Conference 2014

Asian financial system,
Australian financial services

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FINANCIAL REVIEW

THE DAILY HABIT OF SUCCESSFUL PEOPLE.

The internationalisation of the Asian financial system: Prospects and challenges

Mr Warren Hogan, ANZ
Mr John Garnaut, Fairfax Media
Mr Geoff Weir, Financial Sector Services

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ANZ insight

Report 5, March 2014

Caged Tiger:

The Transformation of the Asian Financial System

Warren Hogan

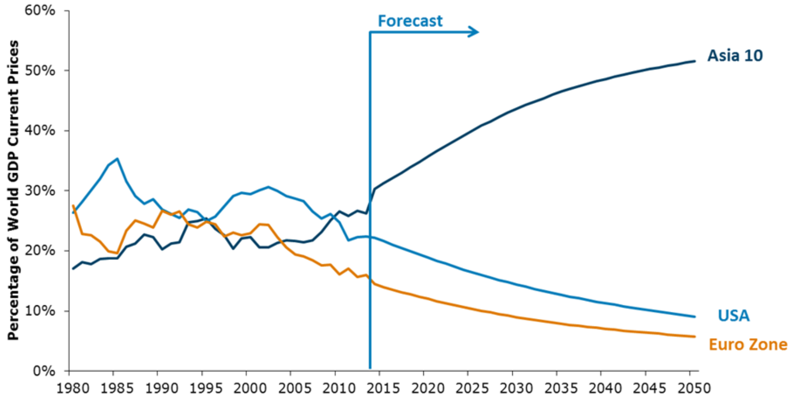
Chief Economist

October 2014

The 'Asian Century' – an economic perspective

A New G10 – The A10!

- Asia's ascension will be led by 10 economies
- These 10 economies could account for 50% of global GDP by 2050



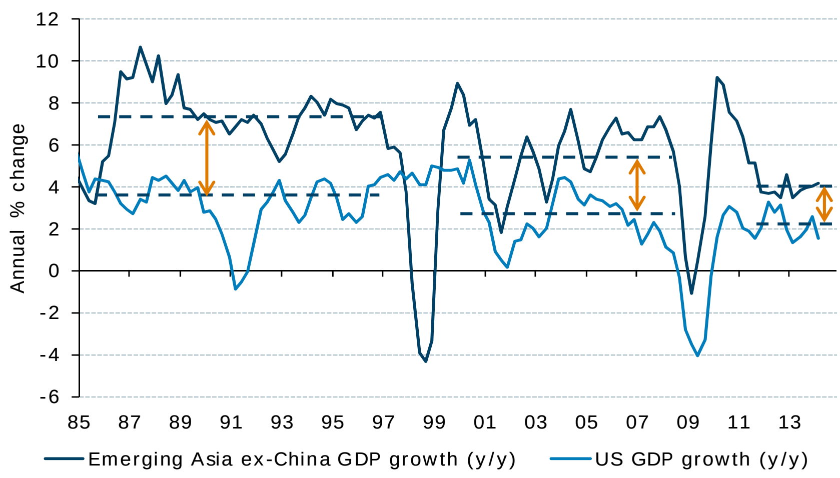
Source: CEIC and ANZ Research projections

Why economic reform is so important to Asia
Avoiding the 'middle income trap'

- Many emerging Asian countries are now at middle income levels* following a rapid industrialisation in recent decades.
- The economic structures and policy frameworks that have underpinned Asia's industrialisation to date are unlikely to be appropriate for the next stage of economic development.
- A high-income consumer driven economy will require broad economic reforms in the emerging Asian economies over the decade ahead.
- Financial reform, that is de-regulation and the internationalisation of currencies, is central to the reform agenda:
  - *Increasingly complex economies require a sophisticated means of allocating capital efficiently;*
  - *Flexible markets and prices need to play a bigger role in emerging economies;*
  - *Regulation and supervision of the economy must be harmonised with worlds best practice.*

*Middle income is defined as GDP/capita of US$5,000 to 10,000 per annum

EM Asia growth outperformance narrowing
Reform is critical to maintaining strong growth



Source: Haver, ANZ Research

What the 'Asian Century' means for the Asian financial system
Three propositions

1. Size

- The Asian financial system will become much bigger than it currently is and will grow to a position of dominance in a global context.

