Harvard Law School Program on International Financial Systems

International House of Japan

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

Virtual | November 5-6, 2020

Final Report

2020 Symposium on Building the Financial System of the 21st Century: An Agenda for Japan and the United States

The twenty-third Japan-U.S. Symposium on Building the Financial System of the 21st Century was held via Zoom on November 5-6 and 17 (small groups), 2020. Sessions addressed the implications of the U.S. elections on the international financial system, the effects of post-global financial crisis financial regulatory reforms on the performance of the financial sector during the COVID-19 crisis, and implications of the COVID-19 crisis for international business and finance.

Topic 1: Implications of the U.S. Election on the International Financial System

For Topic 1, participants discussed the implications of the U.S. election on the international financial system. While vote counts had yet to be finalized, participants anticipated a victory for Joe Biden in the presidential race and a close contest in the Senate that raised the likelihood of divided government. It was also noted that Japan had also seen a turnover of leadership from Prime Minister Shinzō Abe to Yoshihide Suga, although without a general election. With those outcomes in mind, they considered the effects on macroeconomic policies, management of the COVID-19 pandemic, financial regulation and supervision, and U.S.-China relations.

Macroeconomic Policy

Most participants agreed that the effects of the election would be greatest on fiscal policy. While the Trump administration had put in place large-scale, business-friendly tax cuts and had presided over historically high budget deficits, the Biden campaign had called for a partial rollback of the Trump tax cuts, tax hikes on high-income households, and ambitious new social spending plans. Participants predicted that the closely divided Senate, with a possible Republican majority, would likely thwart Biden's tax and spending plans. Several argued that this was ideal from a business standpoint.

In addition to longer-term fiscal policy consequences to the election, there was also discussion of the more immediate issue of spending to address the COVID-19 pandemic. Many participants predicted that the legislative logjam would end after the election, allowing for a renewal of key elements of the CARES Act, including the Paycheck Protection Program (PPP), which they saw as a positive for economic recovery and for preventing further dislocations due to bankruptcies and evictions. While some felt that the shape of the pandemic relief legislation would differ depending on whether Biden or Trump prevailed, many felt that Biden would have little room for maneuver with a Republican Senate and so the package would likely focus on widely-agreed policies such as PPP. It was also noted that hundreds of billions of dollars of potential spending from earlier pandemic relief legislation remained unspent or uncommitted, most notably with respect to the Fed's Main Street Lending Program. Several participants also pointed out that federal support to states and localities remained controversial, and raised concerns that state and local fiscal shortfalls would lead to large-scale layoffs and hamper public health initiatives, including distribution of vaccines.

Participants expected continuity in monetary policy. They noted that a low-inflation environment had prevailed among advanced economies, including Japan and the U.S., for at least 25 years. Low inflation had been accompanied by low interest rates, constraining central banks' monetary policy options. Led by Japan, central banks throughout the developed world had come to rely on quantitative easing as a key instrument of monetary policy. Most participants agreed that slow growth and lack of inflationary pressure would continue to indicate the need for quantitative easing and low or negative interest rates for the being, regardless of the final results of the presidential and Senate elections. A major concern for some participants was whether it would ever be possible for central banks to exit quantitative easing without disrupting markets. What, they asked, were the long-term implications of central banks being major holders of assets in many economies?

Participants also discussed two other roles of central banks: providing liquidity to financial markets and providing credit to the real economy. Both the Fed and Bank of Japan had proactively provided liquidity to financial markets in March 2020, with the Fed working to stabilize Treasuries and corporate bonds and the BOJ working with the Fed to ensure sufficient dollar funding for Japanese financial institutions. Participants agreed that these actions had been crucial in minimizing financial shocks, and in enabling financial institutions to provide the credit needed for the economy. There were, however, some concerns about whether it would be possible for the Fed to withdraw support from corporate bond markets without sparking a new round of illiquidity (subsequent to the Symposium, the Treasury decided to close this facility as of the end of the year). Also, some participants raised concerns that the Fed's intervention in corporate bond markets might open the door to new types of monetary policy actions in US, such as purchasing ETFs, that could lead to growing levels of direct Fed ownership of private debts, or as one participant put it, "further socialization of credit in the U.S."

