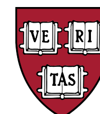
SYMPOSIUM ON BUILDING THE
FINANCIAL SYSTEM OF THE 21ST CENTURY:
AN AGENDA FOR CHINA AND THE UNITED STATES

ZHEJIANG XIZI Hotel
Hangzhou, China • MAY 19-21, 2016



DRAFT AGENDA (AS OF APRIL 21)

THURSDAY, MAY 19

6:00-6:30 p.m. COCKTAIL RECEPTION

6:30-6:45 p.m. GREETINGS

- LU Mai, Secretary General, China Development Research Foundation (CDRF)
- Hal Scott, Nomura Professor and Director, Program on International Financial Systems, Harvard Law

6:45-7:00 p.m. WELCOME SPEECH

- ZHEJIANG Province

7:00-8:00 p.m. KEYNOTE ADDRESSES

- ZHU Guangyao, Vice Minister, Ministry of Finance, P.R. China
- Robert Dohner, Deputy Assistant Secretary for Asia, U.S. Department of Treasury

8:30-9:30 p.m. DINNER

FRIDAY, MAY 20

7:30-8:30 a.m. BREAKFAST BUFFET

8:30-8:55 a.m. KEYNOTE ADDRESS

- WANG Yiming, Vice Minister, Development Research Center of the State Council, P.R. China

8:55-9:25 a.m. PANEL DISCUSSION

Stabilizing Markets: The Role of Individual Countries, the G20, and the FSB

Panellists will introduce and discuss issues relevant to the topic. Each panellist will make a presentation, followed by a plenary discussion, before all of the participants are broken into small working groups.

- Simon Gleave, Regional Head of Financial Services, KMPG Asia Pacific
- Co-panelist to be announced

9:30-10:50 a.m. SMALL GROUP SESSIONS

Participants are divided into working groups for facilitated discussions with the views raised by the panelists serving as a foundation. A facilitator encourages conversations which occur under Chatham House Rules, and a rapporteur will record the major themes (sans attribution) for use during the sessions on the final day.

10:50-11:05 a.m. REFRESHMENT BREAK

11:05-11:35 a.m. PANEL SESSION

Financial Services and Regulation in the Age of "Digital Finance"

Panellists will introduce and discuss issues relevant to the topic. Each panellist will make a presentation, followed by a plenary discussion, before all of the participants are broken into small working groups.

- George Tan, CEO, MetLife, China
- Co-panelist to be announced

11:35-12:55 p.m. SMALL GROUP SESSIONS

Participants are divided into working groups for facilitated discussions with the views raised by the panelists serving as a foundation. A facilitator encourages conversations which occur under Chatham House Rules, and a rapporteur will record the major themes (sans attribution) for use during the sessions on the final day.

1:00-2:00 p.m. BUFFET LUNCH

2:10-2:30 p.m. KEYNOTE ADDRESS

- WANG Zhongmin, Vice Chairman, National Council for Social Security Fund, P.R. China

2:30-3:50 p.m. PLENARY PANEL SESSION

Rate Hike Cycle in the U.S. and the RMB Exchange Rate

A moderator will facilitate a discussion giving all panelists equal opportunity to participate before incorporating the audience as well. Panelist's remarks will provide a point of view that offers Symposium participants the benefit of analysis and insight on the topic.

- Doug Arner, Professor, The University of Hong Kong (*moderator*)
- Michael Taylor, Managing Director, Chief Credit Officer, Moody's
- Co-panelists to be announced

3:50-6:30 p.m. FREE TIME/ RAPPORTEURS MEETING

6:30-7:00 p.m. COCKTAIL RECEPTION

7:00-8:00 p.m. KEYNOTE ADDRESSES

- ZHANG Zhizhou, CEO, DH Fund Management Company
- Paul Michael Romer, Professor of Economics, Stern School of Business, New York University

8:00-9:30 p.m. DINNER

SATURDAY, MAY 21

7:30-8:30 a.m. BREAKFAST BUFFET

8:30-8:55 a.m. KEYNOTE SPEECH

- William Kirby, Spangler Family Professor of Business Administration; T. M. Chang Professor of China Studies, Harvard University

8:55-10:05 a.m. PRESENTATION AND DISCUSSION

Infrastructure Financing and Multilateral Cooperation
A moderator will facilitate a discussion giving all panelists equal opportunity to participate before incorporating the audience as well. Panelists' remarks will provide a point of view that offers Symposium participants the benefit of analysis and insight on the topic

- Jin-Yong Cai, Partner, TPG
- Andrew Cross, Deputy Treasurer, Asia & Pacific, IFC
- Don Kanak, Chairman, Eastspring Investments (moderator)

10:05-10:15 a.m. REFRESHMENT BREAK

10:15-11:15 a.m. PRESENTATION & DISCUSSION
Stabilizing Markets: The Role of Individual Countries, the G20, and the FSB
Panellists will moderate a plenary discussion that uses a synthesis of the small group sessions from the previous day as the basis for session.

- Co-panelists to be announced

11:20-12:20 p.m. PRESENTATION & DISCUSSION
Financial Services and Regulation in the Age of "Digital Finance"
Panellists will moderate a plenary discussion that uses a synthesis of the small group sessions from the previous day as the basis for session.

- Jerry Cristoforo, EVP and CTO, State Street
- Co-panelist to be announced

12:20-1:20 p.m. CLOSING BUFFET LUNCH

Symposium on Building the Financial System of the Twenty-First Century: An Agenda for China and the United States
Hangzhou, China, May 19-21, 2016

The thirteenth annual China-U.S. Symposium was held on the banks of West Lake in Hangzhou, China. Sessions addressed the respective roles of individual countries, the G20, and the Financial Stability Board (FSB) in stabilizing global markets; the ways in which "digital finance" was transforming financial services and regulation; infrastructure financing, including the respective roles of public sector, private sector, and the potential for multilateral cooperation; and the U.S. rate hike cycle and its likely effects on the RMB exchange rate.

Session 1
Stabilizing Markets: The Role of Individual Countries, G20, & FSB

In Session 1, participants discussed the role of individual countries, the G20, and the FSB in stabilizing global markets. They identified a number of global sources of market instability, including low growth, rising public and private debt, and political backlash against globalization in the U.S. and Europe. There was also considerable discussion of China's economy, including how ongoing efforts to rebalance the economy could contribute to more sustainable growth and to domestic and global stability. Finally, participants discussed the goals and institutions of global cooperation.

