

## Hong Kong Finds Its Way

By David K.P. Li

**D**oes Hong Kong have a future?

China's surging economic growth and Hong Kong's malaise over much of the past decade have led many to believe that the former British colony has lost its way, and is unable to compete against hungrier, more determined cities on the mainland.

There is no denying that its economic *raison d'être* has changed. The extended economic slump that the city experienced in the wake of the Asian financial crisis laid bare the reality that Hong Kong is no longer China's gatekeeper. For decades after 1949, it was the main gateway into a China that deliberately isolated itself from the outside world. Hong Kong enjoyed a monopoly position, and lived the high life on that monopoly for as long as it could.

When China launched the era of reform and opening in 1978, Hong Kong continued to dominate commercial relations between China and the West.

It had the only world-class container terminal on the China coast – the lion's share of China's trade had to pass through the city. But more important, the personal connections that Hong Kong businessmen had with Guangdong, Shanghai and Beijing allowed Hong Kong companies to operate successfully on the mainland in the absence of a reliable legal system. While foreign companies complained of injustice and expropriation of profits, Hong Kong companies laid the foundation for China's economic miracle.

However, by the time of the Asian financial crisis, China had changed fundamentally. It presented a far more welcoming environment to overseas business. Rules were becoming more transparent. Multinational companies based in Europe, Japan, Korea, Taiwan and the United States had learned to integrate China's strength in manufacturing into their global supply strategy.

These companies no longer needed Hong Kong partners, nor did they require Hong Kong services. Increasingly, they found what they needed on the mainland itself. Hong Kong had even lost its edge in container traffic. Ports in Shenzhen and Shanghai are closer to users, cheaper and, increasingly, as efficient as Hong Kong.

Of course, Hong Kong has survived. Since the year 2003, healthy growth has returned, with gross domestic product (GDP) advancing by 8.6% in 2004, 7.2% in 2005 and 6.6% in the first half of this year. Hong Kong companies have adapted, finding new roles and entering new markets. There has been a dramatic expansion of Hong Kong based brands in the mainland and overseas. Hong Kong has remade itself as a major tourist destination for China's growing middle class. A Hong Kong apartment is an important status symbol for the mainland's rich – it doesn't hurt that an investment of more than HK\$6.5 million (US\$833,333) also carries the right to reside in Hong Kong. This latter perk is not available direct from the mainland, however.

But the industry that has really taken off in recent years is financial services.

The financial services industry's direct contribution to Hong Kong's GDP currently stands at 12.2%. Add support industries – corporate law firms, accountancy firms, management consultants, public relations specialists, headhunters and many more – and its real contribution is much higher.

Tsingtao Brewery was the first Mainland enterprise to list in Hong Kong back in 1993. By the end of last year, 335 Mainland enterprises had raised a total of nearly HK\$1.1 trillion (US\$141 billion) on the Hong Kong equity markets.

In the process, China's largest companies – from telecommunications to resources, and from property development to banking – have listed on the Stock Exchange of Hong Kong. Mainland enterprises now account for some 30% of the total number of companies listed on the local exchange, with a combined market capitalisation representing nearly 40% of the total capitalisation. In 2005, turnover of their enterprise shares represented 46% of total market turnover.

This year, new records have been set with the listing of China's major state banks. Bank of China was the largest initial public offering (IPO) anywhere in the world in the past six years, raising US\$11.2 billion. China's largest bank, the Industrial and Commercial Bank of China (ICBC), is expected to be jointly floated on the Hong Kong and Shanghai exchanges at the end of October. Present indications are that it will be the largest IPO in history, raising some US\$21 billion.

Ironically, Hong Kong's success in financial services is at least partly due to the fact that it is the only Hong Kong industry that still benefits from a mainland closed door policy. China's foreign exchange regime remains heavily regulated on the capital account, creating a barrier to the free flow of investment capital into and out of the country. Hong Kong financial markets are therefore the destination of choice for overseas investors seeking to participate in the fast growing Mainland economy.

