HONG KONG'S ROLE IN CHINESE FINANCIAL DEVELOPMENT: IMPLICATIONS FOR INLAND DEVELOPMENT *

Hong Kong has long served as the gateway for financial and commercial links between the mainland of China and the rest of the world. In the next century, China is expected to emerge as a major force in the global economy. As an international financial centre, Hong Kong is well placed to provide support to the financial development of the Mainland, including the inland areas. Market reforms require deeper understanding and sharing of experience between the two economies, under the principle of "one country, two systems".

I am honoured to be invited by Mr Lou Jiwei, Vice Governor, Guizhou Province to address this important International Symposium on Guizhou Reform and Development. The subject of "Hong Kong's role in Chinese financial development: Implications for inland development" is an important one. It is a subject that we have devoted some time and effort to study in the light of the imminent and historic return of Hong Kong to China in less than five weeks. I shall first look at the role of Hong Kong as an international financial centre. Next, I shall review the growing trade and financial links between Hong Kong and the Mainland. Third, using World Bank forecasts, we will look at the projected growth in the greater China region in the 21st century. Finally, I shall examine how Hong Kong can play a role in the Mainland's financial reforms.

Hong Kong as an International Financial Centre

Hong Kong is widely recognised as one of the world's leading financial centres. Our financial markets rank high in depth and liquidity. Hong Kong ranks in the world:

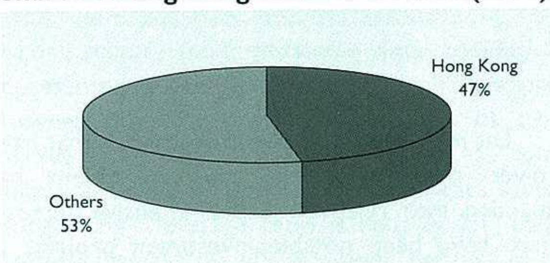
- 5th for foreign exchange turnover;
- 5th for external assets of banks;
- 7th for derivatives turnover;
- 7th for stock market capitalisation (second largest in Asia after Japan);
- 4th largest gold bullion market; and
- the largest loan syndication and debt issuance centre in Asia.

The reasons for Hong Kong's emergence as an international financial centre are well known. These include its strategic geographical location at the centre of East Asia – the fastest growing region in the world, a market-friendly economic policy with free flow of capital and information, a diligent workforce, a sound legal system, low tax rate and one of the best telecommunications, seaport and physical infrastructures in Asia.

Trade and Investment Integration with the Mainland of China

Hong Kong has long served as the gateway for financial and commercial links between the mainland of China and the rest of the world. The two economies by themselves have also become increasingly integrated in trade and investment terms. As a result of China's open-door policy, two-way trade grew rapidly over the past two decades. By far, the Mainland is Hong Kong's largest trading partner. And our trade with the Mainland constituted nearly half of the Mainland's external trade in 1996 (Chart 1).

Chart 1:
Share of Hong Kong in China's Trade (1996)



Source: China Monthly Statistics, Feb 1997
Annual Review of Hong Kong External Trade 1996

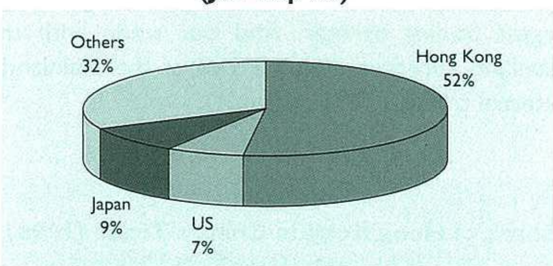
Trade in services has become more important as well. Hong Kong is an important centre of trans-shipments for the Mainland, allowing goods consigned between the Mainland and third-party

* This is the revised text of a speech given by Andrew Sheng, Deputy Chief Executive of the Hong Kong Monetary Authority at the International Symposium on Guizhou Reform & Development held in Guiyang on 27 May 1997. The author is grateful to Carmen Chu for research assistance in the preparation of this paper.

countries to be trans-shipped via Hong Kong or temporarily stored in the territory. Related services include transportation services, offshore trading and purchasing/merchandising services, and financial and banking services. We also supply the Mainland with services in travel and tourism. Last year, visitors from the Mainland accounted for one-fifth of total tourists to Hong Kong, spending 18% of the territory's total tourist receipts.

