Symposium on Building the Financial System of the 21st Century:

An Agenda for China and the United States
Tianjin, China • June 23 - 25, 2006

FRIDAY, JUNE 23

18:00-19:00 Cocktail Reception - Hall of 3rd Floor

19:00 Dinner - TEDA Ballroom, 3rd Floor

GREETINGS
Lu Mai, Secretary-General, China Development Research Foundation (CDRF)
Hal S. Scott, Program on International Financial Systems, Harvard Law School
Pi Qiansheng, Member of the Standing Committee of Tianjin Municipal Government and Director of the Administration Committee of Binhai New Area

KEYNOTE ADDRESS
Wu Xiaoling, Deputy Governor, People's Bank of China
Introduced by: Zhu Yunlai, China International Capital Corporation Limited
David P. Loevinger, Minister-Counselor for Financial Affairs, U.S. Embassy
Introduced by: Hal S. Scott, Program on International Financial Systems, Harvard Law School

21:30-23:00 After-Dinner Cocktails - Renaissance Garden, 3rd Floor

SATURDAY, JUNE 24

7:15-8:15 Breakfast - TEDA Café Bar
Breakfast Meeting of Panelists and Reporters (Meeting Room 9, 1st Floor) Special tables are set up.

8:30-8:40 **WELCOME & OPENING REMARKS** - Grand Room, 1st Floor
Hal S. Scott, Program on International Financial Systems, Harvard Law School
LI Jiange, Vice President, Development Research Center of the State Council, PRC
Cui Jindu, Vice Mayor, Tianjin Municipal Government, PRC

8:40-9:00 **PANEL SESSION**

Topic 1: Protection and Enforcement of the Rights of Minority Shareholders in Public Companies

China Panelist*:* Sun Jie, Director General, Fund Supervision Department, China Securities Regulatory Commission

U.S. Panelist: Jeffrey Small, Partner, Davis Polk & Wardwell

9:05-10:25 **SMALL GROUP SESSIONS**

Group / Room	*Facilitators*	*Reporter*
Grand Room	Guo Tehua, Satoru Murase	Emily Altman
Ball Room 3	Fan Yonghong, William Barron	William Grimes
Ball Room 4	Wu Xiaoqiu, Arthur Mitchell	William Holmes
Meeting Room 1	Chen Zongsheng, Jack Murphy	Michael DeSombre
Meeting Room 2	Cesar Zalamea, Eric Foster	Simon-Hoey Lee
Meeting Room 4	Wang Yuan, Stefan Gavell	Pei Changhong
Meeting Room 5	Wang Boming, Don Kanak	Xin Tang

10:25-10:40 Refreshment Break

10:40-11:00 **PANEL SESSION**

Topic 2: The Value of Strategic Partnerships in the Chinese Financial Sector

China Panelist: Xie Ping, CEO, Central Safe Investment Co.

U.S. Panelist: Harrison Young, Chairman, Morgan Stanley Australia Limited

11:00-12:20 **SMALL GROUP SESSIONS**

Group / Room	*Facilitators*	*Reporter*
Grand Room	Guo Tehua, Paul Speltz	Emily Altman
Ball Room 3	Fan Yonghong, Patricia Haas-Cleveland	William Grimes
Ball Room 4	Wu Xiaoqiu, Robert Dugger	William Holmes
Meeting Room 1	Chen Zongsheng, Richard Stanley	Michael DeSombre
Meeting Room 2	Cesar Zalamea, Jack Wadsworth	Simon-Hoey Lee
Meeting Room 4	Wang Yuan, Chester Murray	Pei Changhong
Meeting Room 5	Wang Boming, Michael Wilson	Xin Tang

12:30-14:00 Lunch - TEDA Ballroom, 3rd Floor

KEYNOTE ADDRESS

Ambassador Clark T. Randt, Jr., United States Ambassador to China, U.S. Embassy

Introduced by: Tony Neoh, Barrister-at-Law

Guo Shuqing, Chairman, China Construction Bank and former Deputy Governor of the People's Bank of China

14:00-15:00 **PANEL SESSION – PLENARY DISCUSSION ONLY**

Topic 3: U.S. Barriers to Chinese Acquisitions (CFIUS) and Trade Sanctions for an “Undervalued” Currency

China Panelist: Zhu Min, Executive Assistant President, Bank of China

U.S. Panelist: Peter Fisher, Managing Director, BlackRock Inc.

U.S. Panelist: Stephen S. Roach, Chief Economist and Director of Global Economic Analysis, Morgan Stanley

15:00-18:00 Free Time, Optional Tour of TEDA

15:00-17:30 Reporters Meeting - Meeting Room 9, 1st Floor

18:00-19:00 Cocktail Reception - TEDA Ballroom, 3rd Floor

19:00 Dinner - TEDA Ballroom, 3rd Floor

KEYNOTE ADDRESS

Dai Xianglong, Mayor of Tianjin and former Governor of the People's Bank of China

Introduced by: Li Jiange, Vice President, Development Research Center of China State Council

21:00-23:00 After-Dinner Cocktails - Renaissance Garden, 3rd Floor

SUNDAY, JUNE 25

7:15-8:15 Breakfast - TEDA Cafe Bar

Breakfast Meeting of Discussion Chairs and Reporters (Meeting Room 9, 1st Floor)

Special tables are set up. Please sit at the reserved tables.

8:30-9:15 **PRESENTATION & DISCUSSION**

Topic 1: Protection and Enforcement of the Rights of Minority Shareholders in Public Companies

China Chair: Gao Xiqing, Vice-Chairman, National Council for the Social Security Fund

U.S. Chair: Dr. David De-zhi Peng, Executive Vice President & Chief Operating Officer, AIG Business Consulting (Beijing) Co., Ltd.

