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CHINA'S TRANSITION: OPPORTUNITY OR THREAT?

Good afternoon ladies and gentlemen,

It's a pleasure to have an opportunity to speak at the Canadian Club of Toronto, an organization that I was proud to be a Director of for several years while living in this great city. While Toronto may not be the center of the universe, it **IS** one of the great cities of the World, the fourth largest in North America (excluding Mexico City) and it is one of the most multicultural in the World, with close to half the population having been born outside of Canada. The largest visible minority in the City are Chinese so the connections with China run deep, both for the city and for HSBC. This is our 25^{th} year in Canada and much of our success both here and Globally can be attributed to our links with China.

My remarks today will focus on the question of whether China's amazing progress represents an opportunity or threat for most of us. Since I'm a banker and we have deep roots in China, I will focus in particular on the threat to China's continued success posed by it's financial system. Today's headlines tout the beginning of the Asian Century, with China in the lead. In reality there are a number of things that could postpone the rise: economic and financial bubbles; uneven development that sparks social unrest; failing to address governance or corruption issues; the impact of pollution; or even a pandemic. It is important to look beyond the headlines that appear on a daily basis.

Let me start with our connections to China. We consider China to be fundamental to our past, our present and our future. The origins of HSBC lie squarely in China; we were founded in Hong Kong and Shanghai in 1865 and we have operated continuously in China ever since. This history makes us almost unique among foreign financial institutions in China. Today we are the largest foreign bank in China (and Canada for that matter). Added to this is the fact that around 20 per cent of my 284,000 HSBC colleagues around the world are Chinese; that one of our core client franchises is Chinese, and that our top global management team has worked with Chinese people for long periods of their lives. So I would go so far as to say that HSBC owes an enormous amount of any success we have achieved over the past century and a half to the Chinese people.

I think it is no exaggeration to describe the opening up of China as an event of historical significance on a par with the rise of America in the late 19th and early 20th centuries.

If the re-emergence of China is of equivalent historic significance, it is also very different. America’s rise was the story of the emergence of a brand new country; in 1820 when the population of China was 360 million, America’s people numbered under 10 million. A hundred years later in 1920, America’s population had swollen to around a hundred million, and it produced 20 per cent of the world’s wealth.

Today, of course, everyone is once again talking about China. The talk is about the astonishing progress the country has made since deciding to liberalise its economy. About China becoming the workshop of the world. About the wide range of goods, from the most basic to the most sophisticated, being manufactured in China. About China now consuming more copper, more tin, more zinc, more platinum, more steel and more iron ore than any other country. About China's expanding thirst for oil and the impact this is having on global energy supply and demand. About China's increasingly affluent consumer market. About exactly when, not whether, China will become the world's largest economy.

History suggests that the typical transition from a developing to developed economy starts with growth based initially on trade and in particular exports – which China has experienced. This in turn tends to attract capital – again which China has done. Eventually the workers who are creating the goods and services themselves become a market – and once again this is happening in China. The country is following the same workers-become-consumers transformation that several other economies in Asia went through during the last 50 years. Economies like Japan, Hong Kong, Malaysia, and Singapore for example.

Does China's transition represent a threat or an opportunity? There is a perception of a looming invasion by Chinese companies into various markets around the world but the reality is that most Chinese firms do not have designs on simply going Global – a recent survey found that 9 out of 10 say their main target is China itself. In fact this survey found that most were looking abroad to find new suppliers. Sounds more like an opportunity rather than a threat.

Of course, any company wanting to capitalize on business opportunities in China needs to keep certain facts in mind when devising their strategy for the coming years.

First, it is naïve to think of China as a single market; it is in fact a collection of markets. Mainland China comprises 23 provinces, five autonomous regions, and four municipalities, as well as numerous special economic zones, open coastal and border cities, export processing areas, bonded zones, provincial-level economic and technological development zones, and new and hi-technology development zones.

Second, while China will eventually become the world’s largest consumer market, the huge geographical spread means tapping the potential of the entire country will require considerable resources. The demand for types of products and services will also continue to vary significantly among the provinces. In China a good local partner can also help you with everything from labour issues to establishing valuable relationships with the appropriate administrative entities. However, finding the right joint venture partner is not easy. Careful selection is critical.

Third, although China’s legal environment is improving, offering better protection to domestic and foreign investors, certain laws continue to favour indigenous enterprises. Likewise, enforcement of judgments has room for improvement. I recall hearing about one survey focusing on the success rates of arbitration cases. It found that only one-third of foreign investors who were successful in arbitration cases actually received 75 to 100 percent of their awards. In other words, two-thirds did not get what they deserved.

Fourth, while China continues to attract foreign investment in part because of the country's business-friendly policies, differences in the interpretation of policies between central and local governments often arise. China has been trying hard to trim down bureaucratic red tape in recent years, with one-stop service counters for foreign investors. But the functions and responsibilities of some government bodies are still not well-defined or coordinated. Approval procedures remain complex.

One of the questions that is frequently asked is, "what is the key to success in China ?". The short answer is there are no shortcuts. Companies have to work hard, even if they have been there 140 years like HSBC. For the record, HSBC's strategy in China is based on both organic growth and opportunistic investments. We are the largest foreign bank in mainland China and it is a position we intend to maintain. In the last 4 years alone, we have made some US$5 billion dollars worth of strategic investments in select Mainland financial services companies.

I should perhaps pause to also point out that we remain patient about the profits that will eventually result from these investments. After all, China is a place where not that long ago a Prime Minister was asked to give his assessment of the success of the French Revolution in the late 1700s. His reply was: - "it is too early to tell".

