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

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Final Report

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

The 19th China-U.S. Symposium of the Program on International Financial Systems was held via Zoom on November 15-16, 2022. The Symposium was held soon after several important events related to China-U.S. relations, including the National Congress of the Chinese Communist Party, U.S. midterm elections, and the first in-person meeting between Presidents Xi and Biden since President Biden took office. While noting concerns over the future of China-U.S. relations and the potential impact on the financial relationship, many participants pointed to positive messages from the Xi-Biden meeting and expressed hope that there could be a pathway for cooperation on several fronts. Accordingly, much of the discussion focused on areas of mutual interest and potential cooperation between the two countries. Topics included promotion of climate investment and financing by China and the U.S., China-U.S. cooperation of audit supervision and the prospects of Chinese stocks listed in the U.S., potential risks of U.S.-China financial decoupling, and other global challenges including inflation, emerging market debt, and regulation of crypto assets.

Topic 1: Promotion of Climate Investment and Financing by China and the U.S.

Topic 1 addressed promotion of climate-related investment and financing by China and the U.S. Participants noted that this was one of the areas of mutual interest agreed by Presidents Xi and Biden in their Bali meeting. They discussed various measures that China and the U.S. were pursuing to ensure that climate-related investment could be sufficiently funded.

Global Growth of Climate Finance

Participants agreed that the demand for climate investment would have continuing effects on global financial markets. Several cited the ambitious goal of $100 trillion over the next three years to achieve carbon neutrality that had been put forward by the Glasgow Financial Alliance for Net Zero, but others projected that even higher spending of up to $135 trillion would be needed to meet that goal. Other climate-related goals, such as adaptation to rising sea levels and changing weather patterns, were projected to further increase the demand for climate investment. Moreover, while significant progress had been made in reducing carbon intensity of economic activities, participants pointed out the need for significant corporate and government investment to developing new technologies and clean energy sources. Generating funds for all that investment was seen as both a challenge and an opportunity for the financial sector.

A number of phenomena were seen as shaping demand for climate finance as well as ESG financial products in general. Participants noted changing investor preferences, as reflected in the growing demand for climate and ESG finance. They also agreed that changing consumer preferences, coupled with increasing transparency about climate impacts of various economic activities, might shift the prospects—and therefore profitability and attractiveness—of many investment opportunities. Responding to that investor demand, a range of leading banks and asset managers had been rapidly expanding their offerings, with one participant estimating that approximately 20% of assets under management could now be considered as ESG. At the same time, many companies were increasing ESG in disclosure and corporate decisions.

Government policies were also seen as important drivers for climate finance. Climate-related infrastructure investments by governments and multilateral development banks would require large-scale private-sector inflows to meet ambitious targets, often supported by official guarantees or other credit enhancements. Government and multilateral guarantee programs were also seen as incentivizing investment in industries such as clean energy technology. Similarly, participants noted that government regulations and fiscal actions, including emissions controls, carbon taxes, and subsidies were also shaping economic activities in many countries and shifting the financial prospects of many industries and firms.

Together, these trends were supporting the growth of a variety of financial products, ranging from traditional ones such as commodities derivatives to emissions markets to ESG bonds and funds. Still, it was argued that green finance remained at a relatively early stage of development. Like most new markets, it had started with bilateral, one-off deals operating on the basis of spot pricing, leading to problems of sporadic liquidity, high volatility, and high bid-ask spreads. As green finance matured, participants anticipated greater standardization and commoditization of products. They predicted that this would lead to more liquidity and better market data, in turn allowing for index pricing and the creation of a forward curve. Eventually, it was hoped, this would include the expansion of derivatives to allow for risk management in the most liquid parts of the market, including standardized and exchange-traded products. Key to all of that, however, would be improved data and analytics to prevent price distortions, misallocation of resources, and potentially financial instability. While markets were not waiting for regulation, it was argued that clear standards and regulation would accelerate that market development and increase participation in green financial markets.

Opportunities for China-U.S. Cooperation

Participants agreed that China and the U.S. played particularly important roles in the future of climate investment and finance. One reason was their sheer scale. China's new issuance of green bonds was the largest in the world in 2021 and was increasing rapidly, up 63% in that year, while new U.S. issuance was the third highest in the world. In terms of green bonds outstanding, the U.S. was the highest, with $300 billion, and China was number two with $250 billion. Overall climate-related investment in China was the highest in the world and its Belt and Road Initiative offered further global opportunities for green infrastructure.

