Good morning. A really important theme that you've heard a lot about and you're going to continue to hear a lot about is change. What evidence do we see that change is happening? How durable and sustainable are those changes likely to be? And most importantly, to what extent do we think these changes are visible in markets? China is a very, very important place to start because the potential contrast between the old China and the new China is absolutely enormous. This contrast is far more important for what it means potentially for financial investors than for what it might mean in terms of China's impact on the world economy, which we all know has been enormous.

China is a paradox—despite this amazing economic growth, tremendous wealth creation for decades, the most successful economy really that we've ever recorded for many, many years in the 1990's and the early part of this decade, there was nothing left on the table for financial investors. Markets realized that China had a different growth model; it was not a profitable growth model, it was a mass mobilization of resources in which capital return was a distant consideration. So they managed to grow tremendously, accumulate a lot of wealth, but there wasn't a lot left in terms of profit. And that is what we see evidence of changing today. We can see it at the highest level, which I'll discuss, but very importantly, you see evidence of that at the micro level of companies. These changes are to some extent the result of long standing trends; the evolution towards a greater role for the private sector means more competition.

The capital formation in China, which has reduced returns, has done a lot to increase competition. There are a lot of market participants in many industries. They go at it aggressively domestically, in the external market. Urbanization and the likely role for consumption will change the way that China grows—the country's balance sheet situation. This is a look at the role of the state sector. Now this chart only captures the industrial part of the economy. The service sector is the most entrepreneurial, most rapidly growing part of China. There we

know there's a much greater role for the private sector to get involved, particularly on a small scale. But you can really see how dramatically the state-owned enterprise sector has shrunk in terms of employment and output. By definition the private sector has grown. This is the result of competitive forces but also it's a result of policies. China wants this to happen. They have policies in place to achieve it and they've been very successful. This is another significant look at why the consumption motor and the overall growth motor of the economy is likely to change. A little busy; sorry for all the lines and the bars. But the bars show you basically the wealth accumulation of the household sector in China.

Now China, they have to save a lot because there's no social safety net and they're concerned about providing for themselves in old age. They've accumulated a lot of wealth by high saving, rapid growth, but you can see the tremendous increase—and this is in USD—of the assets, particularly property, which is up almost $1 trillion in the last four or five years. That contrasts with a very under-leveraged consumer balance sheet. The financial system is not fully developed; borrowing culture is weak, so the wealth accumulation, the asset growth, the under-leveraged status… But the beginnings of credit culture have allowed retail sales to begin to grow. And it's only because capital formation has been so strong that the balance has been in favor of cap x. We think that's very likely to change going forward.

Urbanization is another driver that's been visible in many other countries. So China's following a model that we've seen played out elsewhere. Where do you have evidence that this is making a difference? We see it in companies we visit; there's also top down evidence in the form of tax receipts. The tax share of the economy is going up, particularly the corporate tax share, which means corporate profits are rising. This data shows it's gone up threefold in the last few years and a wide variety of surveys reflect the same thing. So China's becoming more profitable in how it grows. These are all very favorable trends that the

market is beginning to pick up on. This is an interesting way of looking at it. It shows the odd situation in China and the contrast that we've seen over recent years. For a decade ending in the early part of say 2001, 2002, you had a situation where the economy grew rapidly. Nominal growth was above 11% in dollar terms, but ROE was very low. It was barely above the cost of capital, which we know was artificially depressed, and earnings growth was paltry—almost insignificant earnings growth. If you skip ahead to the picture we've seen in recent years—and really what we have in the last year—the change is just enormous. You still have a high growth economy. That's why I don't think the impact of China on the global scene is going to change.

But the things going on under the surface are very different. Notice ROE has surged; it's very, very high. It may be cyclically elevated, but there is an upward trend in ROE that's been visible for a number of years. It's well above the cost of capital, which is still too low but there's a gap there that's favorable. And importantly, the rate of growth and earnings has really begun to fully reflect the way the economy performs and that earnings growth is coming through. It reflects the competition, corporate governance; it's a much more favorable set of fundamentals underneath the growth surface for financial investors like ourselves. And a lot of this has to do with micro changes. But an important driver in China is what's going on in its financial sector, which is very large and experiencing a great deal of change.

One of the key transformations that's happening in China is obviously in the banking sector. The banks have essentially not really operated as banks in the China of the past, in the command economy, and have had to transform themselves. Partly to get rid of a lot of legacy issues, credit quality, etc., partly to start to learn how to operate as banks more in a market economy. It's been a very key part of the transformation in the financial sector the banks dominate.

And within the banking sector, the four large state banks really dominate more than half of assets, as well as 60% of deposits. So whatever happens with regards to these few banks, it really lies at the heart of what China's trying to achieve in its banking sector. If you move ahead—I'm just stepping back again—the legacy issue with China operating previously as a command economy, was that the banks really were just distributors of capital. Capital was distributed on policies set by the government and as a result there was very little credit risk that took place. The result of that, obviously, was that you had very large non-performing loans. At one point the estimated total impairment in the debt on China's banks' balance sheets ranged up to 50% to 60%.

On the chart here you'll see there has been considerable progress that's been made. So if you just look at non-performing loans, which are the yellow bars, they have been steadily declining from over 30% in 2002 to just 7.5% at the middle of this year. There is a question as to whether these numbers have been scrubbed and how reliable they really are. Essentially the Chinese banks are walking a little bit of a tight rope between trying to address the legacy problems of the past and trying to develop an operating banking sector going forward. They have a lot of cushions within the system so you've seen this re-capitalization of the banks come through. A lot of the bad debt has been carved out. The question mark really, going forward, is as you put on the new debt and as we have the balance sheets grow, whether they are able to really affect good credit screening and credit control.

The signs have been good, but it's early days yet. If we look at non-performing loans in terms of vintage analysis and in terms of the new flows that are coming through, they have fallen pretty dramatically down to the mid to low single digits, depending on the banks we look at. And these banks are still really learning the ropes here. This is where foreign investors and foreign strategic investors have been very key, both in terms of bringing in new capital, but also in bringing in new

skills. A lot of what the Chinese banks look to their foreign investors for is really in the credit quality and credit risk control department. On the absorption in terms of the legacy credit cost issues that still have to be worked through, remember that these are still very traditional banks. So over 90% of their earnings come from net interest income. The interest rate structure in China is entirely controlled so there is a minimum spread that the banks can earn on this business. There are also new opportunities with regards to fee income growth, and more importantly, credit. Consumer has been a very small part of it, and even within consumer, over 90% of that has been to mortgage lending. The banks are currently refocusing on looking at the private companies and extending credit to this sector, which previously has been somewhat starved of bank credit. It is still a very new area, and in most of the banks pilot studies are still being run to see how they can actually target this business better.

[End recording]