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China Development Research Foundation

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

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Final Report

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

The 21st China-U.S. Symposium of the Program on International Financial Systems was held at Harvard University on June 5-7, 2024. Topics included the effects of bilateral tensions on the U.S.-China financial relationship, the effects of innovation and regulation on the development of Chinese and U.S. public capital markets, AI applications in finance, and the macroeconomic environment including prospects for growth and global capital flows.

Topic 1: The U.S.-China Financial Relationship

In Topic 1, participants discussed the development of the U.S.-China financial relationship. There was a particular focus on what participants saw as rising political tension between the two countries and its potential impacts on cross-border finance. While participants expressed concern that political tensions could constrain cross-border transactions, they also saw finance as a sector in which there was considerable benefit for both countries and thus opportunities for continued cooperation.

Rising U.S.-China Tensions

Participants agreed that there had been a substantial increase in U.S.-China political and economic tensions albeit that that this was a long-standing issue. On the U.S. side, many participants argued that suspicion of China had become widespread throughout the political system, with both parties taking positions meant to curb China's economic influence and technological progress. Notably, the Biden administration had retained most Trump-era tariffs and restrictions, while also adding new restrictions. While the emphases of the two presidential candidates differed somewhat—with Trump more focused on bilateral trade deficits and Biden more focused on protecting industrial workers—some degree of decoupling or "derisking" had come to be accepted as desirable across the political spectrum. On the Chinese side, a number of participants made the case that policies such as "Made in China 2025" were focused on increasing technological self-sufficiency and reducing dependence on intellectual property and supply chains involving the U.S. and its allies.

Participants advanced several explanations for rising tensions, including economic competition, industrial policy concerns, potential supply chain disruptions, and national security concerns. Some saw parallels to U.S.-Japan economic tensions in the 1980s and early 1990s, but also noted that the U.S.-Japan security alliance had acted as a constraint on both governments. In contrast, China and the U.S. were security rivals, raising concerns that cycles of economic retaliation in would be difficult to contain.

The changing nature of U.S.-China economic competition was cited as a major concern among the U.S. public and policymakers. Three points stood out. First, participants noted that China had moved rapidly up the value chain, which meant that its companies were increasingly competing directly with U.S. companies and production facilities in their areas of greatest comparative advantage. Second, China was seen to be approaching or taking leadership in a number of technologies deemed critical to U.S. economic and security interests, including AI, electronic vehicles and batteries, and renewable energy. Third, China had developed excess capacity in a variety of industries, ranging from basic materials such as steel to cutting-edge industrial products like EVs, which was seen to depress prices for U.S. manufacturers and potentially drive them out of business. Thus, one of the major focuses of U.S. economic policy toward China was protection of domestic companies and workers, as seen in Trump's imposition of tariffs and Biden's "worker-centered" industrial policy.

Related to the issue of competition, many participants identified industrial policy as a battleground for economic advantage. Both China and the U.S. were suspicious of the other's industrial policies. Participants noted that China had reacted strongly to the rise of U.S. industrial policy under Biden, including the Inflation Reduction Act and the CHIPS Act, as being anti-Chinese protectionism. Meanwhile, U.S. policy makers had justified industrial policy at least partly as a response to what policymakers saw as unfair competition from China, including protectionism against U.S. goods, intellectual property theft, and subsidization and lending policies that contributed to excess capacity and artificially low global prices. More broadly, some U.S. policymakers had come to see Chinese industrial policy as the result of a fundamentally different, state-directed economic system that could not easily co-exist with the traditional laissez-faire approach of the U.S.; thus, they had concluded that principles of free trade and market competition needed to be modified to compensate for the systemic differences.

Policymakers also pointed to the importance of supply chain reliability to both China and the U.S. There had already been considerable concern expressed in the U.S., Japan, and elsewhere about the centrality of China to many global product supply chains, with many companies adopting a "China + 1" strategy for new FDI. These concerns were heightened by the onset of COVID-19 in 2020, then further exacerbated by the effects of conflict since 2022, including energy and grain disruptions due to the Ukraine war and Houthi attacks on shipping lanes in the Red Sea. Policy makers around the world, including in the U.S. and China, had thus turned their attention to reducing the risk of such disruptions to supply chains, including by diversification and reshoring. Moreover, due to political and security tensions between the U.S. and China, both countries had reevaluated their mutual dependence, leading to efforts at "friendshoring" as well as increasing the urgency of diversification and reshoring.

Pure national security concerns had also become salient in both countries. U.S. policymakers had become increasingly concerned that China was closing the gap in military capabilities in terms not only of quantity of weaponry but also quality and technological prowess. Not only did they worry that the U.S. would be less likely to prevail in a military conflict and be less able to defend its regional allies, they worried that these shifts would make regional conflict more likely. At the same time, both the U.S. and China were interpreting actions from the other side as signals of hostile intentions, further heightening concerns over conflict. Finally, while in years past some analysts had argued that conflict was made less likely by the considerable interdependence of the two economies, participants noted that in recent years political opinion had shifted toward seeing interdependence as a vulnerability that could be weaponized in the event of heightened tension and thus a possible accelerant to tensions and conflict. Participants expressed concern that U.S.-China relations were characterized by a rising "security dilemma," in which the preventive or defensive actions of one side would be taken as threatening by the other, creating incentives for an upward spiral of mistrust.

Finally, several participants argued that U.S. perceptions of Chinese politics had changed considerably over the last dozen years. In particular, a number of participants pointed to shifting roles of the Party and the state in economic affairs, which they saw as increasingly subordinating the economy to political goals. Evidence for a shift from "state capitalism" to "party-state capitalism" included the increasing role of Party committees inside companies as well as crackdowns on companies including on financial institutions in 2018 and on tech firms like Alibaba in 2020. U.S. public opinion linked increasing domestic control with a foreign policy

that was more in opposition to U.S. interests. Other participants disagreed with the notion that political imperatives were driving economic policy or the behavior of Chinese companies. They argued that there was no fundamental change in the Party's approach to the private sector and no evidence that private sector company returns were being suppressed by state policy or Party involvement. Rather, they argued that Party and government officials were fully aware of the importance of the private sector to Chinese prosperity and retained their commitment to the role of markets.

