

Surviving Through Difference: Can the Hong Kong Markets Succeed?

By Philip Bowring
October, 2009

“Hong Kong will play second fiddle – a pawn – in the overall national financial development ... we will explore ways to make the city further prosper and to upgrade and transform”.

Such is view of Hong Kong's future as a financial center as seen by Xia Bin, head of the State Council's Financial Research Institute. He recently predicted that by 2020 Shanghai will be one of the top three global financial centers, and that by then too the status of the Hong Kong dollar would have changed – presumably to be pegged to the Yuan, an ornament of no international significance, just as the Macau pataca has been for years.

This is certainly a gloomy forecast for those who believe Hong Kong should continue as a unique financial center with its own strengths and not be dependent on whatever crumbs the central government wishes to throw in order to maintain a modicum of prosperity in Hong Kong. How likely is it to become reality? And how far have the traumatic financial market events of the past two years made it more or less likely?

There is an interlinked series of issues here: the currency, the banking system, the stock market, the regulatory and legal environment. Then there is the elephant in the room: the future of global free trade and finance once the dust has settled from recent collapse, bringing partial recovery and longer term issues come back into focus.

Minding the Elephant

Let us start with the elephant. Hong Kong benefited enormously from its free port status. over the past 50 years, first as a manufacturing center able to exploit rapidly expanding western markets and falling tariffs and later by southern China's emergence as “workshop of the world”. Likewise, since the “Big Bang” global financial sector liberalisation of the 1980s, it has played a major role as locus of the major players in international finance for corporate finance, currency, interest rate, debt and related derivative

dealings. It has been a smaller version of London, mainly playing host to institutions based elsewhere but given an extra lift in the past five years by the surge of offshore listings by mainland Chinese enterprises.

At the time of writing it may appear that the traumas of the past 18 months will simply prove big bumps on the road towards further financial market integration. Cheap money and massive government stimulus have extricated the global economy from precipitous decline. However, in a longer view it is not at all clear that we are on the way back to the status quo ante. Trade imbalance issues, involving East Asia generally and China above all, have been ameliorated not resolved, and the issuance of massive government debt to address the immediate crisis has created new sources of instability.

If this is the case, will financial sector activity become more frenzied? Or will the sector be forced to shrink, either because of government efforts to limit risk-taking and volatility, or stagnate because the supply of new dollars into the system – the fuel which fed the massive balance sheet expansion of recent years – dries up as U.S. consumers opt for thrift and the U.S. external accounts move from mega deficits into balance.

It must be pure guesswork whether international financial services are going to suffer a sustained slowdown. They could so even if growth in East Asia remains at relatively high levels and China takes on some of the role that the U.S. has played in stimulating regional demand. Just as financial services have outpaced trade growth and trade growth outpaced overall growth over the past two decades, that trend could go into reverse.

Any such slowdown would generally be thought to be against Hong Kong's interest as a regional and global player, making it even more reliant on mainland business. However, there is another way of looking at a change in the global situation: it could well be accompanied by deterioration in China's external circumstances, with the elimination of its trade surplus, outflow of hot money and worries about the security of its foreign bond holdings. In that case, it is quite possible that the liberalisation of capital controls and other changes, needed if Shanghai is to fulfil Xia Bin's vision that by 2020 of reaching par with New York and London as an international financial center, would come to a halt.

Size Alone is Not Enough

As Tokyo and Frankfurt have found, even the combination of an absence of foreign exchange restrictions and large reserves, plus large domestic as well as trading economies, are not sufficient ingredients to achieve London-type status. Nor, as London and Singapore show, the modest size of the domestic economy need not be a major obstruction. Indeed, so long as China's system is dominated by a handful of state banks and by a political system which emphasises stability and control, it will lack the software for being more than the center of China's huge but domestically-oriented markets.