This begs the question: Is there life for Hong Kong after the mainland removes capital controls and allows the renminbi to float freely? The question is all the more urgent as pressure grows on China to let the market set the exchange value of the renminbi. Beyond the steady pressure from Washington, many question whether China's rapid accumulation of foreign currency reserves is sustainable or even desirable. The blame for this rapid rise in reserves is put squarely at the feet of China's inflexible currency regime.

Further liberalisation of the renminbi is an increasingly attractive option. This has forced the Hong Kong Government to take a more pro-active approach to opening new markets to Hong Kong companies. Increasingly, the focus of attention has been on improving the operating conditions for the financial services industry.

As long ago as the year 2003, the Government identified four pillar industries as the foundation for Hong Kong's economic revival – financial services; logistics; tourism and professional services. More recently, financial services has been elevated to first place. This became evident in the 2006-07 budget presented by the Financial Secretary, Henry Tang, in February this year. He then singled out the achievements of the industry for praise, and a range of support measures were announced under the headings expanding renminbi business; facilitating market development; upgrading market quality; and promoting our brand name.

The leading role of financial services was made explicit in September with the convening of an Economic Summit on "China's 11th Five-Year Plan and the Development of Hong Kong" by Hong Kong's Chief Executive. The Government paper issued for the plenary session described the financial services industry as "the most important one

amongst all major industries for Hong Kong in the future.”

In one sense, the answer to secure the future of Hong Kong as a financial centre is very simple – the Hong Kong market simply needs to be bigger. On a global scale, the total capitalisation of the Hong Kong market makes the city an also-ran. New York, with a market capitalisation of about US\$17 trillion, is 17 times the size of Hong Kong; Tokyo is more than seven times larger, while London is three times larger. Against these numbers, other regional markets are not far behind Hong Kong’s US\$1 trillion. Singapore’s market capitalisation stands at US\$250 billion, while Shanghai stands at US\$400 billion.

Until now, Hong Kong has taken a “build it and they will come” approach to the development of the financial services industry. Government focused on improving the regulatory infrastructure. It engineered the demutualisation of the stock exchange in the year 2000, putting the exchange under professional management. In 2002, it enacted the landmark Securities and Futures Ordinance to bring market regulation into the modern era. The bill was the largest single piece of legislation in Hong Kong’s history. But the Government did little to encourage companies – particularly those from outside Hong Kong – to seek a listing on the local market. Fortunately, this is changing.

In September, the Secretary for Financial Services and the Treasury, Frederick Ma, headed of a group of 120 bankers, lawyers, accountants and brokers to visit Changsha, the capital of Hunan province. At the same time, the holding company for the stock exchange, Hong Kong Exchanges and Clearing (HKEx), held a seminar to encourage Hunan companies to float their shares in the Hong Kong market. Later in the month Chief Executive Donald Tsang visited Hunan to promote economic ties between the province and China. Travelling with him was HKEx Chairman Ronald Arculli. Such active promotion of Hong Kong is both unprecedented and very welcome.

There are also encouraging signs that mainland authorities wish to better integrate Hong Kong into their financial infrastructure. The China Securities Regulatory Commission has proposed new rules on the initial sale of shares which would help companies seeking dual listings both in Hong Kong and on the mainland. It said the changes would enable both markets to have the same initial public offering issuance procedures. Significantly, China adapted to Hong Kong’s procedures, rather than the other way around.

Hong Kong has done more than become more pro-active when seeking new listing business for the stock exchange. The government has also moved to enhance the investor pool. During the past year Hong Kong has made radical changes to its tax structure to attract more business from overseas funds and fund management companies. In November 2005, Hong Kong took the bold step to abolish estate duty. Investment in Hong Kong assets now attracts neither capital gains taxes nor death taxes. Earlier this year, Hong Kong clarified its rules on the taxation of investment funds. Funds managed in Hong Kong on behalf of offshore investors are now free of local tax.

It is hoped that the two measures will accelerate the pace of growth of the Hong Kong fund management industry. Already, the industry grew at a 25% pace between 2004 and 2005. Some HK\$4.5 trillion was under management in Hong Kong at the end of 2005, one-third more than in Singapore.

