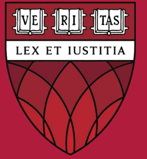

Program on International Financial Systems I

nternational House of Japan

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

An Agenda for Japan and the United States

Odawara, Japan | October 4-6, 2019

Final Report

2019 Symposium on Building the Financial System of the 21st Century: An Agenda for Japan and the United States

The twenty-second Japan-U.S. Symposium on Building the Financial System of the 21st Century was held in Odawara, Japan, from October 4-6, 2019. Sessions addressed cross-border lending, impacts of the rise of passive investment, corporate governance, and implications of trade frictions for global finance. U.S.-China trade frictions and financial market fragmentation were seen to be of particular concern by participants.

Session 1: Promoting Cross-Border Lending for Economic Growth—Regulation and Stability

In Session 1, participants discussed the status and importance of cross-border lending. There was considerable concern that cross-border lending and financial flows were being constrained by market fragmentation. Potential causes put forward by participants included overregulation and lack of trust among national regulators. Participants urged politicians and regulators to prioritize efforts to reduce barriers to movement of capital.

Status of Cross-Border Financial Activities

Participants discussed at length the current status of cross-border lending, as well as other related financial activities. One item of concern was the decline in cross-border bank lending. However, it was emphasized that cross-border lending markets should be understood broadly, and not just as cross-border bank lending. Non-bank lending had increased considerably both absolutely and as a share of total cross-border lending. Other types of financial intermediation, such as swaps, could also be seen as forms of non-bank lending. Even accounting for all of these elements, however, participants felt that cross-border lending was significantly constrained.

Participants also expressed unease about the quality of data and information available to both market participants and regulators. While there was a general sense that cross-border lending was decreasing, some participants argued that the lack of data on non-bank lending and derivatives activities made it hard to know for certain whether overall lending was actually in decline. For regulators, this raised significant concerns about the ability to do macroprudential supervision, since it was not always apparent how much cross-border lending had accumulated, let alone the sectoral patterns or denomination. The problem of data was seen as particularly acute for emerging market economies, which had less comprehensive data and where information on denomination and maturity were most essential to ensure economic stability.

Market participants raised additional concerns as they considered cross-border loans. At the individual loan level, participants felt that there was a lack of data on credit quality, debt concentration, and counterparty risk. This was not just an issue of data sufficiency, but also of data quality. It was argued that weak standards on disclosure and data quality in many jurisdictions, particularly in emerging markets, made it impossible for lenders to understand the risks they faced when lending across borders. This led to high risk premiums and greater reluctance to lend; for emerging market borrowers, that would mean reduced access to badly needed funding.

In addition to the problems of data and information, participants raised several other obstacles to cross-border lending growth. One set of obstacles resulted from regulation. Many participants pointed to regulatory fragmentation as raising the costs and difficulty of cross-border lending. In addition, there was considerable concern over the problem of "trapped capital." It was argued that capital and liquidity rules that forced banks to hold large amounts of high-quality liquid assets restricted their ability to direct lending to firms—and particularly across borders. Another obstacle that some participants identified was weak financial infrastructure in emerging markets, including

poor liquidity in debt and foreign exchange markets, underdeveloped payment and settlement systems, lack of derivatives markets, and limited regulatory and supervisory capacity.

Participants worried that the apparent weakness of cross-border lending was having at least three negative effects. In emerging economies, which had large unmet needs for finance, the reluctance of foreign lenders to provide credit was seen as limiting opportunities for investment in crucial infrastructure and productive capital. They saw this as problematic not only for emerging economies themselves, which would lose opportunities for economic growth, but also for potential lenders, which would have to forego potentially attractive opportunities because of trapped capital and the difficulty of assessing credit and other risks.

A second negative effect that concerned many participants was fragmentation of global credit markets, which they saw as primarily a function of regulation. Regulatory fragmentation raised the costs of cross-border finance. Banks faced multiple regulatory regimes, raising costs of compliance. Moreover, the common regulatory practice of ringfencing capital also created complications for multinational banks. Meanwhile, the fragmentation of derivatives markets due to conflicting regulation and barriers to cross-border clearing made it more difficult and expensive to hedge cross-border financial flows. Fragmentation was seen not only as an obstacle to cross-border finance. A number of participants argued that it was also a threat to financial stability—banks and other financial institutions would be unable to redeploy capital and liquidity across borders in the event of a problem in one jurisdiction, raising the likelihood of failures. Some argued that widespread resort to ringfencing would also make resolution of failed multinational financial institutions much more difficult—in effect, rendering the principle of single point of entry meaningless. There was, however, some disagreement about how far that argument should be taken.

