HSBC

# Rising to the Challenge, Shaping a Different Future

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I understand the building we're in – The PacBell Building – has a long history.

It opened in 1925 and was once the city's tallest skyscraper.

HSBC, too, has a long history in San Francisco.

As some of you may know, HSBC was established in Hong Kong and Shanghai in 1865.

That year, we also set up an agency right here in San Francisco, so we've been connecting our clients in the US with China for 151 years.

We've grown to become the leading international bank in China, and we're well positioned to help you identify and capture the opportunities in the world's second-largest economy.

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

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

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.

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.

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.

China's economy may no longer be growing at double-digit rates, but it doesn't mean China – as the saying goes – "has lost its mojo".

To catch a glimpse of China's future economic development, look no further than the PRD, the Pearl River Delta.

The PRD is the leading economic region in Guangdong province, and is located just north of Hong Kong.

The PRD is now what we like to call the Silicon Valley of China.

But to understand the PRD, we need to first understand Guangdong's recent economic transition.

The province of Guangdong has been front and center of China's economic transformation.

For years – ever since Deng Xiaoping spearheaded China's "reform and opening up" in the late 1970s, Guangdong has been China's leading industrial base.

Garments, toys, shoes, electronics – you name it, Guangdong makes it.

Guangdong has also been China's leading export processing base.

Goods manufactured there are shipped to all corners of the world.

Today, China is the world's largest trading nation – and is America's largest trading partner.

Guangdong accounts for about one-quarter of China's trade – worth about one trillion US dollars.

Recently China has begun moving up the value chain in terms of production – and Guangdong is again leading the charge.

Goods manufactured in Guangdong – especially in the PRD – are increasingly sophisticated.

And they're no longer just items assembled in China on behalf of overseas clients; more and more are designed by Chinese companies.

The PRD is at the heart of this innovation.

Guangdong province is rebalancing towards advanced manufacturing, technology and modern service industries.

Companies are investing heavily in research and development; businesses are pioneering the industries of the future.

The PRD was once labelled "the factory floor of the world"; now, "Silicon Delta" may be a more appropriate nickname.

Internationally active corporate giants such as Huawei and Tencent have their headquarters here; so do plenty of start-ups.

And the PRD's transformation has had strong government support.

The "Made in China 2025" policy aims to promote advanced industries to move China's economy away from the low-value manufacturing model.

As these new industries grow, they create demand for other businesses.

Professional services such as legal and compliance, banking and finance, and logistics are becoming increasingly important.

As I mentioned earlier, 2015 was the first time the service sector accounted for more than 50% of China's GDP.

And one of the targets from the 13th Five-year Plan, which covers the period 2016-2020, is to increase the service sector's contribution to GDP growth to 55%.

China's service economy is now growing much faster than the production sectors.

Services employ more educated and skilled workers; they bring higher income and productivity; and they lead to more consumption and trade.

As a result, the PRD is becoming wealthier.

This newfound wealth is a major reason we at HSBC – and numerous international companies – are heavily focused on the PRD.

The region's economic dynamism, its growing middle class and its increasingly high-tech manufacturing capabilities all make the PRD the place to be.

And Hong Kong has a huge role to play in the PRD's transformation.

Hong Kong is one of the world's most services-oriented economies, and its experience and expertise will be put to great use as the PRD, Guangdong and China increase the size and scope of their service sectors.

In particular, Hong Kong is a leading international financial centre.

It remains an important conduit through which investment capital flows in and out of China.

Hong Kong has always been a testing ground for China's financial opening-up.

We think that the Shenzhen-Hong Kong Stock Connect, for example, is likely to launch later this year.

That would be an expansion of the Shanghai-Hong Kong Stock Connect scheme that was launched in late 2014.

Stock Connect allows investors in Hong Kong to directly buy and sell eligible stocks on the Shanghai Stock Exchange.

It also allows eligible investors on the Mainland to directly trade Hong Kong stocks.

The Shenzhen-Hong Kong Stock Connect will open an avenue for foreign investors to trade in a selection of small, companies, listed on the Shenzhen Stock Exchange, that are the mainstay of China's "new economy".

The Shenzhen Stock Exchange is one of the world's largest stock exchanges – but it has a relatively small global following.

It is home to many Chinese internet, advanced technology and software start-ups.

The launch of the Shenzhen-Hong Kong Stock Connect will mark yet another important step in the evolution in China's financial system.

The past year has been filled with numerous significant developments with regards to the country's capital markets and its currency.

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.

Another exciting area within China's financial system is its bond market.

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.

For foreign issuers, China represents an 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.

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.

So as China's capital markets mature, they will play a bigger role on the global stage.

Let me now turn to China's currency.

Effective October 1, 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 its renminbi-denominated financial investments in its official foreign reserves.

Now for those who don't trade in SDR, the decision 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.

What this means is that as international usage increases, 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 changes happening in China's economy as well as its financial system.

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

The Pearl River Delta, in particular, contains plenty of business opportunities – whether you're in IT, financial services or consumer goods.

China's bond and equity 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.

Thank you.