Renminbi, reform and China’s global future

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One year ago I said that the renminbi mattered and was front page news.

Five years after China resolved to increase the use of its currency to reflect its importance within the global economy, the pace of change meant that it had happened almost beneath the radar of many investors, particularly those outside Asia-Pacific.

I also said that renminbi was increasingly a regular global currency.

Twelve months later, it is even more so today than it was back then.

Onshore and offshore have started to converge, capital flows are increasingly two-way, and the renminbi is increasingly driven by the market instead of Beijing alone.

I want to develop this theme a little more today and to think about the impact of the renminbi in terms of China’s integration with the global financial system.

But I’d like to start with some general observations about the Chinese economy.

There has been a great deal of speculation recently about the implications of slowing growth and a weaker currency and I’d like to put this in perspective.

Ever since China began its current financial reform programme, countless commentators have predicted that China will have a hard landing.

This is totally understandable.

China is trying to shift from break-neck growth to a more sustainable model in a way that no other country has tried to do before.

That it is trying to do so whilst undertaking a comprehensive programme of financial reform only makes that task harder.

As it is, Beijing has managed a gradual deceleration from double-digit growth in a measured and controlled way.

It has avoided reckless reform and quietly but steadily opened China’s markets to outside investors.

And it has started the transition from an economy built on the power of the state to one that relies increasingly on the private sector.

None of this diminishes the fact that China continues to face significant challenges in unwinding local government and shadow banking debt, while simultaneously developing China’s capital markets.

But even in the current challenging growth environment, Beijing retains the necessary tools to manage the transition.

It retains the ability to cut interest rates to keep prices down and increase the credit supply.

It can deliver strong fiscal support for growth.

And moves to bring local government debt back on balance sheet will ease nerves over an imminent fiscal cliff.

If anything, we think that 7 per cent is more a growth floor than a target, and signs indicate that Beijing is preparing to cushion China’s transition through further easing.

I do not believe that China will have a hard landing.
Let’s talk now about the pace of reform. I attended last week the China Banking Regulatory Commission’s International Advisory Council meeting and the China Development Forum in Beijing.

What I know is that China is only part of the way through a reform programme that is ambitious in scale and scope.

Rather than undermining the case for reform, today’s challenges underline the need to continue along the path of reform with both caution and conviction to arrive at what the Chinese leadership term “the new normal”.

China has already made exceptional progress, as reflected in the growing stature of the renminbi.

From a standing start, renminbi is now the world’s number two trade finance currency.

Since 2010, renminbi trade settlement has risen from near zero to 22 per cent of China’s total trade, and we expect it to top 50 per cent by 2020.

In 2014 the renminbi broke into the top five payment currencies in the world for the very first time.

And several central banks already hold the renminbi in their reserves.

2014 saw more market opening, lower capital controls and the roll-out of pilot financial measures worldwide and nationwide.

And the establishment of the Shanghai-Hong Kong Stock Connect shows that financial reform is accelerating, not slowing down.

2015 will be another landmark year.

Last year I revised our prediction for full capital account convertibility, bringing it forward to 2017.

Many saw this as highly ambitious. But China is showing yet again that, if anything, it was not ambitious enough.

Governor Zhou this week promised an accelerated reform programme to make individual cross-border investment more convenient, to make the capital account more open, and to further revise the regulation of foreign exchange.

Beijing now aims for full convertibility not in two years, but in a much sooner timeframe.

Amongst other measures, we expect:

- A deposit insurance scheme in the first half of the year;
- A new stock connect between Shenzhen and Hong Kong;
- International access to domestic corporate bonds through the Shanghai Free Trade Zone;
- New cross-border investment policies and pilot programmes;
- More cutting of red tape to give the market a bigger role in the economy;
- The expansion and merging of the qualified investor schemes;
- And the completion of China’s interest rate liberalisation reform with the final lifting of the deposit rate ceiling.

These will be major steps that will benefit and modernise China’s economy.

Volumes are a good indicator of economic size and importance, but they do not give a clear picture of the true extent of financial and economic integration.

