Directions for Enhancement of the Hong Kong Capital Market

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- Introduction
- Hong Kong as the Mainland’s Capital Market
- Hong Kong as the Belt and Road Capital Market
- Directions for Enhancement
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Introduction

- Historical Background
- Global Economic Trends
- The Comparative Advantages of Hong Kong
- The Vulnerabilities of Hong Kong
- The Economic Complementarities between Hong Kong and the Mainland

Introduction: Historical Background

- Before 1949, Hong Kong was largely an entrepot port, engaged mostly in commerce and trade, serving southern China. There was little industry. And the financial center of the region at the time was clearly Shanghai. Shanghai was much more internationalized and economically much more developed than Hong Kong at the time.
- The establishment of the People's Republic of China on the Mainland and its initial inward-oriented policies as well as the Korean War closed off the entrepot trade and forced Hong Kong to develop its light manufacturing industries in part on the basis of the influx of human capital and financial capital from the Mainland.

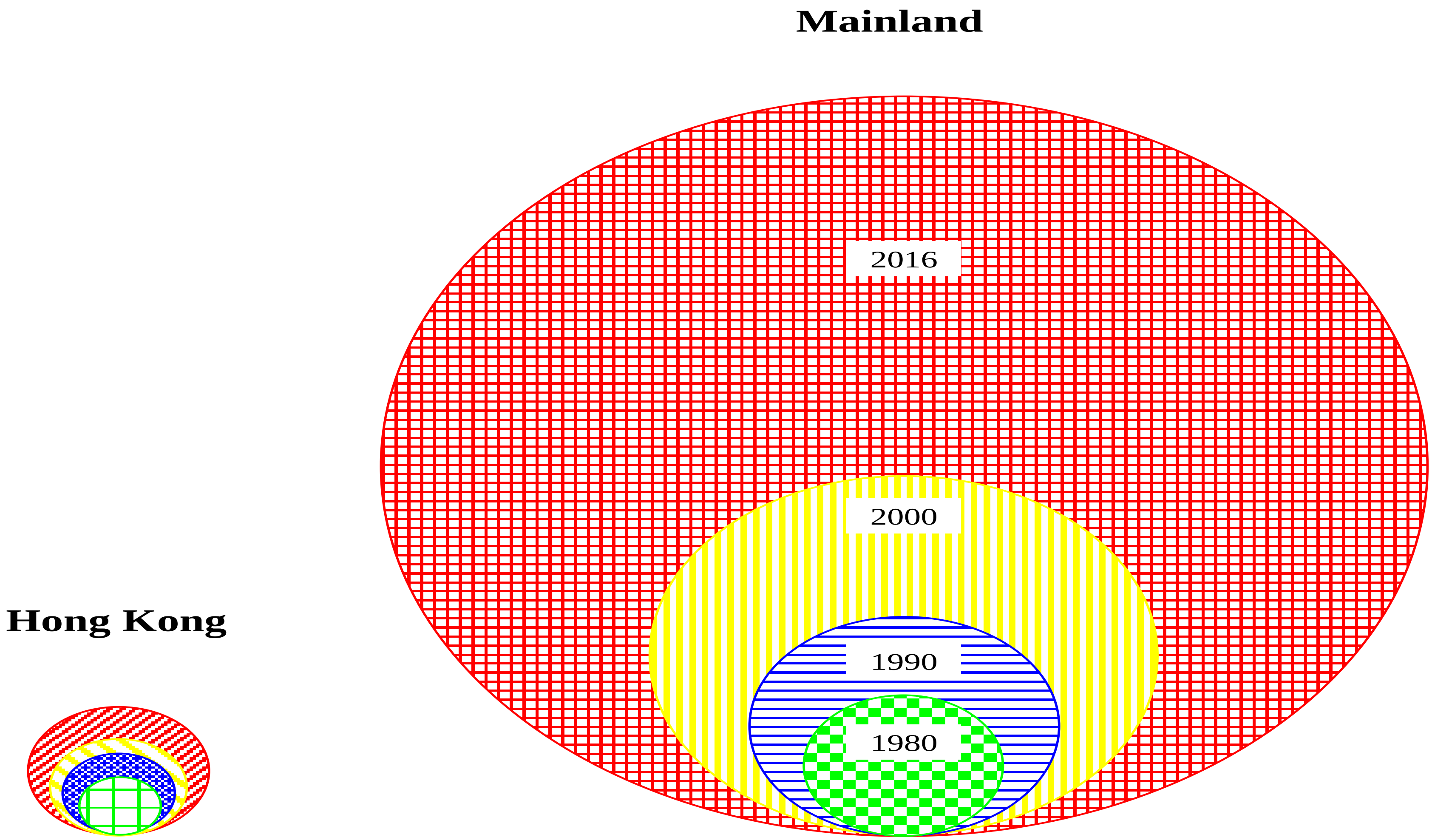
Historical Background: Hong Kong without the Mainland, 1949-1978

- Towards the late 1950s, light industry producing goods such as plastic flowers, textiles, toys and wigs began to develop in Hong Kong, followed by real estate development and re-development. One pioneer of the real estate industry was the late Mr. Henry Y. T. Fok, who introduced the condominium form of ownership of residential units into Hong Kong, thus greatly expanding the potential affordability of residential property ownership, especially owner-occupied housing, and hence the overall market. The result was a real estate boom that sustained the economic growth of Hong Kong for a couple of decades beginning in the mid- to late 1950s.
- In the mean time, the Great Leap Forward (1958) and the Great Proletarian Cultural Revolution (1966-1976) on the Mainland interrupted Chinese economic development and preoccupied the Chinese Government for almost two decades but provided Hong Kong an opportunity to develop and grow (with the exception of a couple of years around 1966-67 during which Hong Kong was also affected by disturbances related to the Cultural Revolution on the Mainland).

