A financial development strategy for Hong Kong

The translated version of a speech delivered by Joseph Yam, Chief Executive of the Hong Kong Monetary Authority, at the Pan-Pearl River Delta Financial Services Forum on 23 March 2006. The speech was delivered in Chinese.

Joseph Yam proposed a five-pronged strategy to Hong Kong's financial development for enabling Hong Kong to assist in the intermediation of funds on the Mainland and supporting Hong Kong's status as an international financial centre: Hong Kong financial institutions to go into the Mainland to provide services; Hong Kong to serve as a gateway for Mainland funds to come out; Financial instruments issued in Hong Kong, particularly those issued by Mainland enterprises, to be made available on the Mainland; Hong Kong to enhance the capability of its financial system to handle renminbi-denominated transactions; and strengthen financial-infrastructure linkages between Hong Kong and the Mainland.

Introduction

Honourable officials, Ladies and Gentlemen, I would like to welcome our friends from the Pan-Pearl River Delta region to this financial services forum. The economies in the Pan-Pearl River Delta region are closely related in trade, movement of people, finance and investment. Each economy has its own characteristics and strengths, and they can further their development through co-operation. Hong Kong, as one of the Pan-Pearl River Delta economies, can make perhaps the greatest contribution in the area of finance.

It is a great pleasure for me to share my views with you on some financial issues and to propose a financial development strategy for Hong Kong. I hope, and I believe, that this strategy will allow Hong Kong to make a greater contribution to reform and liberalisation programme on the Mainland. It will also be instrumental in further deepening and expanding the co-operation among the economies in the Pan-Pearl River Delta region. I also hope that all of you will share this strategy and, wherever possible, to provide policy support to it on the Mainland. In fact, my subject today is one of the major responsibilities of the Hong Kong Special Administrative Region Government: the maintenance of the status of Hong Kong as an international financial centre, as required by Article 109 of the Basic Law.

Hong Kong's status as an international financial centre

Hong Kong is one of the leading international financial centres in Asia. In terms of financial infrastructure, it has the most advanced multi-currency payment, settlement and custodian system in Asia, which meets international standards. The system provides a safe and robust platform for all kinds of financial transactions. In terms of market activity, Hong Kong's equity market is among the ten largest markets in the world. It has become the IPO centre of Asia, outstripping Japan to rank top in Asia in terms of the amount of funds raised in 2005. Hong Kong is also one of the largest asset management centres in Asia, with assets under management amounting to HK$3,618 billion at the end of 2004.

In order to design a strategy for maintaining this leading position, there is a need to analyse the reasons for our success in the past. The rapid economic growth and increasing demand for financial intermediation on the Mainland in the past twenty years have been the two most obvious factors affecting Hong Kong's status as an international financial centre. With its sound legal system and efficient financial infrastructure, Hong Kong has played an important role in channelling foreign funds into the Mainland. Starting from as early as the late 1970s when liberalisation began on the Mainland, many foreign enterprises have been investing on the Mainland, in particular in the Pan-Pearl River Delta region, through Hong Kong. These foreign enterprises have set up regional headquarters in Hong Kong, and a large number of leading financial institutions have established subsidiaries in Hong Kong to gain access to the Mainland market. Many Mainland enterprises, especially those in the Pan-Pearl River Delta region, have set up "window" companies in Hong Kong to raise funds through the Hong Kong banks. That was how Hong Kong's relatively mature and open financial markets became, more than two decades ago, the international financial centre through which Mainland enterprises raised funds and foreign exchange. In the 1990s, Hong Kong became the major IPO centre for Mainland enterprises to raise funds outside the Mainland, enabling them to tap the international capital markets. These IPO activities have also created a critical mass and led to the rapid growth of asset management business in Hong Kong. To seize the business opportunities arising from Mainland-related assets, many leading international fund management companies have come to set up subsidiaries in Hong Kong in recent years.