National Security and Economic Policy

The rise in national security concerns between the U.S. and China raised new questions about the future of the economic relationship. While many participants agreed with the principle that economic and security issues should be separated, they also agreed that this could be difficult in practice.

One key issue was how to draw the line between national security concerns and normal economic competition. In the U.S., national security concerns had been invoked not only for transfer of militarily useful technologies and protection of the integrity of critical infrastructure, but also materials such as steel and other products and services. Chinese authorities had invoked broad and sometimes vague guidelines over data and technology in the name of national security. As a result, the line between national security and economic competition was both blurred and constantly in flux in both countries. Moreover, any company or industry facing competition from the other country (as well as their political supporters) could be motivated to call for protection on the grounds of national security. Thus, despite the stated intention to confine protection via a strategy that U.S. policymakers termed "small yard, high fence," participants expressed uncertainty as to how small the yard and how high the fence, not to mention how they might change over time.

Increased focus on restricting security-relevant economic transactions had been seen in a variety of policies and sectors. Among these were technology controls, including moves by the U.S. to prevent companies in third countries from sharing U.S.-developed technology with Chinese companies, as well as bans on Chinese firms supplying components to some critical infrastructure. A number of participants argued that the Committee on Foreign Investment in the United States (CFIUS) process had been notably tightened toward Chinese firms; meanwhile, China had made use of its own Measures for the Security Review of Foreign Investments to restrict U.S. and other foreign investments into critical sectors. The Biden administration had furthermore put in place a 2023 executive order prohibiting outward investments by U.S. firms in specific advanced technologies to China and other "countries of concern." A number of participants argued that these restrictions were having a chilling effect on cross-border investment and cooperation in a variety of industries, including semiconductors, quantum computing, AI, and biotech.

While security-related restrictions had so far been focused mostly on trade, investment, and technology transfer in critical sectors, some participants warned that the impact could expand considerably in the future. They saw it possible, if not likely, that the "small yard" could be expanded in response to changing economic conditions, domestic lobbying, or increased bilateral tensions. Moreover, many participants anticipated that the types of controls could also be

increased. For example, it was noted that the federal and some state pension systems already prohibited employees from investing their accounts in Chinese securities. Also, a number of participants raised the possibility of wider investment controls, including making it difficult or impossible for Chinese firms to raise money in U.S. capital markets or for U.S. investors to acquire Chinese securities. Some characterized this possibility as "financial containment." They also noted that even the possibility of restricting financial access could lead U.S. and Chinese companies and investors to avoid cross-border fund-raising and investing—and given the state and trajectory of bilateral tensions, some participants saw this as likely.

Finally, several participants raised potential future ways in which national security-driven economic policy might adversely affect the U.S. and China. Observing the assertive use of financial sanctions against Russia in the wake of its invasion of Ukraine, some participants worried that the U.S. might "weaponize" the U.S. dollar against China by denying it access to the dollar-based global financial system. In that case, they argued, China would move quickly to establish alternatives, which could end the global dollar system. It was noted that already, some countries and companies were choosing to transact in and accumulate RMB, and they predicted that this trend would increase rapidly if the U.S. were to cut off access to the dollar system. Moreover, there was evidence that China was diversifying its foreign exchange holdings, especially into gold, possibly as a hedge against losing access to their dollar reserves. Others countered that it was highly unlikely that the U.S. would do either of these things. They noted that even in the case of Russia, several conduits to the dollar financial system had been allowed to stay open in order to prevent disruption to global finance. Since the Chinese economy was far more deeply embedded in the global financial system than Russia, it would be extremely costly (if even possible) to close off all links. Several noted that the Treasury had actually been very cautious about imposing financial sanctions on major economies, except in cases of actual conflict, and that U.S. policymakers recognized the dangers to the U.S. and global economies of dollar weaponization. In addition, some participants observed that sanctions on Russia had proved not to be very effective and that their effects had faded over time. Thus, they argued that sanctions were not particularly useful against a strong rival and that policymakers were aware that large-scale sanctions on China would be dangerous and counter-productive.

Several participants also raised the issue of effects on third countries of economic conflict between the U.S. and China. Already, the U.S. had imposed controls over transfer of U.S. technology by firms in third countries and had sought to discourage third countries from using Chinese technological standards or Chinese technology in critical infrastructure. Participants warned that companies in third countries could face secondary sanctions in the future for some financial or other economic transactions.

Chinese Responses to Security Tensions

While much of the discussion focused on U.S. responses to rising bilateral tensions, participants noted that tensions were also affecting Chinese economic policies in some respects, although many felt that changes in Chinese economic policy had been less dramatic than in the U.S.

Importantly, participants agreed that China remained open to FDI from the U.S. and other economies. Some participants pointed to challenges that remained for foreign businesses in China, including declining profitability. Others countered that formal barriers were mostly

unchanged. Rather, they argued that the biggest challenges for foreign firms were due to the increasing competitiveness of local firms, which was driving down profit margins for foreign companies and increasing the utility of local knowledge and networks. Also, some argued that foreign investors no longer benefited from preferences and expedited approvals, as some had in the past. However, other participants emphasized that China had repeatedly emphasized its desire to welcome FDI, particularly in underdeveloped sectors since U.S. investment in China was generally in the Chinese self-interest.

