Galvanising the Australia-China investment relationship

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HSBC Australia-China Conference
Sydney, 11 November 2016

Ladies and gentlemen, good morning. It's a special pleasure to be back in Sydney.

We're here to talk today about investing in China through its companies and markets, and engaging with China as it globalises its economy.

Tony gave a short overview of some of the opportunities we see, and over the next few hours various sessions will explore these strands in detail.

But I want to talk this morning about the context around these discussions we will have across the balance of the day.

China's relationship with the world – whether political, social, economic or financial – is currently in a period of extended transition.

Part of this transition, in the shape of economic, social and financial reform, is taking place inside China itself.

But the other part, around trade openness, market access and pathways to renminbi internationalisation, is happening beyond China's borders – in governments and boardrooms around the world.

Nowhere is that more evident than here in Australia.

Australia has used China's momentum to propel its own economy more effectively than any other country in the OECD.

The Australian Government has enabled this process where possible. But, fundamentally, the story of Australia's economic relationship with China has been written by Australia's businesses.

As China has loosened restrictions on investment, as Chinese incomes have grown, and as the new Chinese middle class has developed new tastes, Australian businesses have often been the fastest to react.

Today, the Australian and Chinese economies are fundamentally linked, and they will remain so.

That means that China's success is also Australia's success.

So this morning I'm going to talk about three things.

What China's experience over the past twelve months means for the stability of its economy;

What the implications are of China's increasing reach and growing global influence; and

What this means for the China-Australia economic relationship and for Australian businesses seeking to capitalise on the opportunities it presents.

First, China's economic development.

Twelve months ago, when we held our last Australia-China Conference, the spotlight was firmly trained on the impact of China's slowdown on global markets.

The decision in August 2015 to allow the renminbi to move more in line with market forces had surprised investors, causing a chain reaction which had disrupted global equities, foreign exchange and indeed bond market yields.

Sluggish demand, falling commodity prices and weak industrial data were making markets and investors incredibly nervous.

And some commentators were speculating 12 months ago that China's reform programme was therefore drawing to a premature halt.

One year on, these fears have yet to materialise.

The renminbi has largely stabilised; the housing market has rebounded; and stimulus has moderated China's slow-down.

Growth has recovered to around 6.7% and we expect it to stay there into the New Year.

The economic outlook for China is better than it was. And whilst China's challenges haven't disappeared, Beijing has continued to demonstrate that it has the means to deliver a soft landing.

These means are far from exhausted. China has used its fiscal tools effectively to stabilise growth, but the nature and number of its policy options mean that it has room to do more if it needs to, and in a more targeted way.

Macro-prudential policies in the largest city regions are already cooling housing demand in response to fears of a housing bubble.

And Beijing has sufficient monetary head-room to manage interest rates further if the situation demands it.

Of course, none of this diminishes the scale of the task that China faces.

Beijing can't rely on monetary and fiscal stimulus forever, and while securing a platform of stable growth is an important achievement, it is a prerequisite to structural reform rather than an end in itself.

Reducing debt, resolving over-capacity and reining in shadow banking are obstacles that need time and patience – as well as stable growth - to overcome.

However, there are clear indications that Beijing understands the complex issues that it faces.

Even given the preoccupations of the last twelve months, Chinese policymakers have laid the groundwork for a necessary structural shift.

Measures to cut over-capacity in key sectors are starting to work, and the rising non-performing loan ratios in China's banks partly reflect the closure of inefficient state-owned enterprises.

In fact, the recent performance of the banking sector shows that some of the banks are already digesting corporate debt write-offs, and debt-equity swaps and securitisation of non-performing loans are helping the banking system to wind down debt in a controlled and measured way.

In other areas, the necessary structures already exist to tackle China's underlying problems, but are probably not yet sufficiently equipped to have the necessary impact.

The municipal bond market is helping local governments refinance debt, but the lack of a broader investor base continues to limit its effectiveness.

