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Economic Summit on "China's 11th Five-Year Plan and the Development of Hong Kong"

Financial Development

(Translation)

Purpose

1 Expediting financial reform on the Mainland and the maintenance of status of Hong Kong as an international financial centre are two stated policy directions in the 11th Five-Year Plan. This paper discusses the financial development strategy for Hong Kong in response to 11th Five-Year Plan, considering the associated challenges and opportunities. It analyses the issues from the government and public sector perspective, with a view to initiating discussions while an "action agenda" will be formulated in the next few months.

Position of Hong Kong as an international financial centre at present

2 Deng Xiaoping said, "Finance is very important; it is the nexus of the modern economy." The essence of finance is about financial intermediation, or in other words, mobilising savings to economic activities and investments in an effective manner. A balanced and efficient financial system is crucial to sustainable economic growth and development. Financial intermediation is conducted via three channels, namely, banking, equity and bond markets, whereby the investment needs of savers can marry the financing needs of fund-raisers, both domestically and internationally. It follows that the position of an international financial centre depends on its ability in providing an efficient platform for conducting domestic and international financial intermediation activities.

As a global financial centre

3 At end-2005, the total assets of Hong Kong's banking sector exceeded US$800 billion, being the 4th largest in Asia and 17th in the world. With a market capitalisation of US$1,055 billion, Hong Kong's stock market was the 2nd largest in Asia and 8th in the world; and in terms of the amount of capital raised during 2005, Hong Kong came first in Asia and 5th globally as an equity fund-raising centre. The size of Hong Kong's bond market was relatively small, with the amount of outstanding bonds at around US$100 billion, being the 8th in Asia and 35th in the world. Statistics comparing Hong Kong against financial centres in other major economies are presented in Annex 1.

4 Due to the small size of its domestic economy, in the past two decades or so, Hong Kong has largely been providing a platform for international capital to invest in Asia, including the Mainland. As for banking, since as early as the late 1970s, many foreign enterprises have set up regional headquarters in Hong Kong, making use of finance obtained in Hong Kong to invest in Asia and the Mainland. Many of the world's largest financial institutions have set up branches in Hong Kong providing the banking services required. Whereas for the equity market, Hong Kong has developed as a channel for international capital to invest in Mainland enterprises and the major IPO centre for Mainland enterprises. At the end of June 2006, there were 350 Mainland enterprises listed on the Hong Kong Stock Exchange. The market capitalization and aggregate turnover (in the first six months of 2006) for these Mainland companies (H shares) and Mainland-related companies (red chips) respectively amounted to 41% and 53% of the total of Hong Kong's stock market as a whole. These companies also raised in the first six months of 2006 a total of HK$130 billion (or 73% of the market total). The IPO activities relating to Mainland companies have created a critical mass of investment assets and helped promote the rapid growth of asset management business in Hong Kong, attracting leading international fund management companies to Hong Kong for the related opportunities.

As a national and regional financial centre

5 From the country's perspective, in the past Hong Kong has mainly provided a platform for obtaining foreign capital, and this is particularly evident from the developments in the neighbouring Guangdong area. Currently, Hong Kong banks have set up a total of 82 branches on the

Mainland, of which more than one-third are located in the Pearl River Delta area. Furthermore, many of the Mainland enterprises taking loans from Hong Kong banks and those listed in Hong Kong are also from the Pearl River Delta area. That said, this role has already been reflected in Hong Kong's international financial intermediation activities as discussed above. Until now, the use of Hong Kong for Mainland's domestic financial intermediation (i.e. Hong Kong to be Mainland's financial centre for the meeting of Mainland's savers and investors) has been limited.

Shortcomings of Hong Kong

6 The past experience of Hong Kong as an international financial centre, as discussed above, has shed some lights on future development. Hong Kong possesses most of the pre-requisites for an international financial centre, including a sound legal system, efficient financial infrastructure, the most resilient banking system in Asia and a regulatory framework that is of international standards. However, compared with other leading international financial centres such as New York, London and Tokyo, Hong Kong loses out in terms of the size of its domestic economy. The development of New York and Tokyo as financial centres have been supported by the large economies of US and Japan respectively, while London to an extent provides financial services for the economy in continental Europe. The financial intermediation needs arising from domestic economic activities serve as a foundation for the relevant financial centres, creating a critical mass and attracting financial activities from other economic areas.

