

Measuring the position of Hong Kong as an international financial centre

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Hong Kong is often portrayed as the hub for most major multinational companies and an important centre for the provision of financial services to international investors. Yet, traditional measures, such as the concentration of financial market activities, suggest that Hong Kong remains much smaller than the top international financial centres (IFCs) of New York and London. Alternative measures constructed in this paper better capture the ability of an IFC to attract capital flows and international demand for its financial services, and underline Hong Kong's strengths.

Introduction

The development of global financial services has become an important factor in the growth of an economy. It will substantially increase economic activity, create more direct and indirect jobs, and improve tax revenues. In addition, financial institutions provide intermediation services to all businesses which, in turn, expedite more efficient allocation of financial resources. More importantly, a strong financial services sector is critical to the health of the overall economy. Therefore, achieving international financial centre (IFC) status is a goal of many economies, particularly the more advanced emerging economies; while advanced economies, with their well-developed IFCs, strive to protect and strengthen their position.

Although the existence of financial services does not depend on natural resources, and providers are thus not restricted in their choice of location, financial centres tend to concentrate asymmetrically in certain areas. At present, New York and London are the

dominant world financial centres. In Asia, economies like Hong Kong and Singapore are also becoming an increasing threat to Tokyo's leading role in the region.

Nevertheless, comparisons among financial centres are often made by assuming that a certain economy is already an IFC, without providing objective measures for the concentration of financial market activities. And, even when this traditional information is provided, it might not adequately reflect the perceived importance of an economy as an IFC. This is particularly true in Hong Kong's case, which is often seen as the hub for most multinational companies and a major centre for the provision of financial services to international investors. However, its relative size in financial markets still appears to remain far smaller than those of New York and London, which does not reflect Hong Kong's perceived importance. It is, therefore, useful to construct measures for the concentration of international financial activities that can better reflect an economy's position as an IFC.¹

¹ For a more complete analysis, see Cheung, Lillian and Vincent Yeung, "Hong Kong as an International Financial Centre: Measuring its Position and Determinants", *HKMA Working Paper* no. 14/2007.

Measuring the concentration of financial market activities

In general, a financial centre can be defined as “a place in which there is a high concentration of banks and other financial institutions, and in which a comprehensive set of financial markets are allowed to exist and develop, so that financial activities and transactions can be effectuated more efficiently than at any other locality”.² In addition, raising the bar to become an IFC requires an economy to attract international financial activities. As such, its share of these international activities provides a good indicator of the economy’s status as an IFC.

The conventional approach to measuring the relative importance of various financial centres is often based on the degree of concentration of international financial activities in five markets – equities, bond, credit (as represented by the banking sector), foreign exchange and derivatives. In this section, we construct measures for the degree of concentration of international financial activities in an economy based on its share of traditional financial activities in world markets. This is proxied by the turnover in the respective markets wherever possible. However, due to data limitation, activities in some markets are represented by other indicators, such as the outstanding value of the bond market and the foreign assets and liabilities of the banking sector.

Specifically, the measures on each economy’s degree of concentration of international financial activities in various traditional markets are constructed as follows:

- (1) EQ_i/EQ_w measures the economy’s share in world equity market turnover;
- (2) IPO_i/IPO_w measures the economy’s share in world funds raised through Initial Public Offerings (IPOs) in the equity market;

- (3) BD_i/BD_w measures the economy’s share in world outstanding domestic and international bonds in the bond market;
- (4) BK_i/BK_w measures the economy’s share in world foreign assets and liabilities of the banking sector (credit market);
- (5) FX_i/FX_w measures the economy’s share in world turnover in the foreign exchange market;
- (6) DR_i/DR_w measures the economy’s share in world turnover of interest rate and foreign exchange derivatives.

These measures are constructed for 25 OECD countries, as well as Hong Kong, Shanghai and Singapore based on the latest data available. It should be noted that comparisons can only be made at the country level due to limitation on data availability.³ Using these measures, the importance of an economy’s position as an IFC increases with its share in world financial market activities.

