CHINA'S CAPITAL REQUIREMENTS AND U.S. CAPITAL MARKETS

THURSDAY, DECEMBER 6, 2001

U.S.-CHINA SECURITY REVIEW COMMISSION,
Washington, DC.

The Commission met at 9:00 a.m., in Room 124, Dirksen Senate Office Building, Washington, D.C., C. Richard D'Amato (Chairman), Roger W. Robinson, Jr., and Michael R. Wessel (Hearing Co-Chairs), presiding.

OPENING REMARKS OF CHAIRMAN C. RICHARD D'AMATO

Chairman D'AMATO. The hearing will come to order.

Today the U.S.-China Commission will hold its first hearing examining China's growing capital requirements and the role of the U.S. capital markets in addressing those needs.

The Commission was created by Congress to take a comprehensive look at our economic relationship with China and its implications on U.S. national security interests. Part of the Commission's mandate directs us to look at the effects, if any, on the national security interests of the U.S. from the use by the People's Republic of China of financial transactions, capital flows, and currency manipulation.

As you will hear today, China has significant long-term capital requirements that will need to be addressed in the coming years. To date, China has raised significant capital to meet those needs through debt and equity offerings in the U.S. capital markets, and this trend may continue in the future.

It is important that the Commission study the implications of this activity and how it fits into the overall U.S.-China relationship. In addition, Chinese companies raising money in the U.S. capital markets may raise more direct security concerns to the extent they are connected to the Chinese military-industrial complex.

Tomorrow the Commission will hold a hearing on China budget issues and the role of the PLA, or People's Liberation Army, in the economy. Together, our two hearings this week will help move the Commission forward in its examination of the security implications of the U.S.-China economic relationship.

For the interest of those in the room, on the back table is a document entitled "Recommendations for the Consideration of the U.S.-China Commission Regarding Capital Markets Transparency and Security." These recommendations were provided by Mr. Adam Pener of the William J. Casey Institute and are an outgrowth of the larger study funded by this Commission last spring by Mr.

Pener, examining China's broad funding requirements and practices and its presence in the U.S. debt and equity markets.

The Commission is not endorsing any of these recommendations but will take them into consideration as well as the results of today's hearing in its report to the Congress next June. These recommendations as well as the original study by Mr. Pener are on the Commission's website for public information.

We have a distinguished group of panelists today that should provide the Commission with a broad perspective on the capital markets issue at hand.

I am particularly honored that Senator Thompson, who has been a leader in the Congress on this issue, calling for a closer examination of U.S. economic relations, is with us today. Of particular relevance to today's hearing, he sponsored legislation last year that would have barred Chinese and other countries found to be involved in weapons proliferation from the U.S. capital markets, and would have required the Securities and Exchange Commission to be notified of and disclose to investors information about a company's proliferation activities. More recently, he has tasked the General Accounting Office with investigating Chinese companies' activities in the U.S. capital markets.

The Commission looks forward to Senator Thompson's insights into the potential connection between Chinese involvement in U.S. capital markets and national security.

It is unfortunate and I regret that the Securities and Exchange Commission is not appearing at today's hearing. As the principal regulatory body in the U.S. Government on this groundbreaking new policy issue, the Commission's Chairman chose not to appear today despite our request. We expect, however, that the Commission will respond, and the SEC has agreed to respond in writing, to issues raised in today's hearing. Its responses will be posted on our website for public information when they are received.

I will turn the gavel over to our two Commissioners who organized this hearing, Commissioner Robinson, who has been deeply involved and is a leader not only in the United States but in the West on this cutting issue, and Commissioner Wessel.

In conclusion, however, I would also like to say that the materials prepared by the staff in preparation for this hearing were unusually good; I commend them to all Commissioners. They were just superb, and I commend the staff for their work in preparation for this hearing.

I would like to turn it over now to Commissioner Robinson.

[The statement follows:]

PREPARED STATEMENT OF CHAIRMAN C. RICHARD D'AMATO

Today the Commission will hold its first hearing examining China's growing capital requirements and the role of the U.S. capital markets in addressing these needs.

The Commission was created by Congress to take a comprehensive look at our economic relationship with China and the implications of this relationship on U.S. national security interests. Part of the Commission mandate directs us to look at "the effects, if any, on the national security interests of the United States of the use by the People's Republic of China of financial transactions and capital flow and currency manipulations." As we will hear today, China has significant long-term capital requirements that will need to be addressed in the coming years. To date, China has raised significant capital to meet these needs through debt and equity offerings in the U.S. capital markets, and this trend may continue in the future. It is impor-

tant that the Commission study the implications of this activity and how it fits into the overall U.S.-China relationship. In addition, Chinese companies raising money in the U.S. capital markets may raise more direct security concerns to the extent they are connected to China's military-industrial complex.

Tomorrow, the Commission will hold a hearing on Chinese budget issues and the role of the People's Liberation Army in the economy. Together, our two hearings this week will help move the Commission forward in its examination of the security implications of the U.S.-China economic relationship.

We have a distinguished group of panelists today that should provide the Commission with broad perspectives on the capital market issues at hand. I am particularly honored that Senator Fred Thompson will be kicking off today's hearing. Senator Thompson has been a leader in the Congress in calling for a closer examination of U.S.-China economic relations. Of particular relevance to today's hearing, he sponsored legislation last year that would have authorized the President to bar Chinese and other companies found to be involved in weapons proliferation from the U.S. capital markets and would have required that the Securities and Exchange Commission (SEC) be notified of, and disclose to investors, information about a company's proliferation activities. More recently, he tasked the General Accounting Office (GAO) with investigating Chinese companies' activities in the U.S. capital markets. The Commission looks forward to Senator Thompson's insights into the potential interconnection between China's involvement in the U.S. capital markets and national security.

Following Senator Thompson's opening remarks, I will turn the gavel over to today's hearing co-chairs, Commissioners Robinson and Wessel. Commissioner Robinson will chair the morning sessions of the hearing, with Commissioner Wessel chairing the afternoon panels.

Before we begin, I would also like to note that earlier in the year we commissioned a report from Adam Pener, Senior Analyst at the William J. Casey Institute of the Center for Security Policy, entitled "Capital Markets Transparency and Security: The Nexus Between U.S.-China Security Relations and America's Capital Markets." The report is posted on our website at www.uscc.gov. The report included a series of recommended actions that could be undertaken by the Commission and the federal government. These recommendations were not included in the version of the report posted on our website and have not been endorsed by the Commission. Nonetheless, I believe they serve as worthwhile discussion points and therefore we have forwarded them to the participants on today's panels and will place copies for public distribution on the table in the back of the room.

I look forward to the testimony in what should be an enlightening hearing.

OPENING REMARKS OF CO-CHAIRMAN ROGER W. ROBINSON, JR.

Co-Chairman ROBINSON. As time is tight, Senator, and we are most anxious to hear from you and are very grateful for your presence, I would merely like to add my thanks to Senator Thompson for his participation in today's hearing. He has been a leading voice in the Congress on capital markets issues, those before the Commission today as well as Chinese proliferation of weapons of mass destruction, ballistic missile delivery systems, and related security issues. His presence here today I think underscores the importance of this emerging portfolio of financial issues to America's national security as well as to the due diligence assessments, investment policies, and corporate governance of market players and participants.

So, without further comment, I turn the floor over to you, Senator, with our thanks.

[The statement follows:]

PREPARED STATEMENT OF CO-CHAIRMAN ROGER W. ROBINSON, JR.

Thank you, Mr. Chairman.

I am pleased to be co-chairing today's hearing on China's capital requirements and U.S. capital markets, an aspect of the U.S.-China relationship that I believe is vitally important to our Commission mandate.

To begin, I would like to add my thanks to Sen. Thompson for his participation in today's hearing. He has been a leading voice in the Congress on the capital mar-

kets issues before the Commission today, as well as on Chinese proliferation of weapons of mass destruction and related security issues. His presence here today underscores the importance of this emerging portfolio of issues to America's national security as well as to the "due diligence" assessments, investment policies and corporate governance of market players and participants.

China is establishing an ever-more important presence in the U.S. capital markets, raising multi-billion dollar sums through both debt and equity offerings. The importance of the U.S. capital markets as a source of capital to finance China's economic growth as well as the nature of the Chinese entities listing on U.S. markets are important subjects for this Commission's deliberations. Our Commission needs to continue to assess the national security implications of China's fund-raising in the U.S. capital markets, whether proper, disclosure-oriented regulations are in place to monitor this activity, and whether U.S. investors are adequately informed about the identity of Chinese companies in our markets and the nature of their overseas operations (as well as those of their parent and subsidiary companies).

Today's distinguished gathering marks the first time that the Congress—either directly or through a Congressional commission—has held a public hearing to examine the important nexus between U.S. capital markets and national security.

Our hearing today will present various perspectives on this 21st century issue area. During the morning session, which I will chair, the Commission will be provided an overview of China's long-term capital needs and the role the U.S. debt and equity markets have played—and are likely to play in the future—in addressing these needs. On this panel are four distinguished experts: Professor Warren Bailey of Cornell University, Dr. Nicholas Lardy of The Brookings Institution, Thomas Byrne, a Vice President and Senior Analyst on China from Moody's, and Stephen Harner, a financial consultant from Shanghai with extensive government and banking experience in both China and Japan. James Dorn, a scholar from the Cato Institute, will also address the issues being discussed by this group, but will appear on the final panel this afternoon.

During the afternoon session, which will be chaired by my esteemed colleague Commissioner Wessel, the Commission will hear from the Wall Street community, organized labor and representatives of large pension funds. Their testimony will help provide the Commission with the perspectives of those who bring Chinese debt and equity offerings to the U.S. markets as well as those who may invest in them.

Regrettably, the Commission will not hear from a representative of the U.S. Treasury Department, the Securities and Exchange Commission (SEC), or the Department of State. The Commission extended an invitation to these agencies in the hope of gaining the benefit of their views on the current regulatory requirements applicable to foreign registrants in the U.S. capital markets as well as the extent to which the United States Government is monitoring foreign registrant activity for possible national security abuses and concerns. The Commission was privileged to discuss these issues in a closed session with Treasury Undersecretary John Taylor in October. The Commission plans to continue its dialogue with Treasury, State, and the SEC and will submit questions to the SEC and the other agencies as deemed appropriate.

Co-Chairman ROBINSON. I am now pleased to welcome Senator Fred Thompson.

STATEMENT OF FRED THOMPSON, U.S. SENATOR FROM THE STATE OF TENNESSEE

Senator THOMPSON. Thank you, Mr. Chairman.

I appreciate the invitation to be here with you very much. You are doing extremely important work.

Although I guess the United States' relationship with China is off the front pages right now, it clearly will not remain there. It still remains the most important bilateral relationship to us, in my opinion, and will be that way for a long period of time, and the issue that you are dealing with here today is a part of an overall mosaic that I think is extremely important to deal with.

I have a prepared statement and will submit that for the record, if I may, and will talk a little more extemporaneously.

In the first place, with regard to the gentlemen who were just here, I would note that, as you know, we have asked the General

Accounting Office to prepare a report on this very issue. I have received a classified briefing from the GAO with regard to their progress. I would suggest that the Commissioners withhold any judgment with regard to some of these questions that were posed to these gentlemen who were here until you hear that report. They have not made much progress, frankly, since 9/11, for understandable reasons, I think, in terms of getting people's attention and getting information that they need; but they will, and I think it will be a good report, and I think it will be something that you need to hear. So in this open setting, I'll just leave it at that.

I think that as never before, this country is now aware of the threats that face us and have faced us. It certainly didn't start with September 11. We have known for a long, long time. We have had innumerable hearings pointing toward the fact that the country is vulnerable from a number of sources. There are many threats out there; 9/11 was a manifestation of one of them, one of the lower-tech types of threats, I guess you might say, but we still have with us what we have always had with us, or had for a long time, and that is threats from other weapons of mass destruction, including missile threats, biological, chemical, as well as cyber threats and others.

Not only are there many threats, there are many sources of those threats. We are all receiving PhD's now with regard to the fact that there are cells of people around the world in scores of countries who are marrying the most backward radical thinking with the most modern technology and destructive capability that the world has ever known and coming up with something that poses a tremendous threat to the security of this Nation.

We also know and have known for some time that there are states out there, rogue nations, nations of concern, that are developing their own weapons of mass destruction. Nothing has changed since 9/11. It has been going on for a long time; it has been building and continues to build. One of the things of most concern is that we really don't know to what extent nations are developing weapons of mass destruction. The Rumsfeld Commission gave us an insight, and the insight we got from them was disturbing, to say the least. So that proceeds apace with regard to various types of weapons of mass destruction by certain nation states, some of which can't even feed their own people, but they can develop weapons of mass destruction.

Another piece to that puzzle, of course, is the fact that we know that there are supplier nations, nations that on a regular basis supply people, technology, missiles, missile capability, and in some cases, missile factories, the ability probably to produce fissile materials and things of that nature. And we know that, according to the Biennial Report of our intelligence community, China remains the leading supplier of weapons of mass destruction around the world in terms of other nations.

Our response to what happened on September 11, of course, has been dramatic. I think we are demonstrating once again the capability of taking tremendous destructive capability from the middle of Missouri and bringing it to the middle of a place like Afghanistan and what that can do. But the President has also taken additional action with regard to cutting off the money supply of terror-

ists, including freezing of assets and blocking U.S. transactions with terrorists; it blocks any U.S. transactions with any person or institution associated with terrorists or terrorist organizations. The President is also working with our allies to cut off funding to terrorists worldwide. So the President has clamped down on the banking community worldwide with regard to transactions dealing with these terrorist organizations.

So the issue that it looks to me like we are confronted with here today is, under these circumstances, what should we do with regard to, in many cases, state-owned or state-controlled entities—and specifically, this Commission is dealing with the issue of China— state-controlled Chinese entities who are raising billions of dollars in our market. These entities may be engaged in proliferation activities, and should we be concerned about the fact that we don't know whether they are or not in many cases. Should we be concerned that we don't know what they are doing with their money in many cases as the Chinese military continues to build and continues to use the United States as their enemy in their war games? Should we be concerned about that, and should we do anything about that?

I think the answer is yes. I think it would be consistent with and an important part of our approach to terrorism and weapons of mass destruction and the broader category of things that are inimical to the interests of the United States of America. I think we have got to started thinking somewhat differently than we have in times past. We have been asleep at the switch in many respects. It is not just our intelligence community, it is all of us—it is the people on Capitol Hill, it is the people in the news media, it is the people in the Executive Branch of Government. We are rapidly catching up now, and I think we are on the right track, but it is remarkable how much we have to learn and the things that have to happen in order to really get our attention in a time of peace and prosperity.

When I think about the entities, companies, in our markets, I am reminded of the fact that even with regard to the Export Administration Act debate that we have had, we place some restrictions with regard to the exporting of dual-use technology, for example, to China; we place restrictions certainly with regard to weapons and things of that nature; we debate as to what extent we should regulate, in effect, many of those. But we have that scheme there, and it is designed to exercise some control. But these same entities that we are dealing with can come into our capital markets, no questions asked, and raise any amount of money for any purpose. It seems to me to be incongruous—companies that, as far as I know, could even be under United States Government sanctions at the time.

I was first made aware of this concern when I started reading reports of other commissions that had looked into the broad proliferation area, and as they were assessing and looking at things that were of concern to them and making suggestions as to what we might do to address this growing proliferation problem substantially before 9/11. The Deutsch Commission, for example, raised the issue of proliferators using our capital markets, and they said, "It is clear that the United States is not making optimal use of its eco-

nomic leverage in combatting proliferators. Access to U.S. capital markets is among the wide range of economic levers that could be used as carrots or sticks as part of an overall strategy to combat proliferation.''

The Deutsch Commission also concluded that there was a need for enhanced transparency: ''Because there is currently no national security-based review of entities seeking to gain access to our capital markets, investors are unlikely to know that they may be assisting in the proliferation of weapons of mass destruction by providing funds to known proliferators.''

The Cox Commission addressed the issue of China's investment in U.S. capital markets. It concluded, unanimously, that ''Increasingly, the PRC is using the U.S. capital market as a source of central government funding for military and commercial development and as a means of cloaking technology acquisition by its front companies.''

So, Mr. Chairman, it's not a matter of trying to be anti-China or not. I support trade with China. I support their, China's, entry into the WTO. I hope for the best. There is some reason for optimism—that's a big, big subject—but there is also some reason for caution as we look at what is going on. And although I think that my record is pretty good in terms of capitalism and free markets and open access and free trade and all those other things, I must say that I am somewhat surprised sometimes at my compatriots who see no distinction with regard to any of these issues when it comes to matters of national security.

I think we have to take a look, as I say, anew at the way we look at these matters. No one wants to do harm to our capital markets. I don't know what the result would be, quite frankly. If it is that big an issue with regard to Wall Street, that just means that it's a bigger issue that this Commission ought to be looking at and considering seriously.

Questions are raised—will it do any good, placing some restrictions on access? Frankly, politically, as I sit here, I don't see how, with the forces that are aligned on the other side, we can get past disclosure, for example. The opponents don't even want disclosure, but I think that that is a minimum that we should be looking at. The Deutsch Commission suggested that we go past that. They thought it would do some good. Will it solve the problem of proliferation? Of course not. Will the banking restrictions the President is enforcing stop terrorism? Of course not. Will it even stop the funding of Al Qaeda? I doubt it. But it is a part of something that ought to be done, and it is the right thing to do.

Does stopping me at the airport, causing me to miss my plane while I'm holding my arms out and they're giving me the once- or twice-over and going through my bags twice before I get onto the airplane, going to stop terrorism? I doubt it. But they are doing what is necessary. They are doing what is necessary. It is a part of the overall situation that we are dealing with here now in this country.

It is pointed out that we have the most open markets in the world, and it has served us well. That is absolutely correct—but we have the most open borders in the world, too. Are we not reassessing that? Some people want to close the borders now, and that,

of course, is ridiculous. But are we not reassessing that? We have the most open ports in the world. I am 30 minutes late for a hearing where I am ranking Member on Governmental Affairs, and we are getting an assessment today on the vulnerability of our port system. It is scary, scary stuff. People bring an item into California, and it is not checked until it gets to Tennessee.

Are we not having to take another look at things that we have really known all along, but now, don't the American people really require us to take another look at some of these things and see if we can't place some reasonable requirements that may only play a small part in the overall fight against terrorism or weapons of mass destruction that we are confronted with now?

Some people say, well, traditionally, we only require disclosure of things that represent things that would affect the bottom line of these companies. Well, it seems to me that if a company is in fact engaging in proliferation, and our Government makes that determination, that is very relevant to the bottom line. I think PetroChina would tell you that it became relevant to their bottom line. Is it better to let these things float around out there and be discovered by The New York Times and have it brought about that way? Does it not affect the bottom line there? If a company is in danger of being sanctioned, as many Chinese companies have been, does that not affect the bottom line? Shouldn't the investor know that up front if that is a possibility? That is a very bottom line consideration.

Would disclosure drive the stock down and hurt pensioners? That is very possible, I suppose, in some circumstances. It seems to me that with respect to the ones that have been disclosed, some pensions pay attention to it and some don't. Some don't seem to care. That is their right. But are we saying that they shouldn't know if in fact there could be a substantial effect with regard to a particular stock? That just shows that the people care, and it is information that they wanted and they acted on that information. It is an unfortunate result, but which is the best result? We should disclose, it looks like to me, this kind of information from the start. I see no justification for not doing that.

And again, there is only a certain amount we can talk about in an open session like this, but our current circumstances in terms of looking at this, even looking at these issues and these questions, I think are very lacking—very lacking—and we really don't know, as in many other cases—as in our weapons of mass destruction proliferation, we really don't know what we're dealing with here quite yet.

So I would simply again express my appreciation to this Commission for looking at these issues. I realize that I'm probably, in terms of the people that you will be hearing from, in the minority on this, but I really don't think I am in the minority as far as the way that the average person would view things nowadays. Nobody wants to hurt the market or encumber these things or have the Government overly involved and so on—but my goodness, if we haven't learned that we need to pay attention to countries, to companies, to entities that refuse, consistently refuse, to make any progress or pay any attention to us in terms of our proliferation concerns, who consistently violate international regimes, the Mis-

sile Technology Control Regime, and come back and say, "Well, we didn't really agree to that"—that is the level of the continued discussion while we are aggressively trying to embrace them from an international trade standpoint, from the standpoint of changing our export laws to make them more liberal so we can trade even more to help them in international regimes—if, in the midst of all that, we can't do a few things to try to get their attention with regard to proliferation activities, when we are going through this tremendous debate over here and getting ready to spend billions of dollars for a missile defense system, if we can't do a few things, we aren't going to have any credibility. Nobody is going to think that we really assessed this potential problem out there, this array of problems, that we really looked at it very seriously.

We are reacting very dramatically and appropriately with regard to a specific incident, but this is a much, much bigger picture, as you all know, than the specific instance, and the threat is much more much more widespread and multifarious, from many, many more sources than are on the front pages of the papers today, and that is what we need to be looking at today and tomorrow and in the decades that follow.

This is a small part of a very big picture, but I think an important one, and I appreciate your indulgence in hearing me out this morning.

Thank you very much.

[The statement follows:]

PREPARED STATEMENT OF FRED THOMPSON

I would like to thank the Commission for inviting me here today to speak on the important and timely subject of China and our capital markets. As you know, I have long advocated increased monitoring and limiting access to U.S. capital markets of companies doing business with entities that have links to proliferation. I believe that the fight against terrorism and our increased need to enhance homeland security make this issue that much more important. One of the things that we have learned about terrorist organizations like Al Qaeda is that they have used the United States financial markets to provide funding for their terrorist activities. It is possible, even likely, that Americans may have unknowingly provided financial support to the very terrorist organizations that attacked our nation on September 11th. The same is undoubtedly true with respect to organizations that are proliferating weapons of mass destruction.

We have known about the problems that our failure to scrutinize the national security implications of allowing certain companies to raise money in our capital markets has created for many years. Congressionally mandated commissions studying the issue of proliferation have concluded both that the Chinese government *is* using the U.S. capital markets to fund its proliferation activities and that the U.S. needs to address this issue as part of a solution to proliferation. The Cox Commission review of U.S. national security concerns with China concluded that "increasingly, the PRC is using U.S. capital markets as a source of central government funding for military and commercial development and as a means of cloaking technology acquisition by its front companies."

The Deutch Commission study of the threat posed by proliferation stated that "the Commission is concerned that known proliferators may be raising funds in the U.S. capital markets." The Commission also noted that most American investors don't know that they are contributing to the proliferation threat, saying, "Because there is currently no national security-based review of entities seeking to gain access to our capital markets, investors are unlikely to know that they may be assisting in the proliferation of weapons of mass destruction by providing funds to known proliferators."

It is extremely disturbing to think that we are financing China's military development and the proliferation of weapons of mass destruction to rogue nations. But plenty of evidence exists that we are directly investing in companies and programs that may one day be the agents of our own destruction. The California Public Em-

ployees' Retirement System (or Calpers) has invested millions of dollars of employee pension funds in companies with close ties to the Chinese government and the Chinese People's Liberation Army. Calpers has invested in four companies linked to the Chinese military or Chinese espionage: Cosco Pacific, China Resources Enterprise, Citic Pacific, and Citic Ka Wah Bank. The Teachers' Retirement System of Texas was also invested in Cosco Pacific, but it divested its shares of Cosco Pacific less than a month after receiving a congressional letter discussing Cosco's links to the Chinese military.

The case of the Texas Teachers divestment of its Cosco stock demonstrates one element that must be part of the solution to this problem, and that is increased transparency. I believe that most Americans would not want their dollars going to organizations that have either direct or indirect links to the proliferation of weapons of mass destruction. We must provide a mechanism for them to get that information. Right now, there are no requirements for national security reviews and no requirements for companies to provide this information in order to list on our stock exchanges. Earlier this year, Laura Unger, then the Acting Chairman of the Securities and Exchange Commission (SEC), announced important new steps that would provide increased transparency for American investors. These steps included requiring any foreign country that is doing "material business" with a country sanctioned by the United States to provide information on its dealings with countries, governments, or entities with which U.S. companies would be prohibited from doing business. She also indicated that the staff of the Division of Corporation Finance would attempt to review all registration statements filed by foreign companies which reflect material business dealings with governments or countries subject to U.S. sanctions. In addition, she indicated that the SEC would initiate a proposed rulemaking that would require all foreign companies to file registration statements electronically. I have written a letter to SEC Chairman Pitt urging him to continue these initiatives. I believe they will provide important transparency for U.S. investors.

But I think that there is also a role for limiting access to U.S. markets. I do not believe that transparency is enough in all cases. I think that the President's approach to terrorism can provide a model here. In the wake of the September 11th attacks, the President made a decision to attack terrorism on all fronts, including the financial front. On September 24th, the President issued an executive order to freeze the assets and block the U.S. transactions of terrorists, those who support them, and foreign banks that refuse to cooperate in our efforts. The President has cast a wide net, saying that we must take action not only against terrorists, but against those who harbor and support them, and possibly even against those financial institutions that refuse to support our efforts. The President's action blocks *any* U.S. transactions of any person or institution associated with terrorists or terrorist organizations. I believe that we must take the same approach against proliferators. There is a role for denying access to our financial markets to entities that we know have engaged in the proliferation of weapons of mass destruction. I urge this Commission to consider ways to apply the President's actions to cut off financial resources to terrorists to proliferators as well. I believe that proliferation poses as great a threat to our security as terrorism, and that we must attack the problem of proliferation and those who engage in it with the same determination that we are rooting out terrorists and denying them the resources they need to conduct their activities.

Co-Chairman ROBINSON. Thank you, Senator.

As usual, you have posed a number of thoughtful and visionary questions and recommendations to the Commission concerning the task ahead for U.S. policymakers concerning how it should best respond to this new source of financially-based security challenges to the country.

You mentioned being late to a hearing. I don't know if you have time for a question or two, but I would very much like to turn the first question over to the hearing co-chairman for this hearing, Commissioner Wessel.

Senator THOMPSON. That's fine.

Co-Chairman WESSEL. Thank you, Senator, and I'll be brief.

Number one, thank you for your leadership on this issue, and also, you have been a good friend and counselor to this Commission

since its creation, and we value the counsel you have given us over the last months since we started.

Earlier this year, Acting Chairman Unger at the SEC issued a letter which has left many to question what the definition of "materiality" is, the question of what we should know and what we should not know as investors.

As you have pointed out, I think the public has viewed the definition of "materiality" as having changed dramatically since September 11, yet the SEC does not appear to have fully implemented Acting Chairman Unger's new definitions.

What is your view of what the SEC has done? Is more necessary? Are these issues material? I believe you have already said they are, but how should we view them in the future?

Senator THOMPSON. Well, I don't know if it specifically addresses or is limited to the materiality issue, but as I recall, the former chairman indicated that they were going to issue regulations that require greater disclosure with regard to companies dealing with countries that were under United States sanction.

I supported that, and when the new Chairman Pitt came on board, I wrote Chairman Pitt in support of that action. I received a letter back from Chairman Pitt which did not, in my opinion, really address the issue as to whether or not he was going to continue on that same road, and frankly, I don't know where Chairman Pitt stands. But I would endorse the position that Acting Chairman Unger had to require more extensive disclosures by foreign companies doing business in countries sanctioned by the United States.

Co-Chairman WESSEL. Thank you.

Co-Chairman ROBINSON. Chairman D'Amato?

Chairman D'AMATO. Thank you, Mr. Chairman.

I want to also express our thanks to you, Senator Thompson, for your leadership on this issue.

One of the things this Commission has focused on consistently across the board since its inception is the level of resources dedicated across the board in the United States Government with regard to the Chinese, not only in the Executive Branch but in the Library of Congress, which we found to be woefully inadequate in its collections in this area.

You are a member of the Intelligence Committee, and this particular area strikes us that more resources, more eyes on the situation, and more focused attention on the part of the intelligence community given the recent quantum leap in the level of resources being gathered by the Chinese in our equity markets, that it would be appropriate to look at and to recommend an increase in both the level of resources and focused attention on this issue by the intelligence community.

Do you agree that this would be appropriate?

Senator THOMPSON. Whole-heartedly, and if this Commission comes to that conclusion as a Commission, I would like to think that it would be of help to some of us who have had this concern for some time. There is always a battle for resources. Now, after having done too little in so many areas in this Government, we are trying to do everything at once, including forcing money on the President that the President says he can't spend yet. So that's a

danger, and we need to be careful about this. Everybody knows that we have problems in our intelligence community, so we need to go at it systematically and carefully. But I have been concerned for a long time that there have been people in the Intelligence Committee who have made predetermined assessments as to threats or approaches to things that were not based upon empirical evidence. And I think we have to be cautious across the board and look at things realistically. I think that if one did that, one would come to the conclusion that we need additional resources in this area. There is no question about it in my mind.

Co-Chairman ROBINSON. Commissioner Reinsch?

Commissioner REINSCH. Thanks, Mr. Chairman.

Thank you for coming, Senator. It is good to see you again.

Senator THOMPSON. Thank you.

Commissioner REINSCH. I'd like to follow upon Commissioner Wessel's question about the SEC and materiality. If your view is that we need to do something more than what we are doing, and what we are doing is material disclosure, what is the standard that you would apply other than materiality to determine what we should do as far as disclosure is concerned?

Senator THOMPSON. I don't know that I would base my position on the definition of materiality. Legislation that I introduced would have required the President to delineate every year a list of those companies of proliferation concern to Congress; then, the Congress would have informed the SEC, and the SEC would have promulgated regulations requiring companies to disclose that information in their filings, that they in fact had been delineated as a company of proliferation concern.

I think that that fits into the definition of materiality now. I suppose, debating the materiality issue, it looks to me like it would be more straightforward to just simply require them to disclose that the Government had made that determination with regard to that company.

Commissioner REINSCH. So your interest is in making public the fact that a company is on the list that you have described.

Senator THOMPSON. Yes.

Commissioner REINSCH. Your legislation or proposal doesn't reach the point of addressing companies that do business with those companies that are on the list; it addresses only the companies that are on the list.

Senator THOMPSON. That's correct.

Commissioner REINSCH. Okay. And the list is developed by the President or by people whom he delegates?

Senator THOMPSON. Right.

Commissioner REINSCH. And the standard for being on that list is what?

Senator THOMPSON. There is no standard in the legislation.

Commissioner REINSCH. So it's anybody the President wants to put on.

Senator THOMPSON. Much as he's doing with regard to the banking community today.

Commissioner REINSCH. Okay. Thanks.

Co-Chairman ROBINSON. Commissioner Dreyer?

Commissioner DREYER. Senator Thompson, yesterday I asked former SEC Chair Arthur Levitt about whether he thought your suggestion to have the SEC be informed and inform potential investors of rogue state proliferators, et cetera, whether he thought that was a reasonable use of the SEC, and he said he did not and that, furthermore, he doubted that it would have much effect on investors' willingness to invest.

How would you react to that?

Senator THOMPSON. Well, it doesn't surprise me that people do not want additional responsibilities, number one. People have different ideas as to what the effect of that would be. I can't say that I know. I'm convinced it is the right thing. If there is some mom and pop out there who have made a little money in the grocery business and are in some way investing, I think they ought to have a right to have access to information if they choose to avail themselves of it of the fact that their pension fund is investing in a company that our Government thinks is proliferating weapons of mass destruction while their son may be overseas, fighting for his country—things like that. I just think it's the right thing to do.

From reading the Deutsch Commission, I think that they certainly concluded that it was something that ought to be looked at, that we are not using the economic leverage that we have, that not only was there an issue with regard to who might invest and who might not invest, there is an issue of how these companies might look at it, or the countries who control these companies. They say it doesn't really matter on the one hand, and then they move heaven and earth to defeat anything that moves in that direction on the other.

So I think—and probably people on this Commission know better than I; I have not followed it that closely—I think that with regard to those names that have come out in the media and so forth, the result has been mixed. For example, I don't think CalPERS has done much with regard to that, and it doesn't seem to bother them. On the other hand, there have been others—a fund in Texas, for example—who have gotten out.

So I don't know the answer to that, and I doubt if he does.

Commissioner DREYER. Thank you.

Co-Chairman ROBINSON. Commissioner Ledeen?

Vice Chairman LEDEEN. Thank you, Senator.

I just wanted to add to what Chairman D'Amato said. We are finding not only a shortage of resources in areas like intelligence and Library of Congress and information available to whomever—Government specialists, scholars, journalists, or anybody who is concerned about China—but we are 10 years out now from the end of the Cold War, and by and large, the allocation of personnel within the Executive Branch has remained what it was. So there is probably overall, I would guess, based on what we have looked at, a ten-to-one disproportion of manpower working on Russian/former Soviet questions as compared to China.

So we have a real shortage of language speakers, of technical expertise, of historians, of political scientists who are up-to-speed on Chinese questions, and since we are all engaged now with the terrorist issue, this automatically leads to the same kind of lack of preparation that we found on September 11—we had intelligence

failures, we had analytical failures, we simply didn't have sufficient people who were unable to look at this question in context and say, "Hey, this is trouble."

So I think you can anticipate getting stuff along those lines from us, not just on the sort of narrow Library of Congress question but as to the way in which the United States Government is approaching the question of terrorism.

Senator THOMPSON. I appreciate that. It is a difficult thing to do to put one's predetermined notions aside. I know I have difficulty doing that. And on this issue, it is especially difficult to get an objective analysis. And this is not to cast aspersions on anyone, but I have an obligation, I think, to say it the way I see it, and that is it is especially difficult to get objective analysis with regard to the China issue because there is so much interdependence now, there is so much trade, there is so much foreign direct investment, we have so many analysts and people in the field now who have ties there. And as I say, I have my own ties coming from my own direction; I am not immune from all that.

I think that is why this Commission is so important. I'm sure different ones of you have different views on these things, but together, I think every member of this Commission will have an objectivity and an ability to analyze this issue as no one else that I know.

That has been my main concern. It's not that I have the answers to these things. It's that no one else that I know of does, either, and we are lacking in the ability to objectively analyze these things. Everybody has a dog in the fight. It's very difficult to divest ourselves of our preconceived notions and our business ties and our friendships with people and cocktail parties that we have had over the years and things like that. We're all human beings.

But every once in a while, we get a wake-up call, and if coming in one morning and turning on the television and seeing a few thousand of our innocent men, women, and children being murdered in a way that none of us predicted doesn't do it, I don't know what will. That's all I'm suggesting, that it is a dangerous world, much more dangerous than people realize. We are seeing one small aspect of that. All the other possibilities and probabilities are out there. We need to bring not only our military might to bear, but our moral suasion to bear. We need to do the right thing and take off our green eyeshades sometimes. These issues are more important than that, and as I said, I think that's what this Commission will do.

Co-Chairman ROBINSON. Commissioner Bryen?

Commissioner BRYEN. Senator, thank you very much for your leadership on this issue. It is terribly important.

I have a simple idea that I just wanted to get your reaction to. If a Chinese company is involved in proliferation as some were in Iraq recently—in fact, we bombed those sites—shouldn't that company first of all be banned from doing business in the United States 100 percent, and shouldn't American companies that might have any connections to them also be banned from doing business with them? Wouldn't that send a message to some of these fellows?

Senator THOMPSON. Yes, I think so. That's an interesting example. Let's just say the news media reports that a Chinese company

that our companies have been doing business with supplied Saddam with a fiberoptic system to help shoot down our aircraft; they are flying over the no-fly zone. Who is going to explain if one of those pilots gets shot down? Who is going to be designated to explain to that mother back here exactly what happened and why that happened and what we're doing about it?

Yes, I think we should do that.

Commissioner BRYEN. As I said, it's a simple idea, but it's clear, and it sends a very direct message to all concerned. And right now, I don't think we're doing anything like that, and yet we're willing to bomb these things if they become threatening to us.

Senator THOMPSON. Well, you know what the game is. When these countries are caught, first of all, they deny it; then, they get a demarche from us and learn what they can; and then, they say that they'll look into it, that "We didn't know anything about it; I guess you're right, but we didn't know anything about it," et cetera, et cetera.

The question is who bears the burden of proof. It's time we put the burden of proof on them. This is not a courtroom where we have to prove anything beyond a reasonable doubt. I think we need to get away from that.

Commissioner BRYEN. Thank you.

Co-Chairman ROBINSON. Senator, if time allows, we just have a couple more questions, but I want to be respectful of your schedule.

Senator THOMPSON. Well, I've blown that anyway, so let's go ahead.

Co-Chairman ROBINSON. Very good.

Commissioner Lewis?

Commissioner LEWIS. Senator, I'd like to thank you also for your leadership on these issues.

On the question of where do you draw the line for access to capital markets in the United States, those who are opposed to drawing the line say that anything goes, and let the investor make the decision. And you are saying that maybe your colleagues feel that disclosure is all that can occur rather than some kind of prohibition.

That leads me to think, suppose a pre-War Nazi Germany were to be applying for funds in our capital markets; it seems to me that those who say there should be no restrictions would be saying yes, they should be allowed access to our capital markets. It seems to me something is wrong with that.

Senator THOMPSON. I think that's kind of what happened, wasn't it? We were doing a lot of business with Nazi Germany.

Commissioner LEWIS. But we've learned——

Senator THOMPSON. Yes, I think so. It is a line. We can't expect everyone who comes to our markets to adhere to all of our values and agree with us on all of the issues, but we're in the line-drawing business. We have got to draw a line. And what I'm saying is that human rights are important; we have a lot of forceful advocates for that. Labor rights are important. Environmental issues are important. But none of those things directly affects national security. We are in the national security business here. That is a category unto itself.

I think we ought to be fairly liberal in terms of the way we look at it. I don't think we ought to apply unreasonable litmus tests to people, but as I said, just like on some of these other issues, I think we have got to make a determination, and if we can't make that determination, if we don't have the ability to know one way or the other, then we can't do anything anyway. That's a separate problem, I suppose. But if we in fact have the ability to make a reasonable determination that while we are going around trying to eradicate terrorism, while we are building a national missile defense system because we are afraid that rogue nations will soon have the ability to hold us hostage if we don't, the fact that countries and companies that are supplying those rogue nations should be allowed totally unfettered access to our capital markets without taxpayers knowing that they may be doing that activity is absurd to me.

Commissioner LEWIS. Would you go beyond just disclosure? Would you bar them from actually——

Senator THOMPSON. I personally would, yes, yes. I don't think that a company that our Government, our President, makes that determination with regard to—and I assure you it is not done lightly, and I think you all know it's not done lightly—in fact, it would probably be a category of companies that would avoid a determination because our intelligence community wouldn't want to reveal sources and methods as to how they determined that they put the company on the list, so they probably wouldn't go on the list—I don't think our intelligence community has been overly aggressive in flagging potential proliferators or anything like that.

It would not be a long list, it doesn't look like to me. I think it would be carefully done. Our Presidents traditionally have placed great value on trade. Our State Department has placed great value on relationships. You would have all those forces still being brought to bear. You aren't going to have a list made up willy-nilly, without thought and proper vetting and so forth. I say once you get that list, no, they should not have access to our markets to raise unlimited amounts of money for unlimited purposes under those circumstances. But you know, this ain't my first rodeo, and I know the difficulties of getting any movement on something like this, because not many people are paying attention. It is just a matter of the forces that are brought to bear, and I'm not too hopeful that too much can be done in that regard.

I don't know if September 11 changes anything in that regard or not, quite frankly. I hadn't thought of it in that respect. And I don't want to wave the bloody shirt and say that because of September 11, we've got to do everything totally differently, because September 11 was just a relatively small indicator of what is lying out there. I would like to think that we would look anew at all of these various things, like the Deutsch Commission said, like the Cox Committee said. These are not solutions to the proliferation problem; these are just things we ought to do, and it makes a statement that we are willing, perhaps. We had the reputation around the world for a while, apparently, in terrorist circles that we didn't have the guts to fight a war from anything less than 20,000 feet, and they are rapidly being disabused of that notion right now. I think they now have the notion that we will never do anything that

will hurt our capital markets or hurt our trade position or anything like that, that we place tremendous value on that and that we will tend to overlook a lot of things for the sake of that. I place tremendous value on it, too, but I think we have been somewhat out of balance on it, and I think this approach would help us get back to where we should have been all along.

Commissioner LEWIS. Senator, thank you. I would personally like to thank you for your courageous leadership on these issues.

Senator THOMPSON. Well, thank you very much.

Am I excused, Mr. Chairman?

Co-Chairman ROBINSON. Senator, you are. You have been very kind with your time. I only regret that—Commissioner Becker had a quick question——

Senator THOMPSON. I'm sorry. Go ahead, sir.

Commissioner BECKER. Well, I hope it's a quick question, Senator.

I appreciate your candor, and more than anything else, your leadership is beyond question on this. But my question is sort of a follow-up. If we are successful, if we dry up investment capital into known companies of proliferation, these are Chinese companies now—they are in China, they are functioning with everybody's knowledge on that—and at the same time, we permit and encourage investment in other domestic companies in China, aren't we simply freeing up internal Chinese investment capital for these companies of proliferation? Don't we come out at the same point?

I mean, if we invest $1 billion in a year into the Chinese capital markets and, instead of mixing it up, domestic and companies of proliferation, we just concentrate it all in the domestic companies—we have heard testimony that the Chinese capital markets are sufficient, that they can raise the money they need internally, and I was wondering how you feel about that. Beyond making a statement, if we are really wanting to stop these companies, doesn't it require some kind of control on all capital investment in China?

Senator THOMPSON. Well, I don't think so. I would think that if you had representatives of these companies here before you, or if they were to speak candidly, they would very, very much prefer that you not do anything or recommend anything with regard to cutting them off or even disclosure.

Why is that? I think our capital markets are very valuable. They are unlike any other. They could go to London or Tokyo, I suppose, but it's unlike any other. I think that is clear.

But again, I think we have to draw lines. I don't think that we could or should do anything with regard to our foreign domestic investment or our—if I understand your question correctly—our people investing in Chinese companies there, their market, and so forth—sure, money is fungible and all that, but we are talking about a very, very limited area here that I'm looking at, and that is proliferators, and it is a part of a package. It ought to be a part of our foreign policy, and I think we should be doing other things to discourage proliferation and other things to make it uncomfortable on even our friends who are doing things that are inimicable to our interests.

But I think that there is a certain burden on us, a certain burden of proof that we should meet, that you are doing bad things in gen-

eral. That was a PNTR debate—that was a WTO debate—should we not have anything to do with them because they are doing bad things? I don't believe that. I think that's going too far.

I say let's carve out an area that directly affects, potentially affects, our national security and something they shouldn't be doing and make a statement with regard to it, encourage other countries to do it just as the President is doing with regard to financial transactions and banks around the world; take moral leadership, take a position on it. Some of these other people think it will be helpful. I think that it can be incrementally helpful.

It is a broader question here, but it looks to me like we need to be looking for ways that we can make a statement and that we can inflict some pain in discrete areas where we have the moral high ground without having to overreact and terribly hurt our overall relationships.

This is an opportunity more than it is anything else. This allows you not to have to do some of these other things. Would it be more effective in terms of really getting their attention or winding up supplying less money to the military—it very well may be—but I don't think we can bite off a chunk that big. I think we need to keep it more discrete than that.

Co-Chairman ROBINSON. Senator, your generous allocation of time and observations of the morning have been of enormous importance to the Commission, and I think all of us are grateful for your extraordinary leadership of this new family and portfolio of national security issues for the country.

Thank you once again.

Senator THOMPSON. Thank you very much.

PANEL I: OVERVIEW—U.S. CAPITAL MARKETS/CHINA'S CAPITAL REQUIREMENTS

Co-Chairman ROBINSON. We would now like to proceed if we may with our first panel.

With Senator Thompson's departure, I'd like to merely say that I am pleased to be co-chairing today's hearing on "China's Capital Requirements and U.S. Capital Markets," an aspect of the U.S.-China relationship that many of us believe is vitally important to our Commission's mandate.

I would also like to join our Chairman in thanking our own Commission staff for what was an extraordinary effort in preparing for these hearings and the high quality of the briefing materials available.

I would also like to thank my colleague Adam Pener for his groundbreaking and comprehensive assessment of the security dimensions of the capital markets that was provided to the Commission and appears on our website, the recommendations of which are in the back of room, released today.

China is establishing, as you gentlemen know, an ever more important presence in the U.S. capital markets, raising multi-billion-dollar sums through both debt and equity offerings. The importance of the U.S. capital markets as a source of capital to finance China's economic growth, as well as the nature of the Chinese entities listing or traded on U.S. markets, are important subjects for this Commission's deliberations.

Our Commission needs to continue to assess the national security implications of China's fundraising in the U.S. capital markets, whether proper disclosure-oriented requirements are in place to monitor this activity, and whether U.S. investors are adequately informed about the identity of the Chinese companies in our markets and the nature of their overseas operations as well as those of their parent and subsidiary companies.

Today's distinguished gathering marks the first time that the Congress, either directly or through a Congressional commission, has held a public hearing to examine the important nexus between U.S. capital markets and national security.

Our hearing today will present various perspectives on this 21st century issue area. During the morning session, which I will chair, the Commission will be provided an overview of China's long-term capital needs and the role the U.S. debt and equity markets have played and are likely to play in the future in addressing these needs.

On this panel are four distinguished experts—Professor Warren Bailey of Cornell University; Dr. Nicholas Lardy of the Brookings Institution; Thomas Byrne, Vice President and Senior Analyst on China for Moody's; and Stephen Harner, a financial consultant from Shanghai with extensive government and banking experience in both China and Japan, and we are most grateful for Mr. Harner's lengthy travel to join us today.

James Dorn, a Scholar from the Cato Institute, will also address the issues being discussed on this panel, but will appear on the final panel this afternoon because of scheduling issues.

During the afternoon session, which will be chaired by my esteemed colleague, Commissioner Michael Wessel, the Commission will hear from the Wall Street community, organized labor, and representatives of some of our largest pension funds. Their testimony will help provide the Commission with the perspectives of those who bring Chinese debt and equity offerings to the U.S. markets as well as those who may invest in them.

Regrettably, as Chairman D'Amato noted, the Commission will not hear from a representative of the U.S. Department of Treasury, of the Securities and Exchange Commission, or of the Department of State. The Commission extended an invitation to these agencies in the hope of gaining the benefit of their views on the current regulatory requirements applicable to foreign registrants in the U.S. capital markets as well as the extent to which the United States Government is monitoring foreign registrant activity for possible national security abuses and concerns.

The Commission was privileged to discuss these issues in a closed session with Treasury Undersecretary John Taylor in October. You can be confident the Commission plans to continue to seek a dialogue with Treasury, State, NSC, and SEC and will submit questions to the SEC and other agencies as deemed appropriate.

I am now pleased to welcome our first panel. If we may, Professor Bailey, we will begin with you. It should be about a 10-minute presentation, if you don't mind.

STATEMENT OF WARREN BAILEY, PROFESSOR, JOHNSON GRADUATE SCHOOL OF MANAGEMENT, CORNELL UNIVERSITY

Mr. BAILEY. Thank you.

I have prepared some notes, and I'll just talk informally off them.

It has been around 10 years since I started teaching finance at Cornell's Business School, and it has been just about 10 years since the Chinese stock markets really became very active, prominent, and interesting. As a teacher, as a researcher, and as a personal investor, I have paid very close attention to them.

Clearly, the size of the markets that I summarize, as is to all of you is substantial. They are not of the same size as, say, the U.S. markets or the European markets, but they are large and getting larger, largest perhaps amongst the emerging economies. There is a very significant number of companies and a very significant number of local participants in the markets, which is something I'm going to focus a lot of my remarks on.

Within our own stock markets, I prepared, mostly with the help of the Bank of New York's web page, a little appendix in the back that shows us the names of some of the PRC companies listed in the U.S. The amounts of capital that have been raised can be traced through the offerings and other documents. The current values that I list in my table are, of course, difficult to assess because they represent both the amount of share currently traded in the U.S. and those that are traded back in Hong Kong or the home country. But the size is certainly in the tens of billions. It is a very, very important issue.

We can see that there are a variety of types of industries that have come to raise money. Most prominent, of course, have been the energy companies, but also the telecoms, and a variety of other industries. There is a great deal of what we might call "old economy" firms—airlines, highways, and what-have-you. There is also some tech stuff as well.

Now, a textbook 101 discussion of what the markets are supposed to do. We know these markets are supposed to hypothetically serve certain purposes. They are supposed to mobilize savings, hook up savings with the best uses of funds. They are supposed to help the economy in spreading risk. If a company is chopped up into many thousands of shares, it is more likely that people will be willing to invest, instead of having one person plunge a whole chunk of money into such an investment.

We also know that the markets are supposed to give us information, tell us what industries are valuable and growing and thereby deserving of more investment.

We also have the sense that maybe the stock markets are part of a plan to privatize and get the companies out from under the government and into the marketplace, which will help them and the marketplace perform better in a variety of ways.

Now, perhaps most importantly, the stock markets may represent an alternative way to discipline or govern companies. We know that if companies produce shabby products, they may be disciplined by their product market—no one will buy their toothpaste, as it were. We know that if managers or other stakeholders in firms care about what is going on in the company, they may step forward to help control the company; but we also know that having

a stock market where there are mergers, acquisitions, takeovers, stock prices, constant pressure from investors and analysts, itself serves as a form of pressure or a form of governance.

So those are our hypothetical or among our hypothetical good purposes that a stock market might serve. What is actually going on with these Chinese stock markets?

I start by asking what did the Chinese leadership have in mind when they permitted this. I think they did want to raise money for investment, both local money and foreign money. I think they want to have some way of dealing with the propensity of Chinese citizens to save money given that their alternatives in terms of property or in terms of bank accounts are not very attractive.

I think there may have been some desire to put indirect pressure on the banking system—that is to say, by having alternatives for Chinese citizens to invest in, they would not be forced to put their money in low or negative real interest-bearing bank accounts, which might in turn make the banks try to be more competitive, which also has implications for financing of state enterprises.

I also believe there may have been a political or psychological aspect to this. In my write-up, I use the phrase, "own a piece of the rock." I think that, to build consensus among citizens or to make them feel that they are participants in the system in China, it might have made some sense to have these stock markets.

So I think those are probably what the leaders had in mind when they permitted this activity to be initiated.

What does this do for the companies? Clearly, it allows them to raise money. To the extent that there are, in spite of the large pool of savings in China, some issues of both capital barriers or the ability to raise foreign currency, or purchase foreign machinery or equipment, this would have been valuable to the companies in and of itself.

We know that there is also an issue of prestige or high profile involved in doing this. By being able to have a listing in New York or Hong Kong or elsewhere, it does signal to the banks, it does signal to the capital markets, to customers, to other businesses that I have arrived, I am big, I am important, and perhaps it is good for future capital raising or more generally for the company's business perception and environment.

Now, some other issues which I think are at odds with the hypothetical textbook 101 value that stock markets serve.

There is virtually no issue of these companies losing control to outsiders, foreign or domestic, because they are not listing majority stakes. A great fraction of the shares are retained by state or quasi-state agencies, so typically, the amount of shares available to individual investors, be they local or foreign, is substantially less than 50 percent. So they are not giving up much in terms of control.

Furthermore, relative to issuing bonds, they are not promising much. They can sell these shares, and then, if business isn't good, or if the money that the business generated legitimately doesn't end up being made available to the shareholders, they can just say, "Sorry, no dividend." So I think there are advantages and relatively few costs to the Chinese issuers who do this.

Now, what is going on in these markets? The Senator spoke earlier about how little we know about what these firms are up to or what they do. I agree with him. I would also suggest that it may be the case that the Chinese themselves have little idea what is going on.

My perception of these markets, of disclosure, governance, regulation, is that they are very, very chaotic. I could refer you to a number of things in the popular press or in academic work. It is really a big mess.

Coincidentally, as I was struggling to put together my write-up for this talk, a wonderful quotation from Premier Zhu appeared in "The Far Eastern Economic Review." He described bad accountants and bad accounting practices as "a malignant tumor that threatens China's economy"—a fantastic quote.

I put in my appendix a bunch of examples that my graduate students downloaded from Chinese websites—amazing, comic, but very serious examples of how accounting disclosure, law and regulation have been flagrantly abused, almost a Keystone Cops approach to law, accountancy and regulation. It is quite a mess.

This has raised some positive pressures. There are a wealth of magazines, both in print and on line, and there is a growing network of chat rooms where a lot of people inside China are complaining about this. There is some movement within some sectors of the government to try to have more effective regulation and enforcement of the law in securities.

An acquaintance of mine who is a professor at the University of California at Riverside recently returned to Beijing to join the securities commission with a view toward improving things there.

Now, we even see in the courts in China one or two recent decisions where the courts have explicitly said, "We can't rule on this in spite of the fact that it is flagrantly stinky, because there simply do not exist laws or regulations that allow us to say, 'This is illegal, you go to jail.' "

So some pressures are arising to try to fix this.

Now, I think the government has always been concerned about making these markets palatable to and attractive to Chinese citizens. They have, from the start of the markets, been very concerned with crashes and other situations that might anger or alienate the citizens. I guess they view this as part of maintaining or enhancing their legitimacy or their place in a modern country which is increasingly moving away from what we would stereotypically call "communism."

So there is much fear in the government that they have to do something about this.

Now, what does this mean? I view this as potentially unleashing forces that may do some good and which the government may need to address. I think we all agree that China is not a democracy. I think we also agree, however, that there are times and places when the government feels it is necessary to address the concerns of citizens.

I believe these are situations where the government is under a lot of pressure to do something to make these markets work better; otherwise, they are going to alienate several tens of millions of people who invest in these markets quite closely.

Where does this put us? Clearly, Chinese companies come to the U.S. and list their shares because there are benefits to doing so—but there are also costs. They have to adhere to much, much higher disclosure standards, and to the extent that they must file documents and otherwise disclose information, they also drag in their investment banker in the United States, their accounting firm, which is typically an international accounting firm. They draw in other people who have some interest in maintaining some semblance of quality in the information they disseminate.

I am not suggesting that the information that is disseminated even by the largest Chinese issuers is adequate. I don't think it is. I agree with the Senator's remarks on that point. But there is much greater pressure being brought to bear to adhere to those norms that we have in our capital markets.

Now, we also see the sense, of course, that maybe these companies or their underwriters or their accountants may be under more of a threat from the U.S. legal system once they are listed here. That is to say, if a company lists here and its accounts are a mess and someone here has signed off on them, that may represent a liability for them which gives them an incentive to do a better job before something bad slips into a disclosure or an annual report.

So I think there are a lot of potentially good pressures brought to bear by the system. In contrast to our standard pressures on China—don't abuse human rights, don't invest in Sudan—there is actually a substantial clientele within China among the citizens and the government who want to see these forces improve the way their markets work.

We are even beginning to see some evidence that some companies—there are a few names out there in the press—within China that aren't listed in the United States and are beginning to say, we're going to disclose more, we are going to have press conferences, we are going to have conference calls, and we are going to try to behave in a more normal way with regard to the capital market.

So I think there is some potential here for having the workings of our market filter into their market. I am not suggesting that it will be an automatic process. I am not a kneejerk, blind believer in free markets. I think there is some potential that this will have some positive pressure.

[The statement follows:]

Prepared Statement of Warren Bailey

RED STAR OVER WALL STREET: CHINESE COMPANIES AND U.S. STOCK MARKETS

1a. Stock markets in China: a large and growing phenomenon [1]

Over 1,000 listed companies.
About 60 million brokerage accounts.
Market capitalization (the value of all listed companies) is about US$500 billion.
Turnover (the value of all transactions per year) is about US$700 billion.

1b. PRC companies listed on U.S. stock markets (Appendix I)

Several dozen listed formally on a stock exchange, or "over the counter."
Lots of "traditional" industries, energy and telecoms seem largest.
Listing in U.S. often coincides with privatization.

[1] See *http://www.csrc.gov.cn/CSRCSite/eng/tongjiku/199908/e-default.html* for more extensive information.

2a. (Textbook) purposes that stock markets are intended to serve

Mobilize savings and channel funds to economy's most pressing or promising investment needs.