Third, some participants raised concerns about global dollar funding, noting that even Japanese financial institutions were vulnerable. They noted that a great deal of cross-border dollar funding was done by non-U.S. financial institutions that relied on wholesale funding and swap markets, which could dry up in a crisis, as they did in 2008. Some saw new signs of stress in those markets, which they saw as worrisome, especially because of Dodd-Frank restrictions on the Fed's ability to act as lender of last resort. Given the centrality of the dollar to global finance, trade, and investment, an inability to access sufficient dollar funding could easily lead to disruptions for internationally active firms and financial institutions.

Global Standards, Local Practices

As noted, an issue of particular concern to participants was regulatory fragmentation, which they saw as both impeding cross-border lending and hurting financial stability. For banks, especially those designated as systemically important, the Basel standards for capital and liquidity substantially raised the costs of lending and had the effect of "trapping" capital in low-return uses. This was seen as particularly impacting lending to emerging markets and innovative firms and projects with higher risk weighting. The differential implementation of global standards only raised those costs as well as the complexity of compliance.

One important issue was how time-consuming and complex the processes of determining equivalence were. Compounding the challenge was differing approaches to determining equivalence. For example, it was argued that U.S. and Japanese regulators typically followed a

functional approach—i.e., to determine whether the overall impacts of a particular set of regulations was equivalent. In contrast, EU regulators took the approach of trying to determine legal correspondence of each regulation or rule, which many participants felt was unhelpful and more burdensome.

A second set of concerns about regulation had to do with extraterritoriality. While foreign authorities and financial institutions had long seen the U.S. as the major source of extraterritorial financial regulation, many participants argued that EU extraterritoriality had become a significantly larger problem in recent years. Japanese banks had previously expressed frustration with extraterritorial enforcement of U.S. regulations such as the Volcker Rule, but the regulatory reforms and changes to regulatory practice under the Trump administration had reduced their complaints. Other aspects of cross-border equivalence had also been worked out. In contrast, both U.S. and Japanese participants raised concerns about the rise of EU extraterritoriality, which they saw as contributing to fragmentation. For example, the effectively global reach of the General Data Protection Regulation (GDPR) was seen as affecting non-European financial institutions ability to manage client information and to market services. Other concerns included the EU's asserted right to regulate any benchmark used by European financial institutions or investors no matter its location, and the unbundling rule for research by investment banks and asset managers.

A third issue of concern regarding regulatory fragmentation was about data localization requirements, which were increasingly being mandated by jurisdictions around the world, including China and India. In contrast, Japanese and U.S. authorities were resistant to the principle of data localization, which they saw as a barrier to trade in services; indeed, openness of data flows was a principle both had advocated in the Trans-Pacific Partnership negotiations and was included in the new U.S.-Japan trade agreement. Participants expressed concern about the effects of data localization in other jurisdictions on the ability of multinational financial institutions to operate across borders, and urged the U.S. and Japan to continue to champion the principle of not restricting data flows in that way.

Finally, some participants raised concerns about recent reforms to Japan's Foreign Exchange and Foreign Trade Act. The reforms would require prior notification for investments in Japanese sensitive sectors such as information and communication technology. While some participants defended the new rules as a necessary response to the possibility of Chinese state-owned enterprises controlling critical technologies, others worried that it would be an obstacle to cross-border direct investment.

Regulatory Cooperation

Participants discussed at length how to deal with the challenges of regulatory fragmentation. While some bemoaned the lack of consistency of application of global standards across jurisdictions, many agreed that differing local conditions—such as financial system structures, legal systems, political systems, and administrative structures—justified a degree of variation to achieve similar ends. This raised the question of how best to manage the differences across borders. Participants considered several approaches to the challenge.

Many participants looked to ongoing efforts to improve regulatory coordination through various international bodies, from the G20 and Financial Stability Board to the specialized bodies such the Basel Committee. There was some debate over whether that was the best structure to manage

differences. Some argued that there needed to be a more extensive structure with more meetings and working groups to try to reach consensus on how to regulate at a granular level. Others were skeptical. They felt that there were already too many groups and meetings and that granular discussions only tended to focus on small distinctions rather than the main principles, on which there was still often not a consensus. More broadly, they were suspicious of a focus on technical-level coordination and adjustment. They argued that the sometimes passionate disputes over seemingly minor details actually reflected gaps over the underlying principles, and so political leaders rather than technocrats should be driving the discussion.

Given the lack of political consensus on some of the key elements of financial regulation, what would be a better approach to policy coordination? Some argued that there needed to be deeper political buy-in in coordination processes. Others argued that this was not realistic, especially once legislatures had acted. One suggestion was that regulators should focus their efforts at harmonization before legislatures had acted—in other words, regulatory dialogues could help to set a common set of questions and understandings that political leaders could then discuss introducing in tandem, but they would not be nearly as effective in removing differences that had already been legislated.

