

## How Long Is The Dragon's Claw?

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My lords, ladies and gentlemen, good evening. I would like to thank SOAS for the opportunity to address such a distinguished audience on a subject that is of enormous importance in the world today.

And to thank Professor Chan for his introduction. As he so fluently reminded us, the symbol of the dragon has quite different connotations in different cultures. In China, the dragon is a symbol of prosperity, of triumph and success. But in the West it is a creature to be feared and fought. As such the dragon is a symbol that perfectly captures the complexity and ambiguity of relations between the West and the East.

I have titled my remarks "how long is the dragon's claw? Chinese capital and western finance". But it might as easily have been western capital and Chinese finance; these are two sides of the same coin; at once independent and interdependent.

The development of a genuinely global financial system has been one of the most important aspects of the current wave of globalisation that we are experiencing. That global financial system has been created in considerable part thanks to the unprecedented movement of capital across borders.

The mobility of capital today reflects the changed economic and political landscape, in China and elsewhere. Added to China's openness in the last three decades, India's reforms and the collapse of the Soviet empire have brought literally billions of extra people into the global market place for the first time. This has opened new opportunities in terms of economic development and investment, and therefore has had implications for international capital markets.

Capital mobility also reflects the deregulation and the dismantling of capital controls by governments and central banks around the world, allowing capital to move around the world with increasing ease, and giving companies the choice of investing capital in different locations.

Globalisation is a many faceted phenomenon, but the role of international capital, as the oil that greases the wheels of international economic integration, is critical.

Tonight I will be looking at the effect that western capital has had on China, and that Chinese capital is having on

the rest of the world, and concentrating on three areas in particular.

First, foreign capital flowing into China. China is, as many of you will know, the number one recipient of FDI among developing nations and the third largest recipient of FDI overall.

Second, China is herself becoming a major source of global capital. Her export-led growth and strong savings culture are now generating huge capital reserves, and these are beginning to flow out of China with consequences for the rest of the world.

Finally, I'd like to examine what the *Financial Times* recently termed "the trillion dollar question"; the potential impact of China's growing reserves which are primarily invested in greenbacks, on the world's whole financial system.

### capital flowing into China

The first part of this story is probably the one that is most familiar to you all: China's thirst for capital, and the developed world's determination to quench it.

The unusual part of this story, however, is that, with a 50 per cent domestic savings rate, the highest in the world, China should have sufficient capital resources to finance her industrialisation. Yet China is the largest recipient of FDI in the developing world. We are also now seeing increasing portfolio investment in Chinese companies, witness the hugely oversubscribed IPO for ICBC's listing in Hong Kong and Shanghai.

That China has – despite its savings rate – attracted, and continues to attract, huge amounts of FDI over the last two decades largely reflects the weakness of China's domestic financial system.

Although China is moving rapidly towards a modern banking system, much remains to be done and the intermediation of savings into loans remains a weak link. State-controlled banks have pooled large amounts of private savings, but these have been primarily lent to big state-owned enterprises, SOEs, or to support government infrastructure projects. This reflects the close relationship between government, the SOEs and the state banks, although reforms are reducing state banks' policy lending.

By contrast, the non-state business sector, which accounts for 70 per cent of the growth in GDP, exports and

employment, still has little access to bank credit. Non-state-owned businesses accounted for only 16 per cent of the total loans outstanding at the end of 2004.

So China's banks have tended to fund SOEs rather than high-growth private enterprises. Informal credit markets – loans between friends and relatives, credit unions, as well as more sophisticated arrangements between firms – have picked up much of the slack. And of course, the role of foreign capital, in the form of foreign direct investment, has been very significant too.

FDI has been instrumental in making China one of the most competitive manufacturing powerhouses in the world. By 2004, there were 300,000 foreign joint ventures operating in China, bringing in up to US\$500 billion in accumulated capital investment. And although these FDI inflows on average accounted for less than 10 per cent of China's total annual fixed asset investment, they have been the major source of capital investment in China's export-oriented manufacturing sector in the last two decades.

We estimate that foreign joint ventures have contributed about 40 per cent of China's total manufacturing capital investment, but account for over 60 per cent of growth in China's total exports. Exposed to international competition, the export sector is become the most efficient and competitive part of the Chinese economy; and one which also has a positive impact on domestic companies which are also stimulated by the competition to become more efficient and productive and to grow faster. FDI has been good for China.

China is attracting US\$60 billion in foreign direct investment annually, but capital outflows from China are even higher, with the bulk of China's capital so far being channelled into the US Treasury. I'll come back to this later.