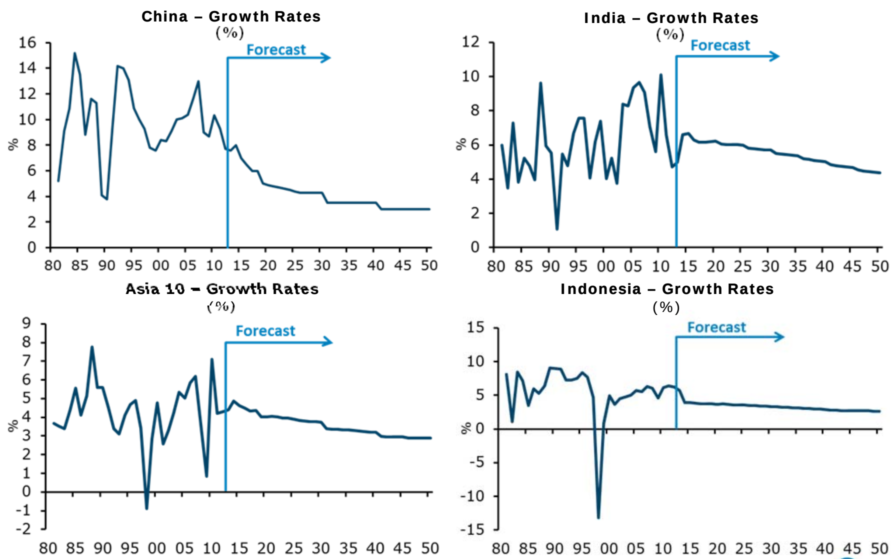
2. Structure

- The underlying structure will change with less dependence on banks and larger capital markets.

3. Global Impact

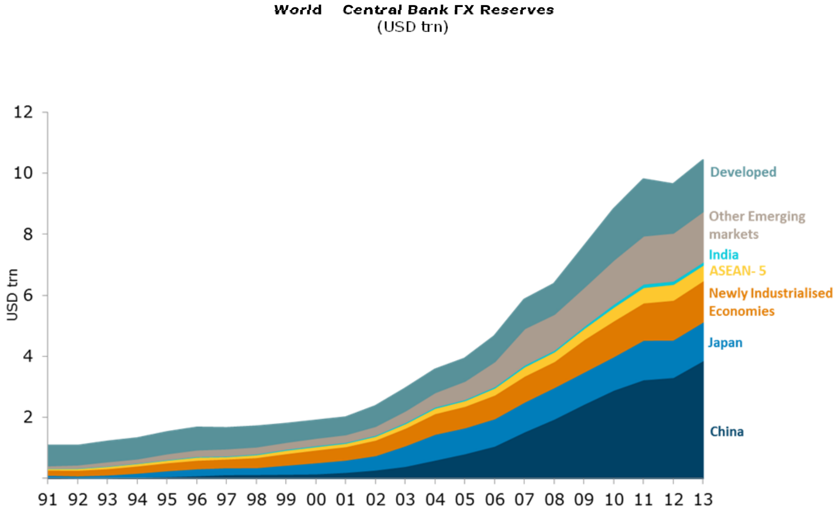
- The way the Asian financial system interacts with the world economy will radically change over the next decade.

Economic growth is the primary driver of the size of a financial system.



Source: CEIC and ANZ Research projections

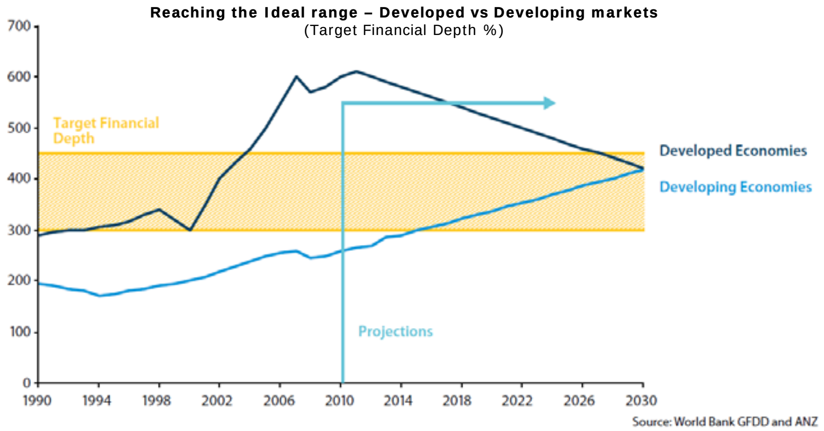
Over the past 15 years much of the 'Asian Surplus' has accumulated in FX reserve portfolios at central banks



