



International Financial Centre

The HKMA stepped up its efforts in regional surveillance and monitoring of risks to financial stability in the region and in Hong Kong. Research into and monitoring of developments in Mainland China were also strengthened. Significant progress was achieved in the implementation of the Action Agenda on “China’s 11th Five-Year Plan and the Development of Hong Kong”. Following a number of upgrades during the year, the credit ratings given to Hong Kong by all major international credit rating agencies were at an all-time high of “AA”.

OVERVIEW

Global financial markets experienced a challenging year in the face of the sub-prime crisis. While there was no sign of a direct impact on Asian economies, tensions in the US and European markets caused increased volatility and heightened risks in markets in the region. Economic and financial developments in Mainland China continued to be favourable, but inflation reached new highs as a result of rising energy and food prices.

These developments highlighted the importance of promoting financial stability in the region and in Hong Kong. The HKMA stepped up its efforts in regional surveillance with the co-ordination of a macro-monitoring framework for the Monetary and Financial Stability Committee (MFSC) established under the Executives’ Meeting of East Asia-Pacific Central Banks (EMEAP)¹. Research into and monitoring of developments in Mainland China were also strengthened. In financial co-operation initiatives with the Mainland, the HKMA played a key role in the implementation of the Action Agenda on “China’s 11th Five-Year Plan and the Development of Hong Kong”. This collaborative work with Mainland authorities resulted in significant achievements, including the issuance of renminbi bonds in Hong Kong, the first outside the Mainland; the addition of five new measures for the banking sector under the Closer Economic Partnership Arrangement (CEPA); and the expansion of

the investment scope of offshore wealth management services offered by banks on the Mainland.

REVIEW OF 2007

Regional co-operation and participation in multilateral institutions

With closer economic and financial integration in Asia, the HKMA continued to organise and participate in regional initiatives and discussions on a wide range of issues. During the year, the HKMA organised a number of international and regional meetings and seminars to bring together monetary and financial experts to discuss issues of significance and interest. This included a high-level seminar, co-organised with the International Monetary Fund, on the role of hedge funds in Asian financial markets. It was attended by more than 40 senior representatives from central banks in the region and the world’s major financial markets, regulatory bodies, international financial institutions and the private sector.

The HKMA attended meetings of the Asia-Pacific Economic Co-operation (APEC) forum, the Financial Stability Forum and the Bank for International Settlements. These forums provide useful channels for the HKMA to exchange views with the international community and promote understanding of monetary and financial issues in Asia and Hong Kong.

¹ EMEAP is a co-operative forum of 11 central banks and monetary authorities in the East Asia and Pacific region comprising the Reserve Bank of Australia, People’s Bank of China, Hong Kong Monetary Authority, Bank Indonesia, Bank of Japan, Bank of Korea, Bank Negara Malaysia, Reserve Bank of New Zealand, Bangko ng Pilipinas, Monetary Authority of Singapore and Bank of Thailand.

The International Finance Corporation, a member of the World Bank Group, expanded its Hong Kong-based Regional Office for East Asia and the Pacific to better serve its increasing operations in the region. This further underscored the role of Hong Kong as an international financial centre in hosting the regional and local offices of international financial institutions.

Promoting monetary and financial stability in Asia

The MFSC was established under EMEAP during the year to strengthen macro-monitoring in the region. Under the auspices of the MFSC, the HKMA developed an integrated monitoring framework, drawing together the macroeconomic developments and financial conditions in each EMEAP economy, and the interrelationship of such factors, with focused analysis of potential contagion risks and implications for regional financial stability. The monitoring framework was endorsed by the MFSC and EMEAP Governors and was launched in November with the HKMA acting as the co-ordinator for inputs from EMEAP members. In support of the MFSC's continuing work on regional surveillance, the monitoring framework will be used regularly at EMEAP meetings.

Upgrading Hong Kong's sovereign credit ratings

The HKMA continued to work closely with the Government to present a balanced assessment of Hong Kong's economic and financial strengths to international credit rating agencies (CRAs). A better sovereign credit rating helps lower the funding costs of Hong Kong debt issuers and increase market confidence in the Linked Exchange Rate system and monetary stability.

Building on previous discussions with CRAs, a more targeted approach was adopted to improve their understanding of Hong Kong's fiscal sustainability and the potential benefits and risks of increasing links with the Mainland. Quantitative analyses established a strong case for an AAA rating for Hong Kong on a stand-alone basis, while stress tests demonstrated that the resilience of Hong Kong's economy and financial systems helps limit the potential impact on Hong Kong of risks originating from the Mainland. Hong Kong was shown to be well positioned to benefit from Mainland China's capital account liberalisation and economic expansion through the financial and real-sector channels.

These efforts contributed to a number of upgrades in 2007 reflecting international recognition of Hong Kong's strong economic fundamentals, improved public finances and growth prospects. Hong Kong's ratings were upgraded by two international CRAs, both by one notch, and the outlook was upgraded to "positive" by another CRA. The credit ratings given by all major international CRAs were AA, the highest ever assigned to Hong Kong.

