

The Belt and Road and
the Guangdong-Hong Kong-Macau
Greater Bay Area Initiatives
and Opportunities
for Hong Kong's Financial Sector

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*All opinions expressed herein are the author's own and do not necessarily reflect the views of any of the organisations with which the author is affiliated.

一帶一路與粵港澳大灣區兩項目 為 香港金融業帶來的機遇

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*以下僅代表個人觀點，與所屬機構立場無關。

Outline

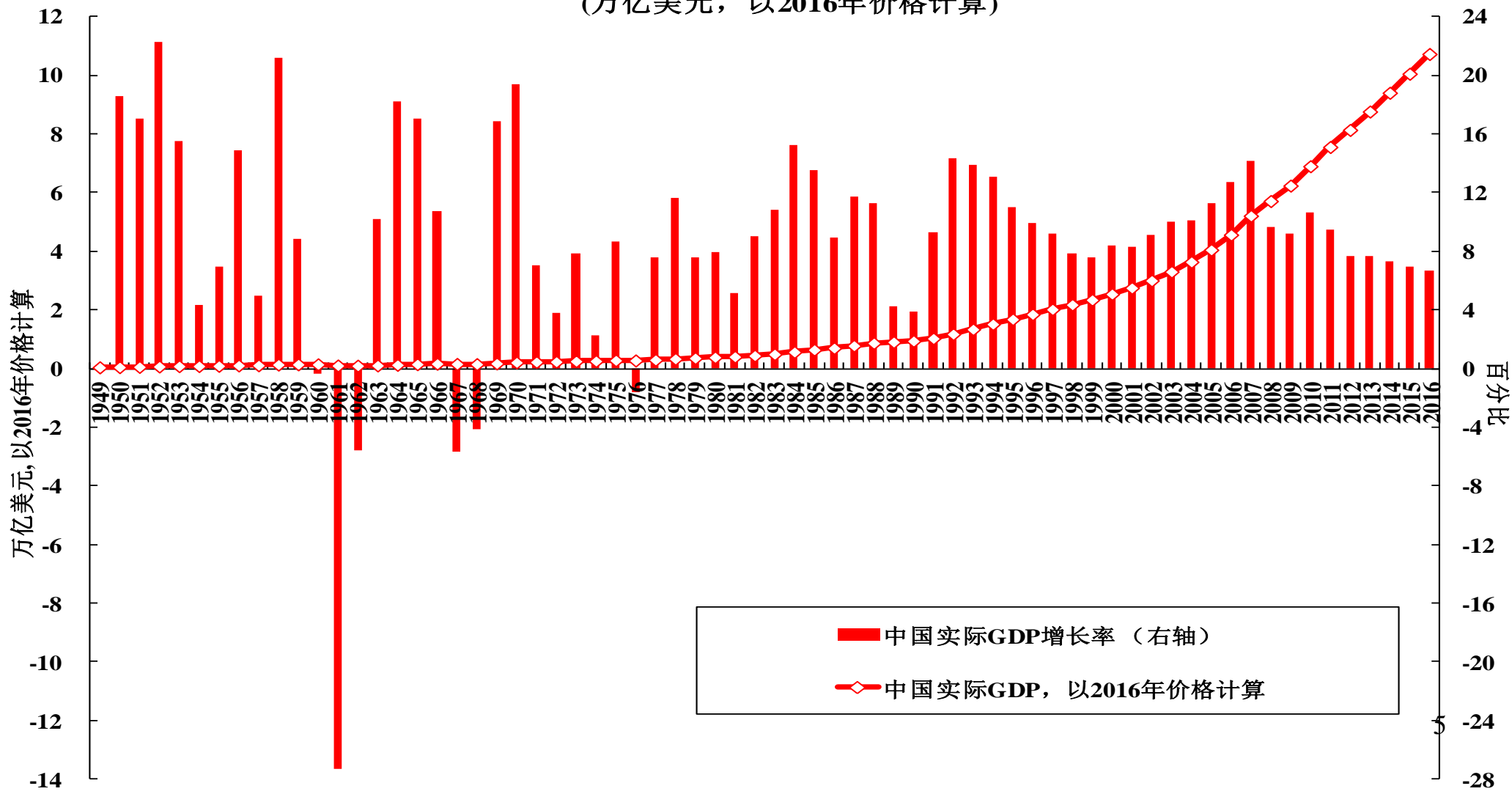
- ◆ Introduction
- ◆ The Hong Kong Economy at a Turning Point
- ◆ The Belt and Road Initiative
- ◆ The Guangdong-Hong Kong-Macau Greater Bay Area Initiative
- ◆ Implications for Hong Kong
- ◆ The Nineteenth National Congress of the Communist Party of China
- ◆ Projections of the Mainland Economy
- ◆ Concluding Remarks

Introduction

- ◆ Historically unprecedented rapid growth of the Mainland economy
- ◆ Slowdown of the growth of world real GDP and trade
- ◆ The transition of the Chinese economy to a new normal
- ◆ Recent developments of the Renminbi
- ◆ Geopolitical uncertainties

历史上前所未有的增长速度

1949年以来中国实际GDP及其增长率
(万亿美元, 以2016年价格计算)

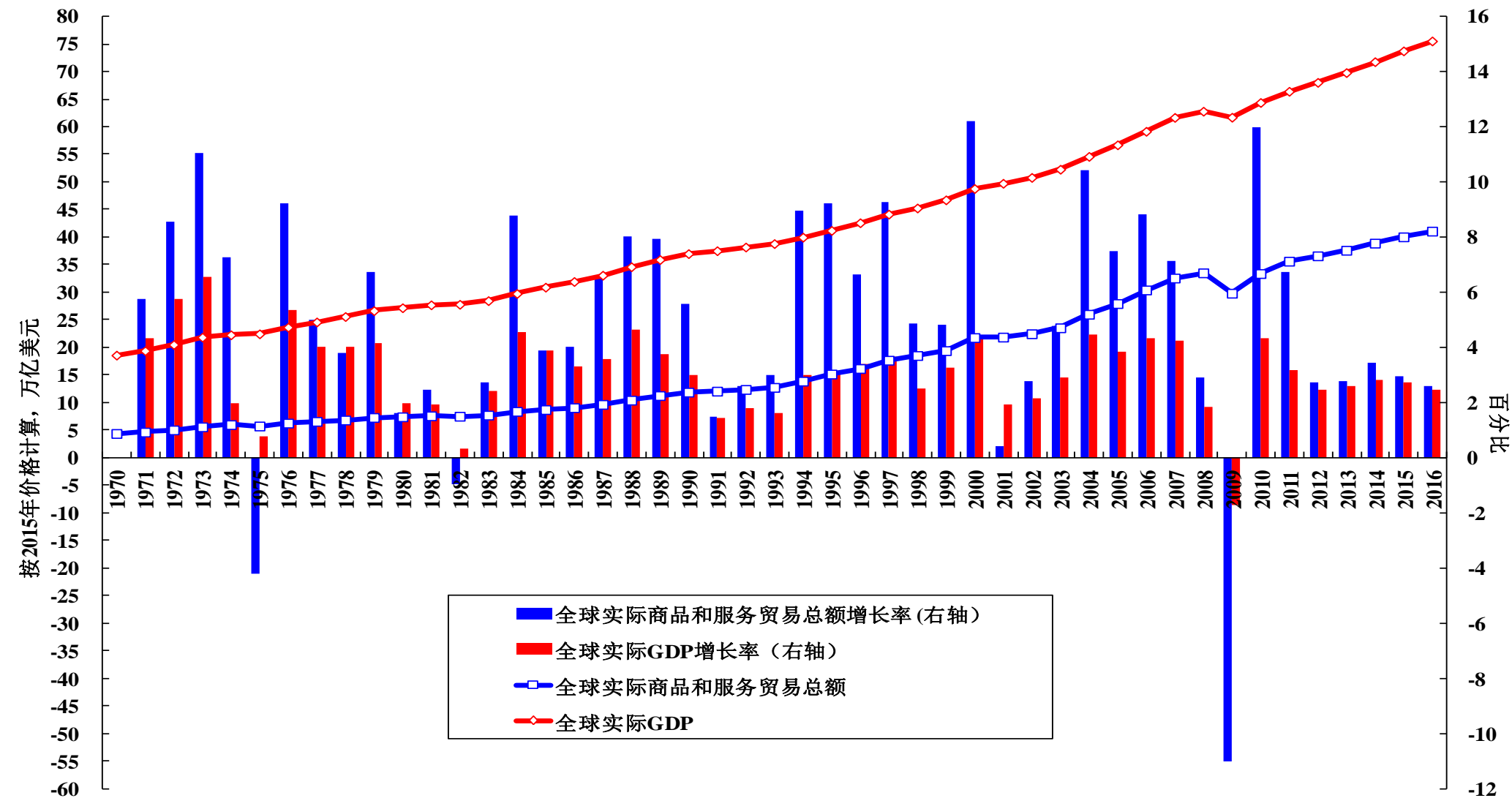


Global and Mainland Economic Development Trends

- ◆ The rates of growth of the real GDP and real total trade of the world has slowed down significantly in recent years. Even though the International Monetary Fund recently raised its projected rates of global growth to 3.6% in 2017 and 3.7% in 2018, up from 3.2% in 2016, it is unlikely that the world economy would resume its heady rates of growth prior to the global financial crisis.
- ◆ Cross-border trade and direct investment are no longer the drivers of world economic growth.
- ◆ Protectionism, isolationism and populism are rearing their heads and the entire world faces the risks of trade wars and economic de-globalization.

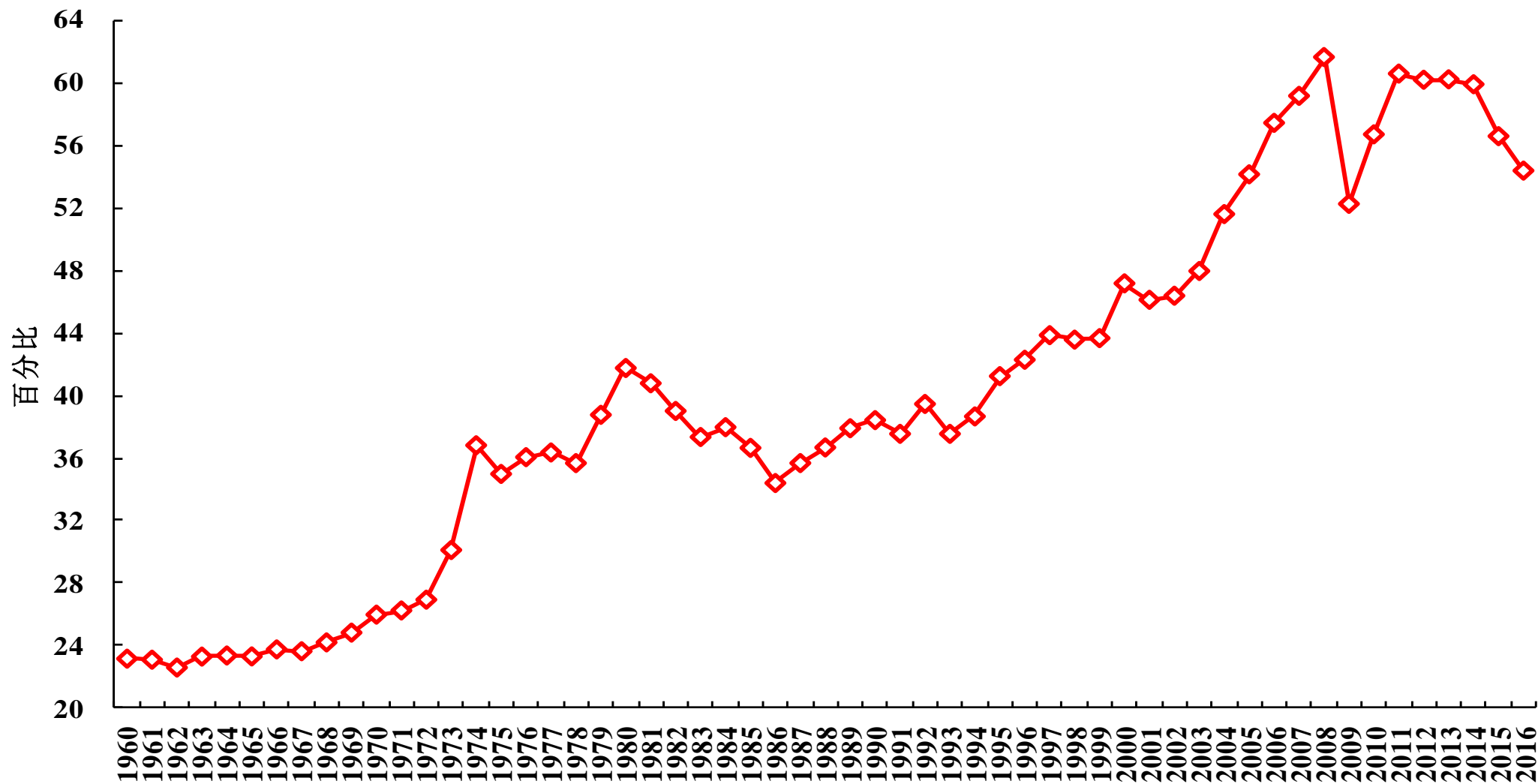
全球实际GDP、实际商品和服务贸易总额及其增长率（按2016年价格计算）

全球的实际GDP和实际商品和服务贸易总额及其增长率（按2016年价格计算）



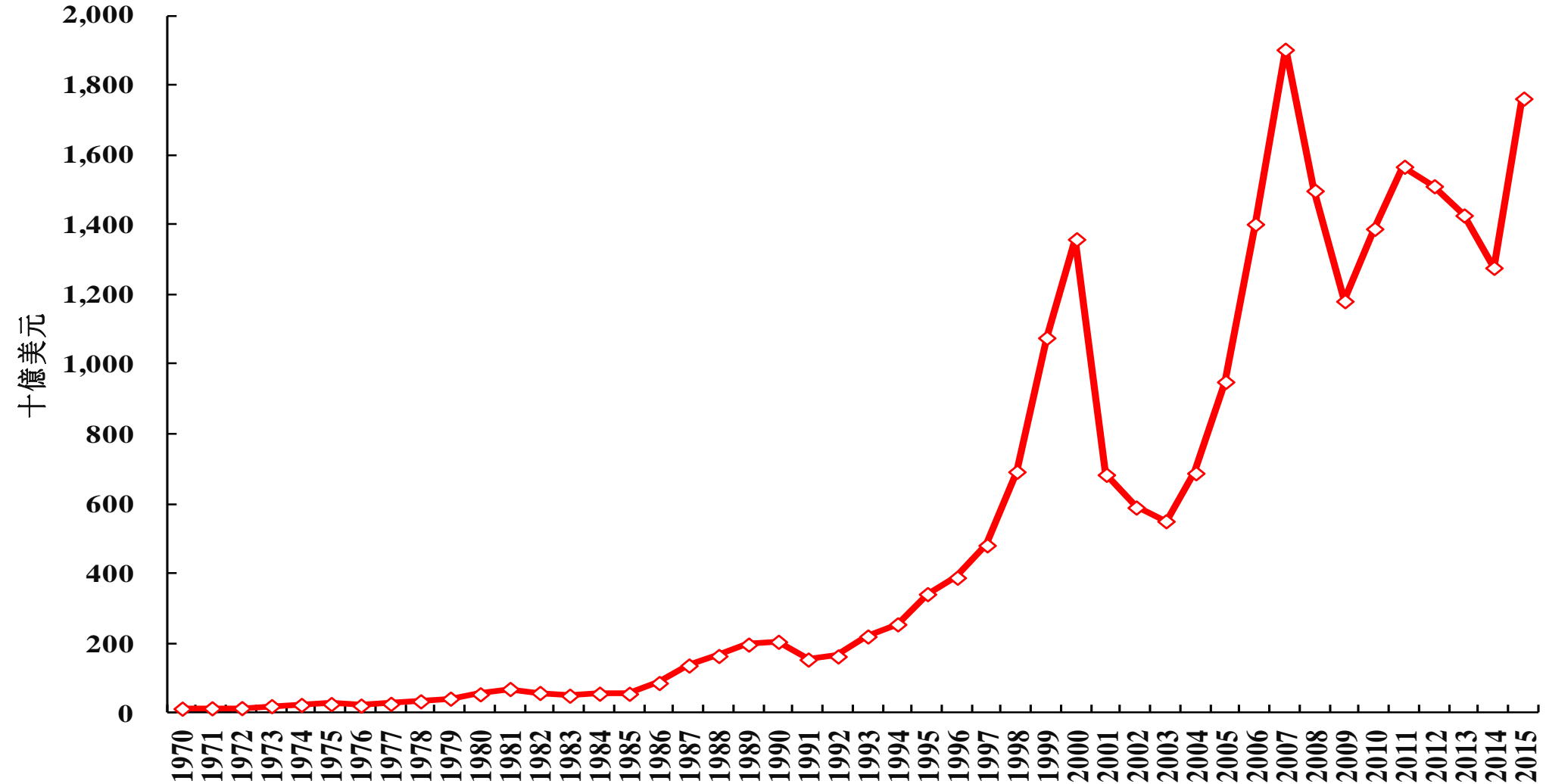
1960年以来全世界货物和服务贸易总额占全世界GDP的比重

1960年以来全世界货物和服务贸易总额占全世界GDP的比重



1970年以來全球跨境直接投資（Foreign Direct Investment）總流入（十億美元）

世界每年FDI流入總額, 1970-2015

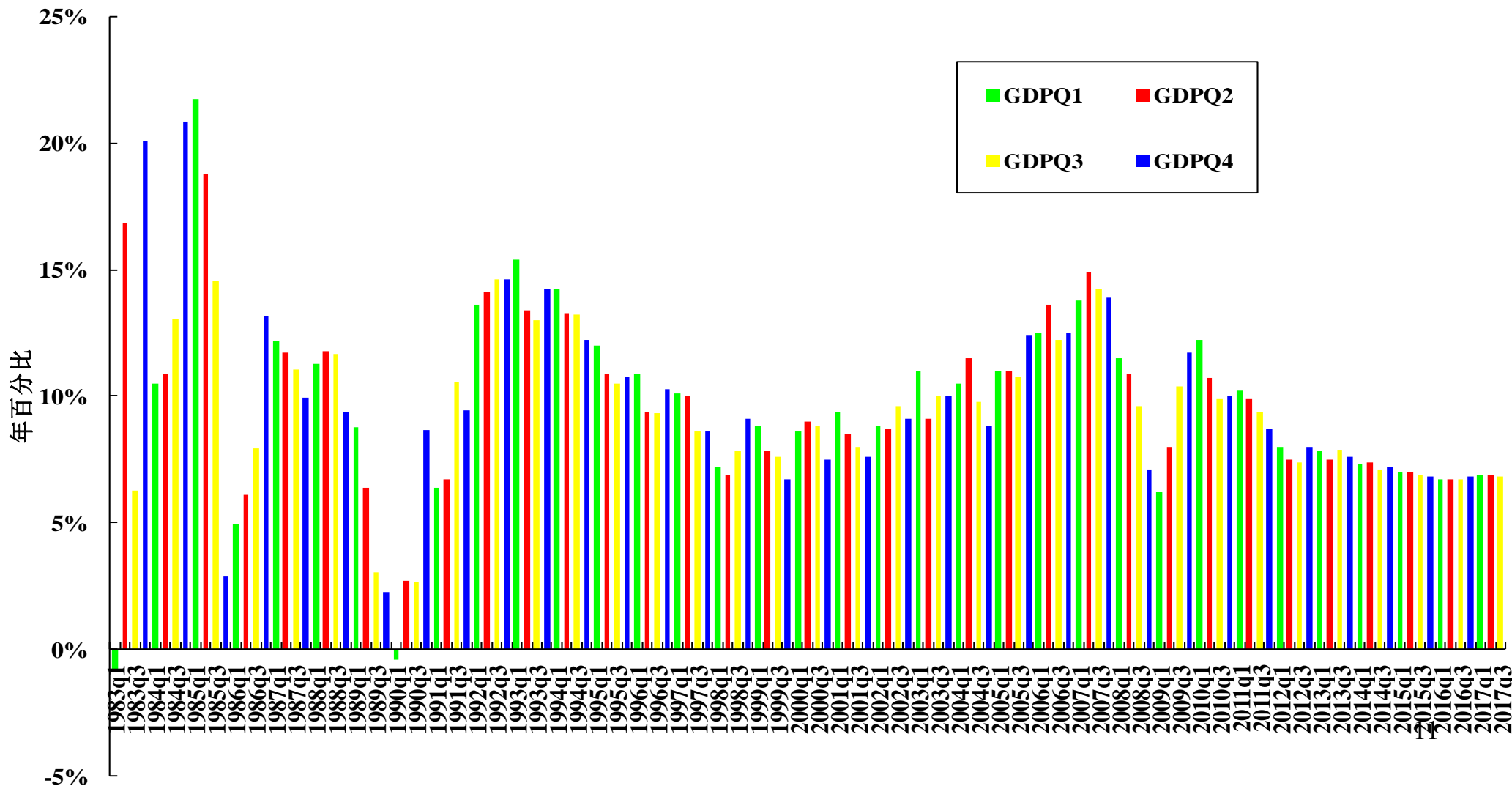


Global and Mainland Economic Development Trends

- ◆ The Mainland economy has transitioned to a “new normal”, with a rate of growth stabilized around 6.5%. It no longer relies on export growth, but has shifted towards internal demand as the principal economic driver.
- ◆ However, the national saving rate remains high. But because of the on-going supply side structural reform and the serious excess production capacities in many industries, the rate of growth of fixed assets investment has been declining, resulting in significant excess domestic savings which need to be deployed abroad.
- ◆ Today, foreign direct investment (FDI) into the Mainland constitutes only approximately 2.5% of total gross domestic investment on the Mainland and is quantitatively no longer important.

