Eddie Yue: Hong Kong as an international financial centre – the China factor

Introductory remarks by Mr Eddie Yue, Deputy Chief Executive of the Hong Kong Monetary Authority, at the "Hong Kong: China's Global Financial Centre" conference, London, 16 November 2010.

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Ladies and gentlemen,

1. It is a great pleasure to be here today. This conference is taking place at an exciting time as there is growing interest in the investment and business opportunities in Asia, particularly in Hong Kong and Mainland China. Indeed, we are already seeing more and more asset managers moving from the West to the East, looking to set up their regional operations in Hong Kong to capture these opportunities. I believe what we are seeing today is only the beginning of a period of exceptional growth in Hong Kong's financial services industry.

2. KC Chan and Martin Wheatley have already set out the key strengths of Hong Kong in serving as a financial hub in Asia. I will not repeat them here. I would like instead to focus on one unique competitive advantage of Hong Kong that is difficult for other financial centres to replicate. And that is the China factor.

3. This China factor is growing in prominence as China continues with its path of very impressive growth: over the past three decades, Mainland China's GDP has registered an amazing 25-fold increase, from US$200 billion to US$5 trillion last year, with an average annual growth rate of 10%. Today, Mainland China is already the second largest economy in the world and the single biggest contributor to the world's economic expansion, creating nearly one-fifth of the world's newly-generated economic activities.

4. The China factor creates many different opportunities for Hong Kong's financial services industry. Today I will highlight two aspects that I believe are key drivers for growth in the next few years. The first is the gradual financial liberalisation in Mainland China and the second is the wider external use of the renminbi (RMB).

The gradual financial liberalisation in Mainland China

5. In the gradual financial liberalisation process in Mainland China, we can observe three key patterns: inflows being de-regulated before outflows, direct investment flows being liberalised before portfolio investment flows, and collective investment schemes being relaxed before individual investors.

6. Specifically, during the early stages of Mainland China's reform process, in the late 1970s and early 1980s, only Foreign Direct Investment (FDI) was encouraged. Hong Kong has been the largest source of FDI for the Mainland, accounting for more than half of the total amount in 2009. In the opposite direction, Mainland China's Overseas Direct Investment (ODI) has also been liberalised gradually over the years. Hong Kong has been the largest recipient of ODI flows from the Mainland. At present, about 60% of ODI from the Mainland has gone to Hong Kong or via Hong Kong to other places. The significant share of Hong Kong in Mainland0's FDI and ODI underscores the unique role of Hong Kong as a gateway for foreign enterprises to access the Mainland market, while at the same time being a springboard for Mainland institutions to gain exposure to international markets.

7. With respect to portfolio investment flows, Mainland China has made important progress after joining the WTO in 2001. Portfolio inflows were allowed through the introduction of the Qualified Foreign Institutional Investor (QFII) scheme in 2002. A few years

later, portfolio outflows were liberalised by introducing the Qualified Domestic Institutional Investor (QDII) scheme in 2006: this allows certain qualified banks, insurers and fund management companies to invest overseas.

8. At present, market attention has been focusing on portfolio flows from advanced economies towards Mainland China. In my view, portfolio flows in the opposite direction – i.e. portfolio outflows from Mainland China – will also present huge opportunities to the asset management industry, especially given the fact that the Mainland economy is the single largest provider of savings in the world.

9. Currently, outward portfolio investment (OPI) from the Mainland is only around 5% of its GDP, still far below 57% for East Asia, 42% for the US and over 100% for the UK. Our in-house research findings show that an economy's portfolio investment outflows as a percentage of GDP tend to grow along with the level of economic development measured by per capita GDP. As such, there remains enormous scope for Mainland's OPI to increase.

10. Japan's experience in opening up its capital account in the mid-80s may also shed some light on the future path of Mainland's OPI. Japan's outward portfolio investment started off with 5% of GDP, then rose to 18% in 10 years' time, and then further to over 40% in another 10 years. If we assume that Mainland's OPI follows a path similar to that of Japan, it is possible that their OPI could reach 18% of GDP in 10 years' time. It is not difficult to get an idea of the potential scale of such flows by simply punching the calculator: this will give a good sense of why we say the potential is huge.

11. So, given the huge potential outward portfolio investments from Mainland China, how will they be allocated across different financial markets? Our internal research shows that, despite the advances in telecommunications and technology, home bias is still very much there, and people do like investing in markets closer to their home countries. As such, Hong Kong is likely to be one of the key destinations of Mainland's OPI. Apart from being the final destination for these investments, Hong Kong can also act as an ideal launch platform for these investment flows to reach other major global markets.

12. Since the introduction of the QDII scheme, US$64 billion worth of investment quotas have been granted up to June this year. It is likely that a significant portion of these moneys is managed out of Hong Kong. In fact, over 40 Mainland companies providing fund management, securities and futures, insurance, and other services have already established a presence in Hong Kong to manage the funds flowing out of the Mainland and engage in fund advisory businesses.