As shown in Table 1, the vast majority of world financial activities are presently concentrated in the US and the UK, with a substantial gap between them and the rest of the economies studied. Based on a simple average of normalised scores for all financial markets, Hong Kong ranks sixth in terms of overall financial activities concentration, trailing behind Japan, Germany and France. It should be noted, however, that Hong Kong’s position has been largely boosted by buoyant IPO activities, while its bond market remains relatively small compared with those of the OECD countries.⁴ The equity market turnover of Hong Kong (1.2% of the world) is also small relative to its share of world market capitalisation.⁵ In terms of foreign exchange and derivatives activities, Hong Kong has captured 4.2% and 2.7% of the respective world markets, compared with 5.2% and 3.2% in Singapore.

² Jao, Y. C. (1997). Hong Kong as an International Financial Centre, Evolution, Prospects and Policies, City University of Hong Kong Press.

³ Data are only available at the country level except for equity markets, in which we include activities in exchanges located in capital cities or established IFCs.

⁴ However, as data on bond markets are only available at the country level, it would be inappropriate to make direct comparison between Hong Kong and other countries.

⁵ The Hong Kong Stock Exchange accounts for around 3.4% of the total market capitalisation of all members of the World Federation of Exchanges.

TABLE 1

World Concentration of traditional financial activities

| | Financial activities concentration (average normalised score) | World share in individual markets (%) | | | | | | | |
|------------------|---|---------------------------------------|----------------------|---------------------------------------|---|---------------------|--------------------------|-------------|--|
| | | Equity turnover | Fund raised thru IPO | Intl Bond Market – amount outstanding | Domestic Bond Market – amount outstanding | Bank Foreign Assets | Bank Foreign Liabilities | FX turnover | FX / Interest Rate Derivatives Market turnover |
| US | 100.0 | 49.0 | 16.3 | 23.3 | 44.6 | 8.9 | 11.7 | 19.2 | 19.4 |
| UK | 90.6 | 10.9 | 16.9 | 12.6 | 2.4 | 19.8 | 22.5 | 31.3 | 38.1 |
| Japan | 32.7 | 8.3 | 3.7 | 0.9 | 18.1 | 7.6 | 3.2 | 8.3 | 6.0 |
| Germany | 23.0 | 3.9 | 3.6 | 10.6 | 4.4 | 10.6 | 7.3 | 4.9 | 4.1 |
| France | 22.1 | 2.8 | 3.8 | 6.2 | 4.4 | 9.1 | 9.3 | 2.6 | 6.6 |
| Hong Kong | 13.2 | 1.2 | 12.9 | 0.3 | 0.1 | 2.3 | 1.4 | 4.2 | 2.7 |
| Netherlands | 10.9 | 1.3 | 3.7 | 7.1 | 1.5 | 3.8 | 3.7 | 2.0 | 2.0 |
| Switzerland | 9.9 | 2.0 | 0.8 | 0.1 | 0.5 | 4.6 | 4.4 | 3.3 | 2.4 |
| Singapore | 9.9 | 0.3 | 1.5 | 0.3 | 0.2 | 2.4 | 2.6 | 5.2 | 3.2 |
| Italy | 9.6 | 2.3 | 1.6 | 4.3 | 5.2 | 1.8 | 2.6 | 0.8 | 1.7 |
| Australia | 8.6 | 1.2 | 3.9 | 1.9 | 0.8 | 0.5 | 1.5 | 3.4 | 2.4 |
| Spain | 8.2 | 2.8 | 4.5 | 4.8 | 2.3 | 1.7 | 2.4 | 0.6 | 0.7 |
| Canada | 7.7 | 1.8 | 2.7 | 2.1 | 2.0 | 1.0 | 1.0 | 2.2 | 1.7 |
| Belgium | 5.4 | 0.2 | 0.1 | 0.8 | 0.9 | 3.3 | 3.0 | 0.8 | 1.5 |
| Ireland | 4.6 | 0.1 | 1.1 | 3.4 | 0.2 | 2.8 | 3.3 | 0.3 | 0.5 |
| Austria | 4.3 | 0.1 | 3.6 | 1.5 | 0.5 | 1.3 | 1.2 | 0.5 | 0.7 |
| Luxembourg* | 4.2 | 0.0 | 0.6 | 1.9 | 0.0 | 3.6 | 2.5 | 0.6 | 0.6 |
| Sweden | 4.1 | 1.1 | 0.3 | 0.9 | 0.7 | 1.0 | 1.4 | 1.3 | 1.0 |
| Denmark | 4.1 | 0.3 | 0.2 | 0.5 | 0.9 | 0.6 | 1.0 | 1.7 | 1.4 |
| Korea | 3.5 | 1.9 | 0.8 | 0.5 | 1.5 | 0.3 | 0.6 | 0.8 | 0.4 |
| Norway | 3.5 | 0.6 | 4.2 | 0.6 | 0.2 | 0.2 | 0.5 | 0.6 | 0.6 |
| Shanghai* | 3.3 | 1.1 | 3.6 | 0.1 | 2.2 | 0.0 | 0.0 | 0.0 | 0.0 |
| Mexico | 1.3 | 0.1 | 0.3 | 0.4 | 0.5 | 0.1 | 0.1 | 0.6 | 0.2 |
| Portugal | 1.1 | 0.1 | 0.4 | 0.4 | 0.3 | 0.4 | 0.7 | 0.1 | 0.1 |
| Finland | 1.0 | 0.5 | 0.3 | 0.6 | 0.3 | 0.3 | 0.4 | 0.1 | 0.0 |
| Greece | 1.0 | 0.2 | 0.0 | 0.8 | 0.5 | 0.2 | 0.3 | 0.2 | 0.1 |
| Turkey | 0.8 | 0.3 | 0.3 | 0.2 | 0.3 | 0.1 | 0.2 | 0.1 | 0.1 |
| Poland | 0.6 | 0.1 | 0.0 | 0.2 | 0.2 | 0.0 | 0.0 | 0.2 | 0.2 |
| Total (%) | | 94.5 | 91.7 | 87.4 | 95.7 | 88.3 | 88.7 | 96.1 | 98.3 |