Spread risk over many investors, therefore more businesses are initiated.

Provide price "signals": which industries are most highly valued and, thus, deserving of more investment?

Facilitate privatization of state enterprises.

—end government subsidies, raise revenue for the government.

—free enterprises of political influences, improve performance.

—help build the local capital market.

—disperse ownership of companies among citizenry.

Enable external corporate control (mergers, takeovers, etc.) as an alternative to internal control, political/legal/regulatory control, or the indirect discipline of the product market.

Attract foreign portfolio investment.

2b. What purposes might the PRC leaders have in mind?

Raise domestic and foreign funds for investment.

"Mop up" vast domestic flow of savings (~40% of GDP?).

Put indirect pressure on the banking system.

Offer citizens the opportunity to own "a piece of the rock."

2c. How does listing (especially in U.S.) benefit PRC firms?

Raise funds for investment.

Raise profile within China and overseas, perhaps to facilitate future issues.

Little risk of loss of control since government and other entities typically hold illiquid shares with effective voting control.

No risk of default since dividend is not fixed, unlike bond interest.

3. Problems in China's capital market

a. Bad accounting and corporate governance

Premier Zhu is quoted (*Far Eastern Economic Review*, November 8, 2001, page 32) stating that bad accountants and accounting practices are a "malignant tumor" that threatens China's economy.

Numerous outrageous examples of misbehavior (see Appendix 2).

Investors are beginning to demand more accountability and transparency.

b. Law [2]

PRC securities law is inadequate, pressure to improve is mounting.

Recent court decisions explicitly recognize the inadequacy of existing securities law and regulation.

c. Government fears of social instability originating in the financial markets

Large sales of new securities (IPOs, state shares) drag down the market.

Market declines generally anger investors.

Corruption and other scandals anger investors.

Sour market conditions weaken support for economic liberalization, or weaken the legitimacy of the Communist Party.

4. Mass public stock investing: Has Zhongnanhai got a tiger by the tail?

Increasing demands from citizens, some politicians, and others for regulation, transparency, good governance, and functional legal remedies.

Crusading journalists and online chat rooms expose fraud, discuss legal matters, and seek a more modern capital market.

It is increasingly difficult for the government to ignore these demands and, indeed, some reformist politicians want to address them constructively.

Implication.—The growth of PRC stock markets unleashes forces that the government must address. If successful, better law, courts, disclosure, and corporate accountability, and a smaller rule for state interference and corruption, may emerge.

5. How raising capital in the U.S. fits reformist Chinese goals (and perhaps U.S. goals too)

a. Listing in the U.S. demands greater disclosure

144A ADR program requires only an English translation of the annual report.

Over-the-counter Level 1 ADR program also requires SEC registration form.

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[2] I thank Professor Zhiwu Chen of Yale University for helpful conversations on this subject.

Exchange listed Level 2 and Level 3 ADR programs require substantial disclosure including an annual Form 20F and a "current events" Form 6K which can include extensive information.

NYSE also requires semi-annual reports by home country GAAP and encourages quarterly reports as well.

Concern.—Do higher reporting requirements have a substantial real impact?

b. Listing in the U.S. puts PRC companies nearer the U.S. legal system [3]

Mismanagement, false reporting, and other misbehavior can lead to delisting, put pressure on auditors, and can draw legal action against companies, auditors, or investment bankers in U.S. courts.

U.S. listing can signal that a PRC firm intends to uphold high standards.

Concerns.—Explicit legal recourse against PRC companies in the U.S. may be limited, especially for over-the-counter listings and for companies with no assets in the U.S.

There is little precedent for using U.S. courts to discipline or reform foreign corporations even if they are listed in the U.S.

c. Listing in the U.S. imposes other types of scrutiny

Recommendations of U.S. stock market analysts affect the market for the company's shares and the ability to sell additional shares.

Environmental and social issues (example: Sudan) draw pressure and attention from the U.S. press, politicians, and NGOs, and can dissuade U.S. institutions from investing.

6. Conclusions

Raising equity capital in the U.S. increases expectations and pressure for higher quality governance, disclosure, and legal standards to be imposed on PRC corporations.

To garner the benefits of U.S. listing, PRC firms must submit to these pressures and adhere more closely to U.S. capital market norms.

Question. Will U.S. norms filter back to China and influence the Chinese trading, legal, and disclosure environment?

Listing in the U.S. adds to the cacophony of voices of PRC investors, reform minded politicians, and economists who want better legal and disclosure standards and better corporate performance.

Question. Are improved stock market practices part of the "thin edge of the wedge" that separates business and government in China, increases the efficiency and fairness of the economy, and compels PRC governmental institutions to be more responsive to the needs of citizens? If so, listing in the U.S. should be encouraged.

[3] I thank Professor Andrew Karolyi of Ohio State University for a conversation on this subject.

APPENDIX I.—CHINESE STOCKS LISTED IN U.S. MARKETS

ISSUE	SYMBOL	EXCHANGE	COUNTRY	INDUSTRY	Dep	Type	SPONS	DATE	USD mil
Sinopec Beijing Yanhua Petrochemical Co., Ltd.	BYH	NYSE	China	Chemicals	BNY	Level III	S	Jun 25, 1997	165.3
China Eastern Airlines Corporation Limited	CEA	NYSE	China	Airlines	BNY	Level III	S	Feb 05, 1997	182.0
China Mobile (Hong Kong) Limited	CHL	NYSE	China	Telecom-Data Ntwking	BNY	Level III	S	Oct 23, 1997	47,196.0
China Unicom Limited	CHU	NYSE	China	Telecom-Data Ntwking	BNY	Level III	S	Jun 22, 2000	13,658.4
Guangshen Railway Company Limited	GSH	NYSE	China	Transp:Services	MGT	Level III	S	May 01, 1996	221.0
Huaneng Power International, Inc.	HNP	NYSE	China	Util-Gas&Electric	MGT	Level III	S	Sep 01, 1997	3,122.5
Jilin Chemical Industrial Company Ltd.	JCC	NYSE	China	Chemicals	BNY	Level III	S	May 01, 1995	264.4
PetroChina Company Limited	PTR	NYSE	China	Oil & Gas-Service	BNY	Level III	S	Apr 07, 2000	3,006.6
Sinopec Shanghai Petrochemical Company Limited	SHI	NYSE	China	Chemicals	BNY	Level III	S	Jul 01, 1993	48.1
China Petroleum & Chemical Corporation—Level III	SNP	NYSE	China	Oil & Gas-Service	CIT	Level III	S	Oct 19, 2000	12,207.5
Yanzhou Coal Mining Company Limited	YZC	NYSE	China	Mining & Minerals	BNY	Level III	S	Mar 27, 1998	834.2
China Southern Airlines Co., Ltd.	ZNH	NYSE	China	Airlines	BNY	Level III	S	Jul 31, 1997	920.6
Netease.com, Inc.	NTESE	NASDAQ	China	Tech:Service	BNY	Level III	S	Jul 06, 2000	19.5
Beijing Datang Power Generation Company Limited	BJDHY	OTC	China	Util-Gas&Electric	BNY	Level I	S	Sep 04, 2001	
China Shipping Development Company Limited	CSDXY	OTC	China	Transp:Services	BNY	Level I	S	Mar 01, 1996	
Guangzhou Shipyard International Company Limited	GSHIY	OTC	China	Engineer-Machinery	BNY	Level I	S	Jul 13, 1995	
Shanghai Waigaoqiao Free Trade Zone	SGOTY	OTC	China	Multi-Industry	BNY	Level I	S	May 01, 1995	
Shanghai Erfangji Co. Ltd.	SHFGY	OTC	China	Engineer-Machinery	BNY	Level I	S	Dec 01, 1993	
Shanghai Tyre and Rubber Co., Ltd.	SIRHY	OTC	China	Indus Gds-Rubb&Plast	BNY	Level I	S	Oct 01, 1995	
Shanghai Jinqiao Processing Dev Co. Ltd.	SJQIY	OTC	China	Real Estate	BNY	Level I	S	Jul 01, 1996	
Shanghai Chlor-Alkali Chemical Co., Ltd.	SLLBY	OTC	China	Chemicals	BNY	Level I	S	Mar 01, 1994	
Shanghai Lujiazui Finance & Trade Zone Development	SLUJY	OTC	China	Real Estate	BNY	Level I	S	Jul 01, 1996	
Shenzhen S.E.Z. Real Estate and Properties	SZPRY	OTC	China	Real Estate	BNY	Level I	S	Aug 01, 1994	
Tsingtao Brewery Company Limited	TSGTY	OTC	China	Beverage	BNY	Level I	S	Feb 01, 1996	
China Shipping Development Co., Ltd. 144A	CSDWY	PORTAL	China	Transp:Services	BNY	144A	S	Nov 01, 1994	
Harbin Power Equipment Company Ltd. 144A	HPECYP	PORTAL	China	Electrical Equipment	BNY	144A	S	Dec 01, 1994	
Maansham Iron & Steel Ltd. 144A	MIS	PORTAL	China	Steel	CIT	144A	S	Nov 01, 1993	
Qingling Motor Company, Ltd. GDR	QINGDR	PORTAL	China	Auto-Auto Parts	CIT	144A	S	Aug 01, 1994	
Tingyi (Cayman Islands) Holdings Corp.	TINGYP	PORTAL	China	Food-Agribus-Tobacco	BNY	144A	S	Feb 01, 1996	
Yizheng Chemical Fibre Company 144A	YCF	PORTAL	China	Chemicals	CIT	144A	S	Mar 25, 1994	
Zhejiang Southeast Electric Power Co. Ltd. 144A	ZHJGYP	PORTAL	China	Electrical Equipment	BNY	144A	S	Sep 19, 1997	
Jiangling Motors Corp. GDR			China	Auto-Auto Parts	CIT	Reg S	S	Sep 01, 1995	
Qingling Motor Company, Ltd. Reg S			China	Auto-Auto Parts	CIT	Reg S	S	Jul 28, 1993	
Zhejiang Southeast Electric Power Co. Ltd. Reg S			China	Electrical Equipment	BNY	Reg S	S	Sep 19, 1997	
Brilliance China Automotive Holdings Limited	CBA	NYSE	Hong Kong	Auto-Auto Parts	BNY	Level II	S	Apr 17, 2000	2,149.5
China National Offshore Oil Corporation—Level II	CEO	NYSE	Hong Kong	Oil & Gas-Service	MGT	Level III	S	Feb 20, 2001	7,727.1

China Resources Enterprise, Limited	CHNRY	OTC	Hong Kong	Multi-Industry	BNY	Level I	S	Oct 18, 1996	
China Online (Bermuda) Limited	COBVY	OTC	Hong Kong	Telecom-Data Ntwking	BNY	Level I	S	May 01, 1994	
Guangdong Investment Limited	GGDVY	OTC	Hong Kong	Multi-Industry	CIT	Level I	S	Aug 01, 1994	
Guangzhou Investment	GUAZY	OTC	Hong Kong	Multi-Industry	BNY	Level I	S	Dec 09, 1999	
Guangnan (Holdings) Limited	GUGNY	OTC	Hong Kong	Food-Agribus-Tobacco	BNY	Level I	S	May 13, 1998	
Great Wall Cybertech Limited	GWCBY	OTC	Hong Kong	Electrical Equipment	BNY	Level I	S	Dec 15, 1997	
Gzitic Hualing Holdings Limited	GZHUY	OTC	Hong Kong	Electrical Equipment	BNY	Level I	S	Apr 20, 1997	
Jinhui Holdings Company Limited	JHUHY	OTC	Hong Kong	Transp:Services	BNY	Level I	S	Aug 09, 1994	
Jinhui Shipping and Transportation Limited	JNSTY	OTC	Hong Kong	Transp:Services	BNY	Level I	S	Dec 09, 1999	
Shanghai Industrial Holdings Limited	SGHIY	OTC	Hong Kong	Retailing	BNY	Level I	S	May 16, 2001	

Source is www.adrbny.com, except for current market value from Telerate/Bridge. ''Dep'' indicates whether American Depositary Receipt (ADR) program is organized through Bank of New York, Citibank, or JP Morgan. ''TYPE'' is the level of ADR program, with II and III being most demanding. ''SPONS'' indicates whether the ADR program is sponsored by the company. ''DATE'' is the effective date of the listing in the U.S. ''USD mil'' is an estimate of the total value of all shares (not just U.S. listed) at approximately midday on November 27, 2001 from Telerate/Bridge. It is missing for companies that do not trade in an organized stock market from which price data is readily available. Several PRC companies that are listed ''directly,'' that is, not as ADRs, are missing from the list. Also included are ADRs for ''red chips,'' that is, PRC controlled entities listed on the Stock Exchange of Hong Kong.

APPENDIX II: RECENT EXAMPLES OF ACCOUNTING CHICANERY

PREPARED BY MY PH.D. STUDENT, MISS YUAN GAO. SOURCE IS HTTP://WWW.CNSTOCK.COM (SPECIFIC LINK NO LONGER WORKS)

Guangxia (Yinchuan) Industry.—Once regarded as the No. 1 blue chip, the company reported a non-existing profit of 745 million RMB in 1999, and 567 million in 2000. They did this by falsifying sales contracts, export custom report, tax documents, and financial/accounting receipts. Widely reported in media.

Zhenzhou Baiwen Co. (retailer).—Inflated profit by 19.08 million RMB before its IPO by reducing expenses, recognizing revenue in advance, and making IPO application based on those manipulated accounting numbers. Within three years after IPO, further inflates profit by minimizing expenses and expensing items across financial periods. The total inflated profits are 143.9 million RMB. Moreover, the firm's assets are unsubstantiated, there are major omissions in its IPO prospectus, and its annual financial statements contain falsified records, misleading statements, and major omissions.

Macat Optics & Electronics.—Falsified three years' profits of 93.2 HK$ before its IPO. They also falsified imported equipment financing-renting contract, and fabricated fixed assets and import-export receipts to be approved for IPO.

Sanjiu Medical & Pharmaceutical.—The company has been listed for about one year. Big shareholders of the company and related parties use (abuse) 2.5 billion RMB in capital, which is 96% of the company's net assets.

Beijing Centergate Technologies.—Provided collateral for one of its major holding company's bank loan of 2.56 billion RMB. The amount of this loan is 145% of net assets.

China Kejian.—The company provided collateral for 24 loans for other people within 12 months of listing in 1994. The value of the total collateral is 639.13 million RMB, which is 300.35% of the company's net assets after year 2000's audit.

Hainan Dadonghai Tourism Center.—Within the five years, 1993–1997, inflated profits to 228 million RMB.

Hubei Lantian.—The firm inflated its intangible assets by 11 million RMB, and falsified the firm's and subsidiaries' bank deposit receipts to inflate bank deposits by 27.7 million RMB. In its IPO application material, it changed the firm's pre-IPO shares from 83.7 million to 66.96 million shares, and decreased state, LP, and employee's holdings correspondingly.

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Commissioner ROBINSON. Thank you very much, Professor Bailey.

Before we move to Dr. Lardy, I would just like to make reference to the exhibits that you see before you on the easels: A, B, and C. For those who may have difficulty seeing these exhibits, we have distributed hard copies to all of our participants today.

EXHIBIT A

Equity fund raising by Chinese entities

Source: Morgan Stanley Dean Witter/Wall St. Journal

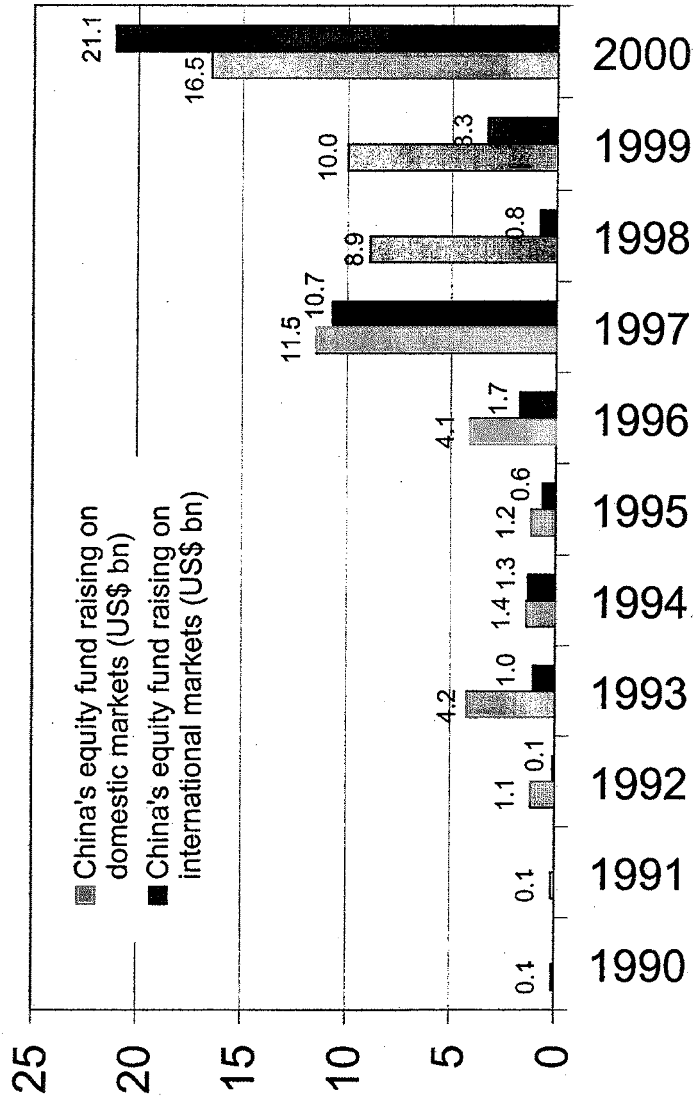
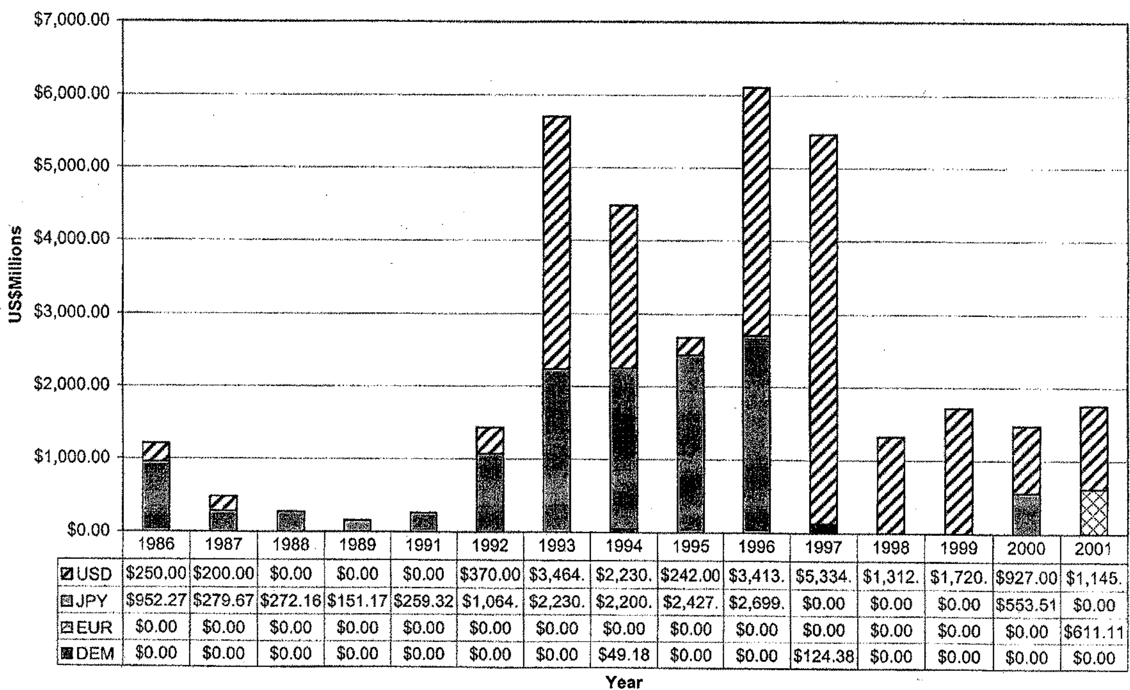


EXHIBIT B

Source: Bloomberg data compiled by USCC staff



	1986	1987	1988	1989	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
USD	$250.00	$200.00	$0.00	$0.00	$0.00	$370.00	$3,464.	$2,230.	$242.00	$3,413.	$5,334.	$1,312.	$1,720.	$927.00	$1,145.
JPY	$952.27	$279.67	$272.16	$151.17	$259.32	$1,064.	$2,230.	$2,200.	$2,427.	$2,699.	$0.00	$0.00	$0.00	$553.51	$0.00
EUR	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$611.11
DEM	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$49.18	$0.00	$0.00	$124.38	$0.00	$0.00	$0.00	$0.00

EXHIBIT C

Breakdown of PRC-related American Depository Receipts Sold in U.S. Markets

Source: Bank of New York data compiled by USCC staff

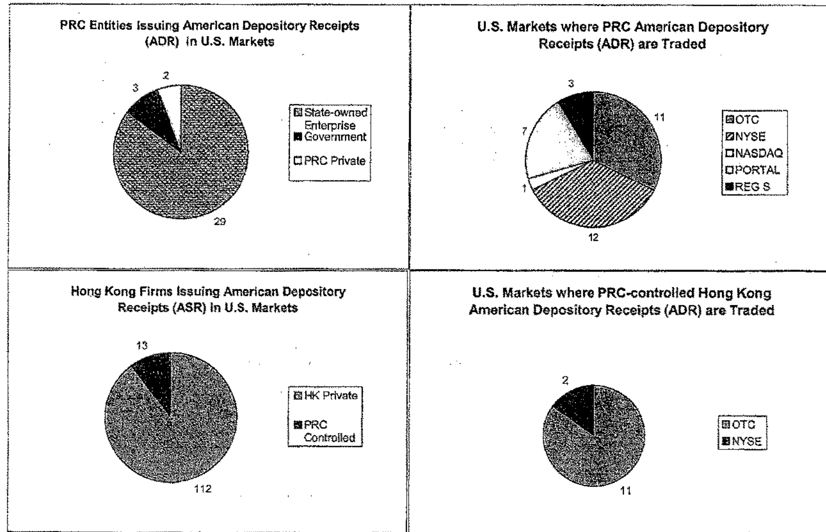


Exhibit A looks at China's fundraising both within China and overseas for the period 1990 to 2000. Exhibit B shows China's bond offerings internationally since 1986, broken down by the currency in which these offerings were denominated. And Exhibit C provides a breakdown of Sino-American depository receipts sold in U.S. markets, first by the type of Chinese entity—state-owned, sovereign, private; the U.S. exchanges in which so-called ADRs are traded, whether it is the New York Stock Exchange, NASDAQ, over-the-counter, et cetera; Hong Kong firms issuing ADRs, as they are called, in U.S. markets; and the U.S. markets where PRC-controlled Hong Kong ADRs are traded. And we thank the staff for that.

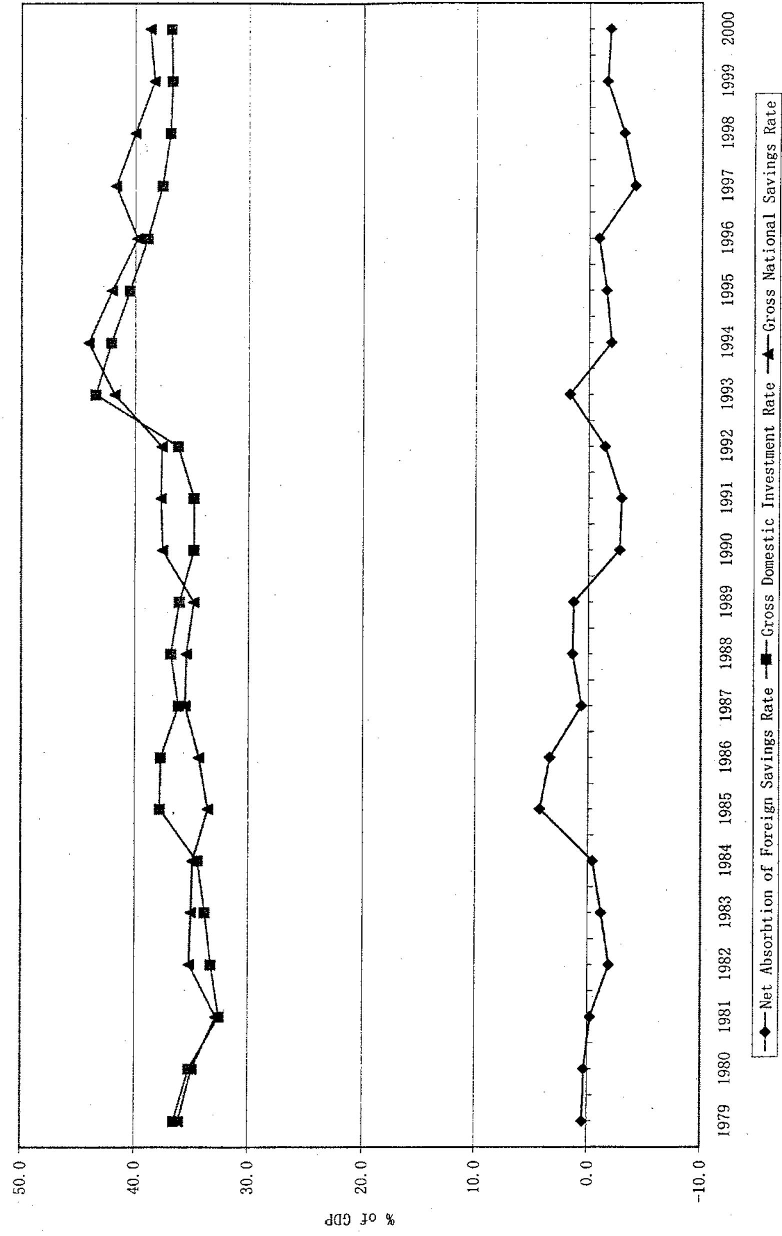
With that, I'd like to turn to Dr. Lardy.

STATEMENT OF NICHOLAS LARDY, SENIOR FELLOW, BROOKINGS INSTITUTION

Dr. LARDY. Thank you very much.

Thank you very much, Commissioner Robinson. I am delighted to have a chance to be here.

I am going to be referring in the initial part of my presentation to a very simple diagram that I hope has been passed out—I gave it to the staff this morning—that gets at this question of what China's capital requirements might or might not be, partly based on looking at the entire period of economic reform from the late 1970s up to the present time. It is a very simple diagram. It shows national savings, domestic investments, and the net absorption of foreign savings.


PRC Net Absorbtion of Foreign Savings, 1979-2001
% of GDP
50.0
40.0
30.0
20.0
10.0
0.0
-10.0
1979
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
Net Absorbtion of Foreign Savings Rate
Gross Domestic Investment Rate
Gross National Savings Rate

The key theme that emerges from this is that China really is fundamentally different from many other emerging markets in that its domestic savings are more than sufficient to finance all of its investment. You can see that, over the last ten years, there has only been one year, 1993, in which China was a net absorber of foreign savings, so I believe this goes to the point that Commissioner Becker was raising in his exchange with Senator Thompson about the fungibility of money and whether or not even providing access to our capital markets for firms with an unblemished record might free up some funds for other less worthy, shall we say, recipients of funding.

But the basic thing that emerges from this is that the savings generated by Chinese entities are more than sufficient to finance all investments undertaken in China in recent years, and I think if you look on balance over the whole period, you'll see that China has actually been a provider of savings to other countries.

I think one of the key things going forward, trying to look at why are Chinese issuers coming to this market, as Professor Bailey mentioned, there is something in it for them, a variety of things, but one of the most fundamental, I would say, is the fact that even though China has a very high rate of savings, it has an extraordinarily inefficient system for allocating those savings, the capital markets, and the equity markets and the bond markets both are at a very, very early stage of economic development. They have not succeeded in allocating capital remotely efficiently. Very large issues are not possible on the domestic market, so there will be some issuers in that market who will seek international sources for financing their activities even though there is no shortage of savings in the domestic economy.

So clearly, I would argue that going forward, the extent to which these domestic entities will want to continue to tap into the international market will depend on the pace of development of domestic capital markets both on the equity side and on the debt side. If they can move toward a much more efficient domestic capital market, I would anticipate that the issuance in the international market would be relatively smaller; if it continues to be hobbled by the kinds of problems we have just heard described, then I think you will see continued significant efforts by Chinese entities to raise money in the international market.

The domestic market should be a very good substitute for the international market. Most of these firms that are raising money don't really need foreign exchange, and quite frankly, for many of them, there is a disadvantage of raising money in international currencies, because then they are exposed to foreign exchange risks. The long-term trend, of course, is that the RMB has depreciated dramatically, so if you are a domestic firm, and your income-generating activities are predominantly or perhaps even exclusively in domestic currency, there is a certain risk in, for example, issuing bonds denominated in foreign currency. So I think that there would be a tendency for these firms to issue in their own domestic market when it became efficient, or when you got a listing process that was driven by economic fundamentals rather than by politics, and when you had a more efficient regulatory system.

I think they are making progress. They are starting to de-list some companies that have failed to perform. The regulators are taking a number of steps in the last couple of years which I think are very promising, but again, we are still at a very early stage.

The other thing I'd like to point out in my remarks is simply that even though China has tapped in significantly to international capital markets, foreign direct investment inflows continue to be far more important than access to international capital markets in terms of accessing foreign savings. I think this is likely to continue to be the case; as you know, they have been receiving foreign direct investment inflows in the range of $40 to $45 billion a year for the last four or five years. Many people believe that with the additional liberalization that is scheduled in their WTO commitments, there will be increased foreign investment in sectors that are being liberalized, notably, telecommunications, financial services, and various forms of distribution. Some of the international investment banks have even predicted that foreign direct inflows will, within a relatively short period of time, be at the level of $100 billion per year. That is a speculative estimate in my judgment, but whatever the actual number turns out to be, there is no question that in the recent past, and I would argue at least for the short term, maybe even the medium term, that foreign direct investment inflows are going to be more important as a source of finance than access to international capital markets on either the equity side or the debt side.

So in summary, I am saying that China has a very, very high savings rate, as you can see from the figure, averaging about 40 percent over the last 10 years—that probably makes it, with the exception of Singapore, the highest rate of savings of any country in the world, or certainly any significant sized economy in the world—and that their own domestic savings are more than sufficient to finance their investment. This makes them quite different from most countries, let's say, in Southeast Asia, where capital inflows of one sort or another allow these countries to invest at roughly, let's say, a 20 percent rate when their domestic savings rate may only be about a 15 percent level. That is not the case for China.

The key determinant in my judgment, going forward, on the extent to which they will continue to tap international capital markets is the pace of development of their own markets. The stock markets, we have heard about. Actually, their own domestic debt markets are even less well-developed and are not a significant source of funds for the corporate sector today.

And finally, the point that foreign direct investment inflows continue to be quite important in aggregate amounts and far outweigh money being raised in international capital markets. I do think the amounts will go up, both because of liberalization of various sectors, and I think it will go up also as we see more cross-border merger and acquisition activity as China continues to liberalize its markets.

Let me stop there. Thank you very much.

Co-Chairman ROBINSON. Thank you, Dr. Lardy. We'll give you more time for questions as you actually came in under the wire.

Mr. Byrne, over to you.

STATEMENT OF THOMAS J. BYRNE, VICE PRESIDENT, MOODY'S INVESTORS SERVICE

Mr. BYRNE. Thank you.

I am pleased to appear before the Commission to testify as a rating agency's perspective on China's foreign capital regime.

I am a vice president and senior analyst within the Financial Institutions Group at Moody's, and my primary responsibilities are not only in China but also Japan, Korea, and the other major countries in East Asia.

I will pick and choose from the paper that I wrote for the Commission. To start with, I think I should say that Moody's ratings as an international credit rating agency are intended to provide capital market participants with a framework for comparing the credit quality of debt securities. The credit rating compresses an enormous amount of diverse information into a single symbol. Credit quality embraces relative default probability, loss severity, financial strength, and something we call transition risk, which is large rating movements.

In addition to economic and financial factors, ratings also reflect political and other systemic features. What I will focus on is how these features I think play a role in determining the composition of capital inflows into China.

While the ordinal ranking of a sovereign rating will not necessarily indicate how much foreign capital a country will attract, other factors will, and other features within the system do. I would just like to point out that, of course, in the emerging markets, the Latin American countries dominate the capital inflows within the emerging markets, and generally speaking, the Latin American countries have much lower country ratings than the major East Asian countries.

In regard to China, Moody's rating universe, including the corporate ratings, is actually relatively small. There are just under 40 issuers in China that are rated. Of course, the country itself is rated A3, which is high, which indicates to us that there is a very low probability of default by the sovereign over a 5- to 10-year period. The sovereign should have very little trouble accessing the international capital market, in other words, if it chooses to do so.

Of the issuers in China that we rate, these companies are dominated by financial institutions. There is only a handful of corporate ratings.

The number of issuers in a particular country having a rating is a function of the existence of globalized corporations, the degree of development of the domestic capital markets, and their integration into the world economy. That is why, for example, Korea has more rated issuers than China and why Japan has hundreds of rated financial and non-financial corporations, and why the United States has more than a thousand, and perhaps thousands.

China attracts huge amounts of foreign capital for an emerging market, as Nick Lardy pointed out, but the composition of the inflows is paradoxical. China's open door policy remains selective and restrictive, encouraging certain forms of foreign capital but discouraging and preventing others.

Industry can be modernized in China with foreign capital, but financial markets have not yet been allowed the freedom to fly out-

side the birdcage of Mao's orthodox economist, Chen Yun, the birdcage that he imposed on non-state economic activity.

This strategy has served China well in its early stage of transition toward capitalism, fostering fixed capital formation and protecting systemic stability. For example, capital controls, together with prudent external debt management by the central government prevented an overhang of foreign bank-financed credit and vulnerability to sudden shifts in creditor confidence. Thus, China escaped unscathed during the Asian financial crisis.

As Nick Lardy also pointed out, the actual inflows into China of foreign direct investment are substantial—$40 billion annually—and likely to increase. In fact, there are signs that they are increasing already in a post-WTO environment.

However, in contrast, foreign portfolio investment into China is actually small, and foreign debt inflows have become marginal in recent years. Government policy still does not seek to develop the domestic bond market, and together with capital controls, prevents foreign investment in corporate or even government bonds.

The domestic bond market in China is growing, but only because of government issuances. Corporate bonds account for only about one percent of the market, and in fact, their place has diminished in recent years.

China's investment regime and capital markets will remain segmented and suppressed, in my opinion, until the government allows the private sector to assume the leadership role in the economy.

Amendment to the Constitution in 1999 stopped well short of that. The Communist Party, acting through the government, remains reluctant to relinquish its dominance in the banking system, corporate sector, and even the stock market.

As I noted earlier, China has fewer rated bond issuers than Korea and much fewer than Japan, and it is not due to the size of the economy, it is not due to the relative trade, but it has to do with other systemic factors. One, I think, is that China is in the process of looking for a new conduit to attract foreign capital other than direct investment. The investment and trust company experience proved to be a bust, and the ITICs, which were the previous windows, are no longer active sources of foreign capital inducement into China.

Rather, it seems that China is cautiously looking into using IPOs and selected state companies to attract capital, but although there have been headline cases that have attracted considerable amounts of funds, this is still a process that is controlled by the government, and I don't think the government is very eager yet to throw open the door of the birdcage. Moody's, just to point out, does not yet have a rating on any truly private entity in China. The imminent demise of the state sector in China I think is exaggerated.

Another important factor in determining the openness of an economy to portfolio investment, particularly debt securities, is the existence of a domestic bond market that is hospitable to foreign participation. Some of the preconditions would mean that capital and interest rate controls must be relaxed, and an institutional framework of legal protection must be there for private sector investor rights and creditor rights.

One indication of such protection is embedded in Moody's ratings for domestic currency obligations of the government. All the other major countries in East Asia have this rating, and these ratings are included in a table in the back of my testimony.

However, China does not, and there are two reasons for this. One is that still because of capital controls and also interest rate controls, there is very little foreign investor interest or capability in investing in China's domestic bond markets. But the second is that there is a lack of legal protection in terms of creditor rights. So until there is a major change in that direction, it is most likely Moody's will not assign a rating to the government in domestic currency. In contrast to the government's rating, we already have in foreign currency international obligations.

So in conclusion, I think that before China can benefit more fully from greater access to the international capital markets, there will need to be a fundamental shift or change in the Chinese economic and political system as well as its legal system.

I'll stop there.

[The statement follows:]

PREPARED STATEMENT OF THOMAS J. BYRNE

CHINA'S PARADOXICAL FOREIGN CAPITAL REGIME: AN OPEN AND CLOSED SYSTEM

Moody's ratings are intended to provide capital market participants with a framework for comparing the credit quality of debt securities. A credit rating compresses an enormous amount of diverse information into a single symbol. Credit quality embraces relative default probability, loss severity, financial strength and transition risk (large rating movements). In addition to economic and financial factors, ratings also reflect political and other systemic features, particularly for sovereign ratings. In corporate ratings, similar factors are described as the operating environment. This paper addresses how these features also play a role in determining the composition of capital inflows into China.

The ordinal ranking of sovereign ratings will not necessarily indicate how much foreign capital a country will attract. Relatively low rated Latin American countries have dominated emerging market capital inflows because of other features at play in addition to default probability of the sovereign. Although the analytical emphasis on sovereign ratings is primarily on default probability (or severity of loss for lowly rated countries such as Argentina), sovereign defaults are rare. The Asian crisis produced no sovereign bond defaults. The three sovereign international bond defaults in recent years happened outside East Asia—Ecuador, Ukraine and Pakistan (Argentina has not defaulted, yet). The analytical emphasis for the banking sector also includes financial strength. This is because, in the case of bank ratings, the regulatory safety net in most countries provides outside support independent of the intrinsic financial strength of the particular bank.

In regard to China, Moody's ratings universe is relatively small, although it is gradually increasing as state-owned companies seek to tap the international bond markets. Sovereign foreign currency securities are rated A3, indicating very low probability of default over a 5–10 year horizon, in Moody's opinion. Only about 40 issuers in China, including the sovereign, have ratings—these are dominated by financial institutions; only a handful of corporations have ratings. The number of issuers in a particular country having a rating by an international credit rating agency is a function of the existence of globalized corporations and the degree of development of the domestic capital markets and their integration into the world economy. That is why Korea has more rated issuers than China, and why Japan has hundreds of rated financial and non-financial corporations and the United States has thousands.

China attracts huge amounts of foreign capital for an emerging market, but the composition of the inflows is paradoxical. China's Open Door Policy, remains selective and restrictive, encouraging certain forms of foreign capital, but discouraging and preventing others. Industry can be modernized, but financial markets have not yet been allowed the freedom to fly outside the birdcage that Mao's orthodox economist, Chen Yun, imposed on non-state economic activity.

This strategy has served China well in its early stage of transition towards capitalism, fostering fixed capital formation and protecting systemic stability. For example, capital controls, together with prudent external debt management by the central government, prevented an overhang of foreign-bank-financed credit and vulnerability to sudden shifts in creditor confidence. China was largely unscathed by the Asian financial crisis. The heavy reliance on domestic financing intermediated by the state-owned banking system and, increasingly, by the state-controlled and dominated stock market, provides key support to the state owned enterprise system as it is gradually restructured and commercialized.

China has a wide, open door to foreign direct investment, typically in the form of joint ventures with state owned non-financial firms. Such inflows, which have been sustained at about $40 billion annually in the past five years, and show signs of rising further in the post-WTO environment, are by far the largest in Asia, and are multiples of FDI inflows into Japan even (see appended Table A). This has served China well in its acquisition of technology and addition of export capacity. Indeed, the value of China's exports may surpass that of Japan's before the end of this decade if recent trends continue. The rapid growth in foreign-invested enterprises has also helped boost official foreign exchange reserves, generate employment, and bolster the government's weak fiscal capacity.

Foreign portfolio investment inflows, in contrast, are very small, and foreign debt inflows have become marginal in recent years. Government policy still does not seek to develop the domestic bond market, and together with capital controls, prevents foreign investment in corporate or even government bonds. The domestic bond market in China is growing, but only because of government issuances. Corporate bonds account for only 1 percent of the market, and their place has diminished in recent years. While China's domestic stock exchanges are the star performers in Asia this year, and market capitalization has risen to more than 50 percent of GDP from zero in the past decade, foreign participation remains relatively minor, and non-state listings are a very small part of the market.

China's investment regime and capital markets will remain segmented and suppressed, in my opinion, until the government allows the private sector to assume the leadership role in the economy. Amendment to the Constitution in 1999 stops well short of that. The Communist Party, acting through the government, remains reluctant to relinquish its dominance in the banking system, corporate sector and even stock market. My guess is that this will remain the case, although WTO-induced liberalization will speed up the commercialization of the state sector. Increased competition in the financial sector from a greater foreign presence, perversely, could weaken the post-Open Door banks that are not under the direct control of the central authorities. On the other hand, the large state-owned banks, which are intrinsically very weak, but too big to fail, remain protected and supported by the central government and will likely continue to dominate the financial sector.

Vulnerabilities to crisis in a closed system such as China are domestic, not external (unless some unforeseeable development chokes FDI inflows and export performance). The low level of exposure to foreign bank credit dampens contagion effects such as those seen in the Asian crisis. In fact, the large reduction in foreign bank debt in the wake of the Guangdong Investment and Trust (GITIC) bankruptcy in 1998 did not affect FDI inflows, which remained large while official foreign exchange reserves continued to rise. The Chinese economic system will remain stable as long as the workers and bank depositors, and increasingly individual stock market investors remain confident that the economic and social policies of the government will continue to lead to a rising standard of living.

If, however, the Chinese authorities shift policy, and decide that large foreign portfolio equity is good for the economy, formidable institutional obstacles will need to be removed. Market-determined interest rates and credit risk judgements will need to allocate financial resources. Corporate governance, in all its facets, will need to be promoted. Limits not only on foreign participation in the stock market will need to be reduced or eliminated, but also government ownership of banks and firms will need to be downsized or relinquished to enlarge the scope for the private sector. Growing fiscal strains, or rising unemployment, may prompt the government to take the next quantum leap in reform, which would provide an even wider opening for foreign capital, potentially.

However, the record in Asia shows that, in government-directed economies, the course of reform was not predictable and gradual, but rather evolved discontinuously. Financial and capital market reform was a by-product of crisis. Korea, precrisis, had a precise blueprint for liberalization, but the system was only marginally changed. Rather, the dire effects of the 1997 crisis galvanized political will and led to liberalization measures which induced unimaginably high FDI inflows and port-

folio investment inflows compared with the pre-crisis regime. This helped stabilize the balance of payments and boost Korea along its V-shaped economic recovery. Reform-induced capital could still play an important role in cushioning the Korean economy from the downturn in global economic conditions, and in enhancing its competitiveness in the global economy. But the political consensus for reform would need to be refreshed.

As I noted early, China has fewer rated bond issuers than Korea and much fewer than Japan. This is not strictly due to size, the Chinese economy is much bigger than Korea, nor is it strictly related to trade, as China's exports are greater than Korea's and catching up to Japan's. Other factors are the reason. One is that China has relied heavily in the past on using financial institutions and conduits of foreign debt capital, namely, the investment and trust companies. But the bankrupt GITIC and other near-bankrupt ITICs in other regions are no longer active windows for the inducement of foreign capital. The government has allowed there institutions to falter and, accordingly, they have very low ratings from Moody's. Other financial institutions in China that continue to receive relatively high ratings from Moody's are those that are important enough to receive government support so as to maintain systemic stability—such as the four large state-owned banks. Prudence on the part of the government will prevent the extension of such support to other, new institutions. In the wake of the ITIC debacle, the government has taken a very cautious approach to introducing new institutions or markets to attract other forms of capital, particularly portfolio investment. The government determines and controls which state owned firms or banks are allowed to seek and international rating, as a prelude to an IPO and eventually to raise funds from international bond markets. And the government is not eager to throw open the door of the birdcage. Moody's does not have a rating on any truly private entity in China, yet.

Moreover, another factor determining the openness of an economy to foreign portfolio capital inflows has to do with the existence of a domestic bond market that is hospitable to foreign participation. These means capital and interest rate controls must be relaxed, and the institutional framework and legal system must offer protection for private sector investor rights. An indication of such protection is embedded in Moody's ratings for domestic currency ratings of the government (see Table B). The government of Japan, like all advanced countries, has a rating for its bond obligations; and Japan has a very active domestic bond market in which Moody's provides ratings consistent with its internationally recognized rating system. The government of Korea was assigned a domestic currency rating for its bonds and notes post-Asian crisis. Weak institutional features in this market have, however, continued to hamper foreign participation and have prevented Moody's from extending its international rating system to the domestic Korean bond market.

In the case of China, Moody's has not assigned a domestic currency rating for the government, in part because of lack of investor interest (interest and capital controls discourage foreign participation), but also because of the lack of protection for creditors under the current legal system in China. Before China can benefit more fully from greater access to the international capital markets, there will need to be fundamental changes in the Chinese economic, legal and political systems. China has much unrealized potential; if WTO means that China has chosen liberalization, China will increasingly attract portfolio investment from the large pool of global capital.

TABLE A.—BALANCE OF PAYMENTS CAPITAL INFLOWS, GROSS

($ BILLIONS)

	1998	1999	2000
China:			
FDI	$44	$39	$38
Equity securities	1	1	7
Debt securities	−1	−1	0
Korea:			
FDI	5	9	9
Equity securities	4	12	12
Debt securities	−4	−5	−1
Japan:			
FDI	3	12	8
Equity securities	16	104	−1
Debt securities	40	23	49
United States:			
FDI	178	301	288

TABLE A.—BALANCE OF PAYMENTS CAPITAL INFLOWS, GROSS—Continued

($ BILLIONS)

	1998	1999	2000
Equity securities	42	112	194
Debt securities	227	242	281

Sources: IMF International Financial Statistics and national official.

TABLE B.—MOODY'S RATINGS

	Foreign Currency Ceiling	Government (dom. currency)	Avg. BSFR [1]
China	A3	Not rated	E+
Korea	Baa2	Baa1	E+/D −
Japan	Aa1	Aa3	D −
United States	Aaa	Aaa	B

[1] Average bank financial strength rating for rated banks in system, ranging from A for exceptionally intrinsic strength to E for intrinsically weak banks requiring outside support.

Co-Chairman ROBINSON. Thank you very much, Mr. Byrne.

Mr. Harner, we'll hear from you now.

STATEMENT OF STEPHEN M. HARNER, PRESIDENT, S.M. HARNER AND COMPANY (SHANGHAI)

Mr. HARNER. Thank you.

I am very pleased to be here. I would say that my experience comes more as a practitioner. Having been active as chief representative of Deutschebank in Shanghai for four years, I personally dealt with many of the companies that I suppose now are under inspection, H share companies or Red Chips or B share companies—in other words, companies that have been raising funds internationally, including from the bank with which I was associated at the time.

I would like also to skip through the presentation and refer to some of the comments made by other panel members.

I would endorse, first of all, the comment of Nick Lardy concerning the overall funding capability of the Chinese financial markets in terms of their own investment needs. There is no question that China has the savings and is able to mobilize the savings domestically to meet the vast majority of their domestic investment requirements if we look at it from a macro perspective.

At the same time, though, we have obviously seen an increase in international equity or international debt and international fundraising by Chinese entities. And let us be clear about what we mean by Chinese entities. Obviously, we are talking about corporate entities in some cases, but it gets a bit more complicated than that.

I would like to clarify the categories of the entities that we have seen issuing in international markets. We should differentiate between red chips, H share companies, and other companies, including B share companies.

Red chips, as the Commission I am sure is aware, are companies in Hong Kong that are controlled by a Chinese entity, that are under Chinese control. And because the controlling companies are always state-owned companies, I would endorse also the point that

the death of state-owned enterprises is certainly prematurely announced.

The companies we refer to as red chip companies, certainly the companies that are H share companies, are state-owned companies, not withstanding that they have offered some minority equity shares in the public markets. Red chip companies include not just operating corporate entities, they also include so-called window companies of government agencies and government entities in China.

In my remarks, I append something called "A Relationship Chart of PRC Companies Listed Abroad." This actually traces those companies—most of them; there are a few missing, but generally speaking, it is pretty up-to-date—and it lists the companies listed abroad, including the B share market, also including the Hong Kong Growth Enterprise Market, the second Board of the Hong Kong Exchange, NASDAQ, New York Stock Exchange, as well as, of course, Hong Kong, and traces back the ownership or the derivation of these companies, generally speaking, to the State Council, also to the Chinese Military Commission.

The point is that the Chinese companies that have been venturing abroad to raise funds are state-owned companies. Of course, this is the nature of the Chinese economy: the big state-owned companies that are now funding themselves in international markets are to some extent privatizing. It is a process that we are observing of sectors in the Chinese economy that have to become more competitive internationally, or competitive domestically, needing funds and therefore seeking funds through the equity market.

The point has been made that the domestic equity market is much more important than the international equity market. That certainly is true, and that will only become truer in the future. The Chinese equity market is very substantial. There are many problems, there are many flaws, but generally speaking, a successful domestic equity market and a dynamic functioning domestic equity market is a strategic imperative for the Chinese leadership and for China's economic development. And the Chinese leadership from Zhu Rongji all the way down is united in wishing to make the domestic equity markets better and to ensure that they function properly. We have seen daily actions of the regulators in China, the CSRC, the Chinese Securities Regulatory Commission, trying to regularize and rationalize and standardize this market.

And we should say that the market, again, is increasingly capable of financing China's requirements. But this has not always been true. Before 1997, before 1998, the Chinese domestic equity market was really very shallow, and that was one of the reasons why so many of the Chinese companies ventured abroad. Particularly, they ventured abroad into Hong Kong.

Another reason that they ventured into Hong Kong was obviously in advance of the handover of Hong Kong to Chinese sovereignty or the reversion of Hong Kong to Chinese sovereignty. PRC entities wanted to establish their positions in Hong Kong and took advantage of the markets there to establish local companies registered in Hong Kong. These are the red chips. And in many cases, these red chip companies were, as I mentioned before, window companies, which is to say they are essentially entities directly

under PRC municipalities and provinces. Most provinces, and many large municipalities, including Shanghai, Beijing, Tianjin, established companies in Hong Kong as funding vehicles through which they raised capital and invested back in China.

In a sense, the Chinese saw that Morgan Stanley and other foreign investment banks were intermediating capital, and they decided that they should take out the middleman. They saw that they could get into the business of establishing their own merchant banks in Hong Kong to raise capital for investment in China, and that explains to a great extent the red chip phenomenon. That phenomenon had its real heyday before the Asian financial crisis and in really a flurry of activity or a bubble of activity, ending in late 1997. But the red chips are still prominent.

There is much to say, but let me conclude by saying that when we consider the impact of Chinese entities in international financial markets, first of all, I think we should look at where the real core of activity is, and that is between Shanghai, or the domestic markets, and Hong Kong. These markets are becoming increasingly integrated. I believe the point was made this morning that H share companies, companies that have issued abroad, particularly in Hong Kong, are now in fact reissuing in China. They are issuing A shares in China.

Red chip companies soon, if news reports are accurate—and I believe they are accurate—red chip companies that have issued in Hong Kong will be allowed to issue China depository receipts, CDRs, on the domestic capital markets, so that those red chips who want to raise renminbi in the domestic markets will be able to do so through a mechanism like an American depository receipt, except in the China market.

So we see an increasing integration of Hong Kong and China where there is really very definitely sufficient capital to meet China's needs and the needs of these corporations.

New York, of course, is also a place where certain of the Chinese companies are raising funds. It is really a matter of, from the underwriter's perspective, where the market is, where there is interest among investors to invest in Chinese equity or debt. In my remarks, I also look at some of the trade reports of where major placements have been done of Chinese equity and debt issues, and what you see is a fairly diversified placement in Europe, Asia, and the United States, and it almost breaks down to 30–30–30 percent in these areas, with a little bit higher weighting in Asia.

Generally speaking, in conclusion, I would say that Chinese markets are active and will continue to be active. The main activity, though, will remain between China and Hong Kong, and there will not be an urgent or a great requirement for China to raise funds from the U.S. market, but to the extent that there is an appetite here for China issues, they will be distributed here as well.

Thank you.

[The statement follows:]

PREPARED STATEMENT OF STEPHEN M. HARNER

It is a great honor and privilege for me to be able to testify before the U.S.-China Commission. During a 25 year career in finance, consulting, and government service in Greater China and Japan, I have observed first-hand how often perceptions and preconceptions about financial and business relations between the United States

and these countries have departed from reality, and how usually U.S. interests—both commercial and national—would have been better served through careful analysis.

I hope that my testimony today will serve to clarify the reality as well as the implications of the relationship between China and Chinese entities and international financial markets. To the extent possible, my testimony will offer quantitative support for my conclusions, as we are, after all, discussing money. I feel strongly that speaking in quantitative terms—putting a price on the matter, as it were—is an important, perhaps the most important, step in reaching justifiable conclusions, at least concerning the question we are discussing.

WHAT ARE CHINA'S CURRENT AND PROJECTED CAPITAL NEEDS?

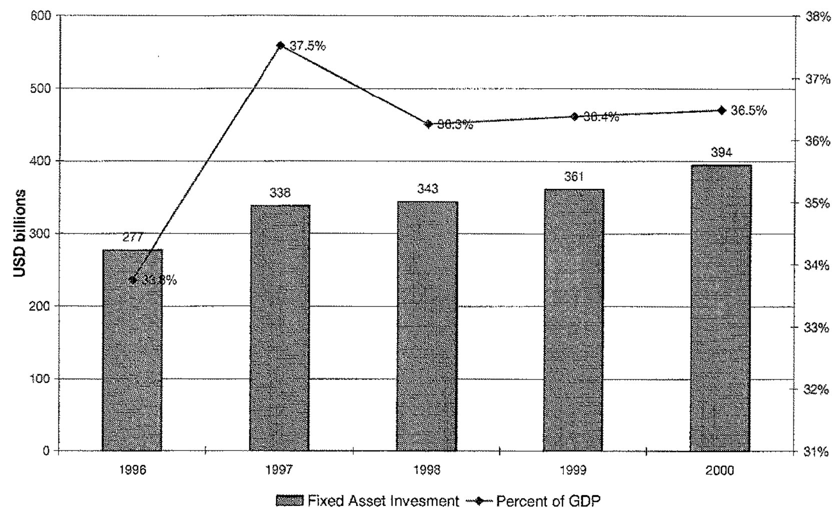
I. China's Development Capital Needs—How Much from International Markets?

A. Investment and Fund-Raising During the Ninth Five Year Plan Period

For most of the past two decades, and particularly since 1992, China's economy has been in transition from the centrally-planned, wholly state-owned system to a "mixed" system with a drastically reduced state-owned sector. This transformation is nowhere complete and, indeed, is certain to last at least another decade. During this period, the hand of government has been and will remain strong, and "five year plans" remain highly relevant as indicators of where government will directly or indirectly (through its control of the financial system and major institutions) direct investment.

What will be the capital needs of China in the coming decade and, particularly, during the next five years or so? And to what extent will foreign capital be accessed or required? To answer this question, let us first observe the record of the five years 1996–2000, the period of China's Ninth Five Year Plan (FYP).

Figure 1 China Fixed Asset Investment as Percent of GDP



Source: *People's Bank of China Quarterly Statistical Bulletin*, No. 3, 2001

Figure 1 provides data from the period 1996–2000 showing the robust investment performance of the Chinese economy. In each of these years, investment in fixed assets—including capital construction, technological upgrading and transformation, and real estate—exceeded 30 percent of GDP. During the last three years the number was between 36 and 37 percent. In absolute figures, this amounted to cumulative investment of over USD 1.7 trillion. (Note: until 1999 these data are greatly under stated, since non-state-owned units were not included. From 1999 the figures are for "the whole society" excluding collective units and individuals.