My point here is that there is much more to do. We’ve seen that renminbi internationalisation is a means to an end – not an end in itself.

Increased use of renminbi does not equal widespread adoption. There is much more to be done.
More capital flows do not equate to normal two-way flows based on business need – as yet.

Higher overseas investment does not mean increased business integration – so far.

And greater economic weight does not mean bigger global influence – as yet.

So I want to use my remarks today to think about how integrated China currently is in terms of trade and investment; how ‘normal’ the use of the renminbi has become; and what roles all actors in the global financial system have to play to ensure that true integration happens as swiftly and efficiently as possible.

Let me start with trade – the financing of which has been the raison d’être of HSBC for the last 150 years.

Trade is the main driver of renminbi turnover, but it is also a major driver of financial integration.

Trade builds international relationships. Trade breeds confidence and trust. It increases foreign exchange flows and interconnectedness. And it accelerates currency internationalisation through currency swaps.

The ascent of the renminbi as a trade currency has been swift, as was always likely given its low starting point and the size of China’s global trade network.

What is remarkable is its ability to withstand fluctuation shocks and depreciation speculation.

At the start of 2014, many expected steps to prevent the one-way appreciation of the renminbi to slow the increase in the proportion of China’s renminbi trade settlement, but it continued to rise.

And in January this year, in spite of widespread speculation that the yuan would depreciate further, the proportion of Chinese trade denominated in renminbi hit an all-time high.

This suggests two things - that the renminbi’s use in trade settlement is rooted in genuine trade need; and that it is supported by confidence in the fundamental and relative stability of the yuan.

This is obviously good news and a vote of confidence in the ability of the Chinese central bank to manage the process of currency liberalisation.

But the geographical spread of China’s partners denoting trade in the renminbi remains narrow.

The lion’s share takes place in Hong Kong, with most of the rest taking place elsewhere in Asia.

We see growing interest in Singapore, South Korea, Australia and some European countries, as well as the United States.

But all of China’s major trading partners outside Hong Kong have significant room to increase renminbi trade settlement from its current limited use.

In this sense, the renminbi is not yet as integrated as a trade currency as it could be.

We do expect this to change.

The barriers to expansion will fall as China diversifies its export markets and its products become more widely sought after.

As trade relations with emerging markets deepen, incentives for buyers and sellers to use the renminbi for trade will increase - particularly in industries like higher-end construction and manufacturing, where China has a competitive advantage.

And inertia remains as much of a challenge as economics.

An Australian survey of Australian and Chinese businesses recently found that 70 per cent of Australian corporates were waiting for Chinese firms to request renminbi invoicing and 76 per
cent of Chinese corporates were waiting for Australians to accept it.

This suggests that incentives to change behaviour are not always sufficient to overcome force of habit.

A deeper FX market and a more developed banking sector will also help to reduce transaction cost and improve hedging ability – both of which matter hugely when choosing an invoicing currency.

So in order for renminbi to fulfil its potential and become truly integrated as a trade currency, institutional and investment use of the renminbi has to increase.

Now let’s talk about investment integration.

In this regard, we know that the renminbi is less developed.

So far, much of the emphasis has been on encouraging investment into China rather than out of it.

The various “Q” schemes have opened China’s borders to overseas investment.

The Shanghai Free Trade Zone has trialled experimental initiatives which are being expanded nationwide.

And the Shanghai-Hong Kong Stock Connect has provided direct access to the mainland equity market.

But whilst some of these schemes also promote two-way capital flows, the overwhelming emphasis has been on opening Chinese markets to international investors.

The Shanghai-Hong Kong Stock Connect has set a crucial precedent in terms of direct two-way market access. For the first time, overseas investors have access to Mainland markets and Chinese investors have direct access to Hong Kong without having to first go through the qualified investor schemes.

As you know, retail investors can also now access the A-Share market.

Some have suggested that the unfilled investment quotas show that the Stock Connect has somehow failed to generate interest - but this ignores the Stock Connect’s true value.