Despite political tensions between the two countries, participants saw climate cooperation as a bright spot that could contribute to a more cooperative relationship between them. Many participants highlighted the inclusion of climate cooperation in the recent Xi-Biden communique, which strongly reaffirmed the priority of both governments to working together to address climate change. It was noted that China and the U.S. already had solid foundations for cooperation, including their April 2021 Joint Statement Addressing the Climate Crisis and their Joint Glasgow Declaration on Enhancing Climate Action later that year, which built on previous cooperation.

Several participants expressed cautious optimism about the prospect for China-U.S. climate finance cooperation. They noted that both countries were emphasizing the importance of greening their domestic economies. Moreover, they noted the two countries' recognition that addressing climate change was a global imperative that affected both them and their partners; even if bilateral tensions were to increase, China and the U.S. would feel pressure from other countries to persist in climate cooperation. Some participants also pointed out that climate and environmental issues were of critical importance for the security of the global supply chains on which both China and the U.S. depended. With regard to the development and adoption of greenhouse gas-reducing technologies, they also warned about the risks of decoupling in environmental supply chains, including photovoltaics, low-carbon steel, and other important goods and industrial processes where the integration of China and the U.S. had contributed to technological progress and lower costs. In this regard, several participants expressed concern that President Biden had added climate technology to the CFIUS review agenda. They also worried about the impact on supply chains if environmental products were to be included in critical technology export controls.

Participants encouraged the two governments to focus on advancing cooperation at the working level. One positive example noted was their joint chairing of the G20 Sustainable Finance Working Group. That was seen as a particularly important venue since it would contribute to the establishment of common global standards that would work for both China and the U.S. In addition, participants called for the two countries to continue to build capacity among financial institutions and regulators for addressing key issues such as accounting for climate risk, ESG and climate classification and verification, and green financial market openness and resilience. Knowledge sharing between regulators from China, the U.S., and other key jurisdictions like the EU and Japan would be important to develop best practices and common standards.

Overall, participants agreed that China and the U.S. should seek to depoliticize climate change policy and climate finance. Moreover, they emphasized that cooperation was needed not only at the official level, but also among companies, financial institutions, and consumers, including through voluntary groupings and private standard-setting. Unless the financial industry could coalesce as an industry behind COP 27, it would not be feasible to fully engage private financial flows to the extent that would be necessary to meet the global challenge.

Green Finance in China

Participants discussed China's climate finance policies at length. In order to meet its ambitious "dual carbon goal" (peak emissions before 2030 and carbon neutrality before 2060) announced in 2021, China had committed to an ambitious package of policy interventions, including tighter regulatory standards, green infrastructure, technology development, and green finance.

Green finance was seen as a major focus of China's domestic finance policies. While participants noted that several Chinese financial institutions had been assertively pursuing lending opportunities in the environmental space, it was agreed that much more still needed to be done. Key elements of the comprehensive approach included establishing standards and taxonomies, improving disclosure, using monetary policy tools to promote climate finance, and making use of carbon pricing. In addition, authorities were encouraging the expansion of financial instruments to ensure funding for climate investment, including the development of climate liability insurance.

Standards and taxonomies were understood to be a prerequisite for regulating and promoting green finance. Participants noted progress in working with other global regulators to develop global standards that could be applied within China. For example, China and EU had issued a joint taxonomy, and Chinese banks had begun issuing bonds based on that "common ground taxonomy." Chinese regulators were involved in several related efforts. For example, the China Banking and Insurance Regulatory Commission (CBIRC) had recently published new guidelines to promote innovative financial instruments. CBIRC was also working with several other government agencies to create a policy framework to help to reduce carbon intensity, reduce carbon emissions, and expand forests, and in that regard had established test cases in 23 cities.

Participants also considered better disclosure and capacity building to be important. In that regard, it was noted that the PBOC was developing carbon accounting methodology and had already started a pilot project for disclosure, which would soon become mandatory. CBIRC was similarly working to enhance statistical monitoring of climate finance to encourage more funding and better governance of climate investment. The PBOC had also begun implementing quarterly green finance evaluations for banks as early as 2018.

Chinese authorities were also strengthening direct financial support for climate investment. In addition to government spending, monetary policy had also begun to target environment and climate finance for promotion, including allowing the use of green bonds as collateral and the establishment of several new lending facilities to support transition finance in steel, coal, electricity, construction materials, and agriculture.

