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Contents

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Offshore RMB Market - 2021 Review and Outlook

In 2021, Covid continued to affect global businesses and RMB businesses. This year, RMB exchange rate fluctuated widely in both directions but remained largely stable. The offshore RMB market continued to develop steadily despite the market volatility. While there were fluctuations across various business indicators, the overall trend was positive with a healthy growth of the RMB funding pool. The Connect Scheme achieved a major breakthrough with its new southbound Bond Connect, strengthening Hong Kong as the offshore RMB business hub. With further opening up of China's financial markets, global investors continue to increase RMB asset holdings, offshore investors holdings of China bonds surpassed RMB 4 trillion, while Bond Connect transactions volume reached a record high.

I. Offshore RMB market saw steady development in 2021

1. The RMB exchange rate rose steadily with two-way fluctuation

The RMB exchange rate in 2021 can be divided into four phases. In the first phase, the RMB exchange rates came under pressure from the beginning of 2021 to the end of March due to US economic recovery, appreciating DXY, and narrower US-China yield spread. RMB depreciated to 6.5713, the lowest point of the year. In the second phase, the RMB exchange rates rebounded from the end of March to the beginning of June, as China demonstrated resilience in export under the global Covid resurgence. The RMB appreciated to 6.3572 on 1 June, the highest in the first half of 2021 because of relatively attractive RMB assets and weakening DXY. In the third phase, RMB experienced volatility from June to the end of September, as the US and Europe started to recover from economic downturn. Meanwhile, China increased Required Reserve Ratio for foreign currency deposits as a supportive measure to RMB. In the fourth phase, RMB exchange rate strengthened from the end of September to the end of December, showing signs of decoupling with USD.

On 31 December, CFETS set USDCNY fixing rate at 6.3757, appreciating 2.29% compared to beginning of the year. According to Bloomberg, USDCNY closed at 6.3561, appreciating 3% compared to beginning of the year; USDCNH closed at 6.3571, appreciating 2.24% compared to beginning of the year.

2. Major offshore RMB indicators hit record highs

In 2021, while there were fluctuations across RMB business indicators, the overall trend was positive with some indicators hitting record highs. According to HKMA, as of the end of November2021, Hong Kong's RMB deposits reached RMB 868.7 billion, , up 20.4% YoY, recorded positive growth for 5 consecutive years, rebounded 70% from the lowest in March 2017.anHong Kong's RMB loans balance was RMB 188.2 billion, up 2.2% mom, an increase of 23.8% compared to end of 2020.

According to Bloomberg, as of the end of December 2021, central bank notes continued to support offshore bond markets. Bond issuance in the primary market amounted to RMB 169.6 billion (including RMB 120 billion central bank notes and RMB 14 billion treasury bond issued in 2021), decreasing 10% compared to RMB 188.8 billion (including RMB 155.5 billion central bank notes and RMB 5 billion treasury bond issued in 2020)in 2020. The main reason of the decrease was due to the rolling expiration of the central bank bills and the issuance scale of non-sovereign issuers increased by 23.5% compared with 2020. RMB settlement in cross-border trade marked record highs again, amounting to RMB 6.38 trillion in total in 2021, an increase of 10.1% over the same period last year. According to HKICL, total turnover of RMB RTGS system in 2021 reached RMB 357.7 trillion, an increase of 26.6% over the same period last year, indicating that the Hong Kong's RMB funding pool continues to support a large number of financial activities.

3. RMB's share of global foreign reserves hits historic high level

With the increased willingness of foreign central banks to hold foreign exchange reserves in RMB, the status of RMB as an international reserve currency has been gradually established. The latest data released by the IMF (COFER) report shows that as of 3Q 2021, RMB reserves rose to USD 318.99 billion, an increase of USD 47.5 billion from the end of 2020, accounting for 2.66% of the total allocated foreign exchange reserves, higher than 2.61% of previous quarter, the highest level since IMF started reporting RMB reserve assets in October 2016.

According to SWIFT, RMB climbed its position as the fourth most used currency in December 2021, increasing from 2.14% of all global currency payments in November to 2.7% in December 2021, second only to the USD (40.51%), EUR (36.65%) and GBP (5.89%). RMB was the first time climbed over JPY (2.56%) to be the fourth most used currency since the RMB reform in August 2015 (Historical high was at 2.79% in August 2015). Meanwhile, RMB payments value increased by 34.60% compared to November 2021, whilst in general all payments currencies increased by 6.44%.

4. Offshore investors continue to increase holdings of RMB assets

The bond yields of global bonds fell dramatically as a result of global major central banks continues to adopt loosen monetary policies. Meanwhile the RMB assets has a low correlation with asset prices and return in developed and emerging economies, attracting foreign investors to invest in RMB bonds.

As of December 2021, foreign investors' RMB bond holdings reached historical high at RMB 4 trillion, increasing from 3.25 trillion at the end of 2020. Proportionally, foreign holding in RMB bond increased from 3.2% at the end of 2020 to 3.5% at the end of 2021.

By the end of December 2021, a total of 1016 foreign institutional investors entered into China market, increased from 905 at the end of 2020. According to Bond Connect, by the end of December 2021, 3233 foreign investors entered into China market through Bond Connect, increasing 37.5% from end of 2020.

Trading remained active with foreign institutions. In December 2021, the total trading volume of foreign institution in the inter-bank bond market reached about RMB 934.5 billion with a daily trading volume of 40.6 billion, increasing 20% YoY. In 2021, Bond Connect recorded a total of 73,929 transactions with a total trading volume of RMB 6.4 trillion, increasing 33.1% compared to 2020.

Foreign holdings of stock and bond market accounted for 3% to 5%, a relatively low proportion comparing to some developed economies and emerging economies, such as Japan, South Korea, Basil. With a relatively low foreign holding, there is room for potential growth.

II. The internationalization of RMB has entered a new period of opportunity in 2022

RMB internationalization has entered a new period of opportunity in its second 10 years. Offshore markets are more willing to accept and use RMB, while overseas central banks and institutional investors continue to increase RMB assets holdings. Looking ahead to 2022, the internal and external environments remain stable for developing RMB business in Hong Kong.

The RMB exchange rate became more flexible with two-way fluctuations. Going forward to 2022, there is some depreciation pressure on the RMB exchange rate, but the range of retracement will be relatively controllable, and two-way fluctuations will be more obvious. Internally, China's economic growth will slow in 2022. In the case of further repair of foreign supply capacity, it is highly likely that export growth will decline, and China's current account surplus will narrow. Second, the possibility of rising inflation in the future has increased with increasing economic uncertainty next year. Externally, with the acceleration of economic recovery in the United States and monetary policy normalization, the interest rate spreads between China and the United States will further narrow, which will support the strengthening of the DXY and cause some depreciation pressure on the RMB exchange rate. The main factors supporting the RMB exchange rate are provided below. First, steady progress has been made in the liberalization of China's financial market, making RMB assets more attractive. Second, the Chinese economy is still resilient. The government has sufficient policy regulation tools and the central bank emphasizes expectation management, which helps market subjects rationally understand the exchange rate market fluctuations and makes the RMB exchange rate fluctuate in both directions within a reasonable range.

RMB policies are becoming more open to meet diverse needs of international investors. The 14th five-year plan clearly states that, China aims to promote the internationalization of its currency, the RMB, in a steady and prudent manner. The country will stick to the market-driven approach, allow companies to make their own choices, and create a new type of relations of mutually beneficial cooperation based on the free usage of RMB. At the beginning of 2021, six government departments jointly issued "Notice on Further Optimising Cross-border Renminbi Policy and Supporting the Stabilisation of Foreign Trade and Foreign Investment".

This move clarify the policies ideas and gradually increase support for cross-border RMB activities and investments in RMB assets, also to further optimize and improve the policy framework for the use of RMB, showing a strong policy synergy. RMB assets have become more attractive, and the allocation of foreign capital to RMB assets has grown rapidly. From 2018 to 2021, foreign investment increased net holdings of domestic bonds and stocks by more than us $700 billion, with an average annual growth rate of 34 percent.