9:15-10:00 **PRESENTATION & DISCUSSION**

Topic 2: The Value of Strategic Partnerships in the Chinese Financial Sector

China Chair: Wang Jianxi, China International Capital Corporation Limited

U.S. Chair: Wade Deffenbaugh, China Global Financial Services Industry Leader, Deloitte Touche Tohmatsu CPA Ltd., Beijing Branch

10:00-10:15 Refreshment Break

10:15-11:00 **PRESENTATION & DISCUSSION**

Topic 3: U.S. Barriers to Chinese Acquisitions (CFIUS) and Trade Sanctions for an “Undervalued” Currency

China Chair: Zhang Tao, Deputy Director-General, Research Bureau, the People’s Bank of China

U.S. Chair: Nicolas Lardy, Senior Fellow, Institute for International Economics

11:20-13:30 Closing Lunch - TEDA Ballroom, 3rd Floor

Chair: Lu Mai, Secretary General, China Development Research Foundation

Speaker: Li Yong, Chairman, the Administrative Commission of TEDA

BUILDING THE FINANCIAL SYSTEM OF THE 21ST CENTURY: AN AGENDA FOR CHINA & THE UNITED STATES
TIANJIN, CHINA, JUNE 23-25, 2006

The third annual China – U.S. Symposium was held at the Renaissance Tianjin TEDA Hotel and Convention Center in Tianjin, China. Sessions considered the rights of minority shareholders in China, the value of strategic partnerships in the Chinese financial sector, and U.S. government responses to Chinese acquisitions and to alleged currency manipulation. Participants agreed that China had made important progress in financial regulation and supervision, but that there was significant room for improvement. This was seen as important, given the rapid rise of the Chinese financial sector and the 2007 opening of banking to foreign competition under the terms of China's WTO accession agreement. With regard to U.S. government responses to acquisitions and alleged currency manipulation by Chinese authorities, discussion focused on structural macroeconomic issues in both countries. Participants expressed concern about the sustainability of the resulting imbalances, and called for renewed attention to domestic imbalances in both the United States and China.

Session 1: Protection and Enforcement of the Rights of Minority Shareholders in Public Companies

In the first session, participants discussed protection and enforcement of the rights of minority shareholders in public companies. Although there was some discussion of general principles and of U.S. experiences, most of the discussion focused on China, particularly on state-owned enterprises (SOEs) that have become publicly-traded companies. Participants noted significant progress in the protection of minority shareholders in China, but also pointed to legal as well as *de facto* gaps in protection. Most participants agreed that furthering improving protection will be important in the development of Chinese capital markets.

Importance of Minority Shareholder Rights

Clear and substantial minority shareholder rights have been a hallmark of the U.S. and UK capital markets. Most participants agreed that protection of minority shareholder rights has several beneficial impacts on the functioning of financial markets.

Most importantly, such protection increases confidence in financial markets among potential investors. Some saw this as particularly important for small retail investors, while others emphasized the role of larger minority investors. For retail investors, the most important aspect of minority shareholder rights was seen to be the guarantee that dominant investors would not ransack the company at the expense of small shareholders. For large minority investors, an additional concern was that their views on management and strategy should be respected. Either way, it was argued that potential investors would be less attracted to equity purchases if they were not confident of their rights as investors.

From a corporate perspective, it was suggested that protection of minority shareholder rights could reduce the cost of capital. Proponents of this point of view argued that the enhanced confidence of minority shareholders would lead them to demand less of a risk premium. This would also improve efficiency of capital markets.

Finally, a number of participants argued that the protection of minority shareholder rights was important from the point of view of fairness. It was suggested that this might have instrumental benefits as well, by contributing to greater legitimacy of capital markets and perhaps dampening instability in cases of real or perceived scandals.

Progress in the Protection of Minority Shareholders in China

While Chinese capital markets are relatively young and underdeveloped, participants pointed to some significant reforms in the rights of minority shareholders in recent years. These have come about in the context of broader shifts in securities and corporate governance reforms.

Perhaps most striking has been the introduction of a full set of legal rights for minority shareholders (see below). At least formally, minority shareholders in Chinese firms now have comparable rights to those of minority shareholders in some of the most highly developed capital markets. Related to this, there has been some development of private rights of action, albeit nothing as extensive as seen in systems such as the United Kingdom or (at the extreme) in the United States.

Another major development has been the shift away from non-tradable shares. Previously, holders of non-tradable shares not only had limited ability to affect corporate actions, they were also restricted from "voting with their feet" by selling off their holdings when they felt that management was damaging them financially. This made such shares very unattractive in many cases, leading to them being sold at negotiated prices and at significant discount to A-shares. The gradual transformation of non-tradable shares into A-shares will allow for full market determination of prices of all outstanding shares.

Third, corporate governance rules mandating independent directors and auditors as well as the establishment of a board of supervisors was seen as having the potential for improving representation of the views of minority shareholders.

Finally, some participants expressed the hope that the growth of institutional and major foreign investors might help to protect retail investors as well. Large investors have the incentive – and are more likely to have the expertise and political power – to make a difference in corporate governance. Although it was assumed that large investors would be focused on defending their own interests rather than those specific to retail investors, it was argued that the key goal of ensuring fiduciary responsibility would be of equal importance to both large and small minority investors.

Unique Features of Minority Shareholder Status in China

While much of the discussion of minority shareholder rights built upon a set of principles and concepts common to any capital market, it was recognized that the Chinese context has a number of characteristics that differ from most, if not all, developed country capital markets. These peculiar characteristics provide special challenges for the protection of minority shareholder rights in China.

Corporate Ownership

Participants observed that ownership of listed companies in China tends to be highly concentrated. This stands in contrast to UK and U.S. markets, in which ownership is far more dispersed. Even in comparison with Europe, where large shareholdings are more typical than in the United States and United Kingdom, China stands out for the prevalence of control by single shareholders. In the absence of cumulative voting or other constraints (such as the requirement of labor representation on German boards), boards are appointed by the majority with little or no need to consult with minority shareholders. This is typically true even of the appointment of independent directors.

Moving beyond the prevalence of control by majority shareholders, many participants also pointed to the importance of different categories of majority ownership. The two primary categories discussed were government entities and private-sector company founders.

<u>State Ownership</u>

The most striking peculiarity of Chinese capital markets was seen to be the legacies of state ownership of major corporations. Most of the largest listed companies are former SOEs, and in many cases government entities still hold controlling shares. This is particularly true in the banking sector, where private (especially foreign) shareholding is strictly limited to maintain state control.

Government-controlled firms are not a monolithic group, as various government entities exercise control over different firms. While much of the discussion revolved around central government ownership (perhaps due to the particular interests of participants in the financial sector), regional governments and the People's Liberation Army also hold major ownership positions throughout the economy. Even within the category of central government-controlled listed companies, different ownership vehicles can be found, including SAFE and the social security system. Each of these types of controlling shareholders potentially has a different set of incentives, making it difficult to make accurate generalizations about their likely behavior. (For example, the social security system may have a greater interest in profit maximization than a regional government that is a shareholder in a major regional employer.)

While participants recognized that different powers and incentives may hold, most agreed that there were some common problems for minority shareholders posed by the dominance of government entities as majority shareholders. Fundamentally, it was seen that effective and unbiased regulation of one government entity by another, e.g. the CSRC, would be inherently difficult. A number of participants also suggested that it was possible that government-appointed directors would be less expert and more willing to sacrifice the fiduciary interests of company shareholders to divert funds to other purposes than directors appointed by institutional or other private investors. Finally, to the extent that minority shareholders have accumulated the right to check or at least protest decisions of the majority shareholder, they would be less likely to exert those rights against government entities.