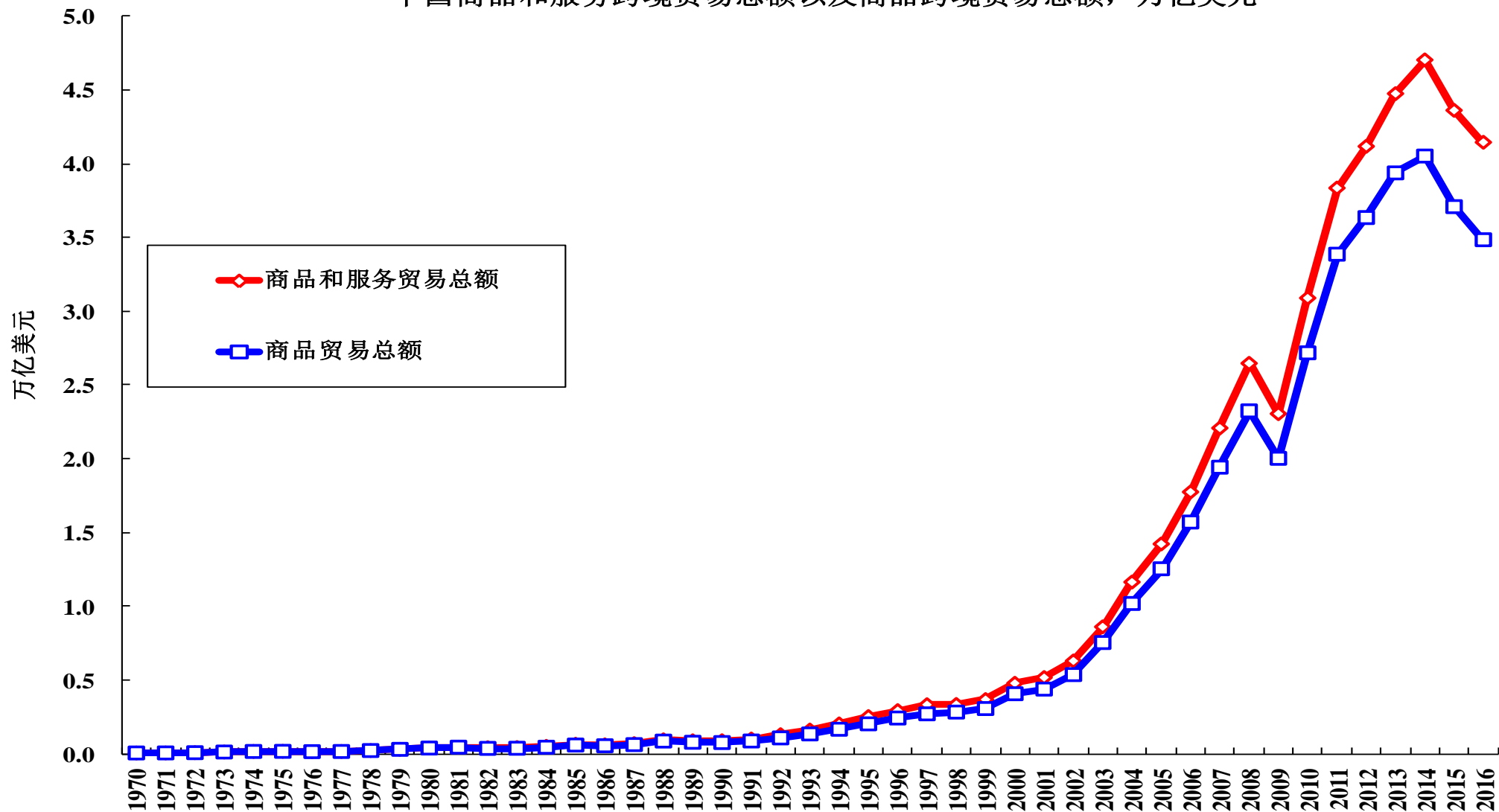
中国大陆季度实际GDP的年同比增长率

中国季度实际GDP的年同比增长率



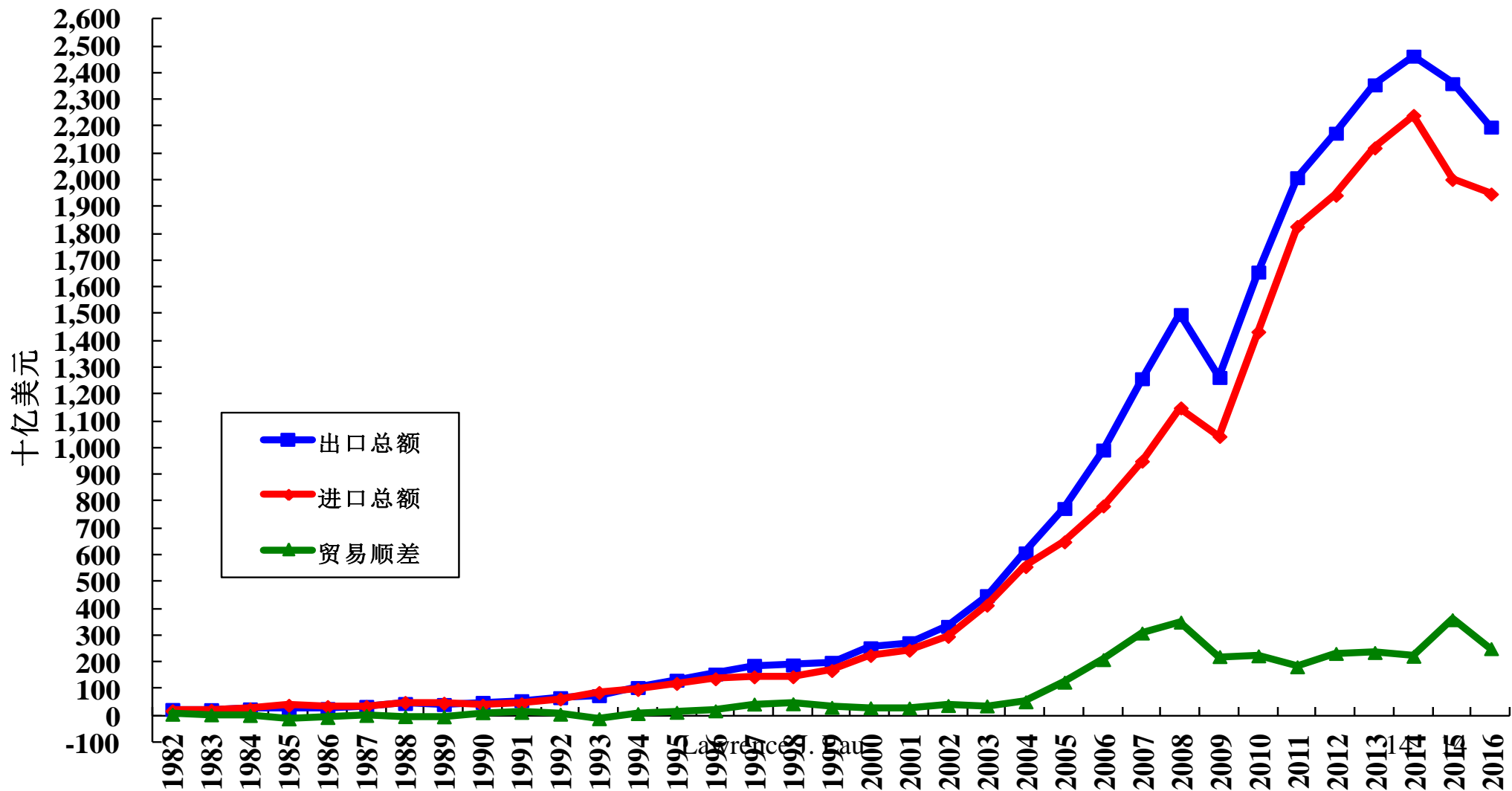
中国商品和服务跨境贸易总额以及商品跨境贸易总额，万亿美元

中国商品和服务跨境贸易总额以及商品跨境贸易总额，万亿美元



中国商品与服务出口总额、进口总额与贸易顺差 (十亿美元)

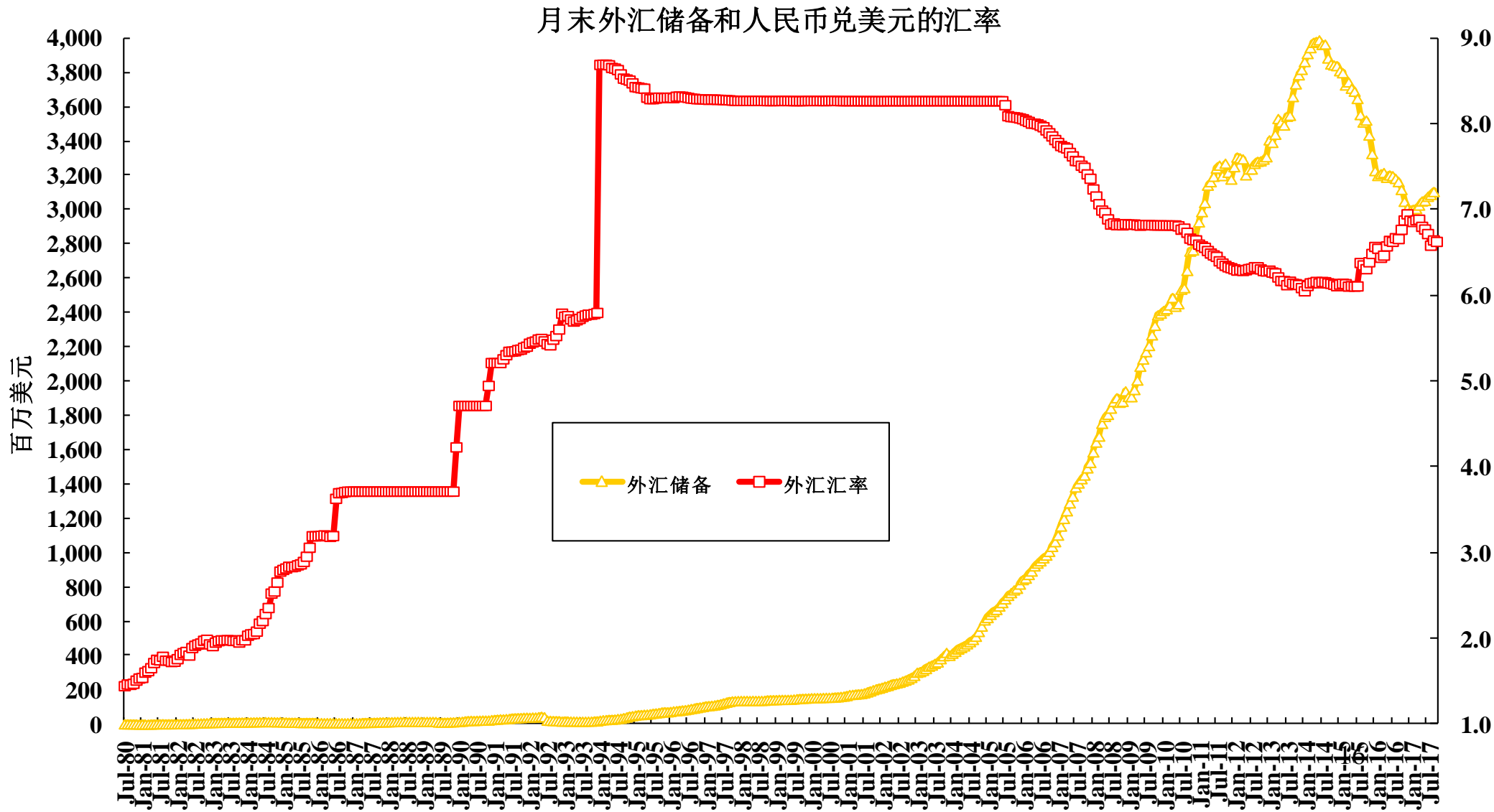
中国商品与服务出口总额、进口总额与贸易顺差 (十亿美元)



Recent Developments of the Renminbi Exchange Rate

- ◆ The stabilization of the Renminbi exchange rate
- ◆ The stabilization of the official foreign exchange reserves
- ◆ The rising use of the Renminbi in international transactions

月末中国大陆外汇储备和人民币兑美元的汇率



The Rising Use of the Renminbi in International Transactions

- ◆ There are many advantages in being able to use an economy's own currency for invoicing, clearing and settlement of its international transactions.
- ◆ (1) Reduction of currency risks—only one of the transacting party is at risk;
- ◆ (2) Reduction of transaction costs—only one currency exchange is necessary; and
- ◆ (3) Reduction in the need for central banks to maintain large foreign exchange reserves as the local currencies can be used to settle and clear international transactions.
- ◆ These advantages apply to all economies, and not just to China.

The Rising Use of the Renminbi in International Transactions

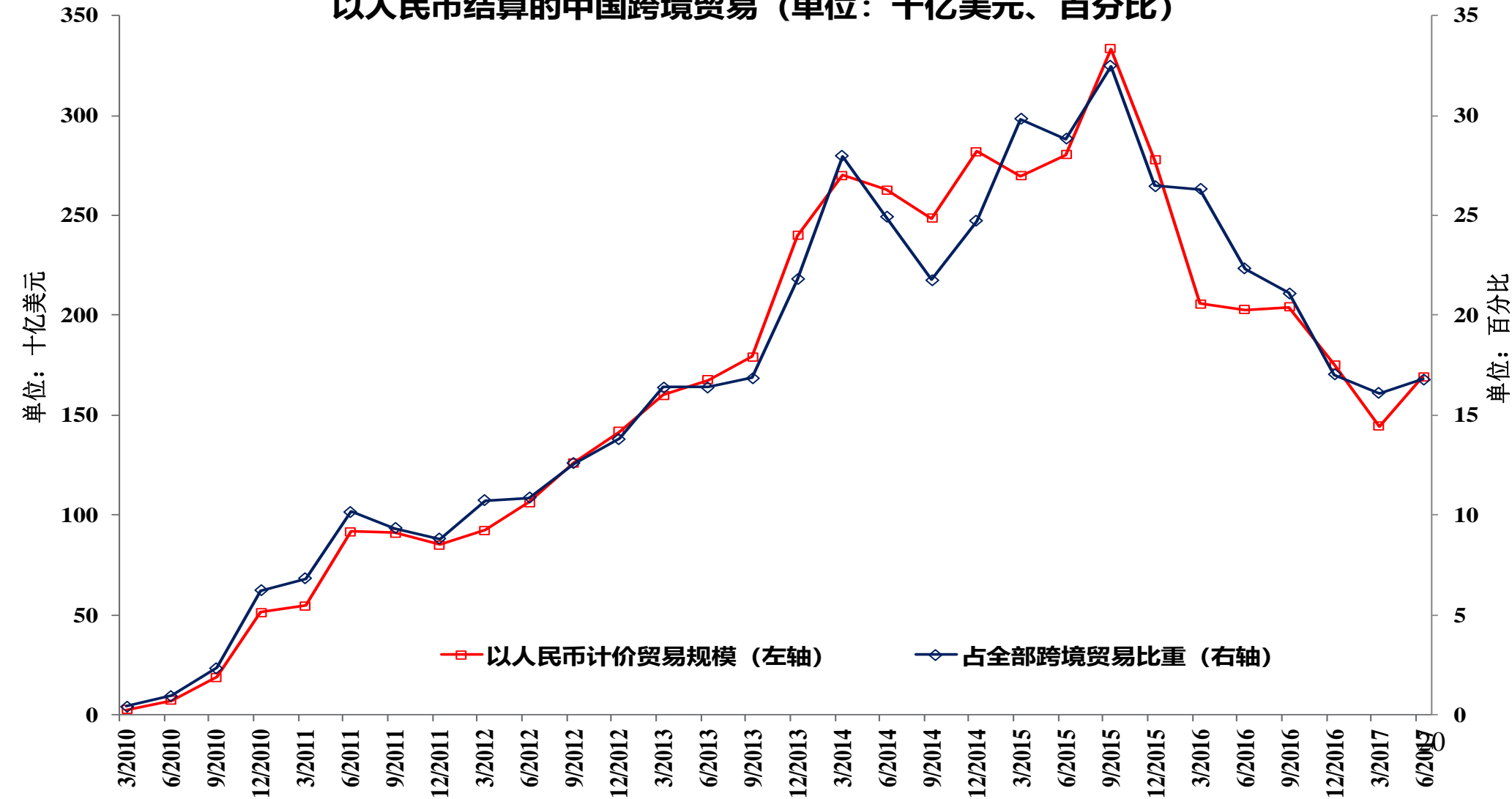
- ◆ There are also significant advantages for the issuing country of a currency being used as a medium of international exchange between other pairs of trading countries. They include:
- ◆ The ability of paying for real imports with pieces of paper (either money or bonds). This is called seigniorage and is similar to the seigniorage enjoyed domestically by the central bank or the monetary authority that has the legal power to supply money.
- ◆ This also enables the issuing country to run significant trade deficits and to enjoy low borrowing costs.
- ◆ Its currency is likely to become a “safe haven” currency, so that at the first sign of any trouble in the world, capital will flee to that currency. The issuing country will therefore benefit whenever there is trouble in the world.

The Rising Use of the Renminbi in International Transactions

- ◆ Mainland cross-border trade used to be all settled in U.S. Dollars. However, since 2010, it has been increasingly denominated and settled in Renminbi. As of 2017Q2, approximately 17 percent, or at an annualized rate of not quite US\$700 billion, of total Mainland trade was settled in Renminbi, compared to almost nothing in 2010Q1 and the peak of almost 35% (and US\$1.4 trillion at an annualized rate) in 2015Q3.
- ◆ The inclusion of the Renminbi in the “Special Drawing Rights (SDR)” basket of currencies by the International Monetary Fund on 1 October 2016 should help to increase the demand for the Renminbi as a reserve currency, but the immediate effect will not be large as there are already many swap agreements between the People’s Bank of China and the central banks/monetary authorities of other countries and regions.
- ◆ Hong Kong is currently by far the largest and most active offshore center for Renminbi clearing, settlement, trading and financing, with an average daily volume of transactions approaching 1 trillion Yuan.¹⁹

以人民币结算的中国跨境贸易规模和占全部跨境贸易比例（单位：十亿美元、百分比）

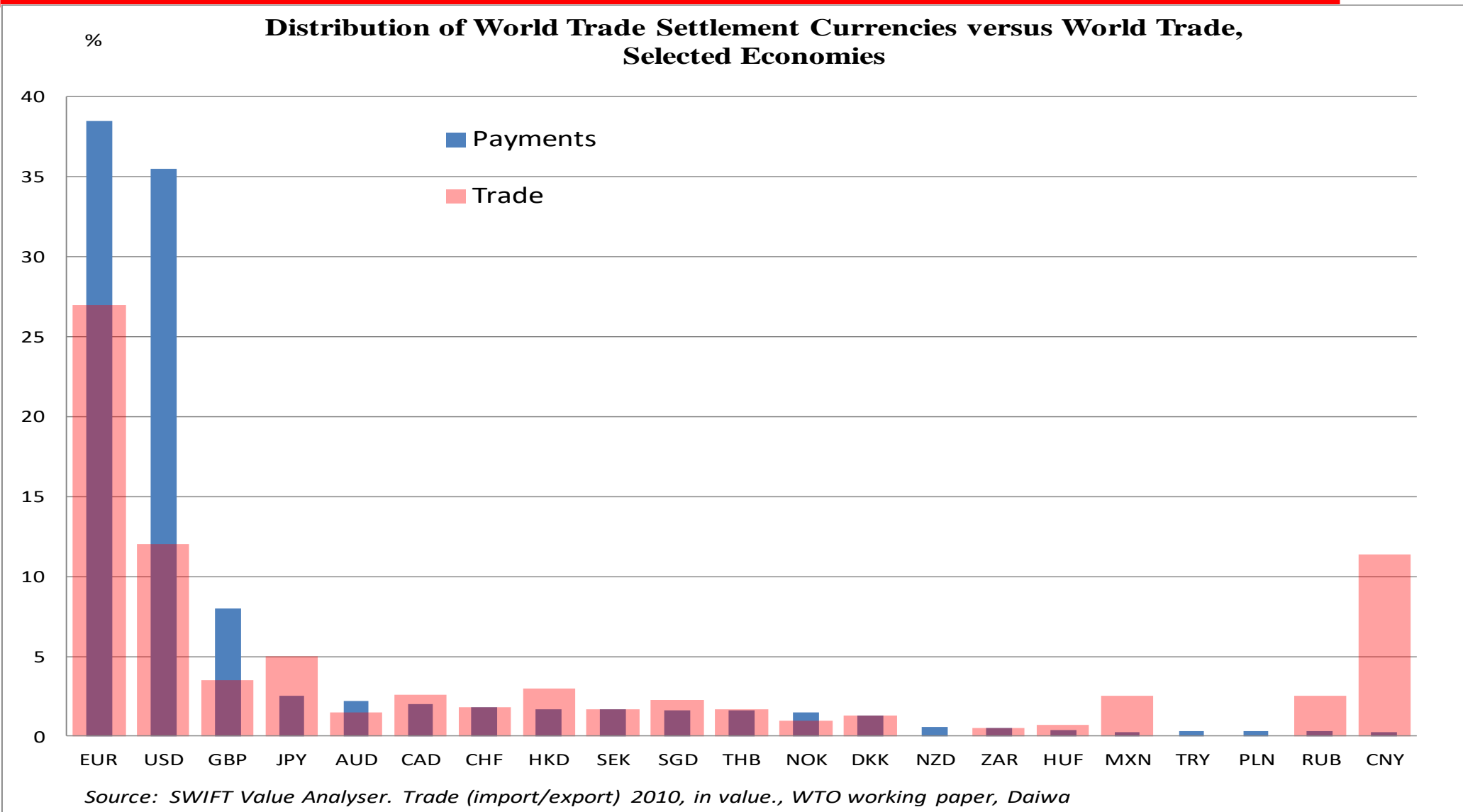
以人民币结算的中国跨境贸易（单位：十亿美元、百分比）



The Rising Use of the Renminbi in International Transactions

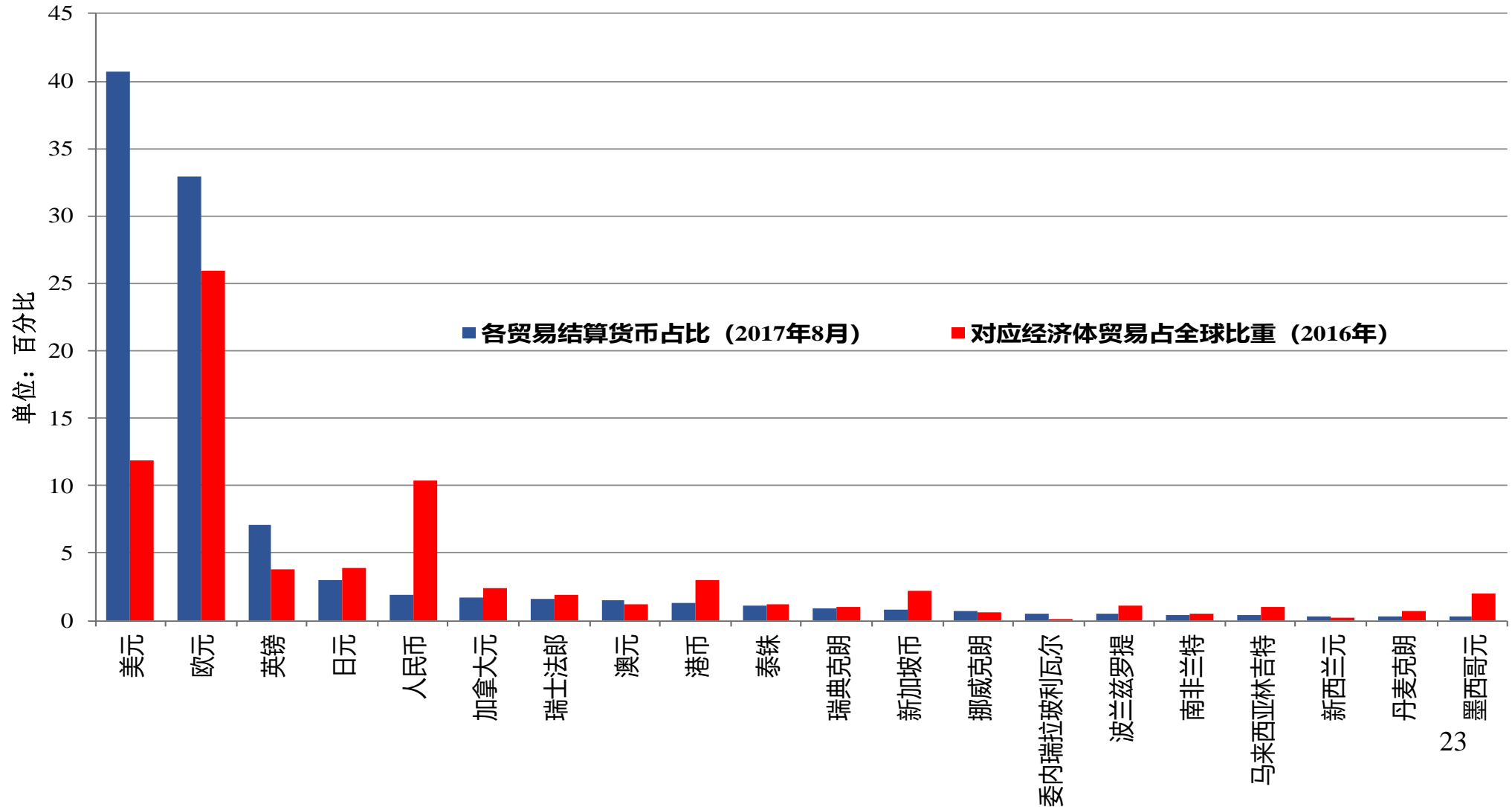
- ◆ It is useful to examine the changes over time of the use of different currencies in world payments. In the next few charts, the shares of the top twenty currencies used in world settlement in 2010 and 2017 are presented in blue columns in the order of their relative sizes from left to right, starting from the highest (using data from SWIFT), and compared to the shares of the respective country or region in world trade presented in red columns.
- ◆ An economy's share of world trade is an important, but not the only, determinant of whether its currency is widely used as a medium of international exchange. Every economy prefers to use its own currency for the settlement of its international transactions because it minimizes both risks and transactions costs.
- ◆ At present, the Renminbi is used for the settlement of international transactions to a much lesser extent than warranted by the Mainland Chinese share in world trade.

