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Hong Kong in the Global Economy: How the Special Administrative Region Rises to the Challenges Posed by China

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SUMMARY

- The Hong Kong Special Administrative Region (SAR) has quickly bounced back from the effects of the global economic recession in 2008/09. Economic indicators for the first half of 2010 are strong and attention is turning to the medium- to long-term outlook and Hong Kong's position in the region.

- The SAR's links with the Mainland economy are still special, though they are evolving and changing. While previously Hong Kong has been seen as the gateway into China, in the future it is also increasingly likely to be the gateway out of the People's Republic of China (PRC). It now needs to focus on how it can best exploit this for its international positioning as others become interested in directly attracting PRC funds and investment.

- Hong Kong currently stands in a unique position to exploit the attractiveness of its stock market for the Mainland, and also to be an RMB (renminbi) market. There are likely to be changes in all these areas in the years ahead, and the SAR cannot be complacent. Government and business policy-makers are now engaging with a Mainland Chinese economy which in terms of size and importance is growing increasingly important globally.

- Shanghai will continue to press its claims to be a major financial centre. It is a policy goal of the government to make it an international centre in the next decade. It will inevitably develop an international role. However, the scale of development needed to serve the Mainland's burgeoning domestic financial requirements is likely to absorb much of Shanghai's energy and resources. The issue for Hong Kong is how to adapt its historic attributes to preserve key advantages, without being overwhelmed by the demands, and indeed the risks, that the Mainland presents: working with Shanghai, rather than against it.

- Hong Kong's advantages are still clear – rule of law, a highly transparent and efficient administration and a free press. Its continued role as a leading international centre for finance and for commerce more broadly depends on strengthening rather than weakening such factors in the years ahead.

INTRODUCTION

This paper looks at the role that Hong Kong continues to play in the regional and global economy, and how it is working to integrate more deeply with Mainland China while maintaining its own advantages and identity. It first deals with the issue of where Hong Kong's economy currently stands after weathering the global financial economic crisis of 2008/09. Second, it looks at the latest data and information about Mainland economic activity involving Hong Kong. Third, it analyses the Closer Economic Partnership Agreement (CEPA) between Hong Kong Special Administrative Region (SAR) and the People's Republic of China (PRC), and looks at the role of Hong Kong as a place to conduct business in renminbi. Finally, it examines how Hong Kong and the PRC are aiming to work together economically over the coming decade, and what kind of synergies might exist, in particular with Shanghai.

Since becoming an SAR of the PRC in 1997, Hong Kong has continued to enjoy a high degree of autonomy and has maintained its own currency, a vibrant stock exchange and its importance as a leading regional and international centre of trade and finance. Its role as an interface between the PRC and PRC companies and the rest of the world continues. It has managed to weather the impact of the Asian Financial Crisis of 1998/99, the Severe Acute Respiratory Syndrome pandemic of 2003 and most recently the global economic recession of 2008/09. In many ways it remains uniquely well-placed to enjoy benefits from the continuing rise of the Mainland's economy. But there are areas in which policy-makers and business leaders in Hong Kong need to think hard about where its key strategic interests lie and how best to engage with the huge dynamism and continuing internationalization of the Chinese economy. The city of Shanghai offers the best example of this challenge. Some commentators talk of it becoming the region's leading international financial centre in the years to come. How can Hong Kong adapt to these changes and what sort of risks and challenges will they present?

A GLOBAL AND REGIONAL FINANCIAL SERVICES DYNAMO

Over the 20 years since China began to emerge on the world's economic stage, Hong Kong has been a key beneficiary of this opening up while remaining cautious about its relationship with China and its long-term regional role. It has been concerned about its high cost base and also challenges around urban planning. Yet Hong Kong has successfully met these challenges, continuing to grow and prosper. It has a low unemployment rate, healthy public finances and a solid financial system and is looking ahead to a new era in urban development. Relations with the neighbouring regions of China have deepened while trade and financial ties with the Mainland have generally grown.