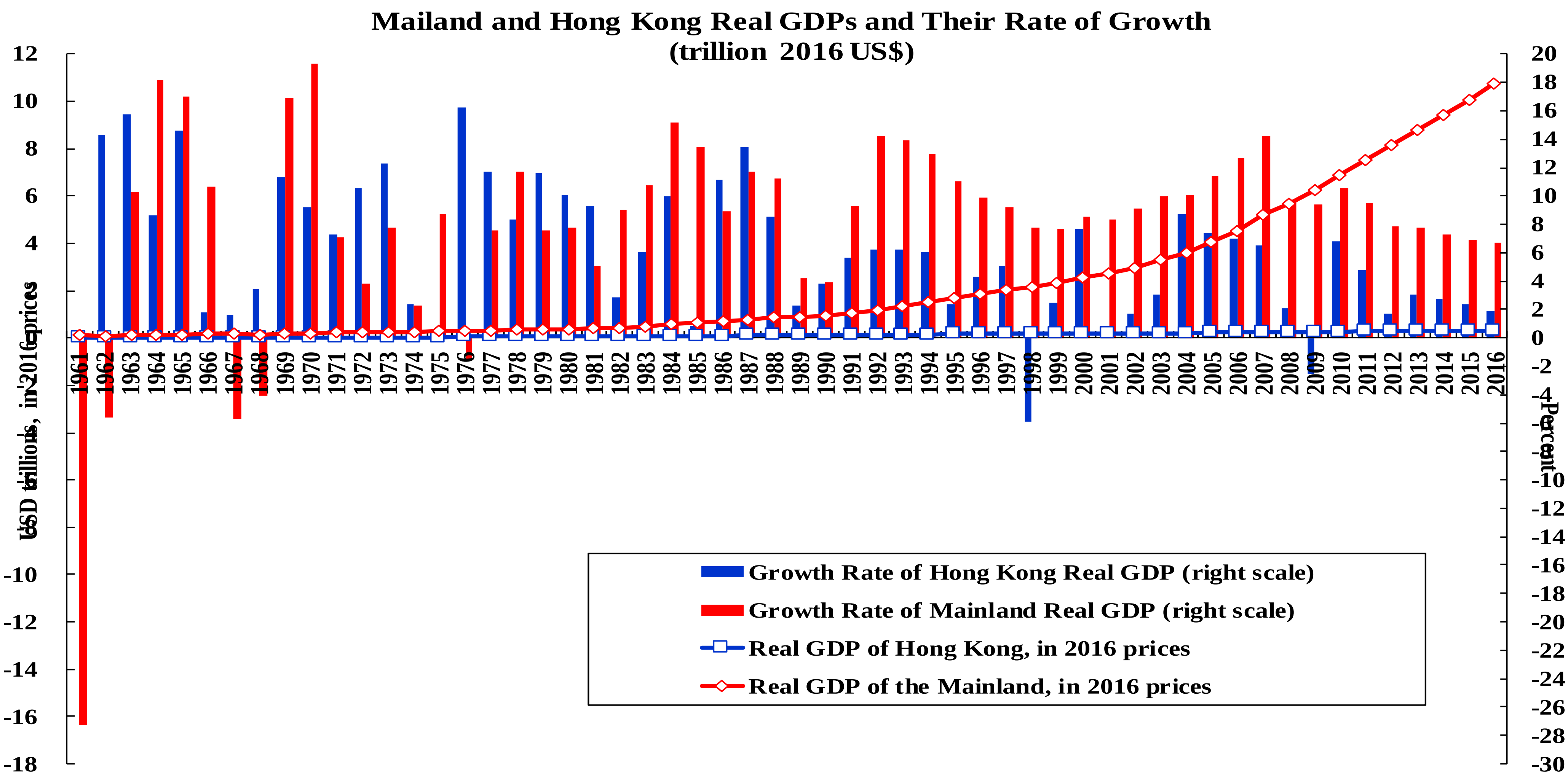
Introduction:
Historical Background

- 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 1980, the real GDP (2016 prices) of Hong Kong was one-sixth that of the Mainland (US$64.55 billion versus US$387.79 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 28 times that of the Mainland in 1980 and still 5.6 times in 2016 (US$43,788 versus US$7,758).
- Given the slowdown in the economies of the Mainland and the world, and in the growth of world trade, the economy of Hong Kong is now at a turning point.
- Hong Kong must embark on new directions in order to continue to grow and prosper. It must further diversify its economy to reduce the over-dependence on any one particular sector.

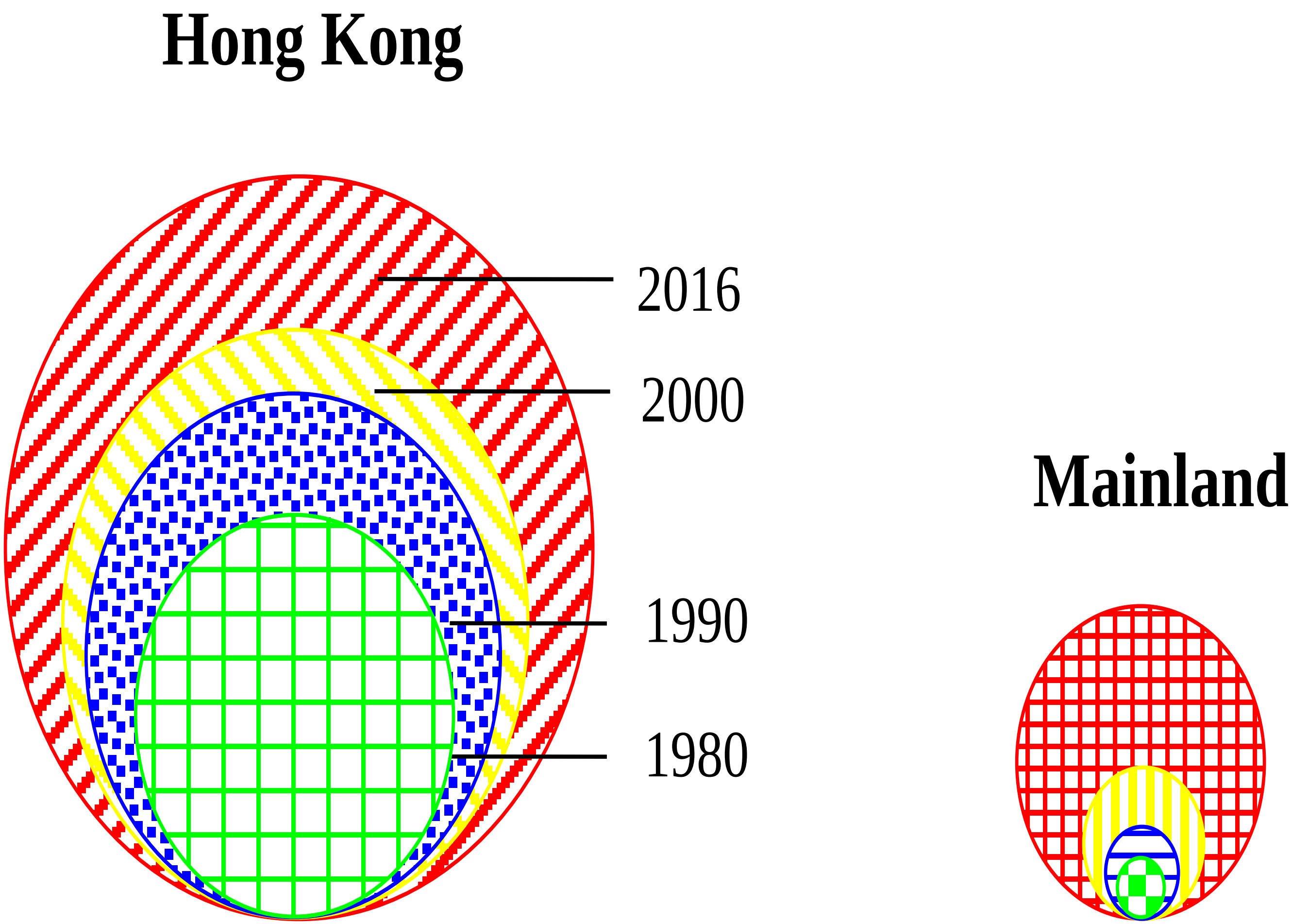
Comparison of the Real GDPs of Mainland and Hong Kong (2016 US$ Billions)



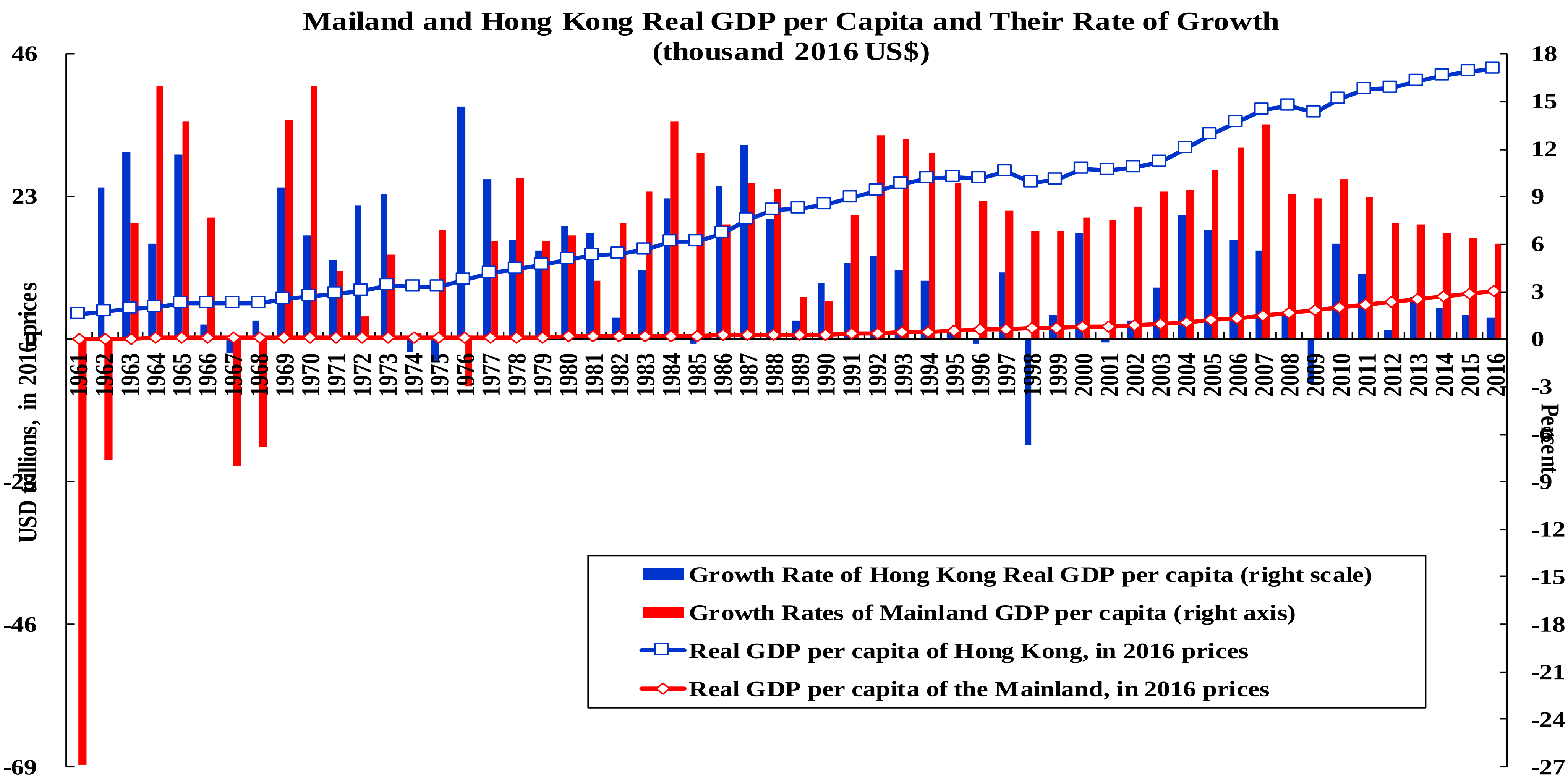
Mainland and Hong Kong Real GDPs and Their Rate of Growth (trillion 2016 US$)