Participants also discussed direct lending programs to address the economic effects of the pandemic. They focused in particular on the Fed's Main Street Lending Program, which was seen by many participants as a disappointment. The program was meant to support bank lending to small and medium-sized enterprises in order to support payrolls and maintain employment, but by the time of the Symposium less than $4 billion of the authorized maximum of $600 billion had actually been lent. Several participants attributed this to the fact that lenders were required to hold 5% of the loan. In contrast, they argued, successful SME loan guarantee programs in Japan and Europe had guaranteed the entirety of the loan. This 5% retention made banks much more wary of utilizing the Main Street facilities. The effects of the poor performance of the Main Street program were seen by a number of participants as significant—they argued that it had contributed directly to the widespread failures of SMEs in the U.S., which would make economic recovery far more difficult.

A final issue regarding macroeconomic policy was what many observers had termed the "fiscalization of monetary policy." Participants questioned where the line should be drawn between fiscal and monetary policy in the era of quantitative easing, in which central banks were increasingly financing government spending. While some participants worried about the potential inflationary effects of monetizing debt, a greater concern for more participants was the ways in which central banks were being drawn into quasi-fiscal activities—in particular, taking risks on their own balance sheets, as in the case of the Fed's corporate bond market intervention and the Main Street program. In contrast, Japan's guaranteed loan programs for SMEs were provided through the budget process.

Financial Regulation and Supervision

Participants also discussed the implications of the election on financial regulation and supervision. Most participants predicted relatively moderate changes. They argued that the Trump deregulation agenda had been rather limited and incremental in nature. Moreover, they saw Biden as not particularly focused on financial regulation. In addition, the likelihood of a Republican-majority, or at least evenly-split, Senate also made it unlikely that there would be significant legislative changes in financial regulation.

With little likelihood of quick or ambitious legislative action on financial regulation, participants agreed that the biggest changes were likely to come from personnel shifts in regulatory and prudential agencies. While it was recognized that some potential appointees had strong positions in favor of re-regulation, participants predicted that a Biden administration would refrain from appointing the most activist candidates due to the challenges of Senate confirmation. Several participants also predicted that there would be bigger changes in supervision than in regulation, largely because of the time and processes involved in regulatory rulemaking.

U.S.-China Relations

Finally, participants discussed at length the likely impact of the presidential election on U.S.-China relations. This was seen to be of crucial importance not only to the U.S. and China, but also to Japan and to global governance in general.

Participants agreed that bilateral relations were especially challenging going into 2021. President Trump had already targeted China over trade, territorial aggression, and human rights since taking office, and in 2020 had repeatedly blamed China for having triggered the globalization of the COVID-19 pandemic. Perhaps surprisingly, most participants expected more continuity in China policy than a sharp break, arguing that elite opinion in the U.S. had fundamentally shifted from a preference for accommodation to active mistrust of China. While they predicted that a Biden administration would make less use of unilateral tariffs and sanctions and would significantly tone down hostile rhetoric, they expected that it would seek to pressure China through multilateral forums and in cooperation with allies. Some participants also expected that a Biden administration would be more selective about the disputes on which it would focus, seeking opportunities for cooperation as well as confrontation and competition. One question mark was whether the Biden administration would be more open to Chinese investment in the U.S. It was noted that the Trump administration had been much stricter than previous administrations in the operation of the Committee on Foreign Investment in the U.S. (CFIUS). Some participants predicted that a Biden administration would be more open to Chinese investment in general; however, they expected the administration to continue to restrict investments that might give Chinese companies access to sensitive technologies or data

For Japan and other economies in Asia, U.S.-China confrontation was seen to create severe dilemmas. They had become highly dependent on China as supplier and customer, and especially in the context of manufacturing supply chains. These would be painful to sever, and participants agreed that Asian economies were fearful of calls for decoupling, as they did not want to have to choose. However, it was also noted that Japanese public opinion had shifted considerably against China over the last decade, and several participants indicated that Japan welcomed a tough line by the U.S., as long as it was done in cooperation with allies. It was also noted that the Japanese government had already started providing incentives for Japanese firms to reduce their reliance on China in their supply chains, albeit with limited effects to date. Japan had also recently introduced changes to its own laws on inward foreign investment to allow the government to restrict investments that could affect national security, including technology and pharmaceuticals. Another matter of particular concern was the lack of transparency over emerging economies' debt exposure to China. It was noted that China was not a member of the Paris Club and that major state-owned Chinese creditors such as the China Development Bank were not subject to the G20's Debt Service Suspension Initiative (DSSI).

