Speech

Speech by SFST at Lujiazui Forum 2011 in Shanghai

Friday, May 20, 2011

The following is the speech by the Secretary for Financial Services and the Treasury, Professor K C Chan, at Plenary Session IV: "New Opportunities for Shanghai in Becoming a Global Financial Centre" at the Lujiazui Forum 2011 in Shanghai today (May 20):

Distinguished guests, ladies and gentlemen,

It gives me great pleasure to participate, for the second time, in the Lujiazui Forum. There is no better chance than this to share with you my views on the new opportunities arising from China's recent emergence as the world's second largest economy.

<u>China in 10 years' time</u>

If we have to predict where China would be in 10 years' time, perhaps the most sensible projection would be derived from the experiences of the recent past.

In 2000, China's GDP was US$1.2 trillion. In 2010, it was US$5.9 trillion, a five-fold increase in 10 years. At the beginning of 2001, the market cap of the Shanghai Stock Exchange was RMB2.7 trillion. By the end of 2010, it was RMB14.3 trillion -- again, a five-fold increase. Looking at the growth figures of China and its economic outlook, some forecasts put the scale of China's economy in 10 to 20 years' time at a comparable level to that of the US.

<u>Progress made in the past year</u>

Last year at this very forum, we discussed the prospect of RMB internationalisation and its effect on China's financial market development. This is what I said:

“The internationalisation of the RMB is part of the new financial order for this region. This will provide a new impetus for the growth of China's financial market. Connectivity with trading partners, investors and financial institutions overseas will increase the demand for international financial services in China and access to the Chinese capital market.

“Shanghai's financial market will become more and more open, more and more international, as a natural part of the process of the internationalisation of the RMB. The pace of the development of Shanghai as an international financial centre will be linked to the pace of the internationalisation of the RMB.”

So, let's review the progress of RMB internationalisation over the past year.

This time last year, RMB deposits in Hong Kong, the offshore RMB centre, stood at roughly RMB89 billion. Today, they stand at more than RMB450 billion.

One year on, we have today a better understanding in the market, both in China and overseas, about the strategic importance of RMB internationalisation. China's policymakers have clearly articulated the vision of this policy in the 12th national five-year plan.

There is a question in many people's mind: With capital controls in place, how could China encourage the use of the RMB as an international currency? The international market now has a better appreciation of how China's policymakers intend to execute this strategy.

Role of the offshore market

The answer lies in allowing the RMB to flow from the Mainland to an offshore market for trade settlement purposes, and for that offshore market to anchor and further develop RMB liquidity there.

An offshore market creates the platform for market forces to build up demand for the RMB as a currency for settlement, funding and investment purposes. Because of Hong Kong's unique position under the one country, two systems arrangement, Hong Kong has developed into the most compelling offshore RMB market.

Development of the offshore market

China's initiative in internationalising the RMB before there is foreign exchange convertibility has no precedent in financial market history. But it turns out to be a successful attempt. Since the last time I spoke here, the pace of the offshore RMB market's development has been breathtaking. Policy encouragement and market forces have worked together to attract RMB to flow offshore, which has naturally led to a host of RMB services being developed, including an offshore interbank market, bank lending, RMB bonds and equity products.

The value of RMB trade settlement conducted through Hong Kong increased from RMB23 billion in the second quarter of 2010 to RMB310.8 billion in the first quarter of 2011. That is a 12.5 times increase, and it is still going strong.

RMB trade settlement is the major source of liquidity for the Hong Kong offshore RMB centre. RMB deposits have registered very remarkable growth, increasing from RMB89.7 billion in June 2010 to RMB451.4 billion as of end of the first quarter of 2011.

The offshore RMB bond market, the "dim sum bonds", took off more recently with a wide range of issuers making use of our platform.

The pace of the offshore RMB market's development has taken the international community by surprise. It reflects a large and healthy offshore appetite for RMB assets, and increasing comfort with the use of RMB in settling trade and investment flows. These are signs that our country's strategy of internationalising the RMB in a gradual manner, even without exchange rate convertibility, could succeed. Of course a lot of work is still ahead of us if we are to sustain the current strength of development.