2009 was a bad year for the world economy. According to the United Nations, world GDP fell by 2.6% compared with growth of 2.1% the previous year.[1] Because of the strength of growth in China (9.1%), East Asia as a whole posted 3% growth. But Japan recorded a 7.1% decline in GDP, Taiwan a 1.9% decline, and South Korea only 0.2% growth.[2] From a positive 6.4% in 2007, Hong Kong SAR fell to 2.2% growth in 2008, and contracted by 2.8% in 2009.[3] Its exports of goods also declined, falling from US$362.7bn in 2008 to US$318.5bn in 2009. As many as 51,000 jobs were lost at the height of the global recession, with Matthew Cheung, the Hong Kong SAR Secretary for Labour and Welfare, stating that 'it is difficult to predict when unemployment will peak'. However, he went on to say that in sectors like the catering industry and insurance, activity was still expanding.[4]

The importance of the financial sector for the Hong Kong economy (see Table 1 below) was only a small part of the reason why the economic downturn hit it as severely as it did. The drop in global exports also has a large impact. Hong Kong was also inevitably affected by the problems facing its neighbouring economies.

[1] `World Economic Situation and Prospects 2009' (updated mid-2009), issued by the United Nations, http://www.un.org/esa/policy/wess/wesp2009files/wesp09update.pdf accessed 15 July 2010.
[2] Ibid., p. 8.
[3] HK Census and Statistics Department.
[4] Radio Television Hong Kong report, 15 February 2009.

Table 1: Key industries: financial services, tourism, trading and logistics, professional services and other producer services

		Financing, insurance, real estate and business services	Financing and insurance	Business services
2004	Volume (HK$)	266,855	152,903	61,552
	% of GDP	21.4	12.3	4.9
2005	Volume (HK$)	294,260	170,284	63,394
	% of GDP	22.1	12.8	4.8
2006	Volume (HK$)	356,371	226,004	67,520
	% of GDP	25.0	15.9	4.7
2007	Volume (HK$)	450,989	301,998	77,725
	% of GDP	29.1	19.5	5.0
2008	Volume (HK$)	418,389	251,760	82,475
	% of GDP	26.7	16.1	5.3

Source: Hong Kong Census and Statistics Department

In the first half of 2010, however, Hong Kong staged a brisk recovery. While the US was able to record barely 2.8% growth, Hong Kong delivered 7.2%. Its exports surged year on year, it continued to enjoy stable consumer prices and lower unemployment, with asset prices rising. The fundamentals of its economy, despite what had happened in 2009, were strong. It had US$256bn in foreign reserves, the eighth highest in the world, and a per capita GDP which stood 15th globally, in purchasing power parity of US$42,800.[5]

The financial sector plays a very important role in the Hong Kong economy. Its stock market is the seventh largest in the world, and third largest in Asia. By the end of July 2010 it had 1,352 listed companies, with a market capitalization of HK$18.2trn (US$2.39 trillion). Many of these were Mainland companies (see below). Banks are another pillar of Hong Kong's economic importance. There were 146 licensed banks, 23 of them incorporated in the SAR, at the end of July 2010. There were also 70 representative offices of foreign banks, from 22 economies and regions. In 2008, banks added HK$160bn to the local economy, contributing 10.2% to GDP. The banking

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[5] https://www.cia.gov/library/publications/the-world-factbook/geos/hk.html (accessed 28 July 2010).

sector was a significant employer, with over 93,700 people engaged in the industry. In addition to this, stock brokerage, asset management and other financial services generated value added of about HK$69bn, contributing 4.4% of Hong Kong's GDP in 2008, a two-fold increase from 1999, employing almost 69,500 people. Hong Kong is also a leading asset management centre in Asia with a combined fund management business of HK$8,507bn (US$1,095bn) by the end of 2009, representing an increase of 45.4% from 2008. A total of 1,968 authorized funds of net worth US$927bn, representing a fall of 6.0% and an increase of 47.5% respectively compared with 2008, were under the management of authorized fund houses at the end of 2009. The Hong Kong Monetary Authority's (HKMA) Monthly Statistical Bulletin puts the value of total banking assets at HK$10.95trn (US$1.41trn) at end-June 2010.

