

Written Statement of Grant D. Aldonas¹
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“U.S. Interests in the Reform of China’s Financial Services Sector”
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Introduction

Chairman Frank, Ranking Member Bachus, and Members of the Committee, I want to thank you for holding this hearing on reforms under way in China’s financial services sector and for offering me the opportunity to appear before you. From the perspective of one who has been involved in our economic relationship with China for over 25 years, since my early days as a Foreign Service Officer in the State Department, there is no single more important topic – for what it says about China’s role in the world economy, for what it portends for our bilateral trade and investment relationship, and for what it means in terms of China’s progress toward a market economy and, ultimately a freer society. I intend to touch on each of those topics as a part of my testimony before the Committee.

I want to start by outlining where China’s capital markets stand today. I will identify the reforms that are needed for China’s capital markets to perform the essential functions of providing liquidity to China’s economic system, steering capital to its most efficient use, valuing assets properly, broadening the vehicles available for Chinese savers and other investors to participate in and contribute to China’s economic success, and the ability of China’s financial markets to serve as a useful economic policy tool.

From there, I think it is important to put China’s reform efforts in a broader economic context, domestically and internationally. After that, I will discuss the potential vulnerabilities inherent in China’s liberalization, the pace of China’s reform efforts, the constructive role that U.S. firms could play as a part of those efforts, and the prospects for U.S. financial services firms in China in the future.

Needed Reforms in China’s Financial Markets

Reform of China’s financial sector is critical to China’s ability to confront the broader economic challenges it faces. China’s capital markets do not currently provide the liquidity for the smaller enterprises that are needed for a shift in its pattern of production and consumption. Failing to address the needed reforms will ensure a

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continuation of the current export-led growth strategy that has caused such friction in the trading system, particularly with the United States, China's most important export market.

In the absence of serious reform and an opening of the Chinese financial system to firms with sound credit practices and healthier balance sheets, China will continue its current pattern of capital inefficiency. The Chinese capital markets should be steering capital to its most efficient use, given that China remains desperately short of capital for longer term investments despite the obvious excess liquidity in the system currently.

China also needs reform in its financial sector to ensure that assets are properly valued. Whether with stocks or real estate or a variety of other speculative investments, China now faces something of an asset bubble without the means to unwind those investments should the market turn down at some point soon.

China also needs reform of its financial sector to ensure that there is a broader range of savings and investment vehicles available to Chinese savers and other investors. Such vehicles create opportunities for a much greater share of Chinese society to participate in and contribute to China's economic success. Access to those vehicles would encourage a much more broadly-shared prosperity than is currently the case throughout China, with all that implies for social and political stability within Chinese society.

China needs financial market reform in order to ensure that its economic policy decisions have some traction in the economy. Currently, the inefficiency of China's capital market prevents Chinese economic leaders from exercising any control over the provision of credit, the quantity or velocity of money, or any other factor without using fairly blunt means of control, generally involving direct controls on the quantity of money in circulation rather than its price, as is the case in most modern economies.

The costs of these weaknesses in China's financial system are manifold, which leads to policies like the current peg of the renminbi to the dollar, which has its own significant negative effects. While much of the debate over China's currency peg here in the United States focuses on the impact on our bilateral trade, in China the peg is viewed as a necessary means to ease adjustment in the financial sector and a means to an end – maintaining export-led growth, which the Chinese believe is necessary until reforms in the financial sector can foster the more balanced growth they need.

That argument is, of course, almost precisely backwards in terms of what China most needs to ensure greater capital efficiency and to regain control over its monetary policy so that it can be used to foster more balanced economic growth and a more broadly-shared prosperity. A floating exchange rate would lead to more efficient use of capital throughout the Chinese system, which would facilitate adjustment, rather than retard it. In addition, it would allow the Chinese central bank to concentrate on domestic economic management and improving the banking sector, rather than spending most of

its time worrying about sterilizing dollar inflows and figuring out how to recycle its foreign exchange surplus.

In that sense, the currency peg and all that it implies about the focus and pace of China's economic reforms offers a counterpoint to the undoubted economic success China has enjoyed since embarking on its path to liberalization nearly 30 years ago.

