SYMPOSIUM ON BUILDING THE
FINANCIAL SYSTEM OF THE 21ST CENTURY:
AN AGENDA FOR CHINA AND THE UNITED STATES

Sheraton Dameisha Resort, Shenzhen, China • JUNE 5-7, 2014

AGENDA

Thursday, June 5

6:00-6:30p.m. **COCKTAIL RECEPTION** BALLROOM FOYER

6:30-6:50p.m. **GREETINGS** BALLROOM

- LU Mai, Secretary General, China Development Research Foundation (CDRF)
- Hal S. Scott, Nomura Professor of International Financial Systems, Harvard Law School
- WANG Rong, CPC Secretary, Shenzhen, China

6:50-7:20p.m. **KEYNOTE ADDRESS** BALLROOM

- LI Wei, President (Minister), Development Research Center of the State Council, China (DRC)

7:20-9:00p.m. **DINNER** BALLROOM

Friday, June 6

7:15-8:00 a.m. **BREAKFAST BUFFET** FEAST

Panelists, Reporters, and Facilitators please sit at reserved tables

8:10-8:30 a.m. **OPENING REMARKS** BALLROOM I

- Simon Gleave, Regional Head of Financial Services, KPMG Asia Pacific

8:30-8:55a.m. **PANEL SESSION** BALLROOM I

What are the most important and difficult macroeconomic actions that need to be taken in the Chinese and U.S. financial sectors?

- Frank Newman, Chairman, China, Promontory Financial, & Vice Chairman, Asia, Global Strategic Associates
- SHEN Jianguang, Chief Economist, Mizuho Securities Asia Limited
- Tom Orlick, Bloomberg LP

9:00-10:25 a.m. **SMALL GROUP SESSIONS** BALLROOM & BASEMENT LEVEL

Group 1(Ballroom I)	Facilitators: Don Kanak/Tony Neoh	Reporter: WANG Gang
Group 2(Caribbean I)	Facilitators: Brian Kelly/ZHANG Hongjiu	Reporter: Bill Grimes
Group 3(Caribbean II)	Facilitators: Allan Smith/Amy Cheng	Reporter: MarshaVandeBerg
Group 4(Caribbean III)	Facilitators: Jack Murphy/FAN Jianjun	Reporter: Chris Wells
Group 5(Andaman I)	Facilitators: Catherine Simmons/LI Ting	Reporter: Mark Wu
Group 6(Andaman II)	Facilitators: Oliver Weisberg/TENG Tai	Reporter: James Shipton

10:25-10:40 a.m. ***REFRESHMENT BREAK***

10:40-11:00 a.m. **PANEL SESSION** BALLROOM I

Promoting cross border investments between China and the US through a bilateral investment treaty

- ZHAO Jinping, Director-General, Research Department of Foreign Economic Relations, DRC
- Jose Luis Guerrero, Global Head of Markets, HSBC Bank

11:05-12:30 p.m. **SMALL GROUP SESSIONS** BALLROOM I & BASEMENT LEVEL

Group 1(Ballroom I)	Facilitators: Hal Scott/Tony Neoh	Reporter: WANG Gang
Group 2(Caribbean I)	Facilitators: Iris Chan/ZHANG Hongjiu	Reporter: Bill Grimes
Group 3(Caribbean II)	Facilitators: Eugene Cheung/Amy Cheng	Reporter: MarshaVandeBerg
Group 4(Caribbean III)	Facilitators: Fabiana Fedeli/FAN Jianjun	Reporter: Chris Wells
Group 5(Andaman I)	Facilitators: James Walsh/LI Ting	Reporter: Mark Wu
Group 6(Andaman II)	Facilitators: Nick Lardy/TENG Tai	Reporter: James Shipton

12:30-1:30 p.m. **BUFFETT LUNCH** BALLROOM II

1:30-2:10 p.m. **KEYNOTE ADDRESS** BALLROOM I

- GAO Xiqing, Former President, China Investment Corporation
  Introduced by LI Jiange, Vice Chairman, Central Huijin Investment Ltd. and Chairman, Shenyin & Wanguo Securities Co., Ltd. (SWS)

2:10-3:30 p.m. **PLENARY SESSION** BALLROOM I

Topic: Capital market financing and the changing role of private equity and venture capital

Moderator: Oliver Weisberg, Managing Director, Citadel

- Yong WENG, Managing Director, CITIC Securities International Co. Ltd.
- William Hay, General Counsel, Baring Private Equity Asia Limited
- LIN Tun, Chief Economist, HONY Capital

3:30-6:30 p.m. **FREE TIME**

REPORTERS MEETING CARIBBEAN I

6:40-7:40 p.m. **KEYNOTE ADDRESS** BALLROOM I

- LU Mai, Secretary General, China Development Research Foundation (CDRF)
- Robert Dohner, Deputy Assistant Secretary for Asia, U.S. Department of Treasury (video)

7:40-8:00 p.m. **COCKTAIL RECEPTION** CASPIAN FOYER

8:00-9:00 p.m. **DINNER** CASPIAN

Saturday, June 7

7:15-8:00 a.m. **BREAKFAST BUFFET** FEAST

Chairs and Reporters please sit at reserved tables

8:30-8:50 a.m. **GUEST SPEECH** BALLROOM I

- TANG Ning, Founder & CEO, CreditEase Group

8:50-9:50 a.m. **PLENARY SESSION** BALLROOM I

Topic: China's Free Trade Zones and their implication for the U.S. financial sector

- Steven XU, Partner, Financial Services, EY
- Yigen Pei, Managing Director, Transaction Trade Services, Citi China

9:50-10:00 a.m. **REFRESHMENT BREAK**

10:00-11:10 a.m. **PRESENTATION & DISCUSSION** BALLROOM I

Topic: What are the most important and difficult macroeconomic actions that need to be taken in the Chinese and U.S. financial sectors?