Stock Connect has been an invaluable testing ground for direct market access.

It has enabled China to refine the model and remove the grit from the wheels, and the lessons learned will increasingly be applied to other exchanges and asset classes.

A new Stock Connect between Shenzhen and Hong Kong has already been announced.

But equities are just one tributary of a far larger potential flow of capital, including derivatives, bonds and foreign exchange.

This is not well known outside China, but China has four of the world’s largest derivatives exchanges and one of the largest bond markets in the world, but foreign participation is low to non-existent.

Expanding access to these instruments using the Stock Connect model would represent a new milestone in the development of deeper and more diverse capital markets.

China’s share of the global FX market has also increased by more than seven times in the last ten years, but it still lags behind China’s rising economic power.

Opening up the FX market carries risks, but controlled exposure to overseas investment through a Hong Kong market with seven times the global market share of China is both prudent and practical.

As these markets open up, the prospect of inclusion in benchmark indices will grow more real, which in turn will boost capital and liquidity and, by its nature, increase integration.
China outbound initiatives, which have gathered some pace over the last 12 months, also help economic integration.

Integration means capital going out of China as well as in.

Opening the door to greater capital outflows is an essential next step in the development of the renminbi as a global currency.

China accounts for 12 per cent of global GDP, with some 4 trillion dollars of foreign exchange reserves.

But China’s direct and portfolio investment assets account for only 6 per cent of the world’s total overseas direct investment.

The signs are that this is beginning to change.

In 2014, non-financial foreign direct investment into China grew by 1.7 per cent year on year, whilst overseas direct investment grew by 10.9 per cent.

Nearly 30 per cent of China’s ODI is now denominated in renminbi, up from 15 per cent in 2013.

And at the current rate, China’s ODI could surpass its non-financial FDI as soon as the second half of 2015.

This is striking for two reasons.

First, it indicates that China’s capital flows are moving increasingly naturally in both directions.

Second, China’s policymakers are not just content to let it happen, they’re actively encouraging it.

It is perfectly normal for an economy with an open capital account to have larger, more volatile two-way capital flows.

When conditions change, so does investor behaviour.

Beijing also realises that greater outflows are a necessary component of China’s integration into the global financial system.

Liberalisation of finance rules, private sector guidance and targeted use of foreign exchange reserves for overseas investment are all geared to expand opportunities for Chinese firms wishing to invest abroad.

The “One Belt, One Road” programme will increase infrastructure capacity in strategic trade markets while increasing export demand in China’s most competitive industries.

By using its foreign exchange reserves China will generate a better yield. But it will also create demand for exports, absorbing excess capacity in the Chinese economy and helping to sustain economic and employment growth at home.

Much of this will inevitably be denominated in renminbi.

China is also supporting its companies going out, increasing their appetite for technology, brands and resources.

The pattern of China’s ODI – once narrow – is growing increasingly diverse. As China’s ODI grows and matures, it is likely to become more diversified sectorally as well as geographically.

Historically, finance and energy are still the primary target sectors, but firms are increasingly diversifying into agriculture, consumer goods and real estate.

This means more than just financial integration – it means integration across cultures, across industries and across markets.

This process is being supported by the development of offshore markets and their increasing integration not just with China, but with each other.

The offshore market continues to mature.
We estimate that European trading of the yuan is now nearly half that in Asia, while international renminbi payments between offshore trading centres outside of Hong Kong have grown by more than eight times in the past two years.

So it’s starting to happen, but there’s a lot further to go.

Previously the offshore market was dominated by one-way flows which were policy driven or based on appreciation expectations.

Now we see more and more round-trip flows backed by compelling business rationale.

And the number of hubs increased further in 2014, increasing time-zone coverage and boosting liquidity.

With this week’s announcement of a new clearing bank in Canada and the growth in stature of renminbi centres in all regions, the renminbi is on the verge of becoming a truly 24 hour currency.

What all this shows is that integration is increasingly advanced, but it remains a very big work in progress.

It’s also clear that multiple actors have a role to play to make integration happen quickly and effectively.