HONG KONG AS THE INTERNATIONAL INVESTMENT INTERFACE WITH CHINA

Over the past few decades, Hong Kong has built much of its prosperity on its proximity to the fast-developing Mainland. This emerged from a symbiotic relationship that developed rapidly as China opened up and it persists today. One of the first major moves when the Chinese economy started opening up in 1978 was the establishment of Special Economic Zones (SEZs) in key strategic positions where they could exploit their ability to be manufacturing centres. SEZs were set up in particular regions (Guangdong and Fujian) as experiments to assess how freedom of operation for companies and outside investment might work and offer China new dimensions to growth in external markets. Entrepreneurs from Hong Kong quickly took up the opportunities offered and much of the Hong Kong's manufacturing base migrated to the eastern coastal regions.

Since 1978, Hong Kong has been the single largest source of capital flows into the PRC. In 2002 alone, for instance, Hong Kong investors (not including those investing through Hong Kong) injected US$17.86bn, almost a third of the total that year. This contrasts with the US (which only invested 10%) and the European Union and Japan (about 8%). In 2004 41% and in 2005 62% of Hong Kong's outward direct investment went to China.[6] However, from 2005 to 2008, the second largest destination for outward investment from Hong Kong was notably the British Virgin Islands (BVI), which received HK$18bn in 2005, HK$78bn in 2006, HK$104bn in 2007 and HK$142bn in 2008. Cumulatively, by the end of 2008, the BVI held the second-largest single stock of Hong Kong's outward direct investment, standing at HK$2,584bn. The key driver of this flow was the favourable tax advantages, with a large proportion working its way back into the PRC. In fact, direct investment from Hong Kong into the Mainland was catching up: from HK$1,477bn at end-2005, this doubled to HK$2,625bn three years later. The combined total of investment in the BVI and PRC made up almost 90% of the region's Overseas Direct Investment (ODI), which stood at HK$5,209bn at end-2008. The other significant recipients of investment funds flowing out of Hong Kong were Bermuda, the UK, the USA, Singapore, the Cayman Islands, Liberia, Thailand and Malaysia.[7]

Along with the outsourcing of manufacturing, there is also the role that the region played as a safe, reliable base for foreign companies which wanted to explore opportunities within the Mainland. The liberalization of the investment

[6] Census and Statistics Dept, HKSAR.

regime in China in the 1990s, and the restructuring of its laws concerning joint and wholly-owned ventures, meant that by the time the PRC entered the World Trade Organization (WTO) in 2001, an increasing number of companies felt confident enough to open offices in Beijing. By this time, however, Hong Kong had started to extend its key function. With the Beijing government announcing a 'Go Global' strategy from the early 2000s, encouraging Chinese state and non-state enterprises to invest overseas, and picking key sectors and companies to do this, Hong Kong became a major springboard.

There have been two strands in this movement. Both of them have been able to exploit the region's cultural and linguistic similarity with the PRC, but have also used its unique legal and governmental system. One has been the extraordinary explosion of Mainland companies listed on the stock exchange in Hong Kong. The other has been the huge amount of cross-investment that the region has seen from the Mainland.

The first Chinese state-owned company was listed in Hong Kong in 1993, only a year after then paramount leader Deng Xiaoping's celebrated Southern Tour. From 1993 to 2009, 524 Mainland enterprises subsequently raised more than HK$2,499bn. In July 2000, the first Chinese state-owned company was launched on the Growth Enterprise Market of Hong Kong Exchanges and Clearing (HKEx). By the end of 2009, there were 156 H (Mainland Chinese) shares listed on the HKEx with a market capitalization of US$604.3bn. There were also 97 'red chip' (state-owned) and 271 private enterprises. About 40% of the firms now listed in Hong Kong are Mainland companies, accounting for 58% of the exchange's market capitalization, and 72% of its equity turnover.[8] These companies are the source of new growth. Companies such as Lenovo, Huawei and ZTC are all active as international concerns because of their Hong Kong listings.

In the last five years, some of the most prominent Initial Public Offerings (IPOs) have been major state-owned Chinese companies that have undertaken dual listings in both Shanghai and Hong Kong. In 2007, PetroChina undertook a listing on top of that which it had already completed in Hong Kong. Sinopec is also listed in Hong Kong. The Industrial and Commercial Bank of China (ICBC) had held an IPO earlier in 2006, which had raised US$21.9bn, again in Shanghai and Hong Kong - at that time a world record. In July 2010, the Agricultural Bank of China, the last of the four major

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[7] Ibid.
[8] https://www.cia.gov/library/publications/the-world-factbook/geos/hk.html (accessed May 2010).