- JIN Luo, Director-General, Financial Stability, People's Bank of China (PBC)
- Michael Taylor, Managing Director, Credit Policy, Chief Credit Officer, Asia, Moody's

11:10-12:10a.m. **PRESENTATION & DISCUSSION** BALLROOM I

Topic: Promoting cross border investments between China and the US through a bilateral investment treaty

- Jesse WANG, Chair, External Audit Committee, IMF
- Nicholas Lardy, Senior Fellow, Peterson Institute for International Economics

12:10-1:00 p.m. **CLOSING BUFFET LUNCH** FEAST

HARVARD LAW SCHOOL
PROGRAM ON INTERNATIONAL FINANCIAL SYSTEMS

2014 Symposium on Building the Financial System of the Twenty-First Century:

An Agenda for China and the United States

FINAL REPORT

Shenzhen, China, June 5-7, 2014

The eleventh annual China-U.S. Symposium was held at the Dameisha Sheraton Resort in Shenzhen, China. With expectations of financial stability and moderate economic growth in China and the U.S., participants discussed remaining challenges for the two economies as well as opportunities for improving cross-border financial opportunities. There was extensive discussion of prospects for further Chinese financial liberalization along the lines mapped out at the Third Plenum of the 18th Chinese Communist Party Congress in November 2013, with particular attention given to the establishment of the Shanghai Free Trade Zone and to policies in support of internationalization of the RMB. Sessions addressed the key macroeconomic policy challenges for the two economies, prospects for promoting cross-border investments through negotiation of a bilateral investment treaty (BIT), the changing roles of private equity and venture capital in China's financial system, and the implications of China's new free trade zones for financial liberalization and for U.S. financial institutions.

Session 1: What Are the Most Important and Difficult Macroeconomic Actions That Need to Be Taken in the Chinese and U.S. Financial Sectors?

In Session 1, participants discussed the major challenges facing the Chinese and U.S. financial sectors. They identified a number of actions to which they felt that the two governments should pay particular attention. These included issues of macroeconomic policy, financial and state-owned enterprise (SOE) reform, and political tensions.

Issues for the United States

In discussing challenges for the U.S., a major question was how the country's fiscal situation should be understood. Some participants expressed concerns about the size of the U.S. national debt. They noted that the aging of society would bring with it higher fiscal burdens and expressed particular concern about what would happen to debt service payments once interest rates started to rise. Thus, they argued that the U.S. should continue on the path of fiscal consolidation to ensure long-term sustainability of debt. Other participants strongly disagreed. They argued that debt-financed fiscal spending could both stimulate the economy and allow investment for the future at a very low cost. They advocated large-scale investment in infrastructure, which they argued would not only stimulate the economy through hiring and purchases, but also address the longer-term needs of the economy as they felt that much of the U.S. transportation, communications, and energy distribution infrastructure was inadequate, out-of-date, or approaching the end of its use-life.

Participants also pointed to the end of quantitative easing as a key U.S. macroeconomic policy challenge. With improving U.S. economic indicators, participants expected that the Fed would continue moving toward an end to quantitative easing and a return to "normal" monetary policy tools. Still, some participants raised concerns about the effects of tapering. One concern was that rising dollar interest rates would likely lead to an inflow of capital to the U.S. While this might provide relief from currency pressures for some economies such as the EU, it could also be destabilizing for emerging market currencies and financial systems. Other participants focused more on the effects of tapering on the U.S. domestic economy. They worried that asset prices and employment had become dependent on the continuation of quantitative easing and very low interest rates, leading to the possibility that attempts to exit quantitative easing would be stymied and that the U.S. economy might enter into a Japanese-style long-term liquidity trap. Both of these effects could slow global economic growth; moreover, several participants predicted that this would be compounded by the withdrawal of fiscal stimulus in the U.S., China, and Japan.

Participants raised two other major issues for the U.S. that they saw as affecting bilateral economic relations. One was what many considered to be excessive legalism. These participants argued that in several fields, especially finance, foreign investors were overly burdened by the difficulty and expense of complying with a wide range of rules. Moreover, they considered the enforcement of many of those rules—whether through criminal investigations, the threat of substantial fines, or lawsuits by shareholders or competitors—to have a chilling effect on Chinese companies seeking to do business in the U.S.

Finally, many participants commented on the apparent deterioration of China-U.S. relations, particularly in terms of security and politics. They worried that worsening political relations would inevitably have negative repercussions for economic relations, and not just on issues directly related to national security (such as through the CFIUS process). If companies expected that political frictions would continue to deteriorate, they might become reluctant to invest or rely on suppliers in each other's economy. Thus, these participants urged both the U.S. and China to look for opportunities for mutual benefit and cooperation, including through the Strategic and Economic Dialogue (S&ED) and perhaps BIT negotiations.

Financial Reform in China

Turning to China, much of the discussion of major challenges focused on financial reform. Participants pointed to several gaps in the Chinese financial system that they felt reform should address. An important one was constraints on credit available to the private sector, especially small and medium-sized enterprises (SMEs). Participants felt that private-sector SMEs had insufficient options to obtain growth and operational capital, even when they were willing to pay high interest rates. Several noted that China's private sector relied to what they saw as an excessive degree on retained earnings for investment. A number of participants also argued that there some sorts of economic activity that were simply unsupported by suitable financial products—one example given was the lack of means of dealing with distressed assets. On the supply side, many participants felt that household savers did not have a satisfactory range of investment opportunities. Most households continued to hold their savings in low-yielding bank deposits, with limited alternatives such as wealth management products, real estate, and individual stocks. Participants expressed hope that addressing these gaps would also improve overall capital allocation in the Chinese economy. Developing a broader range of investment products including insurance products and investment trusts or mutual funds was seen as likely to improve the financial environment for households.

To address these gaps, participants called for a number of interrelated financial reforms, including financial deepening, interest rate deregulation, and capital-account opening. Many participants expressed optimism that these reforms would be carried out, as they were among the goals set out at the Third Plenum in November 2013, as well as subsequent policy documents. With regard to financial deepening, participants argued that allowing a broader range of financial products would address the needs of households and companies alike. For example, many participants called for the development of asset-back securities markets, which they saw as a useful vehicle for expanding lending by banks and other financial institutions to SMEs and some consumer sectors, such as automobiles. They also expressed hope that securitization could help to spread some of the risks of real estate lending, as well as to contribute to better pricing. Another major concern was over the lack of liquidity and depth of bond markets, especially corporate bonds. Participants worried that overreliance on bank loans would not only mean constraints on credit for firms but also a less robust and resilient financial system. They urged the Chinese government to continue its plans to promote better bond markets by improving market infrastructure, allowing more bond issuance, and further liberalizing interest rates. In addition, participants encouraged Chinese authorities to follow through on plans to create a multi-tiered financial system, including institutions ranging from private equity to microfinance, that would focus on the needs of SMEs and other economic actors with limited access to the banking system or capital markets.

