

China and India: Challenges and Opportunities for Mexico

The British Chamber of Commerce in Mexico
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Good morning ladies and gentlemen, and thank you for inviting me to speak at your breakfast today. It's a great pleasure to be in Mexico City this morning.

I've been asked to talk to you today about the challenges and opportunities presented to Mexico by the rise of China and India.

You might be interested to know that this is a subject on which I have been asked to speak this year in Switzerland, Germany, India itself, and on numerous occasions in Britain. No doubt HSBC's heritage – we were after all founded in Asia 140 years ago – partly explains why we are asked for our views. But the requests undoubtedly reflect the feelings of uncertainty that the rise of China, and to a lesser extent, India, bring in their wake to developed and developing nations alike.

That uncertainty is natural, given that profound change is inherently disruptive. And a profound change is afoot, make no mistake.

An article in *Newsweek* magazine characterised it thus: "There have been two great shifts in global power over the past 400 years. The first was the rise of Europe, which around the 17th century started to become the richest, most enterprising and ambitious part of the world. The second was the rise of the United States, in the late 19th and 20th centuries, when it became the single most powerful country in the world. China's rise, along with that of India, represents the third great shift in global power – the rise of Asia."

Change is always uncomfortable, especially when people's jobs are at stake. But economic growth is not a zero-sum game; one person's profit is not another's loss. However, it is a game where the rules and the competitors are constantly changing. In our fast-globalising world, it seems to me that all countries face the same two choices: to sit and lament the past, and acquiesce to the change that will inevitably occur; or to respond proactively to new challenges and help shape a new future. I know which I would prefer.

As Tony Blair said recently: "I hear people say we have to stop and debate globalisation. You might as well debate whether autumn should follow summer. They're not debating it in China and India. They are seizing its possibilities, in a way that will transform their lives and ours."

Let's consider for a moment the historical perspective. For most of recorded history the size of a country's economy was roughly equal to the size of its population. Just 200 years ago, China and India were the world's two largest economies. The US had one per cent of the world's population and about 1.5 per cent of its GDP. The link between the size of a population and the size of its economy was only decisively broken by the industrial revolution.

Europe and US leaped ahead, and Asian nations largely stagnated. Today, the US has five per cent of the world's population and a third of its wealth. By contrast, China and India have roughly a third of the world's people and 5.5 per cent of its wealth.

We will see a more balanced distribution of the world's wealth in the future. In the last few decades, we have witnessed the economic reawakening of these historic nations.

China's implementation of market-based economic policies has enabled it to create GDP growth of around nine per cent a year. As you know, China is dominating many manufacturing sectors, with its seemingly endless supply of inexpensive labour. And if China maintains its current growth rate, the size of its economy will double every eight years; indeed, it is predicted to overtake the size of Britain's economy this year, and the US's by 2040. China's growth path is not a new phenomenon – it is following in the footsteps of Japan. But as it started from a lower base, its period of above-average growth may continue for longer.

India reformed later, and is experiencing a slower, but nevertheless, impressive growth spurt, with particular success in the IT services and business process outsourcing industries. Some estimates suggest that over half of the Fortune 500 companies outsource some of their IT-related work to India.

China and India's rise is posing challenges across the world. And it is not just developed nations that are concerned.

The first wave of Asian "tigers", whose own success was based on labour-intensive industries such as manufacturing, textiles and electronics, have had to show agility to meet the challenge of a rising China and India. Many of the smaller economies in the region

**the rise of Asia is
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have found it tough to retain their export and investment market share in mass-merchandise and labour-intensive industries. But they have been successful in moving up the value chain and developing new competencies. In tourism and transportation in Malaysia. In semiconductors in Taiwan, for example. Hong Kong, meanwhile, has transformed its economy in the last decade; as manufacturing has declined, service industries and tourism, particularly from mainland China, have become more important.

Other Asian countries have responded by positioning themselves as suppliers to a rising China. Japan, Korea and Taiwan have been exporting capital goods and machinery equipment into China. Others, such as Malaysia and Indonesia, are strong in energy and other resource-based commodity sectors, where China has an insatiable appetite for imports.

As a result, south-east Asian economies have managed to maintain their share of world trade, something only one G7 country has managed. So their responses should provide food for thought for other nations.

