Transcript of Interview with Fred Hu

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Interviewed by
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Note: This is a verbatim transcript but with minor editing for clarification.
Garten: Well, Fred, thanks very much. It's good to see you, again. So I want to talk to you about China, and particularly China in the global financial system. But I'd like to start kind of broad question and ask you if you think about China over the next decade – I know it's a long time, but over the next decade. If you had to identify two or three or four really major pressures that are acting on the society, a society within which the financial system will develop, what is actually happening? If you pictured big arrows coming into China, what would you say are the major forces acting on the country?

Hu: Great question, Jeff. First of all, I'm glad to be here with you. For 35 years, China has been going through a truly remarkable economic and a social transformation, really from a very low place where the per capita GDP is among the very lowest globally. China today is the second largest economy after the United States. Chinese citizens are enjoying a solid middle income or high middle-income living standard. Hundreds of millions of people have managed to escape from abject poverty, and China now is truly a global trade powerhouse, number one exporter, and the world’s factory, a critical player in the global production supply chain. So there's remarkable achievement. But at this point in time, China is at a really critical juncture, a new crossroads,
because the kind of growth model that has served China so well for so long is no longer functioning as well as it might be expected.

China now is facing a number of very daunting challenges or pressures as you described. The first and foremost in my mind is that China needs to move away from expert-led growth, investment growth, to move private consumer-led growth, number one.

Number two, China is known as a world factory. Low-end manufacturing competing in global markets on prices. But, again, with the 30-plus year hyper growth, China is no longer a low-cost economy. Labor costs are on the rise. And enterprise, land price, everything is on the rise. So China basically has lost its cost competitiveness vis-à-vis many of the neighbors and others in the emerging world. So China now needs to face the task of moving up the ladder, moving up the chain, from low-cost, low-end manufacturing towards more high-value-added modern manufacturing services, in particular to become from a copycat to a global innovator. So that's the second major challenge.

The third and the last one I have to also highlight is the given the pace of industrialization and urbanization there's really a present environmental crisis –
Garten: Environmental crisis.

Hu: So China now clearly has a huge problem with the air pollution as you might see if you go to Beijing nowadays in the smog. Not just Beijing, but the way much of Northern China and now even Shanghai in the Southern China, even the coastal seaboard is also facing the similar kind of smog.

Water pollution, deforestation. So in other words, China is in the midst of unprecedented environmental crisis. So these three reasons – I could go on with a long list – but for the policymakers, for business dealers, for society as a whole I think these are three probably are really the most important challenges China is facing right now.

Garten: So in making these fundamental changes, and they're really fundamental, a new economic model, a difference in where on the economic ladder people are going to be, the value-added chain, and then this very broad area of quality of living. It's more than quality of life. It's the whole way people live, if you can’t have decent environment. What are the most difficult obstacles to making these transitions? And if you would specify just a few of these, tell
me whether there is also a political obstacle. I mean it would be
tough enough technically to make these changes, but where does
politics come in as well?

_Hu:_ Well, again, great questions. To begin with, I do think China now
has a solid foundation on the back of 30 plus years of amazing
economic achievements. So the country now has a lot more
resources at its disposal to tackle many of these problems. With
regard to government finance globally speaking, China is probably
is one of the best, even though let’s not say it doesn’t have its own
problems, but in terms of debt to GDP ratio, the public sector
indebtedness, China probably looks a lot better than many of its peers. Not just in the emerging world, but also for many of the
developed countries, including the US and most of the European
countries.

So first of all, I just look at the resources. There's a good
foundation for China to continue her transformation, okay? But to
return to the goals or to overcome those three challenges I outlined
at the beginning, a lot of actions ought to be undertaken. Most
important is really to continue and deepen economic reforms
because China comes from, as you know well, from a formerly
central-planned economy, and the transition from a central-planned
economy to a free market economy has been quite successful, but incomplete.

For example, the state - the Chinese government - still plays far too big a role in the economy. So this has really hindered, for example, innovation. When the government is so dominant and is so intrusive that it means the freedom of thinking and independent research can often be severely constrained. China does have a very, very big base of raw human talent.

