ECONOMIC REVIEW (A Monthly Issue) May, 2020

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Rationale Behind the Development of Hong Kong as an International Financial Center and Practical Foundations to Withstand External Shocks

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Since 2020, the sudden outbreak of the COVID-19 pandemic has hampered international trade and investment activities. The global economy faces large-scale bankruptcy of enterprises, rising unemployment, exacerbating social unrest, and potentially another Great Depression. To cover up their ineffectiveness in responding to the pandemic, some American and European politicians took up the banner of populism and protectionism to defame China, deteriorating the international political environment sharply. US President Trump took Hong Kong as a pawn in the China-US trade war and announced actions to revoke Hong Kong's preferential treatment as a separate customs and travel territory outside of China on the grounds of the "Hong Kong National Security Law." The related policies and treaties include the US-Hong Kong Policy Act, extradition treaties, control of military/civilian dual-use goods, etc. With the dual pressures of the China-US trade war and continuing civil unrest, Hong Kong's role as an international financial center is also facing external shocks from looming US financial sanctions.

A preeminent business environment and efficient markets under "one country, two systems" are the practical foundations for the continuous improvement of Hong Kong as an international financial center. The unique advantages of Hong Kong in meeting the rising financing needs of various enterprises in the mainland are a powerful driving force for the long-term prosperity and stability of its economy and the rapid development of its financial markets. The above two pillars together are critical to the long-term development of Hong Kong as an international financial center. This unique characteristic cannot be taken away by social unrest or any US financial sanctions.

1. Rationale behind the development of Hong Kong as an international financial center

As the saying goes, building a high-rise begins with mounds of soil. Hong Kong's international success is based on two pillars. One is related to good business environment, low taxation system, free port of funds, judicial system in line with the West, efficient financial supervision, and the most economically-free market. Another is based on the ever-growing economic relationship between Mainland and Hong Kong. We believe these core values are critical to maintaining Hong Kong's competitiveness as an international financial center and responding to external challenges.

In terms of experiences from current global financial centers, there are three important factors to build a global financial center: talents, financial regulation, and market liquidity.

First, the depth and breadth of financial markets are important indicators for a leading global financial center. The process of growing market liquidity in financial markets is complex and takes a long time to build. Hong Kong has ranked as the world's freest economy for 25 consecutive years until the end of 2018. There are no foreign exchange controls in Hong Kong so that capital can flow in and out of Hong Kong without restriction. In the 1970s, Hong Kong conducted market-oriented reform in foreign exchange markets, gold markets, and banking system controls, which enabled Hong Kong to provide more free and convenient connections between Europe and US markets. As one of the top financial centers worldwide, Hong Kong has one of the highest concentrations of financial institutions in the world and ample market liquidity for capital investment.

The rise of China's economy in the past 30 years has been a positive driving force behind Hong Kong's role as a leading financial center in global markets. Hong Kong has attracted over 1000 mainland enterprises to list and raise capital in Hong Kong. In the past 10 years, Hong Kong also played a key role in RMB internationalization and actively expanded offshore RMB businesses. This made Hong Kong the largest offshore renminbi (RMB) hub. In addition, in recent years, Asia became the fastest growing region in the world. To seize the opportunity in the Asia-Pacific region, the Hong Kong SAR government developed a comprehensive regulatory framework with a predictable tax system that attracts many different types of fund companies to Hong Kong. This enhanced Hong Kong's status as an international asset management center.

Hong Kong has implemented open and efficient talent policy and labor laws that do not hinder business activities. It has attracted outstanding financial talents and professional service talents from all over the world. According to the World Economic Forum (WEF) and the Lausanne Institute of International Management (IMD), Hong Kong's outstanding talent pool is in a leading position among the major economies in the Asia-Pacific region. There are more than 200,000 financial professionals and tens of thousands of accountants, lawyers and technology talents, many of whom are high-level international professionals with rich international experiences. According to the relevant data from the Hong Kong government, the number of employees in finance has increased by over 30% in recent years. At the same time, the number went up about 50% in legal, accounting, auditing and information technology. Attracting talents is a main competitive edge for Hong Kong's role as an international financial center.