Anyone who knows China knows that a significant part of the funds invested will generate little or no returns, or were simply wasted. Still, it is reasonable to accept the input figure as a measure of funds invested.

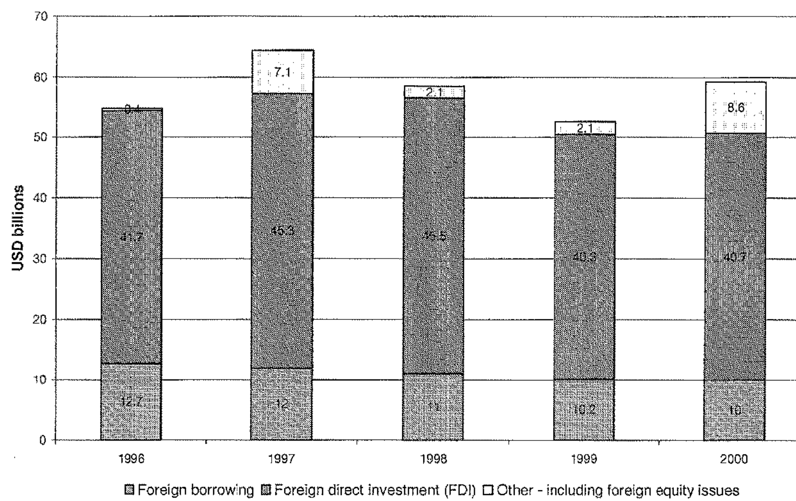
B. Contribution of Foreign Capital

What was the source of these investment funds? More specifically to our inquiry, to what extent did foreign capital contribute funds to these capital investment undertakings?

Figure 2 provides figures and identifies sources of that foreign capital that entered China during the period 1999–2000. The total amount was USD 289.7 billion, a figure roughly 17 percent of total fixed asset investment.

These figures leave no doubt that foreign capital has been a major contributor to China's development, and that foreign capital has played a role in meeting China's capital needs. But the issue becomes more complicated upon analysis.

Figure 2 Sources of Foreign Capital Invested in China (1996-2000)



Source: MOFTEC in *China Statistical Yearbook 2001*

1. The dominant role of FDI

What is clear from Figure 2 is that the lion's share (74 percent) of foreign capital entering China in the five year period was foreign direct investment (which included "in kind" investment, including technology). The cumulative total FDI was USD 213.5 billion during the period. This was money invested by GM, Dupont, IBM, Sony, NEC, Volkswagen, Ford, BASF, BP, Unilever, Proctor & Gamble, GE, Motorola, Coca-cola, and many other foreign companies in productive plants, equipment, and real estate in China. Except for the occasional spin-off floatation of a China-related infrastructure or other investment entity in the Hong Kong market (of which more below), FDI—notwithstanding its substantial volume—had little direct impact *as a use of funds* from the international markets.

After FDI the next largest component of foreign capital was foreign loans, which totaled USD 55.9 billion over the period. This category includes bank and IFI loans to Chinese enterprises and government agencies and bond issues by government entities. Unquestionably, these loans were drawn from the international marketplace, but amount was small at approximately USD 11 billion a year. (It should be noted that there is a discrepancy between the annual increase in this figure—up USD 29.9 billion in 2000—compared with the figure of USD 10 billion for the sources of foreign capital investment. Total foreign borrowing outstanding at the end of 2000 was USD 181.8 billion.

2. International equity issues

The final category of foreign capital absorbed by China, "other," captures the equity sold to foreign investors by Chinese entities, as well as international leases. In 2000 the equity figure was USD 6.9 billion out of a total "other" of USD 8.6 billion. In 1999 the equity figure was USD 6.1 billion out of a total of USD 610 million, out of a total of USD 2.1 billion.

International equity issues, as well as international bond issues, are straightforward examples of capital markets fundraising. The very substantial beginning of this activity was Chinese entities in 1997 was interrupted by the Asian financial crisis which had the effect of shutting out most new issues during the following two years. Clearly, 2000 saw a resurgence of international equity issues by Chinese entities. We will examine this trend in detail below.

3. China's recent record of capital earning self-sufficiency

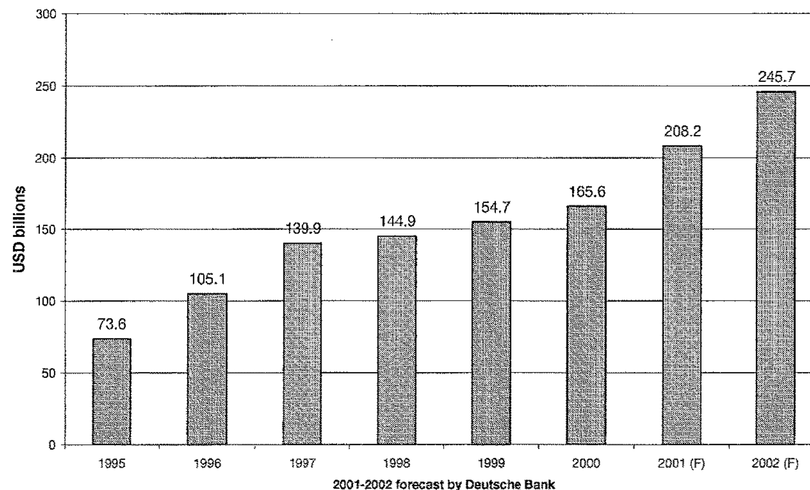
It has been observed (Lardy, 1998) that net-net, China has proven to have a limited absorptive capacity for foreign capital. The more precise and germane point to our current discussion would be that China has proven able since 1992 to attract or earn far from international sources other than the capital markets, than it has been able to use, despite large unofficial capital outflows, with the result that international reserves have grown substantially.

Some figures and calculations illustrate this point. (Of course we accept that these figures are rough and some can only be approximations.) In the period 1996–2000 net FDI (inward investment minus China's outward investment) and current account surpluses reached a cumulative USD 192.7 billion and USD 111.9 billion respectively. Thus, according to official accounts, China's receipt of foreign capital *in excess of and after meeting its import requirements* came to **USD 304.6 billion**. During the roughly equivalent period of 1995–1999 the amount of foreign currency funds calculated to have left China "unofficially" as capital flight was USD 144.5 billion,[1] while from 1996 to 2000 additions to official exchange reserves totaled of some USD 92 billion (Figure 3). This rough total of capital flight and additions to foreign exchange reserves comes to **USD 236.5 billion**.

4. Actually a growing source of capital in the international markets

The difference of USD 68.1 billion between these figures evidences the deficiencies in Chinese statistics. Very likely the figures failed to capture the huge volume of smuggling that plagued the market during the 1996–1998 period. The strong suggestion, however, is clear: At least in the recent past China has been extremely successful at meeting its foreign exchange needs without necessarily accessing international capital markets. Indeed, as its official reserves increase *China has become a net supplier of capital to the international markets*, and, as we see in Figure 3, the volume of such supply is expect to increase in the next few years.

Figure 3 China's Official Foreign Exchange Reserves



Source: *China Statistical Yearbook 2001* and DB Global Markets Research

[1] Li Qingyun, *Journal of Economic Research* (Beijing), August 2000.

II. Capital Needs During the Next Five Year Plan Period

Without question, China's capital needs will increase during the Tenth Five Year Plan period (2001–2005). These needs will include: (1) funds for fixed asset investments (we saw above that during the previous FYP period these needs came to some USD 1.7 trillion), including infrastructure; (2) funds for restructuring the financial system, particularly for recapitalizing the state banks in advance of the new Basel II Accord; and (3) funds for financing its pension system. Let us look at each of these major requirements in turn, particularly from the standpoint of demands on the international financial markets.

A. Fixed Asset Investment and Major Projects in the Tenth FYP Period

If investments in productive assets continue at roughly the same rate over the 2001–2005 period as was witnessed in the previous five year period, China will invest some USD2.5 trillion in projects within the country during this period, *an average of USD 487.6 billion each year*. How much of this will be financed in the international markets?

To help answer this question, it could be helpful to consider four the major projects that will require funding. These are:

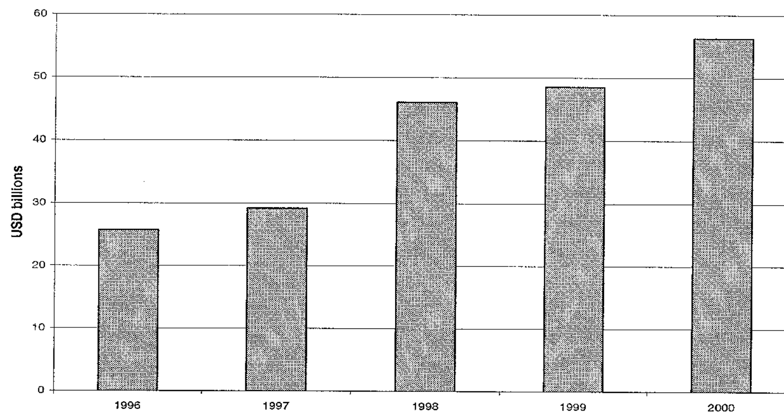
—a. The Beijing-Shanghai rapid train system project
—b. The East-West gas pipeline project
—c. The project to divert southern water to the North
—d. The project to transport hypopower from West to East

In addition to these massive projects, the campaign to "Develop the West" will continue to require substantial funding of extensive infrastructure—highway, bridge, railway—projects. In addition, a number of massive new industrial material projects—particularly in petrochemicals—have been approved and will be developed during this period. Also, localities will continue to build and improve all manner local infrastructure, transport, and public utilities.

Without going into details, suffice it to say that all of these projects will require some foreign technology and, in the case of the Beijing-Shanghai rapid train and East-West pipeline projects, the requirement will be substantial. In the past, when a project required considerable foreign technology, China normally sought first to obtain some portion of foreign debt financing for the project on concessionary terms from the foreign technology suppliers and their governments (this is the case, for example, with the Three Gorges Project). Alternatively, or perhaps concurrently, if the project were in an "open" sector, foreign investment would be considered (this has been the case, for example for the KruppThyssen-invested stainless steel plant in Shanghai, and will likely be the case for the large petrochemical projects, the Beijing-Shanghai rapid train project and East-West pipeline projects). If a new joint venture was to be formed with the Chinese partner matching cash provided by the foreign investor (a good example is the 50–50 percent investment of Shanghai Automotive Industrial Corporation and General Motors in the USD 1.6 billion Shanghai GM project) then the Chinese company could consider raising funds through an IPO or addition equity issue, either in the domestic "A" share market, or in off-shore markets. IPOs of SAIC, Baosteel, Sinopec, Petrochina, and CNOOC (discussed in detail below) are examples the new approach.

In general, as we have seen, China evidences a preference for equity for debt, and for FDI (i.e., equity investment from strategic investors) over portfolio investment. We expect this preference to continue.

Figure 4 Chinese Government Debt Issuance

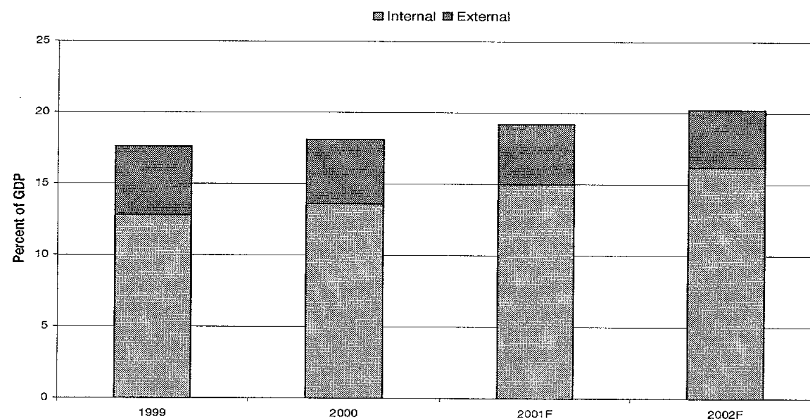


Source: *China Statistical Yearbook 2001*

B. Recapitalizing the Banks

Throughout the past twenty years, China has boasted a relatively low level of budgetary borrowing. (Note: In China's unitary budgeting system, all debt is issued by the central government. Provincial and other lower level government units are prohibited from issuing debt instruments.) While domestic and, to a very limited extent, external government borrowing has increased during the second half of the 1990s to a level of over the equivalent of USD 56 billion annually in 2000 (Figure 4), the volume of outstanding government debt still remains at very low and manageable levels (Figure 5).

Figure 5 Chinese Government Debt as Percent of GDP



Source: *Deutsche Bank Emerging Markets Monthly* November 8, 2001

1. Bank loan assets as disguised government deficit spending

Government debt in China has been and remains low because the state banking system has been used as an extra-budgetary vehicle to provide investment funds to the state-controlled enterprises and projects. In this sense, loans from the banking system to the state sector and infrastructure have been *a disguised form of government deficit spending* (including, of course, investment).

It is the traditionally indistinguishable role of banks and central and government agencies, and state-owned enterprises, in undertaking state-sponsored "investment" and the consequently inextricable involvement large parts of the state-owned enterprise sector that are in financial distress, that account for the massive volume of

uncollectible loans within the state-owned commercial banks, which dominate the financial sector. The four big banks are Bank of China (BOC), Industrial and Commercial Bank of China (ICBC), China Construction Bank (CCB) and Agricultural Bank of China (ABC). Even the banks themselves do not know the scale of uncollectible debts, but I would suggest that 25–35 percent of outstanding loans (an amount equivalent to roughly USD 267 billion or some 25 percent of GDP) is a reasonable estimate. This volume of bad debts is net of the RMB 1.45 trillion (USD 175 billion or some 16 percent of GDP) in non-performing loans (NPLs) transferred by the four state-owned banks to so-called asset management companies (AMCs) set up in 1999–2000 by the Ministry of Finance.

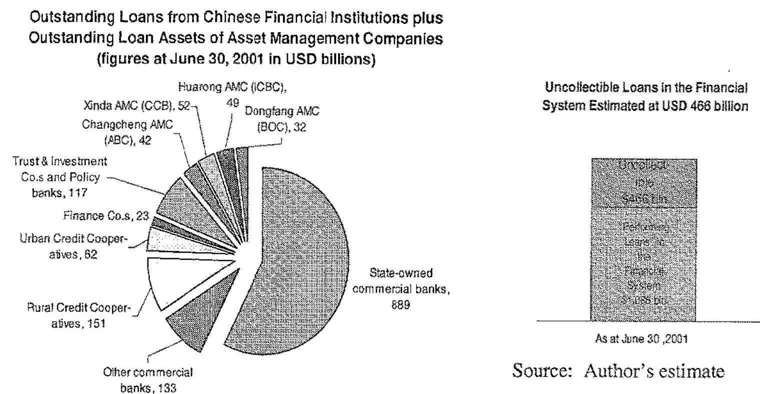
Non-state banks—which occupy a much smaller position—have not been immune to the disease of bad banking practice engendered by the legacy of central planning. As long as the state-owned banks dominate the financial markets and thereby essentially set market and credit standards, "good banking" will be difficult in China. I would estimate that NPLs in the ten commercial banks account for an estimated 10 percent of outstanding loans. This would be the equivalent of some USD 12.1 billion, or 1 percent of GDP.

Much more serious than the NPLs of the commercial banks, or even of the state-owned banks, are the NPLs of the rural credit cooperatives and urban credit cooperatives (now often converted into "city commercial banks") and the international and domestic trust and investment companies (ITICs and TICs) that grew up throughout China in the 1990s. These entities, even more than the state-owned banks, were like piggy-banks in the hands of local officials. Most of the funds extended as loans were for commercially unviable projects or enterprises. NPLs in these entities are certainly greater than 50 percent of loans.

2. The recapitalization challenge: USD 466 billion

In aggregate, what is the magnitude of bad loans in the Chinese financial system? Figure 6 takes outstanding loans of the financial institutions described above (including the four AMCs) and calculates a level of write-offs and subsequent recapitalization requirements of 30 percent of total loans outstanding at the end of June 2001. The resulting figure is USD 466 billion, equivalent to 43 percent of China's 2000 GDP.

Figure 6: China's Bad Loan Burden



Source: Author's estimate

Source: *PBOC Quarterly Statistical Bulletin, New Fortune* (Xin Caifu), October 2001

This is not at all a surprising figure. It is roughly the same as the amount calculated for Thai bank recapitalization in the wake of the Asian financial crisis, and is on an order of magnitude of the amount of bad loans accumulated in Japan's financial sector after the collapse of the bubble economy. This figure shows the extent of waste and resource mis-allocation inherent in the state-controlled, planned economic system that is China's economic legacy. What we can appreciate from this figure is, in a real sense, GDP and GDP growth rates have been overstated in the past twenty years by the magnitude of this bad loan volume. It is equivalent to saying that 2 percentage points of China's recorded GDP growth over the past 20 years has been illusory.

3. How will the recapitalization be financed?

Whether it is the state-owned banks, the commercial banks, the rural or urban cooperative banks, or the ITICs, Chinese policy-makers know that it is critical that they take effective action to clean up the banks and other financial institutions and to restore some measure of solvency to the financial system.

How will the recapitalization be financed? I would suggest three or four primary sources, in order of importance:

Sources of Recapitalization Funds

1. For the four state-owned banks:
   a. Accumulated retained earnings (bolstered by changes in reduction in taxes).
   b. Periodic injections of cash equity or swaps of Treasury securities from the Ministry of Finance (i.e., future repetitions of the process seen in "transfers to the AMCs").
   c. Issuance of subordinated debt (quasi-equity), primarily in the domestic marketplace, but also in overseas markets.
   d. Partial sales of equity in the domestic marketplace.
   e. For Bank of China, China Construction Bank, and ICBC, sale of equity in overseas (especially Hong Kong and London) entities.
2. For the commercial banks:
   a. Sales of new equity in IPOs and repeat issues in the domestic market.
      i. This has already been realized for Shenzhen Development Bank, China Minsheng Bank, and Shanghai Pudong Development Bank. All other commercial banks will follow in the next 12–24 months.
   b. Accumulated retained earnings.
   c. Sales of equity to strategic investors (i.e. other banks).
   d. Issuance of subordinated debt (quasi-equity), primarily in the domestic marketplace, but also overseas.
3. For the urban credit cooperatives (city commercial banks):
   a. Acceptance of new equity investment from domestic corporations and overseas IFIs (e.g., the International Finance Corporation).
   b. Cash injections from provincial governments.
   c. Sales of equity in the domestic equity market.
   d. In a few cases (e.g., Bank of Shanghai), acceptance of overseas investment.
   e. Accumulation of retained earnings.
4. For the rural credit cooperatives:
   a. Direct equity injections from government supervisory organs.
5. For AMCs:
   a. Gradual liquidation through phased write-offs of NPL portfolio values (loss absorbed by Ministry of Finance).

4. Over what time frame?

Recapitalization of the financial system along the lines described above is in process. Completion of the process will take a decade at least.

5. Impact on global and, particularly, U.S. capital markets

As outlined above, recapitalization of China's financial system will involve accessing debt and equity markets outside of China. This is expected to become spectacularly clear in 2002 when Bank of China Group floats its Hong Kong banking franchise in the international equity market. The exact timing and amount of the IPO is not know now, but it certainly going to be massive (see more details on the Hong Kong market below).

Notwithstanding the above, we can confidently predict that for a variety of reasons, international financial markets will play a minor role in financing the recapitalization of China's financial system, while domestic markets will overwhelmingly dominate in this process. The recapitalization steps outlined in the previous section rely primarily on the domestic debt and equity markets, either directly for debt and equity issued by banks, or indirectly, for issues bonds of by the MOF.

6. Real attraction only to domestic investors

As has been shown by the relative success of the few issues of bank shares in China, the domestic equity market has a large and unsatisfied appetite for financial institutions' equity. Even after floating all of the commercial banks shares, financial companies will be under-represented in China's equity market compared with other markets in the world. On a portfolio basis, demand for bank shares (and hence P/E ratios and valuations) will be higher in China's domestic market than in foreign markets (where investors would already have portfolios balanced by sector). Another factor will be that Chinese financial companies—especially banks—are unlikely to

be attractive in risk/return terms, on a comparative basis, to investors outside of China.

U.S. capital markets will primarily continue to be the location for global debt issues and for limited placements in shares of major Chinese financial offerings, like that expected from Bank of China Group in which U.S.-based equity and bond funds will have an interest. This point is discussed further below.

III. FUNDING CHINA'S PENSION SYSTEM

A. A Large and Growing Pension Funding Gap

There is no question that China has a massive problem with unfunded pension liabilities. Of course, it is not alone in this respect. With the former system of cradle-to-grave security provided by state-owned enterprises in crisis, the Central government is trying desperately to implement a new system based with two Pillars: (1) a pay-as-you-go transfer from current enterprises and workers to retirees (pooling funds) funded by a payroll tax and administered at the city level as Pillar One, and (2) funded individual accounts as Pillar Two.

At a conference in Beijing last month that was partly sponsored by the Cato Institute, researchers reported that the Ministry of Social Security calculated a deficit in Pillar One of RMB 35.7 billion (USD 4.3 billion) in 2000, an increase from the deficit position of RMB 18.7 billion in 1999.[2] The actual on-going shortfall in Pillar One is much more severe that these totals suggest, since the deficit has been reduced by local government raids on funds in Pillar Two individual savings accounts. According to the researchers, the amount already transferred from individual accounts has already reached some RMB 200 billion (USD24.2 billion), which creates an unrecorded future liability for the pension system.

Another paper at the Cato conference[3] quoted a 1996 World Bank estimate which put the total size of pension debt (present value of pension obligations to retirees and workers who accumulated pension credit under the old system) at 50 percent of GDP (1996 GDP was USD277 billion).

At some point, surely many years in the future, the vision of the government is to have a fully, or largely, funded pensions system based upon fully funded individual retirement accounts (more or less, the Chilean model). Significant reengineering of the current system are needed to improve incentives for compliance, foster more disciplined administration, and improve investment returns. Witnessing how public pension systems are burdening even the richest countries, China's leadership—always mindful of the pressures of China's huge population—seems determined to avoid a similar fate. Still, China's likely long term pension system solution—fully funded private accounts—will not solve the problem of today's retirees, or, indeed, those scheduled to retire during the next 10–15 years. This is the "transitional" period during which a large and growing shortfall must be financed.

B. Sales of SOE Equity and the Capital Markets

With the Chinese government apparently ineluctably committed to paying retirement benefits to urban workers, a solution to the problem described above must be found. The problem is partly a matter of lack of enforcement of the payroll tax to fund Pillar One. But the problem also seems to be structural.

For the past several years, local and Central government agencies have been seeking to plug the gap through sale of state-held equity in IPO and additional share offerings for enterprises listed on the Chinese securities markets. These sales were mandated under legislation in 2000. But with roughly two-thirds of shares of all 1,000 plus listed companies held by the state, the pressure of state-owned share sales (threat of much more to come) contributed to the decline of the Chinese equity market this year. This led the government in October to suspend the state shares sell-offs.

The suspension is surely temporary. Proceeds from selling state shares are needed both to plug the gap in the pension system noted above, but to pay for many of the costs of the on-going restructuring and rationalizing the state-owned sector, including the costs of providing for or retraining redundant workers.

C. Effect on the International and U.S. Markets

Notwithstanding that the large gap between short- and intermediate-term pension commitments and current resources, the magnitude by which China or its enterprises will seek to fill the gap through the international financial markets is surely

[2] David D. Li and Ling Li, "The Pension Reform Debt: A Simple Resolution of China's Pension System Crisis," November 2001 (unpublished paper).

[3] Yaohui Zhao, "The Feasibility and Benefits of a Fully Funded Pension System," November 2001 (unpublished paper).

small. As suggested above, the gap in financing will be filled by (1) taxation, (2) sale of public assets (including shares in SOEs), or (3) public borrowing, or, most likely, a combination of these three.

The burden of taxation will effectively fall on China's workers in the form of a payroll tax. Given the history and known mentality of China's financial authorities, we can be certain that public borrowing—to the extent it is meant to pay pensions—will be in the form of domestic debt issuance, rather than international issues. This certainty is based on China's record of carefully controlling foreign borrowing and ensuring that such borrowing (to the relatively limited extent it has been used) has been for investment in productive assets, not for consumption.

The one category of sales of state assets, where proceeds have been used to fund pension benefits, has been in the IPOs and subsequent equity offering of state-owned enterprises in international markets. An example is the February 2001 IPO of China National Overseas Oil Corporation (CNOOC) which sold a 20 percent equity share for US$1.26 billion, with the intention of using the proceeds for working capital for employee retirement benefits. Such instances have, however, been few, and their numbers will certainly remain small in the future.

Over time, China's pension system could become *a source of capital* for the international financial markets.

CHINA'S FINANCIAL MARKETS: BIG ENOUGH TO MEET CHINA'S NEEDS?

Are China's financial markets big and deep enough to meet China's needs? This is a critical question. A precise and confident answer is difficult. If forced to commit to an answer, it would be that China's markets are not as big as often thought or publicized, and that these markets are burdened with many problems. Nevertheless, they are functioning well enough to meet most of China's needs. Most importantly, the markets—which are understandably immature given that their history is only about a decade long—are expected to continue to mature and develop, so as to become more capable of meeting the very substantial financing needs described above.

1. The Equity Markets: Still Evolving, And Not What They Appear

Table 1 below describes China's two domestic equity markets. The figures are for end 2000. What is evident is that the markets are already an important part of the economy. By year-end 2000 1,088 firms had listed on Shanghai or Shenzhen exchanges.

The figure for total market value of listed companies is deceptive, because over about 35 percent of the shares of listed companies in China actually trade on the exchanges. Market prices are based on this amount of float. If the remaining 65 percent of shares—held primarily by state agencies and state holding companies, and also by state-owned corporations—were ever to fall onto the market, they would undoubtedly sell at a great discount—perhaps only 20 to 30 percent—to the currently prevailing market price. It is appropriate, therefore, to measure the size of the Chinese equity market, by the value of traded shares, as we have done in Table 1. At the end of 2000 the size was some RMB 1.6 trillion (USD 195 billion), or approximately one half the size of Hong Kong.

TABLE 1.—THE DOMESTIC EQUITY EXCHANGES

	Shanghai		Shenzhen		Combined Shanghai+Shenzhen	
	Total 2000 (RMB billions)	Change vs. 1999 (%)	Total 2000 (RMB billions)	Change vs. 1999 (%)	Total 2000 (RMB billions)	Total 2000 (USD billions)
Total transactions	4,990	39	3,301	103	8,291	1,003
Stocks	3,137	85	2,945	105	6,083	736
Funds	133	–2	147	31	280	34
Bonds	1,690	–3	209	163	1,898	230
Market value of tradeable stocks	848	100	761	92	1,609	195
Listed companies (no.)	572	18	514	11	1,086	....
Listed shares (no.)	614	17	557	11	1,171	....

Source: *Shanghai Securities News*, December 30, 2000.

A. A Market Dominated by Entrepreneurial Institutions

Officially there are over 60 million investors in China's markets, meaning that 60 million is the number of accounts opened by individuals with the securities companies that are members of the exchanges. This figure gives the impression of a mar-

ket dominated by small investors, but this impression is erroneous. For a variety of reasons, the number is probably only one-sixth this number. It is estimated that there may be 6 to 9 million active individual investors in the markets.

More important than these individuals are the many quasi-legal private investment funds run by financial management and financial trust companies. Research by PBOC has found that there are some 7,000 of these companies operating in Shanghai, Shanghai, and Beijing. PBOC estimates[4] that these funds manage an average of USD 18 million. Chinese securities companies also offer discretionary and directed asset management services as part of their core business. The combined total of funds under management by securities companies is estimated by PBOC at USD 24 billion. China also has a fledgling mutual fund industry. Adding all funds under management by these formal and informal institutions together, the amount of funds invested in the stock markets reaches some RMB 800 billion (USD 98 billion), approximately 50 percent of the tradable market capitalization. This is a level similar to the U.S. and other developed markets.

B. Big Problems Requiring a Supply Side Solution

If domination by small investors, and a dearth of sophisticated institutional investors, is not the problem of the China equity markets, there are many others. Most fundamentally, these problems stem from the fact that virtually all of the listed companies are partial privatizations (public sale of a minority shareholding) of a formerly 100 percent state owned enterprises. With majority control still in state hands, and with corporate managers generally unchanged, it has been seen that management style and mentality in many of these firms retains all the pernicious characteristics of SOEs. The result is poor corporate performance, abysmal disclosure or outright fraud, and widespread abuse of minority shareholders' interests.

During 2001 revelations of abuses and malfeasance by listed company managements and auditors and underwriters created a crisis of confidence in the market. The situation was so serious that the China Securities Regulatory Commission (CSRC) was forced to crackdown.

What the abuses, crisis of confidence, and subsequent market downturn revealed in 2001 what that remedial efforts by CSRC and other government authorities, to be effective, must be focused on the supply side. What the equities markets in China and Chinese investors need, desperately, are better companies in which to invest.

C. Performance and Capacity of the Market

As can be seen from Figure 7 below, the equity markets in China—and, to a much lesser extent, abroad—played a crucial role in financing Chinese enterprises during the Ninth Five Year Plan period. In the year 2000, Chinese enterprises raised a total of RMB 153 billion (USD 18.5 billion) in the domestic A share market and RMB 56.2 billion (USD 6.8 billion) in the overseas markets (primarily Hong Kong). This equity financing was one-third as much as the increase in loan volume of RMB 648.9 billion (USD 78.5 billion) of China's state-owned banks during the year.

On the other hand, it can be seen from Figure 7 that the performance of the domestic equity market was uneven during the 1996–2000. To some extent this reflected the Asian financial crisis (the crisis' influence over China's domestic markets was more psychological than direct), but a greater effect was the changing fortunes of listed companies and the conservative, cautious stance of Chinese regulatory authorities evidenced during the period.

It can be said that in 2000 the Chinese domestic equity market finally really proved itself as being capable of absorbing large issues. (Previously, doubts about the capacity of the market was a key reason Chinese authorities pushed large firms to list abroad, particularly in the Hong Kong "H" share market.) Milestone transactions included the sale of RMB 7.7 billion (USD 930 million) in equity in an IPO by Baosteel Group. The floatation of China Minsheng Bank was another such milestone.

D. "B" Share Market Buy-Back

By the year 2000, the domestic "B" share market was playing no material role in financing Chinese companies. This market—comprising foreign currency denominated, non-resident investors purchase only shares of Chinese companies that were listed and traded on the Shanghai or Shenzhen exchanges—became largely irrelevant only a few years after its inception as China's growing foreign exchange reserves allowed the Central bank to relax control on converting RMB to pay for im-

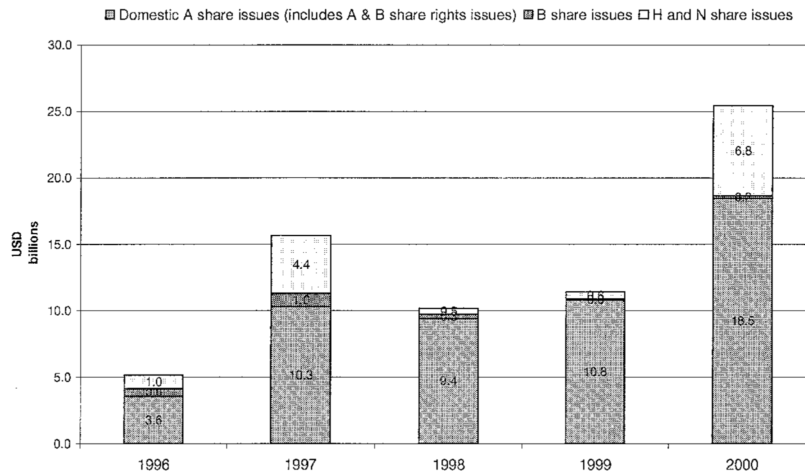
[4] Stephen Green, "Taking Stock," *CFO Asia*, October 2001 quotes a study by Xia Bin, People's Bank of China.

ports. During 2000 B share market liquidity—and share prices—reached new lows, causing disquiet and inconvenience for issuers and regulators.

The solution to the B share market problem—adopted in June 2001—was to remove the "non resident investors only" restriction and allow mainland Chinese investors to purchase the shares with personal holdings of foreign currency. (Foreign currency deposits in individual accounts in banks in China are large, on the order of USD 175 billion. PBOC regulations generally requires that mainland corporations sell foreign exchange to Chinese banks.) For a time, individual and institutional Chinese investors piled into relatively underpriced B shares, causing prices to rise dramatically and liquidity to increase.

Notwithstanding the market's recent revival, the B share market remains structurally flawed and as ceased to be a viable channel for fund-raising for Chinese companies.

Figure 7 Chinese Enterprises' Fund Raising in Domestic and International Stock Markets 1996-2000



Source: China Statistical Yearbook 2001

E. A Healthy, Growing Equity Market is a Strategic Imperative

The continued evolution and development of a healthy domestic equity market is a *strategic imperative* if China is to achieve its many development objectives. China's leadership—and particularly Premier Zhu Rongji—are united on this point. Vast resources are being devoted rectifying abuses and creating the legal, administrative, and technical infrastructure required to ensure the dynamic viability and efficaciousness of the domestic equity market in the future.

I believe that, in essence, China's domestic equity market has come into its own as a one of the main sources of funds needed for China's development. Notwithstanding that funds needs over the foreseeable future will be enormous, as we have observed above, I believe that—to the extent these needs will be finance by equity issues—the overwhelming majority of such issues can be and will be executed in China's domestic market.

a. Far to Go in Developing a Bond Market

While the domestic equity market is in good strategic shape, China's domestic bond market is so undeveloped—except as a receptacle for government debt—as to be practically irrelevant. Given PBOC and CSRC restrictions and a dearth of creditworthy issuers, virtually all bonds issued are by the Central government and certain government agencies. Corporate issuance in 1999 was just 2 percent of total bonds issued. In 2000 corporate issues, at only RMB 8.3 billion (USD 1 billion), were less than 0.5 percent of bonds issued. Total bonds outstanding in the market at the end of 2000 comprised RMB 1367.4 billion (USD 165.4 billion) in government debt, and a mere RMB 86.2 billion (USD 10.4 billion) in corporate debt. Stock market listed bonds represent just 2 percent of outstanding bonds. Treasury bonds are traded exclusively in the interbank market and the volume is miniscule (0.002 percent of outstanding bonds traded daily, compared with 8 percent in Hong Kong).

Obstacles to the development of a significant debt financing securities market in China seem formidable. For this reason, in the future, as in the past, those Chinese entities capable of issuing debt securities (and with funding vehicles abroad) will have to do so in overseas markets, such as Hong Kong.

THE PIVOTAL ROLE OF THE HONG KONG CAPITAL MARKET

During the mid-1990s, and especially in the period 1996–98, dozens of Chinese companies and administrative units sought and found sources of debt and equity financing in the Hong Kong market. During this period, when the China's domestic markets were still young and suffering growing pains, a combination of factors impelled Chinese entities to Hong Kong. Among the factors were:

1. The large number of international banks and securities companies willing to supply of debt and equity financing to Chinese companies registered in Hong Kong but controlled by mainland authorities (so-called "Red Chips").
2. The fear of Chinese regulators that domestic markets were too immature and thin to absorb large equity issues, and therefore the willingness to approve issuance of "H" shares by large domestic companies.
3. The ability of Chinese firms as with Hong Kong vehicles to issue foreign currency debt securities, such as floating rate notes (FRNs), without approval of mainland authorities and without restrictions, taking the proceeds and upstreaming them as "equity" investments in mainland projects.
4. The popularity of mainland infrastructure-related investments among Hong Kong individual investors and funds, which allowed PRC government entities as well as Hong Kong conglomerates like Cheong Kong Group to finance infrastructure investment through "asset injections" into Hong Kong funding vehicles.
5. The ability of key provinces or provincial level entities like Shanghai and Beijing to raise long-term funds through Hong Kong-domiciled investment companies like Shanghai Industrial Holdings and Beijing Enterprises which began to function like captive merchant banks, taking equity positions in local projects and enterprises.

Responding to the positive environment, by the late 1990s an astonishing number of mainland entities had listed vehicles in the Hong Kong market (see *Relationship Chart of PRC Companies Listed Abroad* below).

A. H Shares Issuers

Table 2 provides a list of H share issues and issuers by date and amount of capital raised.

TABLE 2.—CHINESE H-SHARE IPO'S

Listed date	Company name	Total funds raised (USD million)
1–Jul–93	Tsingtao Brewery	114.7
16–Jul–93	Shanghai Petrochemical	[1] 342.4
22–Jul–93	Guangzhou Shipyard International	38.9
23–Jul–93	Beiren Printing Machinery Holdings	29.7
15–Oct–93	Maanshan Iron & Steel	509.2
7–Dec–93	Kunming Machine Tool Plant	17.8
14–Mar–94	Yizheng Chemical Fibre	308.1
3–May–94	Tianjin Bohai Chemical Fibre	52.8
18–May–94	Dongfang Electrical Machinery	62.0
16–Jun–94	Luoyang Glass	118.1
16–Jul–94	Qingling Motors	132.7
26–Oct–94	Shanghai Haixing Shipping	204.1
10–Nov–94	Zhenhai Refining and Chemical	184.7
23–Nov–94	Chengdu Telecommunications Cable	58.0
5–Dec–94	Harbin Power Equipment	145.1
19–May–95	Jilin Chemical Industrial	[1] 200.2
22–Jun–95	Northeast Electrical Trans & Transfer	60.0
18–Jan–96	Jingwei Textile Machinery	30.0
24–Apr–96	Nanjing Panda Electronics	66.9
10–May–96	Guangshen Reilway	[1] 543.9
18–Jul–96	Guangdong Kelon Electrical Bldgs.	96.6
28–Oct–96	Anhui Expressway	112.9
12–Dec–96	Shandong Xinhua Pharmaceutical	33.0
5–Feb–97	China Eastern Airline	[1] 279.1

TABLE 2.—CHINESE H-SHARE IPO'S—Continued

Listed date	Company name	Total funds raised (USD million)
12–Mar–97	Shenzhen Expressway	212.3
21–Mar–97	Beijing Datang Power	465.4
14–May–97	Beijing North Star	219.0
15–May–97	Zhejiang Expressway	440.5
12–Jun–97	Jiangxi Copper Industry Co.	380.7
23–Jun–97	First Tractor Engineering	194.6
25–Jun–97	Beijing Yanhua	229.9
27–Jun–97	Jiangsu Expressway	490.6
25–Jul–97	Angang New Steel	187.3
31–Jul–97	China Southern Airline	[1] 712.4
29–Sep–97	CATIC Shenzhen Holdings	49.1
7–Oct–97	Sichuan Expressway	179.1
17–Oct–97	Chongqing Iron & Steel	91.4
21–Oct–97	Anhui Conch Cement	106.3
30–Oct–97	Guangzhou Pharmaceutical	46.8
21–Jan–98	Huaneng Power International	[1] NA
1–Apr–98	Yanzhou Coal Mining Co.	[1] 267.1
30–Jun–99	Shandong Int'l Power	293.6
16–Dec–99	Shenyang Public Utility	92.8
1–Feb–00	Beijing Capital Airport	326.9
7–Apr–00	PetroChina	[1] 2,922.9
19–Oct–00	Sinopec	[1] 3,468.0
7–Feb–01	Travelsky Technology	143.9
Nov 2001	China Aluminum Co.	[2] 300
Total		15,561.2

[1] Also NYSE.
[2] Approx.

Source: DMG China Digest, April 1998. International Financing Review, September 1997.
Quoted in Yabuki & Harner, *China's New Political Economy* (1999).
Recent listings: Author.

B. H Share Characteristics

Looking at the H share companies, it is difficult to discern any particular characteristic, except that these are all state-owned mainland companies which, over the past eight years, had both the political clout in Beijing to obtain approval to list in Hong Kong, and had some amount of market appeal. The companies came from a variety of sectors, with the common feature that they are virtually all old-line industrial companies with large fixed asset investment requirements.

Very often, the H share companies were in strategic industries in China in which major international companies hoped to become involved. In some cases these industrial sectors were closed to direct investment, or such investment was highly restricted. Under these circumstances, international majors have seized upon the issuance of H shares by PRC companies as a chance to form an equity alliance by buying substantial amounts of the H share issues. This was the case in Zhenhai Refinery's IPO, in which Atlantic Richfield (ARCO) took a substantial share. A large part of the issue of CNOOC was purchased by Royal Dutch Shell. Vodaphone of the U.S. took USD 2.5 billion of the placement of China Mobile shares. It is hoped that.

C. The Growth of "Red Chip" Issues in Hong Kong

In the mid-1990s, as Chinese officials and organizations began to anticipate the reversion of Hong Kong to China in July 1997, a large number of mainland Chinese commercial groups and entities moved to establish or expand their commercial presence in (then) colony.

Many of the PRC entities like China International Travel Service, China Overseas Development, and China Resources had been operating in Hong Kong for many years. In 1994–97 these companies were joined by many others, including large new groups like China Merchants, China Everbright, and CITIC, with strong links to the State Council. (See *Relationship Chart of PRC Companies Listed Abroad* below.)

A combination of the favorable market environment described above, permissive regulation in Beijing, and the need for funds to execute unprecedented expansion activities, including through acquisitions of established Hong Kong companies, encouraged many of the PRC-controlled companies to raise capital in the Hong Kong

market, including through IPOs. These listed companies became known in the market as "Red Chips."

Table 3 presents a list (not exhaustive) of well-known Red Chip companies, including some of the IPOs executed by these companies. The year 1997 witnessed the peak of Red Chip listing. A particular phenomenon during this time was the listing of Hong Kong "window companies" of major mainland municipalities, including Beijing and Tianjin, following the success of Shanghai Industrial which had listed the year earlier.

TABLE 3.—RED CHIP COMPANIES AND RED CHIP IPOS IN HONG KONG

Companies	Date	Funds raised USD millions
Well Known Red Chip Companies:		
Citic Pacific		
China Resources		
Everbright International		
China Overseas		
Citic Ka Wa Bank		
China International Travel Service (Hong Kong)		
Shanghai Industrial		
Guangdong Enterprises		
China Merchants Holding		
Red Chip IPOs Hong Kong Stock Exchange:		
Shun Yip Investment Ltd	07–Mar–97	259.5
Chu Kong Shipping Development Co., Ltd.	23–Apr–97	116.9
Beijing Enterprises	29–May–97	242.0
Gzi Transport Ltd.	30–May–97	435.4
Casil Telecommunications Holdings Ltd.	11–Aug–97	119.0
China Telecom	23–Oct–97	3,943.9
Tianjin Development Holding Ltd.	10–Dec–97	515.8
China National Aviation Co., Ltd.	17–Dec–97	684.8
Zhu Kuan Development Co., Ltd.	26–Apr–98	67.8
Brilliance Motors	22–Oct–99	1,245.7
TCL International Holdings Ltd.	26–Nov–99	465.0
China Unicom Ltd.	22–Jun–00	4,977.5
China National Overseas Oil Co. Ltd. (CNOOC)	28–Feb–01	1,280.1

D. Hong Kong's "Growth Enterprise Market"—Hope for China's Private Companies?

In 1999 and 2000, in a response to the success of NASDAQ in financing small and start-up technology companies, Hong Kong's Stock Exchange launched a second board, called the Growth Enterprises Market (GEM), with less stringent listing requirements than the regular HKSE.

Early optimism about the prospects for the GEM, and a number of successful early listings by mainland companies, caused mainland regulators to consider establishing a GEM-type second board in China. Following the decline in NASDAQ and similar bourses, including the GEM, since early 2000 listing activity sharply declined. PRC regulators apparently have deferred indefinitely any serious efforts to launch a domestic second board.

Between April 1999 and April 2001, at least 17 mainland or Red Chip companies, mostly small and some privately-owned, launched IPOs and listed on the Hong Kong GEM (Table 4). The largest issue was that of Phoenix Satellite TV Holdings in June 2000 which raised USD 680 million. This is double the proceeds of the next largest issuer. Excluding Phoenix Satellite TV the average amount of equity raised was about USD 100 million.

TABLE 4.—HONG KONG SECOND BOARD LISTINGS OF PRC COMPANIES

Date	Company
June 30, 2000	Phoenix Satellite TV Holdings
Jan. 31, 2000	Yuxin Infotech Holdings
April 25, 1999	China Agrotech Holdings
Jan. 31, 2000	Far Eastern Polychem Industries
Dec. 17, 1999	Qianlong Technology Holdings
Jan. 24, 2000	China Data Broadcasting Holdings
Dec. 2, 1999	SIC Medical Science & Technology (Group)

TABLE 4.—HONG KONG SECOND BOARD LISTINGS OF PRC COMPANIES—Continued

Date	Company
Mar. 28, 2000	Prosten Technology Holdings
Feb. 29, 2000	Sino Biopharmaceutical Ltd.
Feb. 25, 2000	Vodatel Networks Holdings
Mar. 16, 2000	Wan Sang Gas Holdings
Apr. 23, 2001	Jiansu Nandasoft Co., Ltd.
July 13, 2000	Greencool Technology Holdings
Oct. 31, 2000	Tong Ren Tang Technologies
July 27, 2000	Beijing Beida Jade Bird Universal Science & Technology
Aug. 4, 2000	Shanghai Fudan Microelectronics Co., Ltd.
July 25, 2000	Neolink Cyber Technology (Holdings) Ltd.

It has been hoped that the GEM—and perhaps a similar board on the mainland—will provide increased financing opportunities for China's private sector. This is not an unrealistic hope, though it is too early to definitely declare success. The few listings in 2001 reflect a skepticism over the quality of mainland companies. In general, as with China's markets, better quality companies are needed.

By its very nature, as a vehicle for small companies, the GEM will not become a significant factor in the Hong Kong or global capital markets for the foreseeable future. Nevertheless, its importance for stimulating growth in China's private sector is not to be underestimated.

GLOBAL PLACEMENT OF CHINESE EQUITY AND DEBT ISSUES

The international capital markets are such that, while issuers and underwriters usually make an effort to list on an exchange in the country or region where the issue is expected to find the broadest and deepest market acceptance, the world's largest institutional investors and securities firms are active in all the leading world markets. Therefore, rather than focusing exclusively on where Chinese issues have been listed internationally (the location has normally been Hong Kong), it is instructive to look the markets into which the shares were placed by underwriters. This information is normally shared among underwriters and is gathered by the trade press. The information in Table 5 was gleaned from the Euromoney publication FinanceAsia.

TABLE 5.—PLACEMENT OF PRC EQUITY ISSUES (RECENT SAMPLING)

Issue/Listing	Date	USD million	Placement markets	Remarks
China Mobile/HK	October 2000	6,600	30% Asia 50% US 20% Europe	New offering of already listed HK company. Vodaphone took $2.5 billion of placement.
CNOOC/HK+NYSE	February 2001	1,260	40% Asia 30% US 30% Europe	Royal Dutch Shell strategic investor. Switch orders out of PetroChina and Sinopec 25% of demand.
Sinopec	October 2000	3,468	35% Asia 35% US 30% Europe	
Travelsky	February 2001	143	50% Asia 25% US 25% Europe	China funds dominated in Asia. Four strategic investors.
PRC (bond) Samurai.	June 2000	284	40% Japan 20% Europe 40% Asia ex-Japan	Half of investors from mainland accounts.
PRC (bond) Global.	April 2001	1,000	Global institutions	10 year deal.

Source: Finance Asia (various issues)

EXPECTED NEW EQUITY ISSUES

There is no doubt that PRC entities and Red Chips will continue to seek new listings and undertake new capital raising issues in the international markets. Reflecting the interest of underwriters, the following table describes the pipeline for large equity IPOs by state owned companies. This is only part of the picture, however,

as an increasing number of smaller companies, including some private companies, are expected to list in Hong Kong in the next few years.

TABLE 6.—GIANT STATE-OWNED ENTERPRISE IPO PIPELINE

Company	Timing	IPO size (USD billions)
China Telecom (fixed line)	1st half 2002	5–6
Baosteel	1st half 2002	1–2
China Power	2nd half 2002	2–3
Shanghai Auto	2nd half 2002	2–3
First Auto	n.a.	n.a.
China Shipbuilding	n.a.	n.a.
Bank of China	n.a.	n.a.
People's Insurance	n.a.	n.a.
Other sectors: metallurgy, non-ferrous metals, textiles		

Source: CLSA Emerging Markets

ISSUES AND ISSUERS IN THE U.S. MARKETS

Table 7 presents the equity issues of Chinese companies that have been made on the U.S. equity markets.

TABLE 7.—CHINESE FIRMS LISTING ON THE U.S. EQUITY MARKETS

	Date	Remarks
NYSE Company:		
China National Off-shore Oil Company (CNOOC)		Hong Kong dual listing
China Unicom		Hong Kong dual listing
China Petroleum & Chemical Corp. (Sinopec)		Hong Kong dual listing
China Mobile (Hong Kong) Ltd.		Hong Kong domicile
PetroChina Company Ltd.		Hong Kong dual listing
Beijing Yanhua Petrochemical Company Limited		
China Eastern Airlines		Hong Kong dual listing
China Southern Airlines		Hong Kong dual listing
Guangshen Railway Co.		Hong Kong dual listing
Huaneng Power International		
Sinopec Shanghai Petrochemical Company Ltd.		Hong Kong dual listing
Jilin Chemical Industrial Company		
Yanzhou Coal Mining		Hong Kong dual listing
Brilliance China Automotive Holdings		Hong Kong domicile
EK Chor Motorcycle Corp.		Hong Kong domicile
NASDAQ Company:		
Sina.com	April 2000	$68.0 million raised
Netease	June 2000	$69.8 million raised
Sohu.com	July 2000	$59.8 million raised
Chinadotcom Corp (China)		Hong Kong domicile
Asia Information		Hong Kong domicile
Utstarcom		
Qiaoxin Universal Telephone		

FUTURE ROLE OF U.S. MARKETS IN CHINA'S DEVELOPMENT CAPITAL FUNDING

What the tables in the previous section make clear is that Chinese listings and fundraising in U.S. capital markets have heretofore been modest. What about the future?

It is certainly to be expected that Chinese entities and (importantly) their underwriters will seek to access the U.S. markets for additional equity and debt fundraising. However, for the many reasons and in view of the circumstances described above, we can posit that for the foreseeable future, both the needs and the efforts of Chinese issuers will be limited.

If the impact of China's fundraising on the U.S. markets is likely to remain small, the converse is not true: U.S. markets have previously exerted and will continue to exert strong influence on the issuers and underwriters of Chinese securities. This is because U.S. markets and market practice set the global standard, and this standard is increasingly being adopted or, at least, aspired to, in major world mar-

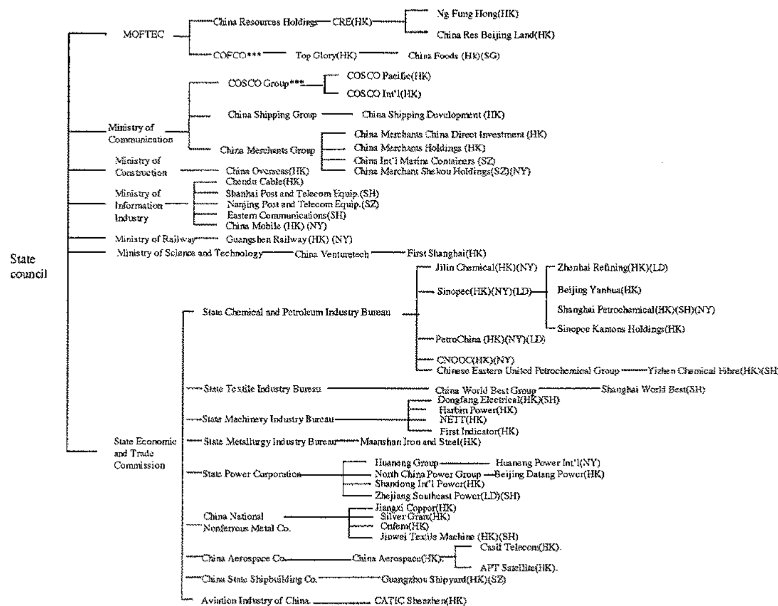
kets, not excluding Hong Kong. Also, New York along with London is a center for global fund management, and the Chinese issuers will always be keen to be attractive to these investors.

Thus, Chinese entities seeking access to international capital markets will have to become increasingly better managed, transparent, and mindful of shareholder interests in order to attract international capital. In China, as in many other countries, entry into global capital markets will become one key factor promoting economic and social reform and progress.

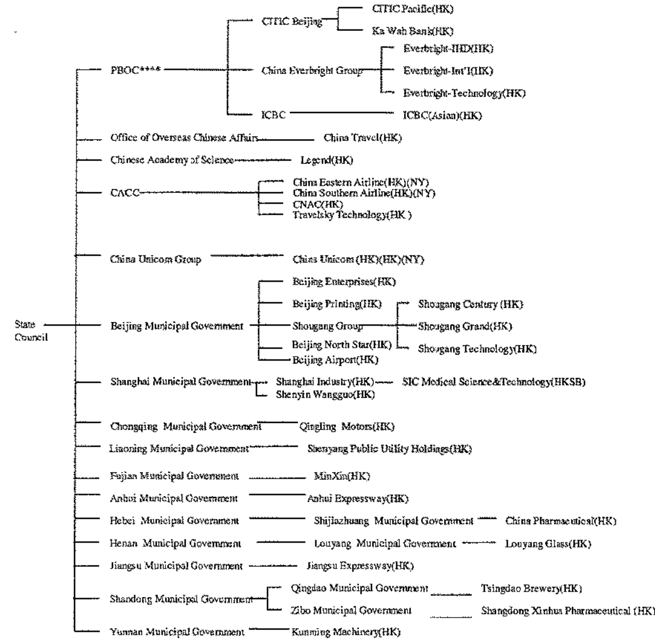
REFERENCES

Yabuki Susuma & Stephen M. Harner, *China's New Political Economy—Revised Edition* (Westview Press 1999).

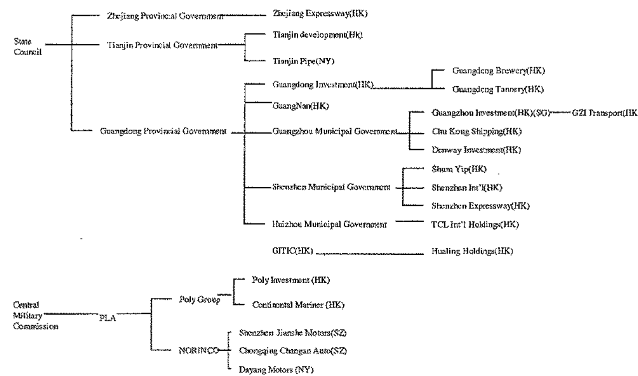
Relationship Chart of PRC Companies Listed Abroad
(including domestic B share listings)



Relationship Chart of PRC Companies Listed Abroad (continued)



Relationship Chart of PRC Companies Listed Abroad (continued)



Notes:
***People's Bank of China
(SH) means Shanghai-listed B share. (SZ) means Shenzhen-listed B share.
(HKSB) means Hong Kong Second Board (Growth Enterprise Market)

Source: Yabuki & Harner, *China's New Political Economy* (1999). Updates by author.

Co-Chairman ROBINSON. Thank you all for your very thoughtful remarks as well as your prepared testimony.

If I may, I would like to begin by turning to Commissioner Mulloy for questions to the panelists.

PANEL I DISCUSSION AND QUESTIONS AND ANSWERS

Commissioner MULLOY. Thank you, Mr. Chairman.

First, I want to thank all of you for the testimony that you have given. Mr. Harner, you really put a lot of time and effort into your prepared testimony, and it was very, very helpful, and the others, Bailey and Byrne, as well.

Let me just ask a general question, and I am going to ask quickly, because I only have five minutes. As a general issue, do you think the United States should prohibit Chinese companies from raising money in U.S. capital markets?

Let's go right down the line—yes or no?

Mr. BAILEY. I think it's pointless, because money is fungible, and it will get there one way or another—although I echo the Senator's concerns.