7 In the past two decades, without a sizable domestic economy, the development of Hong Kong as an international financial centre has focussed mainly on serving Mainland's international financial intermediation activities. Owing to the existing foreign exchange controls on the Mainland, the role played by Hong Kong's financial system in Mainland's domestic financial intermediation is still very limited. In order to catch up with New York, London or Tokyo, therefore, apart from improving its own fundamentals, an important strategy for Hong Kong is to strengthen its integration with the Mainland economy and to serve the financial intermediation needs of the large Mainland economy. To this end, there is a need to have a better understanding of Mainland's financial reform and liberalization process, particularly the implementation of the 11^{th} Five-Year Plan and its implications for the development of the financial system on the Mainland.

Financial policies under the 11th Five-Year Plan

8 Chapter 33 of the 11th Five-Year Plan has set out the policies for expediting financial reform, which cover four areas: (i) to deepen the reform of financial enterprises, improve corporate governance of financial institutions, and develop different forms of financial enterprises gradually; (ii) to speed up the development of the channels for direct financing, such as the equity and bond markets, and to develop futures markets gradually; (iii) to enhance the mechanism for financial and monetary management, which includes developing money markets and introducing renminbi convertibility for capital account items in a gradual manner; and (iv) to improve financial sector supervision.

9 Meanwhile, Guangdong has proposed specific policy measures for implementing the country's 11th Five-Year Plan, which include: to explore and implement reforms for local financial enterprises, for instance through reforming the shareholding structure of financial institutions and improving financial sector supervision; and to enhance market mechanisms and develop capital markets.

10 Considering these reform policies under the country's and Guangdong's Five-Year Plan, going forward, there are three main areas of development of Mainland's financial system that would have particular implications for Hong Kong.

<u>Improvement of financial intermediation to ensure sustainable economic growth</u>

11 First, currently domestic financial intermediation on the Mainland relies too heavily on the banking channel. The function of Mainland's equity market as a fund-raising platform has yet to fully recover, notwithstanding that the reform of desegregating shareholders' rights is helping resolve the long-standing issue of non-tradable shares; while the bond market has yet to be further developed, particularly for medium to long term corporate bonds. It is particularly difficult for smaller companies with growth potential to raise funds due to the under-development of the direct financing channels. Whereas for savers, apart from deposits with banks, there are only limited choices of investment instruments with varying quality. The savings rate on the Mainland is standing at more than 45% of GDP, but these savings are not directed to the hands of fund raisers in an effective manner.

12 In view of this, the 11th Five-Year Plan has explicitly stated that it is necessary to speed up the development of direct financing, in order to broaden the fund-raising channels and improve the overall financial intermediation efficiency. And for the development of equity and bond markets, a pre-requisite is to strengthen corporate governance, and this includes upholding the rights of investors and creditors and improving information disclosures and accounting standards. Moreover, the development of derivatives markets is also needed to provide risk management tools for both investors and fund-raisers.

Towards renminbi capital account convertibility

13 Secondly, renminbi is expected to gradually achieve capital account convertibility. To date, the process of liberalisation in respect of renminbi convertibility has three distinctive features: (i) inflows followed by outflows; (ii) current account items followed by capital account items; and (iii) for capital account items, long-term followed by short-term.

14 The Mainland authorities announced in December 1996, in accordance with Article VIII of the Articles of Agreement of the International Monetary Fund, to allow renminbi to be convertible for current account transactions such as trade payments and travelling expenses. For capital account items, under the principle of “inflows followed by outflows”, renminbi convertibility in relation to foreign direct investments has been allowed for many years. And in recent years, the Mainland authorities are encouraging Mainland enterprises to “go out” and make direct investments overseas, and the related currency conversion quotas were abolished in June 2006. However, the Mainland authorities are more cautious in liberalising conversion restrictions in relation to portfolio investments. From December 2002, overseas institutional investors can convert foreign currencies into renminbi and invest in the securities market on the Mainland through the QFII scheme. In terms of outflows, with the issuance of the [2006] No. 5 Notice by the People’s bank of China in April this year, restrictions on offshore investments by Mainland institutions and individuals have been relaxed.