Source: CEIC and ANZ Research projections

Asia's financial systems will deepen
Making the system bigger compared to the economy

- Financial Depth: Financial System* to GDP ratio



* Financial system is defined in this report as bank assets + equity market capitalisation + total public and private bonds outstanding

Proposition 1: Asia's financial system will become large

Projections for the broad structure of the global financial system

	TOTAL FINANCIAL DEPTH					
	2010		2030		2050	
	% of GDP	USD trillion	% of GDP	USD trillion	% of GDP	USD trillion
World	386	246	395	448	420	976
Asia 10	383	69	420	228	500	678
Asia 10 ex Japan	344	36	404	174	502	603
United States	553	83	485	101	450	132
Eurozone	414	50	390	63	350	84

- Asia will become home to several financial capitals and a number of 'global champion' financial institutions.

Source: World Bank GFDD and ANZ projections

Proposition 2: The structure of the Asian financial system will change. Rise of the capital markets, a transformation of banking

- The Asian financial system is currently **dominated by the bank sector**:
  - Banks are approximately 45% of global system, about 40% in the US and in Asia they are almost 55%.
- Banks will **shed the long-term financing role** for large corporations to the debt and equity markets:
  - Fixed income markets across Asia could triple in size over the next 15 years. Equity market capitalisation across the Asia 10 could rise from around $US15trn at present to almost $US70trn by 2030.
- The focus of the banking sector will shift over time towards the **emerging consumer and funding the SME sector**.
- There are no rules for what the precise structure of a financial system should look like, although a **diversity of funding sources** across the economy appears desirable.

Asia could become home to some of the world's largest fixed income markets

- China will dominate the **growth** of the Asian bond markets as the RMB becomes a regional funding currency.
- The US will remain the largest national fixed income market for the next 15-20 years given the importance of the debt capital markets to the US economy.

USD, trillion	2010	2020	2030
United States	33	46	40
Europe	25	27	23
Asia 10	19	35	64
-China	3	11	27

Source: World Bank GFDD and ANZ projections

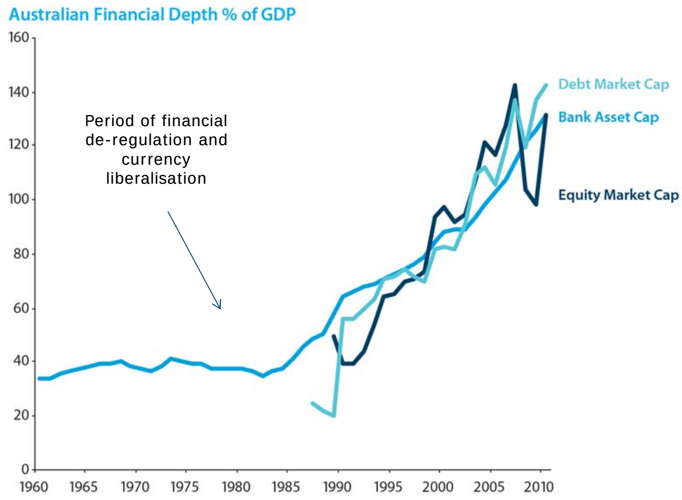
Can China's equity market become the largest in the world?
In the Asian century this is likely to happen by 2030

- The big equity opportunity in Asia will lie in China. This will be heavily associated with the privatisation program of State Owned Enterprises.
- Even with a widespread and successful privatisation program in China, it will still take China 10 years to overtake the US market cap.

USD, trillion	2010	2020	2030
United States	17	27	25
Europe	6	10	12
Asia 10	13	33	68
-China	5	17	41

Source: World Bank GFDD and ANZ Research

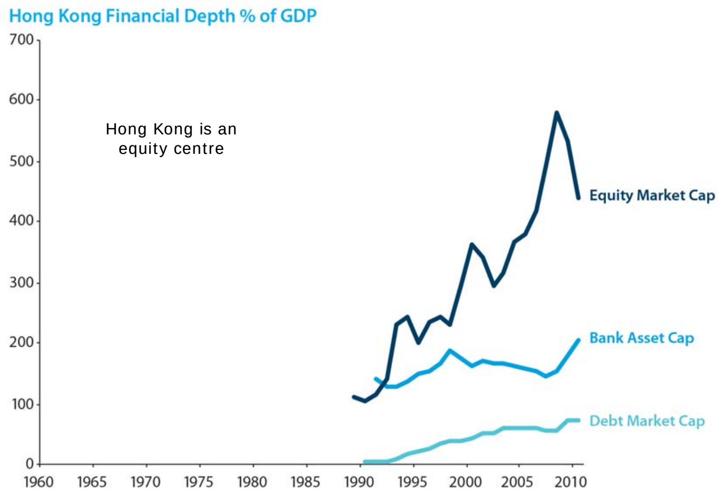
Australia and Canada are examples of a well-balanced financial system



Source: World Bank GFDD and ANZ Research

What does a financial centre look like?

