

**Building the Financial System of the 21st
Century:
An Agenda for China and the U.S.
Cambridge, Massachusetts, June 12-14, 2009**

The sixth annual China-U.S. Symposium was held at the Harvard Law School in Cambridge, Massachusetts amid signs that the U.S. and Chinese economies were bottoming out from the worst global economic crisis in generations. Sessions addressed impact of the credit crisis on the U.S. and China and their responses, reform in the international financial system in light of the credit crisis, and opportunities for innovative post-crisis economic cooperation between the U.S. and China.

SESSION I

Impact of the Credit Crisis on the U.S. and China and Their Responses

In Session One, participants discussed the micro and macro causes of the crisis, the appropriateness and adequacy of U.S. and Chinese policy responses, and the issue of global imbalances. It was agreed that the nature of the crises differed in the two economies and that the policy responses should also differ. There were some differences of opinion regarding how to handle global imbalances, as not all participants agreed on the past and future impact of China's current account surpluses.

Nature of Crisis

Participants agreed that the nature of the economic challenges facing the U.S. and China were different. The U.S., which was the epicenter of the global economic crisis, had experienced first a financial crisis, which in turn affected the real economy through a credit crunch and extensive deleveraging. Given the dependence of U.S. consumption on debt, much of it collateralized by real estate, the credit crunch and bursting of the housing bubble combined to cause pain throughout the economy. For China, in contrast, financial markets continued to function well, but the real economy was directly affected through the impact on exports to the U.S., Europe, and Japan. Thus, much of the initial pain was focused on export industries. The fiscal positions of the two governments also differed going into the crisis. China's strong fiscal position allowed it to undertake a large-scale stimulus and public investment program. The U.S. fiscal position was much weaker, but due to the safe haven status of the U.S. dollar, the government was still able to embark on a large-scale fiscal stimulus.

Macroeconomic Factors

Many participants saw macroeconomic imbalances as having been at the heart of the crisis. On the U.S. side, they pointed to a culture of overconsumption based on leverage. They noted that U.S. household savings had dropped significantly in the last decade while household incomes had not risen nearly as much, with the net result that consumption as a share of GDP had risen to over unprecedented levels. Rising housing prices had contributed to household borrowing both directly—by increasing the amount that purchasers of homes had to borrow—and indirectly—by encouraging them to borrow against the rising value of their homes. This problem was compounded by a set of microeconomic policies that encouraged homeownership and relaxed rules on mortgages, leading to a significant increase in homeownership by uncreditworthy borrowers.

There was some disagreement over where the blame should be placed for all of this. Some participants focused on microeconomic factors instead of or in addition to macroeconomic factors. Among those who focused on macroeconomic factors, many blamed U.S. monetary policy, which they criticized for having been overly loose and not having recognized the pernicious effects of rising household debt. Others felt that the Fed was not alone in its responsibility for easy money. They pointed out the willingness of foreigners—including the Chinese government—to invest in U.S. equities and debt, which contributed to a flood of liquidity and enabled large U.S. current account deficits.

The Chinese economy was seen as a mirror image to the U.S. While U.S. rates of consumption were unprecedentedly high, China's were unprecedentedly low. Although Chinese investment was extremely high, the low levels of domestic consumption fueled massive current account surpluses. Chinese growth was based on a combination of exports and investment, with much of the manufacturing investment going into the export sector. A number of participants also linked China's surpluses with its exchange rate regime. While others argued that the exchange rate had little to do with the competitiveness of Chinese exports, due to their relatively high imported value-added, there appeared to be a consensus that the exchange rate regime had contributed to the build-up of foreign exchange reserves. Those reserves had, in turn, been recycled back into dollar-denominated assets.

For many participants, then, China and the U.S. were engaged in a symbiotic—or perhaps co-dependent—relationship, based on basically different models of economic growth. China's growth was heavily export-dependent, while the U.S. model was based on maintaining high consumption—through borrowing if necessary. They argued that reducing macroeconomic imbalances would require a substantial restructuring of both economies.

Microeconomic Factors

Microeconomic factors in the U.S. were also cited by participants as a primary cause of the crisis. Participants agreed that in large measure the crisis both resulted from and exposed regulatory failure at many levels.

