The U.S.-China Strategic Economic Dialogue and
The Importance of Continued Financial Sector Reform in China

Introduction

On behalf of our member institutions and the broader financial services industry, we[1] congratulate Secretary Paulson and the Treasury Department on the recent establishment of the U.S.-China Strategic Economic Dialogue ("the Dialogue"). By providing 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), the Dialogue will greatly enhance and facilitate economic cooperation between the United States and China. Such close cooperation is essential to ensuring that our two nations effectively address common economic challenges, that China achieve its stated goal of building a consumer-driven economy based on open markets, and that the citizens of both nations benefit fairly from the growing bilateral economic relationship. The Dialogue also provides an important new opportunity to deliver a unified and consistent message to China that the United States regards open, fair, and competitive capital markets in China to be a policy priority.

The rate of China's continuing expansion and the impact of its integration into the global trading system are unprecedented in the history of the world's economy. Since 1980, more than 400 million Chinese have been lifted out of poverty, and over the last four years the United States and China have accounted for half of global economic growth. We agree with Secretary Paulson's statement on September 21st that "the relationship between the U.S. and China is the most important bilateral economic relationship in the world today." How this critical relationship is managed is clearly one of the most important factors determining the growth and stability of the global economy in the 21st century.

Given the high-level nature of the Dialogue and the importance of its work, we very much appreciate the opportunity to provide our collective insights regarding one of the most critical aspects of China's continuing development – the further liberalization and modernization of its financial services sector.

Near-Term Priorities of the U.S. Financial Services Industry

The central theme of the comments and insights provided in this paper is that continued reform, opening, and modernization of China's financial services sector is in the economic and political interest of both China and the United States. While we fully appreciate that a major purpose of the new Dialogue is to establish an effective process for higher level discussions – and understanding that no new framework of communication represents a "silver bullet" that can

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[1] American Bankers Association, American Council of Life Insurers, American Insurance Association, The Council of Insurance Agents & Brokers, The Financial Services Forum, The Financial Services Roundtable, Investment Company Institute, and the Securities Industry and Financial Markets Association.

be expected to immediately resolve difficult outstanding issues – we nevertheless believe that as U.S. authorities initiate the Dialogue later this month, it will be useful and important to bear in mind specific discussion objectives. The near-term priorities of the U.S. financial services industry include:

- the critical importance of open commercial banking, securities, insurance, pension, and asset management markets to promoting the 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 treatment with regard to licensing, corporate form, and permitted products and services;

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

- regulatory and procedural transparency;

- attracting sophisticated institutional investors to China's capital markets through the expansion of the Qualified Foreign Institutional Investor (QFII) and Qualified Domestic Institutional Investor (QDII) programs; and,

- priority issues from the Transitional Review Mechanism that remain unresolved.[2]

Critical Importance of the Financial System to Any Economy

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, efficient, private sector financial system is essential to the health and productive vitality of any economy.[3]

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[2] China's WTO accession included the Transitional Review Mechanism (TRM) as a means for ongoing review of China's compliance with its obligations, and to provide those elements of the Chinese government supportive of further economic reform with information and evidence to urge full compliance with China's WTO commitments.

[3] That the financial services sector should remain primarily private is a critical point. The inherently political nature of government implies that the state is ill-equipped to make capital allocation decisions. Asia's experience in the late 1990s and the experience of the former command economies of Eastern Europe and the Soviet Union make clear just how ineffective and even dangerous "policy lending" can be. In China, the alarmingly high levels of nonperforming loans that remain on the balance sheets of state-owned or controlled banks are perhaps the most conspicuous manifestation of government's misallocation of capital resources. For capital to be rationally allocated and properly priced, decisions as to who receives capital or credit, and under what terms, must be left to private initiative in a context

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. Financial services liberalization promotes opportunity, social justice, and stability by broadening the range of empowering savings and investment alternatives and by facilitating the development of insurance and retirement security products – all of which fosters the growth of a stable middle class, freeing governmental resources to concentrate on society's neediest. Finally, the depth and flexibility of the financial sector is critical to the broader economy's resilience – its ability to weather, absorb, and move beyond the inevitable difficulties and adjustments experienced by any dynamic economy. For all these reasons, an effective, efficient, and sophisticated financial sector is the essential basis upon which the growth and vitality of all other sectors of the economy depend. It is the "force multiplier" for progress and development, amplifying and extending the underlying strengths of a growing economy.