With respect to foreign direct investment (FDI), substantial capital and technological know-how from Hong Kong was invested in the Mainland to support its reform and modernisation. Hong Kong has been predominant among direct investors in the Mainland – the cumulative value of realised Hong Kong direct investment amounted to about HK$770 billion, 57% of total direct investment received by the Mainland. During the first nine months of 1996, HK$118 billion worth of FDI has flowed from Hong Kong into the Mainland, accounting for almost half of the total FDI in the Mainland (Chart 2).

Chart 2:
Share of Hong Kong in China's FDI (Jan-Sep 96)



Source: China Statistical Yearbook 1996

Let me highlight two features of FDI that have evolved over time. *First,* our investment has expanded into relatively capital-intensive sectors. There have been notable investment projects in infrastructure, such as the Daya Bay Nuclear Power Station and a highway construction linking Guangzhou, Shenzhen and Zhuhai. Investment in the services sector has also grown significantly. Many leading hotels in the Mainland are either jointly owned or managed by Hong Kong investors. We have also significant interests in residential and office property developments in the Mainland.

Second, Hong Kong's direct investment in the Mainland has expanded geographically beyond the Pearl River Delta. Due to its cultural and geographic proximity, Guangdong has been the largest recipient of Hong Kong's capital among all provinces, accounting for roughly 70% of the cumulative value of Hong Kong's direct investment in the Mainland. In more recent years, however, about half of these funds went to places outside Guangdong, of which 12% was in inland regions.

Reciprocally, the Mainland has also invested substantially in Hong Kong. In 1993, the Mainland became our second largest "foreign" investor, overtaking the US and Japan. At present, Mainland interests have investments totalling some HK$96 billion in a wide spectrum of businesses across the border, ranging from restaurants to banking.

To support the growing economic integration between Hong Kong and the Mainland, there is a stronger presence of financial institutions across the border. At the end of 1996, more than half of Hong Kong incorporated banks have established branches and/or representative offices in the Mainland. They focus on trade finance, mortgage lending, project financing and a few of them are even selected to provide renminbi exchange services to foreign-based companies and residents. Mainland banks are equally well established in Hong Kong. For example, the Bank of China Group comprises the second largest retail banking network in Hong Kong. Three years ago, the Bank of China became our third note-issuing bank. Since 1995, three Mainland commercial banks – the China Construction Bank, the Agricultural Bank of China, and the Industrial and Commercial Bank of China – were also granted banking licenses.

In essence, cross-border banking transactions have been increasing even faster than the growth in trade. At the end of 1996, total liabilities of Hong Kong banking system to banks in the Mainland amounted to about HK$298 billion; with total assets of HK$358 billion. This demonstrates the importance of Hong Kong as a source of syndicated loans in the Mainland (Chart 3). It is estimated that 90% of the syndicated loans for use in the Mainland were arranged in Hong Kong.

Apart from banking services, portfolio investment has become an important part of the financial integration between Hong Kong and the Mainland. About 50 Mainland-controlled enterprises are listed on the stock exchange of Hong Kong,

Chart 3:
Hong Kong's banking relations with China

(HK$ Bn)

Year	Liabilities to China			Claims on China		
	Banks	Non-banks	Total	Banks	Non-banks	Total
1986	27	0	27	31	12	42
1987	48	0	48	44	22	66
1988	59	0	59	61	39	100
1989	79	0	79	43	49	91
1990	117	0	117	70	50	121
1991	140	4	145	104	47	152
1992	151	7	158	113	56	169
1993	155	7	162	139	56	195
1994	226	8	234	177	62	238
1995	216	9	226	224	65	289
1996	286	12	298	287	71	358

Source: Hong Kong Monetary Authority

representing roughly 6% of Hong Kong's total stock market capitalisation. Twenty-eight Chinese state-owned enterprises have Hong Kong listing (H shares) with a capitalisation of over HK$50 billion. On the other hand, Hong Kong investors have purchased a large portion of the "B" shares issued on the Shanghai and Shenzhen stock exchanges.