The barriers are not simply financial – they are human, social and institutional.

For China, the challenges are to remove the remaining barriers to an open capital account, unlock the doors to greater two-way capital flows, and encourage companies to invest overseas.

The ongoing reform process is dismantling the remaining controls, while the “One Belt, One Road” plan will increase cultural and business integration between Chinese companies and their equivalents in other countries.

This process will continue to accelerate.

For banks like HSBC, there is a role in helping clients break the ingrained habits that hold them back, while avoiding the pitfalls of early adoption.

The greatest barriers to Chinese companies “going out” are cultural rather than financial. Therefore the global financial industry has a responsibility to use its experience and knowledge to help Chinese firms to overcome unfamiliar obstacles.

We also have a responsibility to innovate to meet client demand for renminbi products and to identify demand where it might not otherwise be apparent.

One example is the green bond market. This is an area in which HSBC has taken a special interest because we recognise both a market demand and a real economic need.

Global green bond issuance tripled in 2014 and it will continue to expand.

We expect total green bond issuance in 2015 to reach 100 billion dollars, with significant growth coming from China.

China’s huge pool of savings and limited investment opportunities create the perfect match for the development of a corporate green bond market, which would in turn accelerate the creation of deeper and more effective capital markets.

HSBC recognises the role that we have to play, not only in developing this growing market, but in popularising the issuance of green bonds in renminbi.

That’s why last year HSBC worked with the International Finance Corporation to issue the first offshore renminbi-denominated green bond.

For national governments and central banks, the challenge is to engage with China to develop the infrastructure to allow two-way investment to take place as the onshore and offshore markets converge, as they inevitably will, and also to build the links between renminbi hubs to expand...
renminbi-denominated trade and investment between offshore centres.

They also face the challenge of overcoming the political barriers that stand in the way of China’s global integration.

It is perhaps unsurprising that some western nations have responded cautiously to the establishment of new institutions by China to help it deliver the aims of the “One Belt, One Road” plan.

But if the west wants China to integrate fully and swiftly, then it needs to work with China to adapt its systems and increase transparency.

What is increasingly clear is that while some institutions have been slow to accommodate China’s status as the world’s second biggest economy, the rest of the world is getting on with the process of establishing closer financial and political links with China through its currency and institutions.

The applications of the British, German, French and Italian governments to join the Asian Infrastructure Investment Bank are a striking acceptance of the principle that you improve institutions through participation, not isolation.

This is a highly positive step for China’s global integration.

I want to say a final word on the position of the renminbi as a global currency.

The question I get asked most about the renminbi is whether it will overtake the US dollar as a global currency any time soon.

The answer is simple but also quite complex. It won’t. But that isn’t to say that it won’t – and doesn’t – increasingly represent a viable alternative.

There are milestones that the renminbi has yet to pass, such as inclusion in the IMF’s Special Drawing Rights basket.

All of these would accelerate the renminbi’s adoption, but by and large the markets aren’t waiting for that to happen.

They are already deciding that the renminbi is a viable global currency and are using it to diversify both for stability and yield.

Investors want an alternative to the dollar and the renminbi is still more stable than many other currencies around the world.

The renminbi may not become a reserve currency any time soon. But it will absolutely play an integral role in global financial markets.

I personally believe we will move to a system where there are three reserve currencies – the US dollar, renminbi and euro – and that it is naïve to believe that the renminbi will replace the US dollar. Instead, I believe we will have a three reserve currency system.

China has some way to go to achieve full integration into the global economy, but the conditions for it to get there are increasingly present, and the pace of change is accelerating.

China is doing its part. Capital controls are lifting, onshore and offshore markets are starting to converge, and two-way capital opening is progressing apace.

But China cannot do it alone.

Global and central banks, national governments and international institutions all have a part to play by inviting China to play a fuller role in the global economy.

If they do so successfully, we will all benefit.

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2 Dalian Commodity Exchange; Shanghai Futures Exchange; Zhengzhou Commodity Exchange; China Financial Futures Exchange.