Broader Economic Context of China's Efforts at Financial Sector Reform

For all of the concerns that its financial sector raises, the pace of China's economic growth remains impressive. It surged in the first quarter of this year to 11.1 percent.² The World Bank recently raised its prediction for growth in China's gross domestic product ("GDP") this year above 10 percent. Should China meet that prediction, as I expect it will, it will mark over a decade of near double-digit economic growth.

The benefits of growth have offered real prosperity to a broader range of China's people. Urban per capita disposable income has risen 127% over the past 10 years; rural per capita net income has grown as well, although not nearly as fast (approximately 72% over the same period). China's domestic savings amount to \$1.113 trillion or roughly half the size of China's economy of \$2.512 trillion measured.³

China's international position is probably well known to the Members of the Committee. It has a large and growing current account surplus, both globally (\$250 billion in 2006 or roughly 9 percent of GDP) and bilaterally with the United States (\$233 billion over the same time period)⁴. In the first four months of 2007, China's current account surplus jumped by 88 percent over the same time period in 2006.⁵ That current account surplus has translated into foreign exchange reserves estimated at \$1.2 trillion.⁶

What those reserves, on top of the continued strong economic performance, suggest is that now is the optimal time for China to undertake the needed reforms of its financial markets.

The same holds true of the international economic environment. China's growth has paralleled strong economic performance worldwide. The International Monetary Fund, in its most recent report on the state of the world economy, highlighted the fact that the world economy is growing faster than at any time in the past three decades.⁷ The IMF also sees less risk in the current economic environment than it has in some time – risk that has declined even over the last 6 months.⁸

² *The Economist*, May 19, 2007, at 75.

³ Measured on a current exchange rate basis. *CIA World Factbook (2006)*.

⁴ *Id.* at 73.

⁵ *Id.*

⁶ *Id.* at 74.

⁷ *IMF World Economic Outlook (2007)*.

⁸ *Id.*

While the U.S. economy has slowed, we will still see considerable economic growth this year of 2.6 percent, which, while not dramatic, is reasonable for this stage of the business cycle. In the meantime, growth has improved in a number of other major industrialized countries, Japan (2.2 percent growth in 2006; expected growth of 2.3 percent in 2007 according to the World Bank) and Germany (2.2 percent growth in 2006; 2.3 percent expected in 2007).

The current global economic growth is much more broadly shared than you might expect. In 2005, for the first time ever, the developing world accounted for more than 50 percent of the world's GDP. Those countries contributed considerably more than 50 percent of world GDP growth. China and India combined represented only 25 percent of the developing world's contribution to world GDP growth that year.

In other words, economic growth today is much more widespread and the international economic environment more benign than it has been in many years. That offers a stronger buffer against any potential global fallout from China's efforts at reform and financial market reform. Again, the time would appear ripe for China to undertake the needed reforms in its financial sector.

Potential Vulnerabilities in China's Liberalization of its Financial Markets

China's impressive record of economic growth tends to obscure some serious economic vulnerabilities. Chinese officials often cite those potential vulnerabilities as reasons to delay reform. But, the reality is that any reform entails economic change and some risk and the one thing that can safely be said about each of the vulnerabilities discussed below is that they will only get worse if left unaddressed.

The first and most important Chinese economic vulnerability is the disparity between the high economic growth along China's coast in those portions of the Chinese economy that are already deeply integrated into the global economy and the slow growth in China's interior provinces where most of China's population still lives. In China, those who are fortunate enough to live and work in the coastal provinces that are most involved in China's engagement with the global economy have both the income to afford and access to most of the material benefits of life in a global economy. Individuals have much greater freedom to determine with whom they will work and to bargain freely with their employers for the value of their labor.

By contrast, life farther west in China almost belongs to another time in China, one in which peasants engage in near subsistence farming and what employment exists in local factories is still subject to significant oversight, if not control, by local party officials. Recent years have been marred by a growing number of protests, at times violent, by peasants who are seeing their real income decline while much of the rest of the country prospers.

China's capital markets and financial sector do little to alleviate the conditions in which the vast majority of Chinese workers live. Chinese firms do not help those living in poverty to convert what assets they have to capital in order to create a better life for themselves. Furthermore, the statutorily regulated rate of return on interest rates paid on savings in state-owned banks offers little in the way of return or reward for savings and investment. To that extent, the lack of a functioning capital market and a financial sector in which banks and other financial service providers are competing for customers is contributing to the growing friction between those living on the land and local officials.

