Gresham College Lecture
Wednesday, 4th March, 2009

'The economies of China, the US and Europe'

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I feel somewhat daunted to be asked to talk about the economies of China, the US and Europe. In the current conditions, each would merit a lecture on their own. And then, at the end, I would almost certainly not be able to reach a definitive conclusion of what is going to happen.

But I will concentrate on the one about which I know slightly more, China, and I will then offer some pointers on the impact of developments in China on the relationship with both the United States and Europe.

It is hard not to be astonished at the turn of events. I first visited China 28 years ago, on behalf of Sedgwick - now Marsh - to explore the opportunities to set up in insurance broking. I was struck immediately by the potential, since when I have watched China's transformation. I have now visited the country 115 times, and I almost wish I had kept a photographic log of each of my visits so that I could see on the page exactly how far China has come in that relatively short space of time.

It is not just the physical transformation of China's cities that astonishes. The policy of attracting inward investment and international trade has succeeded beyond anything that Deng Xiaoping, the architect of the policy, can possibly have imagined. China is the world's third largest economy, and the second largest trader. It has foreign exchange reserves of 1.9 trillion dollars.

At the same time, China has come to be known as the workshop of the world, making two-thirds of the world's mobile phones, and half of the world's computers.

50% of China exports have come from wholly foreign owned factories. Factories which have manufactured something like Palm Pilots much cheaper than it would cost in the United States or Europe, with the result that many more units could be sold. Such exports are not really Chinese goods, and it could be argued that these foreign companies had really exported some of their pollution by having their products manufactured in China, but they do provide employment.

China's growth rates of more than 10 per cent for a sustained period have accounted for about a third of global economic growth.

This policy was predicated on the notion that China could provide the land and labour, which it has in abundance, and the Western investors would provide the capital and the technology. Now, after 30 years of successful development, we have almost reached the position where China can provide all four factors of production.

The weak link is still technology but even here China is making great strides as it seeks to move up the value chain from low-cost manufacturing to manufacturing of great sophistication, harnessing its local research and design expertise.

But the tables have been well and truly turned, when it comes to capital flows. From being dependent on the West for finance, now it is the West that is going to China, almost cap in hand, asking for Chinese support.

There is no better illustration of this than the deal struck recently between Chinalco, China's state-owned aluminium company, and Rio Tinto in which Chinalco will inject close to US$20 billion into Rio Tinto either by buying stakes in prime assets or by buying shares. Now, this is still subject to shareholder and regulator approval, so may not happen, but it speaks volumes about the growing wealth and influence of China.

On a more mundane level, I am also amused - but very pleased - that for many years I and others would come back from our trips to China telling everyone we met how they ought to be engaged with China, that China was on an inexorable rise, and that the leadership was visionary. We had not just to convey our enthusiasm to the 'don't knows' but also to disprove the 'nay-sayers' who believed that China would fall at each fence. Well, China has proved them wrong, and spectacularly so.

That is not to say that China is not entering a very difficult phase, indeed uncharted territory, about which more in a moment. But I am an unshakeable optimist and I am absolutely convinced that China will ride out this crisis, just as it has overcome obstacles in the past.

However, what is indisputable is that nowadays, no one needs convincing of the imperative of dealing with China and how important China is.

The China-Britain Business Council exists to help people to export to China, to invest in China and to attract inwards trade and investment.

The China-Britain Business Council is the organisation to which UKTI, UK Trade and Investment, has outsourced responsibility for the promotion of trade between Britain and China, in both directions.

We have 9 offices in the UK with 35 staff, and 11 offices throughout China with 80 staff.

Advice is given to companies getting involved in China for he first time, or those that are expanding there, and a wide range of advice and experience can be shared, for example regarding Intellectual Property Rights.

This was the backdrop to Premier Wen Jiabao's visit to the UK last month. I had the privilege of talking at length to the Premier during a dinner that the China-Britain Business Council hosted for him at the Natural History Museum. Apart from being very good company, he delivered an excellent 40 minute speech - without notes, I might add - and offered some fascinating insights into Chinese government thinking.

The following morning, after a heavy snowfall, he spoke at the UK-China Business Summit, before travelling to Cambridge for a final speech.

I suppose the key questions to ask now, and which I will attempt to answer, are:

How has China *reacted* to the banking and financial markets crises, and to the sudden and dramatic downturn in the world's major economies and its principal markets?

What, then, is China actually *doing* of its own accord to address the situation?

And what *effect* will this have on the economies of the United States and Europe?

So for the first question: how has China responded to the meltdown in banking and financial markets and the slump in global demand?

In a word, actively. China could so easily have said that the banking and financial crises were the problems of others, and that, as a country which has accumulated vast reserves and carefully martialled government expenditure, it could afford to distance itself. In a different era, that would undoubtedly have been the instinct of the Chinese leadership.