Commissioner MULLOY. Dr. Lardy?

Dr. LARDY. No.

Commissioner MULLOY. Mr. Byrne?

Mr. BYRNE. I would say no because of the fungible nature.

Commissioner MULLOY. Mr. Harner?

Mr. HARNER. There is no more justification for that than prohibiting companies from exporting and earning a profit on their exports; it's basically the same thing.

Commissioner MULLOY. Okay. If we are able to identify a particular company as a Chinese PLA company, do you think that that company should be permitted to raise money in U.S. capital markets?

Mr. BAILEY. I'd say if they aren't doing anything naughty, why not, but let's label them as such so we can be intelligent consumers.

Commissioner MULLOY. So you favor transparency—the investor should know that—but you wouldn't prohibit it.

Mr. BAILEY. Unless they are doing something that is a direct threat to our security.

Dr. LARDY. My answer would be the same—a high degree of transparency and disclosure so that investors know what they are buying, but no prohibition unless they are engaged in proliferation activities or other things against U.S. national interests.

Mr. BYRNE. Again, I would be in favor of more disclosure, more transparency.

Commissioner MULLOY. Transparency, not prohibition, on that Chinese PLO——

Mr. BYRNE. Well, I guess that's a legal matter, but certainly, the markets would be greatly improved and benefitted if there is greater transparency.

Commissioner MULLOY. Mr. Harner?

Mr. HARNER. I agree.

Commissioner MULLOY. The same thing. Okay.

Then, the last question—and I think you have already hit on this. If we were able to identify a Chinese company that has aided

in the proliferation of weapons of mass destruction to a country that is under U.S. sanctions or identified as a terrorist-sponsoring country by the State Department, which has a list that they put out, do you think that company should be able to raise money in U.S. capital markets?

Mr. BAILEY. In the end, I don't think we can stop them from raising their money someplace, but tarring and feathering them and pointing them out to the whole world and stopping them from trading here—why not?

Dr. LARDY. I certainly would support a ban on the issuance of debt or equity by those companies, although I fear it might not have much effect on their ability to raise money globally.

Mr. BYRNE. Certain features of that were important in some of the rating actions we have taken on the Chinese companies that have had IPOs, and it affects us and how we judge the credit quality because of these political considerations.

So I would say again that the more disclosure and the more transparency, the better, the more efficiently the market will function.

Commissioner MULLOY. What about prohibition on that type of company that is aiding in the proliferation of weapons of mass destruction to a terrorist-sponsored country?

Mr. BYRNE. Well, if you're asking me in my personal capacity——

Commissioner MULLOY. Yes.

Mr. BYRNE. —I would agree with you.

Commissioner MULLOY. You would prohibit it?

Mr. BYRNE. In my personal capacity, right; it is no reflection on Mr. Moody.

Commissioner MULLOY. Mr. Harner?

Mr. HARNER. I am in sympathy with what is being said here, but I have a question. My question is: Is there no legislation now in the United States? There is or has been lots of legislation about restricting investments in certain companies or in certain countries, countries that are under sanction for one reason or another—South Africa—I don't know how stringent those restrictions were, but there are certainly a lot of restrictions on U.S. investments in certain countries or companies, and I wonder whether there isn't something, directly or in a derivative sense, already available in the legislation.

Commissioner MULLOY. I don't think there is anything on the books. The Iran-Libya Sanctions Act——

Mr. HARNER. On issuers; but on investors.

Commissioner MULLOY. Yes, there would be for investment. There is an Executive Order forbidding American companies from investing in Iran or Libya. But the question is the Chinese company that wants to come to the U.S. capital markets and is aiding in the proliferation of weapons of mass destruction. I don't think there is any law on the books right now to prohibit that.

Mr. HARNER. I imagine there is not.

Co-Chairman ROBINSON. And in fact, I would just add to Commissioner Mulloy's point that the capital markets—and this is one of the reasons why we think this hearing is an important one—the capital markets have never been viewed in a national security context in this country's history, so this issue has never been dis-

cussed. When you talk about the Office of Foreign Assets Control and U.S. sanction regimes around the world, I dare say—perhaps you are better than I in researching this matter—but in the five years that I have been looking at it, we have never found reference to the debt and equity markets, the ability of suspect or companies engaged in wrongdoing having their access curtailed in any way. So it is a very important question, but again, that's one of the reasons why we are here today.

Commissioner MULLOY. Mr. Chairman, I appreciate the very quick and candid answers that each panelist gave to those particular questions.

Thank you.

Co-Chairman ROBINSON. A very good set of questions, I might add.

Commissioner Lewis?

Commissioner LEWIS. Thank you very much for helping enlighten us on the issues that we're discussing.

Several of you said, I think—Mr. Bailey, Nick Lardy, and in fact everybody said—that China has sufficient savings to satisfy their investment needs. We have also heard that there are three major areas of great capital need in China, one having to do with the unfunded pensions, one having to do with energy resources, one having to do with nonperforming bank loans from state-owned enterprises mainly.

There are several state-owned enterprises that will be going into the capital markets, and banks will be going into the capital markets. Hopefully, the banks going into the capital markets will help with some of their nonperforming loans and the same thing with the state-owned enterprises. And some of the Chinese energy companies are going into the capital markets to get funds.

Are the Chinese saving rates sufficient to satisfy those three needs?

Mr. BAILEY. I would pass to the more macro-oriented Dr. Lardy.

Dr. LARDY. The way I would look at it on the banking side, the real constraint there is on the ability of the government to raise tax revenues to ultimately pay for the cost of recapitalizing the banks. So it is really more a question of the fiscal capacity rather than national savings.

I think, quite frankly, that it would be very difficult for the larger banks where these nonperforming loans are concentrated to raise funds on their own domestic markets, because they would be such problematic securities.

I find it very encouraging, for example, that the Chinese Securities Regulatory Commission which controls, in theory, at least regulates, the domestic equity markets earlier this year issued a regulation saying that no financial institution can issue stock on the domestic market unless they have financial statements presented based on international accounting standards. And on international accounting standards, these major banks would be insolvent, and I think it would be very unlikely that people would want to put their equity in them.

So I do think this is ultimately a responsibility of the government, and it will depend on the ability of the government to fi-

nance it through tax revenues or the sale of government bonds and other——

Commissioner LEWIS. Sovereign bonds.

Dr. LARDY. —domestic bonds and domestic currency on the domestic market.

So in the end, I think it comes down to a question of the fiscal capacity of the state more than the national savings rate. Obviously, they are interrelated, but they not only need to reform their capital markets, they also need a more robust tax system. The central and provincial revenues, for example, today are only about 15 percent of GDP, which is very low by international standards, so the tax base is not sufficiently large or effectively administered to generate the kinds of tax revenues they need to finance the recapitalization of banks and I think ultimately, as you mentioned, to make good on the state's implicit obligations on pensions to workers in state-owned companies.

Commissioner LEWIS. How about the energy needs? Is the savings rate sufficient to finance the energy needs of——

Dr. LARDY. Yes, I think, without a doubt.

Mr. BYRNE. I think there are a couple of ways that I look at this. One is that the market is very segmented in China, and even though the state sector exists, it is not a monolithic state sector, so entities have varying degrees of access to this huge pool of savings that is adequate on a national scale. That's one reason why there is entry into the market, because not everyone has an open checkbook with the People's Construction Bank or the Bank of Agriculture.

I think another reason is that there are foreign currency funding needs that have to be met based on the international market that cannot be totally met from the domestic foreign currency pool of funds.

And then, of course, thirdly, but this mainly I think has to do with the foreign direct investment, is the issue of acquisition of technology and also ability to gain market access abroad through partnership with foreign firms.

Commissioner LEWIS. Thank you.

Mr. Harner?

Mr. HARNER. Let me take one at a time. Beginning also with the banks, as Nick said, it is a big issue, but I think if you look at the banks not as a whole but as segments, you see that it is more tractable than that.

The four big banks, state-owned banks, are the bulk of the problem, and taxation will be one way that these banks are recapitalized, taxation meaning funds accumulated by the state and then reinvested in these banks, and tax forgiveness, because these banks are heavily taxed, so forgiveness or reduction in tax on these banks so that they can accumulate retained earnings. But basically, the recapitalization of these four big state banks will take place over a long time; this is a 10-year process. So on a 10-year basis, a combination of tax rebates or reduced taxes or use of tax funds to invest in the banks, borrowing by the Ministry of Finance and using those borrowed funds to invest in the banks, or other measures will, over a period of time, serve to reduce the bad loan burden.

And of course, we have already had approximately $175 billion worth of bad loans transferred to four so-called asset management companies. Those are writeoffs. Even though you have heard in the news that Morgan Stanley or some other foreign-invested joint venture has actually purchased a large amount of these bad loans from one of the asset management companies, the fact is those loans are a writeoff. That $175 billion write-off will have to be off-set by transfers from the Ministry of Finance. The Ministry of Finance can issue bonds and deficit finance without any difficulty, because the savings rate, the total debt of the Ministry of Finance is relatively low; in other words, it has a lot of borrowing capacity.

The bank refinancing issue is a big issue, but I believe it will be handled over time for the big banks. For the smaller banks or the so-called commercial banks, will virtually all list in the next 12 to 18 months, those that haven't already listed. There are 10 of these so-called commercial banks like the Bank of Communications, Everbright Bank, and the China Merchants Bank. They will all list on the domestic exchanges; some will indirectly list on overseas exchanges. Everbright Group has already indirectly listed in Hong Kong. They will also in many cases accept foreign capital. HSBC, IFC, Asian Development Bank are investing in these banks. These banks have access to capital, and they will use this access primarily in the domestic market, and to some extent in the international market, to recapitalize.

Then, there are the rural credit cooperatives, which are a writeoff, and the urban credit cooperatives, which are now reorganized as city commercial banks, which are also pretty much a writeoff. What we can expect here is local government, provincial government, investment or acceptance of the refinancing requirements.

The pension system is a big issue. I believe that will be solved over time in virtually the same way. It is similar; it is a liability that needs to be amortized over a long period of time.

And as far as the energy or other domestic investment requirements, I still think that they have enough savings to finance that requirement going forward.

Commissioner LEWIS. Thank you very much.

Thank you, Mr. Chairman.

Co-Chairman ROBINSON. Co-chairman Wessel?

Co-Chairman WESSEL. Thank you, and I thank all of you for being here today.

All of you talked about the large pool of savings and the tremendous latent liquidity in the market. It seems that in China, we don't yet know the appetite for large issuances and that a number of these large issuances have actually gone to the international markets. Are we seeing a bifurcation in terms of issuances, that the smaller ones will be simply floated on the domestic market, and the larger ones will go to international markets?

Mr. BAILEY. In the long run, I think that as the market develops in China, there will be a greater capability to absorb that.

Co-Chairman WESSEL. To absorb the large issuances.

Mr. BAILEY. Yes. I think a lot of that is just frictions and institutional problems in China. The pool of savings and the desire to invest is certainly there.

Dr. LARDY. I think the largest domestic issuance to date has been in the neighborhood of about $11 billion domestic currency units, which is significantly smaller than the largest issues in the external markets. I think we will see larger issuances as the domestic markets continue to develop.

Mr. BYRNE. I would agree with the statements made by Professors Bailey and Lardy, but I would also point out that the Chinese have been very selective in putting forward companies for international IPOs, so by nature, they are going to be large. You won't see a small marginal IPO that is not a big name going out into the international market. This is a new form of window for inducing capital into China.

Mr. HARNER. There is a great need in the domestic capital market for big, good companies as issuers. A real problem in the domestic equity market is that the companies are small and terribly managed and terribly run, and part of the imperative of the leadership is to improve the supply side of the domestic marketplace, in addition to the demand side. The demand actually—a latent demand is very much there. With more funds available for investment, the issue has been that the companies are so terrible. They are small, they are poorly managed; they are not of international quality. They are generally not of investment quality.

This requirement to introduce blue chip investment-type companies into the market is behind the CDR, the China depository receipt initiative. It is currently focused on having H shares issue A shares in the domestic market.

So we are seeing a cultivation of new companies in the domestic market, because that is what is needed by the marketplace. The market in the year 2001 has been sick, with a real crisis of confidence because of fraudulent reporting, misrepresentation and other failures of corporate governance.

There will be more and more bigger companies issuing, I think, because, first of all, there is capacity to absorb them; secondly, they are needed in the market. But at the same time, what we are seeing again is that the already issued big companies are entering the market, in a back door, in a sense, or in a secondary issuing, entering the market. My sense is that in the future, companies will issue both overseas H share, N share, maybe initially with smaller issues, or perhaps even at the same time A shares, so they will tap both domestic and foreign markets at the same time to give investors in each market an opportunity to invest in the companies.

Co-Chairman WESSEL. Commissioner Lewis talked about the demands for capital in the Chinese market, and we have recently seen the Taiwanese Government open up its restrictions on investing in China.

If the Taiwanese Government were to eliminate the reverse restrictions, allowing Chinese mainland companies to invest in Taiwan, what kind of capital outflow might we see there, as I assume there is a political desire to maintain and strengthen relations with Taiwan?

Mr. BAILEY. It's hard to predict. I think there would not be a lot of interest. I think that a lot of people in China, aside from the political issue, really think Taiwan is small beer. I think they would

be much more interested if there were a more general opening for China's investors to go to other places, even outside greater China.

Dr. LARDY. Well, China is already a large external investor by international standards. I don't remember the year, but in one recent year two or three years ago, they were the eighth-largest foreign direct investor abroad. They are certainly the largest emerging market direct investor abroad, and liberalization of opportunities in Taiwan by the government there certainly might increase it a little bit, but I don't think it would be a substantial increase given the relatively small size of the Taiwanese economy.

The real issue, I think, as Professor Bailey has alluded to, is the regulatory one—what is the degree of freedom for Chinese companies to invest abroad. They have done some, but the scale, although large by emerging market standards, is still quite small in absolute terms.

Co-Chairman WESSEL. I see my time is short, so I'd like to ask one other quick question.

To the extent that companies entering the U.S. market are subjected to higher disclosure standards, SEC, et cetera, to what extent is that driving, if at all, enhanced disclosure in China itself? Is that doing anything to the companies over there?

Mr. BAILEY. I think there are glimmers of companies that want to do a better job even though they are not listed overseas. There is a lot of interest in some of the government bureaucracies. I'd say it's a little bit too early to say.

After the Asian crisis, there were a number of Thai companies that stepped up and said, Yeah, we're going to do the disclosure thing, too—and they sort of petered out to a great degree.

Dr. LARDY. I think it does raise the bar, and I think the CSRC, the Chinese Securities Regulatory Commission, as I mentioned, has stated that financial institutions that list on the domestic markets will have to disclose their results on international accounting standards rather than domestic standards. We'll see if this actually happens when some of these small banks get listed over the next year or so. And there have been pressures, obviously, to crack down on the fraudulent reporting that has been widespread in the domestic market on the equities side, or to crack down on companies that have failed to disclose any information on a timely basis as is required by the regulations.

So I think the regulator is moving gradually but consistently to enforce greater disclosure, and I think the example of companies listing in Hong Kong or the U.S. market is a positive factor in that trend.

Mr. BYRNE. My comment would be general. I think that as we see not only in emerging markets but also in the United States accountants alone cannot—with Enron, with LTC—it is not an accounting matter. You need effective regulation to really get proper disclosure in classification of assets whether it is in the banking system strictly or outside in the wider financial community. And China has a very long way to go to develop an independent and effective and aggressive regulator. I know there is an agency now, and it is coalescing as an institution, but looking at the experience elsewhere in Asia, in economies which are generally the same type of model—government-directed, a lot of moral hazard—you can go

to Korea and Japan—you still don't have effective regulation even in those countries in the financial system—certainly not up to Anglo-Saxon standards.

Mr. HARNER. I would say, and I note in my written testimony, that I think the issue is that U.S. markets exert a tremendous influence globally. The U.S. market, notwithstanding its problems—and Enron is a good example of the problems—is the standard, as deficient as that standard sometimes is. And now, with globalization of financial markets, other markets really do aspire to what is currently the U.S. standard, and Hong Kong is among those that is aspiring to those standards. It falls way short for many reasons, but Hong Kong does aspire to standards. And Chinese enterprises, I think, and Chinese regulators are most focused on the Hong Kong environment.

So to the extent that Hong Kong is raising the bar for disclosure and corporate governance and shareholder protection, that puts the pressure or certainly is an influence to encourage greater transparency and better corporate governance within China.

Co-Chairman WESSEL. Thank you.

Co-Chairman ROBINSON. Chairman D'Amato?

Chairman D'AMATO. Thank you, Mr. Chairman.

We have been hearing for a long time about the increasing interdependence between the U.S. and Chinese economies, and what I am hearing today leads me to think that there may be some exaggeration as to that. On the one hand, we have this huge pool of savings that insulates the Chinese economy from some influences from the outside, and maybe an exaggeration of the extent to which their SOEs are going to be privatized in the near future. On the other hand, we have accession to the WTO. On a recent trip to China, some of the Commissioners and I met with a large number of Chinese officials who, unless they were not being genuine, seemed to have a very deep commitment to opening up their economy in an almost reckless, aggressive sense.

So I am getting this conflicting sense as to whether this interrelationship is deepening or is being exaggerated. I wonder if each of you has a general comment about the question of the growing interrelationship between the two economies?

Mr. BAILEY. I don't want to be a person to disparage securities markets, but sometimes stock markets do one thing where the real economies do something else. There is a growing trade and direct investment linkage. But if the Chinese stock markets lost 50 percent of their value tomorrow, I don't think it would have a lasting impact here, precisely because there are a lot of short-term forces at play in the capital markets.

Dr. LARDY. Well, I am of the view that the interconnections are growing significantly. They are much deeper. Certainly, China's trade has grown at an unprecedented rate. There has been a sevenfold increase in their share of world trade since the late 1970s when they began to open up. They are now the seventh-biggest trading country in the world. In a book that I have coming out shortly, I argue and suggest that within five years or so, they could easily surpass countries like Canada, France, and the UK and become the fourth-largest trading country within the world; within a decade, they might surpass Germany and Japan and be the second-

largest trading economy in the world. It is within the realm of possibility given the very large role that foreign firms in China are already playing in generating exports and the additional liberalization that is coming with their WTO obligations. So I don't think there is any doubt on the real side, there is a very substantial deepening of connections between China and the rest of the world. Certainly—I'm sure you heard it on your trip, and I have heard it on several trips in recent months—the main question now is how soon is the U.S. economy going to recover, because they realize it has an enormous impact on their own exports and on their own trends in employment and GDP growth and so forth. So there is certainly a very acute awareness of the extent to which they have become much more dependent on the international market as a result of the liberalization and opening up that has been going on for more than two decades.

Mr. BYRNE. Right. I would just have to mirror the other panelists' comments. If you take an historical perspective, there certainly is greater integration, and that will increase. And again, it is not even across the board, and in the financial markets, I think it is where it has been the most retarded, particularly in the securities market, say, the bond market.

Chairman D'AMATO. But as they modernize that, they will catch up and become more dependent?

Mr. BYRNE. It will, but it will be very uneven. That is the hardest market to open up. I have tables on the back of my presentation that show that even Korea, which has at least a 10-year headstart and comes from a completely different paradigm from China—there is no communist socialism in China; there is a Korea, Inc. mentality, but it is completely different, it is capitalist—the domestic bond market is still separated from the international bond market. A Korean company has different access to raising money internationally than it does domestically; it is a completely different dynamic. So Korea hasn't completely integrated as, say, Japan has integrated, because Japan does large flows of debt-equity bonds between Japan and the rest of the world. That's not the case in some of the other—Hong Kong is an exception, of course—but it's not the case in the rest of East Asia, particularly in China. And that will take a long time to develop.

It is an institutional and legal and political phenomenon.

Chairman D'AMATO. Mr. Harner, you mentioned in your testimony that you felt that the SOE privatization issue was not moving as aggressively forward as some people——

Mr. HARNER. No, no. I would suggest—well, again, SOEs certainly are being—I believe it is absolutely true that the state is withdrawing from competitive sectors in China. This is a very macro issue. But where there is competition—and the leadership is on record here—where there is competition, the state is not going to compete, at least in terms of pure SOEs. So where there is not competition, and we have transport, energy, in some cases telecom, et cetera, you have purer state-owned enterprises. But where there is competition, particularly with foreign enterprises, internally or internationally—and with WTO, the competition will increase—the state is not going to field pure SOEs, it is going to field companies

like PetroChina, SinoChem, China Unicom, that are quasi-privatized and increasingly privatized companies.

So in that sense, because the amount of the so-called non-open or closed part of the economy is shrinking, the privatization—if you call selling 30 percent of the company privatization—that is proceeding apace throughout the economy in any area where there is competition, and it is only in those areas where there is no competition, pure state-run monopolies, where there will be pure SOEs in the future.

But if I may just comment on your observation or your sense that there may be a contradiction between integration globally and the lack of requirement, apparently, for raising funds in international capital markets, I would suggest that I don't think there is a contradiction. China's increasing integration with the international economy is evidenced by trade flows, which are huge, and investment flows—trade flows which are huge and result in a very substantial current account surplus every year, or have, and investment flows, net FDI which is hugely going into China.

These are evidence that China is very much engaged with the international system and with the U.S., but what this is resulting in is huge surpluses of foreign currency in the hands of the state (which you see net of unofficial capital outflow, basically capital flight) which you see accumulating in the foreign exchange reserves.

So because they have such large accumulated foreign exchange reserves, companies can import and meet other needs that they have for imports or technology simply by converting RMB to foreign currency and importing the goods, or importing the technology. So they don't have to issue in international capital markets for foreign currency purposes.

Chairman D'AMATO. Thank you very much.

A quick follow-up for Mr. Lardy. You characterize the level of priorities in terms of economic resources as FDI being number one its influence in China, as I understand it, much more important than the portfolio or the equity investments in either the domestic or international markets. So, you maintain the increase in FDI going into China from $40 to maybe $100 billion per year over the next couple of years as the single most important single factor. Is that right?

Dr. LARDY. Well, it certainly has been, and I think it's likely to continue to be the largest source of foreign funding for the next few years. Incidentally, I don't think it will go to $100 billion in the next few years, but some investment banks are predicting it could be that much.

Chairman D'AMATO. Have you developed material for your book on this—the mix within the FDI transfers as between the United States, Europe, and Japan? What is the ratio? Do you see that ratio projecting forward in the same way, or is there a change going on in terms of one or another of these suppliers?

Dr. LARDY. Well, the largest single source for many years, of course, has been Hong Kong companies and Hong Kong registered companies, so that's a mixture; some of it is real Hong Kong, some of it is foreign companies that choose to channel their funding into China through Hong Kong, and it's impossible to separate. So at

least in the Chinese statistics, Hong Kong is the number one source. Although the relative importance of Hong Kong has declined over the last 10 years, it is still 60, 65 percent. Taiwan is very large, the second-largest source cumulatively, and then it drops off quite a bit. The U.S. is in there—I think if you take the total amount, total U.S. investment in China as reported by the Chinese, it's about US$32 billion, and their total cumulative FDI inflows are something on the order of about $350 billion. So the U.S. would be the source of about 10 percent of the total gross FDI inflows.

Co-Chairman ROBINSON. Commissioner Reinsch?

Commissioner REINSCH. Thanks, Mr. Chairman.

I can't resist reflecting on one of Mr. Lardy's comments about the growing trade relationship between the two countries. It is almost saying that if we really wanted to hurt the Chinese, the best thing we could do is continue the recession, because that would really hurt—if we start to grow, they're going to start to do better, too, and who knows what will happen? Prosperity might break out. Somehow, I think that won't be one of our recommendations, but it is a thought about the nature of the relationship between the economies.

I want to come back to where this panel began, really, with Mr. Mulloy's questions. You have all come out in favor of disclosure and transparency. Those are happy words. I'd like to get a better understanding of what that means to you—and you don't all have to answer, whoever feels like it—specifically in the context of Chinese entities seeking to access the U.S. capital market, who do you want to disclose and what do you want them to disclose that they are not already being required by the SEC to disclose?

Mr. BAILEY. I don't know how much we could impose on them directly, but let me tell you what I want and just put my two cents' worth in here before I have to leave for the airport.

As an educator, I want to see more of my M.B.A. students able to stay for two and a half or three years to learn the Chinese language, so when they are working for investment banks or they are working for accounting companies, they are able to dig very, very deep. That's the type of disclosure that I want to be enabled.

Another thing that I'd like to see is many of my students having more opportunities to take government jobs. Every year or so, I'll get someone who is very interested in working for State or Commerce or an intelligence agency, and the recruiting cycle of those agencies doesn't suit the students, and the salaries don't suit them, either.

I want to see the resources throughout our economy capable of sticking their noses into these places, because in the end, we can force the companies to adhere to any type of accounting standard we want, but it comes down to pieces of paper, documents, promises, and it is very hard to hunt those down.

Commissioner REINSCH. I don't disagree with any of that, but that wasn't really what I was looking for. I am trying to figure out what it is that we want the Chinese companies to say that they are not already saying that would make you comfortable. We started out with Mr. Mulloy talking about the people doing "naughty" things, to quote your phrase, and I want to explore that in a

minute, too, what that is. But let's assume there are some of those companies. What do we want to know that we are not already finding out?

Mr. BAILEY. I think we could go point by point through balance sheets of American companies and say we get these 72 items, the notes and other details. I think it would be nice to see that, but again, I am not answering your question, I'm arguing with your question. I'm saying that in the end, those things can be manipulated, and I think what we need is more ability to investigate, probe, and develop information. Just as we have analysts sniffing around Silicon Valley looking at little startups, I want to see more Americans sniffing around China, poking around companies, to really get the facts rather than relying on the statements. Ultimately, statements, a la Enron, can always be manipulated or finessed.

Commissioner REINSCH. You are suggesting that as a matter of research, academic interest, professional interest, not necessarily as a matter of extraterritorial enforcement, are you—or are you? Do you want the SEC to——

Mr. BAILEY. I want the SEC to have more capability, I want the CIA to have more capability. I want Goldman Sachs' stock analysts to have more capability. I want everyone sniffing, pushing, poking, and asking questions, as they would for XYZ.com, and we don't have that capability right now.

Commissioner REINSCH. What about the rest of you? Does anybody else want to comment?

Dr. LARDY. I would say that I don't see how it is feasible to require greater transparency on the part of Chinese listers and other listers, but I think the way to solve this problem, or at least one way to address this problem, is to raise the standards for the ADR listings. The ADR listings don't have anywhere near as much disclosure. I think if you look at Professor Bailey's compilation of the Chinese listed companies, the vast majority of them are 144(a) or various methods of listing that require much, much less disclosure than a regular New York Stock Exchange listing.

So I think the way to handle this in part is to raise the bar for all issuers or ADRs so that there is a much higher level of disclosure.

Commissioner REINSCH. In other words, national treatment, nondiscrimination?

Dr. LARDY. Yes.

Commissioner REINSCH. I understand.

Anybody else?

[No response.]

No. Okay. Going, going, gone.

Going back, then—and this may be kind of an unfair question, but I'd like you to take a stab at it anyway, because the issue has come up—going back to the question of the bad guys, if you will, whoever they are, I think Professor Bailey suggested that we tar and feather them, which was a rhetorical thing—I think we all know what he is talking about—and you all sort of came out for that in one sense or another. How do we figure out who these people are, and what is it that they need to do to fall into this category of being "bad"?

Mr. BAILEY. I think that in a system where law and regulation works, a lot of the discovering of who is bad and who isn't goes on by shareholders, lawyers, and big institutional investors who can bring an action. In China right now, they cannot largely bring an action and get it adjudicated fairly and efficiently in the court system. So we can demand good accounting. I think it's a good idea to hold these ADR listings to the highest standards rather than the informal standards, but in the end, we need mechanisms to evaluate—when something is reported, and it doesn't seem quite right, or it doesn't really represent the information, there exists a mechanism outside the accounting for enforcement or for punishment. That does not exist in China right now.

A problem that that causes for us is that even if we do impose the highest-level ADR listing on Chinese firms or all firms, what can we do to enforce this on the Chinese company in the United States if they have no assets here? There may be limits to what we can do.

Dr. LARDY. I thought your question went more to the issue of how capable we are of identifying firms that are engaged in, say, proliferation activities or other activities that are contrary to U.S. national interests.

Commissioner REINSCH. It does, but he said what he was going to say anyway.

Dr. LARDY. Yes. Obviously, academics and people in research institutions cannot do that; you need very highly specialized information that only exists within the U.S. Government, and I think if it's made a higher priority, they could do more in that area.

Commissioner REINSCH. Anybody else?

[No response.]

Thank you.

Co-Chairman ROBINSON. I know you have to be running off, Professor Bailey, and if I may, with apologies to Commissioner Dreyer——

Commissioner DREYER. My question has already been asked by Commissioner Reinsch, so I pass.

Co-Chairman ROBINSON. —very good—I will certainly move to you, George. If I might, though, I'd like to just take the liberty of asking a question while Professor Bailey is still here.

Building on the same question of Commissioner Mulloy and that addressed by Commissioner Reinsch, if we do have an identified bad actor, whether it be a proliferator, or another kind of egregious national security abuser there have been a lot of folks, including Chairman Greenspan and others, who have basically said any effort to penalize that company or restrict them from the U.S. capital markets, no matter how egregious their activities, it is basically not going to have the desired effect of impeding in any significant way their ability to raise funds elsewhere. That is to say, they will just run to London or other markets and in effect be indifferent as though the global markets are seamless in this regard.

Now, that is not my understanding, and I'd like to get your reaction before you go and also hear from the other panelists. For example, Mr. Harner has, I think, very persuasively laid out the argument of the U.S. markets being the standard. He said that, I believe, because the U.S. capital markets are so dominant globally.

Indeed, if I have my facts right, nearly half or more than half of the global demand for securities is made up of American institutional and other investors.

Having said that, is it your view that there would be, for example, at least a good prospect, if not a probability, that an entity denied access to the U.S. market would face an increased cost of funds elsewhere. Let's say you are an identified proliferator; you are restricted from the U.S. markets because Senator Thompson has it his way that this is viewed as a bridge too far on the basis of national security concerns. Wouldn't such a company, if they were restricted from the U.S. market, and wanted to go to London or elsewhere, be subjected to higher cost of funds, a higher risk profile, and possibly a stigma? It's not as though the information of such abuses is going to stop at our shores and not be understood in other markets. that indeed, if they are a multi-billion-dollar annual borrower or fundraiser like some of the big Chinese entities may be, isn't it possible that such an entity would stress out or even exhaust thinner volume markets around the world that just can't handle annual sums, multi-billion-dollar sums, from, for example, a particular Chinese borrower or equity issuer.

If this scenario is accurate, then, a company denied access to U.S. markets is not indifferent to having to raise funds in other markets. That is to say, that such a company would likely be subjected to higher costs and other disadvantages were they to be compelled to go elsewhere.

Could you comment on your view on how you see this?

Mr. BAILEY. Let me give you a loose analogy, and no analogy is perfect. During the time when South Africa was under sanctions of various sorts, in the narrow sense, it is true that South African industry, particularly mines, were able to continue to raise money in various places.

However, it is also the case that there were quite a few investors, even those who didn't have some explicit prohibition, who avoided South African issues. And furthermore—this is something that a student of mine did a term paper on some years ago—South African mining issues, for example, traded at a very severe discount compared to, say, Australian or Canadian or American issues, in part, of course, because of the implicit risk, but in part because there certainly was an odor about them.

So we may not literally be able to prevent a misbehaving bad actor entity from raising money, but I think we can certainly cast a pall over there, and that is of some value and some importance. And even if it were only of marginal value, I think that it is important for us to do so if we can do so carefully and appropriately.

Commissioner REINSCH. Can I interject something on that, Roger?

Co-Chairman ROBINSON. Yes.

Commissioner REINSCH. South Africa's actions were multilateral and UN-sanctioned. I think Roger is suggesting in a sense, at least in the first instance, a unilateral action by the United States. Does that make any difference in your eyes?

Mr. BAILEY. All analogies are weak, but to the extent that multinational sanctions on South Africa might be similar to sanctions from one country which also happens to be the world's largest cap-

ital market, it would be a big sanction. It would not be a perfect sanction, but it would be big. As to say whether it would be stronger or weaker, one of the weaknesses of social science is that we can't run little experiments in petri dishes and tell; we just have to blab about it and suggest what might happen.

I think there would be some cost to this, although it wouldn't stop them in the short run from raising money.

Co-Chairman ROBINSON. Because of the global dominance of the U.S. capital markets, I would assume?

Mr. BAILEY. Yes.

Co-Chairman ROBINSON. I know you have to go, so we want to thank you once again for your terrific participation.

Mr. BAILEY. Thank you very much for inviting me.

Co-Chairman ROBINSON. Dr. Lardy?

Dr. LARDY. I'm sure you could get a more informed judgment on this question than I can offer from some of the participants who will be here in the afternoon from the investment banking community about what this might translate into in terms of the number of basis point additional that an issuer who was banned from the U.S. market would face.

Of course, it also depends in part on whether or not the bans that we are talking about are just the issuance of these securities in the U.S. market or whether there would be a mechanism for preventing U.S. investors, particularly institutional investors, from acquiring those financial assets issued in other markets.

But I think the main comment I would make is that, for better or for worse, I think the capital requirements of proliferators are not that large, so that our leverage may be less than we would like.

Co-Chairman ROBINSON. Mr. Byrne?

Mr. BYRNE. Going back to the analogy of South Africa, I think you are right. I think that actually was costly for South Africa, not only in financial terms but also political and moral terms, because of the multilateral nature. Now, South Africa did have access to Swiss franc bonds that were raised to finance, but it was very small.

But of course, the intended effects took a long time to work through on the South African Government at the time. I would say that if there is going to be any sort of effective political sanction on the part of the U.S. Government, for it to be effective, it would have to be well-justified so that other countries feel that it is worthy to take this up, and it becomes multilateral.

Co-Chairman ROBINSON. Although you appreciate that multilateral sanctions of any kind today are extremely difficult to mobilize even in the most egregious circumstances, like Saddam Hussein and others.

Before I turn to you, Mr. Harner, let's just assume first that, per Commissioner Reinsch's point, I am speaking unilateral here because of the difficulty, again, of recruiting other countries to enact financial or any other types of economic sanctions these days, and second, getting back to Dr. Lardy's point, that there would be a major loophole closed. That is to say, presumably in an egregious case, all U.S. legal persons would be able to hold the securities of such a firm. For example, even if they listed in Hong Kong and sold into the U.S., American entities would be prohibited from pur-

chasing those securities. If you could just add that to your calculation of the potential costs, how would you react to that?

Mr. HARNER. Well, you are getting very close to the frozen assets regime that I once remember with Vietnam and North Korea, which I think was pretty effective. And if that is what is implied here, and even if it is not implied, I was prepared to say that without any question, the scenario that you described or the mechanism that you described of attaching the stigma and blocking companies so stigmatized from raising funds in the U.S. would absolutely raise costs and cause a lot of inconvenience for such companies if they existed and tried to raise funds in international markets.

I would also suggest, though, as Nick Lardy has suggested, that you are probably not talking about PetroChina here or China Unicom; you are talking special-purpose small companies with very specific objectives that probably don't need international funding because they get their funding directly from government sponsors.

Co-Chairman ROBINSON. Although PetroChina took a fairly debilitating hit to its IPO because of, again, a politically related concern on its parent companies' activities in Sudan. It's quite a distance if you buy that it was a $10 billion deal that went down to $2.89 billion deal. But I thank you very much for that, and I'd like to now turn to Commissioner Becker.

Commissioner BECKER. There have been a couple of very brief references made to the WTO and the strong push by China to reach compliance with the WTO. And we know for a fact that there are a lot of efforts underway for China to deal with their industries and come into compliance so there will be a minimum of problems along that line.

But now that all the dust has settled, and they are part of the WTO, and we can forget about the promise that was made that, to use Bill's words, prosperity is going to break out, I would be curious as to your opinion as to just how much penetration or ability our manufacturing industries in the United States are going to have in penetrating the Chinese market.

For example, we were at the General Motors Shanghai plant, and we were told very candidly that there was a difference of $9,000 between a landed GM car in Shanghai from the United States as opposed to one they built in China. And in response to a question as to how much of that will disappear once they come under all of the lowering of tariffs, et cetera, et cetera, on parts and building the automobiles and how all that will interact when they can ship freely into China, we were told that they expect it to drop to a $3,000 difference, which is quite a lot for an automobile. It would indicate that the chances of being able to produce cars in the United States and ship them into China is still going to be prohibitive.

I am just wondering how you feel about the rest of the manufacturing industry—set aside intellectual property, set aside financial benefits—but on manufacturing, what are we going to be able to do?

Dr. LARDY. Obviously, you have to take a disaggregated approach and look at a lot of different sectors. I do think it is going to be quite difficult for American firms—or, not only American firms, but German firms or anybody else—to sell a significant number of

automobiles in the domestic market. Volkswagen today has about 55 percent of the market in its two joint ventures; they have brought their costs down dramatically over the last decade as they have localized production of parts——

Commissioner BECKER. But I am meaning all manufacturing, generally, not just automobiles.

Dr. LARDY. Right, but I'm just giving you automobiles as an example, and automobiles will remain a relatively protected sector because even after all of the phase-ins, they will be allowed to retain a 25 percent tariff on imported vehicles. So I think there will be some increased sales into the market of very specialized high-end vehicles where you won't have sufficient demand to warrant production in China, but I think the vast majority of conventional sedans are going to be produced in China, but by joint venture companies, whether it is General Motors in Shanghai Buick or the Volkswagen joint ventures in the Northeast or in Shanghai.

In other areas, I think we'll continue to do very well, in other kinds of transportation equipment. Obviously, the aerospace sector will continue to be a big sector, and I think we'll continue to do quite well in telecommunications. In some sectors, they are bringing tariffs down very close to zero or actually to zero, for example, in the case of their commitment to reduce tariffs to zero in the case of information technology, including telecommunications equipment, so those will certainly be areas where there are substantial opportunities for increased sales into the domestic market.

Commissioner BECKER. Anybody else?

Mr. BYRNE. I don't have the depth of knowledge that Professor Lardy has on sectors—that is really not my focus—but I would comment that I think generally, the market will be more open for U.S. goods, even though sold abroad, but I think the main thrust of WTO is to make the Chinese firms more competitive and commercial. I wouldn't go so far as to say to privatize them, but to make them more competitive and commercial. And I think that involves having foreigners set up a presence in China to manufacture goods for the domestic market. I think that is the primary intent of this liberalization process, rather than to open up the balance of payments to unimpeded access to foreign imports. China had a bad experience with that in the early eighties, and I think they want to maintain the strength of their balance of payments for the foreseeable future.

Mr. HARNER. If I may say, I think that manufacturing is an area where there isn't really much left to do. There isn't really much for WTO to accomplish in terms of opening the manufacturing sector. Manufacturing has been the activity that the Chinese have wanted, by which we mean importation of foreign technology plus access to foreign markets, and then, local manufacturing, usually for the foreign market, which is why exports have grown to the extent that they have grown, to provide internationally competitive companies with internationally competitive technology. They are now increasing to some extent sales domestically, but the domestic market has always been much smaller than the foreign market. But manufacturing is already there, and yes, WTO will reduce tariffs to some extent over a long period of time. I think WTO has been way oversold in terms of anything that is going to really happen and change

in China. You just don't see it—I don't see it. What's left? Distribution, service-type areas. But that doesn't require a lot of capital, and it won't require a lot of investment or a lot more people. International services is another question.

Commissioner BECKER. Thank you.

Co-Chairman ROBINSON. Commissioner Ledeen?

Vice Chairman LEDEEN. I just have a quick question. Very quickly, do you all believe that China is somewhere along the transition point from whatever it was to some form of democratic capitalism?

Dr. LARDY. I think that that is a complicated question, and the answer depends on the precise definition of your term. I certainly think they are very far along the way—and maybe I differ a little bit from a couple of the other speakers—I think they are very far along in the transition to a much more market-oriented economy. I think they have really effectively working product markets where supply and demand are determining the price of practically everything sold in China today, even things that have been controlled by the government for decades, such sensitive things as petroleum prices. Even in electricity, they are starting to introduce some degree of competition in certain limited markets.

In the labor sector, I think they have very vibrant labor markets. There are still, however, some controls. Obviously, capital markets is where they have made the most limited progress, and the state is still controlling interest rates and limiting access to the equity markets by issuers and so forth. So we have a very early stage of development of capital markets. But in product markets, I think they are very, very far along toward a transition to what we would recognize as a market economy.

Obviously, they have made nowhere near as much progress on the political front, and I think it is a more pluralistic government, but I certainly would not use the word "democratic" to describe where they are today.

Mr. BYRNE. I haven't seen any statements by the leadership saying that they aspire to be a democratic capitalist country. Where China is heading is a state-directed economy. Of course, they are much along the transition path from where they were back in 1978 with the open door policy, and as Professor Lardy said, there are goods markets, there are to some extent natural supply and demand forces at work in China, but it will always be, at least the way the way the present leadership envisages the country, a state-directed economic system.

Mr. HARNER. To answer that question, your question is what do the Chinese themselves aspire to, or what is their vision. The leadership of China remembers when China was a command economy, when it was a centrally-planned economy, and realizes how disastrous that model was.

Their vision is to have a mixed economy, and the vision hasn't changed a lot, but it has been evolving a bit, and the mixed economy includes state-owned enterprises occupying the commanding heights and foreign-invested enterprises. They see foreign companies as dynamic and internationally competitive, and really the driving force of innovation and change in the economy. So they want a substantial foreign-owned sector, and they want a private sector—they are prepared to tolerate, they are increasingly happy

to tolerate, a growing private sector to provide employment and to absorb labor and to also create a certain dynamism in the economy that hasn't been there and wouldn't be there for these larger units.

I'd say state-owned, foreign-invested, private—also, though, another category, which is the final category, of quasi-state-owned, these listed or these partially publicly-owned, formerly state-owned, enterprises, which they hope will be able to compete effectively with foreign-owned enterprises and will be increasingly global, increasingly big companies of international scale.

That's the vision, and that is increasingly the reality of China, and that has nothing to do with politics. Basically, politics, as far as I think they believe, they like the situation the way it is and are doing as much as necessary to keep it that way.

Co-Chairman ROBINSON. Commissioner Mulloy has a comment, and I have what I think will be a final question.

Commissioner MULLOY. In response to Commissioner Ledeen, we just did a trip where we visited a number of cities in China and talked to a lot of people, and the clear impression that we got was that China is moving away from being a Marxist economy but still is a Leninist political system—the party.

We were told that they may be where the [inaudible] Taiwan was in the seventies in terms of the evolution. Does anybody want to offer any comment on that observation?

Mr. HARNER. I was in Taiwan in the seventies, and I'd say that's a very apt and correct analogy, except that, of course, the situation in Taiwan is so different, and what has happened in Taiwan since the seventies tells you absolutely nothing about what will happen in the next 30 years in China.

Commissioner MULLOY. Okay. One of the observations—you know, there is a debate on trade promotion authority today, and it is a big issue—one of the things that you said really made an impact on me was that during the debate on China's MFN or PNTR vote, the spokesperson for the administration would always come out and say, "Boy, did we pull the wool over their eyes. Look at what we're getting. They already have an open run at our market, and look what we're getting in their market. Man, this is a one-sided deal." I remember they kept saying it was a one-sided deal.

Of course, in my view, what the Chinese were thinking of was investment. And what you have said today really implies and makes that clear—they were looking to get the investment flows. I think investment fell off in China in 1998, didn't it—that was the year when they really got serious about the WTO negotiations and in fact put them together that year.

So I think they were thinking investment, and I think that when people aren't candid with the American people and the Congress, it spills over into other things. If that's what is going on, I think you ought to tell people.

That's just a comment; that really bugs me, because we have had people come in here and tell us, "Man, did we get a one-sided deal with the Chinese," and never mention what they were really after.

Is there nay comment on that?

Mr. HARNER. I agree with you.

Dr. LARDY. I would say that it was unfortunate that various people in the Clinton administration in effect oversold the deal in their

attempt to secure the votes to pass the PNTR legislation. The description of the deal as a one-sided market opening, I think, is quite misleading. There are going to be many sectors in the United States that will face increased competition from Chinese goods. As the Chinese open their market, they will have to adjust, certain sectors will shrink, other will expand. The expanding sectors are going to be looking to sell more in the international market. They cannot import more without exporting more, at least, not for any significant period of time.

So I think it was unrealistic to say that somehow you were going to suspend economics and have a single country importing a lot more without ever exporting a lot more. So I think in that respect, the sale of the deal was somewhat unfortunate and created expectations that I think are unrealistic.

Commissioner MULLOY. Thank you.

Co-Chairman ROBINSON. If you will indulge me, a final two-part question. I think Dr. Lardy very usefully made reference to Level 1 ADRs that, as you know, are traded over-the-counter here that are, along with Rule 144(a), Regulation S, are the vehicles that are commonly used to circumvent standard SEC disclosure requirements. And I think Dr. Lardy appropriately expressed concern about those lax disclosure requirements and the greater potential that they might be abused by emerging market and other players for any number of reasons.

If you could put a security-minded hat on for just a moment, which is, as you know, a large part of the mandate of this Commission, would you agree with the observation that a national security abuser, a proliferator of whatever sort, from China or elsewhere could employ the vehicle of a Level 1 ADR, Rule 144(a), or Regulation S to raise funds successfully from U.S. investors who would be largely unaware of the true identity of that fundraiser?

Does it sound plausible to you that those vehicles could be abused in a security context?

Dr. LARDY. Well, I'm not an expert on securities markets, but as I recall, the rationale for offering these alternative forms was that there are going to be a very small number of very sophisticated investors who don't need to have all the information that would be disclosed for a product that would be available to a much larger market.

I, quite frankly, am skeptical. I think there ought to be a higher standard of disclosure and that if they can't meet the disclosure, they should be limited to their domestic markets.

Co-Chairman ROBINSON. Bravo.

Commissioner LEWIS. That's a nice way of saying barred from American markets.

Co-Chairman ROBINSON. Any observations on that, Mr. Byrne?

Mr. BYRNE. My observation would be that, again, I think these instruments have more limited access to the markets and that if there are some future legal or political consequences of investors purchasing into that, then perhaps the risks should be priced into those deals.

Co-Chairman ROBINSON. And given the fact that, at least to my knowledge, no institutional investor, fund manager, or investment bank in the United States today is screening for security-related

concerns or, if you want to put it another way, including these considerations in their due diligence risk assessments, would you conceptually buy that it might be a useful thing for the U.S. Government to pay more attention to these matters in the interest of keeping the markets informed and for investor protection reasons? Does that sound like a sensible, nondisruptive step that might be appropriate?

Mr. HARNER. Well, disclosure requirements are really all about investor protection, and the investor is making his decision based on the perceived risk and the perceived reward, however, on the basis of complete information.

Any information that is relevant would be desired by the investors. If there is such information, the investors would like to know about it, no question about it. The question is how do they get their information; who is going to provide it, and under what circumstances will this information see the light of day.

Mr. BYRNE. Right. I can say from some experience that these are questions that do get asked of issuers. But again, how can you—one, because of the consequences it has on investor rights and then the value of the investment, but how can you get this information? It's difficult.

Co-Chairman ROBINSON. As you know, there is a good deal more attention to these security-related matters post-September 11. Congress was already alert to these concerns before September 11. The Deutsch Commission, the Cox Committee reports—these kinds of reports revealed a number of names of firms that have been linked to proliferation, and that have been doing the wrong sorts of business in terrorist-sponsoring state. Accordingly, I would only argue that this type of data is increasingly available in the public domain. I am getting to the issue of whether you think it might be useful for these types of security-related risk elements to increasingly be incorporated into due diligence assessments in the markets.

Mr. HARNER. I think you're saying they would be—they are. If they are known, they certainly are——

Co-Chairman ROBINSON. Because presumably, they could be material.

Mr. BYRNE. In the PetroChina case, it had effects.

Co-Chairman ROBINSON. Yes.

Well, with that, I would once again thank you all on behalf of all the commissioners present, and staff, and would like to close this portion of the hearings.

We regrettably have to clear this room only because the Commission is going to hold a luncheon discussion here, but everyone is invited back for the afternoon hearing reconvening at 1:30 in this room, at which time the gavel will be taken by Commissioner Wessel.

Many thanks again for the very thoughtful and valuable insights that you provided this morning.

[Whereupon, at 12:17 p.m., the morning session was adjourned.]

(AFTERNOON SESSION, 1:45 P.M., THURSDAY, DECEMBER 6, 2001)

PANEL II: MARKET PARTICIPANTS AND UNDERWRITERS

Co-Chairman WESSEL. Good afternoon.

As we heard from this morning's testimony, China has burgeoning capital requirements for its continued economic development and growth and will likely need or want to look to foreign sources of capital to fulfill them.

The role that the U.S. capital markets will play in this effort is an important issue that is deserving of this Commission's attention.

This morning, we heard from academics and financial analysts about the scope of China's capital requirements and its engagement in the U.S. and other international capital markets. This afternoon, we will take testimony from two panels offering different perspectives on China's U.S. capital market activities.

The first panel of the afternoon will provide the Commission with Wall Street's views and experiences with regard to Chinese firms accessing the U.S. markets. We are pleased to have on this panel Robert Hormats, who has had a distinguish career in government, including a term as Deputy U.S. Trade Representative, before joining Goldman Sachs, where he is now Vice Chairman.

We are also pleased to be joined by Marc Lackritz, President of the Securities Industry Association, and Paul Wolansky, Managing Director of the New China Management Corporation, an investment advisor focusing on direct investment in China.

The second panel of the afternoon features witnesses providing the perspectives of large institutional investors, pension funds in particular. These witnesses will discuss the significance of international investments to the portfolios of pension funds and the criteria these funds use to make decisions regarding their international investments. This panel should help the Commission assess whether U.S. investors are concerned about the national security implications of their investments and if so, whether current disclosure policies properly inform them about the nature of their international investments generally and their investment in China more specifically.

Joining us on this panel will be William Patterson, Director of the AFL–CIO's Office of Investment; Michael Flaherman, Chair of the Investment Committee of the California Public Employees' Retirement System, the Nation's largest public pension fund; and the honorable Steven Nickol, a Member of the Pennsylvania House of Representatives and a trustee of the Pennsylvania Public School Employees' Retirement System. James Dorn of the Cato Institute will also give testimony on this panel, although he will focus on China's capital requirements and its activities in international cap-

ital markets, providing an additional voice on the issues discussed this morning.

As the Commission moves forward in its analysis of this important issue, it will be necessary to hear from the U.S. Treasury Department and the Securities and Exchange Commission, key agencies responsible for regulating and monitoring the U.S. capital markets, as well as from the U.S. State Department.

We had hoped that representatives of these agencies could be here today to brief the Commission. As Commissioner Robinson noted this morning, the Commission did hear from Treasury Undersecretary John Taylor on these matters in a closed meeting in October. The Commission will certainly seek out another appropriate opportunity to query these agencies, particularly the SEC, as their views are essential to our mandate.

I look forward to this afternoon's discussion, and we'll now turn to our panel. I would also like to point out that Mr. Hormats has circulated a study that was recently done, a task force report, which I believe all the Commissioners now have.

We'll start with Mr. Wolansky, please, and go down the row. We are under some time constraints, so please take approximately 10 minutes for your opening statements, and then we will go around the dias for questions.

Thank you, and please proceed.

[The statement follows:]

PREPARED STATEMENT OF CO-CHAIRMAN MICHAEL R. WESSEL

As we heard from this morning's testimony, China has burgeoning capital requirements for its continued economic development and growth and will likely need to look to foreign sources of capital to fulfill them. The role that the U.S. capital markets will play in this effort is an important issue that is deserving of this Commission's attention.

I would like to join Chairman D'Amato and Commissioner Robinson in thanking Senator Thompson for his appearance here today. He has raised awareness in the Congress about China's involvement in the U.S. capital markets and I know he is very supportive of our efforts to examine this issue.

This morning we heard from academics and financial analysts about the scope of China's capital requirements and its engagement in the U.S. and other international capital markets. This afternoon we will take testimony from two panels offering different perspectives on China's U.S. capital market activities. The first panel of the afternoon will provide the Commission with Wall Street's views and experiences with regard to Chinese firms accessing the U.S. markets. We are pleased to have on this panel Robert Hormats, who had a distinguished career in government, including a term as Deputy U.S. Trade Representative, before joining Goldman Sachs where is now Vice Chairman. We are pleased to be joined by Marc Lackritz, President of the Securities Industry Association, and Paul Wolansky, Managing Director of New China Management Corp., an investment advisor focusing on direct investment in China.

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I look forward to this afternoon's discussion and will now turn to our first panel.

STATEMENT OF PAUL S. WOLANSKY, MANAGING DIRECTOR, NEW CHINA MANAGEMENT CORPORATION

Mr. WOLANSKY. Thank you, Chairman, and members of the Commission.

New China Management Corp. serves as investment manager of The Cathay Investment Fund, which has made about 20 direct investments in China in industries as diverse as pharmaceuticals, foodstuffs, real estate, home appliances, toll bridges, insurance, and the internet.

Cathay has been an active investor, and I have served on the boards of directors of and in some cases helped create the companies in which Cathay has invested. Some of those companies are classified as state-owned enterprises and some as red chips, and some have actually been previously identified to this Commission as having links to the People's Liberation Army. Others are privately owned by members of China's emerging entrepreneurial class.

I have been asked to speak on the extent to which China is relying on the U.S. capital markets, the nature of the Chinese companies seeking access to those markets, and U.S. investor interest in Chinese listings, all from the perspective of a financial investor on the ground in China, really just trying to make a buck.

With your permission, I'll summarize my remarks and ask that the full statement be appended to the record.

Foreign investment in China can be categorized according to who is making the investment and in what form or venue that investment takes place. Direct investment came first, and the first direct investment following the opening up of China really came from natural investors—that is, foreign companies seeking to establish new manufacturing facilities and markets for their goods and services. This was followed by financial investors, like investment funds, or institutions willing to put in the time and effort, and direct investment by foreign financial investors then cleared the way for the listing of securities of Chinese companies on established public exchanges. Investment in China was now open to anyone who was really willing to open a brokerage account and write a check.

Since 1999, Chinese companies have raised about US$81 billion through nominally foreign direct investment, of which about 10 percent or $8.1 billion came from U.S. sources. Much of that has come from natural investors, with only a small portion from purely financial investors such as Cathay.

The amount of debt and equity raised by Chinese companies directly or indirectly in the public capital markets open to U.S. investment, which is really the focus of today's discussion as I understand it, has been about US$13 billion over that same period. Of that amount, about $10.6 billion has been raised by companies on U.S.-based stock markets, $1.8 billion in Hong Kong, and a smaller amount on the Chinese domestic B share markets.

But putting those numbers into perspective, during that same period, approximately $267 billion was raised by equity and debt offerings listed on the New York Stock Exchange alone, with another $109 billion through offerings on NASDAQ. The "Chinese" portion, if you will, was really less than 3 percent. So from the standpoint of U.S. investors, investment in China represents a very small portion of the overall national investment portfolio.

From the standpoint of the Chinese, foreign investment has been extremely important, as shown by the figures. Domestic bank loans were only $14.4 billion over the same period, and sale of domestic bonds raised another $4.5 billion. The offering of securities on China's A share renminbi-denominated market, however, has raised about US$27 billion, in the renminbi equivalent over that same time.

As late as 1995, the bulk of investment capital in China came from domestically-generated loans and equity investments from government-related enterprises, largely SOEs and the PLA, which is the largest source of venture capital in China.

As Chinese companies sought to tap the international capital markets, they experimented with a number of different approaches, including red chips, the ITICs, some direct listings, some B share offerings. But overwhelmingly, these companies were SOEs, and their quality was poor, management was weak, they had little understanding of the expectations of foreign investors, and they were really more concerned with covering losses and maintaining unemployment than return on capital.

