

## Financial systems & economic development: the Chinese and Indian experiences

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Good evening, and welcome, everyone. I'd like to extend my thanks to the London School of Economics and the Confucius Institute for hosting this lecture this evening.

I don't suppose anyone, much less a banker, can get away with any kind of conversation without acknowledging the current financial crisis.

It used to be that when I gave a speech to audiences outside the financial services industry, I had to make the case for the importance of the financial system, and remind people just how intimately its fortunes related to that of the economic system as a whole. Well, I don't think that's a problem any longer. It is abundantly clear to any and all that, whatever your views on the world of finance, its health is inextricably linked with the fate of the world economy.

This is certainly a time for reflection, and to discuss the motivations and behaviours of parts of the industry – and, if we're being thoughtful, the motivations and behaviours of regulators and policymakers; investors; even consumers. Some of those behaviours have been found severely wanting.

We do not yet know the extent of the damage. But as we work through the crisis, we're beginning to reassess several models – complex, high-leverage vehicles versus safe and secure; banking as a high-risk thrill ride, versus a dull utility; Milton Friedman versus John Maynard Keynes. And then, by extension, the capitalist system, of which financial services is part and parcel, is once again being debated, its role in society questioned.

I think, therefore, it's important – certainly if we're going to talk about the development of the Chinese and Indian systems – to look at the development of the system we can comfortably call the global norm. Today, the majority of the world's population lives in a market-oriented

world, and if we're to truly understand China's place in it, or India's place in it, or our own place in it, we should look at how it came to be.

Going back to first principles, we must recognise that markets were not built for exploitation. From the central agora to intercontinental trade, markets were meant to promote human advancement.

The system we know now started with trade millennia ago – first locally, within and among clans, then expanding over other areas.

We have been literally trading long-distance since the Stone Age: amber artefacts from the Baltic were found in Mediterranean Stone Age archaeological sites. By 3000 BC, waterborne trade linked the Minoan Cretans and the Egyptians. Medieval trade was so advanced it linked Europe and China.

Simple trade expanded into what would be the seeds of capitalism. This system was developing in Europe in the high Middle Ages – around the 12th and 13th centuries – gathering strength in the 14th. It may sound surprising, especially at this economic juncture, but the capitalist system is actually based on moral premises. Because at its core is trust.

A system of international credit, monetary exchange, investment for trade, contracts, etc, can only exist if society moves from a clan or tribal mentality to one in which it is possible to establish faith in people you can't see – who live far away, or who even live differently. It requires imagination and a commitment to a set of universal values and, as I said, *trust*, that agreements will be honoured.

Just think about it. While you are listening to me this evening, there are countless people in a hundreds of locations who are working for your benefit in myriad ways – whether they are drilling for oil in the Gulf to ultimately power your car, manufacturing shoes in China that you

**Trust is  
at the heart of  
capitalism**

will buy next month, or programming your bank's computer in India.

This 'elaborate task sharing' which, in the words of the economist Paul Seabright, is at the heart of the capitalist system, relies upon integrity and trust to function. In other words, although it is rarely acknowledged, there is a moral underpinning to the capitalist system. And the system itself is the *sine qua non* of economic development. It lies at the root of humanity's search for something better than subsistence survival.

The fundamental truth is that the world cannot operate to its full potential without the markets and without the capital which stimulate economic growth. The system is obviously imperfect. But as Churchill said about democracy: it's the worst system, except for all the others that have been tried from time to time. An economic system is essential to our world – but it must be one that promotes fairness, and is just.

I came of age, as did my company, in a world where a handful of countries – though they constituted only a small fraction of the world's population – created and controlled the vast majority of the world's wealth. There would certainly be no one today with a living memory of any other model; this was the standard to which we had not only become accustomed, but that was generally accepted as the natural order of things. But things began to change.

Before the current crisis monopolised our attention, the biggest story in economics was the shift in the world's economic centre of gravity from West to East. We had been watching what we term 'emerging economies' – though, given their history, 're-emerging' might be a better label – come out from under the shadow of economic hegemony.