The risk of reform, which would involve a considerable restructuring of the banking sector and the potential collapse of state-owned banks weakened by the burden of non-performing loans and the continuing demands to provide credit for politically-motivated investments, could have a ripple effect through the countryside that would exacerbate the continuing friction there. But, the far greater risk comes from failing to undertake the reforms in ways that would help address the needs of Chinese citizens in the western provinces. Done with the goal of serving the bottom of the economy as well as the top, financial sector reforms could do a great deal to alleviate the strains in Chinese society that flow from China's two-speed economy.

The second vulnerability flows from the mix of economic activity in China, which has been heavily distorted by the failure of the financial sector to discipline investment practices (i.e., ensure that investments are made for market-driven reasons, rather than political motives). Easy credit available to state-owned firms or recently "privatized" firms in which the government still holds a significant stake and still influences management decisions has led to a boom in certain investments in heavy industry. When combined with the relative laxity with which Chinese state-owned banks demand repayment from such firms, the system overall has produced considerably greater investment in certain capital-intensive industries than might otherwise have been warranted if credit practices were such that they accurately gauged the risk and likely return of the proposed investments.

In steel, for example, China has added over 100 million tons of new steel capacity (a sum equal to or larger than the entire installed capacity in the United States) over the past few years. The same sorts of credit practices have kept antiquated production in place, rather than forcing it out of business. As significant as that seems, it is even starker against the backdrop of the steel industry globally, where consolidation is still taking place and where there is still considerable excess capacity. What that means is that much of China's investment in steel was unnecessary. Chinese manufacturers could easily have purchased steel at low prices on world markets and the capital invested in steel could have gone to meet other needs within China.

Financial sector reforms that tighten credit practices will inevitably confront well-entrenched economic interests that are likely to prefer the current state of affairs. That will generate considerable conflict between the central government and its provincial counterparts, which are frequently complicit in pressuring the state-owned banks for easy terms for pet industrial projects at the provincial level.

That said, it is also true that the problem of easy credit and politically-motivated lending tends to compound the politically difficult reforms that the Chinese face just like interest compounds on unpaid debts. As difficult as it may seem now, this festering problem will only get worse as time goes on and the needed adjustment will be far more dramatic if the current state of affairs proceeds unchecked.

The third vulnerability in China's economy flows from its heavy dependence on export demand as the main driver of its economic growth. Although there has been a recent increase in consumer demand, much of China's growth continues to depend on exports. To the extent that lax lending practices make credit available for export-driven industries, it is not surprising that they continue to add capacity and drive world market prices for many commodities.

The problem, of course, is that China's heavy dependence on export-led growth, particularly when focused on a limited number of markets like the United States and Japan, makes China's overall economic health heavily dependent on continued economic growth and rising import demand in those target markets. A sharp decline in the U.S. market, for example, would have a serious rebound effect on China's own growth prospects. A general slowdown globally would magnify that problem.

This is what leads to the absurd situation in which China is lending money to the largest and most highly developed economy in the world – the United States – in order to continue its purchases of Chinese goods and services. That is a far more serious economic problem from China's perspective than it is from ours.

Consider what China's export-led strategy means in the context of China's development. China is a labor-rich, capital scarce country that still has a very considerable distance to go in terms of alleviating basic poverty for nearly 700 million of its citizens, much less offering hope of real prosperity. To raise those people out of poverty, China badly needs capital investment in the interior to raise productivity, which will generate higher incomes for individual Chinese currently living in abject conditions.

But, rather than employing its capital in the Chinese economy to meet the needs of those citizens, it is lending the money at extraordinarily low rates of return (relative to the return the same investment could garner if invested on global markets) to the United States government in the form of China's purchases of our Treasury notes. Rather than employing its capital at home, China is lending to the most capital rich nation on Earth.

It is precisely this situation which has led to China's creation of an agency to manage its foreign reserves and to an initial investment of \$3 billion in The Blackstone Group ("Blackstone"). The investment in Blackstone represents an effort to gain a greater return on the foreign reserves China holds and, in that respect, represents a step forward in terms of its approach, but not one that is calculated to lead to capital investments where it is needed most, in China's western provinces.