For example, each year there are two million university graduates in engineering and sciences alone. That's four to five times as many as in the US. But all those talents, the broader social political environment is not necessarily conducive outside – the educational environment is not conducive to critical thinking, to innovation. So this is something that needs to be done. And I would say to reform the state the government steps back from heavy-handed intervention in the economy to let the market play the decisive role in resource allocation, and let the people enjoy greater freedom so they can be more creative. So this is important.

Fortunately, the new leaders in China – presently Xi Jinping, and the premier, Li Keqiang – I believe they are very committed to
reform. The Third Plenary with the ruling party last November unveiled a sweeping blueprint for reforms in the coming decade. And many detailed actions are spelled out in that document. And the overarching goal is to transform China into the modern, competitive, and efficient market economy, and let the market play the decisive role in resource allocation.

So if China manages to make progress on that front, I do think the climate for innovation will vastly improve and China's potential to innovate or be realized to a far greater degree than has been the case so far.

Garten: So in this transformation, let's talk about finance and the role that finance needs to play. What would you say are the two or three financial reforms that are going to be the most important in order to have this market economy flourish? Regarding finance, I sometimes say it's like the circulatory system, it has to work reasonably well or almost nothing else does. It's not the only thing, obviously, but when you think about financial reform in China, what are the things that come to your mind? And then I'm going to ask you to connect that to the global economy. But first, just in terms of domestic reform, what should be the agenda?
Hu: I would say the Chinese financial system has evolved along with the rest of the economy. Now it's clearly one of the most important financial sectors in the world. Look at the banking sector with the assets over $100 trillion RMB, and so that's one of the biggest. It's really one of the top two or three banking systems in the world. China now boasts probably three or four the biggest banks globally in terms of asset bases, in terms of deposits or in terms of market capitalization. So they are among the very biggest in the world.

So a lot has been achieved. But, again, the financial system is still in many ways underdeveloped, and the number of really clear deficiencies which I think could harm China's future growth. The first, as large as the financial system is, there's still many parts of the economy underserved by the financial sector -- namely the SMEs, small/medium-size enterprises, and the consumers. Earlier, we talked about the importance of transition from export investment-led growth to consumer-led growth. Of course, Chinese people are thrifty, so they tend to be high savers. But as their income increases, as their personal wealth increases, they do want to spend more and more, as everywhere throughout human history.
But in the case of China, there's one specific impediment which is the absence of consumer finance. Less than 20 percent of Chinese bank assets are geared towards households or consumer sectors. That's including the mortgage loans and other financing. China today almost ranks neck to neck with the US in terms of the size of the automobile market, so 20 million, more or less, cars sold annually. But most cars are purchased with out-of-pocket cash, not throughout loans.

So consumer finance is highly underdeveloped, which I feel contributes to less than robust growth in consumer spending. That’s why consumer spending is not such a powerful engine for the Chinese economy as you might expect here in the US or in other parts of the world. So I do think this financial reform to make a consumer credit more available, and, by the way, to make SME financing much easier is very critical because China now is rapidly urbanizing. More and more people really flood into the cities, into manufacturing and the service sectors. So there's enormous pressure for job creation. If finance can really play a supporting role for the SME sector, to foster a thriving dynamic SME sector, that actually will create a lot of jobs to absorb the rural migrant population and to make urbanization truly a successful structural change.
The last point I want to mention is venture capital/private equity. Right now it’s quite vibrant, but it's too small. We know the US is such a solid undisputed global leader in technology and innovation, and entrepreneurship, but also in the related highly developed venture capital/private equity industry willing to risk capital to back up budding entrepreneurs, which is really a unique phenomenon in the US. I think China could emulate in the US experience in this regard, and build a domestic venture capital and private equity industry to support.

After all, financial services are really to serve the real economy, whether it's consumer spending, SME development, or innovation. So that's part of the financial reform China ought to undertake.