To assist the growing volume of payments between Hong Kong and the Mainland, the People's Bank of China and the Hong Kong Monetary Authority have set up a joint working group to study the feasibility of payment versus payment (PvP) linkage of the two payment systems to reduce settlement risks.

Mainland China: Future Trends and Directions

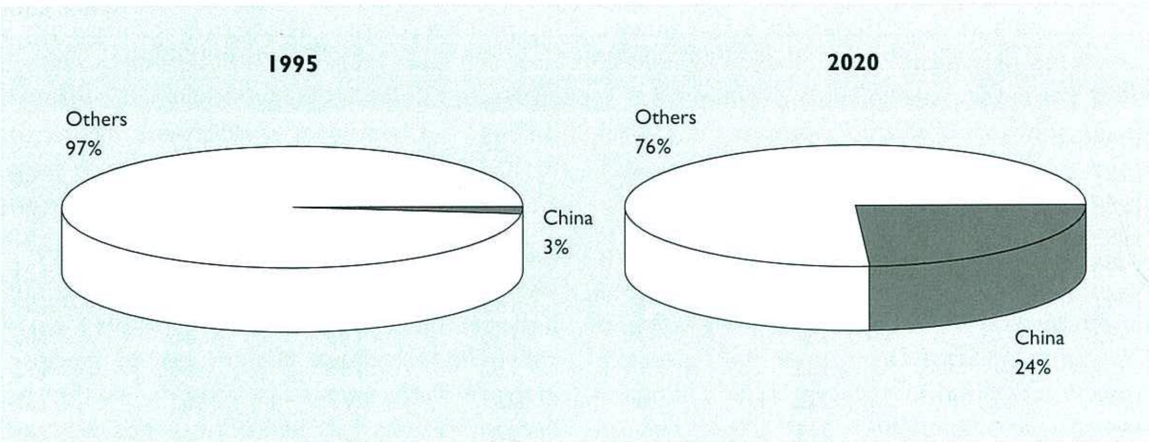
The mainland of China is expected to emerge as a major force in the global economy (Charts 4 and 5). The World Bank's projections also suggest that China would become one of the world's largest economies by roughly the year 2020 (Boltho et al, 1990). The Mainland's demand for outside funds will certainly increase, driven by continued high rates of economic growth. For instance, the World Bank estimated that China's modernisation requires a massive infrastructure investment of some US$800 billion over the next decade. Hong Kong, as a capital exporter and an international financial centre, can help intermediate this enormous need of funds.

The World Bank has also estimated that the Chinese Economic Area (Mainland China, Hong Kong and Taiwan) would, in purchasing power parity (PPP) terms, be larger than the US by the year 2002 (Chart 6). At the same time, financial markets in the Chinese Economic Area are also of vast potential.

The relative size of Hong Kong and the Mainland's financial markets can be seen in perspective from Chart 7. Hong Kong's banking sector and stock market in terms of Gross Domestic Product (GDP) are already comparable to those in the world's leading financial centres. Using the US financial sectors as reference, each major sector (equity, bonds and banking as represented by bank assets and M2) would comprise between 50-110% of GDP. The ratio of stock market capitalisation to M2 is also a rough indication of the leverage of the corporate sector. Hong Kong's leverage ratio is roughly 2:1, about the same level as the US. However, because of the lack of need of the government to borrow, the bond market is relatively underdeveloped, at 10% of GDP at the end of 1995. This is likely to deepen with the creation of the Mandatory Provident Fund, which would increase mandatory savings for retirement, and the Mortgage Corporation, which would facilitate the secondary mortgage market.

