Rapporteur's Report[1]

THE IMPACT OF CHANGES IN THE INTERNATIONAL FINANCIAL SYSTEM ON THE UNITED STATES, RUSSIA AND CHINA

Carnegie Corporation of New York
Financial Services Volunteer Corps

Alexandria, Virginia, U.S.A.
July 11-13, 2018

The latest international symposium organized by the Financial Services Volunteer Corps (FSVC), with generous support from Carnegie Corporation of New York, brought together 29 leading experts from the United States, Russia, China and other key countries to discuss topics related to the state of the international financial system. Topics included the increased use of financial and economic sanctions, the "de-risking" trend, the lack of lending to small and medium-sized enterprises (SMEs), and the risks and opportunities posed by new financial technologies (FinTech).

The FSVC/Carnegie symposia have taken place annually since the start of the new millennium. A core concept underlying them has been that the most intractable problems confronting the world today will require multilateral coordination among key countries if they are to be successfully addressed. A key motive behind this year's discussions was to understand how recent developments and rising trends in the international financial system are impacting, and will continue to impact, relations among the United States, Russia and China, and identify potential areas of mutual interest in tackling shared financial sector issues.

This year's symposium took place in a challenging period of international relations. The emergence of populist sentiments around the world has exposed deep fault lines in both the liberal world order and the liberal model of development. This rising tide has placed decision-makers in power whose approaches to global trade, finance and foreign policy have dramatically redefined traditionally-accepted frameworks of international engagement and diplomacy.

At the national level, polarization in politics and the media, as well as the proliferation of information sources in general, has reinforced tribalism and often validated oversimplified

[1] This report was prepared by Charles Brahaney, the Rapporteur for the symposium. The Principal Investigators for this project are Harry Harding, University Professor and Professor of Public Policy at the University of Virginia and Visiting Professor of Politics and Public Administration at the University of Hong Kong, and J. Andrew Spindler, President & CEO of FSVC. A list of participants in the symposium is provided in the attached annex.

FSVC is a not-for-profit organization whose mission is to help build sound financial sectors to support healthy market-oriented economies in developing and emerging market countries. Additional information about FSVC can be found at www.fsvc.org.

understandings of highly-complex social, political and economic trends. The absence of appealing centrist narratives and champions of moderate views, for example in the U.S., has also eroded the foundations upon which political compromise can be built. Many moderate thought-leaders and politicians simply cannot gain traction within systems oversaturated with louder, more exaggerated viewpoints. Shifting toward the center has seemingly become a disadvantage in today's climate.

While aspects of these trends have been catalyzed by negative externalities arising from technological innovation, the trends themselves appear to be rooted more directly in the legacies of unfettered globalization and the 2008 global financial crisis. Indeed, despite the enormous global economic growth of the past two decades, imbalances and inefficiencies in the global economy have ruminated and gone unchecked, contributing to an acute concentration of elite "winners" above the vast masses of disillusioned "losers". These imbalances and inequalities can be tied, in part, to the overgrowth, overextension and inefficiency of financial sectors in high-income economies.

The U.S. does not appear well-positioned to help address these financial challenges, however. Over the past year, President Trump has executed a sharp withdrawal of U.S. leadership from the international system, leaving a vacuum where the U.S. had traditionally performed agenda-setting functions for the international community. The sudden absence of the champion of the liberal international order has moreover prompted many to question the strength and resilience of global institutions, at a time when they are arguably more necessary than ever for maintaining international security and stability. The U.S. has now adopted an "American First" policy, and other governments seem to be following suit by adopting more opportunistic foreign policies.

Against this troubling backdrop, participants in Alexandria concurred that the rapid expansion of FinTech, the "de-risking" trend in global financial markets and the increased use of financial sanctions are critical challenges that require the urgent attention of the world's policymakers and thought leaders alike. Given the vast scope and complex, interconnected nature of these challenges, reaching an accurate understanding of their drivers and dynamics, and discerning appropriate solutions, require multilateral, multi-disciplinary engagement.

Opening Remarks

With these dynamics in mind, the Principal Investigators of the symposium offered opening remarks to participants. In particular, they noted that multilateral cooperation is especially challenging given three macro-trends: complexity, polarization and exaggeration. As the causes and impact of the most serious global challenges have grown more complex, including financial challenges, many societies are oversimplifying problems in order to make them more manageable. This oversimplification leads to convenient but ultimately dangerous and misguided solutions. "Noise" in the system has also promoted the polarization and exaggeration of viewpoints in order to gain attention, and the media seem only to be

exacerbating this trend. Given these dynamics, participants were encouraged to seek creative ways to address shared financial challenges or frame the issues, with the ultimate goal of identifying recommendations for policymakers.

SESSION I – Current Relations Among the United States, Russia and China, and Current State of Global Financial System

To help frame discussions about shared financial challenges within today's global context, participants first examined current dynamics between the U.S., Russia and China, and how they may impact these challenges. Overall, participants noted that the international environment today is shifting dramatically and rapidly. This has been spurred by the relative decline of the U.S. as an active leader in international institution-building, the emergence of technology that influences interactions between states, and the rise of non-state actors capable of influencing global affairs, among other developments.