_Garten:_ Now let me just ask you, the essence of that reform, am I right, would be some combination of freeing up interest rates and, secondly, deregulating certain parts of the financial system that almost prohibits some of those activities, or provides major disincentives?

_Hu:_ I'm just about to get into that point -- how to improve the financial system so it can play even more important role for the real
economy, SME, and innovation. But you're asking to overhaul the whole environment where financial institutions function. So interest rates are still pretty much fixed regulated, and if we learned a lesson from the global financial crisis in the US, you might argue, as many do, regulations were maybe somewhat too lax. But in the case of China, I can tell you that generally it's over regulated - too much regulation. There might be some excess financial innovation in the US, but in China, I would argue too few or too little financial innovation because it's so heavily over regulated.

So, again, the financial markets play a role, guiding more efficient resource allocation. I think deregulation is highly necessary, and interest deregulation is highly necessary. And the People's Bank of China now is really pushing the process of interest rate liberalization.

The other challenge is really to develop a domestic capital market. The equity market size is probably number two or number three depending on where you come. As the equity market has been underperforming in terms of sheer performance of last few years, but so you could be number two or number three or number four, certainly the top two or three equity markets globally. But it’s
mostly a cash market. So more institutional investors, and more index futures and stock options.

And even more important I would argue, China needs to develop a very efficient deep domestic bond market. You may have read about the local government debt built up in China. That's largely the function that we don't have a municipal bond market, so the local governments, to finance many of the public goods and the services, they have to set up different schemes, vehicles, platforms to borrow. It’s a very un-transparent way and inefficient way that has caused a lot of problems as we have seen very clearly right now. So I do think to have a deeper data market to finance governments, corporations, together with the equity market, that could really help more efficient acquisition of capital in the economy.

Garten: Now let's just make an assumption that over the next decade these reforms unfold, that is, the direction that you're talking about is actually implemented. How do you think about the relationship between domestic financial reform and China's links to the global financial system? Because right now it is more or less a closed economy, and yet it has a massive amount of savings that, theoretically anyway, could find lots of uses outside of China or
let's say at least they could find competitive opportunities, and you have lots of capital outside of China that would like to come in. So where do you see, under the assumption that there is more and more domestic liberalization, how do you think about the integration of the domestic financial system to the global financial system? What does that look like?

*Hu:* When it comes to the real economy, I would argue it is very, very closely linked with the global system in terms of manufacturing and the supply chain. In terms of trade, China’s presence is –

*Garten:* Very integrated.

*Hu:* It's highly integrated. By contrast, the financial system is much more closed as you pointed out. But now this is natural. I think the time has come for China to liberalize and open up and have more integration with the global financial system because China now is the second largest economy and it is the largest trading country, and it's also one of the largest international credit countries because China has been running a current account surplus for 20-plus years. In the past, it was building the world's biggest foreign exchange reserve. And now many of the Chinese companies have global aspirations.
They don't expand into first of all, many other emerging markets in Asia, Africa, Latin America, and now they are also doing M&A and greenfield investments in developed countries including in the US. And sometimes as Chinese urbanization and more and more middle-class consumers, many of the multinational companies want to expand in China if not there already, like we have seen General Motors or Apple or Wal-Mart or Samsung. They all have very, very big presence in China.

So the point is that as the world economy gets so integrated, and as Chinese savings and investments are also increasingly linked with the global economy that the financial reform ought to go hand in hand with the financial opening up. In that regard the critical milestone is capital account liberalization. And, again, encouragingly, the new leadership in the Third Plenary, the reform blueprint has specifically stated that China wants to achieve capital account opening up in the coming decade. Domestic reform, as we discussed earlier, could pave the way for capital account opening up so that China can endure the benefits, the efficiency gains of global integration. But it could then also contain the potential downside, the new vulnerabilities we have seen in other emerging economies where capital account is open, but the domestic
financial fragility is also evident so that it could be a deadly mix to
spark a financial crisis.