Importance of Modern Financial System to China

Almost immediately after assuming leadership at the 16th Chinese Communist Party Congress in 2002, President Hu Jintao and Premier Wen Jiabao sought to distinguish themselves as the "putting-people-first administration." They also enunciated the notion of a "scientific viewpoint of development," by which economic growth is to be balanced with social priorities such as a more equitable distribution of income, poverty reduction, education, improved medical care, and environmental protection.[4] Such adjustments were necessary, according to the new regime, to establish a more sustainable course for China's long-term economic growth and to achieve a more "harmonious" – which is to say, a more equitable and stable – society.

These priorities became the framework of China's 11th Five-Year Plan[5], which broadens China's development policy beyond simply promoting rapid economic growth to include a clear emphasis on "common prosperity" – that is, an effort to extend westward the economic gains enjoyed principally in China's east coast urban areas. This redefinition of economic progress marks a departure from the policies of Deng Xiaoping who, in abandoning the Maoist egalitarian principles of his predecessors in 1978, famously declared that in order for China to rise out of poverty, some must be allowed to get rich first. Over the next 25 years, China's economic model of industrial, export-led expansion produced an average annual growth rate of nearly 9 percent,

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where those making the decisions have a major stake – their own capital and economic livelihood. In a properly functioning financial system, those receiving capital and credit will be the most efficient, competitive, and profitable – those most capable of producing the stream of goods and services that will enable the economy to grow and, as a result, for living standards to rise.

[4] See Wen Jiabao, closing speech at the Specialized Research Course for Province-Level Cadres on Establishing and Implementing a Scientific Developmentalist Viewpoint," February 21, 2004.

[5] The Five-Year Plan, the 11th since 1953, was approved by the fifth plenary session of the 16th Communist Party Central Committee in October of 2005 and ratified by the National People's Congress this past spring.

transformed China into the world's fourth largest economy, and lifted some 400 million out of poverty.

Despite such remarkable progress, the structure and pace of China's economic growth has produced significant problems, both economic and social. The country's fixed investment- and export-driven development – more factories to produce more goods for world markets – has left China vulnerable to economic slowdown elsewhere in the world (particularly in the United States), and to rising energy, materials, and labor costs. The manufacturing and export focus of the economy has also led to widening disparities between rich and poor, made worse by the closing or privatization of state-owned enterprises, which had provided most healthcare services in China. There are, in effect, two Chinas – a wealthy elite and a developing middle class along the coast, and 800 million poor in the central and western interior.[6] The worsening wealth gap and the resulting social dichotomy have led to increasing political instability. Reports indicate that as many as 100 significant incidents of protest occur in China every day.

The Five-Year Plan seeks to address the twin problems of an economy perceived as being too dependent on external demand and the social consequences of the widening wealth gap by pursuing a shift in production from industry to services, facilitating the development of domestic consumer demand, and discouraging internal investment for the purposes of producing exports. Such a fundamental macroeconomic adjustment presents enormous challenges. Government subsidization of energy, land, and other resources continues to encourage investment in fixed assets, which expanded by 30 percent in the first half of 2006. Indeed, a recent analysis by the World Bank indicates that although China's economy grew by 10.9 percent in the first half of 2006 – including a ten-year high of 11.3 percent in the second quarter – growth has continued "along familiar, largely imbalanced patterns," with the growth in manufacturing outpacing the growth in services and the growth in exports outpacing the growth in imports. "The desired shift in production from industry towards services, more reliance on domestic demand, more equally shared growth, and more environmentally sustainable growth that are aimed for in the 11th Five-Year Plan has yet to begin," the Bank reported.[7]

Activating the Chinese consumer will also prove challenging. Chinese households historically save as much as a third of their income as compared to single-digit savings rates in the United States and Europe. This pronounced propensity to save is related to the declining role of the state and the fact that most Chinese depend on their families and private savings to pay for retirement, healthcare, and the economic consequences of accidents or disasters. The Five-Year Plan calls for the establishment of a social safety net – from universal social security and medical care, to insurance schemes for unemployment and labor accidents – but such programs remain at the planning stage.[8]

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[6] According to an unpublished report by the World Bank that has been shared with the Chinese government, from 2001 to 2003, as China's economy expanded by nearly 10 percent a year, average incomes of the poorest 10 percent of Chinese households fell by 2.5 percent. See "In China, Growth at Whose Cost," The Wall Street Journal, November 22, 2006.