China and India, of course, are the prime examples. These are fast-growing economies that, though not thoroughly decoupled from the current crisis – their growth is expected to slow – have continued their impressive rise and are outpacing their Western counterparts. Even with a forecast of slowed growth as a result of the global economic crisis, the projected 9.2 per cent growth for China and the 7.9 per cent projection

for India this year are enviable by Western standards; all G7 countries, by contrast, are slated for stagnation, if not outright recession.

I'd like to take a look at how each of these countries – first China and then India – has arrived at its current destination. I think it's indicative not just of the countries' governmental characters, but of the spirit of the *people* of each of these vast, complex, heterogeneous, multi-faceted countries.

Without question, China has been the most dramatic story over the past few years. China has accelerated from a virtual economic deep-freeze to being one of the fastest growing, and one of the most influential, economies on earth. This advancement in a mere few decades is certainly impressive in and of itself. But it has been achieved while managing change on a much larger scale than any of us could imagine, and I think it's crucially important to remember these obstacles whenever we talk about China's rise.

On the most basic level, there is the logistical hurdle of managing the world's biggest population. Premier Wen used to say that any small problem multiplied by 1.3 billion becomes a very big problem indeed. It's often the case that when we talk about astronomically large numbers, they cease to have any real resonance.

So to put it in perspective: the population of the UK is about 60 million – and there are times, I'm sure, when we all feel as though we're crammed in beyond capacity; compare this to China's 1.3 billion. Can you imagine Britain's infrastructure, trade or educational needs multiplied over 20 times? Or managing the mass transition of large segments of that population through socio-economic strata? Each of these heightened by massive urbanisation, as every year *17 million* people – that's more than 25% of our total population – move from the countryside to the city? Which, of course, brings with it its own set of issues: pollution, increased energy needs, keeping the population healthy, finding sufficient resources and creating jobs.

I am not naïve about criticism of China, something that intensified during this summer's Olympics.

## China's dramatic rise

But the criticisms must be put into historical perspective. I am reminded of the words of Leonard Woodcock, the first US Ambassador to the PRC, who answered such charges by pointing out that during his lifetime in America, women were denied the vote, labour was not allowed to organise, and racial discrimination was legally protected. ‘As time passed’, he said, ‘we made progress, and I doubt if lectures or threats from foreigners would have moved things faster.’ Now, of course, a man who was born in an era where segregation in America was still commonplace, has been elected to the United States’ highest office. A truly historic result.

China herself has moved faster than most countries in similar situations, and criticisms are often levied without regard for context. China’s urbanisation, for example, when compared to other countries’, is miraculous.

When we look at the great demographic shifts of two of the world’s most powerful developed economies – shifts that were key to their dominance as industrial and economic powers – it is a stark comparison. Nineteenth-century urbanisation in Britain and the US was rife with misery – housing congestion was epidemic, public health provisions could only be deemed ‘appalling’, and poverty, ineffective public sanitation and overcrowding fostered rampant outbreaks of cholera, typhus, diphtheria and tuberculosis.

Infant mortality rates were sky high: as late as the end of the 19<sup>th</sup> century, 200 out of every thousand children born died in some industrial centres in Britain – a higher rate than anywhere in the world today – and life expectancy in 19th century British industrial centres generally ranged between 20 and 35. I find it difficult to imagine a world in which the majority of this audience would be statistically middle aged.

Pollution then was at least as bad as the worst we see today – not from cars, of course, but from the belching of toxic smoke from factory chimneys and the burning of coal in home stoves and furnaces. Just hanging out the washing in a city like Pittsburgh made it so dirty it had to be washed all over again. It was an axiom in the industrial US that a clear day signalled a terrible economy.

Or take the urbanisation of the Soviet Union between the wars. Between 1926 and 1937 the urban population doubled, creating massive urban overcrowding. This was a violent shift brought about not by economic growth and reasonably liberal economic practices, but by state-sponsored brutality.

The point of these comparisons is simply to emphasise the relatively problem-free transition that China has managed to achieve. And she has done it on a larger scale than anything we have seen in human history.

I’m sure that most of you will be aware that China’s opening began under Deng Xiaoping in the late 70s.