Topic 2: How has the post-2008 financial crisis regulatory regime affected the ability of the financial sector to support the real economy during the COVID-19 crisis?

For Topic 2, participants discussed the effects of post-2008 financial regulatory reforms on the financial sector. There was a strong consensus that banks had become much more safe and resilient as a result of the reforms. Participants also discussed the impact of reforms on non-banks and financial markets, where there was less agreement. In addition, there was considerable discussion of how effectively the financial sector was supporting the real economy during the COVID-19 crisis.

Regulatory Reform and Financial Resilience

Participants agreed that banks weathered the COVID-19 crisis well. Unlike in the global financial crisis, banks held ample capital and liquidity to continue operations uninterrupted and indeed to expand lending to borrowers in need. They also enjoyed more stable funding, rather than relying on the short-term borrowing that had contributed to financial institution failures during the global crisis. Given the sheer scale of the economic crisis, it appeared that banking reforms had served the financial system well in the face of what some participants termed a full-scale "stress test" of financial regulatory reforms.

The picture was seen to be more mixed outside of the banking sector. While financial infrastructures such as exchanges and clearinghouses had continued to function largely without disruption, liquidity issues in March 2020 in a variety of financial markets including corporate bonds, corporate paper, and even government bonds had required assertive central bank intervention, especially in the U.S. and Europe. Of particular concern to many participants was the disruption in the market for U.S. Treasuries, the classic safe-haven security. There was some debate over the reasons for the liquidity issues in the Treasury market. Some participants argued that there was so much debt that dealers could not fully absorb it on their own. Some suggested that hedge fund withdrawals from the Treasury market due to unwinding of trades was also a concern. Others pointed to the money market funds as being particular drivers of illiquidity. Others suggested that the withdrawal of banks from their traditional role as market-makers was important, fueled in part by leverage regulation, margin requirements and the Volcker Rule.

Supporting the Real Economy

Overall, participants felt that the financial system had been a pillar of stability in the midst of an unprecedented economic slowdown, helping to buffer the economy from crisis, rather than acting as an accelerant. Banks in particular were given high marks for their capacity and willingness to lend into the crisis. Several participants noted that some non-banks had also been active in providing needed funds, including private equity groups.

Some participants expressed concern that banks might be lowering their lending standards excessively, although many felt that prudential standards were being maintained. Banks not only lent on their own accounts, but proved to be the necessary conduits to deliver the funds from massive government credit programs to the borrowers that needed them, especially SMEs. This was the case in many countries, including the U.S. and Japan.

One question mark in this story was the extent to which bank lending relied on government support, whether through direct funding or credit guarantees. Several participants noted that the most successful official lending programs were those in which the government or central bank took 100% of the risk of new loans. Thus, they argued that banks were not important in and of themselves, but just as agents for governments. They worried that the banks would have a hard time adjusting as governments withdrew credit support, potentially leading to future credit crunches or to prolonged government involvement in credit provision.

Lessons and Potential Gaps

Although participants generally saw the effects of post-2008 financial regulatory reform as having been successful both in making the financial system safer and in ensuring that funds were supplied to the real economy, some felt that COVID-19 had also shined a light on some gaps and weaknesses of financial regulation and supervision.