[7] See "China Quarterly Update," The World Bank, August 2006 and November 2006.

[8] In this connection, the U.S. financial services industry appreciates the Treasury Department's previous advocacy that activation of the Chinese consumer can be accelerated by China's leadership permitting,

As part of the policy of promoting social equality by way of more even distribution of wealth, the Plan also envisions moving hundreds of millions of rural peasants to urban centers. To achieve such an ambitious social engineering objective without creating mass urban unemployment and homelessness, China will need to create tens of millions of jobs each year for decades.

The critical importance of an efficient, open, and competitive financial system to the achievement of China's economic plan is clear. Creating the millions of new jobs that China will need each year requires maintaining exceptional rates of economic growth, which in turn will increasingly depend on an effective system for mobilizing and productively allocating investment capital. At present, China's weak banking system intermediates nearly 75 percent of the economy's total capital, compared to about half in other emerging economies and less than 20 percent in developed economies. Despite some improvements in recent years, Chinese banks' credit analysis, loan pricing, risk management, internal controls, and corporate governance practices remain inadequate. A major obstacle to better lending based on rigorous and impartial analysis has been the lack of a national credit information service to provide the information necessary for banks to competently evaluate individual loan applicants. Meanwhile, China's equity and bond markets are among the smallest and least developed in the world. More fully developed capital markets would provide healthy competition to 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.

Facilitating the desired transition to a more services-based economy will require that competitively priced capital and credit be channeled to the most promising emerging service businesses, and that the array of financial products and services emerging businesses require – loans, letters of credit, accounts management services, asset management, and insurance products – be made available. At present, state-owned enterprises, though contributing only a quarter of China's GDP, receive more than a third of bank credit and account for nearly all equity and bond issues. Private enterprises, the most productive of China's economy and the engine of future growth and job creation, account for only 27 percent of bank loan balances. More developed capital markets would enhance access to bank capital by smaller businesses and consumers – banks' natural customer base – who are too often crowded out by large companies forced to rely on banks for funding.

Finally, increasing domestic demand by activating the Chinese consumer requires the availability of financial products and services – personal loans, credit cards, mortgages, pensions, insurance products, and insurance intermediary services – that will encourage and facilitate consumption. As but one example of the potential impact of modern financial products, of

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indeed encouraging, the marketing of new risk protection products that would obviate the need for precautionary savings. Specifically, the leadership should encourage the development of the fledgling defined contribution pension ("enterprise annuity") system by streamlining the regulatory approval process, allowing for provision on a consolidated basis, and by implementing tax incentives to encourage individual retirement savings.

China's 1.3 billion people, 480 million use cell-phones, but less than one million currently have a credit card.[9]

In sum, a more modern, open, and competitive financial system would greatly enhance the productive capacity and stability of the Chinese economy and facilitate the achievement of China's economic goals, as described in the 11th Five-Year Plan. Indeed, research conducted by McKinsey indicates that genuine reform of its financial system would expand China's economic output by as much as 17 percent, or an additional $320 billion a year.[10]

Liberalization of China's Financial System Important for the U.S. Economy

Given that a stronger, more sophisticated, and more resilient financial system is a prerequisite to China's continued economic development, such reform and modernization is very much in the interest of American financial services providers, along with American manufacturers, farmers, and other service providers. At present, the U.S. financial services industry accounts for 5 percent of private sector jobs and contributes $1 trillion, or more than 8 percent, to America's GDP. Fair and competitive access to China's fast-growing middle class and business sector represents an unprecedented commercial opportunity, with major implications for additional U.S. economic growth and job creation.

Moreover, as Secretary Paulson noted during his confirmation testimony in July and in announcing the Dialogue in September, a modern and competitive financial system would also facilitate important aspects of U.S. trade and economic policy with China. For example, a major reason advanced by Chinese authorities to resist further flexibility in the exchange rate is the lack of expertise on the part of China's banks, securities firms, and other businesses to develop and trade derivatives and other structured instruments used to hedge the risk associated with great currency volatility.[11] The ability of U.S. financial services firms to strengthen such expertise in China would clearly diminish those concerns. In addition, successful adjustment of China's economy toward the production of services, and the activation of the Chinese consumer by reducing precautionary savings – goals that, as stated above, require a more developed, effective, and diverse financial sector – are critical to successfully addressing international trade imbalances.