Former US President Carter relates a story about the birth of Chinese economic liberalisation. It started in the countryside, where Deng Xiaoping tried an experiment, allowing small-farms farmers a small portion of the land – about 15 per cent – to grow their own crops for sale. This, of course, was not the most desirable land, it was the ditches and the shaded areas, some of it virtually un-farmable. But almost as much was produced on that 15 percent as on the more fertile government-owned land.

Deng told Carter the Chinese farmers would stay up all night with a sick hog if it was their own; but if it belonged to the government, the hog would die. So he took the next tentative step, allowing free enterprise for some farming families. They had a choice of making clay pots, repairing bicycles, shoeing horses, or raising livestock: they could raise as many as five pigs, or five sheep. That was it.

That first free-enterprise experiment was in 1981. Now, China is home to the world’s largest shopping mall. It is the manufacturer to the world. In three decades, China’s economy has become one of the most vibrant, and certainly the most talked-about, on earth. The forecast for the next three decades is that China will overtake the US to be the world’s largest economy.

It was not, of course, as simple as letting farmers own a few pigs. The late 1970s and early 80s were marked by the agricultural experiments and the opening of China’s doors to international trade and foreign investment; the 1980s to early

## Free enterprise

90s were characterised by a conversion from an administratively-driven command economy to a price-driven market economy – though this would not prove to be anything like an easy task. Nor would be what followed: setting monetary policy in the absence of central planning, and reform of the banking system and the creation of capital markets.

Perhaps because of the importance of banks and capital markets to economic development it is worth dwelling on this aspect of China's growth in more detail.

It is worth understanding how Chinese banks – which were the beginning and the end of the financial system – worked. First off, they were organs of state policy – there was no sense of return on capital, no sense of risk; there was not even a clear central control mechanism, as banks were subject to local government intervention.

Though the 1990s are thought of as their heyday, banking reforms actually started with China's opening in the late 1970s, though the financial sector naturally liberalised at a slow pace and with hiccups.

Significant change came after 2001 WTO entry, when the full opening of China's markets marked a new era of economic development.

First, China developed credit-assessment techniques and brought in foreign ownership as a means of strengthening operations. To date, more than 30 mainland Chinese institutions have received strategic foreign investment, and private sector banks have been allowed to develop.

Strategic foreign investment, of course, builds capital, and provides a further link to the global economy. But there's a cultural benefit as well. A recent study found that foreign investors increased profitability and efficiency of the Chinese banking system.

It also found that strategic investment, rather than purely financial investment, increases the benefit to the institution, particularly if the foreign investor has a seat on the board or a corporate governance agreement.

The former Lord Mayor of the City of London, Peter Levine, sits on the China Construction Bank's board, for instance. And we've found in our own experience – HSBC has

two seats on Bank of Communications' Board of Directors – that this benefit is genuinely two-way. We're immensely pleased with the insights our Chinese colleagues bring to the table.

To further reform the banking sector, China next reduced non-performing loans in bank portfolios, corporatised them, listed them in Shanghai and aggressively recapitalised them – had them audited to IFRS standards, and then listed them on the international market as well – deliberately to strengthen governance and transparency.

Between 2003 and 2005, steps were taken that will sound very familiar to those of you who have been following the US bailout or who've been keeping abreast of the initiatives taken by various countries seeking to shore up their banking systems.

Some 70 billion dollars was injected into the Chinese banking sector, while 50 billion dollars in bad loans were written off by the 'big four'

banks and 90 billion dollars in non-performing loans were sold to newly created 'asset management companies' – i.e. specialised institutions that deal with bad loans, often referred to as 'bad banks'.

The difference from the US bailout is that the Chinese government intended through the capital injection to enable the big banks to list in overseas stock markets in order that they be subject to the rigorous scrutiny of overseas investors and the international standards of corporate governance, in a way forcing the big banks to reform and improve and learn to swim in the sea, as it were, without government protection.

The result of these efforts is that today, most of the major Chinese banks have capital adequacy ratios that meet international standards – for those of you unfamiliar with the term, capital adequacy ratios are a measure of a bank's capital expressed as a percentage of its risk-weighted credit exposures. In other words, most of the major Chinese banks have what is considered a safe measure of capital.

