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Introduction

Commissioners Cleveland and Goodwin, other members of the Commission, thank you for the opportunity to participate in this important and timely hearing.

My name is John Dearie and I currently serve as Executive Vice President at the Financial Services Forum, a financial and economic policy group comprised of the chief executive officers of 19 of the largest financial institutions with business operations in the United States. The Forum also leads Engage China – a coalition of 12 financial services trade associations united in support of high-level engagement between the United States and China, with a particular emphasis on accelerated financial reform and modernization in China.

The topic of today's hearing is enormously important, particularly given the continued fragility of the economic recovery and elevated unemployment. The rate of China's economic emergence and the impact of its integration into the global economy are unprecedented – with profound implications for U.S. economic growth and job creation.

For that promise to be realized, however, China must reform and modernize its financial system – including opening its financial sector to more significant and extensive foreign participation. Progress has been made in recent years as part of the U.S.-China Strategic and Economic Dialogue, but major barriers remain. While China may be compliant with the letter of its WTO obligations, such restrictions and regulations – and the manner in which they are enforced – violate the spirit of China's WTO obligations by creating artificial and arbitrary barriers to greater foreign participation.

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

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

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

largest market for U.S. products outside of North America. According to an analysis by the *Washington Post*, exports to China from almost every U.S. state and Congressional district have grown dramatically in recent years.[1]

As a specific example, Commissioner Cleveland, exports from Virginia to China have increased 787 percent since 2000, as compared to growth of just 42 percent in Virginia's exports to the rest of the world. Similarly, Commissioner Goodwin, exports from West Virginia to China have increased more than 1,000 percent since 2000, as compared to growth of just 293 percent in West Virginia's exports to the rest of the world.[2] Other states have posted similarly impressive growth. Clearly, fair and competitive access to China's fast-growing middle class and business sector represents an enormous commercial opportunity for American manufacturers, services providers, and farmers.

Let me give you a quick sense of what an expanding Chinese economy can mean for U.S. economic growth and job creation. Last year, U.S. exports to Japan totaled $70 billion, while U.S. exports to China totaled $110.5 billion. But China's population is *ten times* that of Japan. If China's citizens were to eventually consume American-made goods and services *at the same rate* as the Japanese do, U.S. exports to China would grow to $700 billion annually.

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

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

Critical Importance of Financial Sector Reform in China

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

Capital is the lifeblood of any economy's strength and well-being, enabling the investment, research, and risk-taking that fuels competition, innovation, productivity, and prosperity. As the institutional and technological infrastructure for the mobilization and allocation of investment capital, an effective and efficient financial system is essential to the health and productive vitality of any economy.

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

[2] Export statistics provided by the U.S.-China Business Council.

As a financial sector becomes more developed and sophisticated, capital formation becomes more effective, efficient, and diverse, broadening the availability of investment capital and lowering costs. A more developed and sophisticated financial sector also increases the means and expertise for mitigating risk – from derivatives instruments used by businesses to avoid price and interest rate risks, to insurance products that help mitigate the risk of accidents and natural disasters. Finally, the depth and flexibility of the financial sector is critical to the broader economy's resilience – its ability to weather, absorb, and move beyond the inevitable difficulties and adjustments experienced by any dynamic economy.

For all these reasons, an effective and efficient financial sector is the essential basis upon which the growth and vitality of all other sectors of the economy depend.

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

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

- China's financial system is very bank-centric, with banks intermediating more than three-quarters of the economy's total capital, compared to about half in other emerging economies and less than 20 percent in developed economies.

- Non-commercial lending – or "policy lending" – to state-owned enterprises continues.[3]

- As a result, the stock of nonperforming loans on banks' balance sheets remains high.

- Off-balance sheet and non-bank lending through trust companies, especially to local government run state-owned companies, has greatly expanded and is largely unregulated.[4]

- China's banks remain undercapitalized compared to western counterparts and lending practices, risk management techniques, new product development, internal controls, and corporate governance practices remain sub-standard.

- Prudential supervision and regulation of the financial sector remains opaque, is applied inconsistently, and lags behind international best practices.

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[3] See "For Top Chinese Banker, Profits Hinder Political Rise," Lingling Wei and Bob Davis, *The Wall Street Journa*l, February 18, 2013.

[4] "In China, Hidden Risk of Shadow Finance," Lingling Wei and Dinny McMahon, *The Wall Street Journal*, November 26, 2012.

- China's equity market, the world's sixth largest by total capitalization, is also one of the most restrictive in terms of foreign participation. Foreign investors currently hold only about 1.5 percent of China's domestic share market and can only invest in Chinese companies through funds managed by brokerage firms, banks, and other financial institutions.

- Despite significant growth since 2008 and especially more recently, China's bond markets, remain comparatively small and underdeveloped.[5] The big five state-owned banks hold over 60 percent of all outstanding bonds, other state-owned entities hold another 30 percent, and 95 percent of all corporate issuers are state-owned enterprises.[6]

- Low penetration of insurance creates unmitigated risks and retards investment and family security.

