

How will banks contribute to global economic growth?

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Good afternoon. I'm delighted to have the opportunity to speak to you today – particularly on the positive subject of how banks will contribute to global economic growth. Indeed the possibility and delivery of global growth is in my view dependent upon a functioning global financial system with banks at its core.

The timing of this speech is very opportune:

- The world has never been more connected and globalised through trade flows, investment flows, money flows, technology, social networks and geopolitically;
- The world is changing and much of the established order will change over the course of the next 5-10-20 years;
- The end of the acute phase of the recent financial crisis is enabling bankers to look forward again with deployment rather than protection of capital to the fore.

It is worth reflecting that since the onset of the financial crisis, our industry has been through four incredibly intense years.

First, we had to deal with the impact of the financial crisis itself. Subsequently, we have had to learn the lessons of the crisis involving re-designing the hugely complex regulatory framework that governs our industry. This work is still in progress, although a huge amount has been achieved already; indeed when one stands back it is truly remarkable how much has already been achieved.

And while we celebrate to some extent the apparent end of the acute phase of the recent financial crisis we are now entering a new phase with even more complex actors and stresses; inter alia:

- A sovereign debt crisis in peripheral Europe with risk of contagion and structural political challenges across the whole Eurozone;
- A period of fiscal consolidation in the West with varying degrees of political buy-in and, in the US, an extraordinary political brinkmanship around raising the Federal debt ceiling;
- Commodity and food inflation across much of the developing world;
- An unprecedented wave of social and political disturbance across much of MENA leading to regime change in many cases;
- The redirection of much of the financial surpluses of four of the largest surplus countries in the world China, Japan, Saudi Arabia and Germany, to meet domestic or regional priorities;
- While at the same time we attempt the complete restructuring and recalibration of the global financial system.

And against this backdrop we still forecast growth across the world – modest in the developed world and strong in the emerging markets.

This leads to a simple question as to what drives growth – partly it's demographics, partly it's economic policy and execution, partly it's supportive monetary policy and enabling financial services – but I would argue that most of all it is about confidence in the future.

It is confidence that supports consuming rather than saving. It is confidence that encourages investment in capacity and infrastructure to meet future demand. It is confidence in sustainable growth that allows governments to design programs to deliver social cohesion and greater equality and so on.

And at the heart of confidence about the future lies confidence in the value of money and security of savings, of pensions and of future income.

The banking system is crucial to underpinning such confidence. It is in this area more than any other that banks contribute – and sadly can all too easily undermine if we get it wrong – to the foundations of global growth.

That is why the recent crisis has caused a proper introspection as to the role that banks play in society and we should all welcome this. Banking as we all know is not simply about money. It is about helping individuals and organisations within society to meet personal and corporate objectives by facilitating access to financial capital and protecting value for those who make capital available. Payment mechanisms, the provision of long-term credit, trade finance, hedging and other risk management products, deposit, investment and retirement services are but a few of the activities through which banking groups contribute to today's financial system and thereby support the activities that drive underlying global growth.

Society cannot function without an effective financial system that delivers value to those it serves at an intermediation cost that is proportionate to the value created. Somehow, many participants and not just banks, lost sight of this basic principle in the run-up to the recent financial crisis and the consequences for all have, inevitably, been far reaching. There is no doubt that the scale of regulatory reform underway will bring many challenges, but it will also open new opportunities and most importantly it will serve to refocus our industry on demonstrating its social value through underpinning the confidence that is the foundation of global growth – that is indeed the greatest contribution we can make.

Many speakers in today's programme are focusing on the reform issues today so I will leave this subject at this point. But happily my role is to look forward rather than back, and to consider in a more granular way how our industry will contribute to global economic growth in the future.

There are several points I'd like to consider today.

- First, where will economic growth come from in the global economy in the next few decades;
- Second, which sectors are going to be most affected by the overarching economic trends;
- And third, where do opportunities lie ahead for the financial services sector to contribute most to delivering this economic growth.

So let's start with where we are going to find global economic growth in the first half of this century.

The most powerful engine for growth in the last few decades has been globalisation. This has opened up the world to greater trade flows and delivered growth rates in many of the world's emerging markets several times those achieved in the developed world. We see no reason why this trend will not continue in the future for some considerable period.

While many commentators in the developed world might be preoccupied with the debt crisis in the Eurozone and the slower than hoped for recovery of the US economy, business leaders in all industries are focussing on the opportunities arising from economic growth in major emerging markets and planning on that continuing its upward trajectory, albeit with occasional hiccups.

Our research estimates that world output will treble by 2050, driven by growth in emerging markets. 19 of the 30 largest economies in 2050 will be countries that we today describe as emerging and collectively, today's emerging world will, by mid-century, be larger than the developed world.

