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The Development of Financial Services in China: The role for Australia



RESEARCH REPORT

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FOREWORD

Finsia has embarked on a campaign to engage with members and educate the wider community about the opportunities that China's market and economy offers to Australian financial services, while also promoting discussion about the impediments and areas that need to be addressed to best engage with these opportunities.

This campaign was prompted by a Finsia roundtable held in March 2014, which brought together business leaders and experts in the finance and legal industries to discuss the areas of technical and professional skills to enable the integration of Australia's financial services sector into international financial markets. Finsia has now collaborated with Professor Kerry Brown, a Professor of Chinese Politics and Executive Director of the University of Sydney's China Studies Centre, as well as an Associate Fellow of Chatham House, London, to prepare a research report in the hope of streamlining proposals that require consideration and further promoting discussion about Australia's role as a regional financial player.

Australia stands as one of the very few developed nations that enjoy a trade surplus with China, with the People's Republic being Australia's largest trading partner. Despite commodity exports remaining dominant, financial services exports have seen a steady increase since 2000. Nonetheless, China accounts for only a fraction of the financial services export market for Australia.

Australia's financial services sector ranks among the highest in the world and there are clear opportunities to enter China's market to provide quality financial services as well as attracting good quality investment in finance from China. The ageing population and rapidly expanding middle class in China, the internationalisation of the Renminbi, and the Shanghai Free Trade Zone, represent ideal partnership opportunities for Australia.

The proposals outlined by Kerry Brown for expanding the relationship between Australia's financial services and China are both thought provoking and challenging. The report views the infrastructure to facilitate the development of a financial services relationship as already existing and engagement of China with the opportunities that Australia offers. The discussion points should be considered in light of China's construction of a domestic finance sector and the importance a partnership with China holds for Australia; which has recently gained prominence due to China's proposal for the Asian Infrastructure Investment Bank (AIIB).



Russell Thomas F Fin
CEO and Managing Director
Finsia

EXECUTIVE SUMMARY

The Chinese economy has now entered a period of complex transition. The main landmark for the future is to reach middle income status by 2020, doubling per capita levels of wealth from their 2012 level of USD7,000. Achieving this will not just be an economic milestone for China but will also mark a moment of important social and political reconfiguration.

The leadership, under the Party Secretary and President Xi Jinping who were appointed over 2012 into 2013, is in charge of this process of reform and transition. While they may be willing to make bold and pragmatic accommodations in order to achieve this quest for greater prosperity and wealth, they do not want revolution. They are focused on addressing key structural challenges in the economy as it stands which act as impediments to a more modernised economy — one fit for the world's second largest economy as it travels, sometime in the next decade or so, to becoming its largest. Through these structural changes, they are aiming to create a higher consuming, urban, service sector orientated economy.

What happens in China matters to the Australian economy, not just because of the profoundly global nature of the People's Republic's economy and its overall size, but simply because of the level of exposure to the Chinese economy. Not since 1952 has Australia had such a large relationship in goods and services with a single economy — and that was with the UK, with which there were very deep cultural, political and historic links. With China, these links are more complex, even though, as this paper shows, there are plenty of foundations for a thriving and dynamic relationship in the future.

If the Chinese economy is in transition, then Australia too is necessarily tracking this transition, but also developing its own narrative for what this means. Fundamentally, the era of supplying vast amounts of resources to China has proved unsustainable, and highlighted the need to now move to a different kind of relationship, one where the core offer will be in goods and services. To take up this new opportunity, Australian governments and companies will need to reconceptualise their understanding of what China means to them, and look more for knowledge partnerships, finance and service relationships, and leveraging of Australia's competitive advantages in terms of people, extant links and its vision of a positive future where the full economic and political relationship with China can achieve its potential. This paper makes proposals about how that might happen.



Professor Kerry Brown
Director, China Studies Centre
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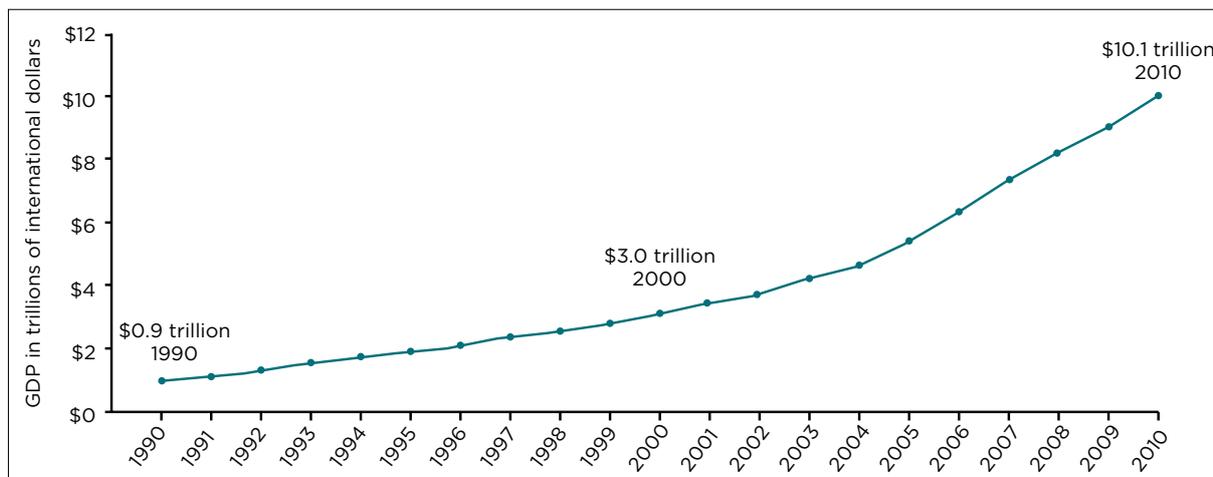
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THE FOUR STRUCTURAL CHALLENGES

Chinese leaders make no secret of the problems facing their country. The era of double digit growth is over. From 2001 the country enjoyed a period of explosive growth. After joining the World Trade Organisation (WTO) in November that year its economy tripled in size by the end of the decade. This was despite the great financial crisis from 2008.

The Hu Jintao and Wen Jiabao period was not just when China became the factory of the world; it was also the period when the country became the greatest producer of gross GDP growth in history. One statistic encapsulates this story: from 2008 to 2012, China was responsible for a staggering 40 per cent of all global growth.