But it did not say that, for two very good reasons. Firstly, it couldn't and secondly it didn't want to. It couldn't, because China's economy is inextricably tied into the world economy. When the world stops ordering all those computers, and mobile phones, and toys, and textiles, and shoes, that has a huge impact on China. And it has done so. China's exports fell by 17.5 per cent in January compared with a year ago. Imports were down by more than 40 per cent. Factories in Guangdong province have been closing. Migrant workers, who flocked to the cities because of the abundance of job opportunities, are returning to their home provinces. Officially, unemployment of migrant workers is 20 million but is probably far more than this. This is out of 130 million migrant workers. 6 million new migrant workers will join the labour market this year.

Whilst so many manufacturing jobs have been cut, attention is being made to the creation of jobs in the services sector, in financial and professional services, what the Chinese refer to as the Tertiary Industries. One of the prime reasons for this is the need to create jobs for graduates. Last year, two million graduates (25% of the total) could not find jobs. This year, a total of 7 million graduates will join the labour market.

A point of no return was reached in December 2001 when China joined the World Trade Organisation. From that moment on, what happened in the rest of the world economy invariably affected China.

But, secondly, and perhaps more interestingly, China has not turned its back on the rest of the world because it did not want to. The Chinese leadership, articulated so forcefully by Premier Wen Jiabao during his recent European visit, positively wants to play an active role in helping the world ride out the current crisis. It knows that it has a responsibility. There are certainly limits. While China will play a key role, do not think for a moment that it is going to use its hard earned reserves and savings simply to bail out failing economies. Premier Wen had some harsh words to say for those economies - no names mentioned, but no guesses for whom he was referring to - for those economies that have been profligate. “A totally unregulated market economy cannot work,” he said both in his Davos speech and in Cambridge. “We must strike a balance between financial institutions and regulation, between the financial sector and the real economy, and between savings and consumption.”

I find this willingness to engage extremely interesting - and encouraging. We should welcome such a stance, and we should work with the Chinese to see how best to achieve that. China will play a vital role in next month’s G20 meeting in London, the main focus of which will be on the reform of international financial organisations and systems.

To me, one more example of China's growing global maturity and confidence, is the fact that in their delegation which attended the G20 meeting in Washington in November, and now in the delegation which will come to London for the next meeting at the beginning of April, President Hu Jintao had in his delegation some senior Hong Kong financial civil servants.

It is also worth remarking how much China has aligned itself with free trade. There is obviously a large element of self-interest in this but I come back to the point that we are really seeing a fundamentally different style of leadership in China today. Coming up through the ranks are highly educated, enlightened and expert decision makers, who are creating a society that draws on the best of the West but which does things the Chinese way. You would not expect anything less.

That then leads me to my second question: what is China doing to address the situation? China responded towards the end of last year with a four trillion renminbi package - which is equivalent to about £400 billion - to boost domestic demand. Banks have been encouraged - or, rather, 'told' - to increase lending to local businesses and individuals, in a reversal of previous policy when they were told to cut back on lending. Such are the benefits of central control and state planning! We learn that there may be further spending packages in the National People's Congress later this month.

The money is being apportioned between provinces and cities. About a quarter of the money is coming from the central government, and the rest from local governments, and bank lending. When I was in China recently, in each of the cities I visited – Dalian, Foshan, and Dongguan – the Mayors told me how much they had been allocated. What is clear is that the money is being disbursed widely so that all of the country benefits.

I have explained the actions which China has taken to take investment and employment to regional cities, ie not just Beijing,, Shanghai, Guangzhou. During the second half of last year, the CBBC commissioned from the University of Leeds Business School, a report on opportunities for the UK in so called second- tier cities.

We discovered that there are 264 cities in China with populations of over one million. From these, a selection was made of 35 cities, whose ambitions for the development of trade and investment, match up with UK expertise and experience.

Many of these cities want to be regional financial hubs and they have each designated parts of their cities as their Financial Streets, citing as their example, the cluster effect which has been one of the secrets of the development of the City of London.

There are different elements to the fiscal stimulus. Some are what one might call conventional, Keynesian measures to boost demand. So, for example, money is being spent on infrastructure, and in particular on the railway system. There is also a proportion allocated to spending on reconstruction of the earthquake-ravaged parts of southwest China; in Szechuan Province.

But the more unusual and interesting aspects involve offering incentives to people in the poorer, rural areas of China to spend more. The Chinese instinct, as it is in most parts of Asia, is to save. A worthy instinct and one from which, in the current predicament, we in the West could learn. But there is no doubt that the high savings rate, which in China can approach 50 per cent of income, could be seen as excessively cautious.

There is one fundamental reason, however, why people in China save so much - and that is the lack of a national health service. Healthcare has to be paid for by individuals and families. So people save for anticipated medical treatment. And when they have to pay, often they have to pay large sums - especially if they need extensive treatment or if they have a serious disease such as cancer.

