INTERNATIONAL FINANCIAL CENTRE

Hong Kong's status as an international financial centre was further strengthened in 2005. The HKMA was involved in several key initiatives, including the successful launch of the second phase of Asian Bond Fund, expansion of renminbi banking business in Hong Kong, and upgrade of Hong Kong's sovereign credit rating. Through participation in international financial institutions and central banking forums, the HKMA also contributed to a greater understanding of Hong Kong's financial and economic development within the international financial community.

OVERVIEW

Conditions in the global financial system were favourable in 2005, supported by an improved world economic outlook, despite rising interest rates, high oil prices and persistent external imbalances. A significant development in Asia was the reform of the renminbi exchange rate regime on 21 July 2005. The move was welcomed by the international financial community and this was reflected in the calm reaction of financial markets in Hong Kong and other parts of the world. Against this background, the HKMA played a leading role in co-operation and discussions at international and regional financial and central banking forums. Working with other Asian central banks, the HKMA led the successful launch of the second phase of Asian Bond Fund (ABF2), contributing to the development of bond markets in Hong Kong and the region.

The increasing economic integration between Hong Kong and Mainland China resulted in a continued strengthening of communications and co-operation between the HKMA and Mainland authorities. The scope of renminbi business in Hong Kong, with the related clearing arrangements being provided by the People's Bank of China, was expanded during 2005.

REVIEW OF 2005

Development of regional bond markets

A milestone in the development of regional bond markets was achieved in 2005 with the HKMA, through its chairmanship of the EMEAP Working Group on Financial Markets, playing a leading role in the launch of ABF2.

Asian Bond Fund 2

The local currency-denominated ABF2, an extension of the US dollar-denominated Asian Bond Fund (ABF1) launched in June 2003, is designed to broaden and deepen the domestic and regional bond markets in Asia.

ABF2 comprises a Pan-Asia Bond Index Fund (PAIF) and eight Single-market Funds. The PAIF is a single-index bond fund investing in sovereign and quasi-sovereign local currency-denominated bonds issued in all EMEAP markets except Australia, Japan and New Zealand. Each of the eight Single-market Funds invests in sovereign and quasi-sovereign local currency-denominated bonds issued in the respective EMEAP markets. The PAIF and eight Single-market Funds, which are passively managed by private-sector fund managers, seek to track the performance of the iBoxx ABF indices, a set of pre-determined and transparent bond indices provided by the Frankfurt-based International Index Company.

ABF2 has yielded important benefits:

- **A low-cost new asset class in Asia with low entry threshold:** The component funds of ABF2 are structured to keep the expense ratio and the minimum investment amount as low as possible to make them more appealing to a broad investor base.

- **Removal of cross-border restrictions:** ABF2 was instrumental in lifting cross-border restrictions to allow greater participation by foreign investors in several EMEAP markets.

- **Enhancing market liquidity:** Market-making arrangements have been introduced to improve the liquidity of ABF2's component funds by maintaining tight bid-ask spreads.

- **Improving price transparency:** Structuring ABF2 component funds where appropriate as exchange-traded funds has helped improve price transparency by making information on trading and order flows available to investors. ABF2 has chosen a set of transparent, replicable and credible bond indices – the iBoxx ABF family of indices – under which the benchmark index performance can be tracked closely by private-sector fund managers.

- **Improving market infrastructure:** ABF2 has accelerated the linking of clearing and settlement systems for equity and debt securities in some EMEAP markets. The global custodian for PAIF and the eight Single-market Funds has also established Asia's first custodian network linking all eight EMEAP markets.

In May 2005, the HKMA, together with the other 10 EMEAP central banks and monetary authorities, announced the completion of funding for ABF2 and the appointment of the master custodian and fund managers for its nine component funds. The EMEAP Group's initial investment in ABF2 amounted to US$2 billion, of which US$1 billion was allocated to the PAIF and the remaining US$1 billion among the eight Single-market Funds. Preparations began soon afterwards for offering the nine funds to other public and private-sector investors. By the end of 2005, the PAIF and three Single-market Funds of Hong Kong, Malaysia and Singapore had been listed. Subject to the approval of the relevant authorities, the remaining five Single-market Funds are expected to be offered to the public in the first half of 2006. ABF Hong Kong Bond Index Fund and the PAIF – two key components of ABF2 — were listed on the Stock Exchange of Hong Kong in June and July 2005 respectively. The two funds have been well received by investors. In particular, the number of outstanding units of the ABF Hong Kong Bond Index Fund has grown by 51% since its listing.