First, however, I'd like to say a few words about the emergence of a new trend: the flow of capital from China to the rest of the world, both developed and developing. This is a trend that flies in the face of traditional economic theory which holds that wealthy economies invest in poorer ones, not the other way round.

Let me put this in context. The developed world is clearly still the major contributor to global outward FDI, accounting for 90 per cent of the total. But FDI from emerging markets is growing rapidly – at 27 per cent a year in the five years to 2004, and intra-emerging market FDI flows now account for more than one third of FDI investment in emerging markets.

Indeed, according to the *World Investment Report*, the cumulative stock of FDI from emerging economies represented 11 per cent of the global stock. Asia's share of this capital stock has been rising steadily. While multinationals in Korea, Malaysia, Singapore and South

Africa have a well-established track record of investing abroad, the more interesting recent trend has been that companies from China, India, Brazil, Mexico and Chile are emerging as important players.

The importance China attaches to this outward investment programme is highlighted by its recent launch of a 'going out' programme, which encourages firms to acquire real assets abroad.

As *The Banker* magazine observed just last month: "Armed with deep pockets of foreign exchange, a thirst for technology and natural resources, and a determination to join the ranks of top-tier multinationals, Chinese companies are buying up foreign assets like never before."

According to *The Banker*, since the beginning of 2005 Chinese companies have done over 140 deals overseas, with an aggregate value of US\$11 billion. The value of overseas investments has increased more than 10-fold in the last five years. Among the highlights of last year's deals were China National Petroleum's US\$4 billion acquisition of PetroKazakhstan; Shanghai Baosteel's US\$1.4 billion joint venture steel mill in Brazil, and the US\$1.8 billion acquisition of IBM's personal computing division by Lenovo.

In my industry, banking and financial services, there has been relatively little outward investment to date – but that may be about to change: at the end of September ICBC, one of China's big four banks, signalled its intentions to acquire Indonesia's Bank Halim Indonesia. This followed the acquisition of the Hong Kong and Macao retail banking operations of Bank of America by China Construction Bank, another of China's big four.

However, most deals have been concentrated in three main sectors: manufacturing, mining and IT, each of which accounts for just under 30 per cent of total outward investment. This concentration partly reflects China's desire to achieve long-term security of supply of key commodities, including oil, an ambition shared, incidentally, by India.

China's hunger for commodities leads us to believe that China could become the dominant source of cross-border capital in the resource sector in the coming years.

Another prime reason for acquiring overseas assets, is that Chinese companies want access to new markets. Companies with incipient brands are beginning to look overseas in the same way that Japanese and Korean companies did before them. They are ambitious to expand, and a number of acquisitions have focused on securing brands and distribution capabilities, as a potential shortcut for penetrating global markets. The Lenovo-IBM and Shanghai Automotive-Rover MG deals are cases in point. What these acquisitions show is that Chinese companies

## China as a major source of global capital

are ambitious; they will not be content simply to be the world's workshop.

However, the journey ahead may be a bumpy one. China's appetite for foreign assets is giving rise to concerns overseas. And this is in spite of their relatively low value when taken in the context of the whole market. *The Banker's* survey showed that Singapore, a city-state of just three million people, made overseas investments with an aggregate value nearly three times that of China's in 2005. Yet public and political opinion is, at best, wary of China's intentions if not downright hostile.

In the US, it was public opinion and political opposition that effectively scuppered the attempt by China's CNOOC to acquire the American oil company Unocal. The strong resistance to Dubai Ports takeover of American ports demonstrated a similar political reluctance to allow emerging markets' firms to acquire a controlling interest in American companies.

Although it is fair to say that protectionist sentiment is not confined to America; it is on the march in continental Europe too. Given that protectionism tends to punish the perpetrator, it is reassuring that the UK remains one of Europe's most open economies and the least likely to oppose foreign ownership.

China may take some comfort from the fact that its experience is by no means unique. In the 1970s and 80s, when Japanese companies began seeking assets overseas, there was similar disquiet, prompted by fears that Japanese companies would take over the world. This reached its apogee with the acquisition in 1989 of the Manhattan landmark, the Rockefeller Center, by Mitsubishi Estates, which was greeted by a xenophobic backlash that bordered on the hysterical. Yet today, overseas acquisitions by Japanese companies cause little apprehension beyond that which might accompany any change in company ownership.

I fully hope and expect that in the next decade or so, as China continues on its chosen path of integration with the world economy, the overseas ambitions of Chinese firms will come to be judged on their business merit, rather than on political grounds. And like Japan, I fully expect to see Chinese brands entering the market today. Sony and Samsung were once domestic firms, unknown outside Japan and Korea. Yet in a few short years they became world players. Today, there are no Chinese world brands – but just wait!