The Current State of U.S.-China-Russia Relations

The U.S.-China relationship contains elements of confrontation, cooperation and competition, the most prominent being competition. China is now a dominant player in the international system and, as such, China will increasingly challenge U.S. interests in the political, economic and security spheres. The U.S.-China relationship will therefore depend in part on whether the U.S. perceives this as an encroachment. Furthermore, while U.S. economic reliance on China precludes open military confrontation, unbridgeable differences limit their potential for full cooperation. On trade, it was noted that both the U.S. and China have significant room to escalate tensions further. It was further noted that the U.S., with its current hyper-polarized political environment, does not appear to have a consistent vision of its economic and political future, both at home and abroad. Indeed, while U.S. leadership seems fixated on the next election cycle, China seems to have a clearer and steadier strategy. For example, China has increased its use of economic power in foreign policy, investing in Africa for the past decade, and in the Caribbean and Latin America for the past five years. China's "One Belt One Road" (OBOR) initiative has also relegated the U.S. to the sidelines with regard to major global infrastructure projects.

With regard to the U.S.-Russia relationship, it is primarily adversarial today, and is recognized officially as such by both countries. At the same time, however, participants noted that the relationship is unlikely to devolve into open conflict as both nations share a history of managing interactions to avoid military confrontation.

As it stands today, the relationship between China and Russia could be a marriage of convenience, or something more. The two countries have a long history of mixed but often highly cooperative relations. China and Russia have grown much closer since the Crimea crisis, and they are now actively aligned on a wide range of issues. China has access to Russia's energy sector, and Russia sells China sophisticated military weaponry, for example. The positive

relations are bolstered by the personal connection between Presidents Putin and Xi, maintained in the face of Western powers. Importantly, however, Russia, with its significantly smaller and less diversified economy, holds the weaker position of the two countries, and will have to be vigilant in managing the relationship effectively.

The Current State of the Global Financial System

Panelists emphasized two market and regulatory failures that required attention:

1. Financialization: One panelist contended that a significant driver behind the current retreat from both the liberal world order and globalization appears to be financialization. This term describes the process whereby the financial sector gains an outsized control over a country's economic policy and outcomes. In the U.S., for example, the financial sector accounts for 7% of GDP, 8% of total private-sector profits, but only 4% of American jobs. Resources therefore are concentrated on activities that are not productive and do not contribute to the real economy. Such dynamics lead to inequality and economic stagnation, and incentivize young adults to enter the financial industry in greater numbers (as can be seen in China and the U.S.). Financialization also makes economies more vulnerable to debt, deflation and prolonged recession as it promotes the use of intermediaries and complex financial instruments. SMEs, in turn, are disadvantaged by their lack of access to capital, limiting their ability to create jobs, particularly for youth.

   Adverse effects of financialization begin to appear in the transition from middle- to higher-income economies, and are marked by the growth of a credit bubble. Financialization is different everywhere, however, including the rate at which it grows. In China, for example, land is a key asset driving urbanization, which has led to over-speculation. Curbing speculation on land in China, therefore, is a major key to alleviating the negative effects of financialization. In the U.S., the problem is manifested more in under-regulated derivatives. A key question for middle-income economies is how to keep a dynamic economy while also achieving a broad distribution of credit as it grows.

2. Dysfunctional Aspects of the Chinese Financial Sector and Economy: Another panelist discussed the global financial ramifications of the large opportunities for financial arbitrage opened by policies in China and global financial markets between 2002 and 2015, which have resulted in serious financial disequilibrium. Arbitrage conditions were created by China maintaining a fixed exchange rate and high interest rates relative to the U.S. dollar. This led to investors borrowing in U.S. dollars and investing them in China; the central bank of China borrowing money; and the growth of shadow banking in China, which the Chinese government wants to rein in. This may require a fluid exchange rate, however, and policymakers in China remain worried about the dangers of opening up the Chinese financial sector. The panelist noted that, historically, countries tend to open their financial sectors only during a crisis despite the fact that it is far better to do so from a position of strength.

These two issues, along with global debt problems, were examples of financial challenges that need to be addressed through structural reforms. Otherwise, current financial imbalances will remain and there may be another global recession in the next two to three years. Participants noted that the next crisis may emanate from the shadow banking sector or even from FinTech, which is currently challenging traditional regulatory regimes. Several noted, however, that the global financial system is generally stronger than ever in terms of capital levels and regulatory oversight (at least over traditional components of the financial sector). The Chinese government, for example, has used various policy tools to stem past financial crises and now has a stability board to monitor potential future crises.