Participants agreed that U.S. financial regulation and supervision had failed to protect the stability of the financial system, citing three major issues in particular. First, it was agreed that incentive structures for many actors in the system were skewed. Securitization was one part of the story. While securitization was seen as having been effective in dispersing risk and increasing the liquidity of a variety of lending markets, participants also agreed that because of the way in which responsibilities had been divided up, there was insufficient incentive for due diligence at each level. Loan originators, who made money on volume and by marketing complex loan products and then immediately sold the loans, saw little reason to ensure loan quality. Moreover, policies meant to encourage homeownership combined with financial deregulation to rapidly expand lending to problematic borrowers—loans that were often particularly profitable for originators. Securitizers similarly made their profits on volume; moreover, they were able to make higher margins on more complex products, many of which traded infrequently. Both originators and securitizers were compensated on a short-term basis, without provisions for clawbacks in most cases. Credit rating agencies also came in for criticism, due to a business model where they could earn more for rating (and approving) ever-more complex financial instruments. Compensation schemes in general were seen by participants to have been too short-term oriented, raising fundamental problems of corporate governance.

A second major problem identified by participants was risk management. Financial institutions and investors were seen as having underestimated the effects of counterparty risk and correlation risk. Participants blamed this partly on lack of transparency and a preference for trading derivative products outside of exchanges or clearinghouses. Lack of transparency was facilitated by regulations and accounting

rules that allowed large off-balance sheet holdings and high levels of leverage in systemically important institutions, both of which weakened the effectiveness of prudential regulations on banking institutions. It was agreed that regulators had little ability to oversee the massive shadow banking system.

Third, regulatory fragmentation—not only among federal regulators, but also between federal and state authorities—allowed many financial institutions to choose their own regulators. Several pointed out, for example, that AIG, one of the world’s largest financial institutions, was regulated in the U.S. by the Office of Thrift Supervision. The strictness and competence of regulators and supervisors varied widely. Moreover, it was argued by many participants that significant regulatory gaps remained, especially for non-bank financial institutions. (Others countered that many of the major institutions that had gotten in the most trouble were in fact among the most heavily regulated.)

Some participants attributed these regulatory failures to a philosophy of deregulation that they saw as having been discredited by events. Others disagreed, arguing that some of the worst problems of regulation and supervision, including regulatory fragmentation, arose from the political compromises that had created the rules and institutions. The political popularity of promoting homeownership was also seen by some as having been a major factor in having impeded stricter prudential regulation and borrower protection.

U.S. Policy Responses—Short vs. Long Term

In assessing U.S. policy responses to the crisis, participants gave generally high marks to policy makers for having prevented a much more severe financial and economic crisis. Participants were particularly complimentary of the actions of the Fed, and most were appreciative of short-term effects of the fiscal stimulus plan. (TARP was not discussed extensively.) Nonetheless, a number of participants expressed concern about the long-term effects of those policies. This led them to question whether U.S. macroeconomic policies were sustainable.

On the fiscal policy side, a number of participants were concerned that the deficit—expected to hit 13% in 2009—would not be reduced quickly or easily. They cited several factors, including the lingering effects of economic weakness, the political difficulty of deficit reduction, the long-term problem of increasing social security and health care obligations, and (for some) an expectation that Democratic Party control of Congress and the presidency would lead to pressures for more spending. Others were more sanguine, arguing that much of the deficit for 2009 and 2010 was cyclical in nature, and that the winding down of TARP and expiration of some Bush administration tax cuts would combine with economic recovery to reduce deficits and debt accumulation to manageable levels.

Significant concerns were also expressed about the sustainability of monetary policy. The massive liquidity provision in which the Fed had been engaged, along with Fed statements that some participants interpreted as a pledge to monetize deficits, were seen by a number of participants as contributing to inflationary expectations. While they recognized that deflation remained a larger problem for the moment, they worried that it would be difficult for monetary policy makers to recognize the inflection point at which monetary policy should be tightened. They also argued that if growth and employment remained weak at that point—which they saw as likely—it would be politically difficult to tighten. A number of participants suggested that rising long-term Treasury bond yields

were already signaling inflationary expectations in the financial markets. This confluence of factors, they feared could make long-term interest rates uncontrollable and also lead to a significant loss of faith in the dollar. This would create a severe problem for the U.S., as monetary policy would become ineffective in stimulating the economy and the availability of credit for further fiscal stimulus would also dry up.

Other participants were less concerned. They argued that inflationary pressures were unlikely to emerge, given the large excess capacity throughout the world economy. There was also skepticism about the emergence of inflationary expectations—some participants suggested that rising bond yields and falling dollar were simply signs of improving economic prospects globally, and that investors were no longer piling into Treasuries as a safe haven. They acknowledged the difficulty of determining when to pull back liquidity, but argued that the predominance of short-term assets in the Fed's balance sheet would make unwinding much simpler. Some also noted Japan's experience, in which massive growth of base money did not lead to inflation or a weakening of the yen, despite the fears of Bank of Japan officials. They suggested that the U.S. was currently in a similar position.

