Eddie Yue: Hong Kong as an international financial center – 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, New York, 1 March 2011.

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Ladies and gentlemen,

It's my great pleasure to be here today.

No doubt I fully agree with Ms Leung and Mr Wheatley as they have rightly set out the key strengths of Hong Kong in serving as a financial hub in Asia. But I would also like to go deeper into the matter and focus on one very important factor, which may explain why more and more asset managers have been looking to set up their regional operations in Hong Kong. And this is the China factor – a unique competitive advantage of Hong Kong that is difficult for other financial centers to replicate.

The 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 29-fold increase, from around US$200 billion to more than US$5.8 trillion in 2010, 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.

As an international financial center of China, Hong Kong stands to benefit the most from the country's phenomenal development. Today I will highlight two aspects that I believe are key drivers for Hong Kong's 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

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.

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 Mainland'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.

With respect to portfolio investment flows, 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.

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.

So, given the huge potential outward portfolio investments from Mainland China, how will they be allocated across different financial markets? Our researchers have studied this particular subject in depth and found that the home bias is still very much there, i.e. the closer the potential investment destination to Mainland China, the more OPIs it will receive from Mainland China. As such, Hong Kong is likely to be one of the key destinations of Mainland's OPIs and the amount of those OPIs Hong Kong will receive will increase as China's GDP grows. 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.

Since the introduction of the QDII scheme, about US$67 billion worth of investment quotas have been granted up to September 2010. 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.

We expect the process of financial liberalisation in Mainland China to be a gradual and controllable one, as it has always been. It is however important to note that this process has begun and Hong Kong is bound to be a key destination as well as the management hub for the expected gradual increase in portfolio flows from Mainland China. This is a trend that financial services providers should not ignore in their business planning process.

The wider external use of the RMB

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

Since the global financial crisis, Mainland China has taken steps to promote 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.

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.

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, wealth management and further to ODI settlement in January this year. These developments have built a solid foundation for developing Hong Kong into an offshore RMB center. Let me briefly summarise these developments in three dimensions.

The ***first dimension*** is RMB financing. Hong Kong is the first place outside the Mainland that has developed an RMB bond market. So far, 34 RMB bonds have been launched in Hong Kong with a total issuance size of 80 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 famous international institutions like McDonald's and the Asian Development Bank last year.

Any issuers, including foreign corporations and multilateral organisations, can now 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 financing to their clients, including enterprises which conduct direct investments under the pilot scheme for the settlement of ODI in RMB introduced in January this year.

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.

The ***second dimension*** is RMB trade settlement. The RMB trade settlement pilot scheme was introduced in July 2009. The initial scope of the scheme was rather limited. But in less than a year, the pilot scheme was 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 2010, to more than 87 billion yuan in the fourth quarter, representing an almost twenty-fold increase during the period.

To date, Hong Kong accounts for about 75% of Mainland's RMB trade settlement. 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.

China is one of the biggest trading nations in the world. 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.

The ***third dimension*** is RMB wealth management business. The RMB wealth management business in Hong Kong took off last year after the RMB Clearing Agreement was revised in July 2010. 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.

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.

In developing our offshore RMB business, let me stress that Hong Kong does not have a monopolistic power and we are also facing competition from other financial centers.

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.

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 promote the use of RMB for conducting cross-border real economic activities such as FDI and ODI. 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. On this, I am glad to see that the People's Bank of China has, as I briefly mentioned a few minutes ago, recently launched a pilot scheme, under which ODIs by Mainland Chinese enterprises are allowed to be settled in RMB upon approval of relevant Mainland authorities. As for FDI in RMB, there have already been some pilot cases (such as McDonald's) and it is hoped that the relevant arrangement can be formalised in due course.

Apart from FDI and ODI, we have been in close communication with the Mainland authorities to explore other possible channels. In particular, we welcome the announcement of the People's Bank of China in August last year 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.

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

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 China.

Thank you.