15 In sum, renminbi convertibility in relation to current account transactions and direct investments has largely been acheived. Going forward, further liberalisations would mainly involve short-term, cross-border capital movements such as portfolio investments. The related framework is already in place, and future liberalisation can be implemented

through increases in the relevant conversion quotas. In this respect, the present favourable macroeconomic circumstances, characterised by strong economic growth, low inflation and sizable trade surplus, provide enabling conditions for further liberalisation. In addition, large foreign exchange inflows in recent years have complicated monetary and exchange rate management on the Mainland, and there is a need to allow orderly outflows in accordance with the gradual, controllable and proactive approach.

Internationalisation of renminbi

16 Thirdly, as the currency of one of the largest economies of the world, the internationalisation of renminbi will be an inevitable process as it becomes gradually a fully convertible currency. With rapid modernisation, the Mainland economy has now become one of the largest in the world. It was the fourth largest in terms of GDP in 2005, and is growing fast – currently at around 10% a year in real terms, much faster than many developed economies. The renminbi, like the currencies of other major economies, will become an international currency.

17 An international currency is a currency which performs the functions of medium of exchange, store of value and unit of account outside its home economy. The advantages of renminbi becoming an international currency include: seigniorage revenue for the central bank as a result of the demand for renminbi offshore; domestic institutions and individuals can avoid exchange rate risk by using renminbi for external trade and investments; and furthermore, Mainland institutions can issue renminbi-denominated bonds overseas, facilitating the finance of any deficits in balance of payments. But on the other hand, changes in the offshore demand for renminbi could pose risks to financial stability and the operation of monetary policy on the Mainland.

18 The process of renminbi internationalisation is expected to be gradual. It will be initially used in international trade, and with an early form being the "border trade" settled in renminbi at present. As the use of renminbi in international trade and the amount of renminbi being held offshore increase, there will be demand for using renminbi for fund-raising and investment activities, and offshore renminbi financial markets will also emerge. In the longer term, renminbi might become a reserve currency and anchor currency for other economies in the region.

Challenges and Opportunities presented by 11th Five-Year Plan

Challenges

19 As reforms of Mainland's financial system are implemented and the developments discussed above take place, they can pose challenges to the status of Hong Kong as an international financial centre:

(i) With the improvement of equity and bond markets on the Mainland, companies can make use of such markets to raise funds, reducing the use of Hong Kong's markets;

(ii) When renminbi convertibility for capital account items is fully achieved, offshore investors can invest in the Mainland financial markets directly, reducing the need to do so through Hong Kong;

(iii) When financial markets on the Mainland are fully liberalised, there is no need for any partitioning between domestic and international segments; nor is there any need for distinction between national and international market participants. Hong Kong's role as an international financial centre may dwindle over time, as activities migrate to the liberalised, larger and more liquid domestic markets on the Mainland; and

(iv) When renminbi becomes an international currency, there will be competition from other financial centres in the region in providing renminbi-denominated financial services.

Opportunities

20 However, if Hong Kong can move with the times in response to the changes on the Mainland, the aforementioned financial developments on the Mainland present opportunities for Hong Kong in at least three aspects as follows:

As a global financial centre

(i) **Hong Kong can strengthen and develop further its role in financial intermediation between Mainland and the rest of the world:** Located within the Asia time zone, Hong Kong can provide 24-hour international financial services alongside with

New York and London. Hong Kong has a comparative advantage in this aspect, particularly in serving as the platform for channelling foreign capital into the Mainland, which should be further entrenched. Apart from bringing foreign savings into the Mainland, as renminbi convertibility for capital account items is introduced, capital flows will become increasingly two-way. With the huge amount of savings on the Mainland but the majority of offshore assets owned by the public sector, the demand of non-public investors for investing offshore are not satisfied. Hong Kong can act as a channel for such outflows, providing services for offshore investments by Mainland institutions and individuals.

