Letter from the President

Will Asia Continue to Power World Growth?

Asian Financial Forum
Hong Kong
13-14 January 2014

Vol. 70

That was the topic for debate among participants at this year's Asian Financial Forum. The answer to that question will be crucial to the performance of the economies of both developed and developing economies. The conference sessions focused on various aspects of this theme, with the delegates and the presenters displaying differing views on the strength of the Asian economy in the coming year, and particularly China's contribution to growth in the region. The general consensus was for continued solid growth in the region and in China, but risks to this outlook were raised.

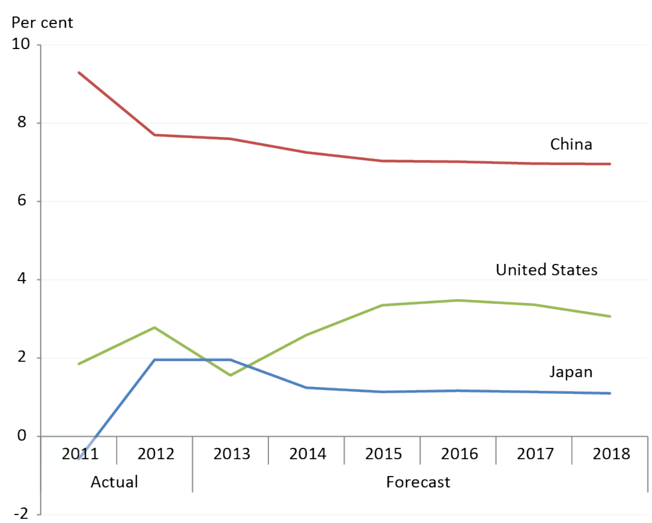
Several presenters expressed concerns about the outflow of speculative capital from Asia and the emerging markets to the developed markets, notably the United States, in response to the strengthening U.S. economy and anticipation of rising interest rates from tightening of monetary policy through the tapering of QE. Will that weaken growth prospects in Asia? Some thought this withdrawal of capital from the emerging markets represents a reprise of the capital retrenchment from Asia in the late 1990s, which provoked a currency and financial crisis in the Asian economies. However, the consensus view was that this was unlikely to happen this time around because of remedial steps the Asian countries have made in the past 15 years. Most of these countries have built up substantial foreign reserves; many are running trade surpluses; many have avoided accumulating large holdings of external debt; and the financial institutions in these countries are well-regulated and in good shape. The exception on the last point would be the strains in the Chinese shadow banking system, with several spectacular failures of trust companies in recent months, the latest being China Credit Trust.

The Impact of Developed Economies: The Prospects for Japan and the United States

Presenters noted that renewed growth in the Japanese economy and the financial markets from the stimulative policies of the Abe government will boost Asian growth in the coming year, reinforcing the contribution of a strengthening U.S. economy to global growth. However, the sustainability of the emerging Japanese recovery was questioned. While it was viewed likely the Bank of Japan will continue aggressive QE and fiscal policies to provide stimulus despite high public debt levels, some questioned if structural reforms could be implemented with sufficient vigor to ensure sustained economic revival in Japan.

Conference presenters had differing views on whether the U.S. recovery would continue to accelerate, or even maintain existing momentum, given fiscal drag from the latest budget deal and the prospect of further Fed tapering of the QE program. It was recognized a buoyant U.S. economy had great potential to boost export demand benefitting Asian businesses.

Forecast of GDP Growth



Source: IMF

China's Trajectory of Growth

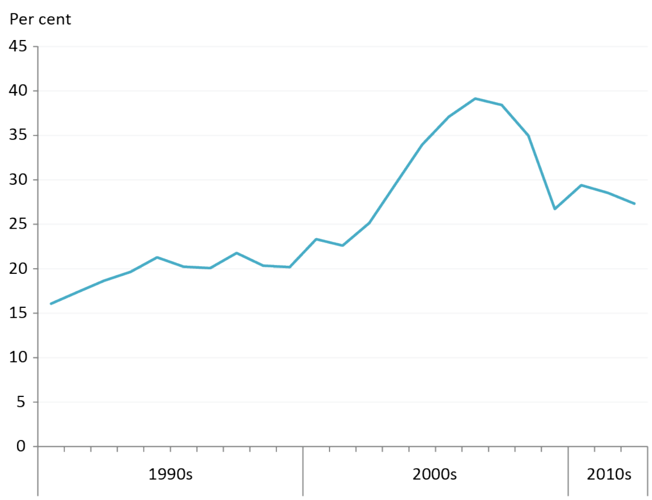
The elephant in the room was the likely trajectory of growth in the Chinese economy. Specifically, will growth remain in the 8-10% range or will it decelerate from current levels? Any