Reform of China's financial sector is absolutely essential to encouraging a shift towards domestic demand. Until Chinese businesses have vehicles that allow them to finance expansion, they will continue to save in order to acquire the needed capital assets for expansion. Until Chinese consumers feel that they have a number of different financial vehicles to hedge different kinds of risk, they are likely to continue saving at extraordinarily high rates since those savings are the only hedge they have against catastrophic illness or the loss of a job.

China's reliance on export-led growth generates the fourth serious vulnerability. China's reliance on exports to fuel growth translates into an extraordinary current account surplus. Critics of trade with China regularly point to China's bilateral trade surplus with the United States as reason for retaliation, which led to the introduction of nearly 30 bills urging retaliation against China in the 109th Congress and the introduction of another dozen such bills in the first five months of the 110th Congress.

Without addressing the merits of each bill or the merits of the underlying complaints that motivated them, the obvious point is that China's heavy reliance on export-led growth stimulates a backlash from competing industries and workers in importing countries for protection. That risk is as serious for China today as I have seen it for any country in nearly 30 years of working in U.S. trade policy.

The phenomenon is not limited to the United States alone. Europe has introduced significant quantitative limitations on Chinese textile exports and is contemplating similar restraints on imports of Chinese shoes. India has become the largest user of antidumping actions – surpassing even the United States – and most Indian antidumping actions are directed against China.

While I disagree with the intense focus on and proposed solutions for our bilateral trade deficit with China, there is undeniably merit to the concerns that distortions in China's economy have serious effects on the U.S. economy.⁹ But, in point of fact, most of the serious distortions flow from the lack of a functioning capital market that adequately prices risk and steers capital toward its most efficient use. In other words,

⁹ Economists frequently suggest that we should be indifferent to subsidies or other market distortions in foreign countries that have the effect of increasing production or enhancing the competitiveness of a country's exports. But, in such instances, the effect is to stimulate investment in the subsidizing country that would not otherwise exist under market conditions. In the economists' jargon, such subsidies or other market distortions imply that the subsidizing country is not operating at its pareto optimal state. With an economy as open as that of the United States, with multiple avenues for the transmission of the price effects that such subsidies or distortions engender, that implies that the United States (or any similar importing country) will see its investment pattern shifted in reciprocal ways that leave it short of its own most efficient (i.e., pareto optimal) state. That holds true even if exchange rates adjust to account for the effect of subsidies (although I am skeptical that exchange rates adjust to such influences given the much more significant impact that real interest rate differentials have on such movements). If exchange rates were to adjust, they would similarly affect the mix of investment in the United States or another importing country in ways that were suboptimal. In other words, there is a cost to both the exporting and importing countries when one country tries to gain advantage or simply distorts its own investment pattern through an inadequately functioning capital market, as is the case in China today.

financial sector reform is the key to resolving many of the underlying problems that create serious tensions in bilateral trade relations between the United States and China.

In fact, rather than exacerbating the vulnerability that might flow from a protectionist backlash against China's export-driven economic growth, financial sector reforms would eliminate many of the underlying distortions that give rise to legitimate complaints regarding the economic effects of China's economic policies, including its regulation of the financial sector.

Pace of China's Reform Efforts

Since the onset of general economic reform in 1979, China's financial sector has gone through what are generally regarded as four relatively distinct phases of reform. The first phase, from 1979 to 1986, involved the breakup of the single bank system in favor of a banking system in which the People's Bank of China ("PBC") served as the central bank. The Industrial and Commercial Bank was created to handle urban commercial banking, joining other specialized institutions such as the China Construction Bank (construction), the Bank of China (international trade and foreign exchange transactions), and the Agricultural Bank of China (rural lending).

The second phase of reform, from 1987 to 1991, saw a decrease in administratively governed speculation among institutions and significant growth in non-bank financial intermediaries. The second phase also saw the establishment of the first state-owned insurance companies and the rudiments of a capital market in the form of a secondary market trading in government securities.

The third phase of reform, from 1992 to 1996, brought further diversification. Shanghai and Shenzhen saw the creation of stock exchanges. An inter-bank market developed. Some interest-rate flexibility was introduced. Life and non-life insurance licenses were granted on a limited basis to foreign firms, with significant limitations compared to similar licenses offered to domestic insurers.