FIGURE 1: Economic growth in China

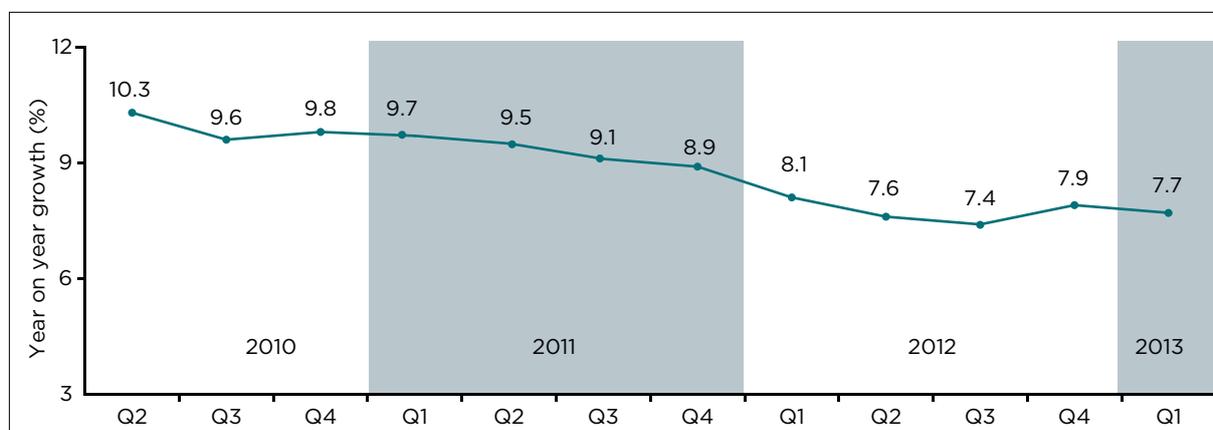


Source: IMF World Economic Outlook Database — October 2010

Those days are now over. In the second quarter of 2014, China delivered 7.5 per cent growth. This is in line with the figures predicted in the 12th Five Year Programme running from 2011, the government's overall macroeconomic strategy. But it is less dramatic than the high points seen over 2009 into 2010 when GDP figures leaped above 10 per cent. Lower growth is here to stay: government leaders have dampened expectations by saying that the future will be lower, steadier figures. For Li Keqiang,

the current Premier and chief macroeconomist, the core task now is to search for 'the empty spaces' within its own economy with which to create 'fast, sustainable growth'. The word 'sustainable' here is a crucial admission that much of the previous growth was built on a resource hungry, investment and capital intensive model that can only work in the short term. Now is the time to start planning for longer term scenarios.

FIGURE 2: Trend of GDP growth



Source data: National Bureau of Statistics of China

Source: chinadaily.com.cn

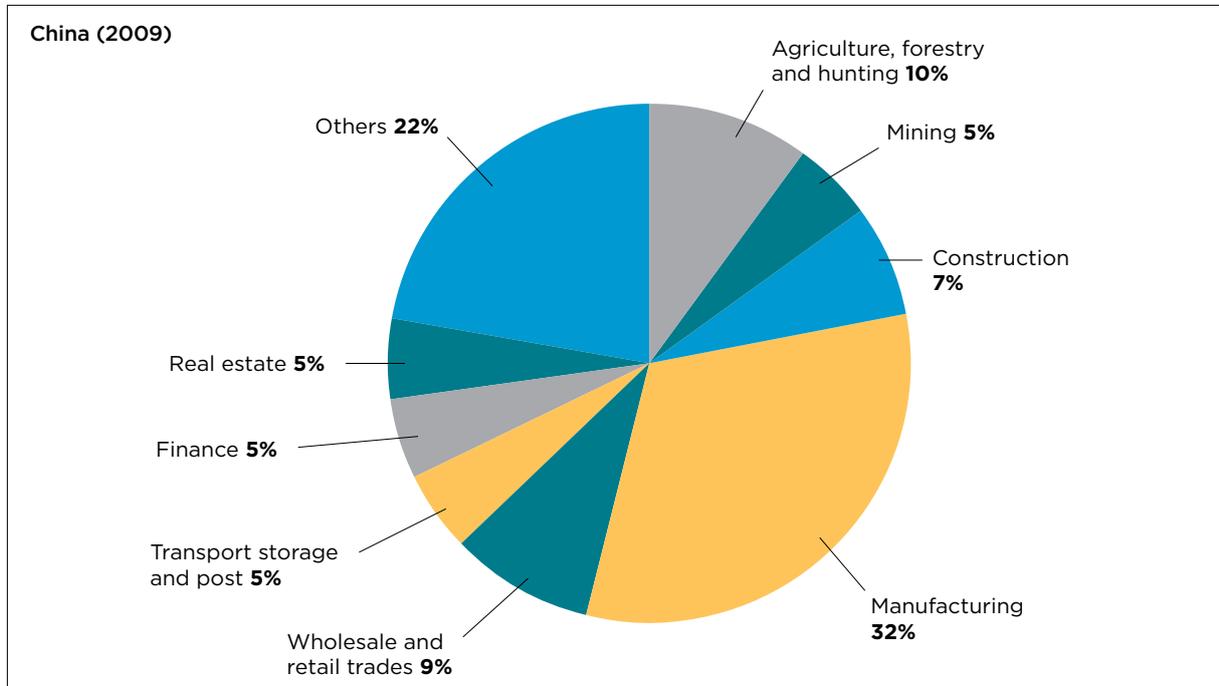
Li Keqiang completed a PhD in Beijing in the early 1990s on China's transition from a rural to a semi-rural economy over the previous decade. He has thought a lot about what characteristics mark the Chinese economy out as unique. In a number of speeches over 2009 and into the early part of this decade before he became Premier, he talked of four core structural issues: consumption, capital investment, services and urbanisation. In all of these areas, he has written that China has specific problems and needs to change.

> For **consumption** China's domestic rate has stayed doggedly at 36 per cent of GDP for over three decades. This is lower than developing economies, which mark about 55 per cent, and way lower than a developed economy like Australia where it is around 80 per cent. Chinese people save, even the emerging urban middle class. This is despite the fact that there are very few high return financial vehicles in which to invest their money. There are only two stock markets in the country, in Shanghai and Shenzhen. Both have been highly volatile in the last 15 years. There is the property market, but this has consistently threatened to overheat in the last few years necessitating frequent government intervention to restrict numbers of houses individuals can own

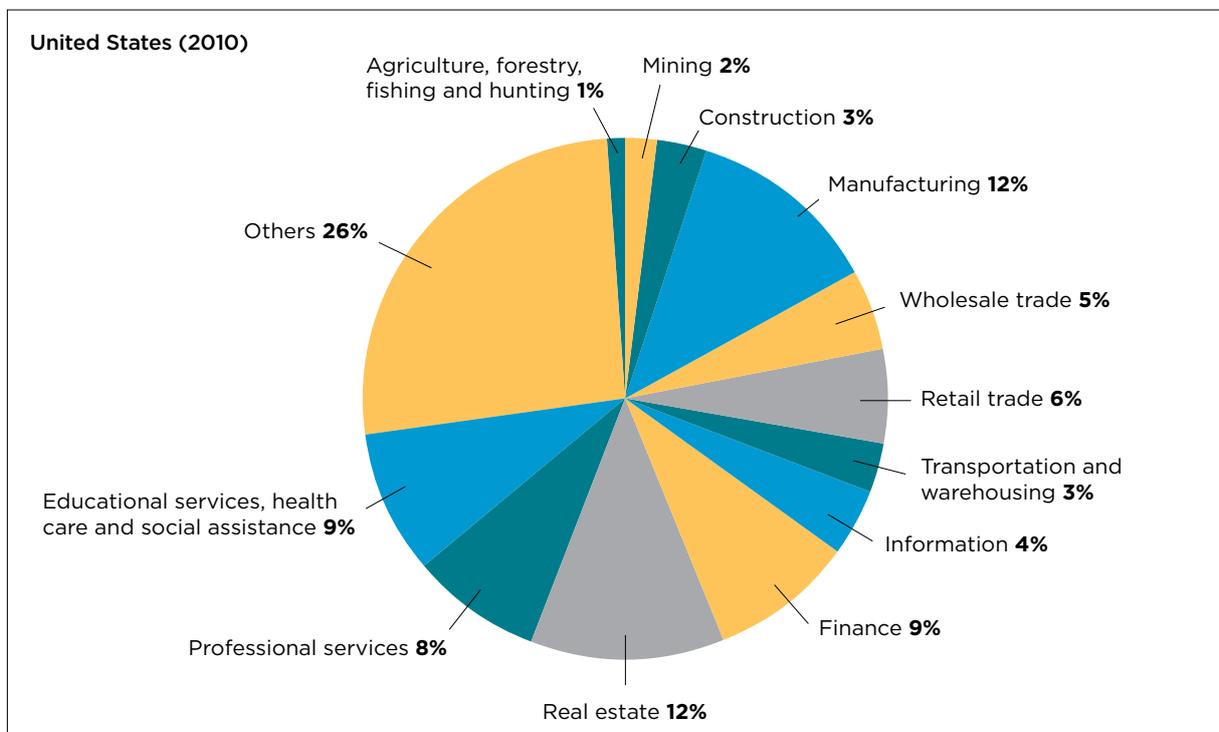
and the profits they can make, etc. Finally there are low yield domestic bank accounts. The interest these deliver is below inflation and serves as a tax on savings rather than creating value for the investors from them. Fiscal stimulus in 2009 tried to encourage more consumption. The challenge of the current government is to raise the 36 per cent domestic consumption rate. At heart, this will mean releasing the burden on individuals and consumers and reducing the role of the state in the economy. That will have political and social as well as economic consequences.