The use of the RMB as an international currency will continue to increase. In recent years, China has established cooperation with neighboring countries and regions (such as “Belt and Road” countries, South East Asia and the Greater Bay Area), increasing offshore investors and users’ demand on RMB and RMB denominated assets. Most “Belt and Road” countries have established monetary cooperation relationships with China, including the appointment of RMB Clearing Banks, the signing of currency swap agreements, etc. Countries such as Indonesia has established Local Currency Settlement (LCS) to reduce dependence on USD, benefiting international use of RMB, and promoting positive synergy between RMB internationalization and the Belt and Road Initiative.

Hong Kong will continue to function as an offshore RMB hub. Over the years, the RMB has been widely accepted by the market. Last year, the PBOC further optimized cross-border RMB policies, and the RMB exchange rate remained stable at a reasonable and equilibrium level. We observed that offshore enterprises and institutions, especially Chinese enterprises in Hong Kong, has significantly increased the proportion of RMB settlement in their cross-border business activities. Hong Kong has established various mutual market access programs with the Mainland, such as Shanghai-Hong Kong Stock Connect, Shenzhen-Hong Kong Stock Connect, Bond Connect, Wealth Management Connect and Gold Connect etc. It will further attract global institutional investors to use Hong Kong as a platform to invest in RMB assets, and drive the development of other ancillary RMB businesses. As the coming year 2022 will mark the important occasion of the 25th anniversary of Hong Kong's return to the Motherland, we believe that the upcoming policies and initiatives will cement Hong Kong’s position as the global offshore Renminbi business hub, and Hong Kong’s offshore RMB business will further progress in 2022.

RMB Internationalization Updates

Six Chinese government departments reunited to optimize cross-border RMB policies

The PBOC, MOFCOM, CBIRC, SAFE and NDRC jointly issued the "Notice on Further Optimising Cross-border Renminbi Policy and Supporting the Stabilisation of Foreign Trade and Foreign Investment".

HKEX launched Mini USD/CNH Futures

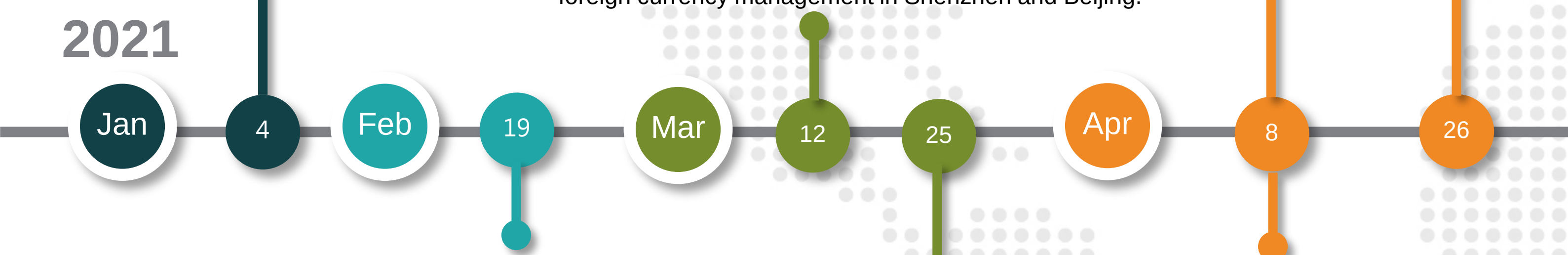
HKEX launched a cash-settled Mini USD/CNH (US dollar/Offshore Renminbi, or RMB) Futures contract. This product was well received by the market with open interest of 9025 contracts

Measures unveiled to relax Hainan market access

China rolled out 22 measures aimed at relaxing market access in the Hainan Free Trade Port, to facilitate the free flow of key production factors and cultivate industries with comparative advantages.

China pilot cash-pooling service integrating local, foreign currency management

PBOC and SAFE launched a pilot cash-pooling service for multinational companies that integrates domestic and foreign currency management in Shenzhen and Beijing.



PBOC issued RMB 25 bn central bank bills in Hong Kong

RMB 10 bn worth of bills will mature in three months, with interest rates at 2.7%; RMB 15 bn worth of bills will mature in one year, with interest rates standing at 2.74%. The total bid amount reached about RMB 76 bn.

China interbank market launched CDS index

CFETS and SCH jointly issued a notice, launching trading and clearing services for China's first credit default swap (CDS).

ISDA and CCDC: Use of RMB bonds as margin for derivatives transactions

PBOC and CCDC published a whitepaper — Use of RMB-denominated Chinese Government Bonds as Margin for Derivatives Transactions, that analyses the use of RMB bonds as initial margin.

PBOC issued RMB 5 bn central bank bills in Hong Kong

PBOC issued RMB 5 bn six-month central bank bills in Hong Kong, with interest rates standing at 2.6%. The total bid amount reached about RMB 25 bn.

Agricultural Development Bank of China undertook trial bond tender for foreign investors in Shanghai

ADBC undertook its first trial issue of RMB 6 bn in one-year bonds via tender directed at both domestic and foreign investors. The issue rate was 2.49%, with subscription ratio of 11.55.

PBOC issues RMB 5 bn bills in HK

PBOC issued RMB5 bn 6-month central bank bills in Hong Kong, with interest rates standing at 2.54%.

Mainland signals Wealth Connect with HK nearing kick off

6 regulators co-released a detailed set of instructions for public comment on Wealth Connect.

PBOC issued RMB 25 bn of bills in Hong Kong

PBOC issued RMB 25 bn of bills. 10 billion of bills will mature in three months, and RMB 15 bn of bills will mature in 12 months. The total bid amount reached approximately RMB 68.2 bn.

PBOC raised Reserve Requirement Ratio for foreign currency deposits

PBOC announced the increase in the required reserve ratio on foreign exchange deposits in financial institutions to 7 percent from 5 percent, to adjust forex liquidity in financial institutions.

28 May 6 21 25 31 Jun 24

Shanghai aims to be Global Wealth Hub

Shanghai municipal government issued a guideline for Shanghai to grow into an important asset management hub in Asia and a leading global asset management center by 2025.

24

PBOC issues RMB 5 bn bills in HK

PBOC issued RMB5 bn 6-month central bank bills in Hong Kong, with interest rates standing at 2.54%.

Jul

9

China freeing up RMB 1 tn to support businesses

PBOC confirmed that it will cut the reserve requirement ratio (RRR) for financial institutions by 0.5 percentage points from July 15.

15

Pudong issued 27 regulations to promote higher standards of reform and opening up

The party central committee and the State Council issued the about support high standards of Pudong new area of reform and opening up to build the opinion of socialist modernization led area.

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People's Bank of China released White Paper on China's Digital renminbi

PBOC released a white paper on China's digital Renminbi research and development. The central bank will continue to steadily push forward the digital RMB research and development pilot.

23

Macao has issued its first domestic renminbi bond

Macao International Bank issued the first RMB 1.5 bn panda bond in the Chinese interbank market, with an interest rate of 3.28% and a subscription ratio of 3.53 times.

The People's Bank of China issued RMB 25 bn bills in Hong Kong

PBOC completed the issues of RMB 25 bn worth of central bank bills in Hong Kong. 10 bn yuan worth of bills will mature in three months, and another RMB 15 bn will mature in one year.

HKEX to launch derivatives product on new MSCI China A 50 connect index

HKEX launched its first A-share derivatives product on MSCI China A 50 Connect Index, tracking performance of 50 Shanghai and Shenzhen stocks available via Stock Connect.

China and Indonesia implemented LCS

PBOC and Bank Indonesia launched LCS. The central banks of China and Indonesia have appointed Bank of China and Bank of China (Hong Kong)'s Jakarta branch as the cross-currency dealers.