Hong Kong has a strict regulatory environment that complies with international standards. International financial regulation is a systematic project involving many aspects such as the legal system, regulatory framework, economic policies, and regulatory costs. Hong Kong's common law-based legal framework is flexible and transparent, which can maintain market fairness and high efficiency to a greater extent, and is conducive to financial innovation and development. The existing financial regulatory framework and its strict regulatory approach will not weaken, but will help enhance competitiveness. The SAR government's economic policies are flexible, and can be adjusted in a timely manner according to the environment. The administrative management system is conducive to commercial activities, and has relatively low financial supervision costs. Such a leading regulatory environment among the major economies in the Asia-Pacific region is a very important competitive advantage for Hong Kong's status as an international financial center.

Hong Kong's business infrastructure is highly mature. Its business environment is highly open and fair, and its corporate and personal tax systems are simple, transparent, and efficient. It encourages business development and investment, and cultivates a large number of professionals with strong international backgrounds. These factors interact with each other to contribute to Hong Kong being a leading global financial center.

Overall, there was a large number of mainland companies that became listed at the Hong Kong Stock Exchange (HKEX) as the mainland economy grew. This in turn pushed the improvement in the development of Hong Kong's financial market infrastructure. In addition, the structure of Hong Kong's international financial center shifted from banking-driven to capital markets-driven, strengthening the competitiveness of Hong Kong as a leading global financial center.

However, operating and living costs have substantially increased in Hong Kong, which would erode its competitiveness in the long run. Therefore, it is necessary for Hong Kong to seek more effective solutions to deal with these challenges.

2. Hong Kong is challenged by the slowdown of the real economy

The trade war between China and the United States, the civil unrest, and the pandemic have introduced three external shocks to the Hong Kong economy. The pandemic has halted economic activity in major global economies. Tourism, hotels, aviation, catering, and retail industries have been greatly affected. The IMF's forecasts for global, U.S., and euro zone economies are -3%, -5.9%, and -7.5% respectively, and will be lowered again according to IMF MD Kristalina Georgieva. The highly outward-oriented Hong Kong economy is once again under threat from an economic recession with a range of -4% to -7% according to the government. The economic contraction may exceed the -5.9% recorded during the 1998 Asian financial crisis.

The struggling real economy has affected the performance of financial markets to a certain extent. The China-US trade war and US extreme pressure may undermine the confidence of international investors in Hong Kong and bring new challenges to Hong Kong's international financial center status.

Since 2018, the deglobalization has led to the continuous deepening of China-US trade frictions, which has a huge impact on Hong Kong's exports and re-exports. As the US and Mainland China are Hong Kong's two largest economic and trading partners, trade disputes between the two will inevitably affect business of related merchants. At the same time, the huge uncertainty caused by the trade friction has rattled global financial markets, eroded Hong Kong's business and investment confidence, and brought more headwinds to the Hong Kong real economy.

From the perspective of economic development since its return and as a representative of a highly open small economy, Hong Kong is driven by external demand and highly susceptible to global economic fluctuations. Also, structural problems such as rigidity of the industrial structure, externalization of the service industry, and the lack of independence in monetary policy exaggerate risks to the economy.

In recent years, Hong Kong experienced difficulties of economic transformation, civil unrest, and exacerbated external shocks, leading to weak economic momentum. The economic downturn and changes in the domestic and external environment pose new challenges to the development of Hong Kong.