Another point of view was that part of the problem was overregulation. The very extent of regulations under the G20 principles meant that there were an extraordinarily large number of rules or interpretations in which different regulators and supervisors could diverge. While they agreed that the increased costs of compliance and fragmentation could be worth it if the G20 financial regulatory agenda improved financial stability, several expressed skepticism that that was the case. Thus, they called for a review of the costs and benefits of financial regulations, both individually and cumulatively, with an eye to stripping out unnecessary or counterproductive ones. By doing so, they argued that financial stability could be maintained, while reducing the conflicts across regulatory systems.

Other participants felt that a more pragmatic alternative would be to develop a common approach to equivalence. They argued that differences across jurisdictions were both inevitable and appropriate, and harmonization was an unreasonable goal. Instead, they argued that some of the most important successes in reducing barriers to cross-border finance had come about through the principle of equivalence, regulatory deference, and substituted compliance even though these determinations were time-consuming and often arduous. To improve the efficiency of equivalence regimes, they called for an agreed approach that was based on principles or outcomes, rather than rule-by-rule correspondence. While there was considerable support for this in concept, some participants cautioned that in practical terms, some degree of dispute over particular rules and procedures was inevitable, so that adopting a common approach would not necessarily make actual equivalence determinations easier (even if they made them more explicable).

For some participants, the key was to build trust. They argued that if regulators could better trust their international counterparts, regulatory deference would be much easier and there would be less need for ringfencing. Others argued that trust-building among regulators would have limited impact. Their reasoning was that the driver for ringfencing and extraterritoriality was the desire to protect domestic investors and taxpayers; since governments could be hit with significant burdens that would ultimately be the responsibility of political leaders who were accountable to their citizens, mutual trust among regulators could not substitute for the political concerns of leaders. Thus, while interpersonal trust among regulators was seen as important for communication and

coordination around technical issues, these participants argued that it would not ensure effective cross-border resolution.

In this interpretation, the key to building trust would be to build robust national systems for protecting investors, managing risk, ensuring capital and liquidity buffers, and managing crises. Crisis management was seen as particularly important, because of governments' primary accountability to taxpayers. The post-crisis reforms had considerably improved resolution mechanisms in major countries and reduced the likelihood of taxpayer money being used for bailouts of banks and clearinghouses. However, several participants pointed to one glaring exception—the weakening of the lender of last resort function in the U.S. They argued that in a crisis, emergency liquidity from the central bank is the key to preventing contagion, as demonstrated by the decisive actions of the Fed in 2008-09. Without confidence in the Fed's willingness and ability do the same in the future, it was argued, regulators and central banks in other countries would continue to see the need for ringfencing and other forms of self-protection.

Nonetheless, participants generally supported efforts by regulators to communicate regularly and to establish common understandings and data on common issues. Even if "trust" were no longer the goal, it was argued that regulators should strive for transparency, predictability, and mutual understanding.

Many participants also felt that trust of international regulators was even more elusive in the contemporary world, which they saw as being in an age of anti-globalist populism. The rise of populist leaders in a variety of developing countries (with the notable exception of Japan) reflected a suspicion and even resentment of elites who were seen to have brought about the global financial crisis followed by unsatisfactory and unequal recoveries but who were never held responsible for their role in the crisis. There was also suspicion of global cooperation—populists in many countries had drawn a picture of global elites and corporations working together to take advantage of local populations, whether through financial regulation, trade policy, or other regulation. Meanwhile, even aside from the populist turn, many participants agreed that it was a challenging problem for leaders to figure out how to be accountable to citizens, stakeholders, and foreign partners.

Among the populist "solutions" to the problem of lack of trust and need to ensure clear accountability, participants noted the increasing popularity of technical alternatives to political discretion. This was particularly pronounced in the enthusiasm of some groups for cryptocurrencies, blockchain, and stablecoins. While few participants viewed cryptocurrencies as viable alternative channels for payments or financial intermediation, they found blockchain applications and stablecoins as being potentially important going forward. In particular, there was considerable interest in the use of permissioned blockchains to improve settlement processes and to manage trading data. However, while participants saw these technological advances as potentially useful for streamlining processes and reducing costs, they did not see them as substitutes for effective regulation and supervision or for cooperation and confidence-building across borders.

Session 2: Passive/Active Investment Strategies and Implications for Market Functioning and Corporate Governance

In Session 2, participants discussed the impact of passive investment strategies on markets, price discovery, and corporate governance. They offered varied perspectives on the benefits and costs of passive investment to retail investors, economic growth, and market function. There was also considerable focus on issues related to corporate governance in Japan.