The CPC Central Committee and The State Council issued "Hengqin Plan" and "Qianhai Plan"

two plans were announced to further develop the Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone and build a new cooperation zone in Hengqin.

China launched the Southbound Bond Connect to facilitate investment

China launched the Southbound trading. On the first trading day, more than 40 mainland institutional investors and 11 Hong Kong market makers completed more than 150 bond transactions with a trading volume of about 4 billion yuan.

The People's Bank of China issued renminbi bills in Hong Kong

PBOC completed the ninth issue of 5 billion yuan six-month renminbi central bank bills in Hong Kong, with an interest rate of 2.5%. The total bid amount reached about RMB 27.8 bn.

Aug 20 Sep 2 5 6 10 24

China set to open new stock exchange in Beijing

The new stock exchange in Beijing is expected to be a major base for serving innovative small and medium-sized enterprises.

China launched cross-boundary Wealth Management Connect scheme in the Greater Bay Area

Wealth Management Connect scheme created new business opportunities for the financial industries in the three places.

Oct

12

Shenzhen bond debut in HK seen as milestone

Shenzhen government became the first municipal government from the mainland to issue an offshore renminbi bond in Hong Kong and Macau as a major step in the financial opening-up.

18

Landmark cross-boundary wealth management connect saw solid start

The WMC pilot program in the GBA saw solid results on its first day of operations, with a strong demand for cross-boundary wealth management products.

21

MOU signed to boost fintech regulation in Greater Bay Area

By signing the MOU, they have agreed to link up the PBOC's Fintech Innovation Regulatory Facility with the HKMA's Fintech Supervisory Sandbox.

Nov

1

China officially applied to join Digital Economy Partnership Agreement

China has officially applied to join the DEPA to strengthen international cooperation on digital economy.

17

Finance ministry sold RMB 6 bn worth of treasury bonds in HK

The finance ministry sold two-year, five-year and 10-year yuan-denominated government bonds worth a total of RMB 6 bn(USD 941.00 mn) in Hong Kong on Nov 17.

22

China extended the preferential tax policy for foreign investors participating in the domestic bond market

The extension will help attract more foreign capital by temporarily exempting the enterprise income tax and value-added tax for bond interest income.

Dec

14

Myanmar accepted RMB as official settlement currency for border trade

Myanmar’s central bank has accepted RMB as the settlement currency for border trade with China. Qualified banks to open RMB account for cross border importers and exporters.

15

China's central bank announced reserve requirement ratio cut

PBOC cut RRR by 0.5% for financial institutions to support the development of the real economy. The weighted average RRR for Chinese financial institutions will stand at 8.4%.

China raised requirement ratio for foreign currency deposits

PBOC raised the RRR for foreign currency deposits by 2 percentage points from the current 7 percent to 9 percent.

SAFE granted fresh quotas in ODII

Up to 15 December 2021, SAFE has granted a total of USD 157.5 bn quotas to 174 ODII investors.

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PBOC issued RMB 5 bn central bank bills in Hong Kong

PBOC issued RMB 5 bn worth of central bills in Hong Kong, with an interest rate of 2.5%. the total bid reached 4.4 times of the issuance.

23

SAFE said to support offshore international trade development

PBOC and SAFE co-issued a notice to support the development of new model of international trade, effective on 24 January 2022.

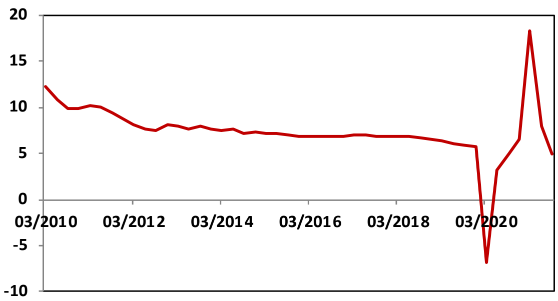
5% to 5.5% Growth in 2022?

Ricky Choi, Principal Economist

After China's economy recovered strongly since 2H 2020, the growth momentum of different economic activities recorded deceleration starting from Q3 2021. Except the external demand held up relatively well, China's activity indicators highlighted slowing domestic demand, as indicated by subdued consumption and service sector performance and further slowing in fixed investment and industrial activities. The slowdown was mainly driven by the fading base effect, regional outbreak of virus variants, tightened mobility restrictions, domestic and global policy normalization, regulatory changes in numerous sectors, gradual reopening of global economic activities, etc.

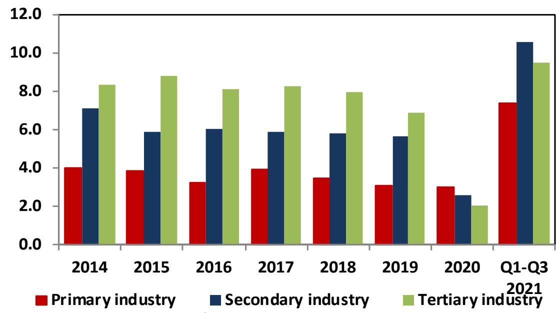
In real GDP terms, China economy slowed from 18.3% in Q1 2021 to 7.9% and 4.9% in Q2 and Q3 2021, against a fading base effect of -6.8%, 3.2% and 4.9% between Q1 and Q3 in the previous year. Taking the first three quarters as a whole, China economy expanded by 9.8% YoY in real terms. The two-year average decelerated to around 4.9% YoY in Q3 2021, 0.6 percentage point lower than that of Q2 2021, indicating the pace of China economic growth was still short of its pre-pandemic trend of 6% to 6.5%. In nominal terms, China economic growth recorded 9.8% and 14.4% YoY in Q3 and the first three quarters of 2021 respectively. On a quarter-to-quarter basis, China economy edged 0.2% higher in Q3, down from 1.2% growth in Q2, extending the positive growth trend into the sixth consecutive quarters.

Exhibit 1. Real GDP growth (YoY%)



Source: National Bureau of Statistics, BOCHK Financial Research Institute

Exhibit 2. Real GDP growth by industry (YoY %)



Source: National Bureau of Statistics, BOCHK Financial Research Institute

In terms of economic sector, the growth momentum has returned to more normal level and evenly spread across different sectors. The growth of service industry (+5.4% in Q3 and +9.5% in the first three quarters) outpaced that of manufacturing (+3.6% in Q3 and +10.6% in the first three quarters), while agriculture stayed solid (+7.1% in Q3, and +7.4% in the first three quarters). However, the recent development in housing tightening and power shortages as well as virus-related mobility restrictions and regulatory changes in new economy sectors could continue to affect the development of both manufacturing and service sectors ahead. According to the value-added data by economic sectors, there were some differentiation among economic sectors, with construction (-1.8% in Q3 and +4.3% in the first three quarters) and real estate (-1.6% in Q3 and +8.2% in the first three quarters) lagged behind, while information transmission, software and information technology services (+17.1% in Q3 and +19.3% in the first three quarters), wholesale and retail trades (+7.6% in Q3 and +13.5% in the first three quarters), transport, storage, and post (+5.9% in Q3 and +15.3% in the first three quarters), and renting and leasing activities and business services (+5.8% in Q3 and +6.5% in the first three quarters) continued to take the lead in recovery.

In the first three quarters of 2021, China's economic growth rate jumped 9.8% YoY in real terms, i.e. a two-year average growth rate of 5.2%, a significant achievement during COVID-19 pandemic. China's economic structure continued to improve. First, the value-added of service industry contributed 54.2% to the overall economic growth in the first three quarters of 2021, 1.2 percentage points higher than that of 1H, and the manufacturing industry contributed 27.4% to the overall GDP growth in the first three quarters, 1.1 percentage points higher than 1H. Second, the role of consumption has strengthened, even though the retail sales recovery has lagged that of investment and industrial production, due to the impact of regional virus clusters, stringent pandemic control and social distancing measures, and lagging household income and employment growth. Final consumption expenditure contributed 64.8% to the overall economic growth in the first three quarters, 49.2 percentage points higher than the total capital formation, with upgrading in consumption and high-tech activities improving rapidly.