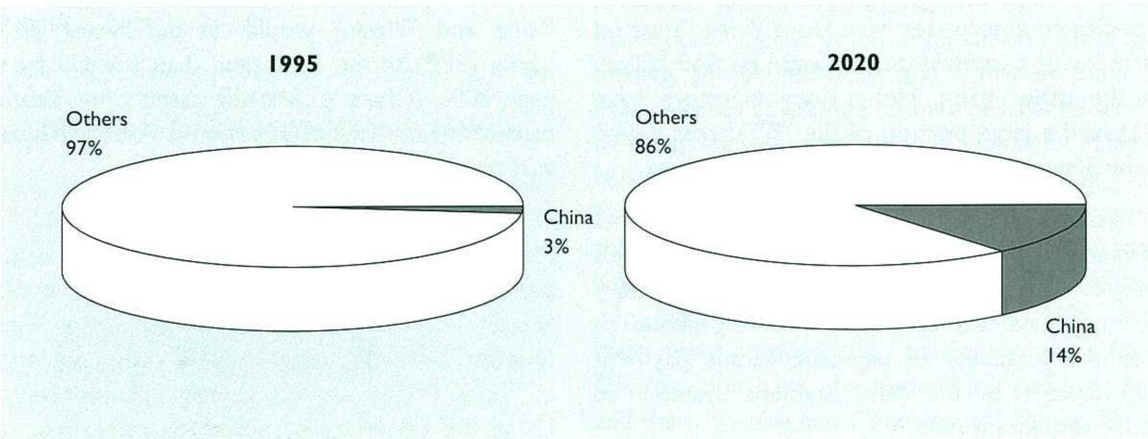
Chart 7 shows the relative imbalance in the development of the financial sector in the Mainland. The Mainland has a deep banking sector, with an

Chart 4:
Share of China in World Trade



Note: HKMA staff estimates

Chart 5:
Share of China in World Output



Note: HKMA staff estimates

M2/GDP ratio of over 100%, comparable with Hong Kong or Japan. However, the bond and equity markets are less developed, at 7% of GDP at the end of 1995. These numbers indicate that the relative underdevelopment of the bond and equity markets constrains the balanced development (and financing) of the enterprise sector. The enterprise sector needs long-term financing, as well as strong capital, in order to undertake its restructuring and transformation to meet international competitiveness. The small size of market capitalisation indicates that the enterprise sector tends to be over-leveraged – that is, too little capital base to bank loans. Such heavy leveraging exposes state-owned enterprises to large interest rate shocks and constrains the ability of the central bank to implement monetary policy through interest rate measures.

The experience of East Europe also suggests that highly leveraged state-owned enterprises are not managed well in terms of risks, because debts are owed to state-owned banks. Thus, the general direction to improve national risk management is to de-leverage these enterprises through listing on the stock market. In addition to restoring their leverage to internationally normal levels, they would not be over-burdened by debt and would respond more effectively to market signals and

Chart 6:
Emergence of Chinese Economic Area

GDP (in US$ trillion)

	Market Prices		Standard International Prices**	
	1991	**2002**	**1990**	**2002**
Chinese Economic Area*	0.6	2.5	2.5	9.8
US	5.5	9.9	5.4	9.7
Japan	3.4	7.0	2.1	4.9
Germany	1.7	3.4	1.3	3.1

* China, Hong Kong and Taiwan
** Standard international prices are based on purchasing power parity.
Source: World Bank, Global Economic Prospects and the Developing Countries, 1993. Quoted in Nomura Asia Focus, January 1995.

Chart 7:
Indicators of Financial Market Development in Asia

	Equity Markets as % of GDP		Bond Markets as % of GDP		Bank Assets as % of GDP		M2 as % of GDP	
	1990	**1995**	**1990**	**1995**	**1990**	**1995**	**1990**	**1995**
HK*	112	211	1	10	936	723	98	118
China	0	6	7	7	105	114	79	105
Memorandum Items:								
Japan	100	72	72	74	164	157	117	114
US	55	95	94	110	54	51	68	59

*HK$M3
Source: Emerging Asian Bond Market, World Bank, June 1995; Emerging Stock Markets Factbook 1996, IFC; Washington Asset Management Inc., 1996; IFS Yearbook 1996, IMF; Key Economic Indicators 1996, Asian Development Bank; HKMA

market discipline/competition. The listing of "H" shares in Hong Kong, for example, has been highly successful not only in raising the international profile of Chinese corporations, but also subjecting them to greater disclosure, accounting and competitive discipline.