各贸易结算货币全球占比与对应经济体国际贸易占全球贸易比重（2010年）



各贸易结算货币全球占比与对应经济体国际贸易占全球贸易比重（2017年8月）

各贸易结算货币占比（2017年8月）



The Rising Use of the Renminbi in International Transactions

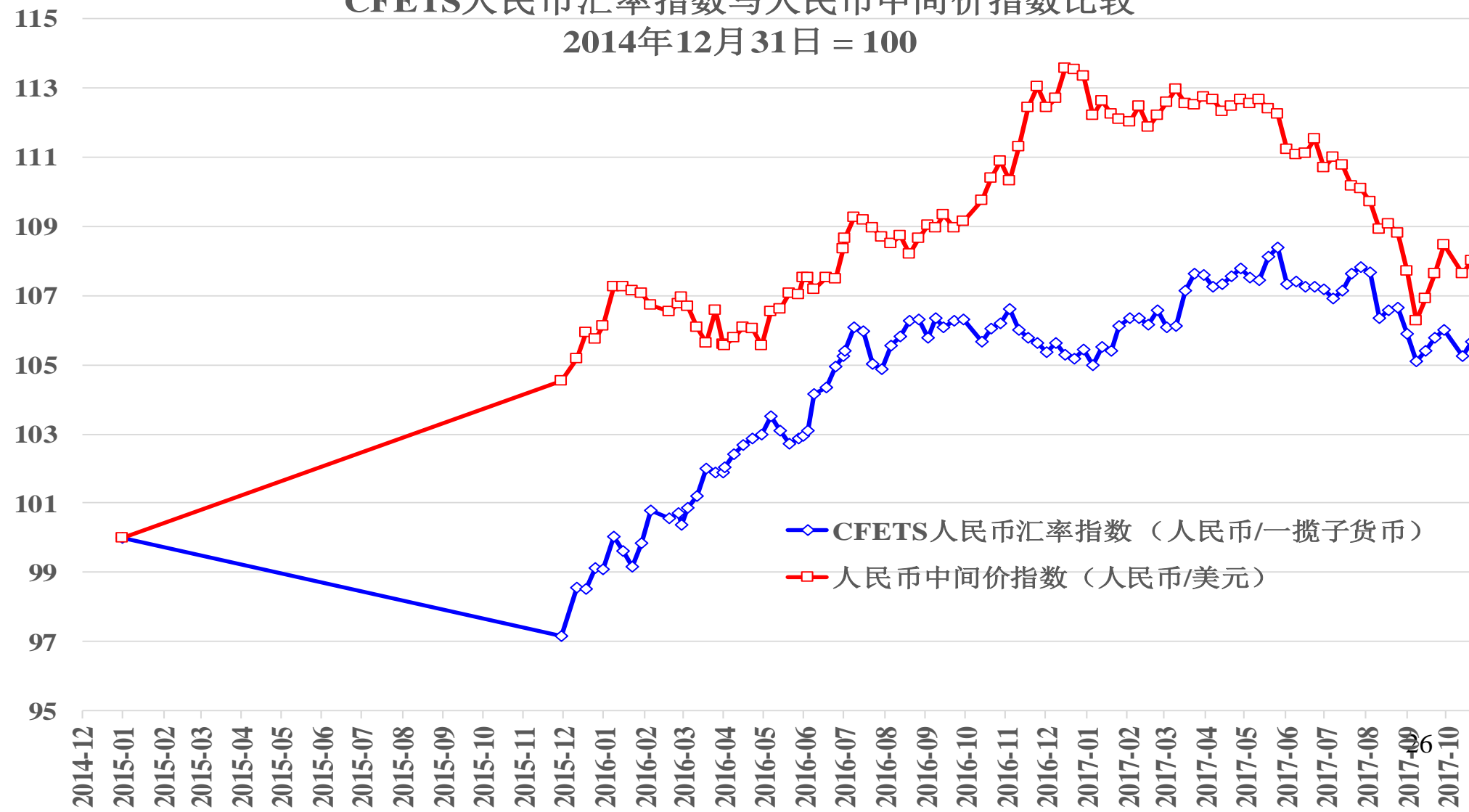
- ◆ The U.S. Dollar was the undisputed champion for world payments as of August 2017, accounting for more than 40% of world settlement, even though the U.S. itself accounted for only 12% of world trade in 2016, followed by the Euro, which accounted for 33% of world settlement, with the Euro Area accounting for slightly more than 25% of world trade. The Chinese Yuan, with 2%, was in the fifth place in terms of world settlement, behind the pound sterling and the Japanese Yen, while Mainland China accounted for 11% of world trade.
- ◆ At present, the Renminbi is used for the settlement of international transactions to a much lesser extent than warranted by the Mainland Chinese share in world trade.

The Rising Use of the Renminbi in International Transactions

- ◆ In contrast, the Japanese Yen accounted for more than 3% of world payments in 2017 while Japan accounted for less than 4% of world trade in 2016.
- ◆ If the Japanese experience is any guide, there is still a great deal of room for the Renminbi to grow in terms of its share of world payments.
- ◆ This would eventually mean even less need for the People's Bank of China to maintain a high level of official foreign exchange reserves for transactions purposes.
- ◆ Throughout the period 2010-2017, the U.S. Dollar and the Euro combined accounted for more than 70% of world payments.

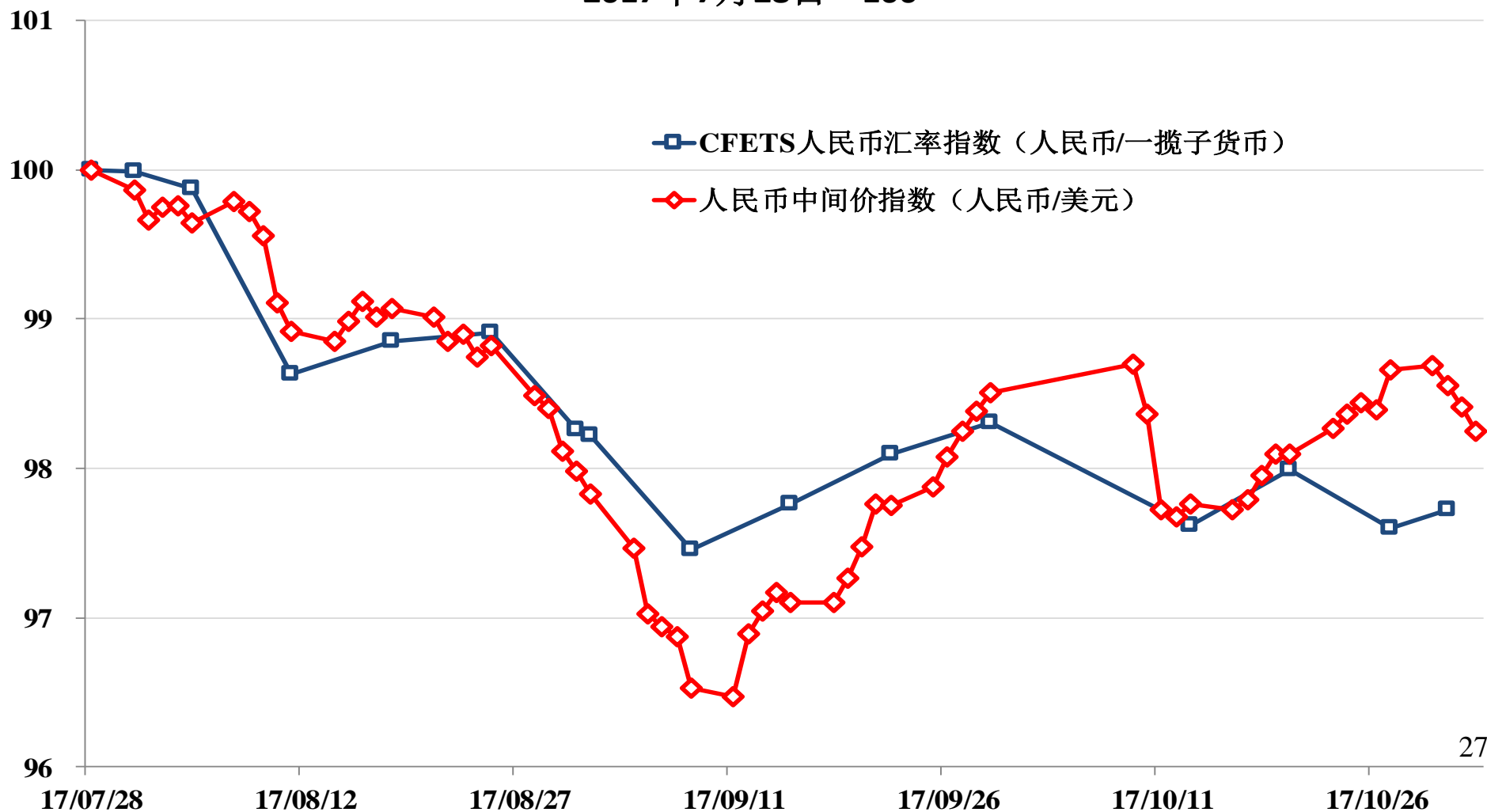
CFETS人民币汇率指数与人民币中间价指数比较 (2014年12月31日=100)

CFETS人民币汇率指数与人民币中间价指数比较
2014年12月31日 = 100



CFETS人民币汇率指数与人民币中间价指数比较 (2017年7月28日=100)

CFETS人民币汇率指数与人民币中间价指数比较
2017年7月28日 = 100



Introduction:

The Geo-Political Uncertainties

- ◆ There are major geo-political uncertainties. What are the real effects of Brexit on the U.K., on the European Union and on the world?
- ◆ The risks of isolationism, protectionism and populism.
- ◆ And then there is the continuing North Korean crisis.
- ◆ Other potential hot spots include the South China Sea, the East China Sea, the Middle East, Africa and possibly the Taiwan Straits.

The Geo-Political Uncertainties: Trumponomics

- ◆ If we go by the rhetoric of President Donald Trump and his administration, there may well be a global trade war with the three principal “villains”--China, Germany and Japan.
- ◆ Even a more limited trade war between China and the U.S. will have significant consequences not only for China and the U.S. but also for the rest of the world.
- ◆ The border-adjustment tax or the destination tax being contemplated by the U.S. will also cause great disruptions in world trade and global supply chains.

The Geo-Political Uncertainties

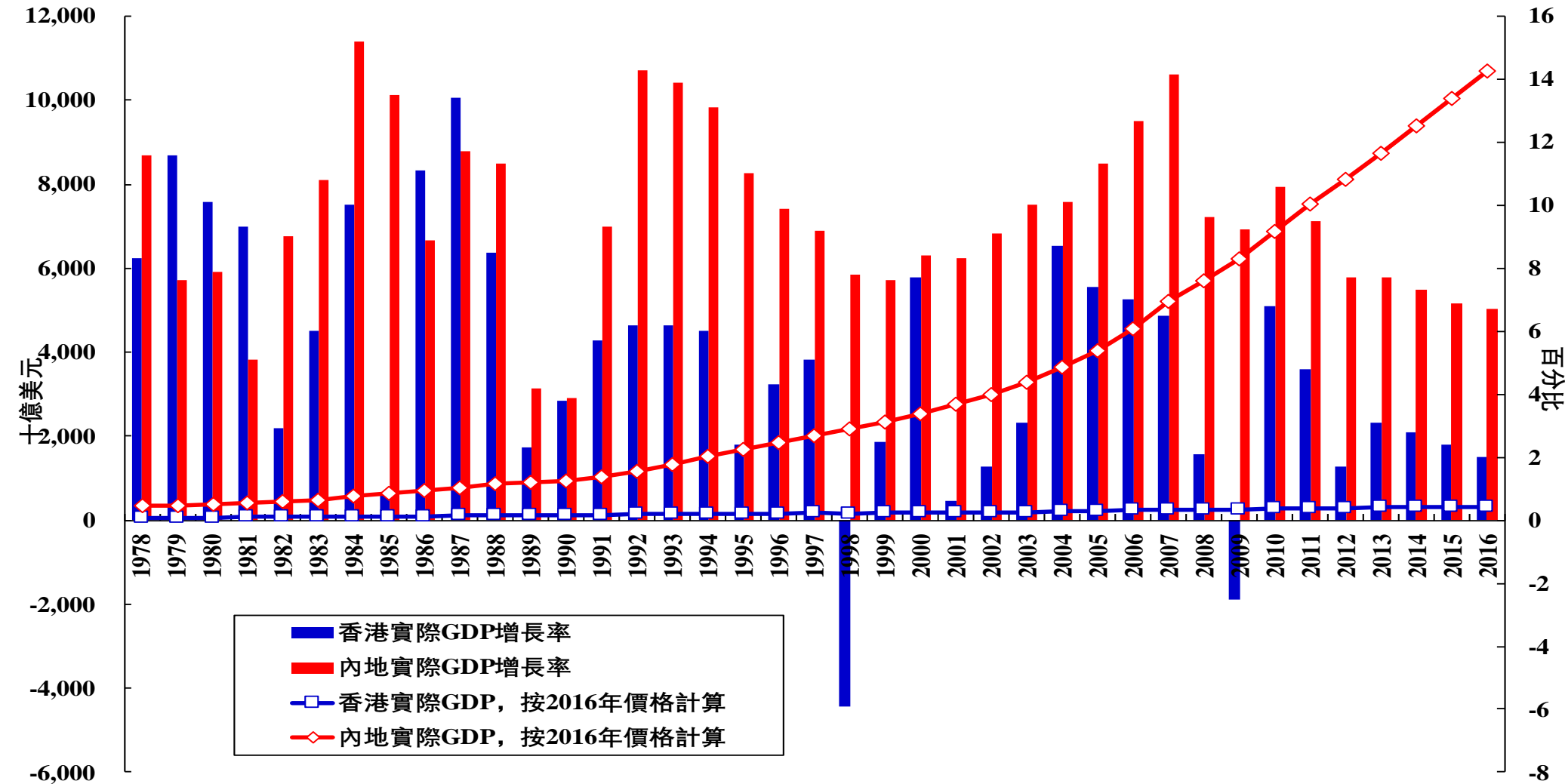
- ◆ The repudiation of the Paris Agreement on Climate Change by the United States opens up the possibility of China and the European Union working much more closely together on the prevention of global climate change. The China-EU cooperation may also extend to the preservation of the existing global economic order in international finance and trade.
- ◆ The withdrawal of the U.S. from the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP) also enhances the probability of success of ASEAN + 3 (China, Japan and Republic of Korea), ASEAN + 6 (3 + Australia, India and New Zealand (also referred to as the Regional Comprehensive Economic Partnership (RCEP)) Free Trade Areas and even a China-EU Free Trade Area.

The Hong Kong Economy at a Turning Point

- ◆ It is useful to compare the economies of Hong Kong and the Mainland over time. Huge changes have occurred since 1978 when the Mainland began its economic reform and opened its economy to the world.
- ◆ The relative economic sizes of Hong Kong and the Mainland have changed significantly. In 1978, the real GDP (2016 prices) of Hong Kong was almost one-sixth that of the Mainland (US\$52 billion versus US\$333 billion). In 2016, the real GDP of Hong Kong was only 3 percent of that of the Mainland (US\$321 billion versus US\$10.7 trillion).
- ◆ The real GDP per capita of Hong Kong was almost 33 times that of the Mainland in 1978 and still 5.6 times in 2016 (US\$43,788 versus US\$7,758).
- ◆ Since 1991, the rates of growth of Mainland real GDP and real GDP per capita have exceeded those of Hong Kong in every single year, often by large margins. The respective Mainland rates average 9.8% and 9.0% annually over this period, compared to Hong Kong's 3.7% and 2.6%.
- ◆ Even then, it will probably take another half-a-century before the level of Mainland per capita GDP exceeds that of Hong Kong.

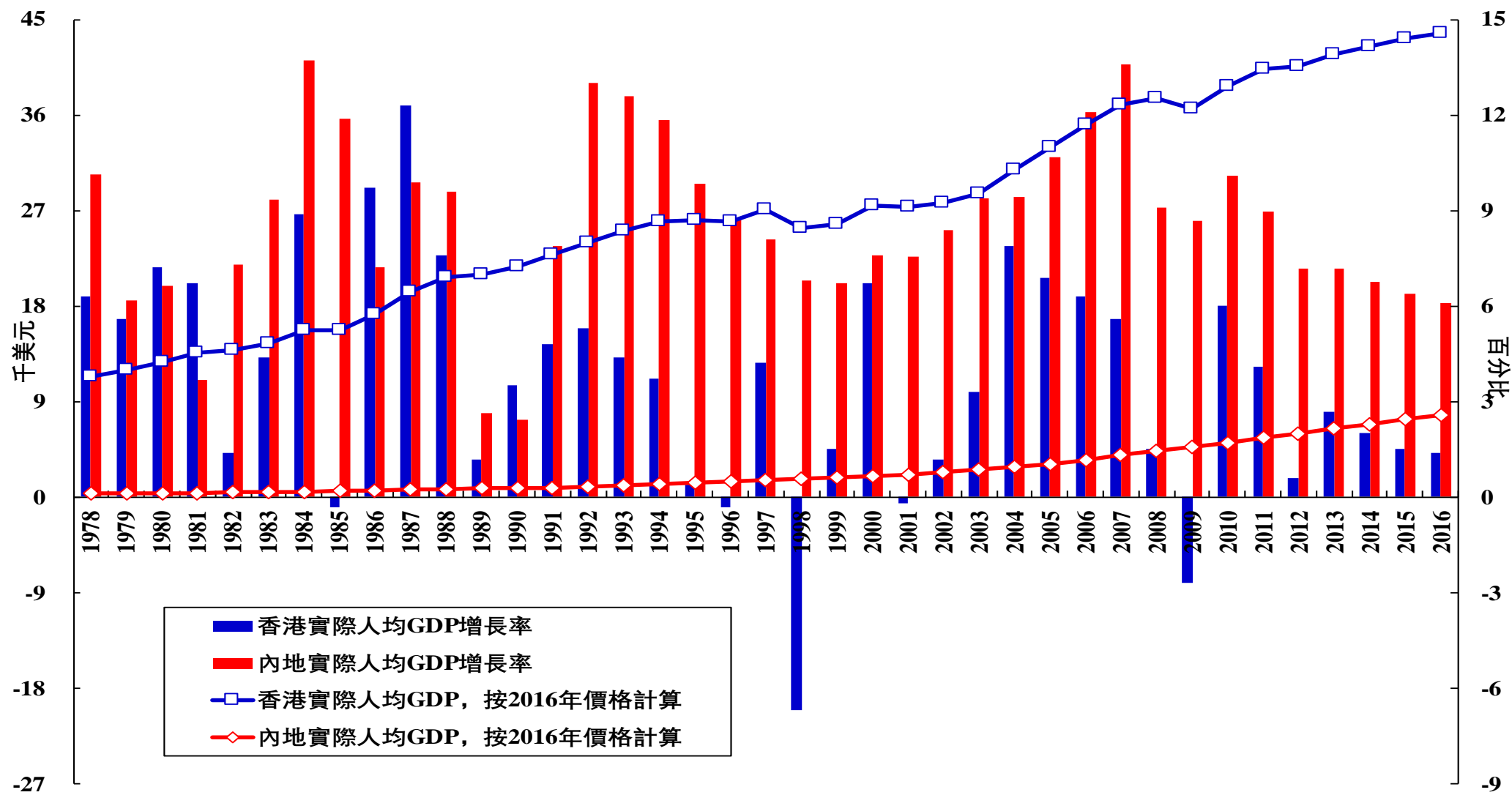
內地與香港實質GDP及其增長率的比較（按2016年價格計算，十億美元）

內地與香港的實際GDP及其增長率的比較（按2016年價格計算，十億美元）



內地與香港實質人均GDP及其增長率的比較（按2016年價格計算，千美元）

內地與香港的實際人均GDP及其增長率的比較（按2016年價格計算，千美元）

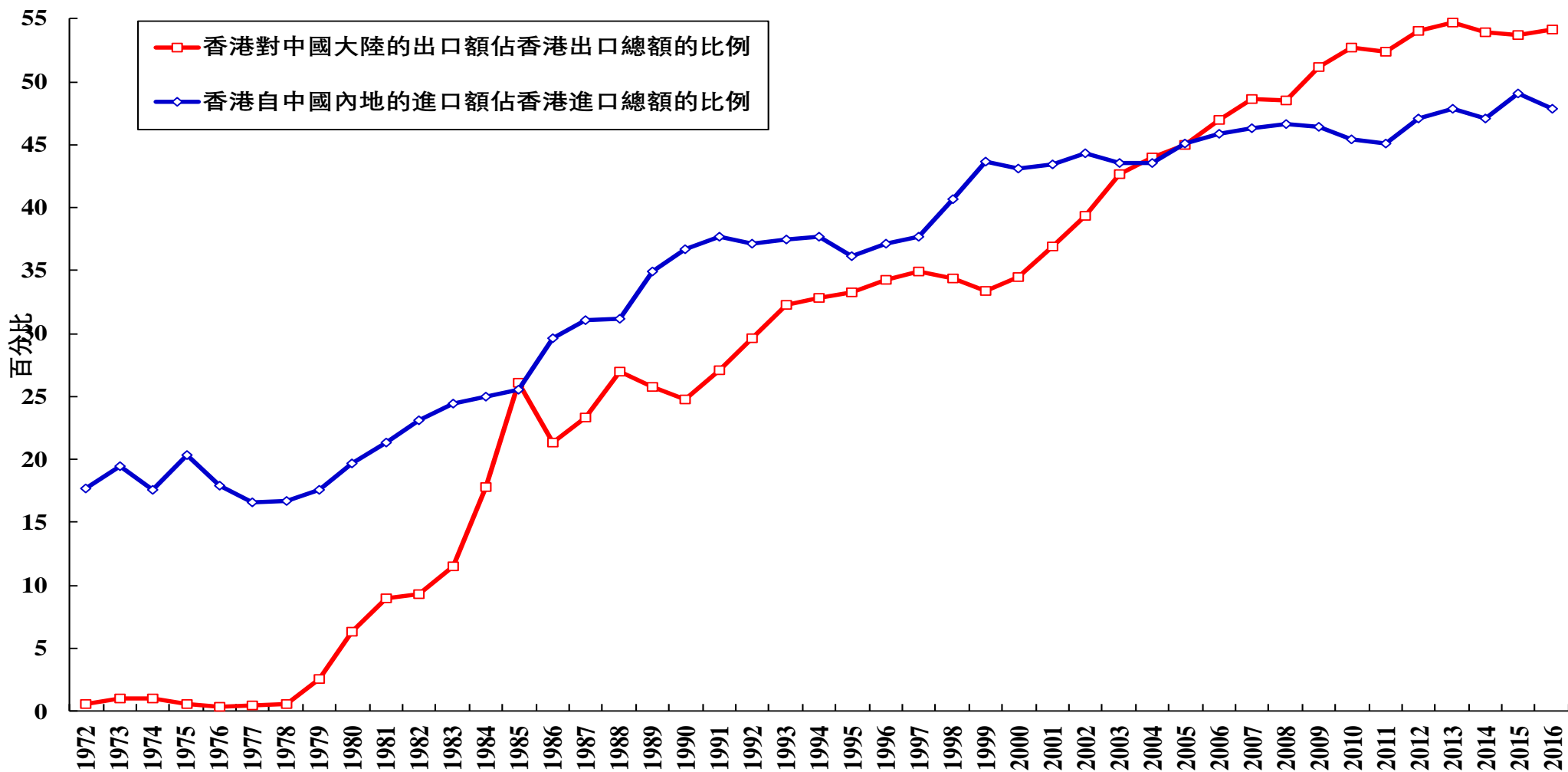


The Hong Kong Economy at a Turning Point

- ◆ The Mainland is Hong Kong's most important export destination and most important import origin (accounting for 52.8% and 46.7% respectively as of March 2017).
- ◆ Mainland annual direct investment in Hong Kong constitutes approximately half of annual total foreign direct investment in Hong Kong.
- ◆ The Mainland is the most important source of tourists to Hong Kong, accounting for more than 70%.
- ◆ Mainland enterprises are the mainstay of the Hong Kong Stock Exchange.