13. So, the implications from the gradual liberalisation of Mainland China's capital account are clear. Hong Kong is bound to be a key destination as well as the management hub for the gradual increase in the portfolio flows from Mainland China. This trend will present huge opportunities to financial institutions, private banks, fund managers, and other financial service providers looking to tap these funds.

14. Having said that, one should expect that the process of financial liberalisation in Mainland China will be a gradual and controllable one, in a manner that will fit the Chinese saying of "crossing the river by feeling the stones" so that one can adjust the speed and tactics of crossing the river without fear of falling in and getting drowned. It is, however, important to realise that this process has already begun: this is something that global financial firms, especially asset managers, should not ignore in their business planning process.

The wider external use of the RMB

15. Now, let me move on to the second important trend: the wider external use of the RMB.

16. Since the global financial crisis, Mainland China has taken steps to allow a greater use of RMB outside the Mainland. The rationale behind this policy move is easily understandable. At present, much of the cross-border trade and investment between the Mainland and other jurisdictions are conducted in US dollars. As the Mainland continues to expand its international trade and investment, and becomes more economically integrated with the rest of the world, Chinese traders, investors and financial institutions will face growing foreign exchange risk if they continue to rely on the US dollar. Thus, it is a natural development for Mainland China to allow a wider use of RMB in its cross-border trade and investment.

17. From Hong Kong's perspective, this policy move presents unprecedented opportunities to us, as we can leverage on our strengths as an IFC and our unique position as a gateway between China and the world to provide a premier testing ground for offshore RMB activities.

18. Offshore RMB business has been conducted in Hong Kong since 2004. While the scope of RMB business was limited to retail banking initially, it has been expanded substantially to cover bond issuance, trade settlement and further to wealth management this year. These developments have built a solid foundation for developing Hong Kong into a RMB financing centre, RMB trade settlement centre and RMB wealth management centre. I will briefly cover these three dimensions.

19. The ***first dimension*** is RMB financing. Hong Kong is the first and so far the only place outside the Mainland that has developed a RMB bond market. So far, 19 RMB bonds have been launched in Hong Kong with a total issuance size of over 50 billion yuan. The issuer base was expanded from only Mainland Chinese banks at the start, to Mainland subsidiaries of Hong Kong banks and China's Ministry of Finance in 2009, and further to Hong Kong corporations and international institutions like McDonald's and the Asian Development Bank this year following an important elucidation regarding the operation of RMB business in Hong Kong in February.

20. The net effect is that any issuers, including foreign corporations and multilateral organisations, are now free to issue RMB bonds in Hong Kong, just as they can issue bonds in any other currencies. Of course, if the proceeds are to be used on the Mainland, the moving of funds into Mainland China will have to meet the requirements there. By the same token, banks can now also offer RMB trade finance, corporate loans, syndicated loans and project finance to their clients in accordance with Hong Kong's existing banking practices.

21. The latest developments have provided more flexibility and larger scope for the further development of RMB financing activities in Hong Kong. As the pool of offshore RMB funds in Hong Kong continues to grow, there will be huge opportunities for financial institutions to take part in RMB financing as well as in the origination, distribution, investment and trading of RMB bonds.

22. The ***second dimension*** is RMB trade settlement. The RMB trade settlement pilot scheme was introduced in July last year. The initial scope of the scheme was rather limited. But in less than a year, the pilot scheme was already expanded to cover enterprises in 20 provinces and cities on the Mainland, and their trade transactions with any parts of the world can now be settled in RMB. The expanded scope has led to a rapid growth in the transaction volume of RMB trade settlement in Hong Kong, which was increased from a monthly average of 4.5 billion yuan in the first half of this year, to more than 26 billion yuan in the third quarter, representing an almost six-fold increase during the period.

23. To date, more than 75% of Mainland's RMB trade transactions with the world are handled by banks in Hong Kong. This clearly demonstrates the strong preference of market players for making use of Hong Kong's platform for RMB trade settlement. The highly efficient and reliable RMB Real Time Gross Settlement (RTGS) system in Hong Kong has played a significant role here. We are the first and so far the only place outside Mainland China that has developed a full-fledged RMB RTGS system, enabling us to handle the

settlement of cross-border trade between the Mainland and other economies in a safe and efficient manner.

24. The potential for further increases in RMB trade settlement is considerable given that the current volume only accounts for a small fraction of total trade between China and the rest of the world. RMB trade settlement proceeds will represent an important and sustainable source of growth in offshore RMB funds in Hong Kong.