Carbon pricing was another element in the green finance plans, and several participants stressed that it was an essential element in promoting energy transition. China had created an integrated carbon trading system to oversee 4.5 billion metric tons of greenhouse gas emissions, making it the largest carbon trading market in the world. However, proponents acknowledged that there was still considerable room for improvement, in particular by expanding to more industries and encouraging financial institutions to participate in trading. It was also suggested that carbon markets on their own may be insufficient to reach the dual carbon goals, in which case the government might need to shift the price of carbon emissions through carbon taxes or by imposing fees on companies not participating in the market.

Topic 2: China-U.S. Cooperation of Audit Supervision and the Prospects of Chinese Stocks Listed in the U.S.

Topic 2 addressed the August 2022 Statement of Protocol between the U.S. Public Company Accounting Oversight Board (PCAOB) and the China Securities Regulatory Commission (CSRC) and Chinese Ministry of Finance regarding PCAOB inspection of auditing of U.S.-listed Chinese firms. The agreement concluded a longstanding dispute between the two countries over the oversight of those audits that had threatened the ability of Chinese firms to be listed on U.S. exchanges. Participants discussed the dispute, its resolution, and implications for the future of financial integration between China and the U.S.

Holding Foreign Companies Accountable Act

The Sarbanes-Oxley law, which established the PCAOB, mandated that the Board have the ability to inspect and review the audits, including work papers, of any firm listed on a U.S. exchange, regardless of where the firm was headquartered. While other authorities had allowed the PCAOB to inspect audits for U.S.-listed firms headquartered in their jurisdictions, China and Hong Kong were an exception, with the Chinese government expressing concerns about extraterritorial enforcement and the revelation of state secrets, thus refusing to grant the PCAOB full access to audits carried out in China and Hong Kong. After years of impasse, in 2020 the U.S. Congress passed the Holding Foreign Companies Accountable Act (HFCAA), which mandated that companies headquartered in jurisdictions that did not allow PCAOB inspections of audits for three consecutive years would not be allowed to trade in U.S. markets.

The HFCAA presented a serious threat to Chinese firms that wished to be listed in U.S. markets. Moreover, since the law is based not on actions by the companies themselves but on the regulatory systems and decisions of the jurisdictions in which they are based, the situation could only be resolved at the official level. Chinese authorities had for several years expressed a desire to resolve the impasse and to satisfy the concerns of the PCAOB, but had been unwilling to grant full inspection rights of auditing practices within the country, even in cases in which the auditors were branches of U.S. or other global firms.

The Statement of Protocol (SOP) agreed in August satisfied both the Chinese and U.S. regulators' concerns, but participants cautioned that the PCAOB would still have to certify compliance on an annual basis. At the time of the Symposium, the PCAOB had not yet conducted its first round of inspections in China and Hong Kong under the SOP, so there was some question about whether it would find those jurisdictions to be in compliance. While participants were confident that the PCAOB would certify that it had full access in 2022, some expressed concern that if that did not happen, there may not be time or sufficient political will to prevent wholesale delisting by Chinese firms. Indeed, it was suggested that Congress might act to accelerate the timetable for prohibition of trading from 3 years from to 2 years of non-certification by the PCAOB, which raised the possibility of forced delisting as soon as late 2023. Even if the agreement held in the current round of inspections, many participants pointed out that the HFCAA required annual certifications of access, raising the possibility that forcible delisting would be a constant threat to U.S.-listed Chinese firms. (Subsequent to the Symposium, on December 15, the PCAOB certified that it had indeed had full access to inspect audit firms in China, thus stopping the clock on delisting.)

Effects on U.S. Investors

According to its proponents, both the HFCAA and the U.S.-China agreement reflected long-established U.S. principles of investor protection. They were designed to ensure that all U.S.-traded equities would be subject to the same level of regulatory scrutiny to ensure that investors would have timely and accurate information on which to evaluate companies in which they invested. In this sense, the HFCAA was not meant to target China, although at the moment the only jurisdictions that did not comply fully with PCAOB inspection rules were China and Hong Kong.

Proponents also argued that there was good evidence that CSRC oversight of Chinese audit firms was insufficient to ensure protection of U.S. investors. They noted some particular examples, such as Luckin Coffee, whose inflated revenue statements had misled investors, leading to its delisting in the U.S. Similarly, it was pointed out that only 2 months before the Symposium, in September 2022, the SEC had fined Deloitte-China for deficiencies in its auditing practices of U.S.-listed Chinese companies. PCAOB auditor review was essential to PCAOB reviews all auditors for US public market issuers.