But by the year 2000, the situation had changed. Private companies, accounting for a disproportionately large percentage of the growth in China, were still largely shut out from foreign and domestic listing markets. Capital continued to be raised through red chips and H shares. However, a large portion of the foreign capital was now being raised through a very limited number of "blockbuster" offerings of privatizing SOEs, usually through dual listings in Hong Kong and New York.

The development of the A share markets which happened around the same time brought about a bifurcation in the way that Chinese companies raised capital. Total capital raised in offerings in Hong Kong and New York from 1999 to 2001 was about US$12.5 billion. But over 80 percent of that came from four large offerings of oil and telecom stocks—PetroChina, CNOOC, SinoPec, and China Unicom. The total for all other companies was less than $2.5 billion during that period. That represents less than 10 percent of the almost $27 billion raised on the A share markets in China at the same time.

The companies listing on the A share markets, however, were in a wide variety of businesses, many of which were not even profitable, at least by our standards.

There are good reasons why this shook out this way. First, required government approval was now more freely granted for A share listings as China sought to develop its own capital markets while absorbing domestic renminbi savings.

Second, valuations for Chinese companies were and remain much higher in the domestic markets than in the Western markets.

But most importantly, many of the companies offering shares in the A share market simply could not sell their shares in Western markets because nobody would buy them.

Investment in China has been negatively affected by risks as diverse as adverse market development, competition from profit-insensitive SOEs, changing government regulation, poor management, lack of transparency—the list goes on and on.

All of this makes the bad actor risk previously identified to this Commission pale in comparison. We have lots of other things to worry about when we are investing in China. And the general perceived risk level is quite high. Investors really aren't stupid. Even as experienced as we are at Cathay, we nevertheless have suffered from some of the issues I mentioned above, most of which we have been able to recover from. But the typical passive investor has very little chance and has taken a lot of losses.

The market is responding, and over time, it has allocated a lot of the foreign capital away from these smaller, less-developed enterprises and toward the larger, more developed companies that are concentrated in a few businesses as described above. The market potential of telecom and petroleum, for example, is understood and well-proved. China is already the largest market for mobile phones, and given the way car registrations are growing in China, I think we all understand where the energy needs are going.

But just as important, the scale of these enterprises has made it worthwhile to go through the restructuring exercises required to make these companies attractive to foreign investors. New management is installed, poor-quality assets are hived off, accounting is improved—basically, the companies are "scrubbed up" before they hit the international markets.

Are these companies operated to the same standards of efficiency as their counterparts in the West? No; unlikely. But that should be reflected in the pricing by Western investors as well.

Do these companies often operate to serve perceived strategic needs of the state? Yes, sometimes. But there is also a perception in the market that these companies are the vanguard of corporate China, and that although the government may occasionally call upon them to do some service for the common good, the government is also going to do what is required to make these companies successful over time. In fact, some of these companies have performed reasonably well given the circumstances.

As for the rest of the lot, the smaller or less strategically blessed companies are more likely to be relegated to the domestic markets or the more speculative end of the Hong Kong market.

The quality of supervision and discipline of management in these companies is questionable to say the least, and a significant amount of funds raised in the Chinese domestic stock market probably never make it to the intended, or at least the announced, use. Some of the money has been recycled into the market in specula-

tion on other A share issues, some has been used inefficiently or wasted in an effort to sustain doomed businesses. But if the A share markets collapse, the main victims are likely to be Chinese investors who buy these stocks in renminbi, not U.S. investors, who are legally prohibited from these markets to begin with.

Despite the lure of this cheap domestic capital, raising money in the U.S. remains attractive to a lot of Chinese companies. First, there is the matter of prestige. Second, foreign investment brings more structural opportunities for personal enrichment of local management through offshore holding companies and listing vehicles. And third, it is still accepted that long-term you can still raise more capital in the international markets than you can in China, at least for those companies which are capital-intensive and need to be going back to the market over and over again.

Lastly, the Government of China has been encouraging foreign listings of its bellwether companies as a means of "technology transfer"—in this case, not patents and scientific processes, but rather, business standards and ethics, corporate process and financial know-how. The government believes that exposure to the discipline and requirements of international markets will cause these companies to raise themselves to international standards in these areas, which are correctly perceived to be currently lacking in China. They hope that this improvement will then set the standard for China, both improving the efficiency of the Chinese economy and creating the necessary conditions for future access to ever larger capital sums from the international market.

With increasing frequency, the presence of foreign investment is the "excuse" used by management to deflect demands by local political authorities for investment in locally-favored but diseconomic projects, or for increased but unnecessary employment levels, not dissimilar to the way that China's WTO membership has been used by political authorities in Beijing as the excuse for much-needed but painful reforms.

True, many Chinese companies still think of foreign investors as "rubes" ripe for the picking. But the desire of many other Chinese companies to reform their methods from the traditional "Chinese style" to the U.S. model is evident enough to be regarded as a genuine trend.

The Chinese economy is too big to be ignored, and as long as there is profit to be made by investing there, investment in China will continue. China's influence in world events will continue to grow with that economy.

We hear a lot of talk about encouraging China to act as a responsible citizen, meaning that it should act to preserve world order, stability, and peace. But it is logical to expect that the bigger the stake China has in that order and stability, the more likely China will act to preserve it. This notion is now new. It was first formulated by John Foster Dulles as "the doctrine of peaceful evolution," originally proposed as a means for dealing with post-War Soviet Union. Mao read Dulles closely, as we now know, and he understood as well the political risk that "peaceful evolution" posed to the maintenance of revolutionary Chinese communism. He feared, as Dulles envisioned, that if China were to become more entwined with the West, and most especially if it became dependent on its

economic system, it would gradually adopt more Western values over time, becoming coopted, leaving the Communist Party communist in name only.

In the 1960s, "peaceful evolution" was a crime to be severely punished. Today, it appears to be de facto state policy.

Thank you.

[The statement follows:]

PREPARED STATEMENT OF PAUL S. WOLANSKY

Messer Co-chairmen and Members of the Commission, I serve as the Managing Director of New China Management Corp., a Greenwich, Connecticut based company that, in turn, serves as Investment Manager of The Cathay Investment Fund, Limited ("Cathay"). Cathay is a closed-end investment company established principally to undertake direct investment in the People's Republic of China. Since its establishment in 1994, Cathay has made close to twenty direct investments targeting greater China, in industries as diverse as pharmaceuticals, foodstuffs, real estate development, home appliances, insurance services, toll bridges and the Internet. Historically, Cathay has been an active, not a passive, investor and I have served personally on the Boards of Directors of the majority of, and in some cases helped create, the companies in which Cathay has invested. Some of those companies are classified as State Owned Enterprises ("SOEs"), and some have been previously identified to this Commission as having links to the People's Liberation Army ("PLA"). Others are privately owned by members of China's emerging entrepreneurial class. I serve on the Board of one Chinese enterprise listed in New York, one listed in Hong Kong and one listed on the Shenzhen Stock Exchange.

I have been asked to speak on the extent to which China is relying on the U.S. capital markets to meet its capital needs, the nature of the Chinese companies seeking access to those markets, and U.S. investor interest in Chinese listings. This presentation will give a short history of where we are and how we got there. Our particular niche, as direct investors, is at the lower reaches of the financial "food chain." The perspective that I bring is not that of a policy maker or regulator of the capital markets, but rather that of a financial investor, on the ground in China, just trying to "make a buck."

Before we begin, some ground rules. While it is possible to define U.S. capital markets simply as those stock and bond exchanges and distribution networks within the U.S., this definition does not adequately take into account the global nature of today's international capital flows. The effect of technology has been to facilitate transactions by U.S. investors in capital markets worldwide. It doesn't matter if a security is sold on a U.S. exchange or some other exchange open to U.S. investors around the world—it still may be U.S.-sourced capital.[1] We should also keep in mind that many of the inputs are subject to varying interpretation, shrouded in the complexities of Chinese government/business relations, or simply unknown. Lastly, many of the impressions reported below are borne out of personal experience and should be weighted or dismissed accordingly.

1. *Development of Investment in China.* Foreign investment in Chinese companies can be categorized according to who is making the investment and in what form or venue that investment takes place. Direct investment—that is, investment in the illiquid ownership equity of unlisted companies—came first. Within that category, the first direct investment following the "opening up" of China came from "natural" investors, largely foreign companies in related businesses seeking to establish new manufacturing facilities and new markets for their goods and services. This was followed by financial investors like investment funds, or institutions with investment portfolios that were willing to commit the time and expend the effort necessary to source, evaluate and monitor these investments on their own. Unlike natural investors, strategic investors generally seek only a good return on their invested capital, without ulterior strategic interest. The emergence of interest in direct investment by foreign financial investors in China then cleared the way for the listing of the securities of Chinese companies on established public exchanges, providing theoretical liquidity to potential investors and greatly expanding the universe of potential financial investors. Investment in China was now open not only to those institutions limited by charter or policy to investment in listed securities, but also to anyone willing to open a brokerage account and write a check.

[1] Similarly, to a Chinese recipient of an investment dollar, it doesn't matter if the provider is American or European—dollars have no nationality.

Using Chinese government generated data, we estimate that, since 1999,[2] Chinese companies have raised US$81 billion[3] through nominally foreign direct investment (before deducting out funds which were actually Chinese but were "recycled" through an offshore entity for tax or other purposes), of which approximately 10 percent, or $8.1 billion, came from U.S. sources.[4] Most of that foreign direct investment has in fact come from natural investors, with only a portion coming from purely financial investors, such as Cathay. Based on our own compilation of the available data, we estimate that the amount of equity and debt raised by Chinese companies, directly or indirectly, in public capital markets open to U.S. investment, has probably been about US$13.2 billion[5] over that same period. Of that amount, approximately US$10.6 billion has been raised by companies listing on U.S.-based stock markets (chiefly NYSE and NASDAQ), $1.8 billion by the sale of securities on the Hong Kong Stock Exchange, and $215 million by companies listing on the Chinese domestic Shenzhen and Shanghai B Share markets (the three most important venues for hard currency-denominated public listings of Chinese companies).

These are big numbers, but they need to be put into perspective. During that same period, approximately $267 billion was raised by equity and debt offerings listed on the NYSE alone,[6] while another $109 billion was raised through offerings of securities traded on NASDAQ.[7] The "Chinese" portion represented only three percent. From the standpoint of U.S. financial investors, investment in China represents a very small portion of the overall national investment portfolio. The typical allocation of investment capital by a U.S. institution to emerging markets is in the single digits, much of which goes to Latin America. For the U.S. financial investment community, investment in China, while large on an absolute basis, is not overly meaningful on a percentage basis. And while China is second in the world in absorbing inbound foreign direct investment capital flows, it is a distant second to the U.S., which absorbs more foreign direct investment than any other country.

In contrast, from the standpoint of Chinese companies seeking financing, the scale of U.S. and other foreign investment has been extremely important. This is illustrated by a comparison of the figures set forth above to relevant figures for both domestically raised equity and commercial debt. According to the World Bank, since 1999, commercial loans made by domestic banks provided US$14.4 billion in renminbi to Chinese companies,[8] and the sale of domestic commercial bonds provided another US$4.5 billion in renminbi.[9] Offerings of securities on China's fast-growing "A Share" reminbi-denominated domestic stock markets was the largest single category of contributor, raising an estimated renminbi equivalent of $26.7 billion in equity capital.[10] The amount of private investment funded from corporate earnings or individual savings—the domestic equivalent of foreign direct investment—is extremely difficult to estimate, but was undoubtedly a very significant contributor as well.

2. *Ongoing Trends.* As late as 1995, the bulk of investment capital in China came from domestically generated loans and equity investments from government-related enterprises (including SOEs and the PLA). Foreign direct investment, as well as do-

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[2] Matters are evolving at a staggering speed, especially in the methods by which Chinese companies raise capital. This portion of the discussion is thus limited to the last two and one-half years.

[3] China National Bureau of Statistics, *Foreign Direct Investment By Country or Territory, 2000*, (*www.china.org.cn/e-company/01–08/web0814.htm*); China National Bureau of Statistics, *Utilization of Foreign Capital, Jan.–Jul., 2001*, (*www.china.org.cn/e-company/01–08/web0813.htm*); China Statistical Yearbook, 2000: *Table 17–14: Amount of Utilization of Foreign Capital and Foreign Investment, 1999*.

[4] Hong Kong was the largest contributor of utilized foreign direct investment for the year 2000 at 38%, followed by the EU at 11%, the U.S. at 10.8% and Japan at 7.2%.

[5] Bloomberg Financial Services, Equity Offerings; China Securities and Regulatory Commission, *Table 2–2 Summary of Raising Capital for Security Market*, (*http://www.csrc.gov.cn/CSRCSite/eng/ tongjiku/199908/e-default.html*); Hong Kong Stock Exchange, *New Listing Report 1999–2001*, (*http://www.hkex.com.hk/index.htm*); NASDAQ, *NASDAQ International Companies: November 2001*, (*http://www.nasdaq.com/asp/NonUSoutput.asp*); New York Stock Exchange, *Complete List of Non-U.S. Companies, 2001*, (*http://www.nyse.com/pdfs/forlist011127.pdf*); World Bank, *Global Development Finance*. International Bond Issues 1999–2001.

[6] The New York Stock Exchange, *NYSE Fixed Income Market, 2000*; The New York Stock Exchange, *NYSE Fixed Income Market, 1999*; The New York Stock Exchange, *Quick Reference Sheet, 2001*; The New York Stock Exchange, *The Year in Review 2000*.

[7] NASDAQ, *Total Initial Public Offerings on Nasdaq*, (*www.marketdata.nasdaq.com/asp/sec3ipo.asp*).

[8] World Bank, *Global Development Finance*. Commercial Bank Loans 1999–2001.

[9] China National Bureau of Statistics, *China Statistical Yearbook, 2000: Table 19–10:Issuance of Domestic Securities*. (1999–2001 corporate bond issuances estimated based on 1998 data.)

[10] China Securities and Regulatory Commission, *Table 2–2 Summary of Raising Capital for Security Market*, (*http://www.csrc.gov.cn/CSRCSite/eng/tongjiku/199908/e-default.html*).

mestic private investment, was just beginning to grow in significance. Industrial investors were the first to bring foreign capital, as they entered into Joint Ventures with SOE partners to establish manufacturing plants in China. As Chinese companies sought to tap international capital markets to fund their own projects, they experimented with a number of different approaches. The early focus was on "Red Chips" listed in Hong Kong (overseas companies controlled by Chinese SOEs or government entities), the "itics" (provincial-based investment companies used to raise foreign debt for equity investment in local projects), a few listings of overseas holding companies in New York and London, a handful of Chinese "H Share" companies listed directly in Hong Kong and Chinese companies listed on the hard currency "B Share" domestic stock markets established in Shanghai and Shenzhen. Given the difficulties of obtaining government approval for these fund raising activities (like U.S. sensitivity to Japanese investment in the 1980s, the Chinese government has always been concerned about the effects of foreign investment on its own economy), the overwhelming majority of participants in this market were either SOEs or recently restructured nominally former SOEs. The quality of most of these companies was poor—management was weak and had little understanding of the expectations of foreign investors. Corporate direction was dictated more by concerns of covering losses and maintaining employment than return on capital (a concept that, even today, remains largely under-weighted in the thinking of many Chinese managers). By the year 2000, the situation had evolved significantly. Private companies, accounting for a disproportionate percentage of economic growth, were still largely shut out from both foreign and domestic listings, which (through the government approval process) remained largely reserved for SOEs and former SOEs. Capital continued to be raised through Red Chip and "H Share" offerings in Hong Kong. But a large percentage of total foreign capital raised was being provided through a very limited number of "blockbuster" offerings of privatizing SOEs, often through dual listings in Hong Kong and New York. The "itics"—after a couple of spectacular failures—were finished as an effective vector for capital raising. The domestic B Share markets had ceased to provide any meaningful capital. But in their place had arisen the now robust renminbi-denominated A Share markets, closed to foreign investment. In addition, private domestic direct investment, provided by successful entrepreneurs and their companies, was playing an important role.

The development of the A Share markets, together with the growth of private domestic capital sources, helped bring about a bifurcation in the markets in which Chinese companies raised capital. Total capital raised in offerings in Hong Kong and New York from 1999 to 2001 is estimated at $12.4 billion.[11] But over 80 percent of that came from four large offerings of oil and telecom stocks: PetroChina, CNOOC, SinoPec and China Unicom. The total for all other companies was less than $2.5 billion. That represents less than ten percent of the almost $27 billion raised in the A Share markets over the same period. The companies listing on the A Share markets, however, were in a wide variety of businesses, many of which were not even profitable (under any internationally accepted standard of accounting). There are good reasons for this phenomenon. First, required government approval was now more freely granted for A Share listings, as China sought to develop its own capital markets while at the same time absorb growing domestic renminbi savings. Second, valuations for Chinese companies were (and remain) higher in the domestic markets. The average IPO valuation on the Shanghai A Share market during the year 2000 was approximately 15 times expected earnings; the market as a whole traded at an average of 39 times earnings.[12] But, most importantly, many of the companies offering shares in the A Share market simply could not sell their shares in western markets: no one would buy them.

3. *U.S. Investors' Perception of Market Risk.* Adam Smith's invisible hand is generally powered by the profit motive. This Commission previously has seen descriptions of perceived "bad actor" risk associated with Chinese companies. While such risk can be demonstrated, it probably pales in comparison with the more commonly understood risks faced by investors in China. Investment in China has been negatively affected by risks as diverse as adverse market development (often too much competition), competition from profit-insensitive SOEs, changing government regulation, poor management, lack of transparency, deficient legal process, dubious accounting, protectionism and corruption. Generally, the perceived overall risk level is quite high—and rightly so. As experienced as we, at Cathay are in the market,

[11] Bloomberg Financial Services, Equity Offerings; Hong Kong Stock Exchange, *New Listing Report 1999–2001*, (*http://www.hkex.com.hk/index.htm*); New York Stock Exchange, *Complete List of Non-U.S. Companies, 2001*, (http://www.nyse.com/pdfs/forlist011127.pdf).

[12] In contrast, the valuation for PetroChina at the time of its international IPO was 9–10 times expected earnings.

we nevertheless suffered from a number of these issues, most of which we have been able to recover from. But the typical passive financial investor would have little chance. The market has reacted appropriately, resulting over time in allocation of U.S. capital away from smaller, less-developed enterprises and towards the larger, more-developed companies described above, concentrated in just a few core industries. This movement is natural. The market potential of the telecom and petroleum businesses in China, for example, is well understood and proved: China is already the world's largest market for mobile phones, and its expected increase in demand for energy (especially petroleum products) is enormous. At the same time, competition is limited in both industries by legal restraints. But, just as important, the scale of these enterprises has made it worthwhile to go through the restructuring exercise, as insisted upon by the Western investment banks that have aided these listings required to make these companies attractive to the type of public investment to which they were trying to gain access. New management has been installed, poor quality (or politically sensitive) assets hived-off to corporate parents, accounting improved—basically, the companies have been "scrubbed up" to be more acceptable to international capital markets. Are these companies operated to the same standards of efficiency as their counterparts in the West? Unlikely, as should be reflected in the pricing of their shares by Western investors.[13] Do these companies continue to operate to serve perceived strategic needs of the state? Yes, often. But there is a perception in the market that these companies are the vanguard of corporate China, and that although the government may occasionally call upon them to perform some service for the perceived common good, the government will also do what is necessary to protect them and cause them to succeed economically. In fact, some of these companies have performed quite well.

As for the rest of the lot, the smaller or less strategically blessed companies seeking access to financing through the listing of their securities are more likely to be relegated to domestic capital markets or the more speculative end of the Hong Kong market. The quality of supervision and discipline of management of companies within these capital market segments are questionable to say the least. While there are some quality companies, a significant amount of funds raised in the Chinese domestic stock markets probably never makes it to the intended—or at least announced—use. Some of the money has been recycled into the market in speculation on other A Share issues. Much of the capital raised has been used inefficiently, or wasted in an effort to sustain businesses long ago doomed by economic realities. But if the A Share markets collapse, as many outside observers fear they may, the main victims are likely to be the Chinese investors (both corporate and individual) who buy the shares in renminbi, not U.S. investors, who are legally prohibited from the market.

4. *Effect of WTO on Foreign Investment.* The biggest effects of WTO as they relate to investment in (as opposed to import/export trade with) China will probably be on the direct foreign investment sector. In 1994, most foreign direct investment in China was in the form of Joint Ventures or other shared Sino/foreign enterprises. Teaming up with a Chinese partner was seen not only as a way of negotiating legal restrictions on investment, but also as a way of learning the market. This business model proved to be largely ineffective. Many foreign investors ran into constant disagreements with their Chinese partners over everything from employment levels, to marketing strategy, to production methods, to employment of capital. In hindsight, this should not have been surprising. Management of the Chinese partner (which was often itself an SOE or a privatized company one step away from an SOE) was often motivated by entirely different concerns than its foreign counterparts. Generally, local political authorities strictly limited management's compensation and rewards were meted out mostly for meeting such non-economic goals as employment, generation of local tax and raw production numbers. Corruption was also a problem, as significant amounts of capital ended up otherwise than intended, to the enrichment of the locals but to the detriment of the enterprise. To make matters worse, the Chinese party to the Joint Venture was often unable to fund its portion of the required capital, leaving the foreign party with the lion's share of the financial risk but only a portion of the potential benefits.

By the year 2000, the situation had significantly evolved here as well. While the idea of the Joint Venture still survived (largely in industries protected by government regulation), more and more direct foreign investment was in the form of Wholly Foreign Owned Enterprises. While these enterprises often had local participation (usually through shared ownership of an offshore holding company), the local par-

[13] Shares of oil giant Sinopec listed in Hong Kong, open to international investment, sell at only about one-third of equivalent Sinopec shares trading in the domestic A Share market, reserved for Chinese investment only.

ticipants were more often private companies and individuals motivated strictly by return on capital and personal gain, rather than the SOEs so common in the joint venture days. WTO will accelerate this trend, as more and more industries and markets become open to wholly foreign owned investment, freeing foreign investors in China (both natural and financial) from the burden of unproductive and potentially uncooperative local partners.

5. *Socializing Effect of Foreign Investment.* Despite the lure of raising cheap capital domestically, raising capital in the U.S. still remains attractive to many Chinese companies. First, there is the matter of prestige. A New York Stock Exchange or NASDAQ listing brings far more prestige than a listing in Shanghai, Shenzhen or Hong Kong. Second, in the case of privatizing SOEs, foreign investment brings more structural opportunities for personal enrichment. Many provinces still strictly limit the amount of money that senior executives of local SOEs can make, irrespective of their company's success. Creating offshore holding companies and listing vehicles provides numerous opportunities for personal enrichment, including more generous cash compensation (along international standards), stock options and other schemes.[14] Third, although a domestic A Share listing might carry with it a higher valuation, it is still accepted that, long-term, more capital can be raised in international capital markets than within China—an important consideration for larger companies in capital intense industries contemplating periodic return to the capital markets. Last, the government of China has been encouraging foreign listings of its bellwether companies as a means of "technology transfer"—in this case, not patents and scientific processes, but rather business standards (and ethics), corporate process and financial know-how. The government believes that exposure to the discipline and requirements of international capital markets will cause these companies to raise themselves to international standards in these areas, which are correctly perceived to be sorely lacking in China. They hope that this improvement will then set the standard for China, both improving the efficiency of the Chinese economy and creating the necessary conditions for future access to ever larger capital sums from the international market, changes so vital to sustaining China's growth. With increasing frequency, the presence of foreign investment (whether private or public) is the "excuse" used by management to deflect demands by local political authorities for investment in locally-favored but diseconomic projects, or for increased but unnecessary employment levels (similar to the way that China's WTO membership has been seen as being used by political authorities in Beijing as the "excuse" for much needed but painful reforms). True, many Chinese companies still think of foreign investors as "rubes" ripe for the picking. But the desire of many other Chinese companies to reform their methods, from the traditional "Chinese style" to the U.S. model, is evident enough to be regarded as a genuine trend.[15]

6. *Nexus with U.S. National Security.* The Chinese economy is too big to be ignored, and as long as there is profit to be made by investing there (the expected returns adjusted by the perceived risk), investment in China will continue. China's influence in world events will continue to grow with its economy. One hears much talk about encouraging China to act as a responsible citizen as it takes its place at the world table, meaning that it should act to preserve world order, stability, and, consequently, peace. It is logical to expect that the bigger the "stake" China has in world order and stability, the more likely that China will act to preserve it. This notion is not new, having been first formulated by John Foster Dulles as the doctrine of "peaceful evolution" (originally proposed as a strategy for dealing with postwar Soviet Union). Mao read Dulles closely[16] and understood as well as anyone the risk that peaceful evolution (in Chinese, *heping yanbian*) posed to the maintenance of revolutionary Chinese communism. Mao feared (as Dulles envisioned) that if China were to become more entwined with the West, and most especially if it became dependant on its economic system, it would gradually adopt more Western values over time, becoming "co-opted," leaving the Communist Party communist in name only. In the 1960s, espousing peaceful evolution or even being seen as facilitating peaceful evolution through word or deed, was a crime to be severely pun-

[14] Employees of SOEs, in general, still expect an across the board raise in pay when the company becomes foreign invested.

[15] The effect of market socialization is evident in foreign direct investment as well, as we have personally witnessed with a number of the companies in which Cathay has invested. The acceptance by Chinese managers of the need for this market socialization has, in turn, reduced many of the difficulties previously faced by foreign direct investors.

[16] "Mao Zedong and Dulles's 'Peaceful Evolution' Strategy: Revelations from Bo Yibo's Memoirs," introduction and translation by Qinag Zhai, CWIHP Bulletin 6–7, Cold War International History Project, Woodrow Wilson International Center for Scholars.

ished. Today, despite denials from the Party's remaining ideologues, it appears to be *de facto* state policy.

Co-Chairman WESSEL. Thank you.
Mr. Hormats, please.

STATEMENT OF ROBERT D. HORMATS, VICE CHAIRMAN, GOLDMAN SACHS (INTERNATIONAL)

Mr. HORMATS. Thank you very much, Mr. Chairman.

First of all let me say that I'm very pleased to be here and to have been invited to participate. I know you have had some lively discussions, and I see a lot of old friends on the panel, and I'm sure we will have a lively discussion after my testimony, which I welcome, and is of course one of the virtues of having a group like this.

I think Mr. Wolansky has laid out very, very well some of the issues and some of the facts that describe the increasing involvement of China in international capital markets I include some of these in my testimony, so I'll skip over them, because I think he laid them out, as I said, quite well.

I just at the outset want to mention again, as you have, Mr. Chairman, that I have given members a copy of a report done on "China's Entrance into WTO: The Transition Period," which now lies before China and before the United States and the importance of working with China to help smooth out that transition period.

While the report deals very largely with trade issues, there are some elements of financial cooperation which are described in it. The basic point is that China's membership in WTO provides an opportunity for China to play a greater role in the global economy but also, as Mr. Wolansky was saying, is part of the effort by the Chinese Government to impose more rigorous disciplines and international standards on their own domestic economy.

One of the important things to remember as we look at China's role in international capital markets is that they use these disciplines—accounting standards, disclosure standards, corporate governance standards from abroad—to strengthen the corporate governance standards and accounting standards and disclosure standards at home. This is a very thoughtful policy on the part of the Chinese Government. They have enabled some of their best companies to go into the markets. They have in many cases restructured their way of governance, the kind of information they provide, the accounting standards. And as they do this, not only are they able to access capital, which it seems to me is in our interest to have them do, but they also provide models for other companies that come along to undertake similar kinds of disciplines and to adhere to these higher levels of international standards.

The particularly important part about the American capital market is that—I believe, and I think members of the panel would probably agree—we have the highest, the best, the most thorough disclosure standards of any major economy in the world. To the extent the Chines are willing and able to adhere to those standards, that is a very important part of their entrance into the global capital markets, and it helps them at home to raise the level of standards in their own home markets. This is a very important link, and therefore, it is very much in our interest to enable the Chinese to have access to these capital markets, because they are willing to

adhere to these higher standards here than exist anywhere in the world. It seems to me it's a big plus for us and a big plus for China.

Let me make one other point of a general nature, and that is that one of the things that we have seen about China over the last several years is that it is becoming increasingly a nation of owners of private capital and of private property. There has been a huge increase in the private housing market in China. Some 60 million people in China own stock—more people than are members of the Communist Party. This is a very important change in China. It is exactly the kind of change that will first of all enable the Chinese economy to be more prosperous, but second, it creates a higher degree of pluralism in the society which is very much in their interest. These people have a stake in society, and as we know from the history of other countries, the middle classes in these countries are the ones that help to create changed social dynamics, political dynamics, of a very positive nature. It seems to me that that movement of China to a nation of owners of private property is something that is extremely important, and again, capital markets play an important role in that process.

Third, the restructuring of state enterprises. The restructuring of state enterprises is extremely important because many of them were making very, very large losses in the past. Now, with the corporate restructuring that is going on, they are doing two things. One, they are becoming more competitive. Two, to the extent they restructure and restructure effectively, they are less of a burden on the banking system. As Mr. Wolansky has pointed out, the banking system had been under enormous stress, taking a lot of money, large portions of which was used to subsidize inefficient practices. That process is beginning to change. Are there still inefficient state enterprises and bad loans? Sure, there are, but far fewer than in the past, and there are many more companies that are growing and are growing profitable on the basis of improved corporate governance management.

The other thing that is important—and here is where I think the Chinese can and should be making improvements themselves—again, a point that Mr. Wolansky made—that is, the private sector in China, private companies (or state enterprises that are in the process of reforming, but for the sake of point I want to make, private enterprises) are a very important aspect of job creation in China. And I think it is important, and it is already beginning to happen, that private enterprises have a greater degree of access to capital markets. It has bene hard for some of them in the past, as Mr. Wolansky has pointed out. It seems to me that that would be in the interest of China and in the interest of capital markets in general that the Chinese enable more of these private enterprises to have access to their own capital markets. Some of them, which are now affectionately known as "P chips" are able to have access to the Hong Kong market. There are not many of them—five or six—it's very few. But it is an interesting and evolving process.

Commissioner DREYER. Sorry, Bob. "P chips" are what, again?

Mr. HORMATS. There are the H shares, the red chips—there are nicknames for these things. But "P chips" are small, privately-owned companies that can have access to the Hong Kong market, "P chips," "private."

Commissioner DREYER. But they are traded.

Mr. HORMATS. Yes, they are traded in the market in Hong Kong. But they are a very small number. I'm using it only as an example of the directional thing as opposed to—quantitatively, they are not important, but qualitatively, they demonstrate that they are beginning to allow some of these private companies to get more access to capital, which I think is a positive thing because private companies are growing. There are lots of very entrepreneurial Chinese and lots of very entrepreneurial companies. Most of them are small—not all of them—but most of them are small, and to the extent they are able to obtain access to capital in China and outside of China, it will help Chinese growth, it will help the entrepreneurial dynamics of Chinese society, which I think is very important.

As I said, I don't want to exaggerate it because there are not many, but it's starting. It's at the beginning of a trend.

The last point I'll make before I run out of time is that there has been a lot of controversy about people who argue that as penalties—or whatever word is used—there should be limits on Chinese access to the American capital market. I thoroughly disagree with this. I think that it is greatly in the interest of the United States that Chinese companies that are willing, as they have been—very large companies have been willing to do this—to adhere to the kind of rules that we set in our capital markets, those companies should have access to our capital markets just as companies from other countries have access.

The American capital markets have evolved. The regulations of those companies have evolved. The accounting standards for those companies have evolved over a great many years. They are the standard of the world. If the Chinese are willing to accept those standards as they are in many circumstances, they should have access to our capital markets, and arbitrary actions that restrict their access to these capital markets are counterproductive in terms of American interests, they are counterproductive in terms of the interests of the American capital markets, and they do not serve our interest in strengthening reforms in China. The more the Chinese are willing to adhere to these standards, the better it is for us, the better it is for our capital markets, and I think the better it is for China.

So I wanted to close on that note. I would also say that I think there will be in the course of the next few minutes opportunities to discuss this. There are a number of factual points that have arisen over specific issues, and I would be very willing to discuss those as well.

Thank you.

[The statement follows:]

PREPARED STATEMENT OF ROBERT D. HORMATS

I very much appreciate the opportunity to testify before this Commission on the subject of China's Capital Requirements and U.S. Capital Markets.

By way of introduction, I have closely followed U.S.-China relations for the last three decades. In the early 1970s I was Senior Economic Staff Member on the National Security Council Staff of Henry Kissinger. During that period we began the search for a basis for more normal Sino-America relations after years of animosity, Cold War tensions, lack of effective communication and an absence of any kind of economic relationship.

How much things have changed over the ensuing years! The last three decades have witnessed dramatic reforms in China, dramatic improvements in Sino-America relations and dramatic increases in China's economic and political ties with the outside world. China's recent admittance to the WTO is just the latest example of the kinds of changes that we now see as almost routine, but that would have been virtually unimaginable 30 years ago. Then China was going through the very destructive and divisive Cultural Revolution and shunning global institutions.

The U.S., China and the WTO

Before I address the specific questions put to me in your letter of invitation, let me make a few comments about China's recent admission to the WTO. I have provided copies of the text of a recent study conducted by a Task Force of the Council on Foreign Relations on this topic—a Task Force I had the privilege of chairing. I thought it would be useful to outline a few of the main conclusions:

—1. China is already the world's seventh largest trading power, with annual two-way trade of over $475 billion and almost $120 billion in bilateral trade with the U.S. For the United States, increasing trade and investment with China brings not only the potential for enormous economic gains but also the opportunity to advance cooperation on a fuller range of political, economic and security interests.

—2. For China's leaders, WTO entry poses a new set of challenges. Chief among these is to manage the tensions between: (a) their desire to maintain the leadership of the Communist Party, and (b) the social and political pressures arising from continued economic reform.

—3. For the U.S. the greatest risk in this process is that short-term difficulties and unevenness in the implementation of China's commitments to the WTO will undermine rather than support the U.S. goal of fostering long-term cooperation with the PRC. And all of this will be taking place along side the cooperation the U.S. seeks from China in combating terrorist activities emanating from Afghanistan and other parts of the world.

—4. The U.S. should support China's overall efforts to adapt its institutions and practices—at national and local levels—to the challenges of globalization. This will produce enormous benefits not only for China but also for the global economy.

—5. Both countries should attempt to build mutual confidence with an agreed agenda of "early harvest" accomplishments in key sectors, such as agriculture and information technology.

—6. The U.S. should foster private sector financial and technical support for China's efforts to develop the market-based rules, institutions and expertise necessary for effective WTO compliance. And it should develop a Congressional-private sector partnership to ensure active oversight of China's WTO compliance in ways that ultimately strengthen Sino-American relations.

All told, members of the Task Force believed that China's entry into the WTO, while not without risks for both sides, presents a major opportunity for advancing market forces in China and for strengthening the fabric of the global trading system. It also can provide a framework for advancing other aspects of Sino-American relationships.

While the Report discussed many of the things that could go wrong during the transition period within which China implements its commitments to the WTO, its primary goal was to address the many ways in which cooperation between the U.S. and China can improve prospects that things will go right. A realistic, determined and supportive approach to WTO implementation now and in the medium-term was deemed to have the potential to shape China's economic and, perhaps, broader political prospects than any policy choice in almost thirty years of bilateral economic relations.

I would only add to this now by saying that a similar level of cooperation on a series of financial matters could also have very positive results. The modernization of China's economy depends to a very great degree on the modernization of its financial sector. That same modernization is turning China into a nation of stockowners. There are today in China 60 million people who own stock—more stockowners than members of the Communist party.

In addition, subsidies to SOES will need to be further reduced in coming years—but the government is sensitive to the need to avoid large bankruptcies that displace large numbers of workers. Competitive companies need to have access to capital to grow and to create the new jobs required to hire the workers that inefficient, money-losing state enterprises—many of which will be subject to greater competition as the result of WTO membership—will be shedding and to hire the growing numbers of workers coming off of China's farms.

Much of the internal, market-oriented restructuring that China must undertake will require enabling new private companies and restructured state-owned enterprises to obtain capital to grow their businesses. The U.S. can play a constructive role in this process by ensuring—on terms similar to those of other countries—access to overseas markets, including our own.

Financial Issues

Turning to the topic at hand this afternoon, let me make a few broad points.

China's economy has shown a remarkable resilience in the recent global downturn. That resilience is primarily the result of China's capacity to sustain relatively robust domestic demand, in part through simulative fiscal policy. And home ownership (growing at around 20% annually) and increases in foreign direct investment (growing at 10–15% annually) have been important driving forces in an investment boom that also has proved to be remarkably robust, especially in contrast to the collapse of investment in many other parts of the world. Private savings continue to average between 15 and 20% of disposable income. This is a vital factor in China's investment boom.

A large and growing investor community—estimated at 60 million at the end of 2000—will be a potent force in China's ongoing economic revolution. Ownership of stocks, bonds and private homes is transforming the country over time into a nation of owners of private assets. Well-managed capital markets, with improving disclosure and regulatory standards, are helping to broaden the scope of the rule of law in China as well.

Capital Market Access

It is useful to consider the role of external financing in the context of overall corporate financial requirements in the country. Foreign investment, while important, represents only about 6% of overall corporate investment. The vast portion of investment in China's companies comes from within China—and draws on the high level of domestic savings mentioned earlier. Nonetheless, investment from abroad is important—not just for the many billions of dollars it brings in but for the quality of technology and management skills, plus the international corporate and marketing networking, that come with it. A portion of it also goes into private companies, many of which have not had much access to domestic funds.

The central government and the state banks are the dominant issuers in international bond markets. In the wake to the problems of the so-called ITICS (International Trade and Investment Corporations), several other types of issuers (including the banks) have been discouraged, if not restricted, from accessing international bond markets.

Because of their depth and variety of maturity choices, the U.S. dollar markets, including the Yankee and Global dollar markets, have been the most important markets for China's overseas financing. But Asian demand for Chinese credits has grown substantially of late, and has become a major determinant of pricing in the new issuance and secondary markets—helping keep interest rates on China's foreign issues low relative to that of many other emerging market borrowers.

But even though strong Asian demand (and cuts in U.S. interest rates) have lowered the price of Chinese foreign borrowing, domestic RMB debt markets still provide a more attractive cost of financing. Thus relatively little major international bond issuance can be expected from China over the next 12 months.

The bulk of domestic bonds that will be issued will come from the Chinese Treasury, while issuance of corporate bonds will likely remain quite low. Most Chinese enterprises still rely heavily on banks for their borrowing; bank loans are equivalent to a remarkable 120% of GDP.

Since 1996 China has borrowed roughly $11 billion abroad. Of this amount, a little more than 44% is sovereign borrowing, a little more than 40% is borrowing by financial institutions and most of the rest is borrowing by corporations. On a percentage basis, 15% was borrowed in the Yankee market, 64% in dollars in the Global and European markets, 11% in Yen, 4% in Euros, and 3% in Deutschemarks.

Turning now to stocks, the capitalization of China's domestic stock market is equivalent at roughly $600 billion. It is the second largest in Asia. By contrast, China's bond market capitalization is $220 billion (third after Japan and Korea).

There are several varieties of issuing vehicles: A-shares denominated in RMB and sold only to local Chinese investors. They have been the key form of stock issuance. Major issuers include Baoshan Iron and Steel. Shanghai Pudong Development Bank and Jiangsu Expressway. B-shares, denominated in both U.S. dollars and Hong Kong dollars, were formerly for foreign buyers only—but have recently been made available to Chinese residents as well. Issuers tend to be much smaller companies than in the A-share market.

Several large Chinese companies have recently issued shares in the H-shares market, in Hong Kong. These include PetroChina, SINOPEC and Huaneng Power International. Other Chinese companies have incorporated in Hong Kong and listed their shares there. These are the so called "red chips" which include China Mobile (HK) Ltd., China Unicom, CNOOC and Legend Holdings. China Mobile, formerly known as China Telecom (HK), in 1997 successfully launched a groundbreaking issue in Hong Kong and New York in ADRs. Others subsequently have done likewise including PetroChina, China Unicom, SINOPEC and CNOOC.

Of the equity issuance since 1991, 75% has been in A-shares, 5% in B-shares and 19% abroad. The total sum of this financing had been the equivalent of 92 billion U.S. dollars.

The role of Japanese and European markets in raising equity for China has been minimal.

Reform of State Enterprises

There is a close correlation between reform of state enterprises and the expansion of China's use of capital markets overseas. The ability to access private investment has facilitated the privatization and restructuring process. And the disciplines imposed on companies by their need to attract overseas private portfolio investment, and provide market returns to investors, requires management to improve performance and market practices. In addition, the ability to access foreign markets imposes accounting, registration and reporting requirements which again require higher performance standards by management.

Chinese enterprise reforms are aimed at increasing competition in many key sectors and over time significantly reducing control of the state. State monopolies in key sectors such as telecom, oil, foreign trade and financial services are being broken up to promote competition. Entry barriers for private and foreign investment are being gradually lowered. Trade barriers have been lowered significantly in recent years—and that will be continued and reinforced under the WTO agreement. Beijing has committed to further opening the country to foreign investment in a number of key sectors such as telecom, banking, insurance and distribution.

Professional management is being introduced into many SOEs. Stock options and other incentive-liked compensation schemes have been established—on an experimental basis—for some listed companies such as PetroChina. Internationally accepted corporate governance practices are beginning to be applied in China, first on a limited basis, with a view to widening their use in the future. Constitutional amendments to recognize the legitimacy of property rights have been established. Price controls have been gradually eased.

More companies have been permitted to list on the stock markets. Over 1,000 SOEs are listed on the stock markets at present. To accelerate growth and job creation more private companies need to be able to access these markets, and bank lending. One key reason China has been unable to tap venture capital more for its rising entrepreneurial class of talented businesspeople, scientists and engineers is that domestic stock markets so far have not been very welcoming to foreign VC-funded enterprises. There are thousands of emerging technology companies in China. If they were able to tap China's expanding domestic capital market they would be able to attract far more domestic and foreign private equity investment than they do now.

Accelerated restructuring is underway to diversify state ownership and impose market discipline on companies through public market scrutiny and the need to comply with more rigorous internal and external financial regulation. The discipline of the private financial markets is pressing management to accelerate the pace of reform and increase transparency.

As part of the effort to strengthen the disciplines of the Chinese capital markets, the China Securities Regulatory Commission (CSRC) has been actively investigating cases of poor disclosure, market manipulation and fraud. Its Chairman, Zhou Xiaochuan, and deputy chairman, Gao Xiqun, are highly regarded in international markets and within China. And a new deputy chairman, Laura Cha, an experienced Hong Kong regulator, has just joined the team. Many of the young professionals in the commission also have a great deal of international experience. The CSRC's efforts are extremely important in increasing investor confidence within China and in global markets.

Conclusion

All of this argues for providing Chinese companies that have good management practices and adhere to sound accounting and regulatory standards access to the U.S. and other financial markets—and helping Chinese authorities to improve the regulation and efficiency of financial markets at home. Capital markets are a cata-

lyst for corporate restructuring and improved management practices across a range of Chinese industries. They help China to become a nation of owners—which increases pluralism and helps to build a prosperous middle class.

China has one of the highest savings rates in the world, but the historic return on capital has been low under the central planning system and as the result of years of chronic mis-lending by state owned banks. The Chinese leadership now understands that well-functioning capital markets are crucial to increasing investment, corporate efficiency, raising productivity and sustaining growth. It is working to improve such markets.

To the extent that we support market reforms in China, and the continued shift from the state sector to the private sector, such changes make an important contribution to a more market-driven and prosperous China and a stronger trading partner for the U.S. Access for Chinese companies to our capital markets is an important incentive for the Chinese authorities to continue moving in this direction.

Co-Chairman WESSEL. Thank you.

Mr. Lackritz?

STATEMENT OF MARC E. LACKRITZ, PRESIDENT, SECURITIES INDUSTRY ASSOCIATION

Mr. LACKRITZ. Thank you, Mr. Chairman.

Let me first of all start by thanking the Commission for the opportunity to be here today and talk about China. I don't have nearly as much experience as either Mr. Wolansky or Mr. Hormats, but my testimony basically echoes much of what they have said, and I only hope I can add something that is of use to the Commission on top of what they have already said, but I generally agree with the thrust of what both of them have said already.

I should note that the WTO accession process of the Chinese has now culminated in China's accession, but despite that accession, our industry, the securities industry, still has substantial concerns related to China's capital markets and the access that they provide to U.S. firms.

I want to focus my testimony more on our access over there, and in the discussion, I'll be happy to address issues about their access to our markets, but my testimony primarily focuses on our access over there, because we still have a long way to go. In fact, I could characterize our gains in the WTO accession talks as being somewhat akin to the joke about the number of lawyers lying face down in the bottom of the Potomac—it's a good start, but that's all it is.

I don't think we should get carried away that this is the end of the process—in fact, we think it is kind of the beginning of the process. We have long supported more open, fair, and transparent markets, and we strongly advocated liberalization in the multilateral and bilateral trade discussions, including these talks, because we firmly believe that the economic benefits of financial services sector liberalization really reverberate throughout the world, from widespread increased opportunities created by new entrants, innovative products and services, and capital markets with greater depth and efficiency. Open and fair markets are really essential to ensuring that markets operate efficiently so that investors can easily and quickly buy and sell shares across borders, while businesses can access capital at the lowest possible cost.

The international finance system has been a major and contributing factor in the marked increase in living standards of those countries that participate in it.

In China's accession commitments for financial services, and more specifically for the securities industry in particular, they

show quite a reluctance to open their sector fully to foreign competition. We firmly believe that China should improve and accelerate its financial sector reform so that it will have the financial tools that they need to sustain the quality of their economic growth.

Prior to the WTO accession, many of our leading firms in the securities industry, including obviously some sitting here at this table, identified China as the largest single emerging market opportunity in the world. With China scheduled to begin implementation of its WTO commitments in the near future, U.S. securities firms will finally be able to broaden their role in China's capital markets. Financing their infrastructure and providing local fund management services really present U.S. financial services firms with particularly important and robust opportunities.

Similarly, China's domestic capital markets will benefit from the entry of our securities firms and their technology, their capital, their innovative products and services, and their best practices. As local firms prepare for this increased competition, they will have to adopt new technologies and improve the quality of the products and services that they offer. More competitive and efficient capital markets will also improve the allocation of capital to borrowers and users, facilitate the hedging and diversification of risk, and assist the exchange of goods and services.

I suggest that financial markets are really inextricably linked to increased investment and economic growth, so that strengthening China's capital markets will also help to alleviate the significant financing constraints that Chinese firms currently face, which I think Paul referred to earlier.

But China's private and public sectors alone cannot mobilize the massive financial resources, advice and expertise that are necessary to sustain its economic growth. Much of the infrastructure development will by necessity be funded through foreign sources, and this opportunity has already generated substantial interest by both U.S. firms and other foreign firms as well. Despite the difficulties entering and operating in China, numerous U.S. securities firms have established offices in China and have been able to participate in China's international securities offerings.

China has also reached out to the international capital markets to fund its growth. Private and state-owned Chinese companies raised nearly $75 billion in debt and equity issues in the international markets in the decade from 1991 through 2000. Of this total of $75 billion, a little more than $48 billion was in equity capital, and a little more than $26 billion was in the international debt markets.

China's remarkable economic reforms over the past 23 years have also begun to reverberate in our own markets. Chinese companies have increasingly tapped our capital markets as they seek to expand their businesses. Trading of Chinese issuer shares on the New York Stock Exchange soared more than sixfold in the past four years, from $872 million in 1996 to $5.6 billion in 2000. The 21 Chinese issues now listed on the New York Stock Exchange represent the largest concentration of listings in the region, and the fifth largest in the world.

Although the United States faces stiff competition for these listings—the introduction of the euro and the creation of a single European capital market are increasingly attractive to Chinese issuers—the U.S. markets are unrivaled in our depth, liquidity, and transparency as well as our political and economic stability.

Chinese issuers, however, are going to have to improve their disclosure and corporate governance standards to meet the demands of the international investing community, as has already been alluded to. The Chinese Securities Regulatory Commission has already promulgated regulations to raise the quality and level of disclosure. Stricter disclosure of financial information is now required for prospectuses, and companies must ensure that they have independent directors, similar to some of the requirements that we have. These rules will not only help China access foreign capital but will also set the foundation for building a more robust retail and institutional investor base in China—and that is on top of the 60 million shareholders that have already been alluded to.

China's accession to the WTO gives our firms some greater market access. Their commitments represent a first step upon which to pursue additional liberalization of China's capital markets. Although China's accession terms still leave our firms facing significant barriers to market access, they do provide some important commitments. For example, there are provisions for minority ownership in local securities underwriting, asset management firms, and advisory companies. Particularly noteworthy are China's commitments for the securities sector that include the grandfathering of existing activities and investments, national treatment, and the elimination of China's "economic needs test."

In addition to its WTO commitments, China is taking other steps to open its markets. These include allowing foreign firms to list and issue local currency, renminbi, shares and the establishment of foreign investment venture capital firms.

But notwithstanding these liberalizing steps, we would strongly urge China to make additional commitments in such crucial areas as market access, asset management, and foreign ownership limits in the ongoing WTO financial services discussions.

In market access, we would urge them to permit foreign firms to set up a securities company in China, either through a wholly-owned entity or some other business ownership structure, with power to engage in a full range of securities activities including underwriting, secondary trading of government and corporate debt and A shares, and so on. Firms should have the right to establish offices without geographical limitations.

In asset management, we urge them to permit foreign firms to manage money for Chinese investors, both retail and institutional, as well as sell internationally diversified mutual funds to individuals through qualified local distributors.

Finally, we would urge them to lift their foreign ownership restrictions and permit foreign investment in certain sectors and/or state-owned businesses such as insurance, banking, and asset management.

Although our firms still lack the basic access needed to compete effectively, the lack of a strong legal foundation in China further complicates the ability of our firms and their clients to participate.

An unwelcome level of regulatory risk characterizes China's business climate and acts as a severe tax on capital.

If China is to sustain long-term economic growth and continue to attract the foreign capital it needs, it must improve its legal infrastructure. Greater transparency will be a critical part of improving the rule of law in China.

Transparent and fair regulatory systems play an integral role in the development of deep liquid capital markets that in turn attract market participants, increase efficiency, and spur economic growth and job creation. There is sort of a virtuous circle that gets created in economic development—the economy grows, institutions arise, capital markets function, which then bring more capital to enhance the economic growth, and as a result, there is a sort of spiral upward during the virtuous circle.

A recently published paper that we put out on transparency underscores the key guiding principles of fair and transparent regulations as follows.

First, rules, regulations, and licensing requirements should be considered and imposed, and regulatory action should be taken only for the purpose of achieving legitimate public policy objectives that are expressly identified.

Second, regulations should be enforced in a fair and nondiscriminatory manner.

Third, regulations should be clear and understandable; fourth, all regulations should be publicly available at all times; and finally, regulators should issue and make available to the public final regulatory actions and the basis for those actions in order to enhance the public's understanding thereof.

The American Chamber of Commerce in China White Paper also noted that "Inconsistent enforcement of contracts and laws continues to limit further increases in foreign investment." So we think the development of fair, clearly-applied and enforceable rules and regulations will attract and improve access to financing.

Finally, continued liberalization of China's capital markets has very clear benefits for China and the global economy. It is a long-established U.S. policy to promote economic growth through open financial services markets. Global economic integration facilitates the importation of capital and intermediate goods that may not be available in a country's home market at comparable cost.

Similarly, global markets improve the efficient allocation of resources. Countries gain better access to financing, and the suppliers of capital—institutional investors or individual savers—receive better returns on their investments.

Finally, open and fair markets increase living standards as well.

We look forward very much to working with this Commission, the Administration and Congress to further expand the U.S. securities industry's access to China through the use of bilateral and multilateral trade forums.

Mr. Chairman, thank you very much for the opportunity to be here and to testify.

[The statement follows:]

PREPARED STATEMENT OF MARC E. LACKRITZ

Commissioners Robinson and Wessel, and members of the United States-China Commission, I am Marc E. Lackritz, President of the Securities Industry Association.[1] I am pleased to appear before the Commission today to testify about China's capital markets and the opportunities for U.S. firms, our clients, and the U.S. economy to do business in China. My testimony will focus on our economic relationship with China, specifically with respect to: (1) cross-border capital markets activity; and (2) the goals and objectives of the U.S. securities industry in our growing relationship with China's economy.

At the outset, I should note that the U.S.-China relationship is still in its infancy. The United States only "normalized" relations with China in 1978, and then in 1999 made them "permanent" when Congress passed legislation to eliminate the annual "Normal Trade Relations" review process. This process has now culminated in China's accession to the World Trade Organization ("WTO"). During this period, the U.S.-China relationship has often been rocky and uncertain. While the U.S.-China relationship has matured, and is increasingly based on mutual economic and political interests, the U.S. securities industry still has substantial concerns related to China's capital markets and the access provided to U.S. securities firms.

SIA has long supported more open, fair and transparent markets, and has strongly advocated liberalization in U.S. multilateral and bilateral trade discussions—including China's WTO accession talks. The economic benefits of financial services sector liberalization reverberate throughout the world from widespread increased opportunities created by new entrants, innovative products and services, and capital markets with greater depth and efficiency. In the global economy, open and fair markets are essential to ensuring that markets operate efficiently so that investors can easily and quickly buy and sell shares across borders, while businesses can access capital at the lowest price. The international financial system has been a major and contributing factor in the marked increase in living standards of those countries that participate in it.

China's WTO accession commitments for financial services, and more specifically for the securities industry, show a reluctance to open this sector fully to foreign competition. We believe China should improve and accelerate its financial sector reform so that it will have the financial tools necessary to sustain and improve the quality of its economic growth.

China's Economy—Transformation and Opportunity

Since 1978, the Chinese government has increasingly realized that private companies would operate more efficiently than government-owned or -managed companies. As a result, the Chinese economy has become progressively more based on competition and open markets. China's recent accession to the WTO will further enhance the development of a thriving private sector, now estimated to account for about one third of gross domestic product (over 50 percent if China's agricultural output is included).

China's tremendous progress over the past decades has, not surprisingly, also been accompanied by significant problems. China faces enormous internal challenges, including non-performing bank loans; the closing down and/or conversion of inefficient state-owned enterprises; and an agricultural sector of 330 million people (about 45 percent of China's workforce) that faces lower prices and more competition. In spite of the tremendous challenges that China's economy faces, it presents the U.S. with 1.3 billion potential consumers, myriad export opportunities for the U.S. goods and services sector, and an economy expected to double in size by 2006. By the end of the 1990s, China's GDP increased by 10.7 percent per annum—a rate more than three times that of the United States during the same period. Foreign investment has played a key role in supporting China's growth. Foreign-funded firms employ more than 18 million Chinese, and account for 16 percent of all industrial and commercial taxes. The U.S. investment in China to date has been modest, accounting for only eight percent of total foreign direct investment.[2]

Propelled by this economic growth, China is now our fourth largest trading partner, with imports and exports totaling a combined $116.2 billion in 2000. Moreover, since 1993, U.S. exports to China have nearly doubled to almost $16.2 billion annu-

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[1] SIA represents the shared interests of nearly 700 securities firms. SIA member-firms (including investment banks, broker-dealers and mutual fund companies) are active in all phases of corporate and public finance. The U.S. securities industry manages the accounts of nearly 80 million investors directly and indirectly through corporate, thrift, and pension plans. In 2000, the industry generated $314 billion of revenue directly in the U.S. economy. Securities firms employ over 700,000 individuals in the U.S.

[2] The American Embassy In China, *http://www.usembassy-china.org.cn/english/economics/*.

ally, providing a market for U.S. exporters comparable to the size of France ($20.4 billion) and the Netherlands ($21.8 billion). Increased U.S. exports lead to more U.S. jobs at home. As China phases in its WTO commitments and continues its economic growth, U.S. firms will find their ability to export significantly enhanced, bolstering U.S. job creation and economic growth. The export opportunities in China—where ownership of new technology products such as fax machines, mobile phones, and personal computers stands well below its Asian neighbors—are enormous. China's WTO accession is a certain catalyst for greater U.S. exports.