Global Sources of Instability

Participants noted numerous sources of instability in global markets. High and rising levels of debt were seen as particularly dangerous. Increasing private-sector debt was matched by declining productivity and returns, raising the likelihood of defaults and non-performing loans in many economies. Public-sector debt was also seen as a problem. In some economies, participants worried that governments might be nearing their borrowing limits in sometimes vain efforts to reinvigorate growth. They saw the problems of both public and private debt as being compounded by slow growth. Moreover, a number of participants raised concerns that the risks might be significantly higher than official statistics. One major reason was the size and opacity of shadow banking—although estimates of the extent of indebtedness were widely cited, few participants felt confident of either the accuracy of the statistics or the quality of risk management in the shadow banking sector. Public-sector debt was also seen as somewhat opaque, since many governments at both the local and national level carried significant contingent liabilities, including not only pensions but also default risk from state-owned enterprises (SOEs), lending programs, and loan guarantees.

A number of participants expressed concerns about the state of financial intermediation, arguing that post-crisis rules may have reduced the resilience of the system even though it had probably increased the safety of many financial institutions. In particular, they focused on Basel III capital and liquidity rules that restricted many banks' lending to only the safest borrowers—sovereigns, highly-rated firms, and wealthy households. They argued that this meant that more marginal borrowers were either in danger of not having access to funding at all or of being forced into the world of shadow banking, with higher interest rates, shorter terms, and less consistent access to credit. Moreover, these participants saw capital rules as not only making banks more conservative, but also perhaps procyclical. They worried in particular about the ability of the banking system to lend into emergencies.

Another concern with regard to the financial system was complexity. Despite post-crisis efforts to reduce the complexity of financial institutions and their interrelations, many participants judged that it was still impossible to get an accurate view of either risk within a complex financial institution or connectedness risk between different financial actors.

A number of participants pointed to what they saw as government policies in many countries that obstructed market discipline. This was partly a story about overregulation and barriers to entry, but the criticism was mostly about governments that had bailed out firms that had made bad decisions. By providing an implicit guarantee to managers and investors, these participants argued, governments were encouraging overinvestment and risky behavior. Some participants included accommodative monetary policy as a form of bailout of unproductive firms—by pushing interest rates near or even below zero, they argued, central banks were keeping non-productive firms alive and allowing them to even to expand their indebtedness.

Finally, many participants were deeply worried about political risk. They noted an increasing popular hostility to all forms of globalization, as well as financial intermediation in general, especially in the developed world. Electorates across Europe and the U.S. were showing little patience for politicians associated with global commerce or finance, and participants worried that this would lead to policies that would balkanize the global financial system, disrupt value chains, and lead to recessions or renewed financial crisis. Many expressed alarm in particular at the populism of the U.S. presidential election campaign, including suggestions that U.S. debt obligations might not be paid back in full. Although some participants jokingly referred to this as the "Donald Trump haircut," they also asked what would be the consequences for the global economy if the dollar—the world's last safe asset—were to become just one more risky asset. Some participants raised the possibility that Chinese authorities might be able to step in to provide safe assets, whether in the form of RMB-denominated debt or synthetic-currency debt, but few considered that a near-term prospect.

China-Specific Issues

In the face of weak growth prospects in the most developed economies, many participants felt that the China's growth would be ever more important globally. Several observed that media commentary, particularly in the U.S., had increasingly raised concerns over the possibility of an economic crisis in China, but participants at the symposium agreed that alarmist analyses were overblown and often based on misunderstandings of basic elements of the Chinese model. Most saw the Chinese economy as still having a relatively positive influence on global economic stability; however, there was considerable discussion of whether risks were building within China and how they could be reduced.

Participants agreed that the Chinese economy was shifting to a lower growth equilibrium as working age population had passed its peak and declining returns to capital investment meant that the era of investment-led growth of heavy industry was nearing its end. They also pointed to rising private-sector debt as a cause for concern. One reason was that unproductive firms in industries that were facing declining demand (particularly those in basic industries like coal, steel, and cement) were continuing to increase debt, despite their decreasing ability to pay back their lenders from revenues. Also as investment opportunities were declining in the industrial sector, many participants saw an irrational build-up of investment into other assets, particularly real estate and financial speculation.

Here too, they worried that demand would not sustain the ability to pay back heavy indebtedness.

Finally, a number of participants expressed concern that structural features of China's financial system were contributing to a build-up of risk, and could also exacerbate the effects of the market corrections that could result. One of these was the growing size of China's shadow banking sector, as banks became more wary of lending to weak firms and investors became more focused on chasing returns. Concerns about the growing size of leverage through shadow banking were exacerbated by the sense that statistics were incomplete due to the lack of transparency in shadow banking institutions and products, as well as about the interconnectedness of shadow banking and the formal banking sector. Lack of transparency was also presented as a broader problem that weakened investors' and creditors' ability to assess risk, and thus increased the tendency toward herd behavior. Finally, the structure of equity markets—characterized by high retail investor participation, high turnover (particularly among those retail investors), and what many participants judged to be low levels of financial literacy—could also contribute to boom-bust cycles that could transmit risks through the Chinese economy. A number of participants noted the potential that, unlike in previous market corrections, volatility in Chinese markets could increasingly have global effects as well, partly because of the impact on expectations for China's real economy and partly because of the much greater ease of moving capital overseas. In this regard, some participants worried that further opening of the capital account could lead to large outflows that could destabilize Chinese and foreign markets.

Despite the concerns about declining growth, rising debt, and potential market volatility, many participants agreed that the Chinese government had correctly diagnosed the problems and was in the process of implementing reforms that would address them. In particular, they pointed to the ongoing efforts to rebalance the economy away from an overemphasis on investment-led, export-dependent heavy manufacturing toward domestic demand-driven growth focused on services and technological innovation. Participants agreed that this was a formidable challenge and that there were political pressures to keep sustaining declining industries and dying firms; however, many argued that the central government's efforts were having positive effects in supporting the rebalancing of the Chinese economy. One challenge that a number of participants noted was that success in overall economic rebalancing could only be assessed over the long term, but that short-term pain and dislocation were inevitable. Still, they also saw immediate benefits to Chinese financial market stability from efforts by banks and others to de-risk, including through reducing new lending and through carrying out debt-equity swaps as a means of reducing outstanding credit.