> A fundamental component of raising consumption will be to lift the proportion of **services** in the Chinese economy. Comparing the Chinese to the American economy, we can see how great a proportion manufacturing, construction and primary industries are a part of GDP for the Chinese. Li Keqiang himself used the figure of 40 per cent of the Chinese economy being in services, compared to 46 per cent for developing economies, and 80 per cent for developed ones. The services sector however is critical for a China that aspires to create a higher value economy, and one where it is less tied to reliance on export to foreign markets that are often fickle and in any case likely to reduce in size in the years ahead.

FIGURE 3: Contributions to GDP by industry



Source: China Statistical Year Book 2011



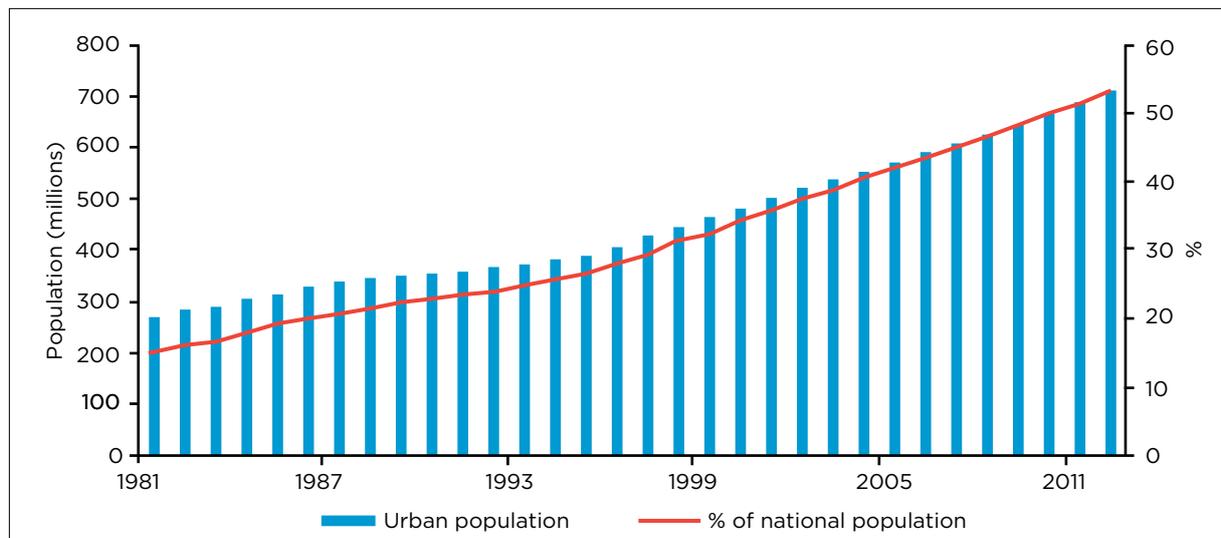
Source: US Bureau of Economic Analysis

- > To create a robust, diverse services sector, China's easiest route will be to **urbanise**. Since 1978, the country has undergone one of the largest processes of urbanisation the world has ever known. It has transformed from a society with around 10 per cent of people living in cities, to one where now as many live in urban as rural areas. But it is clear to the current policymakers in Beijing that this rate needs to increase. By 2020 as many as 70 per cent of people will live in cities.
- > Finally, there is the issue of **capital investment in fixed assets**. In China, this is currently 45 per cent of government expenditure. This is one of the highest in the world, 30 percentage points above that of Australia. For Li, this is the sign that the government role in the economy is still too high, and that there needs to be liberalisation, with a stronger role for more diverse enterprises and the market.

These four areas therefore are the main foci of sustained policy action. Li Keqiang and the central and provincial leadership around him want to see a Chinese economy over the next decade that is higher consuming, more urban, more service sector orientated, and one where the capital investment in fixed assets is lower.

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FIGURE 4: Percentage of China's population living in urban areas



Source: Chinese National Bureau of Statistics

PATHWAYS TO GROWTH IN CHINA: THE ROLE OF THE OUTSIDE WORLD

This is the storyline that Australians wishing to engage in the opportunities of the Chinese market and economy need to constantly bear in mind. For them, there are three key areas.

- > The development of consumption in China is a shared challenge for the Chinese government and foreign companies who seek growth there. Australia is a case in point. The figures are currently good. In 2013, bilateral trade came to AUD140 billion, a fifth up on the year before, with the balance of trade in Australia's favour — two thirds was exports, a third imports. But of the AUD94 billion exports, more than half were in resources. The Chinese addiction to Australian resources to fuel its own growth has decreased as China's growth rate has slowed a little, but still remains strong. When we come to services, however, the numbers reduce dramatically. In 2013, Australia exported only AUD6 billion of services to China. And in terms of supplying goods to export to China, again there was very little. Growth of the consumption sector in China will only go up, and companies need to decide how they can have a role in this market. We will come back to this issue later.
- > Services will be crucial to delivering good quality growth for China in the years ahead. A key issue for a country like Australia is how best to be a partner as a provider in services to the 750 million strong potential consumers in China. The emerging middle class across the country will need insurance, investment products, financial planning, different sorts of consultancy and a more sophisticated services sector overall. Increasing numbers will be employed in this sector, rather than in manufacturing or agriculture, as the economy transitions. In this sector, international partners still have competitive advantage in terms of experience, expertise, etc. That window however won't be open for ever. Australians need to start finding tactical areas for engagement now.

- > China's plans to rapidly urbanise over the next decade will have a massive impact socially, environmentally and economically. An urban China will present immense sustainability challenges. These are ones where the technology and urban management experience of partners like Australia will be important. China's need for more efficient buildings, more sustainable energy use, the transfer from fossil fuels to other less environmentally destructive sources of energy, all offer good partnership opportunities. Some Australian companies are already working in this area. The financing of projects in this area too will be important.

The emerging middle class across the country will need insurance, investment products, financial planning, different sorts of consultancy and a more sophisticated services sector overall.

THE THIRD PLENUM: A DECLARATION OF INTENT

The Third Plenum held in October 2013 was an opportunity for the Party under its new leadership to set out a broad macroeconomic manifesto for where they want to take the country in the coming years. They have inherited the overall objective from the previous leadership of doubling GDP from 2012 to 2020. By the end of this period, China will be a moderately prosperous middle income country. The Plenum issued a major 60 point statement in which it set out some of the key policy focal points in order to achieve this.