The fourth phase of reform, from 1997 to 2001, shifted attention to the portfolios of China's banks and governance issues in the wake of the Asian financial crisis. At the same time, China launched a series of reforms that were designed to prepare the way for China's accession to the World Trade Organization ("WTO"). This brought a host of changes from restructuring the PBC to clarifying the roles of the China's insurance and securities regulatory agencies to the creation of new classes of financial instruments needed to implement specific WTO obligations, such as the opening of automobile financing to parallel the increased market access for foreign-manufactured automobiles.

Just prior to WTO accession, roughly 200 foreign banks operated in China. They largely served the needs of enterprises established by foreign investment. They were subject to restrictions on location, products offered, and investment opportunities. They were also subject to vastly different tax and regulatory regimes, which tended to limit the interaction between domestic and foreign banks in the Chinese market, as well as

competition and technological spillover to the Chinese market for financial services generally.

Relevance of China's WTO Commitments on Financial Services

China's accession to the WTO marked a significant step forward in terms of both liberalization and restructuring, with one driving the other. China agreed to a variety of market openings¹⁰ –

- **Banking:** China allowed foreign banks to begin foreign currency operations upon accession and phased in local currency operations over the next 5 years. Foreign banks began offering local currency services to Chinese enterprises 2 years into the phase-in period; local currency services to all Chinese were to be opened at the end of the 5-year period. China opened 4 cities to foreign banks upon accession and opened an additional 4 thereafter. China also agreed to lift all discriminatory non-prudential measures restricting foreign ownership of banks and their branches.
- **Securities:** China agreed to allow foreign securities dealers to engage directly in B share business immediately upon accession. China agreed to allow investment banks to establish joint ventures with foreign ownership not exceeding 33 percent 3 years following accession. Such ventures were to be allowed to engage directly in underwriting domestic securities (B and H shares, government and corporate debt). China allowed representatives of foreign securities companies to become special members of Chinese stock exchanges.
- **Fund Management:** China agreed to allow the establishment of joint venture fund management companies upon its accession to the WTO, with foreign ownership not to exceed 33 percent. The foreign ownership limitation was to be raised to 49 percent after three years.
- **Insurance:** China agreed to phase out all geographic restrictions within 3 years of accession. It allowed foreign life insurance companies to provide individual (non-group) policies at that time. The policies they could write were to be expanded to include health insurance, group insurance, pension insurance and annuities for Chinese and foreign customers 2 years after accession. China opened its reinsurance market upon accession without restriction. Foreign life insurers were allowed to hold 50 percent ownership in joint ventures and were allowed to choose their own joint venture partners. For non-life insurance, China allowed branching or 51 percent ownership upon accession and wholly-owned subsidiaries 2 years after its entry into the WTO. China agreed to grant licenses solely on the basis of prudential criteria with no economic needs test or quantitative limits on the number of licenses.

¹⁰ The discussion of China's commitments on financial services is drawn from a very helpful survey of its accession to the WTO done by the World Bank. *See China and the WTO: Accession, Policy Reform, and Poverty Reduction Strategies 181-190 (2004).*

What should be immediately evident from that summary is that China did agree to a significant liberalization of its financial sector as part of the accession process. The changes wrought by accession were bound to redistribute the flow of funds within the Chinese system through a series of different intermediaries. Those shifts were bound to bring new pressures to bear on the Chinese banks, which ran high cost operations and had limited flexibility in lending practices due to the political pressures brought to bear on them to lend to specific projects regardless of credit risk. The Chinese banks faced this new competition in a relatively weak state, with portfolios of non-performing loans conservatively estimated at 30 percent or more.

What should also be apparent is that the accession process would continue to allow significant restrictions on the operations of foreign financial service providers, both in terms of their ownership interest, the products they could offer and their geographic reach. The accession commitments, while considerably stronger than any previously agreed to by a developing country, were simply too limited in too many ways to contribute to a fundamental restructuring of the Chinese financial sector.

To the extent that one of the goals of China's accession process was to encourage a much more efficient allocation of capital and resources throughout the Chinese economy, the commitments undoubtedly made an impact – one that will continue to grow over time as improved banking practices and other business processes filter through the Chinese system due to increased competition. But, it is safe to say that the broader access offered to foreign financial service providers did not have and will not have the impact it might have or could have with a much broader opening of China's market.