Overall, many participants expressed a generally optimistic view of the prospects for continued growth in the Chinese economy, as well as reduction of potential risks and causes of volatility. They saw domestic rebalancing as the greatest contribution that China could make to global stability, just as the greatest contribution that the U.S. could make would be to maintain growth at home and to avoid overregulation and protectionist impulses.

Goals for Global Cooperation

While participants agreed that, in most respects, the actions of individual governments in ensuring domestic growth and financial stability would be their greatest contribution to global financial stability, they also discussed at length the potential for global cooperation. Discussion addressed the appropriate goals and the likely limits of global cooperation, as well as the best avenues for improving cooperation.

Participants considered several potential goals for global cooperation, starting with the G20 global agenda for financial reform. Many expressed hope that efforts to increase bank capital, reduce complexity, enhance supervision of systemically important financial institutions (SIFIs), and reduce counterparty risk through exchange trading and central clearing of derivatives could reduce the risk of financial failures and contagion. However, there were several concerns raised about that agenda as well. In particular, some participants questioned whether regulations to stabilize the banking system had gone too far, making risk capital scarce and forcing many borrowers to turn to expensive and poorly regulated non-bank financial institutions to gain access to credit and choking off potential growth opportunities. Even among those who were supportive of the reform agenda, there was a recognition of the tension between global standards and local implementation—while participants recognized the need to adapt global standards to local conditions, they also noted that local adaptation reduced the uniformity of rules, raising the costs for cross-border financial institutions and possibly increasing the likelihood of governments adapting regulation for competitive advantage and of renewed risks due to incomplete implementation.

There was also discussion about the potential benefits of macroeconomic coordination. Several participants argued that it would be important for major economies to jointly pursue growth-oriented monetary and fiscal policies. However, not all participants agreed that this was desirable even in principle. For one thing, there was disagreement about what growth-oriented fiscal and monetary policy might mean in practice. A number of participants were skeptical of the benefits of stimulating demand through further borrowing or monetary easing. They worried about the sustainability of fiscal stimulus in countries with high debt to GDP ratios, including Japan, much of Europe, and possibly the U.S. There were differing concerns about China—although fiscal sustainability was not seen as an issue, some participants worried that efforts to prop up public sector demand would prop up the basic materials industry and SOEs, and thus go against the goals of economic rebalancing. There was also disagreement on the benefits of monetary policy coordination, as a number of participants felt that policies of quantitative easing and negative interest rates had a variety of negative effects, including injuring financial institutions, threatening the solvency of pension systems, and reducing incentives for banks to cut off credit to zombie companies.

One issue that was raised by several participants was the reliance of global finance on U.S. dollar-denominated public debt, which some participants characterized as the world's "last safe asset." They worried that the lack of alternative risk-free assets might make the global economy excessively dependent on the decisions of the New York Fed, especially given post-crisis political developments in the U.S., including legislative

efforts to reduce its powers as lender of last resort and circumscribe its discretion. Although there was some discussion of the potential role of China in addressing this gap, or of expanded use of SDR, few felt that there were viable alternatives in the short- to medium-term. One issue about which there was considerable consensus was on the importance of preventing competitive devaluation of currencies—however, here too there was disagreement on what that would mean and whether existing commitments were being honored in practice.

In general, many participants expressed skepticism about the potential for global considerations to override governments' perceptions of their own economies' needs. Some focused on whether it was possible to constrain the U.S. policies from enacting fiscal and monetary policies that ignored global spillovers; others argued that, in the absence of duress from the threat of currency crisis, local needs would always beat out the demands of global collective action. A number of participants argued that this tendency was exacerbated by the fact that political support for globalization and supranational authority was low and shrinking—particularly in the developed world, as seen in populist and nativist political dynamics in the U.S. and many European economies (including, perhaps most prominently, the Brexit debate, but also seen in the rise of new populist parties throughout many EU members).

Still, participants argued that the effort was an important one, and that it would be important for leaders to emphasize the many benefits that globalization and global rules had brought to economies throughout the world, in order to support global growth and reduce volatility. One potential bright spot in this regard was what many participants saw as significant improvements in communication among governments and central banks. They saw it as both a worthy and achievable goal that governments should know others' intentions before setting their own policies. It was also suggested that governments should better communicate their intentions as well as international commitments to their own citizens in order to avoid political pressure for myopic policies.

Institutions of Coordination

Finally, participants discussed the potential and limits of existing global institutions for fostering coordination. They focused in particular on the G20 and FSB.

There was a general sense that the global institutional structure had improved in the wake of the financial crisis. A number of participants made the case that the G20 had much more global credibility than the G7/G8, due to its more global representation, particularly from developing and middle-income countries. As a result, its substantive decisions—in particular, the global financial regulatory reform agenda—were taken more seriously and implemented more assiduously than pronouncements from other groupings. One downside was that the increased number and variety of members meant that coming to agreement was much more difficult than in a smaller, more homogeneous grouping like the G7. Thus, some participants argued that, with the exception of specific points in time like the global financial crisis, many substantive decisions about the direction of the global economy or financial system were more likely to be made in the G7 or the China-U.S. Strategic and Economic Dialogue (S&ED). The impact of the G20 was also seen to

suffer from other factors. For example, the G20 agenda for any given year was driven primarily by its host country. With China hosting the G20 in Hangzhou in 2016, many participants had high hopes that key elements of the agenda, including its emphasis on infrastructure, would be effectively implemented. However, hosts in other years might not have the same level of commitment to a common objective or the ability to shape the outcome as did China. Another point made by several participants was that, regardless of the legitimacy of G20 agreements, they were not legally binding. This led some to suggest that the G20 should be subsumed in the UN system in some way, but many other participants did not consider that a realistic or useful alternative.