Merchandise exports continued to stay strong despite fading base effect. Taking the first eleven months together, it increased 31.1% YoY, driven by higher export value, trade flow diversion, and robust global demand ahead of the holiday season. The growth of merchandise imports was largely in line with that of exports in 2021. Taking the first eleven months together, the growth of merchandise imports increased 31.4% YoY, reflecting elevated commodity prices and higher coal demand for electricity production. All in all, the merchandise trade surplus widened to US$ 581.7 billion in the first eleven months of 2021, better than US$ 459.9 billion surplus in the same period of 2020, providing solid support for GDP growth in 2021.

Meanwhile, the three major economic indicators, including fixed asset investment, industrial value-added and retail sales recorded some payback in the past few months, due to the fading base effect, policy normalization, regulatory changes, and regional outbreak of pandemic, etc. With all these indicators still posted positive growth over a two-year period, they have decelerated to below trend growth before the pandemic. Driven by the low comparison base, solid external demand, sustainable work resumption and economic recovery, industrial production posted strong recovery after the pandemic hit. It then decelerated gradually in the past few months, rising 10.1% YoY in the first eleven months of 2021, equivalent to an average two-year growth of 6.1%, outperforming 5.7% growth in 2019. Fixed asset investment came in below expectation, decelerating notably from 25.6% YoY in Q1 to 5.2% YoY in the first eleven months of 2021, equivalent to a two-year average growth of 3.9%, and lower than the 2019 full year growth of 5.4%. The single month YoY growth should have slowed to a moderate contraction recently. Earlier this year, the relatively fast recovery of fixed asset investment was driven by effective pandemic control, successful work and production resumption, though it was increasingly offset by the lagged fiscal policy support, such as a slower start of special local government bond issuance and lower than budgeted fiscal expenses, seasonality factor, de-carbonization effort, energy outage, weakening housing market sentiment and continuous housing policy tightening, etc.

Consumption and services sector lagged that of industrial production and investment, dragged down by the lack of direct government fiscal support to the household sector, renewed regional pandemic outbreak, tightened mobility restrictions, and slowly improving employment and income condition. In the first eleven months of 2021, retail sales and index of service production grew 15.4% and 14.0% YoY, equivalent to an annual average growth of 4.0% and 6.0% over the past two years, lower than 8.0% and 6.9% growth in 2019 respectively. It is obvious that consumers are holding back spending and the momentum of shifting from goods to service is delayed, because of the regional outbreak, tightened mobility restrictions, and the lingering pressure on income and employment market outlook.

Supporting real economic growth in 2022

Moving into 2022, a modest recovery in quarter-to-quarter terms is expected, though there could be some slowdown in year-on-year terms, amid a higher comparison base. First, further recovery of consumption and service sector after the recent regional outbreak is under controlled and the local mobility restrictions are released. The sustainable recovery in both consumption and service sector will still hinge on the pandemic condition as well as the pace of household income recovery, with both surveyed unemployment rate and household income recorded improvement over the past months. Second, fixed investment activities are expected to differentiate going ahead, with further slowdown in real estate activities are expected amid weakened sentiment on concerns over housing-related policy and credit tightening, developers' fiscal condition, and the upcoming expansion of property tax pilot program, etc. However, manufacturing and infrastructure investment are expected to improve further ahead, with the former driven by the recovery of global and domestic demand, and some relaxation of energy consumption control, while the latter will be supported by some easing of fiscal condition and the stronger demand for upgrading energy and green investment. Finally, some modest payback in the export front is expected amid higher comparison base and gradual reopening of manufacturing facilitates around the globe, though export growth is still believed to stay solid in the near-term. All in all, the rotation of growth contribution from investment to consumption, from manufacturing to services will continue, and the overall growth momentum will stabilize or pick up slightly ahead, driven by some easing of credit drag, steady recovery in domestic consumption, and positive global demand condition, etc. The recent virus outbreak and regulatory changes are not expected to have meaningful impact on the overall growth performance.

The annual Central Economic Work Conference (CEWC) was held in Beijing on 8-10 December, with the top leaders reviewed the country's economic situation in 2021, and analyzed the economic outlook and decided on the key tasks for 2022. It emphasized three layers of pressure faced by the Chinese economy, i.e. shrinking demand, supply shock and weakening expectations, amid a more complex and uncertain external environment. Policy should promote high-quality development and maintain reasonable growth, but the exact numeric target will only be announced in the National People's Congress in March 2022. It called for adhering to the overarching objective of seeking progress while maintaining stability, fully, accurately, and comprehensively implementing new development concepts, accelerating the establishment of new development pattern, comprehensively deepening reform and opening up, adhering to innovation-driven development, promoting high-quality development, and supply-side structural reform as the main pillar. Well coordinate between epidemic prevention, economic and social development, and security, continue to do a good job of "six stability" and "six guarantees", improve people's livelihood, focus on stabilizing the macro economy, maintain economic operations within a reasonable range, and overall social stability.

Stability will be of top priority for 2022's economic work, with progress to be made while maintaining stability. All local governments must take up the responsibility of stabilizing economic performance, with all of them must actively introduce and appropriately frontload their policies that are conducive to economic stability. Macro-policies must be stable and effective, and continue to implement a proactive fiscal policy and a prudent monetary policy. A proactive fiscal policy must improve efficiency, secure the bottom line of three guarantees at the grassroots level, and pay more attention to precision and sustainability. It is necessary to ensure the scale and pace of fiscal expenditures, through implementing new tax and fee reduction, strengthening support for SMEs, self-employed businesses, manufacturing, and risk resolution, and frontloading infrastructure investment. The government authorities should adhere to strict financial discipline, with a reasonable quota and allocation plan for 2022 based on the actual condition of each region and coordinated regional development requirements, and seriously curb new shadow local government debts.

A prudent monetary policy must be flexible and appropriate to maintain reasonable and sufficient liquidity. It should also facilitate financial institutions to enhance support for the real economy, especially SMEs, technology and innovation as well as green economy, etc. The fiscal and monetary policies must be well coordinated, with both cross-cyclical and counter-cyclical policies to be well collaborated. Policies to support enhancing domestic demand strategy and internal development will also be implemented. Specifically, the People's Bank of China (PBOC) will rely on liquidity management tools, including medium-term lending facilities (MLFs) and open market operations (OMOs), to maintain stable liquidity conditions. A new green financing tool, re-lending to green projects and SMEs, and a reduction of re-lending interest rates to agricultural and SMEs uses, etc., have been introduced over the past month. They could be viewed as targeted easing measures to offset the downward pressure in the short term, while helping achieve the longer-term goal of de-carbonization and supporting the SMEs. A 50 bp RRR cut and a 5 bp 1-year LPR cut in December were to improve the pertinence and effectiveness of macro policy to ensure stable and healthy developments of the economy. All in all, the PBOC is expected to keep a mix of decelerating credit growth, and differentiated credit support, supplemented by macro-prudential measures to address financial stability concerns in relation to housing, local government debt, and shadow banking, etc., with the overall monetary environment remaining generally accommodative. Given the average RRR in the banking system will stand at 8.4% after the latest cut, only modest RRR cuts are expected in 2022 if the economic downward pressure persists, while the room of policy rate cut remains limited.

It is believed that there will be a separation between macro and industry policies, with the macro policies mainly focus on calibrating or stabilizing the growth momentum, while the industry policies will aim to achieve China's long-term economic goals in the long-term. According to the 14th Five Year Plan, dual circulation has been promoted as the theorical basis for China's long-term development, with common prosperity, boosting domestic demand, innovation and technology as well as opening up as the major themes to help China achieve high quality development and resolve its long-term structural issues. As such, the industrial or regulatory policies which could help facilitate long-term economic transformation, manage financial risk, ensure fair competition and sustainable growth, including housing tightening, shadow-banking regulation and regulatory changes in new economy sectors, etc., are expected to continue ahead, though there might be some calibration, such as raising coal production and flexibility of electricity prices, etc., according to the economic situation.