Broader Economic Policy Goals Will Require China to Reach Beyond its WTO Commitments

In the current round of multilateral trade negotiations under the WTO, China has essentially adopted the position that it “paid at the office.” China views the commitments it made as part of the accession process as sufficient for the Doha round as well. That rejection of further liberalization applies to financial services as well as agriculture, manufacturing and other service sectors.

Whether China could ultimately sustain that stance in the face of the rest of the WTO membership's willingness to undertake considerably greater liberalization remains to be seen. The Doha process has ground to a halt over agriculture and little has been done in the way of preparatory work on services that would allow U.S. firms to see the outlines of what a Doha round agreement would mean for them in China or elsewhere.

The reality in China, however, is that its broader economic policy goals are likely to force the pace of financial sector reform even without a Doha round agreement. There is nothing in the current system that will allow the government to exercise greater influence on inflation and economic growth within the Chinese economy, encourage the broader provision of financial services that would ease many of the adjustment pressures

it faces in its two-speed economy, or help in providing a social safety net by providing financial products that would allow Chinese citizens to diversify types of risk and hedge accordingly.

The health care sector offers an interesting example. China's leaders recognize that they will need private health care companies to provide much of the needed expansion of medical services if China is to improve its social safety net. Toward that end, they have recently announced significant reforms in the health care sector. Those reforms will not be effective in reaching a much broader swath of the Chinese people without considerable expansion of the health insurance sector and a diversification of the products they offer.

The same holds true with China's pension system. China is in the long-term process of shifting from an entirely state-owned and operated retirement system to one that depends heavily on the market to create different investment vehicles to allow individual Chinese to provide for their own retirement. That shift simply is not possible without a significant expansion of the Chinese life insurance market.

China's "go west" campaign, which is designed to foster greater economic development in China's interior provinces, has been largely financed by the government itself. That effort has largely focused on infrastructure. As needed as such infrastructure is, real self-sustaining economic growth and a broader, more-evenly shared prosperity will not follow if the financial sector does not provide greater liquidity for smaller enterprises and options for individual Chinese to convert what capital they have in the form of land or other assets to working capital.

China's efforts to renovate its industrial north have been entirely financed by state-owned banks backed by government financial support. That entire process of eliminating outmoded industrial production in favor of more modern production processes, as well as creating new industries and jobs for displaced workers, would be more easily accomplished with a financial sector that was experienced in the process of breaking up bankrupt companies, getting the most value for their assets, or stripping costs out of production processes and putting the companies back on their feet in a healthier form. That is what a well-functioning financial market can do better than any government lending program.

What all of China's economic challenges ultimately requires is a far broader opening of China's financial services sector to competition that will drive down costs and increase the availability to credit and other financial services to a much broader range of Chinese enterprises and individuals. The point is that China needs to open its financial markets not simply due to WTO commitments, but due to the needs of its rapidly growing economy and the rising expectations of its citizens.

What is surprising in that context is that the Chinese do not make virtue out of necessity and use the potential opening they know they have to undertake to their advantage in the Doha Round. Further commitments to financial sector liberalization in

the context of the round would go a long way to permitting China to obtain what it most wants and needs out of the round, which is not just greater assurance of market access for its exports to the United States and other developed country markets, but commitments from its fellow developing countries, where the instinct toward protectionism is far stronger than it is in the United States or other industrialized states.

Role for U.S. Firms in Reform

As the foregoing suggests, there is an extraordinary role for U.S. financial services firms to play in the process of financial sector reform in China. While we do not often think of the financial sector's role as one of facilitating change, that is in fact what it does best. In the process of accurately valuing assets, extending credit, allowing businesses and individuals to mitigate risk, and creating new savings and investment vehicles that allow a broader spectrum of society to participate in economic success, the financial sector also provides the all important grease that eases the transition from one economic state to another.

American financial firms have what China needs. China has proved hungry for U.S. technology in manufacturing throughout the nearly 30-year old process of economic reform launched by Deng Xiaopeng in 1979. What has been missing to date has been an equal interest in the financial innovations that American firms bring that would help China face its most pressing economic problems.

Perhaps most importantly, opening the Chinese financial sector fully to the U.S. financial services industry would also be an extraordinary tonic for U.S.-Chinese bilateral trade relations, although not for the reasons many expect. That opening does not imply a trade off between our financial sector's export interests and the continuing fight import-competing industries face from Chinese manufactured goods in our home market. Rather, opening the Chinese financial market would prove instrumental in ensuring that the competition in the manufacturing sector was fair.