Despite the general openness and welcoming approach to FDI, many participants agreed that China had become more wary of investments and transactions that touched on issues of national security. Since 2021, the Foreign Investment Security Review Working Mechanism had reviewed all proposed inward investments in covered sectors—most notably defense-related technologies, but also including infrastructure, information technology, and others. As with CFIUS in the U.S., participants saw the security review process as adding time, expense, complexity, and uncertainty to the process of investing in some areas. Participants also noted that the Law on Guarding State Secrets was a stumbling block for some companies, especially given the ambiguity of the definition of state secrets. Overall, security-related restrictions on investment and information were seen as dampening the attractiveness of some investments due not only to their content but to the ambiguity as to how the national security was defined and the uncertainty as to how they may be used in the future.

Looking ahead, there was also considerable discussion about how China's policies might evolve in the face of continued or increased bilateral tensions. Some argued that the threat of stricter U.S. sanctions could lead China to build up alternatives to dollar payments. Some also raised the question of whether China might put in place embargoes on the export of critical goods or material such as lithium or batteries in response to rising U.S. technology controls, although most considered that to be a remote possibility.

Finally, there was some discussion of the impact of the upcoming presidential election on China's responses to the national security turn in U.S. foreign economic policy. Opinions were mixed as to which candidate China would prefer to deal with as president, although the bilateral consensus for being tough on China suggested to many that either would likely implement new protectionist policies. One common argument was that Chinese leaders would likely seek to avoid conflict with the U.S. while the 2024 election was approaching, as both candidates would likely seek to prove their toughness against China ratcheting up promises of economic policies that targeted China.

Managing Bilateral Tensions

Participants discussed at length how bilateral security tensions could best be managed to reduce the impact on mutually beneficial economic interactions. They suggested that both government and business could play constructive roles in this regard.

One set of recommendations was for the two governments to address core economic concerns, even if they remained at odds over political and security issues. For example, some focused on bilateral imbalances as a factor driving much of the economic animosity and considered the underlying reason for imbalances to be overinvestment in China and overconsumption in the

U.S. Thus, they argued that each government should take steps to reduce the imbalances in its own economy. Others argued that it was more important to reduce protectionist practices and subsidies that distorted trade, preferably by recommitting to multilateral trade cooperation.

Participants also suggested that governments could focus on cooperating on areas of common interest. For example, several pointed to the potential global and bilateral benefits of cooperating on green finance, given the position of the U.S. and China as the world's largest economies, largest carbon emitters, and technological leaders in green technology. A number of participants also argued in favor of business facilitation to reduce unnecessary obstacles to FDI and cross-border portfolio investment, including by ensuring continued Chinese access to U.S. capital markets.

At the same time, participants recognized the limits of governments in reducing tensions in an era of mutual mistrust and rising contest over regional security and global order. Thus, they encouraged businesses to take the lead in improving relations. A number of participants argued that political leaders did not fully understand the degree of interdependence, the benefits of the bilateral economic relationship, or the costs and difficulties that would be entailed by decoupling. They argued that it was therefore essential for businesses to educate political leaders about the risks of allowing national security concerns to drive hostile economic policies. Many participants saw the financial sector to be particularly well-suited to make the case in favor of continued economic cooperation. One reason was that cross-border financial transactions were relatively uncontroversial compared to high-tech trade and intellectual property rights. Also, the opportunity to invest across borders could contribute to the returns and diversification in the portfolios of households and pension systems in a visible way. Nonetheless, participants recognized the potential for cross-border financial transactions to be targeted as a result of national security-driven tensions, including possible threats to delist Chinese firms from U.S. exchanges or to further restrict U.S. pension fund investments in Chinese capital markets.

Finally, there was a strong consensus among participants that achieving the goals of more cooperation and less friction would require much more dialogue at both official and unofficial levels. While the COVID-19 years had been a low point for in-person interactions, participants spoke favorably about the return of dialogue at all levels, from leaders to working groups, since the summer of 2023. While they saw this as a good start, many saw considerable room for more discussion and with a prominent role for actors beyond executive branch officials, including local governments, business leaders, agencies, and legislators. While disagreements would undoubtedly remain, a number of participants pointed to the ways in which U.S.-Japan dialogue during the 1980s and early 1990s had increased trust and reduced hostility surrounding differences.

Topic 2: Promoting Public Capital Markets—Innovation and Regulation

In Topic 2, participants discussed the state of public capital markets in China and the U.S., as well as how regulation and innovation affected cross-border financial access. There was particular discussion of ongoing efforts by Chinese authorities to improve the quality and openness of public capital markets. Participants also agreed that cross-border access to public capital markets was beneficial to investors and firms on both sides of the Pacific and outlined the ways in which regulation was enabling or challenging transactions. Finally, there was some discussion of alternatives to public capital markets such as private credit, as well as the reasons and implications for their development.

Public Markets in China

Participants discussed at length the current state of capital markets in China, as well as ongoing reforms to address perceived weaknesses. It was noted that capital markets in China had only been in existence for only a little more than three decades but had risen to become the second largest in the world and to attract the most retail investors of any country. China's capital markets had proved effective in raising capital for and facilitating expansion of many companies. Investors had access to a wide variety of financial instruments and key objectives such as market integrity and quality of information had improved markedly. Foreign financial institutions had played an important role in the development of Chinese capital markets and other areas of finance, and participants noted the entrance of wholly foreign-owned financial institutions in a variety of sectors, including banking, insurance, investment banking, asset management, and payments.

Several features were seen as characterizing Chinese capital markets. These included the prevalence of retail investors, many of them inexperienced, who traded actively. This had contributed in some instances to boom-bust cycles in the stock market. Participants also noted the predominant role of state-owned enterprises (SOEs) among issuers; moreover, even many private-sector firms are controlled by founders whose interests do not necessarily accord with those of minority shareholders. Bond issuers were primarily government entities or banks (often state-owned). Thus, while the capital markets had been effective at raising funds for issuers and in providing a retail alternative to bank accounts, they had not offered a market for corporate control or created pressure on corporate management to maximize profitability.