Participants also discussed the efficacy of the FSB. They agreed that the FSB was a significant improvement over previous coordination efforts such as the Financial Stability Forum, which had little institutional authority. The FSB, despite its relatively limited powers of enforcement, had become effective as a venue for substantive policy discussions and as a mechanism for monitoring the implementation of cooperative decisions through more specialized groupings such as the Basel Committee on Banking Supervision (BCBS). The FSB, in this respect, was seen as the working-level arm of the G20. Still, a number of participants emphasized the limits of the FSB as an organization. It lacked significant resources of its own, and its monitoring ability remained dependent on the personnel and commitment of its members. Like the G20, its agreements were not legally binding on members. (However, some saw this as not being a problem, since much of the enforcement was in the form of market access, so if leading FSB members agreed on a given standard, it would likely be implemented globally at least in some form.) Several participants argued that the FSB would become more effective as a mechanism for global standard-setting and regulatory coordination if China were to take an increasing role; others made the case that China was already doing so on issues that were most relevant to its own financial system, and could be expected to expand its role in the coming years.

It was also pointed out that discussion of global coordination should not focus only on global institutions. Participants pointed to the importance of a variety of bilateral, minilateral, and regional organizations in promoting regulatory and economic policy coordination, ranging from the EU to the Trans-Pacific Partnership to the S&ED. There was particular interest in the potential for the S&ED to help make global cooperation more effective—although participants were not advocating a “G2,” they did note that China and the U.S. were major players in the G20 and that cooperation between the two could help to shape both the global agenda and create regulatory solutions that could serve as useful models for other countries.

Overall, participants agreed that, despite considerable progress in developing institutions for cooperation at the global and other levels, there was a need for further efforts to improve the quality of global cooperation. In particular, there appeared to be a consensus in favor of ensuring more consistent communication across more channels, especially between China and the U.S.

Finally, a number of participants raised the question of whether the improvements in global cooperation had made the world economy better prepared to manage the next

crisis. While their evaluations of the progress of coordination varied, participants were consistent in warning against complacency.

Session 2
Financial Services and Regulation in the Age of Digital Finance

In Session 2, participants discussed the ways in which digital finance ("fintech" in the U.S., "internet finance" in China) was transforming financial services and financial regulation. The patterns of adoption of digital finance were seen as very different between China and the U.S.—the growth of China's internet finance was led by technology firms providing retail financial services, while fintech in the U.S. was seen as still operating primarily through traditional financial institutions, despite competition from non-financial corporations in certain functions. Participants identified differing regulatory approaches as a major factor in the differing patterns. They also acknowledged that digital finance created some significant challenges for regulators, and discussed implications for regulatory regimes.

Fintech as Disruptor

Participants agreed that digital finance had the potential to substantially change a variety of aspects of financial intermediation, in both developing and highly developed financial systems. It offered both opportunities and challenges to incumbent financial institutions, new entrants, customers, and regulators.

Many participants observed that some of the most evident examples of change could be seen in the ways in which customers interacted with the financial system. This was perhaps most apparent in developing financial systems, where large swathes of the population lacked access to traditional banking services, but where smartphones had become ubiquitous. In such economies, the shift to digital payments systems had been particularly rapid as a means of making secure transactions and remittances, although participants noted that there were a variety of models for managing digital payments systems, from ones managed by the telecoms monopoly (e.g., Kenya) to ones with multiple vendors and IT services (e.g., China). A number of participants also pointed to the growing popularity of person-to-person (P2P) credit platforms. As a result, digital finance had proved revolutionary in terms of promoting financial inclusion, particularly in developing economies. A number of participants expressed optimism that this expanded financial inclusion would contribute to poverty reduction and more equitable growth, as poorer and more financially marginalized people gained access to lower-cost credit and remittances. It was also argued that digital finance was empowering customers more generally, as innovation was being driven by demand rather than by existing notions of financial products.

Digital finance was also seen as changing finance at the wholesale level, through payments and accounting alternatives, Big Data-based marketing and analytics, and new methods of risk management. Participants agreed that the dynamics of competition were likely to change for a number of functions, but that the extent and type of change in any given economy would depend on the costs of entry and a variety of regulatory issues, ranging from financial regulations to privacy and data security. Indeed, a number of participants saw regulation as central to the effects of digital finance on financial

institutions—in some economies, non-traditional financial institutions could easily enter businesses while taking advantage of regulatory arbitrage to enjoy lower costs of compliance, while in others, potential entrants appeared to be holding back for fear of being regulated like banks across their entire business.

Much of the discussion of digital finance assumed that that the ability to regulate the financial system would be impaired by the rapid innovation. Moreover, since in many cases regulatory arbitrage would be one of the major drivers of cost-competitiveness, there were concerns raised about both consumer protection and prudential regulation. However, a number of participants argued that digital finance offered considerable opportunities to regulators as well. In particular, they noted that digital tracking could improve monitoring of money-laundering and tax enforcement. Some saw particular win-win opportunities in AML and KYC, as monitoring could be made much less expensive and more automated for financial institutions, even as it became more accurate from a regulatory perspective.

Overall, in some functions and in some jurisdictions, participants predicted significant competitive pressure from new entrants from outside the financial sector. In others, incumbents with deep pockets might gain opportunities to drive current or potential rivals out of business. A variety of other questions remained to be tested in the market place, including whether Big Data analytics based on consumer behavior or other publicly available information (e.g., social media posting, group membership, etc.) would prove to be a viable substitute for traditional approaches to financial modeling such as actuarial science and credit scoring. Thus, while few participants were willing to predict the death of traditional financial intermediation, there was a broad agreement that tech-driven market disruptions would likely lead to major changes in the competitive market place, with an assortment of big winners and big losers across financial systems.

Internet Finance in China

Much of the discussion in Session 2 addressed the extraordinary growth of internet finance in China. Many participants identified China as a global leader in the spread of new financial technologies. Perhaps the clearest example was the proliferation of retail payments through providers such as Alipay and WeChat Payments that were created and managed by IT firms rather than banks. However, retail-focused internet finance was advancing rapidly in other directions as well, including the world's largest P2P market and a nascent but rapidly growing crowdfunding market. In addition, a number of internet finance companies had begun to move from payments to becoming more comprehensive financial providers, distributing a variety of financial products and in some cases even creating their own funds.