Private-Sector Controlling Shareholders

Although most of the focus of discussion was on the behavior of government entities as majority shareholders, several participants stressed that concentrated shareholding by private investors might also tend to infringe on minority shareholder rights. In cases where a founder or founding family has maintained a controlling stake, they argued that there have been many cases in which the founder has used the listed company as a source of personal funds. Some even argued that the infringement on minority shareholder rights might be more of a concern in such cases, because unlike the state, entrepreneurs would not have even the pretext of having the same interests as minority shareholders. Moreover, individual or single-family controlling shareholders may be more likely to plunder the company for their own benefit since they are not as subject to organizational constraints as government bureaucracies often are.

Classes of Minority Shareholders

While much of the discussion of threats to minority shareholder rights focused on the characteristics of majority shareholders, participants also recognized important distinctions in the characteristics and interests of minority shareholders. The dividing lines were institutional vs. retail investors, and domestic vs. foreign institutional investors. The opportunities and protections available to the different classes of minority shareholders was seen to differ significantly along these dividing lines.

Institutional Investors

Most discussion of the rights of investors revolved around institutional investors, who were seen to have the wherewithal to contribute meaningfully to corporate governance. The rise of institutional investors was seen by some participants as offering significant potential benefit in terms of protection of minority shareholder rights.

A number of participants argued that foreign institutional investors and firms brought some unique strengths to the table. They often have significant experience in evaluating corporate governance practices and firm management in other countries, and so have considerable expertise that can contribute to better management. In many cases, purchases of significant minority shares by foreign firms have involved agreements for technology transfer and management participation. Such relationships are attractive to domestic firms and to the Chinese government, offering important opportunities for minority shareholders to influence corporate management. Also, the implicit support of foreign shareholders' home governments may play a role in ensuring that they are treated fairly.

Domestic institutional investors are less likely to have scarce, world-class technology, skills, or management. The development of such investors over time will likely be an important aspect of the development of capital markets in China. But there was no clear consensus on whether domestic institutional investors are advantaged or disadvantaged relative to foreigners.

Complicating matters for both types of institutional investors is the segmentation of shares. Both are major holders of non-tradable shares (or, as the non-tradable shares have begun to be phased out, are subject to lock-in periods), and thus incur additional risk without added voice. Foreigners' holdings of tradable shares are mostly confined to H-shares issued in Hong Kong, but these carry no voting rights. Price differentials between A- and H-shares, as well as between A-shares and non-tradable shares, also introduce risk into any investment decision by foreign investors.

Retail Investors

Unlike institutional investors whose voice might be heeded by corporate directors and management, the main strategy available to retail investors who are dissatisfied with management is to sell their shares ("vote with their feet"). For these shareholders, issues of corporate governance might take a back seat to timely and full information disclosure, as well as after-the fact solutions to malfeasance such as shareholder derivative or class-action suits.

But very fundamentally, many participants argued, in the absence of confidence on the part of retail investors that their interests would be respected, they would not be willing to invest in capital markets. This would severely erode the efficiency and liquidity of the markets. Moreover, it was widely agreed among participants over the course of the Symposium that Chinese savers needed to have access to a broader range of attractive financial products. Protection of minority shareholder rights might be an important element in promoting such a range of savings vehicles.

Are Minority Shareholder Rights Important in China?

Some participants raised the question of whether minority shareholder rights were really important in the Chinese context. Drawing a comparison from other countries, they noted that in the U.S. and U.K. corporate ownership tends to be highly dispersed, therefore necessitating stronger protections for minority shareholders. In contrast, European corporations generally have much higher levels of concentration, and regulations have accordingly been more consciously majoritarian there. Noting that Chinese ownership patterns resembled European patterns more than those of the U.S. and U.K. markets, they raised the possibility that protection of minority shareholder rights might be less important in China as a means of enforcing good management. Most participants appeared to hold a conflicting view, however. They were particularly concerned that controlling shareholders – whether SOEs or founding families – would be unconstrained in their ability to use corporate funds for their own benefit, and to the detriment of minority shareholders.

Shareholder Protection in China

As noted above, participants agreed that protection of minority shareholder rights had progressed considerably in China. Nonetheless, concerns remain in terms of regulation, enforcement, and corporate governance. Most of these were seen to relate to broader themes of Chinese political and economic development, such as the role of courts, transition of state-owned enterprises, and state-society relations.

Statutory Rights

Participants noted with approval the development of clear statutory rights for minority shareholders in Chinese capital markets. Overall, at least nominally, Chinese shareholders were seen to have rights roughly comparable to those in more developed capital markets. Indeed, in some respects, statutory rights exceeded those available in the United States. These include the right of minority shareholders to call shareholder meetings and their right of approval of related party transactions.

Despite the introduction of clear minority shareholder rights in recent years, concerns were expressed regarding implementation and enforcement. These concerns were to be found at each level of enforcement – market discipline, corporate governance, regulatory supervision, and judicial enforcement.

In each, a common thread was the importance of credible and timely information disclosure. Participants expressed considerable concern about the quality of information available in capital markets. Even large minority shareholders, who might typically be regarded as having access to more complete information, were seen to be severely disadvantaged relative to controlling shareholders. (The quality of information available even to controlling shareholders was also questioned, but that was discussed more in the context of internal controls and corporate governance.) Regulators as well could not be guaranteed access to reliable information. Thus, one of the major concerns in terms of legal framework was the need to require much higher levels of transparency.

Role of Independent Directors

Often, the first line of defense available to shareholders is the board of directors, and (in China) board of supervisors. Although directors are typically selected by major shareholders in any country and thus are more likely to represent the interests of those shareholders, in most cases the fiduciary responsibility of directors to shareholders generally ensures that they will focus on maximization of corporate profits.

While directors generally have responsibilities to all classes of shareholders, it has been argued that independent directors better solve conflicts of interest between shareholders and management, and can thus contribute to better corporate governance. “Independence” is hard to define, and actual selection of directors is often carried out by top management, existing board members, and controlling shareholders even in a liberal system such as that of the United States. Moreover, there has been little evidence to support the contention that increasing the number or role of independent directors has a meaningful impact on corporate performance in those companies where it has been introduced or mandated by law. Finally, Chinese law mandates relatively few independent directors per board. Thus, many participants were skeptical that independent directors can have a meaningful role in the protection of minority shareholder rights in China.