Advancing financial co-operation with the Mainland

The HKMA assisted in the implementation of the Action Agenda on “China’s 11th Five-Year Plan and the Development of Hong Kong” released in January 2007. The overall aim of the Action Agenda is to develop Hong Kong’s status as China’s international financial centre by establishing a mutually assisting, complementary and interactive relationship between the financial systems of Hong Kong and the Mainland in five areas:

- (i) expanding the presence of Hong Kong financial institutions on the Mainland;
- (ii) increasing the outward mobility of the Mainland’s investors, fund-raisers and financial institutions through Hong Kong;
- (iii) allowing Hong Kong financial instruments to be traded on the Mainland;
- (iv) enhancing Hong Kong’s capability in handling financial transactions denominated in renminbi; and
- (v) strengthening the financial infrastructure links between Hong Kong and the Mainland.

In expanding the presence of Hong Kong financial institutions on the Mainland, following further discussions between the HKMA and the China Banking Regulatory Commission (CBRC), five new two-way measures in relation to the banking sector were added under the CEPA Supplement IV signed on 29 June 2007. In addition to benefiting Hong Kong banks through lower asset requirements for acquiring a shareholding in Mainland banks and fast-tracking the establishment of branches in selected areas of the Mainland, Mainland banks will be encouraged to establish a presence in Hong Kong.

As for facilitating outflows from the Mainland, further to the work of the four-party working group on offshore wealth management services provided by commercial banks on the Mainland, (comprising the HKMA, the CBRC, the State Administration of Foreign Exchange (SAFE) and the Securities and Futures Commission), the investment scope of the scheme was expanded in May 2007. This was followed by the implementation of other Qualified Domestic Institutional Investors schemes operated by fund managers, securities firms and insurance companies on the Mainland. In August, SAFE also announced a pilot scheme to allow Mainland residents to invest directly in overseas securities. Apart from developing Hong Kong as a platform for outflows from the Mainland, these arrangements are expected to help increase the breadth and depth of the market.

The issuance of renminbi bonds in Hong Kong in July was a key milestone in the development of renminbi business in Hong Kong. To facilitate the issuance and trading of renminbi bonds, Hong Kong's Real Time Gross Settlement system and the Central Moneymarkets Unit were upgraded to process the real-time transfers of renminbi funds and renminbi debt securities. The clearing agreements under the renminbi business scheme were also amended. By the end of the year, there were three issues of renminbi bonds, totalling RMB10 billion. The renminbi bond market in Hong Kong has created a new channel for financial intermediation between Hong Kong and the Mainland, providing a new renminbi-denominated investment instrument for depositors and banks in Hong Kong, and a new funding avenue for Mainland issuers.

At the end of 2007, renminbi deposits totalled RMB33.4 billion and the number of accounts exceeded 698,000. Thirty-seven, or almost all retail banks in Hong Kong, were offering renminbi banking services.

Strengthening research on Mainland economic and financial issues

Improving the understanding of economic and financial developments on the Mainland and their implications for Hong Kong as an international financial centre continued throughout the year. *China Economic Issues*, a dedicated research series introduced in 2006, continued to be a useful reference for monitoring and analysing Mainland economic and financial market issues with a significant

bearing on Hong Kong. Projects undertaken in 2007 included studying the impact of the renminbi exchange rate on Asian currencies; the high volatility of the A-share market; the price convergence between A- and H-shares; rural developments on the Mainland; and the profitability of Mainland urban commercial banks. With the increasing use of the renminbi outside Mainland China, a conference was held in October on the internationalisation of the currency. The participants discussed the related international experiences, reviewed the current external use of the renminbi and explored its potential as an international currency.

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Training

Training programmes for officials of the People's Bank of China and the CBRC in Hong Kong and on the Mainland continued to expand. The courses covered monetary policy, financial stability, banking supervision, compliance risk, accounting management, macroeconomic analysis and financial risk management, and prevention of money laundering. Sixteen courses, or 3,081 man-days of training, were provided to 1,401 Mainland officials.

The HKMA also provided training on request to other external parties, including courses for Mainland commercial banks, regulators in the region and a regional course on Operational Risk Management under the APEC financial regulators' training initiative. More than 400 participants attended these seminars in 2007, doubling the number in 2006.

PLANS FOR 2008 AND BEYOND

With the global financial environment expected to remain volatile in 2008, regional co-operation to improve financial stability and surveillance will be particularly important. The HKMA will continue to co-operate with other central banks to develop analytical tools to better monitor risks. Representation in central banking and international financial forums remains a priority and the HKMA will ensure Hong Kong's views and concerns are heard. The HKMA will pursue further upgrades of Hong Kong's credit ratings. These initiatives should serve to improve Hong Kong's leading position as an international financial centre in the region.

On Mainland financial co-operation, the HKMA will work closely with Mainland authorities on implementing the Action Agenda. The main focus of the work in 2008 is the strengthening of the links and interaction between the financial markets of the Mainland and Hong Kong, and the further expansion of Hong Kong's renminbi business. Monitoring of the economic, financial and monetary developments on the Mainland and understanding of their implications for Hong Kong will be further improved. The HKMA will also strengthen co-operation with Mainland regulators, and organise training seminars and courses for staff of Mainland authorities and other external parties.

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