SESSION II – Increased Use of Financial Sanctions and Their Intended and Unintended Consequences

The Effectiveness of Sanctions

A key question was asked at the beginning of the session: When are financial sanctions effective in practice? Despite being economic in nature, sanctions are a political tool designed to serve a political purpose. Sanctions may be appropriate when traditional diplomacy does not yield results, when war is too expensive, or when a theater of security is needed. They may also be appropriate in the eyes of the sanctioning country when it must demonstrate to the public that an international problem is being actively addressed.

Conventional wisdom holds that sanctions are most likely to be effective when the objective is to influence policy rather than to force regime change and when the targeted country's public favors the policy change. Furthermore, it is important for the sanctioning country to honor a deal once it is in place and provide a clear way out to the targeted country in order to build trust. The underlying challenge for American diplomats today, however, is that they cannot guarantee a consistent policy on sanctions, which limits their ability to use the possible lifting of sanctions as a carrot for targeted countries.

A discussion ensued about the use and effectiveness of new types of sanctions, including "smart sanctions" that aim to target only those actually culpable in a targeted country, thereby minimizing impact on the innocent population. There is not much literature on "smart" sanctions, however, and many participants felt that countries should be cautious in using the term "smart" as policymakers do not fully understand the unintended consequences of this type of sanctions. Another sanctions tool is the use of the SWIFT system on cross-border payments. The U.S. leveraged this system against Iran, with SWIFT directors facing possible penalties if they did not cut off their Iranian clients. There is now growing concern over the monopoly that SWIFT has enjoyed for decades in the cross-border payments sector, and its impact on sanctions.

Secondary sanctions, or extra-territorial sanctions, were also discussed. Secondary sanctions put pressure on third parties to stop their activities with a targeted country, by threatening to cut these third parties' access to the country conducting the sanctions. The U.S.

does not have a long history of using secondary sanctions, but has begun to deploy them against Iran. As a matter of prudent policy, participants noted that these sanctions should be used with support from a global coalition and as a one-off mechanism to be effective.

The Disproportionate Leverage of the U.S. Due to the Dominance of the U.S. Dollar

The disproportionate leverage that the U.S. holds over the global financial system given the dominance of the U.S. dollar was also raised as a major concern with regard to financial sanctions. This has resulted in tension and resentment, including in China, and the U.S. may be bending the curve on how long it will be able to maintain this financial leverage. Examples were cited of governments reconsidering holding investments and engaging in trade in U.S. dollars. Russia has developed a domestic credit card payments system, largely out of fear that banking services provided by U.S. banks in Russia could be cut off. China is also pushing for a central trade union, wherein governments would not have to trade through the U.S. dollar. Participants generally concurred, however, that the U.S. dollar would unlikely be upended as the dominant global reserve currency and preeminent international financial medium in the near-term. For example, European Union (EU) members could issue debt in euros, but they choose to issue it in U.S. dollars. Furthermore, the yuan cannot replace the U.S. dollar as China's financial markets are not entirely open and will likely not be so for a long time.

The Use of Sanctions by the U.S., Russia and China

While the U.S. has used sanctions against China, these have been fairly light. The U.S. appears not to want the larger Chinese banks that are expanding overseas to retreat from the global financial system, and therefore is not targeting these banks with sanctions. Instead, U.S. sanctions on China have been aimed at small, if not negligible, targets with little to no relationship with U.S. financial institutions.

China and Russia frequently use sanctions as well, just differently than the U.S. China dislikes traditional sanctions but uses trade and tourism sanctions quite often, for example against South Korea for its U.S.-provided Terminal High-Altitude Area Defense (THAAD) system. South Korea has not revoked THAAD but has leaned away from explicitly broadening it. Therefore, China's sanctions may be an effective deterrent in this case. Overall, however, China has seemingly come to realize that the effectiveness of its sanctions is not measured easily, and has begun to emphasize the use of trade carrots over sanctions sticks. One overarching question from this panel was how countries can create a common diplomatic doctrine around the use of financial and economic sanctions? Countries know what it means to see missile deployments, for example, but this understanding does not exist for financial sanctions.

SESSION III – The Role of Financial and Economic Issues in the Foreign Policies of the U.S., Europe, Russia and China

The Current State of Liberal World Order

One panelist observed that the international system appears to be crossing a tipping point. The liberal order which, since the collapse of the Soviet Union, had appeared the eventual endpoint of international development, may no longer continue steadily in the future. Over the past three years alone, its foundational pillars such as the United Nations, NATO and the Bretton Woods institutions have been eroded. Regimes like the Paris Agreement on climate change and the Joint Comprehensive Plan of Action (JCPOA) on Iran have also been damaged.

On a global scale, liberal trajectories are increasingly coming under pressure from authoritarian alternatives. Rising populism in Europe (e.g., Greece, Hungary, Italy, France) directly challenges the liberal model of development. National and international economic inequalities created by globalization, the displacement of traditional labor opportunities by new technologies, and the oversaturation and polarization of media all contribute to growing uncertainty. In turn, looming uncertainty has amplified the human tendency to engage in identity politics and tribalism, patterns of behavior which seem only to exacerbate and entrench populist sentiments.