Comparison of the Real GDP per Capita's of Mainland and Hong Kong (2016 US$)



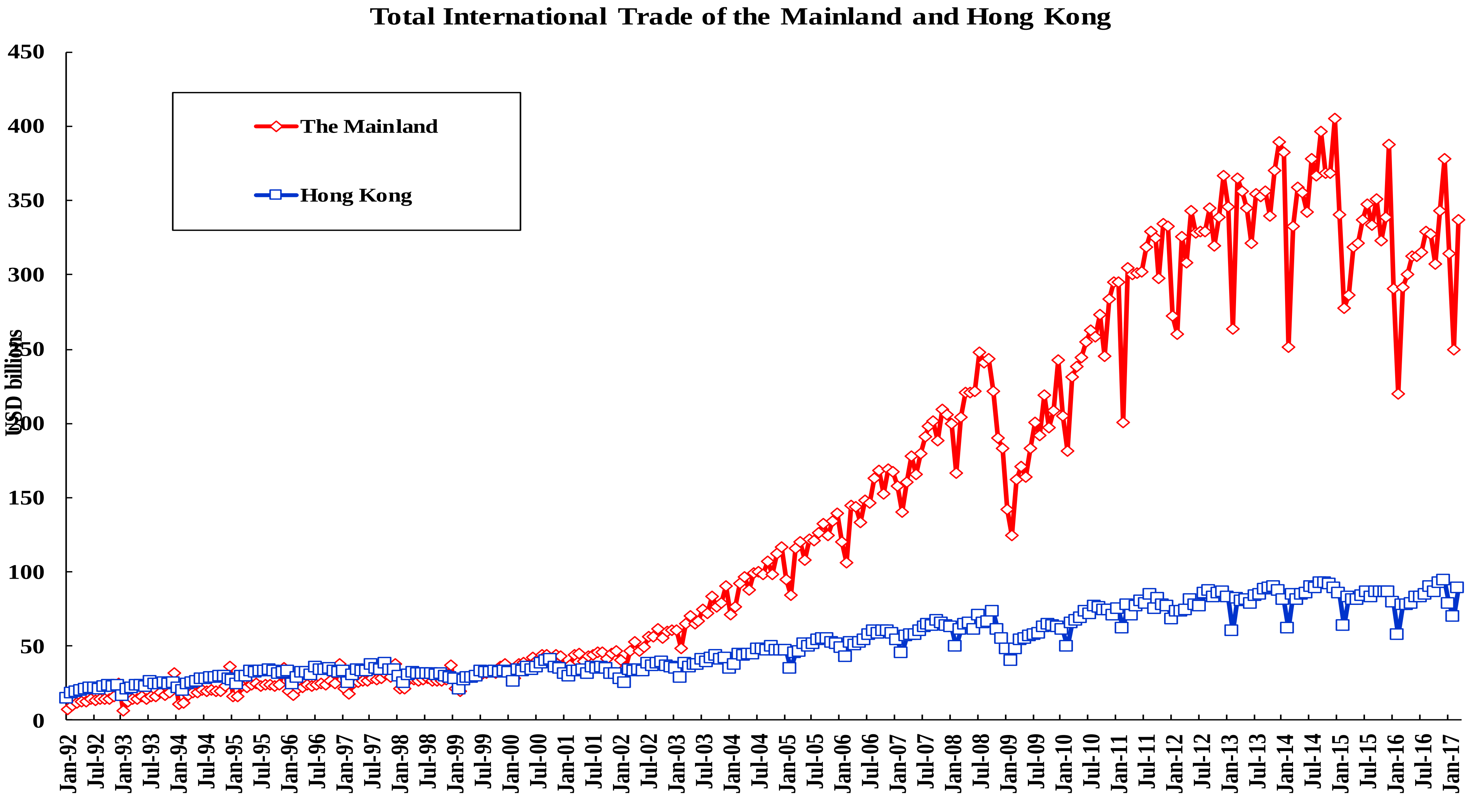
Mainland and Hong Kong Real GDPs per Cap. and Their Rates of Growth (trillion 2016 US$)



Comparison of the Economies of Hong Kong and the Mainland: International Trade

- In terms of international trade, the Mainland, which started out at a very low level in 1978, reached approximately the same level as Hong Kong in the early 1990s. This is because the bulk of the Mainland international trade at the time, whether exports or imports, was trans-shipped through Hong Kong. Hong Kong's domestic exports and imports, by comparison, were quite low.
- However, since the Mainland acceded to the World Trade Organisation (WTO) in 2001, direct Mainland international trade grew rapidly and total Mainland trade is now approximately four times as large as Hong Kong's.

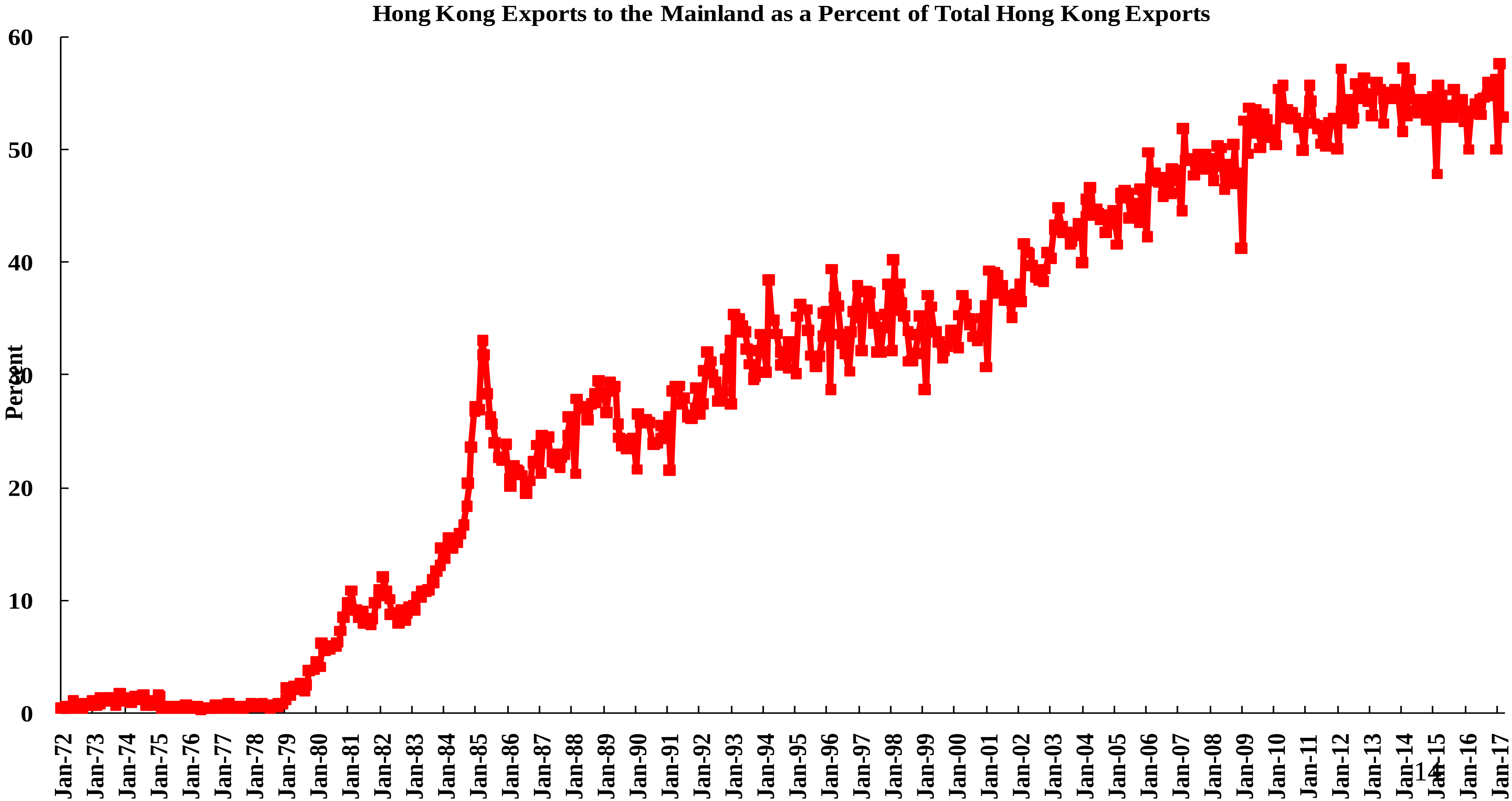
Comparison of the Monthly Total International Trade of the Mainland and Hong Kong



