) of interbank members. The numbers show clearly that the large state banks (The Big 5 plus the Postal Savings Bank) fund a category called “Other financial institutions.” What could these be?

A process of elimination from the list of members of the interbank market leaves only asset management companies (AMCs), trust companies and finance companies belonging to SOEs. This shows that the interbank market has been distorted to provide massive financing to borrowers to which the big banks could lend due to credit reasons or because they do not want to appear to be lending. How else do the huge asset management companies get funding for their acquisition of bank non-performing loans.

The critical source of capital for the banks and the government is retail deposits (see Figure 7). This is why retail investors have such limited opportunities to invest any savings they might have. Until 2007 retail could only put their money into housing, the stock market (too risky) or leave it in the banks.

3. How do China’s banks structure their loans to different actors in the economy and what does this reveal about their capital requirements.

Much of this question has been addressed in Question 2 above. For the state sector funding for SOEs are either structured either as straight loans or as corporate bonds. In both cases the asset winds up on bank balance sheets. For financial institutions the interbank market, particularly for the weakest entities, the collateralized interbank market, provides funding. For the so-called “guidance funds,” these are categorized as interbank investments.

Loans for the retail sector are straightforward and similar to banks elsewhere: mortgages, credit card loans and consumption loans. This leaves the all-important private sector.

Over the past 20 years the private sector has become the economy’s main employer and driving force while the State controlled sector has shrunk. Even so the private sector’s access to capital is quite constrained, why is this? It is not because the big state banks do not want to lend to small and medium size enterprises (SME) that typify the private sector. The problem is that even with personal guarantees and collateral, the big banks incur significant loan losses due to fraud. Given that many SMEs are backed by local governments banks often find it difficult to rely on the court system to recover losses. Nor, due to government policy, are banks able to charge interest rates that would help cover such losses. Banks, nonetheless, keep lending, as government policy requires.

The question might be asked if the private sector is the economy's dynamo why aren't there large private companies? The answer, I believe, is if you become a large company the company is no longer yours. There is a reason why the heads of Alibaba and JD.com have recently resigned. This being the case, it's strategically better to have small companies and many of them and this is one reason why banks find it hard to lend to SMEs.

4. What does the recent spate of regional bank failures reveal about the way capital is raised in China? How does the systemic risk unearthed by these failures impact the ability of banks to raise capital in the future?

Local financial institutions have always been extremely weak throughout China's past 40 years. There are a few reasons for this. First, these entities did not grow organically, i.e. develop a sound customer base and then gradually expand. Instead, the city and rural commercial are made up of all urban and rural credit cooperatives in a given administrative area that are simply thrown together. Since local governments lack capital as well as professional financial staff, the most recent iteration of local banks – the city commercial bank - from its inception in 1997 has been weak. This had the result that for most of them even a Shanghai listing was out of reach. Only 23 of 124 city banks have access to public capital markets.

The fact that Beijing does not allow these entities to simply go bankrupt – there is depositors insurance up to RMB 250,000 – says a few things. First Beijing will not allow confidence in its banks at any level to be called into question. Second, banking licenses themselves represent the result of a lot of administrative work at all levels of China's bureaucracy. Even bankrupt, these entities are worth something to someone. Third, that somebody is the relevant local government that desperately wants its own financial license. The result is that with Beijing's help new, mainly state investors are rounded up and new capital is injected.

China today has 124 city commercial banks owned mostly by local governments. There are also 58 trust companies, 2200 rural banks and 1200 rural credit cooperatives, owned mostly by provincial governments and below, although none owns the coops. These institutions fail to play a big role in lending to local SMEs because they do not have the ability to lend and have few retail deposits.

As Figure 7 shows, however, over the past decade city bank deposits have grown very rapidly. This has largely been due to offering WMPs to attract funding for favored local projects. The difficulties faced by Jinzhou Bank, listed on the Hong Kong Exchange, were caused by its Big 4 auditor refusing to sign off on its report due to questionable loans. Going forward investors will need to take a closer look at local banks as they approach international markets.

As for the unlisted local banks in 2018 the banking and other regulators published a set of new regulations covering WMPs. The effect of these new rules will be to change completely how WMPs have been structured. From year-end 2020 or possibly 2023, limits will be put on the types of underlying assets permitted and how WMPs will be structured. The effect of this has and will create serious funding pressures for city commercial banks beginning now.

5. In what ways does the structural imbalance in the fiscal transfer relationship between Beijing and local governments inform local government capital raising needs?

The fact that fiscal revenues are insufficient for the whole state's objectives combined with "soft" budgets means that local governments will continue to seek additional extra-budgetary funding most of which will come inevitably from bank lending. This threatens the viability of China's major banks. Until and unless the central government establishes a hard budget with adequate revenues within which all governments must live, the political give and take with soft budgets will continue to characterize China's fiscal system. This is the very character of China's fiscal system historically and change in the future is extremely unlikely.

6. What factors are pushing local governments to increase issuance of sub-sovereign and local bonds? What are local governments doing with the capital that is raised from bond issuance?

Table 4 compares total outstanding local government bonds (including provincial bonds) to outstanding local debt figures a provided by the National Audit Office and, for the most recent three years, the MOF. The table shows that over the period of 2013-2018 bank loans have been gradually replaced with bonds. In other words the existing stock of local loans has been refinanced by the issuance of local government bonds. I believe this the government has pushed this process to increase transparency of local debt and, for the banks, to reduce loan loss reserves (loans attract a far greater amount of capital and loss reserves than bonds) and improve bank capital adequacy. The government's expressions that such bond proceeds are being used to finance infrastructure and so on are true but disingenuous, but they are referring to already built (or half built) projects.

7. In addition to exchange rate management, in what ways do foreign exchange reserves act as a backstop for China's economy? How has Beijing deployed its reserves to solve economic problems and what are the challenges doing so?

FX reserves provide both a practical and psychological role in support of not just China's economy, but also its government. Psychologically the general populace is well aware that the renminbi is virtually backed by hard currencies, especially the US dollar. As a result, there is less concern among the public over the government's overall economic management. The reserves are a sort of report card on Beijing's previous export driven development strategy. But the sheer size of the reserves, created willy-nilly during the first 10 years of this century when China was wide open, took the government by surprise. During the buildup of the reserves the government failed to take advantage of them by currency convertibility and capital account openness, both policy goals of the central bank. So, in fact, China's huge FX reserves indicate a missed opportunity.

Practically speaking the reserves have been used to fund the capitalization of two of the major state banks (China Construction Bank and Bank of China through perpetual currency swaps) and are now being used to fund the Belt and Road policy.

As China does not provide detail on its reserves or provide independent audits of the central bank's balance sheet, there is uncertainty not only over the details of the reserves, but how they may be used. We do know the sum total of China's US dollar reserves from Federal Reserve data. But how much of the total reserve number is actually official reserves and how much foreign currency-denominated assets is not known. This raises the question about China's overall reserve liquidity.

Supplemental Questions on how Chinese entities raise capital

1. How do different corporate entities obtain access to financing?

State-owned enterprises (SOEs) have access to all existing channels of finance. They can issue shares domestically and internationally, borrow loans, engage with foreign banks and markets and so on. They may own controlling interests in trust companies and small banks. Their efforts to raise finances will be actively supported by their state owners – the central or local government. Financing is not an obstacle to their operations.

Small and medium-size enterprises (SME) are far less advantaged. They can borrow from banks large and small but at a cost higher than SOEs. They can list on the Shenzhen Exchange and, if their financial strength and economic outlook supports it, list on international markets. But SMEs tend to remain small in business scope; it is difficult to construct a Top 20 list of large private enterprises because of this. This is despite the fact that SMEs and the private sector are the driving force of China's economy. It seems that private capitalists in China prefer to own multiple businesses of a small scale at the same time as they seek to develop the active support of sub-provincial level governments.

The stock exchanges are less important in terms of providing capital. The government has limited the use of the Shanghai and Hong Kong exchanges largely to state or state supported enterprises, while the Shenzhen exchange is the home of private issuers. But the total capital raised by the latter is exceeded by far by the capital raised on the Shanghai and Hong Kong exchanges for state enterprises.

If the investors in initial public offerings of state entities are carefully examined it will be seen that other state entities are both the so-called "strategic" investors as well as investors in the public offering itself. In China, IPOs have become a way for Beijing to move its capital around. [2]

Similarly the huge and growing bond market is largely a state affair with very, very few private companies able to access it. Given its lack of liquidity China's bond market should be seen as just another form of loan, particularly since the big state banks are the principal "investors."

Over the past 10 years the central bank began a process of interest rate liberalization first by nominally releasing controls over lending rates in 2013 and then in 2015 deposit rates. Despite this apparent loosening lending and deposit rate remain governed by central bank benchmark rates even now with the new "prime rate." To achieve policy goals the bank regulator also governs certain lending rates, for example, for SMEs.

Even this partial liberalization of the domestic financial markets has had the effect of increasing competition for retail deposits. This can be seen in the rise of "fintech" banks and, more importantly, the so-called wealth management products (WMP). China's fintech banks as well as city commercial banks have challenged the large state banks for deposits (see Figure 8).[3] In response to this and the need to help banks better manage their balance sheets, regulators from 2007 allowed banks to create wealth management products (WMPs), as mentioned previously.

WMPs are important to this discussion because the city commercial banks used them to attract deposits and then fund local government supported projects. These local WMPs differed from those of the large banks since they involved single ultimate borrowers; whereas the large banks developed a pool of assets to support their WMPs. WMPs all provide rates of return above bank deposit rates and are perceived as guaranteed by the government. Over the last 10 years the amount of WMPs exploded (see Figure 8) and has begun to threaten banking stability.

2. The PBOC introduced a new "loan prime rate" (LPR) in August 2019. What factors drove the bank to introduce this mechanism and what is its objective?

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[2] See Walter and Howie, *Red Capitalism*, (Singapore, John Wiley and Sons, 2012), pp. 196-204.

[3] For a good overview see Wei Wang and David Dollar, "Order from chaos: what's happening with China's fintech industry," Brookings, https://www.brookings.edu/blog/order-from-chaos/2018/02/08/whats-happening-with-chinas-fintech-industry/

The new loan prime rate is just the latest step that the central bank has taken in its effort to make floating rate lending appear to be more market based – within limits - as opposed to set wholly administratively. The new rate is based on data from many banks that presumably represents their best rate for their best customers. This "prime" rate is set by the PBOC only once a month so it is hardly a market rate. Perhaps this gives the PBOC a better idea of the interest rate environment, but this is not LIBOR, SHIBOR or any other market-based system.

China's currently flagging economy is the reason for this effort. The new prime rate is aimed aims at lowering corporate borrowing costs or, put another way, preventing banks from charging high rates in a nominally market-based environment. In any event, making interest rates market based has long been one of the three major policy goals of the central bank alongside RMB convertibility and an open capital account.[4] This goal is even in the longer run now.

3. What corporate entities are active in raising external debt and what are they doing with it?

As of Q2 2019 Chinese issuers had nearly US$228 billion in offshore debt outstanding. Of this amount 20 percent or US$45 billion is non-financial. Based on IMF analysis large SOEs account for most of the issuance. The analysis[5] concludes that these large corporations – oil and gas, real estate and power - use offshore US dollar borrowings to swap into renminbi onshore deposits. Offshore US dollar borrowing rates are lower than onshore renminbi deposit rates plus there is an expectation of renminbi appreciation against the dollar.

In other words, this activity is pursed purely for a financial return and not for capital investment. Stepping back another step, such net financial returns help reduce financing costs in the domestic market. Of course, there is significant market risk involved in such activity. So this external debt raising is mostly speculation on the US$/RMB exchange rate.

Why does the Chinese government permit such activity? The heads of these large central SOEs are on the Central Committee and enjoy ranks equal to or exceeding Chinese regulators. For large local SOEs provincial governments provide support. Therefore, it is quite difficult, barring a crisis, for regulators to have much impact.

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[4] Just before the global financial crisis the Shanghai Interbank Offering Rate (SHIBOR) after Libor was meant to be the basis for all short term lending on the interbank market, for floating notes and derivatives. It never gained traction after the crisis broke out and now when a command economy is reasserting itself, it is no longer a key rate.

[5] https://www.elibrary.imf.org/view/IMF071/25402-9781484372142/25402-9781484372142/ch16.xml?language=en&redirect=true

4. What are the different factors influencing the listing decisions of Chinese companies? How does the Chinese government specifically influence these decisions?

Because public offering approvals are so difficult to obtain except for the most powerful SOEs, Chinese SOEs list only for the marginal money. As an SOE chairman explained to me, "It doesn't matter who owns the money, only who gets to use it." The ownership of SOEs is a moot point since these enterprises report in to administrative bureaucracies that have no understanding of what listing in the Western sense means. Thus at the start of the listing experience in the 1990s the bureaucracies used the stock markets to list companies that were illiquid and uncapitalized. The issue for enterprise management was simply "Can I get approval to list and how much can I get?" Most SOEs could not be structured to support a public offering in Hong Kong or elsewhere. Domestic regulators have proved far friendlier since capitalizing SOEs is as state policy.

Chinese regulators can, however, determine which SOEs and non-SOEs list and which market they can list in. They do this by supporting SOEs as against private companies and there has long been a sectoral list of companies not available for public listing. In any event, only minority positions in SOEs are offered publicly, China's government retains majority ownership and management control through the Communist Party hierarchy.

5. Why are Chinese corporates more attracted to US capital markets as opposed to Chinese ones? What are the shortcomings of Chinese capital markets?

I have documented the shortcomings of the Chinese stock markets at length.[6] They include significant administrative hurdles before and after, administratively fixed pricing that is always less than subsequent market prices by a multiple, capital amounts raised are limited and so on. On the other hand, loose domestic regulatory scrutiny of the operational sustainability of pre-IPO companies and the use of domestic audit firms with very limited experience ensure that domestic listings are highly non-transparent. From an SOE with poor prospects and large capital needs but also good government backing, this situation is perfect. As another SOE chairman told me, "Domestic markets are easier to manage."

As for whether Chinese corporates prefer US capital markets. It used to be that the US markets could support even the largest IPO, but this is no longer the case. Most large money managers have long since set up offices in Hong Kong. This has enabled the Hong Kong exchange to execute even super large transactions such as the recent Alibaba. Consequently, as of now I don't believe Chinese corporates prefer US

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[6] Walter and Howie, **Privatizing China: inside China's stock markets** (Singapore: John Wiley and Sons, 2011).

markets except for perhaps the reputational impact. A US listing shows that a company is able (or willing) to meet US regulations at the time f listing, and more importantly, going forward.

An exception remains now for cases like Alibaba, which was prevented from listing in Hong Kong or Shanghai directly as its sector was off limits to foreign investment. US markets allow the listing of securities representing future earnings flows as well as a variety of other share configurations, whereas neither Shanghai nor Hong Kong permits this yet.

In general, US markets are based on transparent disclosure of all risks. As a result, the US market allows investors to make their own decisions. In contrast, all Asian markets are characterized by regulators act on behalf of supposedly ignorant investors. The result here is obvious; issuers seek to disclose less so there will be fewer questions. In the end, there is far less transparency.

Policy Recommendations on Supplemental Questions

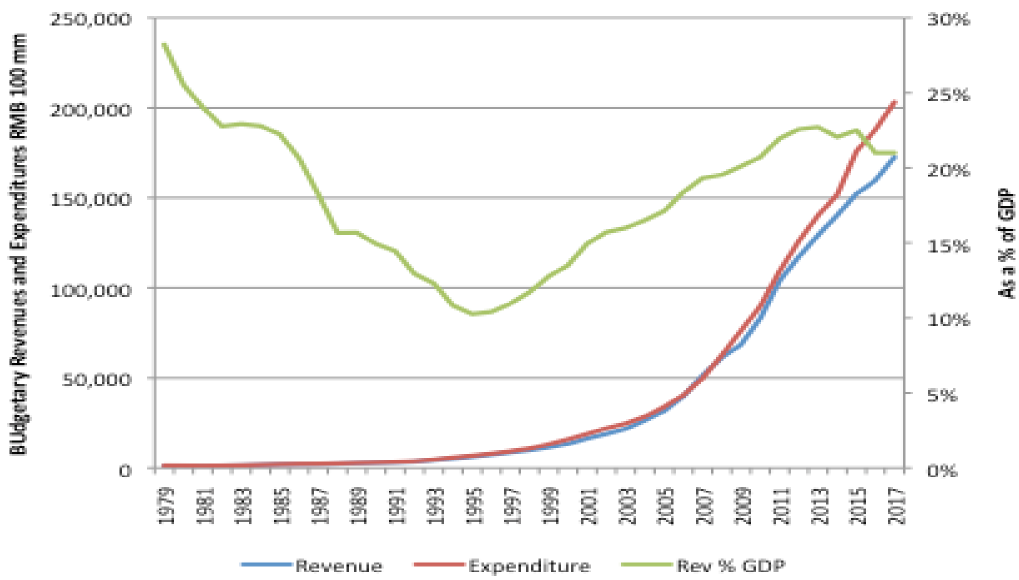
1. The US government needs to do a better job understanding the needs of US financial companies in China. Policy support must be given not simply to controlling ownership of securities firms, but also complete securities licenses including retail brokerage as well as debt and equity underwriting and trading. Chinese companies have broker dealer subsidiaries in the US, the US has none in China.

2. The new loan "prime" rate is an example of administrative obstacle to creating true market-based interest rate yield curves. The fact that interest rates in China are not market based makes it difficult for US banks to price certain kinds of risk management transactions the government need to better understand and promote market-based interest rates in China. Working to further open China's bond markets to foreign investors would be helpful in this.

3. The government should work with the US stock exchanges to promote primary or secondary listings for China's major banks as a way to ensure greater transparency for these systemically important institutions. Hong Kong listings even with professional auditing using international standards may not be enough.

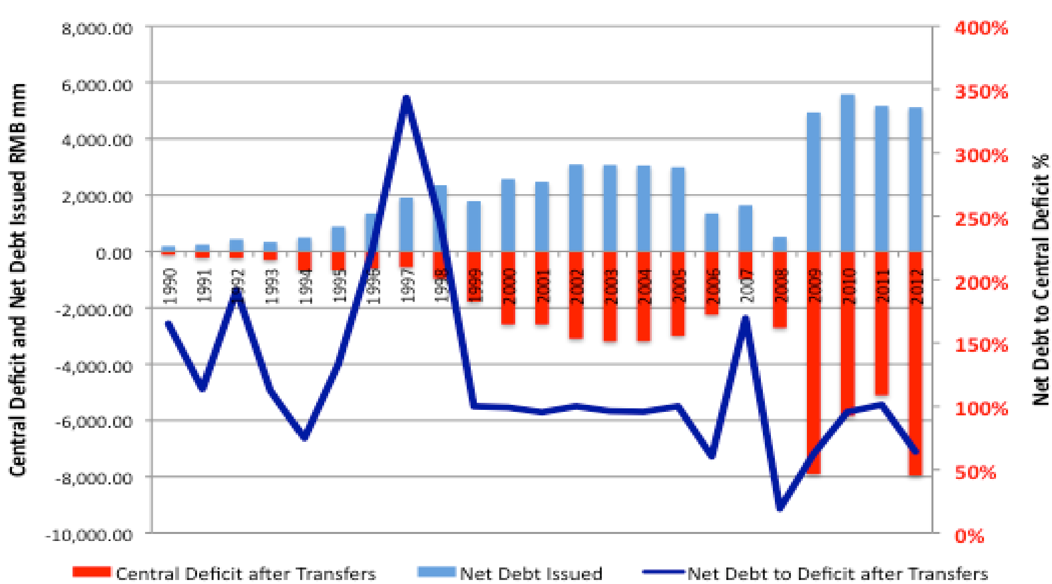
Charts used in the
Testimony before the US-China Economic and Security Review Commission
China's quest for Capital: Motivations, Methods and Implications
January 23, 2020
Carl E. Walter

Figure 1: State budgetary revenues and expenditures, 1979-2017



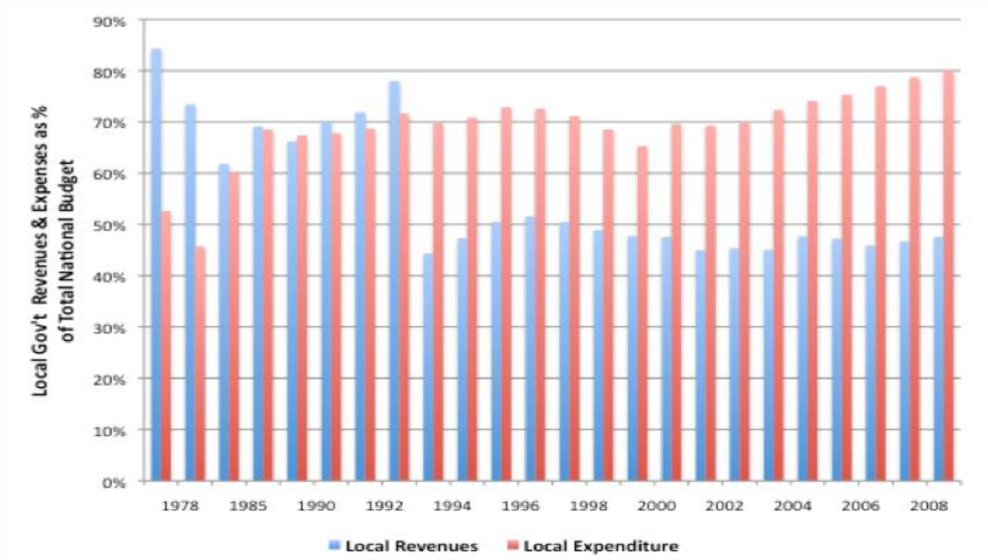
Source: Ministry of Finance

Figure 2: Central government debt dependence post transfers



Source: Ministry of Finance and China Bond

Figure 3: Provincial on-budget pre-transfer revenues and expenditures, 1978-2008



Source: China Statistical Yearbook

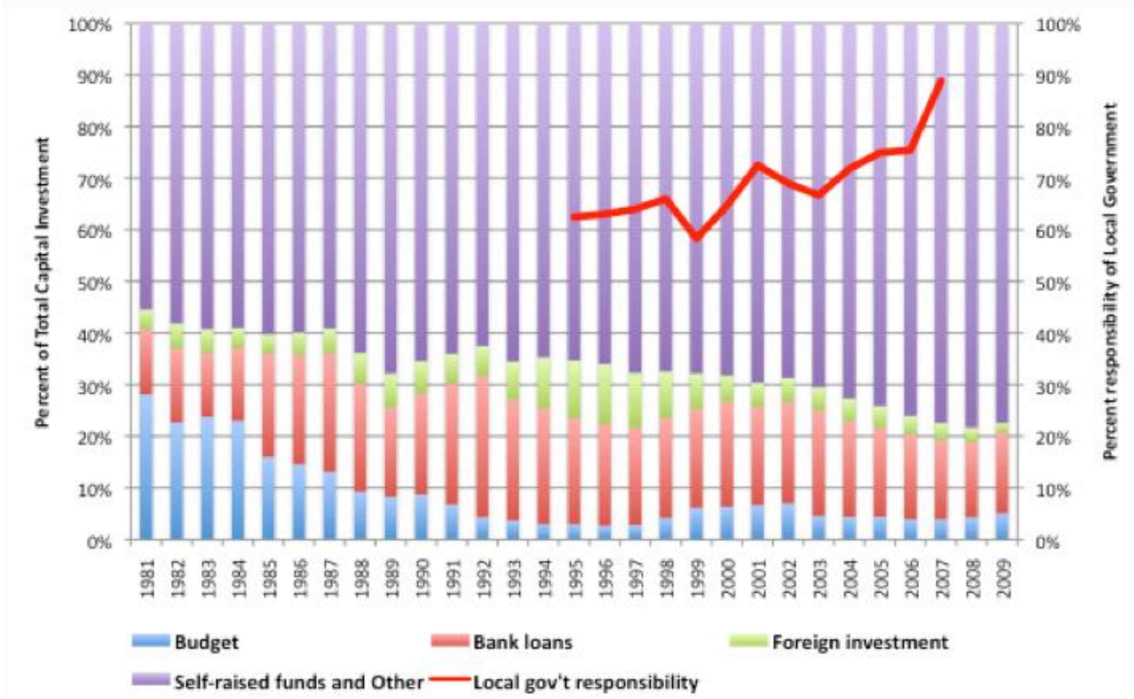
Table 1: Distribution of budgetary revenues and expenditures

%	1993	1998	2002	2006
Revenues				
Central government	34	29	55	53
Province	11	19	12	12
Municipalities	29	24	16	17
Counties	19	11	11	14
Townships	13	9	6	5
Expenditures				
Central government	22	50	31	25
Province	13	11	20	18
Municipalities	34	20	21	23
Counties	16	20	22	29
Townships	11	8	7	6

fiscal

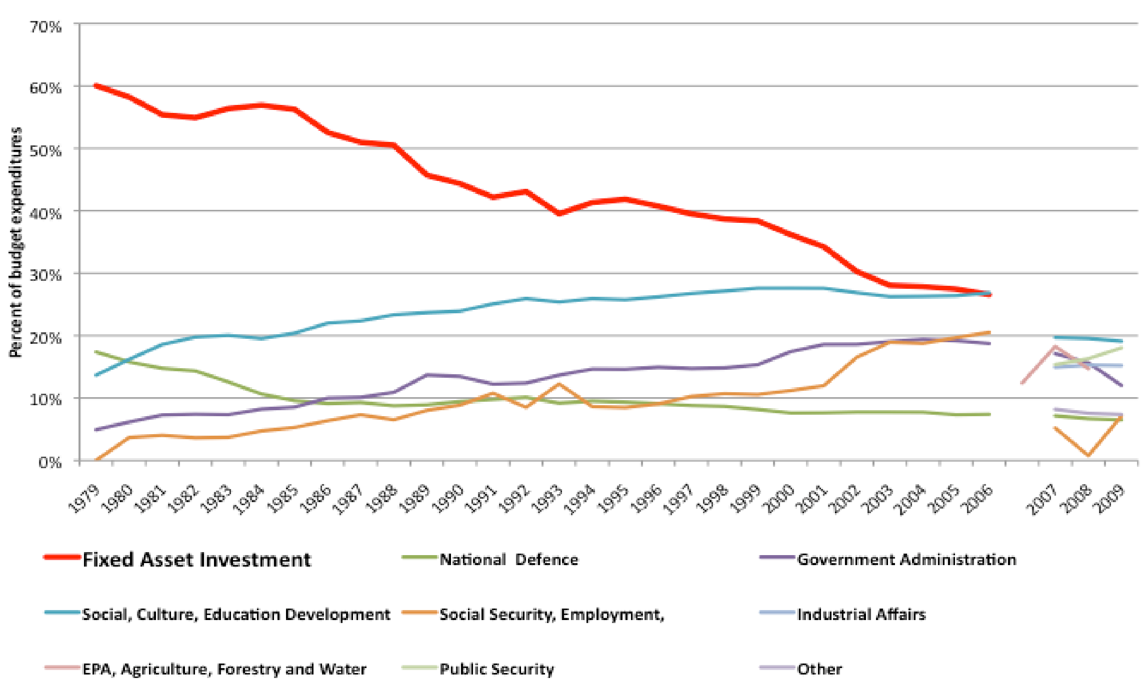
Source: Wong, "Rebuilding government for the 21st century," *Chine Quarterly* 12/2009, p. 944

Figure 4: Sources of capital investment, 1981-2009



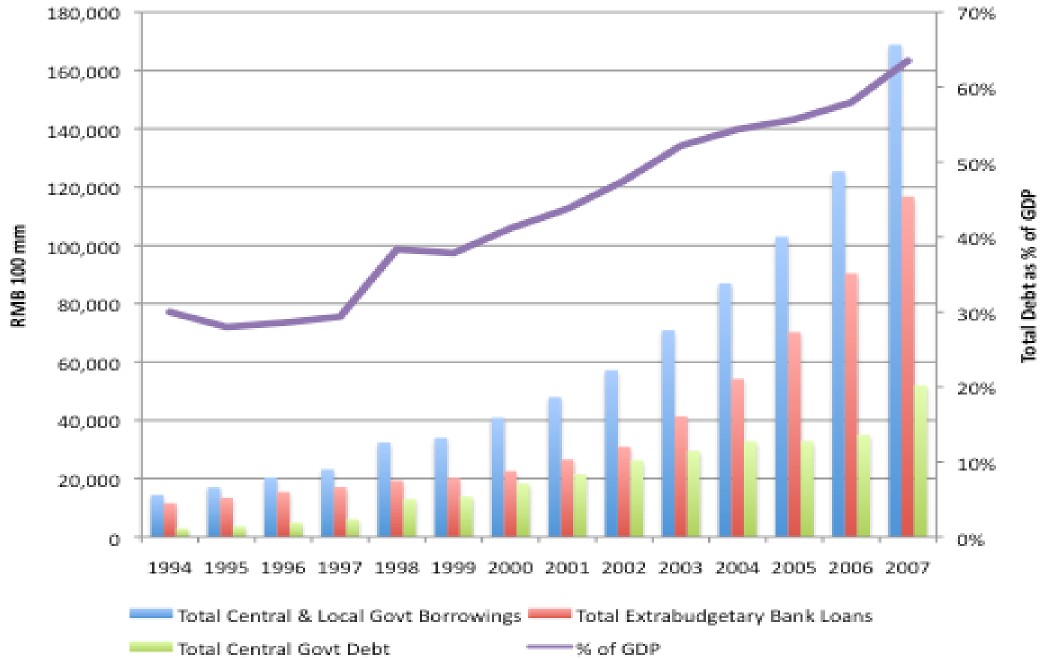
Source: China Statistical Yearbook

Figure 5: Trends in budgetary expenditures, 1979-2009



Source: Ministry of Finance

Figure 6: Total central and local government debt to GDP, 1994-2007



Source: Ministry of Finance, China Statistical Yfvearbook, author's calculation

Table 2: SOE borrowings and entrusted loans, 2006-2017

	SOE alone RMB loans	Corporate Bonds flow	Bankers' Acceptances	Trust Loans	Total SOE Borrowings	Of which: Entrusted Loans	% of Total SOE Borrowings
2006	6,033	840	1,520	8,393	16,785	1,880	11%
2007	12,967	2,310	6,690	21,967	43,935	3,800	9%
2008	10,998	5,560	1,100	17,658	35,315	4,260	12%
2009	28,584	12,960	4,650	46,194	92,387	6,760	7%
2010	15,548	11,980	23,260	50,788	101,575	11,270	11%
2011	12,712	13,700	10,300	36,712	73,423	13,000	18%
2012	15,952	22,500	10,500	48,952	97,904	12,800	13%
2013	54,244	18,113	7750	80,107	160,214	25,466	16%
2014	7,158	23,817	-1,286	29,689	59,378	25,069	42%
2015	19,817	14,630	5,850	40,297	80,593	10,930	14%
2016	41,035	27,767	-19,516	49,286	98,572	21,854	22%
2017	51,244	4,471	3,867	59,582	119,164	7,776	7%