Chinese state-owned banks, broke the former record with a listing valued at US$22.1bn.

Hong Kong's role in investing in Mainland China has been one of the most significant contributors to the PRC's economic liberalization and internationalization. Now, the role has extended to the facilitation of the Mainland's outward investment. The amounts of investment that have flowed out of the PRC into and through Hong Kong since 2001 are enormous, and growing. Since the late 1990s, Hong Kong has not just been a major investor into the Mainland but also the largest single recipient of outward Mainland investment. China's investment into the region almost tripled between 2004 and 2007, from HK$1,211.6bn to HK$3,423.7bn.[9] According to official Chinese government statistics, of the global overseas direct investment stock to the end of 2008 (which stood at US$184bn), a staggering US$116bn was in Hong Kong.[10]

Table 2 presents a simple look at Chinese ODI up to the end of 2008 and shows Hong Kong's dominance:

Table 2: Chinese outward ODI, 2007/08 (US$ billions)

Destination	**2007**	**2008**	**Total**
Hong Kong	13.7	38.6	115.8
Rest of Asia	2.9	4.9	15.5
Africa	1.6	5.5	7.8
Europe	1.5	0.9	5.1
Latin America	4.9	3.7	32.2
North America	1.1	0.4	3.7
Oceania	0.8	2.0	3.8
Total	**27**	**56**	**184**

Source: Hong Kong Census and Statistics Department.

From 2007 to 2008 Chinese ODI into and via Hong Kong almost tripled at a time when investment from the Mainland into Europe and North America, two of the most mature investment markets, actually fell. The Latin America figure is once more distorted, as was the Hong Kong inward investment figure into the PRC, by offshore destinations for 'round-tripping', which may well have returned to Hong Kong or China. Australia's rise stems from the significant mining projects into which PRC companies have bought.

In a 2005 survey many Chinese state and non-state company bosses said

9 http://www.censtatd.gov.hk/hong_kong_statistics/statistical_tables/index.jsp?charsetID=1&tableID=050
10 China Statistics Yearbook 2009, p 752

that they preferred to invest in Europe and North America, where there was greater security and a more benign investment environment. However, research has shown that in many ways Chinese entrepreneurs, because of their lack of international experience, vote with their feet by investing in places where there is a large Chinese diaspora. Hong Kong is the most obvious of these. Its linguistic and cultural similarities to the PRC mean that it is regarded as the softest possible launch-pad for investments further afield.[11]

PRC investment into Hong Kong is often then redirected to other places and into other sectors. Much of China's ODI is driven by the need to secure energy and mineral resources. It often supports business services for other Chinese state or non-state enterprise. Hong Kong's role has therefore been subtly extended - from being at the interface of foreign direct investment into China it is increasingly becoming the interface for PRC money coming out of China. Hong Kong's ability to offer Chinese businesses a secure, reliable environment from which they can internationalize as well as a whole range of world-class financial services is becoming one of its key roles. This role is only likely to increase in importance in the future.

[11] An overview of the main drivers behind Chinese ODI, along with their chief challenges so far, is given in Kerry Brown, 'No Reverse Gear', available at http://www.kerry-brown.co.uk/files/clsa_paper_final.pdf.

THE CLOSER ECONOMIC PARTNERSHIP ARRANGEMENT WITH MAINLAND CHINA

Acting as a conduit for Mainland outward investment is only one specific aspect of Hong Kong's role. Another is facilitation of inward investment through the Closer Economic Partnership Arrangement, through which the Mainland offers preferential terms to Hong Kong (as well as Macau) in the trade in goods and services and facilitates investment.