In 1995, this writer thought that the equity market in the Mainland would reach roughly 40% of GDP (about the same level as Korea) by 2000 (Chart 8). It is quite likely that this would be reached sooner than that. By April this year, the combined market capitalisation of Shanghai and Shenzhen had reached US$195 bn or 23.8% of GDP, compared with US$459 bn in Hong Kong, or 298% of GDP.

With the growing listing of "H" shares in Hong Kong planned this and next year, we expect that Hong Kong would play an increasing role in helping Mainland enterprises obtain capital for their development. To facilitate the development of the bond market, I personally feel that there is potential in developing an "H" bond market, where H listed companies can borrow debt or convertible debt in Hong Kong. We have, for example, established a secondary mortgage market through the creation of the Hong Kong Mortgage Corporation. We expect that this would form the model for the creation of a secondary mortgage market in China, surely the largest mortgage market in the world in the 21st century.

Hong Kong's ability to intermediate the substantial capital flows in the Region can only increase with the growing internationalisation of portfolio and direct investments. Over the past 26

Chart 8:
Financial Market Development in 2000: China, Hong Kong, Taiwan

	1996	2000	2000[1]					
	GDP		M2		Stock Market Capitalisation		Bond Market Size	
	(US$ Bn)	(US$ Bn)	(% of GDP)	(US$ Bn)	(% of GDP)	(US$ Bn)	(% of GDP)	(US$ Bn)
China	817	1,700	110	1,870	40	680	40	680
Hong Kong	156	300	120	360	250	750	25	75
Taiwan	273	550[2]	170	935	100	550	25	138
Total	1,246	2,550[3]		3,165		1,980		893

1 Market sizes are scenarios based on author's estimates.
2 Forecast by Ji Chou "The Taiwan Economy in the Year 2000", Chung Hua Institution for Economic Research, December 1993.
3 World Bank estimates of US$2,516 bn by Year 2002, Paul Armington and Uri Dadush, "The Fourth Growth Pole", June 1993.

Chart 9:
Capital Flows to East Asia and Pacific

(US$ Bn)

	1970	1980	1990	1995	1996
Long-term debt (excluding IMF)	0.9	8.2	13.2	26.2	39.3
Foreign direct investment	0.2	1.3	10.2	51.8	61.1
Portfolio equity flows	0.0	0.0	1.7	14.7	12.9
Others	0.7	1.1	2.1	3.1	2.8
Net capital flows	1.8	10.7	27.3	95.8	116.1

Source: Global Development Finance, 1997, The World Bank

years, we saw a rapid surge in capital flows to East Asia and Pacific. Within this, long-term debts, FDI and portfolio equity flows increased 43 to 304 times. Net capital flows rose over 60 times during 1970 to 1996 (Chart 9).

Financial markets in the Mainland are still at an early stage of development, compared to those in the US, Japan and Europe. Although banking business is not as sophisticated, with each banking office serving twice as many people as in G-10 country branches, surprisingly, Mainland population per branch is comparable to that in Japan and Germany (Chart 10). Although Mainland banks employ more labour because of the manual systems employed, they would rapidly have access to banking technology through Hong Kong.

The Role of Hong Kong

The structure of the Hong Kong economy complements that in the Mainland. With a service sector accounting for over 80% of GDP, Hong Kong specialises in the services sector, which is relatively less developed in the Mainland, at less than one-third of GDP in the Mainland (Chart 11).

The workforce of the two economies also has complementary skills. Employment in Hong Kong is concentrated in the service sector, which accounts for over 70% of total employment in Hong Kong, whereas in the Mainland the share is only 22% (Chart 12).