香港對內地出口佔香港出口總額的比例以及 香港自內地入口佔香港進口總額的比例

香港對中國大陸的出口額佔香港出口總額的比例以及香港自中國內地的進口額佔香港進口總額的比例

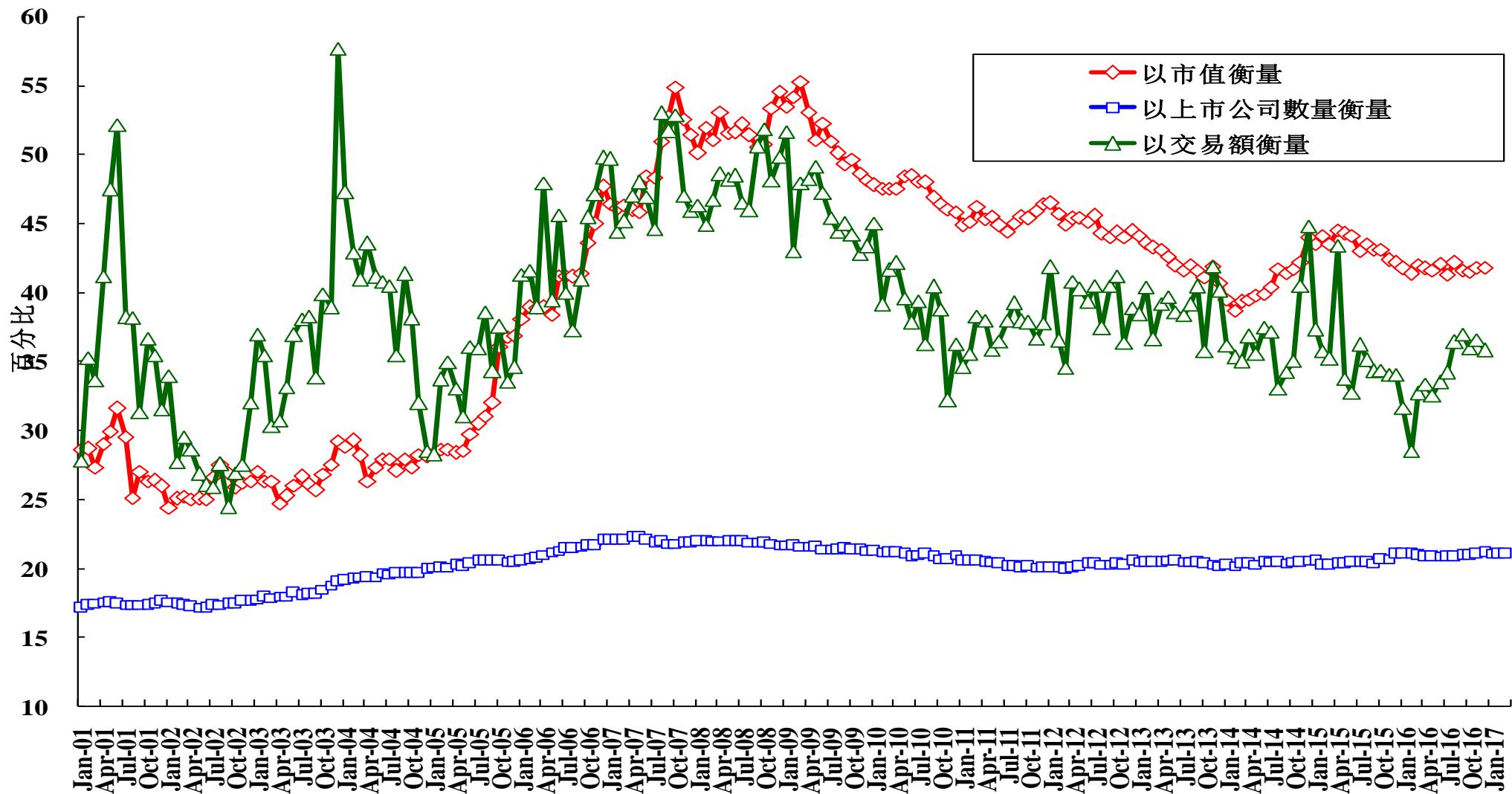


The Hong Kong Economy at a Turning Point

- ◆ Although Mainland enterprises constitute only 20% of the listed enterprises on the Hong Kong Stock Exchange by number, they constitute over 35% of the daily turnover on average and over 40% by market capitalization.
- ◆ They also account for and constitute half of the 50 enterprises included in the Hang Seng Index.
- ◆ From the point of view of IPO volume at the Hong Kong Stock Exchange, with the exception of the years of the Global Financial Crisis, Mainland enterprises account for way over 50%.

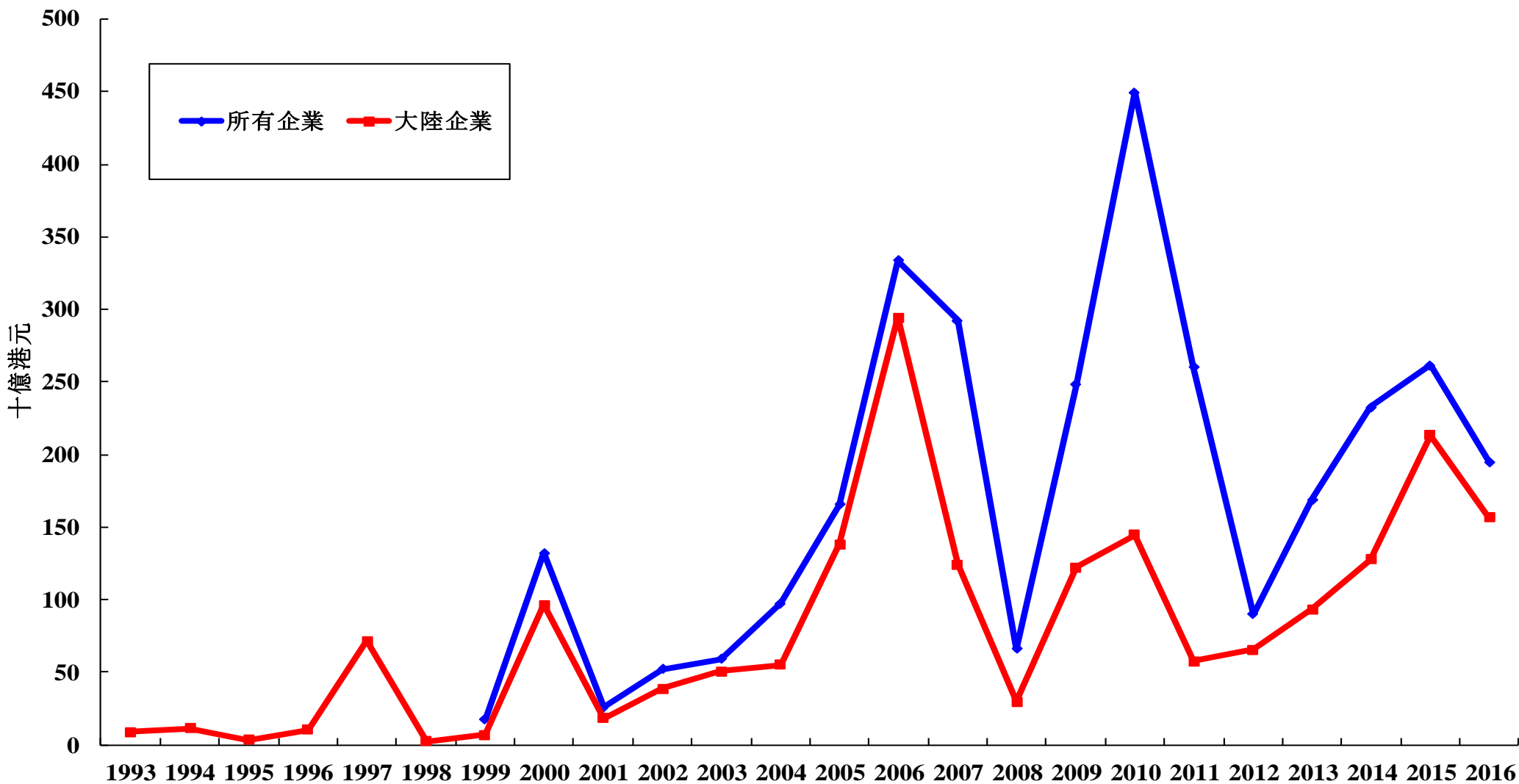
在香港證券交易所上市的內地企業的比重

在港交所上市的大陸企業的比重，分別以市值，交易額，公司數量來衡量



每年所有企業與內地企業在香港證券交易所 首次公開募股總額

每年大陸企業和所有企業在港交所首次公開募股總額



The Hong Kong Economy at a Turning Point

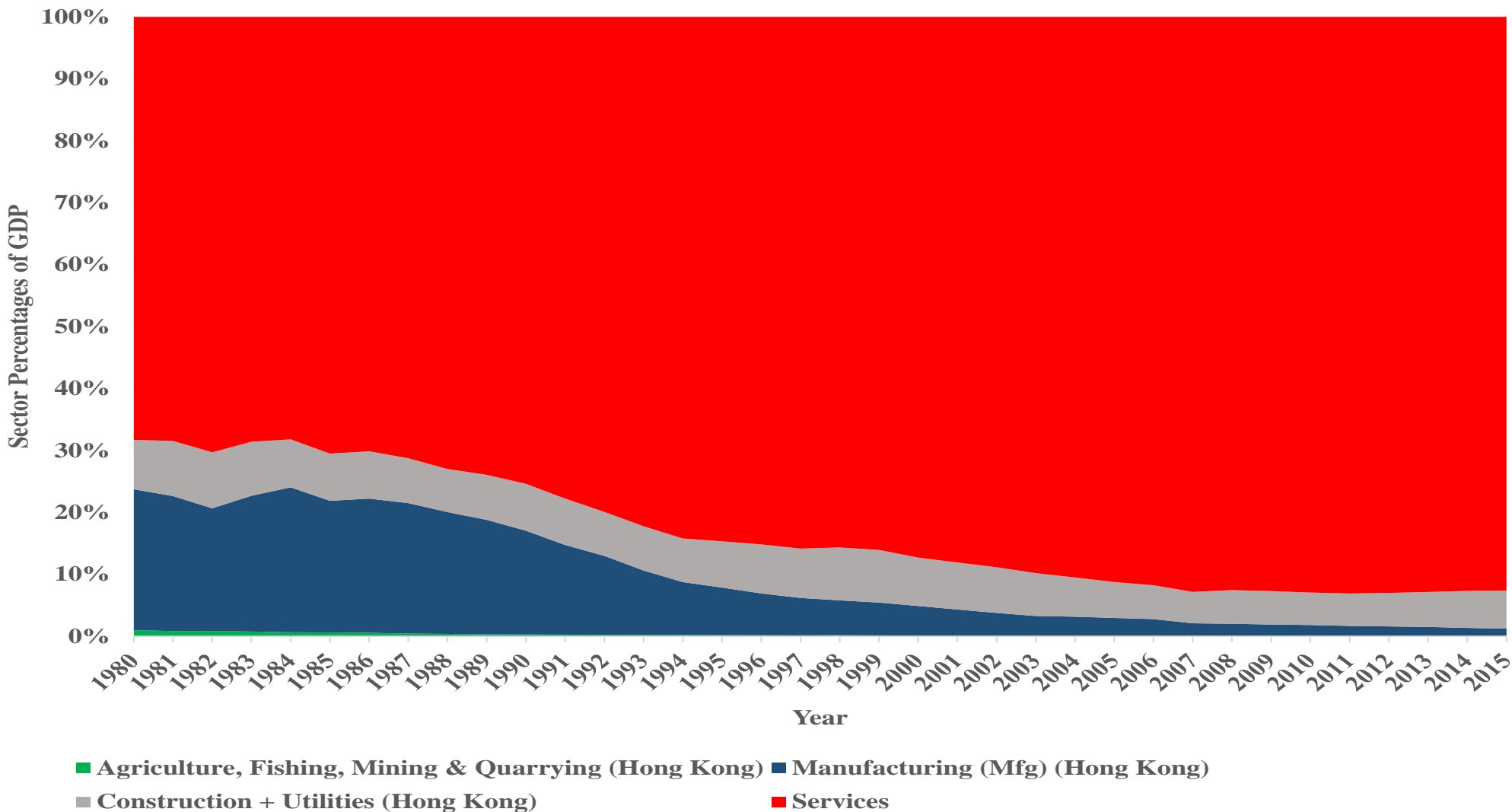
- ◆ The share of manufacturing in GDP has declined from 22.4% in 1980 to 1.1% in 2015. Basically manufacturing has left Hong Kong. Hong Kong direct investments in light manufacturing on the Mainland also face the twin challenges of rising real wage rate and the Renminbi exchange rate.
- ◆ The share of the service sector already exceeds 93%.
- ◆ The four traditional key industries in Hong Kong--financial services, tourism, trading and logistics and professional services—have been providing the main support for Hong Kong's economic development and employment. However, their combined share in GDP has declined from its peak of 60.3% in 2007 to 57.2% in 2016 and their share of employment has not been growing in recent years.

The Hong Kong Economy at a Turning Point

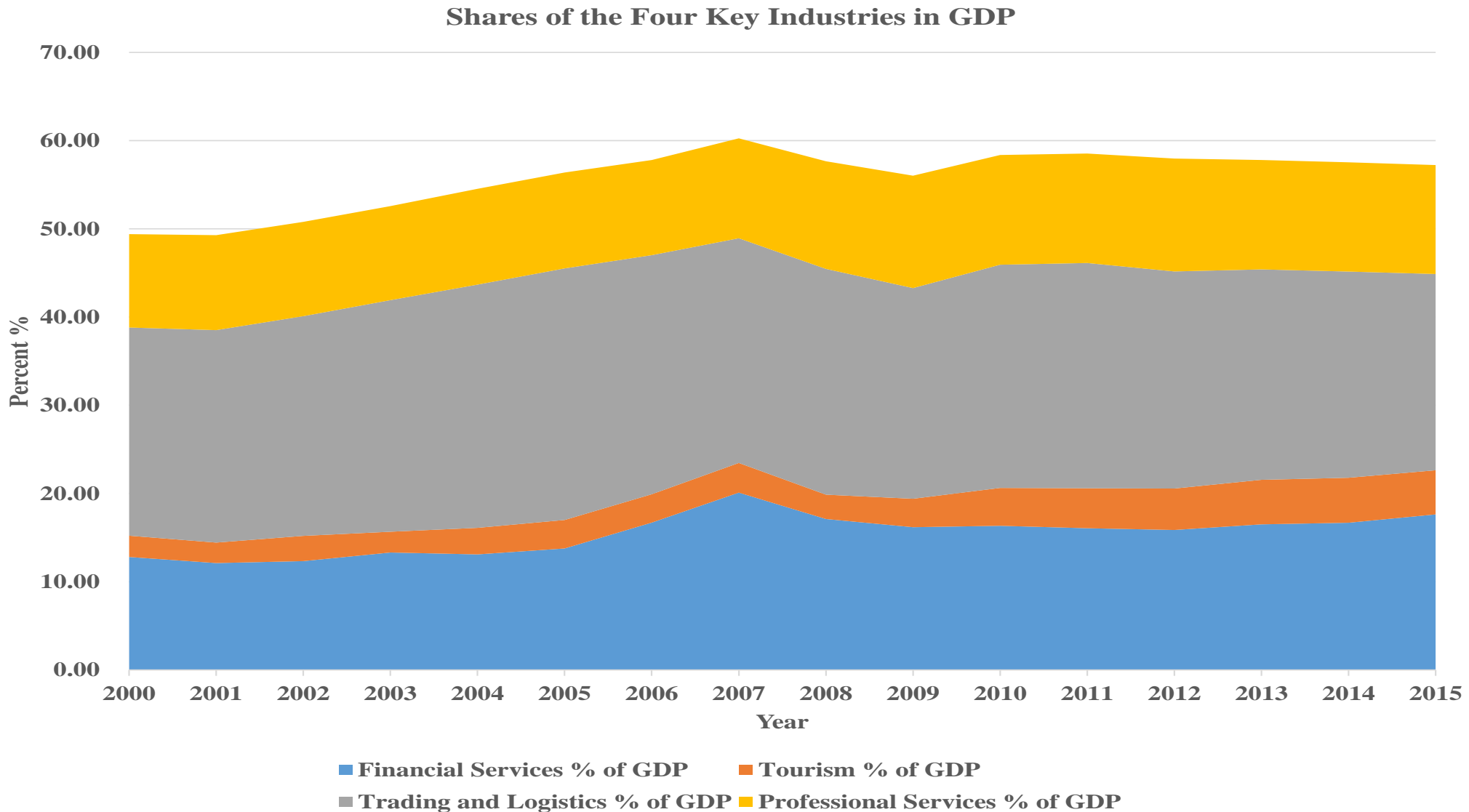
- ◆ For various reasons, the incentive for Mainland enterprises to list their shares in Hong Kong has diminished. That is why Hong Kong has to try to attract potential listings from other economies.
- ◆ The tourist arrivals from the Mainland have already peaked. The value-added of trading and logistics as a percent of GDP has been declining since 2005.
- ◆ The competition from Mainland ports, in addition to the slowdown in the growth of world trade, has caused the proportion of re-exports through Hong Kong in total Mainland trade to decline substantially.
- ◆ Hong Kong must embark on new directions in order to continue to grow and prosper, developing new industries to provide high value-added employment opportunities. It must further diversify its economy to reduce the over-dependence on any one particular sector or region. Above all, it cannot afford to turn inward and must remain internationalized.

四個產業部門佔香港GDP的比重

Distribution of Hong Kong GDP by Sectors since 1980



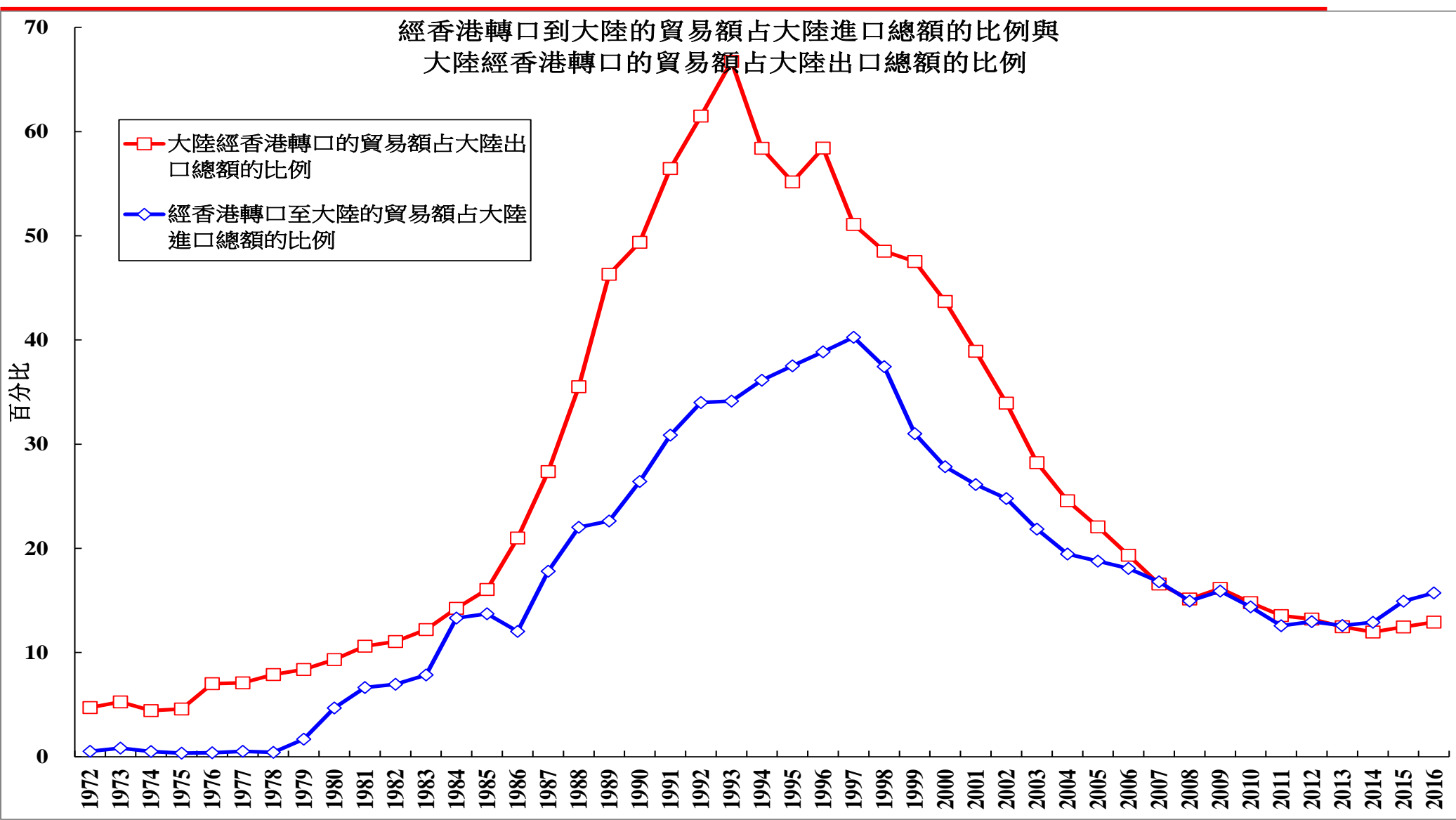
The Shares of the Four Key Industries in Hong Kong GDP



The Hong Kong Economy at a Turning Point

- ◆ Of the four traditional key industries, financial services and professional services still have growth potential. But Hong Kong must enhance its role as a conduit for the Mainland's outbound investments, to provide financial and professional services for the Mainland's growing direct and portfolio investments abroad.
- ◆ The six other selected industries are 1.Cultural and creative industries; 2.Medical services; 3.Educational services; 4.Innovation and technology; 5.Testing and certification; and 6.Environmental industries. In 2015, the shares of cultural and creative industries in GDP and employment reached 4.7% and 5.7% respectively, close to the shares of tourism (5% and 7% respectively), and it has significant growth potential. Educational and medical services, with their huge domestic demands, have also been growing fast. Innovation and technology will require government policy support before it can achieve a high rate of growth.