11 King Street West, Suite 1600, Toronto, Ontario M5H 4C7 • T 416.364.2754 F 416.364.4861 E PublicAffairs_AffairesPubliques@iiac.ca • www.iiac.ca

deceleration would diminish significant momentum from the global economy instead of adding to it, severely constraining Asia as a locomotive for world growth. Perhaps most importantly, the outlook for China's growth will have a key bearing on the strength of commodities markets, the earnings and share prices for resource companies, and the prospects for rebounding growth in the Canadian and Australian economies.

The consensus was for a modest slowing in growth in China, to the 7-8% range, with some prominent speakers anticipating a steeper slide in growth to 6% or possibly lower. The outlook for a modest slowing in growth is recognition that export-led growth, reinforced with the traditional driver of high levels of investment spending, is unsustainable. First, rising labour costs are pricing China out of highly competitive export markets in manufacturing goods. Second, export-led growth, supported by large-scale public spending on infrastructure, has been fueled by extensive lending to state-owned enterprise (SOEs) and private business. This credit expansion has funded increasingly inefficient investment, and put enormous strain on the Chinese banks and shadow banking system. Has the economy, and People's Bank of China, sufficient capacity to bail out the failures in the banking and near-banking system, without negative repercussions on growth rates?

Exports as % of China's GDP



Source: World Bank

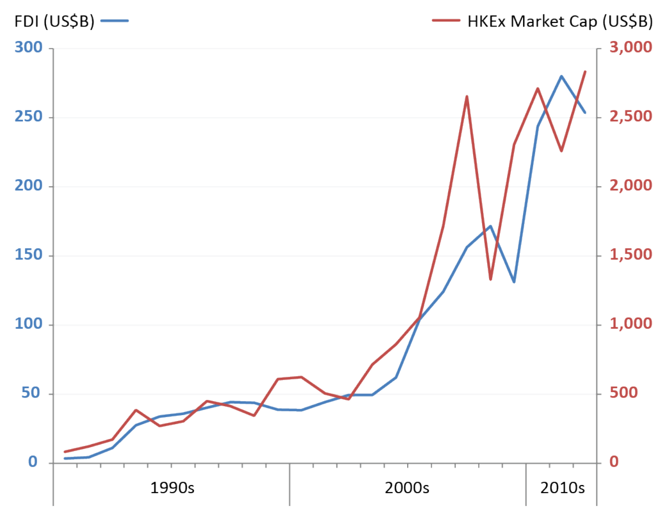
Finally, the ongoing transition to domestically-led economic growth, driven by the consumer demands of an emerging middle class in China, is a necessary evolution of the Mainland economy – but can it be accommodated in the context of continued strong growth? This transition process reflects the natural maturation of an emerging economy as consumer demands increase steadily in response to improving incomes and wealth, and the export sector reaches capacity. Historical evidence of this transition process, based on the experience of Korea and Japan, suggests economic growth decelerates sharply for several years until consumer demand and related investment spending strengthen and offset slowing export sector growth. Investment spending makes a similar transition from the state-owned sector to private business in response to relative investment returns.

The Impact of the Reform Agenda

The debate among conference participants on the factors influencing future growth in China often turned to the reform agenda and its influence on consumer and investment behaviour. The Third Plenum last November announced a comprehensive package of reforms including reform of the SOEs, rural land reforms, change to the one-child policy, focus on support for small and mid-sized business and a vigorous anti-corruption agenda. The skeptics argue that the challenge for policymakers is not the announcement of needed reforms, but the will to implement them. In this context it was instructive to listen to the Deputy Mayor of Shanghai describe the newly set up free economic zone in that city, the extent of government support and popularity of the program. This free economic zone, likely the prototype for similar programs in other parts of the country, could be the vehicle to introduce reforms and the catalyst for future economic growth.