What is happening, essentially, is that Asia is reclaiming its place on the world's economic stage. And it seems inevitable that this will lead to a shift in the balance of international relations over the next 25 years. And there is more to come. Vietnam could well be the next Asian Tiger. They have embarked on rapid growth, and foreign investment is now pouring into Vietnam, reaching record levels last year.

What are the main implications of all this?

Overall, we will see a net gain. Economic growth is not a zero-sum game.

There will be a significant overall gain for world trade, which always grows faster than world GDP. In the last 20 years, aided and abetted by very significant reductions in trade barriers, world trade has grown significantly.

In the next 20 years, we anticipate that over half of the world's growth will come from emerging markets.

But – although there will be an overall gain – there will also be individual winners and losers, which could breed instability. Smith and Ricardo's text-book economic theories of the division of labour and comparative advantage show that overall, trade makes nations better off.

But these theories are based on the assumption that capital is not mobile. However, it is, and has become increasingly mobile in recent decades. In 1870, foreign owned assets as a proportion of world output were less

than 10 per cent, and rose to a peak of almost 20 per cent just before the first world war. Then they crashed.

It took the world until the 1960s to recover to the 1870 level, and by 1980, foreign owned assets as a proportion of world output had still reached only 18 per cent. But by 1995, foreign owned assets represented about 50 per cent of world output, and the figure is certainly higher today. The US, Europe and Japan are pouring investment into China at a rate of over US\$50 billion a year.

This kind of capital movement has a very striking effect.

Firstly, it is causing the geographic redistribution of labour incomes. What does that mean? It means that real wages in countries supplying the capital are being held down, while workers' incomes in markets receiving capital investment are starting to rise. This is visible, in the statistics of muted real wage growth for the US and Europe, and in the rising wages rates in the Far East.

Secondly it is causing a redistribution of income to capital. As we all know, corporate profits have been strikingly robust in the last few years.

But the effects are complex. Labour incomes are under pressure; but for consumers there have been clear gains. In the last two decades, there has been a big

shift in the terms of trade between the US and Europe on the one hand, and China and India on the other. To put the point in lay terms, the real cost of consumer goods has been falling in Europe in each of the last 15 years. It is amazing that you can buy a DVD player in the UK for just £30. So there are very significant real income gains to consumers.

At the same time, producers in the developed world are under pressure, giving rise to a protectionist backlash. We have seen this in the guise of the Schumer Bill in the US, and what the British tabloids dubbed the 'bra wars' in the EU.

However, the consumer gains made in the US and Europe are now being undermined by another major redistribution of income; the redistribution from energy consumers to energy producers.

Why is this occurring? The answer, again, is China and India.

Oil prices are now over US\$60 a barrel, and the five-year forward curve shows that the market expects them to stay very firm. This is not like previous oil price surges, which have been driven by supply disruption. This is fundamentally demand driven. China has only an estimated 15 million cars today; if per capita car ownership should reach US levels, China's cars would

redistribution of incomes

number some 600 million, more than exist in the world today. The pressure on oil supplies would increase exponentially.

There will be all sorts of supply-induced responses to high oil prices for sure: but the best working assumption is that oil prices will remain at least in the US\$40-50 bracket for years to come.

There will be gainers, and losers. Net importers of oil – Europe, the US, Japan, much of Asia – will see their real incomes reduced. The gainers will be the oil producing nations – the Middle East, of course, but also such key countries as Russia, Canada and, yes, Mexico.

There is one other striking thing about all this. If you look at the pure theory, developed countries should be exporting capital and emerging markets importing capital. And as far as it relates to FDI, that is certainly happening. But overall, the position is the exact reverse.

Asia, the Middle East and others are huge capital account exporters; the US has massive capital account imports. Since 1998, virtually every emerging market of any significance has been running current account surpluses. Reserves built up in central banks – and these are immense, some US\$2.2 trillion in Asia – are largely invested in US government securities.

On the US side, the current account deficit is now in completely uncharted territory, representing as it does seven per cent of GNP. Bear in mind that for most of the 20th century, the US carried a current account surplus. Even during the 80s crises, the deficit never exceeded four per cent.

This can't last; the only question is when and how it unwinds. To be clear, the US cannot export its way out of this situation. The US's imports represent 16 per cent of GDP, against exports of 10 per cent. It can't increase its exports, whatever the level of the dollar, by 60 per cent.