A ‘niche’ financial centre will be skewed in it’s financial structure.



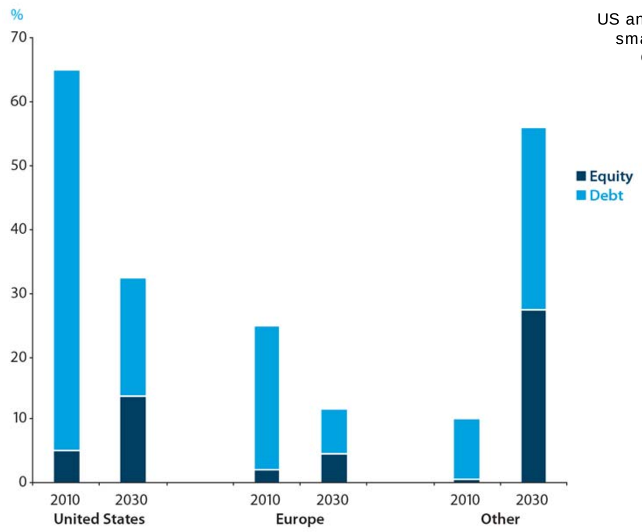
Source: World Bank GFDD and ANZ Research

Proposition 3: The interaction of the Asian financial system with the rest of the world will change dramatically.

- The private sector will take a much bigger role in ‘recycling’ the Asian surplus (at the expense of the official sector). This will fundamentally alter the geographic and asset class characteristics of Asia’s capital outflows.
- The Asian surplus is likely to shrink as currencies are floated and domestic consumption rises (assisting the process of global re-balancing);
- Asian FDI will grow rapidly. We could see Chinese total FDI to the rest of the world rise from less then $1trn to almost $10trn by 2030
- The US and Europe will receive less of the ‘Asian surplus’ potentially raising the cost of capital in those economies.
- The emerging economies of South, South-East Asia and Oceania will benefit from increased direct Asian capital flows – Asia will increasing finance Asia. This should result in a lower cost of capital for these economies

The geographic and asset class characteristics of China’s capital outflows will change radically over the next decade.

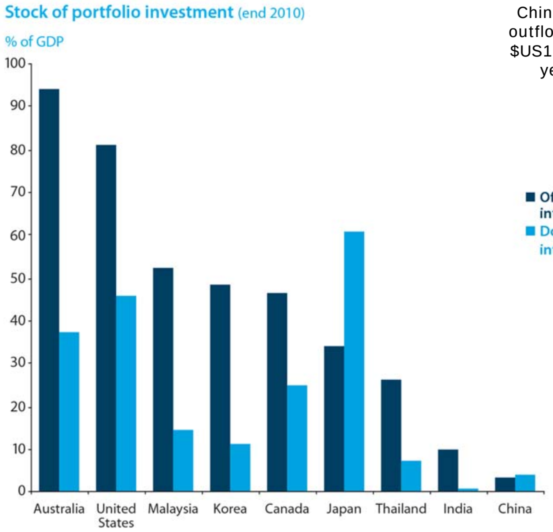
Changing Chinese international portfolio allocations



US and Europe to get a smaller slice of the Chinese ‘pie’

Source: World Bank GFDD, IMF and ANZ Research

As the Chinese capital account is liberalised, private portfolio capital flows will surge



Chinese private portfolio capital outflows could increase by almost $US1.5trn a year for the first five years after the RMB floats