Notes: 1.) Equity figures as of end-2006, 2.) International bond market figures as of Q3 2006, 3.) Domestic bond market and banking figures as of Q2 2006, and 4.) FX and derivative turnover figures as of 2004.

* Data missing from one or more markets.

Sources: World Federation of Exchanges, Individual Exchanges, CEIC, BIS and staff calculations.

(1) A graphical analysis

An examination of how the strength of these financial centres is distributed among individual financial markets, using a graphical analysis, provides a comprehensive overview of the position of each

financial centre in different markets. Using financial markets in the US as benchmarks, a simple graphical framework displaying simultaneously in one chart the six indicators discussed above is developed to offer an overview of how Hong Kong compares with other established IFCs in each

CHART 1

A graphical comparison of Hong Kong with major IFCs in traditional financial markets

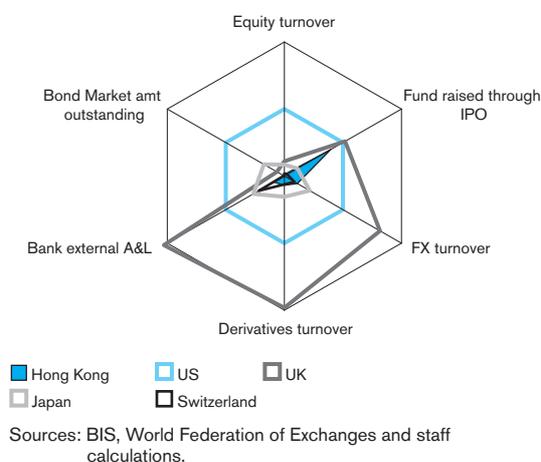
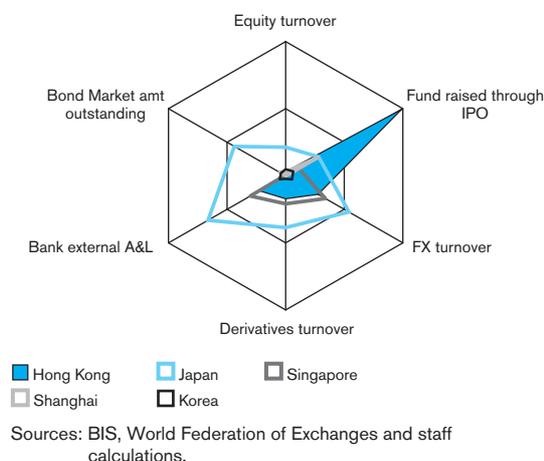