China Policy Responses

China's macroeconomic policy response was positively evaluated by participants for its effects in addressing the economic slowdown. They were particularly impressed by the scale of the fiscal stimulus, which they saw as having significant effects on economic activity in 2009 and 2010. It was noted that China's solid fiscal position had made it feasible to run large deficits, in contrast with some other emerging market economies. Despite the significant stimulative effects for the domestic economy, however, China's macroeconomic stimulus was not seen as likely to have much of an impact on other economies.

As with U.S. policy, participants discussed at length the trade-off between short-term and long-term effects of the Chinese fiscal package. In other words, would private sector investment and consumption be expanded after the cyclical downturn as a result of current policies? And would the package help China to shift away from export-led growth to domestic demand-led growth? A number of participants argued that the package would do exactly that. They pointed out that the package included significant public investment in infrastructure and innovation, which would improve productivity gains and incentives for further domestic investment to take advantage of those gains. They also pointed to lending programs that were meant to ensure that firms could survive the downturn and retool to meet changed circumstances.

Others were more skeptical about the longer-term benefits. Some argued that lending and infrastructure programs were skewed to the needs of large firms and state-owned industries, leaving out the SMEs that were the largest employers and most dynamic firms. They were thus worried that the package might have the long-term effect of making the Chinese economy more state-controlled and less flexible. Many participants also expressed concern that the policies would reinforce export-led growth, which would inevitably exacerbate the problem of global imbalances.

In looking at the feasibility of changing the Chinese growth model away from export-led to domestic demand-led, some participants also noted that much of the domestic demand would have to come from a significant expansion of consumption. There was

some disagreement over whether it would be helpful or appropriate to encourage greater private consumption in China—and even those who most strongly saw the need for higher consumption accepted that it would remain quite low compared to more developed economies—but much of the discussion focused on the feasibility of significantly increasing household consumption.

Participants identified four possible reasons for weak consumption in China: income inequality and low household income, underdeveloped financial markets, weak social safety net, and cultural preferences. On the positive side, it was noted that the Chinese government has been working to improve the social safety net (particularly health care and pensions) and access to education—both before and during the crisis—which was seen as an important element in reducing the need for precautionary savings. The fiscal package was seen by some participants as being a useful hedge against a worsening of income inequality, but many participants argued that significant reductions in income inequality and increases in household income would not be feasible without massive improvements in productivity across the country. Some participants argued that another problem was the difficulty of obtaining consumer credit, and urged China to expand opportunities for both borrowers and investors.

Global Imbalances

The contrast between short-term stimulus and long-term economic effects inevitably led back to the issue of global imbalances. A number of participants expressed concern that, after the crisis had subsided, both the U.S. and China would revert to their previous growth models (excessive reliance on external borrowing for the U.S., excessive reliance on exports for China) and that this would inevitably lead to new problems of sustainability, destabilizing the global financial system again. Participants agreed that the mirror relationship had appeared to both Chinese and Americans to have been beneficial, at least for a while. But many believed that this symbiotic—or dysfunctional—economic relationship had contributed significantly to the crisis and they urged significant rebalancing.

While many participants felt strongly about the need for rebalancing, they also recognized that these economic models had become deeply ingrained on a political and economic basis. For the U.S., the ability to borrow internationally in dollars had abetted a political process that was unable to make hard decisions about fiscal trade-offs, while political gridlock had allowed excessive leverage to grow almost unchecked in many sectors. Some participants saw evidence of U.S. unwillingness to make tough fiscal choices in what they saw as the Fed's deliberate monetization of government debt. For China, many firms had invested based on the expectation of filling U.S. demand for manufactured goods; meanwhile, the government had been cautious about allowing the RMB to appreciate, at least partly in order to maintain high employment growth.

Other participants were more optimistic about the prospects for rebalancing. They noted that U.S. current account deficits had been dropping even before the crisis, and that that trend had only accelerated since. There was also a sense among many participants that U.S. consumer behavior had undergone a long-term shift—that not only were households deleveraging due to the credit crunch, but that both borrowers and lenders had learned important lessons from the housing and financial crisis. At the same time, it was pointed out that China's current account surplus had been falling, the RMB had been rising, and fiscal spending and private investment was also rising. However, as

noted above, there were also a number of participants who believed that Chinese investment was still oriented toward export production, and they worried that the Chinese government may be assuming a return of external demand as an engine of growth.

SESSION II

Reform in the International Financial System in Light of the Credit Crisis

In Session Two, participants discussed financial and economic reforms in China, the U.S., and globally.

U.S. Regulatory Reform

There was considerable discussion of U.S. regulatory reforms. Participants offered a variety of opinions on financial reforms to date, principles of financial regulation, and prospects for further reform. The debate could be broken down into the three questions of who should regulate, what should be regulated, and what should be expected of regulators.

Who should regulate?