In contrast, some participants questioned whether the threat to delist Chinese firms really served the needs of U.S. investors. They noted that deficiencies in auditing were not confined just to Chinese firms, but could be found in firms headquartered in the U.S. and other jurisdictions that had been in compliance with PCAOB inspection requirements. Moreover, some argued that the threat to delist Chinese firms in the U.S. was unnecessarily harsh, stating that U.S. authorities already had sufficient access to Chinese audit firms. They saw the SEC's recent action against Deloitte-China as evidence of effective enforcement of U.S. standards. There were also concerns about the politics of the HFCAA, with many participants expressing the belief that China was singled out in the law due to rising China-U.S. tensions rather than due to the specific practices of Chinese regulators.

Some participants also raised separate concerns regarding the benefits to U.S. investors. One was that, because the HFCAA took a jurisdiction-based approach to companies' ability to trade in the U.S., it had the effect of indiscriminately punishing well-managed Chinese companies as well as those whose disclosure and audits were misleading. With over 200 Chinese companies listed in the U.S., this would restrict U.S. investors' access, at least in U.S. markets, to a broad swath of potentially attractive investment opportunities—indeed, it was pointed out that nearly 6% of listings and trading volume on U.S. exchanges in 2020 were accounted for by Chinese firms. Moreover, U.S.-listed Chinese companies had proved to be attractive investment options for U.S. investors, having produced high returns in comparison with other U.S. public companies and offering opportunities for portfolio diversification. And in the likely event that U.S. investors would still want to invest in Chinese firms even if they were forced to delist, these participants argued that investors would face higher costs and lower-quality information if they had to do so through Hong Kong, Shanghai, or other Chinese markets. Proponents of the audit rule countered that it was essential to have a level playing field and high confidence in corporate financial reporting; if Chinese firms could not be shown to be meeting U.S. standards, then it was appropriate to bar U.S. listings.

Effects on Chinese Firms and Markets

Participants noted that Chinese state-owned enterprises had largely withdrawn their U.S. listings, and predicted that this would continue. Private-sector firms were more ambivalent, however. Although some had made the decision to leave U.S. exchanges in recent years, many more had retained their U.S. listings. One reason was that U.S. markets were seen as good places to raise funds, particularly due to the U.S. markets' distinct edge in trading volume and liquidity. In addition, the Chinese listings review procedure was seen as cumbersome and time-consuming. This was especially true for tech firms, since domestic listing in China required firms to have more extensive track record prior to IPOs, whereas young companies had more opportunities to raise funds in the U.S. than at home. Although this was changing with the development of a registration system more like the U.S. and lower listing standards for newer companies, particularly in the STAR market, access by young companies to Chinese public markets remained challenging. Perhaps equally important, it was argued that listing in the U.S. provided credibility to Chinese firms—and therefore likely a price premium—that domestic listings did not. However, there was also evidence that U.S. companies' IPOs were more underpriced (leaving more money on the table) than were their Hong Kong counterparts.

Looking further ahead, however, some participants argued that there may be a longer-term trend for Chinese firms to withdraw voluntarily from U.S. markets. Their rationale was that annual certification of compliance raised uncertainty about Chinese firms' future access to U.S. financial markets. In a period of rising bilateral tensions, that uncertainty could be heightened by political considerations on both sides. Therefore, it was argued that more Chinese firms might decide that the costs of remaining in U.S. markets were greater than the long-term benefits, and that they may also prefer to withdraw their listings preemptively rather than to potentially be delisted involuntarily. Already, a number of firms were setting up secondary listings in Hong Kong, just in case they get delisted in the U.S.

Several participants suggested that preemptive withdrawals could work to the long-term benefit of Chinese and Hong Kong exchanges, as they would become more important global financial centers as a result. They argued that in the long run, China would prefer to see IPOs and fundraising done at home in order to reduce entanglements with foreign authorities, provide more control over their citizens' financial transactions, and to build their own capital markets. Thus, they predicted that once Chinese markets had reached the point where they could effectively accommodate IPOs by young companies, the attractiveness of U.S. listings and even compliance with the PCAOB audit requirements, might well come to an end. This raised the prospect that an aggressive U.S. approach today might be detrimental to its long-term position in global finance.