One of CEPA's most visible and practical impacts was to allow Mainland tourists into Hong Kong as individual visitors rather than requiring them to be on package tours or parts of groups. According to the Hong Kong Trade and Industry Department, by March 2010, over 49 million Mainland visitors have visited Hong Kong under the Individual Visitors Scheme (IVS):

> The number of individual visitors has drastically increased from 4.26 million in 2004 to 10.59 million in 2009, representing a robust average annual growth rate of 20%. In 2009, benefiting from the implementation of the 'multiple-entry' individual visit endorsement to Hong Kong for Shenzhen permanent residents with effect from 1 April, an additional HK$26.4 billion in spending was generated by IVS visitors in 2009, which was almost 40% higher than that in 2008. In cumulative terms, during 2004-2009, such visitors brought about additional spending totalling over HK$84.8 billion.[12]

The CEPA can be seen as one of a number of liberalization and free trade agreements (FTAs) which the PRC has signed with other countries and territories, culminating in the historic Economic Co-operation Framework Agreement (ECFA) signed with Taiwan in June 2010. The PRC is also due to sign an FTA with the ten members of ASEAN in late 2010. One of the main economic benefits of the CEPA has been to allow Hong Kong enterprises and business people to have tariff-free access, or at the very least reduced tariff access, to the Mainland market. Lured by the incentives China offers to Hong Kong firms, foreign services firms looking to enter the Mainland are investing more in Hong Kong. According to InvestHK, the region's department for foreign direct investment, 26% of the 265 foreign companies assisted by InvestHK cited the CEPA as a key consideration for investing or expanding in the SAR in 2009. Preferential access through CEPA to the Mainland market is becoming increasingly important. With one of the lowest consumption rates in the world (standing at only 37% of GDP, compared with over 60% for developed economies such as the UK or US), the Mainland's domestic market is clearly going to be one of the few areas of significant potential growth in the years ahead. International companies are now focusing much more on how they can break into this market, rather than simply making things in China and then exporting them elsewhere.

This also extends into the export of services, including logistics, travel and financial services. All of these have expanded strongly in the last five years; seven supplements have been added to the original 2003 CEPA, the most recent being signed in May 2010, which will come into effect in January 2011. This aims to loosen trade and investment restrictions in 14 services sectors including banking, distribution, medical and tourism services.[13]

[12] See Hong Kong Trade and Industry Department, http://www.tid.gov.hk/english/cepa/further_liberal.html.
[13] Census and Statistics Dept, HKSAR.

TWO OTHER HK SAR ADVANTAGES: RMB BUSINESS AND MAINLAND ASSET MANAGEMENT

The PRC currently maintains heavy controls on its currency, despite significant pressure for change from, in particular, the US. At the moment, China's policy of control only adds to Hong Kong's unique position within international financial centres, as it pegs its own currency to the US dollar and is one of the few places where RMB business can be transacted outside the PRC. However, this position is unlikely to last. The Chinese government is making the RMB more convertible, albeit slowly, and is progressively liberalizing its foreign exchange controls, lifting the restrictions on RMB business for foreign banks based in China. Hong Kong banks can increasingly tap into domestic business in China in the same way that Hong Kong manufacturers moved into China in the 1980s. There is also outside pressure for a change in the RMB regime: China's protection of the US dollar peg was seen as a stabilizing influence during the 1997/98 Asian financial crisis but many now see it as a disadvantage. In addition, as a result of the freeze in dollar-denominated trade credit during the 2008/09 crisis, the PRC has become more active in trying to increase the ways in which it can use RMB for global transactions. Uniquely, holders of Hong Kong residence permits are allowed to establish savings accounts in RMB. Corporate and PRC government bonds have also been issued in Hong Kong. The HK SAR government is now looking at extending the provision of these services.

2004:	RMB deposits, remittances, exchange and credit cards introduced in Hong Kong.
2005:	RMB checks introduced.
2007:	Introduction of RMB bonds by Mainland banks.
July 2009:	Selected companies (e.g. retailers, trading companies and banks in Hong Kong and a few other regional cities in the PRC) allowed to open RMB business accounts and transact business in RMB.
June 2010:	Trade settlement pilot scheme extended.

Hong Kong's RMB bond market began to develop in 2007, with 23 issues (as of September 2010) for a total of RMB47.5bn (US$7bn). HSBC China, the Bank of East Asia China and other lenders have already issued bonds in

Hong Kong for Chinese Mainland development. In 2009 RMB16bn worth of bonds were issued, including RMB6bn of sovereign bonds. Investors can now access the RMB market in China via the Qualified Foreign Institutional Investors Scheme (QFII), although this is a highly illiquid and expensive tool by institutional investors' standards and does not give them the exposure they need to offer viable RMB products.