Participants also urged Chinese authorities to continue on the path to interest rate liberalization. A number of participants praised the significant progress to date. Some felt that, with the planned deregulation of deposit rates within the next 1-2 years, interest rate liberalization would soon be essentially complete. Others remained concerned about what they saw as a lack of market determination of interest rates in the bond markets, which they saw as likely to retard the growth of those markets.

Along with interest rate liberalization, many participants felt that continued capital account liberalization would be an important element in financial deepening, economic rebalancing, and restructuring in some industries. While there was not a clear consensus on timeline, participants encouraged the Chinese government to continue to expand the full spectrum of current policies and plans, including the QFII, QDII, and RQFII programs as well as the Shanghai FTZ and the Hong Kong-Shanghai "through-train" (which will allow direct stock trading between the two markets). It was pointed out that capital liberalization would be essential to establishing Shanghai as a global market center. Moreover, participants noted that foreign participation would contribute to the general goal of financial deepening—not only by providing new products and investment opportunities, but also by increasing the liquidity of equity and bond markets. With regard to economic rebalancing and industrial restructuring, many participants expressed hope that more efficient, market-based financial services would contribute to better allocation of capital to SMEs and the service sector, and perhaps contribute to the privatization and restructuring of inefficient SOEs as well.

While financial reform and liberalization were high on participants' lists of desired policy changes, this did not reflect a wholesale acceptance of a "Western" model of financial governance. A number of participants cautioned that China should avoid liberalization for the sake of conforming to a market fundamentalist ideology. Instead, they called for the Chinese government to implement liberalization with an eye to avoiding unnecessary volatility and preventing build-up or concentration of risk. Still, they saw liberalization as essential to improving the quality of the real economy through better capital allocation.

Shadow banking

Participants paid considerable attention to shadow banking, a discussion that was made more urgent by statistics showing rapid credit expansion in the informal sector. Discussions reflected mixed perspectives on this aspect of Chinese finance, with some participants emphasizing the risks and problems associated with it and others emphasizing its role in the development of a multi-level financial system.

One issue that complicated discussions of shadow banking was definitional. Participants noted that "shadow banking" included a variety of services and institutions. While much of the attention of media and regulators had focused on wealth management products offered by established financial institutions, several participants pointed out that shadow banking in the Chinese context also included a significant amount of company-to-company lending ("entrusted loans") as well as informal, or curb market, lending. The types of borrowers also varied—some participants expressed particular concern about excessive lending to real estate, while others were more concerned with what they saw as insufficiency of lending to or price gouging of SMEs and entrepreneurs. Much of the discussion in Session 1 focused on the more formal parts of shadow banking (particularly the unregulated growth of wealth management products) rather than curb market activities, although there was some attention to direct lending between related companies such as supplier credit.

A number of participants felt that shadow banking was an indispensable part of the Chinese financial system. They argued that the formal banking system still did not adequately address the financing needs of private-sector companies and SMEs, particularly in the services sector, despite increased attention to SME lending by banks in recent years. In particular, they felt that banks were hesitant to offer credit to entrepreneurs for growth capital, a problem that was exacerbated in services because of the relatively low levels of fixed capital that could be used as collateral. Without a substantial shadow banking system, they argued, the real economy would suffer as SMEs and other private companies would be constrained in their ability to grow. Some participants also suggested that the shadow banking sector, which operated outside of interest rate regulations, was playing an important role in China's ongoing transition to fully market-rate financial system. They argued that lenders, including banks and trust banks offering wealth management products, were gaining experience with evaluating credit and assigning risk premiums for lending to firms with varying business models. Borrowers would also be forced to do better planning to ensure that projects would make enough money to pay back at a higher hurdle rate.

In contrast, a number of participants pointed to evidence that total credit in China was growing rapidly, much of it due to rapid increases in non-bank lending. Some stated that credit in the real estate sector in particular was being driven by shadow banking institutions and products, raising concerns about excessive leverage in real estate markets at the same time that opportunities for profit in that sector were in decline. In this respect, they saw shadow banking as responsible for unregulated credit expansion in the Chinese economy, creating a dangerous situation of overleveraged households and firms, often to support risky activities. Moreover, some participants were not convinced that the higher interest rates attached to loans in the shadow banking sector properly reflected credit risk. In particular, direct lending by non-financial companies was seen as not being driven by adequate credit analysis, increasing the likelihood of overinvestment and defaults by borrowers. A few participants pointed to a different type of disconnect between credit risk and shadow banking interest rates: they argued that lenders, especially those using the mechanism of wealth management products, were taking advantage of their market power to overcharge borrowers for loans. They saw this as both unfairly disadvantaging the SMEs that depended on unregulated markets for credit and feeding a cycle of corruption between managers in banks and their wealth management units. Finally, there were concerns raised about moral hazard for investors in wealth management products issued by banks and trust banks. Although in theory these products could lose money, a number of participants argued that investors assumed that any failure would be bailed out by either the parent bank or by government. They warned that investors needed to accept the possibility of loss of principal in return for higher expected returns.

Participants were somewhat split on the proper course to take in extending regulation to the shadow banking system. Some argued that shadow banking institutions must be regulated more like banks, with strict rules governing their activities, lending practices, and interactions with borrowers. Others called for regulators to tread cautiously, with regulations that were properly tailored to the needs of each institution and product, in recognition of the different roles they played for various types of borrowers.