The Hong Kong Government has also worked behind the scenes to promote the Qualified Domestic Institutional Investor (QDII) scheme, which provides mainland investors a legal route to invest funds overseas. QDII was officially launched in China

earlier this year, with six financial institutions granted a license to sell QDII products on the mainland. While QDII investments are not restricted to Hong Kong, it is significant that all six banks that have been granted an investment quota to begin trading in QDII products as of this writing – Bank of China, the Industrial and Commercial Bank of China, China Construction Bank, the Bank of Communications, the Bank of East Asia and Hong Kong and Shanghai Banking Corporation – have an active presence in the city. Although the size of the quota approved to date is relatively small at US\$8.8 billion, the significance lies in the opportunity to develop product lines and customer channels specifically for the Chinese market.

The business is set to expand as China embarks on further liberalisation of its currency controls. Hong Kong's central bank, the Hong Kong Monetary Authority (HKMA), has taken a similar approach in promoting expansion of renminbi business in Hong Kong. Hong Kong banks have been permitted to accept renminbi deposits from local customers since 2003. However, the scope of business has done little to prepare Hong Kong for free trade in that currency, as all funds received by local banks must be placed with the designated clearing bank, the Bank of China. The HKMA has led the campaign for expansion of this business, most notably laying the groundwork for the issue of renminbi bonds in Hong Kong and for trade settlement in renminbi.

A seemingly minor advance can have far-reaching implications. Under an agreement reached last year, Hong Kong residents can make consumer purchases in Guangdong province by personal renminbi check. Although this facility may not gain wide support from either Hong Kong consumers or Guangdong merchants, it paved the way for the establishment of a check clearing mechanism between Hong Kong and Guangdong.

The exercise has also laid the foundation for the operation of a real time gross settlement system in renminbi, along the lines of the system now used in Hong Kong to clear both American dollars and Euros. Hong Kong and Guangdong will be ready to operate the system once mainland authorities relax currency controls. Hong Kong is thus already positioning itself for the future. Rather than view the gradual liberalisation of China's currency regime and financial infrastructure as a threat, Hong Kong increasingly views these events as an opportunity.

Hong Kong's banking sector as a whole has been a major beneficiary of China's financial sector reforms. Until the year 2003, most locally incorporated banks were not permitted to open branches in China, their natural hinterland. Hong Kong's manufacturing industries had relocated across the border in the 1980s, but Hong Kong banks were prevented by China's restrictive policies from following them into this new market. The barrier was finally lowered by the Closer Economic Partnership Agreement between Hong Kong and the mainland in 2003. Liberalisation of the banking sector has progressed further since then. Later this year, the final restrictions on foreign banks – including Hong Kong banks – are to be removed.

For the first time in more than 50 years, local banks in Hong Kong have a viable new market to cultivate. After years of cut-throat competition in Hong Kong, they are now free to use their well-honed commercial skills to expand their business beyond their home market. Many have already taken the plunge, and those that have have largely been well rewarded for their efforts.

From the foregoing it can be seen that Hong Kong has not stood still as the economic environment has changed around it. After some initial hand-wringing, Hong Kong is adapting very well to the changed circumstances. Chastened by misguided attempts to participate directly in the economy, the government has found a more comfortable and meaningful role as a business facilitator. The role is particularly important in regard to Hong Kong's economic relations with the mainland, where the state maintains a

significant direct and indirect role in the economy. In fact, Hong Kong's ability to interface with policymakers there is essential at this stage, as mainland regulations are still evolving to adapt China to the global economy. A proactive Hong Kong Government will ensure that Hong Kong's voice is heard and understood, before policy is handed down.

Here, then, is the answer to the question about Hong Kong's future. Hong Kong needs a government that remains engaged with the relevant authorities across the border, ensuring that policy decisions that affect the center, the region and Hong Kong are well coordinated and work to the benefit of all. The government can no longer take a hands-off approach to the economy. At the same time, it must stay true to the principle that business leads, government facilitates. It has taken time for the post-handover government to learn this lesson, but it now appears to have the balance just about right. ■

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