In April 2009, the scope of services expanded further when a pilot scheme was launched whereby some select Mainland enterprises were able to use RMB to settle trade in the SAR and other ASEAN countries. The pilot scheme has been seen to be operating well. A joint statement from the People's Bank of China, Ministry of Finance and Ministry of Commerce described the experimental scheme as ‘smooth, in good order, convenient, and popular among enterprises and banks’. In July 2010, the government announced that the pilot scheme would be vastly expanded with cross-border trade settlement using the RMB extending from just two provinces to 20. The pilot scheme to allow settlement of cross-border trade in RMB expanded to banks including HSBC, Deutsche Bank and Citigroup. While significant, this kind of transaction is in its infancy. Cross-border RMB trade in RMB totalled US$10bn between January and June 2010, compared with the US$2.8trn of goods traded across China’s borders in 2009. The overwhelming majority of this was in US dollars or Euros.[14]

With its established RMB financial infrastructure and clearing arrangement, Hong Kong is set to benefit from serving the greater scope of RMB financial intermediation activities. By the end of 2009, 60 licensed banks were conducting RMB banking business in Hong Kong. In 2009, RMB deposits represented about 2.4% of total foreign currency deposits, with an outstanding total of about RMB62.7bn at the end of the year. A supplementary agreement of the CEPA introduced in October 2009 allowed Hong Kong banks, through their branches or wholly-owned subsidiaries in the mainland of China, to apply to establish ‘cross-location’ sub-branches within Guangdong Province. The practical impact of this will be to allow Hong Kong banks to expand their business networks in this neighbouring province, which accounts for approximately 11% of Chinese GDP and is the location for a large proportion of Hong Kong-derived investment. However, the region's success in capturing future RMB business is not guaranteed. The amount individuals are allowed to convert, 20,000 RMB a day, is too small while the interest rate on offshore six-month time deposits is too low - only 0.73%

[14] Financial Times, 13 September 2010.

compared with 1.98% onshore. More Chinese companies should be allowed to conduct their foreign trade in RMB and more onshore institutions need to be allowed to issue RMB-denominated debt in the Hong Kong market. Banks need to offer more RMB investment choices in order to develop greater liquidity. These actions, if conducted within a sensible time-frame, would help to greatly expand the RMB market. Curbs on the free flow of RMB into Hong Kong have been lifted and, since July 2010, 'financial groups in the SAR have been able to create a range of RMB-denominated investment products and hedging tools, all open to global companies and investors'.[15] In August, McDonalds became the first foreign multinational to issue a RMB bond. These can then be used to fund its operations in China.

To supplement its role as a launch-pad for Mainland China, Hong Kong now specializes in the provision of trade-related, banking and financial services to China. It does this by capitalizing on its advantages of currency convertibility, capital mobility, the strong legal sector in Hong Kong and its good record for corporate governance and transparency. The region's tax rates are among the lowest in the world, including a flat 16.5% corporate profits tax, a personal income tax rate of 15% and no taxes on dividends, capital gains and inheritances. The Hong Kong authorities continue to take measures to enhance the city's attractiveness. In February 2010, the government announced that it was to extend tax exemptions for exchange-traded funds, increase tax benefits for bond trading and promote hedge funds by allowing even funds domiciled outside Hong Kong but run by city residents to qualify for tax exemptions on their profits. CEPA also provides a beneficial starting point by allowing Hong Kong service providers preferred access to the Mainland market in logistics, finance and other invisibles.

[15] Ibid.

THE CHALLENGE FROM THE MAINLAND: SHANGHAI AS AN INTERNATIONAL FINANCE CENTRE

Shanghai is likely to pose particular challenges to Hong Kong in the years ahead. It has already stated its goal of becoming a major financial centre. Dr Fang Xinghai, Director General of the city's Financial Services Office, stated in an interview in April 2010 that 'the State Council directive is mainly to speed up Shanghai's transformation… Shanghai will be among the top three *[financial centres]* in the world as early as 2015'.[16] But he continued, 'We don't want to make an international financial centre for the sake of being an international finance centre. We want it to serve the interests of the people.'