The Rise of Passive Investment

Participants recognized that passive investment strategies had become increasingly popular. They agreed that passive investment funds, particularly index funds, significantly lowered costs for investors while also allowing for diversified holdings across a particular asset class or market sector. The reduced costs and risks associated with index funds provided benefits to retail investors, while also increasing pressure for active managers to outperform benchmarks or to squeeze their own costs.

The phenomenon was particularly apparent in the US equity markets, where shares held by passive managers now exceeded those held by active managers. In Japan as well, passive investment strategies were becoming more popular, although still accounting for a much smaller proportion of stock ownership than in the U.S. This raised questions about the functioning of public markets, as well as the potential impact on corporate governance.

Some participants expressed frustration with what they saw as a sometimes inaccurate use of the term “passive investment” in popular debates. In particular, they noted that the term “exchange-traded fund” (ETF) was often used interchangeably with passive investing, but pointed out that this was wrong, since ETFs can follow a variety of strategies. Thus, they emphasized that passive investing was about investing based on a predetermined index, not the wrapper in which the investment was packaged.

There was also considerable discussion of indexes themselves. While the bulk of passive investment funds were based on widely recognized indexes such as the S&P 500 or the Topix, participants also noted the proliferation of bespoke indexes and so-called alpha index funds. A number of participants felt that alpha index funds should not really be considered to be index funds, but rather a type of active fund, where asset managers’ judgment would have a crucial impact on the performance of the fund. There were also mixed feelings about bespoke indexes. Participants expressed concern that the composition of such indexes was often opaque and subject to arbitrary change. Moreover, by not tracking major indexes, it was argued that it was impossible to compare bespoke index funds to a benchmark, making it difficult to judge their performance relative to peers. Some participants called for regulations to increase the transparency of bespoke indexes, but others were more skeptical, arguing that asset managers should have the choice of keeping their investment strategies confidential. Bespoke index funds and alpha index funds were also seen

as raising costs relative to funds tracking the major benchmark indexes; given that low cost was one of the major selling points of passive investment strategies, some participants felt that those funds were thus sacrificing the interests of investors.

Participants discussed at length the impact of passive investment on financial markets. While acknowledging that passive investment offered some valuable benefits for investors including lower cost, more efficiency, lower volatility, and greater transparency, they addressed several concerns as well. One was that the rise of passive investing could reduce the quality of price determination of individual stocks—some participants argued that, if the bulk of trading were driven by passive strategies, prices would reflect only investors' preferences regarding asset classes, not the performance of each company. The lack of differentiation could lead to misallocation of capital, as both underperforming and overperforming firms would experience similar price performance and thus access to capital. In contrast, other participants argued that this was not yet a problem and was indeed not likely to become one. Even in the U.S. equity markets, passive investment accounted for a minority of total shares, and a significantly smaller proportion of trading. Elsewhere, including in Japan, passive investing remained much less common. Several participants also argued that markets would naturally have a self-correcting mechanism—if prices of individual company shares or other securities did not reflect their actual value, it would create opportunities for active traders to profit, bringing active managers back into the market and ensuring that prices would be differentiated by performance. In particular, some participants argued that predominance of passive investment would create new opportunities for active and activist investors. It was also noted that, increasingly, companies were turning to private markets for funding; in the private markets, investors would remain incentivized to closely monitor performance.

Another concern was the possibility of herd behavior. Some participants worried that any sudden withdrawals or increases of funds in passively-managed could move entire markets rather than just having the effects isolated in a small number of stocks or other securities. Others were unconcerned. They pointed out that investors could withdraw funds from actively managed investments as easily as from passively managed ones. Also, they argued that there was no evidence to date that investors in passively-managed funds were more likely to withdraw their money all at once. Rather, they made the case that, since much of the retail investment in passively-managed funds in the U.S. was held in individual retirement accounts such as 401(k)'s, they were less likely to see sudden runs than other types of holdings.

Finally, some participants raised the concern that the sheer scale of the major index funds could lead to excessive concentration of control of shares into a small number of hands. This could in principle lead to conflicts of interest or lapses in corporate governance. This point is addressed in the next section.

Asset Managers and Corporate Governance

There was considerable discussion of whether and how passive managers would be able to carry out effective corporate governance. This was seen as a crucial question by many participants, who argued that companies that followed good corporate governance practices, such as having a majority of outside directors on their boards, would have better performance than similar companies that did not. Some participants questioned the extent of the evidence to support that

statement, pointing out that studies (mostly in the U.S.) had shown relatively little effect on corporate performance. Others countered this skepticism. They pointed out that between-country studies showed strong effects for better corporate governance, even if between-company evidence was lacking. Looking at Japan, measures of corporate governance quality had been quite low compared to the U.S. and other countries, and corporate profitability was also low. Moreover, there was some preliminary evidence presented at the Symposium that suggested that Japanese companies that followed better corporate governance practices also had better performance than their peers.