香港轉口至內地與香港轉口自內地貿易額占內地進口和出口總額的比例



The Hong Kong Economy at a Turning Point: The Comparative Advantages of Hong Kong

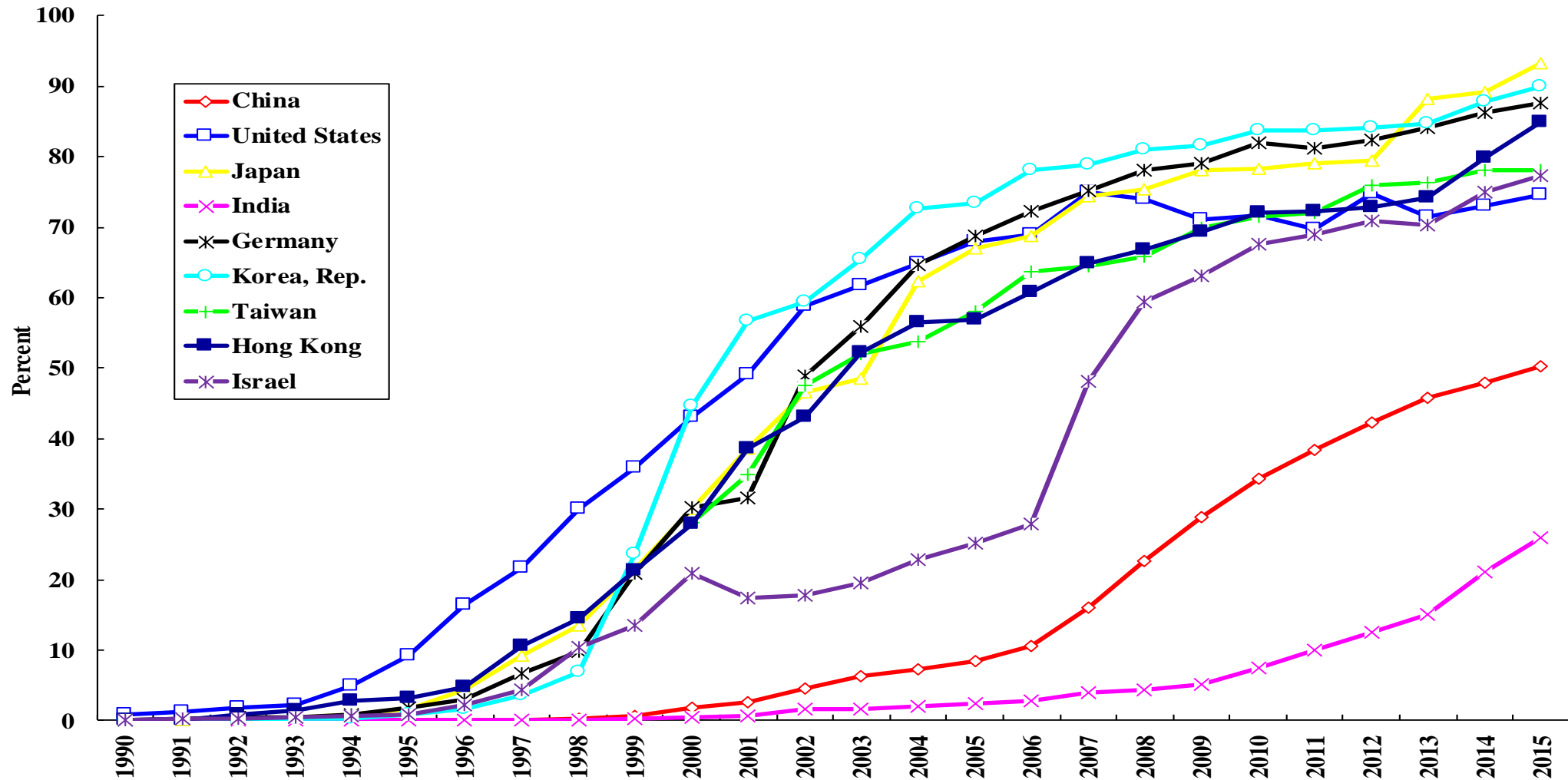
- ◆ A tradition of capitalist free market economy—the flows of people, goods and capital into and out of Hong Kong have always been free and open.
- ◆ A cosmopolitan international metropolis that is bilingual (Chinese and English) and bicultural, and closely connected to both China and the rest of the world.
- ◆ Stable exchange rate, freely convertible currency, full capital mobility and free trade.
- ◆ A well-developed financial market with close links to the other international financial centers.
- ◆ Low corporate and individual income tax rates with exemption for income generated outside the HKSAR.
- ◆ Rule of law, effective regulation and supervision of financial markets, transparent governance, and civil liberties comparable to the most developed countries in the world.
- ◆ An established international arbitration and mediation center.

The Hong Kong Economy at a Turning Point: The Comparative Advantages of Hong Kong

- ◆ An environment hospitable to entrepreneurs and potential entrepreneurs.
- ◆ The favorable commercial reputations of Hong Kong and its firms.
- ◆ Academic freedom, freedom of speech and real-time full access to information everywhere—the internet is entirely open and the press is among the freest in the world.
- ◆ A well-educated and experienced professional labor force.
- ◆ An internet-savvy population.
- ◆ World-class, research-oriented universities.
- ◆ Geographically well located--proximity to the Mainland, a huge market and a huge source of savings, right at the junction between the Mainland China and the emerging ASEAN region and a terminus of the Belt and Road.
- ◆ The Mainland can be a source of huge securities buying power as well as huge demands for capital, both equity and debt, by its enterprises as its GDP and wealth continue to grow. (Even 6.5 percent is a very high rate of growth of real GDP).
- ◆ A supportive central government.

The Number of Internet Users as a Percent of the Population in Selected Economies

The Number of Internet Users as a Percent of the Population in Selected Economies

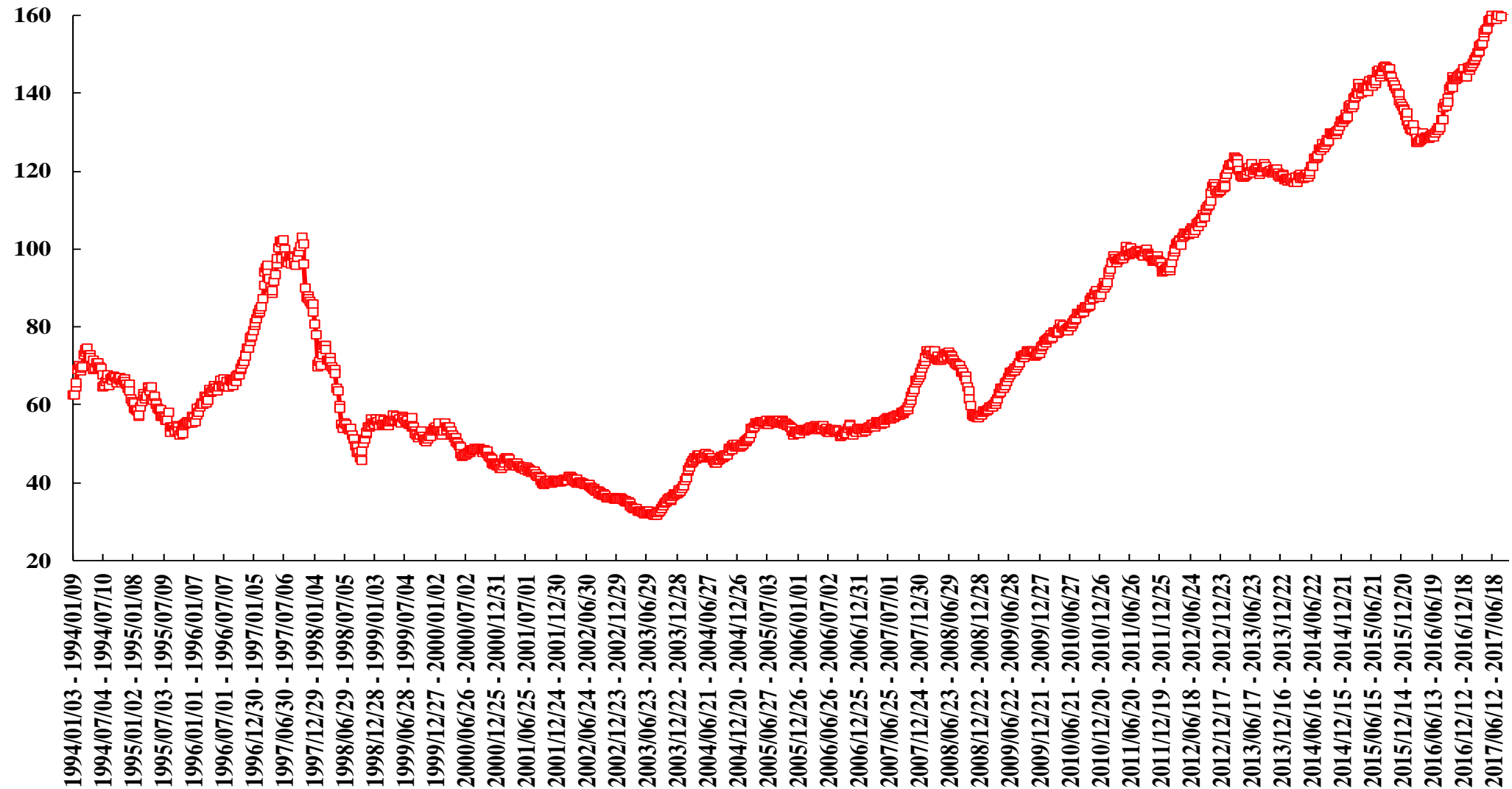


The Hong Kong Economy at a Turning Point: The Vulnerabilities of Hong Kong

- ◆ High cost structure for both local and international businesses, especially the cost of land (and hence the costs of office space and housing) which is artificially high because of out-of-date government policy.
- ◆ The lack of a large domestic market.
- ◆ The lack of an economic hinterland, which New York, London, Tokyo and Shanghai all have. (Nevertheless, under the “one country, two systems” arrangement, the Mainland can and should function as Hong Kong’s economic hinterland, much as the European Union has been for the U.K.)
- ◆ A narrow tax base, and over-dependence of government revenue on land sales, resulting in its excessive volatility and also high and rising land prices.
- ◆ The lack of double-tax agreements (DTAs) with many countries and regions (a problem that is in the process of being corrected).
- ◆ Insufficient support for higher education and for R&D, hindering Hong Kong's transformation into an innovation-based economy (Tertiary education enrolment rate is around 20% compared to almost 50% for the Mainland and 100% for Taiwan; R&D expenditure is only 0.73% of Hong Kong’s GDP, compared to 3% or above for Japan and the U.S., 4.15% for South Korea and 4% for Shenzhen).

Price Index of Residential Real Estate, Hong Kong: Centa-City Leading Index (1997=100)

Hong Kong: Price Index of Residential real Estates, 1997=100

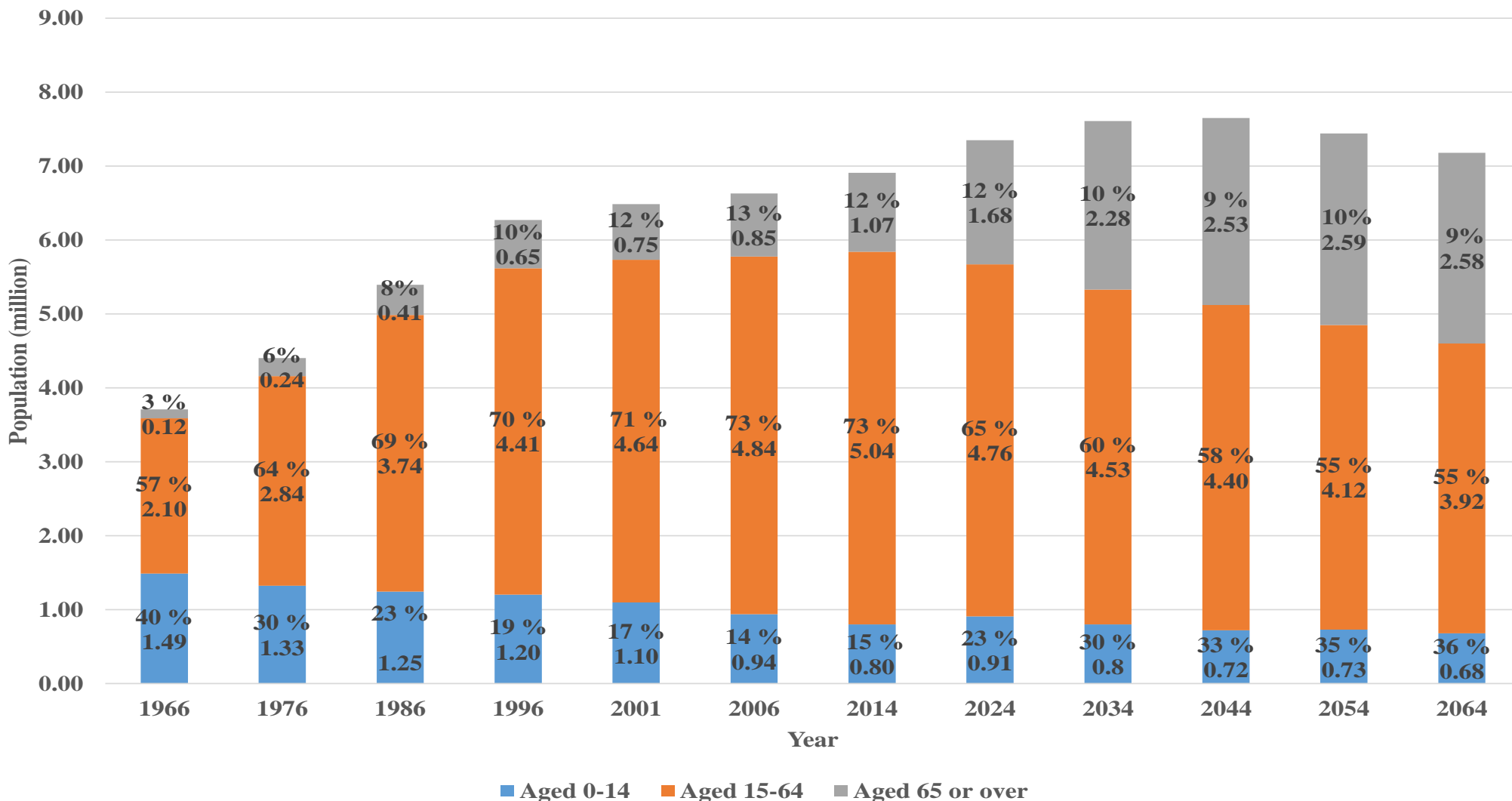


The Hong Kong Economy at a Turning Point: The Vulnerabilities of Hong Kong

- ◆ Local protectionism of many service professions such as the legal and the medical.
- ◆ Declining English proficiency and an increasingly inward-looking mentality.
- ◆ Lack of a long-term plan and strategy.
- ◆ Lack of unity of purpose and a sense of urgency.
- ◆ Diminishing role as an entrepot port.
- ◆ Diminishing importance as a source of capital for the Mainland.
- ◆ Failure to take full advantage of the “One Country, Two Systems” arrangement.
- ◆ Adverse demographic development—the population is rapidly ageing.

The Hong Kong Economy at a Turning Point: The Demographic Profile of Hong Kong

Elderly Population Trend



The Belt and Road Initiative

- ◆ The Silk Road Economic Belt and the 21st Century Maritime Silk Road, collectively known as the “Belt and Road” Initiative (B&R), was launched by President XI Jinping in September 2013. It is a grand, multi-country (72 by last count), multi-decade development plan with the objective of linking and transforming the economies of Asia, Europe, Africa and Oceania.
- ◆ It aims to create a peaceful and secure environment for joint development by building a trade, investment and infrastructure network connecting all B&R nations.
- ◆ It emphasizes the nurturing of mutual understanding and trust and the formation of durable relationships through cultural and educational exchanges as well as industrial cooperation.
- ◆ It promotes open, inclusive, balanced and green economic globalization through enhanced regional interconnectivity.
- ◆ But above all, it seeks to stimulate and create sustainable trade and investment exchanges where none exist before, thus benefitting every country and accelerating economic development for all.

The Belt and Road Initiative:

The Financing of Infrastructure Projects

- ◆ China's own economic development experience confirms that both reform and openness are necessary for success. And infrastructure building is the indispensable first step.
- ◆ This is also true of the B&R. The Asian Development Bank (ADB) estimated that emerging Asian economies would need infrastructure investment totaling US\$1.7 trillion a year in order to maintain economic growth, but only about half the amount would be available.
- ◆ What role can Hong Kong play in the “B&R” initiative? Hong Kong has the advantages of not only complete capital mobility, full currency convertibility, a stable exchange rate and low taxes, but also ready access to the huge market, the excess savings pool, and the support of the governmental institutions in China, the principal sponsor of B&R. Hong Kong is ideal as a center for the financing of the “B&R” infrastructure projects.

The Belt and Road Initiative:

The Financing of Infrastructure Projects

- ◆ Finding ways to finance the infrastructure needs is the first priority. The more cynical observers may suggest that the B&R initiative is only a Chinese ploy to solve its excess capacity problem. However, one should note that B&R is a multi-decade plan whereas the Chinese excess capacity is at most an intermediate-term (five-year) problem. Moreover, it is actually win-win for both China and the host country of the infrastructure project if a Chinese contractor is the successful bidder because it will imply a lower construction cost.

The Belt and Road Initiative:

The Financing of Infrastructure Projects

- ◆ Yet infrastructure projects, especially development-leading ones, are notoriously difficult to finance. These projects often have to be built first, in order to attract the users, who come later. They also have very long payback periods, on the order of thirty years or more, and hence require long-term financing. Some projects, for example, an urban mass transit system, may not even break even directly at all. That is why infrastructure projects are typically financed and/or guaranteed by governments, sometimes with the aid of multilateral development institutions such as the World Bank (WB) and the ADB. But without additional private participation in infrastructure financing, there will not be sufficient resources.
- ◆ Attracting private investment requires organizing the financing in a diversified and structured way--with a combination of public and private equity and debt, loans from commercial and government banks and multilateral development finance institutions, government and multilateral aid grants, guarantees and political risk insurance. Hong Kong, because of its expertise and sophistication, is an ideal place for assembling such financing packages.

The Belt and Road Initiative:

The Financing of Infrastructure Projects

- ◆ Permanent long-term financing for infrastructure projects, typically for 30 years or more after the completion of construction, cannot be provided by commercial banks because they do not have the long-term deposits to fund the loans. Often, the long-term financing is provided by a loan from a government development bank or project bonds, with or without an explicit government guarantee, and occasionally supplemented by a loan or grant from a multilateral development finance institution or a foreign development bank. Once a pre-agreed plan and commitment for long-term financing is in place, commercial banks will be willing to provide the loan during the construction phase.

The Belt and Road Initiative:

The Financing of Infrastructure Projects

- ◆ The long-term lenders and bond investors do not have the expertise to make and monitor construction loans and do not want to assume the construction risk (including possible cost-overruns), so that their funding will kick in only upon completion and start of operation of the project, replacing (“taking out”) the construction lenders.
- ◆ Moreover, in order to prevent moral hazard, the owner/operator, public or private, of the infrastructure project is required to have some equity in the project; because if the project is completely debt-financed, it may have no incentive to see the project successfully completed and in operation. The equity can frequently be a grant from the host government.
- ◆ The HKMA has set up an Infrastructure Financing Facilitation Office (IFFO).

The Belt and Road Initiative: The Development of a Long-Term Bond Market

- ◆ The real challenge is in assembling a long-term financing package that is attractive to private investors. An infrastructure project can be financed with project bonds of staggered maturities--short, intermediate and long—and with different terms for interest payments and principal repayments, that can be related to the expected revenue stream. These bonds are easier to sell if they carry a host country guarantee.
- ◆ The longest-dated bonds should and will be taken up by the government development bank of the host country or by multilateral development finance institutions such as the WB, the ADB, the Asian Infrastructural Investment Bank (AIIB) and the International Finance Corporation. The participation of the multilateral development lenders helps to reduce the probability of nationalization, thus lowering the political risk for all investors in the project. (Political risk insurance can also be separately purchased from the Multilateral Investment Guarantee Agency (MIGA).)

The Belt and Road Initiative: The Development of a Long-Term Bond Market

- ◆ Potential buyers of the long-term project bonds also include life insurance companies and pension funds. Private investors can be attracted to the shorter-dated long-term bonds and possibly even equity if it has reasonable liquidity.
- ◆ The financing can also be done in multiple currencies, for example, the U.S. Dollar and the Renminbi. Since the revenue for most infrastructure projects is in local currencies, to the extent that there is demand for local currency-denominated bonds, either in the host country or internationally, they should be used. However, local currency-denominated bonds may have to be enhanced through indexing the rate of interest to the rate of inflation of the host country.
- ◆ Alternatively, for foreign currency-denominated debt, they may need to be secured with the expected proceeds of exportables—for example, oil and gas and iron ore. Hong Kong is uniquely able to put together a complex financing package that includes both equity and debt and short-and long-term bonds and notes and possibly in multiple currencies.

The Belt and Road Initiative: The Development of a Long-Term Bond Market

- ◆ However, Hong Kong does not currently have an active, deep and liquid sovereign and corporate bond (fixed income) market with both short and long maturities that both New York and London have. In fact, Hong Kong does not at the present time have much of an active bond market at all. This makes Hong Kong unsuitable as a location for raising long-term debt and for many asset managers, including fixed income funds, insurance companies, money market funds, pension funds, sovereign wealth funds and treasury operations of multinational corporations.
- ◆ One reason suggested for the lack of an active bond market in Hong Kong is the fact that the Government of HKSAR habitually runs budget surpluses and hence has no need to borrow from the market through the issuance of bonds. This makes it difficult to establish a (sovereign) benchmark risk-free rate and a long enough yield curve for the Hong Kong bond market.

The Belt and Road Initiative: The Development of a Long-Term Bond Market

- ◆ To serve the needs of the B&R infrastructure bonds, Hong Kong must develop a more active bond market with an established benchmark and yield curve. It can begin by issuing more long-term (say, between 30 and 50 years) Hong Kong sovereign or quasi-sovereign bonds (for example, through the Hong Kong Mortgage Corporation for the purchase of qualified mortgages or the Hong Kong Airport Authority for the financing of the Third Runway), providing a benchmark for other long-term bonds.
- ◆ One factor discouraging private interest in long-term infrastructure bonds is the lack of liquidity--the lack of a secondary market for individual project bonds. Hong Kong also needs to develop a secondary market for the B&R equity and debt securities to ensure some liquidity for the private investors, which will increase their attractiveness.