Some conference presenters saw the implementation of reforms as contributing to short-term inertia in economic activity, but eventually providing sustained momentum to the economy as reforms take hold, with growth accelerating to higher and more sustained levels.

Foreign Direct Investment in China



Source: World Bank, World Federation of Exchanges

The comprehensive reform package is interpreted by some as the latest stage in the gradual opening up process of the Mainland economy. The first stage could be interpreted as the opening of trade flows in the early 1990s, followed by the inflows of direct foreign investment to build China into the workshop of the world. The third stage was access to regional and global capital markets to finance Chinese enterprise, particularly for the SOEs or "Red Chip" companies through large public IPOs, many floated in Hong Kong with the shares listed on the Hong Kong Stock Exchange (HKEx) and other major global stock exchanges. The fourth stage is the progressive outflows of capital through qualified investment programs, with outflows accelerating in recent years.

The reforms of the Third Plenum, if successful, will unleash economic enterprise, notably private business, and enable a faster transition to a more balanced economy. Policymakers in China will still face the difficult challenge of promoting growth and maturation of the economy while, at the same time, maintaining stability – always a key objective of policy. However, the effective management of the economy over the past thirty years, through a gradual opening and concomitant rise in prosperity, suggests China will successfully manage the transition process. Policymaking in the country always takes the long view.

The conference participants recognized that transition to increased growth from the internal economy would have important implications for global non-financial and financial businesses. Non-financial business will find expanding opportunities in China to meet consumer demand for products and services. The economic transition will also re-orient external capital flows from state-managed outflows of capital directed to portfolio and direct investment abroad to capital outflows from private savings in the search for external investment.

The Second System: The Impact of Reforms on Hong Kong

As Mainland China moves forward with reforms, and the economy transitions to a better-balanced economy in the next several years, what will be the impact on Hong Kong as well as the global economy? Hong Kong has consistently taken a leading role in facilitating the opening up and maturation of the Mainland economy. Will Hong Kong continue to play that role? There was some debate, led by HKEx CEO Charles Li, that Hong Kong has not done enough to build out asset management expertise and derivatives markets to hedge commodities and currencies, to compete effectively for the accelerating outflows of capital for China.

However, it would be a mistake to sell Hong Kong short in taking a leading role in this phase of Mainland development. While the city may need to build out increased financial market expertise and markets, it nonetheless remains a dynamic global marketplace, with a sophisticated legal, accounting and logistics infrastructure, and strong business and political links to China, to capitalize on the transitioning Mainland economy. The financial infrastructure in Hong Kong, both local and global institutions, will continue to expand to meet the growing demands of Mainland businesses and individual investors. As a case in point, convergence in regulatory standards now enables managed fund products such as mutual funds, registered in the Hong Kong jurisdiction, to be distributed directly to Chinese investors.

In the past Hong Kong has seized advantage of its distinction from Mainland China – "one country, two systems" – to capitalize on the gradual opening of China. There are those who argue that, as the Mainland economy matures and the country becomes less dependent on export-led growth, and comprehensive reforms are put in place, the "one country, two systems" concept will gradually transmogrify into "one country, one system" – eliminating the distinction between the Mainland and Hong Kong and removing Hong Kong's economic advantage.

This may happen – but not in the foreseeable future. One system is as much about politics as it is about economics. It will be far too soon to see Mainland China and Hong Kong integrate into one system by 2020, even if great strides are made drawing the respective economies and financial markets closer together. Indeed, the handover of Hong Kong in 1997 envisioned a "one country, two system" regime for at least 50 years. As long as the Hong Kong government and its institutional framework remain anchored in the rule of law, and that will certainly be the case, Hong Kong will retain its economic advantage, and prosper as a consequence.

Conclusion

Regardless of the trajectory of growth and the effect of the reform agenda, one thing is certain: China's impact on the global economy will continue to be large. The discussions at this year's Asian Financial Forum provided clear perspectives on what direction it may take, and the likely ramifications for the global economy.

Yours sincerely,

Ian C. W. Russell, FCSI
President & CEO, IIAC
February 2014