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China-U.S. Financial Cooperation

Despite the long-term concerns expressed by some participants, it was generally agreed that the SOP was a significant positive achievement. It would serve the interests of firms and markets, while also protecting U.S. investors and contributing to continued China-U.S. financial integration. Politically, it was also a clear win for pragmatism and compromise at a time when other aspects of the bilateral relationship were on shakier ground, as evidenced by the continuation of Trump-era tariffs as well as more recent export and intellectual property controls imposed during the Biden Administration.

Several participants praised the SOP as a model for cooperation in other areas. They argued that it reflected the rule of law and reciprocity, and constituted a win-win result. Importantly, they noted that the agreement provided a clear and unambiguous framework for action and evaluation. Moreover, the agreement requires bilateral communication between the PCAOB and SEC in advance of inspections to facilitate access and reduce any miscommunications between the two sides. They saw this as a practical offering a model for working-level cooperation on other issues as well.

Participants expressed hope that the cooperative resolution of the audit inspection issue would contribute to a virtuous cycle of cooperation. However, they recognized that this would be contingent on successful implementation of the agreement over time and the evolution of the overall U.S.-China relationship.

Topic 3: Potential Risks of U.S.-China Financial Decoupling

In Topic 3, participants discussed the potential risks of U.S.-China financial decoupling in both trade and finance. In addition to the risk of involuntary delisting of Chinese firms from U.S. markets, as discussed in Topic 2, the main scenario for financial decoupling rested on the threat of financial sanctions. Participants agreed that the costs for China, the U.S., and the global economy of decoupling would be enormous.

Potential Costs of U.S.-China Financial Decoupling

Participants agreed that the costs of U.S.-China financial decoupling would be huge. U.S. capital markets were the largest and most liquid in the world, while Chinese capital markets were second in size. They noted the large-scale participation of U.S. financial institutions and investors in Chinese financial markets, ranging from banking to securities firms to asset managers to insurers, as well as their important role in a variety of financial products and services. Similarly, they pointed to the large number of Chinese firms listing on U.S. exchanges and the important role of Chinese banks in servicing Chinese investments in the U.S. Financial relations also enabled the extensive and complex web of manufacturing supply chains in which both economies were enmeshed.

Several participants made the case that the U.S. had been the world's biggest beneficiary of financial globalization, thanks to role of central role of the dollar. Excess savings in China and Middle East had facilitated low U.S. borrowing costs, enabling households to consume beyond their earnings. Others pointed out that financial globalization had allowed China to run massive sustained surpluses that supported the Chinese industrialization model for decades. A common understanding of both perspectives was that the macroeconomic complementarities of the two economies had been made possible by a global financial system that recycled excess savings.

Thus, participants saw the potential costs of financial decoupling as frightening. Further compounding the dangers, they noted that the global economy was in a fragile state as the lingering effects of COVID-19 and Russia's invasion of Ukraine combined with widespread monetary tightening to threaten recession and possibly debt crises in many economies. In the case of the U.S., for example, declines in equity and debt values, an inverted yield curve, and liquidity challenges were already a possible threat to financial institutions' balance sheets.

Financial Sanctions as Possible Trigger for Decoupling

While participants agreed that U.S.-China financial decoupling would be counterproductive for both economies, many were concerned that it was a real possibility. One possible trigger that was discussed at length was financial sanctions by the U.S. of the sort that had been imposed on Russia in response to its invasion of Ukraine.

Severe trade and financial sanctions had been a central part of the comprehensive strategy of NATO and other major economies to reverse Russian aggression without direct military involvement. While sanctions were credited with blunting the Russian war effort, some participants expressed concerns about how such sanctions might affect U.S.-China financial relations in the future.

The U.S.-led sanctions on Russia, which included freezing reserves of the central bank and excluding some Russian banks from SWIFT, were described as an important turning point in the thinking of some Chinese policymakers. Those sanctions had significantly reduced Russia's ability to operate in the global economy; even trade with non-sanctioning countries was complicated by the inability to operate in dollars or with banks and insurers based in the U.S., Europe, or Japan. If not for high oil and natural gas prices, Russia's economy and war effort would have been even more severely hamstrung. Moreover, the Russia sanctions were not completely unprecedented. The U.S. had been making increasing use of financial sanctions and secondary sanctions for over a decade, including against Chinese entities and individuals with respect to human rights issues, but most notably in the form of blanket financial sanctions against Iran.