Many participants identified regulatory fragmentation as one of the major challenges for effective regulation and supervision of the U.S. financial system. They felt that the crisis had shown the dangers of a regulatory “race to the bottom” when many financial institutions could essentially pick their preferred regulator. They also worried about both regulatory gaps and regulatory overlap, with gaps seen by some as an opportunity for regulatory arbitrage and overlap seen as creating excessive costs of compliance and contradictory directives and retarding innovation. Moreover, financial innovation and the creation of financial conglomerates were seen to have blurred the lines between different types of financial institutions, and thus the correct configuration of regulators.

Some participants argued that the U.S. situation called for a significant amalgamation of regulation and expressed their disappointment with the Obama administration’s apparent decision not to significantly consolidate the federal regulatory structure. Others were less concerned about organizational structure than about the substance of regulation, pointing out that the UK FSA model had not been any more effective in securing system stability or in prudential regulation. There was, however, a general consensus in favor of clear lines of responsibility. Moreover, it was agreed that if regulation were not to be unified, there should be institutionalized mechanisms to ensure cooperation among regulators who had authority over different parts of a single conglomerate.

Regardless of whether regulation was to be under one or several agencies, a question that remained was on what basis lines of regulatory authority should be divided. In theory, many participants agreed that, given the ability to create functionally equivalent product across financial sectors, it might make sense to regulate on a product basis. However, since this would complicate supervision of financial institutions as corporate entities, others felt that a sectoral division of regulation was more practical.

Functionally, participants appeared to agree that prudential regulation and enforcement should be separated. Looking back at the crisis, a number of participants argued that the most effective prudential regulation had been carried out by the Fed and the Treasury. The SEC, on the other hand, came in for considerable criticism for its prudential regulation of Bear Stearns and Lehman Brothers, even though it got generally

high marks for its legal enforcement. Moreover, they pointed out that the SEC had no capability to support liquidity of troubled financial institutions, unlike the Fed or FDIC. For these participants, the lesson was that prudential regulation should be carried out on the basis of economic analysis and the ability to provide liquidity support, while lawyers should be in charge of enforcement and consumer protection.

A number of participants expressed concern with the quality of personnel at regulatory bodies. They argued that the gap in financial rewards between the public and private sectors meant that it was difficult to maintain high quality. Some suggested that the situation called for mechanisms to support a “revolving door” between regulatory agencies and financial institutions; others worried that this might create conflicts of interest. But at a minimum, all agreed on the need for ongoing communications to ensure that regulators understood the nature of the business they oversaw.

What should be regulated?

Much of the discussion of regulation revolved around what should be regulated. One suggestion was that the Fed should be responsible for overall “financial stability.” This suggestion appeared to parallel the March 2007 Treasury Department proposal to make the Fed a “market stability regulator.” Supporters of this idea tended to adhere to the position that the major cause of the financial crisis was macroeconomic rather than regulatory—as one put it, easy money will always move around and pop up in the regulatory gaps, no matter how well credit rating agencies and conduits are regulated. Other participants professed confusion at how financial stability would be defined. They felt that the concept appeared to be designed to give the central bank the authority to decide whether a bull market was actually a bubble and to act accordingly.

Another major concern of participants was how to handle the problem of systemically important institutions. Several participants noted that for many years before the late 1990s, one of the main principles of financial regulation was to prevent institutions from becoming “too big to fail.” The current crisis had made clear, however, that the existing protections against “too big to fail” had been insufficient, as a surprisingly large number of financial institutions had ended up fitting that description. Moreover, the rise of institutions that were not particularly big by traditional measures but were highly leveraged and “too interconnected to fail” was seen to have significantly increased the challenge for regulators. With an increasing number of financial institutions being recognized as systemically important, participants worried about how to prevent moral hazard. Some participants argued that the only way to resolve the problem would be by preventing financial institutions from growing so large as to have their failure threaten the financial system. Others felt that was impractical, and instead advocated tighter prudential regulations, including higher capital requirements, for systemically important institutions. Some participants also suggested that the number of systemically important financial institutions could be reduced if regulators would address the problem of counterparty risk by shifting more financial transactions to exchanges and clearinghouses.

Many of these issues were particularly relevant to the “shadow banking system.” Regulatory gaps with regard to transparency, off-balance sheet activities, and conduits had allowed the extraordinary growth of a system of interconnected and often highly leveraged financial institutions that had helped to create the financial crisis. Many participants argued that all elements of the shadow banking system needed to be

subject to regulation. Among the suggestions offered were consolidated reporting of holdings and required holdbacks on securitizations.

Finally, several participants argued strongly that financial regulation needed to address not only market behavior and transparency of holdings, but also corporate governance of financial institutions. In particular, they expressed dismay about prevailing compensation practices, arguing that they created incentives for excessive risk-taking and the creation of ever-more complex—and therefore illiquid—instruments. They therefore called for regulation to ensure the alignment of compensation with long-term benefits to the firm.