The biggest concern among participants was over the March liquidity issues, which had required assertive central bank action to prevent a seizing up of crucial debt markets in Europe and the U.S. If left unaddressed, the effects could have reverberated throughout the financial system, adding financial fragility to the pandemic-induced economic crisis. Participants offered differing interpretations of the crisis and appropriate policy responses. Some argued that the problem was that financial regulatory reform had not been properly extended to non-bank financial institutions such as MMFs

Other participants were not convinced. They worried that enhanced prudential supervision of non-banks would blur the distinction between banks and non-banks, reducing the choices available to investors and to borrowers, and potentially lowering growth potential as fewer market actors would be willing to provide risk capital. They argued instead that, given the sheer scale and uncertainty of the crisis, it was completely reasonable that central banks had fulfilled their roles as financial backstops by ensuring sufficient liquidity. In this interpretation, central bank intervention was primarily about reducing uncertainty and restoring trust in counterparties and trading platforms; as evidence, they noted that the actual amounts of corporate bonds held by the Fed was only about $28 billion, which they saw as a drop in the ocean, and certainly not enough to distort markets. They felt that the lesson to be drawn from the liquidity freezes was that central banks should take a leading role in stabilizing markets at times of crisis. Their main concern was that the Fed and other central banks should retain the ability to carry out such interventions as needed. In the U.S., section 13(3) of the Federal Reserve Act, as amended by the 2010 Dodd-Frank Act, required authorization from the Treasury Secretary for certain emergency liquidity operations; while Secretary Mnuchin had supported the Fed's actions in March 2020, there was some concern that future Treasury Secretaries might block emergency action in future liquidity crises. Some participants drew a different lesson from the success of the Fed's actions.

They argued that financial market participants could now be confident that the Fed would step in to fix any liquidity problems that might arise in financial markets, thus reducing their own responsibility and creating considerable moral hazard. They predicted that Fed intervention would never be fully withdrawn, even when positions were small, as in corporate bonds.

Another lesson that some participants drew from the performance of financial institutions, central banks, and supervisors over the course of the (continuing) COVID-19 crisis was the importance of coordination both within and across borders. Dollar funding had been assured due to cooperation among central banks, particularly through the Fed's swap lines, reducing pressures on corporations around the world. In the U.S. and Japan, the cooperation between the central bank and the government had allowed for effective fiscal stimulus and quantitative easing. Supervisors too had worked together to manage the trade-offs between prudential and macroprudential concerns.

Finally, many participants noted that the crisis was not yet over. While the financial system, and in particular banks in major countries, had performed admirably to provide credit to the real economy where it was needed while also adhering to prudential rules regarding capital and liquidity (adjusted where necessary), the large expansion of debt could easily lead to big increases in non-performing loans if the crisis were to persist long enough. This was particularly true among certain classes of especially hard-hit borrowers, including SMEs and companies in the transportation and hospitality sectors. In other words, they cautioned, the pandemic would likely have the last word as to the long-term health of the financial sector and its ability lend.

Topic 3: Implications of the COVID-19 Crisis for International Business and Finance

For Topic 3, participants discussed the implications of the COVID-19 crisis for the future of international business and finance. While generally complimentary of the way in which governments, central banks, and financial institutions had managed the economic fallout from the pandemic, they expressed concern about longer-term issues, including the possibility of widespread insolvencies, the need for structural reforms, and distributive effects. Many saw a changed role of the public sector in developed economies, including Japan and the U.S. They also noted that the crisis was occurring in the context of several other important trends that could affect international business and finance. These included digitalization of finance, long-term low interest rate environment, growing concerns about environmental issues, and U.S.-China tensions.

Viewing the Pandemic from Japan and the U.S.

While the COVID-19 pandemic's negative effects were global in nature, participants noted that they varied greatly among countries. In the U.S., inconsistent policies among states, along with political and social resistance to public health measures such as mask mandates and contact tracing, had allowed the pandemic to spread widely. By the time of the Symposium, new daily infections in the U.S. had surpassed their July peak by 70%, although death rates were significantly lower than in the early days of the pandemic, due both to better treatment and to infection of healthier populations. Most states that had loosened restrictions over the summer chose not to reimpose them despite the increased rates of infection around the country. However, participants also noted several bright spots. One was apparent progress on vaccines, seen by many participants as an essential element in ending the pandemic. Participants also noted that the U.S. economy had recovered surprisingly well from the fastest, deepest recession since the 1930s. Following the record unemployment and widespread business closings of the late spring, employment and economic growth had rebounded considerably, helped largely by proactive fiscal policies and official lending programs. While some sectors, such as transportation and hospitality, remained in dire straits, other segments of the economy were relatively resilient.