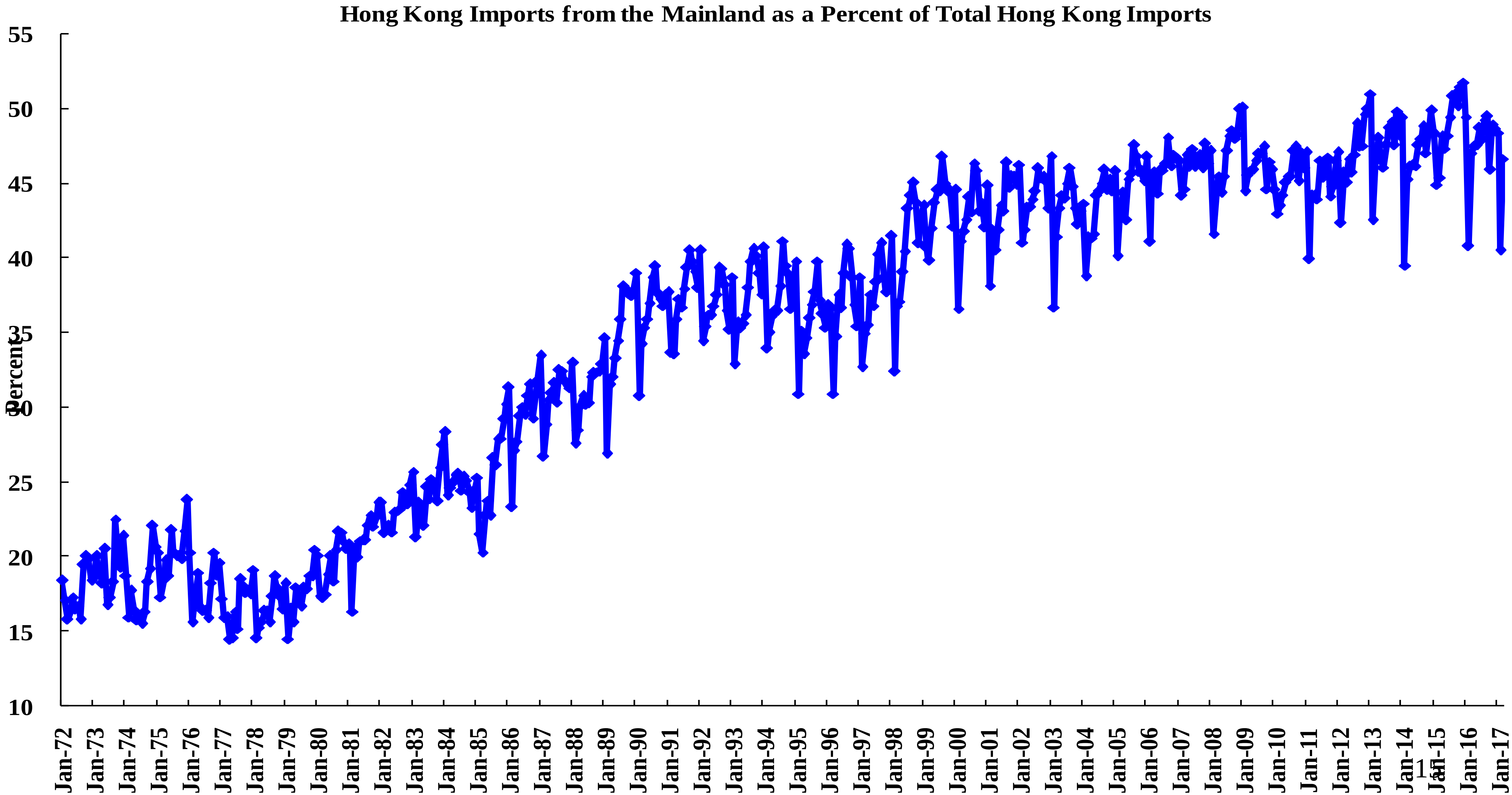
Mainland-Hong Kong Economic Interactions: International Trade

- The Mainland has become the most important trading partner of Hong Kong. It is the most important destination for Hong Kong exports as well as the most important source of Hong Kong imports, accounting for respectively 52.8% and 46.7% in 2017M3.
- Since the Global Economic Crisis in 2008, the Mainland has become even more important to the Hong Kong economy because of the economic problems in the United States and Europe.
- However, Hong Kong only ranks 22nd as the Mainland's trading partner, excluding re-exports to and from China.

Hong Kong Exports to the Mainland as a Percent of Total Hong Kong Exports



Hong Kong Imports from the Mainland as a Percent of Total Hong Kong Imports



Mainland-Hong Kong Economic Interactions: Direct Investment

- Hong Kong investors were the first to invest in the Mainland when it first opened to the world in 1978 and were instrumental for the successful development of the Special Economic Zones such as Shenzhen.
- It is fair to say that without Hong Kong, Shenzhen would probably not have been as successful. The other Special Economic Zones (Shantou, Zhuhai, Xiamen and the entire island province of Hainan) have not been notably successful.
- But today, even total foreign direct investment from all sources constitutes only a very small and quantitatively unimportant percentage of total gross domestic investment on the Mainland (around 2.5%).
- Mainland investment now constitutes almost 50% of all FDI into Hong Kong.

Global Economic Trends

- The Shift of the Center of Gravity of the World Economy
- The Slowdown in the Growth of World GDP and Trade
- Trumponomics
- The Geo-Political Uncertainties

Global Economic Trends: The Shift of the Center of Gravity of the World Economy

- The most important development in the global economy during the past four decades is the reform and opening of the Chinese economy and its participation in the world.
- As a result, the center of gravity of the global economy, in terms of both GDP and international trade, has been gradually shifting from North America and Western Europe to East Asia, and within East Asia from Japan to China.
- The shift is still on-going. With both China and India being currently the fastest-growing economies in the world, the share of the U.S. and Europe in world GDP will continue to decline over time.

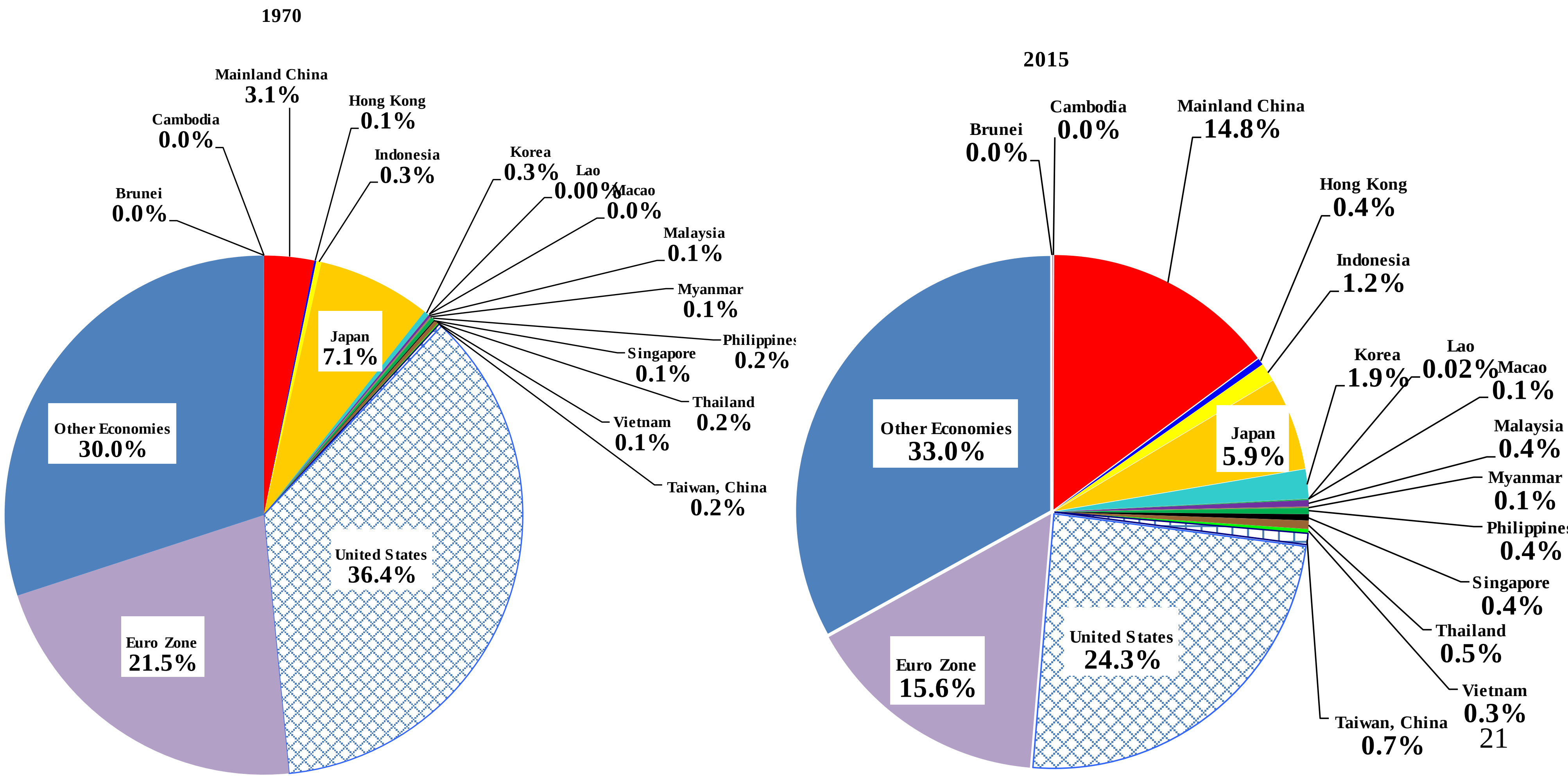
Global Economic Trends: The Shift of the Center of Gravity of the World Economy