These dynamics – populism, tribalism and the desire for simple solutions to increasingly complicated problems – may persist for a while, and can be viewed as growing pains caused by long-ruminating, underlying tensions in the global economy. In the U.S., President Trump has identified real inefficiencies and asymmetries in the global system against which previous administrations took no action. These issues include China's treatment of American firms in China and intellectual property issues, as well as U.S.-EU trade policy. In general, many participants noted the reluctance of liberal elites to fully acknowledge these inefficiencies and asymmetries, and the failure of the liberal international order to deliver broad benefits to the public. The question therefore is how can trade policy and the liberal international economic and political orders be changed to deliver broader-based and equitable outcomes, and thereby reinvigorate public support for liberalism?

A U.S. Perspective

U.S. economic leadership has historically been grounded in "enlightened self-interest," finding the middle ground between global interests and consistent U.S. benefit. The Trump Administration's "America First" policy holds that U.S. economic leadership has been too altruistic and has sacrificed U.S. economic and national interests in the process. This doctrine is difficult for other countries to understand as it does not provide a clear vision of what the world should look like on a global level.

An EU Perspective

From an EU perspective, several key challenges facing Europe were noted. The continuing, unregulated influx of migrants is met by increasingly hostile populations; the euro remains an integrated currency despite the EU's lack of an integrated social policy and budgets; little progress has been made on how to proceed with Brexit; a volatile Russia continues to be an ongoing challenge for EU security arrangements; and China appears to be leaning into Europe, as evidenced by the "16 + 1" summit hosted by China this summer to foster economic cooperation with European countries on infrastructure development. In addition, the EU may have come to the realization that it must become self-reliant on security matters, and not rely on security guarantees from the U.S.

A Chinese Perspective

China has increasingly used economic rather than political resources to influence the foreign and domestic policies of other countries such as Sri Lanka, Pakistan and Burma. The OBOR initiative is aligned with this strategy and highlights the expansion of China's overseas lending. Given these trends, participants wondered what kind of model President Xi Jinping is seeking to establish going forward, and whether this model will be exported to other nations.

China's foreign policy also seems to be defined by asymmetrical openness. China demands open access to other markets but views "reciprocity" very differently from Americans. China likes rules, but the rules should be based on bilateral negotiations and tailored to China's comfort level. The Chinese and American worldviews also differ with regard to the expected pace of improvement. For example, when considering whether to admit China to the World Trade Organization (WTO) in 2001, U.S. decision-makers understood there was asymmetry, but reasoned that it was better to have China inside the system rather than outside of it. The assumption was that Chinese policies would converge toward the world's rules-based liberal order over time. This assumption has generally been correct but China has not changed at the pace originally anticipated.

SESSION IV – Approaches to Addressing "De-Risking"

What is "De-Risking" and What are its Drivers?

"De-risking" can be defined as the reluctance of large international banks to maintain correspondent accounts with banks in numerous emerging market countries. Drivers of the problem seem to vary case to case, though there are some common ones: overall higher compliance costs; impediments to information-sharing that prevent banks from being able to conduct the customer due diligence required; and changes in regulatory and enforcement regimes, yielding heightened standards in anti-money laundering/combating the financing of terrorism (AML/CFT) and an increasing use of sanctions and other enforcement actions.

On the positive side, according to the International Monetary Fund (IMF), aggregate cross-border monetary flows have remained stable at a global level, despite a decline in the total number of correspondent banking relationships (CBRs). This finding suggests that economic activity has been largely unaffected by de-risking. SWIFT published recent data that suggested that the decline in CBRs also seems to be stabilizing in some regions.

On the negative side, pressure on existing CBRs continues to increase. As the number of CBRs overall has declined, the average value and volume of transactions have increased, prompting concerns about competition for these channels, and their costs and fragility. The limitations of existing channels have also impacted remittance flows, which could lead to serious economic issues in low-income countries where remittances represent a large share of GDP. One panelist noted that the exit of banks sometimes results in the concentration of both AML/CFT and political risks in one bank. In certain instances, governments have intervened when banks had to turn away risky customers, thereby entangling banks in domestic politics. Major banks therefore prefer the presence of multiple competitors in a given region or country to help distribute risk. From the standpoint of respondent banks, there is frustration in receiving sudden notifications that their accounts will be closed immediately, with no feedback on what steps to take to revive the CBRs.

Potential Solutions to De-Risking

Participants agreed that a multi-pronged approach will be required to address de-risking. For example, countries facing de-risking should strengthen their AML/CFT regimes in accordance with international standards; however, this may not be sufficient to guarantee the return of banks. One proposed approach to addressing the de-risking challenge involved the following five elements:

1. Actions by U.S. policymakers and regulators: U.S. policymakers and regulators should clarify their regulatory intentions and improve coordination. While some participants felt coordination in the U.S. would be nearly impossible, others noted that some progress had already been made. For example, in August 2016, the U.S. Department of the Treasury and Federal banking regulators published a "Joint Fact Sheet on Anti-Money Laundering and Sanctions Enforcement" to try and clarify the expectations of U.S. regulators, the supervisory examination process and the use of enforcement actions. Participants noted that the Treasury, the Federal Reserve or the IMF could play key leadership roles in further clarifying intentions. Regulators could also adopt the principle of "proportionality" when supervising correspondent accounts, and when determining the size of the penalties.