Participants discussed two explanations for the rapid growth of internet finance in China. The first was that it filled structural gaps in the financial system. Many participants argued that it was still difficult for SMEs and households to access credit from the formal financial system (defined primarily by banks), as evidenced by the burgeoning of shadow banking institutions lending to credit-constrained borrowers at high interest rates. At the same time, many savers either did not have access to bank accounts that would allow

them to transfer money cheaply and easily, or found existing financial products (including wealth management products as well as bank accounts, mutual funds, and stocks) to offer insufficient options or excessive costs. The ability to transfer money easily and safely through internet financing created new opportunities for commerce for companies of all sizes, while reducing transaction costs. Similarly, P2P and crowdsourcing platforms offered the promise of cutting out the fees of the middleman and benefitting both savers and borrowers. In both cases, the relative dearth of existing alternatives—such as the prevalence of credit cards or the existence of comprehensive credit tracking and scoring—created space for new mechanisms of facilitating payments and managing credit risk.

As an alternative (or complementary) explanation, a number of participants pointed to the importance of regulatory gaps. Many participants characterized the government as supportive but vigilant, noting that it had allowed considerable innovation and had even encouraged experimentation in a number of cases. At the same time, regulation on traditional financial institutions such as banks and insurance companies had remained conservative, apparently for prudential and macroprudential reasons. Thus, tech firms and internet retailors had been allowed to take the lead, in contrast to the U.S. pattern in which much of the retail-oriented fintech had been carried out by banks or by using existing bank-based systems (e.g., credit cards). Several participants applauded the Chinese government's approach, and also made the case that one reason for the great vibrancy of China's internet finance was that it was built by the most innovation-driven firms in the country rather than being controlled by incumbent financial institutions subject to strict prudential and legal regulation.

While participants were impressed by the vibrancy and innovation of Chinese internet finance, they also flagged some risks. Primary among those was the potential for fraud. A number of participants noted that there had already been a number of revelations of fraudulent behavior at some P2P and crowdfunding platforms. Similarly, some noted cases of insider trading, in which friends of employees of internet finance companies were informed about financial opportunities before they were made publicly available. Thus, many felt that regulators should step in to ensure that untrustworthy actors did not harm Chinese people or sour them on the potential benefits of internet finance.

Other participants raised concerns about data security and data privacy. Poor attention to data security could expose millions of people to cybertheft, making it a potentially major issue for both regulators and the marketplace. A number of participants wondered if small players in the internet finance space had the ability to properly protect their customer's data. Data privacy was also seen as a potentially significant issue, and a number of participants raised the question of whether internet finance customers understood either the extent of information that was being collected on them, the ability of collectors of internet finance companies to share that information broadly for profit, or the ways in which data could be used to profile and possibly even harm them. Thus, they called for more dialogue regarding the rights and responsibilities of individuals and firms in dealing with privacy issues.

Another concern was that internet finance (and digital finance more generally) appeared to reward scale—not only was the investment in hardware and software substantial, but scalability and network effects meant that transaction costs would be inversely correlated with size. This raised two potential dangers. One was a tendency toward monopoly, such that over time the major firms would be able to crowd out competition and start charging customers much more. Not all participants were convinced that this was a compelling consumer protection challenge, however, as they noted the ever-present possibility of new entrants if oligopolistic or monopolistic activities were to occur. The other concern was that an internet finance company might become systemically important, or too big to fail. This was seen as particularly likely to be a problem to the extent that these companies were holding assets, and not just making transfers.

Finally, several participants noted that credit risk is ever-present in finance, and that it was not known how internet finance companies, customers, or products would respond to financial stress. They argued that it would be important to figure out a way to monitor the financial risks being taken by internet finance companies, as well as the extent to which customers truly understood those risks and how they could be affected by them.

Regulating Internet Finance in China

Thus, there was considerable discussion of how internet finance should be regulated in China. There was strong support for fostering innovation in the system, but many participants emphasized the need to also develop mechanisms for consumer protection and prudential regulation that would not choke off competition and innovation. Discussion of regulation of internet finance addressed the questions of where lines should be drawn, what tools should be used, which regulators should hold jurisdiction, and how to handle cross-border issues.

Participants suggested two main guidelines for where Chinese regulators ought to focus with regard to internet finance. One was that regulators should prioritize consumer protection, including data security. Many participants saw fraud as the single biggest threat both to customers and to the emerging internet finance sector itself if customers lost faith in the integrity of the firms offering to manage their payments and investments. The second guideline offered by a number of participants was that internet finance companies that were effectively taking deposits or offering asset management products should be subject to prudential regulation. They acknowledged that there were some ambiguities. For example, were balances held in retail payments services the equivalent of deposits? And were P2P lenders purely transactional or were they holding risk on their own balance sheets? Thus, they urged further research and monitoring of internet finance companies to determine where the risks lay.

Participants also discussed the appropriate tools to regulate Chinese internet finance. As with banks and insurance firms, some participants felt that capital requirements could be useful in preventing customer loss and the possibility of failure. Some also felt that capital requirements could help to even the playing field between banks and internet finance companies that were fulfilling many of the same functions as banks. However, a number of participants were skeptical of the utility of applying capital requirements to

internet finance companies. They argued that most internet finance companies were not functioning as banks in the sense of storing value or engaging in maturity transformation, so such firms should not be subject to bank-like regulations.

An alternative approach was to focus regulation on technological capabilities. It was argued by some participants that entry approvals based on an appraisal of technological capabilities could weed out fly-by-nights and fraudsters, as well as entrepreneurs who simply lacked the understanding and skills to ensure data security, proper accounting, and effective transfers. While there was some support for the concept, other participants wondered how regulators would be able to determine sufficient technological capabilities and worried that entry barriers would advantage large firms and incumbents.

One point on which there seemed to be a high level of consensus was that regulators should mandate much better disclosure. Participants felt that customers currently lacked a clear sense of the solvency, data security, and investment risks that they faced when they did business with a given internet finance firm. Effective disclosure would allow them to make informed choices and improve market discipline on firms.

There was considerable discussion about whether and how regulators should be given the power to access confidential data. While there was little question that regulators should be able to demand data in the context of a criminal investigation, several participants noted that the Chinese government might desire access to data for national or domestic security reasons, in which case public security agencies could demand a back-door key so that they could access data at will. This idea made many participants uneasy, particularly if it were applied either to foreign internet finance firms or to domestic internet finance firms with substantial foreign presence. National security requirements could also hinder efforts by internet finance companies to improve data security and privacy through stronger encryption.