CHART 2

A graphical comparison of Hong Kong with other regional financial centres in traditional financial markets



financial market (Chart 1). The values of the six indicators are presented using a hexagon. The distance of each corner from its centre represents the magnitude of each indicator, that is, the share of world financial activities of an economy in each market. A larger hexagon suggests higher concentration of financial market activities in an economy, and hence a greater importance of that economy as an IFC. The magnitude of each indicator is normalised against a benchmark economy, in this case the US, for which most indicators are the highest among all economies.⁶ Chart 1 shows that the UK is arguably the only other IFC which achieves a degree of financial activities concentration comparable to the US. Among the remaining economies, only Japan has a more balanced financial structure with significant presence in every market. As noted previously, the strength of Hong Kong lies mainly in its IPO activities.

Chart 2 makes a similar comparison between Hong Kong and the other Asian financial centres. Within the region, Japan remains the leader in most markets. While Hong Kong takes the lead in terms of funds raised through IPOs, Singapore has marginally larger international banking, derivatives and foreign exchange markets than Hong Kong. And the world

share of various financial activities in Shanghai and Korea remains relatively limited.

(2) Problems associated with traditional indicators

Nevertheless, these traditional measures of the concentration of financial market activities do not appear to reflect the perceived importance of Hong Kong as an IFC. In fact, there are a number of caveats. First, the measures reflect both domestically-oriented activities and international financial activities. Such activities increase with the size of the domestic economy and can account for a significant part of the market turnover, especially in large economies such as the US. These indicators therefore do not reflect the pure international element of financial activities on which the importance of an IFC should be assessed.

Secondly, the conventional approach presented above also limits the measurement of the status of IFCs to activity concentration in financial markets. However, the function of IFCs could go beyond this traditional perception. The degree of an IFC's success also includes its ability to attract capital flows, international demand for its wealth management services, and its ability to congregate international financial institutions.

⁶ All indicators are normalised to 100 for the US.

Thirdly, due to data limitations, the measures above are compared on a country rather than on a city level on which activities of an IFC should be based. Any comparison of Hong Kong with other economies on a country basis will be misleading. The problem is particularly pronounced compared with economies that are significantly larger in size. Although financial activities are mainly conducted in the major cities where the financial markets are located, significant differences in the size of the cities also prevent a consistent comparison between them. In the case of the US, comparisons will be against financial activity in more than one city, namely New York and Chicago.

Alternative measures

In view of these caveats to the traditional measures, we construct three alternative measures to assess the importance of Hong Kong as an IFC relative to other major economies – the inward international investment position (excluding foreign direct investment, or FDI), exports of financial services, and inward direct investment in the financial sector. Similar to the traditional measures, these data are available only on a country basis. The measures are therefore scaled by GDP in cities where the respective financial markets are located to allow a more consistent basis of comparison.

(1) *Inward International Investment Position excluding direct investment*

A successful IFC should be able to provide intermediation services for international capital. By excluding direct investment, an economy's inward

international investment position reflects its ability to attract international financial activities, and hence an economy's position as an IFC. The information reflects international financial transactions of portfolio and other investment, which excludes domestic financial activities incorporated in traditional financial market transactions data. Table 2 shows a comparison of the international non-direct investment position among major economies. At US\$11 trillion, the total inward non-direct investment position in the US was substantially above that of other countries. At a modest level of US\$532 billion, Hong Kong fared slightly better in terms of ranking than under the traditional measures, but still lagged behind the US, Japan and most European economies. The scaling of the data by GDP provides similar results.

(2) *Financial Services Exports*

While the inward non-direct investment position better reflects the international element of financial activities in an economy, it is again limited to the financial markets of equity and debt securities in the form of portfolio investment, and banking sector activity in the form of other investment. However, international financial activity includes more than investment that flows directly into the equity, debt and credit markets, but also the provision of non-traditional investment services such as wealth management.

