Economic Analysis

April, 2006

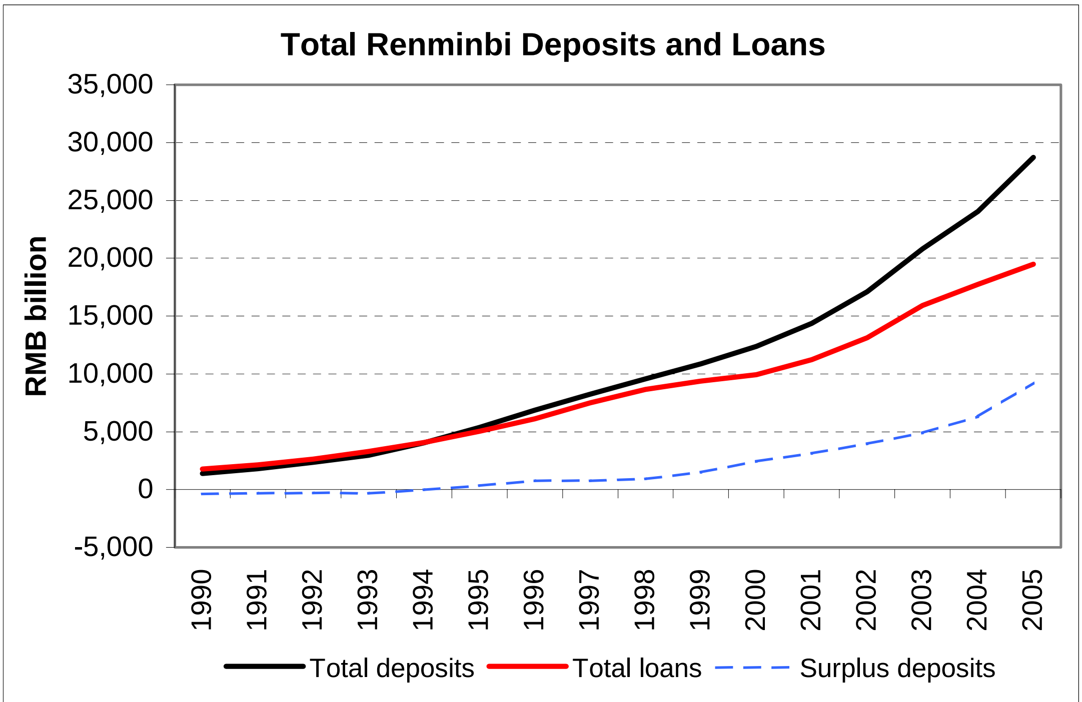
A Publication of the BEA Economic Research Department

Reform of Mainland's Financial System and Its Implications for Hong Kong

China is on course for success in the reform of its financial services industry. The balance sheets of mainland banks are improving, and the banks are now striving to raise their operating efficiency as well, through cooperation with foreign strategic partners and listing on overseas stock markets. The Government must now revitalize the local stock market so that it can play a proper role in matching capital demand with supply. Success in the stock market reform will not only improve capital allocation and enhance corporate governance in listed companies, but also create an effective channel to boost investment returns. While a more mature mainland stock market will pose a challenge to Hong Kong's financial industry, a healthy and sound financial system in China will give the central government confidence to relax restrictions on the country's capital account. The ensuing capital flows will generate new business opportunities and ultimately benefit Hong Kong.

Review of banking reform

China has made great strides in reforming the ailing banking system. Since 1998, the central government has removed over RMB 2.1 trillion of bad debt from the banking system. The improvement in banks' balance sheets has been particularly striking over the past two years. Non-performing loans dropped from 16.61% of banks' total loans in the first quarter of 2004 to just 8.61% by the end of 2005. Yet, even with the financial relief, mainland banks still face a pressing need to enhance their operating efficiency before the domestic banking sector meets the full force of competition from international banks by the end of this year. In response to the impending challenge, mainland banks are courting foreign strategic investors. They hope to acquire the necessary risk management expertise and international experience from their foreign partners to help them stay competitive in a cutthroat business environment.



Source: People's Bank of China

Unfortunately, the ongoing reform measures have failed to address significant structural problems within the financial system. Without suitable investment alternatives, mainland savers had no choice but kept their money in banks despite paltry returns. When the Chinese government decided to curb bank lending in 2004 to prevent overinvestment in the economy, loan growth began to lag behind deposit growth. By the end of 2005, the surplus of deposits had risen to over RMB 9 trillion. These funds are now lying idly in the banking system.