As noted above, China's state-owned banks face continuing pressure to provide credit at favorable terms to pet industrial projects at the provincial level. Those loans often go unpaid, which is precisely the reason for China's ongoing non-performing loan problem. But, what that also means is that the Chinese manufacturers that benefit from such credit practices face a near zero cost of capital. Indeed, the provision of credit on those terms favors heavy investment in capital intensive industries (read manufacturing).

Those practices ultimately have a far more pernicious impact on the competition faced by U.S. manufacturers than does a pegged exchange rate or other Chinese practices that form a part of a more mercantilist approach to trade. In the absence of bad credit practices, that production capacity would not exist and would not depress prices globally, regardless of the rate at which China pegged its currency to the dollar.

The involvement of U.S. financial firms would help in two significant respects. The first is with respect to the Chinese banks themselves and their recurring non-

performing loan problems. The best analogy I can think of in a U.S. context is the savings and loan crisis of the 1980s. When savings and loans went under, what was needed was a significant opening of the market to other credit providers with stronger balance sheets that could take over the troubled savings and loans, sort out the bad non-performing assets from the good, and continue the functions of providing credit to the local market.

The same situation prevails in China today. Chinese banks and the Chinese banking system would benefit significantly from the entry of much stronger U.S. banks with sturdier balance sheets to help clean up the system while continuing to provide much needed liquidity to the Chinese economy.

The entry of American firms would also help reduce the trade frictions we face by squeezing bad lending practices out of the market. Chinese banks that persisted in the bad lending and credit practices of the past would rapidly find themselves competing with much stronger banks and would have to respond by cleaning up their processes or facing bankruptcy or a takeover.

What that would do is end the contribution that those same credit practices make to current trade frictions with China. The process of adding industrial capacity regardless of the actual demand for its output and expecting export markets to provide an outlet for the production when it exceeds Chinese needs would come to a grinding halt.

Moreover, the overall capital efficiency of the Chinese economy would rise. That would steer credit to worthier investments and allow the system to serve a much broader range of Chinese enterprise and citizens than it currently does. That is what the Chinese should be focused intently on in light of the economic challenges they face.

Prospects for U.S. Companies Going Forward

As I indicated earlier, the broader economic reforms under way in China are likely to create significant new opportunities for American financial service providers. In several respects, there is a significant and healthy intersection of interests between what China needs most and what American financial firms can provide. Indeed, China needs exactly what American firms are the best in the world at – financial innovation.

Let me take just one example – health insurance. China's proposed health care sector reforms have only just begun. They point toward a mixed system of state-provided care and a far larger role for private health care providers.

Within that system, China faces a growing challenge in its aging society. Due to the one-child policy, Chinese society is aging before it grows rich. In that sense, the real health care needs will rise due to the age of the population, just as they have here in the United States and as they have in Japan and Germany, which face similar demographic challenges. Costs will rise as well simply because health care in the later stages of life is more complicated.

What the one-child policy also implies is that there is less of a family network to fall back on as an insurance policy against a catastrophic injury or health care crisis. Caring for aging parents will be costly enough, but could spell financial disaster for a single child trying to create his or her own economic future in China's highly competitive market.

What that means is a much broader need for financial mechanisms to hedge the risk of injury or disabling disease. It also means the much broader need for the business processes and technologies that reduce the cost of providing care. The challenges China faces will mean a much broader need for administering a system of mixed government and private care in terms of record-keeping and other management functions. And, perhaps most importantly, it will mean a much broader need for techniques of cost management to control the rising cost of health care in an aging society.

Those are precisely the roles that American health insurance companies play in the American economy. The changes under way in Chinese society and the Chinese economy are creating a demand for the sorts of innovations that American health insurers have used successfully in the United States to expand coverage, reduce administrative costs, and encourage broader cost reductions elsewhere in the health care sector. A much broader opening of China's health insurance market – one that actively recruits American firms to help solve the challenges China faces – is what China should pursue as part of its broader effort to reform its health care system.

There are many other opportunities that Chinese needs create for American firms, but suffice it to say that the potential is vast because the needs are so great. What is needed is the vision and the political will on the Chinese side to allow American firms to help meet those needs.