So a halt to Shanghai's ambitions could help preserve Hong Kong's unique position in intermediation between China and the world, with a real financial barrier between itself and the mainland not only preserving China business but sustaining the basis for remaining attractive to currency traders, fund managers and others with a global or regional rather than just a China perspective. That assumes that Hong Kong does not become a liability by becoming a focus for speculation, for instance, against the yuan, which would be contrary to the national interest. (The creeping physical and political integration of Hong Kong with Shenzhen and the mainland as a whole will make it more difficult for Hong Kong to be treated as a wholly autonomous entity).

China's ambition that its own currency should play a much larger role in both trade and international finance would naturally tend to favor Shanghai as the main domestic center. However, this is likely to take longer to achieve than is often assumed. First, the focus of Beijing policy has been on maintaining trade competitiveness, which in turn effectively means managing the currency in a way that makes its principal alignment with the U.S. dollar as the main global medium of exchange.

Even the yen and euro are still mostly only used for trade denomination only in their own localities – for instance, within the European Union and for exports from Japanese factories to subsidiaries in Asia. Use of the yuan may grow, but only slowly from cross-border trade with neighbors to providing export loans to Southeast Asia. It will be a slow process at best and will happen only if China's global role continues to grow for many years to come. That remains more probability than certainty. It also involves Chinese institutions coming to enjoy a high degree of global trust – something which takes a long time and can easily be set back by displays of xenophobia or bizarre legal judgements.

Hong Kong may well find that for political reasons, if none other, a switch from a dollar to a yuan peg will happen within a decade. However, much will depend on the speed of liberalisation of the yuan itself because Beijing will not want to see the Hong Kong dollar as a means of speculating in the yuan's value if its own market remains closed. Ideally, Hong Kong might be best off with a managed float arrangement as achieved by Singapore, an economy about half its size. However, that is unlikely for political reasons. It would suggest a move to greater autonomy and thus out of step with other trends.

Korea and Taiwan Wait Their Turn

As Hong Kong has not had an independent currency for 25 years, a peg to the yuan would not have any significant impact on the financial sector. It might even be a plus if other Asian currencies move very gradually away from dollar links, formal or informal, towards baskets in which Asian currencies have increasing weights. Significant too could be whether there is much development of trading between Asian currencies, for example between yen and won or baht and ringgit, or whether these remain in local markets and are simply derived from cross-rates with the U.S. dollar. Much the same applies to cross-border trading in Asian currency bonds, which is still in its infancy. Competition for this business, assuming it does grow, will come not just from Singapore and Tokyo but also quite likely from Korea, which is aiming to develop Incheon/Songdo, well positioned vis a vis both China and Japan and with the won itself having a higher international profile, as a financial center.

Taiwan is another potential competitor. Most comment on closer cross-strait ties has focused on a reduction of Hong Kong's transit traffic. But with the partial easing of restrictions has come an increased realization by Taiwan that it has the potential to attract mainland portfolio capital and listings of mainland companies. Already there is talk of Taiwan firms listing depository receipts on the Shanghai market. Taiwan firms with large operations on the mainland may well be allowed to list locally. At the very least, an easing of Taiwan's restrictions means that firms like mobile phone maker Foxconn and footwear giant Yue Yuen will no longer be forced to use Hong Kong-listed subsidiaries for mainland business.

Further liberalization of capital inflow from the mainland is likely. Those processes in turn will attract foreign attention to a Taiwan market that is

already well known to international investors and can offer a wide range of companies active globally and in China. There is no certainty about cross-straits relations, but Hong Kong needs to be more aware of Taiwan's new potential.

As for Hong Kong's stock market relations with the mainland, there are several issues. The first is how far Hong Kong can continue to be attractive for mainland listings. Many of the largest state companies – banks, power companies, telecoms – have already listed H shares (those traded on the Hong Kong exchange in Hong Kong dollars). For smaller firms, the attractions may be limited given that lower prices prevail for H shares compared to their A share equivalents in Shanghai or Shenzhen (traded in yuan and not available to foreigners). H shares also face tighter regulation. At the broadest level, China does not need foreign money. The prestige aspects of foreign listing may also be waning.

Will the Through Train Ever Arrive?