There were some questions about the goals of corporate governance. For example, it was noted that there was increasing investor demand for environmental and social responsibility (ESG) on the part of firms. Similarly, the U.S.-based Business Roundtable had recently called for a shift from pure shareholder value to considering the concerns of a wider variety of stakeholders in making investment decisions. Some participants worried that this complicated the question of how funds could or should work as fiduciaries of their investors' interests. This challenge would hold for actively-managed funds as well.

Some participants raised the concern that passive managers would be hands-off in their approach to corporate governance issues at the companies in which they invested. Passive managers would have no choice but to invest in companies in their index according to a particular formula. Thus, these participants questioned whether fund managers would feel the fiduciary duty to monitor directors and to enforce good practices. Given the low management fees charged by most passive funds, some participants also questioned whether they would have the capacity to monitor companies' governance and activities.

Discussions revealed that passive-managed funds were actually quite active in voting shares and engaging boards in the companies in which they invested, with the goal of improving corporate governance and responsiveness to shareholders' interests. Proponents argued that large passive funds would have as much voice as large actively-managed funds. Others were not convinced. They argued that active managers would have more voice because they would have a credible threat of exit (which could lower a firm's share price), so companies would have to listen to criticisms or concerns. There was also a concern expressed about delegation of voting decisions to proxy advisors, who were a further step removed from the interests of the beneficial owners. It was argued that the push to keep down costs, combined with the challenges of delegation, could lead to a "checkbox" approach to corporate governance, rather than deep and sustained engagement.

Participants also discussed the roles of active managers and activist investors in promoting good corporate governance practices. Active managers were more similar to passive managers in the ways in which they engaged with firms, while differing in two important ways. The first was that active managers were in a position to make investment decisions based on their evaluation of firms' corporate governance—in other words, unlike passive managers, they had a credible threat of exit if they were not satisfied with management practices. Second, because they typically had a smaller number of holdings, they could more directly manage their engagement with firms. Activist investors were even further involved in corporate governance, picking investments that they saw as poorly managed, taking a small number of concentrated positions, then pushing hard to change corporate governance and managerial decision making to improve profitability. It was argued that the relatively hands-off approach of passive managers gave an opening for active and activist

investors to choose underperforming companies and improve them, which could be a way of outperforming the index funds. Although many participants agreed in principle that this approach could yield superior returns and improve companies' performance, some also cautioned about what they called "engagement fatigue." In other words, they argued that the heightened focus by institutional investors on corporate governance and stewardship in recent years in Japan and elsewhere had led corporate managers to be frustrated with the constant oversight of investors and to impede efforts of investors to impose changes.

Some participants suggested that the ability of investors to improve corporate governance and oversee the decisions of managers was inherently limited. They argued that corporate insiders would always have superior information in comparison to outside directors, and would therefore be able to thwart oversight if they wished. For some participants, this implied that efforts to improve corporate governance would only work if management were receptive and actually wanted to incorporate outside perspectives and insights. Others argued that the information gap was insurmountable except in the case of private equity, which allowed for full ownership and direct control of companies. They felt that the advantages of private equity over the public corporation model were driving a more generalized move away from the public corporation toward private equity, especially in the U.S. There was some discussion as to whether private equity would begin to take on a larger role in the Japanese corporate world, but no conclusions.

Corporate governance in Japan

Participants discussed in particular how investors might be driving a transformation in Japanese corporate governance. They saw this as a particularly important issue, as many argued that one of the reasons for Japanese economic stagnation was poor corporate governance and lack of attention to profitability and shareholder value. Thus, they were particularly keen on delving into whether and how new efforts by investors were transforming the Japanese corporate landscape.

Many participants agreed that there had been significant progress in recent years in the quality of corporate governance in Japan. This included some important initiatives such as the voluntary Stewardship Code for institutional investors and the Corporate Governance Code for listed companies on the Tokyo Stock Exchange. This had led to a variety of practical effects, including perhaps most notably a large increase in the number of independent directors, which advocates of corporate governance reform had long called for as a way of injecting new ideas and shareholder interest into companies that had often been insular and characterized by lifetime employment and managerial control. An increasing number of listed firms were also moving toward a committee structure that clarified the roles and responsibilities of directors and executives, and moving away from previous models where the distinction was more ambiguous. Beyond the board room, it was noted that Japan had experienced a significant increase in shareholder proposals, proxy fights, and M&A, albeit from a low base. While the numbers were still fairly low and success of shareholder proposals and proxy fights still uncommon, many participants felt that investors were increasingly taking their role as owners seriously and managers were paying attention.