Participants also discussed the question of who should regulate internet finance. They noted that the segmentation of financial regulation along functional lines had served China well in the early years of the development of its current financial system, but that such segmentation posed significant obstacles to effective regulation of internet finance. Depending on the product or service, CBRC, CSRC, CIRC, the PBOC, or even telecoms regulators might reasonably claim primacy, but that threatened to create a fragmented system in which regulatory gaps—or contradictions—could easily emerge, possibly increasing systemic risks. Participants called for improved cooperation among regulators—although they noted, for example, that a somewhat uneasy cooperation had emerged between PBOC and CBRC in overseeing internet payments, P2P, and crowdfunding, they urged regulators to create more formal and clearly articulated agreements over lines of authority. In general, they suggested, the best way to define the proper regulator was by function or type of transaction, not institution-by-institution.

One principle suggested by a number of participants was that regulation must make very clear who is responsible for managing risk in digital finance. For example, many felt that retail customers in China had been unaware of the risks involved in investing through internet finance companies, as seen in the shock and anger when several crowdfunding

platforms had turned out to be fraudulent. This could leave other actors, including the state, responsible for bailing out losses from underregulated, poorly managed (or even fraudulent) firms. While a number of participants felt that the principle of *caveat emptor* should apply to financial activities by any uninsured financial institution, this might not be politically sustainable. If instead fintech firms were to be held responsible for risk, that might imply mandating either capital reserves or an insurance fund. And if the state were to take on a role as backstop, then it should expect compliance with prudential rules. While arguments could be made for any of those approaches, participants agreed that clarity over responsibilities would be essential to avoid moral hazard and the possibility of a crisis emanating from digital finance. Concerns about clarity of responsibility also motivated participants to emphasize the importance of better disclosure, as well as promotion of financial and technological literacy among both customers and regulators.

Finally, there was some discussion of how to handle cross-border issues, although few concrete suggestions were offered. One aspect of this was the issue of cross-border transactions, which was seen as a potential growth area for internet finance, but also one that raised important questions of capital controls, KYC monitoring, national security concerns, and data security. Another question was whether and how foreign-owned firms would be able to participate in China's burgeoning internet finance markets. It was noted, for example, that PayPal and Facebook (which could be used in the U.S. to transfer funds through Messenger) were blocked in China for national security reasons. Several participants worried that the ways in which the Chinese government implemented national security considerations (e.g., requiring back-door keys or data localization) could exclude foreign firms while protecting national champions. This too could hinder the development of cross-border digital finance.

Fintech in the US

While much of the focus in Session 2 was on China, there was also discussion of fintech in the U.S. The impact of fintech in the U.S., while large, was seen as quite different from that in China.

Participants discussed three main issues, including differences between China and the U.S. with regard to the adoption of digital finance, dynamics of competition between incumbent and new players, and the effects of regulation on U.S. fintech. As noted, in China, digital finance had been a major force for financial inclusion and had transformed the way in which payments were made. In contrast, in the U.S., most people already had access to the formal financial system through bank accounts or credit cards (as well as stored-value cards), transaction costs for credit card purchases and bank transfers were low, and smartphones and messenging were less pervasive. Thus, there was less demand for new types of payments systems and players. Even major "alternative" retail-oriented systems like PayPal and ApplePay operated simply as front-end systems for credit cards and bank transfers, unlike Chinese entities like Alipay. Meanwhile, banks and even brokerages had gotten into the digital retail payments space through their own websites, apps, and cards. Thus, the major change at the retail level had been just the interface rather than the institutions involved or the functions available.

Nonetheless, participants observed that investment in fintech in the U.S. was booming. While some of it was impacting customer interfaces, many participants agreed that the impact was greater in terms of back-office operations. They argued that digital technologies were transforming risk management, transaction flow, record-keeping, and communications. Even the most popularly discussed "disruptive" technology—the blockchain—was being researched heavily by banks as a means of record-keeping and settlement rather than being used as an alternative system (or even currency).

One of the striking differences between China and the U.S. was the wariness of major tech firms about entering finance. A number of participants pointed out that major tech firms including Google, Apple, and Facebook had the ability to ramp up their role in financial transactions, including not only payments but also provision of financial products, but had consciously chosen not to. They offered two possible explanations, one based on economics and one on regulation. Economically, it was suggested many aspects of finance were routine and low-margin in nature. Thus, tech firms might prefer to focus on higher value-added activities like data analytics, credit evaluation, software design, and communications rather than processing transactions and doing record-keeping. Moreover, to the extent that such activities could be profitable, incumbent firms already had significant investments and name recognition that might advantage them in the marketplace. Thus, the competition between traditional financial institutions tech firms in the fintech space, though fierce, was less visible than in China.

The other explanation for why tech firms had not aggressively sought to provide comprehensive financial services in the U.S. was regulatory. As several participants put it, major tech firms would rather give up significant business opportunities than be regulated as banks. This argument made evident how onerous many participants felt that U.S. banking regulations had become, from capital and liquidity requirements to compliance costs to the unpredictable possibility of a significant fine for a KYC failure somewhere within a financial institution's global network. Not only would new entrants need to invest enormously in compliance, it was also noted that bank-style regulation could be applied to a given conglomerate's other operations as well—and for a major tech firm, the benefits of entering the low-margin world of banking were likely to be washed out by the costs of higher regulatory burden across its other business operations.

The regulatory hypothesis for why major tech firms were circumscribing their entry into finance raised a final question for observers of U.S. fintech: Would financial sector overregulation stifle fintech innovation?

Session 3
Infrastructure Financing and Multilateral Cooperation

In Session 3, participants discussed how to finance infrastructure investment, with a particular focus on Asia. They agreed that the economic and social needs for infrastructure development were enormous, but that funding such levels of investment would be a major challenge. They considered the respective roles of governments, private sector, and multilateral institutions. There was a particular focus on China's Belt and Road Initiative, as well as the role of new Asian Infrastructure Investment Bank (AIIB).

Demand for Infrastructure

The starting point for much of the discussion in Session 3 was the vast need for infrastructure development in the developing world, particularly Asia. (A number of participants also pointed out that the U.S. also had increasingly decrepit infrastructure despite the wealth of the country and the historically low interest rates with which projects could be financed.) Participants cited estimates from the Asian Development Bank and others to demonstrate the scale of the challenge—$8 trillion over the course of 2010-20, according to the ADB. They described infrastructure as necessary both to accelerate growth by eliminating bottlenecks and to address social needs and human development. It was noted that bottlenecks were not only about hardware and power production—the Eurasian international railway, running from Chongqing to Germany, for example, was designed to allow goods to have to go through customs clearance only once, in a positive example of combining policy coordination with project design. In addition, it was noted that building infrastructure could contribute to short-term growth as well as long-term growth, as public works would provide fiscal stimulus and employment opportunities.

