HONG KONG’S FINANCIAL CENTER IN A REGIONAL AND GLOBAL CONTEXT

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Geography continues to shape the character and promise of Hong Kong’s financial sector. Its physical and human links to the heartland of China made it a natural center for trade in goods and services. And when trade between nations mediated by merchant companies was largely transformed by the practice of intra-firm transfers within multinational corporate networks, Hong Kong’s adaptation required little detailed direction. Its basic advantages remained the same even as industrial capitalism on a national scale developed into financial capitalism on a global scale. Hong Kong’s location, time-zone and territorial openness to the movement of people made it a clearing house for information.

There was, nevertheless, nothing inevitable about the precise path Hong Kong has followed recently into the top tier of international financial centers. British rule set the policy and legal framework that still supports vibrant business networks with London, New York and other leading global cities. But two key advantages again manifested themselves in the years following the 1997 handover: financial linkages with the mainland remained robust, and Beijing continued to value highly Hong Kong’s role as gateway to the global economy.

Nevertheless, to retain its top-tier position, Hong Kong must deal wisely with a range of fundamental policy issues in the coming years. These will require a more active role for government than has been the norm; continued reliance on a laissez-faire attitude and a low-tax regime by themselves will not be adequate. This brief article frames important policy debates on strengthening those advantages, first in light of high-end competition from within the region and then in the context of the rapid development of greater China.

The Regional Challenge

Across a range of regional financial markets, Hong Kong plays a leading role. Its key rival remains Singapore, where government quite clearly believes in and
remains capable of implementing a coherent and effective industrial policy in the financial sector. In Hong Kong, government often served as behind-the-scenes business facilitator and, occasionally, crisis manager. Although Hong Kong’s property market hardly qualifies as free and competitive, direct taxes are low and a rather decentralized government keeps financial markets open, dynamic and resilient. In Singapore, a centralized government promoted new industries and encouraged the development of locally based ‘off-shore’ banking and bond markets. In Hong Kong, government accommodated often opaque linkages between public and private sectors that, relatively speaking, permitted deep interaction between domestic and international markets, especially in the banking sector. Ever since the mid-1980s, however, the total assets of Singapore-based banks have far exceeded their Hong Kong-based counterparts. Over the same period, Hong Kong emphasized growth in equity markets, while Singapore built a formidable presence in international bond markets.

Broadly speaking, both policy paths led to the development of vibrant and reasonably diversified financial institutions. In Singapore, however, large state-owned institutions like the Development Bank of Singapore held dominant positions in those markets, while in Hong Kong most major market makers are private and relatively small, with certain obvious historic exceptions among its banks. Similarly, the Monetary Authority of Singapore played the most prominent role in regulating and supervising all of Singapore’s financial sectors, including securities, futures, foreign exchange, insurance and banking. In Hong Kong, these functions were broken up across the Securities and Futures Commission (SFC), the Office of the Commissioner of Insurance, the Hong Kong Monetary Authority (HKMA), and various self-regulatory organizations, including Hong Kong Exchanges and Clearing Limited (HKEx) and its subsidiaries. The functional constituency system in Hong Kong’s legislature—which gives certain interest groups (including banking) the right to elect half the legislators—also had a subtle impact in terms of both what was done by regulators and what was not done.

One fact looms very large in accounting for the way in which such differences have evolved over time across the two cases. Singapore’s natural economic hinterland is Southeast Asia and India. In the absence of a clear strategic orientation toward global markets, its financial center would not have developed as quickly and as autonomously as it did during the past half century. Hong Kong’s hinterland is China, and in the absence of an open, decentralized and adaptable system attractive to local entrepreneurs as well as foreign multinationals, it would
not have been in a position fully to take advantage of the staggering opportunities a booming China has placed in its path ever since the late 1970s.