Expanding Business Opportunities for U.S. Financial Services Firms

Prior to WTO accession, many of SIA's leading member-firms identified China as the largest single emerging market opportunity. Indeed, with China scheduled to begin implementation of its WTO commitments in the near future, U.S. securities firms will be able to broaden their role in China's capital markets. Financing China's infrastructure presents the U.S. financial services industry with an especially important opportunity. Analysts predict that China will invest more than $1 trillion in transportation and communications infrastructure improvements and energy-related capital equipment over the next decade.

Moreover, China's nascent pension system must deal with a rapidly aging population. In 1995, the percent of China's population over 65 was 6.1 percent; it is projected to reach almost 14 percent by 2025. World Bank estimates indicate that by 2030, the Chinese pension system will total $1.8 trillion. Already, several U.S. and other foreign firms have begun to capitalize on the enormous opportunities in China's retirement market by signing technical assistance agreements with local fund management companies.

China's capital markets have grown significantly over the past decade and helped finance the country's domestic growth. China did not have a functioning stock market until 1991. By 2000, China's equity market capitalization totaled $581 billion and was the largest emerging stock market in the world. Impressively, between 1995 and 2000, China's stock market capitalization soared by nearly 70 percent per annum, increasing the value of Chinese stocks to 20 percent of all emerging markets. China also boasts 1,086 listed companies, exceeded only by Korea (1,308) and India (5,937).

China's domestic capital markets will benefit from the entry of U.S. securities firms and their technology, capital, innovative products and services, and best practices. As local firms prepare for this increased competition, they will adopt new technologies and improve the quality of products and services they offer. More competitive and efficient capital markets will also improve the allocation of capital to borrowers and users, facilitate the hedging and diversifying of risk, and assist the exchange of goods and services. As China's capital markets develop, Chinese firms will be better able to raise low-cost capital and support job creation.

Eighty percent of Chinese firms recently surveyed by the International Financial Corporation, however, consider access to financing a moderate or major constraint. Since financial markets are inextricably linked to increased investment and economic growth, strengthening China's domestic capital markets will help to alleviate the significant financing constraints that Chinese firms currently face.[3]

China's private and public sectors alone cannot mobilize the massive financial resources, advice and expertise that are necessary to sustain its economic growth. Much of the infrastructure development will, by necessity, be funded through foreign sources, and this opportunity has generated substantial interest by the U.S. securities industry. Indeed, despite difficulties entering and operating in China, numerous U.S. securities firms have established offices in China and have participated in China's international securities offerings.

China has also reached out to the international capital markets to fund its growth. Private and state-owned Chinese companies raised nearly $75 billion in debt and equity issues in the international markets from 1991–2000. Of this total, a robust $48.3 billion in equity capital was raised, with nearly 88 percent raised in internationally targeted offerings. About seven percent was raised in targeted U.S. offerings and about five percent in Asia. The large disparity in international- versus U.S.-targeted equity issues may be a result of the more stringent, if not better, disclosure and accounting requirements for U.S. listings that Chinese issuers currently find difficult to meet. In 2000, Chinese issuers raised $20.1 billion in equity capital, 17 times the $1.16 billion they raised only nine years earlier.

[3] Financial Liberalization and Financing Constraints: Evidence From Panel Data on Emerging Economies, Luc Laeven, World Bank, October 2000, http://wbln0018.worldbank.org/html/FinancialSectorWeb.nsf/(attachmentweb)/wp002467/$FILE/wp002467.pdf.

Chinese issuers also made use of the international debt markets, raising $26.6 billion during 1991–2000. Of this total, about $10.2 billion was raised in international placements, while nearly $9.7 was raised through access to the U.S. markets. The remaining $6.7 billion was raised in Hong Kong and other Asian markets.

China's remarkable economic reforms over the past 23 years have also begun to reverberate in the U.S. markets. Chinese companies have increasingly tapped the U.S. capital markets—the world's largest, deepest and most liquid—as they seek to expand their businesses. Trading of Chinese issuer shares on the New York Stock Exchange soared more than six-fold in the past four years, from $872 million in 1996 to $5.6 billion in 2000. The 21 Chinese issues now listed on the NYSE represent the largest concentration of listings in the region, and the fifth largest in the world. Although the United States faces stiff competition for these listings—the introduction of the euro and the creation of a single European capital market are increasingly attractive to Chinese issuers—the U.S. markets are unrivaled in their depth, liquidity, and transparency, as well as their political and economic stability.

Chinese issuers, however, will have to improve their disclosure and corporate governance standards to meet the demands of the international investing community. Indeed, the China Securities Regulatory Commission has already promulgated regulations to raise the quality and level of disclosure. Stricter disclosure of financial information is now required for prospectuses, and companies must ensure they have independent directors. These rules will not only help China access foreign capital, but they will also set the foundation for building a more robust retail and institutional investor base in China.

China's WTO Commitments For Securities Firms

China's accession to the WTO gives U.S. firms some greater market access. The commitments from China for the securities industry represent a first step upon which to pursue additional liberalization of China's capital markets. Although China's accession terms still leave securities firms facing significant barriers to market access, they do contain several important commitments. For example, there are provisions for minority ownership in local securities underwriting, asset management firms, and advisory companies. Particularly noteworthy are China's commitments for the securities sector that include the grandfathering of existing activities and investments, national treatment, and the elimination of China's "economic needs test." [4]

China's WTO commitments to foreign securities firms

Participate directly in B share transactions [1]
Eligible for special membership on Exchanges [1]
Establish securities joint ventures (⅓ ownership) to underwrite A shares, and to underwrite and trade B and H shares and government and corporate debt
Establish funds management joint venture (⅓ ownership, [1] 49 percent after three years.)
Grandfather existing investments
Elimination of economic means test
National treatment

[1] Upon accession.

In addition to its WTO commitments, China is taking other steps to open its markets. These include allowing foreign firms to list and issue local currency (renminbi) shares, and the establishment of foreign investment venture capital firms. Notwithstanding these liberalizing steps, SIA strongly urges China to make the following additional commitments in the ongoing WTO financial services discussions:

—*Market Access.*—Permit foreign firms to set up a securities company in China, either through a wholly-owned entity or other business ownership structure, with power to engage in a full range of securities activities, including underwriting, secondary trading of government and corporate debt and A shares, etc. Firms should have the right to establish offices without geographical limitation.

—*Asset Management.*—Permit foreign firms to manage money for Chinese investors, both retail and institutional, as well as to sell internationally diversified mutual funds to individuals through qualified local distributors.

[4] Governments often use economic needs tests to discourage new foreign direct investment, and take into account, *inter alia*, the number of existing firms, level of competition, and the size of the market as criteria in the process of granting a license to establish a commercial presence.

—*Foreign Ownership Limits*.—Lift foreign ownership restrictions and permit foreign investment in certain sectors and/or state-owned businesses, e.g., insurance, banking and asset management.

Although U.S. firms still lack the basic access needed to compete effectively, the lack of a strong legal foundation in China further complicates the ability of U.S. firms and their clients to participate. An unwelcome level of regulatory risk characterizes China's business climate and acts as a severe tax on capital. A recent PriceWaterhouseCoopers' report measured the adverse effect of opacity on the availability of capital in 35 countries.[5] Not surprisingly, the report ranked China at the bottom with an opacity score equivalent to an additional 46 percent corporate income tax.[6] China also placed last in legal and judicial opacity, as well as regulatory uncertainty and arbitrariness.

If China is to sustain long-term economic growth and continue to attract the foreign capital it needs, it must improve its legal infrastructure. Greater transparency will be a critical part of improving the rule of law in China. Transparent and fair regulatory systems play an integral role in the development of deep, liquid capital markets that, in turn, attract market participants, increase efficiency, and spur economic growth and job creation. A high level of transparency also ensures that foreign firms are accorded national treatment. Perhaps most importantly, transparency enhances investors' trust and assists international capital flows. Lack of transparency in the implementation of laws and regulations can seriously impede the ability of securities firms to compete.

SIA has published a paper (Appendix I) that serves as a blueprint for establishing transparency. The paper underscores the key guiding principles of fair and transparent regulations as follows: (1) rules, regulations and licensing requirements should be considered and imposed, and regulatory actions should be taken, only for the purpose of achieving legitimate public policy objectives that are expressly identified; (2) regulation should be enforced in a fair and non-discriminatory manner; (3) regulations should be clear and understandable; (4) all regulations should be publicly available at all times; and (5) regulators should issue and make available to the public final regulatory actions and the basis for those actions, in order to enhance public understanding thereof.

We also note an American Chamber of Commerce in China White Paper[7] that commented on the importance that "consistency" has on building the rule of law. Defining "consistency" as ". . . the fair, reliable, and nondiscriminatory application and enforcement of both laws and contracts," the Chamber's report noted, "Inconsistent enforcement of contracts and laws continues to limit further increases in foreign investment." For example, local courts tend to rule in favor of local business in commercial disputes with foreign companies.[8] Rules and regulations on bankruptcy and intellectual property rights, among others, must be clear, fairly applied and enforceable. The development of such rules and regulations will attract and improve access to financing.

Continued liberalization of China's capital markets has clear benefits for China and the global economy. It is a long-established U.S. policy to promote economic growth through open financial services markets. Global economic integration facilitates the importation of capital and intermediate goods that may not be available in a country's home market at comparable cost. Similarly, global markets improve the efficient allocation of resources. Countries gain better access to financing, and the suppliers of capital—institutional investors or individual savers—receive better returns on their investments.

Finally, open, fair markets help increase living standards. We look forward to working with this Commission, the Administration, and Congress to further expand the U.S. securities industry's access to China through the use of bilateral and multilateral trade forums.

Thank you very much for the opportunity to testify.

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[5] PriceWaterhouseCoopers, The Opacity Index, January 2001. Opacity is based on 5 different factors that impact capital markets: (1) corruption; (2) legal system; (3) government and macroeconomic and fiscal policies; (4) accounting standards and practices (including corporate governance and information release); and (5) regulatory regime.

[6] The study uses Singapore as the benchmark, so that an increase in opacity from the Singaporean level to the Chinese level has the same negative effect on investment as raising the tax rate by 46 percent.

[7] 2001 White Paper on American Business in China, February 3, 2001.

[8] China Tackles Murky Local Regulations To Ensure Adherence With WTO Pledges, Peter Wonacott, November 27, 2001.

APPENDIX I

PROMOTING FAIR AND TRANSPARENT REGULATION DISCUSSION PAPER

I. SETTING THE FOUNDATION FOR OPEN AND FAIR SECURITIES MARKETS

Deep and liquid capital markets are the essential building blocks of today's economy, supplying the funds for economic growth and job creation. The firms that participate in the markets price risk, allocate capital, provide investors with advice and investment opportunities, and supply the liquidity needed to make markets work efficiently.

Just as capital markets underpin economic growth and job creation, transparent and fair regulatory systems are essential to the development of deep and liquid capital markets. A system of regulation that is transparent to market participants instills the confidence needed to attract both the suppliers and users of capital to make the best use of the markets.

Governments, regulators and the international financial institutions have undertaken substantial projects designed to improve the quality of the financial systems world-wide. Attention is now focused on building fair and transparent regulatory systems—grounded in the principles of market integrity and investor protection—to oversee those markets. Consistent with those goals and the principles of prudential regulation, discriminatory practices and considerations, such as the nationality of individuals or the place of origin of firms, should not be permitted to influence regulatory policies or actions.

This paper is based on the assumption that a country's relevant laws should promote fair and transparent regulation. The principles outlined in this paper are not intended to prevent a regulator from taking measures for prudential or legitimate public policy reasons recognized under the World Trade Organization, including protecting investors, ensuring that markets are fair, efficient and transparent, and reducing systemic risk.

A consensus view, supporting the development of active, sound and efficient markets based upon established principles for capital market regulation, is rapidly emerging. In September 1998, the International Organization of Securities Commissions (IOSCO) issued a paper entitled "The Objectives and Principles of Securities Regulation" that urged the adoption by all regulators of processes and regulations that are: consistently applied; comprehensible; transparent to the public; and fair and equitable.

The International Monetary Fund ("IMF") is developing a broad-based "Code on Good Practices and Transparency in Monetary and Financial Policies" that complements IOSCO's work.

The securities industry, which today operates on a global basis, supports the IMF and IOSCO efforts to establish principles of fair and transparent regulation. The securities industry strongly believes that by making regulation and the operation of regulators accessible and transparent and by treating foreign and domestic licensed market participants fairly and equitably, governments, regulators and international financial institutions will promote the best markets for investors throughout the world.

Building on the emerging regulatory consensus, this paper provides the views of the securities industry on fundamental regulatory principles and practices that will provide a fair and level playing field for market participants. It also sets the foundation for building strong and vibrant markets worldwide. Moreover, we strongly believe that the principles promoting fair and transparent markets are broadly applicable to all financial services firms participating in the global capital markets. In this regard, we are actively seeking the support of financial services firms worldwide in promoting these principles.

II. GUIDING PRINCIPLES OF FAIR AND TRANSPARENT REGULATION

A. Rules, regulations and licensing requirements should be considered and imposed, and regulatory actions should be taken, only for the purpose of achieving legitimate public policy objectives that are expressly identified, including, for example, investor protection, maintaining fair, efficient, and transparent markets, and reducing systemic risk.

B. Regulation should be enforced in a fair and non-discriminatory manner.

1. Regulations and regulators[1] should not discriminate among licensed market participants on the basis of the nationality or jurisdiction of establishment

[1] The term "regulator" is intended to cover all bodies that are authorized pursuant to law to play a role in the licensing and supervision of the activities of financial services firms, as well

of the shareholders of a market participant or the jurisdiction of establishment of any entity that owns or controls the equity or indebtedness of a market participant.

2. The relationship between a regulator and a licensed market participant should be governed by the standards set forth in relevant rules and regulations, and should not be subject to political or other extraneous or improper considerations.

3. The introduction of new securities products and services by firms should be governed by the standards set forth in relevant rules and regulations.

C. Regulations should be clear and understandable. Clear and understandable regulations and rulings provide market participants with the predictability and necessary knowledge to comply with regulations. Opaque or ambiguous regulations and rulings create uncertainty among investors and licensed market participants.

D. All regulations should be publicly available at all times. All regulations should be made, and at all times remain, publicly available, including requirements to obtain, renew or retain authorization to supply a service. Disciplinary actions should not be taken based on violations of regulatory standards that were not in effect at the time the relevant activity took place.

E. Regulators should issue and make available to the public final regulatory actions and the basis for those actions, in order to enhance public understanding thereof.

III. RULEMAKING AND IMPLEMENTATION

A. The rulemaking process

1. Regulators should utilize open and public processes for consultation with the public on proposals for new regulations and changes to existing regulations. A reasonable period for public comment should be provided. Any hearings at which formal promulgation or adoption of new regulations or changes to existing regulations are considered, if open to a member of the public, should be open to all members of the public. Regulators should not take arbitrary regulatory action against those who participate in the consultation process.

2. In considering whether rules, regulations, licensing requirements or actions are necessary or appropriate, regulators should also consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation.

B.Communicating and implementing new rules

1. New rules and regulations that provide advice for market participants should be made available to them and the public in a timely and efficient manner. Such changes should be made available, in writing, by electronic media or other means of distribution so that all market participants have reasonable access to such material.

2. Market participants should be given a reasonable period of time to implement new regulations. The effective date of a new regulation should provide a reasonable period for market participants to take the steps needed to implement the new regulation under the circumstances.

C. Interpretations of rules

1. Regulators should establish a mechanism to respond to inquiries on rules and regulations from market participants. The titles and official addresses of the relevant regulatory offices should be provided.

2. Interpretations and the grants or denials of regulatory relief or exemptions should be made available to the public. Such interpretations, relief or exemptions should generally apply or should be applied upon proper request, to substantially similar licensed market participants and new products. Under limited circumstances it may be appropriate to delay the publication of individual grants of relief for reasonable periods of time to address legitimate competitive concerns.

IV. LICENSING AND NEW PRODUCT PROCEDURES

A. Procedures for licenses and introduction of new securities products and services.

1. Criteria governing licensing of firms and the introduction of new securities products and services by firms should be in writing and accessible, and should be

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as the bodies that formulate rules, regulations and policies relating to such firms. Where the legislature or authorized regulator delegates its authority to a non-governmental entity such as a self-regulatory organization or trade association, the term is intended to encompass such an entity.

the basis on which decisions are made. All regulations and related explanatory materials governing the consideration and issuance of licenses to firms and the introduction of new securities products and services by firms should be reduced to writing and made publicly available to potential applicants upon request. No licensee should be denied a license, and no new securities product or service should be prohibited, on the basis of any factor not identified in such written regulations or explanations.

2. The introduction of new securities products and services by firms should be governed by the standards set forth in relevant rules and regulations. Where particular requirements are established in connection with the introduction of a product or service, such requirements should govern the introduction of complying products and services. In order to promote flexibility and efficiency in the capital markets, such standards and requirements should enable firms, to the maximum possible degree consistent with principles of prudence and investor protection, to introduce complying new products and services on the basis of sound internal procedures for compliance without additional regulatory review.

3. Information supplied by applicants as part of an application process should be treated confidentially. Such information should be disclosed only in accordance with existing rules permitting public disclosures, such as those that may be triggered by the granting of a license or product approval.

4. Regulators should promptly review all applications by firms for licenses and required product or service approvals and should inform the applicant of any deficiencies. No application for a license or approval that provides all information required pursuant to regulation and is made in good faith by an applicant that meets required criteria should be refused review and action by the relevant regulator. Action on all applications received should be taken within a reasonable period. Licenses should enter into force immediately upon being granted, in accordance with the terms and conditions specified therein.

5. Where an examination is required for the licensing of an individual, regulators should schedule such examinations at reasonably frequent intervals. Examinations should be open to all eligible applicants, including foreign and foreign-qualified applicants.

6. Fees charged in connection with licenses and the introduction of new securities products and services should be fair and reasonable and not act to prohibit or otherwise unreasonably limit licensing requests or the introduction of new product and services.

B. Licensing of entities and their employees

1. An applicant's competence and ability to supply the service should be the criteria used for licensing entities and employees. The terms and conditions for granting licenses should be made explicit, including education, experience, examinations and ethics. Procedures and criteria should not unfairly distinguish between domestic and foreign applicants. In addition, there should be no quantitative limits on the number of licenses to be granted to a particular class of market participants who are otherwise qualified.

2. When imposing licensing requirements, regulators should endeavor to give consideration to comparable testing or other procedures confirming the qualifications of an applicant that already have been completed in another jurisdiction. The ability of qualified and experienced market professionals to provide services in a foreign jurisdiction may be promoted where testing or other procedures used in the professional's home jurisdiction may satisfy all or part of the foreign jurisdiction's licensing requirements.

C. Denials of licenses and product and service approvals

1. When denying an application for a license or a required securities product or service approval, regulators should, upon request, provide an explanation for that action. Any total or partial denial of any application for a license or a required new product or service approval should, upon request, be accompanied by a written statement of explanation from the relevant regulator detailing the reasons for the denial, including the particular requirements of the regulations governing the issuance of such license or required approval that were not satisfied. Applicants should be given the opportunity to resubmit applications or to file additional or supplementary materials in support of their applications.

2. Applicants should be afforded meaningful access to administrative or judicial appeal of a denial of a license or a required product or service approval (or failure to act on an application).

3. An appeal of a denial of a license or a required product or service approval should be decided within a reasonable time period after the appeal is filed. An appli-

cant's decision to pursue an appeal (whether formal or informal) should not prejudice its existing licensed operations.

V. IMPLEMENTATION OF REGULATORY STANDARDS

A. Inspections, audits, investigations and regulatory enforcement proceedings [2]

1. All inspections, audits, investigations and regulatory enforcement proceedings should be conducted pursuant to established regulatory and judicial standards and should not arbitrarily discriminate based on improper or other extraneous criteria like nationality.

2. All inspections, audits, and investigations should be conducted in a manner that does not impinge on the rights of licensed market participants and their directors, officers and employees.

3. A regulatory authority [3] should not publicly disclose the fact that it is conducting an enforcement related inspection, audit or investigation of a particular entity until a determination has been made by the regulatory authority to take remedial or other enforcement-related action, unless otherwise subject to a legally enforceable demand unless made in connection with a generally applicable disclosure requirement imposed on the entity. The inspection, audit or investigation should be conducted at all times with due attention to the privacy and confidentiality concerns of all affected parties, including licensed market participants, their directors, officers, employees, and clients.

B. Regulatory proceedings to impose a sanction

1. Notice and opportunity to be heard

a. *Notice of applicable law and regulation.*—A regulatory proceeding to impose a sanction should only be instituted based on the violation of laws or regulations that were in effect at the time that the relevant activity occurred and where the subject of the proceeding had timely notice of them.

b. *Notice of determination to take action.*—Licensed market participants should be notified in a timely manner both when: (1) a determination has been made to hold a regulatory proceeding concerning the conduct of that participant; and (2) a decision in, or on the status of, that proceeding has been made.

c. *Opportunity to be heard.*—Except in situations where emergency temporary relief is necessary, in all regulatory proceedings, licensed market participants should be given a reasonable opportunity to be heard and to submit, on the record, position papers and other documentary evidence.

2. Representation by counsel and access to evidence

a. *Right to legal counsel.*—The subjects of a regulatory proceeding should have the right to have legal counsel of their choice represent them in all meetings with, and interviews by, regulatory authorities. A regulatory authority should not suggest or imply that the attendance of counsel will in any manner alter the character of the proceedings being conducted, the level of supervisory review to be undertaken, or the manner in which the regulatory authority carries out its functions.

b. *Access to evidence.*—The subjects of a regulatory proceeding should, upon request, be permitted reasonable access to all documents and records that are relevant to the subject matter involved in the pending regulatory action. Documents and records to which access is denied based on privileges generally recognized in such proceedings should not be admissible in evidence in such regulatory proceeding.

c. *Burden of proof.*—The burden of proof to demonstrate that a licensed market participant has not conducted its business in accordance with the relevant law and regulation should rest with the regulatory authorities.

3. Sanctions and Appeals

a. *Sanctions.*—Sanctions by a regulatory authority should be imposed in a fair and nondiscriminatory manner based on the relevant facts and with an effort to treat similarly situated persons and entities in a similar manner. The basis for any decision to impose sanctions by a regulatory authority should be explained in a writing that is made available to the subjects of the proceeding.

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[2] The term "regulatory enforcement proceedings" means administrative or judicial action authorized by the relevant regulatory authority and is intended to cover civil, administrative or criminal proceedings that involve a financial services firm and/or its employees based on their financial services activities.

[3] The term "regulatory authority" is intended to cover all regulatory bodies involved in the inspection, auditing, investigation or prosecution of the activities of financial services firms. Depending on the system, the term may encompass criminal and judicial authorities as well as non-governmental entities such as self-regulatory organizations.

b. *Appeals*.—The subjects of a regulatory proceeding should have available to them a forum for appealing the decisions rendered and sanctions imposed. The body considering a particular level of appeal should be separate from that which made the decision or imposed the sanction that forms the basis of the appeal. Appeals to a regulatory authority should be decided in a timely manner and appeal determinations should be explained in a writing that is made available to the subjects of the proceeding.

Co-Chairman WESSEL. Thank you, and all of your testimony will be made part of the record. We look forward to the upcoming give-and-take as well as your future work with the Commission.

PANEL II DISCUSSION AND QUESTIONS AND ANSWERS

Commissioner Mulloy?

Commissioner MULLOY. I just have a quick series of questions. This Commission was created to look at the national security implications of the trade, investment, capital markets, tech trends, and for all those sorts of issues. You know there has been an issue of PetroChina raising money in U.S. capital markets despite the fact that they were doing business in Sudan, and there was some public discussion of that. The SEC subsequently issued a decision or opinion that that is material information that would be important to disclose to investors, and that has been out there for discussion.

With regard to China, do you all agree that we should keep our capital markets open for Chinese companies to come into this country and raise capital. Starting with Mr. Wolansky, we'll go right down the line, and a quick answer.

Mr. WOLANSKY. The answer is absolutely.

Mr. HORMATS. I agree; absolutely.

Commissioner MULLOY. You make the point that it helps transfer good practices.

Mr. HORMATS. I think it helps transfer good practices, internationally accepted practices, to China, and that our standards are the highest in the world. If the Chinese are willing, as many Chinese companies are, to adhere to those, we should be very welcoming of Chinese capital-raising in our capital markets. It's a plus for us and a plus for them.

Commissioner MULLOY. Marc?

Mr. LACKRITZ. I completely agree with that. I think it's a win-win from the standpoint that the Chinese come in to raise money from our markets and at the same time have to improve their practices. They have to reconcile their accounting with GAAP accounting. They have to disclose information that they wouldn't have to disclose in their own market. They have to improve their practices. So I think it's a win-win.

Commissioner MULLOY. Okay. The second question—tell me whether it should be transparent or whether it should be prohibited in our markets. Should a Chinese company that is owned by the PLA in China be able to raise money in U.S. capital markets, and one, if it is doing so, should it be transparent that that is what it is, or should it be prohibited?

Mr. WOLANSKY. The standards in the American capital markets have always been disclosure standards. We have never had substantive prohibitions on this or that, and I don't see why they should be any different than the general proposition on which these capital markets were built.

Commissioner MULLOY. Bob?

Mr. HORMATS. I agree with that. It has served us well for generations to have disclosure, and the disclosure in the American capital market for a new issuer is, as I said, the highest in the world. Disclosure gives the investor the opportunity to look at the information and to make intelligent decisions based on the information disclosed. The more disclosure, the better for the investor, and it has been a standard that we have adhered to in the past, and we should continue to adhere to it, and this seems to be consistent with that.

Mr. LACKRITZ. I would agree with that, and I would echo something that Bob said earlier, that a prohibition would be both self-defeating and ineffective unless we have the entire rest of the world pulling together on something like this. So disclosure is clearly the answer here, not a prohibition.

But there are lots of incentives in the process of underwriting that help to reinforce that. I mean, firms don't just plop, appear on the New York Stock Exchange and receive money. They have to retain underwriters who are going to try to raise the money for them, and the underwriters have obligations under U.S. law to do due diligence kinds of investigations and that kind of thing.

There is also a huge reputational risk that is involved any time a firm takes on a client to raise money for them.

So there are lots of protections in place, and I think we would come out the winner.

Commissioner MULLOY. One last question, and this came up for a lot of discussion in the previous panel. Let's say you have a Chinese company that has been identified as a company that is aiding in the proliferation of weapons of mass destruction on the means to deliver them, and has been so identified by our intelligence agencies in the same way they have identified some companies that engage in money-laundering to aid terrorism, and that those companies have been doing this with countries that are identified as countries aiding terrorists on that list put out by the State Department. Would you permit those companies to raise money in U.S. capital markets?

Mr. WOLANSKY. Fortunately, I am an investor and not a politician. However——

Commissioner MULLOY. Give me transparency or prohibition.

Mr. WOLANSKY. As I understand, it is not necessarily up to the SEC to carry out State Department policy, and if the State Department were to come up with sanctions on particular countries—and as I understand it, the State Department typically focuses on countries, not individual companies—then I would understand that that might be something that they might look into, but certainly not the SEC or the capital markets.

Commissioner BRYEN. They sanction companies.

Mr. WOLANSKY. But it's really a State Department issue and not an SEC issue.

Commissioner MULLOY. So you would have it transparent but permit the company to continue to raise money?

Mr. WOLANSKY. Correct, if the State Department would.

Commissioner MULLOY. What about you, Bob?

Mr. HORMATS. I don't have a different point of view on that. I think there are American laws and American procedures that deal with national security issues, but it's not an issue for the SEC, and the SEC has more or less said the same thing.

Commissioner MULLOY. Marc?

Mr. LACKRITZ. I think that as you go down the slippery slope, is there any act committed by a company that is so horrible that we should shut them out of our capital markets? You raise an interesting question because you are getting into the intersection between national security, foreign policy, and capital markets.

I agree with the other panelists that the SEC and the securities laws are not intended nor should they be used for foreign policy purposes. We have adequate laws now concerning sanctioning countries and companies that are deemed to be either threats to our national security or rogue nations, and the President has ample authority to exercise that power and has done so with five, six, or seven countries. And if the President determines that a company or a country is in fact aiding or abetting weapons of mass destruction or biological weapons, that kind of they, they can designate that, at which point that company will have no access to our markets, and we won't be able to do business with it across the Board.

But that is apolitical national security decision, I think, rather than an investment or capital markets decisions.

Commissioner MULLOY. Thank you.

Thank you, Mr. Chairman.

Commissioner WESSEL. Chairman D'Amato?

Chairman D'AMATO. Thank you, Mr. Chairman.

I think there will be some obvious followup to this exchange, but I actually wanted to commend particularly Mr. Hormats for his courage and wisdom in coming before this Commission to testify, knowing the situation that he faces.

As an old schoolmate of Mr. Hormats, the Commission will indulge me a couple of softballs before the lions begin to descend.

I have two quick questions. One, we had some testimony this morning that the upsurge in Chinese participation in the American equities market has been exploding in recent years to the tune of some $20 billion in the year 2000, and that it is anticipated that that will continue to grow in the future.

Now, we have a recession, and I understand a number of offerings and IPOs have been deferred as a result of economic weakness, but that will then reverse itself again in the year 2003 or even a little earlier.

Can you give us, Bob, an assessment of what you think the volume and size of Chinese participation looks like in the next 18 months in our equity markets?

Mr. HORMATS. It's hard to say. As you correctly pointed out in your question, the IPO market has not been a particularly robust one over the last several months for anyone. I think, although the market has strengthened somewhat, the IPO market has still not really picked up a great deal of vigor. It may, but it hasn't yet. And I think the Chinese, like other investors, look at market conditions and will probably make their judgment based on market conditions, so it would be very hard to quantify.

But I would say this. There are a number of companies that are more or less in queue and might come to the market if market conditions warrant, but quantifying it at this point would be very hard to do. Maybe Paul has a better idea.

Chairman D'AMATO. Do you think there will be a trend line along those numbers that we have seen?

Mr. WOLANSKY. I'll say the most remarkable thing that I have seen is the discussion in China, and the head of the Chinese SEC, the CSRC, announced over the weekend that they are going to permit, what they call CDRs, Chinese Depository Receipts, basically for the Chinese companies that went public through overseas holding companies on the foreign markets who are now seeking to go back into China to raise money because more money is available currently in the domestic market than overseas. And the first one who is supposed to take advantage of this, through a competitor of Goldman Sachs, Morgan Stanley, is supposed to be China Mobile, which went public in the biggest offering there ever was at the time in Hong Kong and the U.S., and now they are going back to China because the money is more available there given the current economic situation in the West.

Chairman D'AMATO. Secondly, a little bit off this particular line of questioning, I want to commend you on this report of the Council on Foreign Relations task force on WTO. I have read it carefully, and I think it's a real contribution to the developments on the WTO accession.

Mr. HORMATS. Thank you.

Chairman D'AMATO. You also mentioned in your opening remarks the willingness of the Chinese to adhere to accounting standards, to disclosure standards, and so on in entering our markets. And one of the things that this Commission is looking at is the question of adherence by the Chinese to their commitments. There has been some checkered past in a variety of areas here, one of which was the IPR agreements, the question of their capacity to actually fulfill intellectual property agreements, and also their commitments on the Missile Technology Control Regime to us and in several other agreements. So there is a question in the WTO context of Chinese ability and competency to actually fulfill this massive set of commitments that they have committed to adhere to under the WTO, which leads me to this question.

We are going to have a hearing later in January on WTO adherence, but given your testimony and this report, I wanted to ask you if you would think about an initiative or an idea that we could come up with that might help in the way of adherence instead of overloading the dispute settlement process immediately because of a whole variety of noncompliance; whether there is the opportunity to build intermediate or initial bilateral institutions between the United States and China in order to help intermediate this whole process and really start to get serious about the orderly transition to this complicated rule of adherence that we have here.

Mr. HORMATS. I think that's an interesting idea, and I agree. The fundamental point is I think it is in neither the interest of WTO nor of the U.S. nor of China to overload the formal WTO dispute settlement process, which is not as time-consuming as the GATT

was, but still complicated and time-consuming—Pat will know this better than I. Really, this is a little bit better, I think.

And I think that trying to find some pragmatic bilateral or, as they say, plurilateral, which is a few countries, that help to resolve disputes before they go or to avoid their having to go to the formal dispute settlement process could be very useful in expediting the process. And in fact, in this paper, we actually suggest something like that—so some pragmatic way of addressing this would be useful, because you are right, it's going to be hard for the Chinese. Look at how difficult it was for the Europeans, with well-developed economies, to adhere to the agreements they made among themselves for creating single markets. It has taken them years, and many European countries don't comply with their own regulations. In China, you have companies, provincial authorities, ministries; some of them adhere right away, and some may not adhere right away, and working those things out is hard. And Beijing can't necessarily get every province to do what it wants right when the time specified comes due.

So that kind of process could be very useful, and I think the Chinese would probably agree to something like it. It would have to be worked out multilaterally or bilaterally, but I think it is a practical way of addressing these issues, yes.

Chairman D'AMATO. Yes. It seems to me that we could start bilaterally with a series of areas where we know right away they are going to have a lot of problems and try to establish some kind of bridging mechanisms to start working them right away, instead of waiting for them to fail.

Mr. HORMATS. I think it is a very pragmatic suggestion, yes.

Chairman D'AMATO. Thank you.

Co-Chairman WESSEL. Co-chairman Robinson?

Co-Chairman ROBINSON. We spent some time on disclosure this afternoon, and I'd like to pursue that a little. As you know, there are a number of ways to access the U.S. markets—through Rule 144(a), Regulation S, Levels 1, 2, and 3 ADRs, and this is particularly applicable to China as illustrated by some of our exhibits, not necessarily in terms of the volume of money but the number of offerings that are, for example, Level 1 ADRs sold over-the-counter. You are also aware that the use of these particular venues permits less rigorous disclosure than standard, say, Level 3 SEC disclosure requirements. You likewise understand that we have to some extent a security-oriented mandate in looking at these issues.

Is there cause for concern that the wrong sorts—and I'm not thinking necessarily of China, now; it could be other emerging market countries as well, like our Russian friends—but is there a concern that there could be the wrong sorts of enterprises, for example, those that are engaged in egregious national security-related abuses gaining access to U.S. investor funds through these particular vehicles that are not held up to the standards of SEC disclosure, and is that something that we should be looking at? I'd like to get each of your views on that if I might.

Mr. WOLANSKY. There are really two issues as far as I see it. As you know, the reasons behind the 144(a) exemptions are that these are limited to sophisticated investors in theory and that these people are in a position to understand better what is in front of them

and to make better judgments. They don't need a lot of this stuff spelled out for them. They understand it. This is their business.

So I think there is a basic assumption that a lot of this would be understood by them even though the technical disclosure requirements are not what might be required if you are selling a share to the general public.

Second, it takes us back to what we were talking about before—is the SEC scheme going to be a disclosure scheme at whatever level of disclosure the SEC deems is appropriate given who the buyer is, or are there going to be substantive types of limits on what people can buy?

Assuming we stick to the disclosure regime, which has worked for years and years and years and has made us have the most efficient capital markets in the world, it seems to me the only question is what is the appropriate level of disclosure for the particular buyer, and that's the judgment of the SEC as to what level that buyer needs in order to be protected.

Co-Chairman ROBINSON. So Level 1 ADRs, for example, which aren't necessarily ending up with qualified institutional buyers who are the more sophisticated buyers——

Mr. WOLANSKY. I think people understand what they are buying when they buy something like that. People understand that this is not the same as buying a mutual fund. I think generally—I was reading the Wall Street Journal today, and just looking at the disclosure that was in the Wall Street Journal that someone spent five minutes writing on the upcoming Chinese aluminum offering is enough so that you understand that the kinds of risks involved in these issues are not a secret.

Co-Chairman ROBINSON. I agree. One of the things that I found in this process is that we're talking about, particularly when we are dealing with Level I ADR—or Rule 144(a), as Paul said, a different set of buyers—but for the average investor looking at a Level III ADR, those prospectuses are quite rigorous, and an interrogative process with the SEC may be involved. The SEC generally insistents on maximum disclosure, and I think it is quite good at looking at the things they believe need to be disclosed to investors. Is it perfect? Obviously, not. But this is a thorough process, and I have been generally impressed with it.

Mr. LACKRITZ. I understand the source of your concern. We obviously do not want our retail investors to unwittingly or unknowingly be financing activities which are going to hurt the United States. So I understand the source of your question.

I also think that, as Bob and Paul both pointed out, there is an increasing level of disclosure that is inversely related to the sophistication level of the investors that serves to filter out that pretty effectively—obviously, the less disclosure with the most qualified, or the institutional buyers, all the way down, getting back to Level 1 ADRs.

So I actually think the system works fairly well from that standpoint, and I don't think anything has really changed that much today from what it has been for a long time, the only difference being that the technology now permits faster movement of funds and more real-time movement of funds. Otherwise, I think the system has worked very well, and I think it ought to continue.

Co-Chairman ROBINSON. Well, in that connection also on the disclosure topic—as you can see, I am taking Chairman D'Amato's lead, and we are trying to offer up civil, if not softball, questions.

Mr. WOLANSKY. We deeply appreciate that.

Mr. LACKRITZ. We're sorry that Bob didn't have more classmates on the panel.

[Laughter.]

Co-Chairman ROBINSON. One issue that caused some consternation on Wall Street and in the industry was the communication from then Acting Chairman of the SEC Laura Unger and her professional staff to Representative Frank Wolf of May 8th of this year, which as you know was a rather lengthy, involved communication of 15, 16 pages, the essence of which was that increasingly, foreign registrants that do business with countries under U.S.-sanctioned regimes, including terrorist-sponsoring states, are increasingly viewed as representing material risks, particularly if the business in those countries is in fact deemed material.

There were some who basically welcomed this action as a natural evolution of the definition of materiality. Similarly, after Three-Mile Island and Exxon Valdez, environmental risk became more prevalent in the markets. Arguably, September 11, which postdated that SEC memo, brought home the fact that doing business with terrorist-sponsoring states can have very unwelcome consequences.

What is your view of the May 8 communication? Is that a level of increased disclosure that is logical, evolutionary, and supportable, or do you feel as some do, that this was more of a politically motivated lowering of the threshold of materiality that could have a politicizing effect on the SEC and be counterproductive? Which views do you have on that one?

Mr. LACKRITZ. If I could take a shot at it first, as I read the response of May 8 from Chairman Unger to Congressman Wolf, I thought that her explanation and description first of all was a very articulate description of the current requirements involving materiality and that under the evolving definition of materiality under the SEC rules, of course, a foreign registrant doing significant business with a sanctioned country would be a material fact that ought to be disclosed and material.

The tougher question comes as you go further down, if it is just some small percentage of revenue, is that material or not. But I think it is also important that in the evolution of materiality, it doesn't just cover economic materiality, but that it also covers political risk, for example, and other kinds of risk. And as you mentioned, we are learning about new kinds of risks all the time, and as a result, that's why the definition of materiality is sort of a dynamic and expanding one, and it has to be flexible, and to the extent we try to straightjacket that with either bright-line tests or clear, hard definitions, I don't think we are serving either ourselves well or our investors very well.

So I think the articulation in her letter was a very forceful, thoughtful, and articulate updating of materiality.

Mr. HORMATS. I don't have a difference of opinion on that. I think Marc put it very well, and I can't add to that.

Mr. WOLANSKY. I agree.

Co-Chairman ROBINSON. Thank you very much.

Co-Chairman WESSEL. Commissioner Lewis?

Commissioner LEWIS. Thank you very much for your presentations and for the statements you submitted.

There are two lines of questions that I'd like to pursue. The panel immediately preceding you included Professor Warren Bailey of Cornell, Nick Lardy from Brookings, Thomas Byrne, the Vice President of Moody's, and Steve Harner, President of S. Harner and Company. And your statement, Marc, says that "China's private and public sectors alone cannot mobilize the massive financial resources, advice and expertise that are necessary to sustain its economic growth."

Steve Harner's statement was: "China's domestic stock markets are capable of meeting China's financial needs," and in his larger statement, he said, "Are China's financial markets big and deep enough to meet the Chinese needs?" and he says that it's a complicated question. It is not as big as they thought, but nevertheless they are functioning well enough to meet most of China's needs. So there is obviously a direct contradiction between your view and his view, and I don't know how to reconcile that except I suppose I could ask him to read what you are saying and ask you to read what he said and see——

Mr. LACKRITZ. Based on what I have heard, I can tell you that I clearly think we are right.

Commissioner LEWIS. Fair enough, but obviously, he thinks he's right, too.

Mr. LACKRITZ. Well, let me suggest to you—I think you make a good point. I guess what I would point you to would be evidence of why are the Chinese looking outside their own country to help finance their infrastructure.

Commissioner LEWIS. And he gives the reasons why he thinks they are doing that, and some of the reasons are consistent with what you said, but you differ on the needs. He says there are reasons, and you say there are reasons outside of needs, and you both agree on that, but the difference is on the needs. And he has numbers, so I would just appreciate it if you could take a look at what he has written.

Mr. LACKRITZ. I'd be happy to; I'd be more than happy to.

Commissioner LEWIS. Thank you.

The other thing I want to ask you about is that Pat Mulloy asked those four people on the prior panel if, under certain circumstances, companies engaged in proliferation activities were to want access to the American capital markets, would you agree that they should not be allowed to, and they all said yes, they should not be allowed to. This panel is obviously taking exactly the opposite viewpoint, that they should be allowed to with disclosure.

If you were to allow a company engaged in proliferation to have access to U.S. capital markets—I'd like to take you back to 1932—would you allow a pre-War Nazi Germany company to have access to U.S. capital markets? I'd like to ask each of you to respond to that.

Mr. WOLANSKY. If I could answer that, I think the characterization at least of what I was trying to get across is somewhat different. I am not saying that they should have access. What I am

saying is it is really a political decision to be made by the State Department, not the SEC.

Commissioner LEWIS. But I am asking what you believe.

Mr. WOLANSKY. Personally, what I believe—I believe that the State Department should do whatever is necessary in order to stop that.

Commissioner LEWIS. What do you think is necessary?

Mr. WOLANSKY. I don't know.

Commissioner LEWIS. If it were your decision, what would you do?

Mr. WOLANSKY. You know, fortunately, it's not my business, and I can't tell you that I know all the facts and I can make the decision. But I do know that the people who should be making that decision are the State Department and not the SEC.

Commissioner LEWIS. No. I am hypothesizing a pre-War Nazi Germany company.

Mr. WOLANSKY. I would certainly like to stop them in that situation if I had 20/20 hindsight.

Commissioner LEWIS. Okay.

Mr. HORMATS. I think there is a process point here and a substantive point. When national security decisions are made, this industry goes along with them. When there is something that is urgently in the national security interests of this country, money-laundering or any of these things, I can't——

Commissioner LEWIS. You're saying when somebody else makes the decision. I'm asking if it were your decisions, what would you do?

Mr. HORMATS. I'm not in command of all the facts. I am simply making a policy point here, which is the following. This is an industry where, if there are questions of companies or countries supporting terrorism, when the President finds something to be in the national security interest, this industry will go along with it. And I cannot make those judgments; he has to make them. When he makes them, this industry is very supportive of them and has been in the past.

Commissioner LEWIS. Terrorism is an easy one, and the President would make that kind of decision. But I am positing a company from 1932 Germany.

Mr. LACKRITZ. One thing I learned in law school is that hard cases make bad law. And I can tell you personally that I wouldn't want any American or any U.S. citizen to do anything at all to aid, abet, or help anybody who was a Nazi sympathizer back in 1932 or 1933. I wouldn't be making that decision, but I can tell you personally that I wouldn't want that to happen.

I can also just echo what Bob has said with respect to national security concerns in the capital markets and the securities industry, and the most recent example is our efforts to work with Treasury and with the Congressional committees in terms of money-laundering and cracking down on any potential financing of terrorist activities by using any kind of broker-dealers or capital markets whatsoever. And we continue to work very closely with Treasury and everybody else and the law enforcement agencies to make sure that we restrict as much as possible any possibility of any ter-

rorist organizations or anybody like that getting access to money from American citizens.

Mr. HORMATS. Yes, but in answer to what you said on the specific question, we were at war with those countries.

Commissioner LEWIS. No, no, not in 1932, we weren't.

Mr. HORMATS. I can't—I'm not going to quibble on the exact date. I personally would not want any American company to aid countries that we were at war with, that the President finds we are at war—we shouldn't do it.

I don't know what date it would be. There are certainly periods of time when the threat to the national security or the odious conduct of a country that is running concentration camps—we shouldn't be dealing with them. But I have to tell you that the policy decision has to be left to the President; the securities industry and the SEC cannot make that.

Commissioner LEWIS. I know these are very difficult questions, and I'm just trying to see where we draw the line. And I really appreciate your taking this issue on, because it is not an issue that people in the securities industry have to take on. I agree that it's a policy decision.

Mr. HORMATS. If you ask me would I invest in such a company that was helping Nazi Germany—of course not.

Commissioner LEWIS. Right.

Thank you very much for your views.

Co-Chairman WESSEL. Thank you.

Commissioner Reinsch?

Commissioner REINSCH. I was kind of hoping the panel would be more beaten up so I could come in and tell you how wonderful you are, but I will anyway. I want to commend the panel for its wisdom. I think you gave very helpful presentations and thoughtful answers to complicated questions that I think, among other things, demonstrates not how difficult the issue but how complicated it is to try to develop lines, if not bright ones, at least reasonably clean ones, that are helpful to the business community in making these judgments.

In my experience, the business community wants to comply, essentially as Bob said. They want to be consistent, they want to follow government policy. The government can make their job easy or difficult by having a coherent and intelligible policy or not. One of the things that concerns me about some of the ideas that are being floated here is that they don't necessarily lead to a coherent policy. But let me ask a couple questions.

First, to Mr. Lackritz, if you could say one more paragraph about then Chairman Unger's letter. Do you regard it as making—a poor choice of words, I suppose—a material change in the SEC's definition of materiality?

Mr. LACKRITZ. That's a great question. Was the statement on materiality material to the previous statement on materiality? I thought it was basically an articulatio of what I understand the law to be applied to new and different circumstances. In other words, the standard has been the same, which is what would a reasonable investor want to know before making an investment decision, and that has always been the standard of materiality in terms of the law as it has evolved in the securities context. I think that

what she was doing was taking that standard and trying to apply it to a situation of a foreign registrant doing business with a sanctioned country, and would that be a material fact under that standard, and I don't think she said definitively, but she said it probably would it. And in that context, I think she was articulating the current standard as applied to this situation.

Commissioner REINSCH. Of course—I agree with you. I'm not sure that everyone does—and I don't mean just around this table; I mean in the community of people who think about this, there seems to be some ambiguity about this. Is that a fair statement, or——

Mr. LACKRITZ. Well, I have discovered in representing the securities industry that it is quite unusual when we have everybody in agreement on anything. So I probably would agree with your point.

Commissioner REINSCH. Maybe I should ask—my thought had been, especially since she is not the chairman anymore—it might be helpful to have the chairman or the Commission or whatever further articulate or clarify what all this is about and what their intentions are—or, do you think we are better off with ambiguity?

Mr. LACKRITZ. It's hard to be in favor of ambiguity. That tends to be not a particularly thoughtful standard by anybody's terms. But the fact is that this is an expanding notion, and it is a flexible notion, and it is a dynamic concept, and that is why we have courts of law to interpret what that means.

I think the Commission's statement really gave very clear guidance as to what "material" meant from the standpoint of a reasonable investor. On the question of whether or not it's worth doing another iteration of that to clarify it, I actually thought it was a pretty clear statement, and I don't think it would need more clarification.

Commissioner REINSCH. Thank you.

Turning to a different question—and this really as much for the others as for you—let's go down a slightly different road. Let's assume that the Congress were to act in this area and set up some circumstances in which companies that had engaged in a variety of specified activities would be precluded from accessing the U.S. capital market by fiat, I guess, by Presidential order, probably under the statutes that Mr. Lackritz referred to, and supposing that were a decent-size list, whatever that would be. Can you foresee in that circumstance any larger effect on the capital markets or any impact on the capital markets generally, or on confidence in our market or anybody else's market as a result of that action? How would U.S. investors react to that kind of thing happening, how would foreign investors react to that kind of thing happening—or do you think it would be an insignificant blip?

Mr. HORMATS. Are you saying amend current law or use current law to——

Commissioner REINSCH. Amend current law; do something new.

Mr. HORMATS. I think the question would be what—I think what would be important is, first, that the standards were very clear and not arbitrary; second, that there was a very clear national security argument for making such a finding.

For instance, to go back to the question of Germany in 1932, I wish we had known——

Commissioner DREYER. Could I just interject here?

There was no Nazi Germany in 1932, so when you keep talking about helping Nazi Germany in 1932, you are being ambiguous.

Mr. HORMATS. I was referring to the question. That's why I didn't want to use 1932 as the time.

Commissioner LEWIS. Use '37.

Mr. HORMATS. I'll use '37. But I wish we had known more about what was going on there, and I'm sure had the President at that time known more, he would have made a decision not to enable Germany when he made that finding to have access to our capital market, and if there had been a law that he would have used, I'm sure everyone in the securities industry would have gone along with it. But what you don't want to have is arbitrary sets of laws and procedures. The clearer they are, the better, and the more clearly grounded in national security considerations, the better. And then, I think you'd find that the industry would go along with it.

And I think if it were clearly spelled out that there was a specific national security grounds, the President himself found, I think those clear guidelines would probably not have a negative impact on our capital markets. We have denied other countries access to our capital markets where there are very clear national security rounds. The concern I have is that if it is ambiguous, arbitrary, and not grounded in clear national security grounds, then I think it would have a negative impact on our capital markets.

Commissioner REINSCH. Anybody else?

Mr. Wolansky?

Mr. WOLANSKY. Yes. I take a very different tack, but I don't think I come out in a different way. I just don't think it would be effective. If you're talking about sanctioning individual companies instead of an entire country coming to the capital markets—well, if you take China over the last couple of years, they raised $27 billion in the domestic A share market, so those four companies which are on this bad list would simply raise in the domestic market and four different companies would raise in the U.S., or they would raise in Europe or in any of the other capital markets in the world. We aren't the only one.

I think I mentioned in the testimony that of the $81 billion of direct investment that went into China over the last couple of years, only 10 percent came from the United States. So it is not even that we have the ability of market clout to change the behavior of companies by limiting them access to the markets.

So even assuming that you had good standards and you had a coherent way of imposing these sanctions, I am just not sure they would have any effect at all.

Co-Chairman WESSEL. I apologize. We are running out of time.

Commissioner REINSCH. Thank you. I'm done.

Co-Chairman WESSEL. Commissioner Dreyer?

Commissioner DREYER. First of all, I applaud your statement that you are not in favor of ambiguity. It happens to be a State Department mantra—"strategic ambiguity"—and they got really clobbered over it in 1996, and they backstepped, and they said, "Well, actually what we've got is strategic clarity—it is tactical ambiguity." But that's an aside.

Mr. Lackritz, you and several other people have mentioned the lack of a strong legal foundation in China and the need for a rule of law. And as numerous attorneys have remarked to me—the few that are not lying face-down in the Potomac—it really often seems to be going the other way, that China has made some good progress in terms of promulgating laws and regulations, but these get consistently undercut.

If you read "Fazhi Ribao," the legal daily, they are constantly complaining about an increase in local protectionism and tremendous corruption in the courts which all kinds of campaigns don't seem able to stamp out.

So it seems that if one is going to get satisfaction in these securities disputes, one is going to have to get it in international tribunals rather than China's domestic courts. And in that case, are the judgements enforceable?

Mr. LACKRITZ. That's a good legal question in terms of whether they are enforceable or not. I should disclose as a material fact that I am actually a lapsed lawyer, but I don't admit that in public very often, and I certainly hope you don't hold it against me.

Whether they are enforceable or not—I think the point you are raising is actually a very good point in terms of the facts that you are pointing to will actually increase the risks that Paul was talking about earlier. They increase the cost of capital in essence, and they will slow down the flow of capital into China.

It is obviously in China's best interest to evolve a legal system that abides by the rule of law, is transparent, and is perceived by the international community as just and equitable.

My sense from the little I know about it is that it is a long evolutionary process, and it is moving in fits and starts. The more we globalize, though, the more pressure there will be on China and its institutions to compete to the top, or race to the top, not sink to the bottom. And corruption doesn't make it in the long run; it will lose. It's just a question of when.

So actually, I'm pretty optimistic about it, but I think it is going to take more time, perhaps, than we'd want it to take.

Mr. WOLANSKY. I have actually had the opportunity—let me put it that way—to use the Chinese courts and been involved in the Chinese legal process, and I think that to a large extent it's a matter of geography. There is a saying about one of the southern Chinese provinces that "The mountains are high, and the Emperor is far away." So they don't——

Commissioner DREYER. That goes back about 2000 years for all of China.

Mr. WOLANSKY. It's still true, it's still true. So that, for example, if you are talking about the court system in Beijing, the court system in Beijing has seen tremendous improvements over the last few years. But if you're talking about the court system in Henan Province, they've got a long way to go, and I don't think this is Chinese policy to keep it that way—in fact, the central government is doing everything it can to try to bring these provincial areas up to the standards of Beijing or Shanghai——

Commissioner DREYER. But they would be the first ones to admit, and they already have, that they are not doing very well at it.

Mr. WOLANSKY. Absolutely, absolutely. And I guess we can't expect miracles overnight. And for people like me who are actually in the market and need from time to time to have access to these Chinese courts, it's a problem. This is one of the reasons why the Chinese "Go West" campaign so far has not met with a tremendous amount of success.

Commissioner DREYER. And that's being very diplomatic.

Mr. WOLANSKY. Yes, it is.

Commissioner DREYER. Thank you.

Co-Chairman WESSEL. Commissioner Ledeen?

Vice Chairman LEDEEN. We have heard from a variety of very smart people here over the past several months about how hard it is to get a grip on anything Chinese or to understand anything Chinese; numbers are fuzzy, definitions are hard, the legal system varies from place to place, and so forth. So I have a two-part question.

How confident are you, first, that we or anyone else are capable of defining Chinese economic or financial things with a satisfactory degree of precision and accuracy?

And second, the same meta-question about transparency, because this whole process, access to markets, the key thing for us obviously is transparency. So if the whole Chinese economic enterprise, universe, whatever you want to call it, is hard to define and hard to get a grip on, to what extent is their transparency a transparent transparency, or is it a kind of fuzzy transparency which isn't quite as helpful? I don't know how better to put it; I'm not trying to be flip with this use of language, because it is a very serious issue. It is an enormously serious issue both for American investors and for the American Government trying to assess national security implications of the behavior, alleged and imagined, of one company or another.

So how much of it can we know; how do we know when things are being withheld from us, et cetera. I'd like you to address that.

Mr. WOLANSKY. It really breaks down into two different areas. One is what I'll call the macro area where we are talking about government figures, government information. The other is more the micro area where we are talking about what the situation looks like at particular companies.

In terms of the macro area, I don't believe it's that the Chinese are trying to hide information from us. It's that their grip on their own information is tenuous at best.

On the micro level, that is, at the individual companies, it is sometimes more of a cultural situation. The old, traditional Chinese style is that the smallest things are considered confidential and would not be disclosed even to their own people.

What has been remarkable to me in a lot of the companies that I have invested in is how that is changing recently and how we have for the first time board meetings where you actually get the real information given out. And I can't tell you that that's all the companies, but it is certainly an evolving pattern. They think of that as much more modern and the way to go. And it is certainly a good trend. I can't tell you it's as good as it would be in a U.S. company, but on the other hand, in the U.S., we also have Enrons from time to time, so it is not perfect here, either—certainly—better. But I think it's something that they are trying hard to do.