At present, only a small proportion of funds raised in Hong Kong is directly related to domestic economic activities. The fund-raising process mainly involves mobilising foreign funds through Hong Kong into production activities in other places. For example, the subscribers of the H shares issued in Hong Kong by Mainland enterprises are mainly foreign investors. This illustrates how foreign funds are channelled through Hong Kong into investments on the Mainland. There were 209 Mainland limited companies (H shares) and Mainland-related companies (red chips) listed on the Hong Kong Stock Exchange at the end of 2005, representing one-third of the total market capitalisation. The amount of funds raised in 2005 through the listing of H shares and red chips was nearly HK$180 billion, representing 60% of the total funds raised. The aggregate turnover of H shares and red chips accounted for 40% of market turnover.

Moving with the times

Being the "middle-man" for financial intermediation between the Mainland and the rest of the world has become one of the key functions of Hong Kong as an international financial centre. I am sure our Honourable officials will agree that we must always remain vigilant and be prepared for potential problems. We should seek out ways to maintain the status of Hong Kong as an international financial centre in accordance with the Basic Law. Indeed, it is possible that, as financial reforms on the Mainland gather pace, Hong Kong's role as the financial "middle-man" between the Mainland and the rest of the world could be marginalised. Therefore, we have to explore how Hong Kong can move with the times as reform and liberalisation on the Mainland continue, information technology advances and financial markets become increasingly globalised.

There are differing opinions on this. Some have suggested Hong Kong should become the "Manhattan" of China or the "Switzerland" of Asia, and mimic other financial centres and bring in their financial products and ways of doing things. However, as I have pointed out previously, while we should learn from other financial centres, Hong Kong is Hong Kong. We are different from other economies economically, geographically, politically and culturally. As the Mainland economy grows rapidly, thanks to reform and liberalisation, Hong Kong's role on the financial front is far more complicated and challenging than that of Manhattan, London or Switzerland. There are still various controls and restrictions in the Mainland's financial system. Under these circumstances, and with Hong Kong's unique position, is it really true that replicating Manhattan-style derivatives and hedge funds or Switzerland-style wealth management arrangements is the only way for Hong Kong to be competitive? In my view, financial development strategies founded on mere slogans are not meaningful.

Deng Xiaoping once said that one should be realistic and pragmatic in what one says and does. The principal function of a financial centre is to provide a platform for conducting financial intermediation, that is, to efficiently channel savings into investments, putting savings to use in productive economic sectors. Therefore, I believe that, as “Hong Kong, China” under the “one country, two systems” arrangement, we should enhance our role in Mainland’s financial intermediation process, so as to maintain our status as an international financial centre. To achieve this, we should learn more about the Mainland, with a view to opening up new business opportunities in servicing Mainland investors and fundraisers and achieving mutual benefit.

Financial environment on the Mainland

As we see it from Hong Kong, there are three noteworthy observations about the current financial environment on the Mainland.

First, the savings rate on the Mainland has risen continuously in the past 10 years, accounting for more than 45% of GDP in 2004. With such a high domestic savings rate, some may question whether Mainland enterprises really need to raise funds outside the Mainland, and whether attracting more foreign direct investment is always the right thing to do. Personally, I think the priority should be to develop more channels for savers and fund-raisers to come together, either directly or indirectly through financial intermediaries, so that their respective needs for investment and financing can be met.

Secondly, the continuous inflow of foreign exchange in recent years has created pressure for the renminbi to appreciate, and increased the complications for monetary and exchange rate management. The foreign reserves of the Mainland increased by US$208.9 billion in 2005, reaching US$818.9 billion. Sterilisation had to be undertaken because the renminbi monetary base had become too large, making monetary management more difficult and costly. It is therefore time to adjust the foreign exchange policy of encouraging inflow and restricting outflow, and to allow funds to go out and put foreign exchange in the hands of the private sector. In the long run, the capital account should be liberalised to make the renminbi fully convertible.