To date, growth in these emerging economies has been based primarily on the manufacture and export of goods to rich western nations. But partly reflecting an understanding that an over-indebted developed world, much of which is facing a double-whammy in terms of a squeeze on real incomes coupled with government austerity measures to reduce fiscal deficits, is not going to be able to continue consuming at its previous pace, as well as a desire to build up domestic consumption, emerging markets are increasingly focussing on growing their domestic economies. As a result, the future pattern of emerging market growth is likely to change fundamentally.

First, as stated earlier domestic demand will become a much more important driver of growth as people in emerging economies become wealthier.

Second, emerging nations' hunger for commodities will strongly influence trading patterns and geopolitical alliances.

Third, as wealth is generated huge new market opportunities will arise for branded luxury and lifestyle goods. China is already the second largest market for luxury goods in the world. And overall, the middle classes in emerging markets are swelling rapidly in number. At the turn of the century, the emerging world's middle classes were estimated at around 250 million people; by 2030, it could have reached 1.2 billion.

Finally, we will see a further evolution in trade patterns, with huge growth in trade **between** emerging markets.

For the up and coming economic superpowers of China and India, they cannot hope to expand as they plan to unless they are able to increase trading opportunities beyond the industrialised world, and gain access to the resources they need. This represents a fundamental change in EM growth patterns. This means that we are likely to see – indeed we are already seeing – the development of what we might call a Southern Silk Road, a network of trading routes that will connect emerging markets in Asia, the Middle East, Africa and Latin America to each other.

Our research suggests that trade and capital flows between emerging economies could increase 10-fold in the next 40 years. And we are already seeing these new linkages being established. Let me give you just a few examples:

Korea's exports to the emerging world have jumped from half to three-quarters of total exports in the last 10 years.

Meanwhile, China, which is the driving force behind much of the changing patterns of economic growth, has been the counterparty to major cross-border emerging market M&A deals in infrastructure, energy and agriculture.

Let's take just two examples: Sinopec's 7 billion dollar acquisition of a stake in Repsol-YPF, and CNOOC's 3 billion dollar investment in Bridas Corporation, were respectively the second largest and largest M&A deals in Brazil and Argentina in 2010.

When Premier Wen visited India last December, he signed trade deals worth 16 billion dollars. This outstripped the 10 billion dollars worth of deals signed during President Obama's visit the previous month, and the 1.4 billion pounds of trade deals the UK signed during Premier Wen's visit this week.

And, goods designed for a domestic customer base can be sold all over the emerging world, and this will trigger further economic linkages. To give you just one example, Chinese and Indian cars are cheaper, lighter and simpler, than Western counterparts and may appeal to those who simply want transport rather than luxury.

These are just a taste of things to come. We believe that South-South connections have the potential to revolutionise the world economy over the next few decades. Although it is not something that will happen overnight, the direction of travel is clear.

The second area I want to consider is which sectors might be most affected by these overarching economic trends.

In our view, the revolution in trade will have two further consequences.

First, to serve the burgeoning middle classes and to facilitate growing trade between emerging markets, all countries will need to invest heavily in infrastructure – roads, railways, ports, energy, telecoms. China already has five of the world's 10 largest container ports, but other nations are not as advanced. In India, for example, electricity generation is estimated to be up to 20 per cent short of what's required to meet peak demand.

Across Asia as a whole, McKinsey estimates that 8 trillion dollars of infrastructure investment will need to be committed in the next decade to meet the explosion in demand. Four fifths of this is expected to be in the energy and transport sectors.

Here, again, China will be influential as it tries to secure access to the resources and markets it needs to continue fuelling its growth. With the help of Chinese investment – and it is worth remembering that 20 years ago no Chinese port was in the top 20 – the process of infrastructure “catch-up” is being established. For example, coast-to-coast railways have been proposed across Colombia and from China through to Turkey; and there is new port construction in the Indian Ocean.

Second, the revolution in trade will have to be matched by a revolution in capital markets. There needs to be a massive growth in financial infrastructure to go hand in hand with the rapid growth in physical infrastructure.

And this leads me neatly into my third point – how does our industry ensure it plays its proper role in enabling financial markets to support the economic progress and global growth that these trends should generate?

I think they are to be found in a number of different areas.

First, with individuals. At the most basic level, access to financial services is still poor in many emerging markets – the world’s total unbanked adult population is estimated at about 2.5 billion people, almost all of whom are in emerging nations.