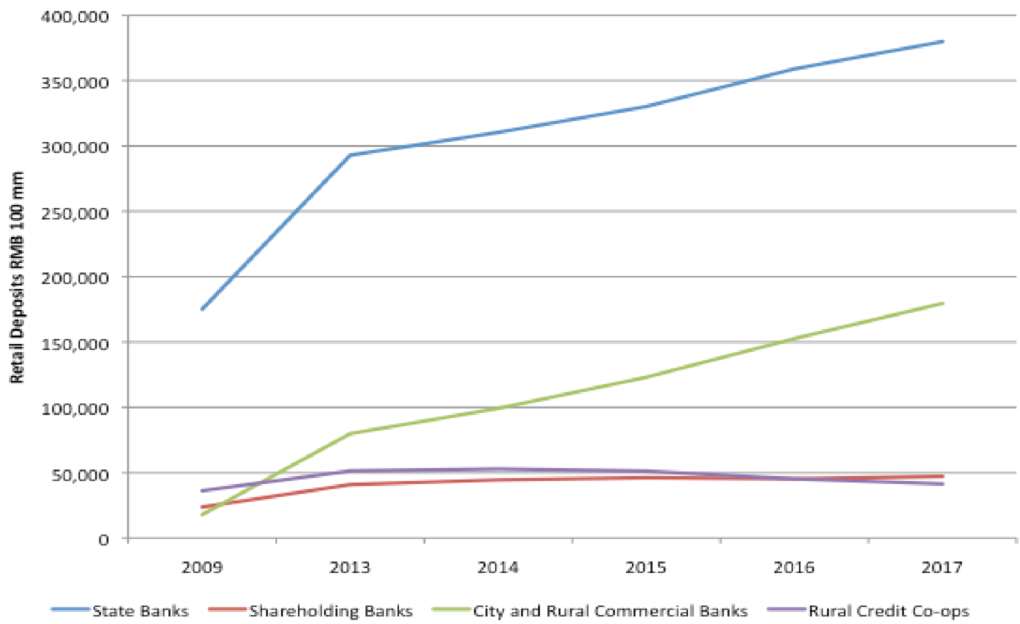
Source: Ministry of Finance and People's Bank of China

Table 3: Collateralized interbank market – net position by institution

Net Position (Negative sign = lending; positive, borrowing)										
100 mm	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
State Banks	-132,849	-129,167	-239,090	-227,637	-184,096	-541,002	-429,049	-798,736	-1,851,870	-1,931,300
Other banks	11,839	15,670	-4,858	91,192	58,161	268,094	177,832	375,205	750,262	552,005
including CCBs	0	0	0	0	0	0	0	191,277	585,260	530,199
Other financial institutions	42,127	27,061	97,797	28,954	37,886	100,871	65,777	82,268	767,759	1,131,453
Insurance Cos.	31,283	26,645	40,352	21,840	24,914	23,272	55,545	89,564	122,936	-31,444
Securities Cos and Funds	13,602	28,695	72,320	53,973	58,290	103,831	118,593	204,467	106,155	0
Foreigners	34,001	31,096	29,477	31,687	9,845	19,935	11,301	47,323	104,768	71,029

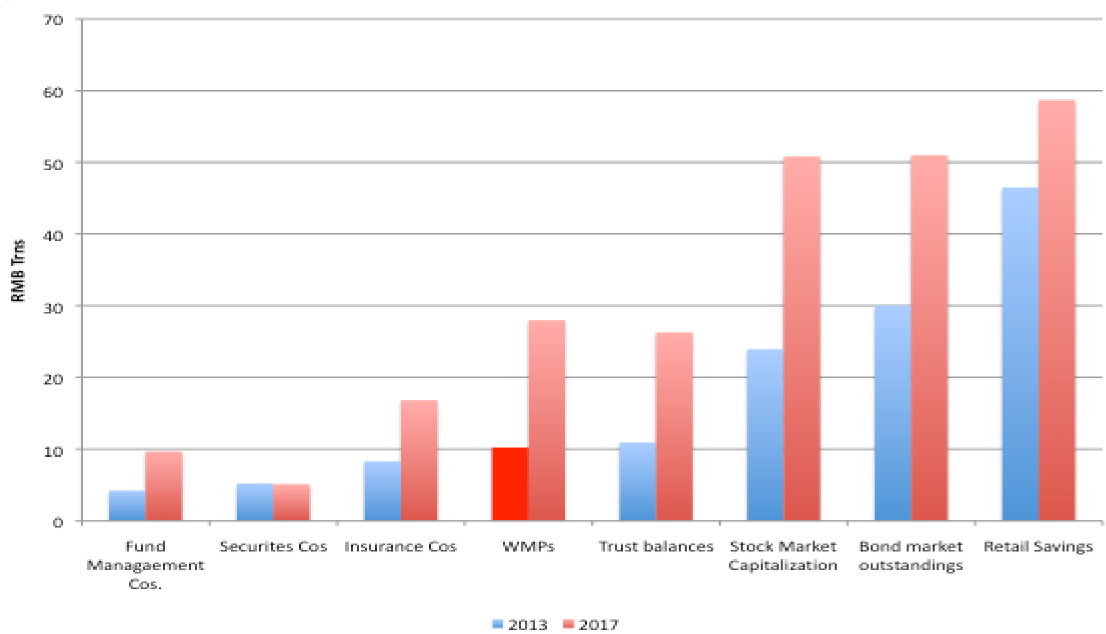
Source: PBOC

Figure 7: Trends in retail deposits by bank category, 2009-2017



Source: PBOC

Figure 8: WMPs vs. other channels of investment, 2012-2017



Source: China Wealth Management Report, China Bond, PBOC, CSRC, CBIRC

Table 4: Local government bond and debt trends

100 mms	Local Govt Bonds held by all banks	% of Total Local Govt Bonds	Local Govt Bonds held by Banks/Total Local Debt	Local Govt Bonds/Total Bonds
2013	8,498	98.6%	6.3%	3.3%
2014	11,472	98.7%	7.4%	4.0%
2015	44,557	92.3%	30.2%	12.7%
2016	93,631	88.1%	61.0%	21.4%
2017	127,556	86.5%	77.3%	25.0%
2018	153,272	84.8%	92.3%	26.6%

Source: China Bond, PBOC; MOF and National Audit Office; non-financial loans include corporate and retail.

OPENING STATEMENT OF GABRIEL WILDAU, SENIOR VICE PRESIDENT, TENEO

COMMISSIONER WESSEL: Thank you. Mr. Wildau?

MR. WILDAU: Thank you to the Commission for inviting me. I've structured my remarks around what I take to be the central issue in this hearing which is what should the role of U.S. investors be in the Chinese financial system.

I heard this morning a lot of very granular discussion about features of the domestic system. I've skated over a lot of that because I'm not, and I'm happy to take questions, but I've focused on the kind of interconnectedness with the U.S.

So with that, I'll just begin. And the first point is that China is financially self-sufficient from a macro point of view because of the high savings rates. China doesn't rely on foreign finance, either from the U.S. or from other foreign countries.

So this means that if the U.S. were to cut off U.S. involvement in the Chinese financial system, it wouldn't inflict significant macro damage on the Chinese economy. Because at a macro level, they don't really need our money.

The second point is foreigners spent 20 years seeking greater access to Chinese capital markets. And you all probably know this. But whether it's the strategic and economic dialogue, or other negotiations that the U.S. had with China, a key agenda item in those talks was we want more access to Chinese stocks, to Chinese bonds, and even to the Chinese banking sector so that foreign banks, U.S. banks can lend to Chinese companies.

Now, I understand that the context of U.S.-China relations has changed quite a bit over the last few years. But I just want to flag that, because it would be a very dramatic reversal of U.S. policy to, it would be sort of an own-goal in a way. It would be ironic for us to unilaterally shut ourselves off when we were the ones clamoring for access for so long.

Now I'll just turn to why do Chinese, given that there's no macro need for foreign finance, why do certain Chinese companies choose to access foreign finance, whether that's listing in the U.S., or bonds in Hong Kong were discussed this morning.

And there's different reasons, and I've put them in my prepared remarks. But the most important, I think, is what I've called regulatory and policy arbitrage. Because although the overall supply of domestic finance is ample in China, certain companies don't have access to that, mainly for policy and regulatory reasons.

And so those companies that are shut off from bank finance, or from the domestic stock markets, or from the domestic bond market, will come to the U.S.

And the important implication of that observation is that the companies that are coming, and particularly that are coming to the U.S., to the U.S. stock markets, they're not national champion companies, Chinese national champion companies, by and large.

They're not companies that the Chinese government is very focused on supporting to meet their strategic objectives. If they were, they wouldn't need to come to the U.S., because they could access that ample pool of savings that is available within China.

And there are some other reasons. In certain cases, costs in U.S. dollars, in particular, might be lower because of interest rate differentials. And companies that want to expand outside China, Chinese companies that want to build a business outside China, it's very logical for them to choose foreign currency financing, because they want to match their assets, for example, some factory or some other investment they're making in foreign currency with the foreign currency, with the liabilities that is with their borrowing in foreign currency. And there are some other reasons I have to discuss.

But the fourth point I want to make is about, you know, China in the context of emerging markets. China is an emerging market. The risks of investment in China are not unique to China, whether it's inadequate corporate disclosures, whether it's unreliable macroeconomic data, as was discussed this morning, whether it's government interference in the economy, none of this is unique to China.

And the problem may be worse in China than other places. But these are the kinds of risks that are intrinsic to emerging market investment. And the universe of emerging market investors is quite sophisticated at assessing these risks.

And I question the ability of the U.S. Congress, for example, to provide any kind of additional protections that these very sophisticated investors are not able to provide for themselves.

And I want to say something now about this issue of the index funds, the inclusion of Chinese stocks and bonds in indexes. I think that what we need to understand is about indexes is that when an index chooses to include a new class of shares, they're not endorsing that these are great companies. It's mainly based on size. It's market cap, whether it's stocks or bonds. And no one is forced to invest in an index fund.

I know there have been some accusations about Chinese pressure on the index providers to bring in Chinese stocks or bonds into the indexes when maybe it's not warranted based on the technical criteria.

I'm not persuaded by that, because I've spent time in China over a decade where I saw a long string of reforms that were meant to ease access, make it easier for foreigners to buy and sell Chinese stocks and bonds.

And the lack of easy buying and selling was the main reason why index providers had not included Chinese stocks and bonds. And now most of those issues have been resolved. And so that is the reason that, I think, the index providers have made their decision.

Now, I'm sure that China wanted index inclusion, and they may have even tried, the government may have even tried to exert pressure. But ultimately, the index companies are accountable to their big clients which are big institutional investors.

Keeping them happy is much more important than keeping the Chinese government happy, because these index companies earn money by having these institutional fund managers track their indexes.

China doesn't pay them money. The only business opportunities that they may have in China, I think, probably pale in comparison to their core business of providing attractive indexes for global investors. And I'll end my prepared statement there.

PREPARED STATEMENT OF GABRIEL WILDAU, SENIOR VICE PRESIDENT, TENEO

Gabriel Wildau

Senior Vice President, Teneo Holdings; former Shanghai Bureau Chief, Financial Times

Testimony before the U.S.-China Economic and Security Review Commission

Hearing on “China’s Quest for Capital: Motivations, Methods, and Implications”

January 23, 2020

Summary

- Due to China's high national savings rate, the country is financially self-sufficient on a macro level. Specific companies choose to seek financing abroad for particular reasons, of which policy arbitrage is the most important.
- This fact means that cutting off US investment in Chinese companies would be unlikely to inflict macro-level damage on the Chinese economy, even though particular companies would suffer.
- US investors have actively sought greater access to Chinese capital markets for the last 20 years. Unilaterally restricting US access to these markets now that they are largely open would mark a dramatic policy reversal.
- Chinese companies seek foreign financing when Chinese monetary policy and financial regulation leaves them unable to obtain enough financing domestically. Far from being "national champions", Chinese companies that seek US listings typically do so because they lack political and policy support within China.
- The financial and ethical risks that US investors face in China are not qualitatively different from those of other emerging markets.
- Emerging market investors are highly sophisticated and skilled at assessing risk. "Investor protection" is not a persuasive rationale for restricting US investment in Chinese companies.
- Recent decisions by securities index providers such as MSCI and Bloomberg to add domestic Chinese stocks and bonds to widely-tracked emerging market indexes appear to be motivated by Chinese reforms that removed barriers to buying and selling. These decisions do not appear to be the result of Chinese government coercion or pressure.
- In addressing ethical risks related to certain Chinese companies' involvement in human rights abuses, policymakers should take a case-by-case approach rather than banning US investment into entire markets.
- Standards should be applied consistently across countries. If policymakers seek to protect investors from financial or ethical risks, then the entire global investment landscape — not just China — should be examined systematically.

1. **China is Financially Self-Sufficient**

China's savings rate is by far the highest among the world's ten largest economies and is among the highest anywhere in the world. From a macro perspective, therefore, China does not need foreign capital to finance its investment needs.

Indeed, one of the most striking facts about China's economy is that its despite extraordinarily high investment share of GDP, China still runs a substantial current account surplus. A current account surplus is defined as the amount by which national savings exceeds investment. Traditionally, many developing countries run current account deficits because as a developing country, they require such high levels of investment that domestic savings are insufficient. This deficit requires them to draw in capital from abroad. China is an exception: its savings rate is so high that it can finance its own high investment rate and still have savings left over to export to the rest of the world.

China's domestic savings are channeled into investment primarily through the commercial banking system. Despite some diversification in recent years, China's financial system remains bank dominated. In fact, after declining through much of the 2010s, the bank share of total domestic financing has rebounded in recent years, as a regulatory crackdown on shadow banking has restricted non-bank sources of lending and forced a significant amount of off-balance-sheet activity back onto commercial bank balance sheets. Though shadow banking is in decline, domestic capital markets — especially the domestic bond market — continues to grow in importance.

I am not going to offer further detail about the internal mechanics of China's financial system here because I do not think this detail is directly relevant to the question of what role US and other foreign investors play in the system and whether US policy changes are desirable or necessary. But I am happy to answer any questions about the domestic financial system during the question-and-answer period.

For the purposes of this hearing, the key point is that on a structural basis, China does not need foreign financial investment (foreign direct investment is a separate issue). This fact means that cutting off US investment in Chinese companies would be unlikely to inflict macro-level damage on the Chinese economy, even though certain Chinese companies would suffer.

2. **Foreigners Spent 20 years Seeking Greater Access to Chinese Capital Markets**

For roughly the last 20 years, one of the key objectives of US policy towards China was to *increase* US investors' access to China's capital markets. Yields on Chinese renminbi bonds were far higher than those available in the US and other developed markets. Though China's stock market was volatile, China's economy was growing quickly, and foreign investors wanted the freedom to invest in promising companies that were riding this wave of macro growth. Increased access to Chinese capital markets was a perennial item on the US wish list during the era of the US-China Strategic and Economic Dialogue.

For most of this period, foreign access was highly limited. In 2002, China introduced the Qualified Foreign Institutional Investor (QFII) program, which allowed foreigners to trade on the Shanghai and Shenzhen stock exchanges. But QFII was limited by investment quotas, and there were also limits on repatriating investment proceeds.

Over the last decade, Chinese regulators gradually loosened the rules on QFII. They also introduced other, more convenient channels for foreign investment. The most important of these were the Shanghai-Hong Kong Stock Connect, Shenzhen-Hong Kong Stock Connect, the Hong Kong Bond Connect, and the China Interbank Bond Market scheme. Rules for this latter set of programs have also been gradually loosened to streamline access, expand eligibility, increase quotas, enable hedging of various types of risk, and resolve technical issues related to clearing, settlement, and legal custody.

The result of this long series of incremental opening measures is that today, foreign investors enjoy largely unfettered access to Chinese capital markets. Some restrictions and red tape remain, but the situation is vastly different from ten years ago. Today, investors decide whether to invest in China's onshore market largely based on their assessment of the underlying market opportunity, rather than concerns about market entry and exit barriers.

Chinese policymakers opened their financial markets primarily because they believed that doing so was in China's national interest, but foreign pressure also played a role. If the US policy were to take unilateral action to restricting US investors' freedom to access the Chinese market, this approach would mark an extraordinary and dramatic reversal of US policy. After years of banging on the door to Chinese capital markets, that door was finally opened. To adopt restrictions now would amount to slamming that door in our own faces.

In a sign of foreign demand for Chinese financial assets and the impact of China's opening measures, total foreign ownership of such assets nearly doubled between the end of 2016 and end-September 2019, reaching Rmb586bn, according to central bank data. Stocks and bonds account for about two thirds of this total, while loans and bank deposits make up the rest.

3. Why Chinese companies Choose Foreign Finance

As discussed in section 1, China is financially self-sufficient at the macro level, but certain companies still seek financing abroad. There are four main reasons that Chinese companies seek foreign financing.

i. **Regulatory and policy arbitrage.** Most Chinese banks are state-owned, and the banking system is highly regulated. Chinese banks are subject to both formal regulation as well as informal "window guidance" on how much to lend and to whom. The property sector offers a clear example. Chinese property developers are major borrowers from commercial banks, but Chinese policymakers are concerned about high housing prices and the financial risks associated with a potential housing bubble. When seeking to cool the market, regulators periodically restrict bank lending to property developers. They also periodically suspend approvals for property developers to issue domestic bonds. Not coincidentally, Chinese property developers are the largest category of issuers in Hong Kong's US dollar bond market, which is not under the direct control of mainland regulators, and also have a large presence on the Hong Kong Stock Exchange.

   Policy arbitrage is also a key factor motivating Chinese companies to list on US stock exchanges. Given the option, most Chinese companies would prefer to list in Shanghai or Shenzhen rather than the US. The reason is that valuations are usually higher on mainland exchanges than in both Hong Kong and the United States. The problem for would-be onshore issuers is that Chinese regulators maintain a tight grip on the flow of initial public offerings in Shanghai and

Shenzhen. The IPO approval process is onerous, unpredictable, and often takes years to complete. The queue of companies waiting approval has often stretched into the hundreds, though it has shortened in recent years. Regulators also exert control over the IPO price and fundraising amount.

Given the preference for domestic listings, those companies that do seek listings in the US are largely those that are unwilling or unable to navigate through China's domestic IPO process. This point is important to remember as policymakers consider restricting US listings by Chinese companies. By and large, US-listed Chinese companies are NOT Chinese national champions that enjoy strong support from the Chinese government. If they were, then they would not need to seek US listings because they would enjoy ample access to cheap financing from Chinese banks or the domestic stock and bond markets, or some combination of all three.

ii. **Foreign expansion.** Chinese companies seeking to expand abroad may choose foreign-currency financing in order to match their foreign assets with foreign liabilities. If, for example, a Chinese company seeks to build a factory in the US or to acquire a US luxury hotel, US dollar financing is a natural choice. Matching currencies eliminates foreign-exchange risk.

Some Chinese companies may pursue a foreign IPO or bond issuance — or even foreign bank borrowing — to build up their reputation among foreign investors and institutions. Doing so may help them forge relationships with potential partners, customers, national regulators, or strategic investors. A foreign financial institution that starts out buying a small tranche of US dollar bonds or US-listed stock today could become a major lender or strategic investor tomorrow.

iii. **Cost.** Some Chinese companies have ample access to domestic financing but choose foreign financing because it is cheaper. US dollar interest rates have been low since the 2008 financial crisis. As the US Federal Reserve has begun to raise interest rates while China has lowered renminbi rates, the interest-rate differential has narrowed, but dollar rates are still lower overall. This cost advantage is especially attractive during periods when Chinese borrowers expect the renminbi to appreciate or hold steady. Otherwise, renminbi depreciation can erase the cost advantage for Chinese borrowers who repay US dollar debt from renminbi revenues.

iv. **Supplementing.** Few Chinese companies rely exclusively on foreign finance. Most use foreign finance to supplement domestic sources.

4. Investment Risks in China are Similar to Other Emerging Markets

Risks of foreign investment in China include the following:

- Inadequate or misleading corporate financial disclosures.
- Uneven or arbitrary enforcement of local laws and regulations, affecting entire asset markets or specific companies.
- Government interference with corporate management or pressure on companies to pursue political or policy objectives rather than maximizing profits.

- An opaque legal system and unfair treatment of foreign litigants by Chinese courts.
- Ethical risks from investing in companies that are complicit in human rights abuses.
- Risks to a company's profitability from potential US sanctions, blacklists, or other restrictions.

None of these risks is unique to China. On the contrary, they are typical of emerging market (EM) risks generally. Indeed, central to the basic concept of EM investment is that investors accept greater risk in return for the possibility of greater returns that come from exposure to fast-growing economies. Anecdotally, I have observed that many EM investors actually cherish the opportunity to assess these risks because doing so creates the best opportunity for investors to achieve "alpha" — the term for excess returns above what a benchmark index would produce.

In a relatively transparent and efficient market like the US, alpha is difficult to achieve. The legal and regulatory environment is predictable, and relevant information is easy for all investors to obtain and analyze. These characteristics are positive for the economy overall, but they mean that individual fund managers struggle to differentiate themselves. The widespread recognition among investors that alpha is elusive in developed markets is the reason that passive investment has become so popular.

By contrast, China and other emerging markets create alpha opportunities for investors with exceptional research capabilities. To be clear, I am not talking about insider trading. There is an entire universe of investment researchers devoted to using legal but unconventional methods to understand emerging market companies. These researchers rely on language ability, understanding of local politics, local industry relationships, and journalistic-style, on-the-ground reporting to supplement the information available from corporate financial statements and government statistics.

In my years as a journalist — and more recently, as a consultant — interacting with EM investors, none ever expressed any desire for the US government to "protect" them from the risks of investment in China. These investors are highly sophisticated and confident in their ability to assess risk. Investment managers and their clients value want full freedom to take on whatever amount of risk is consistent with their investment mandate.

5. Passive investors and indexes

In recent years, major EM index companies such as MSCI and Bloomberg have altered their composition to add Chinese domestic stocks and bonds. This trend has raised concerns among policymakers that investors in passive, index-tracking funds may be exposed to Chinese risks of which they are unaware and for which they are unprepared.

I believe this concern is overstated. As mentioned in section 4, Chinese risks are not distinct from those present in other emerging markets that benchmark EM indexes have included for years. In fact, even exposure to China is not new. Any US investor who owned an exchange-traded fund (ETF) that tracked the MSCI Emerging Markets Index prior to the addition of Chinese domestic stocks was already exposed to Chinese stocks listed in the US and Hong Kong. While Chinese domestic securities may present somewhat greater risk than those traded offshore, this difference is one of degree rather than kind.

A related concern is that the Chinese government may have pressured index providers to add mainland securities, even when mainland markets do not meet the standard requirements. While I do not doubt that Chinese officials earnestly desired index inclusion and may have sought to influence the index review process, I have not seen persuasive evidence that such pressure played a significant role.

Indexers are market-driven institutions that earn profits by maintaining indexes that investors and fund managers want to track. They consult extensively with fund-manger clients before making any changes to an index. Changes that would make a given index less attractive to current or potential clients would undermine the indexers' fundamental value proposition.

As discussed in section 2, China has made significant reforms to increase foreign access to its domestic capital markets. In years past, the obstacles to index inclusion were foreign-exchange controls and other restrictions on foreign investors' ability to quickly buy and sell securities and to repatriate proceeds. In the stock market, there were particular concerns about long trading suspensions for individual stocks. Though some issues remain outstanding, these concerns have now been largely addressed. It is therefore quite plausible that substantive market reforms — rather than Chinese government pressure — are the reason for the index changes.

Nor is the prospect of business opportunities for foreign indexers in China attractive enough that such opportunities could serve as leverage to coerce indexers to sacrifice their global clients' interests. Chinese index companies dominate China's domestic market. While MSCI, Bloomberg, or other indexers may see some niche opportunities in China, I doubt they harbor any illusions that China could ever contribute more than a small slice of global revenues.

Policy recommendations

I. **Insist on full PCAOB audit access.** US and Chinese regulators are engaged in a years-long dispute over whether the Public Company Accounting Oversight Board (PCAOB) can obtain access to audit records for Chinese companies listed in the US. This dispute arises from US requirements that apply to all US-listed companies, regardless of nationality. The case for forcing Chinese companies to meet the same requirements as other US-listed companies is very strong.

II. **Address ethical risks case by case.** The US should champion human rights abroad. If the US government has compelling evidence that a particular company is complicit in human rights abuses, then sanctions that forbid US investment in that company may be appropriate. On October 28, 2019, the Commerce Department added 28 Chinese companies and government agencies to the Entity List for involvement in human rights violations in Xinjiang. The Entity List process offers a potential model for identifying foreign companies in which US investment is prohibited.

    By contrast, a broad-brush approach is not warranted. Though the Chinese government exerts significant influence over the Chinese economy and can exert pressure on specific companies, most Chinese companies are not direct or even indirect agents of Chinese influence or policy. It would be a mistake to conflate all Chinese companies with the Chinese Communist Party or the Chinese state. Thousands of Chinese companies — especially privately-owned companies, but also many state-owned companies — are commercially driven entities that seek to serve customers, earn profits, and steer clear of politics.

III. **Be clear and honest about policy objectives.** The US and China are engaged in a multi-faceted geopolitical competition that encompasses economics, technology, military power, diplomacy, ideology and culture. US policymakers could decide that US policy should aim to weaken China along one or more of these dimensions — and that curtailing China's access to US investment would be an effective tool for doing so (though for the reasons described in section 1, I do not believe such policies would succeed in weakening China economically). Policymakers could also decide that Chinese human rights abuses are so pervasive and severe that *any* investment in *any* Chinese company makes US citizens complicit in government abuses (though for the reasons described in recommendation 2, I would disagree).

Though the wisdom and effectiveness of such policies is debatable, these rationales are at least plausible and coherent. By contrast, "investor protection" is an implausible and incoherent justification for imposing investment restrictions, for the reasons described in section 4. If policymakers insist on citing this rationale, investors in the US and around the world will quickly recognize it as a smoke screen, and US credibility will suffer. Whatever objectives we adopt, we should pursue them forthrightly and without obfuscation.

IV. **Apply standards consistently.** China is not the only country that presents financial risks to investors. China is also not the only country where the government and certain companies are involved in human rights abuses. If the goal is to protect investors from financial and/or ethical risks, then policymakers should examine the global investment landscape — not just China — to identify such risks. Investment restrictions that exclusively target China or Chinese companies would violate recommendation III above because they would rightly be viewed as unprincipled and selective.

OPENING STATEMENT OF BRIAN MCCARTHY, CHIEF STRATEGIST, MACROLENS

COMMISSIONER WESSEL: Thank you. Mr. McCarthy?

MR. MCCARTHY: Thank you so much for the invitation to share my thoughts on China with the Commission today.

I was asked to address a number of sort of specific issues with regard to developments in corporate finance in China. And I'd like to present those in the context of a quick tour of the Chinese financial system.

I want to apologize. I forgot to put page numbers on here, but there's a lot of pictures and headers, so hopefully you can all follow with me.

The first point would echo something that Dr. Walter said. This is a bank-dominated system. The chart on the first page here shows the ratio of M2 to non-financial credits, 80 percent in China, 40 percent in Europe, 30 in the U.S., call it. So not only are banks big providers of credit via loans but, to Dr. Walter's point, they buy most of the bonds as well.

We should not think of a frugal household, you know, saving their pennies, and bringing them to the bank, and generating investment in China. The system works the other way. They decide how much investment they want, they tell the banks to make loans, the loans create those deposits, hence high savings growth because it's the households that end up having to finance all of this activity.

I'd like to make a point on the next page about shadow banking. I have some insights on the specifics of the debate that the first panel engaged in which we do in Q&A if you'd like. The point here is that they have stopped the growth of overt shadow banking.

And the reason is pretty obvious. It's because the Chinese government was writing free checks, basically. They had limited oversight into where the money went, but it was subject to the moral hazard. So basically the government was on the hook for the bailout. They need to control where the money goes.

So they're trying to fix this by stipulating that, effectively, that these will be stand-alone investment vehicles. I'll believe it when I see it. Until we actually get rid of the moral hazard, you simply cannot let non-bank credit intermediation grow any more than it will. So the system is not going to become less bank-dominated, in my view.

Another reform on the third page is about this move to the new loan prime rate. I was asked to discuss this. This doesn't mean much, basically. They're trying to move to a market-based fixing for interest rates. They moved to a market-based fixing for the currency a couple of years ago. And the PBOC rigs it every night.

So the bottom line is the depo rate is one and a half. It's a deposit financed system. If they lower that, they risk capital flight. And if they push banks' lending rates down towards that deposit rate, they will squeeze bank margins, and the whole capitalization problem that Mr. McMahon spoke about in the first panel, you know, becomes much more difficult.

So they're sort of at an end with forcing interest rates lower. And I don't see the recent change to the way they do business really helping much.

Private borrowers I was asked to address, I'll gloss over this. We can come back to it if you would like. They basically ordered more money to private borrowing.

Yes, that should help entrepreneurial activity in China on the margin. But it's still not market-based activity. It was a top-down edict. It will create other problems in this ongoing game of whack-a-mole that they're dealing with. So again, another sort of -- it's a good thing that smaller companies are getting money, not a reform.

Next, on the fourth page, I've got three pies and a bar chart here on the equity market. The equity market is a bastion of potential financing to entrepreneurs, some 60 percent of the market cap is private companies, unlike the flow of bank loans and corporate bonds where the outstanding amounts are generally to SOEs.

But it's not that macroeconomically significant. So if you look at the bottom chart, you're still getting 70 to 80 percent of the financing going to corporates, debt equity is really quite marginal.

And there are bigger problems with the Chinese equity market. So they are reforming the IPO system in March. These laws have been passed. It should be a better system for raising equity capital in China. But there are just some fundamental problems with an equity market in a communist authoritarian system.

One, if you look back to 2015, '16, 1,500 stocks were suspended because the market was falling, and they didn't like the price action. They pledged not to do that again, but until we have another 30 percent decline, you know, who knows? I'm skeptical.