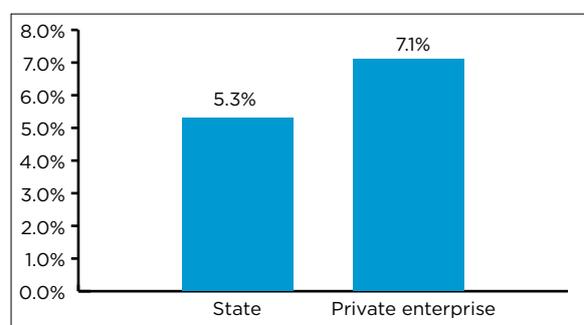
The most powerful overarching message delivered by the Plenum was a shift from saying they regarded the market as useful for further economic reform to stating that it was 'decisive' in achieving efficient resource allocation. This is a major ideological change. Before 1978, the market was regarded as anathema to the socialist system constructed from 1949 in the People's Republic. From 1978, however, the reform process launched by the leadership under Deng Xiaoping tolerated the market as a tool by which socialism with Chinese characteristics might be built. But the Plenum of 2013 conceptualises the market as being fundamental in assisting in the search for growth within the Chinese economy. Li Keqiang has called this task 'unlocking the indigenous sources of growth'. In this context, marketisation is an ally for more efficiency of resource and capital allocation. This hunt for efficiency has become even more urgent in a context where the GDP growth rate is falling.

This declaration is also aimed at attacking a key structural issue. State owned enterprises (SOEs) provide half of central government revenue. They are currently the central state's greatest source of capital. Since the global financial crisis from 2008, SOEs have been a bulwark against instability, producing good profits, and regaining some of the political trust that they had lost over the late 1990s into the early 2000s. An OECD report in 2005 stated that the non-state sector was the true champion of growth for the modernising Chinese economy.¹ But the 2008 external shock threw the state sector back into the limelight. Senior leaders at this time like Politburo member and head of the National People's Congress Wu Bangguo stated in his famous 'Five Nos' that privatisation would not be adopted on the western model:

We have made a solemn declaration that we will not employ a system of multiple parties holding office in rotation; diversify our guiding thought; separate executive, legislative and judicial powers; use a bicameral or federal system; or carry out privatisation.²

Despite their political importance and their profitability in recent years, however, SOEs have become inefficient. They are widely regarded as enjoying subsidies in the form of land costs, utilities, and other factors of production. Even with these advantages, from 2012 they have contributed less to the overall Chinese economy. Their profit margins in the first part of 2013 were 5.3 per cent, against those of over 7 per cent by the non-state sector. They are now a drag on the achievement of the overall goal of producing 7.5 per cent growth and need to become more efficient.

FIGURE 5: Profit margins of core business, January to May 2013



Source: china.org.cn

For SOEs, therefore, the market is the key tool to achieve this, and in particular reform of the pricing of factors of production which until now have been kept down. This is the least politicised and contentious way of achieving more discipline for SOEs, many of which have become important sources of influence and power for vested interests. Making the market 'decisive' in the battle to raise the efficiency of SOEs therefore has a profoundly political as well as economic aim.

As part of a strategy to preserve their key role while making them more competitive, the Plenum decision does talk of reforming SOEs, of diversifying their ownership so that state, collective and private capital can all be more fully utilised, and reforming the pricing of utilities, land and labour to supply some external discipline on them and make them leaner and more efficient. It is clear, however, that a core issue behind many of the challenges that the Plenum statement addresses is the inefficient deployment of capital in the Chinese economy as a whole, not just in the state sector. Liquidity has been good over the last decade as China has grown. Money has been plentiful. In the era of post-WTO globalisation, China has enjoyed excess capital. But with single digit growth, the fat years are now coming to an end. Efficient means to use capital have become crucial.

1. OECD, 'Economic Survey of China' 2005, available at <http://www.oecd.org/eco/surveys/economicsurveyofchina2005executivesummary.htm>.

2. Quoted in Derek Scissors, 'The Rise and Fall of Chinese State Owned Enterprises', April 2011, Heritage Foundation, available at http://www.heritage.org/research/testimony/2011/04/chinese-state-owned-enterprises-and-us-china-economic-relations#_ftn4.

There is an internal and external dimension to this. Internally, the issue is how to construct a domestic finance sector which encourages entrepreneurialism, and is more suitable for the urban, higher consuming, more service sector employed and financially sophisticated emerging middle class. The Plenum decision has a specific statement on this issue. It states that China needs to:

Improve financial markets. Further open up the financial industry. Allow qualified private capital to set up financial institutions such as small- and medium-sized banks, under enhanced supervision. Push ahead with reform of policy-based financial institutions. Promote reform toward a registration-based stock-issuing system and increase the proportion of direct financing. Improve market-based exchange rate formation mechanisms for the renminbi. Accelerate interest rate liberalization and capital-account convertibility. Build a deposit insurance system and complete the market-based exit system for financial institutions.³

Internally, the issue is how to construct a domestic finance sector which encourages entrepreneurialism.

The levels of predictability, proper regulation and legal basis, however, will need to be addressed in an environment where legal infrastructure currently is poor or partially-formed. This is where external partnerships become important. The rapid construction of a domestic finance sector along the lines outlined above will need management, regulatory and intellectual input from experienced actors outside of China. The Plenum decision does refer to opening China to more investment, in more diverse sectors. These investments however are important as much for the knowledge partnerships they bring as for capital and resources. When we look therefore at the internationalisation of the RMB, and at the deployment of Chinese capital abroad, we can see a journey for knowledge partnerships rather than just seeking material gains. And in both areas, the Plenum sets up the basis for engagement, even while it leaves questions of scale and timeframe vague.