Participants also identified some potential pitfalls of infrastructural spending. The long-lived nature of infrastructure meant that errors of planning or execution could have long-term negative effects. One type of example could be seen in the environmental effects of major power and transportation projects; over time, the perceived trade-offs between environment and growth had shifted, but old decisions lived on in the form of coal-fired plants, dams, and other infrastructure. Poor design or construction could also have long-term ramifications for both usefulness and ability to pay back investors and creditors. Moreover, political risk remained a concern in many jurisdictions where corruption was prevalent or governments were unstable, which could lead to infrastructural projects being stalled indefinitely or having terms changed. One example given was Colombo Port City in Sri Lanka, where the China-financed project had been suspended for a year after a change in government. Some participants also warned of the risks of overinvestment in infrastructure, using Japan and China as examples. While aggressive infrastructure investment had been essential to the two countries' economic development, they worried that public works in many areas had reached the point of declining returns, although political pressure for employment and purchases had kept infrastructural spending high as a stimulus measure.

Financing Infrastructure Development

While there was widespread agreement on the importance of infrastructural investment, particularly in developing Asia, participants acknowledged the difficulty of financing it. They agreed that several aspects of infrastructure contributed to this difficulty.

One challenge was that infrastructure projects tended to be large and concentrated, and to have a very long payback period. While this characteristic was attractive to long-term investors such as pension funds and life insurers, it also contributed to greater uncertainty and risk. In addition, many infrastructure projects required long periods of construction, with sometimes unpredictable costs, before revenues began to flow. Thus, investors would be more interested in involvement in the brownfield (operational) phase of a project than in the greenfield (construction phase); unfortunately, it was in the greenfield phase that funds are most needed.

Another challenge was that not all infrastructure projects generated sufficient revenue to cover the costs of building and maintaining them. In some cases, such as sanitation projects, that was because the social benefits exceeded the economic benefits. Others might produce sufficient direct economic benefits but face difficulties in collection of revenue.

Developing countries were seen to face particular challenges. Capital tended to be scarce in developing countries and that challenge was compounded in countries without good bond markets or domestic long-term investors. Moreover, developing country governments were often less effective at tax and revenue collection than developed country governments. In cases where foreign investment or loans were necessary, governments would have to assure foreigners that they would be paid back, often by offering guarantees or assuming currency risk.

In discussing funding sources for infrastructure in Asia, participants agreed that the demand was so great that it was inaccurate to think of the various potential funding sources—governments, domestic private sector, foreign private sector, and multilateral financial institutions—as competing. Thus, participants sought to present models for leveraging public funds in order to maximize the potential benefits of projects. One argument was that governments must provide guarantees to investors, at least at the greenfield stage. Multilateral financial institutions could also take on more of the greenfield risk through guarantees or other methods. However, the multilateral financial institutions expected project loans to be paid back in full. Thus, in principle, they would put significant pressure on host governments to select, design, and manage projects well. To the extent that private investors and lenders were willing to put their faith in such assessments, involvement of multilaterals could incentivize private money as well.

While governments and official lenders were seen by many participants as essential catalysts for infrastructure development, participants agreed that the sheer scale of infrastructural needs in Asia required much more extensive involvement by private investors and lenders. In order to mobilize private money, much of the discussion revolved around bond markets and public-private partnerships (PPPs). The development of bond markets was seen as very important for bringing private money to the table not

only at early stages of projects, but also for the brownfield stage, in order to allow governments to redirect funds toward new projects. Participants focused on the importance of developing local-currency bond markets, since revenue streams would often be denominated in the local currency, but it was noted that foreign investors often preferred offshore markets and dollar-denominated securities as venues for investing. It was noted that multilateral financial institutions like the ADB and IFC were also interested in issuing local-currency bonds as part of their funding for infrastructure projects. There was also considerable interest in PPPs, although participants acknowledged that they varied considerably by jurisdiction and project. In China, for example, PPPs still lacked a consistent legal framework. Syndicated loans presented another potential way of raising funds for infrastructure projects while dispersing risks.

Another approach that was presented as a means of incentivizing private investors' participation was to carry out mixed-use projects. An example was given of the Hong Kong MTR, whose profit model was described as "rail plus property"—in other words, combining rail service with commercial property development, on the expectation that stations would generate foot traffic for commercial investors in the vicinity. While not all infrastructure projects would be able to take advantage of such ancillary activities, this approach could improve the financial viability of some transportation projects, while also improving their economic spillover effects.

Belt and Road Initiative

There was considerable enthusiasm about China's recent efforts to promote regional infrastructure development known as the Belt and Road Initiative (BRI), which included the newly-founded AIIB, the Silk Road Fund, and commitments of funding from several commercial and development banks. It was even stated that, despite reports of opposition, the U.S. government was supportive of the establishment of the AIIB, based on its high-quality governance structure and commitment to global standards in project selection and environmental impact. It appeared that there was unanimous support among participants for the goals of the AIIB and the BRI.

Formerly known as the "One Belt, One Road" (OBOR) initiative, the BRI master plan involved efforts to build multiple economic corridors across both continental and maritime Asia. With the goal not only of linking East Asia with West Asia and Europe, the BRI was predicated on developing connectivity through infrastructure. With Chinese economic growth moderating and the returns on domestic infrastructural investment declining, BRI offered an opportunity to shift China's surplus savings and industrial production to promote economic development—and also attractive markets—in neighboring countries.

While much of the international attention to the BRI had been focused on the political contest over the establishment of the AIIB, participants presented the initiative as a much more multilayered effort. The AIIB, a multilateral development bank itself, would cooperate with other multilateral development institutions including the ADB, World Bank, and IFC, in addition to regional governments, the Chinese government's Silk Road Fund, Chinese and local banks, and institutional investors to support regional

governments in designing and building high-quality economic infrastructure. Importantly, most of the money to be directed to BRI infrastructure projects would be non-concessional in nature—for example, both the Silk Road Fund and the funding pledged by major Chinese banks would make loans and investments based on their assessment of the economic viability of the projects. Thus, a good supply of high-quality projects would be essential to the success of the BRI.