Secondly, speculative investors dominate this market, the news is all fake. I mean, how can you have a $10 trillion equity market in a country where the participants do not have access to the Internet for instance?

So the chart on the bottom of this page is labeled A-share, H-share Premium. This is really an interesting phenomenon. Dual listed equities are 27 percent more expensive in Shanghai than they are in Hong Kong. There's no easy arbitrage via the Shanghai/Hong Kong connect. Why is this? I can't explain it. But it's pretty clear evidence that that market is not really efficient as a capital allocation mechanism.

I'll skip over the stuff about U.S. investments in China. We can come to that in Q&A. I just want to quickly talk about this chart labeled Figure 16-1 which shows a rapid increase in debt, dollar bonds issued by both Chinese property companies and Chinese banks.

The banks are probably asset matched. They're funding Belt and Road. But those assets are of infinite duration. They have a big liquidity mismatch, and the property companies are wrong way risk. When the Chinese property goes down, the currency's going to go down. And those bonds are going to blow up.

So there is a very important and growing avenue of systemic risk transmission from China to the U.S. via this mechanism. It works both ways as well, because if we were to ever cut the Chinese banks off from dollars, they have a huge problem.

I've got some data on the flow of money into China from the U.S. This question came up in the first panel. It's currently at half a trillion dollars and growing quite rapidly.

Why do they need this money? They need this money because they have a dollar problem. So very quickly, the triangle, the impossible trinity, I'd like to delve into this in Q&A as well.

They need really easy monetary policy to keep the credit bubble afloat. They need to protect the currency for domestic and international reasons. That means they have to close the capital account, but they don't really have capital controls. They cannot tease out illicit capital flows from the $4 trillion in trade flows that must happen every year in gross.

So what they have done is basically instituted quotas, where whatever comes in they let out, and they are forcing balance in their balance of payments without using the reserves.

2015 and '16, their reserves fell by a trillion dollars. I'm going to tell you, it was actually a trillion and a half. There's other activity that was hidden there. And they had capital controls then. So what the heck happened? The capital controls don't work.

So all of the pressure between having that very easy monetary policy and the fixed exchange rate is now funneling into this FX market where they are saying we'll only provide access to foreign currency to our domestic companies and investors to the extent that money comes back.

So all the pressure is in the form now of this FX shortage. And MSCI and Barclays Bloomberg Agg have basically bailed them out to the tune of $200 billion. I do agree that this may be -- it's not MSCI's business to address this. But it's just fact that that has happened.

So I would just like to make one pie in the sky recommendation if I could for 30 seconds. And this is really out there. But if there's one thing we could ask China to do, we have a phase two, a list of demands. Boil it down to one. Tell China to allow the free movement of capital.

Now, bad things are going to happen. But we need to stop kidding ourselves that there's a way out of this without a bad thing happening in one dimension or the other.

Restricting the ability of the Chinese citizenry to vote with its wallet is the cornerstone market distortion that enables all others. The forced savings which has financed all manner of Chinese subsidy and market distorting practice becomes impossible to marshal in the existence of a liberalized capital account. This is how they forced the households to pay for all of it.

Of course, this is going to be a big problem. The RMB is going to fall. Immediately we have a reaction that this is impossible. How could we ever do this? This would be a financial cataclysm.

Yes, this simply illustrates how badly corrupted the system of global trade and finance has become as a result of China's persistent prevention of economic equilibrium via brute force policies which are unsanctioned by democratic consensus.

In allowing a large, centrally-planned Chinese economy to become increasingly integrated into the global system, we resign ourselves to persistent macroeconomic disequilibrium which we seem increasingly tempted to offset with market distortions and central plans of our own.

Removing this linchpin of Chinese central planning is the key to restoring a market-based system of global trade and finance, one that will tend towards equilibrium as designed and perhaps save the system from having to defend itself from China by emulating China. Thank you.

PREPARED STATEMENT OF BRIAN MCCARTHY, CHIEF STRATEGIST, MACROLENS

"China's Quest for Capital: Motivation, Methods, and Implications"

Testimony before the U.S.-China Economic and Security Review Commission

Brian W. McCarthy, Managing Principal, Macrolens llc

January 23, 2020

Today's testimony will cover various aspects of China's evolving system of corporate finance.

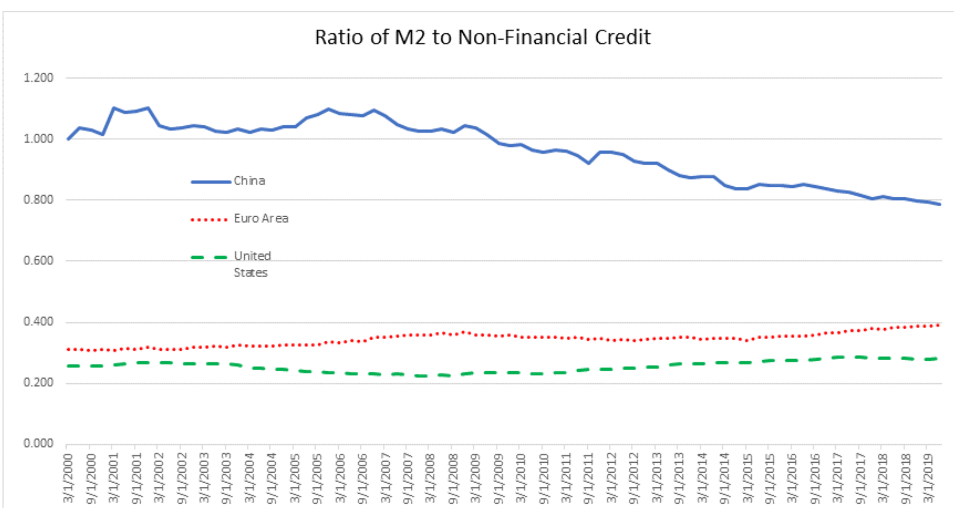
While on the surface the system appears to be undergoing a period of rapid transformation, an underlying reality of China's system of economic management remains the driving force for "change:" **the Chinese Communist Party has no intention of surrendering its control over the allocation of capital to market forces**.

- Credit markets remain bank-dominated and State-entity focused
- The recent push to increase lending to SME's is just a pivot in the central plan
- Increasingly vibrant equity markets provide a bastion for market-based capital allocation, but within strict confines
- Increased openness to foreign investment is driven not by a desire to marketize, but by China's macroeconomic and geopolitical predicaments

<u>China's Credit Markets are Bank-Dominated</u>

Aside from the centrality of bank lending in Chinese corporate finance, **banks are also predominant buyers of all form of bond issue** – central government, local government and corporate

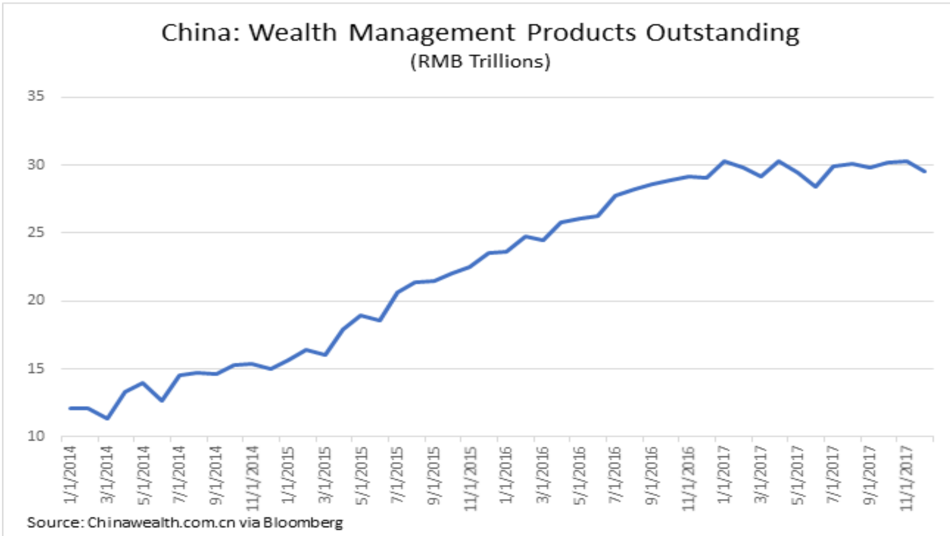
- As a result, some 80% of credit extended is financed through the creation of bank deposits:



Sources: BIS, Bloomberg, Macrolens Calcualtion

Shadow Banking is in Dry Dock

China's credit markets are unlikely to continue the trend towards increased non-bank intermediation, as regulators have put the brakes on expansion of so-called "shadow banking."



- Overt and implied linkages to banks rendered most non-bank financial products subject to the public's belief in implicit guarantees.

- This left the state ultimately responsible for losses on such products, but without the degree of oversight they wield over on-balance sheet activities.

- The combination of implicit guarantee with limited oversight rendered continued expansion of non-bank credit untenable from a systemic risk standpoint. The government was writing black checks to fund risky behavior.

- Regulators are in the process of rolling out new regulations by end-2020 to transform Wealth Management Products from off-balance sheet slush funds into genuine stand-alone asset management products. Proposed changes include:

    - Restrictions on investments in "non-standard assets" (ie. loans)
    - Restrictions on "pooling of assets," by which WMPs would finance a portion of an amorphous pool of assets rather than a list of specific assets
    - A firm pledge that funds will "stand alone" with no form of explicit or implicit guarantee

- "No battle plan survives contact with the enemy." **Extreme skepticism is warranted towards the pledge to eliminate moral hazard from this sector**.

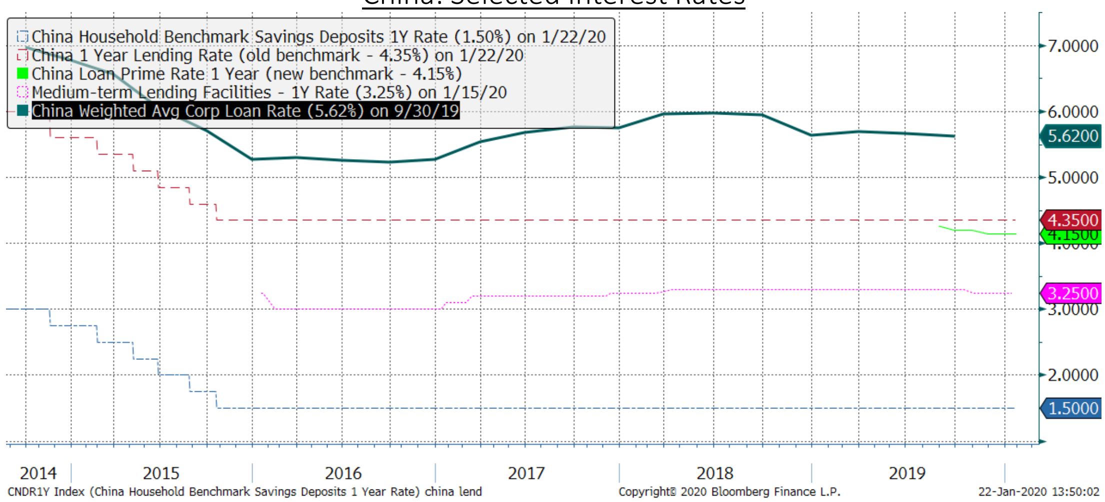
- Until the existence of credit risk is firmly established, Chinese policymakers are **unlikely to**

sanction renewed expansion of Wealth Management Products and other "shadow banking" channels of credit provision.

Is the New Benchmark Lending Rate a Significant Reform?

Late last year, the PBoC began a phase-out of the administered "benchmark lending rate" in favor of a purportedly market-based Loan Prime Rate, based on fixing submissions from 18 Chinese banks specifying their lending rate to prime borrowers, expressed as a spread to the rate on the PBoC's "Medium Term Lending Facility" – a primary PBoC funding facility.

China: Selected Interest Rates



- As with the PBoC's purportedly market-based daily fixing for the USDCNY rate, it should be anticipated that **PBoC will either window-guide or simply jury rig the fixing** to its liking.

- The objective seems to be to squeeze net interest margins under the guise of "market competition." Yet, the **room for a reduction in lending rates is limited**:

    - With M2 at 201% of GDP and 925% of FX reserves, further cuts in administered deposit rates **risk exacerbating capital flight** pressures.
    - Aggressive reduction in lending rates absent deposit rate cuts would compress net interest margins and **further stress a banking system** struggling to remain adequately capitalized, amidst a gathering NPL problem and the need to continually increase lending by double-digit rates.

Private Sector Borrowing Squeezed from All Sides

In late 2018, Authorities became seriously concerned about the plight of non-state corporate borrowers who were being squeezed from all sides:

- **Loan supply**: "shadow banking" – now constrained - had served as a key conduit for credit to non-state borrowers, largely crowded out of official channels by politically connected and implicitly guaranteed State-owned Enterprises.
- **Loan demand**: unlike state actors, private sector actors must be cognizant of repayment ability. With the nominal GDP growth rate slowing towards (and in many cases through) the nominal borrowing rates available to private borrowers, loan demand shriveled.
- **Growing accounts receivable**: payment delays (frequently from SoE to private company) extended significantly throughout 2017 and 2018.

In response, PBoC took several measures in late 2018 to spur lending to private small and medium-sizes enterprises:

- Introduction of the TLMF – Targeted Medium-Term Lending Facility – to provide term funding at the MLF rate less 15 basis points to banks meeting targets for the growth in loans to SME's and private businesses
- Targeted reduction in the Required Reserve Ratio (RRR) for banks meeting SME lending targets
- With carrots failing to do the trick, Prime Minister Li Keqiang wielded a stick in his 2019 work report delivered in March of 2019, announcing a **central target of 30% growth in loans to SMEs** (defined as firms with credit lines of less than RMB 10m). This implied some RMB 2.8bn in new financing to SME's in 2019.

As it turns out, the PBoC can declare victory in having generated a 41% increase in "inclusive financing" to SME's in 2019 (although some analysts allege that they moved the goal posts by redefining the SME lending metric).

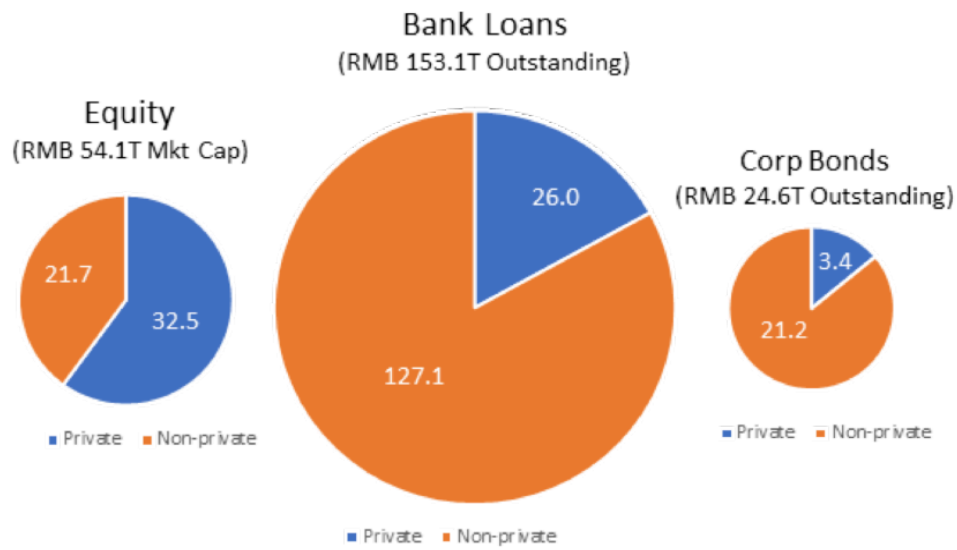
The jury is out as to whether this centrally-commanded push into private sector lending will rekindle entrepreneurial activity or simply cause further distortions which emerge as problems elsewhere in the ongoing game of systemic whack-a-mole. Anecdotally, reports are not positive, with a rash of private firms bailed out from failed share-pledging schemes in late 2018 already relapsing into default, and a sharp increase in the number of private firms being sold to SOEs.

In sum, China's push to increase lending to private companies, whether well-intentioned or simply an imperative of systemic risk-control, is **unlikely to rekindle animal spirits in a way that might improve capital allocation efficiency**.

Equity Markets: Vibrant and Growing, but a Systemic Pip Squeak

Chinese equity markets provide a bastion of market-based financing to entrepreneurial China. While these markets are large in absolute terms, they remain dwarfed by China's massive (and rapidly expanding) credit markets as a source of funds for Chinese enterprises. Also, doubts remain as to the degree to which Chinese policymakers will sanction market movements that run counter to policy objectives, as well as to the level of capital-allocation efficiency Chinese equity markets can achieve in the absence of a free press and rigid accounting standards.

- Equity markets (by market cap) are the least State-dominated asset market in China:



Source: Pensions & Investments, *The Value in China's SoE's*, 3/7/19, PBoC, Fitch Estimates, Macrolens Calculations

- But volumes of funds raised remain a fraction of that sourced through bond issue and bank borrowings:

China recently enacted long-awaited amendments to its Securities Law (with effect March 1), intended to modernize the IPO approval process and improve accessibility of equity financing. Changes include:

- **Shift to a "registration-based" IPO process** intended to simply and shorten the onerous approval process currently in place
- **Stricter disclosure requirements** and heavier punishment for breaches of such rules
- **Removal of the "sustainable profitability" requirement** seen as a critical hurdle to the financing of newer businesses

On balance, these reforms should increase the attractiveness of onshore listings relative to listing in the U.S, Hong Kong or elsewhere.

Despite the improvements in market access and infrastructure, questions remain about the compatibility of Communist Authoritarianism with an efficiently functioning equity market.

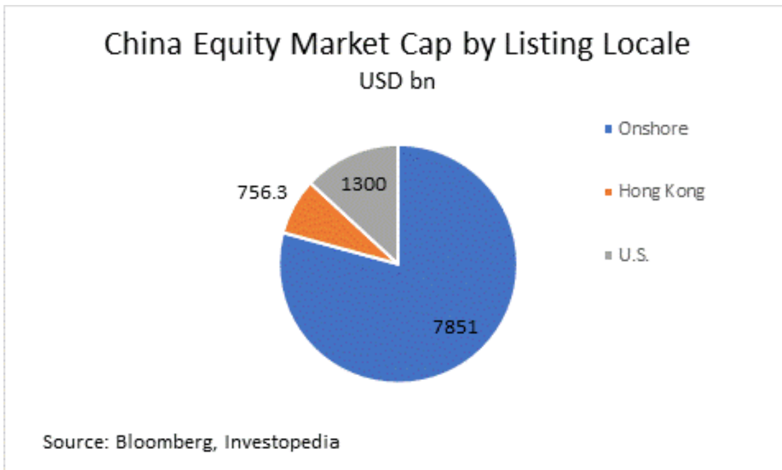
- **More than 1,500 onshore-listed stocks – over half of the universe - were suspended** at some point during 2015's market tumble. Regulators have made vague pledges of having tightened requirements for suspension and shortened (to three months) the allowed timeframe. But **investors remain wary** as to whether any pledged improvements will survive the next market downturn
- **Speculative investors dominate** onshore equity markets for various reasons (some of which were highlighted by Peking University's Michael Pettis in a recent Financial Times piece):
    - o unreliability of both financial statements and macroeconomic economic data
    - o The prevalence of domestic propaganda and a heavily restricted internet
    - o Government intervention in the economy is dominant yet unpredictable
    - o Signals from offshore are repressed by capital controls

Evidence of market inefficiency can be found in the **wide valuation premium of A-shares** to their dual-listed equivalents in Hong Kong, which has persisted despite the 2014 opening of the HK-Shanghai Connect, which provides easy access to arbitraging this valuation discrepancy.

Access to Foreign Capital both Onshore and Offshore

China's access to and integration with pools of global capital remains limited, but is experiencing **rapid growth**. Offshore capital raising by Chinese entities is generally driven by restricted access to domestic capital or a desire to source U.S. Dollars, while foreign investor participation in China's markets is being driven by macroeconomic prerogatives of the Chinese government. In neither case is the evaluation of relative risk and reward by market participants the driving force.

Listing on U.S. equity exchanges has been a significant source of financing for Chinese companies historically, but is **likely to shrink in importance**.



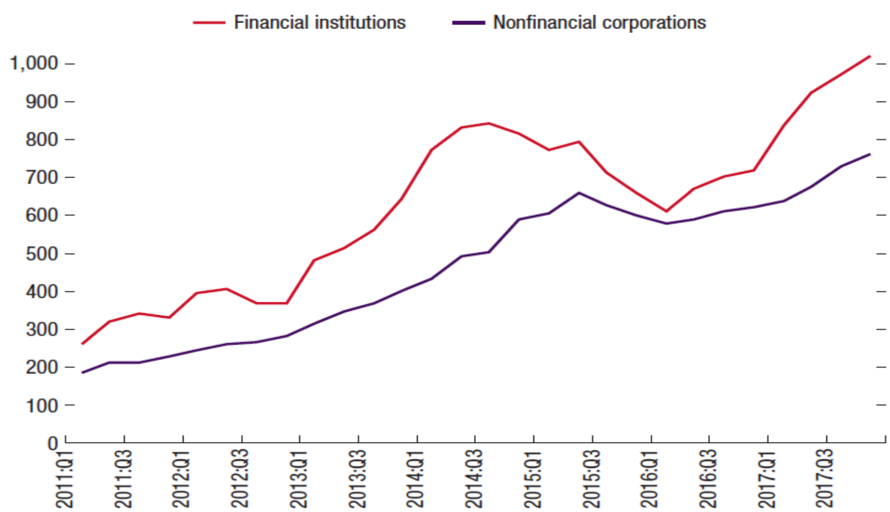
- As noted above, accessibility to onshore equity capital should improve, particularly for companies yet to achieve consistently positive earnings – historically an important factor driving Chinese companies overseas
- U.S. markets are becoming less hospitable to Chinese listings, with the Nasdaq already tightening listing standards and slowing approvals and legislation such as the Equitable Act likely to tighten standards for Chinese listings, in particular by forcing Chinese companies to allow the Public Company Accounting Oversight Board access to audited financials.
- One motivation for U.S. listings should remain strong – the desire of Chinese entrepreneurs to cash out in U.S. Dollars, access to which is becoming increasingly restricted

Chinese banks and corporates have also been active participants in offshore Dollar-denominated bond markets in recent years. Motivations for Dollar-borrowing include:

- Access to finance for Chinese property companies who are frequently restricted in onshore borrowing in the attempt to curtail speculative real estate activity. Property companies were also heavy users of onshore Trust Products and other means of "shadow financing" that has been curtailed in recent years. Chinese policymakers benefit in driving property borrowing offshore in two ways: Dollars sourced are repatriated, helping to support the deteriorating balance of payments, and a prevalence of Dollar financing will "outsource" some measure of the financial disturbance when domestic property markets inevitably cool

- Chinese banks are heavy borrowers of Dollars, presumably to fund the acquisition of Dollar assets. Financing of the Belt and Road Initiative is a likely driver of demand for Dollars by Chinese banks.

Figure 16.1. Offshore Bonds Outstanding, First Quarter 2011 to Third Quarter 2017
(Billions of US dollars)



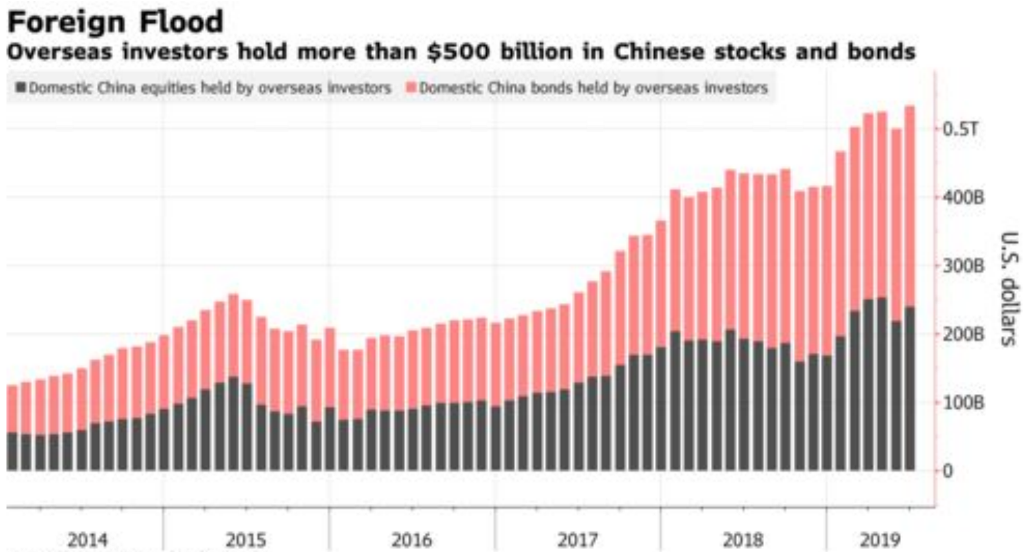
Source: Bank for International Settlements.

From: The Future of China's Bond Market, IMF, March 2019

China's borrowing of U.S. Dollars is a **growing source of systemic risk transmission** from China to the rest of the world.

- Currency mis-matched Dollar borrowing by Chinese property developers is the epitome of "wrong way risk," as an eventual bust in Chinese property markets will undoubtedly be accompanied by RMB devaluation
- Chinese banks are likely currency-matched but badly duration-mismatched. Borrowings are generally short term (including, by my estimate, some $500bn in borrowing via FX swap contracts, not included in the chart above) while the Dollar-denominated assets are likely of extremely long (if not infinite) duration – i.e. loans to Emerging markets with questionable ability to pay collateralized by immovable infrastructure.

Another rapidly growing source of systemic risk transmission is foreign investor participation in Chinese onshore bond and equity markets which is being aggressively encouraged by the Chinese government, providers of stocks and bond indexes, and global banks.



Source: People's Bank of China

From: Bloomberg News

The glaring problem with China's capital market opening is that it is **one-way** in nature. That China must continually tighten restrictions on the outflow of capital is **ipso facto evidence of a disequilibrium condition** in China's asset markets and/or its currency. In layman's terms, if Chinese asset were not overvalued in common currency terms the Chinese government would not have to outlaw the sale of domestic assets for foreign currency.

While index providers might rightfully claim that it is not in their remit to judge the valuation of any respective asset market, investors who are benchmarking to indexes which are increasing their weightings towards China should be fully aware that they are being piled into China asset markets **on top of domestic investors that are effectively prohibited from selling**. Caveat emptor.

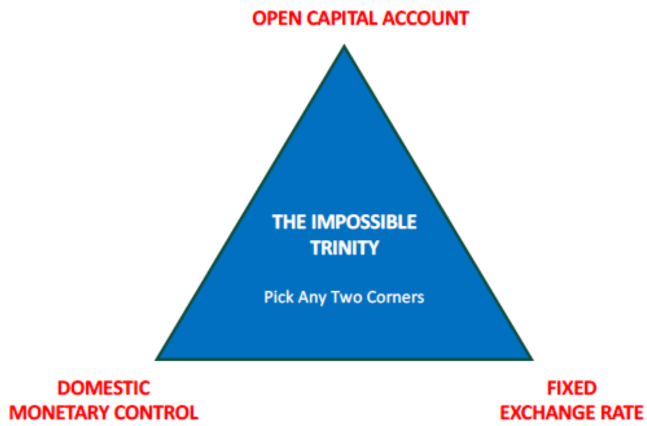
China's objective in welcoming foreign capital is twofold

- Alleviate the Dollar shortage resulting from a policy of "FX rationing"
- Expose the rest of the world to China's risky financial system so as to render it globally "too big to fail"

While a deeper analysis is beyond the scope of today's testimony, I'd like to briefly outline the source of China's increasing "Dollar shortage," to illustrate how the opening to foreign capital fits the overall macroeconomic objectives of the CCP.

The Impossible Trinity and China's "Dollar Shortage" Problem

The "Impossible Trinity" is a basic arbitrage model of global capital flows and exchange rate determination that encapsulates China macroeconomic dilemma.



- In the presence of an open capital account, arbitrage flows dictate that domestic monetary policy and the level of the exchange rate must remain market-compatible

- Policymakers must choose two of the three variables

Growing tension between the **domestic requirement for easy liquidity** in support of the credit bubble and the official desire to maintain **control of the exchange rate** is the force behind China's increasingly **tight control over capital flows**.

However, contrary to the popular impression, **China does not actually have effective controls on capital**. With over one million domestic firms licensed to trade foreign exchange for purposes of trade settlement, and gross trade flows exceeding $4T per year, it is simply **impossible for China to disentangle elicit capital flows** from the massive volume of FX trading that is necessary to accommodate China's foreign trade.

This was in evidence in 2015-16, when China lost $1T in FX reserves in defense of the currency **despite de jure capital controls**.

Defending the RMB through sterilized intervention rapidly became untenable (and was ineffective to boot). While it's commonly said that China has subsequently "tightened capital controls," this is technically inaccurate. As noted, the capital controls don't really work.

No, leadership's solution to was approach common to its form of top-down authoritarianism: command that the desired end result be obtained and worked backwards from there.

Chinese authorities deiged to make "impossible trinity" possible. With domestic monetary conditions remaining incompatible with the RMB's soft peg to the Dollar, and capital controls proving ineffective, authorities simply **commanded that foreign exchange flows be balanced**. Access to foreign currency from within China would be limited by the volume of foreign currency coming into China, and doled out by prerogative of the domestic banks. **What goes out is limited to what comes in**. Voila: balance.

The logical outcome of this policy constellation – easy domestic liquidity, a fixed exchange rate, and forced balance in FX trading – is that **China's policy disequilibrium is now manifest in a shortage of availability of foreign exchange** – i.e a "Dollar shortage." Yes, the FX flows may balance, but since that is not a market-determined outcome, it does not necessarily indicate that the economy's needs for FX liquidity – for imports, for financing BRI and other foreign investment, for satisfying the "diversification" demands of the moneyed elite – are being sufficiently met.

In this light, the objectives of China's "one-way capital account opening" become obvious. Far from desiring to foster a more efficient market-based allocation of capital, **China's welcome mat to foreign investors is meant to forestall a reconciliation of the contradictions in China's macroeconomic policy settings,** by alleviating the growing shortage of FX liquidity.

Lastly, it would be my contention that China's efforts to increase foreign investor exposure to Chinese debt and equity assets are also intended to foster greater integration in order to **reduce the risk of "decoupling"** in trade and finance. China's moves to open its domestic financial markets to greater participation by global banks and non-bank finance companies works in a similar direction. (As an aside, so does a policy of coerced Chinese purchases of U.S. farm product and manufactured goods).