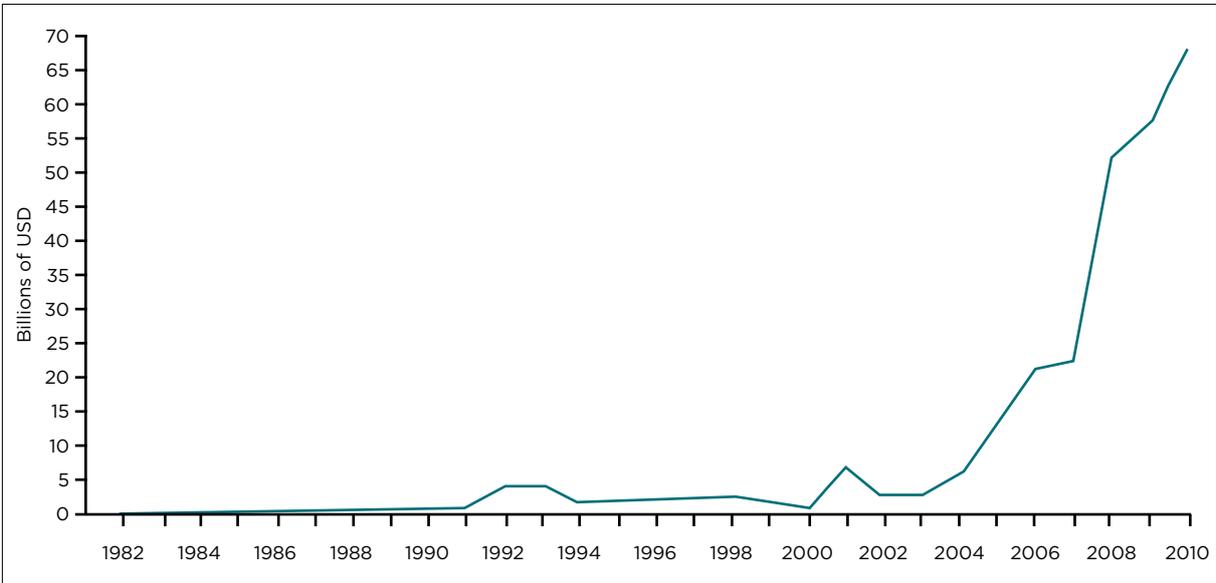
THE TWO GREAT EXTERNAL ISSUES

The most noted issue of Chinese economic globalisation in the last decade has been the rise in investment abroad. The establishment of the China Investment Corporation in 2007 signalled one of the landmark moments, with USD200 billion of available funds which were deployed along the model of a sovereign wealth fund, and brought equity stakes in financial institutions like J.P. Morgan during the nadir of the crisis in 2008. More diverse Chinese overseas investment has increased exponentially since then, as the table below shows. In 2013, China had over USD70 billion in cumulative stock of investment abroad, much of it in Hong Kong, but increasing

volumes in developed destinations like Europe, Australia and the US. For all this activity and the attention that it attracted, however, the simple fact at the moment is that of global stocks of outward investment, the world's second largest economy is still a small player, accounting for about 1 per cent of global levels. Despite steep incremental increases in the last few years, therefore, Chinese outward investment is very likely to increase rapidly.

Chinese outward investment is very likely to increase rapidly.

FIGURE 6: China outward foreign direct investment stock annual (1981-2010)



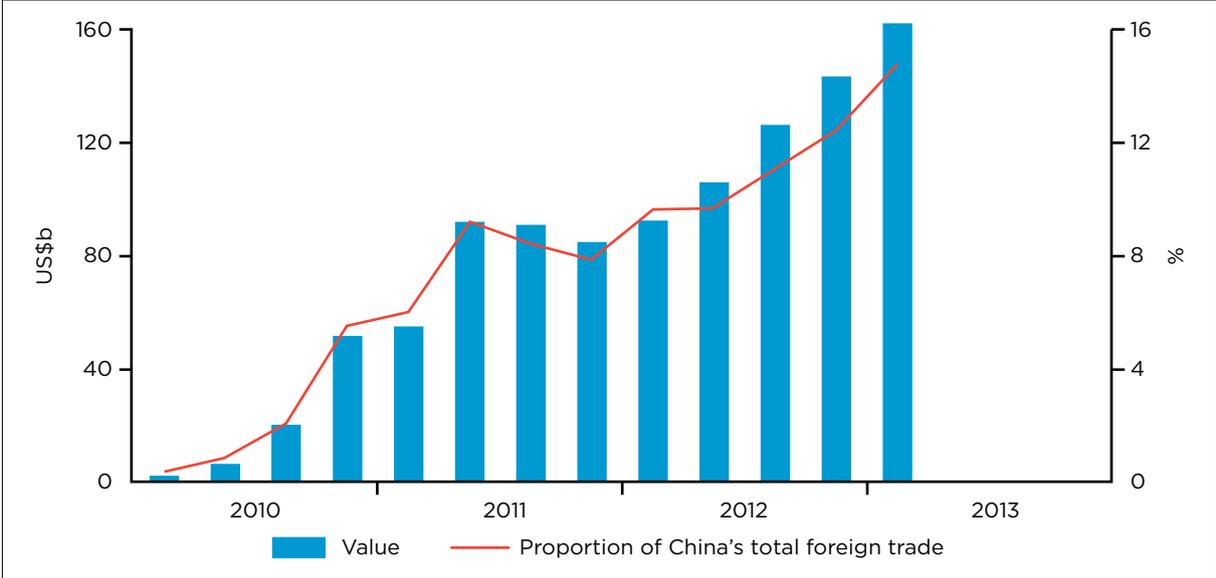
Source: UNSTATS L.E.K. analysis

There is a similar story too over the use of Chinese currency internationally. The Chinese capital account is now a closed one, with heavy government controls. Chinese currency is unconvertible, the exchange rate is set by the central government. Since 2009, modest attempts have been made, under highly-controlled circumstances, to increase the amount of RMB international trade. Hong Kong

has been one location where settlements have been allowed in Chinese currency. London as a finance centre also signed a deal in 2012 to become a RMB currency hub, as did Sydney during Prime Minister Gillard's visit to China in April 2013 (this is discussed below). Singapore is another mandated centre. The amounts of RMB trade settlement in the last three years have risen steeply (see Figure 7).

3. 'Decision on Major Issues Concerning Comprehensively Deepening Reforms in Brief', available at http://www.china.org.cn/china/third_plenary_session/2013-11/16/content_30620736.htm.

FIGURE 7: Renminbi trade settlement



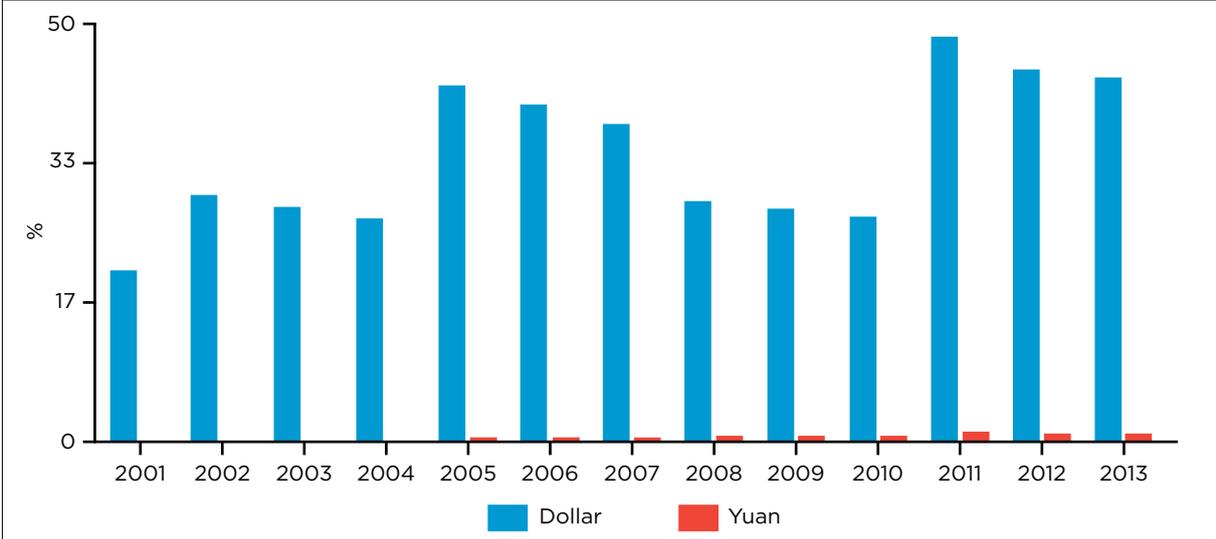
Source: Bloomberg, CEIC

Once more, however, when put in a global perspective, the amounts are tiny — less than 2 per cent of global turnover of currency in 2013. Compared to the dollar, which constitutes over 40 per cent of global turnover, the Chinese RMB barely figures.