2. Actions by large banks: Large banks should be encouraged to review their correspondent banking policies, in coordination with regulators and perhaps the IMF. The social and economic impact of these banks' CBR decisions can be enormous, and there is anecdotal evidence that the analytical basis for these decisions is not consistently rigorous. At a

minimum, the IMF and regulators could encourage large banks to give respondent banks a more detailed explanation, if possible, when account relationships are terminated.

3. Capacity-building in developing, at-risk countries: Developing countries, and respondent banks in these countries, must build their AML/CFT capacities in order to strengthen their own international credibility. As global expectations regarding AML/CFT compliance rise and international review processes become rigorous, there is no way around this requirement.

4. Creating new institutions: New channels for facilitating trade transactions, remittance flows and other international payments to and from fragile emerging market countries should be developed. One possibility is a new "class" of international commercial bank that would engage in correspondent financial activities with emerging market countries as a core business. There is evidence that such banks are already developing this capability. In some regions of the world, such as the Pacific Islands, a regional payments clearing house could play an important role in strengthening correspondent bank linkages, if it meets international standards for customer due diligence.

5. Developing FinTech: Blockchain, digital currencies and mobile payments technologies all offer potential major channels to addressing de-risking. All these digital technologies pose risks as well as opportunities to users, and only mobile payments in many countries currently benefit from an agreed-upon supervisory framework. Much work needs to be done in this area, focused on identifying the most viable, cost-effective funds transfer mechanisms and a supervisory framework for overseeing their use. On a positive note, algorithms employed by artificial intelligence are already providing more effective and efficient predictive analytics, which will help push due diligence (and therefore compliance) costs down for banks.

SESSION V – New Financial Technologies and Their Implications for the U.S., Russia and China

FinTech Today vs. Its Potential

Global investment in FinTech has accelerated rapidly over the past three decades and nearly exponentially in the past five years, and its importance cannot be overstated. The potential for FinTech in helping to address financial inclusion issues, in particular, was explored. According to the U.S. Federal Deposit Insurance Corporation (FDIC), 7% of all households in the U.S. do not have a bank account, and another 24% have some banking relationship but depend on payday lenders, pawn shops and similar services for access to primary banking services. Moreover, these numbers have not changed substantially over the past 10 years. Globally, 50% of the world's population is un- or under-banked. The depth of this challenge is such that, despite massive investment in FinTech in recent years, these technologies have yet to help address the economic, and by extension social, disparities that result from financial exclusion.

This is the case for several reasons. For example, in the U.S., all payments channels are controlled by banks and the Federal Reserve, and the legal structure is designed to protect existing banks. If an entity wants to accept funds from the public that resemble deposits, they must obtain a banking license. These barriers have significantly raised the cost of entry for new FinTech ventures in the U.S., and have therefore limited the capacity for disruptive innovation by smaller competitors in the market.

Furthermore, technologies like Blockchain and digital currencies still need to develop significantly before they can achieve impact on a larger scale. There are currently over 1,600 unofficial digital currencies (not backed by a government) in existence, with a total market capitalization of $369 billion as of March 2018, down from $700 billion some months earlier. Unofficial digital currencies are therefore extremely volatile, and their total market capitalization is relatively insignificant. In terms of the technology itself, much progress has yet to be made. A Bitcoin transaction takes on average 78 minutes to complete. By comparison, Visa processes 24,000 transactions per second. Another unique weakness in digital currencies is the code itself: on average, cryptocurrencies currently have 100 bugs per 1,000 lines of code, compared to 10 bugs per 1,000 lines for Microsoft.

Digital Currencies and their Relationship to Central Banks

Participants were generally confident that digital currencies will become increasingly important in the short- and medium-term, and will likely be ubiquitous in the longer-term. The path forward holds significant challenges, however. The first concerns unofficial versus official digital currencies. Bitcoin is an unofficial digital currency as it is not backed by any government or asset, and is not a legal tender. There is a broad sense that many people engaged with unofficial currencies such as Bitcoin hold a libertarian view and are attracted to them because they are a medium of exchange beyond government control.

One panelist noted, however, that it is unrealistic to expect a sovereign country to relinquish control of its money supply in favor of unofficial digital currencies. Central banks around the world therefore are working to develop government-backed digital currency programs. China is testing a Blockchain-based digital platform and Russia will offer a Digital Ruble soon. In the U.S., the Federal Reserve has been more cautious, noting significant operational challenges to releasing a digital currency, including the threat of cyberattacks and the significant implications of such a currency for the retail banking system. The currency could become a substitute for retail banking deposits, particularly in times of economic stress, and could therefore impact rates and terms of deposits, as well as lending.

