Speech by SFST at China Economic Development Forum
(English only)

Wednesday, March 23, 2011

Following is the speech by the Secretary for Financial Services and the Treasury, Professor K C Chan, on "The Development of Renminbi Market in Hong Kong" at the China Economic Development Forum today (March 23). Professor Justin Lin, Professor David Li and Professor Yi Gang also attended as speakers at the Forum, which was moderated by Professor Leonard Cheng and Professor Francis Lui.

Dear friends,

It is indeed a pleasure and a sentimental journey for me to be here sharing the stage today with my old friends. I hope my service with the university and my being a dean for some years give me a right to be sentimental today, which is clearly a remarkable day for us.

I have known the speakers and the moderators for many years. We shared many university seminars. We talked about theories. We talked about teaching and research. It is quite remarkable, given my long association with them, seeing each of them contribute in an important way in both theories and research and now to see them in the public policy arena. I also want to congratulate the achievements of the Economics Department under Leonard and Francis' leadership.

Overview

Let me turn to the most exciting topic in our financial market development: the internationalisation of Renminbi (RMB). Listening to the speakers, you will know how remarkable and important this policy is. The internationalisation of RMB is one of the most important events of our lifetime. It represents a policy choice in the gradual process of the opening of the capital account.

There is no question of whether the capital account will be liberalised. It will. The only question is when. Given the capital account controls in place, the policy choice is to start the process of RMB internationalisation while maintaining the control of capital flows.

Today, we recognise that RMB internationalisation is very important. However, we must do it gradually. There is a consensus of taking a gradual approach, but don't underestimate the determination. It is going to happen. Governor Yi has talked about all the benefits. Justin and David have also talked about all the benefits associated with having RMB playing an important role in the international financial market. But even in the current stage of development, if the capital account is closed or mostly closed, there are still many benefits associated with RMB internationalisation. For example, an increasing use of RMB in trade settlement will reduce exchange rate risk for Chinese companies. It also facilitates outward investment. As RMB is becoming accepted as an investment asset, in addition to a currency for trade settlement, it leads to a diversification of currency risks for investors as well as Mainland borrowers.

I have to say the current method for internationalising RMB, when the capital account is closed or mostly closed, has no historical precedents. So we are inventing a new method. As David said, we are doing a new way, a new reform. As Justin said, what is going on in China is new to the world. The current approach to RMB internationalisation is through the encouragement of an offshore market.

Why is an offshore market so important? Can RMB internationalisation happen without an offshore market? My view, and that is a view shared by many market observers and economists, is that an offshore market is very much necessary for the internationalisation of RMB.

Although the trade settlement in RMB can be done through correspondent banking arrangement between domestic banks and foreign traders, we won't have the benefits of having an offshore market that allows foreign traders and investors to trade and invest in RMB. An offshore market will allow market forces to work to build up the demand for RMB as a currency for trade settlement as well as a currency for investment.

This is what we are witnessing in the past year. Policy encouragement and market forces have worked to attract the flows of RMB offshore, and the liquidity can be anchored offshore with the development of an offshore interbank market, bank lending and development of RMB bonds or even equity products.

Another interesting aspect of the offshore RMB market is that Hong Kong is again in a unique position to perform a historic role in the opening up and reform of our country. Hong Kong is the most natural and the most competitive offshore RMB market in our country. We have been a testing ground for new products and new ideas for China and now we are a testing ground for financial market reform for the country. There is much cooperation between the regulators on the Mainland and Hong Kong, and we can ring-fence the market with the capital flows being regulated to safeguard the financial security of the nation.

With great wisdom, Hong Kong's role as a developed offshore RMB market is being enshrined in the National 12th Five-Year Plan which was promulgated a week ago. The 12th Five-Year Plan gives explicit support for Hong Kong to be the offshore RMB business centre and an international asset management centre. More importantly, it states the support to strengthen HK's global influence as an international financial centre. This is very remarkable and RMB internationalisation will give Hong Kong an excellent ground to grow and build influence.

What is happening so far with the offshore RMB market in Hong Kong?

The market started slowly with the introduction of the pilot RMB trade settlement scheme back in July 2009. It started very slowly with only a couple of Chinese enterprises entering the scheme. The whole scheme picked up momentum with three key milestones:

(1) the elucidation of the supervisory principles and operating arrangement by the Hong Kong Monetary Authority (HKMA) regarding the RMB business in HK;

(2) expansion of the trade settlement scheme in June 2010; and

(3) amendment of the clearing arrangements made by HKMA in July 2010, which led to the creation of an RMB interbank market in HK.

The pace of development of the offshore RMB market has been breathtaking since June last year.

RMB Trade Settlement

The value of RMB trade settlement conducted in Hong Kong increased from RMB 23 billion in Q2/2010 to reach RMB 260 billion in Q4/2010. So it is a ten-fold increase. There is good reason to believe this momentum will continue.