Indeed, the government's tolerance for economic slowdown could be higher than expected for 2021, given low comparison base implies smaller growth pressure. The government is expected to use fiscal space and monetary policy to support desirable sectors, while a major reversal of industrial policies is unlikely.

Taking the first three quarters growth rate, the recent growth and policy development into consideration, it is believed that the China economy will post a modest recovery in quarter-to-quarter terms, though there could be some slowdown in year-on-year terms amid a higher comparison base. China is likely to maintain a medium-to-high growth rate of around 5% to 5.5% in 2022, amid further recovery of the global and domestic economies, well-controlled pandemic condition, supportive macro-policies, as well as more policy measures to support high-quality growth in the 14th Five Year period, etc.

Seizing opportunity of RMB internationalization to enhance Hong Kong's cross-border financial services

Ying Jian, Principal Strategist
Xi Shuai, Strategic Planner

Cross-border finance, a financial service referring to capital allocation, capital distribution and cash flows that occurs in corporate and personal cross-border business operation, trade settlement, investment, and payment. Hong Kong can leverage its advantage and experience as an international financial hub to seize the opportunity of RMB Internationalization to further develop cross-border finance services business.

New opportunity from cross-border finance

1. Developing cross-border finance in key regional areas for greater synergy

The "14th Five-Year Plan" (the 14th FYP) emphasizes a better regional co-operation between the Guangdong-Hong Kong-Macao Greater Bay Area and Qianhai Free Trade Area, providing a supportive policy environment for the development of cross-border finance services business. The 14th FYP highlights the progress of reaching a new stage with a substantial growth in the country's strengths for participating in international economic co-operation and competition, listing a series of goals and initiatives in the area of regional, industrial and infrastructural development. Among the new initiatives, the Guangdong-Hong Kong-Macao Greater Bay Area is the key area to be fully developed for regional growth strategy. The promulgation of the "Outline Development Plan for the Guangdong-Hong Kong-Macao Greater Bay Area" in the beginning of 2019 signified the importance of expanding the Greater Bay Area to generate new opportunities, encourage international co-operation, and gain advantages in international competition by constructing a high quality and a highly innovative economy.

Following the promulgation of the outline, the "Opinions for Financial Support for the Development of the Guangdong-Hong Kong-Macao Greater Bay Area" was issued by the People's Bank of China and other 3 state regulatory authorities to deliver the concrete initiatives and implementations for banks, securities firms, insurance firms and other financial institutions. The opinions encourage co-operation within the finance industry and define the status of financial institutions in Greater Bay Area.

Afterwards, the "Plan for Comprehensive Deepening Reform and Opening-up of the Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone" was issued, giving the Greater Bay Area a new prospect. With all the supportive policies issued by government, the finance industry in Greater Bay Area can leverage the Qianhai co-operation zone to develop a diversified, world-class, and innovative cross-border financial market and platform.

2. Continuous policy optimization in RMB internationalization to improve the convenience of cross-border investment

The topic of RMB Internationalization was included in the national top strategy for the first time when the Fourth Plenary Session of the 19th Central Committee of the Communist Party of China stated that it is needed to steadily advance RMB Internationalization; In the 14th FYP, the importance of RMB Internationalization was once again emphasized. The emphasis becomes the fundamental principle of RMB Internationalization, aiming to steadily and prudently advance RMB Internationalization with market-driven approach, allowing companies to make their own choices and creating a new stage of relations of mutually beneficial co-operation based on the free usage of RMB. Driving from the supportive policy environment, RMB Internationalization increasingly gained awareness. Also, the People's Bank of China, as the main governing body to RMB Internationalization, has put in numerous efforts in the development. In November 2020, the central bank and the SASAC co-organized a conference for RMB cross-border corporate payment and investment where they required state-owned corporates to actively use RMB in cross-border payment, investment and other economic activities. Apart from that, a more favorable policy environment was emerging for RMB Internationalization advancement. In the beginning of 2021, the PBOC, NDRC, Ministry of Commerce, SASAC, and SAFE co-issued an article to further enhance related policies for cross-border RMB payment, solving the issue of decentralized and unfriendly policies and improving the convenience of using RMB for cross-border investment to strengthen the cross-border RMB usage.

3. With increasingly attractive RMB related asset, Connection Scheme between China and Hong Kong will be the Key

China, as the first country in the world rebounded from economic recession under the worldwide pandemic, increased global investor's faith and confident in RMB. Besides that, RMB's value was stabilized and recorded higher yield as China undertook a normalized monetary policy. Example can be found when capital was outflowing from emerging market generally in the peak of the pandemic, China market remained stable, making RMB an attractive asset among global investors.

On the other hand, the continuous effort in market liberalization, increasing international recognition, and more liberalized and convenience bilateral liquidity in China all optimized channel for foreign capital entering into China onshore market. One example is the Northbound Bond Connect, one of the most important ways for foreign investors to enter into China onshore market since the launch in 2017. Moreover, in 2021, there were more connect schemes launched, including the Southbound Bond Connect and Cross-boundary Wealth Management Connect. Together with the Shanghai-Hong Kong Stock Connect and the Mutual Recognition of Funds between Mainland and Hong Kong, a comprehensive connect scheme has been establishing. Trading volume in multiple connect scheme are increasing and becoming an important indicator to cross-border finance services business

4. Cross-border investment and financing growth from Belt and Road initiative and RCEP

"RCEP" and "Belt and Road" are the two key initiatives to develop regional economic co-operation. In 2013, the Belt and Road initiative featured priorities in enhancing multilateral co-operation to drive global economic sustainability and global economic recovery. In the initiative, financial co-operation is the main driver in improving the co-operation of economic, trade, and investment between participating countries. Implementing the initiative will be the main goal in the near future which will bring countless cross-border financing business opportunities. In November of 2020, China, together with another 15 countries including Japan, South Korea, Australia, New Zealand, and 10 ASEAN countries, signed Regional Comprehensive Economic Partnership ("RCEP"), the largest free trade partnership in the world. Not only is it a comprehensive, modern, high quality, and mutually beneficial partnership, it also creates a favorable global environment to China to seize the new development opportunity by further strengthening financial co-operation.

Among the partnership, ASEAN is one of the most important as ASEAN has become the largest trade partner to China in 2020. Meanwhile, China has been the largest trade partner to ASEAN for the past 12 years. With a stronger connection between partnering countries and China, the areas of co-operation will diversify from infrastructural facilities construction to multiple areas, such as industrial and financial co-operation. The diversification of co-operation can accelerate the RMB usage in the partnering countries.

5. Redefining cross-border financing with FinTech

FinTech, Such as Artificial Intelligence, Blockchain, Cloud Computing and Big Data, are redefining the global financial services in payment, clearing, loan, deposit, insurance, and investment management. FinTech has become increasingly important in cross-border payment with its main feature of borderless. With such technological acceleration, using cross-border payment to achieve betterment in marketing, payment, exchange, and risk management is a foreseeable future. FinTech will be an essential part of the future in developing cross-border financial services business and diversifying financial services.

Hong Kong's advantages in developing cross-border financial services business

The 14th FYP announced a series of initiatives that support Hong Kong's development, including reinforcing its status as an international center for international finance, shipping, trade, and aviation. The plan also strengthens Hong Kong's function as a global offshore RMB business hub, an international asset management center, and a risk management center. Considering that, Hong Kong can leverage its experience and the favorable policy environment to develop cross-border financial services business.

1. Using Hong Kong as a bridge to connect onshore and offshore market to fulfill cross-border financial services demand

Hong Kong is a global financial hub with status of Asia's second and world's top 4 largest FX market. The financial services sector remains one of its most important economic pillars, accounting for 20% of Hong Kong's GDP. Hong Kong's Financial services sector plays an essential role to the economy as well as to Belt and Road initiative, RMB Internationalization, and China's international and domestic liberalization. China leverages Hong Kong's resource and experience as RMB business hub.