The Regulation of FinTech

Many countries observed established domestic FinTech "sandboxes", which facilitate FinTech innovation within controlled environments. Sandbox arrangements in the U.K., for example, allow a certain amount of flexibility for FinTech ventures handling less than $10 billion

in assets. The sandbox framework also enables regulators to learn with FinTech innovators which, many participants emphasized, is a significant step toward helping regulators better understand the benefits and risks of FinTech. Currently, regulators are struggling to keep pace with FinTech innovation and acquire the necessary knowledge to regulate it without preventing innovation. Many participants noted that the U.S. should adopt a sandbox arrangement, while noting that the 50-state framework may pose challenges. For example, while the U.S. Office of Comptroller of the Currency (OCC) proposed a FinTech charter that would have allowed limited activities and created tailored regulation for those activities, State regulators opposed it.

Issues related to FinTech and data privacy were also raised by participants. While Europe has moved progressively toward increased protection of data privacy, the U.S. has been slower to act on this issue. Recent events – including scandals related to Facebook data and Russian interference with U.S. elections – may lead to changes, however, as evidenced by the recent adoption of a tough data privacy law by lawmakers in California. In China, the government is moving in the opposite direction, harnessing the power of FinTech and its data to increase its control over society. For example, the government has leveraged its control over companies like AliPay and TenCent to merge the digital footprints of citizens across industries and establish a social credit scoring system that it aims to roll out by 2020.

SESSION VI – Summary Observations and Discussion of Practical Policy Recommendations

Macro-Trends

Participants felt that the overall picture looked bleak. Some participants contended that at least part of the current troubling situation is rooted in the legacy of pain, frustration and anger associated with the 2008 global financial crisis. Indeed, the U.S. and other countries are continuing to experience aftershocks, as people at the bottom of the socio-economic system before the crisis remain alienated today. This situation incited populist movements in the U.S. and around the world. While several participants noted that these populist movements may dissipate as they are better at opposing existing systems than running actual governments, others noted that the underlying systemic imbalances that lead to the rise of populism must be addressed for populism to die down. In the U.S., these imbalances include excessive government spending, excessive consumption compared to savings and investments, and the erosion of trust in traditional institutions.

Tackling these issues will require stronger leadership and better, more centrist solutions. It was unclear to participants, however, where and how centrists could reassert themselves and capture the attention of more polarized voices. In the U.S., as it stands today, centrist politicians seem more likely to retire as they would not be reelected, and this is worrisome if these trends become a generational problem. To counter this trend, participants noted the importance of liberal elites acknowledging the issues at hand, and identifying solutions to them. The world is not short of ideas for potential solutions; however, the world lacks people who support these

ideas. The notion that great ideas are recognized on the basis of sound reason and rationality is less prevalent today. At critical times in history, such as after the Reformation, the narratives of modernity and modernization were an extremely powerful force that drove people forward. Most could expect that, sooner or later, they would live in a better world and in improved conditions. Today, this belief has been shattered and there is no credible narrative rising above the noise to provide people with hope.

World Order and Global Leadership

Participants agreed that the United States has undeniably begun to abdicate its global roles and responsibilities. There is also a perception in Asia – including among business leaders – that the U.S. is absent and actively forgoing its ability to shape developments on the continent. Examples of this absence include the U.S. withdrawal from the Trans-Pacific Partnership and the lack of U.S. representation at recent business forums in Asia. Importantly, Americans may not understand the extent to which their credibility is being undermined. At the same time, the U.S. seems to be putting up walls to the outside world. Asian professionals are facing difficulties in obtaining visas to work in the U.S., even though many were educated there, and, as a result, many have gone to Europe. This trend suggests that the U.S. could suffer from a lack of high-skilled foreign labor over time.

From a Russian, Chinese or Indian perspective, the withdrawal of the U.S. may not be so terrible. The U.S.-led post-Cold War world order did not evolve the way many expected, with the continuation of wars, conflicts and global financial crises. It was suggested that the world could be more stable with a bipolar or multipolar framework, rather than a unipolar U.S.-led one. This led to a debate among participants about whether and how China may fill the leadership void, and whether liberal democracy or a more authoritarian model will prevail, or neither. For example, to what extent are China and Russia adopting each other's worst tendencies? As the two counties look toward each other rather than the U.S. for guidance, this may cause shifts in the rules of international engagement, if the U.S. does not reclaim its leadership role.

The Global Economy and International Financial System

Participants summarized several dynamics within the global economy and financial system:

1. <u>Infrastructure investment</u>: Infrastructure investment will be critical over the coming decades. The U.S., however, appears to be losing ground to China in this area. As the U.S. moves toward the protection of its own interests and worries about the next election, China is using its economic power to gain leverage in the international system.

2. <u>Financialization:</u> The increasingly exaggerated role of financial sectors in advanced economies has negative implications for the growth of SMEs. Due in part to financialization, the world is also seeing growing income inequality and weaker growth, which contribute to a wide range of problems on the national and international levels.