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[9] See "China's Credit Card Industry is Set to Take Off," The Wall Street Journal, August 31, 2005.

[10] See "Putting China's Capital to Work: The Value of Financial System Reform," by Diana Farrell, Susan Lund, and Fabrice Morin, The McKinsey Global Institute, May 2006.

[11] Answering a question on September 21, 2006 regarding his notion of a "flexible exchange rate regime" for China, Secretary Paulson stated: "It is an exchange rate where the currency's value is set in the competitive marketplace. We're not going to be able to get there until we get China to the point where they have capital markets that are really competitive in an open financial system."

U.S. Financial Services Industry's Policy Priorities in China

Academic studies have repeatedly determined that the development, expansion, and deepening of the financial sector promote faster, broader, and more sustainable economic growth, in developed and developing countries alike. Moreover, the more open a financial sector is to competition – which promotes efficiency, innovation, and productivity – the greater the benefits of the financial sector to the broader economy. Given the contribution a growing China has already made to the global economy and the tremendous potential of its further development, the challenges associated with the structural economic adjustments targeted in China's Five-Year Plan, and the unprecedented commercial opportunity a developing China represents, the U.S. financial services industry strongly supports policy steps toward achieving more open and competitive commercial banking, securities, insurance, pension, and asset management markets in China.

China Must Fulfill Its WTO Commitments

Under the terms of its December 2001 WTO accession, China committed to implement a set of sweeping reforms that require the lowering of barriers to trade in virtually every sector of its economy, progressively increased market access, national treatment, and regulatory transparency. The phase-in period for many of these commitments has already been completed, while in other areas, such as commercial banking, obligations must be met by December 11th of this year, which will mark the five-year point since China's accession. Fulfilling these commitments has required nothing short of a wholesale institutional transformation of China's economy and the relationship between government and major industries – a transformation that has been complex, challenging, expensive, even painful, and that has no comparison in American history. In the five years since its accession, China has made tremendous progress, in some cases exceeding the requirements of its WTO commitments.

With regard to financial services, there have been, and continue to be, a number of procedural and regulatory issues that have frustrated foreign financial institutions as they have sought to take full advantage of China's commitments. For example, in 2002 the People's Bank of China (PBOC) issued working capital requirements and other prudential rules for foreign banks that far exceeded international norms. Chinese authorities have also been slow to act on foreign banks' applications and continue to permit foreign banks to open only one branch every 12 months. Similar problems have been experienced by foreign insurance companies, such as the approval of new branches on a strictly sequential basis rather than the concurrent approval enjoyed by Chinese insurance providers. In addition, in December of 2005 the China Securities Regulatory Commission (CSRC) imposed a de facto moratorium on foreign investments in Chinese securities firms.

The Treasury and Commerce departments, along with the U.S. Trade Representative's office, have worked closely with their Chinese counterparts in the context of the Financial Sector Working Group, the Joint Commission on Commerce and Trade, and other ongoing bilateral policy discussions to identify such problems and seek their swift resolution. The U.S. financial services industry understands that no agreement is self-enforcing and that active and ongoing advocacy by the relevant U.S. government agencies for complete implementation is essential. The industry appreciates these efforts to date and is hopeful that the new Strategic Economic

Dialogue, by elevating such ongoing bilateral discussions to a new level, will accelerate progress toward greater foreign institution participation in China's developing financial sector, national treatment, and transparency.

It should be acknowledged that in addition to working to meet its WTO commitments, China has also taken important steps to liberalize the financial sector and to improve financial regulation. For example:

- the financial sector has been transformed from a single-bank system to a more diversified system with a central bank at the helm;

- meaningful steps have been taken to eliminate state-directed policy lending, and amendments to the Law on Commercial Banks and the Law on the Peoples Bank of China have laid the foundations for commercially viable lending;

- the China Banking Regulatory Commission (CBRC) was established in April of 2003 to oversee all banks in China, investigate illegal banking operations, and punish violations of law; and,

- interbank, equity, and foreign exchange markets have been established and important progress made in the use of indirect means of monetary policy.