As a national and regional financial centre

(ii) **Hong Kong can participate in domestic financial intermediation activities on the Mainland:** Building on the function as a platform for Mainland's international financial intermediation, Hong Kong can increase its participation in Mainland's domestic financial intermediation in two ways to help improve financial intermediation efficiency on the Mainland. First, for financial services that need to be provided on location, the vast market on the Mainland offers a great deal of development potential for Hong Kong's financial institutions. It is expected that Hong Kong financial institutions will have a larger presence in the Pearl River Delta area given its proximity.

Second, as Mainland's capital account is liberalised, fund-raisers and investors move abroad more freely. Hong Kong can provide a convenient, low-risk and efficient platform for Mainland investors and fund-raisers to meet, thereby channelling Mainland savings to the hands of fund-raisers on the Mainland. For instance, currently there are many high-quality enterprises listed on Hong Kong's stock market. With restrictions on offshore investments being relaxed, Mainland investors can invest in the shares of Mainland enterprises listed in Hong Kong.

Hong Kong's role in Mainland's link-up with the global market

(iii) **Hong Kong can provide a testing ground for renminbi internationalisation:** Hong Kong was the first place outside the

Mainland where banks provided deposit-taking, exchange, remittance and card services in renminbi. With the experience of conducting renmibi business since 2004 and the close cooperation between the financial regulators in Hong Kong and on the Mainland, Hong Kong can provide a reliable testing ground for the move towards renminbi convertibility and its increased use in international trade and financial transactions. The State Council is earnestly studying the scope for further expansion of renminbi business in Hong Kong, which includes allowing Hong Kong importers to settle direct import trade from the Mainland in renminbi, and financial institutions on the Mainland to issue renminbi financial bonds in Hong Kong on a pilot basis. In tandem with the process of renminbi internationalisation, Hong Kong should strive to be the first mover and develop into a commercial and financial centre for trade and financial transactions settled in renminbi outside the Mainland.

Recommendations

21 China is unique in having the two different financial systems of Mainland and Hong Kong, and the relationship between the two financial systems should be cooperative, complementary and interactive. The increased use by the Mainland of Hong Kong's financial platform will not only help speed up Mainland's financial reform, but also contribute to the maintenance of the status of Hong Kong as an international financial centre.

22 In order to maintain the status of Hong Kong as an international financial centre, there is of course a need to preserve Hong Kong's sound financial system, and to further increase the depth and breath of our financial markets, particularly the bond market. And in response to the challenges and opportunities brought about by the liberalisation and reform under the 11th Five-Year Plan, Hong Kong should play an active role in Mainland's international and domestic financial intermediation and in the process of renminbi internationalisation. To this end, the financial development of Hong Kong should proceed with the following five-pronged strategy:

(i) Hong Kong financial institutions to go into the Mainland

Through CEPA and other channels, Hong Kong financial institutions (including banks, securities companies and insurance companies) should expand their range of services and actively develop their business on the Mainland. As Hong Kong financial institutions are familiar with the environment on the Mainland and the Pearl River Delta area, and with their international experience, they can contribute by providing transfer of technical know-how and a greater variety of financial instruments and services on the Mainland.

(ii) Hong Kong to serve as a gateway for Mainland funds and Mainland financial institutions to go out

Given that Hong Kong has an efficient, multi-currency platform and Mainland investors are more familiar with the financial markets in Hong Kong than other markets, Hong Kong provides an effective channel for orderly outflows of funds from the Mainland. Moreover, Hong Kong can serve as a springboard for Mainland financial institutions to develop their international business.

(iii) Financial instruments issued in Hong Kong to be made available on the Mainland

For instance, through dual-listing or depository receipts, investors from both Hong Kong and the Mainland can have access to securities listed in Hong Kong. In addition to equity-related financial instruments, making available on the Mainland other financial instruments, such as bonds or derivative products, can also be considered. This will not only provide Mainland investors with more investment tools but also allow Mainland enterprises, particularly those from the Pearl River Delta area, to improve their corporate governance through listing in Hong Kong, while at the same time helping the development of Hong Kong's financial markets.