3. Pace of economic growth versus demographics: In Africa, for example, standards of living have improved in absolute terms. The continent faces a demographic boom, however, and there will be a critical shortage of jobs. Advanced and developing economies need strong and inclusive economic growth to cope with this challenge.

4. Technological innovation: Emerging technologies have the potential to impact the global economy in profound ways, both positive and negative. The rate of technological innovation is increasing exponentially, and regulators must determine how to manage new developments appropriately without stymying progress. It also remains to be seen how the U.S., Russia and China will compete in the technological innovation space.

The Next Global Financial Crisis

Given these dynamics, participants debated about the likely causes and timing of the next financial crisis. Some argued that, compared to the state of the global economy before 2008, we are now in a more dangerous position. The amount of debt that countries have accumulated in order to achieve growth is greater than in the past and, as a result, many countries' debt-to-GDP ratios have increased. Furthermore, the valuations of the housing and stock markets in the U.S. and the current state of world bond rates look worse than before 2008. Regulators worldwide also do not seem to be keeping pace with FinTech and its potential risks. Finally, the institutions and international arrangements (both formal and informal) that enabled the U.S. and other countries to weather the last global financial crisis are today no longer in as strong a position to handle a crisis. Taken together, these facts indicate that the next global financial crisis may be much worse.

Conclusions: Policy Recommendations

Through open, multilateral discussions, participants exchanged ideas and insights about critical global financial challenges that are receiving insufficient attention. They also explored the profound impact these challenges are having on international security, political stability and relationships among the world's great powers. While participants noted that the relationships that the U.S. has with both Russia and China are fraught, they collectively agreed on the critical importance of thoughtful, constructive dialogue and collaboration in this tense global context. In this spirit, participants raised critical questions about shared challenges during the symposium and identified several specific recommendations for policymakers to consider.

Recommendations on Macro-Trends

1. Confronting the unintended consequences of financialization: Middle-income countries, in particular, should take early action to prevent the overgrowth of financialization.

2. Constructing new narratives: New narratives should be developed to reform and re-legitimize the liberal model of development. These narratives would help counter

authoritarian alternatives and should target both ends of the political spectrum, particularly in the U.S. Such narratives could be of great use in the area of economic and financial inclusion, particularly how to create jobs for young people entering the workforce, and retrain workers displaced by technology. New narratives are also needed to discuss growing public-sector debt, and how to handle unsustainable entitlements. Finally, new narratives could help in the area of global trade and integration, to discuss how to avoid trade wars despite unfair trade practices, and to create trade conditions so that people who benefit disproportionately can compensate those who lose.

Recommendations on Sanctions

1. Limiting the use of sanctions: Policymakers, particularly in the U.S., should adopt greater prudence in their policies around sanctions. Secondary sanctions should be utilized only with multilateral support and in exceptional circumstances. Furthermore, once an official deal is reached with a country targeted by sanctions, the country levying the sanctions should take great care to demonstrate its commitment to honoring the deal. Otherwise, trust will erode and future sanctions actions will have a far lower chance of success.

2. Drafting a common doctrine for sanctions: The international system would benefit from a common doctrine outlining appropriate standards for sanctions policy. This doctrine would help clarify and categorize the diplomatic intentions of financial and economic sanctions.

Recommendations on De-Risking

In addition to the recommendations noted on p. 9, the following recommendations were made with regard to de-risking:

1. Adopting a regional approach: While there is no one-size-fits-all solution to de-risking, data show that countries in the same region tend to share common drivers and face similar challenges. Efficiency therefore could be gained through the regional discussion of issues and the development of regional responses. The IMF has already made progress in this area by launching regional initiatives in the Caribbean, the Pacific, the Middle East and North Africa (MENA) region and in Sub-Saharan Africa.

2. Removing barriers to information-sharing between correspondent and respondent banks, and among correspondent banks: As noted earlier, regulators should encourage large banks to give respondent banks a more detailed explanation when account relationships are terminated, as well as some indication of steps that could be taken to restore those relationships over time. Both legal and operational barriers must be rethought in order to allow regulators and banks to make explicit what information is needed from local banks, and what steps respondents can take to ensure continued access to CBRs. Similarly, regulators should encourage more information-sharing among correspondent banks to consolidate transaction traffic, and create economies of scale and reduce transaction costs.

3. Developing public-private partnerships: There is potential to create public-private partnerships jointly invested in a hub, which would provide services for, and build the connections to, local banks.

4. Granting accreditation to intermediary institutions, and utilizing reviews by international bodies: Greater accreditation of intermediary institutions (e.g., a regional payments clearing house) would be helpful in addressing the de-risking challenge and could be provided by regulators. The Financial Action Task Force (FATF), drawing on its periodic reviews of countries' AML/CFT compliance frameworks, could help communicate to the world when countries make real progress.