- In 1970, the United States and Western Europe together accounted for almost 60% of world GDP. By comparison, East Asia (defined as the 10 Association of Southeast Asian Nations (ASEAN)--Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam--+ 3 (China including Hong Kong Macau and Taiwan, Japan and the Republic of Korea)) accounted for only approximately 10% of world GDP.
- Hong Kong, Republic of Korea, Singapore and Taiwan are also known collectively as the East Asian "Newly Industrialised Economies (NIEs)".

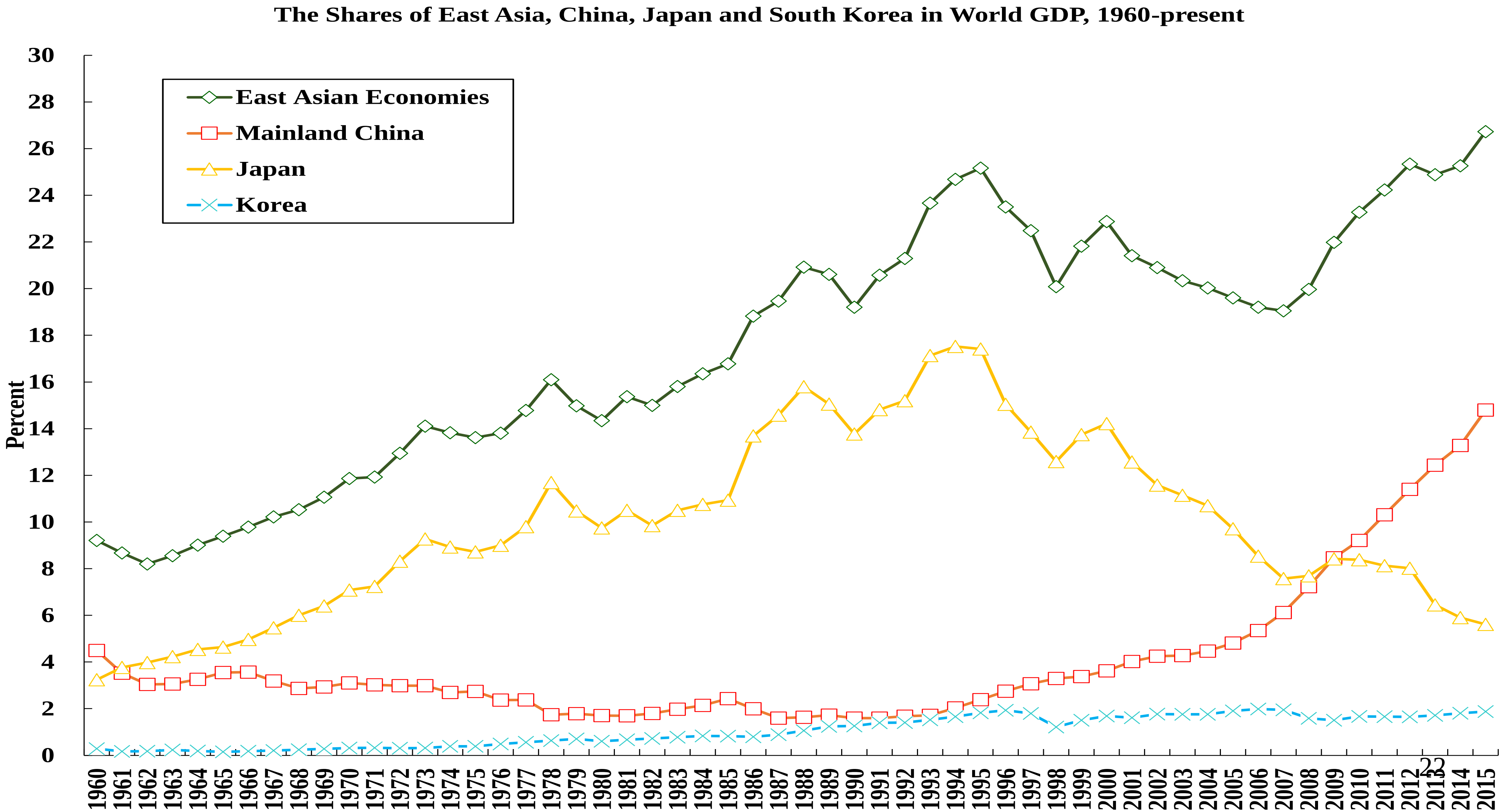
Global Economic Trends: The Shift of the Center of Gravity of the World Economy

- By 2015, the share of United States and Western Europe in world GDP has declined to approximately 40% whereas the share of East Asia has risen to around 27%.
- The Japanese share of world GDP declined from a peak of almost 18% in the mid-1990s to 5.9% in 2015 while the Mainland Chinese share of world GDP rose from 3.1% in 1970 and less than 4% in 2000 to over 14.8% in 2015.

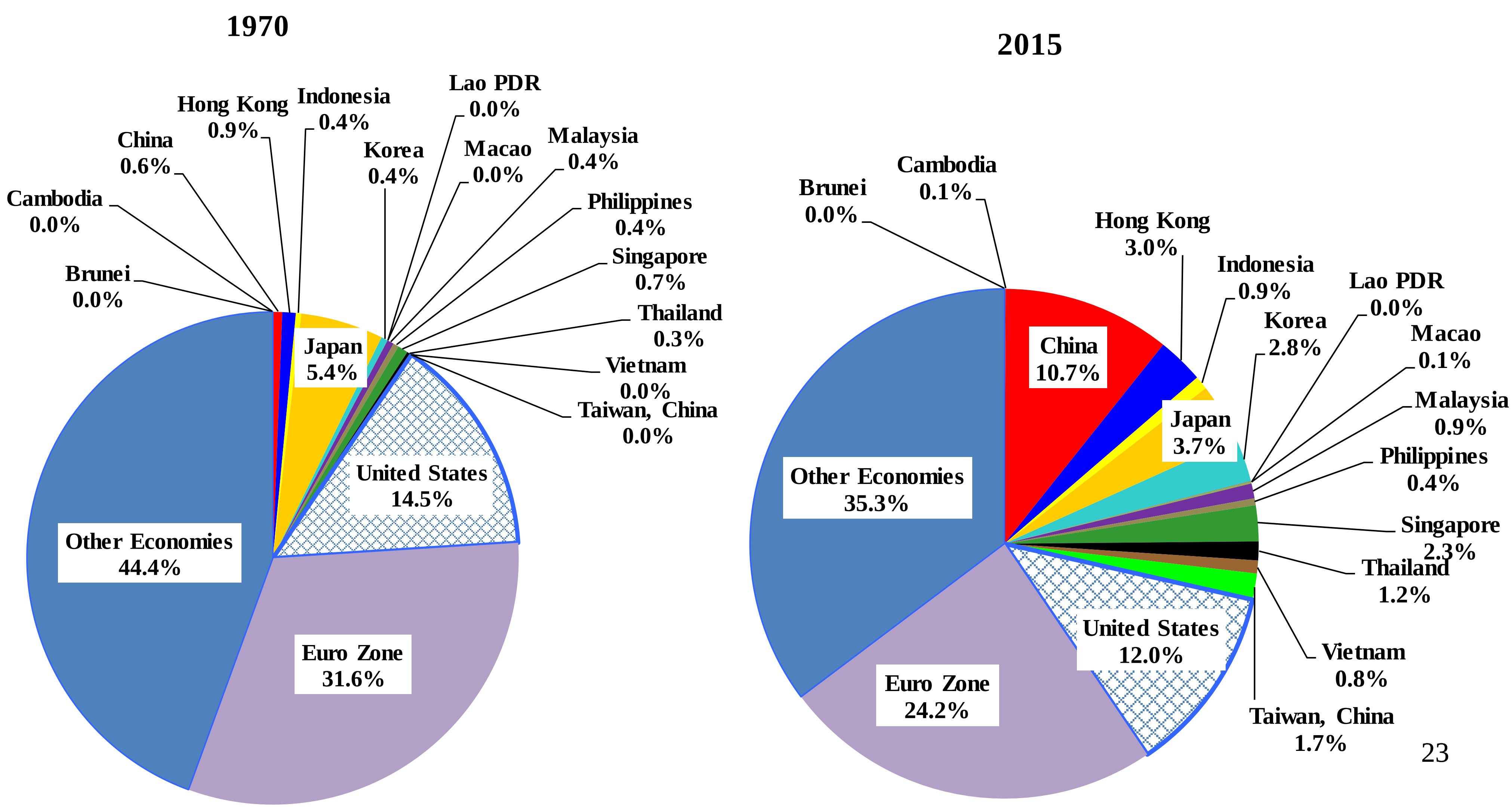
The Distribution of World GDP, 1970 and 2015, US$