Five years ago I was arguing that while China's credit bubble was gargantuan, it was largely self-financed, and the fallout from a Chinese financial crisis would prove eminently containable. Save for the inevitable market adjustment resulting from an RMB depreciation, direct financial linkages at that time remain limited.

I am no longer so sanguine. With each passing day we are increasing the vulnerability of the global financial system, and the exposure of U.S. investors, to a Chinese financial system that **at its core is not market-based**.

Markets inevitably tend towards equilibrium. Like water building behind a faltering damn, market pressures in China have been long resisted by increasingly heavy-handed policies. The pressures continue to build, only temporarily relieved by the index-driven flow of foreign capital into China.

Policy Recommendations and a "Silver Bullet"

We should not counter Chinese policy missteps in finance by emulating them, as we seem to be doing in trade, with the "Phase One" formulation of centrally-directed purchases of U.S. goods. While it would be tempting to consider restricting U.S. portfolio investment to defend the market-based system of global finance from the distortions inevitably to arise from integration with China, that would be anathema to the market-based system itself. **We cannot abandon market-based capitalism in order to save it**.

There are of course some common-sense actions that can be taken:

- Pass the Equitable Act to bring the listing standards for Chinese companies into line with that applied to domestic companies
- Assure that index-inclusion decisions are made behind "Chinese walls," so that Chinese authorities cannot either dangle carrots or wield sticks over associated business lines as coercion
- Encourage index providers to offer ex-China versions of all benchmark indices under the rubric of sound Environmental, Social and Governance (ESG) policies

These are of course but palliatives. Today I propose a "silver bullet" solution to the imbalances and distortions fostered by China's non-market practices.

The United States should reduce its "Phase Two" demands on China to one: allow the free movement of capital.

Restricting the ability of the Chinese citizenry to "vote with its wallet" is the **cornerstone market distortion** that enables all others. The "forced savings" which has financed all manner of Chinese subsidy and market-distorting practice becomes impossible to marshal in the existence of a liberalized capital account.

Of course, opening China's capital account is not costless! A large RMB devaluation would result, necessitating a period of long-overdue global adjustment. That this immediately strikes one as entailing a near-impossible to endure level of global financial instability illustrates how **badly corrupted the system of global trade and finance has already become** as a result of China's persistent prevention of economic equilibrium via brute force policies unsanctioned by democratic consensus.

In allowing a large, centrally-planned Chinese economy to become increasingly integrated into the global system, we resign ourselves to persistent macroeconomic disequilibria, which we seem increasingly tempted to offset with market distortions and central plans of our own.

Removing this linchpin of Chinese central planning is the key to restoring a market-based system of global trade and finance - one that will tend towards equilibrium as designed, and perhaps save the system from having to defend itself from China by emulating it.

PANEL II QUESTION AND ANSWER

CHAIRMAN CLEVELAND: Wow. I just want you to know that I have a picture of the impossible trinity in my house. It's one of my favorite things. So I'll defer to others for questions.

COMMISSIONER WESSEL: I'll choose not to comment on that.

CHAIRMAN CLEVELAND: On my limited imagination?

COMMISSIONER WESSEL: On your choice of artwork. Senator Goodwin?

COMMISSIONER GOODWIN: You made it sound so easy. I'm tempted to just ask you how we do it, right, there at the end. But I want to start off with you, Mr. Wildau.

I referenced your testimony earlier this morning with the administration witness and posed a question to her. Is China different from the challenges that we face in other emerging markets and the risks the investors face in other emerging markets?

In your testimony, you acknowledged that we have seen these before. Other emerging markets have these sorts of risks. They have human rights concerns. They posed some national security issues.

In response, she said perhaps it's the sheer scope, and sweep, and the stated intent of China that does, in fact, make it different. And I would just like your reaction to that?

MR. WILDAU: Well, it's a good question. I guess the approach that I would favor in addressing these risks, well, let me step back, actually. First let's define our objective.

Is our objective really about protecting investors from risk or are we pursuing national security objectives, human rights objectives? Let's separate those, because the policies would be different depending on the objective.

Now, as I said in my prepared testimony, I don't think that the U.S. Congress or the Executive Branch, for that matter, you know, can really do much in terms of protecting, or should, do much or could do much that's useful, let's say, to protect investors from financial risk.

But I do recognize that there are legitimate national security and human rights objectives that we ought to be pursuing and that investment restrictions might have a role to play in those objectives.

And so if those are the objectives, then I would want to look at specific companies. Because my concern, and I heard this in some of the testimony this morning from the administration representative, and from some of the panelists, is that sort of this idea of China Inc., I think, is misleading.

Because my experience dealing with interviewing Chinese companies as a journalist is that there are many Chinese companies that are in no way agents of the Communist Party, that actually want nothing to do with the government. They just want to be left alone to produce goods and services to try to make a profit, to serve their customers.

And so if there are specific companies that pose specific human rights risks, national security risks, by all means, let's find a mechanism to sanction those companies, to restrict investment to those companies. I think that's fine.

And the Entity List mechanism that we used on Huawei and other Chinese entities provides some kind of model for doing that. But let's just not use a broad brush and say any money that flows to any Chinese company is just directly feeding the Communist Party and its nefarious policies. I think that's far too broad a brush.

COMMISSIONER GOODWIN: Well, that's fair. And, you know, we've seen with some of the legislation that you referenced, and the public coverage of that bill, and the public statements issued by the senators who are sponsoring it, the identification of some specific instances where investment has flowed to particular initiatives that may run counter to our stated foreign policy and national security interests.

But getting back to that question, you know, you indicate these risks, such as they are, not just investors but let's focus on the latter, foreign policy and national security interests. You said they're not qualitatively different than comparable risk in other emerging markets. Are they quantitatively different?

MR. WILDAU: Okay.

COMMISSIONER GOODWIN: And does that matter to us?

MR. WILDAU: I mean, clearly, China's bigger than any other country. In terms of population, it's the second biggest economy. So quantitatively, it is different. But I don't know that that quantitative distinction ought to influence policy other than to say, yes, let's take a hard look at China.

But maybe the answer is to, and I mentioned this in my prepared remarks, I mean, let's take a systematic look at the entire global investment landscape and see where new policies, new restrictions might be appropriate to address national security or human rights problems related to a whole range of different investments. And maybe China deserves sort of a large share of attention in that global systematic process.

But I still think it needs to be principal-based. What are our objectives, and what investment regulations are suitable to meet those objections rather to say we have a big China problem? Let's go after China. That would be the approach I'd favor.

COMMISSIONER GOODWIN: Thank you.

COMMISSIONER WESSEL: Commissioner Fielder?

COMMISSIONER FIEDLER: I have a couple of questions. First of all, there is a stark difference in the testimony. You said that China doesn't really need, it's got enough money, doesn't need to raise the money.

Then we get into the capital allocation problems which are severe, right. So the macro view of this probably is not applicable to us in a policy making sense.

I want to get, you do political risk analysis, right?

MR. WILDAU: Mm-hmm.

COMMISSIONER FIEDLER: And I know we haven't done this in looking at those companies in the United States, those Chinese companies in the United States who are raising capital in the U.S. capital markets.

Do you, in a normal day of political risk analysis, look at leadership, family relationships with the companies that your clients are hiring you to look at?

MR. WILDAU: We've gotten requests of that sort about a specific company, whether it's political relationships, yes, that's something I could be asked, have been asked by a client. Yes.

COMMISSIONER FIEDLER: I mean, specifically princeling-related type stuff.

MR. WILDAU: I mean, I can't reveal specific client ---

COMMISSIONER FIEDLER: I'm not asking you to.

MR. WILDAU: But that would be among, I can't quite recall if I've been asked that exact question about princelings. But I've been asked questions about the political relationships that a company might have. And I would interpret a question like that to include, you know, if they have princeling connections, my client would be interested in that. Yes.

COMMISSIONER FIEDLER: All right. You were all here this morning apparently. So I don't have to go through my sophisticated investor attack. You disagree with me, right?

MR. WILDAU: I do.

COMMISSIONER FIEDLER: So you disagree with the fact that sophisticated investors screwed up in the U.S. financial crisis?

MR. WILDAU: I agree with that, yes.

COMMISSIONER FIEDLER: Okay. And that there may be only three or four of them that got it right, that made any money off of it?

MR. WILDAU: Well, could address that briefly? Or do you just want a yes or no?

COMMISSIONER FIEDLER: No, I'm not being glib and funny. Because what I'm getting to is the confidence ordinary people have in the United States, whether it's their 401(k) investments, or their pension handling by state governments, for instance, or state pension funds.

I don't think, if they didn't have the sophisticated ability to see the sub-prime crisis when all of the bad loans were listed out there, and that's what short sellers found, in an opaque investment environment of China why should we have confidence in anyone's judgment of what to invest in?

Now, I don't care whether or not it matters to the Chinese government or has great impact on the Chinese economy. That's not what we're talking about. We're talking about the risk to U.S. citizens of these opaque investments by so-called sophisticated investors.

So there's a danger level. And everybody sort of agrees that there's a serious danger level here that levels political stuff. So why should we encourage this?

And why, for instance, give me another example of an emerging economy that was listed on the U.S. Stock Exchanges and won't comply with the audit requirements and why the foolish United States government has been spending 12 years trying to get them to agree to it? And why should we let them come to just violate our rules for 12 years? I mean, it's, like, ludicrous. I mean, you think we should do that?

MR. WILDAU: Well, as I said in my prepared testimony, I mean, just briefly on the listing, I agree with you on the listing. Those Chinese companies should follow the same rules as any other company. To me, that's obvious. And we would agree 100 percent on that.

But I would separate that issue from the issue of sophisticated investors. So let me just address that very briefly, which is when I look at the financial crisis my takeaway lesson is not the government should have come in and restricted investors from buying mortgage bonds.

I would look at the lesson a lot differently. I would say we need better capital, higher capital standards, less leverage. Banks shouldn't have been using borrowed money to make these investments in risky mortgage loans. They should have been using, you know, equity. They should have higher capital standards, lower leverage.

But sophisticated doesn't mean they never make mistakes. The stock market moves every day. What that means is that everyday investors -- sophisticated investors change their mind or are proven wrong about the, quote, unquote, true value of investments.

So even sophisticated investors will face raw losses, and there's risk. So it doesn't mean they're always right, but it means making money means accepting risk.

I saw an article a couple of days ago about the thrift savings plan millionaires. Who are they? Number one, they're people who have invested for a long time. But they're also people that took more risk. They stayed in the stock market.

If the people that invested for the same amount of time but chose the safer option, they're not millionaires. The ones that accepted risks are millionaires. So higher risk means higher rewards. And that should be up to individuals to make.

But if we're talking about systemic risk, which is the lesson from the financial crisis, it's about capital standards. It's not about restricting people's options for investment. Thank you.

COMMISSIONER WESSEL: Senator Talent? Well, you raised your hand. I just called on you. You're next.

COMMISSIONER TALENT: So, Mr. McCarthy, loved it, it was a tour de force, very helpful. Your proposal at the end, to reduce all of America's demands down to that China allow the free movement of capital, strikes me as very ingenious.

I think we probably would agree, however, that they're not going to do that, right? So assuming that they don't do that, would you then be more open to the idea of investment restrictions which earlier you say would be an abandonment of market-based capitalism?

MR. MCCARTHY: Yes. In the abstract, I agree with everything my colleague was saying about caveat emptor, these are professionals. If they lose money, tough tiddlywinks.

Unfortunately, you know, we're not dealing in the abstract here. I look at it, there are basically two options. China's not going to change. They're not going to open their capital account, they're not going to change the way they do business, I'm pretty certain of that, which leaves two options, frankly.

We can allow China to continue to be increasingly integrated into the system of global trade and finance. In which case, we will find we no longer have a market-based system of global trade and finance.

Or we can decouple them. And, you know, again, not to sugar coat any of this, we're well beyond the point where there's an option that, like, the S&P doesn't go down six percent. This doesn't exist anymore.

So, you know, again, looking out five or ten years, we're either going to have a Chinese economy that is the largest in the world, and its distortions are distorting everything globally, or, assuming that China doesn't change its political system, we're going to have to be less integrated with them.

So, you know, I think that's really the message, whether it's trade or finance, that needs to be relayed to the Chinese. You're not going to change, okay. Then we need to change how we're interacting with you. And again, it's going to be expensive.

COMMISSIONER TALENT: I'll yield back --

COMMISSIONER WESSEL: Commissioner Lewis?

COMMISSIONER LEWIS: Thank you for your presentations. One of you said that the large banks did have an overseas offering. And one of you also said that the accounting rules that are applicable to U.S. companies should be applicable to Chinese companies.

Who is making the decision allowing the Chinese companies that use the stock exchanges not to follow the accounting rules or even to comply with the accounting system that was set up to verify the accounting rules are being followed? Who's making those decisions?

MR. WILDAU: My understanding is that there's been some, and I'm not an expert on this, but the Public Company Accounting Oversight Board has been seeking audit records from U.S.-listed Chinese companies for a long time and has been unable to obtain them for over 100 companies but has forbeared in the sense that those companies have not been de-listed, even though they're, in some sense, out of compliance. That's a fairly general answer, but I think it's a matter of forbearance.

COMMISSIONER LEWIS: Why aren't they de-listed?

MR. WILDAU: Well, I mean, you'd have to ask that Board. But I've already said, I mean, I think it makes perfect sense to thoroughly apply all the relevant, you know, the Chinese companies should have to obey the exact same rules, not just as U.S. companies but as any

U.S.-listed company, including companies from other countries listed in the U.S.

So that's just a matter of applying the same rules to everyone. I mean, I think that's obvious. But why exactly hasn't it been done, I think you'd have to ask the SEC, or the Public Company Accounting Oversight Board, or the stock exchanges.

COMMISSIONER LEWIS: Okay. My other question is, excuse me, in 1932, before Hitler came to power, we were investing in companies, Krupp Ironworks, which helped to fuel the rise of Germany as a military power.

Why do we allow Chinese companies, any company, to raise money in the United States when their whole system of treating the Uyghurs, treating the protestors in Hong Kong, is so antithetical to United States values? Why should we allow them to raise even one penny in this country?

DR. WALTER: Okay, I'll jump in. I think maybe there's three things I say on this. The first one is ten years ago, before 2009, the strategy of the United States with regard to China was to bring it into the global trading system and the global economy.

We freely invested in it. We encouraged their companies to list in New York and on NASDAQ, and they did. We helped open the Hong Kong Stock Exchange to large Chinese listings. We invested trillions of dollars in the Chinese manufacturing sector. We've basically made Guangdong and Shanghai greater area what it is today.

After the global financial crisis, the tone of the Chinese government changed. And so our tone also has changed. I agree that we need to take a more direct line with China, and I welcome the administration's efforts. It is not easy to do this.

But I think our entire system of capital markets is based upon letting the investor take on the risk and our regulators work at trying to provide the information that investors require to make that decision. And I think that system has worked well, notwithstanding the mortgage-backed security crisis.

My third point is that most of the companies that are listed on the various exchanges in the United States are listed indirectly via American depository receipts. This is different than having direct IPOs and raising capital from the United States.

In the ADR, a bank like JPMorgan buys shares in Hong Kong and holds them in a trust which people buy the certificates of. It does, perhaps, boost the market value of these companies by providing more demand and allowing 24-hour trading. But on the other hand, it does not really raise new money.

In terms of the companies in the ADRs, and the companies that list in Hong Kong, these are audited based on international financial accounting principles. They're very similar to U.S. GAAP. The information is there. What we've been trying to get are the notes that lay behind these accounts. And I've suggested that will be extremely difficult to get.

Nonetheless, the information about whether to invest or not in these entities is well available. Thank you.

COMMISSIONER LEWIS: Does anybody else have any views as to the decisions of investors to invest in a company and the U.S. policy of wanting to restrict investments by U.S. citizens in a country that has values antithetical to our own?

MR. MCCARTHY: Yes. So, again, I'm not sure what the role of government is in this. But there's an increasingly popular, you know, ESG investing guidelines. Many big investors, I think BlackRock recently said they're not going to invest in any energy companies, or something like that.

So I really don't know why there is not a push by investors from, you know, the grass roots, to put pressure on large asset managers to make this decision.

And again, I don't know what the role for government is, and I don't know why it hasn't happened. But there would seem to be, you know, something that could be done there in terms of just these indices, for instance.

It's very easy for them to have a component with China and a component without China. So, you know, here's the component where you're investing in the company that is engaging in ethnic cleansing, and here's the index where you're not and you, the investor, decide. But it just doesn't seem to ever get framed that way.

COMMISSIONER LEWIS: Well, it seemed to me that you're saying what's the role of government? The role of government is to make sure that government policies and government values are followed by American citizens. And obviously, if Nazi Germany were alive today but we weren't at war with them, obviously we wouldn't want people investing in that kind of a country.

MR. WILDAU: I know we're over time, but I'd love to jump in, because I think this really gets to the heart of why we're all here. And I think it's a great question you've asked. But I think the answer goes back to the point I made earlier about this idea of China, Inc.

I mean, your question, if I recall it, was why should Chinese companies be able to raise any capital on U.S. stock exchanges when China is abusing the Uyghurs.

And I think there's just a big leap inherent in that question that I would question, and that is that any Chinese company that might list in the U.S. is complicit in human rights abuses against the Uyghurs.

And I just don't think that's so. And I think it's really worth looking exactly what the companies are. And I said this earlier. They're not national champion companies, primarily, that are listing in the U.S.

So again, the entity listing process, I mean, in addition to Huawei, as you all probably know, we sanctioned 29 companies and government entities involved in those human rights abuses in Xinjiang and said U.S. companies can't sell to them. And so, yes, let's look at restricting investment to those 29 companies and agencies.

But that's a targeted approach. Because these companies are implicit. It's not saying any Chinese company is a human rights abuser. I just feel that that's too broad a brush, you know, and I'm not sure the Nazi Germany analogy is completely apt in the sense that, you know, we're not at war with China. So, you know, there's --

COMMISSIONER LEWIS: I'm talking about Nazi Germany before we were at war with Germany.

MR. WILDAU: Well, even then I would question the analogy, you know, even pre-war.

COMMISSIONER WESSEL: Mr. McCarthy, for a quick response?

MR. MCCARTHY: This is a whole other topic, but where's the line between public and private companies in China. Because we know even private companies in the United States are having to do the bidding of the Chinese government if they want to do business in China.

So let's not kid ourselves that a Chinese company is not going to, you know, do the bidding of the Chinese government. So I would suggest they're all complicit in some indirect sense. And again, another huge issue is China's pressure on U.S. companies that are clearly, at the very least, altering their language not to upset the Chinese.

COMMISSIONER LEWIS: Isn't it true that the Communist Party has members on the Board of all the companies?

DR. WALTER: Of course it's true. I mean, the Communist Party has re-written the

Articles of Incorporation of all the listed companies in Hong Kong, all the state-owned enterprise companies in Hong Kong, to explicitly include the Party in its functions.

Before, when these were originally listed back in the '90s, in the early part of this century, there was a distinct effort by the Chinese government to separate the Party from these kind of economic functions.

Under the new government that's happened since, I don't know, 2016, 2012, it's gone in the opposite direction. You've seen a reverse in the cycle. That does not mean the cycle won't reverse again.

The second thing I want to just follow-up on, the private sector in China is the key sector in China. If you disallow, I can't believe the government in the U.S. can do this, but if you disallowed investment in private sector companies in China, where funds flow from U.S. banks to private sector companies in China, it'd be a tremendous loss. Thank you.

COMMISSIONER LEWIS: I would just like to make an observation, one final observation. The Chinese companies are doing things that the United States government does not want them to do. And every company that's involved is complicit, because they're part of the system. And I think that we should not be allowing companies to invest in those countries where the values are very different from ours, like them. Excuse me.

COMMISSIONER WESSEL: Thank you. I'll ask the next round of questions. And, Mr. Wildau, I am somewhat familiar with your firm and activities. So I want to ask, as it relates to the information and the approach you're advocating, and you talked about, you know, for 20 years we're seeking X, opening, et cetera, and now we're getting it, we shouldn't pull back.

It seems to me that, and you've also talked about the entities list, et cetera. And, you know, if there's a situation where they're aiding and abetting, clearly specific entities should be potentially subject to some kind of restriction.

It seems to be running head on into your comments about index-based investing. MSCI, and I've gone through and still going through the MSCI list, versus the entities list. And there are a number of entity list companies that are within the MSCI index, and Vanguard Total International Stock Fund, Capital Group American Funds, EuroPacific Growth Fund, other Vanguard.

Then we have, you know, countless institutional, sovereign, and other entities that are sharing, not sharing funds, investing in companies that are engaged in surveillance, human rights deprivation, et cetera, with regard to the Uyghurs, the Huis, and many others.

Where do you draw the line in terms of putting our money where our mouth is, right? You know, the U.S. government has certain policies articulated again through the entities list.

PARTICIPANT: And values.

COMMISSIONER WESSEL: And values. Yet the index is going to guide, you know, pension fund investors for the I Fund, for the TSP. Where do you draw the line in terms of what the U.S. government should be able to do to advance those interests and ideals?

MR. WILDAU: It's a very good question. Hypothetically, if the U.S. government adopted investment restrictions, let's say, mirroring the entity list restrictions, but investment restrictions targeting those same companies, I think you'd very likely see the index company, because as you mentioned, many of these companies are in the index. So that's a problem. But it's not an insurmountable problem. The index could be adjusted. MSCI could do a sort of MSCI emerging markets X entity list.

COMMISSIONER WESSEL: I understand.

MR. WILDAU: That could be done over the weekend. So that's a technical issue that's surmountable. So when the U.S. government acts, the index companies will respond.

COMMISSIONER WESSEL: Is it an appropriate action for Congress to take to say that if, in fact, you're on the entity list, you should not be in an index through which there is U.S. government exposure, taxpayer fund exposure?

MR. WILDAU: So I would just, basically I would say yes. That very well could be. I'd want to see the details of the proposal. But provisionally, that sounds like a good idea.

The only tweak I would make to the suggestion you just laid out is to say instead of legislating or imposing policy on the index companies, why not just impose it directly on the investors?

And then the index companies, because let's say other countries may not have the same laws. These index companies may want to keep serving other countries. But you could just, you'd essentially be forced into creating a parallel index. You don't have to legislate it on the index companies, you just legislate it on the investors, and the indexes will adapt. But broadly, I think I agree with the ---

COMMISSIONER WESSEL: I think, and you probably have more information on this than I do, but the indexes drive billions of dollars of investment. I believe for the MSCI the view is $405 billion over the next two years.

It is impossible for a service member, a military member, who is in the I Fund, to ask that their funds not be in a MSCI sub or X fund, right? So there has to be something that comes out of the indices and not just the investors, correct? The investors don't drive it when they're small retail investors.

MR. WILDAU: Well, I think we, it sounds like you and I are broadly on the same page in terms of the type of approach we would favor. I mean, these are sort of technical problems.

But I would look at in this way which is that, you know, you could create a transition period, say within one year, so you could give people time to react. And it wouldn't be sort of military service members having to start, you know, getting online and changing their investments.

The benefits manager, whoever the managers are for the TSP or these other index funds, they would, during this year of transition period, find a new index to track that excludes these restricted companies.

So I agree, we don't want to burden retail investors with having to sort of look at the entity list and say am I allowed to, obviously, that's a non-starter. But I think, you know, you leave it to the fund managers and the benefit managers. They're choosing between the fund managers to make that transition.

COMMISSIONER WESSEL: And for your clients who are seeking risk assessment, risk analysis, do you provide them? I believe, Commissioner Fiedler asked about the Party affiliation, et cetera. Are you advising them as to those possible investments, their activities with regard to the Uyghurs, with regard to the mil-civ fusion, or anything else? Are you providing that kind of granular analysis?

MR. WILDAU: Yes. But I do want to say, and I should have said this at the outset, my remarks are on my own behalf. I'm not speaking on behalf of Teneo. But yes, I can answer that question.

And we've put out research flagging these issues, flagging the ethical risks around investment in companies that may be complicit in human rights abuses and the policy risks that Congress may act and in a way that forces them to change their investments. And so, yes, you know, these discussions are swirling, and I'm keeping tabs on them and helping my clients keep tabs on them.

COMMISSIONER WESSEL: Okay. Dr. Walter, one question, and I realize I'm over time, but I'm chairing the panel. So with regard to the social credit system, is that having an impact on portfolios or investments?

How do you see that as in any way impacting the risks, the returns, et cetera? Is that something that will be a corrosive tool for the Chinese over time?

DR. WALTER: The issue is how much the use of this idea, this thing has spread. I'm not aware that it's nationally used right now. But it would certainly have an impact on individuals' access to certain types of financing. I have no doubt.

COMMISSIONER WESSEL: Okay, thank you. Chairwoman Cleveland?

CHAIRMAN CLEVELAND: I'm feeling confused. I'm interested, Dr. Walter, in what you said at the beginning about there really are no medium-sized enterprises. There are small and medium enterprises that fall into this category of high risk. They tend to be screened based on who the owner potentially is of the company.

But mostly when we think of medium enterprises in China, we're talking about what you've said was people managed enterprises which used to be SOEs and have now largely been handed off. But they are directly supported by local governments.

I'm curious about the screening process for what is in that second category, not in the people managed enterprises. What does that process look like? How does the change in the loan rate, or this facility that was set up to support small and medium enterprises, affect the availability of credit? Could you just talk a little bit about what that looks like?

And then, Mr. McCarthy, you had, I think, said in rapid fire, so I may have gotten this wrong, that the new prime rate loan, intended to sort of create a rate against the basket of 18 bank loans, really isn't going to have an effect on this market.

So I'm just trying to understand. Because the small and medium enterprises that generate the jobs, that generate revenue, everybody's sort of betting on the rise of that group of entrepreneurs. I'm hearing today that it's not likely to happen.

DR. WALTER: You're asking me?

CHAIRMAN CLEVELAND: To start with, yes, please.

DR. WALTER: Let me talk about the loan prime rate. There are three, like in the U.S., well, there is a SHIBOR interest rate in China like the LIBOR interest rate used to be. But the SHIBOR rate, the Shanghai inter-bank offering rate is for the inter-bank market only.

There is a government bond yield curve like we have government bond yield curves. And theoretically, that should be used to price loans and so on. That yield curve is set, not set by the market but set by the PBOC each day. And it is subject to the influence, the severe influence of the Ministry of Finance which does not want to pay a high coupon.

Therefore, over the last five years when the PBOC liberalized deposit and lending rates, they in fact created two benchmark rates. So they're still administratively set.

Now, as part of the whole discussion with the current administration on opening up the financial markets and so on, the PBOC has removed one of the benchmark rates, the benchmark rate for lending, and calls that a real liberalization rate. Because now it is replaced by this new loan prime rate which is set every month by the bids of 18 banks who, in turn, set their bids based on the PBOC's medium term lending rate.

So in fact, nothing has changed administratively at all. You still have an administered market by the PBOC for banks. That's that comment.

I think your second question was about the SMEs and not the people's enterprises?

CHAIRMAN CLEVELAND: Right. You differentiated in a way that ---

DR. WALTER: There is a big difference. Because the people's enterprises are big. These are the enterprises you see if you take the train up to Nanjing from Shanghai. These are really significant exporters in China.

Small and medium-sized enterprises in China are tiny. And it is extremely difficult to lend to them. The government wants the banks to lend to them, but when they do lend to them, they lose their shorts. Because you cannot, there is no way you can protect your loan.

CHAIRMAN CLEVELAND: Is there data on that in terms of what the consequences of lending to small and medium ---

DR. WALTER: Yes, I think, if you look in the annual reports of the big state banks, you'll find comments about that. For example, I know for a fact that China Construction Bank, and I can talk about this, no problem, we've made a lot of loans in Shandong Province. This is the richest province in China. And we've lost everything.

CHAIRMAN CLEVELAND: Well, that's, I'm grateful for your honesty. When you've extended these loans, what's the size of the company, what's the process for, when you say you've lost everything, to what size enterprise?

DR. WALTER: The enterprises are extremely small. They are not even close to being what you might call a middle-market firm here in the United States which is up to a billion bucks. That's the size of the people's enterprises that I'm trying to talk about.

CHAIRMAN CLEVELAND: Okay.

DR. WALTER: The size of these are much, much smaller than that, maybe tens of millions. The question for me is really, well, why are there not any larger private enterprises, whether people's enterprise or not? Why aren't there any big ones?

And I think my answer is that if you get big you are no longer private. And that's your problem with Huawei. It's also a problem with Alibaba, Tencent, and so on. That's why you see Chairman Jack Ma step down. Why take the political risk?

CHAIRMAN CLEVELAND: Can you ---

DR. WALTER: So people have a lot of small enterprises.

CHAIRMAN CLEVELAND: And then ---

DR. WALTER: If one goes bad, they have others.

CHAIRMAN CLEVELAND: Okay. And the prime ---

MR. MCCARTHY: So just for perspective, the PBOC's order to increase lending to small companies, they defined as companies with a credit line of $10 million RMB or less. So that was at $1.3 million, so they're small.

And again, I would reiterate what Dr. Walter said, that there are two economies in China. There is this very active entrepreneurial capitalism that takes place in this small company economy. But then they are naturally capped by the systemic features.

And from a macro perspective, they're not really that relevant. The debt is all in these large industries. So China's nominal GDP will swing with commodity prices. It has nothing to do with entrepreneurial activity.

And so from a macro perspective, there's different issues here. The things U.S. investors might be invested in will tend to be more in this private sector. And these other macro imbalances are in the state sector, and they're extreme, and they're extremely dangerous.

And I think, from a fundamental economic standpoint, I think we also need to be cognizant of the fact that while private sector China has grown very quickly in the last 20 years, for the last ten, the system has been growing credit at 16 percent annually compounded. So you really would have had to not know what you were doing not to make money in that environment.

So I'm not sure that even this more entrepreneurial, smaller sector where investors are looking to make money is going to hold up when they find themselves in a situation where they can no longer grow credit at these high rates and keep the bubble inflated.

CHAIRMAN CLEVELAND: So aren't the indices, the global, the MSCIs, built around the idea -- I think, Mr. Wildau, you mentioned -- it's size, right? It's -- we can have -- we can quibble about whether there were political judgments or -- but essentially it is the size of the company that gets them into these indices, right?

So, isn't size also about debt? So, the more indebted these companies become, the more likely they are to be in the indices and the more likely there is to be risk.