Proximity to the mainland has, however, both shaped and constrained Hong Kong’s competitive advantages. It is true that its financial sector shone brightly in recent years because of its stock markets and the remarkable IPO activity taking place there because of its expanding expertise in funds management and lately because of Beijing’s decision to experiment with an offshore renminbi, the national currency. When Chinese business is excluded from the comparison, however, Singapore retains durable leads in foreign exchange and derivatives trading, as well as in global banking and equity underwriting. In other words, at base Singapore looks more like an international center and Hong Kong more like a financial entry and exit point for a booming greater China. Although the future for intra-Chinese finance looks bright, if perhaps at times volatile, the regional challenge for Hong Kong is to diversify and deepen its financial markets and continually to enhance the infrastructure supporting those markets. To maintain its overall leadership position in the region and retain its global ranking alongside London and New York, Hong Kong needs to keep its focus on the challenge from Singapore.

**Complementing the Mainland**

If Singapore represents a continuing competitive challenge for Hong Kong, rapidly expanding financial centers in mainland China should largely be viewed as present opportunities and future complements. Undoubtedly, finance in Shanghai, as well as in cities like Shenzhen, is on the rise. But this does not mean that Hong Kong’s financial center will suffer relative decline.

Shanghai’s financial markets are at an early stage of development and it will be a long time before they achieve world scale. That said, the city plays a prominent role in raising domestic bond financing, and its market for domestic equities is vibrant and growing. The expanding equity and banking markets in Shenzhen and elsewhere on the mainland cater mainly to small firms focused on the domestic Chinese market or linked to supply chains controlled by larger state-owned enterprises. The Shanghai and Shenzhen stock markets thrive as state-owned enterprise (SOE) privatization remains a national objective, and they began their operations with two separate kinds of listings: A-shares in local currency for domestic investors, and B-shares in foreign currency for foreign investors.
Notwithstanding such distinctions, most firms entering these markets already had complicated ownership structures, with much of their equity ‘non-negotiable,’ that is, primarily controlled by governmental entities. Despite some loosening of restrictions after their inaugural periods, including the post-WTO accession Qualified Foreign Institutional Investor (QFII) initiative that permitted limited foreign purchases of certain A-shares, government planners continue to limit the liquidity of the Shanghai and Shenzhen markets and to subject share prices to abrupt changes in policy.\(^4\) By 2009, and after the worst of the recent global crisis had passed, the market capitalization of those two equity markets had increased almost three-fold. As impressive as their expansion remains, the larger financial context surrounding them remains distorted by unacknowledged losses carried on the books of major banks, by a range of policies intended to steer capital flows within China and across its borders, and by regulatory opacity and inconsistency.

In contrast to Shanghai and Shenzhen, Hong Kong’s equity markets are well developed, open and competitive. Domestic listings do account for the lion’s share of trading activity, but a major source of contemporary growth has been IPOs for mainland incorporated and state-owned enterprises, and, intermittently, new listings for ‘red-chip’ Chinese companies incorporated outside the Mainland, albeit most of which remain under the majority control of mainland shareholders like provincial and municipal governments.

After stability had returned to the Hong Kong equity market in 2009, the differences between Hong Kong and its mainland counterparts had become clear. Chinese authorities apparently continued to see the Shanghai, Shenzhen and other local exchanges as useful mechanisms mainly for propelling domestic economic growth but not for undermining Hong Kong’s external role. Compared to Hong Kong, disclosure requirements on mainland exchanges and other standards associated with listing shares are less onerous. Accordingly, the risks, especially for investors lacking inside knowledge of the condition of such firms and of associated government plans, are comparatively high. With its access to foreign capital providers and higher listing standards, on the other hand, Hong Kong continues to attract large mainland companies, ones that find the ‘seal of approval’ implied by a Hong Kong listing crucial not only to raising funds but also to enhancing the prospects of core businesses as they venture out into the wider world.
In short, Shanghai is now a national financial center that looks set gradually to become much more important as China develops its internal financial markets. With a domestic focus in the long run not entirely unlike the focus of Chicago, Toronto or Paris, for the foreseeable future Shanghai remains constrained by capital controls and subject to periodic bouts of regulatory change. Shenzhen and other rising mainland financial centers remain similarly constrained.