International Dimensions

Participants also discussed international dimensions of Chinese financial reforms at length, in particular RMB internationalization and the Shanghai FTZ. A number of participants advocated moving forward assertively with plans to internationalize the RMB. For some, the main point was to facilitate cross-border investment and trade. While some felt that increased international use of the yen would benefit Chinese companies by reducing some currency risks, the major interest appeared to be in the reduction of barriers to currency conversion and cross-border movement of funds. Participants argued that both domestic and foreign investors would benefit from being able to invest across the border more easily in both financial products and real assets. Moreover, foreign investors would find investments in China to be more attractive if they could be assured that they could repatriate money easily.

Beyond these relatively specific effects, many participants saw RMB internationalization as having a potentially much broader set of effects on the Chinese economy and financial system, or as some put it, acting as a "catalyst" for other reforms. They argued that RMB internationalization could best be seen as an umbrella for a variety of policies that would support financial deepening and reduce distortions in the domestic economy. In order to achieve effective internationalization of the RMB, they noted, a series of other reforms would need to be put in place, including currency convertibility, elimination of many barriers to cross-border investment, expanded financial products to attract foreign investment and allow for hedging of currency and other risk, and interest rate liberalization. Several participants further argued that a shift to a market-determined exchange rate could help to reduce distortions in the Chinese economy and support government efforts at rebalancing. Ending the one-way bet on the value of the RMB could also provide more flexibility to monetary policymakers (although some participants felt that the era of the one-way bet was already over thanks to the significant real appreciation of the RMB over the previous five years or so).

Participants also spoke of the importance of prompt and thorough implementation of the Shanghai FTZ. There was significant enthusiasm about the SFTZ among participants who argued that the rules that had so far been announced showed a strong commitment to reform on the part of the Chinese government. Three points in particular were emphasized as central to the success of the SFTZ. One was fulfillment of the principles on which the SFTZ was based: the negative list, in which activities would be allowed unless specifically prohibited, and investment on a registration rather than approvals basis. Participants urged regulators to ensure that the negative list would be short and get shorter over time, and that the registration principle would be respected in practice. A second aspect of the SFTZ that gained approval of a number of participants was its focus on services (including not only financial services, but also logistics, distribution, and others). They hoped that the SFTZ would prove to be a laboratory for developing and demonstrating new business models and practices that could be extended throughout the Chinese economy. Third, they saw the SFTZ, along with complementary policy initiatives such as the Shanghai-Hong Kong through-train, as being a potentially major step in the liberalization of the Chinese capital account that would provide many new opportunities for foreign investors while also helping to develop Shanghai as an international financial market center.

There was also some skepticism about the SFTZ, however. Some participants felt that the real impact of the principles of negative list and registration would not be known for some time. They noted that such rules could be quite restrictive in practice, depending on how authorities might choose to enforce them. Some participants also felt that the rules announced so far remained overly conservative on the issue of convertibility and cross-border funds transfers. They further wondered whether effects would be felt beyond the FTZ, or if it would remain a localized "offshore market." Finally, some participants worried that, despite the rhetoric of serving the real economy, the FTZ might end up only serving the needs of a small group of mostly financial services companies if rules constrained deep connections with the economy outside the FTZ.

Sequencing, Pace & Commitment

Overall, most participants appeared to be pleased with the commitment demonstrated by the Chinese government to further financial reform in support of efficiency in financial markets and credit provision to the real economy. They noted in particular the principles enunciated in the Third Plenum, the more recent 9 Principles published by the Development Research Council, and the rules announced so far for the SFTZ.

Still, there were questions about the future sequencing and pace of reform. Participants did not express a clear consensus on the correct sequencing of policies, particularly as it related to liberalization of interest rates and exchange rates, opening of the capital account, and expansion of financial products. Some also questioned whether the pace would be maintained if financial and other reforms (such as SOE reform, as discussed below) were to cause politically painful dislocations. For the most part, however, there was support for what participants saw as rapid but still incremental and carefully planned liberalization. Several pointed to the success of the Chinese government to date in moving purposefully but flexibly by "crossing the river by feeling the stones."

Other Issues for China

While financial issues dominated discussion of major challenges for Chinese policymakers, participants did raise several other issues that they saw as very important for China going forward. These included SOE reform and fiscal reform, as well as issues that were seen as affecting foreign investment more directly.

SOE reform received particular attention from participants. In keeping with the mandate of the Third Plenum to move toward a market-dominant economy, they saw the current status of SOEs as a significant obstacle to competition and efficiency. Despite significant SOE reform in the late 1990s under former Premier Zhu Rongji, many participants agreed that the footprint of SOEs in the domestic Chinese economy had again grown too large, crowding out private competitors in some sectors and continuing to have privileged access to bank loans. It was also noted that, as a group, SOEs showed significantly lower productivity growth and profitability than private-sector firms. Thus, SOE reform would be important to improve growth in the Chinese economy both by further unleashing the potential of private-sector firms and by pressuring SOEs to perform better.

Participants identified four key elements of effective SOE reform: competition, access to credit, ownership, and governance. The advantages granted to many SOEs in the form of restrictions on competition (whether by sector or in specific local areas) were seen by many participants as an important obstacle to productivity growth in a number of sectors. They recommended opening up some currently restricted areas, such as some specialized media, to private-sector and foreign firms as a means of increasing competition. At the local level, smaller service-sector SOEs were also seen as being helped by anti-competitive regulations and practices, which were retarding the growth of private-sector services firms. SOEs' preferential access to credit was another major concern of participants. Recalling the policies of Premier Zhu to enforce a hard budget constraint on SOEs in order to force improvements in productivity, they argued that many SOEs still had preferential access to low-cost credit through the banking system or through local government lending schemes. They argued that reimposing a hard budget constraint through stricter lending standards for SOEs would also free up capital for the private sector.