MR. WILDAU: I mean, we are talking about how a company finances itself. Like, how a company gets big, it could be debt, it could be equity.

I mean, I just -- I would encourage again to think of this in a global context. Like, that observation would be equally true of any ---

CHAIRMAN CLEVELAND: Sure.

MR. WILDAU: -- so --

CHAIRMAN CLEVELAND: I'm not singling out China in this case. I'm just trying to -- we are all struggling because we are not ---

MR. WILDAU: Yes.

CHAIRMAN CLEVELAND: -- we don't invest as much on a day-to-day basis in banking and the financial sector and the beautiful, impossible trinity. I'm just trying to understand.

You get on an index because of the size in a pure sense, no matter where you are from ---

MR. WILDAU: Market cap, yes.

CHAIRMAN CLEVELAND: Right, right.

And given the concerns we have about how debt has bloomed in China and the lack of transparency, and whether it is shadow banking. As we learned this morning, the definition -- the definition varies, but there is still a lot -- a lack of transparency.

Isn't there a fundamental risk that the companies -- setting aside human rights and other issues -- the companies that are likely to be included on these indices are the companies that present the most concern, in terms of the lack of transparency of the means of their financing?

MR. WILDAU: I ---

CHAIRMAN CLEVELAND: Am I over simplifying?

MR. WILDAU: I think you are, because you can't just look at the raw amount of debt. You would look at debt ratios, like debt to equity ratio would be the simplest one.

So, a company could have a lot of debt but also have a lot of equity and therefore it's not financially risky.

So, I mean, I think I would step back, actually, and observe this. Like, I've heard a lot of talk today about this debt -- the debt risk to the Chinese financial system. And it is an issue that I covered as a journalist for such a long time, and I -- and when I did that I was thinking about serving the needs of investors, you know, who were the FT readers, or now, you know, my clients are financial institutions.

For the purposes of this Commission, I question how important this issue of China's debt risk really is. This is a Chinese -- I mean, China's financial system has a lot of problems, but there is only a small slice of those problems and those issues that I think really concern public --

U.S. public policy. Because, I mean, we can talk about will there be a financial crisis in China but, you know, that is their problem. And so ---

CHAIRMAN CLEVELAND: Mr. McCarthy is saying it is not, and that's I think, what we're -- I don't think we're quarreling. We are really trying to understand that you have two very different points.

MR. MCCARTHY: So, so I -- as I wrote in my testimony, five years ago, who cares if China blows up? That was my story. It's -- they finance it themselves, it is their own households that are -- households finance the Bridge to Nowhere -- they are going to take the loss. And each day that goes on, it is becoming more of a systemic problem for us.

So again, you know, Vietnam is a communist country and they control the capital account, right? But they're not going to present a systemic risk to the U.S. economy.

And I would just say, everyone will acknowledge that China is increasingly having to tighten its capital account,that is ipso facto evidence of a disequilibrium in their system. So there is a problem there that is getting bigger and the pressure is building, it's not getting less.

So, are we increasing a systemic vulnerability here by being integrated with them? Now, telling a mutual fund manager not to invest there, I'm not sure if that is the role of government. However, I -- the banks are regulated by the government. The banks are large.

I will tell you by my metric, global banks, not just U.S. but global banks, there is, you know, a trillion dollars of Chinese bank bonds out there. There's another half a trillion dollars of forward foreign exchange contracts from global banks to Chinese banks that no one really talks about, and it's not written about, but I'm fairly sure it's there.

And so, there's a large and growing vulnerability to the U.S. financial system to an economic system that we know is in disequilibrium.

So, I don't know if a banking regulator can handle that. It's a macro issue. But it's an issue that needs to be examined, for sure.

DR. WALTER: It's not only the banks. I mean, the reason China exists today the way it does is because we -- our companies invested there.

If China does -- if China really has the kind of problem that we are talking about, then those companies are going to have a heavy impact.

And ultimately the consumer will have an impact because we -- even though it's a small part of our, of our trade, nonetheless it's an important part of Walmart, so.

CHAIRMAN CLEVELAND: But -- and the reason we're asking these questions is because, whether it's debt or any of these other issues, it's coming at a point where, theoretically, the markets are opening in a way to American enterprises that -- because of the deal that has been signed, in a way that hasn't been open before.

So, we're just trying to understand what the potential risks, as well as opportunities, may be.

Mike.

COMMISSIONER WESSEL: Vice Chairwoman Bartholomew ---

VICE CHAIRMAN BARTHOLOMEW: Thanks very much and thank you to our witnesses. It's a stimulating conversation.

I think some of what you are saying, Mr. Wildau, I'll start with you, it's that same sentence, it's that same bullet point in your testimony, about the financial and ethical risks are qualitatively -- they are not qualitatively different from other emerging countries.

And so, it ties together a bunch of things. One is, set human rights and national security aside, which is what you say. I don't believe we should be doing that, but let's just do that. It's the nature again of kind of the economic -- it's the impact of the economics that I'm questioning that you can say that. I don't mean macroeconomics, I mean the fact that Dr. Walter, you said, when companies get big they get taken over, right? I mean, it's the nature of the private sector.

I think we do a disservice to investors all over when we talk about the Chinese private sector. Because if you're talking about little mom and pops or somebody who is raising pigs, or, you know, somebody who's got a business delivering things, that's one thing, but these other companies that are purportedly private.

So I was just looking about Anbang again and a paragraph in a Reuter's -- you didn't work for Reuter's at any point did you?

MR. WILDAU: I did actually, but please say whatever you want about Anbang.

(Laughter.)

VICE CHAIRMAN BARTHOLOMEW: It's a current -- I just want to quote this paragraph which says, in February, 2018, the Chinese government seized control of the previous high- flying Anbang as part of a campaign to curb financial risk in the aftermath of a massive asset buying spree by a handful of private sector conglomerates.

So, I don't -- I guess I just don't understand how you can say that the risks are the same. Right?

I mean, Mr. McCarthy, you mentioned Vietnam, but people -- I mean, China is just so much bigger, so there is the scope question. But, but when people -- when we say there are private companies in China, unless you are educated about China issues, people are going to presume that that means that they are private companies like we have. And so, I guess I'm really -- I'm troubled.

We have struggled for a long time here to try to understand what private companies are.

MR. WILDAU: Yes. Well, thank you for the question and I really -- I cherish the opportunity to address it, because there is a lot of misunderstanding about this and I would respectfully disagree with Dr. Walter, even though I've learned so much from his work over the years.

To say that there are no private companies in China or that Alibaba is a state-owned company, or that Tencent is a state-owned company, or even that Huawei is a state-owned company -- I would readily concede that the degree of government influence over private companies in China is higher than in many other countries.

But there is still a meaningful distinction between state and private companies. And there is actually still a meaningful distinction between some state companies, which really serve directly as agents of public policy rather than as commercially driven companies, and other state-owned entities where the state-owned shareholders are kind of hands off and are just holding the shares with the company operations are on commercial principles.

So -- but in terms of the financial risk, because I heard you say let's put aside the national security, human rights thing and so, yeah, let's zero in on that.

Even if I concede, as I do, that there is a lot of risk associated with -- you raised Anbang, that a foreign -- that the government can suddenly swoop in and sort of expropriate assets from a -- but again, that's a risk that, you know, I make a living helping my clients assess those risks so that they can make intelligent decisions.

So, you know, it's tough out there in the investment landscape. There is a lot of risk, and so you need people like those of us, you know, at this table to help investors figure that out. But again, I just question whether -- number one, I do think those risks exist in other emerging markets where the U.S. is invested. So I would, you know, reiterate that there is not a qualitative difference. But also, I just question the ability of Congress to do a better job of assessing those in order to protect -- I mean, we live in a free market -- I mean, the whole point is investors have options and they can take on risks.

And so, you know, I mean --- I mean, there was a question about what is risk pricing this morning.

So I mean, with respect to you guys, I mean, are you guys going to be the ones --

CHAIRMAN CLEVELAND: No.

MR. WILDAU: -- to like, do that? I mean, so, are you guys better equipped to protect investors from those risks than they are to protect themselves?

And I'm sorry, I really didn't mean any disrespect by that. But just to say that --what is the mechanism that should be -- that we should rely on to protect from risk? I don't deny that the risks are there, but is the answer to shut off access to that market? We're going to say the risks are too big, so you can't use your own money to invest in these companies.

I think that is probably the wrong approach.

COMMISSIONER TALENT: Carol, can I just jump in for a second?

VICE CHAIRMAN BARTHOLOMEW: Yes.

COMMISSIONER TALENT: And the Chair will let you have the time back.

You know I -- after we -- I was the one who asked about risk pricing this morning and after your answer, you're very ably defending this. I was, in my own mind, trying to think down to the second or third level. And you said -- and you're right, I mean, political leaders are not as good as experts at assessing risk.

But it's -- there's a broader policy question here which goes beyond simply whether somebody will be allowed to try and get a bigger profit at a higher risk, which is the -- and Jeff has referred to it several times, so has Mike -- the social stability that comes with confidence that the broad public has in big institutions, public or private. And that is a judgment for political leaders to make.

In other words, are we willing to sacrifice the opportunity of some investors to get a higher return in order to protect the stability of the system, and the confidence and credibility of the system? I'm not trying to be, you know, snarky in responding to you, because you make a very good point.

MR. WILDAU: I was a little snarky in referring to you and I apologize for it.

(Simultaneous speaking.)

COMMISSIONER TALENT: It goes beyond just the question -- the -- which, in isolation, yes, people should be able to judge risks.

There were -- and that's precisely why I said this morning, it makes a difference, in my opinion, if I was still on this side of the table, whether we're talking about the very sophisticated Goldman Sachs investor who wants to put in five million dollars, and the person who has a stake in the pension fund or something like that. So, thank you for yielding for a minute and I hope you don't penalize her the time.

VICE CHAIRMAN BARTHOLOMEW: I have a --

COMMISSIONER WESSEL: We'd never do that, please.

VICE CHAIRMAN BARTHOLOMEW: Well, I'm going to jump off of that and actually go to Dr. Walter first.

You were shaking your head when Mr. Wildau was talking about private companies, so I'm interested -- but I'd like actually a little bit of a historical perspective from you, which as you've been involved since, essentially since the beginning of China's opening, right? You say in your bio that ---

DR. WALTER: I'm as old as time.

VICE CHAIRMAN BARTHOLOMEW: Yes, for a long time. Some of us have been working on these issues for a long time, so we're right there with you.

But I'm just curious when you started down that path in the 1990s and then when we went through the PNTR debate, is the Chinese economy what you thought that it would be, or did you not think slightly longer term, twenty, thirty, right?

I mean, the promise of the WTO was that China was supposed to become more of a free market capitalist, right? And that hasn't happened. So I'm just curious, as you've watched this unfold, how it differs, or maybe it doesn't.

DR. WALTER: I could write a book.

(Laughter.)

DR. WALTER: But I think the -- when I went there in '79, it was like Pyongyang before it was reconstructed. The place was fully depreciated. Shanghai didn't have any air conditioning anywhere. There were no trains worth mentioning. There were steam engines. And the government was trying to find a way forward after 30 years of being lost.

And so, when I came back again, I was fortunate enough to come back again with some kind of professional skills in 1992 and listed the first company with the New York Stock Exchange from China in Chinese history.

I mean, and then watched the next 20 years. I can tell you, we all -- I'm a little bit different than a typical investment banker, this should be obvious. And I'm not rich --

CHAIRMAN CLEVELAND: It's the sweater vest.

(Laughter.)

DR. WALTER: But the point is that we really -- you could see what people wanted to do.

When you restructure a Chinese SOE, you have a full understanding of the society that surrounds that company. And when you work with the regulators and the senior people in Beijing -- we all had access to these guys --- you have an understanding of what their broader effort was made to be -- was aimed at.

Yes, it may not be wanting to be like the United States a hundred percent, but they wanted their own version of the United States. It wasn't meant to be what it has become now. And it felt so much different in 2008 than it does in ten years later.

VICE CHAIRMAN BARTHOLOMEW: Thank you.

CHAIRMAN CLEVELAND: Can I just comment on Carolyn and Jim's point?

I don't think any of us at this table would suggest that we are going to substitute our judgment for the chairman of Goldman Sachs or Blackstone or anybody. That's not -- God knows, that's not our expertise. But the challenge is -- we met yesterday with the SEC to talk about how they supervise the process and what their standards are for looking at investment funds and the transparency that they do or don't enjoy.

So it's -- our job is to try to understand the entire complexity of rules and regulations and then make recommendations where there are gaps. And so, I appreciate your point.

No, we are not in a position to second guess very smart people in the financial markets, but if there are legislative or regulatory gaps,that is something where we can provide guidance. Sorry, go ahead.

COMMISSIONER WESSEL: Commissioner Fielder.

COMMISSIONER FIELDER: Mr. McCarthy, you actually bothered me a lot in a positive way. You basically are the first person to come before this Commission to say that you are concerned that the Chinese will distort the world economy.

Is that not what you basically said?

MR. MCCARTHY: Yes.

COMMISSIONER FIELDER: Now, to me, the implications of that -- I mean, there is no other qualitative country in the world that could do such a thing -- that I can think of. Not the Russians, okay -- yeah.

Now, when -- what bothers me about it is that part of that distortion will be geopolitical objectives, which then impinges greatly on national security concerns.

You know, there's always been --there's a grey area between national security and national economic security. But when you talk about worldwide economic distortions, you are also talking about serious national security distortions mixed up in that, and that becomes something that should concern ordinary people, because it has effects on ordinary people in a much more historically dramatic way, I think, than anything I can think about.

So, that's something that -- to your points, that's something that this Commission should be thinking about and I'm -- do you know anybody else like you that shares your view of the world distortion?

MR. MCCARTHY: You know -- yes. Just a couple of points on this question of distortion.

So, you know, we've seen it in trade. They dominated ship building. They dominated solar. People will argue we have a subpar solar technology now because of what they did. They have dominated 5G and now, of course, you're bleeding into these national security issues.

And it -- just to look at all of the issues we're talking about here today, let's also look at trade. I look at this phase one trade deal and it's effectively managed trade, so we can either do nothing about China and just take the consequences of them deciding maybe they want to wipe out who knows what industry next, AI or we don't know, steel has been wiped out. We don't know what would be next.

We can try to defend ourselves by saying, well, you're going to distort this, so we're going to force you to buy a hundred billion dollars a year of our goods and we'll have a central plan of our own and direct where that money goes. Or we decouple, and you know, you asked if there are others out there, yes, there is a contingent of thinkers on this issue that think that decoupling is actually where this needs to end up if China is not going to change.

And I would say more broadly, again, this is going to be expensive in one dimension or the other. If you want to look out ten or twenty years, will China have had a financial crisis or not? And I think we hope they will have had one, because if the answer is not, then we have a 30 trillion dollar communist authoritarian economy that's dominating the planet.

So you know, again, this decoupling issue is -- it's fraught, it's emotional and it's going to be super expensive. And I'm not sure it will ever happen for those reasons.

COMMISSIONER FIELDER: Well it's certain to create a huge domestic, political discussion.

Thank you very much.

COMMISSIONER WESSEL: Wait --- did you have a question?

CHAIRMAN CLEVELAND: Yes.

COMMISSIONER WESSEL: Go ahead. Mic.

CHAIRMAN CLEVELAND: I would like to go from that global, universal risk of distortion, and come back to household finance, because there is some debate in the literature and preparing for this hearing as to whether or not household deposits, the households in China, essentially there is an evening-out of -- there is enough self-sufficiency in terms of deposits in the bank to address any potential concerns about debt.

Can you talk about household finance? Because I understand the extension of credit is on the rise, there is a risk associated, it's not huge, it's starting from a low base, but I'm really curious about how families are managing finances and how that factors into the economy.

MR. MCCARTHY: I'd just like to make one macro point about this deposits idea.

So again, as I touched on in my remarks, I think the proper way to think about it is, everything starts with a central plan. We will grow by X percent. We need to build Y quantity of stuff to do that. We need to lend state-owned entities Z amount of RMB that creates deposits that someone has to hold in a system where the governments and the corporates are borrowing to build all this stuff, and by various means they force a current account surplus, the only sector left to finance that is the households.

So while Chinese households have high savings in the form of bank deposits, the other side of the bank balance sheet is the third airport in town that's not making any money, so none of these chickens have yet come home to roost, again, because credit is still growing at double digit rates. And if that ever stops then the households will be -- it will be revealed to them that what they own is effectively an interest in the third airport in town that's not making any money. And that's going to be a bad day for China, a bad day for the Communist Party, which is why they're doing everything they can to prevent that.

MR. WILDAU: I'll just talk briefly about household balance sheets.

So, household debt was, for a long time, quite low in China. It's risen quite rapidly in the last few years. Most of that is mortgage debt, but increasingly we've seen the rise of consumer lending in China, which a few years ago barely existed and now is quite -- more prevalent.

It's not primarily credit cards. Some of it was through peer-to-peer lending platforms. There's also other kinds of household lending, just dedicated household finance companies.

But picking up on the macro picture or maybe I want to just go back to this issue of, you know, what does the macro risk assessment of China -- how does that bear on U.S. public policy? There's no question there are risks. And, as I've said, I've been writing about them for years.

But, to put this in a global context, I mean, we live in an interconnected global economy and that means we are exposed to risks --not just, again, not just from China -- I want to put this in a global context. The domestic economic policy decisions in Europe, in Southeast Asia and everywhere will affect the United States. And so, how do we respond to that?

We could shut ourselves off. We could decouple. We would be insulated from risks, by and large, if we did that. But there would be huge costs to that and I hear -- you know, I respect -- although I disagree with his recommendation, but I really respect Mr. McCarthy for being upfront -- but, yeah, there are actual costs if we take his proposed course of action.

But I -- in my opinion the costs are too high. And so, I guess there's a third -- we can decouple or we can remain interconnected and I guess the third option is we remain interconnected but we try to impose some kind of -- the kinds of regulations that we're discussing here in this hearing, and say we're going to remain interconnected, but we are going to try to hedge the risks, or reduce the risks by putting --- and that's where I really question, you know, whether that's feasible.

Because again, I mean, there is a whole industry of people like Mr. McCarthy, global economists, regional economists, who are answering investors questions, such as, if South Korea goes into a recession, how will that effect the U.S. economy, how will it affect certain companies? If China goes -- has a financial crisis, what will happen? So when I said before that it's their problem, I didn't mean to say that, you know, we shouldn't pay any attention to it, but I guess I meant to say that there should be a -- there is a market-based risk assessment, there's a whole industry devoted -- and again, they make mistakes -- but there's a whole industry devoted to sort of trying to figure out how we can manage those risks, how investors and companies can manage those risks.

I mean, if China had a financial crisis, interestingly, I mean, the most important impact on the U.S. would not be financial. The degree of financial interconnectedness between the U.S. and China, although it's grown a lot, as Mr. McCarthy has pointed out, it's still quite low and it's grown from a very low base.

The Chinese banks are not very internationalized. The degree of U.S. investment into -- because the capital market is only recently opened up, it's grown quickly, U.S. investment, but it's still low. The most important impact would be on the real economy, not on financial markets.

It would be -- global trade would plummet. U.S. companies that export to China would suffer. The, you know, real economic activity would be the main casualty, and so, if we think about that we recognize that actually our capacity to impose risks, controls against that kind of risks are even less than they would be if we were to impose restrictions on financial investments, because finance isn't even really the big problem.

If China's financial system grows up -- blows up, you know, the stock market impact is the least of the U.S.'s problem. It's workers in -- you know, around the country in the U.S. are affected because a big market is shut off. So I just want to put into that context to say that, you know, yes there are risks and let's worry about them, but let's also not throw the baby out with the bathwater in sort of trying to address risks that really we may have to just end up living with.

DR. WALTER: I think that Mr. McCarthy has drawn a beautiful picture of the Chinese government balance sheet. And that, it is true that the retailed -- retail depositor is the one who is the real investor in the Chinese real economy. And they are the one that's going to end up not owning the whole local third airport, but part of it only. If -- that's my first comment.

My second comment really is, I agree with Mr. Wildau in the sense that the global financial and trade system after World War II has been created and managed by the United States government. It is for the benefit of U.S. companies, for the U.S. public, and so on.

It is a responsibility of the government, I believe, to try and come to grips with the new situation in China. But it is my firm belief that this situation cannot last forever. So, whatever the Commission decides is the right thing, right actions to recommend, I would support. But I would hope that you would moderate that by the understanding that the way China is today is not going to be the way it is in ten years. The way China is now is not the way it was ten years ago.

The people who are running the government now are very capable people and they understand everything you're talking about. But they live in a sea of personal connections and a huge bureaucracy and it is very hard to create change.

So, I would hope that the U.S. remains engaged, that the system of valuing risk remains in the hands of people like Mr. McCarthy and Mr. Wildau, and that we try and move forward on a basis of sophisticated national security.

Thank you.

COMMISSIONER WESSEL: There are a lot more questions, but we have run out of time.

We appreciate all of your engagement, the active debate and discussion we've had. Some of those questions we can hopefully put in writing and our staff can work with you. This has been very helpful.

We will recess for ten minutes, and start with the next panel.

(Whereupon, the above-entitled matter went off the record at 2:18 p.m. and resumed at 2:27 p.m.)

PANEL III INTRODUCTION BY CHAIRMAN CLEVELAND

CHAIRMAN CLEVELAND: Well, for the sake of beginning on our final panel, I don't know if we're becoming more combative as the day is wearing on or less, but I'm confident that you all will handle us well.

So, the third panel, the final panel will address the implications of China's capital raising efforts for the United States, as well as the risks and opportunities that this -- I don't know what that sentence says.

We're going to begin with Andy Rothman who will discuss U.S. investor engagement with China and the opportunities afforded by China's growing integration into global financial markets.

Mr. Rothman is an investment strategist at Matthews Asia, where he researches economic and political developments in China to support the firm's China fund. He previously had a 17 year career in the Foreign Service, including as head of the Macroeconomics and Domestic Policy Office at the U.S. Embassy in Beijing.

We'll then hear from Dr. Derek Scissors, resident scholar at AEI, who will outline the risks of investing in Chinese securities both for U.S. investors themselves, and for U.S. foreign policy and national security interests.

Dr. Scissors has had a distinguished research and teaching career focusing on the Chinese and Indian economies, and he has frequently provided the Commission with valuable insight. He is also the author of the Global Investment Tracker, something we rely on frequently, a proprietary data set for monitoring China's outbound investment.

Finally, we will hear from David Loevinger, who will testify on the opening of China's capital markets -- which, he was there at the beginning, I think -- the growing inclusion of Chinese securities and global indices and how best to manage the risks and opportunities these developments create.

Mr. Loevinger is a sovereign analyst and managing director at the Emerging Markets Group at TCW, where he covers the Asia region. He was previously in the U.S. Department of State's Senior Treasury -- sorry, the Department of Treasury's Senior Coordinator for China Affairs, and the U.S.-China Strategic and Economic Dialogue. While at Treasury he also served as Minister Counselor for Financial Affairs at the embassy in Beijing, and, I think, has worked on this issue as long as I have. I think we started out as children in government together.

So, welcome to all of you. If you were here before you know that we ask lots of questions, so try to keep your comments to seven minutes.

Mr. Rothman, we will start with you.

OPENING STATEMENT OF ANDY ROTHMAN, INVESTMENT STRATEGIST, MATTHEWS ASIA

MR. ROTHMAN: Thank you for the opportunity to appear before the Commission today. A lot has happened in U.S.-China relations since I last spoke to the Commission in 2003.

My testimony today is based on over 30 years of writing about the Chinese economy, including more than 20 years working in China, first, as you noted, as a Foreign Service officer and then as a financial services analyst.

The Commission's charter tasks you with providing recommendations for action by the Congress or the President or both, so I would like to focus my remarks today on five recommendations you might consider. Each of these is intended to promote America's long-term interests with respect to China.

My first recommendation is that the Commission ask Congress to undertake a study of what the U.S.-China relationship should look like, ideally, 40 years from now.

Today, in my view, there is too much attention on specific problems, such as protection of intellectual property and 5G. These are important concerns, but they are reactive, not a foundation for a long-term, strategic relationship between the world's most important nations.

Among the starting points for this study would be that China today accounts for about one third of global economic growth. That's a larger share of global growth than from the U.S., Europe, and Japan combined. China is already a strategic power in Asia, and whether we like it or not, China is likely to be governed by the Communist Party for the foreseeable future.

My second recommendation is that Congress should assess the best policy approach for achieving the objectives set out by the first study.

The second study should objectively assess the results of the so-called engagement approach, which characterized the last 40 years of U.S.-China relations. There is, in my view, evidence to support the conclusion that engagement has significantly advanced a broad range of U.S. interests with China.

For example, from the economic perspective, while China has clearly not lived up to all of its WTO commitments, it's done enough to enable GM to sell more cars in China than in the United States last year. Nike has enjoyed 22 consecutive quarters of double-digit revenue growth in China. And China is especially important to the U.S. semiconductor industry, accounting for about one quarter of Intel's global revenue, 44 percent for Texas Instruments, and two thirds for QualComm.

Since China joined the WTO, U.S. exports to that market are up by more than 500 percent, compared to a hundred percent increase to the rest of the world. Prior to the current tariff dispute, China was our largest overseas market for agricultural goods, up by a thousand percent since they joined the WTO.

The structure of the Chinese economy has also changed for the better. When I first worked in China in 1984, there were no private companies at all. Everyone worked for the state. You couldn't even find a privately run restaurant.

Today, 87 percent of urban employment in China is with small, entrepreneurial, privately-owned restaurants, and hopefully during the Q&A we can have a little bit more conversation about what constitutes a private company following on on the earlier conversation.

From the strategic perspective, China has helped us pursue our objectives with Iran and North Korea. This second study should also examine carefully the approach that some describe as decoupling.

The first question should be, is it even possible to decouple from one of the world's largest economies which is highly integrated into global supply chains? What would be the impact in our economy of decoupling with China, which accounts for one third of global economic growth? The study should also consider if decoupling, or taking a generally more confrontational approach to China, will advance American interests. If we are perceived by the Chinese government as wanting to obstruct their efforts to make their country richer and stronger, will Beijing be incentivized to cooperate more with us on Iran and North Korea --- on non-proliferation, on money laundering, on climate change, on Hong Kong, on Xinjiang? What will happen to companies like GM, Intel, Nike and our farmers and ranchers if they get less access to what I call the world's best consumer market?

The study should also consider how our allies and partners around the world might respond if the U.S. adopts a decoupling or confrontational approach. Some of our most important allies including Japan, South Korea, Australia, and Germany conduct more trade with China than they do with the United States.

How many of those nations want to choose sides in a U.S.-China dispute? Are we consulting with those countries as we consider our approach to China? Will companies from those countries take the market share in China abandoned by American firms under a decoupling approach?

Now I share the frustration that many of you have over the limitations of engagement in achieving our objectives with the Chinese government, but I think we need to be clear about what has been accomplished and realistic about whether alternative policies will achieve more or less.

Now, I'd like to turn now to the investment relationship with China. In our recent paper, two of my colleagues at Matthews Asia report that we are seeing positive change among companies trading on the domestic A-share market on a variety of environmental, social and governance, or ESG factors. Overall, we see progress in greater reporting and transparency on key governance issues, providing a market place where majority and minority shareholder interests are increasing aligned.

In my view, engagement by foreign investors in China's equity and bond markets promotes the continued liberalization of those markets. And this impact is far greater than the dollar value of foreign holdings in China, which are only equal to about three percent of the equities market capitalization and the on-shore bond market.

So my third recommendation is that Congress and the administration should not restrict this positive contribution by American investors to China's evolution to a more market- oriented economy. Chinese companies' auditors and regulators do, however, need to play by the same rules as other participants in the U.S. capital markets, which means complying with the Sarbanes-Oxley Act and the related rules promulgated by the Public Company Accounting Oversight Board.

My understanding is that the Chinese regulators have recently undertaken joint audits with their PCAOB counterparts and have proposed a solution to the outstanding audit issue, so my fourth recommendation is that the Commission invite the PCAOB to come and provide an update on this topic.

Finally, my fifth recommendation concerns the draft legislation that you've been discussing earlier today which would prohibit the federal government's Thrift Savings Plan from giving federal employees and retirees the option of investing in securities listed on Chinese exchanges. I've participated in the TSP since its inception when I was a Foreign Service Officer,

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and in my view, this legislation would discriminate unfairly against federal employees, stripping them of the freedom that private sector employees have to choose where to invest.

It's important to note that the TSP has five underlying funds, only one of which invests outside of the United States, the international fund. If participants in the international fund so wish, they can, at no cost, easily transfer their money into one of the four domestic funds. This would protect their freedom of choice.

So, to conclude, I believe continued engagement with China is the path that is most likely to serve our long-term interests. And I think this Commission can play an important role in helping Congress and the administration reach a similar conclusion.

Thank you.

PREPARED STATEMENT OF ANDY ROTHMAN, INVESTMENT STRATEGIST, MATTHEWS ASIA

Testimony of Andy Rothman, Investment Strategist, Matthews Asia

US-China Economic and Security Review Commission

Hearing on China's Quest for Capital

January 23, 2020

Thank you for the opportunity to appear before the Commission today. A lot has happened in US-China relations since I last spoke to the Commission in 2003.

My testimony today is based on over thirty years of writing about the Chinese economy, including more than twenty years working in China, first as a Foreign Service Officer and then as a financial sector analyst.

The Commission's Charter tasks you with providing "recommendations for action by Congress or the President, or both," so I would like to focus my remarks on five recommendations you might consider. Each of these is intended to promote America's long-term interests with respect to China.

My first recommendation is that the Commission ask Congress to undertake a study to determine what the US-China relationship should ideally look like forty years from now.

Today, in my view, there is too much attention on specific problems, such as protection of intellectual property and 5G. These are important concerns, but they are reactive, and not a foundation for a long-term strategic relationship between the world's most important nations.

Among the starting points for this study would be that China today accounts for about one-third of global economic growth, a larger share of global growth than from the US, Europe and Japan combined. China is already a strategic power in Asia. And, whether we like it or not, China is likely to be governed by the Communist Party for foreseeable future.

Last week, President Trump spoke in positive terms about the US relationship with China, saying "it's the best its ever been." Earlier this month, National Security Adviser Robert O'Brien said, ". . . the Chinese don't have a democracy, they don't share our values. . . At the same time, there's a huge opportunity to work with the Chinese." What policies can the US pursue that can deliver on that opportunity to work with the Chinese government?