What do we expect of regulators?

Participants agreed that there were many, sometimes contradictory, ideas about what should be expected of regulators. At a political level, they noted the populist appeal of mandates to punish those who had violated laws or created havoc in the financial system.. While participants were sympathetic to such intentions, many worried that attempts to create rules to ensure those goals were likely to create as many problems as they solved. They expressed concern that the level of regulation and government intervention being advocated by some politicians was likely to inhibit innovation and competition. Some argued that policy making in times of crisis was not necessarily responsive to the issues of cost effectiveness, and cautioned against driving financial markets out of the country.

One idea that appeared to have traction among participants as a way of using regulation to reduce the impact of bubbles was the introduction of countercyclical prudential regulation. Participants recognized that capital requirements have tended to have procyclical effects, encouraging lending as the economy strengthens (and thus reinforcing upward spirals) and discouraging lending as the economy weakens (and thus compounding credit crunches). A number of participants were thus drawn to the idea of an automatic stabilizer in the form of countercyclical prudential regulation. Others, however, were skeptical that it could be effectively put into practice. It was also noted that such regulation, if it could be made practical, would probably need to be agreed at an international level so as to reduce regulatory arbitrage and concerns about unfair competition.

Unlike in previous symposiums, there was not a great deal of discussion about principles-based versus rules-based regulation. However, the question of how to ensure that regulation kept pace with changes in the financial industry was of concern to many participants. There was a general sense that economic logic should govern the application of regulation and that rules should be responsive to the marketplace. For many participants, the situation therefore called for recruiting highly capable personnel and providing them with significant discretion in applying regulations. Others were more concerned about the possibility of regulatory capture. This problem might be compounded if there were more movement between regulatory agencies and financial institutions. It was agreed that there was no simple structural solution to the basic problem.

Politics and Reform

A number of participants expressed pessimism about the prospects for effective financial regulatory reform in the U.S. Many were concerned about the legislative process, arguing that interest groups, populism, and turf battles among agencies were likely to combine to prevent regulatory consolidation and to undermine the balance between competition and regulation. An even more intractable issue was seen to be the balance between federal and state jurisdiction. Between constitutional issues and the very strong interests of states in maintaining their own powers, there was considerable skepticism that financial reforms would clearly assert the preeminence of federal regulators except with regard to market stability. Some participants argued that there was still an opportunity for political leadership and that the broad contours of effective reform were likely to be enacted. Others countered that politicians' sense of urgency appeared to be abating as the worst of the crisis receded, allowing them to return to politics as usual.

FDI Regulation

Besides such large-scale financial reform issues, a number of participants argued that U.S. regulations on inward investment by Chinese firms should also be significantly liberalized. They cited restrictions based on national security concerns (including CFIUS and technology export restrictions) and on ownership of banks by state-owned enterprises. They saw this as ironic, given the need for China to recycle vast amounts of dollars. Moreover, they pointed out that foreign-invested firms tend to have higher rates of exports, and argued that barriers to Chinese FDI would have the effect of reducing potential U.S. exports to China and elsewhere. Finally, they were particularly critical of what they saw as barriers to investment in or acquisition of high-tech companies, arguing that they amounted to an effort to prevent Chinese technological upgrading.

In response to the concerns voiced over FDI access, several U.S. participants argued that the U.S. remained one of world's most open markets for foreign direct investment. They recognized that some Chinese firms had encountered difficulties, but argued that these were exceptions to the rule. They also stressed that most of the obstacles facing Chinese FDI were not targeted at China, even though some (such as the rules on bank holding companies) were more likely to affect Chinese investors than those from other countries. In response to complaints about the CFIUS process, these participants agreed that some streamlining would be useful, but also pointed out that CFIUS itself had prevented very few investments. Other participants were not convinced, arguing that both the uncertainty about how CFIUS appraised national security risks and the potential political fall-out from going through the process discouraged Chinese investment. They also expressed concern about the general political environment for Chinese takeovers and investment. Some participants advised Chinese firms to learn from the Japanese example and work on creating long-term relationships with state and local leaders and communities.

Chinese Reforms

While much of the discussion about reform focused on the United States, participants also considered what types of economic reform would be appropriate for China. They discussed how to address issues in both the financial sector and the real economy.

Although some observers had argued that the problems of the U.S. financial sector have discredited financial liberalization, participants were unanimous that China should continue to reform and liberalize its financial sector. They agreed that the country's financial system still had a long way to go in improving the reach of financial markets and efficiency of allocation of capital, and that maintaining existing controls would not be an effective way of ensuring stability over the long term.

