Growth of RMB as an investment currency and the development of RMB products in Hong Kong

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Introduction

Good morning, ladies and gentlemen,

I would like to first thank the organiser for inviting me here today.

This is an opportune moment to talk about Hong Kong's next steps in its development as an offshore RMB market. Last month, Vice Premier Li Keqiang led a delegation of senior Mainland officials to Hong Kong. During the visit, Vice Premier Li unveiled a series of policy initiatives that uses Hong Kong as the platform to further the Mainland's currency liberalization and capital market opening goals. Since then, the city has been busy analysing the implications of each of these initiatives, how and when they would be implemented, who will benefit from them and what they mean for Hong Kong's development as a RMB offshore centre.

What I hope to do today is to take a step back, and explain how these recent events fit within the broader context of the liberalization of the RMB - a journey that will ultimately transform the RMB into not just a currency for international trade but also a store of international capital.

My speech today will cover three areas. First, I will briefly take stock of the journey of the RMB so far. Second, I will examine why in order to promote the wider use of RMB, the journey must necessarily entail the important step of turning RMB into an investment currency. Then I would like to share with you my thoughts on Hong Kong's role in helping the Mainland advance along the roadmap and, within that context, examine how the policy initiatives announced during Vice Premier Li's visit could be successfully harnessed.

The RMB journey so far

The need for the journey has been compelling. The Mainland is the world's largest trading nation. It follows that at least some of its trades with the rest of the world should be priced and settled in its own currency, particularly in view of the turbulent currency volatility in today's global markets. The Mainland should also have the ability to finance some of its foreign projects and investments in its own currency.

As governments and central banks of the developed world continue to concoct toxic financial cocktails involving near zero interest rates, balance sheet expansion and stealth devaluation, the Mainland may need to diversify away from its concentrated portfolio of US treasuries and halt or even reverse the continuing build-up of its foreign reserves. Consequently, the need to usher in wider reforms to further open up the use and circulation of RMB outside its borders has taken on a more urgent note.

While some may argue that the RMB liberalization journey began as early as 1994, when the Mainland opened up its current account, it remains a fact that the RMB only ventured out of the Mainland's doors in 2004, when the Mainland allowed Hong Kong banks to accept RMB deposits from Hong Kong individuals, and to clear RMB with the PBOC Shenzhen Branch, with a limit of RMB 20,000 per day per customer. The objective behind this guarded experiment was simple. As the Mainland continued with its capital market reforms, its currency and interest rate regime would eventually need to become more liberalized. Using Hong Kong to start this experiment made the most sense.

As we all know, the experiment took on a new impetus in July 2010, when further liberalization measures were introduced - for the first time corporates were allowed to open RMB bank accounts, and transfers could be made between RMB accounts. From there on, the size of RMB deposits in Hong Kong rocketed. For instance, in the months of July to December 2010, the average month on month increase was 24%. At the end of July 2011, RMB deposits in Hong Kong totalled RMB572.2 billion, a stunning 452% rise from the previous year.

But volume only tells part of the story. The remarkable growth in the size of Hong Kong's RMB pool masks some underlying imbalances. While Hong Kong banks continue to take RMB deposits, thus creating liabilities in their balance sheets, they have precious few opportunities to create RMB assets and, as a result, have not been able to put these deposits to good use to earn a decent deposit return for their customers.

The creation of RMB assets has been slow. Since 2007, Hong Kong investors have been offered a steady stream of RMB bonds – first the retail issuances by Mainland financial institutions, followed by the Mainland subsidiaries of several Hong Kong banks, then sovereign issues by the Ministry of Finance and since July 2010, a multitude of issuances offered at the institutional level by red chips, Hong Kong companies and international corporations. The total aggregate issue size now stands at over RMB140 billion. Other RMB investments, such as RMB bond funds, banking and insurance products have also been created on the back of these bonds. The Hong Kong RMB bond platform is attractive to issuers. Because of the imbalance between the supply and demand of investible RMB assets outside the Mainland, issuers willing to tap the Hong Kong RMB bond market can typically expect to pay lower coupon rates. The Hong Kong MTR Corporation, for instance, was able to issue RMB 1 billion two-year notes at a rate of 0.625% per annum. Yet, there is an automatic brake at work here. Unless the RMB funds raised from these issuances are used for trade settlement purposes (RMB cross border trade settlement started as a pilot scheme in 2009 and has been expanding in scope and reach steadily), any plans to remit the money into the Mainland for capital or investment purposes require special approval or quotas from the Mainland authorities. Obtaining such approval is not a matter of course.