More fully developed capital markets would provide healthy competition to Chinese banks and facilitate the development and growth of alternative retail savings products such as mutual funds, pensions, and life insurance products. And by broadening the range of funding alternatives for emerging companies, more developed capital markets would greatly enhance the flexibility and, therefore, the stability of the Chinese economy.

Simply stated, China's underdeveloped financial sector presents substantial risk to the continued growth and diversification of the Chinese economy – and, given the importance of China's economy, to the U.S. and global economies as well.[7]

China's Commitment to Financial Reform

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

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

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[5] "China's Corporate Bond Market Booms," Simon Rabinovitch, *Financial Times*, July 12, 2012.

[6] *Red Capitalism: The Fragile Financial Foundations of China's Extraordinary Rise*, Carl E. Walter and Fraser J.T. Howe, Wiley, 2010. Also see "Of China's Financial Bondage," Carl E. Walter and Fraser J.T. Howe, *The Wall Street Journal*, January 17, 2013.

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

But accelerating the shift to a more consumption-based Chinese economy requires a more modern and sophisticated financial sector.[8] Chinese households currently save as much as half of their income, as compared to single-digit savings rates in the United States and Europe. This pronounced propensity to save is related to the declining role of the state, and the fact that most Chinese depend on their families and private savings to pay for retirement, healthcare, education, and the economic consequences of accidents or disasters.

Activating the Chinese consumer requires the availability of financial products and services – personal loans, credit cards, mortgages, pensions, insurance products and services, and retirement security products – that will eliminate the need for such "precautionary savings" and facilitate consumption.

This observation was confirmed by an important report entitled "China 2030," jointly issued a year ago by the World Bank and China's Development Research Center. The report emphasized that achieving China's macroeconomic goals requires a number of urgent reforms, including "commercializing the banking system, gradually allowing interest rates to be set by market forces, deepening the capital market, and developing the legal and supervisory infrastructure to ensure financial stability and build the credible foundations for the internationalization of China's financial sector."[9]

Given the unique and critical role an effective financial sector plays in any economy, reform of China's financial sector is a *prerequisite* to China achieving its own economic goals.

Fortunately, China's leadership has recognized the connection between faster financial reform and the goal of a more consumption-based economy. In a speech opening the National People's Congress last March, Premier Wen Jiabao confirmed that China seeks more balanced and sustainable development, stating "we will move faster to set up a permanent mechanism for boosting consumption." Importantly, as part of the restructuring strategy, Wen also appeared to endorse further reform of China's financial system, stating: "We will improve both initial public offerings…and ensure better protection of return on investors' money and their rights and interests."[10]

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

More recently, on January 14th of this year, Mr. Guo startled global markets when he said during a speech in Hong Kong that foreign participation in China's stock market could be increased by as much as ten times. "For our capital markets to mature, they must be open more

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[8] "Financial Sector Reform Vital to Rebalance, Sustain China's Growth," International Monetary Fund, November 14, 2011.

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

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

in the future," Mr Guo said. "Our goal is to make it easier for non-residents to issue and trade securities in the domestic markets."[11] Mr. Guo's statement was interpreted by some observers as an indication that foreign individuals may soon be permitted to buy shares directly in Chinese companies.

A very recent indication that China's new leadership remains committed to financial reform is the decision that Zhou Xiaochuan, Governor of the People's Bank of China (PBOC), will remain at that post. It was originally reported that Zhou would leave the Bank this month.[12] Zhou has been Governor since 2002 and is the longest serving head of the PBOC. He has been a key reformer, presiding over the Bank during the financial crisis and helping implement important reforms, including the further appreciation of the yuan, as well as liberalization of the corporate bond market and bank deposit and lending rates.[13]

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

The U.S.-China Strategic & Economic Dialogue

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

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

Limited but meaningful progress has been made by way of the Dialogue. For example:

- China has agreed to allow qualified foreign companies to list on its stock exchanges by issuing shares or depository receipts;

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[11] "China Hints at Far Wider Welcome to Overseas Investors," Neil Gough, *The New York Times*, January 14, 2013. Also see "Forget China's Leaders – Watch This Man for Reforms, *CNBC.com*, January 22, 2013.

[12] "China Bank Chief Set to Keep Job in Reshuffle," Benjamin Kang Lim and Victoria Bi, *Reuters*, February 20, 2013.

[13] "China Extending Zhou Stay Seen As Aid to Financial Overhaul," Kevin Hamlin and Scott Lanman, *Bloomberg*, February 21, 2013.