So China now has so many lessons that can be learned from around
the world, so you can push forward internal financial reform and
also extend to open up in a very important way without
succumbing to any kind of financial crisis down the road. So I do
think that China is at a very exciting stage in its financial
development right now.

Garten: So if you have, let's say, domestic reform moving steadily and you
have opening of the capital account, slowly opening up in
coordination with the domestic reform, eventually you reach a
situation where China becomes a massive player in global finance,
not only because of its size, but the sheer amount of capital that is
there. So it would be it seems to me this is the really the crux of
the matter because at that point, China is fully integrated and all of
the independent action that it has had over the last 35 years of
being kind of walled off financially. That goes away, right?

So this is a change not only in situation. It's a change for China.
It's major change for the global financial system. But my question
is it requires a change of mentality I think, not only in Chinese
government and Chinese society because no matter how skillful, you then become susceptible to big swings in the global economy, big swings in the global financial system because you don't have the walls. Do I have this right? I'm saying that this is a river to cross domestically, internationally, but preeminently, psychologically, you're really part of the world at that point.

_Hu:_ Yeah, I guess a fresh way of looking at that. Reform is about changing the status quo which entails –

_Garten:_ It changes everything.

_Hu:_ It changes your mindset, yeah, and outlook.

_Garten:_ It changes because the city and the interior of China is suddenly affected by what is happening in New York or what is happening in London, and that has not been the case – well, at least hasn't been the case since the Second World War.

So my question is this, do you think that China in the development of these five-year plans, in the development of the strategy that you have talked about, that there is a deliberate, or there is an understanding that this is a transformation of China internally. It's
a transformation of the global economy which maybe China would care less about, but there's a reverberation back, that China loses a tremendous amount of its autonomy. If it was accepted, obviously you say the benefits outweigh the cost. But I'm just wondering if it's understood exactly where this plan eventually goes.

Hu: Well, further integration with global system currently would entail a new level of uncertainty and risks, but also tremendous benefits. China has been one of the biggest beneficiaries of globalization. So with such solid foundation, with the successful track record, China should probably feel more confident among the developing world about the need and also the benefit of integrating into the global system. You yourself in your previous career, played a role in bringing China into the global trade system. So now China has reached such a stage of development that to integrate it with global financial system is also going to happen I think really in this decade. So that's a very exciting thing.

I do think that it's a win/win for China and for the rest of the world. Take one specific example. During the last five years with the global financial crisis, many Western financial industries really, really retrenched, cut back, from lending to developing countries; Africa, for example. But China has really stepped in to fill the
void. So Chinese banks have been really expanding to Africa, Latin America. And so that has played a really, really critical role in financial and economic development in some of the poorest regions of the world.

So today our role – not just in Africa, China is also a very big creditor to –

_Garten:_ Latin America.

_Hu:_ Well, also here in the US to finance the US government debt. Again, it’s mutually beneficial.

So in the coming decade, China will continue to be a very large international creditor, and we will see the Chinese banks some of them will remain among the very biggest, the top ten in terms of market cap or size or profitability or return on equity. We also see now there are three Chinese insurance companies among the big ten globally, and we are going to see probably some of the biggest security firms and asset managers among the global top ten or among the top players.

_In a nutshell, I expect Chinese financial system will join the US_
and European Union as one of the top three global financial systems in terms of size, scale, and depth. I think the US will still be the primary leader but that China will probably join the rank of the top three financial systems. China will also become more and more from an exporter of merchandise goods and services, to increasingly become an exporter of capital providing loans to many countries, regions, and industries. But China will also become a more and more permanent direct investor. Chinese companies will be highly active in cross border mergers and acquisitions, like the Chinese company buying Smithfield – we’ll see more and more of those examples. And making greenfield investments, opening up new plants and equipment. So China will become a significant exporter of capital.