Japan's experience with the pandemic was quite different. Despite its proximity to China and large elderly population, Japan had seen consistently low numbers of infections and deaths. It had eschewed mandatory lockdowns and mask-wearing, but had achieved high compliance with government directives, while focusing on contact tracing and containment rather than on mass testing. Participants also predicted that the Japanese people would be much more willing to accept vaccinations than Americans, many of whom had become vaccine skeptics or just distrustful of the government. Japan's economy, though negatively affected by the pandemic, had done well relative to the U.S. and Europe, partly because infection rates remained low and partly due to proactive government policies and credit provision. As in the U.S., economic effects of the pandemic were not evenly distributed. In addition to transportation and hospitality, other labor-intensive service industries faced particular challenges. Although Japanese labor practices discouraged spikes in unemployment, it was evident to many participants that structural changes were likely to be accelerated by the pandemic and its economic effects, as described below.

A Tale of Three Crises

In discussing the economic effects of the pandemic, participants talked about three types of crises that could occur: liquidity, insolvency, and structural. The timing of these challenges ranged from short- to long-term.

Participants agreed that a serious liquidity crisis had been averted, despite the severe economic blow caused by the pandemic. One reason identified by many of them was the post-global financial crisis regulatory reforms, which had left banks and many other financial institutions better capitalized, more stable, and more resilient than in 2008, allowing them to be part of the solution rather than the cause (or accelerant) of the problem. Both the U.S and Japan had largely implemented Basel III and other internationally-agreed standards and had also implemented effective macroprudential supervision. A second reason was the proactive measures by the Fed, Bank of Japan, and other major central banks to ensure financial market liquidity in the spring as well as continued massive provision of credit through quantitative easing.

While a liquidity crisis had been averted, participants worried about the potential for insolvency crises. Although they lauded the contribution of banks to keeping businesses afloat through lending, they recognized that if economic weakness were to persist, it could lead to widespread non-performing loans and bankruptcies. This was seen as particularly true of loans to hard-hit sectors and regions. Some participants were relatively optimistic, predicting that the pandemic would be contained by mid-2021, when they expected vaccines to be widely available. Others worried that might be too late for many businesses—particularly in the U.S., where the Main Street Lending Program had largely failed to support SMEs and PPP had not been renewed. These participants feared that a widespread failure of small businesses would make it difficult to rebuild the private-sector economy. Japan was seen by many participants to have been more successful in preventing SME insolvencies, both because per capita COVID-19 infections were thirty times lower than in the U.S. and because the Japanese government had moved swiftly to activate existing SME support programs.

Longer-term, a number of participants argued that developed countries, especially Japan, faced structural crises over the allocation of capital and labor. A familiar structural challenge for Japan was its aging society and declining population, which was weakening regional economies outside of Tokyo. Another challenge was the overemployment in labor-intensive service sectors. Although stable employment practices had prevented sharp shifts in employment in service sectors such as finance, the pandemic was seen as accelerating the trend toward digitization and away from high-touch service. In terms of its distributive effects, the pandemic weakened sectors such as hospitality, transportation, and retail and offered new opportunities to tech firms and major financial institutions, while also advantaging knowledge workers over others. For many participants, this confluence of trends called for a large-scale reallocation of capital and labor to the places where they could be most productive. While the challenges were common to developed economies, Japan was seen as facing particular obstacles to such structural changes, due to its stable labor system and long-term relationships that advantaged established firms and financial institutions.

Many participants noted that these crises also faced emerging markets, which had fewer resources with which to manage them. Liquidity and insolvency concerns were of particular concern, since emerging market governments faced constraints in borrowing, particularly in dollars. While this point was not discussed at length, participants agreed that this could be a major concern for the global economy and for international organizations going forward.