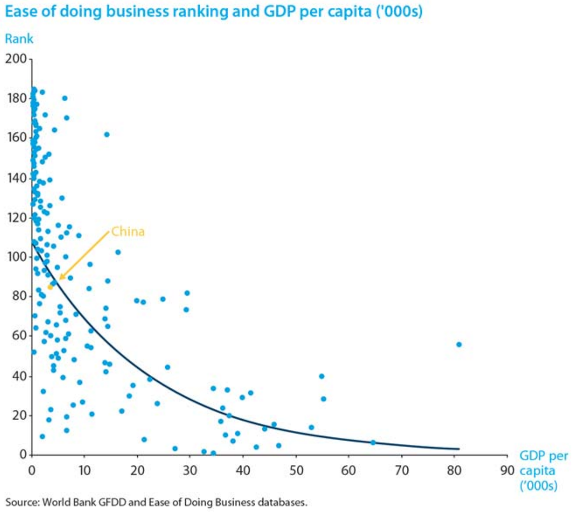
Source: World Bank GFDD, IMF and ANZ Research

Risks and Challenges

The reform agenda is extensive and gives a greater role to markets

- Financial liberalisation is historically associated with financial imbalances – macro economic policy settings are critical throughout the reform process.
- Reform requires strong political support as it will challenge incumbent interests.
- Government must relinquish some control of the economy to private markets and then establish strong policy and supervisory frameworks.
- Trust and confidence are critical factors to internationalising a financial system. Many jurisdictions will need legal and governance improvements.

Political and regulatory improvements are required



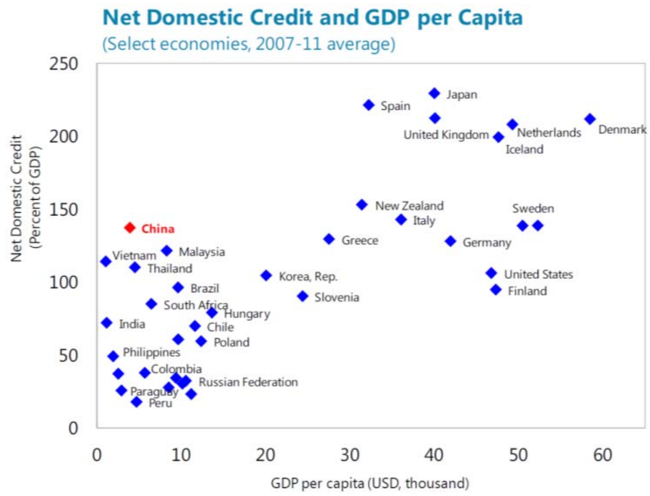
Improvements in governance typically occurs as income increases

There are very few middle to high income countries that are regarded as difficult to do business within

China Now!
The why, how and when of Chinese financial liberalisation

- China's financial system is no longer able to serve an increasingly sophisticated and complex economy. This is creating problems:
  - Shadow banking activities are booming;
  - Parts of the property market are at extreme valuations.
- The Chinese leadership is now well advanced in the financial de-regulation and internationalisation process:
  - Offshore RMB trading centres and swap lines with foreign central banks;
  - Partial capital account liberalisation;
  - Domestic market reform agenda including interest rate liberalisation in 1-2 years.
- Sequencing of reform is important:
  - Get the domestic markets right first, then open them up to the international financial system.
  - Cannot simply open up capital account until domestic financial system is able to cope.
- Market determined domestic interest rates by 2015 and RMB floating by 2017?

China's debt levels have over run it's development

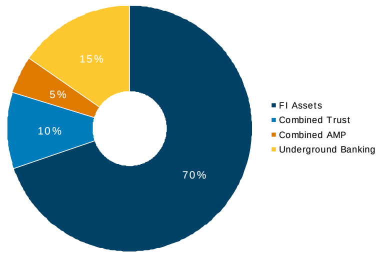


Source: IMF, ANZ Research

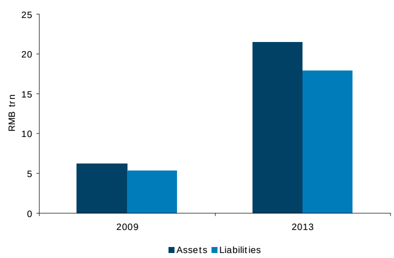
Shadow banking activities have expanded rapidly in the past few years

- China's shadow banking consists of financial institution business (off-balance-sheet assets by banks not falling into normal regulation), trust products, and underground banking.
- We estimate that China's shadow banking could have reached around RMB33trn by mid-2014, equivalent to about 58% of 2013 GDP or 20% of total bank assets in China.