I mentioned earlier that cross border trade settlement in RMB has been in the works since 2009. While banks in Hong Kong could provide trade finance to corporates, and this would have enabled the banks to create loans and thus RMB assets, they have not been able to do much in this sector because the use of RMB as a trade settlement currency has been extremely skewed. While the volume of such settlement has dramatically increased since Q4 2010 (as at end of Q1 2011, almost 7% of the Mainland's total trade was settled in its own currency, mostly through Hong Kong) the absolute bulk of all cross border trades has been one-way outward payments of RMB (by Mainland importers). Mainland exporters, on the other hand, have predominantly had to continue accepting USD or other foreign currencies. There are two issues to note here. One, those outside the Mainland do not have access to sources of RMB to pay for their trades, and they find it difficult or undesirable to source RMB trade finance. Second, this situation does not facilitate a healthy circulation of RMB outside the Mainland, nor does it help banks in Hong Kong create loans and thus RMB assets. So the key obstacle goes back to the fundamental issue of finding ways to grow an offshore RMB pool of sufficient size.

We have begun to make inroads towards growing an offshore RMB pool. In January this year, the Mainland promulgated rules allowing Mainland entities to make overseas direct investments (ODI) in RMB. A number of overseas mergers and acquisitions, for instance, have been accomplished with payments or capital contributions remitted in RMB outside the Mainland. Again, much of these remittances have come to Hong Kong and have contributed to our RMB pool.

The need to develop RMB investment assets

Despite a dearth of investment opportunities, many are still willing to hold RMB are because of the near unanimous expectation that the currency will continue to appreciate. Over the past 12 months, RMB rose by more than 6% against USD. Yet logic and experience dictates that this trend cannot continue indefinitely. Many have started asking what will happen when RMB ceases to be a one way bet, or more specifically, whether there is any incentive to continue to hold the currency.

For RMB to enjoy broad usage and circulation outside the Mainland, there must be a deep and liquid pool of the currency offshore. Trade settlement is no doubt a key component in the Mainland's financial eco-system. Yet trade settlement alone cannot sustain a healthy need and desire by the outside world to hold RMB. To stimulate that desire, there must be plenty of investment and financial products for offshore RMB. Such products would give outside investors good reason to accept and hold the currency, and would plug the value accretion gap once the RMB exchange rate stabilises, which it eventually will. In other words, RMB must first establish itself as an international investment currency, a currency that can be used to store international capital outside the Mainland.

How Hong Kong could help plot and manage the roadmap ahead

Since the further liberalization in July 2010, there have been intense debates and speculation in Hong Kong and on the Mainland about the future roadmap of the RMB. Two main, and to some extent, conflicting streams of thought are at work here. One stream of thought is that the RMB deposits in Hong Kong should be given wider and easier access back into the Mainland to invest in the Mainland market. In other words, the Mainland and Hong Kong RMB fund pools should have open flow channels between them, allowing funds to flow freely. The other stream of thought is that the purpose of letting this offshore RMB flow out of the Mainland is to allow it to circulate outside, where it should operate like any other internationally accepted currency. Therefore, while it may need some help in the beginning in terms of having access into the Mainland, once it reaches a certain size it should be able to create sufficient investible assets to sustain a healthy existence and velocity of its own.

Each of these streams of thought is influenced by a complex web of policy considerations and concerns. At this time, the Mainland still enforces capital control which restricts foreign investors' general access to the onshore market. The Mainland is not ready to completely open its capital account, or to allow RMB to be freely traded on international markets overnight. Its market infrastructure is not quite ready. Yet, by introducing its currency to the rest of the world, the Mainland is effectively integrating with, and potentially exposing itself to the shocks and volatility of global financial markets. There is concern that if the Hong Kong RMB pool were to rush onshore, it could create an unacceptable pressure on the Mainland system. Yet, there is also the desire that the operations and activities of the Hong Kong pool of RMB could provide important lessons for the Mainland as it moves forward with its currency and interest rate reforms; and the counterbalancing anxiety that somehow this experiment might run ahead of itself, or create uncomfortable precedents for the Mainland. These are real and understandable concerns.