Moving on now, I'd like to talk about one of the world's economic conundrums: the global imbalances brought about by higher capital flows, notably the very high current account deficit in the US.

The size of today's imbalances has prompted much political and economic posturing: there has been talk of an Asian savings glut; of an undervalued renminbi with

concomitant calls in the United States for swingeing tariffs on Chinese goods – the so-called Schumer bill, now thankfully dropped.

The level of the deficit is clearly a cause for concern, largely because it is counter-intuitive that poorer countries should subsidise richer ones. As the *Economist* remarked in its survey of the world economy last month: "the flow of capital from poor countries to the richest economy in the world is exactly the opposite of what economic theory would predict. According to the text books, capital should flow from rich countries with abundant capital, such as America, to poorer ones, such as China, where capital is relatively scarce, so returns are higher. This is what happened during the globalisation of the late 19<sup>th</sup> century, when surplus European saving financed the development of America."

However, the reality of course is that this is not a black and white scenario. There are alternative ways of looking at the current account deficit in the US. It can be argued that developing economies whose financial markets are still developing, China among them, are unable to absorb their high savings domestically. That capital therefore continues to flow to the US because it has the world's most developed capital market structure, and one which serves the world and not just the US economy. In this context, the US can be seen as 'the world's bank', taking deposits from emerging markets and recycling some of them back into those markets through foreign direct investment.

This will not last forever. As emerging markets improve their capital allocation skills, we anticipate growth of domestic capital markets in emerging economies, especially in Asia.

In the meantime, the State Administration of Foreign Exchange, appropriately abbreviated to SAFE, is the agency that manages China's foreign currency holdings – its reserves are forecast to top \$1 trillion in the next few weeks.

So the trillion dollar question is, how will these global balances unwind? Let me put forward a bull and a bear case.

The bear case, which, for what it's worth, I think an unlikely outcome, is that the imbalances will unwind suddenly, in a disruptive and painful fashion.

Perhaps as the result of protectionist sentiments spilling over into anti-trade measures. Perhaps because investors take fright at the size of the deficit and pull out of dollars. Personally, I believe that this is unlikely; the interests of the counterparties are too deeply intertwined for this to be a desirable outcome for China or for America. A sharp reduction in the value of the dollar would produce a major paper loss to America's creditors, China principal among them. As the chief economist at China International

## China's reserves: the trillion dollar question

Capital Corporation pointed out: “One trillion is a big amount, but it is also a hot potato... any erosion in value will be a source of shame for whoever is responsible for it.”

The bull case is that the imbalances will unravel over a period of time. I think no-one is sure when the size of the US current account deficit will peak relative to GDP, but a number of factors will lead to a peak, followed by a slow decline.

The growth of domestic demand in economies like China will lead to the recycling of surplus capital within those countries and regions. Less of it will seek a home in American treasuries. That same domestic demand growth will create export opportunities for America and the other G7 economies. These gradual changes will lead to a realignment of currencies, with the value of the dollar declining slowly, and Asian currencies rising, especially the renminbi.

This more optimistic scenario – and given the interdependencies between economies, is the one I believe will prevail, although it will probably lead to slower world growth overall as part of the readjustment process.

Let me draw these threads together and a conclusion simultaneously.

It is clear that FDI will continue to flow into China at a

high rate for the foreseeable future. China may not need the capital, but she does need the credit allocation skills, the management techniques, the governance, that foreign capital brings. Similarly, China’s export-led growth will continue to generate huge stocks of reserves, and China will become a bigger source of investment capital overseas, particularly in the resource sector.

Both these trends will contribute to continuing global imbalances, characterised by the American current account deficit, and this will certainly need to unwind, probably gradually over a decade or so.

Of course, these factors are just one aspect of a much bigger story: that of the rebalancing of the world economy, in which emerging markets are playing a larger and larger role. In the last year, China swept past Italy, France and the UK to become the world’s fourth largest economy; and is second largest on a purchasing power parity basis. Before our very eyes, Asian nations, and China in particular, are regaining their place in the world economy.

And while a lot of ink – or perhaps I should say a lot of air! – has been expended on this subject, the west has yet to come to terms with the truly sweeping nature of the changes that are taking place around us, and what they may mean for our futures. China’s opening up was the big story of the end of the 20<sup>th</sup> century; I suspect it will be the big story of the first half of the 21<sup>st</sup> century as well.