Looking ahead, a number of participants emphasized the importance of shifting from what they called a "financing market" to an "investor-focused" market. They argued that better corporate governance and more focus on profitability would be important to both improve corporate productivity and to give investors better alternatives to bank accounts and housing. They argued that improving performance would contribute to a number of national goals, including increasing household wealth—and therefore potentially increasing household consumption—as well as releasing stuck capital that could fuel more rapid economic growth.

Participants identified a number of challenges that were currently obstructing Chinese capital markets from fulfilling their potential to support economic growth and household wealth. From the perspective of investors, they noted that the quality and consistency of information and disclosure remained works in progress. This was a concern for institutional investors in particular, including U.S. and other foreign asset managers. A number of participants also saw the prevalence of inexperienced retail investors and low penetration of institutional investors as contributing to a culture of momentum trading rather than stock-picking based on corporate fundamentals. Corporate governance was also seen as an issue, particularly in SOEs and in private-sector companies with controlling shareholders, where there were continuing concerns about whether management was acting in the best interest of all shareholders as well as whether investors had access to accurate and timely information. Some participants argued that the role of Party committees further compromised the principle of profit maximization; others disagreed, however, saying that Party committees were typically highly aligned with top management. Finally, despite considerable strides in regulation and supervision, a number of participants had concerns over continued problems of market integrity and investor protection.

Capital markets also were seen as having some challenges on the issuer side as well. The biggest concern was the multilayered and long IPO approval process. Companies looking to enter public equity markets faced a bottleneck that had severely restricted the flow of new listings in recent years, although several participants argued that the IPO market was now "normalizing." This created several problems for growing Chinese companies that needed funds. Not only did the bottleneck delay their access to the large pools of funds available in public markets, but the lack of exit options was seen as restricting the development of venture capital and private equity investors. With regard to bonds, participants noted that corporate bond markets were still quite small and very illiquid. The illiquidity increased risks for investors and spreads on bonds, leaving companies reliant on banks or private lenders for their borrowing needs.

Participants observed that Chinese financial authorities were well aware of these issues and were committed to continuing their already considerable progress in addressing them. In this regard, a number of participants emphasized the importance of the most recent revision of the State Council's Nine Guidelines for Capital Markets. First issued in 2004 and revised in 2014 and again in 2024, the Nine Guidelines had in each instance provided a roadmap for financial regulation and supervision over the next decade. Some participants saw the 2024 revision as the most significant one to date, arguing that it was laying out the necessary steps not only to address problems in Chinese capital markets but was also reflecting a commitment to refocus their operation on the needs of investors. The Nine Guidelines were expected to be made official policy in the upcoming Third Plenum to be held in July 2024, after which the various financial regulatory agencies and exchanges would make and enforce the rules needed to implement the guidelines. The approval of the guidelines at the Third Plenum was seen as an important indication of the commitment of the government to improving capital markets.

Key themes that emerged from the new Nine Guidelines included marketization, openness, and improving functionality. With regard to IPOs, they sought to reduce bottlenecks by simplifying and standardizing the approval processes. There was also considerable attention to improving corporate governance, through closer scrutiny of listed companies, creating a more rigorous delisting process for underperforming firms, and potentially requiring underperforming

companies to submit improvement plans. In addition, they called for more and better information disclosure and sought to encourage more participation by institutional investors.

A number of participants argued that all of this should be very reassuring for international investors. It represented a high-level commitment to opening access to Chinese markets, continuing the considerable work that had already been done, including increasing foreign financial institutions' ability to enter a variety of sectors. They also noted the reaffirmed commitment to encouraging cross-border flows through multiple channels, including the Stock and Bond Connects as well as expanded Qualified Foreign Institutional Investor (QFII) and Renminbi Qualified Foreign Institutional Investor (RQFII) programs. Moreover, foreign investors would benefit from putting in place the shareholder protections and corporate governance improvements laid out in the Nine Guidelines. Some participants also pointed to the recent introduction of shareholder class litigation as further evidence that investors' interests would be protected.

Cross-Border Access to Capital Markets

There was considerable discussion of cross-border investment in the capital markets of China and the U.S. With respect to Chinese firms accessing U.S. capital markets, after nearly an extended period in which Chinese companies actively sought listings on U.S. exchanges, the number of Chinese IPOs had plummeted, and a variety of companies had delisted in recent years. This raised questions about whether U.S. capital markets had become less attractive to Chinese firms and how the situation might change in the future. Participants discussed the effects of the U.S.-China auditing agreement, the prospects for a resurgence of Chinese demand for U.S. IPOs, and prospects for continued openness or restrictions.

While the COVID-19 pandemic had had some negative effects on Chinese listings in the U.S., participants focused on regulatory and policy issues as the primary reason for the decline, in particular the confrontation over auditing. U.S. financial regulation requires that the Public Company Accounting Oversight Board (PCAOB) ensure the quality of audits of listed companies. For companies based outside the U.S., the PCAOB had developed the practice of inspecting auditing firms in the home country, but Chinese authorities had balked at some of the PCAOB's expectations, leading to a stalemate over how the quality of audits of U.S.-listed Chinese companies could be assured. In 2020, Congress passed the Holding Foreign Companies Accountable Act, which would ban trading and mandate delisting of foreign companies within three years (later shorted to two years) whose home country did not allow PCAOB inspectors full access to inspect auditors of U.S.-listed companies. The stalemate was addressed with a memorandum of understanding in 2022 between the PCAOB, China Securities Regulatory Commission (CSRC), and the Chinese Ministry of Finance to allow full access for PCAOB inspectors in Mainland China and Hong Kong. When inspectors visited in 2023, they certified that they had received full access, allowing Chinese firms to continue listing in the U.S. However, the inspections also revealed a range of major and minor deficiencies in the auditors' processes. Although it was common for the PCAOB to find such deficiencies when they would begin inspections in a new jurisdiction, the findings provided a warning that deficiencies must be corrected for present auditors, usually affiliates of U.S. auditing companies, to continue auditing U.S.-listed firms.