Shanghai, with its population of 17 million, its stock market, its wave of non-state entrepreneurial companies, its wealth and new regenerated areas, is taken as the supreme symbol of how China itself has developed over the last three decades, posting figures above the national average growth rate of 9–10% for the last decade. There is no better embodiment of this than the dramatic, regenerated Pudong area with its futuristic skyscrapers. In 2000, Shanghai had a per capita GDP of US$4,000 which rose, in the space of four years, to US$8,330, nearly five times the national average. The city government promulgated a policy of 'Speeding up the Going Out' of Chinese non-state and state companies in 2005. By 2006, there were 909 overseas investments with committed investment of US$2.2bn. In the first three quarters of 2009, Shanghai companies were the second-largest outward investors in the whole of the PRC, sending abroad a total US$700m.[17] Shanghai companies have appeared in St Petersburg, which has a development zone, Hamburg, San Francisco and the UK. At the centre of this has been the expanded, redeveloped port, now chasing both Hong Kong and Singapore to be the busiest and largest in the world.

What do Shanghai's aspirations to be an international trade and finance centre mean for Hong Kong? According to Chen Yuan, then Deputy Governor of the People's Bank of China, speaking in the UK in 1996, Shanghai and Hong Kong could have complementary and mutually reinforcing relationships as financial centres.[18] Almost a decade and a half later, how do things stand?

According to one analyst for a multinational investment company based in Shanghai in 2007, the more excitable claims about Shanghai's ability to become a global finance centre need to be taken with some caution. The

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[16] Interview in *International Institutional Investor*, April 2010, pp. 34-5.
[17] Statistics released from the Chinese National Bureau of Statistics, December 2009.
[18] Speech on 1 Sept 1996 at a Bank of England seminar held in London.

financial structures, led by the Chinese Security Regulatory Commission, have been developed over the last two decades, but are still relatively immature. A reputable legal framework will also take time to develop. In the context of China, a well-regarded legal and regulatory system needs political reforms, which will also take time. Shanghai stocks remain highly popular as a means of raising capital for domestic companies but they are also highly volatile. Nor are they a good means, at the moment, of internationalizing. Companies of any size in China still look to list in Hong Kong rather than Shanghai. Shanghai's main flotations are of former state-owned enterprises. Minority shareholders have almost no protection. Boards are unaware of their powers and responsibilities and overwhelmed by the rafts of new legislation coming through as a result of China's WTO entry. Chief executives of Chinese companies now need to develop some awareness of their accountability to investors. Capital held by Western companies can only go into Shanghai 'A' shares via local brokers who have a limit to the amount of capital they can commit each year. 'A' shares and the foreign `H' shares are not interchangeable. And even though investment banks such as Macquarie have now based themselves in Shanghai, their main work is still conducted in Hong Kong.[19]

There is no disputing the fact that, since entering the WTO, China has opened its financial sector in a way never managed before, with the four main banks all achieving major listings in the last few months. Citigroup, HSBC (which made Shanghai its regional headquarters in 2009) and Standard Chartered are all active in the city. For the 71 foreign banks active in China in 2007, 55% of their business is done in Shanghai. But at a micro level the options for Chinese investors are very limited. They can either put their money in low-interest accounts, in property (and this is something the government is trying to rein in owing to the fear of an overheated property market) or in the stock exchanges. They have no other real asset classes, nor are there any corporate bonds. The dramatic fall on the Shanghai Stock Exchange in 2008 and 2009, which saw stocks fall in value by as much as 40%, gives further food for thought. Long-term observers of the performance of the stock market in Shanghai know that there was something familiar about this. Between 2000 and 2004, Shanghai stocks fell by 49%.

