Letter from the President

A Contrarian Analysis: China to Defy Forecasts and Lead Asia in Re-Shaping Global Landscape
Perspectives from the Asian Financial Forum

There is no shortage of media analysts forecasting a slowing of Chinese economic growth. The export model appears to be faltering, with domestic demand apparently unable to fill the gap. Resulting social unrest and instability could exacerbate the slowdown. That’s why many of the 2,000 delegates to the Asian Financial Forum (AFF) were probably surprised at the conclusions drawn from the many presentations at the two-day conference, pointing to an optimistic near-term outlook.

As several conference speakers noted, economists’ pessimistic growth forecasts for China have rarely proven correct, defying projections for years. Many of the speakers and panelists at the sixth annual AFF conference in mid-January expect growth in China to stay in the 8-9% range this year — a significant harbinger as the Asian Financial Forum is one of the foremost global conferences analyzing financial and economic trends in the Asian region and their impact on the global economy. The conference brings together world experts as speakers, panelists, and delegates. For the past several years, I have had the privilege of leading the Canadian delegation, including business executives and participants from the financial sector.

Further, a growing China, expanding and modernizing business to meet internal demand, will attract significant portfolio and direct investment from abroad. In turn, the vast Chinese savings will seek investment opportunities in emerging and developed countries. In coming years China will be the engine of growth in East Asia, and will shape the financial and economic landscape in Asia and the global economy.

So what are the reasons for the optimistic near-term outlook?

1. The export sector will remain an engine for growth despite rising labor costs and concerns about eroding competitiveness.

Foreign direct investment did fall 3.7% last year, the first setback since the 13% decline in 2009. But when put in perspective, this decline is modest, reflecting cyclical weakness in global export markets. It is not the harbinger of a significant investment shift out of the Chinese exporting sector and into South-East Asia.

Some investment at the margin may shift outside China. However, rising domestic labor costs will have little impact on exporting companies and related investment trends. First, many exporting companies have moved into more profitable higher value-added manufacturing to boost revenue and profitability. These companies rely heavily on sophisticated technology and skilled labor, mitigating the impact of rising costs in the coastal regions. Second, the massive fixed costs and scale of many export companies, with heavy reliance on trained labor, cannot easily shift operations from China, and therefore must absorb rising costs or find ways to offset their impact on the bottom line. For example, companies like Foxcomm in the sophisticated manufacturing and technology sector have huge scale and production flexibility to manufacture sophisticated and constantly innovating products on tight production schedules.

The newly launched offshore renminbi (RMB) market will have an important influence drawing new investment to China. The RMB market is an effective way for offshore businesses to invest in China, lowering currency transaction costs and risk, by enabling these companies to issue RMB-denominated bonds. The funds are converted to renminbi, invested in China and repaid to the bondholders at maturity. Some 270 billion RMB has been raised so far in the Hong Kong market. The offshore

The conference consensus on China was for sustained strong growth this year, ensuring continued import demand for resources, machinery and equipment, and finished goods.
market, with RMB accounts held at foreign banks, provides an effective way for Chinese businesses to pay foreign companies for products and services through settlement at banks in the offshore RMB centre.

### Offshore RMB Bond Issuance in Hong Kong

![Graph showing Offshore RMB Bond Issuance in Hong Kong](chart.png)

**Source:** Hong Kong Monetary Authority

The Hong Kong market has built up an array of interest-paying instruments, such as bond funds and ETFs, to support the liquidity pool in the RMB market. While these offshore RMB investments would eventually run up against the ceilings on QFII (qualified renminbi-denominated investment holdings) limiting foreign investment, China has committed to expand the allowable investments to ensure a well-functioning offshore RMB market. At the AFF conference, the Chairman of the China Securities Regulatory Commission stated that allowable ceilings under the QFII program would increase ten-fold in the coming few years – partly anticipating rapid expansion in the offshore RMB market. Finally, the Hong Kong Monetary Authority provides an active repo and swaps program for the commercial banks to backstop the liquidity program.