Now, with most of China's offshore RMB business, Hong Kong can promote RMB business to worldwide and attract global capital by leveraging international advantages and a special status of offshore financial hub to connect the world to China. Other than that, Hong Kong has been providing a safe and an efficient business environment to different investors and markets.

There are currently 1541 foreign firms that have regional headquarters in Hong Kong; 2490 foreign firms and 5009 foreign firms that have regional representative offices and local representative office respectively in Hong Kong. To many foreign investors and multinational corporates, Hong Kong is always their preferred channel to enter into China market. For example, two-thirds of foreign direct investment are done through Hong Kong and most of the financial investment are done in Hong Kong.

2. Hong Kong will be the offshore RMB hub to provide liquidity in cross-border finance

Hong Kong is the largest offshore RMB clearing hub in the world, accounting for 75% of RMB payment transaction in the world. In the first half of 2021, the total clearing volume of Hong Kong's RMB Real Time Gross Settlement (RTGS) reached 178.4 trillion, increased 27.6% yoy. Besides, with the issuance of central bank's bills in Hong Kong, RMB Dim Sum Bond issuance reached 133.64 billion dollars until October 2021. Meanwhile, up to September 2021, Hong Kong recorded 855.9 billion dollars of RMB deposits, reaching a 6-years high and 18.6% of growth ytd. Together with 30 billion dollars of certificate of deposit, Hong Kong's capital accounts for approximately half of the entire offshore RMB liquidity pool. Moreover, Hong Kong's RMB loans was 197.1 billion dollars, up 29.7% ytd. The number has been above 160 billion dollars since 2020, rising almost 50% compare to 100 billion at the beginning of 2019; In the first 9 months of 2021, RMB remittance in Hong Kong's cross-border trade settlement accounted for 5.27 trillion dollars, up 8.7% yoy. With the enormous money pool, highly efficient financial infrastructure, and multichannel for cross-border capital flow, cross-border financing has a strong foundation.

3. Hong Kong can provide diversified cross-border financial products and services as an international financial hub

As one of the leading international financial center, Hong Kong not only is the first choice for financial service to enter but also an operational hub for numerous financial institutions. The financial market in Hong Kong operates with an effective, transparent, and international standardized manner.

Together with Hong Kong's advantages in banking, capital market, and asset management, it provides a comprehensive and first-class financial platform to global investors, financers, asset managers, funds, and financial institutions. As the most significant crowdfunding platform, Hong Kong has a stable and highly efficient banking system, playing an important role in the region in providing diversified products and services.

Also, Hong Kong has an active securities market that allow inflow and outflow freely, making Hong Kong securities market the key fundraising channel for corporate shares and bonds issuance. As Asia's largest international asset management hub, it gathers world-class global fund managers, business consultants, and private banks, allowing Hong Kong to be the best place for corporates to setup treasury center. In addition, as a bridge to connect Mainland China and the world, Hong Kong continuously explores new channel to strengthen the connection, enabling Hong Kong to have a unique position for foreign investment to enter into Mainland China and be the pilot place for many new financial initiatives in cross-border finance. For instances, Qualified Foreign Institutional Investor (QFII), Renminbi Qualified Foreign Institutional Investor (RQFII), Shanghai-Hong Kong Stock Connect, Shenzhen-Hong Kong Stock Connect, and Bond Connect are the ways that foreign investors can use to enter into China markets. Leveraging Hong Kong's rich products and services, the future of cross-border business will be much diversified and differentiated.

4. Hong Kong's FinTech development can benefit cross-border financial services business

In June 2021, Hong Kong Monetary Authority issued "FinTech 2025" strategy where it aimed at advancing Hong Kong FinTech development. By now, the strategy has attracted more than 600 FinTech corporates to locate and operate in Hong Kong. Furthermore, Hong Kong launched FinTech Supervisory Sandbox (FSS) to provide a clear, safe, and regulated environment for financial institutions and FinTech corporates with the intention of achieving research effectiveness, cost efficiency, and high product quality. By far, there are currently 8 virtual banks, 5 virtual insurers, and 1 virtual asset trading platform got license to operate in Hong Kong with the aim of providing innovative and advanced financial services. Hong Kong will continuously enhance FinTech infrastructure construction, such as launching Faster Payment System (FPS) and expanding the usage and service of FPS to government bill payment. FPS can provide a new e-payment option for government bill and licensing fee starting from mid next year.

Apart from it, HKMA will promote and implement more FinTech related projects to encourage a wide range of FinTech application in banking and other enterprises. In October 2021, Mainland and Hong Kong entered into a memorandum in FinTech regulatory, reaching a mutual agreement in co-operation in regulation for future FinTech application in cross-border finance business.

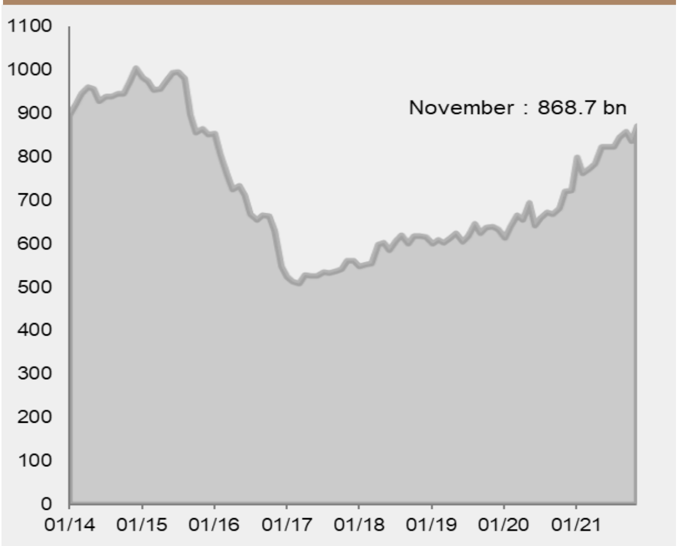
5. Further advancement in Hong Kong cross-border financial service

With the further opening-up in Mainland China geographically, from costal area to inland, from north to the south, China has transformed to an externally oriented economy. Hong Kong can first seize the advantage of national strategy and favorable policy to further improve regional collaboration in cross-border financial services between Greater Bay Area, Yangtze River Delta, Hainan Free Trade Port, and Guangxi and Yunnan Free Trade Zone. Second, Hong Kong should explore new business and develop edges on areas with foreseeable prospects, especially in Green Finance, Digital Finance, FinTech, TechFin, commodity trading. Third, Hong Kong should further strengthen offshore RMB business hub to promote RMB business by encouraging using RMB for settlement in commodity trading, offshore industrial area and cross-border investment. Fourth, Connect scheme between Mainland and Hong Kong should be further progressed to explore the demand in cross-border investment. Last but not the least, Hong Kong should establish a co-operating and strong relationship between financial institutions in Hong Kong and China for better client servicing and marketing.

2022 marks the 25 anniversary of Hong Kong's handover. It is believed that more supportive policy in developing Hong Kong as the RMB business hub will be on its way. With significant progress in RMB Internationalization and offshore market construction and optimization, Hong Kong will strengthen and enhance its status in cross-border financial services.

