Norman T L Chan: China's reform and liberalisation – the positioning and future of Hong Kong

Speech by Mr Norman T L Chan, Chief Executive of the Hong Kong Monetary Authority, at a roundtable, organized by Pacific Pension & Investment Institute, Hong Kong, 27 October 2016.

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Mr Lionel Johnson, distinguished guests, ladies and gentlemen, good morning to all of you!

1. I would like to extend a warm welcome to all of you and to express my sincere thanks to Pacific Pension & Investment Institute for inviting me to speak at today's Roundtable.

2. What I will do today is to talk about the role that Hong Kong plays in China's reform and opening up, which has led to the miraculous accomplishment of the growth story of China over the last three to four decades.

3. I am sure that you are familiar with China's growth story. However, I still think it useful if I try to recap on what has happened. In 1980, the Chinese economy was a mere US$200 billion. Now, it is the second largest economy in the world with a size of close to US$11 trillion in 2015. The IMF's forecast is that China's GDP will further expand to US$16 trillion by 2020. During the 35-year period from 1980, China has managed to lift 700 million people who earned less than US$1 a day out of poverty and transformed itself into a nation with a per capita GDP of around US$8,000 lately. Much of China's outstanding economic and social accomplishments can be attributed to its bold and unprecedented reform strategies, particularly in moving towards a model which allows the private sector and foreign capital to play an increasingly important role in, using the words of Deng Xiaoping, a "market-based economy with socialist characteristics". The reform and opening programme is still continuing.

4. Put it in another way, China's growth story at the initial stages was about opening up China to the outside world. This makes sense because when the reform first started in the 1980s there was serious shortage of necessary capital and technology to develop its industrial base. So a major pillar of the reform strategy has been to attract foreign direct investments (FDIs) into China.

5. As a result, China's FDIs has grown phenomenally over the past three decades, reaching US$136 billion in 2015, making it the second largest destination of FDIs in the world, only next to the USA.

6. In this context, it is important to note that, Hong Kong has always been the largest source of FDI into China, accounting on average for around 50–60% ever since the FDI data became available in 1986. This means that both local as well as foreign enterprises have been using Hong Kong as the main gateway for venturing into Mainland China to help turn China into the factory of the world. This is not surprising at all if one understands the fact that Hong Kong, which has created and accumulated enormous amount of capital and wealth in the past few decades, enjoys unique advantages in making it a lot easier for companies wishing to tap into the rapidly growing Chinese market, not only in terms of production and supplies but also in terms of a huge and rapidly expanding consumer market.

7. About 10 years ago, China has entered into a new phase in its growth story. This new phase came about because, over the years, China has gradually developed its own technology and accumulated surplus capital which could be usefully and profitably deployed in the overseas markets. China's overseas direct investments

(ODIs) grew from virtually nothing in 2005 to over US$146 billion in 2015, which actually surpassed the amount of FDIs that went into China in the same year. Looking ahead, as China will continue to gain technical and financial know-how, China's "reaching out" programme has now become an integral part of the growth strategy of China. There are now 110 Chinese companies on the 2016 Fortune 500 list, 13 of which made their debut this year. Three of the top five companies are from China. Only the US has more companies on the list than China. It is only natural to expect that more and more major Chinese enterprises will reach out and become truly global companies in the next 10 to 20 years. I believe this trend of "going out" will definitely intensify as China pushes forward its latest Belt and Road (B&R) Initiative.