The Belt and Road Initiative: The Development of a Long-Term Bond Market

- ◆ But most project bonds are one-off. A steady flow of mortgage bonds can also be issued by the Hong Kong Mortgage Corporation (HKMC) for the financing of long-term, say thirty-five-year, fixed-rate, owner-occupied mortgage loans for lower-income households (because of the ceiling on the amount of the loan).
- ◆ The Government of the HKSAR should be able to command a rate of interest on its bonds as good as the U.S. Treasury because of the very low public debt to GDP ratio of Hong Kong compared to the U.S.
- ◆ By buying qualified mortgage loans, the HKMC can bring down significantly the monthly payments for the borrowers (both because of the lower rate enjoyed by HKMC as a quasi-sovereign issuer and because of the longer maturity) and eliminate their interest-rate risks, thus making home ownership more affordable and less risky.

The Belt and Road Initiative: The Development of a Long-Term Bond Market

- ◆ Commercial banks in Hong Kong and for that matter anywhere else are unable to offer fixed-rate mortgage loans of long maturity because they do not have fixed-rate deposits of similar maturity. If they offer long-term fixed-rate mortgage loans on their own, it will result in a serious maturity-mismatch between their assets and liabilities, with potentially disastrous consequences. However, they can originate these mortgage loans, sell them to HKMC, and service them for fees.
- ◆ With a risk-free rate and a full yield curve established, other HK\$-denominated bonds such as “green” bonds and corporate bonds can be issued based on their own individual credit ratings. Hong Kong can become a green finance hub.
- ◆ US\$-denominated bonds and Renminbi-denominated bonds can follow. Issuers can include sovereign governments, quasi-sovereign institutions, multilateral organizations and corporations from all over East Asia and beyond.
- ◆ With U.S. interest rates expected to be rising, this is an opportunity₆₃ to promote long-term, fixed rate bonds and mortgages.

The Belt and Road Initiative: The Development of a Long-Term Bond Market

- ◆ Hong Kong can also develop into an international center for “Sukuk” or “Sharia (Islamic Law)-compliant” bonds. Many of the B&R projects will be located in Islamic countries, such as Indonesia, Pakistan, and countries in Central and West Asia, the Middle East and Africa. So there should be significant interest from Islamic investors, including the oil-rich countries in the Middle East, in these projects. Hong Kong issued its third Sukuk bond in February 2017. Hong Kong should beef up its talents in this area to complement its deep capital market expertise. It should aim to become the largest and most liquid market for sharia bonds worldwide.
- ◆ The size of the buying power and the liquidity will decide which market will win. Ultimately, there is going to be one such market in the world that can attract international investors.

The Belt and Road Initiative: The Organization of Large Infrastructure Bond Funds

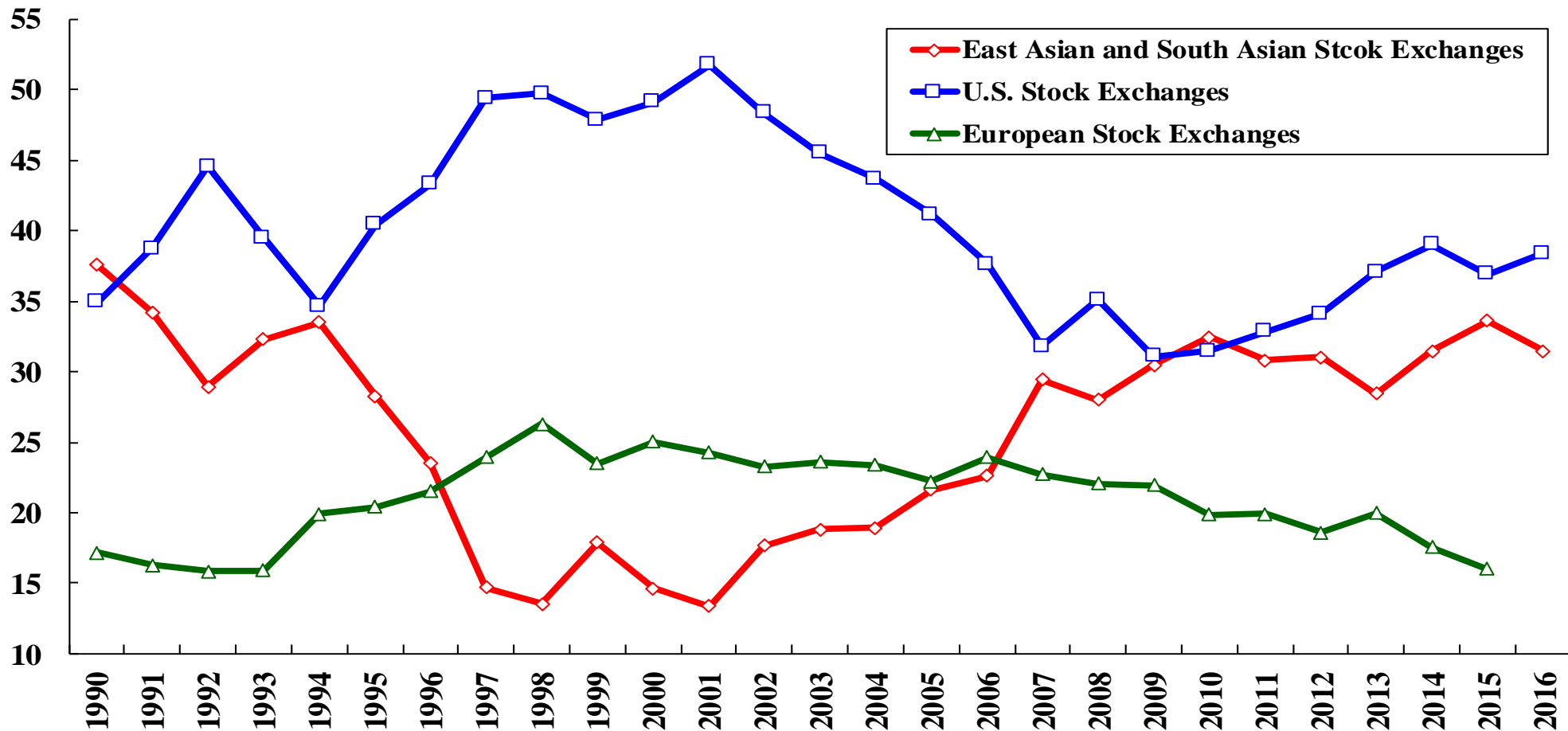
- ◆ The organization of large (enough for meaningful diversification and low expense ratio) infrastructure bond funds open to private investors can help to overcome this problem as fund units are more liquid than the individual bonds and risk is lower from diversification. These bond funds can also operate as buyers and market-makers of the individual project bonds, thus providing the liquidity in the secondary markets, thereby helping to increase the demand for individual project bonds and lower the cost of financing. Hong Kong should actively encourage the organization of large infrastructure bond funds specializing in B&R project bonds. It can add significant value if it can maintain an active and liquid secondary market for the individual project bonds.

The Belt and Road Initiative: The Development of a Belt-and-Road-Wide Stock Market

- ◆ The buying power of Asian investors has been growing very rapidly since 2000, driven by the rapid rate of growth of their GDPs and wealth as well as the high saving rates.
- ◆ The share of East Asian and South Asian stock exchanges in the total world market capitalization stood above 35% in 2016, compared to 38% for the U.S. and 17% for Europe.
- ◆ The average annual turnover of the Shanghai and Shenzhen Stock Exchanges combined was more than US\$41 trillion, higher than that of the New York Stock Exchange of US\$30 trillion in 2016. In contrast, the average annual turnover of the Hong Kong Stock Exchange was only US\$2 trillion. This demonstrates the potential stock-buying power of the Mainland investors. For the international stock market in Hong Kong to succeed, Hong Kong must harness the buying power of the Mainland investors in addition to attracting the Mainland enterprises to list their shares in Hong Kong.
- ◆ Sooner or later, the investment portfolios of Mainland investors will have to be diversified into investments outside the Mainland. Hong Kong is the ideal place to provide a channel for such investments.

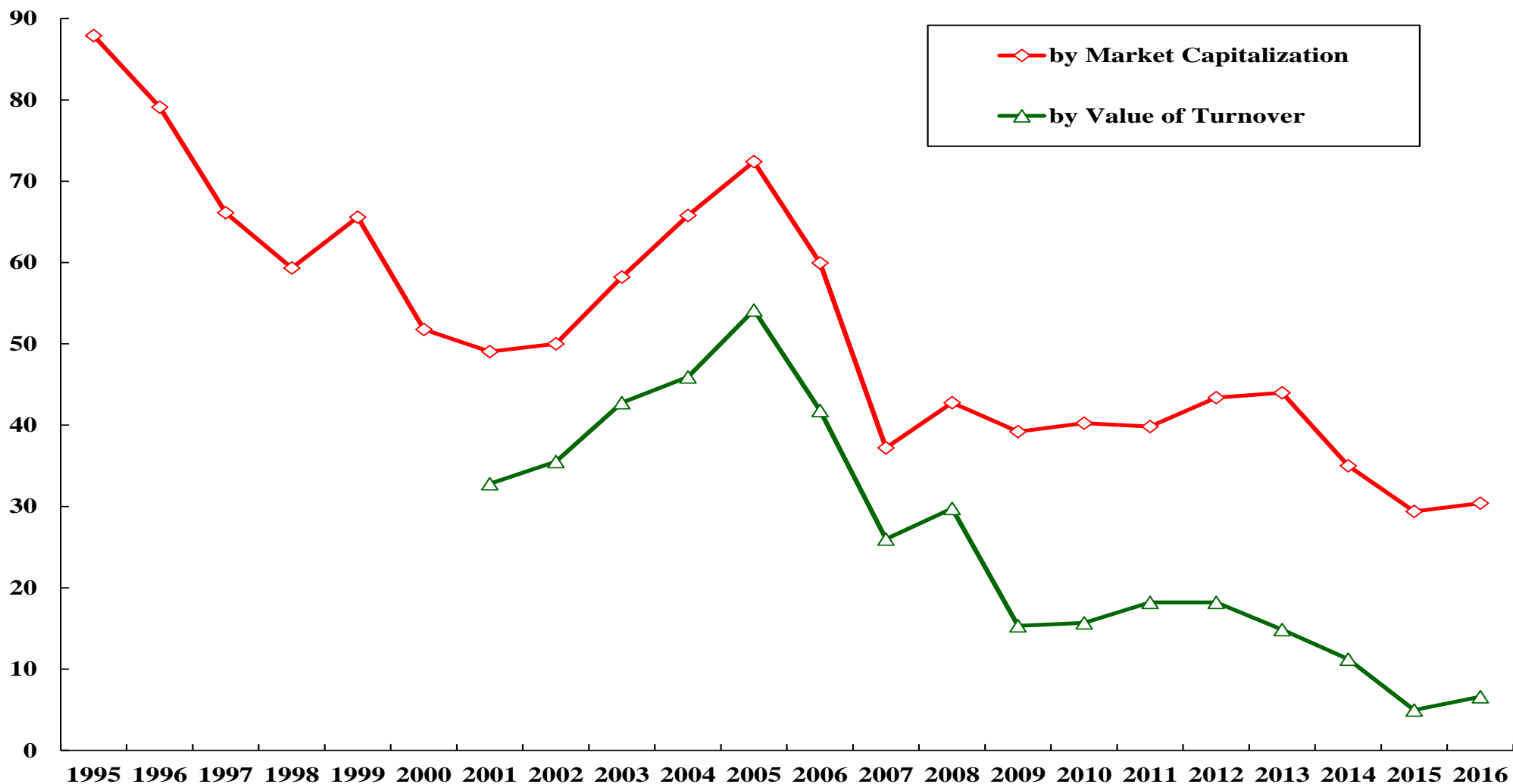
The Distribution of the Market Capitalization of World Stock Exchanges by Region, percent

The Distribution of the Market Capitalization of World Stock Exchanges by Region, percent



The Share of Hong Kong in the Total of All Chinese (including HK) Stock Exchanges

The Share of Hong Kong in the Total of all China



The Belt and Road Initiative: The Development of a Belt-and-Road-Wide Stock Market

- ◆ At present, there is no single market in which the stocks of all major enterprises in East Asia (let alone the stocks of enterprises in the other Asian Belt and Road countries) are traded. Investors both inside and out of East Asia would welcome a single exchange where they can buy and sell the equity and debt of blue chip East Asian enterprises (e.g., the MSCI Far East Index components) in US\$ or HK\$ (which is pegged to the US\$), and without having to worry about foreign exchange conversions and restrictions on capital inflows and outflows.
- ◆ In addition, Mainland investors would also welcome the convenience of being able to buy and sell the equity and debt of blue-chip enterprises in developed economies (e.g., the Dow Jones 30 companies), in a single market, if and when capital controls are lifted on the Mainland. (Right now we already have Shanghai-Hong Kong Connect and Shenzhen-Hong Kong Connect.)
- ◆ It therefore behooves Hong Kong to solicit, encourage and solicit blue-chip enterprises around the world to do secondary listings in Hong Kong as Hong Kong Depositary Receipts (HDRs).

The Belt and Road Initiative: The Development of a Belt-and-Road-Wide Stock Market

- ◆ Why would enterprises listed elsewhere want to have a secondary listing in Hong Kong? One of the attractions is the current and future buying power of Mainland investors and potentially of other East Asian and Belt and Road investors as well. (The geographical and time-zone proximity also makes a difference.)
- ◆ Another is the expectation that institutional investors from developed economies also prefer to be able to buy and sell East Asian blue-chip securities in one place and one currency, without any red tape. Thus, a secondary listing in Hong Kong for an enterprise listed elsewhere will increase the potential demand and liquidity for both its equity and its debt securities.

The Belt and Road Initiative: The Development of a Belt-and-Road-Wide Stock Market

- ◆ International institutional investors will also be attracted to Hong Kong by newly listed Chinese enterprises, especially the private ones.
- ◆ Hong Kong is an ideal location for the establishment of an East Asian region-wide and eventually Belt-and-Road-wide stock market because of its location and time zone, its efficiency, its free mobility of capital, rule of law, stable currency (fixed peg to the U.S. Dollar), and no tax on dividends and capital gains.
- ◆ Once such an international securities market gets going, it should start a virtuous cycle of more trading volume leading to more listing, and more listing in turn leading to more trading volume, thus feeding on each other.
- ◆ Hong Kong should allow differential voting rights.

The Belt and Road Initiative: The Development of a Belt-and-Road-Wide Stock Market

- ◆ The B&R initiative is especially important now because the growth of both world GDP and world trade has stalled since the 2008 global financial crisis due to insufficient aggregate demand. B&R, by creating new demands and new supplies, can propel the world economy forward. And economic development will in turn foster peace, security and harmony among the B&R nations.
- ◆ In order for Hong Kong to succeed in becoming the leading international financial center for the Belt and Road countries, including East Asia, a pro-active Government of the HKSAR is needed to plan a long-term strategy and to rally everyone in Hong Kong, including its major enterprises, to work together to make it happen. (Already an Infrastructure Financing Facilitation Office (IFFO) has been established within the Hong Kong Monetary Authority (the central bank of Hong Kong).)
- ◆ It will also need the support of the Central Government.
- ◆ Once Hong Kong is established as the home of the Belt and Road region-wide equity and debt securities market, it will be almost impossible for it to be displaced or replaced.

Hong Kong as a Derivatives and Financial Technology (Fintech) Hub

- ◆ Derivatives trading can be profitable although they can also play havoc with the financial markets if not properly regulated and supervised. But it is best that the trading is done in as transparent a way as possible.
- ◆ “Fintech” is also important, but again it is a two-edged sword. My own personal view is that whatever is done, the degree of leverage must be controlled so as to limit the potential of moral hazard.

Hong Kong as a Corporate Treasury, Int'l Asset Management and Headquarters Centre

- ◆ Once an active and thriving international capital market in both stocks and bonds is successfully established in Hong Kong, it will greatly enhance the attractiveness of the Hong Kong market to not only bond and stock issuers and investors worldwide but also to asset managers and treasury operations of major multinational financial and non-financial corporations.
- ◆ As of year-end 2016, total assets under management in Hong Kong reached US\$2.4 trillion, higher than that of Singapore. Assets under management worldwide, excluding foreign exchange reserves and sovereign wealth funds, may be estimated at approximately US\$150 trillion.
- ◆ Hong Kong is the second largest private equity hub in Asia, with approximately US\$120 billion of assets under management, or 7.5% of the global total. Hedge funds based in Hong Kong total approximately US\$100 billion, or 3.5% of the global total. There is therefore still a great deal of room for growth, especially relative to the geographical distribution of wealth in the world.

Hong Kong as a Corporate Treasury, Int'l Asset Management and Headquarters Centre

- ◆ Global and regional financial institutions such as banks, insurance companies and asset management companies will be even more likely to establish their global and regional headquarters in Hong Kong, thus further strengthening Hong Kong's position as Asia's leading international financial center.
- ◆ The Asian Infrastructural Investment Bank (AIIB) and the New Development Bank BRICS should be encouraged to establish branch operations in Hong Kong (just like the China Development Bank) to facilitate raising capital for themselves as well as financing activities for their Mainland and foreign borrowers. The financing can be denominated in Renminbi, U.S. Dollars or the Euro, or a combination of all these currencies.

Hong Kong as an International Re-Insurance Market

- ◆ As the demands for casualty, property and life insurance have been increasing by leaps and bounds in the East Asian region, including the Mainland, so do the derivative demands for re-insurance—all insurance companies need re-insurance so as to diversify and share their risks. Similarly, the demands for insurance will also grow in the other Belt and Road countries.
- ◆ In addition to helping with infrastructural project financing, Hong Kong can also provide various types of insurance as well as re-insurance for the infrastructural projects. It is the ideal place to do so because of the unrestricted capital movement, stable currency, and efficient and fair judicial system.
- ◆ Re-insurance, like insurance, is a scale business, and the East Asian economies have now grown sufficiently large to realize the economies of scale of re-insurance based on their own demands alone.

Hong Kong as an International Re-Insurance Market

- ◆ In addition, the Mainland, the other East Asian and the oil-rich Middle Eastern economies, with their high saving rates, are potentially major sources of risk capital for the re-insurance business.
- ◆ Moreover, once sufficient scale and expertise are achieved, insurance companies worldwide will also want to re-insure with re-insurance companies in Hong Kong, so as to diversity and share the risks.
- ◆ An international re-insurance center can be developed right here in Hong Kong. What is needed is some concerted governmental action to establish one or more large re-insurance companies that are licensed to do business everywhere in East Asia and in Belt and Road countries. Ideally, such re-insurance companies should have multinational ownership.

Hong Kong as an International Re-Insurance Market

- ◆ There are four necessary requirements for an international re-insurance center:
- ◆ First, there must be an abundance of investors and capital willing and able to assume risks. The appetite for risks in East Asia is clearly demonstrated by the booming casino business in Macau and the A-share markets in Shanghai and Shenzhen.
- ◆ Second, there must be a stable currency and complete freedom of capital flows to and from everywhere, so that insurance premia can be received and claims can be paid expeditiously worldwide.
- ◆ Third, there must be political stability, a tradition of adherence to the rule of law, and a credible, efficient, fair and transparent judicial system that is ready to adjudicate and enforce insurance contracts and claims in a timely manner.
- ◆ Finally, there must be a large supply of highly seasoned professional expertise in accounting, actuarial sciences, law and risk assessment.
- ◆ Hong Kong is uniquely suited to become an international re-insurance center for the Asian region, including all the Belt and Road countries.

Hong Kong as an International Professional Services Centre

- ◆ Capital-raising for B&R projects will create significant new demand for accounting and legal services in Hong Kong. Because of its long tradition of rule of law, its efficient and fair judicial system, and its abundance of seasoned professional legal manpower, Hong Kong can also serve as a center for international legal, arbitration, dispute settlement and mediation services in relation to the “B&R” projects.
- ◆ Hong Kong can also provide the necessary accounting, legal and other professional services, such as mass transit management, and the infrastructural support for Mainland and foreign enterprises seeking to invest in the B&R countries.
- ◆ Hong Kong and Mainland enterprises can also collaborate on specific projects: for example, on an urban mass transit project, Mainland can supply the equipment and the construction, with possibly support from the Export-Import Bank of China, and Hong Kong can supply the project management and assemble the financing package.
- ◆ In addition, Hong Kong can also offer many project-related services, such as architectural, design, and engineering. In order to do so effectively, Hong Kong should encourage its citizens to acquire more knowledge and expertise on the culture and language of the different R&R countries.

The Guangdong-Hong Kong-Macau Greater Bay Area Initiative

- ◆ The Vision
- ◆ Opportunities and Challenges
- ◆ Sharing of Infrastructure Facilities
- ◆ Specialization, Division of Labor and Coordination

The Guangdong-Hong Kong-Macau Greater Bay Area (GBA)



The Greater Bay Area Initiative:

The Vision

- ◆ In 2016, the total population of the eleven cities within the GBA were 68 million, with a combined GDP of US\$ 1.39 trillion and an average GDP per capita of US\$ 20,412. The U.K., as of 2016 the world's fifth-largest economy, has a population of 65.1 million people, with a combined GDP of US\$ 2.63 trillion and an average GDP per capita of US\$ 40,399.
- ◆ Although these two regions share similar size of population, the GDP of the U.K. is almost twice that of the GBA.
- ◆ However, based on the current growth rate of the GBA, its economy will at least double in size after a decade. As the U.K. economy has slowed down, together with the impact of Brexit, it seems increasingly likely that the economy of the GBA will overtake that of the U.K. by 2027 to become the world's fifth-largest economy.
- ◆ The GBA has the potential to eventually become an enormous international metropolis, with an average GDP per capita exceeding US\$ 40,000, maintaining a strong position among the developing economies.

The Greater Bay Area Initiative: Opportunities and Challenges

- ◆ The cities within the GBA should move towards economic integration to make efficient use of their resources, giving full play to their potential and complementary economic structures and realizing the advantage of economies of scale with a view to creating a multilaterally beneficial outcome.
- ◆ In order to integrate the economic activities in the GBA, it is imperative to consider establishing a pilot free trade zone for trial implementation. A pilot GBA free trade zone should be established before expanding it to the entire Guangdong Province.
- ◆ Economic integration requires the free flow of four major elements in the GBA: (1) goods and services; (2) people; (3) capital; and (4) information.
- ◆ The role models for the GBA are the bay areas of San Francisco, New York and Tokyo, which all have the free flow of the four major elements within them. The GBA has to achieve the same, but it will not occur overnight. It will also require a long transition period (at least five to ten years) and it will be very promising if the GBA can achieve the free flow of the four major components during the transition period.

The Greater Bay Area Initiative: Sharing of Infrastructure Facilities

- ◆ The infrastructure facilities within the GBA should be shared among the GBA cities. Different GBA cities should coordinate among each other in their development plans, develop respective areas of expertise and promote the segregation of duties to avoid duplication of construction, mismatch and waste of resources so as to achieve a multilaterally beneficial outcome.
- ◆ For example, the GBA can follow the examples of New York and New Jersey to establish a GBA (or HK/Shenzhen) Airport Authority to manage all the civil airports in the area. As a first step, the Hong Kong International Airport should cooperate with the Shenzhen Baoan International Airport, with the linkage of the express rail link, to arrange flights between Hong Kong/Shenzhen and mainland cities to take off and land in the Shenzhen Baoan International Airport, whilst international flights in Hong Kong/Shenzhen to take off and land in the Hong Kong International Airport, to facilitate the “segregation of work and sharing of income”. Air China can enjoy Hong Kong’s air traffic rights, while Cathay Pacific can enjoy Shenzhen’s air traffic rights. Hong Kong and Shenzhen can jointly share the revenues from the two airports.
- ◆ Guangdong, Hong Kong and Macau may also consider coordinating with the military department and establish a GBA air traffic control area to manage the civil aviation activities in the region, and open up the GBA cross-border civil helicopter business to strengthen ties between the GBA cities.