Canada has the natural attributes to become a second-tier offshore RMB centre: deep liquid bond and money markets; vibrant markets for foreign currency trading; a sophisticated derivatives market; a multiple currency clearing, settlement and depository system (CDS); strong globally-oriented financial institutions; four Canadian banks (BMO, RBC, Scotia and TD) already participating in the RMB clearing platform in Hong Kong; the right time zone for active investment from the major centres in North and South America, notably New York, Chicago, Rio de Janiero, and Sao Paulo; and the reluctance of Chinese firms to establish affiliates in the United States. A Canada-based RMB marketplace would draw foreign financial institutions, expanded trading and financing activity, and financial services businesses.

The Canadian financial community should work actively with the Hong Kong Monetary Authority to build the necessary infrastructure and coordination mechanisms to operate as an ancillary RMB centre.

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2. Domestic demand fueled by a growing middle class more than 300-400 million strong triggers substantial consumer and investment spending.

While consumer spending will be constrained by the continued high savings rates required in part to compensate for the modest social safety net, increased consumer demand driven by an expanding middle-class with concomitant rising living standards will spur investment in the indigenous manufacturing and service sectors to expand productive capacity, improve manufacturing and distribution efficiencies and adapt to changing consumer tastes. This widespread investment activity will accelerate, boosting growth in coming years.

The combination of growing business sophistication and much improved transportation infrastructure to link supply chains and product distribution has enabled the integration of local businesses, building scale and modernization of production techniques, transforming many businesses from local firms to state and national enterprises. Foreign companies like Wal-Mart and Danone are participating in renovation of the retail sectors. An interesting example discussed at the conference was the food production and distribution business, notorious for low quality standards. It was noted there are some 3,300 meat producers across China. Significant consolidation of this industry is underway, a process that will not just yield greater efficiencies, but address the pressing need for increased food safety and security.

Improving food safety has become a huge priority for government as it is linked to potential social unrest. This provides opportunities for Canadian companies (and universities) to export food technology and know-how.

Chinese companies that might otherwise seek markets abroad are finding investment opportunities in their home market more attractive, particularly in the burgeoning consumer sector. Several Chinese executives noted that State-Owned Enterprises are finding it more difficult to build markets abroad through acquisition, facing greater host government scrutiny. This focus on the uneven playing field between private enterprise and state-owned enterprise will likely intensify in coming years, as China is increasingly perceived as a wealthy and sophisticated economy.

3. General recognition that inflation is under control and fear of a property boom has largely subsided.

With the brakes now coming off bank lending as frenetic activity in the housing market has cooled, residential construction could quickly move back up to its traditional 40% share of fixed investment, from a depressed 35%. This could quickly add several percentage points to overall growth. More stable conditions in the property market would mitigate the prospect of potentially destabilizing shocks and encourage broad-based investment spending.
4. Adequate spending stimulus to supplement weakening demand.

There is a general consensus that additional spending stimulus would be forthcoming if needed. The national and state governments have demonstrated effectiveness in reacting to economic problems quickly and taking necessary remedial action to solve problems.

China: Likely to Grow – and Exert More Global Influence

There are risks with any forecast. However, based on the presentations and dialogue at the Asian Financial Forum, the likelihood is that strong growth will continue in China in the coming year. It is important to recognize that this not only means an expanding Chinese economy, already 40% larger than four years ago, but an increasingly sophisticated and modern China. Large investments in transportation and energy infrastructure will continue, but strong investment flows, both domestic and foreign-sourced, will be directed to the domestic manufacturing and service industries to meet expanding domestic demand. These investment flows will complement capital flows into the thriving and competitive export sector. A strongly growing China will exert significant influence on trade and investment flows in international markets, shaping the global economic and financial landscape. The once ‘sleeping giant’ has no intention of snoozing again.

Yours sincerely,

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