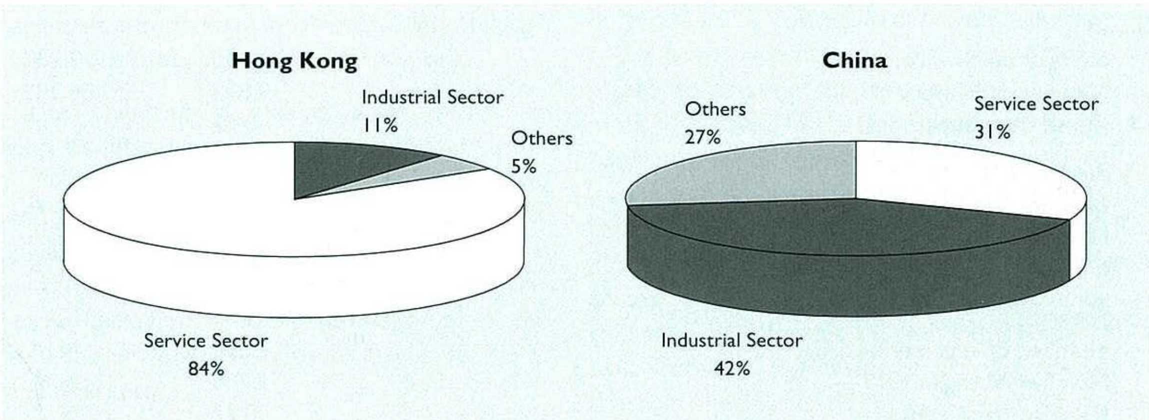
Hong Kong is well endowed with a substantial pool of professionals engaging in business and

Chart 10:
Banking Structure: China and Other Economies, 1993

	China	HK	Japan	US	Germany	EU	G-10
Commercial banks	19	172	150	10,971	330	2,598	13,377
Branch offices	138,837	1,433	14,997	54,129	7,604	95,960	146,274
Population ('000s)	1,178,400	5,998	124,764	257,908	80,975	368,975	705,941
Population per banking office	8,486	3,737	8,237	3,962	10,206	3,744	4,422
Staff	1,778,059	72,438	417,000	1,494,564	221,000	1,746,089	3,559,600
Staff per bank	93,582	421	2,780	136	670	672	266
Staff per banking office	13	45	28	23	28	18	22
Total assets (US$ bn)	398.4	739.4	6,130.2	3,707.2	963.2	8,772.0	18,201.2
Assets per staff (US$ mn)	0.2	10.2	14.7	2.5	4.4	5.0	5.1
Deposit-to-asset ratio (%)	64.4	29.3	63.9	74.3	42.8	50.2	61.0
Loan-to-asset ratio (%)	77.4	61.8	69.7	58.0	65.6	51.4	61.7
3-bank concentration ratio (%)	n.a.	n.a.	28.3	13.3	89.5	n.a.	n.a.
Commercial bank share of total credit institutions (%)	n.a.	94.2	n.a.	77.1	27.0	n.a.	n.a.

Source: China Financial Outlook 1995
Barth, Nolle and Rice, Commercial Banking Structure, Regulation, and Performance: An International Comparison, March 1997

Chart 11:
Hong Kong's service sector complements that in Mainland China
GDP by Sector (1995)



financial services, and possesses a wealth of investment and management expertise (Chart 13). The world's leading law, accounting, consultancy, engineering, architecture and other professional firms are all represented in Hong Kong. For instance, at the end of 1996, there were 1,300 accounting firms operating in Hong Kong, and the ratio of accountants per thousand persons stood at 0.35, significantly higher than 0.04 in the Mainland. Similar ratios for lawyers and other professionals are also substantially higher in Hong Kong than in the Mainland, so that through Hong Kong, the Mainland can have access to international standard professional expertise in virtually all fields.

The above comparison shows Hong Kong's comparative advantage in high-value added professional services. In particular, Hong Kong is a fully-fledged international financial centre. It is well equipped to provide financial advice and funding for

Chart 12:
Labour force by sector (1995)