The Shares of East Asia, China, Japan and South Korea in World GDP, 1960-present



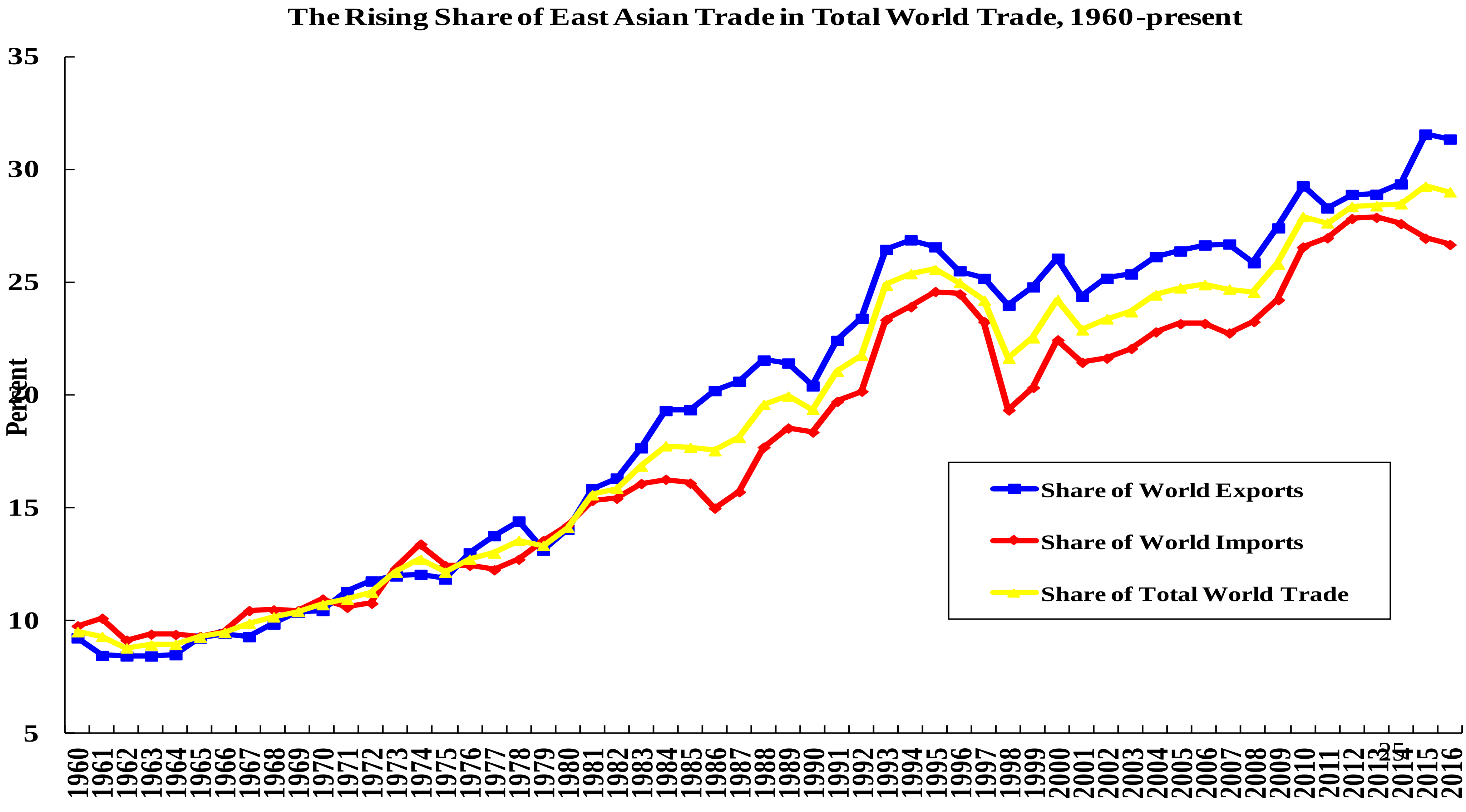
The Distribution of International Trade in Goods and Services, 1970 and 2015



Global Economic Trends: The Shift of the Center of Gravity of the World Economy

- In 1970, the United States and Western Europe together accounted for almost 46% of world trade in goods and services. By comparison, East Asia accounted for 9.5% of world trade.
- By 2015, the share of United States and Western Europe in world trade has declined to 36.2% whereas the share of East Asia has risen to almost 28.6%.
- The Mainland Chinese share of world trade rose from 0.6% in 1970 to 10.7% in 2015. The growth in Chinese international trade may be attributed in part to adoption of current-account convertibility of the Renminbi by China in the early 1990s, accompanied by a significant devaluation of the Renminbi, and to Chinese accession to the World Trade Organisation in 2001.
- In 2015, Mainland China has also become the largest trading-partner country of the U.S., surpassing Canada. China is also the number one trading partner for Germany, Japan, South Korea, India and Australia.

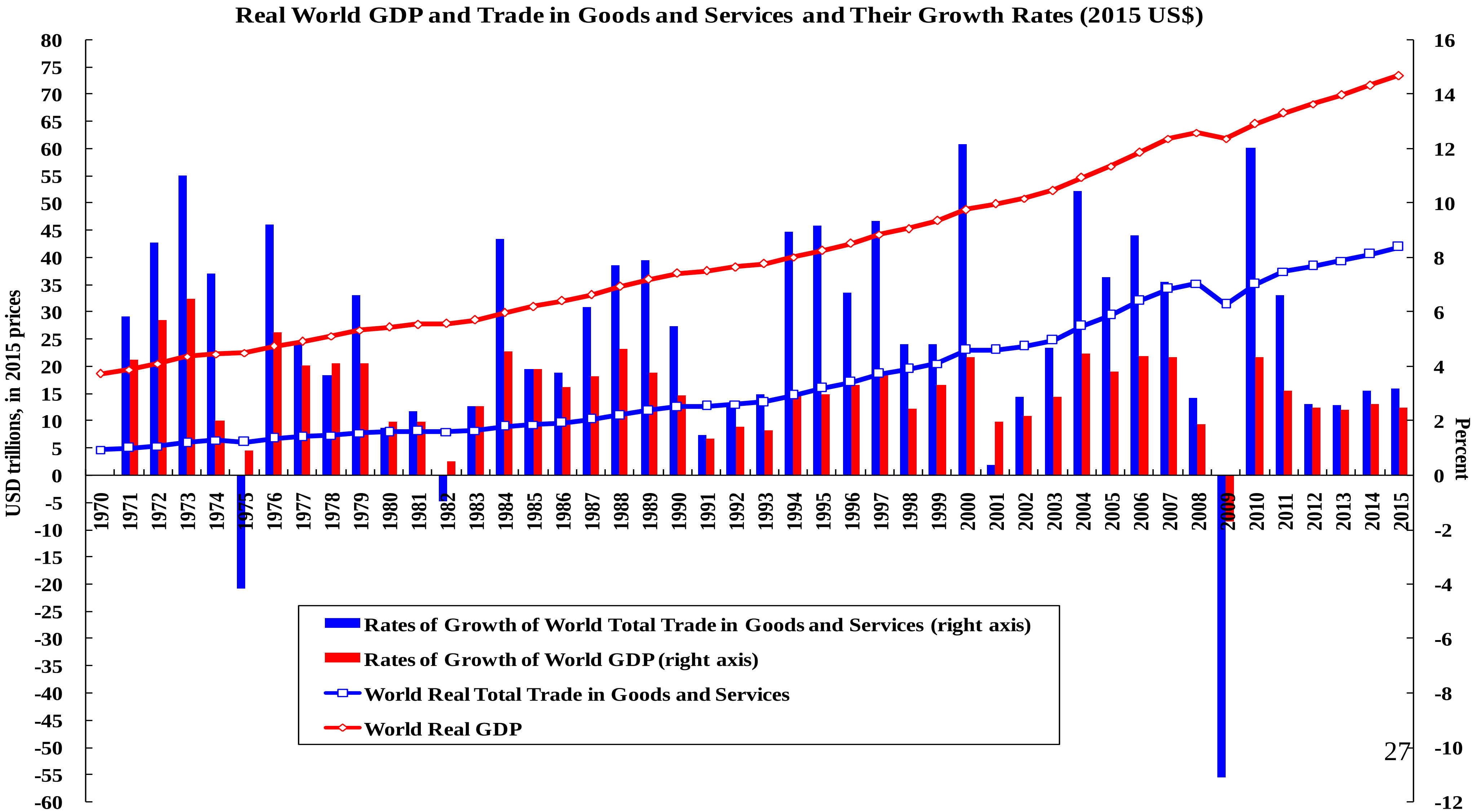
The Rising Share of East Asian Trade in Total World Trade, 1960-present