The U.S. financial services industry applauds such efforts to open and modernize the Chinese financial system – and urges continued progress. Indeed, despite the achievements to date, China's financial sector still faces serious challenges:

- non-commercial lending to state-owned enterprises continues, although on a diminishing scale;

- the stock of nonperforming loans on banks' balance sheets remains high;

- banks are undercapitalized and lending practices, risk management techniques, new product development, internal controls, and corporate governance practices remain inadequate;

- prudential supervision and regulation of the financial sector is opaque, applied inconsistently, and lags behind international best practices; and,

- China's equity and bond markets remain small and underdeveloped.

With these problems in mind, we are of the view that efforts to build on the significant progress achieved to date should focus on:

- the critical importance of open commercial banking, securities, insurance, pension, and asset management markets to promoting the 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 treatment with regard to licensing, corporate form, and permitted products and services;
- non-discriminatory treatment with regard to regulation and supervision;
- regulatory and procedural transparency;
- attracting sophisticated institutional investors to China's capital markets through the expansion of the Qualified Foreign Institutional Investor (QFII) and Qualified Domestic Institutional Investor (QDII) programs; and,
- priority issues from the TRM that remain unresolved.

In light of the substantial liberalization of China's capital markets that was achieved within the context of China's accession to the WTO, the U.S. financial services industry urges the Treasury Department and the other relevant U.S. government agencies to address the issues highlighted above not only through the Dialogue, but also in seeking China's commitment to additional financial sector liberalization in multilateral fora such as the Doha Round of trade negotiations.

<u>Increased Market Access for Foreign Financial Services Institutions</u>

The fastest and most effective way to address the current deficiencies of China's financial sector is to expand foreign institution participation. Foreign institutions bring world-class expertise and best practices with regard to products and services, credit analysis, risk management, internal controls, and corporate governance. In addition, the competition brought by foreign institutions would accelerate the adoption of such techniques and methodologies by domestic financial institutions.[12]

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[12] Secretary Paulson spoke directly to this critical point in announcing the Dialogue on September 21, 2006: "I am a very strong advocate of [China] opening up its capital markets to foreign investment. I believe when they open up and let foreign competition in, the biggest beneficiary will be China, and it will mean more jobs in the financial services industry for the Chinese people. It will mean better training. It will mean more competitive capital markets that will have all sorts of other benefits for the economy…I can't think of a single example anywhere of a situation where a country has a strong capital market system and they haven't opened themselves up to competition."

Despite these clear benefits, regulatory barriers continue to impede greater participation by foreign financial institutions. For example, foreign investors in Chinese banks remain limited to 20 percent ownership stakes, with total foreign investment limited to 25 percent. Chinese authorities also continue to require three years of operation and two continuous years of profitability before foreign banks' branches are permitted to carry out local currency business. Due in large part to such obstacles, foreign financial institutions currently account for less than 2 percent of the assets of the Chinese banking system.

The China Securities Regulatory Commission (CSRC) continues to limit foreign ownership of Chinese asset management companies to 49 percent, and since December of 2005 has imposed a de facto moratorium on foreign investments in Chinese securities firms. The moratorium is inconsistent with the letter, and is certainly a violation of the spirit, of China's WTO commitments. Foreign life insurance companies remain limited to 50 percent ownership in joint ventures and to 25 percent equity ownership of existing domestic companies.

The U.S. financial services industry urges that such restrictions on foreign ownership of Chinese financial institutions be eased and eventually eliminated, and that branching restrictions be eliminated. We also urge that China permit the supply of financial services on a cross-border basis, particularly when such services are provided to institutional investors and other sophisticated clients. For example, in order to properly mitigate large commercial risks such as marine, aviation, and transportation risk, insurance and reinsurance brokers require broad access to the global insurance markets.

<u>Non-Discriminatory Treatment with Regard to Licensing, Corporate Form, and Products</u>

Efficient deployment of the capital and other resources of foreign financial institutions in China requires the flexibility to determine which particular corporate reform – whether a wholly-owned subsidiary, branch, representative office, joint venture, or majority equity investment in an existing Chinese company – is most appropriate economically and within the broader strategic parameters of the foreign institution. Restrictions on operational form can discourage foreign financial institutions from initiating business activities in China, despite finding the market attractive, which will not serve the interests of the Chinese consumer.

