HSBC

Rising to the Challenge, Shaping a Different Future

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HSBC China Forum
New York City, 1 August 2016

Today I will talk about some of the momentous developments happening in China's economy as well as in its financial system.

I will also talk about how these are shaping the global economy and financial system.

Before I begin, I'd like to draw your attention to Grand Central Terminal, which is located across the street.

As many of you know, Grand Central has more tracks and platforms than any other train station in the world.

Because it's so well connected, more than 750,000 people pass through it on an average day.

750,000 people – that's more than the population of Seattle.

Some of you may be thinking: what does a train station in New York have to do with China?

In some ways China's economic transition is not unlike the development of Grand Central.

You may recall that Grand Central was first a Depot – then a Station – before it finally became a Terminal.

Likewise, China, since it began to "reform and open up" in 1978, has been building more connections – stronger connections – with the rest of the world.

In other words, the tracks are getting longer, and the platforms are getting bigger.

China hasn't yet reached its full potential.

Let me offer you an illustration: China's economy is now the second-largest in the world.

Its GDP is about three-fifths the size of America's, but its GDP per capita is only about one-seventh that of the US.

Clearly, there is plenty of room for catch-up.

But it is precisely because of this that now is the time to better understand it.

HSBC is the leading international bank in China – our presence dates back to 1865 – and we're well positioned to help you identify and capture the opportunities in China.

China recently announced its second-quarter economic data – and they surprised on the upside.

Second-quarter GDP came in better than expected at 6.7% year-on-year.

Retail sales grew by 10.6% year-on-year in June – which was also better than expected.

Worries about China's economic slowdown have dissipated – at least for now.

Yes, last year China's economy grew by "only" 6.9%, its slowest pace in more than two decades.

But even at that rate, it added roughly the equivalent of Turkey to its GDP in 2015.

And it contributed 47% of global GDP growth in the first quarter of this year.

Let me give you two more examples:

In 2015, more passenger vehicles were sold in China than in the US, the UK, Japan, India and Germany combined. And this year, the film "Zootopia" has grossed more than 1 billion US dollars worldwide – with China accounting for almost one-quarter of that.

China is a huge market – and that may be an understatement.

What is more, China's economy is shifting:

- from "blue collar" to "open collar"
- from "low-tech" to "high-tech"
- and from export-oriented to consumption-led

Some of these changes and reforms are creating tougher business conditions in some areas – but they are also opening new opportunities in others.

Last year, for the first time, China's service sector made up more than 50% of the economy.

China has always been known as the world's factory.

But it is now more focused on doing things than making things.

China is also becoming a more consumption-led economy.

Despite the rapid developments over the past three or four decades, the Chinese are still significantly less wealthy than Americans.

As I mentioned earlier, China's GDP per capita is only about one-seventh of that of the US.

But we estimate that by 2025 60-80% of China's urban population will be middle class.

They will increasingly spend more of their income on "discretionary" purchases – also known as the less necessary but more fun things in life.

They will spend more at home, and they will spend more overseas.

The Zootopia box office revenues are a case in point, and they illustrate that for markets like the US, with such an advanced service sector, China represents a massive opportunity.

In 2015, the US and China were each other's largest trading partners.

It is crystal clear that the two countries have well-established trade, investment and people-to-people connections.

And these bonds will only strengthen as China's economy continues to mature.

Now let me turn to China's capital markets.

Let me start with the recent big news.

In June, it was announced that US investors would gain access to China's onshore capital markets via the Renminbi Qualified Foreign Institutional Investor programme – better known as RQFII.

RQFII allows eligible foreign institutional investors to invest in mainland China's capital markets.

The US has been granted an RQFII investment quota of RMB250bn.

That's the second-largest quota in the world; only Hong Kong's is bigger.

When it comes to opening up to global portfolio flows, China has always taken a gradualist approach.

It typically sets up trial programmes; and if and when the conditions are right, it expands their size and scope.

RQFII is one such example.

Hong Kong was the first market to participate in 2011 when RQFII was introduced.

Initially, Hong Kong's quota was set at a modest RMB20bn; now, it stands at RMB270bn, which has been exhausted by strong investor demand since late 2014.

And the programme has been expanded geographically to 17 markets, including South Korea, Singapore, Canada and the UK.

Globally – before the US announcement – the total RQFII quota stood at more than RMB1.1trn.

So the US quota represents a significant increase – more than 20% – in the global quota.

This is a boon for the US, as this is the home of some of the largest institutional investors in the world – and investors are searching for yield in a low-interest-rate environment.

And RQFII is a space HSBC is an expert in.

We rank first in all active RQFII markets in terms of market share and participation.

You can say we've been a helping hand in China's opening-up of its capital markets. Now, it is true that the opening-up still has some way to go: foreign ownership of China's bond and equity markets is less than 2%.

The good news, though, is that China has continued to demonstrate its commitment to driving further financial reforms.

In July last year, the Chinese authorities made it easier for foreign central banks and sovereign wealth funds to buy and sell on China's interbank bond market.

In February this year, they opened the bond market up to "real money investors" – medium- and long-term institutional investors such as foreign banks, insurance companies and pension funds.

Then in April, they announced that other central banks investing in China's bond market would be able to freely remit funds without regulatory approvals.

Last but not least, a Shenzhen-Hong Kong version of the Shanghai–Hong Kong Stock Connect is in the works.

When launched, this will introduce foreign investors to a selection of small, private companies that are the mainstay of China's "new economy".