Add to that the lack of hospitals and modern healthcare facilities outside the city centres, which means that people from the countryside have to get themselves to where there are medical facilities, and you can see how costs mount up.

The government solution is to invest in medical care centres, hospitals and other facilities and to work towards providing a national health service. Over the next three years RMB 850 Billion (£85 billion) will be spent by the Government increasing and improving healthcare coverage. That should then help to reassure people that they can get treatment on the state and that they will not need to save for that particular rainy day. That, in turn, may persuade people to open up their wallets. Old habits die hard, however, so don't expect an immediate change in consumer habits.

By contrast, another step taken by the government may yield immediate gains. That is the discount of 13 per cent - why 13 per cent I don't know! - on purchases of white goods - washing machines, televisions, household appliances and such like that is available to people in China's poorer rural areas. This also partly serves another purpose - to reduce the huge oversupply that has built up as a result of falling export orders.

An important part of the discount scheme is that it also covers farm implements. That, in turn, is an element of a much more fundamental change of policy introduced last year to extend what are called "land use rights" – the equivalent of title - to farmers over their land. This really is significant because it enables farmers to borrow with land as collateral. The lack of rural finance has been one of the key factors holding back the development of China's interior.

What now has to happen is for banks to provide the flow of finance to rural customers. Both HSBC and Standard Chartered Bank have identified this as an area of opportunity and are setting up branches - much to the liking of the Chinese government, as I have been told on many occasions. In fact, they are the leading foreign financial institutions in rural finance.

So a very ambitious programme. And well within China's means, thanks to years of surpluses. But what effect has the fiscal stimulus had so far? It is obviously a little early to say but the initial signs are encouraging. Retail sales have increased. Bank lending has also resumed and increased. The wheels are moving. Some analysts are predicting that overall the stimulus may add 3 percentage points to China's economic growth this year. That should bring growth to at or near the magic figure of 8 per cent that China has set itself.

Eight per cent is deemed to be the minimum growth that China has to achieve to provide employment for the millions that come on to the job market each year. Over and above that, the government has set itself the priority of full employment, or as near to full employment as it can achieve, to maintain social stability. The number of disturbances and protests had been growing even before the current downturn hit. This is clearly a cause of some anxiety for the leadership, and it knows full well that these protests are rooted in genuine concerns which stem from lack of jobs or unfair allocation of what work there is.

So that is what the Chinese government is doing to address the current crisis. A huge programme of government expenditure and incentives to encourage people to spend more and to boost domestic demand, coupled with a policy of full engagement with the rest of the world to attempt to ensure that the world economy emerges from the recession stronger and better.

Now to my third question: what impact will China's fiscal stimulus and reflationary measures have on the economies of the United States and Europe?

As I have already said, the focus is more on China itself, but there will be something for others. Just last week, China sent over a buying mission to Europe, headed by the Minister of Commerce Chen Deming, to seek out European companies with good products and services that China was prepared to buy. Whilst it was not quite the 'splash the cash' that some papers called this trip, it was a very important mission and, more encouragingly still, others are promised in the near future.

Major contracts were signed. Rolls-Royce signed a deal worth US$1.2 billion to supply engines to Hainan Airlines. Jaguar Land Rover an order worth £600 million to supply more than 10,000 vehicles to China. China also agreed to buy aircraft parts, marine equipment, 'greasy' wool – whatever that is – and chemical pipes. After many years, where we have been encouraging China to buy more British goods, in order to reduce the trade imbalance, this is now really starting to happen.

To tell you the truth, the visit last week came as something of a shock to us. It was suggested by Wen Jiabao himself during the UK-China Summit earlier in the month, when he was responding to the proposal by Gordon Brown to try to double the UK's exports to China within the next 18 months. In the way that these things are done when the Chinese are involved, I was expecting a visit some time in the summer, but Chen Deming arrived less than four weeks after Premier Wen had raised the possibility. And he was accompanied by a 160 strong delegation. That is I think an indication of the sort of man that Premier Wen is - if he thinks that something is a good idea or necessary, he instantly puts a plan of action into place.

It is also worth highlighting that the relationship between the governments of UK and China is really excellent. There is no doubt that Gordon Brown is committed to full engagement with China and has built up an excellent rapport with Wen Jiabao, both during his visit to China in January 2008 (when I was a member of his delegation) and again at their meetings last month.

The two foreign secretaries, too, have also built up an excellent understanding. One small story illustrates this well. Last year, the CBBC held a dinner in honour of China's foreign minister, Yang Jiechi. He was already well disposed to the UK, having studied at the University of Bath and at the LSE. During the day, he met David Miliband but had to leave before they had finished their discussions. So David Miliband agreed to meet Yang Jiechi after the dinner to carry on their talk. Our dinner was running slightly late, but David Miliband was happy to wait, sitting in his car outside the hotel and working on papers before the two of them went back to the House of Commons for a drink.