In contrast to that point of view, other participants argued that independent directors potentially play a useful role in China and presented three main benefits. First, they may be able to bring outside perspective and new skills to the analysis of major business decisions. Second, most of the other directors come directly from the parent company, meaning that they are embedded within an authority structure that may make it difficult to raise dissenting voices, where as independent directors may be able to improve corporate performance by raising alternative perspectives. Third, and most specific to the protection of minority shareholder rights, independent directors are not representatives of the controlling shareholder *per se* and may be more likely to take seriously the concerns of other shareholders.

Several ideas were put forward for increasing the role of independent directors, although there was no clear consensus reached. The simplest would be to increase the number of independent directors required, or to mandate their participation in specific types of decisions. A second would be to make the definition of “independence” more stringent. A third possibility offered was cumulative voting, which in principle would allow minority shareholders to choose one or more directors. Some participants objected on the general basis that director independence has not been proven to increase corporate performance or protection of minority shareholder rights in the United States or elsewhere, as already noted. With regard to the suggestions listed, more specific counter-arguments were also raised. As for numbers of independent directors and specification of their roles, the main counter-argument was that this would have little effect in the context of firms with a single dominant shareholder or parent firm. With regard to defining “independence” more stringently, two concerns were raised. One was that there is in many cases a trade-off between independence and expertise – in other words, that completely independent directors may lack the knowledge of the company and industry needed to contribute effectively to corporate governance. Especially in a developing economy like China's, this might make the pool of potential independent directors too small to make expansion a positive move. The other concern was that the further outside a director was, the more s/he would have to rely on information channeled through top management to the board. Finally, with regard to the suggestion of cumulative voting, it was pointed out that this does not exist in the United States or most other developed markets. There was also concern that it might have unintended consequences on effectiveness of corporate governance as China's economy changes and the centrality of the issue of controlling shareholders (especially by government entities) recedes.

There was also discussion about the request of independent auditors. Participants felt that they are important in ensuring the accuracy of disclosed information and play a role in preventing controlling shareholders from plundering company funds for their own benefit. These values are important to minority shareholders, although auditors do not focus on protection of minority shareholder rights *per se*. There was a general sense of approval of the requirement, but many participants felt that in terms of effectiveness the independent auditor rule was still a work in progress. They felt that there was still a lack of experienced auditors, and thus a long learning curve ahead for the auditing profession in China. Moreover, they expressed concerns about the quality of internal controls and willingness of management to disclose complete and relevant information in many Chinese companies. Without access to accurate information, the role of auditors is necessarily limited.

Boards of supervisors are meant to enforce laws, and thus in principle could act as a check on self-dealing. But there was considerable skepticism about the willingness and ability of supervisory boards to carry out these responsibilities. From the perspective of protection of minority shareholder rights, boards of supervisors have no responsibilities at all.

Enforcement

There was considerable discussion of legal enforcement of minority shareholder rights. This discussion focused on four issues: the role of regulators, the role of courts, the effort of the predominance of government entities as controlling shareholders, and alternative methods of enforcement (media and markets).

While participants offered positive evaluations of the progress made in financial regulation and supervision, there was a consensus that there was still considerable room for improvement. In particular, lack of resources and expertise was seen to limit the ability to effectively supervise abuses in the financial sector. Some participants argued that supervision in the insurance and banking sectors had progressed further than in securities, where the CSRC was seen as more cautious in promoting consolidation of the securities industry. The reason given was that the WTO accession agreement allowing foreign competition in insurance and banking by 2007 forced regulators to be much more ambitious in improving the performance of local financial institutions by promoting consolidation and foreign joint ventures.

A second avenue for the protection of minority shareholder rights is the court system. Most participants expressed the opinion that to date this avenue of protection is poorly developed. As with other institutional checks on the power of management and controlling shareholders, participants expressed concern that judges were still limited in numbers, expertise, and experience. More generic problems of the Chinese court system were noted as well, including its perceived lack of independence and lack of clarity of procedure. Moreover, minority shareholders have few opportunities for recourse through court action. American participants emphasized the non-recognition of class action suits, shareholder-derivative suits, and contingency fees for multiple litigants as barriers to the ability of minority shareholders to protect their rights. Thus, while case law was a significant source of minority shareholder rights in the U.S., this is not now a viable route for China.

Other participants, both Chinese and American, cautioned against reliance on the U.S. model. They pointed to the costs of excessive litigation, high and unpredictable punitive fines, and the ability of small numbers of shareholders to use the threat of court action to threaten management and directors. The last of these was described as a form of “extortion” by some. Others identified the problem as one in which settlements essentially led to the transfer of wealth from one group of shareholders (many minority) to another group of minority shareholders rather than a means of disciplining corporate behavior.

Suits against directors were seen by some to address that problem, but several problems were seen to derive from targeting directors. It was pointed out that directors in China typically have limited financial resources, so that even if large judgments were possible it would not be in the interests of plaintiffs to pursue them. In this regard, it was noted that only a small percentage of directors have directors' insurance. While some participants suggested the usefulness of directors' insurance to protect directors' personal assets from accusations of mismanagement or malfeasance, others strongly questioned this evaluation, for two reasons. First, they felt that it was not necessarily appropriate for shareholders to take on the cost of insuring directors from indemnity. Second, they argued that directors' insurance helped to fuel excessive costs found in U.S. shareholders' litigation.

More generally speaking, many participants expressed skepticism about the ability of either regulators or courts to defend minority shareholder rights. The basic problem was presented as lack of independence of the enforcers. Until rule of law and both formal and informal independence of regulators can be more firmly established, this problem is likely to continue. However, gradual reduction of large-scale government participation in ownership should help.

Finally, participants addressed two alternative methods of enforcement of minority shareholder rights: market discipline and the media. For market discipline to work effectively, participants agreed that continued improvement in disclosure would be necessary. Several participants also argued for the need for the existence of a market for corporate control. They felt that movements in stock prices would have little disciplining effect on corporations controlled by government entities or by those with strong government connections, since they might be able to continue to obtain financing through directed (or policy) loans.

The other alternative means of enforcement discussed was the media. Many participants argued that the Chinese media has become a prime enforcer of minority shareholder rights through its increasingly active role in exposing government and corporate malfeasance. Several examples were given of cases in which media exposés had prompted action by regulators.

Session 2

The Value of Strategic Partnerships in the Chinese Financial Sector

The second session examined the role of strategic partnerships in the Chinese financial sector. While the policy of encouraging such partnerships is relatively new, there have been a considerable number of high-profile investments in the banking sector, including some by participants at the Symposium. While Chinese authorities and bank leaders have expressed satisfaction at the results, such partnerships have become an increasingly popular target of attack within China. The session focused on foreign strategic partners in the banking sector, with an emphasis on the major commercial banks. There was only limited discussion of the insurance and securities sectors. Participants considered the costs and benefits for both the Chinese government and banks on the one hand and for foreign strategic investors on the other.