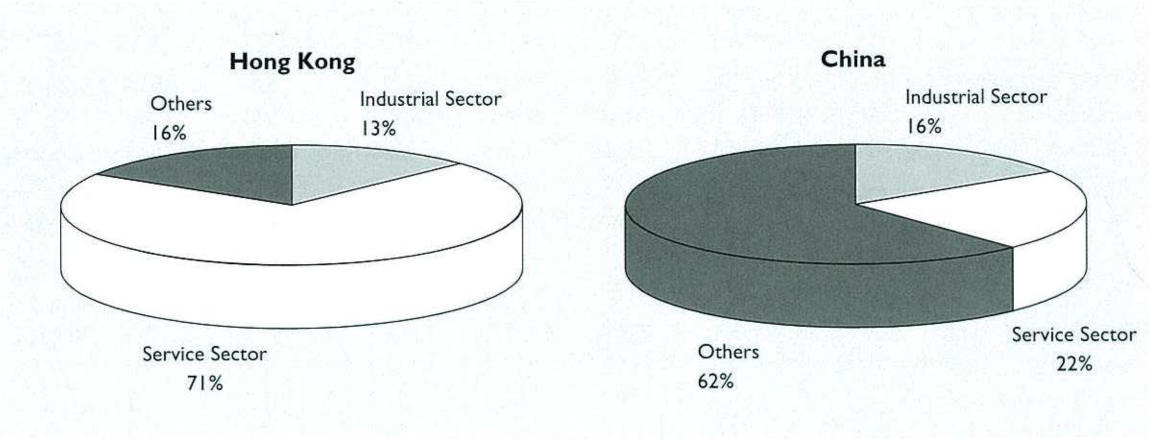


Chart 13:
Availability of Professional Staff

	Hong Kong	China
Accounting		
Number of accounting firms	1,300	6,399
Number of accountants	2,233	53,000
(Per thousand persons)	0.35	0.04
Law		
Number of law firms	1,100	7,237
Number of lawyers	3,893	86,282
(Per thousand persons)	0.62	0.07
Architecture		
Number of architectural firms	300	N. A.
Number of architects	1,356	N. A.
(Per thousand persons)	0.22	N. A.
Engineering		
Number of engineering firms	2,200	N. A.
Number of engineers	1,700	N. A.
(Per thousand persons)	0.27	N. A.
Insurance		
Number of insurance companies	223	129
Number of actuaries	108	N. A.
(Per thousand persons)	0.02	N. A.
Management Consultancy		
Number of management consultancy firms	3,000	N. A.

* Figures for Hong Kong are for 1996 or March 1997, while China's are for 1995.
N. A.: not available

all types of ventures, and I am pleased to hear that Guizhou also has a listed vehicle in Hong Kong.

With rapid growth in trade, the demand for financial services in the Mainland will undoubtedly increase in volume as well as in sophistication. There are good reasons to expect the Mainland to look to Hong Kong for the large share of its increasing funding. In particular, Hong Kong has excellent *Build, Operate and Transfer* (BOT) expertise in infrastructure construction, such as container ports, power stations and toll roads, bridges and tunnels.

In the financial sector, Hong Kong has international class regulation, risk management techniques, and also one of the most modern financial technology infrastructures in the world. In December 1996, we installed one of the most modern real-time gross settlement systems in Asia, enabling payment versus payment (PvP) and delivery versus payment (DvP) capability to be realised. I am sure there are lessons that the Mainland can draw on Hong Kong's experience. In addition, the Mainland can benefit by tapping into the huge reservoir of expertise in Hong Kong to help strengthen financial regulation, improve risk management and also enhance productivity through the use of the latest information technology.

The Mainland is making great efforts to develop its financial markets. In the classic Art of War, Sun Tzu said that ultimate success would depend on five factors: generalship, heaven, earth, discipline and the moral order. In the 21st century, competition in markets has replaced warfare. Using the same analogy, the sound development of the financial sector depends on five principles (5 P's) of financial markets:

People – the quality of human skills;

Products – the range, depth and liquidity of financial services and products, which can help market participants manage their risks;

Policy – a sound policy environment that encourages efficiency and competition to flourish in fair and non-distorted manner;

Prudential Framework – a clear, firm and equitable legal and regulatory framework that minimises market abuse; and

Platform – a robust and efficient information technology, tele-communications and market infrastructure that ensures secure and reliable transactions and settlement.

With well established laws and regulations, an internationally recognised regulatory framework, a sophisticated financial infrastructure, a wide range of products, a competitive business environment and a large pool of expertise, Hong Kong is well placed to provide support to the Mainland as a model of a world-class financial system. As one country, but under two separate systems, it is vital that we have deeper understanding of and share experience with each other. The Hong Kong Monetary Authority is happy to be the bridge across which such further understanding and exchange of information and experience can be built between the financial systems abroad and those in the Mainland, particularly those in inland areas.