Thirdly, the Mainland’s financial market reforms are still underway. Financial intermediation is still not efficient enough and relies too heavily on the banking channel. More than 80% of the financing obtained by enterprises is in the form of bank loans. Investment tools available in the market are limited. Mainland’s equity market has been in the doldrums in the last few years, and many of the high-quality enterprises have chosen to list outside the Mainland. Mainland investors are therefore unable to buy these shares. This is unfair to the investors, whose interests should be taken care of. Channels should be developed to enable them to invest in the capital markets outside the Mainland and earn a higher return. This will, in turn, stimulate consumption and further promote economic growth.

The financial development strategy for Hong Kong

To maintain Hong Kong’s status as an international financial centre, I believe that it is necessary for Hong Kong to move with the times and formulate a development strategy that takes into account these three inter-related aspects of the evolving financial environment on the Mainland. On the one hand, Hong Kong should strengthen and continue to develop a convenient, low-risk and efficient channel for financial intermediation between the Mainland and the rest of the world, channelling savings to meet the demand of Mainland fund-raisers while providing investment tools for Mainland savers to invest overseas.

On the other hand, Hong Kong should also proactively develop a similarly convenient, low-risk and efficient platform for the Mainland’s domestic financial intermediation, bringing together Mainland investors and fund-raisers. Advances in information technology allow the provision of financial intermediation services, especially financial intermediation conducted through capital markets, to be free from geographical limitations, at least at the wholesale level.

Some people have asked me whether Hong Kong would be "trespassing" if it became involved in the provision of financial intermediation services within the Mainland. Some also reminded me of the "one country, two systems" principle, and that Hong Kong should stick to its own job and not meddle in other people's business. I do not share these views. It is in the interests of the country to improve the efficiency and effectiveness of financial intermediation on the Mainland because this will allow the economy's rapid growth to continue. Deng Xiaoping also said, "Finance is very important; it is the nexus of the modern economy." Under the "one country, two systems" arrangement, there are two financial systems in China. It is sensible to use one financial system to help improve the other, and to use the efficient financial intermediation platform in one financial system to help achieve financial intermediation for the other.

There are of course still some constraints in Mainland's financial system, such as capital account control. The Mainland is therefore unable to take full advantage of the strength of Hong Kong's financial system. Hong Kong is also unable to contribute fully to financial intermediation on the Mainland. But I think the current financial and monetary conditions on the Mainland provide an opportunity for further liberalising the financial system.

Risk management is crucial, of course. We can develop appropriate channels which can be monitored, adjusted and controlled, with a view to enabling Hong Kong to assist in the intermediation of funds on the Mainland and at the same time supporting Hong Kong's status as an international financial centre.

I propose a five-pronged strategy to Hong Kong's financial development:

1. Hong Kong financial institutions to go into the Mainland to provide services;

2. Hong Kong to serve as a gateway for Mainland funds to come out;

3. Financial instruments issued in Hong Kong, particularly those issued by Mainland enterprises, to be made available on the Mainland;

4. Hong Kong to enhance the capability of its financial system to handle renminbi-denominated transactions; and

5. To strengthen financial-infrastructure linkages between Hong Kong and the Mainland.

This is a win-win strategy benefiting both the Mainland and Hong Kong. Let me elaborate on the details of these five components.

1. Hong Kong financial institutions to go into the Mainland

With the vast opportunities offered by the Mainland, Hong Kong financial institutions should go into the Mainland to expand their business by providing services to customers on location, such as retail banking. CEPA has helped relaxed some of the restrictions on Hong Kong financial institutions going into the Mainland. Thanks to CEPA, Hong Kong banks receive preferential treatment compared with foreign banks, such as lower asset requirements for establishing branches. As a result, medium-size banks from Hong Kong can expand their network in Shenzhen and other places on the Mainland, strengthening the financial links between Hong Kong and the Pan-Pearl River Delta region. Other preferential treatment includes more relaxed requirements for the number of years a bank must have been in operation, profitability, and the level of operating funds it must have before it may conduct renminbi business on the Mainland.