These developments were seen by participants as significant, but they offered varying observations as to how profound the changes were. In some firms, it was argued, the role of outside directors and clearer board responsibilities had been very important in bringing in outside ideas and improving shareholder oversight of managers. In contrast, some participants described other firms

where the structural changes had had limited practical effects. They argued that many companies resisted the influence of outsiders through various strategies. One of these was the informational asymmetries between insiders such as long-term employees in executive positions and outside directors who had to rely on the insiders for access to information. (Participants agreed that this was not unique to Japan, and several stated that they had observed the same problem in U.S. firms as well.) A number of participants argued that the ability of outside directors to really understand what was going on in a given firm was dependent on how receptive the executives were to outside input. In those companies where executives saw the outside directors as a resource for new ideas and analyses, the impact of outside directors could be substantial, whereas executives who resisted giving up control were often effective in minimizing outside directors' influence. Participants suggested that another reason that outside directors' impact was limited in many firms was the lack of director diversity. Instead of welcoming director diversity and new ideas, they argued that executives often preferred to appoint outside directors whose ideas and experiences were similar to their own. Still, a number of participants felt strongly that corporate governance changes were already having substantial impact on the decisions and performance of firms. Some pointed to preliminary evidence that Japanese firms that scored higher on corporate governance scorecards had higher productivity and return on equity than those that scored lower, and that firms that added more outside directors improved their performance on those measures. Many participants found this to be a hopeful sign.

Participants discussed at length the role of institutional investors in corporate governance in Japan. They noted that the Stewardship Code had been signed by virtually all major domestic and international institutional investors in Japan, including the Government Pension Investment Fund (GPIF). The code obligated institutional investors to constructively engage with the firms in which they invest in order to improve long-term profitability. While participants agreed that not all signatories to the Stewardship Code were particularly active in engaging with management, many were taking the responsibility seriously.

The activities of GPIF and the Bank of Japan were topics of particular interest in this discussion. Participants were enthusiastic about the engagement of GPIF in promoting better corporate governance in Japan. They noted its strict adherence to the Stewardship Code and its enthusiastic embrace of the cause of corporate governance reform. Given the size and prominence of GPIF in Japanese financial markets, including holding approximately 5% of Japanese equities in addition to a large bond portfolio, the actions of GPIF were seen as having considerable impact both on the companies in which GPIF was invested and in the behavior of the asset managers that it used. The desire of institutional investors to manage GPIF funds pushed these asset managers to adhere to the code and to prioritize corporate engagement.

Participants contrasted the role of GPIF in improving corporate governance with that of the BOJ, which also held about 5% of total Japanese equities. In contrast to GPIF, the BOJ had taken a much more hands-off approach to corporate governance. Since its equity holdings were for the purpose of monetary policy rather than maximization of returns, it had been careful to only invest passively. Moreover, it had outsourced all asset management decisions to outside professionals in order to prevent the appearance of favoritism. In turn, most asset managers were said to have outsourced voting of shares, engagement, and other matters of corporate governance to proxy advisors. Thus, some participants made the case that the BOJ was not contributing to improving corporate governance in Japanese firms, and argued that it should be encouraged to do more. Other participants were less critical. They argued that, even if the BOJ did not have a clear, coordinated

approach to corporate governance, the asset managers it contracted with were all major institutional investors that were signatories to the Stewardship Code.

Session 3: Implications of Trade Frictions for International Finance

In Session 3, participants discussed the implications for international finance of trade frictions between China and the U.S. They debated whether the U.S., China, or third countries such as Japan had been most adversely affected by the ongoing trade disputes. They also raised the question of whether either China or the U.S. was likely to try to use access to their financial systems as a weapon in the disputes.

Economic Impacts of Trade Frictions

Participants noted that the impact of frictions on actual trade relations had been significant. Tariff hikes had been more severe and sustained than most had predicted the previous year. On the U.S. side, imports from China had been hit hard, particularly in those product lines where the tariff hike had been the greatest. With more U.S. tariffs planned by the end of the year, substantially all imports from China would be subject to tariffs ranging up to 25%. Given the effects to date, participants expected further reductions to Chinese exports in those product areas.

Meanwhile, Chinese imports of U.S. goods had also been significantly affected. Curiously, it was noted that drops in Chinese imports of U.S. goods were not differentiated by level of tariff; some participants argued that this was an indication of coordinated actions by Chinese importers rather than simply a market response to changed prices. This suggested a government role in shunning U.S. goods, which could be used as a weapon to pressure U.S. consumers, firms, and trade negotiators.