And while steps to limit shadow banking helped slow lending growth in 2015, the need to shore up stability and minimise sharp market corrections has made it harder to rein in new forms of shadow banking this year.

There is a great deal more that China needs to do, particularly to reform state-owned enterprises and rebalance investment between the public and the private sectors.

But the last twelve months have demonstrated Beijing's ability not just to exert control over the levers of the economy, but to manage the pace of reform while laying the groundwork for future progress.

Let me next speak of China's influence on the world.

In the meantime, the influence that China exerts on the global economy continues to strengthen.

While the world was worrying about China's slow-down, China's financial markets have continued to open up, and China's middle-class has continued to emerge.

Progressive, controlled reform has accelerated – and continues to accelerate - capital flows in and out of China, and the inclusion of the renminbi in the IMF's Special Drawing Rights has confirmed it as a global reserve currency.

Since the IMF's announcement late last year, China has opened up the onshore interbank bond market to foreign private investors; eased QFII and RQFII regulations; and announced the launch of the Shenzhen-Hong Kong Stock Connect, perhaps as early as later this month; and clarified the dollar-yuan fixing mechanism, making it more market-oriented and transparent.

New inbound channels are already boosting inward investment.

The value of onshore government bonds bought by foreign investors in 2016 is already five times greater than the whole of 2015. And we, at HSBC, expect that the share of the onshore government bond market owned by foreigners to increase from around 2 per cent today, to about 10 per cent in the next two years.

That means, as much as 100 billion dollars of additional inflows.

A secure source of reliable portfolio inflows should pave the way for looser restrictions on ownership of overseas assets by Chinese residents – potentially unlocking the large stock of surplus savings that is heavily under-invested outside China.

This itself could have a transformative impact on the global economy at least on a par with the existing ‘going out’ policy, which is already injecting Chinese capital into companies and businesses across the globe.

Corporate China’s appetite for investing overseas is growing, not shrinking.

Chinese firms announced more than 600 overseas M&A deals worth over 100 billion US dollars this year alone.

And in the first nine months of 2016, Chinese companies have increased their investment by about 70 per cent on 2015’s figure.

The size of China’s economy and the shift towards consumption and services are already changing the nature of those acquisitions, from resources to services, technology, luxury goods and foods that meet the demands of increasingly affluent consumers.

And as China’s middle class grows, so do the opportunities for foreign brands with the cachet that Chinese consumers increasingly demand.

At the same time, Chinese money is revitalising infrastructure and laying the foundations of stronger growth in emerging economies in Asia and Europe.

China’s “Belt and Road” initiative is bringing east and west closer together by investing in rail, ports and power along centuries-old trade routes.

Together, these improved land and maritime routes will drive bigger and faster flows of trade and capital.

China anticipates its annual trade with countries along the Belt and Road will pass 2.5 trillion US dollars in the next decade.

But Belt and Road also enables Chinese firms to build partnerships and provide supply-chain support to local companies; to acquire and share machinery, technology and expertise; and to gain a stronger foothold in those local markets.

Last year, half of China’s overseas deals happened along the Belt and Road routes.

And in 2016, Chinese companies have already signed 4,000 engineering contracts along the Belt and Road, with a combined value of nearly 70 billion dollars.

The explicit link drawn between Belt and Road and the Northern Development Plan by President Xi during Prime Minister Turnbull’s recent visit to China was a significant gesture that paves the way for renewed investment interest from Chinese investors.

But it is also a timely reminder of the value of Australia’s proximity, not just to China, but to other recipients of investment along the Belt and Road routes.

This creates more than just opportunities for increased trade and capital flows.

It gives Australia’s financial and professional services a privileged position from which to build links with businesses and governments along the Belt and Road, and in particular to help investors identify which projects are investable, legal, feasible and sustainable.

Finally, let me tell you what this means to Australian businesses.

China is not only continuing to grow steadily, it is extending its reach and influence as it opens up and uses its financial strength to influence the pace and direction of trade and capital.