8. Again, in China's reaching out efforts, Hong Kong has consistently been the largest destination of China's ODIs, taking up around 50–60% of Mainland's total flow over the past decade, just like the case for FDIs. Behind these striking statistics lies the important fact that most Chinese companies prefer to use Hong Kong as the springboard for reaching out to the overseas markets. In theory, a Chinese company wishing to invest overseas could go direct to the country in which the investment project is located. In fact, many Chinese companies did just that in the earlier phases of reaching out. However, more and more Chinese companies have found it easier and more convenient to reach out to the rest of the world through Hong Kong. This is because Hong Kong offers a number of important advantages for these Chinese companies, including the ease of obtaining a wide spectrum of finance at different stages of the overseas investments, the availability of a large pool of bilingual talents and a cluster of highly qualified legal, accounting and related professional support services firms. With the proximity to the Mainland and under the One Country, Two Systems arrangements, Hong Kong's unique advantages have helped attract many Mainland corporates to Hong Kong in their ODI ventures.

9. What would be of greater relevance and interest to today's audience who are institutional investors is the fact that the Chinese financial markets have been growing very rapidly in the last two decades. The sum of China's stock and bond markets capitalisation has risen to a size of US$16 trillion last year, equivalent to around 140% of China's GDP. But comparing this ratio to the developed countries and some more mature emerging market economies, China's financial markets still have much room to grow alongside the opening and liberalisation of its capital account.

10. So how has Hong Kong been contributing to China's financial market reforms and development? First, Hong Kong is the most important equity fund raising centre outside of the Mainland for the Chinese corporates. In the past 25 years, there have been 951 Mainland corporates listed in Hong Kong, raising a total of US$300 billion in IPOs and US$347 billion in secondary offerings. As a result, Hong Kong has consistently attained the world's top rankings as an equity fund raising centre over the last 15 years or so.

11. As you know, a company seeking listing in Hong Kong will need to meet our usual high governance, accounting and disclosure requirements, which are fully in line with the international standards. So for a Mainland company to succeed in an IPO listing in Hong Kong, it is not just foreign capital that it wishes to attract. Listing in Hong Kong also helps impose stringent external discipline for these Mainland companies to revamp their corporate governance, management and risk culture.

12. The upgrading of corporate governance standards was particularly evident at the height of China's banking sector reform, when Hong Kong's capital market helped the major Chinese state-owned banks to turn around and raise sizable funds from international investors through the Hong Kong stock market in the mid-2000s. You

may recall that it was a period in which the Mainland's banking and financial systems went through some serious challenges, while the Chinese A-share IPO was suspended between 2005 to 2006 due to the launch of the non-tradable share reform.

13. Again, Hong Kong was fortunate to have played a pivotal role at the critical stage of China's banking sector reform. These major Chinese banks made very good use of the Hong Kong market in their IPOs, a point that can be illustrated by the much larger amounts of capital raised through H-share IPO in the Hong Kong stock market compared with that raised through A-share market on the Mainland.

14. I am sure you will agree with me that the internationalisation of renminbi (RMB), which began in 2009, is another crucial strategy of the reform and opening up of China. RMB internationalisation has made very significant progress in the last seven years, with RMB becoming the fifth largest global payment currency, according to the latest figures from SWIFT, behind USD, EUR, GBP and JPY. Last year, more than 20% of China's external trade was denominated and settled in RMB, compared to almost zero in 2009. As from 1 October this year, RMB has become one of the currencies of IMF's Special Drawing Right basket. As Mainland corporates continue to reach out and expand their trade and investment in the B&R region and elsewhere, there will undoubtedly be wider use and acceptance of RMB as a currency for trade, financing, payment and store of value.

15. In the context of RMB internationalisation, Hong Kong is the global hub for offshore RMB businesses. Hong Kong has the largest RMB liquidity pool outside Mainland China totalling around RMB1 trillion in 2015, and RMB trade settlement handled by banks in Hong Kong amounted to RMB6.8 trillion in 2015. Hong Kong is also the largest RMB financing centre outside Mainland China, with the largest RMB dim-sum bond and loan markets. The average daily turnover of our RMB RTGS system was around RMB1 trillion in 2015. According to SWIFT, Hong Kong has about 70% of the global RMB payments. The average daily turnover of Hong Kong's RMB foreign exchange market reached US$77 billion in April 2016, having expanded by over 50% from three years ago, according to the latest BIS Triennial Survey. Lastly, the CNH Hong Kong Interbank Offered Rate fixing (CNH HIBOR fixing) launched in 2013, has become a significant piece of financial infrastructure for the offshore RMB market, providing a benchmark for a variety of RMB interest rate instruments, thereby helping foster the development of the RMB offshore market.