As such, exports of financial services provide a comprehensive measure of all international financial activities in an economy. They represent all business receipts from the provision of financial services to

TABLE 2

International Investment Position (excluding FDI), 2005

| | Inward IIP ex FDI, USD bn | Normalised (US = 100) | Inward IIP ex FDI to city's GDP | Normalised (US = 100) |
|----------------|---------------------------|-----------------------|---------------------------------|-----------------------|
| United States | 10,828 | 100 | 11 | 100 |
| United Kingdom | 7,779 | 72 | 12 | 103 |
| Germany | 3,611 | 33 | – | – |
| Japan | 2,658 | 25 | 6 | 51 |
| Switzerland | 1,409 | 13 | 9 | 78 |
| Hong Kong | 532 | 5 | 3 | 27 |
| Singapore | 294 | 3 | 3 | 22 |

Sources: IMF international financial statistics and individual countries' authorities.

TABLE 3

Top exporters of financial services (including insurance), 2005

| | Exports of financial and insurance services, USD mn | Normalised (US = 100) | Exports of financial services to city's GDP ratio | Normalised (US = 100) |
|----------------|---|-----------------------|---|-----------------------|
| United Kingdom | 42,637 | 118 | 64 | 169 |
| United States | 36,122 | 100 | 38 | 100 |
| Switzerland | 14,266 | 33 | 89 | 236 |
| Germany | 8,286 | 19 | – | – |
| Hong Kong | 6,715 | 16 | 38 | 100 |
| Japan | 5,572 | 13 | 12 | 32 |
| Singapore | 4,228 | 10 | 36 | 96 |

Sources: OECD and individual countries' authorities.

overseas investors, like stock broking, foreign exchange, bank lending and borrowing, insurance services, as well as services that are not captured by the activity indicators for the financial markets. These include services provided by wealth management companies, hedge funds and private equity. Thus, exports of financial services should reflect the external demand for all financial services from an economy, and therefore its attractiveness as an IFC.

Table 3 shows that, in 2005, Hong Kong was the fifth largest exporter of financial services among the group of economies in the study.⁷ Indeed, financial services exports from Hong Kong increased by 88% from 2004 to 2006, surpassing Japan, although they remained small relative to the US whose financial services exports were four times larger.

Nevertheless, after scaling by GDP, Hong Kong moves up the ranking to the level as the US.

(3) Financial Sector Foreign Direct Investment

In addition to providing financial services to overseas investors, the competitiveness of an IFC is also reflected in its ability to attract major multinational financial institutions to establish a base in the city. An appropriate measure is the inward financial sector direct investment of an economy. This reflects long-term investment into the financial sector from abroad, such as setting up local operations by international financial institutions through both greenfield investment, and mergers and acquisitions. Hong Kong has been a leader in this field, suggesting that it is the favourite location for international financial institutions wishing to engage in business in the region (Table 4).

TABLE 4

Financial sector foreign direct investment, 2004

| | Financial sector FDI, USD mn | Normalised (US = 100) | Financial sector FDI to city's GDP | Normalised (US = 100) |
|-----------------|------------------------------|-----------------------|------------------------------------|-----------------------|
| United States | 329,837 | 100 | 344 | 100 |
| United Kingdom* | 164,630 | 50 | 246 | 71 |
| Switzerland | 124,888 | 38 | 781 | 227 |
| Hong Kong | 91,090 | 28 | 514 | 149 |
| Singapore | 59,980 | 18 | 514 | 149 |
| Germany* | 20,603 | 6 | – | – |
| Japan | 9,806 | 3 | 21 | 6 |

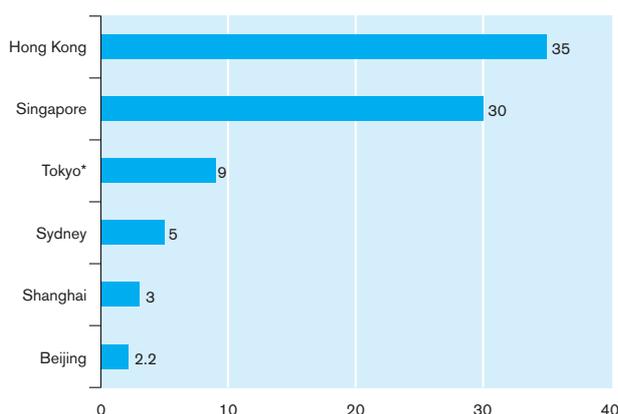
* For the UK and Germany the latest available figure is from 2003.