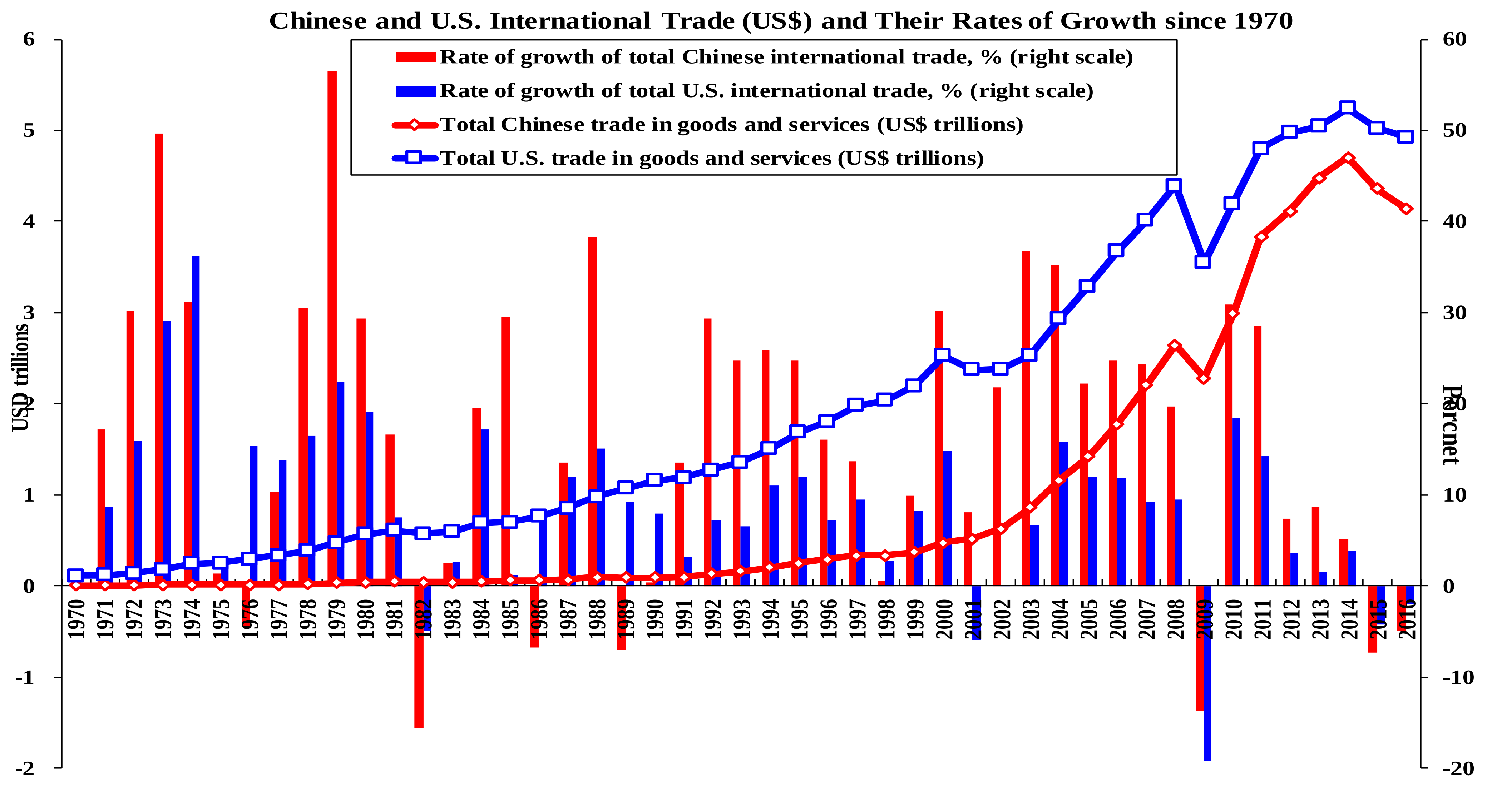
Global Economic Trends: The Slowdown in the Growth of World GDP and Trade

- The growth of world trade led and propelled the growth of world GDP since the 1970s. Japan, the four Newly Industrialized Economies (Hong Kong, Singapore, South Korea and Taiwan), and Mainland China all adopted export-led economic growth policies in the early stages of their economic development.
- Between 1970 and 2008, the beginning of the Global Financial Crisis, total world real GDP grew at an average annual rate of 3.3% while total real world trade grew at a much faster average annual rate of 5.5%. (Since 2008, the average annual rates of growth of real world GDP and real world trade have declined to 2.2% and 2.5% respectively.)
- For both the U.S. and China, the two largest trading economies in the world, total value of trade has fallen in both 2015 and 2016. This may be attributed, in part to the recent fall in the world price of oil.

Real World GDP and Trade in Goods and Services and Their Growth Rates (2015 prices)



Chinese and U.S. International Trade and Their Respective Rates of Growth since 1970



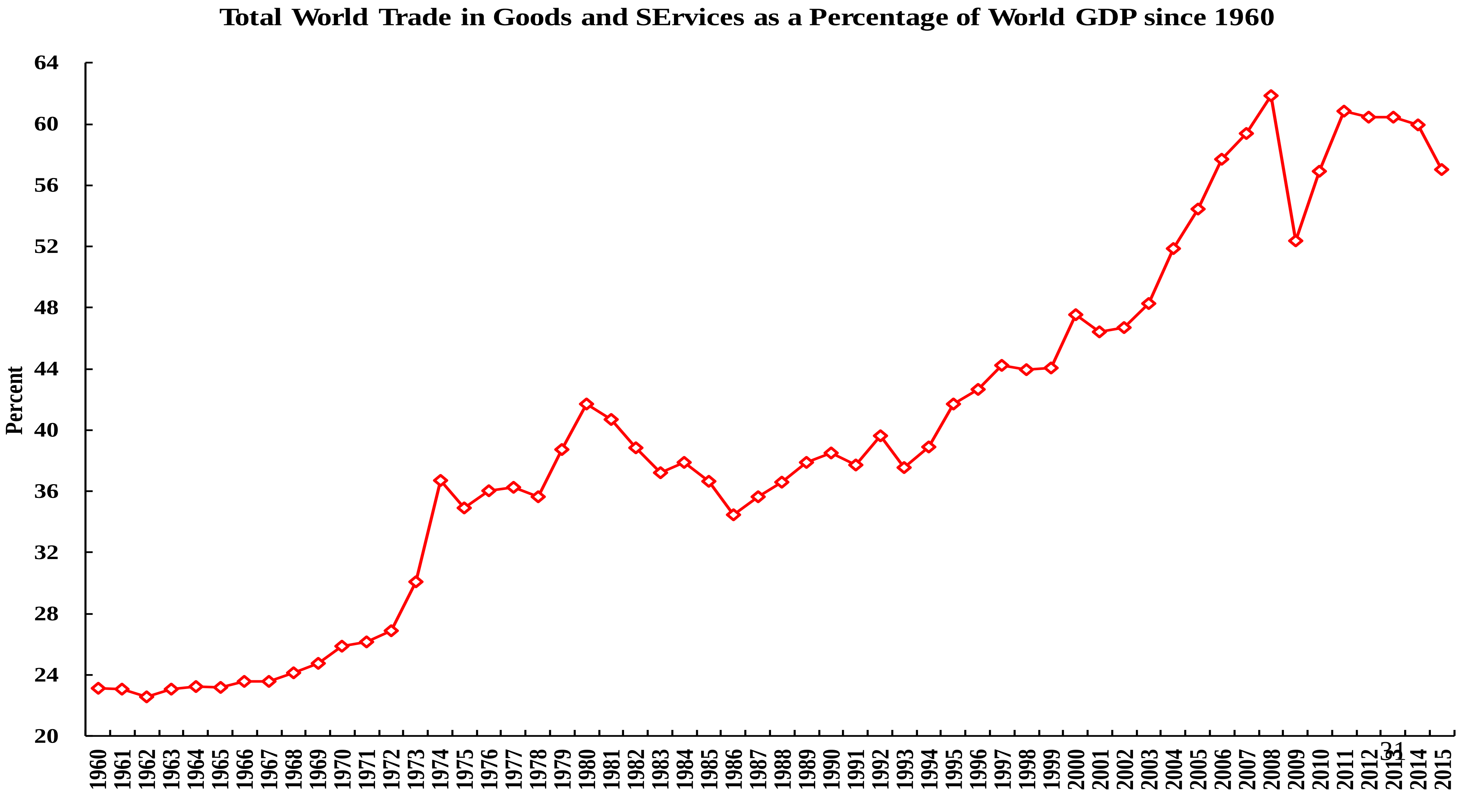
Global Economic Trends: The Slowdown in the Growth of World GDP and Trade