Costs and Benefits for China

As noted, there has been considerable debate in the local media about the costs and benefits to China of recent strategic partnership arrangements. Many of these have focused on the allegedly bargain prices at which foreigners have purchased minority stakes in banks, and whether any tangible benefits had been gained by Chinese banks or the banking system.

Transfers of Skills and Technology

The policy of encouraging strategic partnerships was meant to attract not only foreign capital but also foreign skills, technology and know how (referred to below by the shorthand of "technology transfer"). Since most of the attention was on the big five centrally-owned commercial banks, capital was treated as of secondary importance compared to technology transfer in discussion among participants. However, it was also noted that the foreign capital injections as well as the funds raised in subsequent IPOs have been very attractive to a government that had committed massive funds to previous recapitalization efforts.

Strategic partnership agreements have explicit arrangements for transfer of skills and technology. Technology and skills of particular interest to Chinese banks have included introduction and integration of information technology into banking operations, risk management, and internal controls. Typically, agreements stipulate substantial personnel exchanges, in which managers and accountants work within the Chinese bank to introduce global best practices. The seconded personnel help to train local employees and implement changes, while also offering a window into the operations of the Chinese bank for their home firms.

Several participants described Chinese banks as having been very strategic in their pursuit of partners, selecting partners whose strengths best matched their own weaknesses. In a number of cases, banks had solicited multiple strategic partners, with each selected for a specific set of skills or technology to be introduced.

While participants with direct experience in these deals from both the foreign and Chinese sides mostly agreed that substantial technology transfer had occurred, a few of the other participants were more skeptical. Their skepticism was represented by three questions. First, to what extent could a small number of foreign personnel affect the management of extremely large, government-controlled banks with limited central control over the lending activities of far-flung branches? Second, could the banks have achieved the same level of technology transfer by purchasing it through consulting contracts instead of giving up a degree of ownership at apparently attractive prices? Third, have the alleged improvements in management and lending practices had any discernible effects on bank performance?

Participants with direct experience of strategic partnerships between Chinese banks and foreign financial institutions recognized that limited internal control mechanisms within Chinese government-owned banks would remain an issue in terms of managing large numbers of often distant branches. But they argued that strategic partnerships could have a profound effect on the management of Chinese banks. They argued that bank management is highly motivated to improve performance and learn global best practices, for several reasons. Under its WTO accession agreement, China's banking sector is set to be opened up to foreign competition in 2007, meaning significant new competition for the dominant banks. This might also lead the most financially viable borrowers to raise funds elsewhere, leaving the government-owned commercial banks with the least attractive clients, which would worsen concerns of non-performing loans. Bank leadership recognizes the extent to which faulty lending practices placed their institutions in jeopardy in the past, and has good reason to take seriously improved risk management and internal controls.

Participants defending the strategic partnerships also argued that consulting or licensing agreements would be unlikely to have as far-reaching effects on the behavior of the banks. They also argued that leading global financial institutions would be far less willing to put serious effort into technology transfer unless they had a stake. Coming at the question from the opposite angle, many also argued that Chinese bank management would be much less likely to "buy in" to profound changes unless there were some long-term ownership stake. A final point made by some participants was that the process of due diligence had been very eye-opening for bank management, in many cases constituting the most thorough overview and examination of bank practices they had ever experienced. The pictures presented to both sides of the transactions by the due diligence process gave additional incentive to carry through with reforms that might not have existed in a more arms' length process.

With regard to the question of whether improvement in management and lending practices had had any positive effects on bank performance, most participants agreed that it was too early to tell. But many expressed confidence that this would materialize, based on anecdotal evidence or personal experiences.

The Pressing Issue

One of the major issues regarding the value that strategic partners may have brought to Chinese banks is the issue of share price. Participants approached the issue from two distinct but not exclusive perspectives.

One question was whether investments by foreign strategic partners actually increased IPO prices, as has been widely claimed. Many participants gave an unqualified positive response to this question, pointing out the extraordinary successes of Hong Kong IPOs such as that of the Bank of China, which was completed as the Symposium began. Given the general suspicion in which Chinese banks were previously held by capital markets, these participants argued that the strategic partnerships had had a dramatic effect. Two main reasons were presented. First, the process of technology and management skills transfer was seen as improving the financial performance (or at least, potential investors' expectations of financial performance) by the banks. With fewer concerns about the likelihood of major expansion of non-performing loans or policy-based lending, investors were willing to bet on the strong market positions of the major banks. Second, it was argued that the strategic partners were seen by capital markets as having given their imprimaturs to the banks in question – this would increase share price both by implying commitment to the success of the banks and by vouching for the solidity of the banks based on the information gained in the due diligence process.

Other participants thought explanations were plausible in theory, but were more skeptical that they actually explained the situation. They argued that three other forces might be leading to higher IPO prices. First, due to the government recapitalizations of the major banks and the generally high growth of the Chinese economy, investors may simply have increased their assessment of the value of the banks. Second, they pointed out that share prices for Chinese firms had been rising across the board, and suggested that the high prices of bank IPOs was not out of line. Third, they argued that foreign institutional investors had developed a strong interest in the Chinese banking sector, but that there were limited opportunities for them – in other words, that the bank IPOs had achieved such high prices due to their scarcity value.

Closely linked to the question of whether strategic partnerships had improved IPO prices was the question of whether the price at which strategic partners had purchased their shares was appropriate. Debate on this question paralleled debate within China about whether the government had "sold out" to foreigners. If the price was in fact significantly below what the assets were worth at the time, the sale of stakes to strategic partners would constitute a significant opportunity cost to the government entities that sold them. Those participants who agreed that IPO prices had been positively affected tended to feel that the share price for strategic partners had in fact been appropriate, while those who denied that the foreign role had had positive effects felt that the price had been unduly low. Most participants agreed that it was impossible to determine a uniquely fair price, and seemed satisfied that the boards and strategic investors had followed a reasonable process to arrive at the final share prices (although some concerns were expressed about the transparency of the process).

From a slightly different perspective, many participants took issue with the argument that the high IPO prices constituted windfall profits for foreign investors. They argued instead that the investors had in fact taken on significant risks at the time, and were continuing to take risk in the form of the three to five-year lock-in period on sales of their shares. Moreover, they cautioned against using the IPO price as the final word on the actual gains of strategic partners. Some of these participants considered the current period to be a high-water mark for Chinese equities; given the substantial lock-in period and the likelihood of future corrections, they argued that it made no sense to engage in an emotional debate based on the facts on hand. Finally, many of the financial professionals argued that in markets for new assets for which little reliable pricing information exists, it is typically the case that early entrants find “bargain” prices. The markets for non-performing loans and distressed assets in many countries have demonstrated this, they argued, and China should be no different.