A number of participants anticipated that the apparent success of the agreement would encourage Chinese companies to start listing in the U.S. again. They argued that U.S. listing was attractive to Chinese companies for several reasons. Not only did it give them access to fundraising in the deepest and most liquid capital markets in the world, but more importantly U.S. listing was seen as a testament to a company's quality of disclosure and corporate governance, which could make it more valuable and a more attractive partner to global firms. Several participants argued that the agreement was also beneficial to Chinese regulators, who could use PCAOB inspections and recommendations to help improve the quality of auditing and information in domestic markets as well. Thus, they expected that the MOU would hold up and that more Chinese companies would seek to list in the U.S.

Others were skeptical. They noted that certification of access could be withdrawn at any time, starting a two-year countdown to reconstitute cooperation. Ongoing certification would dependent on continued willingness of Chinese regulators to accept intrusive inspections of auditing companies there as well as satisfactory progress on fixing deficiencies; it also assumed that Congress would not pass more restrictions on Chinese companies. Also, the Chinese review process for external IPOs added an extra layer of cost and inconvenience. In addition to the challenges of IPOs, participants noted that a number of Chinese companies had voluntarily delisted from U.S. exchanges for other reasons. For example, SOEs had withdrawn because of restrictions by the Chinese government on providing full disclosure. Most private companies that had delisted had simply found the costs of compliance in both the U.S. and China to be higher than the reputational and/or financial benefits of dual listings.

In principle, the benefits of Chinese companies listing in the U.S. would flow in both directions. For U.S. investors, it would make it cheaper and easier to invest in Chinese firms, while also providing assurances of adequate information, auditing, and disclosure. Investing in Chinese companies would be attractive both for diversification purposes and because of the rapid economic growth of China. Meanwhile, Chinese companies would gain access to more capital, better price discovery, and higher external credibility. If the number of Chinese companies listing in the U.S. were to continue to decline, it would raise costs and reduce choices for U.S. investors (albeit not necessarily by very much). However, thanks to the range of Chinese cross-border investment programs such as the QFII and Stock Connects, it would not eliminate the ability to invest in Chinese stocks even for retail investors. Moreover, U.S. investors could also access stocks listed in other jurisdictions such as Hong Kong, Singapore, or London. As a result, a number of participants argued that delisting would not be that big a deal and therefore that the Holding Foreign Companies Accountable Act was not particularly threatening. There were, however, a number of direct restrictions imposed on any U.S. investment in Chinese companies, wherever listed. For example, the federal government pension system, along with some state-level pension systems, had imposed restrictions on holdings of Chinese stocks in both the defined-benefit portion and individual accounts, and some participants expressed concern that practice could spread more broadly. Moreover, participants noted that the U.S. government had imposed restrictions on U.S. investments into listed entities in some sensitive technological sectors. With no guarantee that the range of targeted entities would not expand in the future, a number of participants argued that U.S. investors were being wary of investing in Chinese companies in those technologies regardless of whether they were currently on an entity list.

While there had been considerable interest in cross-border opportunities for Chinese firms to list on U.S. exchanges and for U.S. investors to access Chinese capital markets through GFII and Stock and Bond Connects, there was little discussion of the opportunities for U.S. firms to raise funds from Chinese domestic investors. The introduction of Chinese Depositary Receipts would in principle allow for Chinese investors to purchase shares in foreign companies through one of the Stock Connects, although CDRs appeared to have been issued primarily by Chinese companies incorporated in Hong Kong or internationally.

U.S. Investors and Chinese Capital Markets

Participants agreed that access to Chinese capital markets had improved substantially over time, offering a variety of benefits to U.S. investors and U.S. financial institutions.

For investors, Chinese capital markets offered several important benefits. They noted that Chinese equity and bond returns were not highly correlated to those in the U.S., making access Chinese capital markets a useful tool for diversification. A number of participants were also bullish on Chinese equities. While Chinese growth had slowed, they argued that it was still among the fastest-growing economies in the world and that U.S. investors would benefit from being a part of that growth. There was some disagreement on this point, as economic growth did not necessarily correlate with corporate profits or stock market appreciation. Some participants pointed out that the performance of Chinese equities, which had at times in the past excelled in global terms, had been unimpressive in recent years, leading many international asset managers to reduce their China weighting. Some attributed the declining performance to increased political controls in the economy. Political issues weighed heavily in other respects as well. Investors were wary of sectors that could be hurt by U.S.-China tensions or by expansion of U.S. sanctions. Several also noted that industries could be disrupted by executive actions, pointing to the collapse of the tutoring industry and off-and-on restrictions on real estate investment as examples. Another potential concern for international investors was the possibility of reimposition of capital flow measures that could affect both markets and ability to repatriate profits. Optimists disagreed with the notion that Chinese equities were becoming unattractive to investors. Studies showed that the apparently lackluster recent performance of Chinese equities was driven by large companies, particularly SOEs. Small-cap A-shares, in contrast, had performed quite well as a class. Several participants also argued that a reason for relatively low overall returns in the market was that the Chinese economy had such a high degree of competition that profitability was lower for many firms. However, they made the case that this competition meant that companies that were succeeding in the Chinese economy, such as the electric vehicle maker BYD, could become dominant in global terms and scale up rapidly; therefore, reducing exposure to China would mean missing out on excellent investment opportunities.