Session 4
Rate Hike Cycle in the U.S. and the RMB Exchange Rate

In Session 4, participants discussed the U.S. rate hike cycle and the RMB exchange rate. Beginning with monetary easing following the global financial crisis of 2008-9 (including quantitative easing and, in some jurisdictions, negative interest rates), developed country monetary policy was seen as having had significant effects on global markets and exchange rates. Participants anticipated a divergence in monetary policy between the U.S. on the one hand and Europe and Japan on the other, with the U.S. embarking on a gradual tightening of monetary policy while Europe and Japan continued on an easing path. Meanwhile, the RMB exchange rate regime was undergoing an uneasy shift from dollar peg to basket-based managed float along with capital account liberalization. Participants discussed how that process could be done in a way that minimized disruption, as well as the implications for the Chinese economy of potential misalignment of the RMB exchange rate.

Monetary Policy Expectations

The U.S. interest rate cycle was seen by participants as a major question for the global economy. Although in principle countries with their own currencies should be able to use monetary policy to manage business cycles, due to the outsized role of the U.S. dollar in the global system, many participants expected that changes in U.S. interest rates would cause significant repercussions for other economies. Either they would experience capital inflows or outflows, or they would be forced to shift their own monetary policies in response. Despite the size of its economy as well as its persistent current account surpluses, participants saw China as also at least partly subject to the U.S. interest rate cycle.

Many participants expected that the Fed would be raising interest rates soon, in recognition of the country's low unemployment rate and continued (albeit languid) economic recovery. Thus, there was considerable discussion of how it would affect China's exchange rate, given that there was little domestic justification for the PBOC to tighten monetary policy along with the Fed.

Participants also expected a greater divergence between the dollar and China's other major trading partners. Having followed a soft dollar peg in recent years, China's RMB had been appreciating against a trade-weighted basket; with the expected hike in U.S. interest rates, Chinese policy makers were seen to be facing a choice between continued appreciation against the basket or choosing to allow for depreciation against the dollar.

China's Policy Trilemma

Much of the discussion of the effects on China referred to China's policy "trilemma." Participants drew on macroeconomic theory to the effect that policy makers could not simultaneously meet more than two of three financial conditions among: independent monetary policy, fixed exchange rate, and capital openness.

Adapting this to contemporary China, it was argued that policy makers held three simultaneous goals: to maintain growth at a rate of at least 6.5%, to implement reforms to rebalance the economy, and to ensure macroeconomic and financial stability. The policies to achieve those goals were seen to be partly in conflict. Economic reforms necessary to support long-term growth would lead to dislocations that would slow growth in the short-term, while fiscal and monetary stimulus would prop up growth and perhaps reduce volatility but would reduce impetus for structural change. To simultaneously maintain growth and support rebalancing, Chinese policy makers would thus have to abandon monetary policy as a means of reducing volatility; thus, the upturn in the dollar cycle was seen as likely to lead to greater volatility in Chinese financial and currency markets.

Participants pointed to several signs that this was the choice that the government had made. The key sign was downward pressure on the RMB—although interestingly, that was the result of capital outflows rather than a decline in the trade surplus. For the time being, the PBOC was using China's massive foreign exchange reserves to moderate the depreciation of the RMB. In the long term, this may not be sustainable, but most participants agreed that China's reserves were more than sufficient to manage its transition to a new foreign exchange regime.

China's Foreign Exchange Regime and Transition

As part of China's financial market reforms, it had been gradually shifting away from the dollar peg and strict currency controls. Currency controls had been increasingly relaxed for both inward and outward investment over a period of years as the authorities had at least partially embraced the goal of capital account liberalization; moreover, enforcement had become quite porous, as seen in the size of the "errors and omissions" category. Thus, despite a more recent slowdown in liberalization and some very recent efforts to improve enforcement, it had become more difficult to manage the currency except through use of monetary policy or the purchase or sale of foreign exchange reserves.

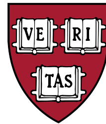
China's managed float had evolved significantly over time. Wholesale and retail markets remained partly separate, but were being increasingly integrated. The foreign exchange regime was based on allowing fluctuation in the interbank market around a central rate, with bands expanding over time. In August 2015, the PBOC announced the policy of setting the central rate at the closing level of the previous day, further shifting the exchange rate toward market determination and reducing the former "one-way bet" on the value of the RMB. Since May 2016, PBOC had been explicitly targeting the real effective exchange rate (REER), completing the shift away from the nominal dollar peg that had contributed to bilateral tensions for a decade or more. Most participants agreed that China's foreign exchange regime was indeed being shifted toward a managed float based on a currency peg rather than seeking to achieve an undervalued currency.

The transition to the new regime presented a real challenge. The August 2015 announcement of the shift in how the PBOC would determine the RMB fixing had created much more turmoil in foreign exchange and domestic financial markets than central bankers had expected. This was seen by participants as partly a failure of communication—it had come out of the blue for many observers, and was accompanied

by a relatively large overnight depreciation—but it did appear to illustrate the difficulties of shifting currency regimes. In the wake of that turmoil, the PBOC was seen to have been very wary of allowing too much movement against the dollar, using reserves to the RMB.

Participants observed that there was no clear consensus either in the PBOC or the economics profession about how best to sequence and manage the transition—i.e., whether to liberalize currency controls first or to focus first on widening the band. Most participants seemed to expect that the PBOC would not choose one or the other, but would rather use a blend of policies that included both those tools, as well as foreign exchange reserves management and monetary policy, in the hopes of preventing excessive volatility on the way to the new equilibrium.

The transition to the currency basket regime was seen to be complicated by two factors. As noted in the discussion of the trilemma above, one was China's own economic transition, in terms of both slowing growth and structural rebalancing. The addition of expectations of rising U.S. interest rates further complicated both the task of transition and its signaling, as developments in both China and the U.S. would tend to increase downward pressure on the RMB and financial volatility. Given the importance of expectations in driving asset prices and capital flows, participants predicted that the PBOC would be pragmatic and reactive in the short term, while continuing to work toward a market-based exchange rate.



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