This is not to deny that Shanghai faces some major challenges as it develops. There is an unclear division between politics and finance that lies at the heart of Shanghai's current weaknesses. Economist Yasheng Huang, in his book,

[19] Material and interviews in this section first appeared in an article on Beijing, Shanghai and

Capitalism with Chinese Characteristics, devotes a chapter to the issue of 'What is Wrong with Shanghai'. Chen Liangyu, when Party Secretary of the city, used to boast that over 85% of its economy was in the hands of the state. Huang concurs. Far from being a city of free-wheeling entrepreneurialism, in fact, Shanghai is at the moment the embodiment of state capitalism. Huang outlines a number of key problems with Shanghai's performance over the last two decades since it was belatedly made a Special Economic Zone in 1990. 'Although it is true', Huang states, 'that Shanghai has had excellent GDP performance, much of this performance seems to have only moderately improved the living standards of the average Shanghainese'.[20] His second complaint is that 'Shanghai's GDP growth … since the late 1990s … has been sharply anti-poor'. What GDP is generated in the city has gone to enterprises, and the vast majority of these are state-owned. Shanghai 'lacks entrepreneurial development' and has a 'blatant anti-rural bias in policy orientation'. Huang's controversial argument is powerfully supported by data about companies and enterprises in the city. In order to become an International Financial Centre, Shanghai will need to fulfil key preconditions. It must have currency convertibility and free capital mobility and will need to prioritize this in the coming decade to fulfil its ambition.

The relative advantage of the Hong Kong financial market is that it is a fully internationalized market with the presence of international players, a regulatory regime aligned with international standards and free flows of information and capital. Hong Kong will play an important role in the process of the opening of Mainland China's financial markets and RMB convertibility. The relative advantage of the Shanghai financial market is its access to domestic liquidity and RMB-denominated capital markets including equities, foreign exchange and commodities futures. The role of Shanghai is to fulfil the financial intermediation need in Mainland China's domestic economy. The offshore RMB market in Hong Kong will facilitate the internationalization of the RMB. This process will inevitably lead to more opening of the onshore capital market in Shanghai. The offshore market will naturally complement the onshore market for the market as a whole to function. Hong Kong and Shanghai can complement each other, and contribute jointly to the development of China in this way.

Hong Kong, published in June 2007 in *Business Monthly*, London by Kerry Brown.

[20] Yasheng Huang, *Capitalism with Chinese Characteristics: Entrepreneurship and the State*, Cambridge University Press, 2009, p. 177.

CONCLUSION

Hong Kong SAR boasts that it is a world city. In terms of the immense flows of capital through its markets and the ways in which it now stands as a key interface between the rest of the world and a Mainland Chinese economy powering ahead, this is no mean boast. If the story of the continuing rise of Mainland economic might is one of the key ones of our times, then Hong Kong has a role right at the heart of that.

Hong Kong is focusing on three major directions of development:

(1) to be an international capital formation centre: Hong Kong is the international equity funding centre for Mainland China enterprises. Hong Kong is also broadening the source of listed companies and becoming the leading financing market for world mineral and exploration companies;

(2) a regional asset management hub: Hong Kong is the leading fund management centre and a hedge fund hub in Asia. Underpinned by the shifting of financial centre gravity to the East, Hong Kong has a rapidly expanding fund management business;

(3) an offshore RMB centre: Hong Kong's RMB business includes RMB banking, RMB trade settlement and financial products denominated and settled in RMB and an RMB bond market. RMB business is growing fast alongside a more important role for RMB internationally.

In order to fulfil these directions, Hong Kong has been able to exploit its two great assets – a liberal, open, and free environment, and a strong tradition of the rule of law. These aspects of Hong Kong gives it very strong advantages. Greater management of Mainland assets and a larger role for RMB business are all part of this story of how Hong Kong is a hub, and an interface, between China and the world. Shanghai, the most aggressively aspiring 'Hong Kong' of the Mainland, is still a long way from actually competing. At the moment, it is simple: the Hong Kong for the PRC is Hong Kong, not Shanghai.

But in the longer term, there are issues about identity and dependency, which the SAR will need to think about and address. As China develops, if all goes smoothly, it will liberalize and open its markets more and more, integrating into the global economy. Hong Kong has to maintain and develop its strengths especially in terms of law and governance, and the role of civil society. It has passed some important tests over the last decade. But the greatest challenges lie ahead. And if Hong Kong's greatest asset is its people, it will be its people who will need to find a way to address these so that Hong Kong is maintained not just for the next decade, but for long after that.

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