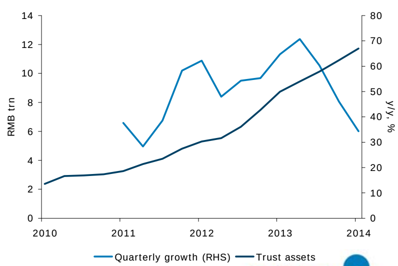
China – Shadow banking



China – Financial institutions' assets and liabilities

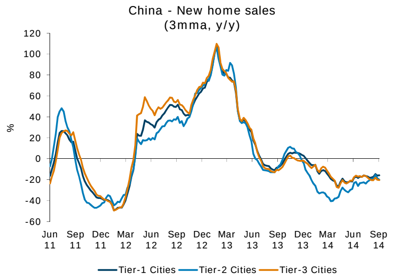


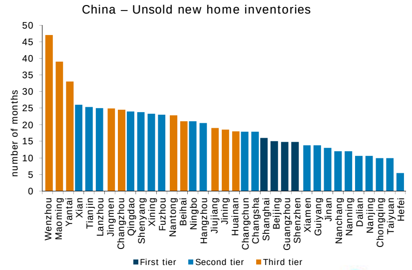
China – Trust assets under management



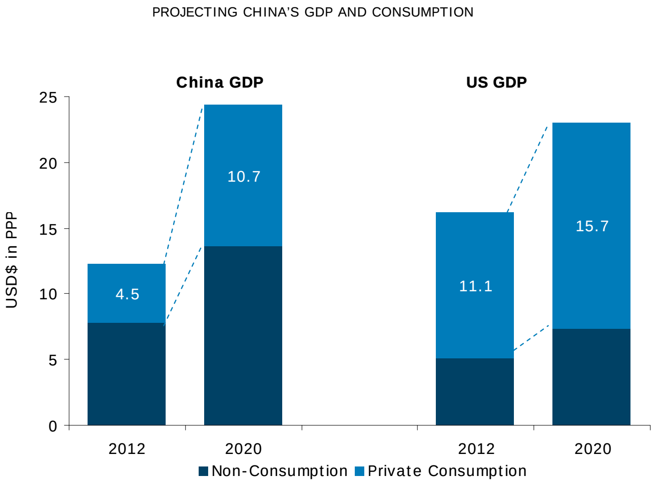
With limited options for saving, Chinese individuals have been pouring money into residential property – a bubble?

- New home sales in all tiers of Chinese cities dropped sharply in the past few months, and the unsold new home inventories have picked up significantly since Q4 2013 as well.
- The second-hand housing market is also slowing. The Centaline second-hand home index, which is largely driven by housing prices, trended down on a year-on-year basis since the beginning of 2014 in first tier cities.
- While all these indicators appear to have pointed to a slowdown in China's property market, we do not think they foretell that China's housing market is about to collapse.
- In our view, China's property market is experiencing a cyclical slowdown, which is normal and has occurred repeatedly in the past economic cycles.





By 2020, China's private consumption will represent 44% of its GDP and 70% of the size of the U.S. consumer market



Note: China's GDP is assumed to grow at an average real rate of 6.7% and the price level is assumed to grow by 3.5% a year. For the US, the respective assumptions are 3.0% and 2.5%. In nominal terms, the values of GDP of China and the US will be USD18trn and USD24trn respectively by 2020, keeping the exchange rate unchanged.

Source: IMF, ANZ Research

Implications for Australia

Chinese capital inflows could reduce the cost of capital in Australia

- Current FDI stock in Australia is AUD650 billion or about 40% of GDP. China accounts for less than 5% of this.
- FDI accounted for around one-third of all capital formation in Australia since 2000 – half in the mining sector
- Chinese FDI could top AUD200 billion (over a tenfold increase from 2012 levels) by 2030 if Australia's share of Chinese FDI (2.5%) remains unchanged.
- In 2012-13, most of Chinese FDI approvals were for investment into the resources sector and real estate. This should expand to a broader range of industries
- Chinese investors are likely to significantly increase their exposure to Australian dollar portfolio assets after a full liberalisation of the Chinese capital account. This would effectively lower the cost of capital to the Australian economy.

Implications for Financial Centres

Shanghai as the world financial centre

- Shanghai (China) and Singapore (SE Asia) could become the world largest financial centres.
- Hong Kong, Tokyo, Seoul, Sydney and Mumbai would could be second teir regional specialist centres.

THANK YOU

'Caged Tiger: The Transformation of the Asian Financial System' is available from
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