In particular, participants agreed with the need to extend market determination of prices. While equities were seen to trade freely, interest rates and exchange rates remained tightly controlled. Participants agreed that flexibility in both would be essential to the development of Chinese financial markets and to better allocation of capital. It was noted, for example, that there is very little risk-pricing of corporate debt and that monetary policy makers have not been able to rely on market pricing to determine inflationary expectations. No one expected or advocated a sudden, one-off deregulation of financial prices, but they supported a continuation of China's ongoing and deliberate actions to move in that direction.

Also, there was a consensus that there should be a greater diversity of financial institutions and products. A major emphasis was on improving the environment for SME financing. There was particular interest in venture capital and private equity, with a number of participants noting difficulties in both entry and exit—especially for foreign investors, but also for locals—as well as differential tax treatment for foreign investors. Moreover, despite the clarity of Chinese rules regarding FDI in different sectors, some participants with experience in the field stated that there remained a great deal of bureaucratic discretion (and thus uncertainty) at both the national and local or provincial levels. Some participants expressed the view that such policies hurt China's efforts to upgrade its economy, since they prevented firms from being exposed to new techniques and business models.

In addition, several participants agreed that new financial products could also support lending to SMEs and start-ups. Asset-backed securities were seen as one useful asset class; more generally, the development of a clear yield curve and mechanisms for risk pricing of loans would likely lead to much more availability of credit to SMEs. Some participants also cited listing rules for stock exchanges as complicating the ability of SMEs to grow and of venture capitalists and private equity firms to exit their positions. For foreigners, these difficulties were compounded by capital controls that made it difficult to repatriate funds when they chose.

There was some discussion of whether China should merge the CBRC, CSRC, and CIRC back into a single regulatory agency. Most participants felt that the current division was working well, and that in addition Chinese financial institutions were still segregated enough that a simple sectoral division remained appropriate. However, there was a general sense that major Chinese banks may be moving indirectly toward universal banking, which would increase the need for cooperation among the financial regulators and the PBOC; in this regard, there were concerns raised about the quality of existing communication and cooperation.

Overall, participants agreed that Chinese financial authorities were likely to continue reforms according to the existing blueprints. However, the current crisis was seen as likely to slow the process, and it was predicted that reforms would be cautious and incremental.

Real economy reforms were seen by many participants as being both more important and more difficult for China. Discussions focused on issues that were seen to be particularly important to savings and consumption, including pensions, public health, and education. Deficiencies in the social safety net and public access to education were seen as contributing to a variety of problems, including economic inequality, poverty, and excessive household saving, as well as potential social unrest. It was also pointed out that China's continued economic growth would increasingly depend on a well-educated, healthy workforce. Although specifics were not discussed, participants urged the Chinese government to continue its efforts to address these needs.

International Cooperation

In addition to domestic regulatory reform, participants discussed the potential for reforms at the international level. Discussions focused on regulatory standard-setting and on how to enhance international cooperation in enforcement.

Participants agreed that one of the major changes in international standard-setting already underway was the increasing inclusion of emerging market economies in key forums, including the G-20, Financial Stability Board, and Basel Committee. China in particular was seen as taking an important role. Participants saw the increasing role for China and other emerging market economies as a positive development, for several reasons. First, participants noted that their importance in global finance and macroeconomics had significantly expanded, and so their participation would be essential in addressing global issues (particularly with regard to macroeconomic and currency issues). Second, they agreed that international standards would achieve greater legitimacy through greater inclusion in standard-setting. Finally, several participants argued that standards created for developed economy financial markets were often costly and inappropriate for emerging markets—one example given was Basel II.

Participants also discussed the appropriate scope of international regulatory standard-setting. There was a general agreement that prudential standards in interconnected financial markets should be subject to a uniform minimum level (although not everyone approved of Basel II). Beyond that, participants discussed a variety of issues that might be appropriate for international cooperation. Among these were deposit insurance and bankruptcy laws, but there was no clear consensus on whether and how they should be handled at the international level. There did appear to be more consensus about the need for some sort of international standards concerning financial transactions, with many participants supporting international agreement that would shift much of the OTC derivative trading to clearinghouses and exchanges. Within that general consensus, however, participants differed over whether all derivatives should be centrally cleared, as well as over the importance of trading on exchanges relative to central clearing. Participants did, however, support continued international communication among regulators on such matters.

Participants also discussed the issue of cooperation in enforcement. Some worried primarily about how internationally-agreed standards could be translated into action by national regulators. Others were more concerned about the problem of transnational supervision of multinational financial institutions.

