

How Will Reform of China's Financial Sector Help American Workers?

The rate of China's continuing expansion and the impact of its integration into the global trading system are unprecedented in the history of the world's economy. Over the last four years the United States and China have accounted for half of global economic growth – and that already stunning figure will only increase in coming years. Since China's accession to the World Trade Organization (WTO) in December of 2001, trade between the United States and China has nearly tripled, exports to China have grown at five times the pace of U.S. exports to the rest of the world, and China has risen from our 9th largest export market to our 4th largest.

Fair and competitive access to China's fast-growing middle class and business sector represents an unprecedented commercial opportunity for U.S. manufacturers, farmers, and services providers, with major implications for U.S. economic growth and job creation. But to continue growing, China desperately needs a more open, competitive, and effective financial system.

At present, China's weak banking system intermediates nearly 75 percent of the economy's total capital, compared to about half in other emerging economies and less than 20 percent in developed economies. Despite some improvements in recent years, Chinese banks' credit analysis, loan pricing, risk management, internal controls, and corporate governance practices remain inadequate. Meanwhile, China's equity and bond markets are among the smallest and least developed in the world.

A more open and effective financial system in China is also the key to resolving two of the major issues that have complicated the economic relationship between the United States and China: 1) the need for greater flexibility in China's currency, the yuan; and, 2) meaningfully addressing the U.S. trade deficit with China.

- **A More Market-Determined Exchange Rate:** Chinese authorities have repeatedly argued – reasoning generally acknowledged by most foreign analysts – that a more rapid shift to a market-determined yuan is not possible given the underdeveloped state of China's capital markets. More specifically, China's banks, securities firms,

and other businesses lack the expertise to develop and trade derivatives and other structured instruments used to hedge the risk associated with greater currency volatility. Sophisticated derivative products and hedging techniques provided by foreign financial services firms would clearly diminish such concerns.

- **Reduction of Trade Deficit:** Activating China's 1.3 billion consumers is essential to successfully addressing international trade imbalances. Chinese households historically save as much as a third of their income, as compared to single-digit savings rates in the United States and Europe. This pronounced propensity to save is related to the declining role of the state and the fact that most Chinese depend on their families and private savings to pay for retirement, healthcare, and the economic consequences of accidents or disasters. Activating the Chinese consumer requires the availability of financial products and services – personal loans, credit cards, mortgages, pensions, insurance products, and insurance intermediary services – that will eliminate the need for such “precautionary savings” and facilitate consumption.

The fastest way for China to acquire the modern financial system it needs to continue growing, allow for a more flexible currency, and activate the Chinese consumer is to import it – that is, by opening its financial sector to participation by foreign financial services firms. Foreign institutions bring world-class expertise and best practices with regard to products and services, technology, credit analysis, risk management, internal controls, and corporate governance. In addition, the competition brought by foreign institutions would accelerate the adoption of such techniques and methodologies by domestic financial institutions.

By providing the financial products and services that Chinese citizens and businesses need to save, invest, insure against risk, create and protect wealth, and consume at higher levels, foreign financial institutions (including U.S. providers) would help create what every U.S. manufacturer and service provider wants – an unleashed Asian tiger hungry for U.S. products.