3. Financial markets in Hong Kong still show strong systemic stability

The struggling real economy has dampened the market confidence in Hong Kong. However, as an international financial center, Hong Kong is still able to function normally in 2019, a testimony to its economic resilience. The main reasons are:

First, Hong Kong is an offshore market for mainland companies. Currently, mainland companies account for about 70% of the market value and trading volume of the Hong Kong stock market. As long as the mainland China maintains stable economic growth, the Hong Kong stock market will remain attractive to global investors. In 2019, thanks to the large-scale fund-raising projects of mainland enterprises such as Alibaba, Shenwan Hongyuan, Hong Kong topped the global IPO market. Hong Kong is still the main platform for mainland enterprises to explore the international market and for overseas enterprises to enter the mainland China. What's more, the total assets of the Hong Kong banking system exceeded HKD 21 trillion. More than half of bank loans are for use outside of Hong Kong. Therefore, the impact of the local economic performance on the banking industry is limited.

Secondly, the Aggregate Balance of the banking sector all remained generally stable. We haven't observed large-scale outflow of funds. Recently, HKD interest rates exceeded USD interest rates, leading the HKD exchange rate to the strong end of its currency band.

Third, the P/E ratio of Hang Seng Index is only about 10 times, meaning stocks are still cheap for international investors.

Fourth, compared with financial crises in 1997, 1998 and 2008, the current Hong Kong financial market is more resilient, and the financial system operates with higher transparency and stricter supervision. Foreign exchange reserves and government fiscal reserves are more abundant. The monetary base exceeds one trillion yuan, and the Hong Kong stock market capitalization is over 30 trillion yuan. The above factors are all helpful in protecting against short-term shocks.

Fifth, the interconnection between Hong Kong and Mainland's financial markets has provided Hong Kong with a buffer to cope with external shocks. In recent years, with the internationalization of RMB, the Mainland has successively launched Shanghai-Hong Kong Stock Connect, Shenzhen-Hong Kong Stock Connect, Bond Connect, and Mainland-Hong Kong Mutual Recognition of Funds and other schemes. These schemes provide Hong Kong's financial and professional services companies with greater room for development. They also help Hong Kong to withstand external shocks and maintain market stability.

4. The SAR government still has policy space to hedge against economic downturn and the adverse effects of external pressure

The economic downturn and the development of the pandemic has affected the performance of Hong Kong's labor market, leading to an increase in the unemployment rate. Between Feb and April, the average unemployment rate rose to 5.2%, up one percentage point from the previous three months. The unemployment rate for April alone may have risen to 6.5%. The construction industry, retail, accommodation, and food services industry, and manufacturing industry recorded the largest increases in unemployment, reaching 10.0%, 9.0% and 6.2% from Feb to April respectively.

First, faced with the severe economic and employment situation, the SAR Government has launched two rounds (HKD 30 billion and HKD 137.5 billion) of "Epidemic Prevention and Anti-epidemic Fund" in addition to the HKD 120 billion relief measures announced in the fiscal budget. The total amount is HKD 287.5 billion, including HKD 80 billion under the "employment protection" plan, and payment of HKD 10,000 in cash to Hong Kong permanent residents aged 18 or above etc. It also supports industries most affected by the pandemic, such as passenger transport, tourism, construction, aviation, and catering etc., to comprehensively keep enterprises in operation, to maintain employment of employees, to reduce the financial burden of enterprises and citizens, and to allow the economy to recover as soon as possible.

Second, Hong Kong has ample fiscal reserves and large policy space to expand fiscal policies to support economic growth, to increase the role of domestic demand in stimulating the economy, and to hedge the adverse impact of possible financial sanctions from the United States.

Third, in response to the adverse impact of global protectionism, the SAR Government has focused on promoting the development of a diversified economy and has launched some long-term measures: signing more bilateral and multilateral agreements to maintain Hong Kong's trade impact in the region and closely monitoring the impact of US trade frictions and possible US financial sanctions on Hong Kong. The SAR Government will promptly implement measures to support the industry. The measures of the SAR Government to provide export insurance and financing guarantees to support the development of small and medium-sized enterprises are also seeing success.