All the major banks – both state-owned and private sector – are developing broader product ranges, including mortgages, consumer finance and credit cards, and better business banking,

## Transforming the financial sector

allowing the Chinese people greater access to the benefits of broad financial services, and allowing Chinese banks to be competitive in the international market, further boosting economic growth.

There has also been a marked improvement in overall corporate governance, including the development of modern management techniques and structures. Public listings and outside investors have required banks to introduce highly visible reporting and disclosure methods. All of which are marks of an increasingly open system, and all of which have paid off: profitability at listed Chinese banks was up across the board in 2007.

As an indicator of the rapid rate and massive scale of change in China's financial sector, it is worth noting that, in the 23 years since its restructuring, the People's Bank of China has become one of the world's most influential central banks, while ICBC has become the world's largest banks in terms of market capitalisation.

So in general, the reform of the banking sector has gone very well. But there's still a good deal to do in financial markets, and I see three major challenges over the next five to 10 years; challenges that are entwined with overall social and economic growth.

One is that big banks have largely withdrawn from rural areas. In order to become profitable commercial enterprises ahead of public listings, the big banks closed unprofitable branches. This was arguably necessary to help transform China's financial sector, but as this commercial focus has intensified, it's created a retreat from rural areas. From 1998-2002, the 'big four' closed some 45,000 branches and laid off 250,000 employees. Our research shows that none of the 'big four' banks have rural branches in the entire Northwest province of Qinghai.

The rural economy has lost access to finance, creating a large underbanked market, which is an issue both for the financially excluded, and for all of China, as this creates a socio-economic divide, something of great concern to the government. The rural market numbers, conservatively, more than 600 million, so there is no question that this segment of the population

must be addressed, and that it can be an attractive prospect to business – our own experience, as the first international bank to enter China's rural market, has been extremely positive.

It must be said that China is working to meet the challenge. In 2006, the government put a renewed emphasis on rural development, and China's Banking Regulatory Commission dramatically lowered the threshold to enter rural areas and eased access to the rural marketplace.

And the Chinese government has recently committed to doubling incomes and eliminating poverty in rural areas by 2020, making the population that much more attractive to the banking industry. A new policy for land reform was also recently announced by the Chinese authorities, and although the detail is yet to be confirmed, it is being seen as another effort to lift the income and productivity of China's massive rural population.

Challenge number two is the still rudimentary nature of the capital markets, both debt and equity – although the immaturity of these markets has been a protection in the current crisis. The

bond market has seen movements toward reform, but as corporate bond issuance is highly regulated, these have been very stop-and-start.

The market for exchange-traded corporate bonds is very small, and something of a catch-22. Banks cannot buy bonds traded on the stock exchange, and insurers cannot buy bonds not guaranteed by banks – yet the banks are barred from issuing such guarantees.

As for the equities market, it has classic emerging markets characteristics: it's volatile, far from fully transparent, dominated by retail, and rules on insider dealing are still evolving. There have been improvements to China's equity markets – particularly the release of non-tradable state-held shares onto exchanges in 2005-2006. Since about two-thirds of the equity of publicly traded companies had been held by the government or state-owned enterprises; unwinding this shareholding did a great deal to broaden the market, though not yet much to deepen it.

A third challenge faced by the markets is the shortage of talent. While China produces a vast

## Rural areas underbanked

number of graduates each year, there is a huge lack of professional experience.

Competition for qualified staff is particularly intense in financial services, exacerbated by the increasing ability of domestic institutions to offer competitive packages.

The *Financial Times* reported that it is becoming common for domestic fund management companies to offer Wall Street-equivalent bonuses of US\$1 million or more. Although with China's stock market falling over 70% this year, such bonuses are unlikely to recur this or next year.

This indicates a broader educational issue, of course, which China is addressing with significant investment in education and training. Education spending increased by 76% last year and the 2008 education budget raised it an additional 48%. And more private international educational institutions are establishing campuses within China, particularly business schools.

China has taken steps to address each of these three areas – a large underbanked population, the developing of capital markets and the competition for skills. This is encouraging, but reform needs to stay on track. The bottom line is, to support rapid economic growth you need an efficient, competitive, transparent, well-regulated financial services industry; without these, that growth will eventually be hobbled.

China is clearly addressing the major concerns, but it is, of course, subject to the vicissitudes of the global economic situation. The question here must then be: what is China doing in the face of the current crisis?