Several participants described U.S. financial sanctions as "very unfortunate" since they had the effect weaponizing the global dollar payment system, which they saw as a key international public good. Some also referred to Russia-style sanctions as a "nuclear option" that would cause enormous harm to China (and reciprocal damage on the U.S. and others) if the U.S. decided to impose them on China. While it was agreed that the likelihood of the U.S. imposing such sanctions on China was extremely unlikely, several participants argued that the imposition of sanctions on Russia meant that the probability was not zero. These concerns were reinforced by the fact that the U.S. was already making greater use of export controls and sanctioned entity lists against China. Indeed, the U.S. had put hundreds of Chinese companies on the entities list. Some participants also expressed concern about the possibility of Chinese firms and financial institutions being targeted with secondary sanctions, even though it appeared that globally-active Chinese firms and financial institutions were being careful to avoid violating U.S. rules.

Some participants argued that removing China from the global payments system might well be impossible from a practical perspective since China was so integrated into the global supply chain. In contrast, Russia was much less integrated, so decoupling was less disruptive to the countries imposing sanctions. This did not necessarily mean that the U.S. and its allies would not miscalculate the real costs of such sanctions on China, but they argued that using this sort of financial sanctions on China would be devastating to the world economy. Given the depth and complexity of Chinese involvement in supply chains, an enormous amount of world commerce would come to a halt.

While few participants imagined large-scale financial sanctions being imposed on China in conditions short of war, it was argued that China was likely to be planning for the remote possibility that it would happen. Indeed, some suggested that the threat could provide long-term benefits for China if it were able to build a non-dollar-based international payments system—not only would it be less vulnerable to U.S. threats, but being the center of an alternative payments system could provide important economic and political benefits. There was some debate as to how realistic a goal this was. Some pointed to China's Cross-Border Interbank Payment System (CIPS) and pilot digital yuan project as nascent efforts to provide a non-dollar international payment system that would allow participants to avoid U.S. financial sanctions. While many participants were skeptical that these systems could be a viable alternative any time soon, it was pointed out that several European countries had set up a non-dollar financial arrangement to allow for trade with Iran after the Trump Administration withdrew from the 2015 Iran nuclear agreement, although it was very limited in size and scope.

Even among those participants who were skeptical about the likelihood of a Chinese system challenging or displacing the dollar system, some had qualms about the degree to which the U.S. was using financial sanctions of various sorts. They argued that long-arm U.S. regulation on money laundering and terrorist financing, as well as growing use of entities lists, inevitably would hurt U.S. interests by creating incentives for countries to circumvent the dollar payments system. Even when though such circumvention would be costly and inefficient, it might be seen as an insurance policy for political rivals of the U.S. In this perspective, freezing Russia's reserves was a wake-up call for such countries, and more generally had the effect of hurting confidence in the USD system and US markets. They argued that it would be in the best interest of the U.S not to use the payments system as an offensive weapon.

Could the U.S. and China Stumble into Decoupling?

Participants also discussed other possibilities for how U.S.-China financial decoupling could come about. Rather than the sudden imposition of financial sanctions for strategic purposes, one alternative pathway to decoupling was incremental protectionism, resulting from the two countries closing off their markets to each other in a gradual, piecemeal fashion.

Some participants suggested that financial decoupling had already begun in capital markets. The possibility of delisting under HFCAA remained a real threat and some Chinese firms had already preemptively delisted in the U.S. or started making preparations for that contingency. Meanwhile, some argued that there was declining U.S. interest in participating in Chinese capital markets as the Chinese economy slowed and a financial regulatory reset increased financial volatility. Moreover, restrictions in both the U.S. and China on investments in technology and other sensitive areas were countering previous trends toward greater financial integration. Some participants also argued that the SEC's aggressive regulatory agenda was likely to make U.S. capital markets less attractive in general, discouraging Chinese and other foreign firms and investors from operating there.

Many participants, however, appeared skeptical of concerns that creeping protectionism in China and the U.S. might lead to financial decoupling. On the Chinese side, many participants argued that China had been redoubling its commitment to financial opening. This had not only been strongly reaffirmed at the recent 20th National Congress of the Chinese Communist Party, but regulatory authorities had been consistently implementing plans to liberalize despite the disruptions of COVID-19, trade frictions, and the threat of global recession. For example, they noted that CSRC fully lifted the foreign equity cap on securities and futures, had successfully pushed for inclusion of A shares in MSCI, and continued to allow more entry into securities and futures. They emphasized that these measures were being implemented to further China's own interests rather than to satisfy other countries. With regard to the U.S., a number of participants argued that its financial markets remained the world's most open and that its strong institutions and the interests of domestic investors, financial institutions, and households would prevent backsliding.