Recommendations on FinTech

1. Creating more regulatory sandboxes for FinTech: The U.S. should implement a regulatory sandbox program similar to those established in the U.K. and Dubai. A sandbox would promote innovation in a controlled environment (without structural risk), while allowing regulators to learn in lock-step with innovators.

2. Building regulatory capacity on FinTech: Regulators must develop greater knowledge and technical capacity to understand and manage the benefits and risks posed by FinTech.

3. Placing emphasis on regulatory technologies: Focus should be placed on developing regulatory technologies as part of a near-term solution to de-risking. The underlying technology has been proven reliable, and innovation in this area has the potential to reduce regulatory compliance costs and increase the accuracy of due diligence.

4. Developing new international measurements on FinTech: An international rating system could be developed in order to measure FinTech innovation across different countries and monitor global trends. This system could provide a benchmark against which countries can measure progress in FinTech innovation.

5. Establishing an audit regime for digital currencies: An international audit regime should be established to monitor errors and vulnerabilities in digital currency code.

6. Conducting a study on the relationship between financial inclusion and money laundering: This study would aim to better understand the extent to which increasing formal financial inclusion affects money laundering in a given region.

FSVC as well as symposium participants will be looking for ways to advance these policy recommendations and bring them to the attention of responsible public officials and thought leaders, particularly in the United States. Since the end of the symposium, FSVC has begun to hold roundtable discussions on several of these themes and plans to hold additional discussions over the coming months.

Annex I – List of Participants

Andrei Arofikin is Chairman of the Board of Directors of the Russian fintech brokerage firm Septem Capital, and former Managing Director at Bank of America Merril Lynch in Moscow.

Deana Arsenian is Vice President of the International Programs at Carnegie Corporation of New York.

Andy Baukol is Principal Deputy Assistant Secretary for International Monetary Policy at the U.S. Department of the Treasury.

Andrew Bury is the Deputy Chief of the Political and Economic section of the U.S. Embassy in Tajikistan.

Michael Creed is Senior Manager of Policy and Strategy at the Dubai Financial Services Authority (DFSA).

Ambassador Cui Tiankai is China's ambassador to the United States.

John L. Douglas is Senior Executive Vice President and Chief Oversight and Advocacy Officer at TIAA. He is Chairman of the Executive Committee of FSVC's Board.

Nancy Gallagher is Director at the Center for International and Security Studies at Maryland and a Research Professor in the University of Maryland's School of Public Policy.

Vadim Grishin is a Consultant at the International Financial Corporation (IFC) and an Adjunct-Professor at Georgetown University, and a former Executive Director at the World Bank.

Randall Guynn is head of the Financial Institutions Group of Davis Polk & Wardwell LLP. He is an FSVC Board member.

Harry Harding is a University Professor and Professor of Public Policy at the University of Virginia, where he is also Senior Fellow in the Miller Center of Public Affairs.

Charles E. Kilbourne is a Managing Director and Secretary of the Corporation of FSVC.

Wei Li is Professor of Economics at the Cheung Kong Graduate School of Business in Beijing.

Syaru Shirley Lin is a board member of Goldman Sachs Asia Bank, and a member of the founding faculty of the Master's Program in Global Political Economy at the Chinese University of Hong Kong.

Yan Liu is Assistant General Counsel in the Legal Department of the International Monetary Fund (IMF), and head of the IMF's Financial Integrity Group.

Angela Mancini is Head of the Southeast Asia business at Control Risks.

Bill Mills is Chief Executive Officer of North America for Citi.

Andrea Perraud is Managing Director of Programs at FSVC.

Klaus Segbers is Professor of Political Science, International Relations and East European Politics at the Free University of Berlin, and Director of its Center for Global Politics.

Nathan Sheets is Chief Economist and head of Global Macroeconomic Research at PGIM Fixed Income, and a former Undersecretary of the Treasury for International Affairs.

J. Andrew Spindler is President & CEO of FSVC and a Board member of the Dubai Financial Services Authority.

Yun Sun is co-Director of the East Asia Program and Director of the China Program at the Stimson Center.

Adam Szubin is Of Counsel at Sullivan & Cromwell LLP and the former Acting Under Secretary for Terrorism and Financial Intelligence at the U.S. Department of Treasury. He is an FSVC Board member.

Congyan Tan is Vice President of the China Institute of Finance and Capital Markets (CIFCM), the research institute of the China Securities Regulatory Commission.

Ivan Timofeev is Director of Programs at the Russian International Affairs Council and heads the Euro-Atlantic Security program at the Valdai Discussion Club.

Mikhail Troitskiy is Dean of the School of Government and International Affairs at the Moscow State Institute of International Relations (MGIMO).

John L. Walker is a retired Partner at Simpson Thacher & Bartlett LLP, where he practiced banking and corporate law for 30 years. He is an FSVC Board member.

Andy Xie is a Shanghai-based independent economist specializing in China and Asia.

Haiying Zhao is the Executive Vice President and Director General of the Department of Non-Banking Financial Institutions at Central Huijin Investment Ltd.