As mentioned above, Chinese authorities have been slow to act on foreign banks' applications, continue to permit foreign banks to open only one branch every 12 months, and continue to approve new branches of foreign insurance firms on a consecutive basis rather than concurrently. Also, many foreign insurance companies, under pressure from Chinese authorities to do so, have sought to convert branches to subsidiaries – but the approval period, which is supposed to be no more than 60 days, often stretches beyond a year.

Regulatory restrictions on the approval of new products, services, or other activities also obstruct foreign financial institutions' ability to serve the needs of Chinese customers. For example, China's authorities have yet to approve the marketing of political risk insurance products or to provide adequate tax treatment for defined contribution pension products or producer commissions to encourage the sale of sophisticated commercial insurance products. Given the importance of integrating Chinese businesses into the global trading system, U.S. non-life insurance companies and insurance intermediaries should be permitted to market their international expertise and global coverage to Chinese exporters by offering political risk and other similar products. Regarding China's recently created defined contribution pension system ("enterprise annuities"), licensing procedures have not been clearly defined after two years and no U.S. company has been authorized to be a provider.

On the banking side, Chinese borrowers are prohibited from converting foreign currency loans into local currency, and local currency borrowers are not permitted to use stand-by letters of credit denominated in foreign currency. Securities firms continue to be prohibited from developing and distributing derivative products and services. The U.S. financial services industry urges that all restrictions on corporate form be eliminated and that meaningful steps be taken to expedite regulatory approval of new products and services.

Non-Discriminatory Treatment with Regard to Regulation and Supervision

In recent years, foreign financial institutions operating in China have been subject to special, non-prudential – and at times discriminatory – regulation and supervision. As mentioned above, regulations continue to require three years of operation and two continuous years of profitability before foreign banks' branches are permitted to carry out local currency business. Recently announced rules require foreign banks to incorporate locally with minimum capitalization of one billion yuan ($120 million) and an additional one hundred million yuan for each branch. A portion of foreign banks' branch capital must be deposited in Chinese banks, and foreign banks remain subject to minimum interest rate rules when borrowing from Chinese banks. Most problematic, the 75 percent loan-to-deposit cap discriminates against foreign banks because their small number of branches – made worse by a slow approval process – limits foreign banks' deposit base.

China has similarly promulgated a fixed minimum capital requirement of 500 million yuan ($50 million) for securities and asset management firms wishing to participate in joint ventures permitted under China's WTO commitments. This requirement dissuades smaller foreign entrants, reduces the overall attractiveness of the joint venture vehicle, and discourages foreign direct investment. Foreign minority-owned joint ventures are also limited to underwriting the A-shares of Chinese corporations, and to underwriting and trading government debt, corporate debt, B-shares and H-shares. Trading in A-shares – the most liquid domestic market – by foreign joint ventures is not permitted, which significantly compromises their underwriting business. Foreign entities are also restricted in many cases from trading yuan and yuan-linked products with foreign and domestic enterprises in China. Without the ability to trade local currency, any progress otherwise achieved in expanding the permitted activities of foreign securities firms is difficult to realize competitively.

The U.S. financial services industry urges continued vigilance to ensure that foreign financial institutions receive national treatment with regard to regulatory and supervisory requirements.

Regulatory and Procedural Transparency

Related to the issue of non-discriminatory regulatory and supervisory treatment, China must also continue to make progress regarding the critical issue of regulatory and supervisory transparency. Fair and transparent regulation plays an integral role in the development of deep and liquid capital markets that attract market participants, increase efficiency, and spur economic growth and job creation. Transparency generally means that the public and industry participants have the opportunity to participate in the rule-making process, to access information about proposed rules, to question and understand the rationale behind draft rules, to have sufficient opportunity to review and comment on proposed rules, and that final rules and regulations be clearly articulated and easily understood.

Unfortunately, regulatory ambiguity continues in China and administrative procedures and the rule-making process continue to be inconsistent and unnecessarily opaque. New regulatory guidelines are too often promulgated without notice or consultation with the industry. Even when industry consultation has been sought, the response period has often been insufficient. While China has agreed to publish the laws and regulations governing financial services as its WTO accession protocol requires, it has not committed to all of the essential elements of modern regulatory transparency, including advance notice of new rules or rule changes, public comment, and the right to judicial review.