There must be some risk of a sharp adjustment and market disruption. This would not be good for anyone. What is more likely are multi-faceted adjustments over time.

The US consumer has been the engine of world growth in recent years; others will begin to take up the pace, especially in Asia. The traditionally high savings rates – of over 40 per cent in China, for example – will probably trend down and consumer demand will pick up. Wage differentials will change and demand for all kinds of consumer goods and services will rise. Asia will not be autarkic in its development, any more than the US and the EU have been.

Second, US growth will slow, and as a result, import demand will be more restrained.

Finally, the dollar will be weak systemically.

How is Mexico placed in this shifting world economic scene. In many ways, very well. In the last 20 years trade liberalisation and privatisation have transformed the country's economic landscape, and provided a platform for growth. Since Nafta was signed a decade ago, trade with the US and Canada has tripled, and Mexico has subsequently signed more than 40 trade agreements, making it one of the world's most open economies. It also has a young population, and will have a growing workforce for the foreseeable future. As of 2000, the median age in Mexico was 22 years.

Mexico is also benefiting from increased demand from China and India for resources, particularly oil, in which Mexico is naturally wealthy.

Nor should we forget that Mexico has the benefit of proximity to the world's largest economy. Sharing a 3,000 km border and a free trade agreement with the world's wealthiest nation is a tremendous strategic advantage.

Mexico has achieved a huge amount in the last decade, but in a world that is changing faster than ever before, countries, like companies, need to be flexible to adapt to the changing environment. Successful economies will be those that consider change and reform to be a continuous process.

China's development has been more threatening to Mexico than India's because it challenges Mexico in the arena of manufacturing, an area of comparative advantage. But although lower-cost manufacturing in China is causing alarm here, again the reality is more complex. Mexicans, as consumers, are benefiting from the global mobility of production, in the same way that Americans and Europeans are – ie, they have access to lower-cost goods, which help depress inflation and boost competitiveness.

Despite Mexico's significant economic opening during the last two decades, in a world that is changing faster than ever before, the challenge for any country – developing or mature – is to ensure high-quality physical and educational infrastructure, efficient energy supplies, and a regulatory environment that allows economic progress to flourish.

You know the specific issues for Mexico better than I. Creating education systems that will allow future generations to respond flexibly to the challenges that the future will bring is crucial. Indeed, Mexico can perhaps learn some lessons from India.

US current account deficit in uncharted territory

Investment in education in India is paying dividends in the offshoring industry and elsewhere. Nowadays, someone in the US looking for accounting services online can send their information to an accountant in India who is an expert on American fiscal law.

Likewise we need to reflect on the importance of investing in R&D as part of building a country's human and intellectual capital. Although investment in R&D has doubled in recent years, only last week an OECD report found that Mexico had the lowest level of investment in R&D, at 0.51 per cent of GDP, of any OECD member. The OECD average was 2.24 per cent. Yet we know that the technology and human resources are available in Mexico, because HSBC in Mexico has some of the most advanced technology in our Group.

And to take just one example, Mexico's strength in medical care and telecommunications, could be a basis for a major service industry as the US's baby boomers move into retirement.

Promoting a business environment that encourages enterprise is likewise important. I am sure that I need not tell you that setting up and running a business is challenge enough, without the added burden of over-enthusiastic regulation.

Reducing the costs and administrative burden of running a business will stimulate enterprise and create jobs. It would also encourage people to enter the formal economy. A recent World Bank report on *Doing Business* shows a correlation between the greater ease of doing business and a smaller informal sector. The same report estimated that it takes an average of 58 days to start a business in Mexico, compared with an average for OECD countries of 19 days. In Britain it takes 18 days, in Australia, just two.

There is still lots to do, of course, to ensure Mexico is better placed to meet the rising challenge from economies such as China and India. But the prize that is within reach, according to the OECD, is well worth having. It is the opportunity to lift Mexico's annual economic growth rate to above six per cent.

Ladies and gentlemen, at HSBC, we are offered the chance to participate in almost every economy in the world, so we think long and hard about where we invest. We have invested over US\$2.3 billion in Mexico, because we have great confidence in Mexico's future. Thank you.