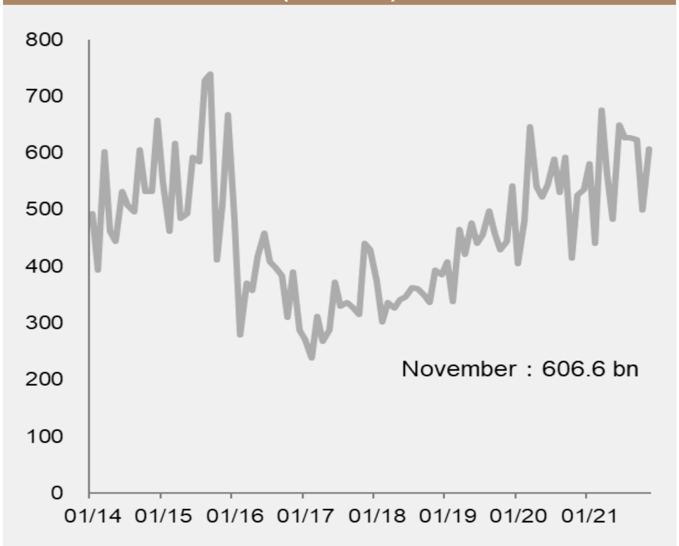
Market Indicators

Hong Kong RMB Deposits (RMB bn)



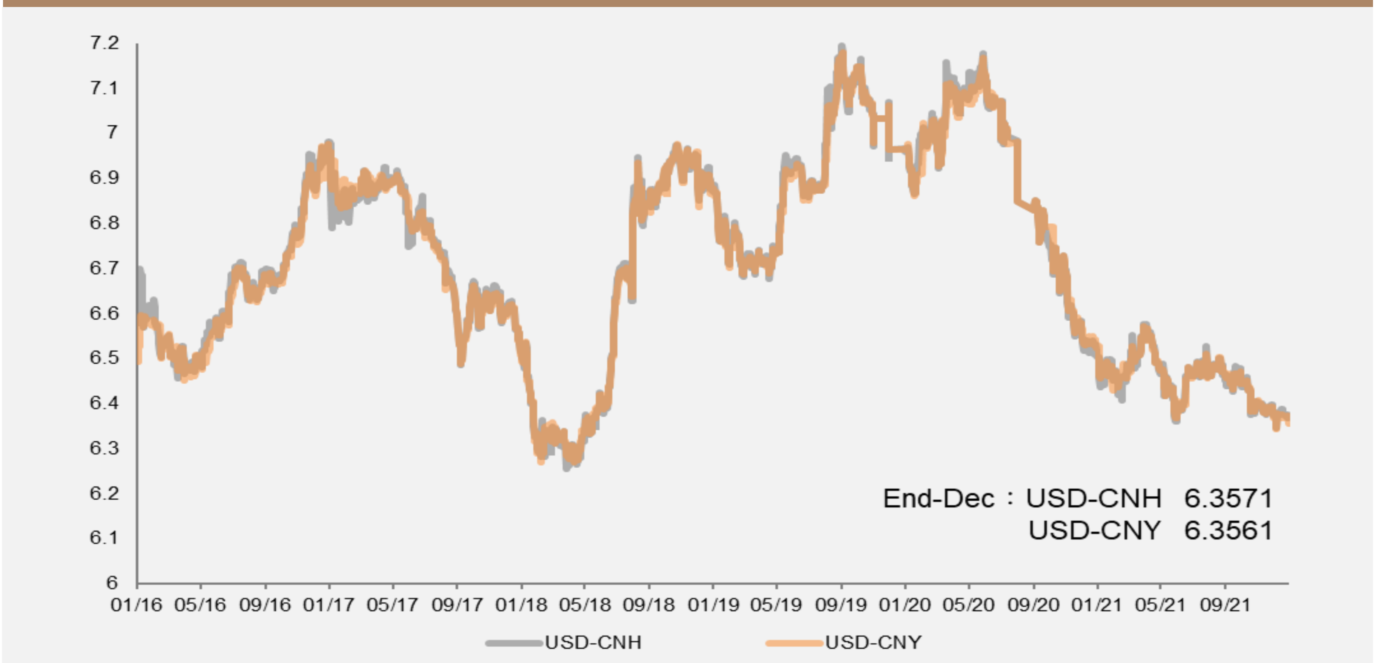
Source: HKMA

Hong Kong RMB Cross-border Trade Settlement (RMB bn)



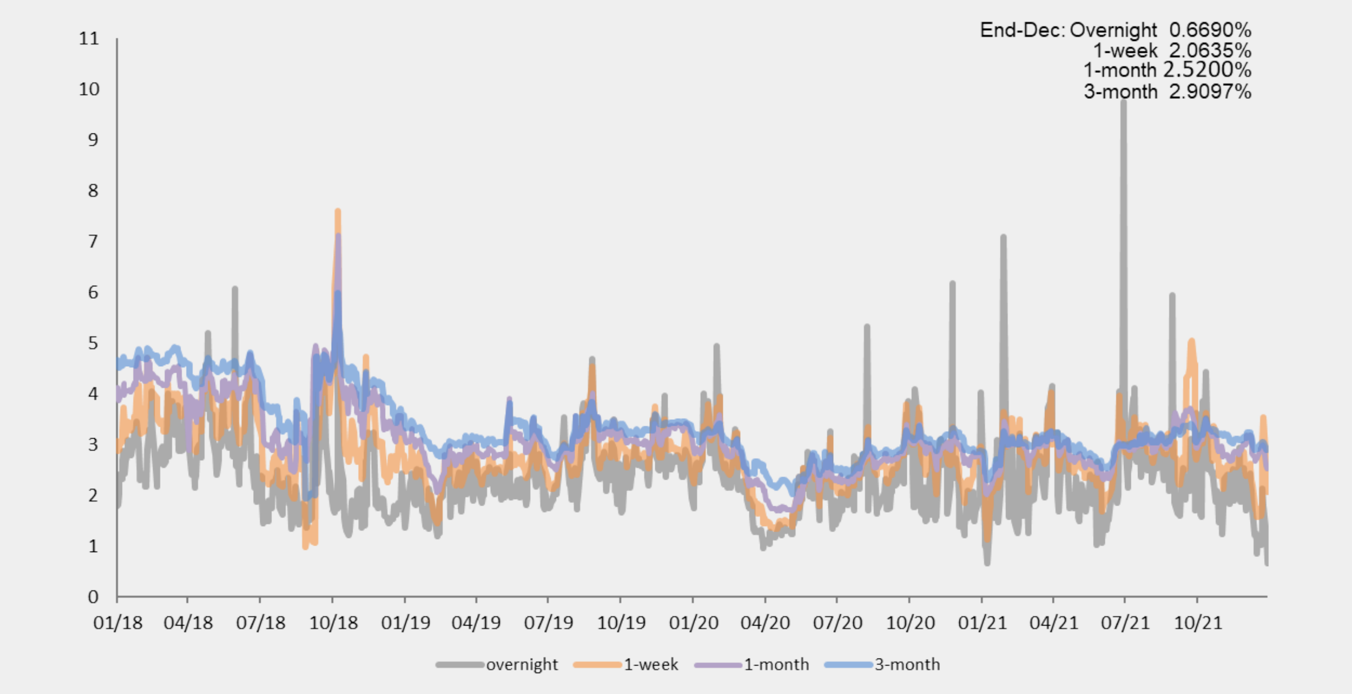
Source: HKMA

USD-CNH and USD-CNY Exchange Rates



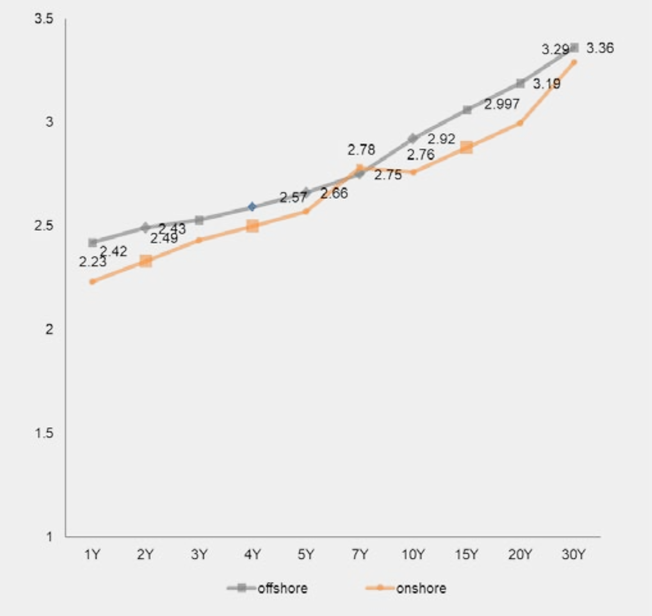
Source: Bloomberg

CNH HIBOR Fixing (%)