Allowing financial instruments between two markets to be fungible in a gradual manner can reduce the price differential of same shares and promote harmonisation of regulatory standards across the border.

(iv) Enhance the capability of Hong Kong's financial system in handling renminbi-denominated transactions

Financial activities conducted by Mainland investors and fund-raisers are denominated in renminbi. Thus, in order to play a role in Mainland's domestic financial intermediation, Hong Kong needs to enhance the capability of its financial system to handle renminbi-denominated transactions. As a first step towards this goal, the HKSARG has been pushing ahead for the expansion of renminbi business in Hong Kong, which can proceed in tandem with the process of the move towards renminbi convertibility for capital account items on the Mainland.

(v) To strengthen financial infrastructural linkages between the Mainland and Hong Kong

To facilitate cross-border fund flows, monitor the associated risks and enhance the efficiency of financial intermediation and supervision, there is a need to strengthen financial infrastructural linkages between Hong Kong and the Mainland. Meanwhile, as Mainland's financial system is opening up, to cater for the increasing cross-border trade and financial transactions, there is a need for Mainland's payment systems to link up with the international payment systems.

At present, the financial infrastructural linkages between the Mainland and Hong Kong were first forged with Guangdong and Shenzhen, including the cross-border clearing mechanisms for Hong Kong dollar, US dollar and renminbi cheques. This underscores the strategic importance of Guangdong and Shenzhen in financial cooperation between the Mainland and Hong Kong. Going forward, further studies on regional linkages in support of Guangdong's planning can be conducted.

23 Strengthening the cooperation between the regulatory bodies in Hong Kong and the Mainland is a pre-requisite for the implementation of the above five-pronged strategy. This is also crucial for the financial stability and development of the two places. Furthermore, in promoting the use of Hong Kong's financial system for Mainland's financial intermediation through the five-pronged strategy, there is need and room for developing a wider range of instruments for risk management purposes.

Closing remarks

24 The five-pronged financial development strategy is proposed with a view to responding to the challenges and opportunities presented by the financial reform and liberalisation on the Mainland. This is also envisaged that, by doing so, Hong Kong can contribute to Mainland's financial reform and development, and the status of Hong Kong as an international financial centre can be enhanced.

25 Panel members are invited to provide comments on the above recommendations and any other proposals for consideration.

Issues for discussion:

(i) Has the paper provided a thorough analysis on the competitiveness of Hong Kong as an international financial centre? Is there any other consideration?

(ii) Has the paper provided a thorough analysis on the challenges and opportunities for Hong Kong as an international financial centre arising the country's 11^{th} Five-Year Plan? Is there any other consideration?

(iii) Has the paper provided a thorough analysis on the challenges and opportunities for Hong Kong as an international financial centre arising from Guangdong's 11^{th} Five-Year Plan and regional developments? Is there any other consideration?

(iv) Are the recommendations proposed from the government and public sector perspective relevant for the maintenance and development of Hong Kong as an international financial centre? Are there any adjustments needed for any of the recommendations?

(v) Are the recommendations proposed for the maintenance and development of Hong Kong as an international financial centre appropriate for further studies?

Hong Kong Monetary Authority
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Annex 1

Comparison of Hong Kong against financial centres in other major economies

	Total assets of banks	Equity markets capitalisation	Amount of bonds outstanding	Total assets of banks	Equity markets capitalisation	Amount of bonds outstanding
	（US$ billion）			(as % of GDP)		
Hong Kong	808	1,055	99	454%	592%	56%
US	10,530	17,001	23,779	84%	136%	190%
UK	7,629	3,058	2,913	362%	145%	138%
Japan	7,077	7,543	8,512	166%	177%	200%
Singapore	217	257	107	186%	220%	92%
Mainland of China	3,563	402	622	158%	18%	28%

Figures for 2005

Sources: IMF, World Federation of Exchanges and BIS