Potential Concerns

Several political concerns were raised regarding the role of strategic partners in government-controlled banks. For both the government and bank management, the key ones had to do with fairness. The perception that strategic investors had been given a windfall in the form of excessively low share prices was seen as a concern by many participants. They pointed to the political firestorms surrounding Lone Star in Korea and Shinsei Bank in Japan. Popular outrage about allegedly preferential deals is of course a concern for the foreign investors (see below), but also raises serious concerns for the Chinese side. Management, board members, and regulators alike were seen to have reason to fear use of this accusation as a political weapon against them personally or to force undesirable changes in lending or corporate governance practices.

A second aspect of the fairness issue is that strategic partnerships were only offered to *foreign* financial institutions. Although participants recognized the logic that domestic financial institutions lacked the capital base, technological capabilities, or market stature to contribute to the banks in the manner envisaged by the legislation allowing strategic partnerships, the fact that apparent preferences were being denied to Chinese investors was seen by some to potentially exacerbate the political issue.

While much of the discussion of politics focused on concerns, some participants suggested that strategic partnerships might provide some useful political cover for commercial banks to improve their lending standards. They argued that one of the major problems for the government-owned banks has been the need to continue financing state-owned enterprises of dubious quality. While many participants felt that this was unlikely to disappear, it was argued by others that the participation of foreign strategic partners might provide justification for bank management to turn down (or make more stringent the loan conditions on) such borrowers. As some put it, the strategic partners’ stress on profits might lead to a decrease in “policy lending.” They saw this as positive for the Chinese economy as well as for the specific banks.

Finally, an unrelated issue was also presented as a benefit to the Chinese government and Chinese banks. A number of participants argued that foreign financial firms that had taken strategic partner stakes would be far less likely to enter the Chinese banking market on their own in 2007, when the WTO accession agreement legally allows them to do so. In other words, strategic partnerships could have the effect of *limiting* foreign participation and competition in the banking system rather than increasing it.

Benefits and Risks for Strategic Investors

Strategic partners in Chinese banks faced a different cost-benefit calculus than the government, although several of the costs and benefits revolve around the same issues. Key concerns included market access and risks.

Market Access

Participants identified market access as the key issue for foreign strategic investors. With the rise of the Chinese economy and the increasing liberalization of the financial sector in general and the banking and insurance sectors in particular, major foreign players see a significant presence in the Chinese domestic banking market as essential to their global strategies. To underscore this point, a number of participants argued that China would become the most important financial market of the 21st century.

The juxtaposition of the introduction of China's policy encouraging strategic partnership agreements with major domestic banks and the upcoming liberalization of foreign entry to the domestic banking market presents foreign banks with a choice regarding how to enter the market: either as a strategic partner in an established (but possibly troubled) domestic bank or as an independent start-up in the market.

The path of strategic partnership offers several conspicuous benefits for potential foreign entrants to the Chinese banking sector. Most importantly, participants pointed to the existing banks' vast branch networks and relationships with borrowers, which allow for bypassing the uncertainties inherent in starting up a business from scratch. Particularly if foreign financial institutions believe that their partners' risk management and performance will improve under the influence of technology transfer, stricter regulation, and fiercer competition, they should be more interested in taking such a stake.

Strategic partnership agreements also provide foreign financial institutions with immediate credibility as major players within the Chinese market, and potentially offer opportunities for funneling business to other parts of the global entity, especially for financial conglomerates or universal banks. Possibilities include future sales of financial products through the branch networks, consulting services to the banks and their clients, and credibility and connections for their underwriting and other services. Conceivably, these additional opportunities might provide sufficient profit potential to make strategic partnership agreements attractive even if the foreign financial institution harbors significant concerns about the risks of investing in government-controlled banks whose accounting and internal controls may take many years to reach global standards.

Finally, it was suggested that foreign strategic investors might expect that limits on shareholdings may be relaxed in the future. If the future were also to bring significant further sales of government-owned shares, strategic partners would be in a position to exert much greater control of the banks.

The other option for entering the Chinese banking sector would be to enter independently in 2007 or later. Two main benefits were seen to such a strategy. First, it would solve the control issues that strategic partners will inevitably face as minority investors in banks with a single controlling shareholder. Second, entry could be better timed based on the development of the Chinese banking sector. Particularly for those who are suspicious of the commitment of the Chinese government to free and fair competition, this might be an important consideration.

Control Issues

In terms of costs, lack of control was presented as a major concern for strategic investors. As minority shareholders, their control over key business decisions is necessarily limited, and indeed many of the financial institutions that have entered into strategic partnership agreements have demonstrated a clear preference for full or majority ownership in their other global ventures.

The problem was seen to be compounded in the case of Chinese banks by three factors. First, control is held by a single majority shareholder, reducing the leverage of even significant minority shareholders. Second, and most important, that majority shareholder is a Chinese government entity, making it presumably even more powerful vis-à-vis strategic partners (all of which are currently foreign-based). Third, the lock-up period of three to five years for sale of shares at least temporarily eliminates the option of exit in cases of serious disagreement.

Vulnerabilities and Risks

Participants highlighted several vulnerabilities and risks inherent in strategic partners' situations. These are related to the issues of control, share price, intellectual property protection, and potential changes in the competitive environment after 2007.

As noted, control is a serious issue for minority investors, particularly when they are unable to cash out at a time of their own choosing. In the case of Chinese banks, participants offered a number of specific concerns created by the fact that government entities are majority owners. A number of participants argued that the commitment of the government to sound lending practices may wane if that were to mean cutting off lending to politically important borrowers or restricting loan growth during a future recession. Some termed this the problem of "policy loans" that were especially likely to become non-performing, and expressed skepticism that the role of strategic partners (either as minority shareholders *per se* or through technology transfer) would have any effect if the government or the party were to find it politically expedient. As an analogy, some pointed to pressures on Shinsei and other foreign-controlled banks in Japan to expand lending to small and medium-sized enterprises. An alternative version of this concern was the possibility that the banks might be forced by the government to expand their holdings of government debt.

In addition, as minority shareholders, strategic investors might find themselves under heavy pressure to contribute to future recapitalizations if new non-performing loan problems were to emerge. Many participants assumed a confluence of interests between regulators, party, and the government entities actually holding ownership of shares that would make such pressures essentially irresistible.

Some participants also pointed to significant risks with respect to share price. As noted in the section entitled "IPO Issues," the lock-up period inherently exposes strategic investors to risks of future market shifts, expansion of non-performing loans, bank mismanagement, and politically induced decisions on share issues or dividends. Yet another concern was that, even after lock-up periods end, strategic partners may be unable to find buyers for their stakes or may be under enormous pressure from the Chinese government not to sell, effectively extending their lock-up periods indefinitely. Given the risks, some participants argued that strategic partners may even have overpaid for their current shares.