Fourth, the SAR Government has increased investment in infrastructure and increased public expenditure. Accelerated government consumption will provide stable support for economic growth. The government vigorously promotes innovation and technological development, and invests in resources in areas such as university research, re-industrialization, and applied technology to enhance Hong Kong's global competitiveness. The SAR Government takes a long-term view by actively taking measures to increase the supply of land and houses, and to control the rise in property prices. It reduces overall business costs, and fundamentally promotes the development of the real economy. The coordination of short-term relief measures and long-term structural policies has enhanced Hong Kong's economic resilience to a certain extent.

5. China's financial opening will provide a long-term opportunity for the development of Hong Kong as an international financial center

Since the beginning of this year, mainland China has successively launched 12 new measures to open up to the outside world and canceled the policies on investment quotas for qualified foreign institutional investors (QFII) and RMB qualified foreign institutional investors (RQFII), as well as RQFII pilot country and regional restrictions, to attract foreign capital to enter mainland capital markets. These measures promote the continuous increase in the proportion of foreign capital in the mainland stock and bond markets, and further promote the opening of the mainland capital market. Obviously, China's financial services industry will enter a new era of opening up, and will provide space for the long-term development of Hong Kong as an international financial center.

First, Hong Kong, as the main channel for China's capital market to connect to the outside world, provides diverse options for the interconnection between the mainland and international financial markets, while also enhancing its own international influence. Shanghai-Hong Kong Stock Connect, Shenzhen-Hong Kong Stock Connect and Bond Connect were the first to connect domestic stock and bond markets with Hong Kong capital markets. As a free port of global capital, Hong Kong has innate conditions to connect with other major financial markets. Over the past 20 years, the Hong Kong financial industry has vigorously strengthened its links with major global financial markets through various types of cross-regional financial cooperation. The Chinese financial industry has also made full use of the overall advantages of the Hong Kong financial market, built a regional operation and management platform, comprehensively accelerated the accumulation of overseas assets, and enhanced capabilities in global investment, financial services, and international management and operations.

Second, the Hong Kong financial market has a sound financial supervision system to ensure the steady development of the banking system. During the period between the Asian financial crisis in 1997 and the global financial crisis in 2008, the HKMA had launched extraordinary liquidity facilitation measures and deposit protection plans to effectively control the systemic risks of the banking system. Since 2010, the Hong Kong Monetary Authority has continuously launched multiple rounds of prudential supervision measures for mortgage loans to prevent the risk of deterioration in credit quality due to the reversal of the property market. The international banking industry generally regards Hong Kong as the preferred platform to enter the Chinese market. Chinese banks also use Hong Kong as a base to build global comprehensive risk management capabilities and enhance the awareness and level of compliance operations.

Third, Hong Kong provides the banking industry with a completely competitive market environment, regulates the development of financial institutions and the construction of risk management mechanisms, and effectively prevents and resolves operational risks faced by individual banks. Hong Kong has a friendly business environment, a simple and low tax system, a judicial system that is in line with international standards, and the most liberal economy. It is one of the most concentrated locations for banks around the world. The total assets of the Hong Kong banking system exceed HKD 21 trillion, about 8.5 times the GDP of Hong Kong. In recent years, Chinese banks have continued to focus on the development of basic businesses such as deposit loans, while taking advantage of the parent bank's strong funds and personnel, mid/back-office operational support capabilities, and low cost-income ratio. They have increased investment resources to build private banking, custody, asset management and other diversified business development platforms. Hong Kong has become the flagship of the international development of the Chinese banking industry.

Fourth, Hong Kong has further improved the financial technology level and service capabilities of the banking industry. Hong Kong has completed the marketization of interest rates earlier, which urged the banking industry to vigorously expand its income from intermediary business to make up for the reduction in interest income caused by the narrowing of net interest margins. Over the years, mainstream banks in Hong Kong have kept a close eye on market development needs, strengthened its financial product innovation capabilities, and actively explored diversified sources of income. Virtual banks will further increase the investment of information technology in the banking industry, providing customers with more diverse options and use more convenient and low-cost service channels to enhance customer experience.