Nevertheless, the aspirations of great mainland cities present myriad business opportunities for experienced Hong Kong firms. A high-end service sector is developing in those cities, payments systems must be developed, back-office infrastructure requires investment and talent, and established product lines can be imported and adapted to local needs. Especially because of deep cultural and economic linkages across the Pearl River Delta, places like Shenzhen and Guangzhou represent for Hong Kong-based financial-service providers burgeoning markets much like those Hong Kong’s manufacturing firms helped develop decades ago. Certainly such opportunities were on the minds of officials on April 7, 2010, when they signed a new framework agreement on Guangdong-Hong Kong Cooperation in Beijing. In fact, Hong Kong-based organizations like The Greater Pearl River Delta Business Council had already prepared the way for mainland centers to be viewed as complements, not strategic threats.

**Hong Kong in a Changing World**

To keep Hong Kong’s financial center strong and to strengthen it further thus requires a two-track strategy. By helping mainland cities, it builds up expertise, shares the benefits, and keeps a step ahead. At the same time, by focusing on the external competitive challenge from Singapore, it is pushed continuously to enhance its own internal infrastructure, product lines and general efficiency in global terms. With systemic technological, economic and political transformations now underway, Hong Kong in fact lives at the edge of similar strategic choices facing all of the world’s leading financial centers. They all want the benefits of cross-border integration—the prosperity, peace and freedom promised by an open world order—while retaining the necessary capacity to stimulate and deepen key industries.

Hong Kong is now an integral part of a fast-changing China, but it still possesses the essential degree of regulatory and institutional autonomy needed to craft a sophisticated dual industrial strategy. If the term “laissez-faire” ever captured the
essence of an appropriate general policy line for Hong Kong, it no longer does. If “one country, two systems” is more than a slogan, it suggests a unique and powerful policy line that is both active and subtle. The private sector can certainly carry the main burden of competition in dynamic national, regional, and global financial markets. But government must play a more energetic role.

The financial crisis of 2008 and its aftermath revealed three main issues for Hong Kong’s financial policymakers: the need for clearer mandates and better coordination among regulators, including the Financial Services and Treasury Bureau, the HKMA, the SFC, the Mutual Provident Financial Authority, the Deposit Protection Board, a new insurance overseer and the privately held HKEx and its subsidiary, Hong Kong Securities Clearing Company Limited; the need to reconsider the range of responsibilities and policy targets assigned to the HKMA and the Exchange Fund it manages; and the need for a more strategic approach to assisting the process of financial deepening on the mainland, to enhancing the competitiveness of Hong Kong-based intermediaries, and to diversifying the broader economy of Hong Kong itself. The task of strengthening Hong Kong’s international financial center should be seen as a vital element in a much larger policy agenda.

Hong Kong’s traditional advantages persist. They include: a geographic location attractive for international firms; a confidence-inspiring and institutionalized commitment to the rule of law that, among other vital things, can sustain a robust regime for the protection of intellectual property rights; the HKMA and the foreign currency reserves it manages; efficient and liquid systems for clearing and settling local and cross-border payments; an expanding network of bank branches and related businesses that have already followed promising clients to the mainland; openness to inward and outward-bound capital flows; well-developed links to external financial markets; a pool of skilled financial managers and professional service providers; modern transportation networks capable of moving people very efficiently locally and into and out of China; increasingly strong universities; the tactical flexibility that comes from deep knowledge of business culture and practices on the mainland; the capacity to remain useful to Chinese authorities as a test-bed for economic and political innovation; a relatively transparent financial regulatory and supervisory system; a prominent position in global media networks; and the foundations for a democratic political culture capable of rendering long-term policies legitimate and enduring.
In comparison with such advantages, the actual importance of Hong Kong’s much-vaunted low-tax regime is debatable, especially since it depends upon a highly problematic system of land-use and development that distorts housing markets and artificially ratchets up general business and living costs. As a tool for attracting corporate relocations, moreover, tax incentives are easy for alternative centers, like Singapore or Shanghai, to meet.