Similarly, many participants called for improved governance of SOEs. Some complained that SOEs were often not operated on the basis of maximizing benefits for the government units (municipalities, pension funds, etc.) that owned them, but rather appeared to be managed on the basis of the interests of managers and employees. In non-competitive environments, that would typically mean inadequate attention to productivity and innovation. Finally, and related to the issue of governance, a number of participants applauded calls for renewed privatization of SOEs (or at least hybridization—i.e., opportunities for mixed private-public ownership). They argued that, as in the late 1990s, SOE privatization could be highly beneficial both to foreign or private investors who could enter new markets and for the efficiency of the SOEs themselves as a result of injection of new capital, technology, and managerial knowhow. Several participants suggested that privatization or hybridization of SOE ownership could also be a good opportunity for private equity firms with expertise in turnarounds. Others were somewhat skeptical of the opportunities remaining, noting that many SOEs were comparatively far weaker than those that received outside investment in previous waves of privatization and hybridization; still, they felt that there were undoubtedly some good opportunities remaining, particularly in services where entry had been restricted. Several participants made the additional point that governance and ownership reforms would need to work together. If foreign or private-sector investors were to buy into SOEs, it would be essential that they gain commensurate input into management decisions; if not, the injection of capital would have little effect on improving productivity.

Participants also identified fiscal reform as an important priority for the Chinese government. They expressed concern that local governments lacked sustainable fiscal bases. Without the ability to collect sufficient taxes to fund their operations, local governments were left with two main options for generating revenues: SOE profit and selling land rights. Both of these were seen by participants as problematic. Reliance on SOEs would perpetuate the problems discussed above, while continuous sale of land rights was seen as both unsustainable economically and likely to create political problems as existing tenants were expelled. One element of fiscal reform advocated by a number of participants was the broad introduction of property taxes.

Some participants also argued that Chinese authorities should continue to address what they saw as issues in the legal system. One concern was over clarity of regulations, but the primary concern had to do with enforcement. Participants called on Chinese authorities to continue to work to improve the rule of law in court decisions and administrative procedures. With regard to foreign investment, many participants expressed concern that approvals processes were often opaque and judgments were inconsistent, particularly at local and provincial levels.

Finally, there was relatively little discussion of exchange rates at the Symposium. A few participants expressed concern that recent depreciation of the RMB against the dollar (which reversed just after the completion of the Symposium) might signal a resumption of active exchange rate management to help exporters, although they recognized that the depreciation was fairly small and might reflect other fundamentals. Most participants, however, agreed that the RMB exchange rate reflected market supply and demand. While they anticipated further liberalization of capital controls and exchange rate policy, they did not feel that the exchange rate could be characterized as out of equilibrium or consider it to be driving trade dynamics.

Session 2: Promoting Cross-Border Investments Between China and the U.S. through a Bilateral Investment Treaty

Session 2 addressed the potential benefits of a China-U.S. bilateral investment treaty. Participants agreed that cross-border investment offered substantial mutual benefits and expressed concern that regulatory barriers and uncertainty stood in the way of companies' ability to take full advantage of the investment opportunities in each other's economy. Participants discussed the progress of negotiations on a high-standard BIT, as well as other ways of encouraging more cross-border investment between the two economies.

Benefits of U.S.-China Cross-Border Investment

Participants noted a number of ways in which increased cross-border investment could help both economies. They discussed benefits to both home and host economies. It was agreed that there were numerous opportunities for mutual benefit.

Participants noted a number of areas where Chinese firms could benefit from investing in the U.S. Companies looking to upgrade technologically could accelerate their transition by acquiring U.S. firms with desirable technology, while a similar story could be told for brand names or distribution networks. (Some participants mentioned the Smithfield acquisition as an example of the latter.) In some cases, Chinese firms might also want to upgrade U.S. manufacturing plants in order to gain access to specific market segments in the U.S. or elsewhere in the Western Hemisphere. Meanwhile, U.S. communities could benefit from the creation or retention of jobs.

With regard to FDI in China, U.S. firms could gain access to China's large domestic markets, as well as high-quality, relatively low-cost labor (even given the trend of rising wages). A number of participants saw particular opportunities in services and technology-intensive manufacturing. China would benefit as well, they argued, not only from infusions of technology, knowhow, and managerial innovation, but also from increasing competition in services.

Participants also saw benefits from China-U.S. cross-border portfolio investment. Investors in both countries could gain opportunities for diversification and access to securities that would fit their risk and maturity needs. Host countries too could benefit. For China, many participants pointed to the potential role of foreign investors in improving liquidity and depth of financial markets. In the U.S., a number of participants advocated the development of markets for infrastructure bonds, which could address what they saw as the critical infrastructure funding needs of U.S. state and local governments while also providing a new asset class that could meet the needs of Chinese investors.

Status of Cross-Border Investment

One topic of discussion in Session 2 was over the current status and likely prospects for cross-border investment between China and the U.S. A number of participants expressed the view that cross-border investment appeared to be lower than economic fundamentals would suggest. They discussed at length the reasons whether and why that was the case, with answers differing based on type and direction of investment.

Chinese Investment in the U.S.

With regard to Chinese investment into the U.S., participants noted very different patterns for portfolio and direct investment. Portfolio investment, particularly by government entities, was recognized to be very high, as exemplified by the holdings of U.S. government securities in China's official foreign exchange reserves. Portfolio investment by the private sector was much more limited, due largely to formal restrictions on outward foreign portfolio investors (now being lifted by rising QDII quotas) and partly to the lack of international investing experience among Chinese institutional investors and households. Several participants felt that the amount of private cross-border portfolio investment was likely to rise as capital outflow restrictions were loosened and as new financial products such as mutual funds made overseas investment easier and more attractive for Chinese residents.

Most of the discussion of Chinese investment in the U.S. centered on direct investment, which was seen to be growing rapidly over the previous decade, albeit from a low base. (There was some skepticism about the accuracy of statistics on Chinese FDI in the U.S., however, and several participants emphasized that the official numbers probably underestimated actual Chinese FDI, as some Chinese companies made extensive use of offshore platforms in Hong Kong or tax havens such as the Cayman Islands to manage their outward FDI.) Still, Chinese FDI to the U.S. was seen to be relatively small, both as a share of inward FDI to the U.S. and of China's total outward FDI.