These are two core areas where the Chinese economy interfaces with the rest of the world. In both of them, we see hints of the beginnings of a new phase of Chinese globalisation. At the moment, there is little more than a basis. But both

these sets of figures imply that a dramatic policy change which liberalises exchange and outward investment regulations, reducing the controlling role of the central state, will have massive impact. The more practical question now is not whether these areas will see further expansion. That is already almost certain. The real issue is how potential foreign partners can best prepare for these events, and place themselves in the best tactical position.

FIGURE 8: Daily currency exchange turnover as a per cent of M2



Source: National Bureau of Statistics, Bank for International Settlements

THE UNIQUE ROLE OF SHANGHAI AND THE FREE TRADE ZONE

As China moves to deliver on its construction of a domestic finance sector, the strategic importance of Shanghai will grow. Shanghai is the one centre in China which has the conceptual framework for a finance centre. It is home to one of China's current two stock exchanges, and the largest of them. It has over 450 international banks based in the specially designated finance district, Lujiazui. Historically, the city has been a major player in finance, and in the 21st century is returning to this role. With the establishment of the Shanghai Free Trade Zone in 2013, however, a new dimension is added to Shanghai's aspirations to be the portal through which domestic and international companies wish to reach the emerging market of 750 million potential users of their services and products within China.

The creation of the Free Trade Zone (FTZ) places Shanghai at the heart of the development of China's financial sector. While the FTZ has the support of the central government, signalled by President Xi Jinping's visit in May 2014, its immediate strategy for growth and development is currently being worked out. What is already clear however is that important reforms include capital account convertibility, interest rate liberalisation, RMB cross-border usage and foreign-exchange management. These are already happening.

To develop the financial products that Shanghai wishes to offer, these reforms will include:

- > The development of the Shanghai Equity Exchange. This opened on 15 February 2012 with 19 listings. A report in the *People's Daily* stated that 'as part of a uniformly regulated over-the-counter market, the exchange will serve as an equity trading platform for high tech start ups and other small- and medium-sized, non-public companies based in Shanghai and other regions.' The report continues: 'The exchange will encourage cooperation between start-ups and commercial banks as well as insurance companies, in order to promote the establishment of a diversified financial system in Shanghai.'
- > Capital markets: A report in the *Financial Times* from 30 January 2012 stated that Shanghai 'intends to expand greatly the size of its capital markets and open them more widely to foreign investors by 2015 as cornerstones in its strategy to become a global financial powerhouse.' According to the report, Shanghai's stock exchange was ranked sixth in market capitalisation in 2010. According to the Shanghai City Government and the National Development and Reform Commission, Shanghai's interbank bond market was the fifth biggest in the world in 2010, and is likely to be within the top three by 2015. China's derivative market is also aiming to be in the top five by 2015.

- > Futures market: regulated by the China Securities Regulatory Commission, this was formed by amalgamating the Shanghai Metal Exchange and the Shanghai Commodity Exchange and Foodstuffs Commodity Exchange in 1999. It deals in futures for copper, aluminium, zinc, natural rubber, and gold. In 2012, for the first time in over half a century, the exchange also began to trade in silver contracts.
- > Insurance market: Wu Dingfu, head of the China Insurance Regulatory Commission (CIRC) stated in 2011 at the National People's Congress that 'setting up an insurance exchange is part of Shanghai's plan to become an international financial centre, which is something the CIRC as a financial regulator, strongly supports.' It is likely the exchange will initially deal in liability insurance, reinsurance, and property and group life insurance products, with risk securitisation products, catastrophe bonds and insurance derivatives coming online later.
- > Hedge funds: According to the *Wall Street Journal* in April 2012, 'Shanghai officials plan to launch a pilot programme that would allow some foreign hedge funds and others to raise yuan funds on the mainland for overseas investment.'

As opposed to Hong Kong Special Administrative Region's role as an international finance hub, Shanghai will be domestic facing. It will operate increasingly as the entry point for finance and services into China, and a strategic relationship with the city will be critical.

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THE FINANCIAL SERVICES SECTOR IN AUSTRALIA

Australia is little understood as a services centre, particularly in China where the traditional partners via Hong Kong of Singapore, London and New York figure more in their thinking. Despite this, Australian financial services have a strong base and plenty of potential. Most Chinese in finance know that Australia came out of the Global Financial Crisis well with the lowest ratio of non-performing loans compared to similar developed economies such as Canada, the UK and the USA.⁴ Its banking sector was one of the least affected. According to the Economist Intelligence Unit it ranks seventh in the world for quality and attractiveness of business environment; Governance Metrics International ranked it fourth in terms of corporate governance with low levels of uncertainty. For all aspects of governance, from regulatory quality to accountability and rule of law, Australia rates within the global top ten according to the World Bank.⁵ Its financial development index level is also excellent, with an overall ranking of fifth after Hong Kong, the USA, UK and Singapore in terms of financial access, financial stability, institutional environment and financial markets.⁶ Australia's investment funds have assets that rank them third in the world, coming to a total in December 2013 of USD1.6 trillion. The contribution of the finance and insurance sectors to the wider economy is sizeable: in 2013 this sector came in second in terms of contribution with 8.6 per cent, as opposed to mining which stood at 10 per cent. Financial services outdid mining, contributing 5 per cent to Australia's real gross value added in 2013, about the same as professional scientific and technical services and construction. Services contributed 3.6 per cent growth to GDP, compared to non-services which stood at only 2.7 per cent.⁷

Financial services outdid mining, contributing 5 per cent to Australia's real gross value added in 2013.

Despite the fact that professional services (of which finance forms a part) only came to 1.4 per cent of Australian exports, in terms of dynamic growth they showed the second highest rise, with an 18.9 per cent increase from 2012 to 2013.⁸ It is this dynamism that needs to be supported by entrepreneurialism and government support. And the main area where growth will come from is almost certainly China. Most independent evaluation of Australia's financial services ranks it among the best in the world. Because of this, Australia clearly has solid foundations to exploit both in entering China's market and attracting good quality investment in finance from China here.

4. IMF Financial Soundness Indicators (FSI) Database.

5. The World Bank Worldwide Governance Indicators, 2013 Update.

6. World Economic Forum, The Financial Development Report 2012, released 31st October 2012).

7. Australia Bureau of Statistics, Cat No 5206.0, Australian National Accounts: National Income, Expenditure and Product, December 2013, Table 3, Gross Value Added by Industry, Chain Volume Measures, Austrade.