Role of Public Sector

Participants agreed that government and central bank action in Japan, the U.S., and elsewhere had been instrumental in blunting the worst economic consequences of the pandemic, even though they had mixed appraisals of particular policies. For example, while participants agreed that policies such as the CARES Act, Fed liquidity actions, and regulatory relief for banks had been highly effective, many criticized U.S. authorities for their handling of public health issues, their failure to pass a third COVID-19 relief bill, and the shortcomings of the Main Street Lending Program.

Shifting perspective from the short-term effects of pandemic responses, many participants agreed that the long-term effects would likely be profound. One aspect, as noted under Topic 1, was the likelihood that macroeconomic policy support for developed economies was seen as likely to continue for many years. Not only would this include quantitative easing and low or negative interest rates, but also continued fiscal support. Some participants were not deeply concerned about the likelihood of continued high budget deficits, arguing they would be sustainable. Others worried that fiscal irresponsibility and monetization of debt would ensue. One concern was that this would lead to inflation, but a larger concern was that government intervention in the economy would be pervasive, distorting prices, capital allocation, and incentives—and ultimately reducing productivity and income growth.

A particular concern is whether and how it would be possible to withdraw government and central bank support in the form of fiscal spending, quantitative easing, and liquidity injections from the economy once they had been put in place. Several participants worried that, in the absence of consumer and producer price inflation, monetary policy's main effects were in inflating asset prices. If the Fed and BOJ sought to consolidate their balance sheets, they predicted that asset prices would drop, leading to the prospect of a new financial crisis. Thus, central banks would be perpetually locked into quantitative easing. Another area of particular concern was how governments would be able to discontinue the massive loan guarantee programs they had put in place during the pandemic. Some participants also worried that government intervention would extend ever further into the economy, and that it would be politically difficult to shift risk back to the private sector.

Financial Systems

Although participants generally agreed that financial systems had done well during the pandemic, thanks to post-global financial crisis reforms and proactive central bank liquidity injections, many predicted that major changes were in store for the financial systems of Japan and the U.S. Some trends, like digitization and an increased attention to environmental, social, and governance (ESG) factors, were seen as occurring at a global level. Others were more particular, such as an expected transformation of Japan's regional banks.

Participants agreed that Japan's regional banks had long been facing serious challenges, due to declining rural populations, the pervasive low interest rate environment that led to fewer good lending opportunities, and a surfeit of branches and employees. In response to those challenges, a number of participants argued that regional banks had chosen to increase the riskiness of their portfolio, in particular through accumulating foreign debt that seemed to take them far from their expertise in local businesses. Ironically, the pandemic offered a temporary lifeline to the regional banks, as government-guaranteed loan programs offered them safe and profitable new lending opportunities. However, few participants believed that this would last beyond a couple of years. At that point, the regional banks would again be confronted with the challenges of declining local economies and low margins.

Participants discussed two not mutually exclusive alternatives for the future of Japan's regional banks. They noted that the new Suga government had decided soon after taking office to actively support consolidation of the regional banks, breaking from previous hands-off approaches. By offering financial and regulatory support for consolidation, there was an expectation that rationalization of the regional banks would happen in an orderly manner. While recognizing that consolidation and rationalization would be the likely fate for many regional banks, some participants also suggested the possibility of a more hopeful future. They noted that several major financial institutions, including Nomura and SoftBank, had recently acquired regional banks—not primarily for their traditional lending business, but as a means of distributing other financial products through dedicated customer bases and strong reputations. One way or another, however, most participants predicted significant changes in the number of banks and in their business models.

One long-term trend that was discussed at length was digitization of the financial sector. While this trend was already well-established, many participants argued that the pandemic was accelerating the transformation of traditional banking—particularly in Japan, where personalistic service had survived in banking much longer than in the U.S. or elsewhere. With reduced capacity and usage of branches due to COVID-19, banks were accelerating their shift to online services. Participants noted some important differences in the ways in which various countries' financial systems were adapting to digitization. In contrast to China and the U.S., where banks were facing considerable competition from fintechs or other non-bank financial institutions (e.g., online brokerages or payments platforms), it was argued that in Japan the larger, established financial institutions continued to hold an advantage over non-traditional entrants. This might slow adoption of digital financial services, but it also would allow incumbents to continue to profit based on their strong reputations and weight in the economy.