Topic 4: Global Economic Challenges

Over the course of the Symposium, discussion ranged over a variety of global economic challenges, including inflation, emerging market debt, and regulation of crypto assets. Participants urged China-U.S. cooperation to address these common challenges.

Managing Inflation and Recession Risk

After years of stable prices in much of the world, inflation returned with a vengeance in 2021-22. Central banks that had been more concerned about the prospect of deflation and secular stagnation than of inflation were slow to react, with the Fed starting to raise interest rates only in March 2022. But once reaction began, concerns over historically high inflation prompted rapid tightening, with the Fed raising the Federal Funds Rate 7 times over the course of 2022, from zero to over 4%. Other developed economy central banks, including the European Central Bank and the Bank of England (but noticeably not the Bank of Japan or the PBOC) soon were battling inflation as well.

Some of the price increases were attributed to supply shocks, of which there were many. The Russian invasion of Ukraine had contributed to spikes in both energy and food prices, with energy shortages hitting Europe especially hard and grain shortages hurting African and other food importers. COVID-19 had also had significant effects on both supply and demand, leading to mismatches. Early in the pandemic, demand for goods had increased while demand for services plummeted; more recently, demand for services including hospitality, food service, and transportation had increased markedly but shifts in employment led to labor shortages and therefore price hikes in the service sector. Meanwhile, high levels of savings due to fiscal support for households as well as reduced household spending at the peak of the pandemic fueled high levels of consumption that did not respond quickly to tighter monetary policy.

The big question mark was whether inflation would fade along with supply bottlenecks or would become self-sustaining through wage-price spirals. By 2022, many economists and central bankers had decided that tight labor markets threatened to create wage-price spirals that would be difficult to bring back under control, which was why they had tightened so aggressively.

This raised two questions: First, how long would high inflation persist in the face of rising interest rates? And second, would it be possible to quell inflation without inducing recessions?

Optimists noted that goods price inflation was moderating in the U.S. and other major economies, even though it was still above the target range. Some interpreted this as meaning that the big pandemic-era imbalances between supply and demand were gradually being rectified. The politically important price of petroleum had also subsided significantly since mid-summer. On the downside, services prices were still rising rapidly because services tend to be labor-intensive and labor shortages were driving higher prices in the U.S. and Europe. It was predicted that this would persist well into 2023. In China, in contrast, core inflation was much lower as consumers were more cautious about spending down savings.

The aggressiveness of monetary tightening outside the U.S. was further driven by the value of the dollar, which had appreciated significantly due to higher U.S. interest rates. Some participants predicted that the Fed would raise short-term interest rates to the 5% range and keep rates high through 2023. The BOE and ECB were also expected to increase rates, but less rapidly than US.

While central banks publicly expressed confidence in their ability to engineer soft landings, many participants were skeptical. Several predicted global recession. Others expected a series of “rolling recessions” starting in Europe followed by the strong possibility of a mild U.S. recession in the second half of 2023. There was some optimism that Chinese growth in 2023 would likely rise from the low levels of 2022 due to an expected fiscal stimulus and expected exit from its “zero COVID” policy. However, there was little prospect that China alone could play the role of global growth engine.

Emerging Market Debt and Financial Stability

While considerable attention had been paid in the media about inflation, some participants were particularly alarmed about the potential impact of rising interest rates and weakening demand on the ability of emerging markets to service their debt. Already, several economies were facing severe stress and were seeking support from the IMF and from other countries.

Nearly 3 years into the COVID-19 pandemic, a variety of factors were coming together to threaten debt sustainability in emerging markets. Pandemic-era fiscal policies had in many cases led to ballooning debt, often denominated in dollars. The Fed’s assertive monetary tightening meant increasing debt service for dollar debt, at a time when weak global demand limited emerging markets’ ability to increase exports and global commodity inflation increased the price tag for imports. Meanwhile, they faced limited fiscal space due to pandemic-era borrowing and in most cases their central banks were raising domestic interest rates to deal with inflation and to prevent dollar outflows. As a result, macroeconomic policymakers were facing multiple dilemmas ranging from inflation to recession to geopolitical risk to financial risk.