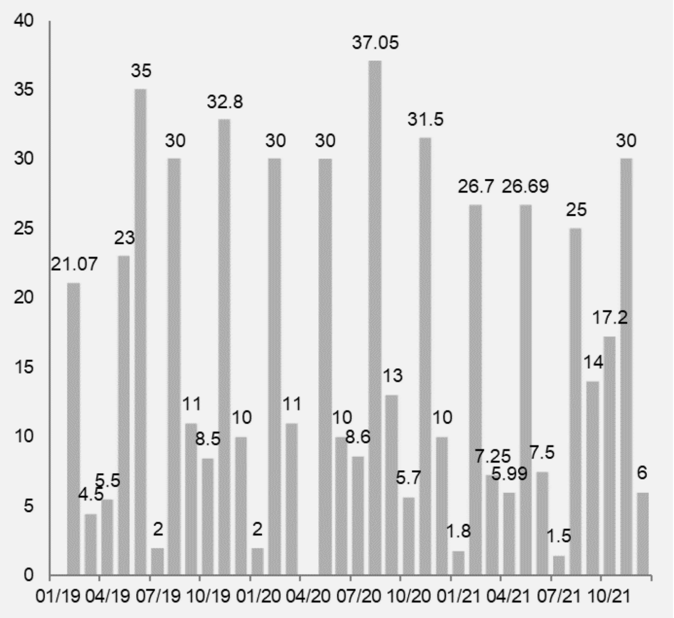
Source: Bloomberg

CNH & CNY China Sovereign Curve (%, 31 Dec 2021)



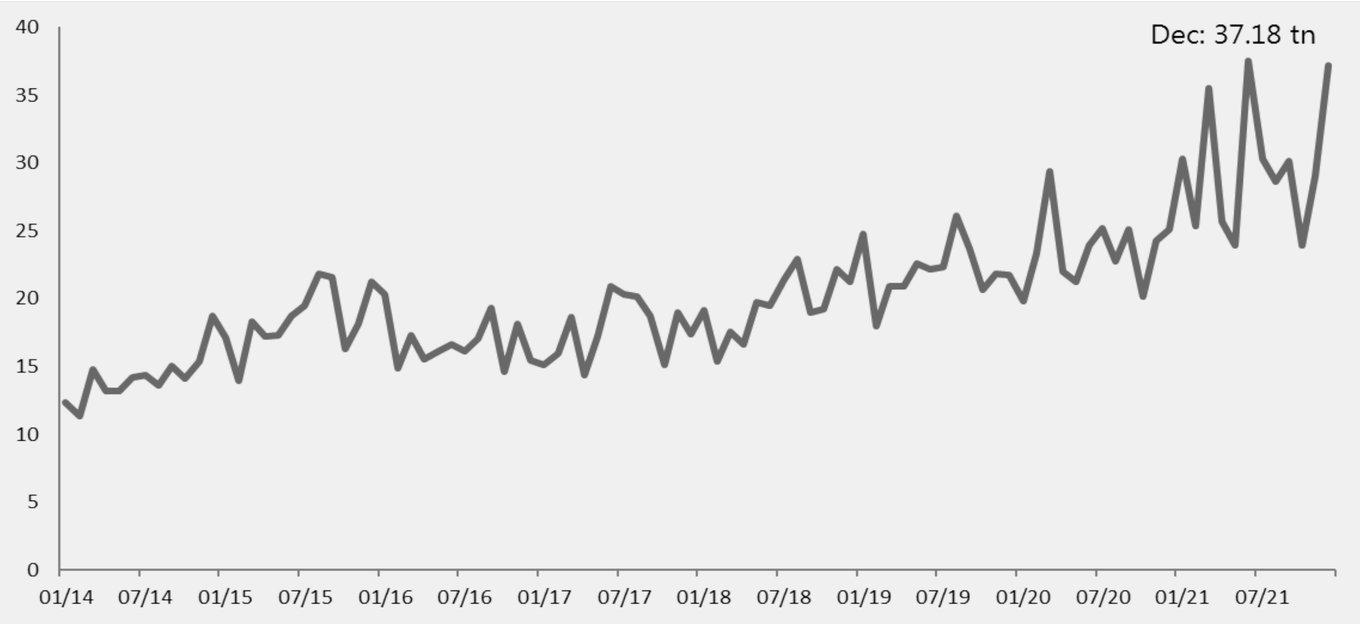
Source: Bloomberg

Hong Kong Offshore RMB Bond Issuance (RMB bn)



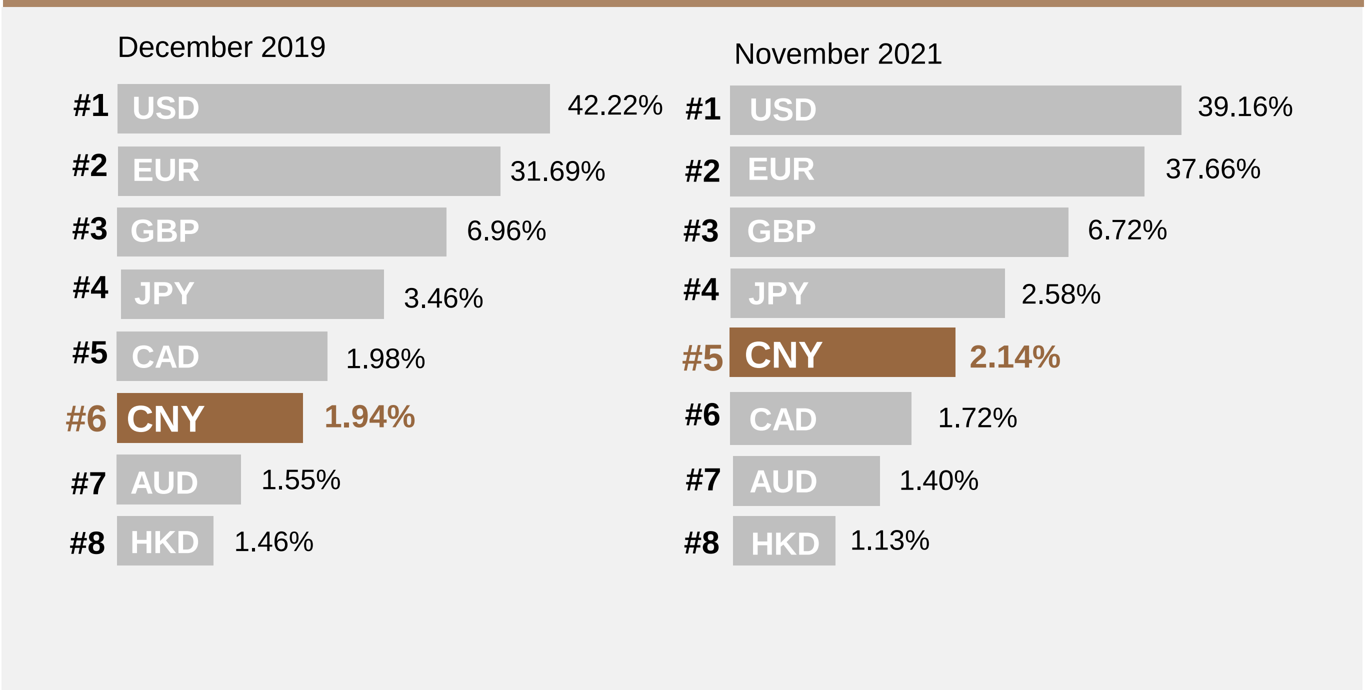
Source: BOCHK Global Market estimate

RMB Clearing Transaction Value (RMB tn)



Source: HKICL

SWIFT World payments currency ranking & market share



Source: SWIFT

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