There was also considerable discussion of ESG. A number of participants argued that the post-COVID-19 recovery should be a green recovery. They noted a growing enthusiasm in a variety of countries for applying ESG principles to lending, investing, and infrastructure. While Europe was the furthest along in mandating ESG and creating formal taxonomies to identify and rate projects based on their adherence to ESG principles, a number of participants pointed to increased interest in Japan as well. They noted that the Tokyo government had recently issued a green bond and that there was increased attention to ESG and the UN's Sustainable Development Goals in the Japanese asset management industry. There remained more ambivalence in government ministries—although several were studying the EU taxonomies and actively discussing what ESG standards ought to look like for Japan and how they could be incorporated into regulation, they were still reluctant to go beyond voluntary standards. Participants identified some similarities to the U.S. as well. They pointed to growing popularity of ESG (especially environmental) among investors, as well as green bonds and green infrastructure initiatives in some states, but conceded that there had been no support for ESG at the federal level, although that could change under the Biden Administration. Participants did not expect that the U.S. would go the EU route of mandatory rules—which could potentially lead to frictions between the two jurisdictions—but did anticipate growing investor appetite for ESG-compliant financial products.

U.S.-China relations

A final area in which participants discussed the possibility of major long-term changes was the effects of rising tensions between the U.S. and China. Like other trends discussed in Topic 3, rising U.S.-China tensions was not a new phenomenon, but the pandemic seemed to accelerate trends that had already been accelerated under the Trump administration and Xi Jinping's consolidation of power in recent years.

Participants offered a somewhat pessimistic picture of the impact of worsening U.S.-China relations on East Asia and on the world economy. Several participants argued that China had taken advantage of the Trump administration's suspicion of international organizations and law to step into what they saw as a void in international governance created by U.S. withdrawals from some international agreements (e.g., World Health Organization, Paris Agreement) and rejection of rules-based trade agreements such as the World Trade Organization and the Trans-Pacific Partnership. A number of participants spoke to increasing uneasiness in Japan and elsewhere in East Asia about China's aggressive actions toward its neighbors over territory and other issues, and made the case that Japanese people strongly preferred more U.S. support and involvement in the region. Many expected that a Biden administration would be less antagonistic toward China while also being more effective at building coalitions to positively shape Chinese behavior, but they also expected that U.S.-China relations would remain tense, due to long-term clashes of interests. They expected that the biggest change would be a reversion to multilateralism and support for transparent international rules and agreements.

Participants discussed two other possible long-term outcomes of U.S.-China tensions. One was the reshaping of supply chains. Few expected decoupling, which Asian economies strongly opposed. But a number of participants argued that there was already considerable rethinking of supply chains, shifting from emphasizing efficiency to resilience, especially for products related to national security (including pharmaceuticals and medical supplies, thanks to the pandemic). Already, some U.S. and Japanese firms were seeking to diversify their supply chains in order to rely less on China, and the Japanese government had put in place incentives for reshoring production from China to Japan or other countries. A number of participants also predicted that this could have potential implications for financial and investment links, as already seen, for example, in the strengthening of CFIUS and of Japanese regulation of technology-related inward investments. They warned that investors should be aware of the possibility of more serious disruptions as well.

Finally, there was some discussion of central bank digital currencies, driven by Chinese moves toward creating a digital RMB. Several participants argued that Japan and the U.S. should be seriously considering creating their own digital currencies, and encouraged the Fed, BOJ, and regulators to work together to create international standards for them. Some were concerned that China may have first-mover advantage, and worried that this would create a possibility to displace the global role of the dollar. Many participants were skeptical of that possibility, but took seriously the possibility that China was either seeking to create an RMB zone or hedging its bets in case the U.S. increased the use of financial sanctions against Chinese enterprises or the government. It was also suggested that China was seeking to digitize the RMB as one more method of increasing control over its residents' personal information, rather than trying to build global advantage.

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