8. Australian Government Department of Foreign Affairs and Trade, Trade in Services Australia 2013, p 2.

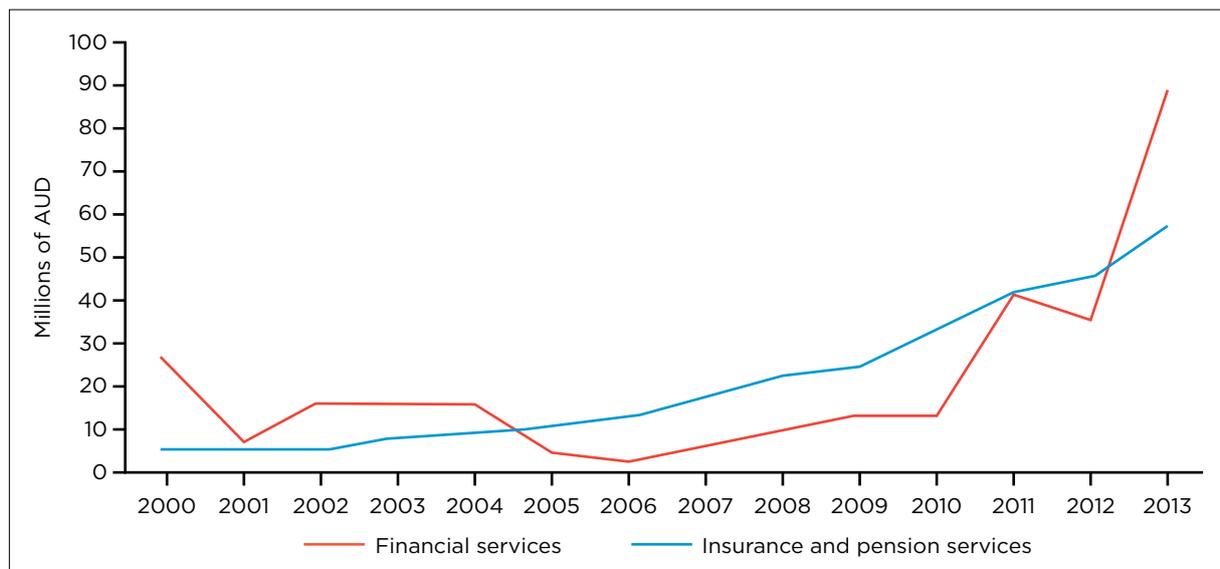
THE CURRENT STATUS OF AUSTRALIA'S FINANCIAL SERVICES AND CHINA

China is Australia's largest trading partner and in 2013 accounted for 26.2 per cent of its exports, and 14.3 per cent of imports. Australia is one of the very few developed nations, alongside Germany, that enjoys a trade surplus with the People's Republic. And while commodity exports still dominate, financial services have increased substantially since 2000, rising from only AUD2.6 million then to AUD8 million in 2013. Despite this rise, however, China still only accounts for 4 per cent of the financial services export market for Australia.⁹

Insurance and pension services in particular have increased vastly over the last decade. Coming to only AUD5 million in 2000, they rose to AUD57 million in 2013, now making up 11.3 per cent of all exports in that sector. While Chinese

foreign direct investment has also risen steeply in Australia in the last five years, totalling AUD31.9 billion in 2013, it still only constitutes 1.3 per cent of total investments.¹⁰ Finance and insurance only account for 11 per cent of direct inward investment in this total. Data from the Foreign Investment Review Board shows that in 2012-13 of the 6,102 investments approved from China, coming to a total of AUD15 billion, only AUD23 million were in the finance and insurance sector, less than 1 per cent of the total. It was a similar story running the other way. Of the AUD9.8 billion Australian companies invested in China in 2013, coming to 22 per cent of its global total, only a small number were in the finance and insurance sector.

FIGURE 9: Exports in services



Source: Australian Bureau of Statistics

9. Australian Government Department of Foreign Affairs and Trade, 'Trade in Services Australia 2013', p 59.

10. Australian Government Department of Foreign Affairs and Trade, 'Australia and foreign investment: Which companies invest in Australia?' Available at: <http://www.dfat.gov.au/trade/investment/investment-by-country.html>.

Australian 'big four' banks active in China

ANZ, Commonwealth Bank, National Australia Bank and the Westpac Group have presence in and are engaged with China.

ANZ under its Super Regional Strategy is pursuing expansion in Asia with a focus on institutional banking. In this area it has two associates and one wholly owned enterprise in China:

1. The Shanghai Rural Commercial Bank, an arrangement set up in 2007, of which it owns 20 per cent coming to USD252 million. This bank has 2.5 million customers, with 330 branches, and is China's largest commercial rural bank, with a strategic focus in the future on risk management, small and medium enterprise lending and retail banking.
2. Bank of Tianjin, running from 2006 where ANZ holds a stake of 18 per cent for USD120 million: This bank is China's fourth largest among city commercial banks for assets, with 5 million customer accounts. ANZ focuses on risk management and retail banking.
3. ANZ has a fully owned rural bank in Liangping county, Chongqing.

In both associate arrangements, ANZ provides technical resources and access to its intellectual property.¹¹ In addition to these, ANZ also had six outlets in Beijing, Shanghai, Chongqing and Guangzhou, and according to its chief executive aims to have 'further network expansion, growth in customer lending, employee recruitment and product development to better service customers'. It plans to increase its network in China to 20 outlets in the next five to 10 years. ANZ also has a branch in the Shanghai Free Trade Zone, and a RMB license for retail banking.

Commonwealth Bank has one branch in Shanghai, and a representative office in Beijing, and has two main joint ventures:

1. Jinan City Commercial Bank, (Qilu Bank) in Shandong Province, northern China, of which the Commonwealth Bank owns 20 per cent and which was set up in 2004. This is the 10th largest city commercial bank by assets, and the partnership aims to introduce new financial products and technical skills, speed up compliance with international standards and improve the bank's competitiveness.
2. Bank of Hangzhou: Commonwealth Bank has owned 19.9 per cent of this bank since 2005, with AUD100 million invested.

In addition, Commonwealth Bank also purchased a Shanghai-based mortgage broking business in 2005, a fund management joint venture, and, with Bank of Hangzhou, its first county bank in Jiyuan, Henan Province, set up in February 2011.

Commonwealth Bank also has a joint venture in insurance in partnership with China's Bank of Communications set up in 2010.

National Australia Bank (NAB) provides a range of corporate, institutional, trade and selected personal banking services from its branch location in Pudong, Shanghai. It first opened an office in China in 1982, and currently has a representative office located in the China World Tower in Beijing.

NAB has partnerships and relationships with national bankcard association China UnionPay, and banks including China Development Bank, Agricultural Development Bank of China, Shanghai Pudong Development Bank, and Industrial Bank. In addition, it works with wealth management institutions China International Industrial Trust and China Huarong Asset Management Corporation. NAB's strategy in Asia is a relationship-driven approach supporting Australian business in Asia and Asian business in Australia, and focuses on natural resources, energy, food/agriculture and utilities.

The Westpac Group

Westpac first opened an office in China in 1982, and since then has established offices across Hong Kong, Beijing, Shanghai, and soon to be opened Shanghai Free Trade Zone sub-branch with specialist teams focussed on Trade, Structured Commodity and Asset Finance, Debt Capital Markets, Derivatives, FX and Natural Resources.

It has recently deepened its offering to support the increasing domestic and international Renminbi flows, and in 2013 was awarded a CNY/AUD market makers licence to trade the currency pairs in mainland China, followed by a Derivatives Licence. Westpac established an Asia Advisory Board in November 2013, to provide insight, leadership, knowledge and senior level connectivity across Asia.