U.S. financial institutions had also benefited from China's strategy of financial opening. Over time, foreign financial institutions had gained access to more areas of business in China, and recent years had seen an increase in investment and wholly-owned subsidiaries in a variety of financial spaces. However, some noted that prior restrictions had narrowed the range of profitable investments for foreign financial institutions. For example, although restrictions on entry of wholly-owned foreign banks had largely disappeared, the government had only done so once the domestic banks had become competitive. The result was that the share of banking held

by foreigners had actually declined even as barriers were lowered. Many participants saw more opportunities outside of banking and pointed out the entry of U.S. and other foreign financial institutions into sectors including insurance, payments, and investment banking.

Moreover, liberalization and opening of capital markets were offering new opportunities to a variety of U.S. financial institutions and investors. One example was quant trading, where U.S. asset managers had a big advantage in terms of expertise and execution. Similarly, a formal China presence had become less important for portfolio investors due to the constant expansion of the Stock and Bond Connects, although the use of QFII and RQFII quotas still required formal presence.

While access had been expanding constantly for decades and the government had affirmed its commitment to continue to do so through the new Nine Guidelines, participants did flag some concerns over the investment climate in China. One of these was the Chinese approach to regulation on data. National security laws created considerable ambiguity about what sort of data could be collected and commercialized, and some participants said that the potential for severe penalties had made many financial services firms very cautious about doing so even for information that seemed relatively innocuous. Strict data localization rules, including the Personal Information Protection Law (PIPL), were another concern. The inability to transfer customer data or even some personnel files across borders made it difficult for international financial institutions to manage their China businesses or to make use of that information to operate globally. Some participants were optimistic that these challenges could be fixed, however. It was noted that the regulatory bodies had been active in coming up with concrete rules for implementing PIPL, with sensitivity to different sectors and to the needs of cross-border transactions. For example, the Shanghai Free Trade Area had just published rules for data transfer by public funds that several participants saw as allowing for reasonable business uses while also protecting the principle of personal data protection.

More broadly, many participants expressed concerns that U.S.-China tensions and demands for decoupling would inevitably increase in importance. While there was considerable skepticism that decoupling would even be possible, participants acknowledged that there were a variety of ways in which cross-border access to capital markets and other financial services could be negatively affected by new regulations or policies.

Alternatives to Public Markets

Finally, there was some discussion of alternatives to public markets, including private equity and private credit. Private equity had become a significant rival to public markets in the U.S. due to its higher returns, lower costs of compliance, and what advocates considered to be a superior model of corporate governance. In the U.S., the shift to private equity had been accelerated by increasing regulation in public markets, which added considerably to the costs of operating public companies but often without improving governance or profitability. At the same time, private and public markets were not necessarily in a zero-sum game. In a well-functioning financial system, public and private markets could operate synergistically. In the U.S., the relative ease of public market entry and exit contributed to the growth of private equity. Investors could take existing public companies private or take over other private companies. Private equity had also become popular in China prior to 2021, but participants expressed concern that in recent

years the bottleneck in IPOs had made it harder for some private firms to exit positions. Recent moves to improve the processes of listing and delisting offered some optimism that the situation would improve.

Participants also considered private credit as an alternative to bank loans or bond issuance. They noted that private credit had grown rapidly in the U.S. and, to a lesser extent, in Europe. However, statistics had shown limited growth in China. Thus, participants discussed why private credit had not taken hold in China, whether this was a good thing, and what the prospects were for the growth of private credit in the future.

Advocates of private credit argued that it allowed for alignment of time horizons of lenders and borrowers, as seen in the significant role of pools of long-term capital such as life insurers, pension funds, publicly-traded business development companies, and university endowments in the U.S. private credit markets. Holders of long-term capital could benefit from higher rates and lower costs than in public markets without the type of maturity risks that characterized banks, open-ended funds, and others. Private credit also filled gaps in credit markets that could not be adequately addressed by bank lending, due to risk-weighted capital regulations and mark-to-market accounting. Some participants were skeptical of these arguments. Some argued that the profitability of private credit was primarily due to risk arbitrage driven by bank regulation. This could mean that the growth of private credit was creating new concentration of risk that might require public bailouts. Also, some noted that the prevalence of leverage among some private lenders meant that there were could be dangers to other parts of the financial system including banking if lending came under enough stress. However, most participants recognized the important role that private credit was playing in the broader financial ecosystem in taking on debt that banks could not profitably hold and that public markets could not effectively serve.

In contrast to private credit's rapid growth in the U.S., participants asked why it had not taken off in China. They noted that, like the U.S., China had many SMEs that were not well served by either the banking system, public markets, or other forms of private funding like private equity and venture capital. They also pointed out that private equity had grown rapidly in China prior to 2021, which suggested that there could be an investor base that would be interested in providing private credit. Some participants argued that a primary reason for slow growth was the caution of regulators, who were uncertain of the costs and benefits of private credit. Others questioned whether there were definitional issues at play, noting that shadow banking in the form of trust companies and wealth management products had burgeoned in the 2010s, before being reigned in due to concerns over illegal activities and excessive risk-taking. At least some of those lenders could potentially be defined as private credit, meaning that China's private credit markets might be larger than they appeared in statistics. Given the similarities with shadow banking, a number of participants anticipated that Chinese regulators were likely to be more wary of private credit, potentially stunting its growth. Moreover, some participants pointed out that the Chinese government had been encouraging over mechanisms for financing mid-market firms, such as SME lending programs through banks. Thus, many participants predicted that private credit would not make rapid inroads in China.

Topic 3: The Applicability of Artificial Intelligence to the Financial System

In Topic 3, participants discussed the role of artificial intelligence in the financial system. They addressed current and future uses, as well as the potential benefits and pitfalls of AI. They also discussed the roles of government and business in regulation and self-regulation to minimize any dangers posed by AI.