In conducting the RMB experiment, the Mainland has picked Hong Kong as its partner and the Hong Kong platform, its laboratory. The two have had a long, successful history of collaboration and cooperation. Hong Kong is part of China, and regulators on both sides have forged a strong partnership over the past two decades. Since the very beginning of the Mainland's market reforms, we have been working closely with Mainland regulators on a wide range of issues. Together, we saw the listing of over 260 H-share and "red chip" companies in Hong Kong. We have turned the city into an efficient springboard for Mainland financial institutions that wish to expand internationally. Hong Kong has become the launch pad of many important liberalization measures that have contributed significantly to the success of the Mainland's market reforms. Hong Kong knows that its key role is to first understand the objectives and constraints of each reform initiative and second provide and implement a workable and effective solution.

The recent message by the Vice Premier is clear. The Mainland is ready to accelerate the pace of promoting the wider use of RMB outside the Mainland. The RMB pool in Hong Kong must continue to grow, and we must promote wider use of the currency by the international community. Hong Kong must rise to effectively become the premier RMB offshore centre to serve the Mainland's and the world's needs. To achieve this, the Mainland will roll out a series of measures. Let me now examine some of these measures, and offer a few ideas on how we can connect them together successfully.

Connecting policy initiatives and the product market

As I see it, the measures that will give Hong Kong the scope and mandate to develop a wider and deeper pool of RMB investment products are as follows:

- the RQFII, which will allow Hong Kong-based quota holders to create products that invest in RMB in the Mainland equity and bond markets;
- the FDI program, which will establish channels for foreign investors to make direct investments in RMB in the Mainland;
- an expansion of the types of Mainland enterprises permitted to issue RMB bonds in Hong Kong (at present only Mainland financial institutions are allowed to do so);
- an increase of this year's RMB bond issuance quota to RMB50 billion;
- making cross border RMB trade settlement available to the whole country; and
- a deepening of the program that allows Central Banks, clearing banks in Hong Kong and Macau and participating banks worldwide to purchase bonds in the Mainland interbank bond market.

Let me briefly explain how we could develop some of these measures to their full potential. First, let's take a look at the RQFII. While the implementing rules are yet to be introduced by the relevant Mainland regulatory authorities and therefore the details are still not known at this stage, we are given to understand that the initiative will operate under the same concept and mechanism applicable to the USD QFII. Applicants, who must be SFC licencees, must first obtain a qualification certification from the CSRC, then a RMB quota from SAFE, and must have opened a RMB account with the PBOC.

Hong Kong already has a wide range of investment products that are linked to the Mainland market, some of them using the existing USD QFII quota. A good number of these funds are authorized by the SFC. We have also authorized five RMB retail bond funds, which do not require any QFII quota as they invest in RMB bonds outside the Mainland. All our authorized funds are authorized using the same set of rules and processes, i.e., the Unit Trust Code. RQFII products will be treated no differently. In other words, we have in place an established platform that is prepared and ready to authorize RQFII funds. Of course, where the Mainland rules impose additional conditions, e.g., investment restrictions and custodian requirements, the RQFII funds will be expected to comply with those as well. We also expect that these funds would be Hong Kong domiciled and managed. We are in close dialogue with the PBOC, SAFE and CSRC regarding this initiative and will be setting up a co-operation and information sharing platform.

The RQFII, we understand, is modest in size – an aggregate quota of RMB20 billion. It is, however, an encouraging start. The RQFII will add breadth to Hong Kong's existing product range. More importantly, it gives the Hong Kong pool of RMB a new form of direct access into the Mainland A-share and bond markets. This may in turn attract more outside investors, and their liquidity, to the Hong Kong RMB platform.

Although the initial quota is small, the expectation is that once the products are launched and the Mainland regulators become more comfortable with the initiative, the quota size, and the scope of quota recipients, will grow. I would add a word of caution, however, that we should not expect the RQFII initiative alone to provide the answer to our quest for RMB investment products. While this would give the Hong Kong market another valuable means of connecting with the Mainland market, we need to also work on developing our own RMB assets in Hong Kong.