16. The HKMA also designated two years ago seven banks as Primary Liquidity Providers (PLPs) for offshore RMB market in Hong Kong (i.e. CNH market). These PLPs are expected to expand their market-making activities in Hong Kong for various CNH instruments, and make good use of the Hong Kong platform in promoting their global offshore RMB business. In return, the HKMA provides a dedicated repo facility of RMB2 billion to each of the PLPs so as to facilitate more efficient liquidity management when they carry out more market-making and related activities in the CNH market. Having reviewed the operation of the PLP regime in the past two years, we are of the view that it has proved to be a useful arrangement to promote market development and help smooth market volatility when there is a sudden surge in the demand for RMB liquidity in the offshore market. The HKMA has therefore decided to expand the PLP regime and to enhance the transparency of CNH market liquidity by disclosing the usage of the liquidity facilities offered by the HKMA. Further details will be announced later today.

17. Ladies and gentlemen, Hong Kong has all along played a crucial and irreplaceable role to intermediate trade, direct investments, and portfolio flows into and out of China. Putting it simply, Hong Kong serves as a bridge linking Mainland China with the rest of the world.

18. For the global institutional investors and asset managers like you, there has been gradual and incremental opening up of the Mainland capital markets. You can now access the Mainland markets, initially through the QFII and then RQFII schemes, as well as the liberalisation of China's interbank bond market. In this connection, it is useful to note that the majority of asset managers with QFII quotas have set up offices in Hong Kong as their platforms for managing their investments in the Mainland markets.

19. In addition, the launch of Shanghai-Hong Kong Stock Connect in November 2014 and the upcoming Shenzhen-Hong Kong Stock Connect by the end of this year has opened up a major corridor for global investors to access the A-share markets through the platform in Hong Kong. I am sure Charles Li, Chief Executive of the Hong Kong Stock Exchange, will tell you more about the Stock Connect later this morning.

20. Today, over 60 out of the top 100 global money managers have a presence in Hong Kong. Some of the most prominent asset owners have also chosen Hong Kong as their base to conduct China and pan-Asia investments. These include the likes of Canadian Pension Plan Investment Board, Ontario Teachers' Pension Plan, China Investment Corporation, Church Pension Fund and the list goes on. The growing community of asset owners should continue to draw more asset managers to Hong Kong, creating a virtuous cycle in our asset management eco-system.

21. It is our firm belief that the B&R Initiative would be a key component in the next phase of China's ODI story. With this in mind, the HKMA has recently set up the Infrastructure Financing Facilitation Office (IFFO). IFFO aims to provide a platform for key industry stakeholders to exchange information and share experience, and to make better use of Hong Kong in servicing the growing infrastructure investment and financing needs in the region. If you are interested in the work and activities of IFFO, please visit the HKMA website for more details.

22. Ladies and gentlemen, let me conclude by making this final point about the China growth story. As institutional investors who manage huge amounts of money for your clients, you have to take a view on whether or not the China growth story is a real and credible story and, if so, whether or not you want to be part of this growth story by investing in it. If you subscribe to the China growth story, then there comes the question of how best to invest in the Chinese markets. Any investments, as we all know, entail not just opportunities but also risks. It is absolutely crucial you pick the right place and platform for you to access the Mainland financial markets and manage the associated risks prudently. It is an important choice because you wish to be using a platform that offers the best hard as well as soft infrastructure for good investments to be made on a day to day basis. I hope that you, just like many of your peers, will agree with me that the optimal place and platform for managing financial and portfolio flows into and out of China is Hong Kong. Thank you.