My second recommendation is that Congress should assess the best policy approach for achieving the objectives set out by the first study. This second study should objectively assess the results of the so-called "engagement" approach which characterized the last forty years of US-China relations.

There is, in my view, evidence to support the conclusion that engagement has significantly advanced a broad range of US interests with China.

From the economic perspective, while China has clearly not lived up to all of its WTO commitments, it has done enough to enable GM to sell more cars in China than in the US last year. Nike has enjoyed 22 consecutive quarters of double-digit revenue growth in China. And China is especially important to the US semiconductor industry, accounting for about one-quarter of Intel's global revenue, 44% for Texas Instruments and two-thirds for Qualcomm.

Since China joined the WTO, US exports to that market are up by more than 500%, compared to a 100% increase to the rest of the world. Prior to the current tariff dispute, China was our largest overseas market for agricultural goods, up by 1,000% since they joined the WTO.

The structure of the Chinese economy has also changed for the better. When I first worked in China, in 1984, there were no private companies - - everyone worked for the state. You couldn't even find a privately-run restaurant. Today, 87% of urban employment is in small, privately-owned, entrepreneurial firms.

From the strategic perspective, China has helped us pursue our objectives with Iran and North Korea. Between 2000 and 2018, China supported 182 of 190 UN Security Council resolutions imposing sanctions on states violating international rules.

I only have time for a brief summary here, but more details are available in my research published on the Matthews Asia website, as well as in recent speeches by former US Trade Representative Robert Zoellick and former Deputy Secretary of State Jim Steinberg, and a 2019 paper by Harvard Professor Alastair Iain Johnston.

This second study should also examine carefully the approach that some describe as "decoupling." The first question should be, is it even possible to decouple from one of the world's largest economies, which is highly integrated into global supply chains? What would be the impact on our economy of decoupling from China, which accounts for one-third of global growth?

The study should consider if decoupling, or taking a generally more confrontational approach to China, will advance American interests. If we are perceived by the Chinese government as wanting to obstruct their efforts to make their country richer and stronger, will Beijing be incentivized to cooperate more with us on Iran and North Korea, on non-proliferation, money laundering and climate change? On Hong Kong and Xinjiang?

What will happen to companies like GM, Nike and Intel, as well as to American farmers and ranchers, if they get much less access to what I call the world's best consumer market?

The study should also consider how our allies and partners around the world might respond if the US adopts a decoupling or confrontational approach. Some of our most important allies, including Japan, South Korea, Australia and Germany, conduct more trade with China than with the US. How many of these nations want to choose sides in a US-China dispute? Are we consulting with those nations as we consider our approach to China? Will companies from those nations take the market share in China abandoned by American firms under decoupling?

I share the frustration many of you have over the limitations of engagement in achieving our objectives with the Chinese government. But we need to be clear about what has been accomplished, and realistic about whether alternative policies will achieve more, or less.

I would now like to turn to the investment relationship with China.

In a recent paper, two of my colleagues at Matthews Asia report that we are seeing positive change among companies trading on the domestic A-share market on a variety of environmental, social and governance (ESG) factors, especially around state ownership, shareholder friendliness, ownership and control structures, disclosure, board composition, environmental stewardship and corporate conduct. Overall, we see progress in greater reporting and transparency on key governance issues, providing a marketplace where majority and minority shareholder interests are increasingly aligned.

In my view, engagement by foreign investors in China's equity and bond markets promotes the continued liberalization of those markets. For example, Chinese regulators are actively seeking foreign investors' input regarding regulations on defaults and restructuring. This impact is far greater than the dollar value of foreign holdings in China, which are only equal to about 3% of the equities market capitalization and the on-shore bond market.

Despite a similarly small market share, foreign banks have also contributed to the modernization of China's banking sector, which contributes to global financial stability. This topic is discussed in more detail by James Stent in his book, "China's Banking Transformation."

My third recommendation is that Congress and the administration should not restrict this positive contribution by American investors to China's evolution to a more market-oriented economy.

Chinese companies, auditors and regulators do, however, need to play by the same rules as other participants in US capital markets, which means complying with The Sarbanes-Oxley Act and the related rules promulgated by the Public Company Accounting Oversight Board. My understanding is that China's regulators have recently undertaken joint audits with their PCAOB counterparts and have proposed a solution to the outstanding audit issue. My fourth recommendation is that the Commission invite the PCAOB to provide an update on this topic.

Finally, my fifth recommendation concerns draft legislation which would prohibit the Federal Government's Thrift Savings Plan from giving federal employees and retirees the option of investing in securities listed on Chinese exchanges. I have participated in the TSP since its inception, when I was a Foreign Service Officer, and in my view, this legislation would discriminate unfairly against federal employees, stripping them of the freedom that private sector employees would continue to have, to choose where to invest.

It is important to note that the TSP has five underlying funds, only one of which invests outside of the US. If participants in the international fund so wish, they can, at no cost, easily transfer their money into the four domestic funds. This would protect their freedom of choice.

To conclude, I believe continued engagement with China is the path that is most likely to serve America's long-term interests. This Commission can play an important role in helping Congress and the President reach a similar conclusion.

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OPENING STATEMENT OF DEREK SCISSORS, RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE

CHAIRMAN CLEVELAND: Dr. Scissors?

DR. SCISSORS: Glad to see everybody here at the Commission again. Andy just said he wanted to take a 40-year view. In the last few years I think my attention span has shrunk to 40 minutes.

(Laughter.)

DR. SCISSORS: But fortunately I only have to speak for seven.

The main point I want to make is that China has set itself up to need American capital and other foreign capital for a long time, and I'll get into detail on that because I want to drive that point home.

Right now most American money, notwithstanding the attention paid to the Thrift Board and Chinese firms listed here actually goes to China through trade as an import payment. People tend to overlook it because they think of it as trade instead of investment, but the money is in trade. Portfolio investment could spike.

The most important action, I'll start off being generic, if we're going to take sanctions against China for whatever reason, without taking a position on that, whether it's human rights, technology, retaliation against Chinese economic action, rule of law, whatever it is, investment has to be part of those sanctions. Maybe we shouldn't take very many; maybe we shouldn't take any, but if you take a sanction, you don't allow American money then to go to the sanctioned entity and support it while you're trying to punish it for the other action.

So that's a generic recommendation. It doesn't take a position on what the U.S. should do, but how we should do it. Sanctions should extend to investment when we think they are warranted.

Now let me spend most of my time on the state of Chinese finance, and I'll note in advance that Andy and I are probably going to sharply disagree on this.

There's a lot of talk this year, including from the Chinese. They have not talked about GDP per capita very much, but now it's hitting $10,000. That's an accounting result. Who the hell cares? The Chinese report their own personal income as $4,400 per year. Consistent -- there's a consistent roughly 55 percent gap between Chinese GDP per capita and personal income because China’s economy is structured to reward firms instead of households. The comparable U.S. figure is about $50,000 a year higher. What the Chinese call upper income in their latest documents, this is just me repeating them, is $10,900. So this is not an on-the-way-to-be-wealthy economy.

The main reason for low wealth is that the state owns all rural land, and you can imagine what rural Americans would be like if they couldn't own land, what their incomes would be like. Income in China reported by the Chinese is 2,300 in rural -- is $2,300 per year. That's not middle income. It's just poor. There's no sign of the Chinese changing their priorities.

Median Chinese age may surpass American age this year. We have some problems with the data. The U.N. says in a generation China will be older than the U.S. is in three generations. China's fertility rate is falling much, much more rapidly in terms of its income level than the Japanese did, meaning that the Chinese at the same income level have a much lower fertility rate or the same fertility rate have a much lower income level. So there's a lot of burden on trying to make this economy wealthier that's shifted to the capital stock because it's not going to be done by labor.

The Chinese have --

(Phone ringing.)

Somebody's already objecting to my testimony. The Chinese have in the last 11 years wildly inflated their money stock with less and less return. It used to be a little smaller than the United States at the end of 2008. Now it's bigger than the United States, Britain, Japan combined, and the gap continues to spread. There are people who will tell you that money stock is not a good measure. I use it because it's a Chinese figure rather than a foreign figure.

If you want to use a foreign figure, Chinese outstanding credit as a share of GDP at the end of 2008 was 143 percent; ours was 240. Middle of last year ours was 250. Still too high, but only went up a little. Theirs went up from 143 to 262. So we can use a foreign figure to show leveraging. We can use a domestic figure to show leveraging. They're leveraging like crazy, and they're getting less growth out of it.

That growth,that credit expansion started in households. It spread to -- started in firms, spread to households and the government.

So you are all to be commended because China is going to want to have American capital for many years to come because of their own mistakes. And by the way, that has nothing to do with the U.S.-China trade conflict. These are longstanding fundamental Chinese errors independent of tariffs and whatever we may have done to them.

With regard to the specific relationship, as I said, the specific financial relationship, I don't want people to overlook the trade balance. Thea and I have talked about this over the years. I don't agree with the trade balance being a good representation of the economic relationship between the two, but the fact is that amount of money is so large it actually affects Chinese money stock.

Direct investment from the U.S. may convey a lot of technology and may be very important. It's not important to China financially. U.S. trade is important to China financially. So when you're considering the financial relationship, you have to think about the payments made in return for Chinese imports.

Portfolio investment is the dynamic area, as you are aware. It could rise due to Chinese inclusion in global funds. And so that's something to watch. It hasn't been really that important until now. It has a fair amount of potential. I don't think direct investment has that much potential in terms of the quantity of money. Whether it has potential on the technology side is yet to be determined.

So recommendations. And the first thing is, and I tipped this off, we're doing a lousy job determining what our priorities are. Okay. So Congress, as you all well know, has become more confrontational with regard to China. All right? The Chinese in my opinion are a much more brutal regime than they were 20 years ago. So do we emphasize human rights?

They're also more advanced technologically with a more advanced way of stealing technology. Do we emphasize technology? They're a greater national security threat with rising military capabilities that of course come with their development. Do we emphasize that?

We need to have some sense of priorities. We can't be casting about and using sanctions in response to everything. They don't work. They cause harm to the United States. So that's point number one, and there's -- I have my own set of priorities, you have your set of priorities, but that's the number one goal for the United States. We need to be focused in our Chinese strategy. We cannot get everything we want.

That leads to my -- the point I tipped off with. Whenever we apply sanctions, let's say it's on technology because I'm very upset about how weak our export controls are and how slow

Commerce is being in strengthening them, there has to be an investment component. You can't say, all right, we are separating the U.S. and China in these certain key areas of advanced technology in terms of direct contact with Chinese businesses, but American money can still flow to China and build up those industries in China. That doesn't make the slightest bit of sense.

So whenever we consider tightening export controls or any other action, there must be an investment component to it. And I'm not advocating for any specific action. I'm not happy with export controls, but the point is that we make our actions comprehensive rather than partial.

An action I've advocated for for a long time is Chinese firms which benefit from IP theft break American law, they harm the economy, and they potentially harm national security. Those firms should see comprehensive U.S. punishment including financial punishment. All right? We should not be doing investment business with firms which break American law and benefit from stealing IP.

And finally, I'll close with one of the live issues, and I think I agree with Andy. I don't want to put words in his mouth. If you can't obey American law, you don't -- you shouldn't be listed here as a company. You can list somewhere else. That's fine. We're not going after you and punishing you everywhere and saying everybody has to obey American law, but you have to obey American law to be listed here. This is the no-brainer of the century. All these things that we say about, oh, it's tough to trade off human rights and technology. Those are hard; that one's easy.

PREPARED STATEMENT OF DEREK SCISSORS, RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE

Hearing of the US China Economic and Security Review Commission

"China's Quest for Capital: Motivations, Methods, and Implications"

January 23, 2020

More Important than Financial Gain:

Protecting the Rule of Law and Advanced Technology

by Derek Scissors

The starting point of assessing Sino-American financial ties is that Beijing has wasted a huge amount of money in the past decade and seeks foreign capital to meet still-ambitious development goals. US portfolio and, especially, direct investment flows to China are not especially large but Chinese need and American corporate interest could cause them to jump.

This could benefit the US, but only if multiple important changes are made quickly. In particular, the rule of law must in all ways prevail over financial interest and present and future American technology restrictions should include restricting investment that could support Chinese development in targeted sectors. Combining those: Chinese entities involved in advanced technology which have broken the law should be entirely cut off from US capital.

China Needs Money

The Communist Party seeks to minimize foreign influence over the People's Republic of China (PRC). It follows that the Party does not allow American influence in the economy unless it needs something. For a full generation, it needed to generate employment and did so in part by selling to American consumers. With the Chinese labor force set to shrink for a least a generation,[1] employment is less of a concern. In the second half of the reform era, of course, the PRC has also chased American technology, legally and illegally.

And Beijing at all times has wanted American (and other foreign) money. This was obvious in the early years, when the PRC's foreign exchange reserves were inadequate to pay for desired imports. Casual observers see China as now wealthy enough to no longer care much about American capital or at least rich in foreign reserves. The former has never been true and the latter is no longer true.

The minor one: the PRC's total foreign exchange in the banking system fell over $1.2 trillion from 2014 through 2016, then stopped being regularly reported. Official reserves – a subset of total foreign exchange -- peaked in mid-2014 and fell $900 billion from there until the end of 2019.[2] While still huge at $3.1 trillion, reserves finance annual imports of about $2 trillion as well as China's global spending in hard currency, such as on the Belt and Road Initiative. Beijing does not yet need a foreign exchange boost; it does now need foreign exchange stability.

The domestic financial situation is considerably worse. The economy is large but far from rich. There will be talk this year of China's GDP *per capita* hitting $10,000 but that is an accounting result, not money people can actually spend. Beijing's reports 2019 personal income *per capita* at $4400. The most comparable American figure is $50,000 larger. In mid-2019, Credit Suisse put China's average wealth per adult at less than one-seventh that of the US - $370,000 lower.[3] The ratio shrunk over the previous decade but the absolute size of the gap widened.

[1] http://www.china.org.cn/china/2019-01/25/content_74408194.htm
[2] China Monthly Statistics, Volumes 277-301, National Bureau of Statistics, People's Republic of China and https://www.safe.gov.cn/en/2018/0517/1433.html
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That the PRC badly needs to keep growing should not be news. Prospects are mediocre and deteriorating. Beijing does not permit competition with state-owned enterprises in two dozen major sectors, unavoidably limiting innovation. The top reason for low wealth is the state owns all rural land, [4] robbing nearly 600 million people of their most valuable asset. As is well known, China is aging. Another 2020 event may be median Chinese age surpassing American. By 2045, the PRC is projected to be older than the US will be by the end of the century.[5]

This puts the burden of growth on the country's capital stock, a burden it has not met. There are constant, breathless reports about how much China is spending across many industries and even in other countries. It has not altered the (extremely) steady deceleration in official GDP growth over the past decade.[6] The reason for this: Beijing has wasted enormous sums of money, as shown in indicators compiled by the central government and independently.

Following international practice, China has published broad money M2 for decades. At the end of 2008, American M2 was almost $1 trillion larger than Chinese. At the end of 2019, it was almost $12 trillion smaller, despite American GDP still being about $7 trillion larger. There are frequent comments that the PRC faces liquidity squeezes in one place or another.[7] This is only sensible if huge amounts of money stock are basically dead.

A typical defense of the PRC's excessive money supply is its financial system differs from that of the US and EU and has diverged rather than converged, as some hoped. Independently organized data from the Bank of International Settlements show the situation is plainly worse than that.[8] At the end of 2008, China's outstanding credit as a percentage of GDP was 143 percent. America's was 240 percent and India's was 129 percent. In the middle of 2019 (latest), America's was 250 percent, India's was 124 percent, and China's was 262 percent.

India could stand a bit more credit growth and the US less. The explosion in Chinese credit is unmatched among major economies in the past 20 years. It began with corporate credit but since 2012 has latched onto government and households. Everyone has borrowed faster than GDP grew, even net of repayment. China still needs rapid growth but is aging and refuses key reforms. It has borrowed and spent but became worried about foreign exchange stability and, more so, domestic debt and in late 2017 turned to American and other external sources of capital.[9]

Sino-American Financial Relations

The PRC receives American capital in multiple channels. The largest is often overlooked. From 2010 through 2019, the US merchandise trade deficit with the PRC reached $3.4 trillion (services

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[4] https://www.aei.org/research-products/report/making-new-normal-meaningful/ and https://www.nytimes.com/2019/09/26/world/asia/china-land-rights-farming.html

[5] https://www.economist.com/finance-and-economics/2019/10/31/chinas-median-age-will-soon-overtake-americas and https://population.un.org/wpp/DataQuery/

[6] http://www.stats.gov.cn/tjsj/ndsj/2018/indexeh.htm

[7] https://fred.stlouisfed.org/tags/series?t=m2 and https://www.wsj.com/articles/chinese-regulators-try-to-calm-fears-of-a-funding-squeeze-11560770645

[8] https://www.bis.org/statistics/totcredit.htm?m=6%7C380%7C669

[9] https://www.ey.com/Publication/vwLUAssets/ey-china-further-opens-up-financial-sector/$FILE/ey-china-further-opens-up-financial-sector.pdf

were in surplus).[10] Until reserves fell in 2014, this was a luxury. From then, the goods surplus with the US has been necessary to avoid balance of payments instability the Party has feared since the Asian crisis. The magnitude of American payments is so large as to matter even to China's huge money stock. Without goods trade with the US, Chinese finance would involuntarily look very different.

Tariffs trimmed the 2019 bilateral merchandise imbalance to about $350 billion and either the Chinese purchases promised in the "phase 1" trade deal or, in their absence, more tariffs will likely cut into it further in 2020. But $300 billion in 2020 is about as much a drop as can be expected. The trade surplus with the US will be less important to Chinese finance this decade than the previous one, but it will still have sizable impact.

The conventional way American money heads to the PRC is through direct investment. The amounts here are not impressive. At the start of 2010, the US direct investment position in China and Hong Kong combined was $105 billion, by 2019 it was approximately $210 billion.[11] The doubling is not trivial but Singapore – among other things a route to Indonesia and Malaysia -- saw more growth and a higher total by 2019.

The stock of American direct investment abroad exceeds $6 trillion, so it is certainly possible investment in the PRC could soar. But there was no sign of this in 2019 and, with China's economy continuing to slow, the country may be turning into a sector play in health care and the environment, for instance, rather than a truly national draw. American direct investment may be vital to China technologically but it is not financially. (Note: sales of American affiliates in the PRC are much larger than direct investment but do not qualify as a source of capital.)

The core series for portfolio investment is Treasury's US holdings of foreign securities. American portfolio investment in China and Hong Kong is noticeable, but still a small fish in the portfolio flow sea.[12] At the start of 2010, it stood at $193 billion; in September 2019 (latest), it was $366 billion. This easily outweighs Singapore but is barely more than one-third of the total for Japan, much less Canada and western Europe.

The trend should be for more US investment, due to the market opening in late 2017. However, after a rush for the first few months then, interest has been restrained. American holdings are dominated by common stock and it remains the case that the PRC's stock market is deeply flawed, featuring dubious accounting.[13] American portfolio investment in India and Taiwan grew faster last decade – China matters to US portfolio investment, but not much.

Two facets of holding Chinese stock have received outsized attention. There will be an increase in passive investment by perhaps unwitting Americans due to global funds assigning the PRC higher weights.[14] That process has begun but its full weight will only be evident in 2020. There

[10] https://www.census.gov/foreign-trade/balance/c5700.html
[11] https://www.bea.gov/international/di1usdbal
[12] https://www.treasury.gov/resource-center/data-chart-center/tic/Pages/ticsec2.aspx and https://www.treasury.gov/resource-center/data-chart-center/tic/Pages/shcreports.aspx
[13] https://www.ft.com/content/6ae569ee-b336-11e9-8cb2-799a3a8cf37b
[14] https://www.msci.com/documents/10199/238444/China_A_Further_Weight_Increase_PR_Eng.pdf/43f3ee8b-5182-68d4-a758-2968b4206e54

are also disingenuous claims that delisting Chinese firms could "destroy over $1 trillion in market capitalization" and the like. For Chinese enterprises, market capitalization is many times the value of outstanding shares. The true loss would be in active trading of companies with few peers, which is much closer to $10 billion than $1 trillion.

The New Policy Menu

At the level of transactions worth tens or hundreds of billions of dollars – the level that matters to Beijing – Sino-American financial relations are fairly simple. US policy choices are more complicated, with now a wide range of motives. American financial gain is of course the starting point, but that has been discussed at length for 25 years. The recent focus is on reasons to curb rather than expand financial ties, including protecting the rule of law, human rights, advanced technology and national security, and retaliating against predatory economic practices.

For each of the non-financial motives, there are multiple possible goals: deterring bad behavior, outright punishment, a "level playing field", or decoupling. Possible actions connect to those: provide public information on the Chinese entity, impose a one-time penalty, indefinitely halt one or more types of US business transactions, or seek to bankrupt the entity. These should vary with the extent of the harm caused and whether a first-time or repeat offense.

While this is messy, focusing on capital flows helps clarify. The most important aspect of merchandise import payments are their size - the most money but also the most Americans affected. Inhibiting trade on a large scale should be done only in response to large-scale harm, such as military aggression or intense rights violations. Narrower actions could be used in concert with investment or other restrictions, to better deny American money to targeted entities.

The most important aspect of direct investment is that it can convey technology, including dual-use technology. Reform of the Committee on Foreign Investment in the United States and recent expansion of the Department of Commerce's Entity List both nominally tighten control over technology. But neither directly address American money headed to the PRC, which can either embody technology transfer itself or financially support China's technology development.

Finally, the most important aspect of portfolio investment is its multiple channels – listings here or in the PRC, through retail funds, or by major financials. It has not yet become a political issue like trade or a national security issue like direct investment but portfolio investment can subtly undermine other actions, when American funds in some way reach and support Chinese companies that have been hit by tariffs or other sanctions.

Current Recommendations

Different motives, for example simply maximizing yields versus technology control, make for legitimate differences about whether and what steps should be taken with regard to American capital supporting PRC activities. Here are four overdue actions and one longer-term proposal, all aimed at reducing the emphasis on pure financial gain:

1) The provision of information is a core government function, and vital for sound investment decisions. Chinese entities raising capital in the US which refuse to meet American disclosure requirements threaten investors and weaken the rule of law. They should be penalized and warned of removal, then removed if necessary. It should not be legitimate for any group to argue that any Chinese firms should operate in the US without obeying the law.

2) Concerns about unwitting investment in PRC entities should also be addressed with information. The Department of State should, for this and other reasons, compile a list of Chinese entities which are proven to have broken US law or helped suppress human rights. American financial brokers should be required to attach a short, general warning to all relevant funds that may include these firms, identifying the State Department site.

3) US actions aimed at controlling technology for national security purposes should include restrictions on direct and portfolio investment. It is not sensible to decide to block technology exports to Chinese users or block Chinese acquisitions of technology firms, yet permit American capital to freely support the PRC's development in the same sectors. Beijing just agreed not to require technology transfer, so of course there will be no retaliation.[15]

4) Chinese entities which have benefited from outright theft of intellectual property are breaking US law and harming the American economy. If the technology is dual-use, they are also threatening national security. Confirmed repeat offenders of this type pose serious risks and the US should seek to put them out of business, if possible. Any exports to the US and all types of American investment should be banned, backed by criminal penalties.

5) The first four steps should be taken quickly. In the longer term, the determination of how to respond to intense Chinese subsidies and continuing industrial policy should include evaluating responsive investment and trade restrictions. When China is directing funds on a non-market basis to companies and sectors, potentially warping the global economy, the US should not ease the financial burden of doing so by providing our capital.

Finally, policy-makers should be aware that in cases of sustained and serious damaging acts by Chinese firms, the true perpetrator is probably the state. And the state can juggle the firms it is using at will. In these cases, American sanctions should be aimed more at the general behavior and less at the specific entity involved at the moment.

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15 https://ustr.gov/sites/default/files/files/agreements/phase%20one%20agreement/Economic_And_Trade_Agreement_Between_The_United_States_And_China_Text.pdf

OPENING STATEMENT OF DAVID LOEVINGER, MANAGING DIRECTOR, EMERGING MARKETS GROUP, TCW

CHAIRMAN CLEVELAND: Mr. Loevinger?

MR. LOEVINGER: All right. Chairman Cleveland, Commissioner Wessel, other Commission members, thank you for giving me the opportunity to testify. Responding to China's rise is among the most important policy challenges of the 21st century. There are significant threats, but there are also opportunities.

A bit about TCW. We manage over $200 billion in assets for thousands of retail investors and large pension funds and other institutional investors. We have long invested in stocks and bonds of Chinese companies issued offshore outside of China, and more recently been investing in Chinese markets on shore.

As Chairman Cleveland mentioned, before going to TCW I had the honor of working for more than two decades for five U.S. presidents as a non-partisan civil servant, both Republican and Democrat. I had the honor of working with several of you on the Commission, and I also had the honor of learning a lot from the other two gentlemen sitting next to me, though not surprisingly listening to Andy and Derek, I kind of feel like you should have put me in the middle.

(Laughter.)

MR. LOEVINGER: Foreign investment in China's financial markets has been increasing rapidly, and there's the potential for it to increase a lot more. Why is China opening up its markets? I think a big reason is to adjust to dramatic changes in China's balance of payments. When China joined the WTO in the earlier part of this century, there were massive twin current and financial surpluses with a wall of money going into China. Those days are long gone. They're not coming back.

After peaking at over 10 percent of GDP in 2007, China's current account has fallen to roughly around one percent last year. I think a big driver of that is what Derek mentioned, which is China's aging population, which is drawing down its household and public savings. Chinese investors, not surprisingly, are also investing more abroad as they seek to diversify their portfolios.

I think another important driver is Chinese regulators' desire to broaden, diversify, and increase the sophistication of their own investor base which remains too heavily dependent on retail investors. If they bring more sophisticated institutional investors, they believe it will improve price discovery and market discipline in their own markets.

Allowing foreign financial services firms to enter into China and expand their operations as recently codified in the phase one trade deal will further catalyze portfolio flows into China as investors like TCW, like Matthews, are more likely to enter markets if they can go in with their longstanding financial services partners.

But of all the actions China has taken to open its capital markets, perhaps the most impactful one was meeting the requirements for inclusion in the major equity and fixed income indices. Don't underestimate the power of indices. They are an increasingly powerful allocator of global capital.

Decisions to include countries like China in indices aren't made by index providers alone, but in consultation with asset owners and managers like Matthews and TCW. The bottom line is we won't use an index that we can't effectively or efficiently track. That means we need to be able to enter and exit markets, we need to be able to set up accounts, we need to bring funds in and out, we need to be able to buy and sell foreign currency, and -- whatever the constituent bond or stock in the index -- and we need to all -- to do this without undue delay or cost.

But just because a country is in an index doesn't mean we're necessarily going to invest in it. I'm sure like Matthews we work with our clients to align our investment strategies with their financial objectives and values. This includes choosing an index. If an investor doesn't want to invest in China, there are lots of indices that exclude it.

Why are we and other investors investing in China? It's attractive for many reasons including the size, volatility, adjusted yields, diversification, and liquidity, but there are a lot of risks including poor policy and data transparency, the lack of free expression and a free media, rising debt and defaults, and the threat of financial sanctions as tensions over technology, foreign policy, and human rights are set to worsen even with the phase one deal.

Thinking about proposals to restrict investment, U.S. investment in China, it's important to consider how effective these measures would be. They're most effective if the target of the sanctions is dependent on U.S. financing. The bottom line is China and most Chinese companies aren't. Chinese domestic savings, as was discussed in the last panel, are more than enough to finance most Chinese domestic investment. As Andy said, foreign investment flows into Chinese markets are relatively small.

And if we go it alone, we're even going to have a smaller impact. The difference between technology sanctions and financial sanctions is a dollar of financing is the ultimate commodity. It doesn't matter to the issuer whether they get a dollar by listing in New York or London or Singapore or Hong Kong, and they don't care where that dollar comes from. A dollar is a dollar is a dollar.

To finish up quickly on proposals that the Commission is considering, I think we have violent agreement on the panel on Sarbanes-Oxley. Gosh, it was 17 years ago. I'm happy to hear that we're making progress, but I think the bottom line is if we can't reach an agreement between our regulators and their regulators, it's time to put up or shut up. And Chinese firms need to abide by the same rules as other firms. We don't need a new law. We need the existing law to be enforced.

For other proposals to have any meaningful impact, they need to be done with other major financial centers. If you just restrict U.S. investors, it's just going to push business offshore and won't meaningfully limit Chinese financing. I would keep index decisions based on market access.

It's up to Congress if they want to restrict TSP investment in Chinese stocks. Just understand that pulling back a couple billion dollars in U.S. investment isn't going to make a lick of difference to China. There will be lots of other investors that will be willing to make the same investment. If you want to push particular stocks or bonds out of indices, the best way to do it is through targeted multilateral sanctions on specific bad actors.

And then I will just end it here by saying it's important to think long-term about how we respond to China's rise. Having the world's primary reserve currency, having the world's most developed capital markets is an enormous competitive advantage for the U.S. It allows our businesses to do business all over the world in our currency. It allows them to raise large amounts of money at low cost.

Our currency and our financial system is far superior to China's that remains dominated by massive state-owned banks, but we shouldn't be complacent about what a former French prime minister called an exorbitant privilege. We shouldn't think that this is our right and always our privilege. If we overreach by weaponizing access to the U.S. dollar or the U.S. financial markets, I guarantee other countries, not just China, will set up alternative centers of finance and alternative mechanisms for clearing international transactions. Thank you.

PREPARED STATEMENT OF DAVID LOEVINGER, MANAGING DIRECTOR, EMERGING MARKETS GROUP, TCW

Testimony before the U.S./China Economic and Security Review Commission

China's Quest for Capital: Motivations, Methods, and Implications

David Loevinger
Managing Director, TCW
January 23, 2020

Chairman Cleveland, Commissioner Wessel, other Commission members and staff. Thank you for the opportunity to testify on the implications of rising capital flows to China. Responding to China's rise is among the most important policy challenges of the 21st century. There are significant threats, but also opportunities. How we respond will have a material impact on our future prosperity and security. By helping to inform Congress, policy makers, and the public, the Commission continues to play a vital role.

Founded in 1971, TCW manages over $200 billion in assets for thousands of retail investors, and many of the largest corporate and public pension plans, financial institutions, endowments and foundations in the U.S. Our clients also include a number of foreign investors, including central banks and sovereign wealth funds. We employ over 600 staff in offices around the U.S. and the world. We have invested in Chinese stocks and bonds listed in markets outside of China for many years and have more recently invested in China's onshore markets. The views expressed in this testimony are strictly my own and should not be construed as reflecting TCW's.