This is probably where RMB bonds would serve a crucial function. Under this new policy initiative, both the scope of Mainland enterprises eligible for issuing RMB bonds in Hong Kong and the size of the aggregate issuance would be expanded. This year alone, the total size of issuance by Mainland enterprises will increase to RMB50 billion, half that amount will be for Mainland financial institutions and the other half for Mainland enterprises. This initiative, together with the FDI program, which will allow foreign companies to directly invest in RMB in the Mainland, will work in lockstep to give us the necessary ingredients and scope to create RMB assets in Hong Kong.

In my view, developing a deep RMB bond market is the key to building a successful offshore business in Hong Kong. The Euro dollar centre in London is a good example. While London has developed its offshore dollar business under a very different set of circumstances, we should take note of the key elements of its success as a guide. The pool of US dollars in London is both deep and liquid. This pool supports a broad range of US dollar debts which, in turn, allows for creation of products that are securitized or otherwise structured on these debts. Although the US dollars raised from these debts may eventually return to the US, they can be put to good use to earn decent returns while outside the US. This is possible due to the US dollar's versatility as a globally accepted currency for trade, investment and storage of international capital.

At present, the RMB, of course, is nowhere close to the status of the US dollar whether in terms of global recognition, circulation or use. However, the analogy must hold true that provided we can find ways for RMB debt to be created in Hong Kong and for the debt proceeds to be used for investment or trade purposes, thus earning a return, we would have established the fundamentals necessary to creating real RMB assets in Hong Kong.

Following this logic, once the FDI measures are in place that permit RMB raised or borrowed in Hong Kong to flow into the Mainland for direct investment, Hong Kong could attract significant volumes of RMB bond issuances. We are ideally positioned to facilitate the RMB bond market through our efficient platform, the relative ease with which bonds could be issued and offered to institutional investors, the strong accounting, legal and administrative talents we have to offer, and the very competitive borrowing rates now available in our market for RMB. Assuming that the Mainland economy continues to grow, together with the investment opportunities it offers to the rest of the world, the volume of FDI can only increase. With these fundamentals in place, there is every reason to believe that our RMB bond market will take off in an impressive fashion. With more RMB bond issuances, there will be wider secondary trading and related activities. A deeper and more liquid RMB bond market would lead to more bond funds and other RMB products.

Hong Kong is, without doubt, a leader in market and product innovation in Asia. For instance, we are the jurisdiction that authorized and offered the world's first A-share ETF. We also have listed and traded on our exchange the first RMB equity product outside the Mainland. Promptly after the liberalization measures in July 2010, we authorized Hong Kong's first RMB bond fund. With deeper and wider bond issuances, we may eventually start to examine whether ETFs tracking indices of offshore RMB bonds could be allowed. Provided that the underlying index is sufficient broadly constituted and rules-based, and it satisfies our requirements for acceptable indices as set out in our Unit Trust Code, we believe that there is a basis for these products to be authorized and offered in Hong Kong.

Last but not least, there is the prospect of RMB equity listings and IPO's. The story of RMB product development in Hong Kong will not be complete without exploring this avenue. If we look at the euro dollar market in London, its business is not built on US dollar IPO's or equity listing and trading. However, Hong Kong's model is arguably different. Over 50% of our listed market capitalization is from Mainland companies. The remainder has significant operations and investments in the Mainland. They all have a real need for RMB. Again, this underscores the fact that once the FDI measures are in place, RMB capital-raising in the equities market could begin in earnest.

All these bring us to the most important question – who are the players who will create and develop Hong Kong's RMB investment products? The answer is obvious. The RMB journey is not just the Mainland's journey. It is a journey that connects China with the world. It requires international participation and support. Consequently, the players must include not just Mainland firms but also Hong Kong and international entities who bring to the table the best of international experience, global liquidity and world standards. Once again, it is Hong Kong's role to connect all these players, and give each of them an open opportunity to excel.

Conclusion

I am mindful of how much we have covered in the past 20 minutes. So let me summarise what I have said here today. We are now at the cusp of a new breakthrough. From here on, the RMB journey will move into higher gear. We, the market regulator and supervisor, are ready. The Hong Kong market, being the super highway, is well equipped. And I'm sure market participants, as the motorists and users of the highway, are well trained, disciplined and very eager. I urge all of you to put your best foot forward as we embark on this journey, leverage on your considerable skills and experience to capture the business opportunities as they unfold and, in the course of it, contribute towards anchoring Hong Kong's position as the world's premier offshore RMB centre. Let us work together towards the goal of the RMB becoming an internationally accepted and widely used currency.

Thank you.