Expansion of renminbi business and financial integration with the Mainland

Renminbi business in Hong Kong has developed steadily since its launch in early 2004. At the end of 2005, renminbi deposits totalled RMB22.6 billion yuan (more than 428,000 renminbi deposit accounts), with 38 banks (most of the retail banks) in Hong Kong offering renminbi banking services.

With such favourable response, the plan is to further develop the business along three strategic directions: (i) diversification of the renminbi assets and liabilities of Hong Kong banks; (ii) provision of appropriate renminbi banking services for trade and other current-account transactions between Hong Kong and the Mainland; and (iii) establishment of a renminbi debt issuance mechanism in Hong Kong.

Some progress was made during 2005 with the scope of renminbi business in Hong Kong being expanded in several areas. Since December 2005, the definition of designated merchants has been widened, and designated merchants can open renminbi deposit accounts, in addition to conducting one-way exchange of their renminbi receipts into Hong Kong dollars. Limits for exchange and remittance of renminbi by individuals have been relaxed and the cap on credit limits for renminbi cards issued by participating banks has been removed. With the launch in March 2006 of the new Renminbi Settlement System, which caters for the expanded renminbi business and ensures more efficient settlement of renminbi transactions, Hong Kong residents are able to use renminbi cheques for consumer spending in Guangdong Province. The HKMA is also continuing its discussions with the relevant Mainland authorities on proposals for settling cross-border trade in renminbi and the issuance of renminbi bonds in Hong Kong.

A further concession was achieved for Hong Kong banks operating on the Mainland under the third phase of the Closer Economic Partnership Arrangement (CEPA III) signed on 18 October 2005. The level of operating funds required for branches of Hong Kong banks on the Mainland offering renminbi and foreign currency business to local customers under CEPA III will be assessed on an aggregate basis. The requirement for each individual Mainland branch has been relaxed to RMB300 million yuan on the condition that the average level of operating funds of all Mainland branches of the bank concerned is not less than RMB400 million yuan.

As part of its effort to keep up with financial and economic developments on the Mainland, the HKMA continued to engage in research co-operation and discussions with Mainland academics and think-tanks. During 2005, a number of Mainland officials and academics were invited to Hong Kong to exchange views on issues of common interest. A topic which has been receiving considerable attention as a result of the increasing economic integration between Hong Kong and the Mainland is Hong Kong's role as an international financial centre in the light of the Mainland's changing circumstances.

The role of Hong Kong as an international financial centre in the light of changes on the Mainland

The most significant development affecting Hong Kong's role as an international financial centre in the past few decades has been the rapid economic growth of the Mainland and its expanding needs for financial intermediation. So far, the financial sector in Hong Kong has taken advantage of this development, mainly through the equity market by serving as the primary location for Mainland companies to raise foreign capital. By the end of 2005, 209 Mainland companies (H-shares and red chips) were listed on the Stock Exchange of Hong Kong, accounting for one third of total market capitalisation and 40% of market turnover. In 2005, nearly $180 billion (or 60% of the market total) was raised by Mainland companies.

The changing circumstances

The reliance of Mainland enterprises on Hong Kong as a fund-raising centre reflects to a large extent the deficiencies in financial intermediation in Mainland China. However, as financial sector reform and liberalisation proceed, questions are being raised as to how long fund-raising activities by Mainland enterprises will continue to be conducted in Hong Kong. The Mainland's need for inward cross-border financial intermediation is likely to become smaller as domestic savings are substantial (a savings rate of over 40%). With domestic commercial banks on the Mainland holding excessive liquidity, the need for bringing in additional foreign capital through fund-raising in Hong Kong or other financial centres abroad is also being questioned.

The way ahead

To maintain Hong Kong's position in the Mainland's financial intermediation process, Hong Kong needs to play a role not only in intermediating funds between the Mainland and the rest of the world, but also in the domestic intermediation process: In essence, marrying the needs of both savers and fund-raisers from the Mainland. In practical terms, it means:

(i) For financial services that need to be provided on location, such as retail banking, access on the Mainland by Hong Kong financial institutions needs to improve. To some extent, work in this area has begun with the Closer Economic Partnership Arrangement and other channels already helping to lower entry barriers in the past few years;

(ii) For financial services that are not required to be provided on location, such as capital market activities, improved mobility from the Mainland to Hong Kong will be required for investors and investment funds through, for instance, qualified domestic institutional investor schemes; and for fund raisers, to obtain financing through banks and the equity and debt markets in Hong Kong with fewer restrictions.