A third concern was the difficulty of protecting intellectual property. Given weak IP protection generally in China, as well as the already noted points about majority ownership and government control, some participants argued that strategic partners' proprietary technology and trade secrets might not be sufficiently safeguarded. They articulated the prospect of foreign financial firms finding their knowledge, skills, and technology bases being used against them in domestic or global competition.

Finally, some participants argued that strategic partners might be adversely affected by the entrance of foreign competitors in the banking sector starting in 2007. Two issues were raised. First, it was suggested that taking a position as a strategic partner in a Chinese bank would make a given financial institution less able to enter independently as a direct competitor. Thus, strategic partnership was seen to create opportunity costs for the foreign financial institution. Second, a number of participants argued that much of the perceived benefit of strategic partnership in major Chinese commercial banks would derive from their oligopolistic position. If significant competition were to arise in lucrative sub-markets as a result of foreign entry, this benefit would be eroded.

Session 3

U.S. Barriers to Chinese Acquisitions (CFIUS) and Trade Sanctions for an "Undervalued" Currency

The final plenary session addressed two of the most sensitive aspects of U.S.-China relations. Congressional opposition to CNOOC's 2004 attempt to acquire Unocal had highlighted for many the potential political barriers to Chinese acquisitions of U.S. assets. While the Unocal bid ended before going through the Committee on Foreign Investment in the United States (CFIUS) procedure created to vet investments for their national security implications, CFIUS remains a threat for at least some potential Chinese acquisitions. Congress is also reviewing legislation meant to make CFIUS stricter. Meanwhile, various Congressional efforts to punish China for maintaining an "undervalued" currency (especially the Schumer-Graham bill and the less well-known Baucus-Grassley bill) have demonstrated the renewed political salience of bilateral trade imbalances. Many participants agreed that the atmosphere was reminiscent of policies and political sentiment that focused on Japan in the 1980s although the situation of China is quite different, due to the openness of China to U.S., foreign direct investment, U.S. financial institutions and exports.

While these issues have been a matter of great concern to the media and many observers of U.S.-China economic relations, there was a high level of consensus among participants that neither national security-based barriers to corporate acquisitions and currency manipulation evaluations by U.S. government agencies are a promising way of dealing with the issue of bilateral imbalances. Consensus was so high that there was little actual discussion of the CFIUS process, the role of Congress in investigating Chinese acquisitions from a national security standpoint, or the various bills pending or being formulated to pressure China on its currency management. Rather, participants spent most of both the Saturday and the Sunday sessions discussing the nature and causes of economic imbalances and potential effects on the Chinese economy of floating the RMB.

Causes of Imbalances

Participants agreed that it was not fruitful to focus on bilateral trade imbalances between the United States and China. Rather, they felt that it was important to look at the global imbalances of the two economies.

U.S. deficits were seen by most participants as structural in nature: there was a strong consensus that the problem of overconsumption in the household sector constitutes a long-standing trend. A core long-term reason for low household savings was seen by most to be the favorable tax treatment of debt. Several exacerbating factors were presented, including increased access to consumer credit and real estate lending for high-risk borrowers over the last two decades, rising asset prices (first equities, then real estate) over the last decade or so, and the role of the Federal Reserve in keeping interest rates low in the face of asset price inflation. There appeared to be a consensus that maintenance of low interest rates had been possible only because of continued willingness of foreigners to invest in the United States debt; a number of participants pointed in particular to massive purchases of Treasury bills by East Asian central banks, as well as the People's Bank of China. Some participants pointed to the high returns on investment in the United States to argue that the effects of low or negative household savings had been overstated; even these participants, however, were generally not willing to claim that low household savings rates did not constitute a problem.

It was also observed that the U.S. federal deficit had widened enormously since 2001. While debate on the causes of this fact was limited, there appeared to be four separate analyses of why the deficit had widened so much: reversion to earlier trends, the natural result of the end of the technology boom and the challenges of post-9/11 economic and security policy, the tax and spending priorities of the Bush Administration, and the tax and spending decisions of Congress.

The contrast with China was striking. The Chinese economy has been characterized by extraordinarily high rates of investment and low levels of consumption. While some participants expressed concerns about the quality of official Chinese data, none disagreed with the significance of that general picture. Participants pointed to several potential dangers for the Chinese economy.

First, many participants were very concerned about the possibility of overinvestment. They pointed to apparent real estate bubbles in major cities, low returns on investment, and the apparent inability of monetary authorities to restrain lending as serious warning signals. They warned that, if domestic conditions were to change even slightly, many investments of marginal quality could quickly go sour, depressing relevant prices and creating severe new non-performing loan problems. The resulting bankruptcies or credit crunches could have a serious impact on employment (at least in some locations) and the health of the financial system. Some pointed to the problems of post-bubble Japan as instructive.

Second, participants agreed that underconsumption in China has led to an unfortunate overreliance on foreign goods markets. They argued that this has had several pernicious effects, although there was less consensus on which were of greatest importance. Overreliance on foreign goods markets makes China more vulnerable to shifts in demand outside its borders. It skews economic development toward export-oriented manufacturing, while suppressing growth of services. Trade surpluses create political tensions with trading partners. And high net savings combined with current exchange rate policies contribute to excess liquidity throughout the economy (see below).

Finally, high net savings were seen by many participants to be an economically inefficient use of China's resources. Many saw it as ironic that a developing economy with serious problems of regional poverty should on net be lending to the world's richest economies, instead of spending more at home to stimulate employment. Another concern was that excessive savings was leading to low returns – whether in the form of interest payments on U.S. Treasuries, large-scale lending to inefficient state-owned enterprises, or real estate bubbles. A somewhat different way of looking at the problem was presented by some participants who noted that most Chinese households have no options for investing their savings other than bank deposits. Given insufficient social safety nets to prepare for retirement or health contingencies, households need to save enough money to self-insure; as long as they are building up those savings in low-yielding savings accounts, the extraordinarily high observed levels of savings may not in fact be excessive from the point of view of the savers. Participants supporting this analysis thus saw significant liberalization of financial products as a necessary step to addressing the problem of underconsumption.

U.S.-China bilateral imbalances, in turn, were attributed by participants partly to the coincidence of the two economies' massive global imbalances and partly to the complementary structure of the two economies. In other words, although the United States has trade deficits with virtually all of its trading partners, reflecting its massive net dissavings, the deficit with China reflects the global division of labor. The large deficit with China was seen as partly an effect of trade diversion from other low-cost Asian producers of consumer products. Moreover, much of China's production has been built on low-cost processing of imported components.