Despite the impact on China-U.S. trade, there was some disagreement about the impact on the Chinese economy. Several participants pointed out that Chinese exports had been redirected to Europe and Southeast Asia. There were also suspicions that at least some of the trade diversion to Southeast Asia was actually an illusion and that it actually constituted transshipment to the U.S. For example, one participant pointed out that the rise in Chinese exports to Vietnam over the last year was approximately equal to the rise in US imports from Vietnam. While this was an effective safety valve for those Chinese exporters, others argued that domestic Chinese firms could be adversely affected if the Vietnamese government were to crack down on the practice. Others participants argued that the slowdown in the Chinese economy was greater than admitted by the official statistics. For example, reductions in electricity use were considerably bigger than the GDP statistics suggested. Thus, they concluded that Chinese economic authorities were trying to camouflage the negative impact of reduced trade. In contrast, several participants were skeptical that the Chinese economy had been particularly badly affected. Moreover, they argued that foreign—including U.S.—firms in China had been hurt more than local firms.

Participants agreed that U.S. consumers were largely paying the price for tariffs, despite some efforts by firms to insulate them from price hikes. U.S. farmers as well had been badly affected by Chinese retaliation. It was argued that the Trump administration was acutely aware of this pain, despite continued tough talk. On the consumer side, several participants pointed out that the administration had delayed tariff hikes on a number of key consumer goods, including toys and personal computers, until after the Christmas shopping season ended. In agriculture, they noted the decision to compensate farmers financially for losses due to inability to export to China, as

well as the U.S. focus in recent bilateral negotiations (with Japan as well as China) on promoting U.S. agricultural exports. Moreover, it was also noted that the U.S. trade deficit had only worsened despite the trade war—as a number of participants pointed out, this was not surprising given that trade balances are driven by macroeconomic forces, and the rapid economic growth and high fiscal deficits of the Trump era naturally led to larger trade and current account deficits.

Some participants argued that EU economies were the winners in the trade conflicts, as evidenced by their increased exports to China and increased imports from the U.S. However, other countries, particularly in Asia, were seen to be adversely affected. One reason was increased competition from Chinese producers of final goods. Another was the disruption of regional production networks, which constituted much of the regional trade in East Asia. Japan, for example, was very adversely affected by the China-U.S. trade dispute due to its role in regional production networks, even though Japan-U.S. trade frictions had been less heated than in the China-U.S. case.

Overall, participants appeared suspicious of both official and popular narratives that one side or the other was the primary victim of trade conflicts. They felt that both the U.S. and China were suffering. For some participants, this was actually a hopeful sign. They argued that both sides had strong incentives to come to an agreement soon, which would help not only China and the U.S., but also trading partners in Japan and elsewhere. Not everyone expected a comprehensive solution—indeed, most expected a temporary "truce" or partial agreement in the short term that would address the concerns of certain key constituents, such as farmers in the U.S.

There was some debate over which side was more likely to make concessions in order to get to an agreement. Some participants argued that the strength of President Xi's political position within China made it unnecessary for the Chinese government to back down in the face of U.S. pressure; rather, China could just wait it out until the next election. Other participants countered the Xi was actually in a weaker domestic position than he appeared from the outside, but were split as to the implications. On the one hand, a weaker Chinese administration facing a softer economy could be more willing to strike a deal. On the other hand, it was argued that if Xi's position really was more precarious than it looked, then he would be wary of making compromises and potentially looking weak. A similar set of questions was raised on the U.S. side. Since the economy had been negatively affected by the trade frictions and this was creating political challenges for the Trump administration, most participants appeared to agree that the administration was looking for opportunities to declare victory even if it meant a partial agreement. However, several participants cautioned that political weakness on the part of the administration would mean that even a limited agreement would become politically difficult to justify as the 2020 presidential election season started to heat up, as the administration would be wary of being criticized by Democrats as having backed down to China and lost the trade war. Thus, while most participants saw mutual interest in some sort of agreement, many were skeptical that a lasting or comprehensive agreement would be feasible before the 2020 election.

Financial Impacts of Trade Frictions

Participants agreed that the impacts of China-U.S. trade frictions were not limited to trading relations or the real economy, but also extended into cross-border financial transactions.

One major concern was about foreign direct investment (FDI). Looking globally, cross-border mergers and acquisitions (M&A) had been in decline since 2016, which a number of participants

attributed to trade conflicts. One reason they put forward was that trade conflicts had increased uncertainty about global economic conditions, leading companies to defer decisions about investments. For some industries, the possibility of "decoupling," or eroding global production networks, compounded the uncertainty and deterred cross-border M&A.