Fifth, Hong Kong has outstanding first-mover advantages and scale advantages in the offshore RMB business. It has the world's first offshore RMB clearing system, the world's largest RMB capital pool, an active RMB trading market, and a more diversified RMB product system. With the advancement of RMB internationalization, the offshore market gradually expanded from Hong Kong to Southeast Asia, forming a network of offshore centers across Asia, Americas, and Europe. Under the new trend of accelerating China's opening to the outside world, the internationalization of the RMB will be market-driven, serving more of the real economy and companies going abroad. Southeast Asia, as an important region of the Belt and Road Initiative, will provide new experiments for RMB internationalization.

6. Enhance the position of Hong Kong's role in the Greater Bay Area's financial sector

In May 2020, People's Bank of China, China Banking Regulatory Commission, China Securities Regulatory Commission, and SAFE jointly issued the "Opinions on Supporting the Construction of the Guangdong-Hong Kong-Macao Greater Bay Area through Finance", which implements the main ideas for the financial sector found in "Greater Bay Area Development Planning Guidelines". These ideas, specifically implemented in the fields of banking, securities, insurance, etc. through 26 major measures, helps to build a vibrant and internationally competitive first-class bay area.

The continuous improvement of financial service and real economy capabilities of the Guangdong-Hong Kong-Macao Greater Bay Area will inject new momentum into regional economic growth, promote the coordinated development of the regional economy, and effectively expand the strategic buffer for national development. Against the backdrop of downward pressure on the global economy and international governance facing unprecedented changes in a century, the Guangdong-Hong Kong-Macao Greater Bay Area has kept pace with world-class bay areas such as Tokyo and San Francisco in terms of population, area, GDP, trade, etc. In addition to the effect of greater scales, the Greater Bay Area actively explores innovative, open, green, and shared development paths, which not only provides an important growth engine for China but the whole world. The financial industry in the Greater Bay Area will present a new development pattern, providing Hong Kong with a new historical opportunity to fully enhance the positioning of its role in the financial sector of the Greater Bay Area.

First of all, the Greater Bay Area will promote the interconnection of financial markets and infrastructure, gradually open up Hong Kong and Macau RMB clearing banks to participate in the interbank lending market in the Mainland, and optimize and improve arrangements such as Shanghai-Hong Kong Stock Connect, Shenzhen-Hong Kong Stock Connect and Bond Connect. Research on Southbound Connect will be conducted in due course. The above measures will bring enormous room for business growth to the Hong Kong banking industry.

Secondly, the Greater Bay Area will expand the scale and scope of cross-border usage of RMB within the region. Under the premise of compliance with laws and regulations, the Greater Bay Area will jointly set up relevant funds to attract capital from Mainland, Hong Kong, Macau, and overseas to provide funding for the construction of the Greater Bay Area. Promoting convenient cross-border circulation and exchange of RMB in the Greater Bay Area will help Hong Kong stand out from the competition with other offshore RMB centers and strengthen its position as a global offshore RMB business hub.

Third, the Greater Bay Area will accelerate the promotion of green financial cooperation, support Hong Kong in building a green financial center, build an internationally recognized green bond certification agency, encourage more Greater Bay Area companies to use Hong Kong for financing and certification of green projects, and support relevant financial institutions with issuing green financial bonds and other green financial products in Hong Kong. Hong Kong and Macao's distinctive financial sector is promising. It will continue to strengthen its functions as an international asset management center and risk management center, and build and service the investment and financing platform for the construction of "One Belt One Road".

Fourth, the Greater Bay Area will build a diversified, international, and cross-regional technology innovation investment and financing framework, a technology innovation financial support platform, and promote the transformation of scientific and technological achievements. "Opinions on Supporting the Construction of the Guangdong-Hong Kong-Macao Greater Bay Area through Finance" also launched measures such as cross-border currency exchange for venture capital funds, block chain applications in the field of trade finance, big data and artificial intelligence application etc., for the construction of a habitat for large financial institutions in the Greater Bay Area, the creation of favorable conditions for precise marketing and intelligent risk control, and the promotion of digital transformation of financial institutions. Hong Kong's financial industry should seize the new opportunity to strengthen its financial technology capabilities as soon as possible.