The next step will be for Hong Kong financial institutions to make better use of CEPA and other means to go into the Mainland. They should expand their range of services and actively develop the Mainland market. As Hong Kong financial institutions are familiar with the environment on the Mainland and have international experience, their presence on the Mainland will allow the transfer of technical know-how and provide Mainland enterprises and people with a greater choice of financial instruments and services.

2. *Hong Kong to serve as a gateway for Mainland funds to come out*

Hong Kong can be a gateway for funds to come out of the Mainland. Hong Kong's efficient multi-currency platform can provide a meeting place for Mainland's savings and investment needs, so that Mainland investors can directly or indirectly purchase shares issued by Mainland enterprises listed in Hong Kong. The State Administration of Foreign Exchange has made "actively developing more channels for outflows of funds and gradually moving towards capital account convertibility" one of its objectives for 2006. The market is anticipating the introduction of QDII. Hong Kong financial institutions are familiar with the operation of the Mainland and international financial markets. They also have an edge over foreign institutions in terms of language and culture when providing services to Mainland investors. Mainland investors are more familiar with the markets in Hong Kong, and can therefore initially focus on equity and debt instruments issued in Hong Kong by Mainland enterprises. This will meet the objectives of ensuring orderly outflows from the Mainland, supporting the development of the Mainland enterprises listed in Hong Kong, and opening an effective channel in Hong Kong for financial intermediation between Mainland investors and Mainland fund-raisers.

3. *Financial instruments issued in Hong Kong to be made available on the Mainland*

To facilitate investments by Mainland residents in enterprises listed in Hong Kong, financial instruments in Hong Kong (particularly those issued by Mainland enterprises) should be made available on the Mainland when the relevant Mainland regulations permit. There are a number of ways to do this, for example by means of depositary receipts or dual-listing, so that investors in both Mainland China and Hong Kong can trade shares listed in Hong Kong. It is worth noting that, however this is done, the same shares might end up with different prices in the two places. To address this, it is necessary to introduce an arbitrage mechanism to equalise the prices of the same shares in the two markets.

If financial instruments in Hong Kong can be made available on the Mainland to satisfy the demand of Mainland investors, not only will Hong Kong's status as an IPO centre be maintained, Mainland fund-raisers, in particular the enterprises in the Pan-Pearl River Delta region, will also be able to continue to use Hong Kong's advanced platform to raise more funds. This will not only provide Mainland investors with a more diversified range of investment products but also improve the efficiency of financial intermediation on the Mainland.

4. *Hong Kong to enhance the capability of its financial system to handle renminbi-denominated transactions*

The renminbi is the currency used by Mainland investors and fund-raisers, it is therefore necessary for Hong Kong to enhance the capability of its financial systems to handle renminbi-denominated transactions if it is to meet the Mainland's financial intermediation needs more effectively. The development of renminbi business in Hong Kong in recent years is the first step towards this goal. Renminbi business in Hong Kong has been developing in a steady and orderly manner since its launch in 2004. At the end of 2005, outstanding renminbi deposits in Hong Kong amounted to RMB22.6 billion yuan, with 428,000 renminbi deposits accounts having been opened. Thirty-eight banks were engaged in providing renminbi business, representing almost all the major retail banks in Hong Kong.

The launch of renminbi business in Hong Kong is conducive to economic integration between Hong Kong and the Mainland, especially within the Pan-Pearl River Delta region, and it facilitates cross-border consumption. As the next step in developing Hong Kong's renminbi business, the HKMA is working closely with the Mainland authorities on proposals for the issuance of renminbi-denominated bonds in Hong Kong and the use of renminbi to settle trade transactions between Hong Kong and the Mainland.