Uses of AI in Finance

Many participants considered advances in AI, particularly generative AI based on large language models (LLMs), to have the potential to transform the way that financial institutions and markets worked. While versions of machine learning and AI had already been used for a variety of financial functions, generative AI raised the possibility that decisions could be made without human intervention, which could increase efficiency, accuracy, and speed of some transactions while also raising profound questions about legal liability, market function, and investor protection.

Several participants mapped the course of AI development, from early efforts that were basically statistical models using structured data to machine learning systems that created their own internal models based on data to the current generation of generative AI that drew on unstructured data such as natural language texts to generate predictive models. While mathematical models had long been a core component of financial services, the new generations of AI were able to make use of massive amounts of unstructured data to find patterns and make predictions using internally-generated models.

AI could be used across a variety of financial categories, including fintech (big data, cloud computing, etc.), digital finance (digital payments, trading of tokenized assets, lending, etc.), and smart finance (financial modeling, fraud detection, financial advising, etc.). Already, AI was widely used in fraud detection and anti-money laundering, where its ability to detect patterns and anomalies in enormous data sets was highly effective, and increasingly in financial modeling as well. Over time, AI offered the possibility of taking over much of the work of financial analysts, from accumulating and analyzing data to writing reports and making recommendations, at greater speed and in response to the specific needs and preferences of clients.

Several participants foresaw some of the most transformative effects occurring in digital finance. For example, they noted that, to date, digital banking had essentially been operating on top of a superstructure of traditional banking. However, generative AI could be used to not only to make automated lending decisions but also, in conjunction with tokenization, to provide funds nearly instantaneously and without the need for multiple layers of settlement. Generative AI together with identity verification and instant transfer of value could similarly transform market making, potentially eliminating the need for collateral given instant settlement and vastly increasing the number of actors capable of providing liquidity. A number of participants were especially enthusiastic about the potential uses of unstructured data to improve credit evaluation. Others were skeptical of the wisdom of relying on unstructured data for credit decisions, however.

Without having a track record for the use of new types of data, it was difficult to know whether they added useful information or just noise, or how the models would respond to surprises such as market crashes and financial crises.

Managing Risks of AI in Finance

Despite excitement about the transformative potential of AI in finance, participants also discussed concerns and pitfalls. One of the biggest of these was the inability to directly observe the model by which machine learning and generative AI systems make judgments and decisions. Because these systems were essentially teaching themselves off of training sets, there was no guarantee that they would follow logic or legal frameworks.

Participants also emphasized the importance of the content of training sets: would they be accurate, unbiased, and comprehensive? If not, reliance on LLMs could lead to bad analysis and decisions, potentially harming clients, endangering financial stability, and perpetuating inequalities. Moreover, because training sets would necessarily be based on prior information, AI models may not be able to adapt quickly to rapidly changing situations.

Fairness was an issue for a number of participants. One concern was the potential for perpetuating biases and discrimination, such as red-lining. Because of the non-transparency of any given lending decision, it would be difficult to prove that biased data had been used or that the models themselves contained biases. Moreover, the high costs of data and processing for generative AI systems could lead to market concentration. At the global level, the high costs could exacerbate the digital divide between rich and poor. Some participants also raised the issue of intellectual property rights, suggesting that there were ethical if not necessarily legal problems with creating profit-making systems using texts that were produced for a different purpose and without prior approval or compensation.

Participants agreed that it would be important to have clear legal frameworks for how AI could be used in finance. Such frameworks would need to clarify legal liability and standards of behavior. For example, there was considerable consensus that liability should continue to rest with financial institutions who were providing AI-based services, even if they had not developed the applications themselves. However, many were wary of moving straight to regulation, given how quickly AI was developing and the inherent trade-offs between innovation and safety. Thus, they suggested that practitioners, regulators, and supervisors should create general guidelines for appropriate uses of AI in finance and stay in regular contact regarding how those guidelines were working in practice. Companies should also disclose to supervisors and clients the ways in which they were using AI.

Regardless of what happened with regulation, participants agreed that it was essential for individual financial institutions and fintechs to effectively manage the risks posed by their own use of AI. For functions of importance to the interests of clients or the health of the financial institution, many participants recommended that human supervision be built into decisionmaking. Moreover, since few board members and top executives were expert in AI or the potential financial and legal implications of expanding its use, it was suggested that a senior executive be given ultimate responsibility over how AI would be used. Similarly, boards of directors should have a technology or subcommittee to ensure effective governance.

Finally, looking internationally, it was noted that the U.S. and China were at the forefront of research, development, and application of AI. Therefore, some participants argued that it was essential that the two countries cooperate closely in developing global norms and practices of AI governance. Moreover, AI development in the U.S. and China were intertwined in some ways, including the large number of Chinese-trained specialists who were working in the U.S. tech industry. National security concerns could endanger collaborations between U.S. and Chinese firms and labs, as well as the free movement of specialists across borders.

Topic 4: The Macroeconomic Environment—Rates, Growth, and Global Capital Flows

In Topic 4, participants discussed broader factors in the Chinese and U.S. financial relationship. Much of the discussion focused on prospects for Chinese economic growth, both in the near future and longer term, with a particular emphasis on rebalancing—i.e., reducing reliance on investment, manufacturing and exports in favor of increasing domestic consumption and developing the services sector. The other main topic was the status and prospects for FDI, particularly in China.

Prospects for Economic Growth and Rebalancing in China

Participants discussed China's growth prospects from multiple perspectives. Key economic issues included societal aging, productivity growth, and household consumption. Participants also considered the impact of changing politics, including not only economic policies aimed at rebalancing but also the economic and political priorities of Chinese leadership.