This clearly carries profound implications for businesses and governments outside of China, who face no choice but to adapt to this shifting landscape whilst it is still moving.

This landscape continues to be poorly understood.

To start with, China’s need for Australian resources will not end any time soon.

For all the recent media emphasis on China’s need to cut capacity and close down inefficient production, China’s development story still has far to go.

China’s capital stock per worker is only a third of South Korea’s and a quarter of the United States’, and its infrastructure investment still lags behind developed countries.

To give just one example, railway density in China is only 29 per cent of that of the United States' and 12 per cent of Japan's, with a total rail network that is still shorter than that of the United States in 1890.

China therefore continues to need high-quality new infrastructure to increase productivity and support future growth, which in turn will require secure channels of resources to achieve this.

At the same time, measures to increase China's capital efficiency and reduce capacity in key sectors are a help, not a hindrance to Australia's growth.
As China cuts its own iron ore production, Australian iron ore - which is both higher grade and lower cost – is becoming increasingly valuable.

And as China seeks to clean up its environment and grow in a more sustainable way, its desire for cleaner burning fuels – like LNG – will only increase.

Over time, as China's income grows and tastes change, other sectors – like health, education, tourism, agriculture and professional services – will become a bigger part of the Australia-China investment story.

But for the time being, the potential of those sectors remains considerably larger than their current value.

Chinese visitors are already swelling tourist numbers, but the proportion of Chinese taking trips abroad remains small – even among the young and affluent.

Spending on healthcare in China continues to rise, but remains low in relative terms.

And Australia's financial and professional services have yet to make the most of their position in relation to China and China's investment.

The emergence of Chinese companies on the regional and world stages means greater competition.

As China's role in the world economy continues to grow, Chinese firms will become much more visible.

The acquisition of overseas knowledge and technology will make them more competitive.

And improvements in logistics and transportation mean that Chinese products will enter the global market in greater numbers.

China is also still fundamentally a low-income country.

It may be the world's second biggest economy, but it is also very much a developing one.

With per capita GDP of less than 8000 US dollars, China's current developmental stage is on par with Japan in the 1950s and Korea in the 1980s.

So any company seeking a foothold in the Chinese market has to think about how it competes on price as well as quality – with potential consequences for cost control, business efficiency and supply-chain management.

The rise of China could also have implications for freedom of trade.

While governments around the world have extolled the commercial benefits of China's emergence, there is a growing risk of protectionism in response to the competition that it presents.

This isn't unprecedented. The rise of Japan created a similar wave of caution in the 1980s.

However the risk is arguably more acute at a time when western countries and regions are struggling with the impact of globalisation.

Put plainly, increasing global openness is no longer a given in today's political and social climate.

This creates, though, opportunities as well as challenges, and Australia already has a considerable advantage.

Aside from its open and flexible economy, the China-Australia Free Trade Agreement provides a significant means of leveraging Australia's strengths.

And through collaboration, foresight and ambition, there is no reason why Australia's industries shouldn't capitalise on the caution of other nations.

So this is the context around our conference today.

China's economy is stronger and more stable than it was this time last year, and Beijing is using its platform of stability to embark on both structural and social reforms in the intervening period since we last met.

China continues to increase its already powerful influence on the global economy.

And there are profound opportunities for Australian business from China's rise, as well as several things to consider about the way that it needs to adapt to seize them.

Increasing the chances of success means fostering better understanding of China, working across industries to identify ways of working together towards the same aims, and building new and better connections with China and Chinese companies.

It also means working closely with policymakers to create an environment that enables business to compete in the most effective way.
Australia's government has been a very powerful advocate for Australian industries and Australian expertise.

But just as Australian business forged the investment relationship with China, it is incumbent on business to galvanise the next stage of the Australian-Chinese relationship.

Equipping our clients with the knowledge, the insight and the expertise to seize that chance is what HSBC has done for more than 150 years.

So, I hope that all that you hear this morning will help you to build your businesses in China and that you have an informative, constructive and illuminating morning.