Of more particular concern was cross-border FDI between China and the U.S. particularly Chinese FDI into the U.S., including M&A. Participants saw a number of factors that reduced the desire of Chinese firms to invest in the U.S., including the Trump administration's strongly-stated criticisms of trade and investment with China, the failure of a number of high-profile acquisitions (e.g., Moneygram, Skybridge, Chicago Stock Exchange), and the strengthening of the CFIUS process. Some participants saw this as an opportunity for Japan to draw more Chinese investment. It was argued that a number of Chinese government investment funds, including CIC, CICC, and SAFE, were looking at investing in Japan, in the forms of both portfolio investment and private equity, and that Japan should take advantage of the opportunity. However, there were also concerns raised about whether Japanese authorities were comfortable with high levels of Chinese FDI, especially by the Chinese government. In fact, it was argued that recently proposed changes to Japan's Foreign Exchange and Foreign Trade Act were meant to reduce the ability of Chinese investors to take major stakes of Japanese firms.

U.S. FDI to China was also under pressure, although the decrease was much less severe than that in Chinese FDI in the U.S. Several participants pointed out that, in contrast to the U.S., which had tightened CFIUS rules on inward FDI, China had continued to liberalize its FDI rules. This was particularly notable in the financial sector and some other sectors such as resource extraction, where restrictions on foreign ownership continued to be loosened. Some participants felt that this was a signal that China was trying to keep trade frictions from bleeding into other areas, as it continued with its existing strategy of liberalization and market development. Others argued that China was actually doubling down on liberalization in order to reduce the effects of trade war and to extend the process of integration with partners outside the U.S. Another possibility was that this was meant to encourage U.S. firms to advocate for a less confrontational stance on the part of the Trump administration in managing the trade conflict.

Participants also discussed the impacts of trade frictions on other aspects of finance. They agreed that so far the effects were limited. For example, the VIX had remained low despite the tensions between the U.S. and its trading partners, with only occasional minor spikes following presidential tweets. Advanced economy equity benchmarks appeared unaffected as well. It was noted that while developing country equity markets had been weaker, but there were no reductions in portfolio investment to major emerging markets, let alone capital flight. Emerging market currency values had weakened, apparently tracking the RMB. However, a number of participants predicted that the RMB would remain stabilized around the RMB 7/$1 mark, because the Chinese capital account was balanced and Fed was not raising interest rates. Overall, in other words, they saw considerable resilience even in the markets that had been most adversely affected by China-U.S. trade frictions.

Prospects for Trade Frictions

Looking forward, participants discussed likely prospects for the future. Picking up on the characterization of China-U.S. trade frictions as "trade war," some asked where the two countries

were in the cycle of escalation. So far, it was noted, the "weapons" that were being used were primarily tariffs, as well as some non-tariff measures such as purchasing decisions by Chinese state-owned enterprises. However, a number of participants worried that escalation could go beyond just raising tariffs and move to even more disruptive measures, including currency manipulation, capital controls, and even financial or trade sanctions.

In this context, participants discussed the prospects that the U.S. would use its financial markets as a weapon in the trade wars. Some pointed to published rumors that U.S. regulators might deny Chinese firms access to U.S. markets. Most participants were skeptical that the government either could or would force a wholesale de-listing of Chinese firms from U.S. public markets. However, some participants warned that the lack of transparency of Chinese companies the unwillingness of the CSRC to allow the PCAOB or other U.S. regulators to examine the books of Chinese firms that were listing in the U.S. could lead to selective de-listing that would become politically charged. Meanwhile, most participants appeared skeptical of claims that the U.S. could impose capital controls on China—indeed, they were not even sure that there would be a legal basis for selective currency or investment controls against China. Another form of significant escalation would be the imposition of financial or trade sanctions. It was noted that the U.S. had been using financial sanctions much more aggressively in recent years, and that there had been some speculation that U.S. authorities could block Chinese access to US markets or even dollar settlement systems such as SWIFT. Participants expressed doubt that this would happen, however.

Whatever were to happen in terms of the trade war itself, many participants expressed concern about the broader economic effects of a continuing conflict. They pointed to slowing manufacturing investment around the world and the disruption of global value chains, both of which were occurring in the context of weakening growth prospects in China, the U.S., and Europe. Thus, a number of participants expressed concern that a recession was on the way, at a time when fiscal and monetary authorities around the world were constrained.

One important question on participants' minds was how long the trade conflict would last. As noted, some felt that the Trump administration would accept a partial deal soon, in order to improve the president's reelection prospects, whereas others worried that both Trump and Xi had painted themselves into rhetorical corners that would make compromise difficult. Looking even further forward, a number of participants argued that the situation was unlikely to improve after the 2020 U.S. elections. On the one hand, they argued that a Democratic victory would not necessarily increase the chance of compromise, as Democratic suspicions of Chinese trade practices and resentment of human rights practices was likely to propel more confrontation. On the other hand, they reasoned that a Republican victory also might give the president and his party more reason to resist backing down. A contrary view was that a Trump victory might actually increase the likelihood of a grand bargain, as President Trump would be less worried about elections in his second term, and more interested in establishing his legacy as an economic statesman and strategist.

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