Mr. HORMATS. Yes. Let me add to that. I think that's a very interesting and important question. It is important in the Chinese context, and from the point of view we were all making, that more transparency is important for American investors to better understand what they are investing in. I think it's a valid point.

One thing that I think has contributed to the evolution that Paul was mentioning a moment ago is that the way markets are structured now, there is a penalty paid for opaqueness. Companies or countries, for that matter, that are seen not to be fully transparent or to be dramatically less than fully transparent pay a penalty on the markets, because people almost equate non-transparency with having something to hide.

It is true in a number of countries in East Asia—Thailand in 1997 couldn't figure out what their foreign exchange circumstances were, and it caused a major problem—so I think it is a general problem.

I think a number of the Chinese companies have concluded that they will do better in capital markets to the extent that they are able and willing to provide a lot of information and be more transparent. And I think investors now, particularly as you know as well as I, in this very turbulent markets, investors are much more insistent on transparency in information. So I think the market incentives themselves are driving the process. Is it as far along as we would like it to be? Probably not. But I think the incentives themselves for raising capital require a higher degree of transparency over a period of time, and I think that view is also shared by the Chinese Securities Regulatory Commission, which has been pushing them toward a higher degree of transparency precisely because their issues do better when they provide them than when they don't.

But it is an ongoing issue, and I think it is a reasonable one to keep pursuing in these dialogues. And I think investors and underwriters and accountants do this.

Mr. LACKRITZ. Can I respond just briefly?

Vice Chairman LEDEEN. Please.

Mr. LACKRITZ. I would echo that, but I would also say that there is a real premium or cost to opacity or opaqueness. Price Waterhouse Coopers has tried to measure that in a number of emerging markets and has found that China ranks at the bottom on almost all of these different opacity indexes. But when they have tried to quantify it, they have said that in China, it is the equivalent of an increased corporate income tax of 46 percent.

So that's a fairly strong economic incentive, it seems to me, to push them toward greater transparency. So I think that as China becomes part of the world economic community, those market pressures will actually force more transparency. Now, whether or not we'll be able to determine——

Vice Chairman LEDEEN. Excuse me. Could I just pose one more quick question—I want to link it to what Pat asked before.

Co-Chairman WESSEL. Yes, quickly, please.

Vice Chairman LEDEEN. So if that's the case, and if they are paying a penalty for it, number one, why then don't they just take their own money to finance their various issues? And the answer has to be not strictly economic—right—there will have to be other

factors driving it. And if there are other factors driving it, and they are so obviously crucial to these operations, do we not, then, have an enormous amount of leverage over them, but it's a leverage which can't be measured by just pure economic factors, because they are looking for something else if they are raising the money in external markets when they don't need them, when the external markets impose things on them that they would not on their own wish to do.

Mr. LACKRITZ. Well, it seems to me it also goes back to the point that Commissioner Lewis questioned me about in terms of whether they can in fact finance everything. If they had to pay a 46 percent penalty to go outside, in essence, why do they keep doing it—presumably, because they don't have the resources to handle it internally.

Vice Chairman LEDEEN. But you could reason the other way, though, just as easily, couldn't you, because they do have the resources, but what they want by going outside is not just the money which they could have anyway—it's other things.

Mr. HORMATS. I guess it's a possibility, but you have to question—there is a real question in terms of the viability of continuing to do this.

Commissioner LEWIS. Marc, I'll give you Harner's paper; we'll get that for you.

Mr. HORMATS. Great.

I think it's interesting—what they do get from the external accessing of capital in additional to capital is that they have used this—as I think a couple of us mentioned earlier—to get this externally-imposed discipline internally, to sort of project it internally. I think that is something they do get. It's qualitative rather than quantitative.

Vice Chairman LEDEEN. Well, that's something, but they get legitimacy, too——

Mr. HORMATS. Oh, yes.

Vice Chairman LEDEEN. —and you can quantify that, too. They get a lot of legitimacy from it.

Mr. HORMATS. It helps—and that's one of the arguments the New York Stock Exchange makes about domestic companies—it gives you visibility.

Vice Chairman LEDEEN. Right.

Mr. HORMATS. But I think it's also that they get an external discipline, which is one reason they joined the WTO, to get that external discipline that helps them improve corporate governance internally. In some cases, I think that's part of the process as well.

Co-Chairman WESSEL. Let's move on to Commissioner Becker.

Commissioner BECKER. A quick question. I don't want to beat a dead horse to death. We have heard a lot of cliches here today, but I want to take another stab at this.

One of the largest sources—maybe the largest source—of investment capital in the United States today is public pension funds or employee pension funds. You are all investors. Do you think it is appropriate to use those pension funds and invest those pension funds in foreign firms and industry or entities that undermine the interests of the United States—of those employees—either

through—well, I'll just leave it right there. I'd like each one of you to take a stab at it.

Mr. WOLANSKY. I guess I look at it a little differently. I am personally against smoking as well, and I would be unhappy if my investment dollars were used for tobacco investments.

However, I understand, especially when you have a shared investment vehicle like a pension fund, that someone has got to make a decision as to which investments are offensive for the group. And in my mind, that is better done through the State Department if we are talking about foreign affairs than it is through the SEC imposing some type of——

Commissioner BECKER. You feel no obligation as the person who handles the investment to consider the source of that investment?

Mr. WOLANSKY. Well, it really depends on what their mandate is. If their mandate is to act as fiduciaries to get the highest return possible, how does it change that mandate?

Commissioner BECKER. Let's say it's an employee investment fund where the workers are involved in the steel industry, and you would use those funds to fund a new steel mill being built in China that is going to bring imports into the United States and put them out of a job. How would you feel about that?

Mr. WOLANSKY. Well, I guess there are really two answers to that. One, if the pension fund in its charter decided that it would limit its investments to socially responsible investments, there are certainly investment funds in the United States that do exactly that. If they don't choose to do so, I don't see why the SEC or anybody else should mandate that they do.

Commissioner BECKER. Mr. Hormats?

Mr. HORMATS. I think that's the right answer. I think you have to leave it that different funds have different mandates, and they have a fiduciary responsibility to the people who have put that money in. It may be that some people put money into funds that will not fund companies that produce cigarettes; it may be that some companies put their money into funds that they don't want any overseas investment. There is a whole panoply of funds with different types of mandates, and I think you have to just leave it up to the funds to make their decisions. But I don't think it should be superimposed on them by the Securities and Exchange Commission.

Mr. LACKRITZ. I would tend to echo that. I think one of the real factors underlying the robustness and the dynamism and the success of our capital markets is that we don't put straightjackets on how and where and when investment managers or investors can or should or will invest. I think the reason the market works very efficiently and very effectively is because there is a wide range of choices.

But if the workers, for example, at a steel company decided they wanted to make sure that their pension money wasn't going in any way, shape or form to subsidize foreign competition that might in fact hurt them, they certainly have the right to do that. But having that requirement imposed from a governmental entity or a public entity would be very counterproductive in the long run.

Commissioner BECKER. I was really getting at what do you think is appropriate to do that, without any mandates, just considering

the source of the funds and the purpose of the investment. I understand that you are saying that for workers to have some say on that, they should all mandate, and we should strive to have restrictions put in there so that you would have to comply with the wishes of the workers. But absent that, do you feel any responsibility or any sense of direction to see that those funds are used for the best interest of the workers.

Mr. WOLANSKY. Just as a matter of first principle, people tend not to do things that hurt them. I don't want to do something that's going to hurt myself. I think the more interesting question is whether that is imposed on somebody or not. I thought the thrust of your question was going to be whether or not there ought to be an SEC rule or some broad law or regulation that would mandate something.

Commissioner BECKER. That's where we will probably wind up, but I'm really wanting to know what your——

Mr. WOLANSKY. I would say that I think that would be a terrible mistake, that you would be restricting and restraining investment managers who are under law obligated as fiduciaries to do the best they can for their clients.

Commissioner BECKER. But if it is used to the workers' detriment, what choice do they do except to seek some kind of mandate?

Mr. HORMATS. I think there is a difference between an external "mandate" and what a group of workers decides the "mandate" of its particular fund ought to be. One is an externally-imposed mandate, and one is a decision made by the group of workers who invest their money. If the group of workers who invest their money don't want to put money into a steel plant in Britain or in Austria or in China or in Singapore, individual funds make choices based on that internal guidance all the time. Those are discretionary decisions. But it shouldn't be mandated outside.

It goes to a point that Commissioner Reinsch made a few moments ago, and that is if the United States Government starts mandating all sorts of restrictions on choice for pension funds and mutual funds, then you are going to have a very disorganized market, and then a lot of companies are simply going to go elsewhere to raise their capital. You'll have a confused market internally; funds will not be able to make decisions in the fiduciary interest of the people who put their money into them; and you'll have a market that is gradually going to evolve overseas and not in the United States. It will be very harmful for the American capital market and to the large majority of people who invest in pension funds and want them to be managed in a fiduciary-responsible way.

Co-Chairman WESSEL. I am going to yield my time to my co-chair for the final question.

Co-Chairman ROBINSON. That's very generous of you. Thank you.

Stephen Harner and other members of the previous panel made a compelling case for the global dominance of the U.S. capital markets, namely that our markets far and away set the world standard, and I don't think there is any disagreement here about that.

There have also been statements by Mr. Wolansky and others, including Fed Chairman Alan Greenspan, that even if you had the

President or the proper Executive Branch authority determine that a proliferator of weapons of mass destruction, for example, is ineligible to raise capital in the U.S. markets or have any U.S. person, legal person, invest in those instruments—thereby, eliminating the demand side, of the markets, I think you would agree, a fairly comprehensive sanction—there are lots well-informed folks who have suggested that this would be in effect a shoot-in-the-foot exercise. For example, the designated company could, according to some people run off to London or any number of other markets with virtually no costs and raise funds there.

As some of you know, I have been looking at this issue for quite a while and have a Wall Street background at some level myself, and that's not my understanding. I want to clarify that, because there are some costs, it strikes me. If you are precluded from accessing the U.S. capital markets by the proper authority, and you try to go elsewhere for funds, wouldn't that in all likelihood increase the cost of funds? Wouldn't there be a higher risk profile and a certain stigma attached, seeing as this development would be communicated far and wide? Then, over time, if you are a multibillion-dollar large state-owned enterprise that is compelled to come back to the markets every year or so, couldn't that company theoretically stress out or even exhaust thinner-volume overseas markets over time? They can't absorb especially large amounts of a certain type of Chinese risk, for example.

So isn't it a little simplistic to say that such a company can go elsewhere with complete indifference and at no cost—or do you basically buy that this is exaggerated, and there would indeed be potential costs for such a designated company?

Mr. WOLANSKY. I would start by saying that depending on the circumstances, depending on the company, depending on the country, et cetera, the costs could be rather small. In some cases, a smaller country with smaller domestic capital markets, the costs would be higher. But if you're talking about the case of China, for example, which has a very deep domestic market now, the costs are going to be much, much smaller than if the country were, say, Zimbabwe, obviously.

Co-Chairman ROBINSON. I'm assuming that they need to get those funds on international markets, and they simply weren't going to go to the A share market.

Mr. WOLANSKY. Obviously, today, the U.S. capital markets are the largest around the world, but they aren't the only ones. Again, if you look at the direct investment numbers, we are only providing 10 percent of the direct investment to China today. If you are looking at the public markets, we are a much higher portion of that, because the U.S. markets account for a much higher portion of offerings in the world—but would they continue to do so if we started to put limits on the ability of people to use the U.S. markets, or would we be in fact pushing business to our overseas competitors? I don't know. That's a theoretical question. I can't tell you I can answer it completely.

But I do believe in the case of China, because they do have a deep domestic market, the costs would be rather small.

Mr. HORMATS. Yes, I think that's correct.

Mr. LACKRITZ. I would just add that I don't think you should underestimate how competitive international markets actually are with our markets. I think we are extremely successful; we have the preeminent markets—but we have lost significant business in some aspects of those markets. For example, in equity derivatives, that market has moved almost completely over to London. And it's not because of cost; it's a regulatory factor.

So from the standpoint of international competitiveness around the world, we have other countries and other markets trying to emulate our success, so I think we would be naive to think that we are so preeminent that we have more leverage than perhaps we in fact do in this competitive environment.

Co-Chairman ROBINSON. Thank you.

Co-Chairman WESSEL. I want to thank you all for what has been a great panel, and we look forward to your continuing input and advice as we move forward.

We're going to take a five-minute break before we start the next panel and then we'll go right into it.

[Recess.]

PANEL III: INVESTORS AND RISK ASSESSMENT

Co-Chairman WESSEL. I want to thank the witnesses for being here this afternoon. A number of the commissioners will be back in a minute, but we're running a little late, so I think we should get started.

This is the last panel, although I can assure you there is strong interest from all the commissioners in the subject matter and what each of you have to say.

So without further introduction, Mr. Dorn, if you'd care to start, understanding that some of your subject matter relates to issues we dealt with earlier in the day, and then we'll go straight down the panel.

STATEMENT OF JAMES A. DORN, VICE PRESIDENT FOR ACADEMIC AFFAIRS, CATO INSTITUTE

Mr. DORN. Thank you very much.

That is right. I was supposed to speak on this morning's panel, and I thank the Chairman and the co-Chairman for accommodating my schedule and allowing me to shift from Panel 2 to this afternoon's panel.

I would also like to congratulate them and the other commissioners for their work thus far. It is an honor to testify before the U.S.-China Commission.

I would like to begin by giving some highlights from my written testimony on "China's Capital Requirements and U.S. Capital Markets," and then answer any questions that you may have.

Two of the main issues the Commission asked me to address were, first, how much capital does China need to meet current obligations, and second, how much is needed to facilitate future economic growth.

The first question is rather easy to answer, and I just looked at Steve Harner's paper, and he does a superb job of giving the detailed data on this particular question, so I'll just briefly address that and then move on to the second question.

In terms of China's current capital requirements, the cost of bank recapitalization and implicit pension debt are the two key issues.

Nick Lardy has estimated that the cost of bank recapitalization in China ranges from 40 to 75 percent of GDP. That's a huge range, but that variation indicates the uncertainty and the poor quality of the data we are dealing with in China.

The 75 percent figure is on the high end, but That figure is more in line with international capital standards, so we shouldn't discount it. That figure is the sum of three things—the nonperforming loans or NPLs still held by the four largest state-owned commercial banks; the implicit guarantee of the asset management company debt by the Chinese government; and the government bond issues so far to increase bank capital.

With respect to the implicit pension debt, the figures range from 50 to 100 percent of GDP. The 100 percent figure was recently reported by the World Bank. That is a huge implicit liability of the Chinese government.

There is no question that the government debt burden in China is not sustainable at current levels. Even if the implicit pension debt is excluded, the government debt burden could reach 110 percent of GDP by 2008, according to Lardy.

Let me now move to the Commission's second question, "How much capital does China need to facilitate future economic growth?" I believe that question is somewhat of a red herring. It is very difficult to model a national economy and say exactly how much capital is needed for economic growth. I think a much better question is, What institutional changes does China need to create real capital markets?

At this point, China still has mostly planned or directed investment. There are no freely determined interest rates and no private capital markets.

When we consider the real meaning of capital, in fact, we ought to think not merely of physical capital. Rather, we ought to think of capital as the net value created by entrepreneurs in the market place. The process of value creation depends on the institutional infrastructure of an economy, in particular on the rule of law, private property rights, and freedom of contract. China has none of those institutions.

Indeed, the rights that attach to physical capital are what give capital value. Those countries that protect private property rights have created much more value and much more wealth than those that have plundered property, Figure 1, in my written testimony, shows that relationship fairly dramatically.

China lacks real capital markets. Indeed, the emperor in this case has no clothes. What China has is pseudo-capital markets, because there are no well-defined private property rights. Indeed, there are no private firms listed on the Chinese stock exchanges; government is the dominant owner. Freedom to specialize in ownership and risk-bearing means there is a lack of trust and liquidity in the China's capital markets. It also means, there is a socialization of risk, and socialization of risk, we have learned the hard way, causes a problem of moral hazard and actually increases the total amount of risk over time.

China's financial problems, in sum, are all due to the lack of private property rights. This proposition can be further supported by considering China's Stock market bubble, the heavy reliance on foreign direct investment (FDI), and the problem of net capital outflows.

P/Es in the China's stock markets ranging from 50 to 70, reflecting the low earnings of state owned enterprises. China's stock markets should be looked upon as casinos for raising funds for struggling SOEs. What the Chinese Communist Party wants to do is to "revitalize" SOEs, not privatize them. As a result, much of the savings of the Chinese people—about 40 percent of their income is saved, the highest rate in the world—is wasted on struggling state-owned enterprises. Unfortunately, there are few investment alternatives, no transparency and little accountability in Chinese financial markets.

In addition to the stock market bubble there is another problem—the heavy reliance of China on FDI. Some people see foreign direct investment in China as a strength, but it is really a weakness. It indicates a repression of private firms in China.

Yasheng Huang at the Harvard Business School has written extensively on this topic and is coming out with a book, which I have cited in my written testimony.

The third major problem is net capital outflows. China has a large current account surplus, it is true, but that surplus has been financed by net capital outflows. First, there are the outflows of portfolio and other investments—for example, trade credits and loan repayments. Those outflows nearly match the net inflows of FDI.

However, two other outflows have resulted in an overall net capital outflow. One is the accumulation of foreign reserves. China has large foreign reserves approaching almost US$200 billion, and about 40 percent of those reserves are invested in U.S. Treasury bonds. China's large foreign reserves in fact indicate that the Chinese currency, the renminbi, is really undervalued. It also indicates a huge misallocation of resources away from private sector uses.

In addition, there are the illegal private capital outflows revealed in the errors and omissions component of China's balance of payments. In most countries, the errors and omissions component is very small. China has a very large errors and omissions component, and it is due to these illegal private capital outflows and over-invoicing of imports, under-invoicing of exports, and so forth. It has amounted to over US$50 billion in the last three years alone.

It is silly for China to be a net capital exporter at this stage in its development, I'll come back to this point in a minute.

What China needs, is real, not pseudo, capital markets. To increase capital freedom, China needs to take several steps:

First, remove restrictions on private ownership and on internal and foreign trade. China's accession to the World Trade Organization will help in that respect, but of course, the Communist Party has no big incentive to privatize.

Second, allow interest rates to be freely set by demand and supply. The People's Bank of China is already moving in that direction.

Third, allow SOEs to go bankrupt. China was doing that, but the Chinese Supreme Court recently reversed course by deciding not to allow medium and large-size firms to declare bankruptcy, for obvious reasons.

Fourth, allow workers to have private pension accounts that are separately administered by private firms, whether foreign or domestic. China's Deputy Minister of Social Security, Mr. Sun Jian Yong, who Cato Institute conference in Beijing favors private accounts or what he calls "marketization." Jose Piñera, who privatized the Chilean social security system, also spoke. Mr. Sun is very interested in the Chilean model, so I'm sure China will probably move in that direction.

Fifth, allow full convertibility of the renminbi and allow full transferability of shares in SOEs so that wealth can be maximized by those individuals who wish to specialize in ownership and risk-bearing.

Some of these reform measures have been initiated and will be advanced by China's accession to the WTO, as I mentioned. Others, such as privatization, need to be pushed much further.

Selling off SOEs to fund private pensions would be a step in the right direction.

What about the benefits of privatizing or normalizing China's capital markets? According to John Greenwood, who is chief economist at INVESCO Asia Limited who also spoke at Cato's conference, "If China's capital markets and its industries were normalized (through deregulation, proper implementation of the rule of law, the encouragement of private markets and extensive private ownership), then China's balance of payments would no doubt undergo a major transformation. The balance of payments would witness a shift from current account surplus and capital outflows to current account deficit and capital inflows"—which is a normal development for a country like China.

I agree with Greenwood, that the renminbi should gradually be floated while maintaining domestic monetary policy and opening capital markets. If China maintains a sound domestic currency by controlling inflation, opens capital markets establishes more secure private property rights, capital will stay in China. The global markets will test that resolve very quickly.

Co-Chairman WESSEL. If you could make your final points, please.

Mr. DORN. Yes. The benefits from liberalizing China's financial sector are that, China would achieve a more efficient use of capital and attract new investment; the Chinese people would have an important human right, the right to own property protected by law; U.S. firms and investors would have new opportunities for business in China; and China's adoption of a genuine rule of law protecting life, liberty, and property would put China on the road to freedom and dramatically improve U.S.-China relations.

That is why one of China's leading liberal thinkers, Liu Jun'ning, when asked about the future of China, replied: "Whether China will be a constructive partner or an emerging threat will depend, to a very great extent on the fate of liberalism in China: a liberal China will be a constructive partner; a nationalistic and authoritative China will be an emerging threat."

In closing, I would like to reiterate that capital value depends on freedom. By opening markets and standing by our founding principles, the United States can help to promote peace and prosperity in China and at home.

Thus, I recommend that the Commission in its report to Congress stress three things—first, the importance of trade liberalization and capital freedom for improving U.S.-China relations; second, recognize that ultimately, the Chinese people must determine their own political future and that liberal trade policies will help grow civil society and create incentives for political liberalization, as in Taiwan; finally, permit more Chinese students and scholars to study in the United States, especially law, economics, and the humanities. Visa procedures should be reexamined. So long as individuals pose no threat to our national security, they should be encouraged to learn about our free society first-hand.

China is a rising power that the United States must watch closely. Economic liberalization has not yet had a substantial impact on the political regime. But that can change. China's accession to the WTO will accelerate capital freedom and, with it, political freedom. Free trade and privatization can help normalize China and transform it into a modern economy and a civil society under the rule of law. China will then have one country and one system.

The United States must be patient and not lose sight of the long-run benefits of a firm commitment to the principles of market liberalism and capital freedom.

Thank you.

[The statement follows:]

PREPARED STATEMENT OF JAMES A. DORN

Mr. Chairman and Members of the Commission, I commend the Commission for its work thus far and am honored to testify on "China's Capital Requirements and U.S. Capital Markets." Anyone who has been following China since the economic reform movement began in 1978 recognizes the important strides that country has made in moving toward a market economy and reducing abject poverty. But one also recognizes the institutional incompatibility that still exists between remnants of the old central planning system—especially investment planning—and a free-market system based on private property rights and the rule of law.

With China's accession to the World Trade Organization (WTO), liberalization will continue. The pace of liberalization, however, will depend on both internal political forces and external influences, particularly U.S. policy. That is why the work of this Committee is so vital.

In thinking about China's capital markets, one must never lose sight of the fact that the Chinese Communist Party (CCP) seeks to use those markets to "revitalize" state-owned enterprises (SOEs). The real question is whether China can overcome the ideological barrier to large-scale privatization when that institutional change would end communism and the CCP's grip on power.

If China is to become a world-class financial center, it must create real—not pseudo—capital markets in which the state protects private property rights and lets market participants, not government officials, determine the best uses of scarce capital. Until that time, China's socialist capital markets will be inefficient and corrupt casinos in which the Chinese people will squander their hard-earned savings.

The list of questions the Commission has proposed addressing deal primarily with China's current and future capital "needs" or "requirements," whether China can meet those needs, and what role U.S. capital markets can play in that process. Those issues are important, but even more important are the questions of what China needs to do to create real capital markets and what the implications of further financial liberalization under the WTO are for U.S.-China relations.

In the following testimony, I shall

—Discuss China's current capital "needs" with regard to funding explicit and implicit government debt.

—Question the usefulness of the capital-requirements approach when thinking about how to facilitate China's future economic growth.
—Take a property rights or institutional approach to analyze China's financial sector and show that all the major problems China is facing—from the high percentage of nonperforming loans (NPLs) to the large implicit pension debt (IPD)—stem from the dominance of state ownership and the suppression of the private sector.
—Consider the reforms that need to be taken to "normalize" China's capital markets by privatizing them and how such reforms would benefit U.S. capital markets and improve U.S.-China relations.

CHINA'S CURRENT CAPITAL REQUIREMENTS

The Commission poses two major questions with regard to China's capital requirements: (1) How much capital does China need to meet its existing obligations, which stem primarily from the NPLs of the big four state-owned commercial banks and from the large IPD of urban SOEs? (2) How much capital is required "to facilitate future economic growth"? The first question can be answered directly by looking at the existing data; the second question is much more difficult and I will return to it.

Nonperforming Loans

The politicization of investment decisions and the socialization of risk in China under state ownership has led to a massive waste of capital. State-owned banks have lent primarily to SOEs, starving the emerging private sector of capital, and have based their lending decisions on politics, not on sound market criteria. The so-called commercialization of the four major state commercial banks—the Bank of China, the Industrial and Commercial Bank of China, the Construction Bank of China, and the Agriculture Bank of China—is intended to stem the tide of bad loans, but ownership still remains firmly in the hands of the state, and the bad debts keep piling up.

Estimates of the true size of the NPLs vary. The official estimate is that about 25 percent of outstanding loans from the big four state banks are NPLs. Nicholas Lardy of the Brookings Institution has estimated that the cost of bank recapitalization is already at least 40 percent of GDP and may be as high as 75 percent, if international standards are applied. He bases his calculation on the Rmb 270 billion in bonds the government has already issued (in 1998) to increase bank capital; the Rmb 1,400 billion in bonds that the asset management companies (AMCs) have issued (in 1999 and 2000), which have an implicit guarantee by the central government; and the Rmb 2,000 to 5,000 billion in NPLs still on the balance sheets of the big four state banks (Table 1).

TABLE 1.—*The Cost of Bank Recapitalization in China*

Policy Action or Condition	*Cost (Billions of Rmb)*
Government bond issue to increase bank capital, 1998	270
Implicit guarantee of AMC debt, 1999–2000	1,400
NPLs still held by four big state commercial banks	[1] 2,000 to 5,000
Total Cost:	
Rmb (billions)	3,670 to 6,670
US $ (billions)	443 to 806
Percentage of GDP, 2000	40 to 70

[1] The larger figure applies when international accounting practices are used.

SOURCE: Nicholas Lardy, "China's Worsening Debts," *Financial Times*, 22 June 2001, p. 13.

Compounding the NPL problem of the four state commercial banks is the dismal condition of the three policy banks, the loans in the financial system that cannot be recovered, the insolvency of the rural credit cooperatives, and the undercapitalization of many of the trust and investment companies. The World Bank estimates (in its September 27, 2001, *East Asia Brief*) that China's contingent liabilities, or "hidden debt" due to the weak condition of the financial sector, are more than 50 percent of GDP. Moreover, those liabilities continue to grow at a rate of at least 2 percent of GDP per year.

Implicit Pension Debt

The figures stated thus far do not include China's IPD, which the World Bank estimates to be nearly 100 percent of GDP (more than US$1 trillion). That is the

amount of money China would need today to pay off current and future promised benefits. The existing pension system is clearly not sustainable, and that is why China is moving toward a multi-pillar system with a public PAYGO component and a private fully funded component. Some individual accounts have been established, but they are "notional" accounts. Funds allocated to them have already been used to help cover the deficit in the PAYGO pillar, which amounted to Rmb 40 billion (US$4.8 billion) in 2000 and will climb steadily in the future.

China's current pension system covers only urban workers in SOEs. Many of those workers are not receiving their promised pensions. Local governments and the central government are already strapped for revenues and cannot afford to bail out pension funds. Raising payroll taxes from an already high level of 24 percent of wages would serve only to further alienate overtaxed workers and reduce actual taxes collected because of noncompliance. What is required is fundamental reform that will give workers secure property rights to future income.

China's current capital requirements cannot be met within the present system of widespread state ownership. SOEs are parasites that suck the capital out of state-owned banks and waste it on policy-directed investment rather than market-directed investment. Nearly 80 percent of bank lending goes to the state sector, which produces only about 30 percent of industrial output value. If China continues to adhere to market socialism and fails to institute market liberalism, total government debt will continue to grow. Indeed, Lardy estimates that government debt, excluding IPD, could reach 110 percent of GDP by 2008.[1]

HOW MUCH "CAPITAL" DOES CHINA NEED TO FACILITATE ECONOMIC GROWTH?

The question of how much capital is required for China's future economic growth is a difficult one to answer. If one were to ask that question at the level of an individual firm, one could construct a capital budget and project capital needs over time to achieve growth of plant capacity. But one would have to make many assumptions, including that consumers' preferences for the firm's product do not change adversely, that demand grows, and, most important, that there are no unexpected changes in the institutional and policy environment. At the level of the national economy, it is virtually impossible to accurately predict capital needs to fuel future growth. Moreover, such an approach diverts attention from the complex nature of a market economy and the real meaning of capital.

The Market Economy as a Complex System

The market economy is a complex network of trust relations held together by a system of property rights and the rule of law. In contrast to central planning, the market relies on millions of individuals pursuing their own interests to generate a spontaneous order based on freedom of contract and private property rights. Government exists to protect individual rights, including the right to own property and to exchange property rights to increase wealth. Property rights are human rights.

In a market economy, no one plans the total amount of saving and investment. Individuals are free to choose how much to save and to invest, and those individual decisions—not government planning—will determine the rate of capital accumulation and future production and consumption opportunities. The institutional, or property rights, arrangement (including tax and regulatory policies) will shape incentives to save and invest and thereby affect future economic growth. For that reason, I shall focus on China's current institutional arrangement and show that it is the lack of private property rights and the absence of the rule of law that are at the root of China's financial difficulties.

The Meaning of Capital

The concept of capital cannot be understood in an institutional vacuum. Capital is not merely physical assets (e.g., machines and buildings); it is the *net value* of those assets and ideas to consumers as determined in private markets in which individuals have the right to specialize in ownership and risk bearing, are free to buy and sell capital values—so that future expected profits can be capitalized into their present values—and are able to prevent others from violating their rights. Physical and human capital mean little if the institutional infrastructure permits property to be plundered rather than protected.

Hernando de Soto, author of *The Mystery of Capital*, is right when he says, "Capital is that value, that additional value, that comes from things that are duly ti-

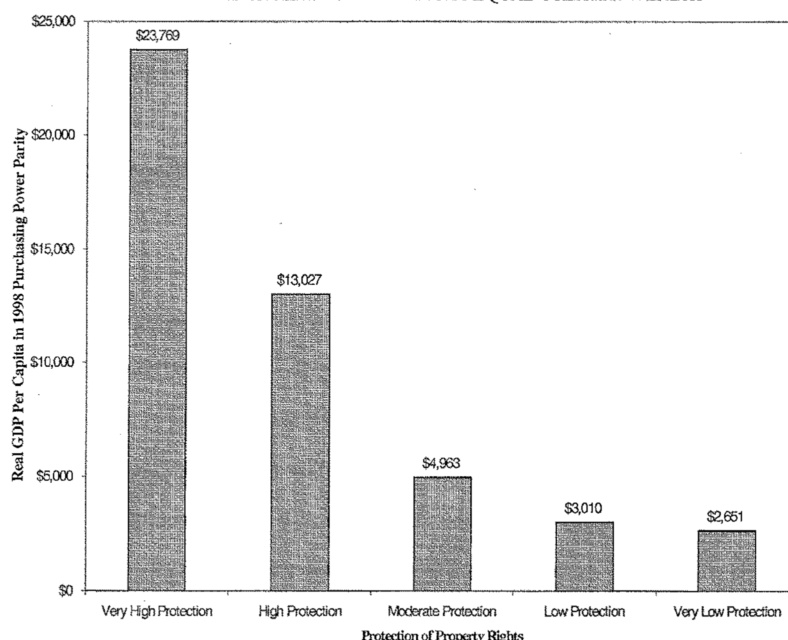
[1] Nicholas Lardy, "Fiscal Sustainability: Between a Rock and a Hard Place," ChinaOnline, 16 June 2000 (*http://www.chinaonline.com*).

tled; . . . capital is also law."[2] Countries are poor when their leaders prevent privatization and fail to abide by the rule of law. Hong Kong is rich because it adheres to the rule of law and has market-supporting institutions, not because it has abundant physical capital.

The more secure rights to future income streams are, the more confidence individuals will have in the future, the more breadth and depth capital markets will have, and the more liquidity will be created. Likewise, any attenuation or weakening of private property rights—including the rights to use, to sell, and to partition property—will mean less trust, less liquidity, and less wealth. Figure 1 shows that nations with stronger private property rights have a much higher average level of real GDP per capita than countries with less secure rights.

FIGURE 1

STRONGER PROPERTY RIGHTS EQUAL GREATER WEALTH



SOURCE: Lee Hoskins and Ana I. Eiras, "Property Rights: The Key to Economic Growth," in *2002 Index of Economic Freedom*, ed. G. P. O'Driscoll, Jr., K. R. Holmes, and M. A. O'Grady (Washington and New York: The Heritage Foundation and the Wall Street Journal, 2002), p. 40.

China's physical capital infrastructure is expanding rapidly, but its institutional infrastructure is still weak. If new value and wealth are to be created, China needs real, not pseudo, capital markets.[3] People must be free to choose their own investments, including foreign investments, and state ownership must give way to widespread privatization if China is to develop world-class financial markets. Injecting more funds into state-owned banks to lend to state-owned enterprises is a recipe for disaster.

CHINA'S PSEUDO CAPITAL MARKETS: THE COSTS OF CAPITAL REPRESSION

China's listing of SOEs on the two major stock exchanges in Shanghai and Shenzhen, as well as listings in Hong Kong, New York, and London, gives the ap-

[2] D. Fettig, "An Interview with Hernando de Soto," *The Region*, 15 June, pp. 23, 26. Published by the Federal Reserve Bank of Minneapolis (*www.minneapolisfed.org*).

[3] See James A. Dorn, "Creating Real Capital Markets in China," *Cato Journal* 21 (Spring/Summer 2001): 65–75 (*http://www.cato.org/pubs/journal/cj21n1/cj21n1.html*).

pearance of a vibrant capital market, but the emperor has no clothes. The listed companies are still controlled by the central and local governments. Those companies have no transparent balance sheets or financial reports that inform individual investors about the true profitability of the underlying assets, and the lack of fully transferable shares means that it is impossible to discern real capital values. The stock markets in China are really casinos to raise funds for struggling SOEs, not efficient capital markets.

The CCP's ideological bias against private free capital markets places a heavy burden on the economy in terms of the value lost to society from the misallocation of scarce capital resources. The repression of the private sector means that the savings of the Chinese people are directed into low-interest deposit accounts at state-owned banks or rural credit cooperatives and then invested in SOEs. The SOEs benefit from the low cost of their funds but have no incentive or flexibility to direct capital to its highest-valued uses. Since local protectionism is rampant in China, capital is held hostage by local politicians and mostly wasted on nonviable projects. That is why returns to investment are so low in China.

The costs of capital repression in China are evident in (1) the stock market bubble, (2) the heavy reliance on foreign direct investment (FDI), and (3) the fact that China is a net exporter of capital. What appear at first as strengths of the Chinese market socialist system are upon reflection serious defects. Let us see why.

The Stock Market Bubble

The extremely high price/earnings ratios (P/Es) on China's domestic stock exchanges—stocks on average are selling at more than 50 times earnings—reflect the low expected earnings of SOEs, not bullishness about the future of those companies. The quality of information about SOEs is poor, and investors rely mostly on gossip to make their "investment" decisions. The 50 million Chinese who gamble in the stock markets do so only because their investment options are so limited. If they could freely invest in foreign markets, their funds would quickly leave China—*unless ownership reform took place*. Placing SOEs in the hands of private owners would transform those companies and redirect capital to more productive uses. Earnings would rise and P/Es would fall to normal levels. Without ownership reform, share prices are bound to fall to bring about more normal P/Es.[4]

The government has been trying to boost share prices by delaying new listings of SOEs, by injecting capital into dying SOEs, and by trying to talk up the markets. But those are stopgap measures and will only worsen the long-term problems. Delaying fundamental ownership reform will make it more difficult to bring about the institutional changes necessary for long-run stability and growth.

Heavy Reliance on Foreign Direct Investment

China is the second largest recipient of FDI in the world. In 2000, FDI in China amounted to nearly $41 billion. But instead of reflecting the strength of the Chinese economy, it reflects an inherent weakness—the inability of private firms to acquire the capital necessary to expand their market share. Private entrepreneurs are not allowed to enter the equity markets to raise capital, and they stand at the end of the line when it comes to bank loans, so they must turn to foreign investors. Those investors acquire the assets of private firms and SOEs through joint ventures. The newly created foreign-funded enterprises (FFEs) increase allocative efficiency when they take over SOE assets, but private domestic firms are not allowed to bid on those assets, so the prices are less than they would be in a competitive open market. Privatization would allow private entrepreneurs to acquire SOEs and to have greater access to the savings of the Chinese people, so more of China's assets would belong to the Chinese people.

Yasheng Huang of the Harvard Business School has emphasized the above points and concluded that, because of the ideological bias against private enterprise:

> There have been huge losers in the Chinese reform process, notably private entrepreneurs who have foregone business growth opportunities [by not being able to raise capital or to acquire SOE assets] and lost control over their businesses [through joint ventures]. . . . These foregone benefits are financially equivalent to actual losses. Thus, the argument for gradual reform is a political one, not an economic one.[5]

[4] See Zhang Dingmin, "Ownership Reform to Deflate Stock Bubbles," *Business Weekly* (Supplement to *China Daily*), 30 October–5 November 2001, p. 15.

[5] Yasheng Huang, "Internal and External Reforms: Experiences and Lessons from China," *Cato Journal* 21 (Spring/Summer 2001): 62 (*http://www.cato.org/pubs/journal/cj21n1/cj21n1.html*). This article is based on his forthcoming book, *Selling China: The Institutional*

Continued

What is needed is to allow private Chinese firms the same rights as foreign firms, but that change will not occur without political reform.

Net Capital Outflows

Although China has attracted large net inflows of FDI, those inflows of private capital have been nearly offset by the outflows of portfolio and other investments (e.g., trade credits and loan repayments). Moreover, when one takes account of China's large accumulation of foreign reserves (now standing at about $193 billion) together with the substantial illegal private capital outflows as seen in the errors and omissions component of the balance of payments (which amounted to nearly $50 billion over the last three years and more than $100 billion from 1991 through 1998),[6] one sees that China's current account surpluses have been financing *net capital outflows*.

In a recent article in the *Cato Journal*, John Greenwood, chief economist at Invesco Asia, Ltd. gives a detailed view of this phenomenon and argues that for a poor country like China, it makes no sense to be a net exporter of capital. Indeed, by holding such large stocks of foreign exchange and using them to acquire foreign assets (e.g., U.S. Treasury securities), China is misallocating capital and denying its citizens the right to earn higher returns overseas. According to Greenwood, "The accumulation of foreign assets by the [Chinese] government in place of the private sector amounts to the backdoor nationalization of what would otherwise have been potentially profitable overseas investments by private individuals and businesses."[7]

The fact that China denies its citizens the right to freely invest abroad or at home provides them with a strong incentive to find higher returns illegally. The lack of capital freedom is a major cause of corruption in China.

It is also true, as Huang points out, that

> foreign exchange reserves are China's claims on dollar assets. When FDI inflows are financing the growth of China's foreign exchange reserves, that amount of FDI is not used productively to develop the Chinese economy. . . . This is surely a strange outcome. The Chinese are striving to give up the ownership of their economy only to use the capital surpluses to invest in low-yielding government bonds in America.[8]

The combination of discrimination against the private sector (as evidenced by China's high dependence on FDI), the ban on full convertibility of the renminbi (which has been maintained by capital controls), and the undervaluation of the renminbi (as evidenced by the large accumulation of foreign reserves) indicates that China cannot get out of its current financial situation without ending its repression of capital and allowing greater capital freedom.

CREATING REAL CAPITAL MARKETS IN CHINA: THE BENEFITS OF CAPITAL FREEDOM

Piecemeal reform has helped China move slowly toward a more open market. China's entry to the WTO will help speed the pace of reform and bring about greater liberalization. Foreign banks will have greater market access, and foreign companies will gain direct distribution rights for the first time. But the real challenge for China will be to allow its own citizens full private property rights, including the right to raise capital in the financial markets, the right to establish fully funded pensions, and the right to full convertibility of the renminbi. Unless there is widespread privatization, China's citizens will remain handicapped in their efforts to improve their lives and futures.

Reform Measures to Increase Capital Freedom

Creating real capital markets in China will require the following measures:

—Removing restrictions on private ownership and on internal and foreign trade;
—Allowing interest rates to be freely set by demand and supply;
—Allowing SOEs to go bankrupt;
—Allowing workers to have private pension accounts that are separately administered by private firms, whether foreign or domestic;

Foundations of Foreign Direct Investment during the Reform Era (New York: Cambridge University Press, 2002).

[6] See Dong Fu, "Beyond the Border: Capital In and Out of China" (*http://www.chinaonline.com*) 4 April 2000, and William Dudley, "The Emperor's New Clothes," in *The 2001 Guide to Foreign Exchange* (London: Euromoney Institutional Investor PLC, 2001), p. 15. Published with the September 2001 issue of *Euromoney*.

[7] John Greenwood, "The Impact of China's WTO Accession on Capital Freedom," *Cato Journal* 21 (Spring/Summer 2001): 92 (*http://www.cato.org/pubs/journal/cj21n1/cj21n1.html*).

[8] Huang, p. 51. He notes that about 40 percent of China's reserves are invested in U.S. Treasury bonds.

—Allowing full convertibility of the renminbi;
—Allowing full transferability of shares in SOEs so that wealth can be maximized by those individuals who wish to specialize in ownership and risk bearing.

Some of those reform measures have already been initiated and will be advanced by China's accession to the WTO; others, such as privatization, need to be pushed much further.

Selling off SOEs to privatize pensions would be a step in the right direction. Private pensions would create new capital that could help China grow in the future. Moving to a fully funded pension system is economically feasible. According to Peking University economist Zhao Yaohui's estimates, the cost of moving to a fully privatized system—the transition costs plus the costs of funding individual accounts—would be 15.8 percent of payroll compared to the current 24 percent.[9] Full privatization is gaining support and may become politically feasible in the near future. But the obstacles are still substantial.

Individuals would have a strong incentive to participate in a fully funded system, whereas they have little incentive to participate in the current PAYGO system. As Zhao notes:

> The best alternative in solving the financial crisis is to give individuals incentives to participate. The best way to give incentives to individuals is to put all pension contributions (from employer and employee) into individual accounts and make sure that the investment earns competitive returns. This gives individuals the property rights to these accounts. Otherwise, individuals would be better off saving and investing the money on their own.[10]

If SOEs were transformed into private companies in which individuals held saleable shares, the stock market would reflect more accurately the present values of the listed companies, and P/Es would come back to normal levels. Chen Mingxing, senior researcher with the State Information Centre, recognizes this fact and has recommended more rapid ownership reform. As the *China Daily's Business Weekly* reported, "Chen said that the government should leave the adjustment of share prices to market forces, but put more effort into establishing a marketplace that is 'just, fair and transparent,' and reforming the ownership systems at the listed companies."[11]

By failing to create real capital markets, China is failing to take advantage of the gains to be had from specializing in ownership and risk bearing. The socialization of risk under the current system of state ownership reduces incentives to innovate and create wealth. The value of Chinese firms is below what it could be if capital were free to flow to its highest-valued uses—and there is no way to discover those uses without competitive markets, which depend on private property rights. That is why China has had to rely so heavily on foreign capital to fuel the growth of the economy.

Benefits of Capital Freedom

Privatizing state-owned banks and allowing interest rates to be set in private capital markets would depoliticize the allocation of bank credit and increase investment returns to the private sector. Allowing both Chinese and foreign investors access to China's capital markets would put China's vast pool of private savings to better use than they are under the current discriminatory system. One of the key lessons from the Asian financial crisis, as Federal Reserve Chairman Alan Greenspan has observed, is that "diversity within the financial sector provides insurance against a financial problem turning into economy-wide distress." Thus, "the difficult ground work for building the necessary financial infrastructure—improved accounting standards, bankruptcy procedures, legal frameworks [to protect property rights] and disclosure—will pay dividends of their own."[12]

Privatizing SOEs and state-owned banks and creating private markets for distressed assets would help China solve its NPL problem. Moreover, as Greenwood, emphasizes:

[9] Zhao Yaohui, "The Feasibility and Benefits of a Fully Funded Pension System," paper presented at the Cato/CCER conference on "China's Pension System: Crisis and Challenge," Beijing, 8 November 2001, p. 3 (forthcoming in the *Cato Journal*).
[10] Ibid., p. 1.
[11] Zhang, p. 15.
[12] Alan Greenspan, "Lessons from the Global Crises," remarks before the World Bank Group and the International Monetary Fund Program of Seminars, Washington, D.C., 27 September 1999, p. 10.

> If China's capital markets and its industries were normalized (through deregulation, proper implementation of the rule of law, the encouragement of private markets, and extensive private ownership), then China's balance of payments would no doubt undergo a major transformation. The balance of payments would witness a switch from current account surplus and capital outflows to current account deficit and capital inflows.[13]

He recommends, as a first step in that direction, "the adoption of a progressively more flexible nominal exchange rate regime." Such liberalization need not create instability provided China continues to liberalize on other fronts and maintains domestic monetary stability. The renminbi would then gradually *appreciate* against the dollar, and the current account would gradually move into a deficit position as exports slowed and imports increased.

The benefits to China and to foreigners from liberalizing the financial sector are great: China would achieve a more efficient use of its capital and attract new investment; the Chinese people would have an important part of their human rights—the right to own property—protected by law; and foreigners would be able to deal with private firms and offer more options to China's savers.

Implications for U.S.-China Relations

Improving capital freedom in China by securing property rights and liberalizing capital markets and capital flows would increase wealth in China and increase the demand for U.S. goods, services, and investment. As China's internal markets expand (because of privatization and liberalization), so will U.S.-China trade. Increasing economic freedom is a win-win strategy—both the United States and China can gain.

As economic ties strengthen between China and the United States, as well as China and other nations, the increase in economic interdependence will help lessen the chance of conflict. Expanding the private sector will help shrink the relative size of the state sector and exert pressure for political liberalization, as has happened in Taiwan.

Empowering China's workers by allowing them to have property rights in their pensions will create a huge positive force in favor of private enterprise and capital freedom, just has happened in Chile.[14] U.S. investment firms and insurance firms would benefit from such a regime change.

China is a rising power that the United States must watch closely. Economic liberalization has not yet had a substantial impact on the political regime. But that can change. China's accession to the WTO will accelerate capital freedom and, with it, political reform. Indeed, leading intellectuals are advocating laws to protect property rights, and one can even read about the importance of property rights in the *China Daily*. For example, that government-backed newspaper recently carried articles that stated:

—What China needs "is a 'rule of law' system to fuel the formation of a freer market, instead of increasing controls."[15]

—"The main purpose of the [new] property rights law is to define and specify rights of possession in China, according to Wang Liming, a professor of civil law at Renmin University. . . . Moreover, it is the basic rule for the regulation of a market economy because the prerequisite for any transaction is the ownership of property and the result of the transaction is the shift of property rights, he added. The lack of basic rules in tangible property rights has hampered the functioning of current legislation such as the Contract Law and the Guarantee Law, Wang said. [The new law] is expected to encourage and stimulate people to create more wealth for society by giving equal protection to property under different ownership."[16]

China's adoption of a genuine rule of law—protecting life, liberty, and property—would benefit both the Chinese people and the United States. That is why one of China's leading liberal thinkers, Liu Junning, when asked about the future of China, replied, "Whether China will be a constructive partner or an emerging threat will depend, to a very great extent, on the fate of liberalism in China: a liberal

[13] Greenwood, p. 93.

[14] For a discussion of the Chilean pension system and its importance for China, see José Piñera, "Empowering People: What China Can Learn from Chile," in *China in the New Millennium: Market Reforms and Social Development*, ed. J.A. Dorn (Washington, D.C.: Cato Institute, 1998).

[15] Zi Xun, "Nobel Theory No Panacea for China," *Business Weekly* (Supplement to *China Daily*), 30 October–5 November 2001, p. 15.

[16] Meng Yan, "Draft Law to Protect Property," *China Daily*, 3 September 2001, p. 1.

China will be a constructive partner; a nationalistic and authoritarian China will be an emerging threat." [17]

CONCLUSION

Private property makes owners responsible for their actions. What China needs is a system of property rights that assigns liability to individuals, not to the state. That means a system of rights that also allows individual owners to benefit from allocating resources where consumers—rather than CCP officials—want them. The main barrier to large-scale privatization in China has been the fear of the rulers that privatization will mean the end of Party rule, and they are right. They hold on to Marxist ideology in the hope that the people will listen, but more and more people are beginning to see the benefits of private property and free trade. The United States can best help the Chinese people gain political freedom by first supporting economic freedom. Isolating China would only further empower the hardliners.

At base, capital value depends on freedom. By opening markets and sharing ideas (e.g., through student and faculty exchanges, conferences, etc.), and standing by our founding principles, the United States can help to promote peace and prosperity in China and at home.

Thus, in closing, I recommend that the Commission in its report to Congress stress the importance of the following for improving U.S.-China relations:

—Continue to liberalize U.S.-China trade relations and hold China to its commitments under the WTO.

—Recognize that ultimately the Chinese people must determine their political future and that liberal trade policies will help grow civil society and create incentives for political liberalization.

—Permit more students to study in the United States, especially law, economics, and the humanities. Visa procedures should be reexamined. So long as individuals pose no threat to our national security, they should be encouraged to learn about our free society firsthand.

Free trade and privatiztion can help normalize China and transform it into a modern economy and a civil society under the rule of law. China will then have one country and one system. The United States must be patient and not lose sight of the long-run benefits of a firm commitment to the principles of market liberalism and capital freedom.

Co-Chairman WESSEL. Thank you. I appreciate it.

Mr. Patterson?

STATEMENT OF WILLIAM B. PATTERSON, DIRECTOR, OFFICE OF INVESTMENT, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS (AFL–CIO)

Mr. PATTERSON. Thank you, Mr. Chairman, members of the Commission. I want to thank you for the opportunity to speak to you today.

As members of the Commission are aware, the AFL–CIO is a federation of trade unions that represents 13 million men and women and their families. In addition to the direct contribution that they make to the American economy at work, our members also participate in the global capital markets as investors through defined benefit and defined contribution plans as well as through mutual funds and individual accounts.

The AFL–CIO has become particularly concerned by recent efforts by Wall Street investment banks and international financial institutions such as the World Bank to structure transactions that tap into our members' retirement assets in order to aid regimes around the world that violate fundamental human rights, core labor standards, and basic principles of effective corporate governance.

[17] Liu Junning, "The Intellectual Turn: The Emergence of Liberalism in Contemporary China," in *China's Future: Constructive Partner or Emerging Threat?* ed. T.G. Carpenter and J.A. Dorn (Washington, D.C.: Cato Institute, 2000), p. 60.

We believe that the traditional approaches to valuation used by Wall Street and a narrow approach to disclosure of information to investors mandated by our existing securities law regime reinforces the creation of such transactions and makes it all but impossible for our members, the beneficiaries of these funds, to understand how their retirement assets are being invested.

Further, we think there is a direct link between, on the one hand, the encouragement of the investment climate that promotes human rights, labor standards, and strong corporate governance, and on the other hand, the creation of long-term economic value and political stability.

Thus, it is our view that this Commission is well-situated to make a significant contribution to the development of policies toward the financial markets that genuinely enhance America's sense of security and stability in its relationship with the People's Republic of China.

The AFL–CIO became keenly aware of the complexity of America's relationship with China during its role in the campaign that our Federation became involved in last year against the initial public offering of the common stock on the New York Stock Exchange by PetroChina, a subsidiary of one of China's two leading state-owned oil companies. At the request of many of our members and beneficiaries who serve as trustees of large pension funds, the AFL–CIO examined this transaction in great deal and we discovered that the structure of the transaction, put together in a joint program involving the Chinese Government, the World Bank, and major U.S. financial banks, consulting firms and law firms, was the kind of model that is being replicated in many countries around the world. Far from creating a level playing field that encourages stable and constructive forms of competition and economic growth, the strategy is an attempt to privatize only a small part of large state-run industry in order to tape into the global financial markets while retaining control safely in the hands of the government—and in the case of China, the Communist Party insiders.

With billions of other people's money safely in their hands, the Chinese regime planned to lay off nearly a million workers at the parent company of PetroChina and turn PetroChina into a Korean-style chaebol, a government-backed near-monopoly built to compete with the international oil industry.

In our economy and that of both Western Europe and genuine emerging market democracies such as South Africa, Brazil, and South Korea, there are a series of checks and balances in place to ensure that major financial decisions are not taken without some examination and consideration of their real costs.

Inside the workplace, workers and employers can if they choose engage in collective bargaining about basic wages, hours, and working conditions. Although we believe there is much that can be done to improve the ability of workers to organize, democracies do at least provide a general climate of support for free speech and free association. This encourages workers to express their interests and make their voices heard. Employers are not in theory free to arbitrarily alter workers' lives.

Similarly, in the financial markets, investors rely on boards of directors with legally protected oversight powers, securities law re-

gimes that mandate the disclosure of material information necessary to make reasonable investment decisions and a variety of legally-established mechanisms for management accountability.

While we advocate reforms to this institutional framework, in general, it too provides a kind of check on arbitrary power by corporate insiders.

But these basic democratic institutions, these checks and balances on arbitrary power, are sorely lacking in China. The unfortunate tendency to centralize power in the hands of a few in our Wall Street-driven economy is magnified enormously in an environment like that found in China where an authoritarian government remains in the hands of the Chinese Communist Party.

As you have heard from previous testimony from AFL–CIO Secretary-Treasurer Trumka and United Steelworkers President Leo Gerard, there are no real trade unions in China, there is no collective bargaining, there is no right to strike, and there is no effective guarantee of freedom of association or free speech.

As China has proceeded in the last decade with a kind of muted shock therapy—restructuring its state-owned enterprises by laying off millions of workers—it has triggered what one researcher has called "a labor insurgency," with thousands of wildcat strikes, demonstrations, and protests across China each year.

The absence of democratic institutions like collective bargaining has forced workers to take desperate action, sometimes risking their own lives just to make their voices heard. We believe the so-called reform process contributes to the insecurity inside China and to the unstable and unpredictable relationship between China and the rest of the world.

A similar kind of problem exists in the financial markets. None of the three basic protection devices for outside investors are present. At PetroChina, for example, in a pattern that repeats itself at most companies that have attempted to raise funds on the international financial markets, there are only three outsiders on the board of 13. One of these three and all ten of the inside directors are members of the Chinese Communist Party. A second outsider is a senior figure in Hong Kong and considered friendly to Beijing. So there is no clear voice for shareholders inside the company.

There is, of course, no real accountability for management, either. PetroChina remains majority-owned by the state-owned China National Petroleum Corporation. China lacks a strong independent regulatory agency like the U.S. Securities and Exchange Commission. In sum, investors who buy shares in companies like PetroChina have no idea how their money is being used, and they have almost no legal recourse either to monitor or change corporate behavior.

In case it is not yet clear, let me point out that we believe there is a link between the checks and balances that investors count on in the United States and the existence of basic human rights and labor standards. The right to free speech and the freedom of association cannot be said to exist in any meaningful way if they are denied to workers inside their own workplace. And where they do exist, they reinforce the existence of freedom in general social and political life. Without these rights, investors would be unable to

voice their interests inside the financial markets or corporate board rooms. For example, the basic provision of financial information to investors began as a task of financial journalists in the early 19th century evolving over time to our present system of securities regulation, both here and in the United Kingdom. Today, a free and independent press continues to serve as a valuable source of insight and information for basic financial decisions by Wall Street and corporate America.

It is in this spirit that we welcome the initiative described by the United States Securities and Exchange Commission in a recent letter to Congressman Frank Wolf. In that letter, the SEC's then Acting Chairman, Laura Unger, noted that the SEC was now "sensitized" to issues involving human rights and capital markets. She stated that the Commission would be "looking for creative ways to enhance investors' access to material information" about issuers who have access to U.S. capital markets and have investments in countries like Sudan, where PetroChina's parent company has had significant operations, and the impact of such investments on human rights.

We believe that this approach is entirely consistent with existing standards under our securities laws. It is particularly important now because of the effort by some foreign issuers to access U.S. investor capital through our domestic stock exchanges that they would otherwise not be able to attract in their own national exchanges precisely because of inadequate provisions for investors.