- China has expanded its Qualified Foreign Institutional Investor (QFII) program and reduced the initial "lock-up period" for certain investors, creating new opportunities for foreign mutual funds and money managers to invest in China;

- China has agreed to allow non-deposit taking foreign financial institutions to provide consumer financing;

- China has agreed to ease qualifications for foreign banks to issue yuan-denominated subordinated bonds, which will allow foreign banks to raise capital in China;

- China has issued regulations specifying requirements to allow insurance companies – including foreign-owned companies – to invest assets overseas; and,

- Since July of 2005, the yuan has appreciated against the U.S. dollar by more than 25 percent in nominal terms and almost 40 percent in real terms.[14] Last April, China widened the yuan's trading band to allow market forces to play a greater role in setting the exchange rate.[15] Some analysts believe the PBOC hopes to make the yuan fully convertible by as early as 2015.

Additional progress achieved at the most recent S&ED meetings last May included:

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

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

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

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

[15] "Chinese 'Currency Manipulation' Is Not the Problem," Edward Lazear, *The Wall Street Journal*, January 7, 2013.

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

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

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

U.S. Institutions Still Confront Major Restrictions

Despite such important progress, U.S. financial institutions continue to face a number of substantial obstacles in China. For example, foreign investment in Chinese banks is limited to 20 percent ownership stakes, with total foreign investment limited to 25 percent. Foreign ownership amounts to less than 2 percent of the Chinese banking system, the lowest foreign share among major emerging markets according to the IMF.[16] Foreign banks also face a number of regulatory restrictions on their ability to branch within China (see Appendix for details). According to Treasury Department data, as of December 2011, only eight U.S. banks were operating in China with a total of just 76 branches.[17]

To give you a sense of the impact of China's ownership and branching restrictions, consider that Citigroup, which first established a presence in China in 1902, operates just 50 branches in China. By contrast, Citigroup operates approximately 70 branches in Taiwan – which has a population of just 23 million.[18]

Foreign-owned securities and asset management firms are limited to joint-ventures in which foreign ownership is capped at 49 percent. Meanwhile, foreign life insurance companies remain limited to 50 percent ownership in joint ventures and to 25 percent equity ownership of existing domestic companies.

While such caps were agreed to in the course of WTO accession negotiations, the limitations are among the most restrictive of any large emerging market nation and stand in the way of a level playing field for financial service providers. More importantly, they limit access to the products, services, know-how, and expertise that China needs to sustain high rates of

[16] "Foreign Banks: Trends, Impact, and Financial Stability," Stijn Claessens and Neeltje van Horen, International Monetary Fund, January 2012.

[17] "Banks Find Promise Unfulfilled in China Forays," Alison Tudor, *The Wall Street Journal*, January 13, 2013.

[18] "China Wall Hit by Global Banks with 2 Percent Market Share," Jun Luo, *Bloomberg*, June 5, 2012.

economic growth, and that China's businesses and citizens need to save, invest, and create and protect wealth.

Such investment caps also stand in stark contrast to the Federal Reserve's decision last year to approve Industrial & Commercial Bank of China's acquisition of the Bank of East Asia's U.S. banking subsidiary,[19] Bank of China's application to expand its U.S. operations to Chicago[20], and the application by Agricultural Bank of China Ltd. to establish a branch in New York.[21] As strong proponents of cross-border trade and investment, the U.S. financial services industry applauds the Fed's decision – but also calls on China to lift remaining restrictions to U.S. investment in China's financial system.

Other remaining barriers to U.S. activity in China include non-prudential restrictions on licensing and corporate form; arbitrary limitations of permitted products and services; and, arbitrary and discriminatory regulatory treatment.

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

- The critical importance of open commercial banking, securities, insurance, pension, and asset management markets to promoting the services- and consumption-led economic growth that China's leaders seek;

- The clear benefits to China of increased market access for foreign financial services firms – namely the introduction of world-class expertise, technology, and best practices – and the importance of removing remaining obstacles to greater access;

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

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

- Regulatory and procedural transparency; and,

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

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

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

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

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

Conclusion

The fastest way for China to develop the modern financial system it needs to achieve more sustainable economic growth, allow for a more flexible currency, and increase consumer consumption is to open its financial sector to greater participation by foreign financial services firms.

By providing the financial products and services that China's citizens and businesses need to save, invest, insure against risk, raise standards of living, and consume at higher levels, foreign financial institutions – including U.S. providers – would help China develop an economy that is less dependent on exports, more consumption-driven and, therefore, an enormously important and expanding market for American-made products and services. In doing so, U.S. financial services firms can help China become a more stable and responsible stakeholder in the global economy and trading system.

It is also important to emphasize that Congress has an important contribution to make toward expanding market access generally, and encouraging faster financial reform in China specifically, by bringing the same kind of attention and pressure to these issues as it has to the relative value of China's currency. Chinese policymakers care what members of Congress think and carefully monitor the content of statements, speeches, and hearings as they gauge the state of the bilateral relationship. For example, the letter that Senators Warner and Johanns sent to Secretary Geithner on April 24, 2012 just prior to the S&ED in May, urging him to ensure that accelerated financial reform be a central aspect of the Dialogue, is an excellent example of the kind of pressure that makes a real difference.

Again, thank you for the opportunity to appear at this important hearing.