With regard to how to make national regulators adopt internationally-agreed standards, participants put forward two competing approaches. One approach, which some participants identified as similar to the preferences of the Chinese and French governments, called for hard and fast obligations to enact international standards. Proponents of this approach pointed to the problem of tax havens reducing the efficacy of standards. The other approach, which was seen as similar to U.S.-UK-Australian preferences, was to focus on the use of market discipline. Proponents of this approach pointed to the successful worldwide adoption of the Basel standards, although those standards had been found wanting in the financial crisis.

Even in cases in which countries had roughly similar regulatory standards and supervisory practices, participants recognized the current difficulty of transnational supervision of multinational financial institutions. There was consensus on the need to create institutionalized means of communication among national regulators, such as “colleges of regulators.” Not all participants saw such a mechanism as sufficient to deal with the challenge, however. They suggested that major economies should consider actual joint regulation of multinational financial institutions operating within their jurisdictions. A similar challenge was noted with regard to resolution of failed multinational financial institutions. A number of participants called for governments to set up protocols for managing the orderly resolution of such institutions.

International Monetary System

A final topic of discussion in Session Two was the international monetary system. Participants generally agreed that the crisis had been handled well by national governments and central banks, but opinions about future prospects were more divided. In looking to the future, participants considered the potential for international cooperation to reduce global imbalances and possible changes in the role of the dollar and RMB.

With regard to global management of the current crisis, participants pointed to several successes. They were impressed that central banks had effectively cooperated to prevent breakdowns in liquidity. Moreover, it was noted that successful domestic responses of central banks (including expanding discount and other lending windows, and purchases of non-traditional assets as part of monetary policy) had resulted from communicating with and learning from their counterparts in other countries. While fiscal policy had not been as effectively coordinated, participants were generally positive in their appraisals of simultaneous fiscal actions in the U.S., China, Japan, and some other major economies. The proactive policies of the IMF—and the financial support provided by major members—were seen as another aspect of successful crisis management. Finally, many participants expressed relief that major economies had eschewed protectionism and competitive devaluation as a means of transferring pain to other countries.

Going forward, however, there were concerns about the international monetary system. Some participants voiced their hopes that international cooperation could help to reduce global macroeconomic imbalances to more sustainable levels. They suggested that the U.S., China, Japan, and other economies with large current account deficits or surpluses should act jointly to facilitate the adjustments that would be needed in each country. Others were skeptical of the role of coordination, however, pointing out that the economic models of each of the countries was deeply ingrained and that there would be no mechanism for ensuring compliance even if clear agreements could be reached. For

them, the best hope lay in market incentives for each economy—for example, that interest and exchange rates would encourage deleveraging in the U.S. and increasing demand in China. Some argued that a more flexible Chinese exchange rate regime would be essential to creating the right market pressures.

Another concern expressed by a number of participants was over the continued dominance of the U.S. dollar. They argued that global overreliance on the dollar had contributed to excessive U.S. borrowing and that it also endangered the value of the reserves of other countries. Several participants cited PBOC Governor Zhou's statement at the G-20 in April calling for the creation of international money and floating the idea of currency baskets or expanded use of the SDR.

Most participants were skeptical of the feasibility of international money. However, they recognized that Governor Zhou's statement reflected serious dissatisfaction with the current system. Therefore, much of the conversation revolved around the respective roles of the dollar and RMB. Most participants agreed that the dollar would remain the world's most important currency well into the future, based upon its natural advantages—large and liquid dollar-denominated financial markets, global use in invoicing commodities and other products, and relative stability (although it was noted that concerns were growing about the value of the dollar). Nonetheless, many participants expected a gradual erosion in the preponderance of the dollar in international trade and lending and in foreign exchange reserves, with one participant predicting that about half of all Chinese trade would be RMB-denominated within ten to twenty years.

While there was some discussion of the possibility of new regional currencies taking some of the role of the dollar, most participants focused on the role of existing non-dollar currencies, especially the RMB. Some participants noted recent steps being made by the Chinese authorities to make the RMB more internationally useful—including improved foreign access to domestic bond markets, efforts to make the RMB more convertible, and the extension of RMB trade credits to Asian neighbors affected by the crisis. Most participants saw such efforts as being preliminary at most, however, arguing that the RMB could not have a significant regional role until it was fully convertible and Chinese financial markets were much deeper and more liquid. Nonetheless, in the medium term, many saw a rising role of the RMB as likely.

Leaving aside the likelihood of shifts in the roles of the dollar and RMB, an important topic of discussion was what impact such changes might have. Some participants argued that the dominant role of the U.S. dollar had eliminated many economic and political constraints on the U.S. government by allowing it to borrow without limit in its own currency; they saw this as more important than seignorage. Thus, they argued that one benefit of an erosion in the role of the dollar would be to reimpose market discipline on the U.S. Conversely, they argued that expanding the role of the RMB would also allow China to gain some of the benefits of being a key currency. Others were more cautious in making optimistic predictions. In terms of the RMB, they pointed out that key currency countries lose some of their ability to manage their exchange rate, and questioned whether China was ready for that. More broadly, they argued that in every post-Bretton Woods crisis the Fed had acted as global lender of last resort and that U.S. fiscal flexibility had allowed the U.S. economy to absorb the exports of distressed economies. If the Fed and U.S. government were to face greater market discipline, they asked, who would act as lender of last resort and market for distressed goods?