These foreign issuers are, with the assistance of leading investment banks, engaging in a kind of regulatory arbitrage, relying, we think, on the inability of American investors to expend the resources necessary to engage in adequate due diligence of issuers located halfway around the globe.

We believe that then Acting Chairman Unger properly targeted the concept of materiality in her letter. As should be clear from our assessment of the PetroChina experience, appropriate disclosure to investors about an issuer's human rights record, respect for core labor standards, and corporate governance goes to the heart of value creation at a company and is thus clearly material to investors.

More broadly, attention to such issuers in the disclosure regime highlights the need to ensure that our financial markets are not left unchecked and thus free to channel the retirement assets of working Americans into environments like currently found in the People's Republic of China that undermine our security and contribute to the deterioration of basic values that we consider central to stable and constructive economic growth.

Co-Chairman WESSEL. If you could finish up, we'll put the remainder of your statement in the record for the rest of the Commission as well.

Mr. PATTERSON. Very good. I actually wanted to set the stage for my co-panelist, Michael Flaherman, whose fund, CalPERS, has provided an excellent example of an investment policy that will require active management of its emerging equity markets. This policy will require managers hired by CalPERS to include in their investment decisions criteria that include human rights and core labor standards. I am sure Michael will describe this further. This

is a policy that is being looked at by a number of public employee pension funds in an effort to try to identify risk and set standards and new approaches to emerging markets.

If countries like China shape their legal regimes and corporate structures to provide investors with reliable information, we believe they have a welcome place in America's capital markets. But absent such a commitment—and in our view, such a commitment has indeed been absent in the case of China—we believe that U.S. regulators much engage in heightened scrutiny of disclosure interest in any attempt to market financial instruments from such countries to American investors.

Thank you.

[The statement follows:]

PREPARED STATEMENT OF WILLIAM B. PATTERSON

Mr. Chairman, members of the Commission, I thank you for the opportunity to speak to you today. As the members of the Commission are aware, the AFL–CIO is a federation of trade unions that represent 13 million working men and women and their families. In addition to the direct contribution that they make to the American economy at work, our members also participate in the global capital markets as investors through defined benefit and defined contribution plans as well as through mutual funds and individual accounts. Our member unions sponsor benefit plans with over $400 billion in assets, and our members are participants in public employee and collectively bargained single-employer plans with over $5 trillion in assets. Nearly $800 billion of these assets are invested outside the United States. The largest 1,000 public sector defined benefit funds invested, on average, 15.7 percent of their assets internationally at the end of 2000, and the average Taft-Hartley portfolio invested 5.3 percent in international assets. To give one example, the California Public Employees Retirement System, or CalPERS, with more than 1.2 million members, currently has nearly $31 billion invested in international equity and fixed income instruments, out of a total portfolio valued at nearly $144 billion.

The AFL–CIO has become particularly concerned by recent efforts by Wall Street investment banks and international financial institutions, such as the World Bank, to structure transactions that tap into our members' retirement assets in order to aid regimes around the world that violate fundamental human rights, core labor standards and basic principles of effective corporate governance. We believe that the traditional approaches to valuation used by Wall Street and a narrow approach to disclosure of information to investors mandated by our existing securities law regime reinforces the creation of such transactions and makes it all but impossible for our members, the beneficiaries of these funds, to understand how their retirement assets are being invested. Further, we think that there is a direct link between, on the one hand, the encouragement of an investment climate that promotes human rights, labor standards and strong corporate governance, and, on the other, the creation of long-term economic value and political stability. Thus, it is our view that this Commission is well situated to make a significant contribution to the development of policies towards the financial markets that genuinely enhance Americans' sense of security and stability in its relationship with the People's Republic of China.

The AFL–CIO became intimately aware of the complexity of America's relationship with China during its role in the campaign last year against the initial public offering of common stock on the New York Stock Exchange by PetroChina, a subsidiary of one of China's two leading state-owned oil companies. At the request of many of our members who serve as trustees on large pension funds, the AFL–CIO examined this transaction in great detail. We discovered that the structure of the transaction—put together in a joint program involving the Chinese government, the World Bank and major U.S. investment banks, consulting firms and law firms—was a kind of model that is being replicated by many countries around the world. Far from creating a level playing field that encourages stable and constructive forms of competition and economic growth, this strategy is an attempt to privatize only a small part of a large state-run industry in order to tap into the global financial markets while retaining control safely in the hands of government—and in the case of China—Communist Party insiders. With billions of other people's money safely in their hands, the Chinese regime planned to lay off nearly a million workers at the

parent of PetroChina and to turn PetroChina into a Korean-style chaebol—a government backed near monopoly built to compete with the international oil industry.

In our economy and in that of both Western Europe and genuine emerging market democracies such as South Africa, Brazil and South Korea, there are a series of checks and balances in place that ensure that major financial decisions are not taken without some examination and consideration of their real total costs. Inside the workplace, workers and employers can, if they so choose, engage in collective bargaining about basic wages, hours and working conditions. Although we believe that much can be done to improve the ability of workers to organize, democracies do at least provide a general climate of support for free speech and freedom of association. This encourages workers to express their interests and make their voices heard. Employers are not, in theory, free to arbitrarily alter workers' lives. Similarly, in the financial markets, investors can generally rely on boards of directors with legally protected oversight powers, securities law regimes that mandate the disclosure of material information necessary to make reasonable investment decisions and a variety of legally established mechanisms for management accountability. While we advocate reforms to this institutional framework, in general it, too, provides a kind of check on arbitrary power by corporate insiders.

But these basic democratic institutions, these checks and balances on arbitrary power, are sorely lacking in China. The unfortunate tendency to centralize power in the hands of a few in our Wall Street driven economy, is magnified significantly in an environment like that found in China, where an authoritarian government remains in the hands of the Chinese Communist Party. As you have heard from AFL–CIO Secretary-Treasurer Trumka and United Steelworkers of America President Leo Gerard, there are no real trade unions in China, there is no collective bargaining, there is no right to strike, and there is no effective guarantee of the freedom of association or free speech. As China has proceeded in the last decade with a kind of muted shock therapy—restructuring its state owned enterprises and laying off millions of workers—it has triggered what one researcher has called a "labor insurgency" with thousands of wildcat strikes, demonstrations and protests across China each year. The absence of democratic institutions like collective bargaining has forced workers to take desperate action, sometimes risking their own lives, just to make their voices heard. We believe this so-called reform process contributes to insecurity inside China and to an unstable and unpredictable relationship between China and the rest of the world.

A similar kind of problem exists in the financial markets. None of the three basic protection devices for outside investors are present. At PetroChina, for example, in a pattern that repeats itself at most of the companies that have attempted to raise funds on the international financial markets, there are only three outsiders on a board of thirteen. One of these three and all ten of the inside directors are members of the Chinese Communist Party. A second outsider is a senior figure in Hong Kong and considered friendly to Beijing. So there is no clear voice for shareholders inside the Company. There is, of course, no real accountability for management, either. PetroChina remains majority owned by the state-owned China National Petroleum Corporation. And China lacks a strong independent regulatory agency like the U.S. Securities and Exchange Commission, or SEC. In sum, investors who buy shares in companies like PetroChina have no idea how their money is being used and they have almost no legal recourse to either monitor or change corporate behavior.

In case it is not yet clear, let me point out that we believe there is a link between the checks and balances that investors count on in the United States and the existence of basic human rights and labor standards. The right to free speech and the freedom of association cannot be said to exist in any meaningful way if they are denied to workers inside their own workplace. And where they do exist they reinforce the existence of freedom in general social and political life. Without these rights, investors would be unable to voice their interests inside the financial markets or corporate boardrooms. For example, the basic provision of financial information to investors began as a task of financial journalists in the early 19th century evolving over time into our present system of securities regulation, both here and in the United Kingdom. Today, a free and independent press continues to serve as a valuable source of insight and information on basic financial decisions by Wall Street and corporate America.

It is in this spirit that we welcome the initiative described by the U.S. Securities and Exchange Commission in its recent letter to Congressman Frank Wolff. In this letter, the SEC's then Acting Chairman, Laura Unger, noted that the SEC was now "sensitized" to issues involving human rights and the capital markets. She stated that the Commission would be "looking for creative ways to enhance investors' access to material information" about issuers who access the U.S. capital markets and have investments in countries like the Sudan—where PetroChina's parent company

had significant operations—and the impact of such investments on human rights. We believe that this approach is entirely consistent with existing standards under our securities laws. It is particularly important now because of the effort by some foreign issuers to access U.S. investor capital through our domestic stock exchanges that they would otherwise not be able to attract to their own national exchanges precisely because of inadequate protections for investors. These foreign issuers are, with the assistance of leading investment banks, engaging in a kind of regulatory arbitrage—relying, we think, on the inability of American investors to expend the resources necessary to engage in adequate due diligence of issuers located halfway around the globe.

We believe that then Acting Chairman Unger properly targeted the concept of "materiality" in her letter. As should be clear from our assessment of the PetroChina experience, appropriate disclosure to investors about an issuer's human rights record, respect for core labor standards and corporate governance goes to the heart of value creation at a company and thus is clearly material to investors. More broadly, attention to such issues in the disclosure regime highlights the need to insure that our financial markets are not left unchecked and thus free to channel the retirement assets of working Americans into environments—like that currently found in the People's Republic of China—that could undermine our security and contribute to a deterioration of the basic values we consider central to stable and constructive economic growth.

We do not believe that this is simply a matter for government regulation; however, and thus we support initiatives to expand the investment criteria that are traditionally relied upon by fund managers in making investment decisions, particularly in emerging market countries. For example, last year, the board of trustees of CalPERS, the nation's largest pension fund, established a policy that will require active management of its emerging market equity investments. This policy will require fund managers hired by CalPERS to include in their investment decisions criteria that include human rights, core labor standards, and effective corporate governance. A similar policy is also now in place at the New York City Employees' Retirement System.

The success of the American economy is due in large part to the shared role that all stakeholders, including investors, managers, workers and the surrounding community, play in creating lasting and stable economic organizations. Major investors now are demanding information about the state of these relationships in the countries and companies they invest in the global capital markets.

If countries like China shape their legal regimes and corporate structures to provide investors reliable information, then we believe they have a welcome place in America's capital markets. But absent such a commitment—and in our view such a commitment has, indeed, been absent in the case of China—we believe that U.S. regulators must engage in heightened scrutiny of the disclosure interest in any attempt to market financial instruments from such countries to American investors.

Thank you for this opportunity to present the views of the AFL–CIO on this important issue. I look forward to your questions and comments.

Co-Chairman WESSEL. Thank you. I appreciate it.

Mr. Flaherman?

STATEMENT OF MICHAEL FLAHERMAN, CHAIR, INVESTMENT COMMITTEE, CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

Mr. FLAHERMAN. Thank you.

Good afternoon, ladies and gentlemen of the Commission. I am going to make a very brief statement today, a statement which, when I showed it to my good friend Bill Patterson here, he said it constitutes little more than clearing one's throat in Washington, but I want to make myself available, of course, for your questions.

I am a member of the Board of the California Public Employees' Retirement System, CalPERS, where I chair the Investment Committee of the Board.

CalPERS has $24.2 billion of its $143.7 billion portfolio held in non-U.S. equities and $6.7 billion held in non-U.S. fixed-income investments. Of our domestic equities, about 85 percent are held in

a passive portfolio, an index of securities, while the remainder is actively managed by outside investment advisors.

In our non-U.S. equity portfolio, 65 percent is indexed and 35 percent is actively managed.

In the purchase of non-U.S. equities, we consider several important things including the existence of U.S.-legislated sanctions or embargo programs of the U.S. Treasury Department. Sanctioned countries, as you well know, including Libya, Iran, Iraq, Sudan, Afghanistan, Cuba, North Korea, Burma, Angola, Sierra Leone, the Federal Republic of Yugoslavia which consists of Serbia and Montenegro, and Syria.

We also recognize and adhere to the existence of foreign investment restrictions placed on financial institutions by the U.S. State Department.

CalPERS strongly believes that U.S. citizens need more and better information with regard to foreign investing. We support the work of this Commission as far as it has gone to date.

Some have expressed concern that certain investments in China amount to national security risks. It is significant, however, to note that our national policy actually encourages investment in China. I would point to several things, including that Congress overwhelmingly approved Permanent Normal Trade Relations with China, as well as the fact that our government has supported membership for China in the World Trade Organization. I would also point out that many products purchased by Americans are made in China and that the United States Government maintains full diplomatic relations with China.

Despite all this, public pension funds have been criticized for certain China-related investments, with some critics charging that the companies in which the funds are investing are fronts for the Chinese military. Mutual funds, representing millions of Americans, have invested vastly greater sums in these same companies.

I am here today to say to you that we need the Federal Government to identify companies that pose national security risks. Our national government can screen for questionable activities or ownership of any foreign-based companies that intend to enter domestic or foreign-based capital markets. It is the Federal Government that is in the best position to review and monitor the offering of securities by a foreign government or its surrogates. And only the Federal Government has the authority as well as the Constitutional obligation to restrict U.S. nationals and entities from doing business with or investing in a foreign company if it would pose a threat to national security.

Entities that are deemed by our Government to pose national security risks should be denied access to capital from the United States through not just domestic but also foreign markets.

Accordingly, we encourage this Commission to broaden its scope and to consider the activities of U.S. nationals in world markets.

Thank you.

[The statement follows:]

PREPARED STATEMENT OF MICHAEL FLAHERMAN

Chairmen Robinson and Wessel, I am Michael Flaherman. I am a member of the Board of Administration of the California Public Employees' Retirement System and the Chairman of its Investment Committee.

CalPERS has $24.2 billion of its $143.7 billion in holdings in non-U.S. companies and $6.7 billion is invested in non-U.S. fixed income investments.

Of our domestic equities, about 85 percent are in a passive portfolio, an index of securities, and the remainder are actively managed by investment advisors.

Of our non-U.S. equities, 65 percent are in indexes and 35 percent are actively managed. In purchasing non-U.S. equities, we consider:

—The existence of U.S. legislative sanctions or embargo programs of the U.S. Treasury Department. Sanctioned countries include Libya, Iran, Iraq, Sudan, Afghanistan, Cuba, North Korea, Burma, Angola, Sierra Leone, the Federal Republic of Yugoslavia (Serbia and Montenegro), and Syria.

—The existence of foreign investment restrictions placed on financial institutions by the U.S. State Department.

CalPERS believes U.S. citizens need more and better information with regard to foreign investing. We support the work of this Commission as far as it has gone.

Some have expressed concern that certain investments in China amount to national security risks. It is significant to note, however, that our national policy actually encourages investments in China.

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—Our government has supported membership for China in the World Trade Organization.

—Many products purchased by American consumers are made in China, and

—We maintain full diplomatic relations with China.

Despite all this, public pension funds have been criticized for certain China-related investments, with some critics charging that the companies in which the funds are investing are fronts for the Chinese military. Mutual funds, representing millions of Americans, have invested even greater sums in such companies.

We need the Federal government to identify companies that pose security risks.

Our national government can screen for questionable activities or ownership of any foreign-based company that intends to enter domestic or foreign capital markets.

It is in the best position to review and monitor the offering of securities by a foreign government or its surrogates.

And only the Federal government has the authority—and the constitutional obligation—to restrict United States nationals and entities from doing business with or investing in a foreign company if it would pose a threat to national security.

Entities that are deemed by our government to pose national security risks should be denied access to capital from the United States through not just domestic but also foreign markets.

Accordingly, we encourage this Commission to broaden its scope to consider the activities of U.S. nationals in world markets.

Co-Chairman WESSEL. Thank you.

Representative Nickol, please.

STATEMENT OF STEVEN R. NICKOL, REPRESENTATIVE, PENNSYLVANIA HOUSE OF REPRESENTATIVES

Mr. NICKOL. Thank you.

The last several weeks have been among the more difficult for me as a legislative member of the board of the Pennsylvania Public School Employees' Retirement Fund, PSERS. With little warning, I suddenly found myself in the crosshairs of fellow legislators searching for some way to join in the war against terrorism.

Public opinion polling has moved terrorism and public safety to the top of most voters' list of concerns. So it correspondingly moved quickly to the top of the list for the leadership of the Pennsylvania House of Representatives. They decided to hold Terrorism Week, and among the measures introduced were two hastily-drafted proposals to force Pennsylvania's State pension funds, PSERS and SERS, the State employees' retirement system, to divest of all assets in companies doing business in or with the seven countries that the U.S. State Department lists as sponsors of terrorism.

There are varying levels of sanctions involving trade with these countries, ranging from very strong against Iraq to few if any against Syria. And even where sanctions are strong, exceptions are granted.

The legislation would have established a "go it alone" Pennsylvania foreign policy. In the name of fighting terrorism, PSERS would have had to divest of holdings in many major U.S. and foreign companies operating in full compliance with Federal law. Indeed, whole market sectors like pharmaceuticals would have been wiped off the books of our pension funds.

When I first shared these concerns with my fellow legislators, they took turns hammering me as being soft on terrorism. One member actually quoted from former Soviet Leader Kruschev as to capitalists being willing to sell the rope to hang themselves, and later suggested that I was a communist for being the only committee member to vote no on the legislation. Although I may have been incorrectly disparaged as the communist in that comparison, I think you get the point as to the passions of the day.

By the end of the week, we were able to get a fiscal note showing that PSERS would have to divest of an estimated $3.4 billion in holdings, or 7.84 percent of total fund assets. The negative impact on fund performance was estimated in the range of minus 41 to minus 72 basis points, reducing the projected rate of return and generating an annual increase in employer contributions estimated in the range of $471.5 million to $810 million a year.

Soon, the House leadership had me working on amendments to tame the impact of these bills. They now only require our State pension funds to divest of assets in companies specifically listed by the Federal Government as violating sanctions. This will have a de minimis impact on our State pension funds.

Investments in China were not directly at stake, but I believe there are some relevant lessons. PSERS has allocated 62 percent of our core assets to equities, including 20 percent to non-U.S. equity. Our fixed income allocation is 25 percent, including a special 5 percent global fixed income allocation, and there is also international exposure in real estate and private equity, but not significant as a percentage of total fund assets.

The market value of PSERS non-U.S. equity assets is about $7 billion, and global fixed income, $2.3 billion.

In addition, we have five global asset allocation mangers, each with about $1 billion, who are able to move money outside our core allocations between asset categories, both domestic and foreign.

PSERS' total China exposure is about $257 million, or a little more than one-half of one percent of our total $45.4 billion in investments.

Our sister fund, SERS, is about half the size of PSERS. It has proportionately greater exposure to China, with $284 million in holdings, or a little more than one percent of the fund total.

Despite my earlier story on terrorist-related investments, Pennsylvania has generally resisted using nonfinancial criteria for investing. There have been a few exceptions. We are required by law to follow the McBride principles in investing in companies doing business in Northern Ireland. At the board level, SERS has steadfastly avoided applying nonfinancial criteria. PSERS meanwhile

did adopt restrictions on investments in South Africa and froze new tobacco-related investments.

Allow me to share several observations. One, the citizens of the Commonwealth of Pennsylvania, the members of the Pennsylvania General Assembly, and the Trustees of our two State pension funds are all willing to coordinate our pension fund investment practices to reflect national security concerns, especially following September 11.

Two, neither the Pennsylvania General Assembly nor the State Pension Board has the ability on its own to determine what investments are of national security concern. This is especially the case when some countries are one day our enemy and the next day cooperating with the U.S. interests in a place like Afghanistan. Individual States and pension boards taking unilateral action could, despite the best of intentions, actually do harm to U.S. interests.

Most international investments are made through money managers and not the pension boards themselves. We are not familiar with the individual companies let alone any undisclosed affiliated interest they might have. Pension funds cannot and should not be expected to set foreign policy.

Three, concerted action by public pension funds and other Government-related or controlled investments could be useful tools in putting pressure on domestic and international companies and the countries in which they do business. However, the Federal Government would need to take the lead in identifying investments we should avoid.

China is the most populous nation on the face of this earth, rich in natural resources and human talent. Its development opens the possibility of earning tremendous investment returns that could accrue to the benefit of members of our retirement systems and taxpayers alike.

The vast majority of PSERS' investment in China is made through Hong Kong. Only $18.4 million of the $257 million we have invested in China did not go through Hong Kong. This is because Hong Kong offers a sophisticated exchange, rule of law, and a transparent legal system. If similar standards are adopted in the rest of China, it would open China to higher levels of investment.

Despite the great potential, a number of board members remain concerned about the political risk of investing in China. The Chinese Government reportedly provides military aid and support to our enemies. This provides a security threat to our Nation and a political risk to any pension fund that invests in China.

One misstep by China in aiding the wrong enemies, with a high-profile outcome where Americans are killed, and the public pressure would come for funds like ours to drop our investments.

This overhanging uncertainty in relations with China does cause some board members to ask international money managers about exposure to China. Concern is evident, although I can't recall anyone yet rejected on this point. But I do perceive there are unspoken limits by many board members—we just haven't reached them yet.

We want to invest in China; we just don't want to find ourselves hanging with the consequences if some national security crisis impacts negatively on our fund's performance.

Thank you for allowing me to share my views.

[The statement follows:]

PREPARED STATEMENT OF STEVEN R. NICKOL

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Observations

Allow me to share several observations:

(1) The citizens of the Commonwealth of Pennsylvania, the members of the Pennsylvania General Assembly, and the Trustees of our two State pension funds are all willing to coordinate our pension fund investment practices to reflect national security concerns, especially following September 11th.

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We want to invest in China. We just don't want to find ourselves hanging with the consequences if some national security crisis impacts negatively on our fund's performance.

Thank you for allowing me to share my views.

Co-Chairman WESSEL. I appreciate your testimony and that of all the panelists, and we will clearly put your testimony in the record.

PANEL III DISCUSSION AND QUESTIONS AND ANSWERS

Commissioner Reinsch has the first question.

Commissioner REINSCH. Thank you, Mr. Chairman. I apologize for being in and out, but the House is voting on trade promotion authority, which is of intense interest to some of us, so I have been ducking out to see how it's going.

For Mr. Flaherman and Mr. Nickol, I gather, but I want you to affirm for the record, from your testimony that you don't believe that States should have their own foreign policies; is that right?

Mr. FLAHERMAN. I would say that it is my understanding under our federalist system of government that States may not have their own foreign policies.

Mr. NICKOL. That correctly sums up my views.

Commissioner REINSCH. Good; I'm glad to hear that.

Mr. Nickol, I had the opportunity to read summaries of the way the two bills that you mentioned read prior to the amendments that you described in your testimony, and I confess that from the summary, I couldn't tell everything that I wanted to know about them.

I guess my question is are you familiar with the Supreme Court decision last year in Crosby v. NFTC, which had to do with the Massachusetts Burma sanctions?

Mr. FLAHERMAN. No, I am not.

Commissioner REINSCH. I wonder if perhaps you might help us out and ask your staff or the relevant attorneys in the Pennsylvania legislature to examine the bill in light of that decision and let us know if they think the bill as amended, or as reconfigured, is consistent with the Supreme Court decision or not? Frankly, that is self-serving, because if it isn't, I'm going to have to sue you, and you can save us some time. But I hope you'll take a look at that, and I hope you'll encourage your fellow legislators to keep that case in mind when they draft additional decisions. It was a narrow decision, but it was unanimous.

Co-Chairman WESSEL. You mean the NFTC and not the Commission, I assume.

Commissioner REINSCH. Yes, I do.

Commissioner DREYER. What do you mean by a narrow decision that was unanimous?

Commissioner REINSCH. It was not a broad decision about all such statutes; it related solely to the one that was in question, but others can be measured against it.

Anyway, if you could take a look and let this Commission know what your lawyers, think, I would be very grateful.

Mr. NICKOL. I'd be glad to.

Commissioner REINSCH. Mr. Patterson, I am curious about something, and it's sort of personal, and I don't want to pry. I assume you are in the AFL–CIO's retirement program, retirement system, whatever it is.

Mr. PATTERSON. Yes, sir.

Commissioner REINSCH. Good. I am in mine, so I guess we all do that.

Do you know where your funds are invested?

Mr. PATTERSON. Yes, we do.

Commissioner REINSCH. Where?

Mr. PATTERSON. Ninety-five percent of them are in the United States, and 5 percent are invested abroad.

The underpinning of the investment strategy of the fund is the S & P 500 Index. Indexing has been a good cornerstone, and there is significant global exposure through——

Commissioner REINSCH. Sort of like CalPERS. Have you given your managers instructions with the respect to the other 5 percent with respect to socially responsible investments?

Mr. PATTERSON. Indeed, we have. We have guidelines which underscore shareholder rights, transparency, core labor standards, and political stability in international investing.

Commissioner REINSCH. Good. Then, to go back to one of Commissioner Becker's questions before, that seems to be a responsible approach and certainly one that is appropriate for the members of that program. Do you favor that as a government mandate, or do you think it is better for the funds themselves or the retirees themselves to set their own standards for their own funds?

Mr. PATTERSON. I think the first line of defense here for protecting investment value are the funds themselves and fund standards. So we have spent a huge effort trying to encourage funds to adopt investment standards that are given to managers. Pension funds do not make direct investments. They hire managers to do that and delegate their fiduciary duties. But their duty is to monitor the investments of their managers and make sure that they are generating value using those guidelines, and we think that's a good approach.

I do think—and I think it is the position of the AFL–CIO—that there are cases where investments should be barred by the government. This is a last resort, but in countries with overt slave labor—Burma, the Sudan—these are cases that are inappropriate for investment.

In China, we have approached investment on a case-by-case basis. We felt the PetroChina offering was clearly inappropriate but argued through the capital markets against the inappropriateness of this market.

We developed a financial critique which we shared with investors through the internet and argued against the investment.

Commissioner REINSCH. Thank you. This is interesting. If I could have one follow-up, Mr. Chairman—Mr. Flaherman, assuming, of course, that CalPERS would do what the government told it to do, and certainly wants to, do you think it is better for the government to identify a list of bad people or bad places or bad countries and then leave it to managers to make the judgment as to whether they want to participate in that or not, invest in those destinations or not; or do you think it is better for the government simply to prohibit that kind of investment?

Mr. FLAHERMAN. I think it would go to the question of what you mean by "bad."

Commissioner REINSCH. That's what we're wrestling with.

Mr. FLAHERMAN. I think "bad" in the sense of posing national security threats to the United States represents a core responsibility of the Federal Government and that the Federal Government should prohibit those investments.

I also would agree with Mr. Patterson that there are also kinds of activities that do not bear on national security, but things like slave labor, that are so noxious that they become a foreign policy issue for the United States. I think the existence of slave labor as a sanctioned activity in a country is intrinsically a foreign policy

issue for the United States, so that would also rise to the level of something that should be prohibited by the Federal Government.

I think that for many other modes of behavior by companies or countries, it is important to preserve decisionmaking at the individual investor level. My argument here is that those distinctions that one would draw are subjective intrinsically and that only the process of experimentation that occurs continuously by individual decision makers trying to find the right answer is most likely to produce an optimal result both financially, but also in terms of most enlightened in terms of shunning the bad and promoting the good.

Commissioner REINSCH. Suppose the government told CalPERS that China was a national security threat and prohibited all investment in Chinese entities?

Mr. FLAHERMAN. Then, we would not invest in any Chinese entities.

Commissioner REINSCH. Right. But how would you feel about that? Do you think that would be an appropriate judgment?

Mr. FLAHERMAN. I am not a national security expert, and I would respect the decision of the Federal Government. You know, I sit here as a representative of the State of California right now, and I find it troubling at times when the Federal Government tries to tell the State of California or local jurisdictions in California how to do things that I think are intrinsically a State or local responsibility, and I think that even though Members of Congress may believe they know better and have a strong personal feeling, they need to respect people who are in a better position to make those decisions, and I think this is just the converse of that.

Commissioner REINSCH. A fair answer to I think an unfair question; but I think the point that needs to be made is that some of these issues are debatable, and they may not be debatable between the State and the Federal Government, but within the Federal Government, there is not 100 percent agreement on what constitutes a national security threat and what does not, and that's something that we have to think about.

Thank you for your indulgence.

Co-Chairman WESSEL. Commissioner Robinson?

Co-Chairman ROBINSON. I have a number of quick questions similar to those of Commissioner Reinsch, if you don't mind.

First, Mr. Patterson, I think you would agree that the first item referenced in the May 8 letter from then Acting SEC Chairman Laura Unger to Frank Wolf was national security as well—it was national security, human rights, and religious freedom. And I believe that AFL–CIO has likewise been attentive to and sensitive to that security-related dimension of what has now been deemed increasingly to be material risk, particularly in respect to foreign registrants doing business in U.S.-sanctioned countries, including the terrorist countries. Is that so?

Mr. PATTERSON. Yes, although we are not experts in security concerns. We do have expertise in workplace and core labor standards and creating value through worker partnership. We are supportive of the thrust of that missive, which includes security concerns.

Co-Chairman ROBINSON. In the case of the so-called PetroChina coalition, which I would agree was an extraordinary display of non-

governmental organizations from across the political spectrum joining together—I think it represented an estimated 20 million Americans, including your good organization, in total combined membership of that coalition that opposed that initial public offering for reasons that were primarily Sudan-related, as you have mentioned—do you see that kind of market activism in areas of concern to AFL–CIO continuing in the future and possibly even that kind of coalition structure coming together from time to time as took place in the PetroChina case?

Mr. PATTERSON. I do, and I see it coming together around Burma right now. I think there are a number of initiatives dealing with companies investing in Burma which are going to reverberate in the same way.

But the push to develop investment guidelines was an outgrowth of the whole PetroChina episode. It was a sense that more pension funds need a framework to address these initiatives, address the issues in the critique that we were raising. So it is not just running initiatives; it is a question of developing a framework an approach in the governance of pension funds that allows the funds and their investment managers to make judgments about investment value based on the information generated from these initiatives.

Co-Chairman ROBINSON. I think that point is well-taken, and I think that you have had a fair amount of success, as illustrated in the CalPERS case and others, from your initiatives. But obviously, more needs to be done.

Mr. Flaherman, I was curious that you mentioned that CalPERS was now looking at—or considering, I think you put it—foreign entities that are doing business in U.S.-sanctioned countries. Is that a new initiative for CalPERS to be alert to companies that are doing business in U.S.-sanctioned countries, or do I have that wrong?

Mr. FLAHERMAN. I think I wasn't clear in what I said.

Co-Chairman ROBINSON. Okay.

Mr. FLAHERMAN. What I said was that we are extremely alert to the restrictions that the various arms of the United States Government place on investment in various sanctioned countries and that we believe that we are enthusiastically compliant with all of those restrictions.

Co-Chairman ROBINSON. I see—so, just a matter of compliance with existing sanctions.

Mr. FLAHERMAN. Yes.

Co-Chairman ROBINSON. I understand.

I was wondering about—I have seen a press report indicating that CalPERS does not screen for national security-related concerns. Of course, that was a couple of years ago. Has that changed,—no security considerations factored into the due diligence risk assessments of either CalPERS or its external fund managers based on the belief that that properly should be the purview of the U.S. Government, and therefore, CalPERS or its external fund managers do not look at it.

Mr. FLAHERMAN. You are correct. We have not done it in the past, and we continue not to do it, and the reason why we continue not to do it is essentially because we believe that it is properly the province of the Federal Government and that it would be imprac-

tical for us to do it, especially considering that essentially all of the allegations that we have seen made have been allegations of covert involvement, sub rosa involvement, of military entities, for example, in China and that to make those judgments would require access to intelligence that only the Federal Government really has access to.

I was trying to get to the point that there is a lot more information that is security-related that is in the public domain now, whether it has to do with proliferation or other security abuses that are surfacing through Congressional commissions, and through much greater alertness to this family of issues because of September 11.

Representative Nickol, do you think that as this data becomes increasingly available, is it still something that you would just as soon push off onto the shoulders of the U.S. Government exclusively, even if that data is available publicly, given the fact that, frankly, the U.S. Government has not stepped up to this responsibility—do you envision a time when the Pennsylvania public pension system would begin to at least include security-related concerns as one of a number of considerations in the due diligence assessments of the funds and those of the external fund managers that represent the funds?

Mr. NICKOL. We have had a difficult time over the last decade. Our fund size has way more than doubled, and our staff allocations have remained fairly well frozen at the same place they were at that point in time. That is a large part of the reason why we index over half of our equities. We don't even have the time to manage our managers. So for us to try to undertake reviewing every individual investment and what involvement some company may have with some subsidiary in some Third World nation, we don't begin to have the time and expertise to do that, nor do we wish to do that.

Co-Chairman ROBINSON. Or calling on the external fund managers perhaps to take a look at those issue down the road, as is quite prominent today.

Mr. NICKOL. Perhaps if we had clear things to ask them to look for, it might be of assistance, but frankly, as a member of the board for ten years, until I was scheduled to appear here, I never saw a list of the individual companies we hold in Hong Kong or China.

Co-Chairman ROBINSON. Thank you.

Co-Chairman WESSEL. If I can for a moment, if I remember correctly, under ERISA, I believe it was Section 408, there are certain limitations on socially responsible investing. For example, if I remember, building trades are limited in investing in projects that might actually benefit their workers. I don't know whether the same type of social investing prohibitions exist in CalPERS and the State plans as well.

Can you comment on that in terms of if you had information relating to activities in China that actually undermined the jobs of your pension beneficiaries here—for example, the creation of a steel industry with overcapacity in China. Could you act on that? Would there be any limitations under U.S. law for you to do that, and similarly for the State plans?

Mr. PATTERSON. The trustees are required to act in the economic interests of their beneficiaries. We have argued that the collateral interests of workers and investments in China in the steel industry, for instance, are inappropriate for worker funds because the violation of worker rights is part of the lack of transparency, the lack of stability—these are not good environments to create long-term value. Worker pension funds are long-term investors. They generally don't get their return by churning their portfolios or by jumping in and out of issues and stocks. They generally buy and hold. Therefore, there is a premium on looking at the long term, and worker rights and political stability contribute to that.

Co-Chairman WESSEL. But here in the U.S. if I remember correctly—and the law may have changed—there were limitations on what building trades, for example, could invest in building trade projects.

Mr. PATTERSON. No. A fund is required to maximize its return and develop an asset allocation formula that does that. If that return can be generated through collateral benefits, there is no prohibition on that—or socially responsible.

Co-Chairman WESSEL. There is not. Okay.

Mr. PATTERSON. But these are worker benefits, and the issue of generating a return has to be paramount.

Co-Chairman WESSEL. So if there were an investment in China that would broaden your portfolio internationally—again, say, enhancing steel capacity in China—that paid three times the rate of return as any other investment, could you use the "socially responsible" criterion that you don't want to be putting our own workers out of work as something you look at in terms of what investments you might make?

Mr. PATTERSON. I think most investment managers that work for pension funds can find alternatives to the investments that undermine the collateral benefits of beneficiaries. For instance, when—and Michael could speak to this—I'm sure that when CalPERS puts forward these criteria, managers are exceedingly creative, can find ways of developing investment opportunities that meet the sensibilities of beneficiaries and the criteria. Most managers of our funds are able to construct portfolios of investments that get a very good return and a safe return without venturing into the kinds of investments you are raising.

Co-Chairman WESSEL. So if the U.S. Government were to provide information, for example, on security risks—countries, companies, entities that were security risks—there are no prohibitions and no legal impediments for you to apply those to your investments and simply say, "We don't want to do business with these companies, we don't want to invest in these companies"?

Mr. PATTERSON. If there is an investment logic that follows that, yes.

Co-Chairman WESSEL. Other panelists?

[No response.]

Commissioner Lewis?

Commissioner LEWIS. Thank you all for your presentations and for your statements.

Mr. Dorn, I have a factual question for you, and then I have a separate question for the other three panelists.

We have had two panels here today, and they seemed to conflict with each other on a significant question. One panel said that China's private and public sectors cannot mobilize the massive financial resources that are necessary to sustain economic growth, and they have to go into the capital markets. The other panel said that China's domestic stock markets are capable of meeting China's financial needs, and they deemphasized the importance of going to the capital markets.

What is your view?

Mr. DORN. Well, your first statement, that the private sector cannot go to the capital markets to get the funds—I think that is what I would emphasize. The fact is it is basically against the law in China for private firms in China to go to the capital markets. There are no private firms listed on either the Shanghai or the Shenzhen stock markets. Listed companies are all basically state-owned enterprises where the government holds a majority of the shares. Some of them are jointly held by individual investors plus the government, but the government dominates the stock market.

As I said, the magnitude of foreign direct investment in China is an indication of the repression of private capital growth in China. The joint ventures—the foreign direct investments in China—are really situations where the foreign firms come in and take over part of the control rights of Chinese domestic private firms.

So in effect, if China had a vibrant private capital market, the private sector would be growing tremendously. Yet the truth is that the state discriminates tremendously against the private market.

Consequently, when you think of the stock exchanges in China, you should not think of them in terms of U.S.-style capital markets; rather, they are what I call pseudo capital markets.

Commissioner LEWIS. You don't think that China has the financial resources in and of itself to finance their domestic needs?

Mr. DORN. They have to rely on foreign direct investment. The major growth sector in China has been the non-state sector.

Commissioner LEWIS. But the conflict seems to be whether or not they need to go into the U.S. capital markets. One panel this morning said yes, and the other panel said no.

Mr. DORN. Well, they aren't going into the U.S. capital markets. Most of the investment that goes into China is foreign direct investment. That is not portfolio investment; it is mostly investment by overseas Chinese.

Commissioner LEWIS. I'm sorry, I'm not making myself clear. I understand what you are saying, but do you think it's necessary to finance China's domestic needs for them to come into the U.S. capital markets as they did to some extent last year, in the billions of dollars?

Mr. DORN. Let me put it this way. The current debt burdens of China are not sustainable. They can't raise the tax revenue enough to pay those off, so they have to go into the capital markets to do so. They are going to have to borrow abroad. There is no question about that.

Commissioner LEWIS. Okay, okay. Thank you. There was just a conflict between the two groups this morning, and I wanted to

know where you come out, and you're saying they have to go into the U.S. capital markets.

Mr. DORN. That's the only way they're going to recapitalize the banks; they're going to have to go into the international capital markets, not solely the U.S. capital markets.

Commissioner LEWIS. Thank you.

I'd like to ask each of you this question. Do you think it would be an appropriate investment by a pension fund to invest in a company that is on a proliferation list as designated by the President of the United States. That is, if a company that is engaged in the proliferation of weapons of mass destruction came to the U.S. capital markets, should they be able to do that?

Mr. FLAHERMAN. So this would be a case where the President of the United States has said that this country is involved in the manufacture or proliferation of nuclear weapons——

Commissioner LEWIS. Or aiding.

Mr. FLAHERMAN. —but we are not going to exercise our foreign policy and military prerogative to act on it.

Commissioner LEWIS. Right.

Commissioner DREYER. He likes to ask hard questions.

Mr. FLAHERMAN. I have difficulty imagining such a scenario occurring. I think the firestorm of criticism that would fall on the shoulders of any administration that would do that would make it an inescapable conclusion that that position is untenable and would quickly devolve into an outright prohibition.

Commissioner LEWIS. There are two limitations that can occur. One is that there be full disclosure and the other that there be an absolute bar. So I'm asking you which one, or both, would you favor?

Mr. FLAHERMAN. The scenario that you paint, to my mind, I cannot imagine that if an administration did that that it wouldn't, within a matter of days or weeks, become an outright bar.

Commissioner LEWIS. Mr. Patterson, what do you think?

Mr. PATTERSON. I can't imagine that company being a good investment value, period.

Commissioner LEWIS. Do you think they should be allowed to go to the capital markets in the United States?

Mr. PATTERSON. The fund perspective is that we would avoid investment in a company like that.

Commissioner LEWIS. Right, but do you think they should have access to the capital markets?

Mr. PATTERSON. No.

Commissioner LEWIS. Mr. Nickol?

Mr. NICKOL. My personal view is no.

Commissioner LEWIS. The next question I have for each of you——

Co-Chairman WESSEL. Your time has expired. We can come back to you.

Commissioner DREYER. I yield two minutes.

Commissioner LEWIS. Thank you very much.

The next question I have for you is: Is it appropriate for U.S. investors, particularly public pension funds, to be investing in foreign firms whose activities are undermining the interests of the workers in the United States? In other words, suppose you have funds from

the Steel Workers of America, and one of the options is to invest in a foreign steel mill, and it's a great investment that will give you a 15 percent return, but it would undermine the working conditions of the people whose funds you are investing. Is this a factor to be considered?

Mr. PATTERSON. I think I have answered that already. Our funds would avoid it. Our funds would think that this is an inappropriate investment and consider the collateral benefits and believe that we can match the return of most of those investments by encouraging managers to go elsewhere.

Commissioner LEWIS. Thank you.

Mr. Flaherman?

Mr. FLAHERMAN. I'm sorry, I don't mean to play definitional tag with you, but I am unclear about what you mean by "undermining the interests of workers." Do you mean undermining the interests of Americans who have jobs——

Commissioner LEWIS. The people whose funds you are investing.

Mr. FLAHERMAN. So you mean that it would undermine the interests of CalPERS members?

Commissioner LEWIS. Yes.

Mr. FLAHERMAN. And it would do that by—we only provide benefits to government employees, so I'm not sure how I can wrap my mind around the scenario that——

Co-Chairman WESSEL. Investing in firms that privatize all state services.

Mr. FLAHERMAN. Overseas.

Co-Chairman WESSEL. No, no. I believe domestic is—maybe, yes, you could move transcription overseas.

Mr. FLAHERMAN. Well, I think—I understand your point, then. What I would say is that it is something that pension funds wrestle with all the time, and I think my friend Mr. Patterson can offer many really good examples of the real dilemmas in industrial labor unions where this happens in a very large way. But I think your attempts to come up with an example shows that the reality is that for a government pension plan, this is much, much less of an issue and is really something which is so at the margin that it's not really an issue.

Commissioner LEWIS. For you. Okay.

Mr. Nickol?

Mr. NICKOL. That would be true for ours as a government pension fund, too. However, it's such a slippery slope—and I appreciate the difficulty your Commission has—because we could take it to its next conclusion—should the Commonwealth of Pennsylvania be investing in Southern States with right-to-work laws because we are losing steel jobs to those States? They are very uncomfortable questions, and——

Commissioner LEWIS. Is that something you consider when you make investments?

Mr. NICKOL. No, we don't—although, to be perfectly honest, I don't know that the investment manager coming and wanting to invest in a firm like Edison, which privately operates schools in competition with public schools, would necessarily be favorably looked at by our board. That hasn't occurred yet, but I would foretell that that might be a problem.

Commissioner LEWIS. Thank you very much.

Thank you, Commissioner Dreyer.

Co-Chairman WESSEL. Commissioner Mulloy?

Commissioner MULLOY. Thank you. I want to follow up on that area.

I don't know if all of you were here for the other panel, but the idea that you guys who manage pension funds have a fiduciary responsibility to seek, I guess, the best return—is that what each of you has? Is it fiduciary responsibility, or are there other criteria?

The reason I ask is because, Mr. Flaherman, you say in your testimony that "when purchasing non-U.S. securities, we consider the existence of legislative sanctions," which implies that there is something that you are doing there beyond fiduciary.

Mr. FLAHERMAN. No. I think that a legal definition of fiduciary responsibility would at its core embody or incorporate adherence to all applicable law. That's what I'm saying.

Commissioner MULLOY. Okay.

Mr. FLAHERMAN. But to answer your question directly, we are bound by a fiduciary standard. That standard is a strict classical fiduciary standard that is written into the California Constitution, and that is our charge. A unique aspect of being a fiduciary is that unlike other government offices, as a fiduciary, one actually has personal liability and recourse to one's own personal assets for breach of fiduciary duty.

Commissioner MULLOY. Okay. Let me ask you this, then. On the issue of PetroChina, that they were going to raise money in the U.S. capital markets, and the fact that they were investing also in Sudan, and I think the SEC opinion said something like that would be material and should be disclosed to U.S. investors. Would that make a difference to your plan and whether you invested in PetroChina, and can you do that within your fiduciary responsibilities?

Mr. FLAHERMAN. Yes. We didn't participate in the PetroChina offering, and I think that is actually very easily resolvable within our fiduciary responsibility in a couple of different ways.

One way that I would point to as a way of resolving it is the reality that Mr. Patterson through his efforts succeeded in producing such a taint on the PetroChina offering that it raised significant questions about whether it was an appealing offering from a purely financial perspective even if one didn't give a hoot about any of these other issues.

And then, secondly and much more importantly, quite frankly, we have a fundamental philosophical outlook which comes from the reality that we are an organization that has a perpetual time horizon as an investor, and what that leads us to is a conclusion that the best way to make money over the long term is to avoid making money in any way that is subject to ultimately being discredited; that an enlightened investment strategy is the one that over the very long term pays off best, that you can make a lot of money over the short term by associating yourself with bad actors, but there is a comeuppance for bad actors even if it takes a very, very long time for it to happen.

Commissioner MULLOY. Mr. Nickol, do you think that you could have handled that one and stayed out of that and stayed within your fiduciary responsibilities?

Mr. NICKOL. I think we probably could have. We wouldn't have made a direct investment at the fund level; it would have been one of our managers. But if a controversy like that became fairly high-profile, it would just quietly not happen, probably.

Commissioner MULLOY. Okay.

Then, I liked what both of you had to say, and I thought the question that Bill Reinsch asked Mr. Flaherman—I think you said that on national security matters, you would prefer not to have that be disclosed, and that you would prefer the Federal Government to tell you not to invest in things that are national security problems rather than for it to just be disclosed and for you to have to make that judgment.

Mr. FLAHERMAN. Yes. I would just—I didn't say this, but I would like to amplify on it—I would hope as an actor in the financial market and as a citizen that the Federal Government in doing that would make it applicable to every American investor and not just single out U.S. pension funds. I don't know why U.S. pension funds would be singled out for such a prohibition and yet other investors not be singled out. It seems to me that if it is in the U.S. national interest, it's in the U.S. national interest to have that happen to everyone that the U.S. can control.

Commissioner MULLOY. Representative Nickol, I think you had the same plea, that the Federal Government ought to be doing that.

Mr. NICKOL. Yes. We are in no position in Harrisburg, Pennsylvania to make judgments on national security concerns, and we shouldn't be asked to do that. We should be told what investments are not appropriate from a national security standpoint, and we will gladly abide by that.

Commissioner MULLOY. Thank you.

Co-Chairman WESSEL. Commissioner D'Amato?

Chairman D'AMATO. Thank you, Mr. Chairman.

It is a pleasure to have you gentlemen before us today.

Representative Nickol, it is particularly delightful to have you here since I am a Representative from Annapolis in the State Legislature of Maryland, of course.

Mr. NICKOL. Seven miles further, and I could have run for the House of Delegates.

[Laughter.]

Chairman D'AMATO. Given the attack that you have received by other commissioners, I want to say a few things. First, the Federal Government did not organize the revolution against King George, if you recall those years. Second, the State legislatures are the laboratories for experiments from which come most creative actions in the United States Government. Third, South African apartheid was eliminated primarily because of state action and the initiative by the locals, not by the federal government. Fourth, Maryland is prepared to enter into an alliance with Pennsylvania at any time regarding China investment policy if it becomes clearly necessary. Fifth, the Supreme Court is not always right.

Commissioner REINSCH. So you're right instead; is that what you're saying?

Chairman D'AMATO. Sixth, the West Point motto "Recourse to technicalities should not be tolerated," certainly applies here.

Are you a member of the Appropriations Committee?

Mr. NICKOL. Yes, I am.

Chairman D'AMATO. Congratulations. So am I. So you would know that the power of the purse to implement your priorities would be critical.

The seventh and last thing is that powers of the pen and the dollar are mightier than the sword.

In any case, I encourage you to keep going on that. We have to confer more completely on these China investment policies between Maryland and Pennsylvania, and we welcome your testimony today.

Co-Chairman WESSEL. Commissioner Becker?

Commissioner BECKER. I have just a couple of small points. Listening to you relate the difficulty, Representative Nickol, of how to deal with this, most of the problems that I have been aware of within the struggle on investment from public service funds is once the investment has been made, to try to change it. As you said in your testimony, you are going to shy away as much as you can from China because you don't know how this is going to unfold—which may be good, or it may be bad in the long run. I think several people have said, both on this panel and the other panel, that they would look to the Federal Government for guidance. How do you feel about looking to the employees for guidance?

Mr. NICKOL. I actually take a lot of guidance from the employees. What has always amazed me in our fund is that we have four union members and one retired member who was previously active in a labor union, and those members in fact are the ones who probably live more by the rule that we shouldn't use nonfinancial criteria to make investments. It is we politicians on the board, the elected officials, who tend to look to gain instant advantage by hopping on whatever issue may come along.

Commissioner BECKER. Let me extend that just a little bit. With public service employees, public pension funds, by and large, that's true. I know that in CalPERS, you have run into that same type of thing, because that is a State employee fund of some kind. Just for a bit of information, in single-employer funds, which most manufacturing entities fall into, the workers have no say whatsoever; those are strictly management decisions, just like it was a management decision with the collapse of this huge company, Enron, to invest all of their 401(k) money back into their own stock. These are management decisions, and there is a huge struggle for workers to have a voice in this, and they have not been able to obtain a voice in this, and consequently, we run into these difficulties.

So I would ask Mr. Patterson or you what would you recommend—what do you recommend to be able to deal with this, to enable workers who actually create the fund to have some voice in how that fund is handled—and certainly, I think everyone would agree that they should have some role in that.

Bill?

Mr. PATTERSON. That's a challenging question. Workers have an essential role in governance of their funds, and we think are champions of fiduciary duty. It's their money that—when they are involved in the governance of their assets, they are going to make sure, one, that that fund is a superior benefit, and wherever possible is going to reflect the sensibilities and values and be an extension of worker interests.

So I think that having worker representation in fund governance is a critical piece.

Commissioner BECKER. But how do they obtain this? I am probing a little bit. We don't have that in single-employer pension funds. A tremendous amount of money is lying out there. The company could invest it back into their own stock——

Mr. PATTERSON. I think the Enron situation is outrageous. That type of situation is going to create a climate for——

Commissioner BECKER. —or they could invest it——

Mr. PATTERSON. If workers had been involved in the governance of that 401(k) plan, they would not have allowed the lock on that stock.

Commissioner BECKER. My point is this. An employer can take a single-employer pension fund and guide the investment into a replacement facility for those workers and cut them out entirely. Surely there has to be some voice, some way for those workers to have a voice. And what I am asking you is how should that come about. You don't want government interference. But what would you suggest to give them that voice?

Mr. FLAHERMAN. If I could just jump in here to say that we are not looking for Federal Government interference in that regard, but you should know that CalPERS, for example, has a 13-member board, and there are six of us who are elected from the employees. I actually happen to be one of them. I represent everyone who works for a city, county, or special district in California and participates in the system. Those people every four years have an opportunity to vote up or down on whether they are satisfied with my role in the governance of the fund.

I don't have an answer to your question about single-employer private sector or ERISA plans. I can't speak to it, and I think you pose some good questions.

Mr. PATTERSON. We have supported legislative approaches to this, and I think that's one way to get at it.

Mr. NICKOL. Since we are dealing with Federal law, I am not well-versed on it at all, but I do take great comfort with the Public School Employees' Retirement Fund in Pennsylvania that the workers themselves are adequately represented and helping to make those decisions, and I think we actually gain strength from that participation.

Commissioner BECKER. But that's by law. That is by law, is it not?

Mr. NICKOL. That's by State law when we create a plan.

Commissioner BECKER. And that's by law in California for State employees; right?

Mr. FLAHERMAN. It is actually in the California Constitution.

Commissioner BECKER. And what you are suggesting, Bill, is that there should be a similar law for the single-employer funds; right?

Mr. PATTERSON. Yes, and we have supported attempts historically to achieve that.

Commissioner BECKER. Thank you.

Co-Chairman WESSEL. For the last question, co-Chairman Robinson.

Co-Chairman ROBINSON. Thank you, Mr. Chairman.

This is for Mr. Flaherman and Representative Nickol. Some States restrict the amount of money that can be invested outside the State or, alternatively, require that a minimum amount be spent within the State. Do either of your pension systems have that kind of guideline?

Mr. FLAHERMAN. No, sir, we do not. I don't believe at this point that there are any States that actually restrict the amount that can be invested outside the State, and I think it is pretty well-documented history that the States that have attempted to put walls around the State by having minimum investment requirements within the State have suffered major losses. It becomes a very, very difficult environment in which to make investments.

Co-Chairman ROBINSON. I am not an advocate for it, believe me.

Mr. NICKOL. We likewise have no legal restrictions to that degree, but in all honesty, we do give Pennsylvania investments more than adequate consideration, and there is a heavier-than-usual concentration of our portfolio on Pennsylvania-based companies.

Co-Chairman ROBINSON. And one additional question. Mr. Flaherman, I was gratified to hear your remarks about the way you defined "enlightened investing," namely, avoiding potentially controversial bad actors over the long haul as being a prudent approach.

I was wondering, just as a concluding question, if either of your pension systems, again, screen for the business involvements of foreign in U.S.-sanctioned countries. Now, that's rather a specific question, and perhaps I should repeat it.

Again, if you have a foreign entity whose stock you may be thinking of purchasing, do the pension systems or your external fund managers to your knowledge examine the issue of whether that particular foreign entity has business activities in U.S. terrorist-sponsoring and other sanctioned countries today?

Mr. FLAHERMAN. So, for example, in making a decision whether to buy Nestle, a Swiss company, does it do business in Cuba.

Co-Chairman ROBINSON. Or Talisman Energy, Inc. of Canada, PetroChina, or others that have involvements in Sudan or may run afoul of the Iran-Libya Sanctions Act—these kinds of, global flash point countries, particularly in the terrorist-sponsoring area.

Mr. FLAHERMAN. What I would say is that the screening for political risk is always properly part of the decisionmaking process and that I would expect that if there were a company that was engaged in the kind of thing that you cite, which is involvement with terrorists, that that would represent a form of political risk that would rise to the surface very quickly.

Co-Chairman ROBINSON. Or just doing business in terrorist-sponsoring states, which actually could be more subtle and benign than treating with terrorists themselves I just thought I'd clarify that.

Mr. FLAHERMAN. Yes, and I think the challenge of it is that you have a continuum where, on the one hand, you have a Talisman Energy where we have none of that in our portfolio, and I think it's fair to say that the reason we have none of that in our portfolio is because none of the people making investment decisions on our behalf would ever touch that because of those activities. And then, at the other end of the spectrum, you have Nestle, which I would venture to surmise sells chocolate in Cuba.

Co-Chairman ROBINSON. So there are gradations, in other words.

Mr. FLAHERMAN. Right, it is a continuum. And clearly, at the Talisman Energy end of the continuum, that rises very quickly to very high prominence, and then, at the chocolate in Cuba end of the spectrum, it does not.

Co-Chairman ROBINSON. Although CalSTERS, interestingly, holds Talisman Energy, Inc., as I understand it.

Mr. FLAHERMAN. I can't account for that, sir.

Co-Chairman ROBINSON. Just an observation.

Representative Nickol?

Mr. NICKOL. Following this legislation, I think we'll probably start to do screening. Prior to September 11, we did no screening, although our investment staff did several years ago try to access lists at the Federal level to see if we could get a proper list of companies to do any screening. And frankly, what they found was that there really wasn't much, and what they did find was not routinely updated. So therefore, the whole effort fell by the wayside.

Co-Chairman ROBINSON. Thank you both very much, and Mr. Dorn and Mr. Patterson.

I turn it back to you, Mr. Chairman.

Co-Chairman WESSEL. I appreciate your time. We have gone over, and I think that indicates the interest of the members up here. So we appreciate it.

We are adjourned until 9:30 tomorrow morning when our public session begins.

[Whereupon, at 4:55 p.m., the proceedings were adjourned, to reconvene on Friday, December 7, 2001, at 9:30 a.m.]