You might be interested to know that in 2005 HSBC made considerably more money in Canada than it did in China. Bottom line – you have to be patient.

Let me turn to the issue of China's financial system, which is often raised as one of the biggest, if not the biggest threat to China's economic miracle. Financial systems play a pivotal role in every successful economy. Can you think of any economy where a weak banking and financial services system has not, in the end, hobbled growth? I cannot. The role of financial markets is to match people who have money to people who need it. It's a bit like dating, but somewhat riskier!

We have heard China's financial system described as the "shadow side of the Chinese economic miracle" so it's worth pausing a moment to consider the role that banks have been expected to play in a state-planned economy. Banks tend to reflect the economies they serve, so in China's case, this has meant that its financial system, like its manufacturing industry, has been State or supply-driven rather than demand-driven. That is to say, feeding the state run companies rather than responding to market demands.

China's challenge now is to manage the transition of its financial system to a demand-driven system. This is a difficult task for two reasons. First, unlike China's manufacturing successes, it is less easy to convince people of the need for a demand-driven financial system. In manufacturing it is easy to prove to people that demand-driven production is a more efficient form of enterprise than supply-driven enterprise.

This is because it is easy for people to compare a warehouse full of unwanted goods produced by a state-owned company, with a manufacturer that produces goods people really want to buy.

Under a supply-driven financial system, the allocation of funds is decided by the State, and the move to a demand-driven process, led by the market, is a much more complicated process. In a state planned financial system, if officials decide that money should be made available to, for example, build a toll bridge over a given river, a bank will be told to fund it. But what if there are no users of the toll bridge? Then you have created a loan with no visible source of repayment, and it is little surprise that the loans aren't repaid. In a state run economy, loans are made for policy reasons; for employment, infrastructure and so forth, but not necessarily for the ability to be repaid.

Second, it is not possible to emulate the transition to demand-driven manufacturing in the financial services industry, and to start with a single bank and demonstrate that demand-led financial services work. A whole financial system is just that, a system that is interconnected, and it is this that makes the challenge of financial reform so difficult.

In the last two years, China has taken some aggressive measures to reform its banking system, but state-controlled banks remain the dominant player in the financial sector. Meanwhile, the non-state owned business sector which accounts for 70 per cent of growth in GDP, exports and employment, currently receives less than 10 per cent of all bank credit.

This is why, in spite of its 50 per cent domestic savings rate, one of the highest in the world, China has been attracting huge amounts of foreign direct investment. The Foreign Direct Investment inflows reflect the ongoing weakness of the domestic financial system, which is still channeling the bulk of savings to State-Owned Enterprises rather than to the non-state sector that is driving growth and job creation.

Let us be clear, with a savings rate of 50 per cent and massive foreign exchange reserves, China does not need financial capital, she has all the capital she needs. What she does need is know-how; the ability to channel capital into productive investments.

A report issued this month by the McKinsey Global Institute calculates that China's GDP would be higher by a staggering US$320 billion or 16 per cent if, as the Economist magazine puts it, 'Their lenders knew how to lend'. Allowing foreign banks to take control of domestic banks could help introduce some healthy competition but China is loathe to allow foreign ownership of banks to exceed 20 per cent. If this sounds familiar, it is because the same rule applies in Canada, a much more developed economy with a sophisticated financial system. (I couldn't resist taking a shot on this issue!) This is not to say that foreign banks will not play an important role in the development of China's financial services industry. In the course of 2005 foreign banks invested some US$11 billion in minority investments in China's financial institutions. And this year more of the large state owned banks plan limited Initial Public Offerings.

The role of a financial system is to move resources from people who do not need them to people who do need them and can use them. Despite what you might believe from reading some of the headlines, China has in fact made significant progress. Government reforms are continuing and the liberalization of the financial markets is proceeding in line with the timetable set by the WTO. And the proportion of non-performing loans, while still unacceptably high by international norms, has dropped significantly in recent years aided by China's ongoing economic growth. The scale of the challenge remains impressive, but so too is the quality of leadership undertaking it.

China's economic development and engagement with the wider world has prompted questions from the West about whether political evolution will go hand in hand with economic progress. Indeed, I often hear Westerners state that the Internet, consumerism, and exposure to other countries, will inevitably lead to demand for political change.

This would clearly be a sensitive subject for any nation, and China is no exception. But I'm not so sure that political reform will follow economic reform as surely as night follows day. I wonder if this isn't just another example of the West looking through a western prism at a nation that is unique.

It is often said that the Chinese people have an immense ability to live with ambiguity that is not well understood in the West. When Deng said: "It doesn't matter whether the cat is black or white, as long as it can catch mice", and embarked upon the economic reforms that he described as “socialism with Chinese characteristics”, he neatly summed up the Chinese ability to combine pragmatism and philosophy.

Let me draw some conclusions. If China continues on its present growth path, its economy will be equal in size to that of America in less than 30 years.

This is not just an economic phenomenon. The rise of China will have a major effect on the balance of influence in international relations. I would go further and say that the economic modernization of Asia is the most seismic consequence yet of the globalization of human commerce.

The balance of influence is tipping; and the world will move from an era of economic domination by a small group of wealthy nations mostly in the West, to one where power is more evenly shared, as the East takes its place on the world stage.

I think the evidence is fairly clear: China’s rise represents far more an opportunity than a threat for the World at large and Canadians too. But the road may not always be smooth so be prepared for a few bumps along the way!

Ladies and Gentlemen, thank you for your attention today.