While Hong Kong's multi-currency, multi-dimensional payment system, which supports efficient international financial intermediation, puts Hong Kong in a good position to take on such an expanded role, more needs to be done. First, Hong Kong should increase its capability to handle financial transactions denominated in renminbi. The development of renminbi business in Hong Kong is an important step in this direction. Secondly, when the need arises, links in the financial infrastructure, particularly those of the payment, clearing, settlement and custodian systems between the Mainland and Hong Kong, should be further improved for the orderly, safe and efficient cross-border movement of funds and financial instruments.

The proposition of an expanded role for Hong Kong in the Mainland's financial intermediation, which requires even greater co-operation, should be seen in the context of increasing integration between the two economies. The participation of Hong Kong intermediaries in the Mainland's domestic financial intermediation process, whether on location or not, will benefit both Hong Kong and the Mainland. The introduction of new products and technical transfers in risk management and product development will help the Mainland market to mature, and the expansion of renminbi business in Hong Kong provides a testing ground for the gradual move to renminbi convertibility. There are benefits for both sides, and further discussions are envisaged for the next step in this area of closer integration.

Upgrading Hong Kong's sovereign credit rating

The HKMA continues to play a major role in adopting a more proactive approach towards international credit rating agencies on Hong Kong's credit ratings. Through more effective communication between the international credit rating agencies and the relevant authorities, the HKMA's role is to ensure the agencies maintain a more balanced view on Hong Kong. These efforts paid off during 2005 amid improved economic prospects in Hong Kong. In July 2005, Standard & Poor's upgraded Hong Kong's foreign currency sovereign credit rating by one notch to AA- from A+. Moody's, Fitch Ratings, and Rating and Investment Information all affirmed Hong Kong's sovereign credit ratings in 2005.

Regional monetary co-operation and participation in multilateral institutions

The HKMA continued to contribute to policy dialogue in international and regional forums and was involved in regional monetary co-operation in 2005. The HKMA's Chief Executive became a member of the Review Group on the Organisation of Financial Sector and Capital Markets Work of the International Monetary Fund. The Review Group advised the IMF's Managing Director on ways to restructure its existing framework for improving the effectiveness of financial sector analysis and surveillance activities. The HKMA also participated in meetings of the Asia-Pacific Economic Co-operation (APEC) forum, the Financial Stability Forum and the Bank for International Settlements, and in regional central banking co-operation. Through its involvement with the Working Group on Offshore Financial Centres of the Financial Stability Forum, the HKMA supported the promotion of supervisory and regulatory standards and better practices in information sharing and cross-border co-operation by offshore financial centres.

Training

The training programmes for officials of the People's Bank of China (PBoC), the China Banking Regulatory Commission (CBRC) and other Mainland authorities in Hong Kong and the Mainland expanded in the scope of training, and the number of courses conducted and people trained in 2005. The courses covered areas in financial stability, banking supervision, financial infrastructure, accounting management and market analysis. They included

- two banking supervision courses for senior officials of CBRC
- nine specialised courses for CBRC bank supervisors
- three financial stability courses for senior officials of PBoC
- one bank accounting management course for PBoC accounting officials
- one financial stability and market analysis seminar for PBoC market research officials
- two clearing and settlement infrastructure courses for PBoC clearing officials
- one course for securities regulators of the China Securities Regulatory Commission
- one course for officials of the State Administration of Foreign Exchange.

In total, 20 courses, or 4,095.5 days of training, were provided to 1,129 Mainland officials in 2005.

The HKMA also provided training on request to other external parties, including courses for Mainland commercial banks and a regional course on Risk-focused Supervision and Risk Assessment under the APEC financial regulators' training initiative. A total of 206 participants attended these seminars in 2005.

PLANS FOR 2006 AND BEYOND

The HKMA will continue to monitor developments in globalisation and financial integration, and will ensure the views and concerns of Hong Kong on other important issues, such as financial stability and monetary co-operation are heard in central banking and international financial forums.

In further developing Hong Kong as a premier international financial centre, the HKMA will work with the Government in nurturing a deeper understanding of Hong Kong's economic and financial strengths among major international credit rating agencies. The HKMA will also co-operate with other EMEAP central banks and fund managers to launch the remaining five Single-market Funds under ABF2 in 2006.

Integration between Hong Kong and the Mainland is expected to strengthen in the years ahead with the continued development and expansion of renminbi business in Hong Kong and the full implementation of the three phases of CEPA. The HKMA will maintain close relations with the Mainland to promote Hong Kong's role in facilitating fund flows and serving the financial needs of Mainland China, as well as organising training seminars and courses for the staff of Mainland authorities and other external parties.

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