The GBA Initiative: Specialization, Division of Labor and Coordination

- ◆ Cities within the GBA should coordinate their efforts according to their respective areas of expertise to promote the division of labor. For example, after the opening of the Hong Kong-Zhuhai-Macau Bridge, the Macau Airport can be used exclusively for serving private and business aircrafts in the GBA, so that the landing and taking-off of private aircrafts will be shifted from Hong Kong International Airport to Macau Airport. Zhuhai International Airport can be developed into a transnational air cargo express delivery hub within the Eastern Asian region (similar to the FedEx America Centre in Memphis, Tennessee, U.S.) for serving Northeast and Southeast Asia.

Implications for Hong Kong: What Hong Kong Should Do

- ◆ (1) Make Hong Kong into a comprehensive, full-service international financial center;
- ◆ (2) Together with Shenzhen, build Hong Kong into an all-encompassing international hub for innovation;
- ◆ (3) Develop the cultural and creative arts industry; and
- ◆ (4) Grasp the opportunities presented by the “Belt and Road” and the “Guangdong-Hong Kong-Macau Greater Bay Area” initiatives.
- ◆ This should usher in a third spring for the Hong Kong economy.
- ◆ Every effort should be made for the financial sector to support the real economy and create employment.

Make Hong Kong into a Comprehensive, Full-Service International Financial Center

- ◆ In addition to the Mainland, Hong Kong must also grasp opportunities to provide financial services to East Asian and Belt and Road countries.
- ◆ In addition to an equity market, Hong Kong must have a broad-based and active long- and short-term debt market, with the ability to trade in Hong Kong Dollar, U.S. Dollar and the Renminbi.
- ◆ Hong Kong needs to provide a one-stop financial service.
- ◆ Hong Kong should become a hub attracting fund-raisers, investors and asset managers worldwide.
- ◆ Hong Kong is ideally placed to provide related professional services.

Build Hong Kong-Shenzhen into an All-Encompassing Int'l Hub for Innovation

- ◆ Hong Kong and Shenzhen can join forces in building the GBA into a global innovation, venture investment and financing hub, combining the Silicon Valley, Route 128, NYSE and NASDAQ exchanges into one, serving not just Hong Kong and the Mainland but also the entire Belt and Road region.
- ◆ Hong Kong and Shenzhen should each specialize based on their respective comparative advantages: Universities in Hong Kong may focus on fundamental research, while Shenzhen, and in particular Shenzhen enterprises, may focus on application and development research, pilot manufacturing and commercialization.
- ◆ Hong Kong can be developed into a hub of venture capital, while Shenzhen a hub of start-up businesses to attract inventors, entrepreneurs and venture investors. The Hong Kong and Shenzhen Stock Exchanges together can fulfil the function of the NASDAQ exchange in the U.S. capital market for new enterprises in the GBA seeking an initial public offering (IPO). Successful enterprises can obtain a listing to raise funds or issue corporate bonds in HKEx at a later stage.

Build Hong Kong-Shenzhen into an All-Encompassing Int'l Hub for Innovation

- ◆ Hong Kong-Shenzhen can specialize in the creation of intangible capital (human capital, R&D capital, goodwill, intellectual property and knowledge capital) and the capitalization of its commercial value through “Initial Public Offerings (IPOs)” and “Mergers and Acquisitions (M&As)” for the entire region.
- ◆ This requires a four-pronged approach: 1.increasing investment in human capital, specifically, in tertiary and research-based postgraduate education; 2.increasing investment in research and development (R&D); 3.creating a nurturing eco-system for venture capital; and 4.facilitating the IPO and M&A markets for successful start-up firms so that they can raise the additional capital needed and their initial investors can exit. The objective is to make Hong Kong/Shenzhen an international innovation hub, attracting inventors, entrepreneurs, venture capitalists and investment bankers to congregate to raise capital as well as to invest.
- ◆ With the support of the central government, Hong Kong and Shenzhen can also cooperate with each other to develop Shenzhen’s Qianhai district into a reinsurance hub for Asia.

Build HK-SZ into an Int'l Hub for Innovation—Increasing Intangible Investment

- ◆ Intangible capital include human capital, R&D capital, brand names, trademarks, copyrights, patents, other intellectual property and knowledge capital.
- ◆ However, Hong Kong lags significantly behind New York and London in terms of human capital. It also lags behind other developed and developing economies. In 2010, the average number of years of schooling of the working-age population in Hong Kong was 10.7 years, behind those of the other East Asian NIEs of South Korea, Taiwan and Singapore, and still substantially below those of the U.S. and Japan. Hong Kong should increase its tertiary education enrollment rate. IN 2014-15, Hong Kong's enrollment rate was 32%, far below that of South Korea (over 90%) and Taiwan (over 100%). The Mainland's enrollment rate was over 30%.

Build HK-SZ into an Int'l Hub for Innovation—Increasing Intangible Investment

- ◆ To augment its human capital, Hong Kong must try to increase its own tertiary education (bachelor-degree) enrolment rate substantially from its current 32 percent (2014-15 figure) . By comparison, the corresponding tertiary education enrolment rates are over 30 percent on the Mainland, over 90 percent in South Korea, and over 100 percent in Taiwan.
- ◆ In Hong Kong, many graduates of secondary schools are actually enrolled in two-year sub-degree programs, including associate-degree programs. These associate-degree programs are similar to those offered by junior colleges or community colleges in the U.S. and essentially cover the first two years of a conventional bachelor-degree curriculum. They are socially desirable because they provide students who for one reason or another have not done well in secondary schools a second chance.
- ◆ However, as implemented in Hong Kong, they have two basic problems. First, they are too expensive (in the U.S., such programs are virtually free). Second, the graduates from the associate-degree programs do not have a ready career or education advancement path in Hong Kong.

Build HK-SZ into an Int'l Hub for Innovation—Increasing Intangible Investment

- ◆ The Government of the HKSAR should subsidize the tuition fees of Hong Kong citizens or permanent residents enrolled in qualified associate-degree programs in the same way that public primary and secondary education are subsidized. The publicly funded universities in Hong Kong should allocate more places for entry in the third year by applicants with associate degrees.
- ◆ However, this alone is not likely to be sufficient to accommodate all of the annual associate-degree graduates. As there are more than two thousand tertiary educational institutions on the Mainland, the Government of the Hong Kong SAR can negotiate with the Ministry of Education of the Central Government to allow selected universities on the Mainland to each allocate 50 or 100 student places annually to be open to application by associate-degree holders from Hong Kong for admission to the third year. The Government of HKSAR can also provide a tuition grant to any such Hong Kong citizen or permanent resident admitted.
- ◆ An important necessary government commitment is that the graduates from these Mainland universities under this articulation program will be eligible to apply for government civil-service or government-funded public-service positions after receiving their bachelor degrees and returning to Hong Kong.

Build HK-SZ into an Int'l Hub for Innovation—Increasing Intangible Investment

- ◆ Hong Kong's R&D expenditure is only 0.73% of its GDP, the lowest of the four newly industrialised East Asian economies, and far below those of Beijing and Shenzhen.
- ◆ In 2015, South Korea, Taiwan and the Mainland were respectively granted 17,924, 11,690 and 8,166 patents in the U.S. By comparison, Hong Kong was granted only 601 patents.
- ◆ There is a strong positive correlation between the number of patents granted and the cumulative R&D capital.

Build HK-SZ into an Int'l Hub for Innovation—Increasing Intangible Investment

- ◆ Investment in R&D capital is also important for promoting innovation (technical progress) in an economy. Hong Kong's R&D expenditure as a percent of GDP has been persistently and pitifully low. It invested only 0.76% of its GDP in R&D in 2015. By comparison, the R&D Expenditure-GDP ratio was around 2% for Singapore, 3% for Taiwan and over 4% for South Korea. Hong Kong's ratio is also significantly below the historical averages of 2.5% for the U.S. and 3% for Japan, and the 4% of Hong Kong's closest neighbor, Shenzhen, and 6% of Beijing and also below the world average of 2.13% (2013 figure).
- ◆ We recommend that the Government of HKSAR should set a long-term target for overall expenditure on R&D at 4% of GDP over the next decade or two, comparable to the current ratios of Israel, South Korea and Shenzhen and that of government-funded R&D to 1.6% of GDP from its current 0.4%. It is only through continuous innovation that Hong Kong can create more higher-paying jobs and thus increase both the level and the rate of growth of real disposable income per capita in Hong Kong in a sustainable manner.

Build HK-SZ into an Int'l Hub for Innovation—Increasing Intangible Investment

- ◆ However, this also means that the non-Hong Kong Government-funded R&D expenditure should increase from 0.33% of GDP to 2.4% of GDP over the next couple of decades. It is essential for the Government to encourage the private sector to increase its investment in R&D by providing the enabling conditions, environment and incentives for the private sector to support R&D.
- ◆ It can do so via its land, tax and intellectual property registration and protection policies. In particular, Hong Kong should consider allowing corporations to deduct twice their current R&D expenditure against their revenues for profits tax purposes.
- ◆ The government can strengthen the protection of intellectual property such as patents, copyrights, trademarks, trade secrets and know-how.
- ◆ The government can also try to provide the incentives for domestic and foreign private equity and venture capital firms to locate their global or regional headquarters in Hong Kong and to invest in Hong Kong-based start-up enterprises. It can also facilitate the listing of successful invested enterprises on the Hong Kong stock exchanges or other means of exit for the venture investors.

Build HK-SZ into an Int'l Hub for Innovation—Increasing Intangible Investment

- ◆ A useful comparative indicator of the national potential for innovation (national innovative capacity) is the number of patents granted each year. In the following Chart, the annual number of patents granted in the United States each year to the nationals of different countries, including the U.S. itself, over time is presented. It shows that the U.S. has been the undisputed champion over the past forty years, with 140,969 patents awarded in 2015, followed by Japan, with 52,409. (Since these are patents granted in the U.S., the U.S. may have a home advantage; however, for all the other countries and regions, the comparison across them should be valid and fair.)
- ◆ Hong Kong ranked the lowest among the four East Asian NIEs with 601 patents in 2015. (In terms of the number of domestic patents, Hong Kong is even lower.)
- ◆ There is a positive relationship between the number of patents granted to each economy and its stock of R&D capital (defined as cumulative real expenditure on R&D less an annual depreciation of 10%)—the higher the capital stock, the higher the total number of patents.
- ◆ Human capital, R&D capital and venture capital are complementary to one another.

Develop the Cultural and Creative Arts Industry

- ◆ The cultural and creative arts industry has been growing reasonably rapidly in recent years.
- ◆ Hong Kong can become a center like Hollywood, New York and Bollywood, where professionals serving the cultural and creative arts industry, such as movie directors and producers, actors and actresses, script writers, movie editors, special effects professionals, cinematographers, can congregate and develop screenplays, movies and television shows. The production or shooting does not have to be done in Hong Kong, but it will generate significant income and employment as Hong Kong becomes the principal hub for the creation of these products for the mass market.
- ◆ The cinematic and video (not limited to television) audience has been growing by leaps and bounds in China and the cinema box receipts will soon surpass that of the U.S. to become number one in the world.
- ◆ Many such professionals are already resident in Hong Kong which will facilitate Hong Kong becoming the place where deals are made.

Grasp the Opportunities Presented by the “B&R” and the “Greater Bay Area” Initiatives

- ◆ The financing of the Belt and Road and Guangdong-Hong Kong-Macau Greater Bay Area projects can help create an ample supply of different types of sovereign and quasi-sovereign as well as non-sovereign bonds for the Hong Kong bond market.
- ◆ Belt and Road countries can provide the venture capital as well as the new markets for innovative products, supporting Hong Kong’s development into an international innovation hub.
- ◆ Hong Kong has signed double-tax agreements (DTAs) with 20 of the 72 Belt and Road countries. Hong Kong should seek to conclude DTAs with the remaining Belt and Road countries as soon as possible.
- ◆ Hong Kong should also facilitate the exchange of academic and research personnel between Hong Kong and B&R countries by adopting reciprocal taxation waiver for them.

Servicing Other East Asian Economies

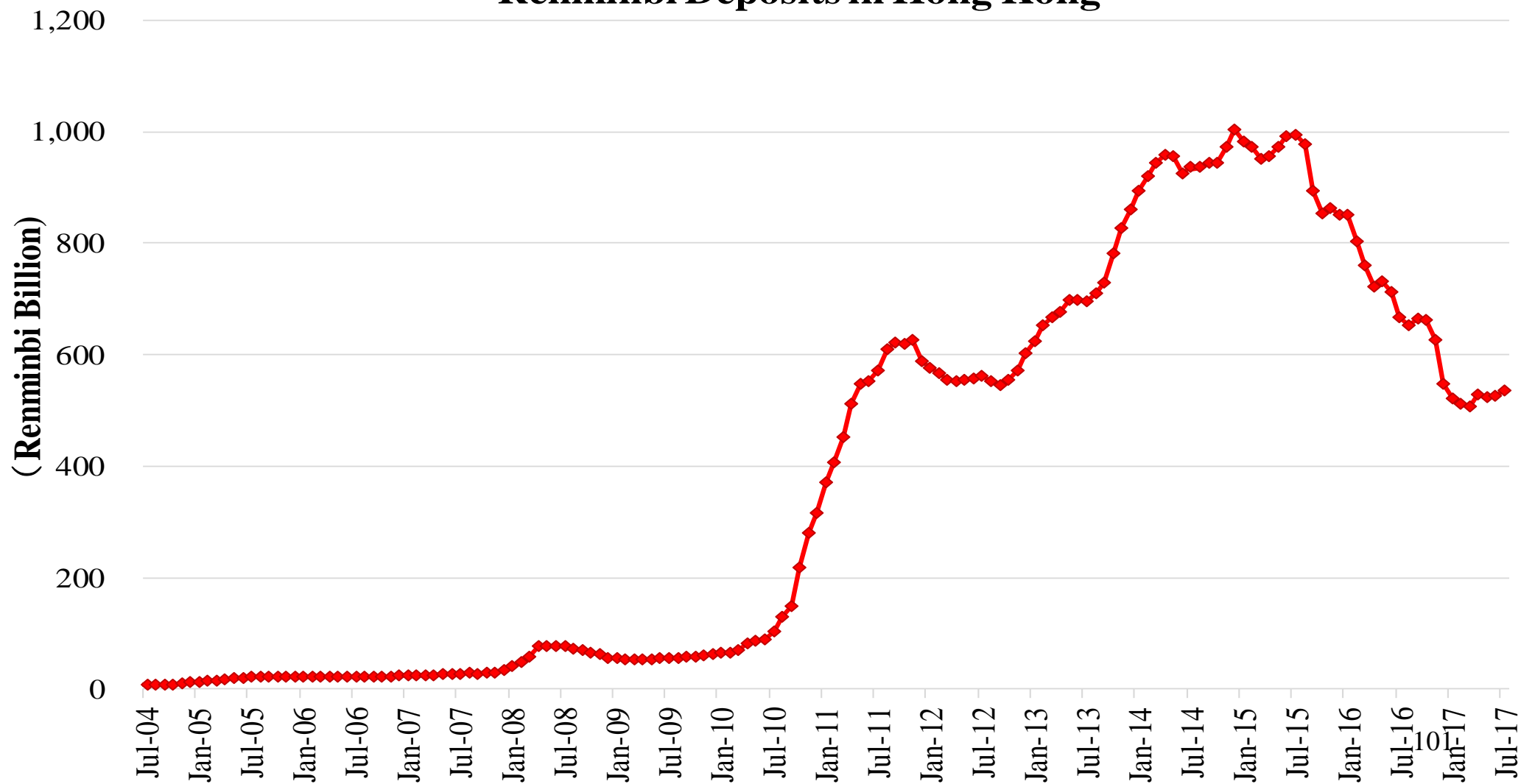
- ◆ The Renminbi is regularly used in the settlement of Chinese international trade. Currently, approximately 17% of Chinese international trade is settled in Renminbi.
- ◆ If the experience of Japan is any guide, this percentage should eventually increase to 50%, or even more.
- ◆ What this means is that the Chinese demand for foreign exchange reserves for international transactions purposes will greatly diminish. The People's Bank of China will need to redeploy its excessive foreign exchange reserves.
- ◆ Almost all East Asian economies have trade surpluses with China and thus have ready access to Renminbi if they need it. They can certainly use their excess Renminbi for settlement and clearing purposes.

Servicing Other East Asian Economies

- ◆ In the longer run, it is desirable that all economies should be able to not only settle and clear their current transactions in their own local currencies but also issue debt in their own respective local currencies. Again, an international platform may be necessary, with partial guarantees or undertakings by the major economies under appropriate conditions, e.g., by offering for sale non-transferrable credit default swaps on these bonds to bond purchasers (and only bond purchasers).
- ◆ The advantage for an economy being able to borrow in its own currency is that it is no longer subject to the difficulties of a currency mis-match as it is able to service and repay its debt in its own currency.
- ◆ However, in order to protect the purchaser of these bonds, the bonds should be indexed to the local inflation rate, so that whatever happens to the exchange rate, the purchaser will always have a real rate of return.
- ◆ These bonds should also be available in the borrowing economy so that there is local supervision and pressure by the local citizens against an intentional default on the part of the government.

Renminbi Deposits in Hong Kong

Renminbi Deposits in Hong Kong



Hong Kong as the Premier Offshore Renminbi Centre

- ◆ One may ask: Would Hong Kong continue to be an important Renminbi center after the Yuan becomes completely freely convertible?
- ◆ We believe that, for tax and many other reasons, Hong Kong would continue to be important, perhaps even more important, even after the Renminbi becomes completely and freely convertible. One only has to look at the Euro Dollar market in London to realize that an offshore Renminbi market can continue to flourish and prosper even after all capital controls are lifted by the Mainland.

The Nineteenth National Congress of the Communist Party of China

- ◆ President XI Jinping is able to consolidate his control over the party, the government and the armed forces. He is the undisputed leader, with his political theory—his interpretation of Marxism—enshrined into the Constitution of the Communist Party of China (CPC) in the form of “Xi Jinping Thought on Socialism with Chinese Characteristics for a New Era” as the guiding ideology for the party. This puts President XI at the same level of reverence as the late MAO Zedong and DENG Xiaoping.
- ◆ The anti-corruption campaign launched after the Eighteenth Party Congress has succeeded in significantly reducing corruption. Altogether, 440 high-level cadres were disciplined, including 43 members and alternate members of the Central Committee of the CPC, 9 members of the Central Commission for Discipline Inspection, and approximately thirty percent of the officers of general rank in the armed forces.

The Nineteenth National Congress of the Communist Party of China

- ◆ Under the leadership of President XI, the Mainland economy successfully avoided a hard landing and was able to transition smoothly into a “new normal”, with a steady rate of growth of approximately 6.5 percent per annum, a still very respectable rate of growth compared to developed economies.
- ◆ China was also able to raise its external profile and participate in global governance without appearing either too aggressive or too accommodating. It managed to play a leading role at the 2015 United Nations Climate Change Conference in Paris and was instrumental in bringing about the Paris Agreement and remained steadfast in its commitment to fulfil and even over-fulfil its promised targets for the prevention of climate change. Mr. XI has also initiated the ambitious Belt and Road Projects, which is likely to have a huge and lasting impact in the economies of Asia, Europe and Africa.
- ◆ China also managed to maintain peace in its disputes in the East China Sea and the South China Sea.

The Nineteenth National Congress of the Communist Party of China

- ◆ President XI subscribes to the view that “the nation can be governed well only if the party is governed well; and the party can be governed well only with the strictest discipline.” After the Congress, it will be through the party that he will exercise his power to move the government and the nation.
- ◆ For example, it would be possible for him to push forward the economic reform and further opening-up programs such as letting the market play the determining role, resolving the problem with “zombie” enterprises and facilitating international trade and investment, both inbound and outbound.

The Nineteenth National Congress of the Communist Party of China

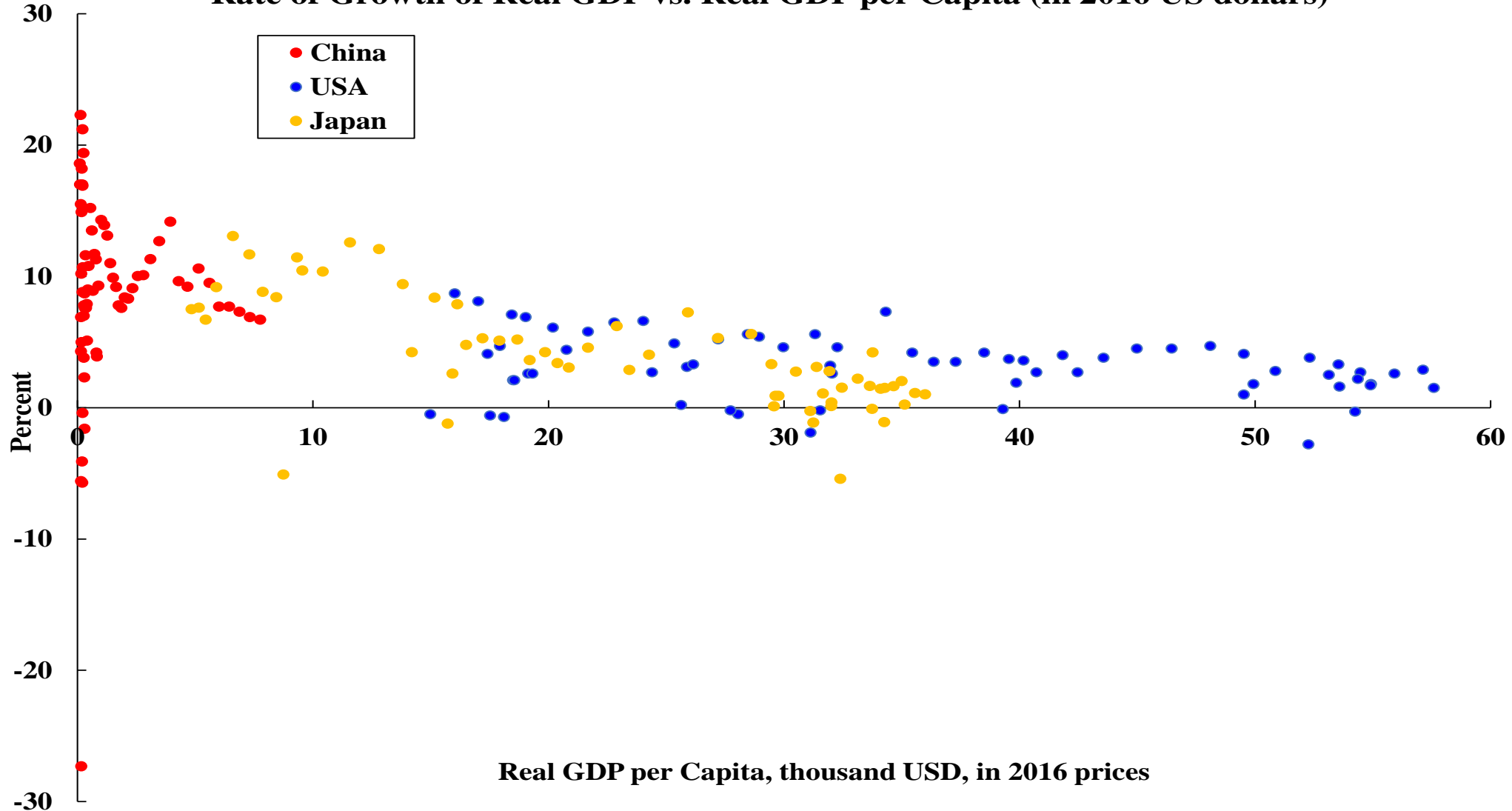
- ◆ President XI must have reflected on the question: How was it possible to have so much corruption within the Communist Party of China, the Government and the armed forces? In his work report to the Congress, President XI repeatedly emphasized the importance of Chinese culture and Chinese philosophy. This may reflect the realization that ultimately character and values, and not just talent, ability and popularity, are important determinants of actions and behavior of government officials. In order to make the Party a clean and effective governing body, it is important to try to motivate the members through ideology and to appeal to their idealism and patriotism, and not to rely solely on potential punishment as a deterrent.
- ◆ The expected establishment of a State Supervisory Commission, also mentioned in the work report, is a momentous decision with far-reaching consequences. It will actually be similar to the Independent Commission Against Corruption (ICAC) of Hong Kong established in the 1970s and hopefully will have a similarly large and positive impact.