In short, the status of Hong Kong as an international financial center has been continuously built through the long-term hard work of several generations. Hong Kong's financial industry is confident to face challenges, to plan ahead, to pioneer and innovate, to continuously improve the efficiency and capabilities of financial markets, and to effectively control hidden risks while better serving the opening up process of China's financial markets. It plays an irreplaceable role in the deepening development of "One Belt One Road" and the comprehensive development of the Greater Bay Area. The two core pillars mentioned above are the practical foundations on which Hong Kong, as an international financial center, could respond to external shocks.

主要經濟指標 (Key Economic Indicators)

一. 本地生產總值 GDP	**2018**	**2019**	**2019/Q4**	**2020/Q1**
總量(億元) GDP($100 Million)	27,355	27,030	7,238	6,371
升幅(%) Change(%)	2.9	-1.2	-3.0	-8.9
二. 對外貿易 External Trade			**2020/4**	**2020/1-4**
外貿總值(億元) Total trade($100 Million)				
總出口 Total exports	41,581	40,961	3,095	11,407
進　口 Total imports	47,214	45,714	3,328	12,680
貿易差額 Trade balance	-5,633	-4,753	-233	-1,273
年增長率(%) YOY Growth(%)				
總出口 Total exports	7.3	-5.6	-3.7	-8.1
進　口 Imports	8.4	-8.1	-6.7	-9.1
三. 消費物價 Consumer Price				
綜合消費物價升幅(%) Change in Composite CPI(%)	2.4	2.9	1.9	1.9
四. 樓宇買賣 Sale & Purchase of Building Units				
合約宗數(宗) No. of agreements	79,193	74,804	4,866	17,610
年升幅(%) Change(%)	-5.5	-5.5	-50.9	-34.6
五. 勞動就業 Employment			**2020/1-2020/3**	**2020/2-2020/4**
失業人數(萬人) Unemployed(ten thousands)	10.5	12.4	16.2	20.3
失業率(%) Unemployment rate(%)	2.8	3.3	4.2	5.2
就業不足率(%) Underemployment rate(%)	1.1	1.2	2.1	3.1
六. 零售市場 Retail Market			**2020/4**	**2020/1-4**
零售額升幅(%) Change in value of total sales(%)	8.8	-11.1	-36.1	-35.3
零售量升幅(%) Change in volume of total sales(%)	7.6	-12.3	-37.5	-37.1
七. 訪港遊客 Visitors				
總人數(萬人次) arrivals (ten thousands)	6,515	5,590	0.4	349.3
年升幅(%) Change(%)	11.4	-14.2	-99.9	-85.3
八. 金融市場 Financial Market			**2020/3**	**2020/4**
港幣匯價(US$100=HK$) H.K. Dollar Exchange Rate (US$100 = HK$)	783.6	779.3	775.5	775.1
貨幣供應量升幅(%) change in Money Supply(%)				
M1	-0.4	2.6	8.1	6.8
M2	4.3	2.8	2.2	2.0
M3	4.3	2.7	2.0	1.9
存款升幅(%) Change in deposits(%)				
總存款 Total deposits	5.0	2.9	1.6	1.1
港元存款 In HK$	3.6	2.5	-0.1	-1.1
外幣存款 In foreign currency	6.4	3.2	3.3	3.3
放款升幅(%) in loans & advances(%)				
總放款 Total loans & advances	4.4	6.7	7.2	7.3
當地放款 use in HK	4.0	7.1	8.4	7.2
海外放款 use outside HK	5.3	5.8	4.8	7.3
貿易有關放款 Trade financing	-7.7	-0.7	-1.4	0.6
最優惠貸款利率(%) Best lending rate (%)	5.1250	5.0000	5.0000	5.0000
恒生指數 Hang Seng index	25,846	28,189	23,603	24,644