Counting on tax policies and the traditional advantages that are easy to enumerate would nevertheless be extremely short-sighted. A vibrant financial center thrives within a larger economy. Although Hong Kong’s financial sector today contributes significantly to gross domestic product (lately about 16%), it is not likely to be a big future employment generator. Accounting for about 6% of total employment in recent years, it already falls well behind the 40% of total employment generated by trading and logistics, professional and producer services, and tourism. Especially as mainland cities become stronger and their financial and service markets more open, the need for industrial diversification in Hong Kong—beyond finance and the other three “pillar” industries—will become more pressing.

**An Essential Government Role**

It may be true that most governments around the world are not good at picking the specific firms that might become winners in the future. But they are very good, indeed irreplaceable, at funding and shaping environments within which basic and applied intellectual work can flourish and sow seeds for the industries of the future. Fair competition in markets open to the fruits of that work can be ensured by pro-active policies. Even to sustain its current position in vital information-based industries like commercial banking, investment banking, funds management and insurance, government and corporate leaders alike must take seriously the challenge of nurturing a broader and more competitive innovation system within Hong Kong itself.

In the overarching interest of maintaining the relative autonomy of Hong Kong’s society and enhancing its dynamism, even after 2047 when 50 years of rule by the “one country, two systems” principle may end, deepening financial-industrial linkages with the mainland is not inconsistent with promoting broader innovation and development at home—and not just in the financial sector. Considerations along this line surely underpinned earlier strategic investments in the New Territories’ Science and Technology Parks, in the spectacular Chek Lap Kok
international airport facilities, in efficient internal transport systems and in an expanding university system. Similar considerations justify building on such investments to stay competitive with Singapore, not least by thinking more creatively about the use of foreign exchange reserves, about better land-use policies and about reasonable fiscal reforms. Objectives should include rapidly improving air quality, bolstering basic and secondary education systems, improving the linguistic and other competitive skills of the local population and developing an attractive cultural sector.

Progress on all of these fronts will strengthen Hong Kong’s international financial center and keep it in the top global tier. Wise political and business leaders can surely demonstrate that the continuing distinctiveness of a vibrant and open Hong Kong enhances its long-term role as a positive contributor to sustainable economic and political development throughout greater China. History suggests that the larger society within which Hong Kong’s international financial center is and will remain embedded is resilient. A secure future for that center depends upon designing and implementing an ambitious, multi-faceted and long-term strategy aimed at both competitive efficiency and shared prosperity.

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1 By happy coincidence, this article reinforces the main theme well presented in “Hong Kong’s Financial Vitality Continues,” by William Overholt, published in Hong Kong Journal, Issue 21, April 2011. It is drawn from an independent policy report commissioned by the Savantas Policy Institute, entitled “Hong Kong’s International Financial Center: Retrospect and Prospect,” released on-line 5 February 2011, at www.savantas.org. Full acknowledgments and references may be found there.

2 Lingnan University, Department of Economics, Report on Hong Kong as an International Financial Center for China and for the World, (Collaborative project (No. LU 3002-PPR-5) led by Jesús Seade, Hong Kong: Lingnan University, 10 December 2010, p. 4.


4 Introduced in 2002, the QFII program aimed to attract longer-term foreign investors and curb speculation. It was complemented in 2006 by the Qualified Domestic Institutional Investor (QDII) program, which sought to utilize a portion of China’s foreign exchange reserves more strategically, and at better terms, in offshore markets. For an overview, see Y. Nancy Ni, “China’s Capital Flow Regulations,” Review of Banking & Financial Law, vol. 28, 2009, pp. 299-337.