Other Important Issues

Expansion of QFII and QDII Programs

Enacted in December of 2002, the Qualified Foreign Institutional Investor (QFII) Act permits qualified foreign institutional investors to invest in the securities of Chinese companies. Qualified investors must meet various size (i.e., assets under management) and experience requirements, must invest a minimum of $50 million, and must submit to restrictions on repatriation. Liberalization of these and other restrictions[13] would encourage greater foreign portfolio investment in China – which would contribute significantly to the further development, broadening, and deepening of China's capital markets, with all of the associated benefits discussed above.

China's Qualified Domestic Institutional Investor (QDII) program, initiated last May, allows approved financial institutions in China to make overseas portfolio investments in foreign currencies, both for themselves and on behalf of clients. The program has been slow to gather momentum, however, due to limited knowledge of the program, a lack of understanding on the part of potential investors regarding overseas investing, and comparatively low returns associated with regulatory restrictions on investments. Permitted investments are generally limited to bonds and money-market instruments. The programs success has also been hampered by restrictions on qualified investors. Broadening of the QDII program to include more investors such as insurance companies and mutual and pension funds, and expanding permitted investment

[13] Liberalization should include crediting the Chinese operations of global companies to account for the international experience and asset base of the parent for purposes of authorizing access to newly permitted asset classes.

alternatives to include higher-yielding instruments, would help educate Chinese institutions about overseas investing and expose them to quality research and international best practices with regard to brokerage services. It would also provide opportunities for foreign asset managers through sub-advisory or pension mandates, as well as the creation of local investment funds with an international focus.

Private Credit Bureaus and Rating Agencies

To meet China's stated goals of continued rapid economic growth and a more services-based economy more reliant on consumer demand, Chinese banks must more effectively serve the needs of small and medium-sized private companies and consumers. To successfully lend to these segments, banks must be able to assess the credit quality of borrowers and price their risks accurately. A major obstacle has been the lack of a national credit information service to provide the information necessary for banks to competently evaluate individual loan applicants.

In 2002, the Shanghai Information Office and the Shanghai branch of the People's Bank of China established the first personal credit data organization involving 15 commercial banks. Large cities such as Shanghai, Beijing, Guangzhou, Shenzhen, Chongqing, and Chengdu had repeatedly called for a reliable credit data system. Experian, one of the world's largest credit reference agencies headquartered in the United Kingdom, and currently serving as an advisor to the People's Bank of China, has estimated that the credit analysis costs of Chinese banks could drop as much as 80 percent if credit decisions were facilitated by the computerization of standardized credit performance information.

In early 2006, China's official credit management authority, the State Credit Bureau, expanded its operations to cover most of the country. But Chinese banks also need the services of independent, private consumer credit agencies. To speed their development, regulators should provide incentives for lenders and utilities to report payments histories of borrowers.

China would also benefit from greater and more reliable information on corporate borrowers, particularly small- and medium-sized businesses. The United States should work with China's financial regulators to strengthen financial reporting and auditing standards, as well as support the further development of independent, private rating agencies such as Moody's Investors Service and S&P, which at present provide only limited coverage.

Conclusion

China's membership in the WTO beginning in December of 2001 was the culmination of more than 25 years of political and economic engagement by the United States. Such cooperation has broadened and deepened the relationship between our two nations, to the benefit of both. Since 2001, trade between the United States and China has more than doubled from $121 billion to $285 billion, exports to China have grown at five time the pace of U.S. exports to the rest of the world, and China has risen from our 9th largest export market to our 4th largest.

But our work to help China integrate into the global economy is not finished. Indeed, in a very real sense, only the easy part is over. As China's transition period as a new member of the

WTO comes to an end, U.S. policy should move beyond the monitoring of China's compliance with a discrete set of obligations to one seeking more proactive cooperation in an increasingly dynamic relationship. The aim of our efforts should be to ensure that China participates fully and constructively as a mature and responsible stakeholder in the WTO multilateral trading system and the global economy. For the United States, this means a bilateral relationship that is more balanced, equitable, and durable.

Again, on behalf of our member institutions and the broader financial services industry, we congratulate Secretary Paulson and the Treasury Department on the establishment of the U.S.-China Strategic Economic Dialogue. We very much appreciate the opportunity to provide the ideas and insights contained in this paper, and stand ready to assist Secretary Paulson and the Department in any way that we can.