The importance of stock market reform

It is therefore imperative that China should further develop its capital market in order to mobilize its savings. A competent capital market will provide mainlanders the necessary channels to earn higher investment returns, and the resulting wealth effect will help to turn traditionally frugal mainlanders into more willing spenders, achieving one of the principal goals of the 11th Five-Year Plan. Yet there is a long way to go before achieving this objective. While the Chinese economy expanded by 66% between 2001 and 2005, its stock market actually lost 16% in value. The effectiveness of the stock market as a fund-raising platform pales in comparison to the banking system; the amount of funds raised through stock market offerings amounted to only 4.9% of the increase in Renminbi loans during the period.

To promote healthy development of the stock market, the Chinese government embarked on the Split Share Structure Reform of Listed Companies last September. The main objective is to achieve full circulation of non-tradable shares, which account for two-thirds of total shares. Prior to the reform, major shareholders were prohibited from selling their non-tradable shares in the stock market. Deprived of the opportunity to leverage a rising stock price, major shareholders often lacked incentive to ensure proper management, and the lax control thus produced a ripe breeding ground for embezzlement and other illegal activities.

Hence the essence of the stock market reform is to align the interests of both non-tradable and tradable shareholders to enforce effective monitoring on management. Listed companies can also use stock options to boost managers performance in order to enhance corporate governance and raise firms' profit-earning ability. The reform will also pave the way for merger and acquisitions to force out bad companies and improve the quality of listed firms. Investors' confidence will be restored, in turn boosting market turnover and fuelling the development of the stock market. Given that China's stock market capitalization was a mere 17.5% of its GDP last year – far below the level in other major Asian markets – there is clearly room for further expansion.

Ratio of Stock Market Capitalization to GDP (2005)

	Market Capitalization (USD bn)	GDP (USD bn)	Ratio
China	**395.9**	**2,259.2**	**17.5%**
Hong Kong	1,153.5	208.6	552.9%
India	546.1	510.6	107.0%
S. Korea	694.9	703.2	98.8%
Taiwan	515.5	363.5	141.8%
Thailand	119.9	93.7	128.0%
Philippines	39.6	22.0	180.3%

Source: Bloomberg

Despite the promise, initial response to the reform was lukewarm – the Shanghai A-Share Index twice declined by nearly 10% within one month after the launch of two pilot projects. This is because the conversion of non-tradable shares into tradable shares has raised concerns about oversupply, creating downward pressure on the market. To relieve such pressure, the government has further relaxed restrictions for overseas investors. Starting from February this year, foreign investors are allowed to make an initial purchase of no less than 10% of the shares of any listed companies that has completed the reform, provided that they agree to hold on to the shares for a minimum of three years. These extra measures should give investors a vote of confidence. Moreover, the resulting improvement in companies' performance and transparency should help facilitate the long-term development of the mainland stock market.

Impacts on Hong Kong's financial industry

The lacklustre performance of the mainland stock market in recent years created a ripe opportunity for the Hong Kong stock market, which has now developed into the main fund-raising centre for mainland companies. Last year, H-share and red-chip companies raised HKD 160 billion through initial public offerings (IPO) and placement activities on the Hong Kong stock market, accounting for 70% of the total funds raised. The Hong Kong bonanza could be threatened as the mainland reforms gradually bear fruit. As investors regain their confidence in the mainland market, the enormous size of China's investment base offers great potential for growth in listings and other fund-raising activities. A healthy mainland stock market will therefore pose serious competition to Hong Kong as a fund-raising centre for mainland companies.

On a positive note, a healthier banking system and a more efficient stock market will strengthen the Mainland financial system and make it more capable of weathering external shocks. This will allow the government to relax the remaining capital controls, and the resulting capital flows will generate new business opportunities for Hong Kong. Hong Kong will have a strong advantage in attracting China's outbound investment, given its close integration with the mainland and the high profile it enjoys among mainland companies and individuals. As restrictions on overseas investment continue to wane, more mainland companies and individuals will choose to invest in or through Hong Kong. The recent relaxation on overseas investments by individual and institutional investors represents a first step toward such development.

Conclusion

Continued progress in China's financial reform will narrow the gap between the mainland and Hong Kong's financial markets, and the absolute advantages long enjoyed by Hong Kong's financial industry will fade as a result. Hence, Hong Kong must remodel itself by expanding beyond its present role as a channel for foreign funds entering China, to being a platform for mainland companies that aim to invest overseas. Furthermore, as the mainland financial sector faces great challenges in matching its huge savings with productive investments, Hong Kong's advanced financial infrastructure and depth of market still have much to contribute. While bolstering its status as an international financial center, Hong Kong must also develop itself into the mainland financial hub.