# Economic Analysis

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## Opportunities Emerged from Mainland Financial Reform

Reform of the Mainland financial system has progressed rapidly in recent years, with the main focus centered on building and strengthening the financial infrastructure. Foreign companies share an important role in this process by bringing in financial expertise along with their investments. Now, with the successful listing of most of the major state-owned banks, as well as good progress in equity market reform, it appears that the financial industry is ready to enter the next phase of development – accepting the challenges of competition coming from global financial markets.

### QDII a Prelude to the Further Opening of Mainland Financial Markets

The introduction of the long awaited Qualified Domestic Institutional Investor (QDII) scheme could mark the first step in this new direction. Under this regime, the banks are permitted to exchange Renminbi (Rmb) deposits into foreign currency fixed income products according to a set quota. Separate quotas are available for securities houses to invest foreign currency savings held by companies and individuals overseas, and for insurance companies to allocate Rmb assets to foreign currency fixed income products.

With the Rmb seemingly locked into a trend of long-term appreciation, Mainland investors who wish to take advantage of the scheme must weigh the benefits of expanded investment choices from overseas against the potential exchange loss. While corporate investors are more prepared to take advantage of this added flexibility, retail investors with limited overseas investment experience would face a steeper learning curve regarding the risk-to-return trade-offs involved. Although this may dampen market interest in the new products introduced under the scheme, the learning process involved will help prepare Mainland investors for the future, when controls over fund flows become further relaxed.

The competition for Mainland capital from the international financial community will facilitate the maturation of the Mainland financial industry. However, care and patience are required to ensure a smooth transition, as any major problem could shrink if not close the window of opportunity.

Successful implementation of QDII is particularly important to Hong Kong. The financial services industry has grown dramatically in recent years, and the Government has made a number of high-profile changes to the tax code and the regulatory regime in order to attract greater fund flows. At present, the Mainland's tight capital control regime prevents Hong Kong from utilizing its financial intermediation expertise to channel China's savings to productive uses. Hence, the success of QDII is critical to Hong Kong's goal to serve the vast demand for financial services coming from the Mainland.

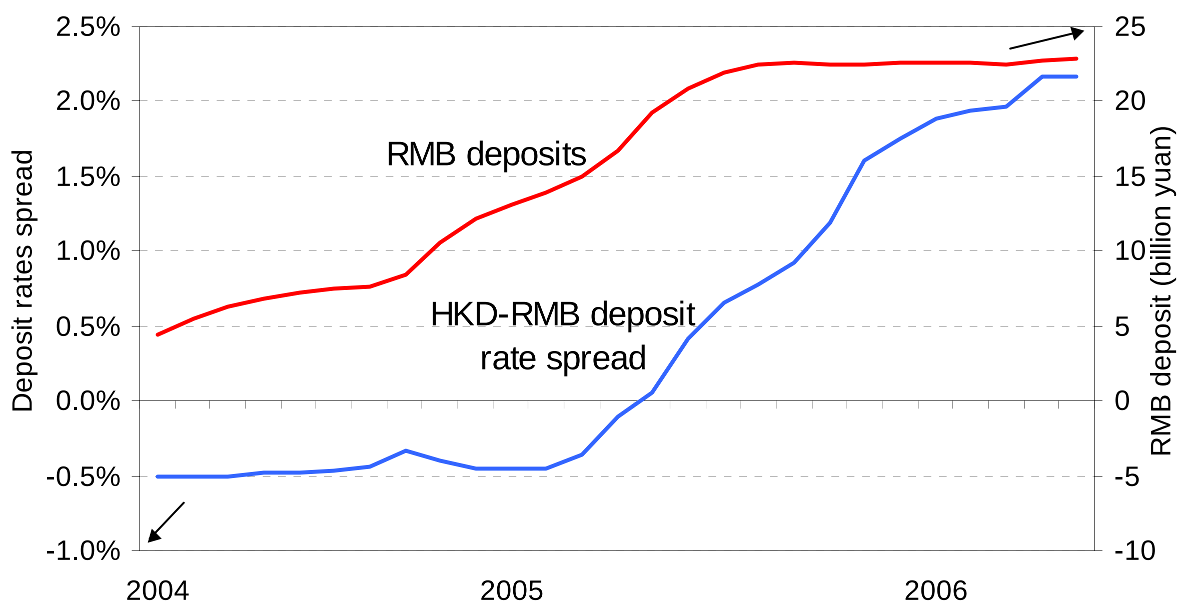
### Local Renminbi Banking Business will Give Hong Kong a Unique Edge

Hong Kong should spare no effort to carve out a separate niche for itself, to maximize its advantages vis-à-vis other financial centres. The development of Renminbi banking business in Hong Kong offers such an opportunity. The business leverages off Hong Kong's close business ties with the Mainland. 90% of its re-export trade is Mainland related. 275,000 Hong Kong people work on the Mainland. Hong Kong companies have invested an accumulated USD260 billion in the market. At the same time, Mainland organisations have invested an accumulated USD110 billion in Hong Kong, while Mainland tourists spent HKD36.6 billion in the city in 2005 alone. The potential for developing a Rmb denominated financial market in Hong Kong is therefore huge.