China's financial sector has been relatively sheltered from the crisis due to capital controls and the relative conservatism of its banks, which has resulted in minimum foreign exposure losses. Nevertheless, Chinese banks, insurers and securities firms posted slower profit growth year-on-year in the third quarter – due to investment losses and low demand for loans and securities trading – and GDP growth has slowed from an average 11 per cent over the past few years to, as I mentioned, just over 9 per cent. Not at all bad from a western perspective, but enough

to prompt the Chinese authorities to move away from their previous efforts to cool the economy and into pump-priming mode.

Thus, the People's Bank of China lowered interest rates twice last month.

And the government has launched a host of measures to boost domestic consumption and stimulate the stock markets and the property and export sectors, including of course, this week's 4 trillion yuan – around US\$586 billion – stimulus programme.

So it seems to me that China's in a good position to ride out the storm.

So now let me turn to India, the other part of my lecture this evening.

India, of course, is often spoken of in the same breath as China. In some respects this is understandable – they have a number of similarities. Two of the world's fastest growing economies; the world's two largest populations; two countries that have, at times throughout history, dominated the region economically.

But the differences are obvious and substantial and their development paths very much reflect the individual character of each nation.

If 1978 was the pivotal year for China, when Deng began the reforms that would bring China into the world economy, in India the pivotal moment didn't arrive until 1991.

Prior to 91, India's economic development post-Independence was dominated by an approach that was influenced by central planning and a formal economic planning system. Growth had been pretty slow – the so-called 'Hindu rate of growth' was lacklustre by comparison with the trajectories of the Asian Tigers.

Although growth started to pick up and accelerate in the 1980s, by the end of the decade India was running into macro-economic difficulties that culminated in the balance of payments crisis.

With India down to its last two billion dollars of reserves, Manmohan Singh, then finance minister, kicked off the reforms for the liberalisation of trade and investment regulation that have helped create a dynamic economy. India's growth accelerated to around 6 per cent by the end of the 1990s, and continued to rise.

## Reform in India kickstarts growth

Before the current financial crisis GDP growth had hit an excellent 9 per cent a year.

Today, Indian entrepreneurs and industrialists are now world leaders in many areas, from information technology to steel.

People from India are also leading industrialists in California, the UK and other parts of the world. In the Forbes list of the world's top 2000 companies for 2008, 34 Indian companies were listed, and India's top 10 included three energy companies; two banks; two telecommunications companies; and two steel.

In just 15 years, India has doubled its national income and world exports. In less than three decades it is projected India will be the world's third largest economy, and it is currently the world's second largest producer for software applications; its third largest market for aircraft; the fourth largest producer of medicines; and the fifth largest market for telecommunications.

But growth and development have been uneven. Those sectors that have been liberalised have grown rapidly; those that have not, have been sluggish.

And perhaps the most compelling success story – certainly the most written about – has been the astonishing success of India's IT and outsourcing industries, which followed the liberalisation of the IT sector.

I doubt anyone in this room has not had a call to a local company answered in Bangalore rather than Birmingham. Certainly, HSBC has a number of centres servicing international customers in India, and there's a story running around the bank about a customer in Lancashire who was planning a holiday in Goa and called up our customer service line to ask what the weather would be like...

The success of this industry is the result of a fruitful combination of educated people, technological advances and de-regulation. On the people front, India has a longstanding and deeply held respect for education. And its high standards of technological education, epitomised by the Indian Institutes of Technology, are highly regarded the world over.

The industry has developed so quickly that Indian companies are beginning to 'outsource

outsourcing' – they have so much business that they've set up outsourcing offices across the globe – Wipro has offices in countries including Canada, China, Portugal and Saudi Arabia; Tata has offices in Brazil, Chile & Mexico; and Infosys has offices in the US, the Czech Republic, China and Thailand.

So the IT industry has been hugely successful. The IT and BPO sector has a 2-million strong workforce growing annually at a rate of 26 percent. India accounts for 65 per cent of the global industry in offshore IT and 46 per cent of the global BPO industry. And predictions are that the sector will keep growing, at a rate of over 35 per cent over the next few years.