11. ANZ, '2013 Annual Report'.

RMB INTERNATIONALISATION AND AUSTRALIA

The incremental liberalisation of China's capital accounts over the last decade has been one of the most closely watched developments for the globalisation of the Chinese economy, and one that Australia sits on the front line of. As one analyst explained, with the RMB in 2013 ranking the ninth most traded in the world, its 'impact on the Asian currencies has become increasingly significant'.¹² As was argued above, the likelihood of significant increases in RMB trading in the coming decade is very high. The fact that China accounts for 9 per cent of the global trade in goods, compared to 12 per cent for the US in 2013 means that the scope for increase in RMB in international trade transactions to match its trading status is huge. Already, China accounts for 6 per cent of global cross-border financial transactions. In the words of the Reserve Bank of Australia, 'these developments are particularly relevant given the very strong trade linkages between Australia and China, as well as the potential for deepening financial linkages'.¹³

Direct trading between the Renminbi and the Australian dollar was instigated during former Prime Minister Julia Gillard's visit to China in April 2013, with a deal signed on 10 April in Shanghai. The practical impact of this was to allow use of RMB as the invoicing currency for trade and investment transactions between the two countries, reducing the costs of currency conversion by removing the former intermediary currency, (overwhelmingly the US dollar). The impact of the 2013 agreement was almost immediate with a rise from USD324 million of trading between the Australian dollar and the RMB in March 2013 to over USD3.1 trillion in May the same year.¹⁴

Despite this, the uptake for settlement by importers and exporters remains low. A survey presented to the first Australia Hong Kong RMB Trade and Investment Dialogue in Sydney in April 2013 at which the Australian Treasury, Reserve Bank of Australia and Hong Kong Monetary Authority took part showed that of the Australian exporters trading with China who took part only 60 per cent had used RMB trade settlement. The Federal Reserve Bank concluded that:

[M]ore than half of respondents cited shortcomings in the availability of instruments allowing them to hedge their RMB currency ... Around half of firms also noted that unfamiliarity or uncertainty around the RMB trade settlement process was a significant deterrent, and a sizeable proportion also cited administrative difficulties and concerns regarding payment delays and rejections.¹⁵

Despite this lack of initial take up by companies, there was a sobering reminder that 'as capital account liberalisation progresses and Chinese financial markets deepen, the RMB is likely to become a major reserve currency'. The risk therefore is of not optimising this opportunity rather than of engaging with it. In this context, Sydney in particular figures as a RMB hub. Australia because of its regional location, its well developed and capitalised finance sector, the world's seventh largest foreign exchange market and the funds already located here stands to gain from the development of RMB international trading. This offers a key opportunity for the finance sector, particularly in view of the strong presence of Chinese banks in Australia, with total combined assets of AUD12 billion.

12. Chang Shu, Dong He and Xiaoqiang Cheng, 'One Currency, Two Markets: The Renminbi's Growing Influence in Asia-Pacific', Bank for International Settlements Working Paper No 446, p 1.

13. Reserve Bank of Australia, 'Developments in Renminbi Internationalisation', Bulletin, June Quarter 2013.

14. Reserve Bank of Australia.

15. Reserve Bank of Australia, Bulletin, June 2013.

IMPROVING AUSTRALIA'S COMPETITIVENESS

Australia is well placed to seize the finance opportunity with China. It has developing links between banks, in insurance, and a growing RMB trade settlement market. It can also leverage off the good trade links that already exist. Australia has one of the most highly educated work forces in the world, and has one of the biggest cohorts of Chinese overseas students coming to study here. Services as a proportion of GDP are growing and contributing more.

Despite this, the finance sector in Australia is low profile in China and less understood than it could be. Australia needs to include its finance and services strengths in the core messages that it sends to key Chinese interlocutors.

There are a number of specific challenges that need to be addressed in the coming years to allow this finance relationship between the two countries to grow as fast and well as it should. This is of critical importance to Australia now that resource demand in China in particular, at least for the present, has dropped. Some of the issues for finance companies from Australia looking to develop a relationship in China involve strategy and placement. As the services sector develops across China, if the current government in Beijing's plans go smoothly, this will offer a continental sized and complex territory, one where there will be significant differences between regions. Shanghai is almost certainly the key location to try to get a foothold into this market, and closely tracking developments there especially in the role out of the Free Trade Zone will be important.

In the development of Australian involvement in the internal Chinese finance market, there are a number of core issues:

- > Licensing issues and regulatory impediments mean that China still favours local operators.
- > Australia in terms of size and attitude of its financial sector is still regarded in China as being too small and too conservative. Australian financial entities see China as high risk.
- > Bureaucratic hurdles in China remain steep, with documentation for foreign banks 15 times more time consuming than for Chinese banks coming to Australia for similar permits and operations.
- > China's finance sector is seen as heavily regulated.

In these areas, for better and easier access it is likely that a coordinated government-business approach from Australia will seek common cause with other international finance partners in order to lobby on regulatory and access issues. Australia also has the opportunity through some of its own current impediments to Chinese actors coming here to negotiate these for better access back in China, despite the issue of size. According to Johnson Report issued in November 2009 on Australia as a finance centre there are a number of issues that are seen to impede the development of the finance and services sector in Australia. These relate to the new necessity to attract more interest in and partnership from China. Of particular importance are the following:

- > Creating a stronger government and private bond market by facilitating restrictions on inward and outward capital flows into Australia, and reducing regulatory requirements on corporate debt issuance to retail investors in order to promote a debt market.
- > Reforming the 'national interest' provisions in Australia. At the moment the application of the test on certain classes of foreign investment transactions is regarded as lacking clarity, and susceptible to political vagaries. This probably lies behind the perception amongst Chinese that Australia is too conservative, and creates an erroneous belief that there is no liberal ownership regime here. The OECD for instance places Australia fifth to bottom of 42 countries in its FDI Regulatory Restrictiveness Index.
- > Especially when investors need to deal with state and commonwealth authorities, regulatory issues can be difficult to navigate. A more uniform and welcoming approach would help, especially for investors from China who are relatively new and inexperienced.
- > The Johnson Report also raised a number of tax issues, where Australian regulations currently raise the costs of capital borrowing offshore, and restricts Australian banks from accessing offshore retail and wholesale deposits.¹⁶

16. 'Australia as a Finance Centre: Building on Our Strengths,' Report by the Australian Financial Forum, November 2009, available at <http://www.fex.com.au/media/AFCF.pdf>, pp 54-65, accessed 20 September 2014.

CONCLUSION

Australia starts from a good place in aspiring to develop its financial services relationship with China. The fact that its economy emerged from the great financial crisis of 2008-09 reflected well on its governance and the robustness of its economy. Australia has a comparative advantage, a strong regulatory system, and inspires high levels of confidence and trust externally. It is an open economy and one with some of the best-regarded governance globally. The main issue is of profile. Australia does not figure in the thinking of Chinese policy makers and regulators as a place to partner more deeply in finance because of a lack of knowledge of what opportunities there are here. The infrastructure is in place to change this, with Chinese banks already present here, and Australian banks deepening their commitment to China. The main task now is to promote this understanding.

This task is one that is particularly important to engage political leaders on. In their visits to China, a consistent message about the openness of the Australian economy to Chinese finance partners, and of the willingness of Australian companies to work with Chinese in China itself, needs to be promoted. China needs to be reconceptualised in Australian thinking from a vast commodities export market to one where there are also huge opportunities in services.

In this strategy, Shanghai in particular figures large as the most accessible and largest local finance centre across the People's Republic, and one where there are already active partnerships which can grow in the coming five to 10 years.

Australia needs to think constantly of how it can marry its own economic narrative with those unfolding within China. In particular, the framework of structural challenges listed above, of a shift to consumption, services, urbanisation and less capital investment provide an accessible framework within which to do this. Access to the domestic services opportunity in China, strategic partnerships through joint investments in each country, and working on raising the profile of Australia as a major finance partner are all good investments. The greatest challenge at the moment is for Australia to avoid becoming complacent. It is working with its largest trading partner at a time when many others across the world are also trying to figure ways of having the best possible relationship with China. Working in terms of partnership, mutual interest and a common understanding of challenges offers the most sustainable strategy. Australia has a good story to tell in this area. It should now put all its energies into telling that story, and making sure the right people in China hear it.

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