Many participants saw the potential for significant growth in Chinese FDI in the U.S. While much of China's outbound FDI in previous years was focused on resource extraction, often carried out by large SOEs, they felt that a number of developments in the Chinese economy would inevitably lead to more interest in the U.S. These included Chinese firms' desire for technological upgrading, increased brand consciousness of Chinese consumers, and the rise of large-scale services companies, as well as policies to support outward FDI such as looser outflow controls and support of FDI by the China Development Bank and Export-Import Bank. Participants observed increasing interest among Chinese companies in investing in the U.S. and other developed economies to obtain intellectual property, technology, market access, and brand names. Several predicted that if regulatory obstacles in the U.S. could be addressed, there would be a significant increase in Chinese FDI there.

U.S. Investment in China

Participants noted that, while U.S. FDI to China had started the decade at a much higher level than Chinese FDI to the U.S., new investment had plateaued in recent years. There was some disagreement over whether the U.S. FDI figures were lower than they "should" be. Given the large share of the U.S. as a source of FDI globally and the China's large role as a recipient of global FDI, some participants argued that U.S. FDI in China should be significantly higher than it was, and pointed to regulatory obstacles (discussed below) as a reason for the relatively low level. Others felt that the scale of U.S. FDI into China was appropriate to the two countries' economic structures. They noted that the bulk of FDI into China was focused on manufacturing, especially in capital-intensive and (to a declining degree) labor-intensive manufacturing. In contrast, U.S. manufacturers were typically involved in more technology-intensive manufacturing, which benefited much less from inexpensive labor. Also, U.S. services companies, which comprised a larger share of overall U.S. economic activity and outward FDI than manufacturers, were limited in their ability to invest in China due to restrictions on foreign ownership in activities such as financial services and internet services. Some participants also argued that the scale of U.S. firms' activities was higher than portrayed by official statistics because of substantial reinvestment of subsidiaries' profits inside of China.

Meanwhile, participants agreed that U.S. portfolio investment in China was growing but remained low. They attributed this to due to legal limits on inbound portfolio investment and to the relatively undeveloped nature of Chinese financial markets.

Impediments to Cross-Border Investment

Participants saw a number of impediments to cross-border investment between China and the U.S. These included both regulations and enforcement practices.

With regard to Chinese investment in the U.S., participants agreed that U.S. capital markets were very open to portfolio investment. Thus, they expected growing levels of private portfolio investment as Chinese outbound investment restrictions were loosened, investment vehicles such as investment trusts increased, and Chinese investors gained more experience in investing their savings abroad.

Direct investment was another story, according to a number of participants. As in previous Symposiums, there was considerable discussion of national security-based restrictions on Chinese inbound FDI through the Committee on Foreign Investment in the U.S. (CFIUS) and for investment in "critical infrastructure." In particular, there was criticism of the opaqueness of the CFIUS process—a number of participants expressed frustration that there were no clear guidelines about what would be considered injurious to national security, due to the vagueness of the definitions and the closed nature of both the process and final judgments. Although some participants pointed out that there were very few cases in which CFIUS actually disallowed investments, others argued that the uncertainty of the process made many Chinese companies shy away even from deals that would probably be found acceptable. Not all participants agreed that this was a major problem. They encouraged potential Chinese investors not to be deterred by rumors or scare-stories. Other participants, while empathizing with the uncertainty created by national security restrictions, pointed out that these restrictions applied only to brownfield investments. They noted that there were no restrictions on greenfield investments, and encouraged Chinese direct investors to consider going that route.

Participants also pointed to other impediments to Chinese FDI in the U.S. In particular, these included restrictions on investment in sectors including banking, media, and energy. Some argued that enforcement of strict U.S. immigration laws further disadvantaged Chinese companies that sought to take over U.S. firms or to build their own operations in the U.S. Overall, a number of participants felt that, even though in principle it appeared that entry into U.S. markets through FDI was completely open, in practice there was a variety of effective barriers, whether in the form of approvals processes, ambiguities in laws, political opposition, or immigration. Referring to what was seen as the persistence of such informal barriers, one participant stated that in the U.S., "the big door is wide open, but then you encounter lots of little doors that are closed." A number of participants also expressed concern about anti-Chinese sentiments on the part of some politicians and media, which they saw as dissuading some Chinese firms from investing in the U.S. Others argued that anti-Chinese sentiment was largely confined to the national level, while state and local governments were much more receptive to Chinese FDI, which could bring needed investment and opportunities for local workers.

Turning to China, participants raised a number of impediments that faced U.S. and other foreign investors. One of the major issues was the persistence of sectoral restrictions, which could be found in a variety of areas including finance, energy, telecommunications, media, distribution, agriculture, and food processing. Given the global strength of U.S. firms in a number of these sectors, the inability to invest freely was seen by many participants as a major impediment to U.S. investors. Even in some sectors where foreign investment was allowed, such as banking and insurance, full ownership remained restricted, reducing the attractiveness for firms of entering Chinese markets. While acknowledging that such sectoral restrictions might be barriers to foreign direct investment, some participants defended them, arguing that it was appropriate for a developing economy such as China's to try to promote indigenous ownership in some sectors, even if it did not maximize efficiency in the short term.

Restrictions on certain financial institutions and their activities were seen by a number of participants to be a barrier to foreign direct investment not only in terms of their impact on financial services. For example, restrictions on private equity and venture capital firms also were seen to have effects on potential investments in manufacturing and elsewhere in the "real" economy.

In addition to specific sectoral barriers, a number of participants argued that there remained considerable uncertainty regarding approvals and regulatory enforcement. In some cases, they stated, local authorities did not necessarily permit activities or foreign acquisitions even where there were no obvious legal restrictions. Other participants felt that informal processes often worked the other way—while the formal rules were strict, there were often ways of working within the system ("the big door is only partly ajar, but you can always find someone to open a little door for you"). Some U.S. firms had additional problems in Chinese markets, including what they saw as weak enforcement of intellectual property rights.

<u>Prospects and Potential Benefits of a China-U.S. BIT</u>

Looking at the partially unfulfilled promise and persistence of impediments to China-U.S. cross-border investment, a number of participants argued that a comprehensive solution was necessary, rather than just piecemeal, voluntary liberalizations and improvements. Thus, they were encouraged that Chinese and U.S. negotiators had entered talks to conclude a high-quality BIT that would govern cross-border investment between the two countries.