Notwithstanding its success, the IT sector remains a relatively small part of the Indian economy. And the most important lesson to learn from the success of this industry is that it could not have been achieved if it hadn't been preceded by reform of the telecoms sector.

Occasionally people refer to India's development path as being 'bottom-up' rather than 'top-down', but it is the 'top-down' reforms that have first unleashed entrepreneurs.

In other industries that have benefited from reforms, the same basic process has worked through.

Airlines were liberalised; the crotchety people and cranky aeroplanes of 20 years ago have been replaced by a plethora of well-run successful airlines. Media liberalisation has brought satellite TV and thus the outside world into India for the best part of two decades – and vice versa.

India is richer for these reforms, which free entrepreneurs to create products and services, and ultimately, wealth.

There is certainly no shortage of entrepreneurial spirit in India, but there is more that could be done to unleash that talent further. Financial sector reform would be close to the top of that list.

Some of you might be familiar with the novels of R K Narayan, often described as India's answer to Graham Greene. In Narayan's *The Financial Expert*, access to banking is denied to many of the townspeople of Malgudi who instead have to rely on the advice and money dispensed by the central character,

## Indian entrepreneurs are world leaders

Margayya, from under a banyan tree – with ultimately disastrous results.

Access to formal banking services is still an issue in India. It was one of the principal areas for attention identified in the influential Raghuram Rajan Committee on Financial Sector Reforms.

The Committee recommends broadening access to finance, so that 90 per cent of Indian households have access to a deposit account and the payment system within a matter of years. Currently, a large part of the India's financial system is still conducted outside formal financial institutions, with less than half of household savings finding their way into the formal sector.

Other recommendations are:

To level the playing field between state-owned banks, private banks and foreign banks, to increase competition and thus efficiency of financial markets. Currently, too much lending is directed to inefficient sectors – such as agriculture and others designated 'priority' sectors – at the expense of the more productive private sector. A problem, incidentally, also shared by China.

to create more efficient and liquid markets through consolidation. State owned banks control 76 per cent of financial assets, private banks 17 per cent and foreign banks account only 7 per cent. This concentration limits competition and efficiency, contributing to a much higher cost of capital for Indian businesses and lower savings rates for consumers.

These factors combine to make India's financial system less efficient, and more expensive than it might otherwise be, handicapping growth. A research report by McKinsey two years ago estimated that an integrated programme of reforms of India's financial system would add US\$47 billion to India's GDP each year, raising GDP growth by over two percentage points.

In fact, the Reserve Bank of India has a roadmap in place for further reform, to consolidate state-owned banks and open up the financial sector, with an ambitious target completion date of 2010. But the combination of next year's elections, plus the fallout of the

global financial crisis, mean these plans will almost certainly be at least delayed.

India has largely escaped the global financial crisis – notwithstanding a wobble in early October when depositors began withdrawing cash from one of India's largest banks, prompting the RBI to step in and reassure depositors and offer liquidity. But, as in the Asian financial crisis a decade ago, India's resilience reflects the underdevelopment of its financial system, rather than a more robust financial system. It's a little like using a generator to provide energy, rather than the national grid. In the event that the grid goes down, you're protected. But in the long-term, the generator is not going to provide the same amount of energy or degree of efficiency.

So the danger for India from the financial crisis – and this is true for China too – is less the potential contagion effects, and more the risk that the crisis will stifle further financial reforms that are much-needed.

As the FT commented in October: "An impaired financial system may help weather a global financial crisis in the short term, but it will not help India reach the higher growth levels to which it aspires."

As the global economy slows, India will need to look to further reforms to sustain its growth – and reform of the financial sector could provide a crucial boost to the economy, and thus to the incomes, opportunities and lives of a population that is still poor in world terms.

So there you have an overview. It may not have felt brief, but believe me, that's the executive summary of the abridged version – just one word for every half million people living in these two extraordinary countries.

And what of the future? I have been lucky enough to have visited China and India repeatedly over the last two decades, to enjoy the richness of their culture, to feel the dynamism of their people, to wonder at the strides each has made in such a short time. It is the energy and vigour of their people that will place China and India centre stage, economically-speaking, in the 21st century.

### China and India's economies are centre stage