There is, I believe, an openness and transparency in the relationship which makes it much easier for both sides to address the 'difficult' issues, particularly those surrounding human rights, environmental challenges, Tibet and Darfur, and from time to time, tariffs and trade questions. It was noticeable that the UK managed the visit of the Dalai Lama here last May, without any diplomatic fallout.

By contrast, the Chinese viewed the French government’s invitation to the Dalai Lama as a direct provocation, which culminated in the cancellation of the EU-China summit which was due to be held in Lyon in December, and which I was going to attend as President of the EU-China Business Association.

I think it also helps that, in Peter Mandelson, we have someone who in the Chinese perception fulfils two roles. He is both Chen Deming’s opposite number in the UK, but also someone who in his previous role as European Trade Commissioner promoted strong ties between China and Europe. They see him as highly influential in the continuing growth of links between China and Europe. And, although there have been disagreements in the past over quotas and tariffs affecting textiles, he is recognised as a passionate advocate of free trade. That is in no small measure why Chen Deming’s visit to the UK last week was so successful.

Europe is increasingly important to China. Just under one fifth of China’s trade is with the EU, and Europe is now China's largest export market. Europe is also becoming an attractive destination for Chinese investment. I know of Chinese companies manufacturing components for liquid crystal displays in eastern Europe. They have invested in leather shoe making operations in Italy. And, increasingly, they are investing in the UK. Huawei, the electronics manufacturer has a big operation in Basingstoke, and they do a lot of business with BT.

I have met their director who set up that factory, and he told me that they now bring senior executives from China to see how such an international operation is managed and to gain practical experience of corporate governance.

We should encourage this. Just as we attracted Japanese and Korean companies to invest in car manufacturing, and electronics, so I believe - present conditions notwithstanding –that it is in our interests to attract Chinese investment.

This extends to sovereign wealth funds. Ten of the top twenty sovereign wealth funds have offices in London. I and others have been encouraging the China Investment Corporation - which is one of China's two sovereign wealth funds; the other is the State Administration for Foreign Exchange - to set up in London as well.

But there is another important reason why we should encourage Chinese investment in Europe. When Chinese businesses set up in Europe, they become European companies. And that means they can enjoy the benefits associated with coming under the European regulatory regime.

This is a key message which we need to convey to the Chinese. And we are doing so. The European Commission has an active office in Beijing and its people there produce authoritative and excellent papers and studies about developments in China. The China-Britain Business Council is taking a lead among the European organisations promoting business with China. As I have said, I am the President of the European grouping, which is called the Europe

China Business Association, and CBBC's chief executive, Stephen Phillips, is its Chairman. That is helping to put the UK in a prime position in China's dealings with Europe.

And what about the United States? This has always been a difficult but important relationship for China. It was of course the United States under Richard Nixon that helped in the early 1970s to draw China back into the international community. As China opened up a decade later, the United States was regarded as the primary target market for Chinese exports. And bilateral trade has flourished. The US has become a leading investor in the China market. US-Chinese joint ventures are selling their products back to the US, a fact which is often overlooked or simply not understood by those who say that the Chinese are stealing American jobs.

As James Kynge points out in his excellent book, China Shakes the World, those who complain loudest about China undercutting the US are the very same people who do not think twice before buying cheap goods imported from China. Nonetheless, the bilateral trade deficit is a perennial source of diplomatic rift which rises and falls in importance with the cycle of US presidential elections.

But perhaps the biggest issue that currently confronts the US and China is that of debt. Quite simply, China has become the United States' biggest banker. China holds more in Treasury Bonds - nearly US$700 billion - than any other nation. This has helped to sustain the economic boom over the past decade and has, many suggest, helped to create the financial crisis in which we are now mired. China has the power to pull the plug on the United States, but for exactly the same reasons that I mentioned earlier in relation to China's reaction to the banking and financial markets crisis it will not do so. China knows that it owes a responsibility to the rest of the world to assist in global recovery, and that means working with the United States.

Nonetheless, China will use this position of leverage to influence US and global policy. That is why next month's G20 summit in London will be so important. The very fact that the G20 has assumed more importance than the G7 is welcome. I expect China to play a prominent role in the discussions about reform of international financial institutions.

At the end of Hillary Clinton's visit to China last month, she said that the three main matters of concern to the world today, could not be resolved without the help of China.

1 was the Economic Crisis
2 was the environmental issue
3 was the Nuclear Threat, from North Korea.

In the past 30 years we have watched China going global, in terms of trade and investment, outwards and inwards.

Now we are seeing the political globalisation of China, and China is taking its place and sharing responsibilities in world organisations.