Participants agreed that one implication was that even if U.S. imports shifted away from China due to exchange rate shifts, protectionist legislation, or other factors, it would simply redivert trade back to other Asian economies and U.S. global imbalances would not be affected.

An additional point of view was offered by some participants from the perspective of international capital flows. They argued that Chinese savers were in effect lending funds at low, fixed rates to U.S. households, that were in turn using them to make higher-yielding investments in real estate or equities that allowed them to enjoy high consumption while also adding to their wealth, at least on paper. Some expressed concern that this cycle would prove to be unsustainable, leading eventually to losses for both sides.

Finally, it was noted that, as long as China continues to accumulate U.S. dollars, it will continue to acquire U.S. dollar assets. So far, much of this has been in the form of portfolio investment – most famously, the nearly $1 trillion in foreign exchange reserves – but participants argued that Chinese direct investment in the United States would inevitably play a larger role in absorbing net dollar earnings. They noted with concern the recent spats over acquisitions by Lenovo, Haier, and CNOOC, and predicted that, unless the two economies took steps to address the real causes of their global imbalances, bilateral trade and investment politics would become increasingly unpleasant.

Addressing Imbalances

Participants agreed that imbalances in both the United States and China could only be resolved through macroeconomic changes, rather than through trade barriers or appreciation of the RMB relative to the U.S. dollar. The consensus appeared to be that a coordinated, or at least simultaneous, shift away from consumption on the part of U.S. households and government sector and toward consumption by China would be optimal. The mechanics of a coordinated shift were not discussed.

Most discussion centered on Chinese macroeconomic issues, and the U.S. situation was considered briefly. Participants differed on the severity of effects of adjustment (particularly on housing prices), as well as on the relative responsibilities of monetary and fiscal policy. Nonetheless, participants appeared to agree nearly unanimously that some level of retrenchment of demand would be necessary.

Chinese Imbalances – Exchange Rate and Monetary Policies

The greatest level of disagreement in Session Three was to be found in discussion of how China should address its problems of overinvestment and excess savings. While few if any participants were willing to make the argument that RMB appreciation alone would resolve U.S.-China bilateral imbalances, a considerable number argued that exchange rate policy would be central to any attempt to address China's international surpluses. Others expressed concern that any shifts in exchange rate policy and/or currency controls could have unexpected or even adverse effects. Finally, there was some discussion of the political dynamics that are likely to govern such economic policies.

While much popular debate, particularly in the United States, has focused on the need for appreciation of the RMB as a solution for bilateral imbalances, participants dismissed such claims quickly on the grounds that the cause of imbalances is more fundamental. Nonetheless, there appeared to be a general sense among participants that the RMB is indeed undervalued and that the cost of maintaining that policy may be growing.

One approach to analyzing the issue began with the observation that it is impossible to maintain a fixed exchange rate, capital mobility, and an independent monetary policy all at once. A number of participants argued that Chinese monetary policy is being held hostage to the need to expand foreign exchange reserves in order to maintain the current RMB-dollar exchange rate despite high current account surpluses. They argued that although the PBOC has made efforts to sterilize dollar purchases, the difficulty of doing so has contributed to excessive liquidity in the Chinese economy. Meanwhile, the expectation that the RMB will appreciate significantly at some point (referred to by several participants as the "one-way bet") has stimulated additional private investment, despite the existence of strict capital controls meant to make speculation impossible. These private inflows compound the liquidity problem by requiring even greater dollar purchases and put pressure on the system of capital controls. Excessive liquidity, in turn, promotes overinvestment, possible asset price bubbles, and lack of discipline in lending. Since higher interest rates would presumably place even more upward pressure on the RMB and attract greater capital inflows, the PBOC is stuck relying on crude quantitative restraints on lending to the extent that it can do anything at all. This impedes the development of modern monetary policy implementation and debt markets.

According to this interpretation, greater RMB flexibility and a loosening of capital restrictions are essential to allow for the absorption of excess liquidity, to curtail overheating, and to improve efficiency of capital allocation. Some participants holding to this point of view argued that, moreover, the RMB was unlikely to appreciate as dramatically as some analysts have argued – once flexibility is introduced, speculative capital inflows will dry up, reducing upward pressure on the RMB. Additionally, a number of participants argued that even export industries would not be badly hurt by appreciation, given the relatively high proportion of imported inputs in many Chinese manufactured exports. In the end, the argument went, RMB flexibility should be adopted because it is good for the Chinese economy rather than to satisfy the demands of U.S. politicians.

Counter-arguments actually accepted the main points of this analysis. However, they emphasized two concerns. First, they argued that improper sequencing of exchange rate liberalization and lifting of capital controls could lead to serious problems. Before fully lifting capital controls, they argued that it would be necessary to put into place effective financial regulation, better supervision of financial institutions (especially banks), and market-based monetary policy implementation. Insofar as these preconditions to full liberalization are not yet fulfilled, they felt that it would be irresponsible to move too far in that direction. Second, a number of participants were uncomfortable making predictions about the macroeconomic effects of a sudden shift of exchange rates throughout a large, complex developing economy such as China's. They pointed to potential vulnerabilities in specific industries and regions as well as the banking sector as reasons to believe that effects might not be easily deduced from standard macroeconomic models.

Participants concerned about these possibilities felt that the Chinese government was acting responsibly in adopting a deliberate approach to liberalization. They noted that the infrastructure is being put into place to allow for better control of potential negative effects, including in the areas of financial regulation and capital market development. Moreover, the current ambiguous currency basket system provides a channel to introduce greater exchange rate flexibility, even if concrete steps have been limited. In this regard, it was pointed out that, although the RMB-dollar rate has remained extremely stable over the last year, the RMB's real effective exchange rate as against all currencies had seen an appreciation of nearly 10%. It was suggested that this could be seen as a controlled experiment by macroeconomic authorities about the effects of appreciation. In the end, the debate came down to timing, with proponents of quicker action focusing on the ill effects of excessive liquidity, and proponents of more deliberate action emphasizing instead uncertainty and vulnerabilities in the Chinese economy.

As a final element of the discussion, some participants argued that the political implications of increased RMB flexibility could not be ignored. First, the likely appreciation of the RMB (at least over the short-term) would create winners and losers within Chinese society. Second, any efforts to control “overheating” would likely mean significant dislocations. With the growing inequalities among regions and between rich and poor as the most salient political and social issue in China, it was argued, as a practical matter it was unlikely that abrupt policy shifts would be adopted. Rather, deliberate or even stop-and-go policy changes were seen to be more likely and perhaps more preferable.