Benefits of BITs

A number of participants expressed hope that the negotiation of a China-U.S. BIT would address many of these issues, improving regulatory uncertainty and sectoral access. While BITs vary significantly in coverage, at the least they are intended to provide protection and improved transparency for cross-border investors. In some cases, BITs offer preferential treatment of investors from the counterpart country, including improved sectoral access and special arbitration mechanisms in case of disputes.

Participants noted that China had BITs with over 120 countries, including major trading partners in East Asia and Europe, but not with the U.S. Most of these BITs had been relatively modest in scope and ambition; negotiations on the proposed China-U.S. BIT, in contrast, were premised on the expectation that the two countries could conclude a "high-standard" BIT based on the U.S. "model BIT" that would include national treatment for investors, sectoral opening on the basis of a negative list, investor dispute. For U.S. investors, the major payoffs in terms of FDI were seen as entry or full ownership in sectors such as services and energy, a more level playing field in competing with SOEs, and better enforcement of property rights; portfolio investors could also benefit from provisions that would ease the movement of funds across borders and relax restrictions on various types of investment (although some felt that this would be better addressed through Chinese policy initiatives such as the Shanghai FTZ and other efforts aimed at financial deepening and RMB internationalization). For Chinese investors, the focus was on FDI, where they wanted greater regulatory certainty (particularly with regard to what they saw as arbitrary national security rules and interventions by politicians), access to more sectors including telecommunications and energy, and equal treatment of SOE investors. Finally, participants generally agreed that productive BIT negotiations could be an important confidence-building exercise for China and the U.S. that could help to reduce rising political tensions and perhaps even build a bilateral consensus that could be extended to WTO-level negotiations.

While the two countries had agreed to negotiate based on the basic principles listed above, participants agreed that a final agreement on implementation would take significant time to accomplish. They identified several issues as likely to be contentious. With regard to treatment of investors, the U.S. demand for pre-establishment of national treatment (which would have the effect of eliminating restrictions on entry of FDI, and not just ensuring equal treatment of established activities) was seen as going well beyond existing national treatment clauses in China's previous BITs. Participants also predicted extended negotiations on what sectors or specific activities would remain on China's negative list. Items such as disciplines on SOEs (meant to level the playing field with private-sector firms) and protection of real and intellectual property rights, which could contravene existing Chinese laws and governance practices, were also seen as challenging. Finally, a number of participants pointed to national security carve-outs as likely to perpetuate existing security-based restrictions such as CFIUS. Given the central importance that many Chinese firms placed on removing U.S. national security restrictions on their investments, some participants questioned whether Chinese negotiators would be willing to make major concessions on other items if U.S. national security restrictions were not significantly lifted. Others countered that the Chinese government had just as firm a position on national security carve-outs as the U.S., so the contours of agreement on that issue would be more straightforward than on items such as preestablishment of national treatment, disciplines on SOEs, and property rights.

Progress and Alternatives

Overall, participants expressed a mixture of optimism and skepticism about BIT negotiations. On the plus side, many participants considered it a promising sign that Chinese authorities had agreed to begin negotiations on a high-standards BIT with the U.S. They saw it as further evidence that the Chinese government was truly committed to the market reforms outlined in the Third Plenum. Like the Shanghai FTZ and plans for RMB internationalization, they felt that BIT negotiations would help the authorities to experiment with and accelerate reforms that would improve the competitiveness and openness of the Chinese economy. Other participants were more skeptical of prospects for success. They felt that, despite the existence of substantial common ground, the goals of the Chinese and U.S. were too far apart unless the U.S. were to compromise significantly from its model BIT. Some also felt that political mistrust between the two countries would make agreement even more difficult, especially since some the most contentious issues had to do with national security or basic functions of the state (e.g., SOE disciplines). Opposition to foreign trade and investment agreements in Congress was seen as yet a major obstacle. Even if trade and finance officials could agree to a BIT, such a treaty would have great difficulty securing congressional approval.

Although there was no clear consensus on the prospects for ultimate success of the BIT negotiations, participants agreed that it would likely take years to come to a resolution. This raised the question of what could or should be done in the meantime to promote cross-border investment. Several participants suggested that more informal bilateral understandings such as sectoral MOUs could promote more investment between the two countries, and urged the two governments to keep investment facilitation high on the Strategic and Economic Dialogue (S&ED) agenda. Others questioned whether a BIT was actually necessary to expand cross-border investment. They pointed out that such investment had grown to significant levels in the absence of a formal agreement, due largely to unilateral measures, and argued that a focus on liberalization on the part of the Chinese and U.S. governments to promote domestic economic growth was more likely to have the desired effects than more negotiations. Some participants even worried that the BIT negotiation process would slow down unilateral measures or intermediate MOUs, as negotiators would be apt to resist hold off on implementing such policies so they would not be seen as concessions. However, a number of participants expressed confidence that the Chinese government would continue to lower barriers in accordance with the strategic priorities laid out in the Third Plenum and SFTZ plans, even without reciprocal action by the U.S. government.

Session 3: Capital Market Financing and the Changing Role of Private Equity and Venture Capital

In Session 3, participants discussed prospects for private equity and venture capital firms in China. Among the questions they addressed were what sectors were most attractive for such firms, whether exit opportunities were improving, what the comparative advantage would be for them, prospects of private equity as an asset class, and the biggest challenges going forward.

Current Status and Opportunities

Participants described private equity and venture capital in China as sectors in flux. They noted that there had been a large increase in the number of institutions identifying themselves as private equity and venture capital firms, although they saw large variations in their basic approaches. Some felt that there had been considerable overexpansion and that it was likely that there would be some rationalization. Still, there was substantial optimism about long-term prospects for private equity and venture capital funds, as well as other asset managers, given the vast savings of Chinese households, most of which remained in the form of bank deposits.