These patterns were widespread, despite considerable cross-country variation. Constraints to policy had appeared even in developed economies—most notably in the UK, where an ill-advised mini-budget had led to financial market turmoil and the resignation of the prime minister. Emerging economies, which had fewer options to borrow on domestic and global markets, were being faced with a variety of unpalatable choices, leading to increased use of IMF facilities as well as urgent moves toward debt forgiveness among official lenders.

In order to prevent local pressures from expanding to a global financial crisis, many participants called for more cooperation among the world’s leading economies, including China and the U.S. They expressed hope that cooperation between China and the U.S. as well as among G20 economies could help to reduce the likelihood of crisis and contagion. In addition to debt forgiveness or restructuring and support for crisis lending through the IMF and other mechanisms, central banks and financial regulators would need to ensure dollar liquidity. On the bright side, many agreed that the global banking system was well-capitalized and not over-leveraged, making it a bulwark against contagion.

Regulation of Crypto Assets

There was some discussion of crypto assets at the Symposium, with a particular focus on stablecoins. The failure of FTX only a few days before the Symposium, as well as the earlier failure of Terra and questions about the reserve backing for other stablecoins, raised serious concerns over whether and how stablecoins should be regulated and whether they posed a systemic risk to financial systems. This discussion focused on the U.S. and on general principles, since China had banned all private crypto asset transactions as of 2021.

Stablecoins had taken on an important role in the crypto world as "on-chain money," which allowed for movement of funds across decentralized platforms and centralized exchanges. This was necessary because banks in most jurisdictions were not allowed to lend directly for crypto assets or to maintain accounts in them. As a result, stablecoins were seen as the main potential conduit for crypto asset volatility to be transmitted to the formal financial system.

As many participants noted, the problem with stablecoins was how to ensure that their price actually remained stable relative to the dollar or other chosen asset. In the U.S., stablecoins were regulated under state-level money transmitter laws, which were designed in the telegraph age, and did not entail prudential regulation. To some participants, stablecoins looked like unregulated money market funds, whereas others felt that banks were a better analogy since they were primarily a payment rail. Even for stablecoins that claimed to be fully backed with reserves, there were many questions about the extent, composition, and quality of the claimed reserves. As a result of that lack of transparency and regulation, participants emphasized that they were susceptible to runs, which they would not be able to stop if not fully backed by liquid reserves.

This raised the question of what prudential regulation of stablecoins should look like. Participants agreed that reserves should be held in cash and liquid assets and that reserve backing should be publicly disclosed. Some suggested that stablecoin prudential regulation should parallel that of banks, including not only rules about composition and adequacy of reserves, but also rules on capital and leverage. In addition, a more bank-like resolution mechanism would prevent holders of stablecoins to be tied up in bankruptcy proceedings for years.

Participants raised other regulatory issues as well. For example, how should issues of concentration be managed? Moreover, there would be thorny issues in dealing with basic financial regulations in space dominated by decentralized blockchain trading, including anti-money laundering, know your customer, and data security.

China-U.S. Cooperation

Participants agreed that China-U.S. cooperation would be important in dealing with all of these global economic challenges. However, they also recognized that political tensions would make that difficult.

Participants expressed concern over rising rhetoric of a new "cold war," which they saw as a self-fulfilling prophecy. Instead, some offered the alternative formulation that "the world is big enough for both of us." In other words, that China and the U.S. should cooperate on areas of mutual interest even as they competed on a variety of issues. The Xi-Biden meeting and its agenda of cooperation on issues like climate change and financial stability was seen as a good start, but participants agreed that concerted efforts would be needed to prevent greater confrontation. Financial institutions could be a part of that, given the high levels of mutual interest and years of effective interaction and cooperation.

There was also agreement that economic and financial decoupling was not the right answer. Not only would the economic costs be enormous, but declining interdependence could also lead to more direct and dangerous confrontation on the political and security fronts. It was noted that the pandemic had seen many countries increasing their use of protectionism and subsidies, including in the name of "friendshoring" or supply chain resilience, which distorted trade and challenged globalization. Some suggested that the G20 was an essential venue for managing these issues, but that it would be dependent on leadership from China and the U.S. Participants urged the two countries to provide positive leadership to ensure global trading and financial systems would continue to be built on clear rules that were respected by all players.

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