Many participants pushed back against the popular narrative that Chinese growth was faltering. That narrative emphasized the impact of aging society, low or negative productivity growth, build-up of local government debt, and the possibility of financial crisis brought on by excessive lending to the property sector. While recognizing that problems existed in all these respects, participants agreed that the story was not nearly that dire. Rather, the division of opinion was between those who expected moderate but slowing growth versus those who anticipated the resumption of strong growth. In particular, participants agreed that China continued to enjoy considerable growth potential. Despite societal aging and a decline in surplus labor, they noted that China had the benefit of an educated workforce that in many areas was still underemployed and therefore ready to upgrade to higher productivity jobs. While low productivity growth was an issue for many companies, they also pointed out that many companies were performing strongly and moving up the value chain. Thus, they saw continued headroom for economic growth, albeit at a lower level than in the rapid growth era of the 1990s and 2000s.

The main distinction between relative optimists and relative pessimists was their assessment of efforts to rebalance the economy. For more than a decade, economic officials had sought to shift the basis of Chinese economic growth from investment- and export-led to domestic consumption-led. This would require an overall reduction of investment, shifting allocation of capital away from low-productivity growth industries, encouragement of household consumption, and increasing the relative size of the services sector. Some participants were skeptical of rebalancing efforts, arguing that little progress had been made over the last dozen years in which these goals had been in place. They focused particularly on the stubbornly high share of investment in the economy, as well as more micro indicators such as the continued large role of SOEs in the economy, overcapacity in materials and some other manufacturing, and the likely rise of non-performing loans to real estate, local governments, and inefficient SOEs. With the labor force shrinking and capital no longer scarce, they argued that growth could only be sustained through improved productivity, which they did not observe.

Other participants disagreed with this assessment, arguing that rebalancing was real and was transforming the Chinese economy. Several factors supported this view. Most importantly, they argued that household consumption was indeed increasing, driven by rising household income. Crucially, other than a brief period of suppression of household income and consumption during the COVID-19 pandemic, Chinese household income had grown around a percentage point above GDP growth since the 2010s other than a brief period during the COVID-19 pandemic. Consumption grew slightly more in turn than income. Thus, although the share of consumption remained low compared to other economies, its share had been consistently increasing. Moreover, these participants anticipated that household income would continue to grow strongly due to the technological upgrading of the Chinese economy as well as the expectation that wages would rise due to increasing scarcity of labor as aging proceeded. Wages would rise especially for less skilled, lower-income positions, which were the population with the highest propensity to consume. Meanwhile, they predicted that consumption would rise as a share of household income as the senior population increased. In addition to the benefits of rising household income and consumption, they disputed the notion that the government was advantaging SOEs over private-sector companies in allocation of capital. Despite a widely publicized reduction in overall private investment, they pointed out that all of the decline was accounted for by reductions in real estate investment. Not only did this begin to address the problems of overinvestment in real estate, but it also meant that investment in private-sector corporations remained strong and still accounted for around 50% of total investment. Finally, optimists rejected the notion that non-performing loans were severely threatening future growth. While some local governments were facing real fiscal danger, that could be effectively addressed by the central government if it chose to do so. Moreover, despite the slowdown in property price rises, they foresaw continued—albeit significantly slowed—growth in demand for real estate over the coming years and thus expected that losses on bad loan portfolios would be smaller than some commentators had predicted.

One wildcard for participants was how public policy would evolve, especially in response to political considerations. Several participants argued, for example, that the reason that overinvestment in real estate had persisted even though economic policy makers understood it was a long-term problem was that increasing real estate lending had repeatedly been used by political leaders to address short-term economic downturns by providing a lifeline to distressed labor and to prevent construction companies from failing. They said this political lending cycle had compounded problems of misallocation of capital and hidden non-performing loans. Some also argued that Chinese government initiatives often overshot because they were "campaign-driven"—i.e., once the central government set a direction, local and prefectural governments and SOEs would all seek to fulfill it. This was seen as an explanation for issues such as the development of massive overcapacity in some manufacturing sectors. Additionally, some participants raised the question of whether the Party's desire for greater control over the direction of the economy would threaten the independence and vitality of private-sector firms, particularly ones that were extremely large or engaged in critical technologies. Others were unconcerned, arguing that the government was committed to supporting economic growth and technological development, and therefore would not punish companies for advancing those goals. Responses to national security threats or increased international tensions could also have profound effects on economic policy.

Foreign Direct Investment

Turning to cross-border issues, participants discussed the evolution of FDI into China. Despite a common narrative that FDI to China has fallen precipitously, they presented evidence that FDI had held relatively steady. The misunderstanding had been due to the common use of balance of payments data, which were skewed by a rapid reversal in repatriation of profits which was due to interest rate differentials that could be narrowed by the lowering of rates in Western countries.

One major change had been in the composition of FDI. Manufacturing no longer dominated the FDI picture; rather, investors were increasingly looking to China as destinations for technology and financial services. Participants noted that the rise of investment in technology and scientific research suggested that China's efforts at technological upgrading had been successful in making it an attractive location for the development of new technology. They anticipated that technology and services would become increasingly important in China's inward FDI.

Continued demand to invest in China reflected the ongoing strengths of the Chinese economy, as well as shifting competitiveness. This was true even in manufacturing. While aggregate data showed an apparent decline of FDI in manufacturing, this effect was driven by a drop in FDI in labor-intensive and low value-added manufacturing. In contrast, high-tech and precision manufacturing was still attracting considerable investment.

Most participants agreed that Chinese authorities had continued to show a commitment to openness to foreign investors, including by expanding the range of industries that they could enter. However, some argued that foreign investors, especially from the U.S. and Japan, were showing some wariness about FDI. While some attributed this to political concerns over future access or the stability of supply chains, others made the case that wariness resulted from conditions on the ground, including uncertainty of approvals processes and business conditions. Several argued that the biggest disincentive to investing in China, especially in goods and services for domestic markets, was that the market was so competitive in many sectors that it was not feasible to make good profits.

Program on International Financial Systems (PIFS)
134 Mount Auburn Street, Cambridge, MA 02138
www.pifsinternational.org