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Challenges Facing Hong Kong Financial Industry

Protected behind the thick walls of a closed capital account, China's financial system has been spared the direct force of the financial tsunami. Reminiscent of its experience during the Asian financial crisis, China has thus escaped a major financial catastrophe. Nevertheless, just when some were wondering whether the current crisis would give China's leaders cause to further delay liberalization of the country's financial system, it was announced that Shanghai will become a developed international financial centre by 2020. This is a clear indication that China will push ahead with the opening and reform of its financial system.

China's Growing Economic Influence in the International Arena

As China gains in economic strength, it is gradually playing a more active role in shaping the international financial system. Since last December, China has signed 650 billion yuan in currency swap arrangements with South Korea, Hong Kong, Malaysia, Belarus, Indonesia and Argentina. These agreements extend the range of options for each economy in managing their reserves, enhancing the ability of the governments to defend against speculative attack. Further, the agreements provide a framework for settling bilateral trade in yuan in the future.

According to IMF estimates, intra-regional trade accounted for more than 50% of the total trade in Asia in 2008. With China being the central export hub in Asia, the use of yuan to conduct trade in the region is a logical choice. As a matter of fact, a Chinese central bank official has recently commented that, as the yuan exchange rate has remained stable throughout the current economic crisis, companies in the region are increasingly willing to settle trade in yuan. This indicates China's interest to internationalize the yuan.

The same rationale applies across China's trading relationships. For example, China is a major importer of energy and commodities, and thus its presence in the market has a significant impact on the prices at which commodities trade. Because China operates a closed capital account, it must rely on overseas commodity markets for price discovery. Further opening up China's financial system would allow the development of active commodity exchanges on Chinese soil, helping to shift the balance back toward China.

Dual Financial Centres

However, liberalization has a price. A closed capital account is the easiest and best protection against an external financial crisis. If China wants to gain the benefits of an open financial system, its own financial system will need to be robust enough to absorb the occasional external shock. In pursuit of this objective, the country has opted to champion a "two financial centres" model. In the 2009 Government Work Report, delivered in March, Premier Wen Jiabao said the country will consolidate Hong Kong's position as an international financial center. Meanwhile, a statement issued by China's State Council in late March gave Shanghai the green light to open up its financial sector and improve its financial services to develop itself into a multi-functional international financial center by 2020.

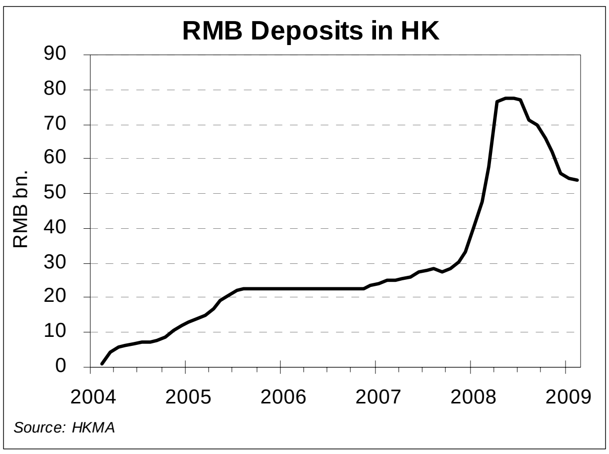
The twin engine approach utilizes the comparative advantages of both cities. Hong Kong boasts a free market economy, and a tradition of business and legal practices that is firmly grounded in international practice. Meanwhile, Shanghai is fully integrated into both the Mainland economy and Mainland business and legal traditions. The competitive and complementary nature of the arrangement should bring out the best of both cities to support the further development of the country's financial infrastructure.

Adjusting to the Changing Landscape of China's Financial System

This development has profound implications for the Hong Kong economy. If Shanghai is to establish itself as an international financial centre, significant progress must be made in the next eleven years in terms of liberalization of China's capital account and internationalization of the yuan. This will provide great stimulus to Mainland financial markets, and open up new opportunities for Hong Kong financial institutions.

The announcement that Mainland subsidiaries of Hong Kong banks will be able to issue yuan-denominated bonds will provide a great boost to the local banking industry. Meanwhile, the issue of yuan-denominated bonds in Hong Kong by the Ministry of Finance will help to establish a benchmark yield for Mainland government debt. This will provide a great stimulus to the debt market in Hong Kong, just at the time when the Hong Kong government is itself preparing to launch an active bond programme locally.

Earlier, it was announced that Hong Kong will become the first city outside the yuan zone permitted to settle trade in yuan. Mainland exports to Hong Kong totalled USD190.7 billion, or 13.4% of China's total, in 2008. Even if only a fraction of this trade is settled in yuan in Hong Kong, it will significantly expand yuan-denominated financial activities in the city. More importantly, it could considerably enlarge the local yuan deposit base, which remains small at 54 billion yuan or 1% of total deposits in February. As yuan is destined to become a popular international currency, demand for yuan-related financial services will surge in future. Hence, Hong Kong's head start will give us the advantage in responding to this need.



Hong Kong has an advantage in other areas as well. Financial service has a human relationship dimension. Being able to reach out to customers is just as important as having the right products and services. On this account, Hong Kong has its own charm. In 2008, one in every three Mainland outbound tourists visited Hong Kong – 16.8 million in total. From shopping to cultural activities, our glamorous city life has a strong appeal to our neighbours. Hong Kong is thus well positioned to establish itself as a wealth management centre for affluent individuals.

In order to encourage this trend, it is essential that Hong Kong is physically accessible to our Mainland neighbours; thus, the latest measure to allow Shenzhen residents to obtain multiple entry permits for Hong Kong is a step in the right direction. It is hoped that the plan will be extended to cover the entire 95.4 million population of Guangdong province. Also, more research attention is needed to enhance our understanding of the needs and tastes of this customer segment. Meanwhile, education, medical and cultural sectors are among the six industries the SAR government has highlighted as a future focus of development. Success in upgrading these industries to attract Mainland customers would generate positive externalities, and will strengthen our competitiveness.

Conclusion

With the current financial turmoil, world leaders are convinced that international financial activities should be under tighter supervision. This should result in a more stable international financial environment in the next few years, and China appears ready to seize this opportunity to accelerate the pace of liberalization of its financial system. Hence, recent discussion of whether Shanghai's emergence as an international financial center will sideline Hong Kong is misplaced. The focus should be on the implications of the opening of the Mainland's capital account on Hong Kong.

The process should increase China's international financial activities, which will serve to benefit Hong Kong. The speeding up of the development of yuan financial business in Hong Kong is a case in point. However, the capacity building of China's financial infrastructure following the opening implies that some of the financial activities in Hong Kong, such as IPO activity, could migrate to Mainland. In response to the challenge, Hong Kong should look into its own comparative advantages. As the Chinese Premier said, "if you don't forge ahead, you will simply fall behind."