The first steps in liberalising the use of Rmb in Hong Kong were taken in 2003 when local individuals were given permission to open Rmb denominated bank accounts for the first time. The scope of services was expanded in 2005. Rmb business received a further boost when Premier Wen Jiabao indicated that the next round of liberalisation would permit imports from the Mainland for local use to be settled in Rmb in Hong Kong. He also indicated that an agreement on the issue of Rmb denominated debt in Hong Kong would be close.

These measures, while welcome, have only a moderate business impact. Settling retained import trade in Rmb would save Hong Kong traders the currency conversion process and eliminate exchange rate risk. However, only those with Rmb funding would benefit from the scheme. For those who do not, borrowing Rmb would expose them to exchange risk from the appreciating Rmb even if Rmb trade finance is made available. For Rmb denominated debt, due to the widening HKD-Rmb interest rate spread, growth of the Rmb deposit base in Hong Kong has decelerated since late 2005. The deposit size, at Rmb 22.9 billion, is relatively small to support the development of the Rmb denominated debt market.

**HKD - RMB Deposit Rate Spread and RMB Savings Deposits**




*Source: National Bureau of Statistics of China; HK Monetary Authority*

The increased usefulness of Rmb funds in Hong Kong in both day-to-day business activities and investment is crucial to the development of the Rmb financial market in Hong Kong. It enhances the willingness of the public to hold Rmb funds, and strengthens the growth of the local Rmb deposit base. However, it is only when Rmb deposits reach a certain critical size that the market would have sufficient depth to attract significant new businesses.

Therefore, the overall significance of the proposed measures should be appreciated more from the point of view of strategic development than from any immediate business prospects. Allowing retained import trade from China to be settled in Rmb in Hong Kong opens the door for other businesses to be settled in Rmb in the future. Meanwhile, the issuance of Rmb debt in Hong Kong and the possibility of using Rmb deposits to provide trade finance will expand the Rmb denominated asset and liability spectrum in Hong Kong. As long as Hong Kong is able to prove that the new measures have no significant adverse impact on the Mainland financial system, more investment products, such as Rmb denominated H-shares, could be introduced in future.

The emergence of a Rmb denominated financial market operating on the world class financial platform in Hong Kong will be the best of both worlds, under the "one country two systems" setting. The elimination of exchange risk offers the greatest appeal. Taking the current QDII scheme as an example, as mentioned earlier, exchange rate risk could cause Mainland customers to hesitate to invest in other markets. Rmb denominated products in Hong Kong offer a unique solution. Meanwhile, businessmen will also be glad to take advantage of the Rmb infrastructure in Hong Kong to carry out their business and investment activities on the Mainland.

**Implications for the HKD**

While there is substantial excitement regarding the potential for local Rmb business, there are still some important concerns for authorities on both sides of the border to consider. The development of Rmb denominated financial services in Hong Kong will accelerate the circulation and acceptance of Rmb in Hong Kong. And with Rmb approaching full convertibility, more people may favour the Rmb over the Hong Kong dollar due to two reasons.

Firstly, the Rmb is a national currency, circulating in both Mainland and Hong Kong. The Hong Kong dollar, on the other hand, is only a local currency.

Secondly, businesses are increasingly tied to the Mainland economy. As reform of the Rmb exchange rate regime progresses, the Rmb exchange rate level will be increasingly determined by market forces. If the HKD remains pegged to the USD, more Hong Kong companies will prefer to hold Rmb to conduct their business in order to avoid exchange rate volatility. This could explain the recent emergence of the view that the HKD should be pegged to the Rmb instead of the USD when the Rmb approaches full convertibility.

**Conclusion**

China has accumulated huge savings. The challenge is to channel these savings to productive uses and generate the highest returns. Hong Kong as a financial centre has a lot to offer in this aspect. Rmb financial services would raise Hong Kong to another level as a financial intermediary for the Mainland market. This is another form of financial integration, and is only natural as the two economies become more closely integrated. With the close working relationship of the regulators in Hong Kong and on the Mainland, reforms can be introduced in a controlled manner. The measures would help the Mainland assess the impact of reforms, and prepare for the eventual opening of the Mainland financial industry. This is a win-win proposal. As the Mainland is ready to open up its financial market, Hong Kong must be ready to respond to the upcoming challenges.