SESSION III

Innovative Post-Crisis Economic Cooperation Between the U.S. and China

Session Three looked to the future of China-U.S. economic relations, with the goal of enhancing cooperation in existing and new areas. Many participants saw important opportunities for mutual benefit.

State of China-U.S. Relations

In assessing prospects for bilateral economic cooperation, there was considerable discussion about the current state of China-U.S. relations. Some participants expressed deep concern over populist and nationalist sentiments in the two countries. It was argued, for example, that there had been many Chinese firms that had decided not to invest in the U.S. due to opposition at either the local or national level, and that political discourse about the “threat” of China was fueling popular resentment. Likewise, a few participants worried that populist Chinese reactions to perceived U.S. insults or abuses of its international power had the potential to create a backlash against cooperation with the U.S. even in mutually beneficial areas.

Most participants disagreed with these assessments, however, and expressed confidence that animosity and suspicion would not block effective cooperation. Indeed, many argued that China-U.S. relations in 2009 were perhaps the best they had ever been. Some participants saw the positive dynamic created by the contributions of the two countries in responding to the crisis as increasing the potential for cooperation of all sorts. There was also a generally positive appraisal of the Strategic Economic Dialogue (SED; renamed the Strategic and Economic Dialogue under the Obama administration) and the role of the U.S. Treasury in preventing political posturing from interfering with concrete cooperation between the two countries.

Opportunities for Cooperation

Participants identified several areas in which cooperation could be mutually beneficial. These included facilitation of economic rebalancing in both countries, improvement of FDI environments and technology trade, energy and environmental issues, and exchange programs for up-and-coming leaders.

One suggestion was that China and the U.S. should cooperate in the SED and other venues to rebalance their respective economies—shifting away from consumption and net foreign borrowing for the U.S. and toward domestic demand for China. Some participants suggested that China should use its leverage as a major holder of U.S. Treasuries to encourage greater fiscal discipline, noting with approval recent statements by Chinese leaders about the importance of maintaining the value of the U.S. dollar.

There was some disagreement over how to encourage rebalancing. Several participants expressed concern that U.S. calls for China to increase domestic demand and try to alleviate “underconsumption” appeared punitive. Some were also concerned about the resource implications of a massive increase in Chinese material consumption. Rather than trying to negotiate changes in macroeconomic variables, these participants

argued that it would be better for the U.S. to concentrate on reducing imbalances not only by improving fiscal discipline, but also by expanding its exports to China. In this regard, the argument went, the U.S. has been reducing its export capabilities to China by barring certain high-tech exports and by making Chinese FDI more difficult.

Improving the FDI environment was seen by a number of participants as a useful area of cooperation, even though not all agreed that it would have any meaningful effect on macroeconomic imbalances. Some participants urged the U.S. government to relax what they saw as restrictions on Chinese FDI, including those on state-owned enterprises investing in the U.S. banking sector, which they saw as prejudicial to Chinese banks that operate as profit-making firms, and to clarify and restrict the scope of national security restrictions. Others called for relaxation of constraints on foreign investment in the U.S. tech sector. Both suggested that this was an issue on which official cooperation should focus.

Moving beyond finance and economics, several participants pointed to the potential importance of cooperation over energy and environmental issues. As the world's largest energy consumers and producers of carbon dioxide, it was argued that the U.S. and China had some common interests in pursuing use of alternative fuels and energy conservation techniques, not only because of the positive impact on the global environment, but also because it could improve the efficiency of both economies and reduce external energy dependence. For example, it was noted that China is the world's largest producer of wind turbines, while U.S. firms have been leaders in various pollution abatement technologies. China in particular is in a position to vastly improve energy efficiency by adopting the most up-to-date techniques; several participants argued that the two countries had not made sufficient efforts to take advantage of the potential benefits of accessing U.S. environmental technology. Water management and industrial pollution were also suggested as opportunities for environmental cooperation.

Finally, there was a call for continued people-to-people exchanges. Participants hailed the positive effects of increases in the number of Chinese who had spent time in the U.S. and Americans who had lived in China on improving positive perceptions of each other. Several participants called for exchange programs for up-and-coming leaders in order to expand the range of Chinese and Americans who had good knowledge of their counterparts across the Pacific. There was also a call to reduce barriers to entry into the U.S. for Chinese students and employees.