Sources: OECD and CEIC.

⁷ The 2005 data is the latest available from every member of the group.

Chart 3 shows that of the 23 largest financial institutions in the world, 19 have their Asia-Pacific (excluding Japan) headquarters located in Hong Kong, compared with five in Singapore and one in Australia.^{8, 9} On a more general level, Hong Kong is also the favourite location for international enterprises wishing to engage in business in the region. According to a study conducted by the Economist Intelligence Unit in 2000, 35% of the 8,000 multinational companies surveyed had their regional headquarters in Hong Kong.¹⁰ After adjusting for GDP, Hong Kong outperforms most major financial centres to become the leading location for international direct investment in the financial sector after Switzerland.

CHART 3
Location of multinational companies' regional headquarters, 2000

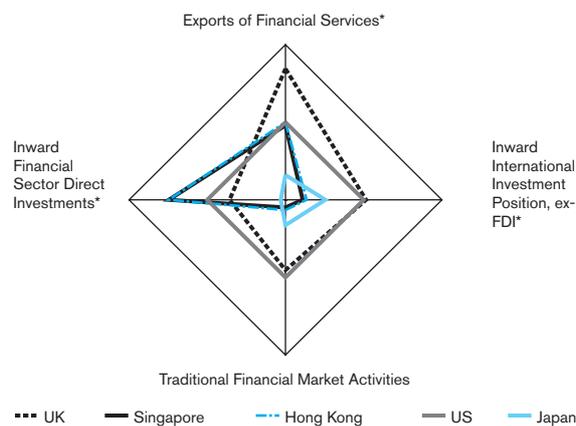


* 2003 figure. Japanese MNCs are excluded for Tokyo.
Source: Economist Intelligence Unit

A comprehensive overview

Taking into account both the concentration of traditional financial market activities and the alternative measures above, Chart 4 presents a comprehensive framework comparing different economies' performance as an IFC, using the US as a benchmark. The US and the UK remain the dominant locations as IFCs based on activities in financial markets, which is also reflected in international investment positions excluding FDI. While Hong Kong lags well behind when adjustments are made for GDP in major cities, the alternative measures suggest that Hong Kong has been the leader in inward financial sector direct investment and comparable to the US in exports of financial services, closely followed by Singapore. On the other hand, Japan, despite its large financial markets, is relatively small in terms of exports of financial services and, in particular, inward financial direct investment.

CHART 4
A comprehensive comparison of Hong Kong with other major IFCs



* scaled by GDP in the respective economy.
Sources: BIS, individual countries' authorities, IFS, OECD, World Federation of Exchanges and staff calculations.

⁸ The list includes the largest commercial and investment banks, fund managers, and insurance companies based on rankings drawn from different sources and criteria.

⁹ Some FIs have more than one regional headquarters in Asia.

¹⁰ According to a more recent report by the Hong Kong Government, the number of foreign companies with their regional office in Hong Kong has increased by 30% from 2002 to 2006. However, the exact numbers from EIU and the HKSAR Government may not be directly comparable as the sample size may be different.

Concluding remarks

In summary, traditional measures for identifying financial market activities may not fully reflect Hong Kong's position as an international financial centre. This is highlighted by the three alternative measures constructed in this paper to assess the importance of Hong Kong as an IFC relative to other major economies – the inward international investment position (excluding FDI), exports of financial services, and inward direct investment in the financial sector. These measures suggest that Hong Kong has been one of the leading centres for the inward financial sector direct investment and fares well in exports of financial services. Looking ahead, the rise of Mainland China represents a potentially important push factor for the demand for financial services exports from Hong Kong, and hence its status as an IFC.