Before coming to TCW, I had the honor of working as a non-partisan civil servant for five U.S. Presidents, Republican and Democrat, over more than two decades as well as working with you, Chairman Cleveland. This included working with Treasury Secretary Paulson to establish the U.S./China Strategic Economic Dialogue and leading Treasury's efforts in the Strategic & Economic Dialogue under Secretary Geithner.

Since then China has turned more authoritarian, with the Party's hand extending more into the affairs of private businesses. Still, I believe many of the principles that guided our China strategy remain relevant today. These include:

- While the U.S./China relationship has areas of disagreement and outright conflict it is not all zero-sum. We still share some common goals.
- As much as some in the U.S. might like, China's not going away. Addressing global challenges and advancing our interests will require finding a way to cooperate with China.
- Change in China, for better or worse, is driven by domestic politics. Don't overestimate the impact of external pressure. We should make clear our concerns over Chinese policies and bad actors. But we should not turn our fight into one against the Chinese people. Like elsewhere, Chinese leaders are boxed in by public opinion. And there are still many Chinese who share our concerns.

China's Capital Markets are Opening Up to Foreign Investment

While foreigners have bought stocks and bonds of Chinese entities for many years, China has recently taken steps to open its capital markets to foreign investors. And as a result, foreign portfolio investment has increased rapidly. In the last six years, foreign investment in in stocks issued by Chinese companies, both on and offshore, has risen more than 60% to $747 billion (as of the end of September 2019), and investment in bonds issued by Chinese entities is up over six times during the same period, to $474 billion, but still low relative to many other major markets.

Why is China doing this? One reason is to offset dramatic changes in China's balance of payments. The years when a wall of money was gushing into China from massive "twin" current and financial account surpluses are long gone and aren't coming back. After peaking at almost 10% of GDP in 2007, China's current account surplus fell to be almost balanced in 2018 before rising slightly last year. There are many reasons for this, but an important one is China's aging population, which is drawing down household and public savings. China's accession to the World Trade Organization in 2001 unleashed a wave of inward foreign direct investment (FDI). Relative to its economy, net FDI flows are now much smaller, with incoming FDI declining and outward direct investment rising. Outward flows of portfolio investment are rising as Chinese investors seek to diversify their portfolios and reduce their underweight allocations to foreign assets. And capital flight has increased whether to evade capital controls, taxation, anti-corruption campaigns, or the rising role of the Party in private business.

Another important driver is regulators' desire to broaden, diversify, and increase the sophistication of the investor base, which remains heavily dependent on volatile retail flows, both to improve price discovery and strengthen market discipline.

Chinese officials took a number of important steps to open their markets including creating a range of channels to get through China's capital controls. Perhaps the most important was the establishment of stock and bond "connects," giving foreigners access to onshore markets through accounts set up in Hong Kong and governed by Hong Kong law.

Allowing foreign financial services firms to enter China and expand their operations, as recently codified in the Phase 1 trade deal, will further catalyze portfolio investment, though it remains to be seen whether Chinese regulators, even after foreign firms are allowed in, will take their thumb off the scale that has long favored Chinese firms. Firms like TCW are more likely to enter new markets if we can go in with our longstanding financial services partners. As fixed income investors, we are particularly pleased that China agreed to, and the Phase I deal codified, allowing foreign credit rating agencies to establish wholly-owned affiliates to rate onshore bonds. That said, it also remains to be seen whether they will be able to "call it as they see it" in an environment where information is increasingly controlled, and whether they can make a profit competing for corporate ratings against more "ratings friendly" local firms.

Inflows Are Likely to Accelerate With Inclusion, and a Rising Weight, in Major Indices

Of all the actions China has taken to open its capital markets, perhaps the most impactful one was meeting the requirements for inclusion in major equity and fixed income indices, which some analysts have equated to the financial equivalent of China's WTO accession. While shares of Chinese companies listed in Hong Kong (H-shares) have long been included in the main emerging market equity index (MSCI-EM), onshore stocks (A-shares) were included in 2018 and China's overall weight is now more than a third of the index. In fixed income, China was included last year in the Bloomberg Barclays Global Aggregate (Global Agg) Index, with their weight to rise to around 6%. Next month, China will be included in the JP Morgan Global Bond Index-Emerging Markets (GBI-EM GD), with their weight rising to the maximum of 10%. While FTSE Russell declined in their last review to include China in the World Government Bond Index (WGBI), they are likely to do so in the next year, with a weight also around 5-6%.

Don't underestimate the power of indices. They are an increasingly powerful allocator of global portfolio flows, as more assets move to index funds, ETFs and other passive strategies, particularly in publicly traded equities. Even for some active and fixed income managers indices can have a strong gravitational pull. On a static basis (not accounting for growth in the assets that track these indices), China's inclusion in the three main indices is likely to induce around $300 billion in inflows.

Decisions over whether to include countries like China in indices and how big a weight to give them are not made by index providers alone, but rather after lengthy consultations with their clients, including asset owners and managers like TCW. There's little point in constructing indices that investors won't use, and we won't use an index that we can't effectively or efficiently track. This means we need to be able to enter and exit markets, by setting up accounts, bringing funds in and remitting them back, buying and selling both foreign currency and the constituent stock or bond, and settling trades, all without undue delay or cost (including taxation). And we need to be able to do this under a range of market conditions. There are many other factors that affect countries' inclusion and weight, including the ability to hedge exposures and undertake block trades that can be allocated to multiple accounts, as well as sanctions that restrict investors' ability to hold or trade assets.

But just because a country is included in an index, it doesn't mean that we'll automatically invest in it. Like many asset managers we work with our clients to align our investment strategies with their and their stakeholders' financial objectives and values. This includes choosing which index to use. In some cases, we'll use custom indices. Other times, we'll exclude or underweight certain assets in an index. If investors don't want to invest in China, there are plenty of indices that exclude it.

Why Foreign Investors Are Flocking to China's Markets

While China still has a long way to go in developing its capital markets, they are attractive for many reasons, including:

- Opportunity: China's stock and bond markets are the second largest in the world. Even as it slows, China's growth remains one of the highest among major economies. Many of the world's fastest growing companies are listed in China, and will be for many years.
- Volatility-adjusted yield: For a global bond investor a 3% yield on a 10-year government bond looks pretty good for a single A-rated sovereign credit in a world where 20% of investment grade sovereign bonds (in the Global Agg index) have <u>negative</u> yields. And if you're a dedicated emerging market investor like TCW, Chinese bonds and the Yuan have relatively low volatility compared to other bonds and currencies, making them attractive as a defensive investment.
- Diversification: While China's economy and markets are linked to the rest of the world, given its size and capacity to run counter-cyclical policies, Chinese assets are less correlated to other major markets (like the U.S. or Europe) than many other markets.

- Scale and liquidity: Given the size of Chinese markets, investors are usually able to buy and sell in large amounts, at low cost and without unduly moving market prices, particularly if they stick in fixed income markets to benchmark bonds.

China also has relatively strong credit fundamentals that we think broadly justify its single A rating. These include high growth, a diversified economy, large domestic savings, large foreign exchange reserves, and high scores in global surveys of domestic business environments (ranked 31 out of 190 countries by the World Bank and 28 out of 141 countries by the World Economic Forum).

But There Are Plenty of Risks

In our business, opportunities come with risk, and in China there are plenty, including:

- Poor policy and data transparency: Tracking China's economy is challenging due to notable gaps, particularly for national income and fiscal data. Data that are policy targets, like real GDP growth, are prone to manipulation. Despite China's significant impact on global markets, Chinese central bankers, finance ministry officials and regulators remain behind their counterparts in major emerging markets in communicating with and guiding markets.
- The lack of free expression, a free media and independent sources of information.
- Rising debt and defaults: Having undergone three credit booms in the last decade, leverage has risen notably among corporations, households, and local governments. Chinese regulators are trying to promote greater credit discipline by paring back guarantees, made all the more precarious by doing it during a cyclical downturn. Last year, even a hint that large depositors or creditors might take a haircut in Boashang Bank led to a spike in borrowing costs to other regional banks. Foreign creditors could end up with the short end of the stick in informal workouts. And recoveries from a still relatively new bankruptcy regime remain largely untested.
- Convertibility: While the ease of moving funds in and out of China was an important condition for index inclusion, the proof will be in the pudding, when markets come under stress as they inevitably do. Regulators swear they've learned lessons from the stock and currency markets debacle of 2015-16 when investors were locked into stocks when trading was official halted, even if they could theoretically get their money out. We'll see.
- Sanctions: Even with a tariff truce, tensions over technology trade and investment, foreign policy, and human rights, and financial sanctions against Chinese companies, are set to worsen.

Proposals to Restrict US Portfolio Investment in China

There have been a number of recent proposals to restrict U.S. portfolio investment in China and Chinese companies. In assessing them, it's important that policy makers consider:

What's the objective?

If you don't have a clear destination, it's hard to know if you're on the right path. Proponents of investment restrictions have cited a range of objectives from targeting specific bad actors, protecting U.S. investors, slowing China's capabilities in specific technologies, and more broadly impede China's growth and development.

How effective will the measures be?

U.S. investment restrictions are more likely to have an impact when the target is dependent on U.S. financing. For the most part, China and Chinese companies aren't. With a current account surplus, China is a net capital exporter, with domestic savings that exceed its demand for domestic investment. That doesn't mean that foreign financing doesn't matter, particularly for China's private companies that are underserved by their state dominated financial sector. It just doesn't matter much. To put it in perspective, foreign investment flows into China's bond market, for the four quarters ending in September last year, amounted to just 2% of China's credit extended to households, government agencies, and non-financial sector corporations. If you include all foreign equity flows, it amounts to about 3% of all financing (equity and credit) to these sectors. This could double or triple and it still won't amount to a hill of beans.

Moreover, this includes all foreign financing. If we go it alone, it won't even be a small mound of beans. U.S. dollar financing is the ultimate commodity. Markets are global, as are pools of savings. To the issuer there's little difference whether a dollar of financing is raised in or comes from New York, London, Hong Kong, Shanghai, Singapore, or Dubai. And it doesn't have to be dollar financing as money can be raised in other currencies. Moreover, if an investment is attractive enough for a U.S. investor, there'll be plenty of foreign investors willing to step in if we step back.

This highlights the broader challenge to the notion of financial "decoupling." Money's fungible. We can restrict U.S. investment in China but we're not going to stop investing in the rest of the world. And that will transfer resources to countries that can invest in other countries, including China.

At what cost?

Restrictions on portfolio investment would harm U.S. asset owners and managers. If we faced broad restrictions on investing in the world's second largest markets, there are plenty of foreign competitors who would be happy to serve our clients, both foreign and domestic. Many U.S. public pension funds and other asset owners already face pressure from stakeholders not to invest in a broad range of assets, while at the same time not having enough funds to meet the promises they've made to their beneficiaries. And if U.S. index providers are prohibited from including Chinese entities, or pressured to consider non-financial criteria, there are lots of foreign competitors who could provide alternatives.

Listing of Chinese companies in U.S. Markets

After the Enron accounting scandal, Congress passed the Sarbanes-Oxley law, creating the Public Company Accounting Oversight Board (PCAOB), to ensure that auditors of companies listed in U.S. markets are fit and proper. This was an important step in protecting investors. However, more than 17 years after passage, PCAOB and the SEC have yet to come to an agreement with Chinese regulators over inspections of Chinese based accounting firms (including affiliates of the major global firms) and access to internal working documents.

While my work on this issue is dated, I expect the main obstacles haven't changed much. First the U.S. has little leverage. The risk that Chinese firms won't be able to list on U.S. exchanges and would have to list either in China or other markets isn't much of a threat to Chinese regulators. It's what they want as they work to develop their own markets. Second, not appreciating the regulatory independence of the PCAOB and SEC, I suspect that Chinese military and foreign policy hawks remain opposed to giving them access to internal accounting documents of large Chinese companies, particularly state-owned enterprises or those run by relatives of senior Party leaders.

We don't need a new law. We need existing law to be enforced. Not doing so undermines the integrity of our financial system. Chinese companies who want to list in the U.S. should play by the same rules as others, even if China's private sector and U.S. investors are the ones that ultimately get hurt if firms are delisted (To the extent U.S. investors just buy stocks in China's market instead of ours, they'll end up less protected).

As for other proposals to restrict U.S. investment in China, to have any meaningful impact actions, they should be taken in concert with other major financial centers. Restrictions only on U.S. investors will just shift business offshore and won't meaningfully limit China's access to finance. Keep index inclusion and weighting decisions based on market access. If Congress decides that investing the TSP I fund in Chinese stocks is inconsistent with U.S. interests, it has that prerogative. But don't pretend that holding back a few billion dollars will make a lick of difference. That's not even one bean. Well targeted, multilateral sanctions on specific bad actors would probably be the best way to force specific constituents out of indices.

Our Permanent Position As the Center of Global Finance Is Neither A Right Nor Foregone Conclusion

I'll end by looking longer-term, past the next election cycle. That's what responding to China's rise requires. Having the world's primary reserve currency, along with the world's most developed capital markets and asset management industry, is an extraordinary competitive advantage for the U.S., able to provide significant and low-cost financing to our most promising companies and entrepreneurs. Our currency and financial system are far superior to China's, with their financial sector still dominated by behemoth state banks.

But the dollar wasn't always the world's reserve currency and we weren't always the center of global finance. It took many decades to build and sustain this. We shouldn't be complacent that, what former French Prime Minister Valery Giscard d'Estaing called an exorbitant privilege, will be ours alone forever if we overreach and abuse it by weaponizing access to our currency and markets too broadly. Other countries will surely promote alternative centers of finance and mechanisms for settling international transactions.

In a rush to contain and decouple China, we should be careful not to do the same to us and to safeguard our institutional strengths.

Thank you.

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PANEL III QUESTION AND ANSWER

CHAIRMAN CLEVELAND: Thank you all.

Commissioner Wessel?

COMMISSIONER WESSEL: Thank you all for being here. Appreciate it. This has been a very interesting day on what most would consider to be a dry topic, but I think we all understand its import or increasing importance.

To me, and I said this in my opening statement, what's happening now in terms of China's access to international financial markets in a variety of ways is as consequential as their accession to the WTO, but with the WTO it was a multiyear negotiation based on a set of rules. China -- we didn't apply every market-based rule to China. We gave them some flexibility. And certainly in terms of enforcement I think, at least from my perspective, we didn't do what we needed to do.

But we seem to be limping along in terms of allowing China into the international financial market in larger and deeper ways without any adherence to the rules. SDR package, we allowed them in without fully complying with all of the standards that would allow a currency into the basket.

PCAOB has been talked about. That's a 12-year discussion. We still have many Chinese companies listed on U.S. exchanges. We have, as we've talked about, PCAOB and now the MSCI I believe has close to 200 companies that are not in compliance with PCAOB standards, but are in the index and therefore will drive investment decisions including U.S. government funds, et cetera, et cetera.

So on the one hand there's a question of whether we can impact it, because I think as several witnesses have said, if we don't do it, somebody else will. But do you view China's now entry into many of these financial products, indices, opening up via stage one and many other things as consequential or is it an incremental issue?

Mr. Loevinger, you want to start?

MR. LOEVINGER: Sure, and thank you. I think it's hugely consequential. I think many Americans in their 401(k) plans or their pension plans are going to be owning a lot more on-shore Chinese assets in the years ahead, and this will increase their exposure, their already large exposure, to China. As Andy said, if you own stock in General Motors or Apple or a whole bunch of companies, you're already exposed to China risk. So I do think it's very consequential.

COMMISSIONER WESSEL: But would you as a former government official -- and I've been doing this 42 years so I follow the S&ED, the -- all of the various iterations, et cetera. It seems we have as a government, and stage one I think shows that, are seeking access without necessarily adherence to the rules. We are viewing, as we did with WTO, getting them in and being part of the world system, world trading system will ultimately yield change. I think China has shown with finance it has no intention of changing. Twelve years with PCAOB, no audit transparency.

So we seem to be giving up right now and just moving forward. Am I -- as a government -- as one of the negotiators do you see it that way, or am I wrong?

MR. LOEVINGER: Well, I guess from an investor standpoint I would separate the PCAOB issue --

COMMISSIONER WESSEL: It's just one --

MR. LOEVINGER: Yeah.

COMMISSIONER WESSEL: Agreed. Agreed.

MR. LOEVINGER: But that's about kind of the integrity and protecting investors in our market.

COMMISSIONER WESSEL: Correct.

MR. LOEVINGER: The reason why we and other investors are going into China's market is because they are opening up. They offer attractive investment opportunities. If -- there are, as I said, lots of risk. If you want a less risky asset, there's Danish or Swedish bonds that have a negative yield, but that's not going to kind of --

COMMISSIONER WESSEL: But China wouldn't be opening up if it wasn't in their interest. They're not doing this for us.

MR. LOEVINGER: Of course it's in their interest.

COMMISSIONER WESSEL: Right. So it seems again we are placating, abiding by China's interests. They pushed hard on the MSCI to let them in and then to increase the weighting. It doesn't seem that policymakers understand what is in China's interests here and what's ours.

MR. LOEVINGER: Well, I mean you certainly could invite the index providers up here to explain to you better than I can how they operate --

COMMISSIONER WESSEL: Right.

MR. LOEVINGER: -- and how they set their criteria. I know we work a lot with the index providers, and I'll bet you Andy does as well. And it's not just on China. But they are regularly consulting with us, asking us do we have market access, can we buy and sell at ease. Because if we can't, we don't want stocks or bonds in the index. We have to be able to replicate whatever the index providers put in the index.

CHAIRMAN CLEVELAND: Dr. Scissors?

DR. SCISSORS: I don't want to spend too much time adding to that discussion, which I thought was useful. I will say I completely agree with you; it is absolutely crucial to party control of the economy that they have control of the financial system. They're not going to give that up. They're not going to liberalize it away. They're not going to say, oh, you know, it's okay. This isn't that important. This is restaurants. They're not going to do that.

So I'll make a shocking prediction that in five years you'll have American financials complaining about their access to China. Right now they're all excited, and in five years they will not -- they will be considerably less excited and demanding that the U.S. do something about this.

So I mean we know how this is going to go. There are opportunities for American financials in China, right now especially, but there are long-term opportunities as well. The Chinese are not going to liberalize their market very much because this is an absolutely crucial sector for party control. So we're giving up -- we're trading limited access to the Chinese financial system in exchange for whatever you -- characterize as not really enforcing the rules.

And as long as everybody understands that trade, which I don't think we understood during the WTO negotiations, for example, then that's fine. I mean let's look at the -- what we're really going to get from investing in China, which is not gigantic market shares in anything, and then what we're giving up and what's the harm of what we're giving up?

I thought the IMF calling the renminbi reserve currency was hysterically funny since the renminbi is a derivative of the dollar, but I don't think there's much harm to that. It's symbolic, which is why the Chinese wanted it. So if we're getting small concrete gains, and we're just giving up symbols, that's still worth it. But that's all I would say. The Chinese are not going to give up access to their market, and in five years we're going to hear complaints just like we hear complaints about market access in every major industry in China.

COMMISSIONER WESSEL: Mr. Rothman?

MR. ROTHMAN: Thanks. I spent a good part of my opening statement talking about kind of big picture issues and looking at what's been achieved and not achieved yet and how we might get ahead there because I think that really kind of sits on top of all the other things we're talking about. Otherwise, these are really small issues.

Having an overall idea of what we want the relationship to look like, do we want to collaborate and partner in most cases with China over the coming 40 years and use that collaboration and partnership to put pressure on them to improve their behavior in places where it's obviously misguided and wrong?

If we try and cut them out of our investment schemes, if we put too many limitations on them, if we confront them every place except on the items issued -- listed out on the trade deal that was signed last week, are we going to get more leverage from them? And I think that it's worked.

So I think that -- and I played a very, very small role in the WTO negotiations back in the '90s. I think it's really worked well, way better than I would have expected at the time. I gave you some statistics in my statement. It's worked well for most American consumers. It's kept the price of tradable goods down, which is what working class people spend most of their disposable income on. It has brought new competition which has been a challenge, some fair, some unfair, for a lot of American workers. But we knew that when we brought them into the WTO.

In fact President Kennedy, when he signed the legislation for GATT, understood that this was going to cause disruption and wanted to get legislation in place that would help take care of American workers who were displaced by that. And we have done a terrible job of helping deal -- of helping our workers deal with the impact of globalization and automation. We need to fix that. We need to get our own house in order. The China part of it is relatively small.

But China has made a lot of changes. And as you noted it's in their interest. Like us they will only do things that are in their own self-interest, but we can push them to understand what that self-interest is.

And one of the consequences of having more market-driven economy and more private enterprise -- I mentioned before, 87 percent of all employment in urban China now is with small entrepreneurial privately-run firms, not state-run. A hundred percent of all the net new job creation is from these firms. It's generating all the wealth.

This has put tremendous pressure on the Communist Party to be less repressive and more responsive and to provide much greater personal freedom to most Chinese people. Now there are still serious problems that we're all familiar with, but how do we get leverage to push them more in that right direction?

Now on MSCI specifically I would agree with David. I think you should ask them if they'd be willing to come in here because I think from my conversations with MSCI that they have put more pressure on China to change their rules and regulations than any pressure they've received from China. Because they've gone to China and said, hey, we're just the middle man here, all of our clients, the global asset managers, will not use and pay for an index unless you guys do the following 20 things.

And it took a little while, but the Chinese accepted that. So I think, as I said in my opening statement, our money has a disproportionate impact on making -- on liberalizing their system, which is then good for their people because they're putting their retirement money into that system and they get wealthier and they put more demands on their government.

COMMISSIONER WESSEL: You've raised a number of issues that for me kind of raise other debates, but my time is up, so I will yield back.

CHAIRMAN CLEVELAND: Commissioner Wortzel?

COMMISSIONER WORTZEL: Mr. Rothman, I have to say that as entranced as I was by all this discussion, I was glancing at The Economist of 18 January, and it has a very interesting article. In the first Gulf War Iraqi scuds had a circular error of probability of 2,000 meters. The 20 missiles fired at an Iraqi airbase used by the U.S. had a CEP of about 5 to 10 meters. Most of the ballistic missile technology that China got -- or that Iran got came from China. Surface-to-air missiles came from Russia, as we've learned in the downing of that aircraft.

So that improvement is due to very highly advanced inertial navigation systems that calculate position, velocity, and altitude even without the help of GPS. So why would we not want to protect intellectual property?

MR. ROTHMAN: Well, I will certainly defer to you as an expert on military issues with respect to China --

CHAIRMAN CLEVELAND: I don't think we've ever had CEP in an economic hearing before, but --

(Laughter.)

MR. ROTHMAN: -- but my understanding is, and I'm not an expert on this issue at all -- my understanding is that since we reached a higher plane of engagement with China on a whole range of security issues that -- non-proliferation is one of them and that -- I'm assuming that the technology that you refer to, if it was transferred from China to Iran, took place quite some time ago before we had a better relationship --

COMMISSIONER WORTZEL: Well, interrupt a second. I hate to dispute that, but proliferation generally is about weapons of mass destruction. The legal sale of technology that falls within, what is it, 500 kilograms and 500 nautical miles, is not protected by anything.

MR. ROTHMAN: I'm going to have to plead ignorance on this one, I'm afraid.

DR. SCISSORS: Larry, do you mind if I give you a little answer? This is an example. If we have evidence that specific Chinese firms provided this technology to Iran, on one hand there's no point punishing the specific Chinese firm because the Chinese will just wind them up and create new firms, right?

So it's not -- now this is what we do on North Korea, like, oh, I found you breaking North Korea sanctions. Like, you sanction the company, the company dies, another company shows up. And that's what I meant by -- just like Andy, I don't know how to judge your figures there, but if the national security community says this is an intolerable transfer of technology, we need very comprehensive sanctions on that basis. If it reaches the threshold that sanctions should be used, they should be used in comprehensive fashion including eliminating all financial benefit that China can receive from the U.S. financial system.

So I would just -- without being able to judge your example, it's an illustration of what I mean by if you're going to swing the stick, you better think, and then it better be a big stick.

MR. LOEVINGER: Could I add just one point? Again, not about the military technology, but about sanctions in general. I think it highlights the importance of doing things multilaterally. I mean for those who see China as an existential threat, it's important to remember during the Cold War and the Soviet Union that we had CoCom and the Wassenaar Group. And the U.S.' monopoly on certain technologies is much less so today than it was then.

So if we want to keep certain technologies out of China's hands, and I understand that, it's more important to do that with our allies and friends.

And my point on financial sanctions is there's nothing unique about a dollar of financing. So if they don't get it from us, they're going to get it from someone else unless we're working all together multilaterally.

CHAIRMAN CLEVELAND: Commissioner Fiedler?

COMMISSIONER FIEDLER: Mr. Rothman, so on a 40-year policy or a 40-year view of what the U.S.-China relationship should be requires some assumptions, right? So you -- clearly if you've recommended this to us you've thought about it a little bit. Have you assumed that the Communist Party of China will last for the next 40 years?

MR. ROTHMAN: I think that's a reasonable assumption that they will be around for some time.

COMMISSIONER FIEDLER: Why? Why reasonable?

MR. ROTHMAN: Because I think for most Chinese people they have done a reasonably efficient job of running the country, and also because the Communist Party has eliminated the possibility of any opposition to them.

COMMISSIONER FIEDLER: For the last decade or more that I've been in and out of this Commission, everyone has articulated that the party leadership is primarily concerned about its survival. So it doesn't necessarily share your -- it itself does not share your view that it's a reasonable expectation that they're going to survive.

MR. ROTHMAN: I'm not aware of the -- of party officials predicting their imminent demise, but I think that they understood from what happened in the Soviet Union and Russia that the old style of Communist Party leadership was not going to survive. And therefore, we've seen a dramatic change in the structure of governance there and the structure of the economy and the personal freedom that people there enjoy, just over the period of time that I've been living and working there.

And so I think they understand that they cannot survive simply by ordering people to support them or by sending the tanks back out. And so they've been focused on staying in power and surviving by providing a steady improvement in people's lives.

COMMISSIONER FIEDLER: We also have heard today and in earlier hearings that the sort of economic objective is to maintain growth, maintain employment. Social stability has a major role. Okay. These are all survival -- so now we have economic decisions being made whose objective is to maintain a political position. Right? Strength. Power. Right?

So I'm getting -- all of you were sitting here when Mr. McCarthy was speaking. So I'm getting back to the distortion problem. So even -- I mean essentially what I'm saying is that their economic actions are distorting things, right, in the direction of maintaining all these other objectives. And we talk about investing in China, doing this, that, and the other thing as if these things don't exist. Right? I mean these objectives on the part of the government don't exist. And it impacts the idea of change that you are advocating.

And I'm maybe as old as you or older than you, and I've heard all these arguments for the last 25 years about how great -- all these great things they've done. But the change has been certainly incremental.

And so now the question becomes on a world scale that Mr. McCarthy raised how distorting is all of this and can we in a 40-year plan actually assume that the Communist Party is going to be there? And we have to assume our national objectives, too.

MR. ROTHMAN: Well, I guess I would start in terms of national objectives by -- that it's not up to us to -- as to whether or not the Communist Party is still running China. That should be up to the Chinese people. And I think that --

COMMISSIONER FIEDLER: Oh, no, I didn't mean that. I meant is it in our interest that the Communist Party continue? That's different from what you just articulated.

MR. ROTHMAN: I think it's in our national interest that any government in China behaves as much as possible in line with the way we would like the world to behave regardless of what form that government takes. And I also think that if we look at the change that's taken place just in the period of time that I've been working in China, I think for most Chinese people it's not incremental.

If you just go back to the early 1980s when I was there, the Communist Party told everybody in China where to live, where to go to school, what to study. When you left school, they assigned you to a job with the state. You had to get permission to get married to a particular person. You had to get a chit from the party to get a plane ticket or a train ticket. It was really hard to leave the country. Couldn't send your kids to school here. You couldn't run your own business.

COMMISSIONER FIEDLER: Mr. Rothman, I'm a trade unionist in the United States who believes in freedom of association. Okay? What I do would get me arrested within 24 hours in China. Give me the incremental change that has happened in freedom of association for workers in China. They're in the same position today, if not worse because of the surveillance, and repressive machinery is more effective than they were in 1972. Forget 1979. That doesn't seem to concern you whatsoever.

MR. ROTHMAN: Mr. Commissioner, it concerns me a lot, but what I'm focused on is what's the best way to achieve the objective that you're talking about. And that's why I was emphasizing in my opening statement that I think it's really important that we go back and look at what's worked and what hasn't worked over the last 40 years, because China is not yet in a place where all Chinese people are happy, where we can be happy with it. But a lot of progress has been made.

And given the alternatives that we have available to us in terms of what's the best way we can keep prodding China to move in the right direction so that they get to where you'd like them to be, I think continued engagement is the way to get there.

COMMISSIONER FIEDLER: Thank you.

CHAIRMAN CLEVELAND: Mr. Loevinger, I liked the characterization of sort of what motivates investment and your list of this means we need to be able to enter and exit markets by setting up accounts, bringing funds in and remitting them back, buying and selling both foreign currency and the constituent stock or bond, settling trades, all without undue delay or cost, including taxation. That was in your written testimony and I think you emphasized that in your statement.

Are those -- is that list something that you feel you can do now in China?

MR. LOEVINGER: Absolutely. And that's why China got put in the MSCI, the JPMorgan Global Bond Index for Emerging Markets, the Bloomberg Barclay's Global Agg, and I expect later this year they'll be in the FTSE Russell World Government Bond Index.

Again all these index providers call us up monthly, quarterly; and they did it with China, and we gave them a ton of complaints about our ability to access markets and trade in those markets. And they kept saying, well, now can guys do it? Now can you guys do it? And I think -- it wasn't everybody, but it wasn't like a slim majority. When they heard from most of their clients that they could now get into the market and buy and sell and -- that's when they made the decision to put China in the indices.

The one thing I should point out, getting back to the consequential issue, is -- so China is 33 percent roughly of the MSCI for emerging markets. China is going to be 10 percent of the JPMorgan index for emerging market bonds. There's a cap. It can't go above 10 percent. It's going to be five to six percent of the big global bond indices. That's going to pull money away from other countries towards China.

CHAIRMAN CLEVELAND: Hence your statement don't underestimate the power of the indices?

MR. LOEVINGER: Exactly.

CHAIRMAN CLEVELAND: And I think that is a double-edged sword for us, because I think on the one hand opportunity and yield is a good thing; on the other hand transparency is critical.