Participants pointed to a number of areas in which private equity could have a big impact on the Chinese economy. Some felt that it could contribute to growing businesses to meet the burgeoning demand of urban consumers for goods and services, and described opportunities ranging from automobile dealerships to education and training. SOE reform was also seen as offering opportunities for private equity firms with expertise in turnarounds. Moves toward industrial consolidation could also benefit the sector, as private equity firms could engineer M&A in overcrowded sectors. Meanwhile, the continuing difficulties of SME financing were seen to provide many potential opportunities for private equity and venture capital firms. The wide range of opportunities reflected an equally broad range of strategies and business models in the sector. Some participants predicted that the market would be segmented over time by firm size as well as approach.

A number of participants made the case that private equity and venture capital had the potential to be important factors in the Chinese financial system. Some noted the recent surges in leverage among Chinese firms (and the concomitant growth of loans in the banking and shadow banking systems), and argued that both borrowers and creditors could benefit from the conversion of some of those loans into equity. Given the difficulty of accessing formal capital markets, private equity and venture capital firms could play a valuable intermediating role, both in improving access to capital and in improving the balance of equity and debt for many companies. In fact, it was suggested that some “shadow-banking” products were *de facto* a form of private equity, and that formal private equity firms were already competing with them.

Challenges

Private equity and venture capital firms were seen to face several challenges. One was the crowded (perhaps overcrowded) field. Several participants suggested that in many cases new entrants had little relevant experience or expertise to distinguish themselves from competitors, so the numbers were bound to fall. The firms that survived would be those that were able to add value to the companies they acquired or in which they invested, by virtue of their expertise in management and operations or their knowledge of the sector. A number of participants argued that success in the industry required high levels of local knowledge; even experienced foreign players, they said, needed to rely on local staff or local partners to succeed. It was also noted that most funding for private equity and venture capital in China was local, which also called for a high degree of localization of operations.

Participants cited two major constraints on the business models of private equity and venture capital. One was the limited exit options. With only around 300 IPOs per year in recent years, many investors would be unable to exit through capital markets. (Private equity or venture capital arms of securities firms were seen to have an advantage over others in terms of their ability to exit positions.) The paucity of IPOs was seen to be largely a regulatory issue, as authorities had been very conservative about adding to the IPO pipelines. One hopeful sign was the attention given to exit options by the Development Research Council in its recently published nine principles. Also, some participants noted the emergence of securitization of buy-out funds, which some participants saw as an attractive alternative to IPOs. For foreign firms, the challenges of exit were seen to be compounded by capital controls. A second constraint was the web of regulations facing private equity and venture capital firms. One participant stated that foreign private equity firms had to "go through a regulatory gauntlet for every deal," but the need for approvals for many types of deals was seen as a complication for domestic firms as well. For firms configured as general partnerships, double taxation was seen as an additional challenge.

Participants saw recent economic developments as having mixed effects on the sector. For example, the renewed attention to SOE reform appeared likely to provide new opportunities for restructuring. However, some participants cautioned that many SOEs were overvalued, unlike at the time of the previous wave of SOE privatizations and restructurings in the late 1990s and early 2000s. Moreover, some participants noted cases in which the management of weaker SOEs was interested only in capital infusions by investors rather than in taking advantage of private equity investors' expertise in restructuring or refocusing companies' operations. They stressed that it was important for private equity firms to ensure that they could have a positive impact on governance and decision making rather than being taken for granted as passive investors. Another major question was the impact of slowing growth at the macro level. While acknowledging that this would undoubtedly reduce growth prospects for many firms, several participants suggested that the new macroeconomic environment offered some opportunities for private equity and venture capital firms that could contribute to firms' competitiveness, so as to solidify their positions within their sectors. It was also noted that, despite a slowdown at the macro level, some sectors were bound to continue to grow quickly, especially those that catered to the needs and wants of the growing urban middle classes.

Session 4: China's Free Trade Zones and Their Implication for the U.S. Financial Sector

In Session 4, participants discussed the implications of new services-oriented free trade zones for U.S. financial institutions and the development of China's financial sector, an issue that also came up in Session 1, as already previously discussed. There was considerable enthusiasm about the recently-opened Shanghai FTZ (SFTZ), and many participants hoped that it and future FTZs would help to accelerate liberalization and reform of services, including financial services.

Participants noted several special characteristics of the SFTZ in addition to its focus on services. One was the principle of the negative list, which they saw as a potentially important precedent for Chinese regulation. By allowing in principle all activities that were not explicitly prohibited, the SFTZ would encourage innovation and managerial flexibility. Equally important was the principle that investors in the SFTZ, including financial institutions, could enter new businesses and create new products by registering rather than having to gain approval from regulators. Regulations were seen to be unusually transparent, with consistency of enforcement ensured by a special court of arbitration. Finally, the political commitment of authorities could be seen not only in high-level pronouncements such as in the Third Plenum, but also in the cooperation among regulators including CBRC, CSRC, CIRC, PBOC, and SAFE to create comprehensive and rational rules for the zone.

The SFTZ was seen as allowing a variety of new activities. These included cross-border account management, access to new financial products such as RMB bonds issued by foreign entities (panda bonds) and offshore derivatives, cross-border settlement in RMB (including pooling, payment netting, payment on behalf of (POBO), and receipt on behalf of (ROBO)), foreign currency reforms, and interest rate liberalization starting with CDs. While offshore banking was still technically off-limits, foreign financial institutions with operations in Hong Kong would be effectively able to link Shanghai and Hong Kong operations.

There were some questions raised about how deep the changes really were. Some participants wondered, for example, whether the allowance of limited issuance of CDs would have a noticeable impact on financing options even within the SFTZ, and noted that the impact outside the SFTZ was limited by restrictions on how funds raised through CD issuance could be used. It was also noted that, at least for the moment, regulators were trying to restrict the experiment to a relatively small group of firms in a limited set of sectors.

For the most part, however, participants were optimistic that experimental reforms in the SFTZ would serve as a template for future FTZs and regulations for services sectors throughout the country. They saw the FTZ movement as an important element of a significant new round of financial liberalization and promotion of RMB internationalization that had begun in 2012. Already, PBOC and SAFE had significantly reduced documentation for foreign exchange transactions, moved toward more market-determined interest rates, and lifted capital outflow controls on firms; many participants saw this as a firm commitment to the principles on which the SFTZ was based.

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