If emerging economies continue to grow, to build middle class lifestyles, and to develop a consumer society, then there will need to be greater access to the bank accounts, the consumer credit and the payment mechanisms that we take for granted. And emerging markets will create products and services that will play back to a developed world hampered to some degree by legacy physical infrastructure – e.g. mobile payments in Africa.

But getting back to the key point I made at the outset, people in emerging economies will only consume if they are **confident** that their long-term financial future is secure in terms of their employment, retirement provision and health provision.

Today that confidence is delivered through personal savings, with over a third of household income in China and India currently channelled into savings, compared with about 4 per cent in the US. People will need confidence in their government’s ability to create the social security systems and the financial industry’s ability to build the pooled savings and pensions systems that we in the west take for granted if they are to exchange saving for consumption. Governments are tackling this. For instance, China’s 12th Five-Year-Plan makes very clear and firm commitments to investing in healthcare, education and social security.

And of course, the creation of a long term savings and pensions market is essential if emerging economies are to raise the long term funds necessary to facilitate the needed investment in infrastructure, and that will also require in parallel much deeper, more liquid and more sophisticated financial markets.

Both these factors will be catalysts for the development of emerging market financial markets, particularly in Asia. And although Asian financial centres are becoming, and will be, increasingly important, London and New York still remain the dominant international financial centres. But in this year’s ranking of global financial centres, the five centres cited as most likely to advance were all Asian – Shanghai, Singapore, Seoul, Hong Kong and Beijing.

Fixed income markets in particular will develop to meet demand for life, annuity and retirement savings products for newly affluent households. Domestic bond markets in Asia are typically between 50 and 100 per cent of GDP, while equivalent markets in the developed world are 150 to 200 per cent of GDP, so the scale of the growth opportunity is very large. The Asian Bond Market Initiative seeks to reform and grow this market, and if governments are successful in doing so, there is likely to be plentiful demand not only from local retail investors, but also from international institutional investors looking to diversify their holdings.

Second, trade finance will grow – increasingly through mid size and smaller companies now much more connected to trade finance and much more willing to see markets as global. There are huge opportunities to service this sector which has been historically underserved in international business products but is now growing hugely in relevance.

Third, the environmental challenges already evident in today's world, and heightened as the largest emerging markets grow, will necessitate huge infrastructure spend all over the world to improve the energy intensity of global growth and reduce emissions. There will be huge financing opportunities around both the infrastructure and the research sciences needed to deliver this.

Fourth, as China and other EMs increase their export of capital as they invest abroad to gain access to resources, markets, distribution and intellectual property, that investment will be enabled by the international banking community as the domestic EM banks currently lack both the expertise and international presence.

Finally, as the renminbi emerges firstly as a major trade settlement currency and in due course as an international currency and ultimately as a future reserve currency, this will require the support of the global capital markets and trading infrastructure to incorporate it into the global settlement architecture.

It is worth observing that RMB internationalisation is moving faster than many previously expected. Offshore RMB deposits have boomed, quadrupling between 2009 and 2010. Trade settlement in RMB is also fast gaining pace and widening in reach. We estimate that as early as 2015 around a third of China's total foreign trade – equivalent to 2 trillion dollars annually – will be settled in renminbi. This would make it a top three global trade currency. Meanwhile, companies have moved quickly to issue RMB bonds, as investors eye the currency's further appreciation.

A question that London, which currently dominates the world FX markets with 37 per cent of global FX turnover, might well want to ask itself is: what is it doing to position itself as the predominant centre for RMB settlement?

So where does all this leave our industry?

As I said at the start, the industry has been focused for some years now on managing its way through the crisis and its aftermath, but once again we can look to how we can best contribute to the global economy, focussing on the future through understanding the major trends that are re-shaping the global economy and the patterns of economic activity.

And what this tells us is that the economic distribution of wealth and activity and the shape of the financial system that supports the generation of that wealth and activity are going to evolve in ways different from the last fifty years. We – the industry – and policymakers and regulators need to ensure as we build our business models and our regulatory frameworks that we reflect this reality.

It is well established that financial services and economic development go hand in hand. So if the positive growth trajectory of global economy is to continue – and we should remember that this growth trajectory has transformed and is transforming the lives and opportunities of millions of people – the global economy will require a massive amount of financing and the development of more sophisticated financial systems in – and to serve – the emerging world.

And for economies (and most specifically the governments, businesses and people within them), to have a shared confidence that the future is worth investing in – and that it is safe to do so – our industry has to be undoubted in its integrity, its sustainability, its social value, its expertise and its shared values with society in its vision for the future.

Re-establishing the trust - by actions and not words – that creates such confidence is the greatest contribution that banks can make to global economic growth and I believe firmly it is a journey we are all embarked upon.

Thank you.