Projections of the Mainland Economy

- ◆ President XI Jinping identified several milestones in his speech at the Nineteenth Congress of the Communist Party of China, at 2020, 2035 and 2050 respectively.
- ◆ Projections of Chinese and U.S. real GDP and real GDP per capita between now and 2050 have been made.
- ◆ It is assumed that the Chinese economy will continue to grow above 6% per annum for a few years, declining gradually to between 5% and 6%, and that the U.S. economy will grow at an average rate of 3% per annum.
- ◆ It may be thought that the Chinese economy will be unable to sustain an approximately 6% average annual rate of growth for such a long time. But given the still relatively low level of real GDP per capita in China, such a rate of growth should be possible. Please see the following charts.

中美日三国实际GDP增长率 (以2016年价格计算)与人均实际GDP水平的关系

Rate of Growth of Real GDP vs. Real GDP per Capita (in 2016 US dollars)

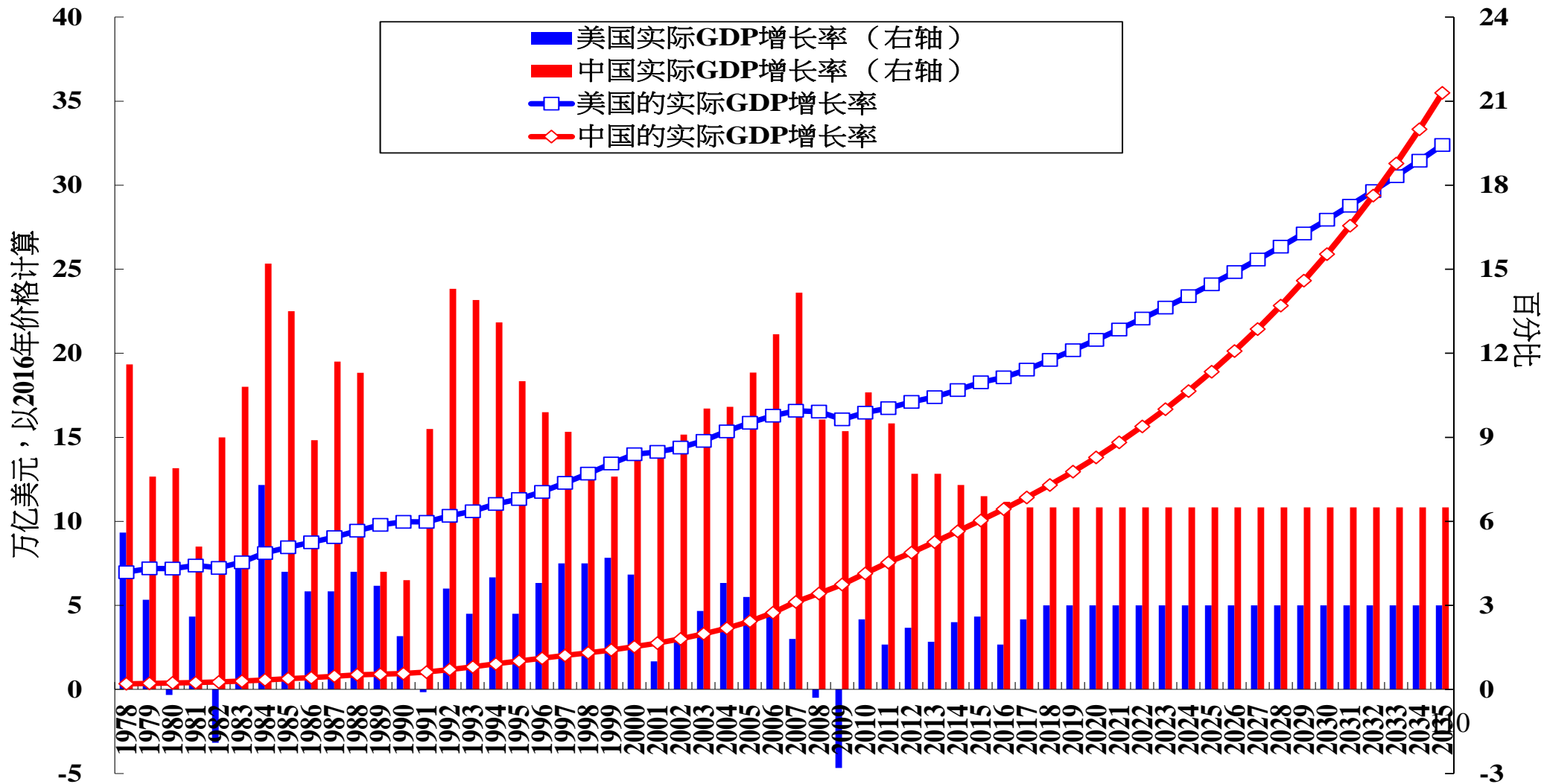


Projections of the Mainland Economy

- ◆ The first milestone is to become a moderately well-off society by 2020. Our projections show that by 2020, Chinese real GDP per capita (in 2016 prices) will exceed US\$9,800 (compared to US\$62,600 for the U.S.).
- ◆ The second milestone is to become a modernized nation by 2035. Our projections also show that by 2033, Chinese real GDP will surpass U.S. real GDP (US\$31.3 trillion versus US\$30.6 trillion), making China the largest economy in the world. However, in terms of real GDP per capita, China will still lag behind significantly, with US\$21,000 compared to US\$84,000 for the U.S.
- ◆ The third milestone is to become a strong and wealthy nation by 2050. Our projections show that by 2050, Chinese real GDP will reach US\$86 trillion compared to US\$50 trillion for the U.S. In terms of real GDP per capita, China will reach US\$54,000, approximately the current level of U.S. real GDP per capita, compared to US\$123,500 for the U.S.

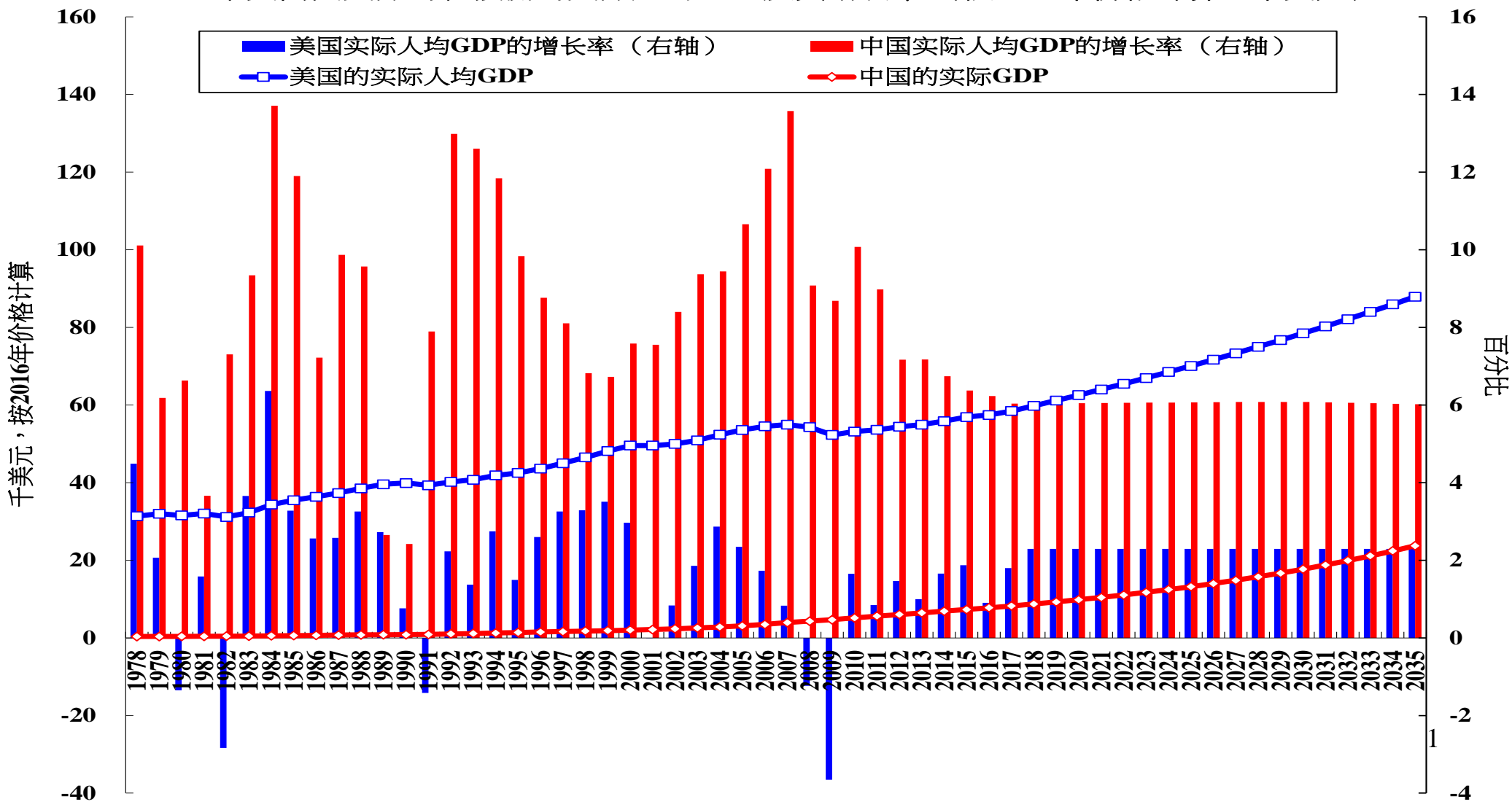
中美两国实际和预测GDP及其增长率 (万亿美元，以2016年价格计算)

中美两国实际和预测GDP及其增长率 (万亿美元，以2016年价格计算)



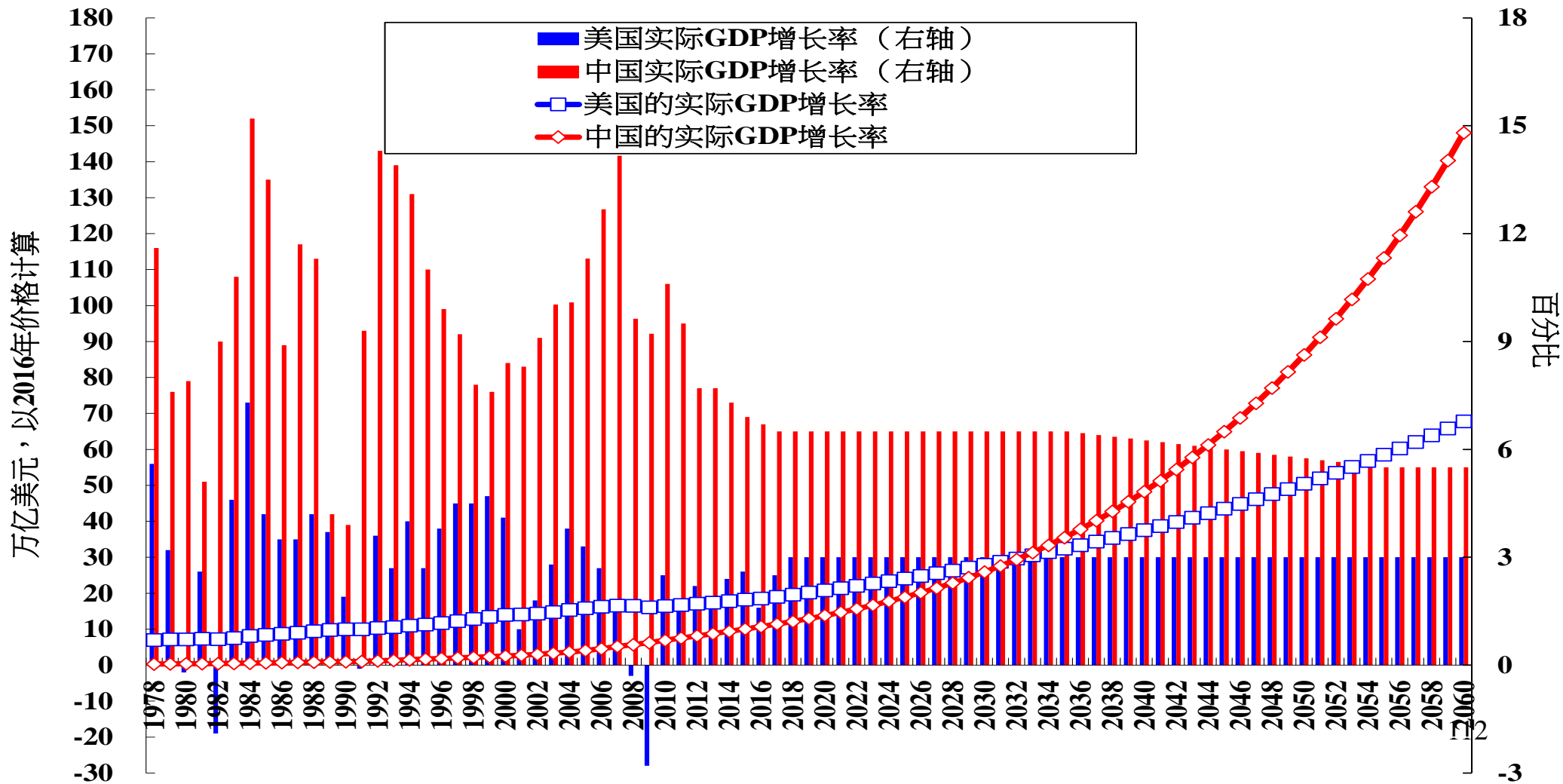
中美两国实际的和预测的实际人均GDP及其增长率（按2016年价格计算，千美元）

中美两国实际的和预测的实际人均GDP及其增长率（按2016年价格计算，千美元）

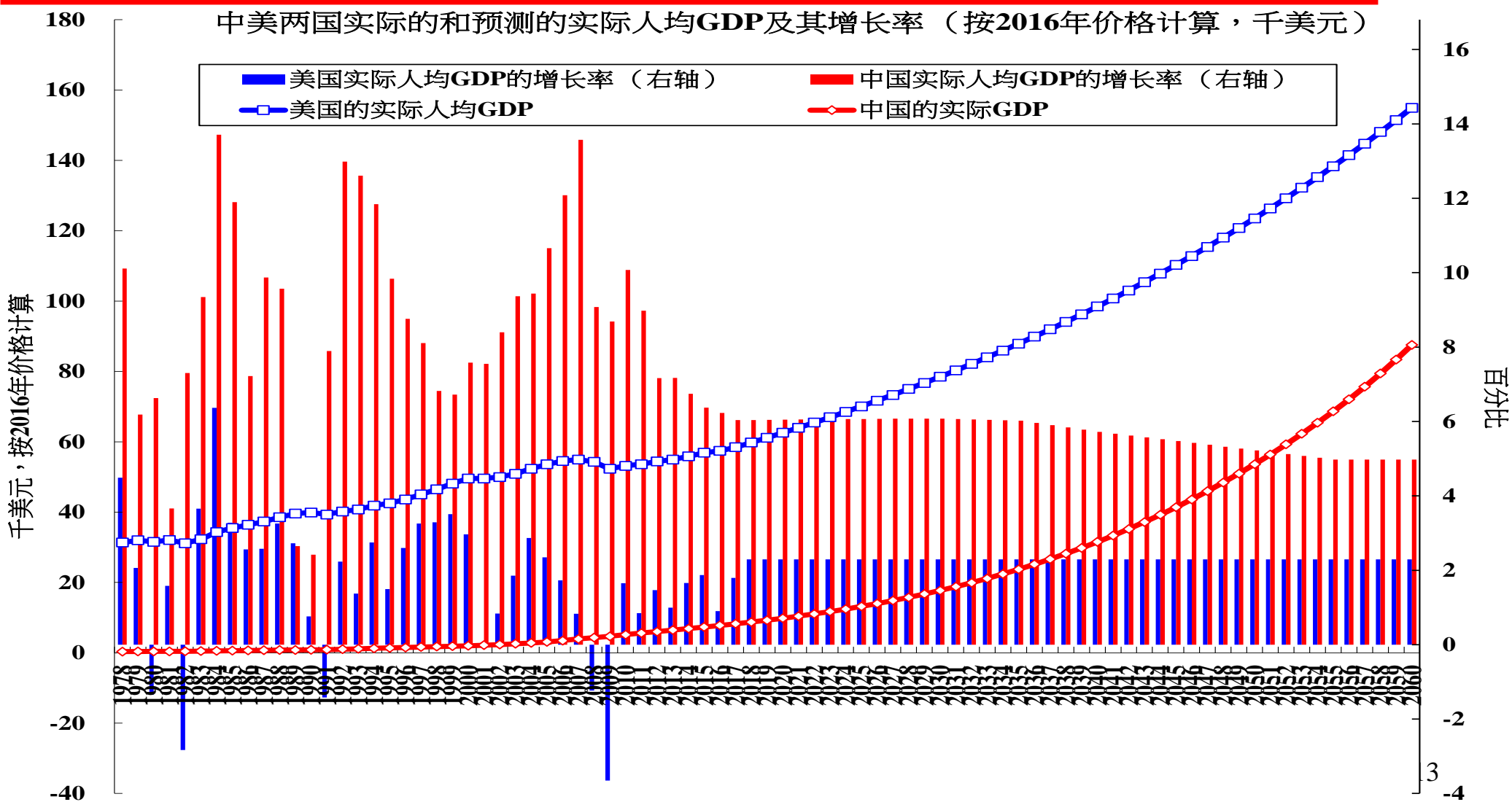


中美两国实际和预测GDP及其增长率 (万亿美元，以2016年价格计算)

中美两国实际和预测GDP及其增长率 (万亿美元，以2016年价格计算)



中美两国实际的和预测的实际人均GDP及其增长率 (按2016年价格计算, 千美元)



Concluding Remarks

- ◆ Hong Kong definitely has the potential to become the world's leading international financial centre and together with Shenzhen an international innovation hub. Once Hong Kong achieves these positions, it can use its first-mover advantage to remain in them indefinitely.
- ◆ In order to become a comprehensive, full-service international financial center, Hong Kong must work hard to develop an active and liquid bond market (including Islamic bonds), and an international equity market serving the entire Belt and Road region.
- ◆ However, to achieve these goals requires the HKSAR Government, the enterprises and the public to work together. Medium- to long-term strategies and pragmatic implementation plans must be put in place. Moreover, the HKSAR Government must also seek the help and support of the Central Government. The time for “laissez faire” or “positive non-interventionism” of the government is over.

Concluding Remarks

- ◆ The Belt and Road and Greater Bay Area Initiatives should bring great opportunities to the Hong Kong economy and to its financial sector in particular. It has the potential of ushering in a “third spring” for the Hong Kong economy.

Concluding Remarks

- ◆ Hong Kong definitely has the potential to become the world's leading international financial centre and an international innovation hub. Once Hong Kong achieves these positions, it can use its first-move advantage to remain in them indefinitely. However, to achieve these goals requires the HKSAR Government, the enterprises and the public to work together. Medium- to long-term strategies and pragmatic implementation plans must be put in place. Moreover, the HKSAR Government must also seek the help and support of the Central Government. The time for “laissez faire” or “positive non-interventionism” of the government is over.
- ◆ In order to become a comprehensive, full-service international financial centre, Hong Kong must work hard to develop an active and liquid bond market (including Islamic bonds), and an international equity market for the entire Belt and Road region. In order to become an international innovation hub, it must vigorously promote higher education, R&D and venture capital in Hong Kong and its surrounding areas.
- ◆ Hong Kong should take maximum advantage of the opportunities offered by the Belt and Road and Greater Bay Area initiatives.
- ◆ Hong Kong must increase its land supply in order to reduce the high cost of office space and housing.

Concluding Remarks

- ◆ Hong Kong should strive to develop a deep and liquid bond market for itself and for the Belt and Road countries. It can become the financing center for Belt and Road infrastructure projects.
- ◆ Hong Kong can also further develop into an international center for sukuk bonds (Islamic bonds) structured in such a way as to generate returns to investors without infringing Islamic law which prohibits pure interest payments as many Belt and Road countries are Islamic.
- ◆ The Government of the HKSAR is already actively promoting double-tax treaties with countries on the Belt and Road so as to facilitate investment by Hong Kong entities as well as subsidiaries of Chinese and multinational corporations established in Hong Kong to do Belt and Road related business in the countries concerned.
- ◆ It can develop into an international stock market for the Belt and Road countries.

Concluding Remarks

- ◆ It is necessary to promote the freer flow of goods and services between Guangdong and Hong Kong and between the Belt and Road countries and Hong Kong. There should be a pilot programme for a Guangdong-Hong Kong Pilot Free Trade Zone.
- ◆ It is also necessary to promote the freer flow of people—the simplification of entry/exit and customs formalities, the mutual selective recognition of academic degrees and professional qualifications.
- ◆ Finally, it is necessary to promote the financial cooperation between Guangdong and Belt and Road countries and Hong Kong and to facilitate the cross-border two-way flow of capital.

Concluding Remarks

- ◆ Hong Kong should capitalize on the opportunities provided by the “Belt and Road (B&R)” Initiative.
- ◆ Hong Kong can also further develop into an international center for sukuk bonds (Islamic bonds) structured in such a way as to generate returns to investors without infringing Islamic law which prohibits pure interest payments as many Belt and Road countries are Islamic.
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Concluding Remarks

- ◆ We have tried to suggest some feasible directions of significant potential in which the capital market of Hong Kong can aspire to develop. The goals may appear ambitious, but in our opinion, they are all achievable with sufficient commitment and resolve.
- ◆ It is essential to try to make Hong Kong more competitive once again. This means trying to do something to the high price of land, and the resulting high office space and housing costs.
- ◆ Hong Kong indeed has the potential of becoming the leading international financial center in the world. However, the development of Hong Kong as an international hub for flows of people, goods and services, and capital is a long-term undertaking and will require the long-term commitment of the Government of the HKSAR, its citizens, and its public and private institutions.

Concluding Remarks

- ◆ There is now an opportunity for Hong Kong—with the center of gravity of the world economy shifting from North America and Europe to East Asia, and within East Asia from Japan to China, the continual rapid economic growth of the Mainland, and the savings and wealth that it has generated for its enterprises and households.
- ◆ The unwillingness and inability of Tokyo to become more internationalized, the inability of Shanghai at the present time, and the recent Brexit by the U.K. all provide a unique opportunity for Hong Kong.
- ◆ Singapore has many of the same advantages that Hong Kong has, but it lacks one important thing—a large and supportive potential economic hinterland.

Concluding Remarks

- ◆ Hong Kong must do its part in devising implementable plans and strategies and in addition seek assistance and support from the Central Government on the basis that these initiatives are win-win for both Hong Kong and the Mainland. It is up to Hong Kong to make itself indispensable once again, as it was during the early days of the Chinese economic reform and opening to the world.