Another area of financial of reform and opening-up concerns debt issuance.

Recently, China has made it easier for foreign entities to issue what are known as "panda bonds" in China.

These are denominated in RMB; traded on mainland China; but issued by non-Chinese entities.

For foreign issuers, this development means increased access to an as yet nearly untapped source of funding.

The Chinese are some of the most avid savers in the world, and they too are looking to diversify their portfolios.

This is why the panda bond market is something we've been paying attention to.

Last year, HSBC was among the first foreign commercial banks to issue a panda bond.

We were also instrumental in the issuance of the first sovereign panda.

Let me give you a short history of the panda bond market.

The first pandas were issued – on the same day – in 2005 by the International Finance Corporation, which is part of the World Bank Group, and the Asian Development Bank.

Fast forward to 2014: Daimler became the first issuer of a corporate panda.

Then last year saw the first panda from a commercial bank, as well as the first sovereign panda.

The panda bond market has seen a revival: in 2015 companies alone raised more than RMB7bn in panda bonds, which is more than the amount raised during the previous ten years.

In addition, the Province of British Columbia issued a sovereign panda earlier this year.

This issuance sets a benchmark not only for other sovereigns, but also for Canadian – maybe even American – companies.

China's bond market is booming: it's the third-largest in the world, after the US and Japan.

But depending on how you look at it, it's not that big.

If, say, measured by the amount outstanding as a percentage of GDP, China's bond market is smaller than Malaysia's and Thailand's.

Also, China's bond market – unlike, say, South Korea's – is dominated by government bonds.

So China's bond market, in terms of width and depth, has plenty of room to grow.

And this growth has implications for China and the world.

As the door opens wider, foreign investors will receive more opportunities to diversify their holdings.

Similarly, they will have more opportunities to buy into one of the fastest-growing major economies in the world.

We estimate China's economy will grow by 6.7% this year – compared with 1.8% in the US, 1.4% in the euro zone, and 0.6% in Japan.

China's commitment to further open up its capital markets may pave the way for onshore Chinese bonds and stocks to be included in global indices such as MSCI.

This could automatically direct tens of billions of dollars into China's bond and stock markets.

Let me now turn to China's currency.

Effective October 1, exactly two months from today, the renminbi, or the people's currency, will be included in the International Monetary Fund's Special Drawing Rights basket.

It will become the fifth currency in that basket, along with the dollar, the euro, the yen and the pound.

In some ways, this puts the renminbi on par with main reserve currencies such as the dollar and the euro.

And it represents a major step along the renminbi's path from a domestic currency to an international one.

Just over a decade ago, renminbi usage was largely confined to mainland China.

Hardly any of China's trade with the world was settled in renminbi.

Today, the renminbi is now among the top five or six international payments currencies – which more closely reflects China's standing in the world in terms of GDP and trade.

But what does the renminbi's inclusion in the SDR basket mean?

After all, most of us here don't trade in SDR.

The answer is multi-fold.

For those who do trade in SDR – namely, central banks and reserves managers – the SDR decision means that the renminbi's status as a reserve currency is growing.

In a survey conducted by HSBC earlier this year, 32 out of 77 central banks indicate that they invest in RMB – both on- and offshore; this is up from just 3 in 2012.

Also, these central banks believe that the renminbi's share of global reserves will rise to 7% in 2020, and 10% by 2025.

They also say that they may invest up to 6.7% of their reserves in the renminbi by 2025; this is up from 5.5% from the 2015 survey.

They will not all buy renminbi-denominated assets over night, but the trend is clear.

In fact, in June Singapore's central bank announced that it would include renminbi-denominated financial investments as part of its official foreign reserves.

Now for those who don't trade in SDR, the inclusion serves as a sign of long-term quality assurance.

It underlines that the currency is liquid and stable as a store of value.

It gives greater confidence to companies and institutions around the world to settle trade in renminbi and invest in renminbi-denominated assets.

Today, more than 25% of China's trade is settled in renminbi.

We believe this figure will increase to 50% by 2020.

One of the drivers of this growth is to have renminbi clearing banks set up in the US.

We know from other markets – Korea, Singapore, Australia, etc. – that these offshore clearing banks can act as a catalyst to drive further cross-border renminbi transactions.

They can also generate awareness in the business community about renminbi and its usage.

(As reference only: about 30% of Japan's trade is settled in yen; 50-60% of the EU's trade is settled in euro; and 80-90% of US trade is settled in dollar.)

What this means is that international usage will increase – and the renminbi will play a bigger role in your daily dealings.

Just as you would settle transactions in euro or yen or pound, you would, as your businesses and investments in China grow, increasingly settle in renminbi.

In that sense, the renminbi is becoming more like other major trading currencies, and it should be part of your armory.

By transacting in renminbi, you would reduce your foreign-exchange and interest-rate risks.

Other benefits include improved liquidity and cash management as well as improved price transparency.

Being renminbi-ready gives you flexibility in your dealings with your counterparts in China.

Over the past 15-20 minutes, I have talked in detail about the developments happening in China's economy as well as its financial system.

China remains one of the fastest-growing major economies in the world.

Its capital markets are becoming more open – and that's good news for those looking for portfolio diversification or a new source of funding.

And China's currency, the renminbi, is becoming more "international", meaning that it's used more and more on a daily basis.

With an RQFII quota and a clearing bank in the US, there will be plenty of China- and renminbi-related opportunities.

And HSBC is ready to help you identify and capture them.