

Remarks by David Loevinger
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Cooperation between U.S. and Chinese officials, business leaders and self-regulatory agencies is essential, as the global economy and financial system enters into another period of turbulence. It's now as important as ever for the two largest economies to work together to support confidence in the global economy and create a global financial system less prone to booms and busts.

Through bilateral engagement such as Vice President Biden's recent visit and the Strategic and Economic Dialogue, multilateral bodies like the Financial Stability Board and IMF, and conferences like today's, the United States and China are working together to promote economic growth that is strong, sustainable and more balanced.

I will highlight several issues today: 1) the implications for China of changes in the U.S. economy; 2) the role of financial sector reform in promoting sustained and more balanced growth; 3) the importance of open investment policies; and 4) how we must work together to strengthen our financial systems.

People have predicted America's economic demise before, and been proven wrong. We have a mobile, flexible, resilient, and innovative economy. Some of the current weakness in the U.S. economy, such as the constrained growth of household consumption, is because households are making the necessary but painful adjustments, such as reducing their debt, to put their finances on a more sustainable position. We are also working to keep our long-term public finances on a sustainable path. The debate about our budget is fundamentally about how we are going to increase public sector savings to complement the increase that has occurred in household savings (*slides 2 and 3*).

An important implication of these adjustments in the United States for China is that, in order to sustain growth and bring prosperity to its people, China must shift its growth model to rely more on consumption, as set forth in its 12th Five Year Plan. U.S. and Chinese efforts to rebalance won't be easy. But we have a shared interest in each other's success.

Financial Sector Reform Key to Rebalancing

Financial sector reform has a critical role to play in this economic transformation. While growth of China's inter-bank market is an indication of how far China's financial market reforms have progressed, more work is needed to channel China's savings efficiently to its most productive firms and sectors, and provide a broader range of financial products for Chinese households to meet their financial goals and insure against life's risks.

Chinese officials often say that China's financial institutions aren't ready for a more flexible exchange rate. As highlighted in the IMF's most recent China Article IV report, however, China's rigid exchange rate policy impedes financial sector development and increases financial

risks. As the People's Bank of China (PBoC) buys foreign currency to slow the RMB's rise, it forces banks to maintain more low yielding reserves at the PBOC to contain money supply and inflation (*slide 4*). To mitigate the adverse impact of these operations on banks' income, the PBoC has kept deposit rates low, even as inflation has increased. So naturally depositors move assets to less regulated, higher yielding instruments. With important benchmark interest rates fixed, it is also more difficult to create a robust and market oriented bond market where credit is appropriately priced.

Another important financial development is the growth of the offshore RMB market in Hong Kong. While still at an early stage, over the long-term this development could impact Chinese financial markets and institutions. An increasingly liquid and diverse offshore RMB market – where companies can raise funds as long as they meet listing requirements, and can access all of the world's major financial institutions and institutional investors and a broad array of sophisticated financial instruments – could become over time an increasingly viable alternative for some Chinese companies to the onshore market that limits access to global financial services firms, and requires regulatory approval for many listings and new products.

Foreign Participation in the U.S. and Chinese Financial Sectors

Foreign direct investment can contribute to economic transformation and financial development in both countries. Vice President Biden was very clear about our openness to foreign investment, including from China, and in the financial sector.

We benefit greatly from the participation of foreign firms in our financial sector. For example, foreign banks control more than a 20 percent share of the total assets in our banking system.

In recent years Chinese banks and securities firms have opened bank branches in the United States, the Chinese sovereign wealth fund CIC acquired a substantial stake in a major U.S. bank, and a Chinese bank successfully purchased a U.S. securities firm in November.

The Committee on Foreign Investment in the United States, or CFIUS, implements our open investment policy by focusing solely on genuine national security concerns.

CFIUS applies the same rules to each transaction it reviews, without regard to the investor's country of origin. Numerous Chinese investments in the United States have passed successfully through the CFIUS process. Investments by state-owned enterprises and other foreign government-controlled investments, from both China and other countries, have also passed successfully through CFIUS. On the relatively few occasions that a foreign investment raises national security concerns, CFIUS works to resolve such concerns expeditiously so that the transaction may proceed. Rarely does CFIUS recommend that the President prohibit or unwind an investment.

In comparison, foreign participation in China's financial sector remains severely constrained. Among its peers in the G-20 and Financial Stability Board, China stands out as the nation with the most restrictive policies (*slide 5*). See for example the OECD's chart on how China

measures up in the financial services industry, or the World Bank's data on openness to foreign equity ownership in the banking sector (*slides 6 and 7*).

While our legal and policy commitment to open investment is clear, it is more challenging to sustain public support for open investment policies when U.S. companies face investment barriers in China, like the kind they face in China's financial sector. It is difficult to explain to the American people why it is fair to allow Chinese companies to acquire 100 percent ownership of U.S. companies when U.S. companies are prohibited from wholly buying Chinese companies in many sectors.

Chinese financial institutions that aspire to be global leaders and want to follow their Chinese corporate customers, who are increasingly investing in the United States, cannot avoid the U.S. market, the world's largest and most innovative. As Chinese financial services companies increasingly seek to go out and invest abroad, the reception they will face in the general public, and in popular opinion, will be impacted by the extent to which China maintains such pervasive restrictions on FDI in its financial sector.

U.S.-China Regulatory Cooperation Essential

Finally, as companies from both sides are increasingly active in each others' financial markets, robust cooperation between financial regulatory agencies has become increasingly important.

Such cooperation serves to support essential market confidence in a sector characterized by information asymmetries. Market confidence is hard to gain, but easy to lose.

After scandals at Enron and WorldCom, investors lost confidence in U.S. accounting practices, which raised the cost of capital for many innocent companies. Now investors have raised questions about accounting practices at some small Chinese companies listed in the United States. This has led to a drop in confidence in Chinese firms by overseas investors in both equity and debt markets, pushing up their cost of capital (*slide 8*).

The Sarbanes-Oxley law that responded to the earlier accounting and corporate governance scandals established a system to give investors confidence that auditors of companies listed on U.S. exchanges, from all countries, were qualified. To that end, our regulators have developed cooperative agreements with regulators from all major financial markets, except for China. China and the United States have a shared interest in assuring that investments made by U.S. citizens in Chinese companies can be made with confidence. With the support of the U.S.-China Strategic and Economic Dialogue (S&ED), regulators are working to find a mutually agreeable way to be able to review auditors' internal procedures while respecting national sovereignty.

Beyond bilateral coordination, the United States and China have worked together effectively in multilateral bodies to develop international regulatory reforms to respond to the financial crisis. For example, both the United States and China have promoted the importance of higher levels of high-quality, loss absorbing capital at internationally active banks, which has become a key feature of the Basel III capital framework.

Starting with President Hu's visit, the S&ED, and most recently Vice President Biden's trip, we've made much progress in strengthening our economic and financial relationship. But our biggest enemy is complacency. Both countries are entering a period where domestic political considerations are paramount. In the United States, jobs are the most important economic issue, and this is reflected in the political campaign. China's continued intervention to suppress the rise of its currency, refusal to join major international agreements such as the WTO code on government procurement, and lack of protection of foreign intellectual property, open up China to accusations that it is stealing jobs. Whether or not the accusations are fair, they will make it more difficult to promote the cross-border trade and investment that enriches us all.