25. The ***third dimension*** is RMB wealth management business. The RMB wealth management business in Hong Kong took off this year after the RMB Clearing Agreement was revised in July. The RMB Clearing Agreement lays down the framework for RMB business in Hong Kong. I will not bore you with the details but just to highlight two important changes made in the Agreement. ***First***, the restrictions on the types of institutions that can open RMB bank accounts were lifted. This effectively means that securities firms, asset management companies and insurance companies are now free to open RMB bank accounts. ***Second***, the restrictions on RMB interbank transfers between personal accounts and corporate accounts were also removed.

26. With these relaxations, the key hurdles that had previously limited the development of offshore RMB wealth management business have been eliminated. Market players have been responding to these relaxations quickly with the launch of a wide range of RMB investment products. These include RMB-denominated insurance policies and investment funds. Investor interest in these products has been phenomenal.

27. In developing our offshore RMB business, I have to say that Hong Kong does not have a monopolistic power and we are also facing competition from other financial centres. However, Hong Kong does enjoy the first mover advantage over the others in a number of ways. Over the years, the HKMA has built up a very good working relationship with the Mainland authorities. We have accumulated a wealth of operational and regulatory experience in RMB business. We have also developed the most advanced financial infrastructure for RMB transactions with cross-border links with the Mainland. These are some of our unique strengths, and it is not easy for others to replicate them, at least in the short term.

28. With all these developments, where should we go next? At the policy level, I believe it would be important to build an effective two-way channel to increase interaction between the RMB onshore and offshore markets. A potential area that can be explored is to allow such real economic activities as FDI and ODI to be possibly settled in RMB in a gradual and controllable manner. If this can be done, offshore RMB liquidity can be channelled back to the Mainland in the form of FDI to support Mainland's economic activities, while in the opposite direction, Mainland enterprises can make use of RMB for the settlement of ODI to eliminate foreign exchange risk. Given the significant share of Hong Kong in Mainland's FDI and ODI, building such a two-way channel will also be conducive to the sustainable development of the offshore RMB market in Hong Kong.

29. In addition to FDI and ODI, we have been in close communication with the Mainland authorities to explore other possible channels. In this regard, we welcome the announcement of the People's Bank of China in August regarding the introduction of a pilot scheme allowing eligible entities in Hong Kong to make use of their RMB funds to invest in the Mainland's interbank bond market. The launch of this scheme has opened up a channel for offshore RMB funds to invest on the Mainland. Market responses to this scheme have been very positive.

30. As I mentioned at the beginning, Mainland China is now the second largest economy and the single largest source of new economic activities in the world. The increasing use of RMB in the international stage – although that will be a gradual process – will have profound implications on the global financial landscape in the years to come.

Concluding remarks

31. So, the trends are very clear. Now is a critical time for market players, including banks, financial institutions and asset management companies, to prepare themselves well for the unprecedented opportunities presented by these two important trends in China.

32. Before I conclude, I would like to say a few words about the Linked Exchange Rate System in Hong Kong. As the offshore RMB business continues to develop in Hong Kong, there are views that the RMB may undermine the status of the Hong Kong dollar. Some have even said that it would be natural to consider pegging the Hong Kong dollar to the RMB instead of the US dollar. We do not agree with these views.

33. Let's take a look at the UK's experience in developing the Eurodollar market. Despite the sheer size of the Eurodollar market in the UK, it has not undermined the role of the British Pound in serving the domestic economy. Likewise, in the eyes of local investors in Hong Kong, RMB mainly represents an attractive investment choice in addition to other foreign currencies, and does not create any problems at all to the Hong Kong dollar's role as a locally-used currency.

34. What about the idea of pegging the Hong Kong dollar to the RMB instead of the US dollar? In thinking about this question, it is important to recognise that the RMB can only be an anchor currency when it meets a number of important fundamental conditions.

35. ***First***, there should be a high degree of synchronisation between the economic cycles in Hong Kong and the Mainland. At present, Hong Kong's economic cycle is more affected by the flows of trade between the Mainland and the advanced economies, rather than domestic demand of the Mainland. And the business cycle synchronisation between Hong Kong and the US continues to be higher than that between Hong Kong and the Mainland. ***Secondly***, to make it technically feasible for the RMB to be a reserve currency, the RMB must be freely convertible, the capital account control on the Mainland removed and all currencies allowed to flow freely. ***Thirdly***, the financial and asset markets on the Mainland should be wide, deep and liquid enough to allow the Exchange Fund of Hong Kong – the backing for our Linked Exchange Rate System – to hold substantial amounts of RMB assets to support the Hong Kong dollar, preserve capital, grow in value and meet contingent needs.

36. Obviously these fundamental conditions are not met, and the Hong Kong dollar Link to the US dollar remains the most appropriate policy for Hong Kong. So, let me take this opportunity to reiterate that we have no plan to change the Linked Exchange Rate System. It has served Hong Kong well since 1983 and is the pillar for the monetary and financial stability in Hong Kong.

37. Thank you.