Finally, last, but not least, is that the emergence of Chinese yuan as one of the major global currencies. There's a been talk even here in the US that the Chinese yuan might displace US as the international reserve currency. I don't see that risk. I think the US dollar will remain on top of the global monetary financial system and still enjoy the preeminent status for a long, long time to come. But the China yuan after the capital account opened up, could join the dollar, the euro, as one of the major global currencies. And we're also likely to become a significant reserve currency being
held by central banks around the world as reserve assets. But, again, dollar will be the predominant, followed by euro, and possibly by the Chinese yuan.

So that's kind of the vision or future of China finance in the global system a decade down the road.

Garten: One final question. Any way you look at it, unless there is a crisis that no one can envision now, a really major crisis, China will be playing a much larger role, a huge role in the global financial system. This is speculation, but will it bring a new set of ideas about how that system ought to be organized and managed? And the reason I ask this is until now even in the trading system, China comes from a very low base. There was already a system that it could plug into, and it benefited an enormous amount from a system that others built, basically, an Anglo American system. But when you think about the heft that China will bring, and you think about you say that the yuan may be subordinate to the euro, a lot of people might say it won’t. But any way you look at it, China will play a huge role, have a huge voice.

Is there anything about Chinese society, is there anything about Chinese values that would lead someone to say that at some point,
China actually may have some different ideas about how the global financial system is organized? For example, right now we're headed in a direction where these huge financial institutions are going to be much more heavily regulated, international demands on their capital, maybe even down the road, huge pressures for some of them to break up. I don’t know if that will happen, but this seems to be something that is certainly talked about a lot.

Or, the IMF operates in such a way that while it respects sovereignty, in many cases, it pierces sovereignty. When a country is in distress, when all is said and done, take away all the diplomatic niceties, the IMF is imposing. It is giving loans in return for conditions that the sovereign wouldn't ordinarily take.

These are things that happened long before China entered the global system, and the question I'm asking, which I think is a very fundamental one, is will Chinese influence change the system as we know it?

_Hu:_ Well, it's an interesting question. What's remarkable is up to this point since China opened up in 1978, China has been generally adaptive to the global system. China has embraced the prevalent global standards and the practices and the rules and regulations. In
some ways better than others, but in general, the trend is more and more really adapting, adjusting into the existing global order, if you will.

At this juncture, particularly since the global financial crisis in 2008 when there's a lot of blame game going on around the world, there are two schools of thinking in China, like in the rest of the world, one school is thinking the existing dollar-centric monetary financial system is broken, right? So there's a subprime crisis here in the US that really sent shockwaves throughout the world. The world was taken away with it. Therefore, [the system] needs to be drastically reformed, right? So the US dollar is to blame, the existing order is to blame. We should replace it with it a radically new system.

The second school, which actually I myself belong to, is that with all the imperfections, all the deficiencies, drawbacks of the existing system, actually, by and large, it has functioned well. It is a fundamentally liberal, multilateral trade, financial system, since World War II led by the US, that generally has served global interests very well. Actually, China's own developmental success is a very powerful example to what China has benefitted from the existing monetary and the financial system. Of course, the trading
system as well.

So I think as China pushes ahead at domestic reform and also forges a greater integration, by and large as a latecomer, I would argue and I think the understanding that the Chinese leaders also share is that we need to learn from global best practice, okay? As we accumulate experiences, standards, in case of banking regulations, Basel III, maybe capital standard, liquidity, management, and transparency disclosure content, all those rules have been tried and revamped and improved.

Again, nothing is perfect, but that China could add benefit from that kind of new regulatory system. Of course, as China is more and more plugged into the global economic system, it's natural for China also to have certain perspectives, and to provide some input into the continuous process of reform and refining to improve the system. Since World War II, Bretton Woods collapsed, fixed rates were replaced by flexible rates. So it's never stand still. I think China has the opportunity to provide some input. But I think it's farfetched to suggest either by outside activists or by Chinese themselves that we can come up with the drastically different vision and replace the US dollar-centric monetary and financial system. I just think it's unrealistic. I don't think that's China's
ambition. China's ambition is to join the system and hopefully contribute to the improvement of the existing system.

_Garten:_ That's a great place to stop. Thank you very much.

_Hu:_ Thank you, Jeff.

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