Shanghai

The internationalisation of the RMB has important implications for Shanghai's development as an international financial centre. First and foremost, RMB internationalisation could not succeed without the support of Shanghai, which has the largest pool of onshore liquidity and is the recognised onshore RMB business centre.

As I have highlighted, the degree to which Shanghai can build an international financial centre directly correlates with the pace of RMB internationalisation. Over the past year, Shanghai's influence in the world market has grown with the rapid development of RMB business, its financial institutions expanding their scope to many parts of the world, facilitating trade and investment.

Capital account convertibility

The question that comes after RMB internationalisation - the one question that is of importance to Shanghai's further development - is when financial portfolio flows will be liberated between the Mainland market and the rest of the world.

The inflow of international capital has many benefits. It can bring about lower costs of capital to China's capital market and build a more diversified investor base. Opening up the capital account also benefits Chinese investors in the opposite direction, by giving them direct access to international capital markets.

Such moves will also bring onshore market valuation in line with the international markets and promote more efficient financial intermediation and innovations.

All along, our country's policymakers do recognise the benefits of some opening up of the capital account, and this is why we saw the creation of the QFII and QDII schemes, even before the start of the RMB internationalisation process.

But the existing schemes are very limited in scope and may no longer fully meet the needs of market development. With RMB internationalisation, isn't it time to consider opening up further and faster?

There is certainly a logical connection between RMB internationalisation and some opening up in the capital account. First, the RMB deposited in the offshore market will need to find their way back to the onshore market, either as FDI or investment in the onshore capital market. Second, as the offshore RMB market develops and we have more experience and confidence in addressing financial security concerns, that will open up more policy room for allowing domestic investors to invest in the overseas capital market.

This is an important issue to consider in terms of the RMB internationalisation strategy. It is even more important for Shanghai. The opening up in portfolio flows will lead to a breakthrough in the development of Shanghai as an international financial market.

In light of the experience gained in RMB internationalisation, the opening up of the capital account in this manner can be done in a gradual and orderly manner. How shall that be done? I am confident we can come up with various schemes if we put our mind to it. But the most immediate and obvious step that is worth exploring is to expand and extend the exiting QDII and QFII schemes. For example, these schemes could be enlarged in terms of the quotas and the number of qualified institutions. Or the definition of qualified investors could be extended to cover professional individual investors, so long as there is adequate investor protection. There could also be additional channels for portfolio investment into the Mainland. Allowing overseas investment in the primary market could offer liquidity as well as international valuation for initial public offerings.

There are also many ways to connect the domestic market with the offshore market. The cross-listing of exchange traded products, such as exchange traded funds (ETFs), is an example. Cross-listing of futures market products is another.

As the offshore RMB liquidity pool grows in size, capital flows are no longer restricted to being denominated in foreign currency. RMB denominated foreign direct investments and QFII represent natural extension of the existing arrangements. These will in turn support the growth of the offshore RMB market, allowing more investment products to be offered to satisfy the demand of offshore investors.

Complementary and interactive relationship

Shanghai is the biggest onshore financial centre and Hong Kong the biggest offshore financial centre of China. With gradual opening of the capital account, we believe there will be increasing interaction between the onshore and offshore pools of funds through intermediation between the two centres. We would both become bigger centres serving national development. In the process, Shanghai markets will be fully internationalised and pricing will be integrated with that of the rest of the world. Last year, I described the relationship between Shanghai and Hong Kong as a set of twin engines propelling the progress of RMB internationalisation forward. In the process of the internationalisation of China's capital market, we will work even more closely.

We look forward to co-operating with Shanghai to contribute to the financial security and the stable economic growth of China. Next week, Hong Kong and Shanghai will embark on a joint roadshow to Indonesia and Malaysia. This is just one of many examples of the co-operation that is going on between Hong Kong and Shanghai to jointly serve our country's development needs.

China will no doubt be taking centre stage as the world's economic and financial powerhouse in the coming decade. Hong Kong and Shanghai, by playing the roles of offshore and onshore markets, will work together to accord the RMB the international status commensurate with China's economic and financial might.

Ends