But how likely then is the “through train” which would make arbitrage between Shanghai/Shenzhen and Hong Kong possible? Some in Hong Kong would welcome it as a boost to the local market. It would certainly narrow the price gap to the benefit of H shares, which trade at big discounts despite the assumption that the Hong Kong market is better regulated. But it seems unlikely that China can operate a system whereby locals can buy mainland shares listed in Hong Kong but not other shares. To go beyond that and open up the whole Hong Kong market would amount to an almost complete dismantling of outwards investment barriers. That looks unlikely. A through train for Shanghai and Shenzhen B shares (a mainland-listed category that is traded in foreign currencies) could happen as one already exists in practice and B trading could be allowed in Hong Kong. But the B market is small and largely irrelevant today. Trading in the mainland of H share depository receipts may be allowed, but if so Beijing will retain control of the amounts available so two-tier pricing would likely remain.

Another issue is how far China will go in allowing listing of foreign shares in Shanghai – now approved in principle but still awaiting changes to laws and regulations. That issue brings up another: how far will it be possible to arbitrage between, say, Shanghai and Hong Kong if and when shares in HSBC, for example, are listed in the former?

The nature and extent of China's policies on these issues will be critical for Hong Kong's role – assuming that the interaction between the Chinese and global markets continues to grow. It is unlikely that Hong Kong itself will have more than marginal policy influence on Beijing.

Hong Kong's attitudes to the mainland bourses often seem schizophrenic. On the one hand, market and government officials emphasise the importance of getting closer to the mainland, integrating with the Pearl River delta, etc. On the other, they worry about losing their position because of decisions taken by Beijing to develop the markets as it sees fit, rather than as a response to Hong Kong's specific needs.

The Failings of Sino-centric Disdain

Meanwhile, Hong Kong has almost totally failed to develop itself as a market for non-local stocks other than mainland and a few Taiwanese ones. Too much money was being made from the mainland listings boom to bother. Added to that was a Sino-centric disdain for stocks from non-Chinese Asia, Russia and others. Unlike Singapore, let alone London, it has failed to broaden its listings base and only recently woke up to the existence of Islamic finance products. Its second board, the Growth Enterprise Market (GEM), has been a disaster following a scam-ridden birth during the tech stock bubble.

Most recently, the Singapore exchange has jumped ahead of Hong Kong by announcing, in conjunction with Chi-X Global, a platform for “dark pool” (large volume, off-market) trading of major Japanese, Australian, Chinese and local counters. This could take existing business away from Hong Kong as well as showing up its inability to think regionally.

Not helping matters has been the structure of the stock exchange itself – or to be precise, Hong Kong Exchanges and Clearing, which has a monopoly of all stock, future and commodity dealing. Government controls half the board seats and has packed it with parochial establishment names. With small brokers and listed companies having a major influence on regulations, decisive efforts to develop new business and improve regulation have been lacking.

The only way Hong Kong can in the longer run compete with Shanghai is to stay ahead in terms of regulation, trustworthy legal and accounting support

services, free flow of information and international flavor. And making itself a center for trading in Asian and international shares, with listings and active trading in counters from the likes of Indonesia, Russia, India and Brazil. Its strength lies in its difference and must remain so as Shanghai's market continues to develop in terms of quality as well as quantity, plus in regulation as well openness to non-Chinese companies and intermediaries.

There is however hope that things may change with the appointment of a new chief executive of the Hong Kong Exchanges, Li Xiao-ja, a mainlander with long experience with western investment banks. He takes office in October after running JP Morgan's China operations. He is seen as capable of making a break with Hong Kong's inward-looking and bureaucratic mindset. But whether his agency can moderate its mainland obsession remains to be seen. Li's appointment was couched in terms of developing Hong Kong's role China's capital markets rather than its regional and global role.

If that is the limit of the vision and ambitions of the board of Hong Kong Exchanges, thinking entirely in Chinese terms, the "pawn" predictions of Xia Bin are sure to be fulfilled. Only by throwing its energies into global positioning can Hong Kong avoid becoming a minor player in the Chinese world, and avoid being not just trounced by Shanghai but absorbed by Shenzhen.

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