And so I want to turn to something else in your statement where you talk about one of the risks as poor data transparency, poor policy and data transparency. And I think we have all struggled with that issue, and earlier panels spoke to it.

So given the context of poor data transparency how would you assess allowing foreign credit rating agencies to establish affiliates in the context of this current deal? How -- do you see that as a -- transparency being viable or acceptable within a year, with five years? Can you sort of offer a time table?

And then speak to something that Senator Goodwin talked about earlier, which is you can set up a credit agency, but if it doesn't have good data, the evaluation isn't going to be helpful to investors.

MR. LOEVINGER: Yes, so I think I said in my written testimony the agreement in phase one to allow foreign credit rating agencies into China and rate Chinese bonds on shore is a huge step forward for bond investors like us. We don't see Chinese credit rating agencies as credible. We don't use them. We kind of ignore their ratings.

But we do have fundamental questions. Will foreign credit rating agencies like Fitch and Moody's and S&P -- will they be able to call it as they see it in a place like China? I think that's an open question.

I also think they have competitive challenges. If they do -- it's the same model in China as it is in other countries. It's the companies that pay for the rating. And will Chinese companies be willing to pay for maybe a less favorable rating from foreign agencies than from local agencies?

CHAIRMAN CLEVELAND: You anticipated my next question, which is who pays for the rating?

How will -- I'm going to ask you a question I ask in therapy all the time, which how will we know? How will we know that the influence exercised either by the government or companies is moderated in some way, that -- how will we know it's a healthy transparent system?

MR. LOEVINGER: Yes, I mean we are suspicious cautious investors in every market we invest in. We send our analysts to meet with corporate managers. We go over books. But in China I think our level of skepticism is going to be higher. And I just view that as a -- just another risk we have to manage, so we're going to want to be compensated for those risks. So we will demand a higher return in a place like China than we will in the U.K. or France.

CHAIRMAN CLEVELAND: Each time you answer I'm more curious. So you'll demand a higher return, and as we know, as somebody said earlier in China there's the five-year plan and it lays out various benchmarks and objectives. How confident are you that when you demand a higher return than the current bond yield of 3.7 percent in Jilin or wherever -- how confident are you that that is based on fundamentals that are sound as opposed to Beijing says, okay, we want TCW in and the price of admission is a 4.2 percent yield?

I'm not in your position so this is all kind of murky to me. How do we know that the very policies that put at risk the economy aren't going to support your higher yield?

MR. LOEVINGER: Yes, so -- and I also should have been better in use of my term. Like obviously we can't demand --

CHAIRMAN CLEVELAND: Right.

MR. LOEVINGER: -- a return. We can calculate what we expect a return to be and then make a judgment. Are -- do the -- does the return compensate us for what we perceive the risks to be?

I will -- we invest in emerging markets all over the world. Lots of countries have different kinds of risk. Recently investors in Argentine bonds saw the risk of investing in Argentina. China has the risks that -- and many more, but I enunciated some of them in particularly kind of policy and data transparency, but they're -- China has kind of fundamental credit strengths that other countries don't have. It's a large diversified economy with still relatively high growth at four, five, six percent. It has a kind of large domestic savings. It has relatively large foreign exchange reserves. And we kind of look at all that stuff.

I will say in the fixed income world what you're seeing us and other foreign investors do on shore is essentially we're only buying three kinds of assets: We're buying Chinese government bonds, we're buying bonds of policy banks, and we're buying short-term negotiable certificate deposits of kind of big Chinese banks. We're not kind of getting too exotic beyond that.

CHAIRMAN CLEVELAND: Okay. That's helpful.

And, Mr. Rothman, in your -- in a report that you authored you talked about -- I should tell you the title so you don't -- you're not -- China's Debt Problem. You talked about the fact that the products that broke Lehman and caused havoc throughout the U.S. financial system don't exist in China and that there are no sub-prime mortgages and very few mortgage-backed securities, no secondary securitization and -- so no collateralized debt or loan obligations.

I think we've heard from other witnesses that there is this emerging space of CDO-like for -- it may not be specific. I'd ask you to speak to -- it might not be a mirror of Lehman, but do you anticipate any other kind of debt instruments?

MR. ROTHMAN: Secondary market-type --

CHAIRMAN CLEVELAND: Secondary risks. Because it feels to me when you very narrowly define it and say, well, there's no Lehman-like sub-prime kind of risk, I'm wondering, all right, what else is out there that is like that?

MR. ROTHMAN: Thank you. Can I first make a brief comment to follow up on your exchange with David?

CHAIRMAN CLEVELAND: Please.

MR. ROTHMAN: I think at Matthews Asia I have over 40 colleagues on the investment team who are focused on running around China and the rest of Asia looking at companies. And so we don't accept any reports at face value, whether they're from the company or a rating agency. It's all about doing due diligence on the ground, it's meeting with management, but also meeting with customers and suppliers and bankers and competitors and really coming to understand the company and not just taking reports from people. And I think that's really important in any market, especially a less-developed market.

On the debt side what I was trying to emphasize is that there are a lot of problems in the Chinese economy, so -- and we need to focus on those and not create problems that don't really exist.

CHAIRMAN CLEVELAND: Yes.

MR. ROTHMAN: And so when we talk about shadow banking we need to be careful that shadow banking in China is very different than what we had here. For example, if you look at the New York Fed's definition of shadow banking here, they're focused on an institution, a company let's say that is going to intermediate credit and is lightly regulated and has no recourse to the central bank. There is nothing like that really in China.

So what I was highlighting in that report about China's debt problem is it's a significant problem, but the risks of it becoming a systemic crisis are very, very small in my opinion because the debt problem was the result of the Chinese government's response to the global financial crisis. Back then exports were a much bigger part of the Chinese economy, net exports. The value of the country's exports minus their imports was about 10 percent to GDP. Now it's about one percent.

CHAIRMAN CLEVELAND: Yes.

MR. ROTHMAN: And so when global demand collapsed, there was massive unemployment in China. The government was worried about social stability. So the kicked of the biggest Keynesian stimulus since Keynes. And they did that by calling up all the banks which are controlled by the state and ordering them to lend to state-controlled companies to build state-directed public infrastructure. So the states' on all side of this.

It doesn't mean this was all great projects. It doesn't mean they can all be paid back. But what it does mean is that there's no mark to market pressure like with the Lehman's Brothers or Bear Stearns. No state-controlled bank can order a state-owned company to pay loans back that it doesn't have the money for and force them into bankruptcy unless the state agrees to a work-out plan. So they have a lot of control over how and when the problem gets fixed. It does contribute to more volatility and slower growth, but the risk of a crisis is low.

And I'd also disagree with one of the earlier panelists in that the data that we track on off-balance sheet or shadow banking shows an especially firm continuing reluctance to allow that to happen.

So shadow banking peaked a few years ago, was maybe growing at 20 percent year over year. For the first two years it's been negative year over year, even multiple years now. And even with the economy slowing down a little bit the pressure from the trade dispute, no sign of that coming back. So I think that the government is determined not to allow the riskiest parts to come back and what they're focused on is de-risking the financial system. And I've seen no sign that they're backing away from that.

CHAIRMAN CLEVELAND: Okay. Thank you. Sorry. I ran way over.

Commissioner Lee?

COMMISSIONER LEE: Thank you. Thanks to the Panel.

Dr. Scissors, you lay out five I'd say tough by common-sense policy recommendations around companies that break the law or violate human rights shouldn't be rewarded and sanctions should work and so on. Recognizing that it is very early days how do you assess what we see in the phase one trade deal in terms of whether it will be a help or a hindrance to the kinds of reforms that you think are needed? In other words, does -- the phase one deal does many things. It gives some leverage, some enforceability for certain commitments and so on, but it also opens up in terms of the financial sector. Do you have an assessment at this stage? And I welcome the other panelists to weigh in as well.

DR. SCISSORS: I don't want to let them talk. I'm going to use up all the time. I have an enormous amount of things to say about the phase one deal. I'll try to confine them.

To be blunt, the phase one deal is to make purchases over the course of this year during the election. I don't believe in anything that is operable necessarily. We will evaluate after the election, whether it's a continuing Trump administration or a new administration. The Chinese will evaluate the value to them of the deal after the election.

This is a 10-month; not even a year -- this is a 10-month purchases agreement where the Chinese are paying a tax of diverting their imports from other suppliers to the United States in exchange for not getting hit with angry President Trump tariffs in July during the middle of an election. That's what the deal is.

Now could we take the terms of the deal and extend them further? Could the next Trump administration or a Democratic administration say, oh, no, we like this and negotiate with the Chinese? Yes, absolutely.

So we have something on paper, but this isn't like USMCA. USMCA is going to be American law. This is just some stuff we negotiated that can go away with the next president. It can go away with the next Trump term. Even if he's president it can go away.

So I'm really at loathe in my opening diatribe to imagine that this is going to have any long-term effect at all; negative, positive in financing IP and so on.

If we -- what's driving the multiyear impact is something we've all talked about and I think we all agree on, which China wants more foreign capital, and in particular American capital. That's not going to go away next year or the year after and so on. So we're still going to have that demand for foreign capital.

So you could use that as a launching point.

I don't see anything in the phase one deal that matters. If somebody would come up with we have devoted these resources to these departments, in Treasury, in USTR, wherever they happen to be, to monitor the status of the Chinese financial system or their compliance with IP regulations, they will report in the following way to the following people, this is the decision process, this is the threshold they need to reach to show compliance or violation, nothing. We don't have anything like that.

So I'm not saying we wouldn't have it next year, and maybe we'd start, but we'd start with the phase one deal as like, oh, these are some nice ideas and then we would move on to the negotiations almost as if we haven't done most of this in the first place.

COMMISSIONER LEE: Thanks.

DR. SCISSORS: Good luck following that, guys.

(Laughter.)

MR. LOEVINGER: I'll make a couple comments. First let the record show I completely agree with Dr. Scissors. I feel like this is a temporary truce to get us through the election. I'm pretty skeptical that we'll ever see these commitments being met in 2021.

And again this -- trade policy is not really my area. I'll just make a couple points.

One is these detailed and secret purchase agreements are a very different approach. It's a very state-managed approach. It's an approach that rewards companies that have political access and lots of lobbyists. They're not necessarily the most innovative products.

I think the whole notion of we just want you to buy from us and not from our friends and allies is another step in separating us from the people we should be working with together to take on China. Again for those who really feel that China is an existential threat there is this amazing gap between rhetoric and action compared to kind of what we did with the Soviet Union and the Cold War.

And lastly, I think this is going to turbocharge Chinese industrial policies now that we have clearly told them that they cannot count on access, not just to technology, but a whole other set of components. They are rapidly accelerating their efforts to develop non-U.S. alternatives, either domestically or from other trading partners.

MR. ROTHMAN: I don't want Dr. Scissors to get a big head, so I'm only going to say that I agree with a lot of the things he said, particularly that we now have an opportunity with a short-term pause in the tariff dispute. So I think it's most likely through the first week of November everything is going to be pretty good.

Then the real questions for me are do we take advantage of that pause to think about what we can do next to get what we want out of the Chinese government on trade issues. And I think that's going to require two decisions.

The first is, getting back to my opening statement, what do we want the U.S.-China relationship to look like? If we believe that the Chinese government presents an existential threat to the United States, then we shouldn't want any trade deal with them. Doesn't make sense. But I think obviously from what you've -- if you've been listening to me so far that that's not the right approach.

The right approach would be to get together with our allies and partners and say let's come up with a collaborative list of all the things that are really happening in China that are unfair and create an unfair playing field for all of our companies and approach China together, because before all this started the U.S. only took about 20 percent to China's exports. So if we don't have the rest of the world with us, it's too easy for China to ignore us.

DR. SCISSORS: I just have to push back a little bit on this work with our allies business. It's absolutely the right thing to try to do and it probably won't work. We don't have the same interests as the Europeans economically, much less in security terms. We have a couple of allies in Asia that we can work with, the Japanese in particular.

But I just -- I'm not disagreeing with -- that it would be better if we could do that. I just -- I get the Europeans coming in every week and I'm like what planet do you live on? We're not going to be able -- we're going to have to make very serious compromises in how we want to approach the Chinese, including like on moral issues if we want a big coalition. And it will take years and the Chinese will game the demands from the group. There are trade-offs in working with our allies because they have legitimately different interests than we do.

MR. LOEVINGER: I mean my concern then is we're not leveling the playing field. We're ceding the playing field to others.

MR. ROTHMAN: No question working with some of our partners can be more difficult than working with China; I've had that experience, but I do not see a better alternative. That's the only way that we're going to get things done with China.

And then finally back to the secret codicil to the phase one trade deal that Dave alluded to earlier, I would love to see the Commission ask the administration to come in and unveil all of the secret stuff, because that's a pretty unusual way for the United States to manage trade.

CHAIRMAN CLEVELAND: Many things are unusual in this day and age. Commissioner Bartholomew?

VICE CHAIRMAN BARTHOLOMEW: Thank you very much, and thank you all for your comments on the phase one deal, because honestly I've been stunned at how many people are like, whoa, yes, look at this. And I thought have you not seen them promise on intellectual property rights protections for the past 30 years? Have you not seen them promise over and over and over again? So thank you on that.

Mr. Rothman, first with you and then for all of you, I guess I just feel like I need to set the record straight, because I worked on these issues all through the 1990s and all through the 1990s we heard we can't do anything to upset China because we need their help on North Korea. And look where we are today on North Korea.

You talked about cooperating with them on climate change. So I hesitate to bring coal into the mix because of our West Virginia colleague, but China in the first three quarters of 2019 approved 40 new coal-fired power plants. They've increased their coal power capacity by 4.5 percent. It's great that they are saying that they're going to ban single-use plastic bags in the major cities by the end of 2020, but the steps that need to be taken, I just don't see the cooperation taking place there. So for me in some ways what you are saying is the same argument that we have heard for 30 years.

And, Derek, you said, yes, this is going to take many years, but I mean again we've been doing it for 30 years. How many more years do we have on some of these issues in order to be able to -- that's it.

What I wanted to ask about was the comment that you made about ESG, because I find that very interesting and I wondered if you could give some concrete examples of where you guys have seen improvement in environmental, social and governance issues.

MR. ROTHMAN: Thanks for all those comments. Could I comment briefly on the first remarks that you made?

Again going back to what I've been saying earlier, I think we should recognize that we've made a lot of progress with China. Again as frustrated as you are that it hasn't been everything that we wanted to get done, but I think it's been significant and I don't see looking backwards that an alternative approach would have done better.

On North Korea for example I think in recent years the Chinese have worked pretty hard to support our strategic objectives there. To a certain extent I think we're playing good cop/bad cop, but in general I think we've gotten a lot of cooperation from them.

On the environment I can tell you as someone who's lived in China for many years the improvement there is visible and noticeable in many Chinese cities and they -- the Chinese government is under tremendous pressure from Chinese people over the environment. And there have been a lot of improvements in terms of phasing out thermal for solar and hydro, and I think they're going to keep moving in that direction because it's in their own interest. And that's what people are really pressing on them to do.

On ESG what we have found is that there's a lot more transparency about governance issues, about control of shareholders, about states' involvement in individual companies. And so where it's really helped us is with the due diligence process that I was describing before and going to individual companies and being able to now have a selection to choose from, because our clients are really concerned about these issues, too.

And they only really want to be invested in companies that are not only going to help their clients; their retirees for example, make money for their pensions, but they also want to invest in a responsible way. And we now have more companies to choose from where we have transparency and where they're actually taking steps in the right direction. So I think the biggest element has been on a company-by-company basis.

VICE CHAIRMAN BARTHOLOMEW: So this transparency, is this you're seeing transparency where they are acknowledging the role of the Chinese Communist Party in -- either in board decisions or in actions within the company? Because I mean some of us really believe that that kind of control is something that's pretty significant.

MR. ROTHMAN: We invest primarily on privately-owned, publicly-listed companies. So the Communist Party does not have a role in the management of those companies. And we invest in some state-owned enterprises, and what we're interested in is how the companies behave and how they operate and whether or not they're profitable. Obviously they're controlled by the state, those companies.

VICE CHAIRMAN BARTHOLOMEW: So again, I feel like I keep going back at you on this, and if other people have things that they can talk about, that would -- in response, that would be good.

But I used in the last Panel the example of Anbang, right? I mean that was a privately-held company and the Chinese government moved in and they were like, well, first, you're corrupt. Of course corruption is endemic and they pick and choose who they're going to do on that, but they took over and dismantled this privately-owned company. I mean that's not not state intervention in what's happening. I always feel like we have these discussions and people just gloss over the differences between the corporate structures and the role of the Chinese Communist Party in China.

MR. ROTHMAN: There's no question that it's a different environment. There's no rule of law in China. But our job for our clients is to find companies that are likely to avoid that kind of situation.

DR. SCISSORS: Two things: One small and one big. I'll try to keep them both short.

Anbang was actually state-owned before it was private. It was kind of run off the rails by this guy who was married to Deng's granddaughter and -- but just as a technical point the state had previous authority, a previous call on core Anbang assets that he like did illegal things with. That company has a long history of serious problems.

Onto your bigger question and to sort of respond to your point about how long it will take. Andy talks about 40 years. A lot of people talk about 40 years, blah, blah, blah, blah, blah. I'm sorry. The Chinese economy start is a -- this is not a 40-year period. It's a 25-year period of reform and a 15-year period of, um, not so much on the reform.

And then capping that 15-year period of not so much on the market-based reform you have Xi taking over. And this is a different government than it was under Hu Jintao. It's less corrupt. It's more popular. It's also more brutal, it's more totalitarian. It's a much different government than under Jiang Zemin. So not just looking backward and saying 40 years is not 40 years. There are segments within these 40 years obviously corresponding to different leadership.

I would also look forward and say I don't think we're going to get any withdrawal from the party of the private sector. I don't agree with the idea that there are private firms that don't -- that are listed that don't have a CCP role. That's kind of the price of listing. It's a different role than in state-owned enterprises obviously. And the trend is under Xi for more. It's not China will always be more totalitarian. It's inevitably -- there's something about China that makes it totalitarian. It's not even that the party will always become more invasive. But under Xi it has.

And so when we're talking about waiting years we're talking about how long is the cult of personality dictator who won't name a successor going to be in power? Then we can talk about the party's role is not forever. It doesn't look this way forever. But I don't think you can look back at 2013 to now and claim the party is withdrawing from the private sector or withdrawing from areas of the economy. I think the trend is the opposite. Even though -- if you look back to 1979, the trend is obviously that the party has withdrawn.

VICE CHAIRMAN BARTHOLOMEW: Mr. Loevinger, anything to add?

VICE CHAIRMAN BARTHOLOMEW: No?

(Laughter.)

MR. LOEVINGER: I mean I agree with Derek. I think it's a rising concern that the party is sticking its hands into the affairs of private enterprises in China. And again there's lots of troubling trends in China.

But kind of the broader point I think you raised with Andy, does cooperation with China matter? Yes, absolutely. We have to find a way to get a relationship where we can address the concerns we have and move China in a positive way, but we also have to find a way to cooperate. When I was at the Treasury Department in 2008, September 8th we intervened in Fannie Mae and Freddie Mac. China held hundreds of billions of dollars of Fanny and Freddie-backed securities.

I don't know about -- according to press reports, right, the Russians were pushing China to join them in dumping these bonds. And what I do know is when we intervened we had the relationship in place where Hank Paulson could call China's leadership, explain what we were doing, dispatch a team from Treasury to again explain our strategy for dealing with Freddie and Fannie.

And I firmly believe that the financial crisis we experienced in 2008 and 2009 was horrible for many U.S. homeowners. It had been -- it would have been far worse if we didn't have a relationship where we could get together and cooperate when we needed to with China.

VICE CHAIRMAN BARTHOLOMEW: Again simply I don't think any of us would be advocating up here that we shouldn't be having communication going back and forth and relationship building, and clearly the investment banking world is doing that. So again I'm very sensitive going back to sort of the debates of the 1990s where people said engagement or not engagement. And that was a way to pitch a particular position.

What's interesting to me now is we actually have people talking about decoupling, though again today nobody has acknowledged the fact that China is decoupling as all of this is going on. Everybody's sort have been putting the burden on the U.S. as well. Are you going to decouple? In some sectors that's the case. Certainly in terms of technology and things like that the Chinese -- I mean Made in China 2025 is a blueprint for decoupling. So to me it's about keeping the terms of the debate sort of honest and clear.

And on ESG I really hope that as the movement is growing here in the United States we don't dumb it down or water it down enough that we can point to progress in China if progress really isn't there. Thank you.

CHAIRMAN CLEVELAND: Thank you.

Commissioner Lewis?

COMMISSIONER LEWIS: Thank you for very interesting provocative comments. I'd like to refer to three comments that you made and to ask each of you to expand on the comment.

One of you said what will the U.S. relationship with China be 40 years from now? I'd like you to tell us your thoughts.

One of you said we should establish our priorities. I'd like your thoughts on that, too.

Then one of you said China needs American capital. We were told earlier that China doesn't need our capital, so I'd like you expand on that also.

DR. SCISSORS: I think two of those might be mine, but that's -- I'll let Dave take credit for one, if he wants.

On priorities, I love working with the Congress and because of that I don't like try to say that I understand how we're going to aggregate priorities. My first priority here is rule of law because the worst thing the Communist Party does is undermine rule of law at home and wherever it goes, in other countries.

And so whenever somebody says, as we have had in this debate over listing Chinese firms; not this Panel, but in the White House, in this administration, it's too expensive to enforce our laws. That is the most distressing thing for me. I find that intolerable.

Now there are national security experts here who would talk about technology slipping. I'm not arguing against that. I've been crusading against Chinese firms which receive stolen IP for years.

But to me the starting point is the first thing you do is you enforce your laws, because everything else you do, if you're not going to enforce your laws, ultimately is undermined by the fact that you won't act to enforce your own principles.

So that's where I would start with my priorities. I would look where China is breaking American law and say this is intolerable. We'll talk to you about it, but in the meantime you're engaging in criminal action and we're going to punish you accordingly.

With regard to the U.S. needing Chinese capital, which maybe other panelists want to talk about -- sorry, China needing U.S. capital -- little slip there in terms of my research priorities -- the Chinese are running up and they continue to leverage. Andy and I can argue or even agree on is it shadow leverage or state and how you define it? Aggregate leverage continues to rise. Loan growth is considerably faster than nominal GDP. They are spending more and more money to get less and less result as a consequence of that.

Dave mentioned needing foreign funds because the balance of payments. To me that's secondary, but it's a reflection of domestic balances. They're going to be looking to draw foreign capital and for a long time. We don't have to settle this this year because we can talk about in next year and the year after. That's what I meant by this, is saying to the Commission you've touched on an issue which may or may not feel acute, but the issue will remain and dimensions of the issue will persist for at least a decade.

COMMISSIONER LEWIS: The last comment was where do you think that we will be in 40 years from now?

MR. ROTHMAN: Am I allowed to say I have no idea, but I have some thoughts about where I hope it will be? I hope it will be a relationship where we are comfortable that we've done everything possible at home to maintain our competitive advantage, building up our -- rebuilding up our institutions, reinvesting in education and R&D. And so -- kind of responding the way we responded to Sputnik. And so that we are comfortable sharing economic and strategic power with a China that is behaving a lot better than they were 40 years prior to that.

In terms of priorities I think the priority to get to that point is to decide that's the kind of relationship we want to have rather than to decide, as I believe some people have in Washington, that China is an implacable enemy akin to the Soviet Union and out to destroy us, whereas I don't see that that's what their ambitions are.

I think it's very different from the Soviet Union. They are globally-integrated. They are in our institutions that we built after World War II. They're just trying to out-compete us. And we do need to change some of those rules to account for them. They don't have any allies. So I think it's quite a difference.

COMMISSIONER LEWIS: Where does Taiwan fit into your views?

MR. ROTHMAN: I am pretty sanguine about Taiwan. I had the opportunity to be the Taiwan desk officer at the State Department back when China was firing missiles over Taiwan during the first democratic elections and I think since that time Taiwan has become a thriving and wealthy democracy. And I think Taiwan has largely won this battle and I think that's been tremendous progress. And the rest of the issues will come over time, but largely that's been resolved as far as I'm concerned.

COMMISSIONER LEWIS: So you don't think that Xi Jinping really means what he says when he says we'll think about force when necessary?

MR. ROTHMAN: I'm always skeptical of a lot of politicians, whether they say what they mean, and I tend to look at what's practical and realistic and what they're likely to do. So, no, I do not think that the Communist Party of China thinks that military conflict with Taiwan is in their interest, or winnable. So I'm pretty relaxed about that. Doesn't mean that we should give up what we've been doing to support Taiwan. We need to continue that with the same amount of enthusiasm that we've done that in past years.

COMMISSIONER LEWIS: Do you two agree?

DR. SCISSORS: About what in particular?

COMMISSIONER LEWIS: What he was saying.

DR. SCISSORS: About Taiwan my concern, because I have a very negative view of Xi, is that if he does not deliver a transformative event for China -- whether that's technological or diplomatic -- he has encouraged the press to refer to him in ways that were referred to Mao; he sees himself as Mao, at least publicly. Never met him. That is what drives him. Him personally, not the party, to look at Taiwan as an opportunity to look at reunifications opportunity. I don't disagree with what Andy said. I think he has not factored in the power of one person, which is -- I don't mean to say Xi is all powerful and he'd get away with it. I mean that he has ambitions that go beyond our previous discussion about party stability and party survival. They're his personal greatness. And that to me is the primary threat to Taiwan that I see now in terms of politics.

CHAIRMAN CLEVELAND: Commissioner Lewis, Commissioner Goodwin has a question.

COMMISSIONER GOODWIN: Thank you. In our last few minutes I'd like to actually circle back to the question that Commissioner Bartholomew raised, which I think is a really powerful question and certainly built on this assumption that we had going into our relationship with China, that engagement would bring reform: economic reform, market reform, democratic reforms. And I don't think we believe that's the case. So now what to do about it?

Getting into these somewhat provocative conversations about decoupling or other imperfect efforts like perhaps pulling back investment, which I've heard you all express concerns. How effective would that be? What does that do to investments and so forth?

But I think her question was really good, which is wait a second, are they decoupling? Are they making that decision? And I suppose my follow-up question would be are we helping them by continuing to allow this investment to flow, not just generally to their economy, but specifically to those sectors, to those businesses, to those entities where they are seeking to gain competitive advantage?

MR. LOEVINGER: Yes, I think I'll just make a couple comments. I always thought I understood the need to sell WTO accession. I think WTO accession was the right thing for the United States. It was the right thing for the world. But in that and other endeavors I never believed that engagement would lead China down a path similar to Japan or Korea or the United States. China is on its own path. And missionaries and companies and people in Washington have been making mistakes about this for decades, if not centuries. Not in Washington, but missionaries.

(Laughter.)

MR. LOEVINGER: Is China decoupling? Absolutely not. China's trade with the rest of the world is increasing. More countries -- for more countries China is the biggest trading partner -- their biggest trading partner than the U.S. is. And what we've been talking about is now financial integration, and China is increasingly becoming integrated with other countries' markets, both as a source of capital that's investing outward and as a destination for other savers around the world to invest in China. And I think that's only going to accelerate.

Are we helping it? I'm not sure we have a big impact. We can certainly I think accelerate the use of other currencies if, again as I said, we overreach and try and use access to our markets and our currency as a weapon where we don't have kind of broad multilateral consensus, we will accelerate other countries' efforts to work with China to figure out ways around our financial controls.

DR. SCISSORS: I think I'm going to be one of the rare people that accuses Commissioner Bartholomew of not being radical enough in her criticism of the Chinese. They're not trying to decouple. Made in China '25 is pre-Trump. Xi Jinping didn't come into office saying I love the United States. I totally trust them. Let's -- we'll just maintain the relationship with them. They're trying to change the terms of trade so that they have the prime position in the technology supply chain.

That's not decoupling. That's like you need to use our stuff like you need to use American stuff now, but now it's ours and we're going to dictate to you like the Japanese have been dictating to the South Koreans in their dispute because the Japanese have the core elements that are non-substitutable in that trade relationship.

So they don't want to decouple. They want to warp the world trading system more to their advantage. And I say warp because it's not being done on a market basis. So warp is correct. Distort.

So there's no decoupling goal here. It didn't start with Trump. It started arguably before Xi, but certainly with Xi. It was announced very nicely in their industrial policy. And the Germans understand this very well. The Chinese aren't trying to separate from Germany. They're trying to take the leadership position in advanced manufacturing away from Germany and then sell those products instead of low-margin manufacturing, which they're becoming less competitive in.

So let's be careful about the language. China doesn't want to decouple from the global economy. It wants a different place in the global economy that suits its advantages going forward, that involves higher technology, less labor, because it's an aging society. And they're going to by our standards cheat to get it, certainly cheat by anyone's standards in terms of stealing IP; we completely agree on that, that's not going to stop, but also cheat in terms of subsidies.

So the goal isn't to decouple and we're not helping them with real goal. The goal is to displace, the Germans and the Japanese and keep technologies and then integrate with the world on the basis of Chinese advantage in those supply chains.

MR. ROTHMAN: So then you're advocating, Derek, that we should collaborate with our allies who are running into these same problems with China and come up with a joint solution to try and create a level playing field? Thank you.

(Laughter.)

MR. LOEVINGER: Yes, I agree that they're not trying to decouple. They are trying to become a richer and stronger and more powerful country. That's what most countries achieve -- strive for. The question is do they do it by rules that we consider to be fair?

But the other side of it is that I think with the threat of us decoupling they're now scrambling to postpone the day when that might happen by signing a trade deal for -- that might work through November to give themselves more time to prepare for when we might decouple, so to rejigger their own global supply chains, to accelerate their own semiconductor production because they're dependent on American semiconductor IP.

I don't think that's an irreversible process, but the longer we do it, the more they have to feel that whether it's soy beans or semiconductors how reliable a treading partner are we?

CHAIRMAN CLEVELAND: So on that final note, I want to thank the Panel for provocative testimony which will be helpful to informing our annual report. And I think, Leslie -- is she in the room? There she is.

So this is the last hearing that Leslie will manage for us. She has been a wonderful, wonderful staffer. So I think we should give her a round of applause.

(Applause.)

CHAIRMAN CLEVELAND: We tried to thank her this morning, but she was not here both times.

And thank you again to the staff for just really superb support on a complicated set of issues.

So with that we're adjourned until February 20th. So thank you all.

(Whereupon, the above-entitled matter went off the record at 4:02 p.m.)

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