First, the proportion of Mainland trade settled in RMB is still small. The proportion increased from less than 1% in Q2/2010 to about 5% in Q4/2010. It is a very small base and there is a lot of growth potential.

Second, a high proportion of Mainland traders and their trading partners expect to settle some trade transactions in RMB in the short term. According to some surveys conducted by HSBC, over 20% of Mainland traders expect to settle their trade in RMB. Given that the value of the Mainland's total trade in 2010 was RMB 20 trillion, the potential for RMB trade settlement would be RMB 4 trillion.

Compared to the figure for 2010, which was only RMB 506 billion, the upside potential in the short term could easily fall in the range of five to ten times for Hong Kong market.

There is a lot of work being done to facilitate this growth. We are working very hard to promote RMB trade settlement. We conduct a lot of promotion overseas and HKMA has been doing some of this work. In fact, Mr Norman Chan has just got back from Australia and New Zealand where he was promoting the use of RMB. I was in London some time ago. Our bankers are all over the world promoting it. RMB trade settlement is new to foreign traders and we go out of our way to promote it.

The Mainland's total trade has been growing fast at double-digit level. This has also added momentum. Hong Kong banks handled over 70% of all Mainland's RMB trade settlement in 2010. So we have a major share of the business.

RMB Deposits

RMB trade settlement provides the major source of liquidity to the Hong Kong offshore RMB centre. Most of the deposits growth last year was due to trade settlement, not the conversion by Hong Kong residents of Hong Kong dollar into RMB. In the first 11 months of 2010, payments from the Mainland to Hong Kong amounted to RMB 180 billion while payments from Hong Kong to the Mainland amounted to RMB 50 billion, resulting in a net inflow. This constitutes a source of RMB liquidity in Hong Kong.

Given this trade settlement development, RMB deposits registered very remarkable growth, increasing from RMB 89 billion in June 2010 to about RMB 320 billion by the end of last year. I expect the figure to roughly exceed RMB 400 billion in February 2011.

The increase in RMB deposits in Hong Kong has narrowed the gap between the RMB exchange rate in the offshore market (CNH) and that in the onshore market (CNY). Again, there is a growth momentum for RMB deposits this year.

Firstly, the continual growth in RMB trade settlement would continue to enlarge the liquidity pool in Hong Kong.

Secondly, the announcement of the pilot scheme for the settlement of overseas direct investments (ODI) in RMB in January will give another boost to the liquidity pool in the offshore market in Hong Kong.

Thirdly, the continued development of RMB products and services will serve to anchor RMB liquidity in Hong Kong.

What's the forecast? Industry forecasts expect RMB deposits to reach between RMB 800 billion and 1 trillion by end of this year. Some optimistic forecasts put the figure at RMB 2 trillion by the end of 2012. So the market expects an increase of RMB deposits in the short to medium term of about RMB 2 trillion.

What does RMB 2 trillion mean? In Hong Kong, the HK dollar deposits are more than 3 trillion. So with RMB 2 trillion deposits in Hong Kong, there is going to be a very efficient banking market in this new currency.

RMB Bonds/Direct Investment

Hong Kong is very privileged, being the first and only place outside the Mainland to develop an RMB bond market.

The RMB bond market started off slowly in June 2007. To date, there have been 38 RMB bond issues, with a total issuance of over RMB 80 billion. The offshore RMB bond market took off more recently, along with growing RMB deposits with the issue of so called 'dim sum bonds' issued by a large range of issuers and available to institutional investors. These issuers range from Chinese corporations to bond corporations of foreign agencies.

HSBC's base case forecast for issuance of CNH bonds for RMB 60 billion for 2011 (vs. RMB 42 billion last year), which would bring the total outstanding 'dim sum bonds' to over RMB 100 billion.

Here I should also mention synthetic bonds, bonds that are denominated in RMB but settled in USD. A total of RMB 19 billion worth was issued by six issuers last year.

Issuance in the form of synthetic bonds is likely to continue in the near future. From the issuer's perspective, the process for remitting the bond proceeds in USD is relatively smooth. The issuers find it easier to issue synthetic bonds and bring US dollars back to the Mainland for direct investment. To some investors, no advance FX conversion is required.

Further development of the CNH bond market will depend on the facilitation of the remittance of fund proceeds back to China as foreign direct investment. The Mainland authorities and the People's Bank of China are working on simplifying and streamlining the so called FDI channel, so that RMB raised in Hong Kong can be remitted to China for direct investment. With the channel being clarified and simplified, this should be good news for Hong Kong’s market development. It will be very useful to encourage the growth of the market and anchor liquidity here.

What about the equity market? Are we going to see an RMB IPO? It will be an exciting phase in our development. It will take a lot more work than the bond market because the equity market critically depends on facilitation in secondary market trading. The Hong Kong Stock Exchange has been working to set up a system and to ensure that the secondary trading system can run smoothly. That is another piece of infrastructure that we need to build so that the equity market can actually develop in Hong Kong.

Ends