Further expansion of renminbi business not only strengthens Hong Kong's status as an international financial centre, but also provides a testing ground for the gradual move towards full convertibility of the renminbi.

5. To strengthen financial-infrastructure linkages between the Mainland and Hong Kong

Over the years, the HKMA has been in co-operation with the authorities in Shenzhen, Guangzhou and Beijing in establishing cross-border links for clearing, settlement and custodian systems. There are already several payment system links for different currencies and different regions, and further links (including the central clearing systems for bonds and equities) are being pursued. The further development of renminbi financial infrastructure in Hong Kong and its links with the corresponding systems on the Mainland will enable the increasing cross-border capital flows and financial activities to be conducted efficiently in a safe and reliable environment.

Financial co-operation

Financial co-operation between Hong Kong and the Mainland, if pursued through this five-pronged strategy, will make Mainland's financial intermediation more efficient, while meeting the requirement of Article 109 of the Basic Law on the maintenance of the status of Hong Kong as an international financial centre. Because Hong Kong operates a capitalist market economy, its financial system and markets are free of restrictions. There is no policy obstacle to the proposed five-pronged strategy, and it is ready for implementation. For example, the groundwork for introducing the renminbi into Hong Kong's multi-currency RTGS system has already been done. It will take only five weeks to complete the process once the green light is given, achieving payment versus payment for foreign exchange transactions in Hong Kong involving the renminbi, the Hong Kong dollar, the US dollar and the euro, meeting the highest standard in terms of settlement risk management. The mechanism for issuing renminbi-denominated bonds is also ready, once the green light is given by the Mainland authorities to allow the bond issuers to remit the renminbi funds raised to the Mainland.

The strategy has five components, and there are five hopes. We hope for the green light to allow us to proceed. We hope for consensus to be reached on the related policies on the Mainland. We hope that there will be more specific measures to enhance the efficiency of the Mainland's financial intermediation as the eleventh five-year plan is implemented. We hope that Hong Kong can contribute more to the Mainland's financial intermediation. We hope that we can continue to implement policies for the maintenance of the status of Hong Kong as an international financial centre as required by Article 109 of the Basic Law.

The green light will also bring about plentiful business opportunities to the Pan-Pearl River Delta region. Many of the Mainland enterprises listed in Hong Kong are from the Pan-Pearl River Delta region. The favourable economic development in the region has also attracted banks and financial institutions in Hong Kong to set up businesses there. Hong Kong banks now have a total of 69 branches on the Mainland and more than half of them are located in the Pan-Pearl River Delta region.

Many of the financial-infrastructure links between Hong Kong and the Mainland started with the Pan-Pearl River Delta region. For example, the cross-border Hong Kong dollar and US dollar cheque clearing systems were first established between Hong Kong and Shenzhen and Guangdong before they were expanded to other cities. Renminbi cheques, an item of renminbi business recently introduced on 6 March, were also rolled out in Guangdong Province as a trial. This reflects the strategic role of the Pan-Pearl River Delta region.

Conclusion

In my speech today I have put forward a five-pronged financial development strategy for improving the efficiency of the Mainland's financial intermediation and maintaining the status of Hong Kong status as an international financial centre. I also look forward to the realisation of our five hopes. Hong Kong's past and current positions have been built upon its role as the window for attracting foreign funds into the Mainland. In the future, in an ever-changing international financial environment, Hong Kong should seize the opportunities brought about by reform and liberalisation on the Mainland, move with the times and participate fully in the Mainland's financial intermediation, so as to enhance our status as an IPO and asset-management centre. In line with the reform strategy of the Mainland, Hong Kong should serve as a testing ground for the Mainland's reform programme, and provide appropriate and diversified services to Mainland investors and fund-raisers, especially those in the Pan-Pearl River Delta region. The Mainland is now the fourth largest economy in the world. The continuous development and expansion of the Mainland's economy represent a golden opportunity for the maintenance and strengthening of Hong Kong's status as an international financial centre.

Thank you.