- At the same time, the growth of world GDP has also slowed down from its historical trend rate. In April 2017, the International Monetary Fund (IMF) projected that world GDP would grow at 3.5% in 2017 and 3.6% in 2018 and that world trade would grow at 4%, slightly higher than the projected rate of growth of world GDP. More recently, the World Bank forecast that world GDP would grow at 2.7% in 2017 and 2.9% in 2018 and 2019, and that world trade would grow at 4%, slightly higher than that of world GDP.
- The IMF forecast of U.S. economic growth for 2017 is 2.3%. Growth forecasts for Europe and Japan have remained at between 1% and 2%. The outlook for the developing economies is slightly better, with China projected to grow at 6.5% (6.6% by the IMF) and India to grow at 7% or higher.

Global Economic Trends: The Slowdown in the Growth of World GDP and Trade

- Total world trade as a percent of total world GDP increased from 26% in 1970 to 62% in 2010. (It has also been declining gradually since 2010.)
- However, the ratio of world trade to world GDP has stalled since 2007 and has begun a gradual decline.
- Economic globalization has reached a turning point. Is it likely to be reversed in the future?

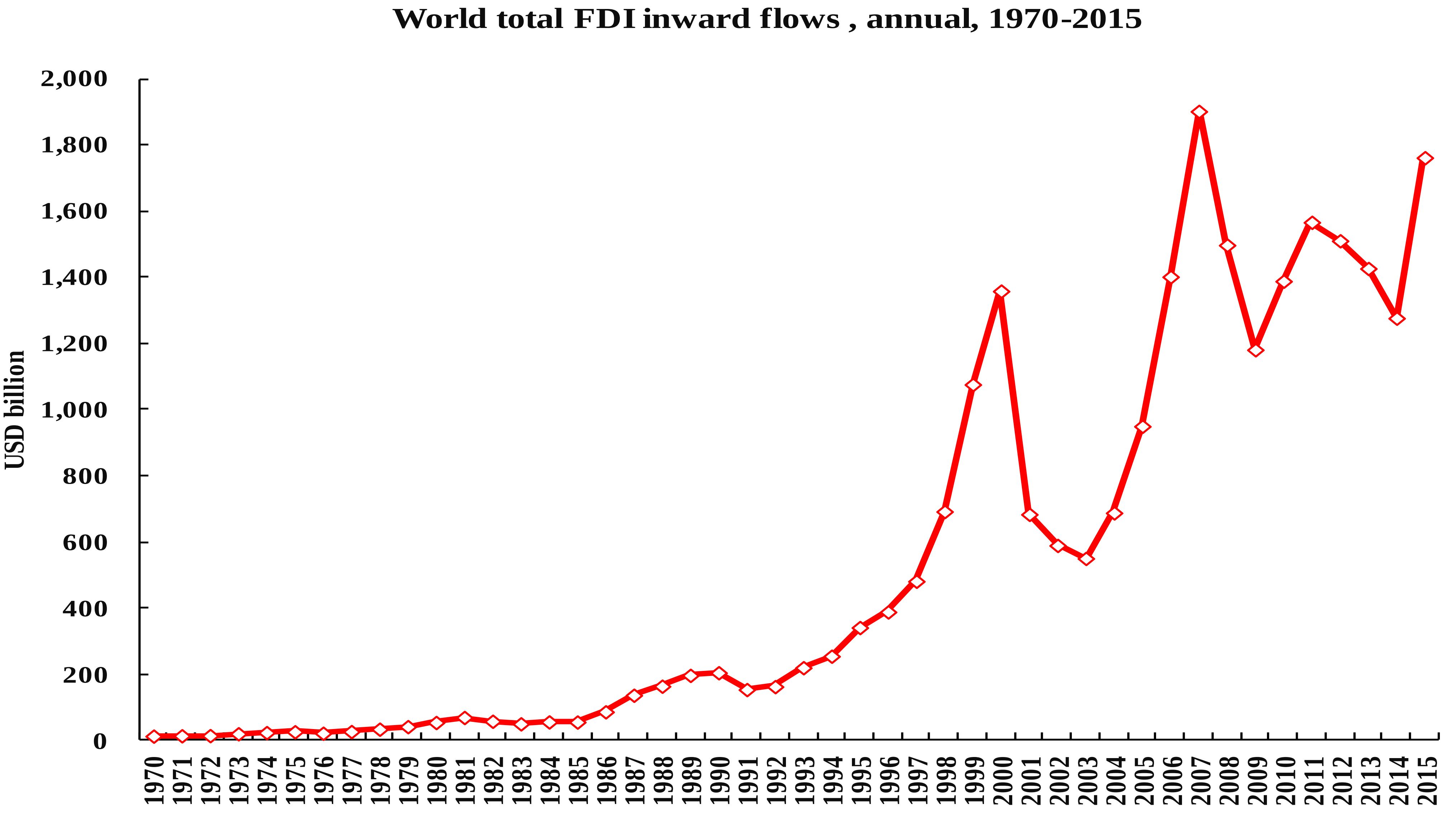
Total World Trade in Goods and Services as a Percentage of World GDP since 1960



Global Economic Trends: The Growth of Foreign Direct Investment (FDI)

- Falling barriers to as well as incentives for foreign direct investment (FDI) provided by investee countries have also greatly increased cross-border direct investment. National treatment for foreign direct investment is becoming increasing standard under the World Trade Organisation (WTO) and similar agreements.
- Data from the United Nations Commission for Trade and Development (UNCTAD) show that total world FDI increased at the average annual rate of 14% between 1970 and 2007, the beginning of the global financial crisis, also much faster than total world real GDP.
- However, since 2007 total world FDI has been declining by 1% per year. Total world direct investment has also grown significantly.
- Annual total world FDI may be estimated at approximately US$ 1.7 trillion in 2015. The U.S. and Mainland China are the world's top two leading destination countries of foreign direct investment (FDI) with an annual average of approximately US$100 billion currently.

Total World Foreign Direct Investment (FDI), billion US$



Global Economic Trends: The Growth of International Capital Flows

- International capital flows include direct and portfolio investment, foreign aid, foreign loans and short-term capital flows such as “hot money”.
- Foreign direct investments (FDI) often follow trade—e.g., to secure long-term supply of raw materials and natural resources; and trade often follows foreign direct investments—e.g., production by captive subsidiaries in foreign markets. A large proportion of world trade consists of intra-industry and intra-firm trade.

Global Economic Trends: The Growth of Foreign Direct Investment (FDI)

- FDI permits the leveraging of intangible capital (patents, technology, knowhow, goodwill, brand name, reputation, business methods) over a much larger market. Intangible capital has several characteristics:
  - The creation of intangible capital (e.g., a patented product or process) often requires a high fixed cost, but the expanded application of such intangible capital, once created, has low marginal cost (e.g., Coca-Cola expanding into a new market; introduction of existing drugs into a new market; and the i-phone entering the Chinese market) and hence high marginal revenue and profit.
  - Intangible capital is much more industry-specific than location-specific. It is much easier for an existing firm to enter the same industry in a different geographical market than to enter a different industry in the same geographical market.
  - The protection of the intangible capital in the new market often requires direct supervision, management and control and hence direct investment. Franchising does not work in many economies.

Global Economic Trends: 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 being contemplated by the U.S. will also cause great disruptions in world trade and global supply chains, but at this time appears unlikely to be implemented.

Global Economic Trends: 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?
- Will the European Union and the Euro survive? The election of Mr. Emmanuel Macron as the President of France on 7 May by a large margin (66% versus 33%) is somewhat reassuring. Unfortunately, the outcome of the British election on 8 June is far from assuring. There is still the and the German election in September and the Nineteenth Congress of the Chinese Communist Party in October.
- And then there is the continuing North Korean crisis.
- Other potential hot spots include the Middle East, the South China Sea, the East China Sea and possibly the Taiwan Straits.

Global Economic Trends: 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 Trace Area.

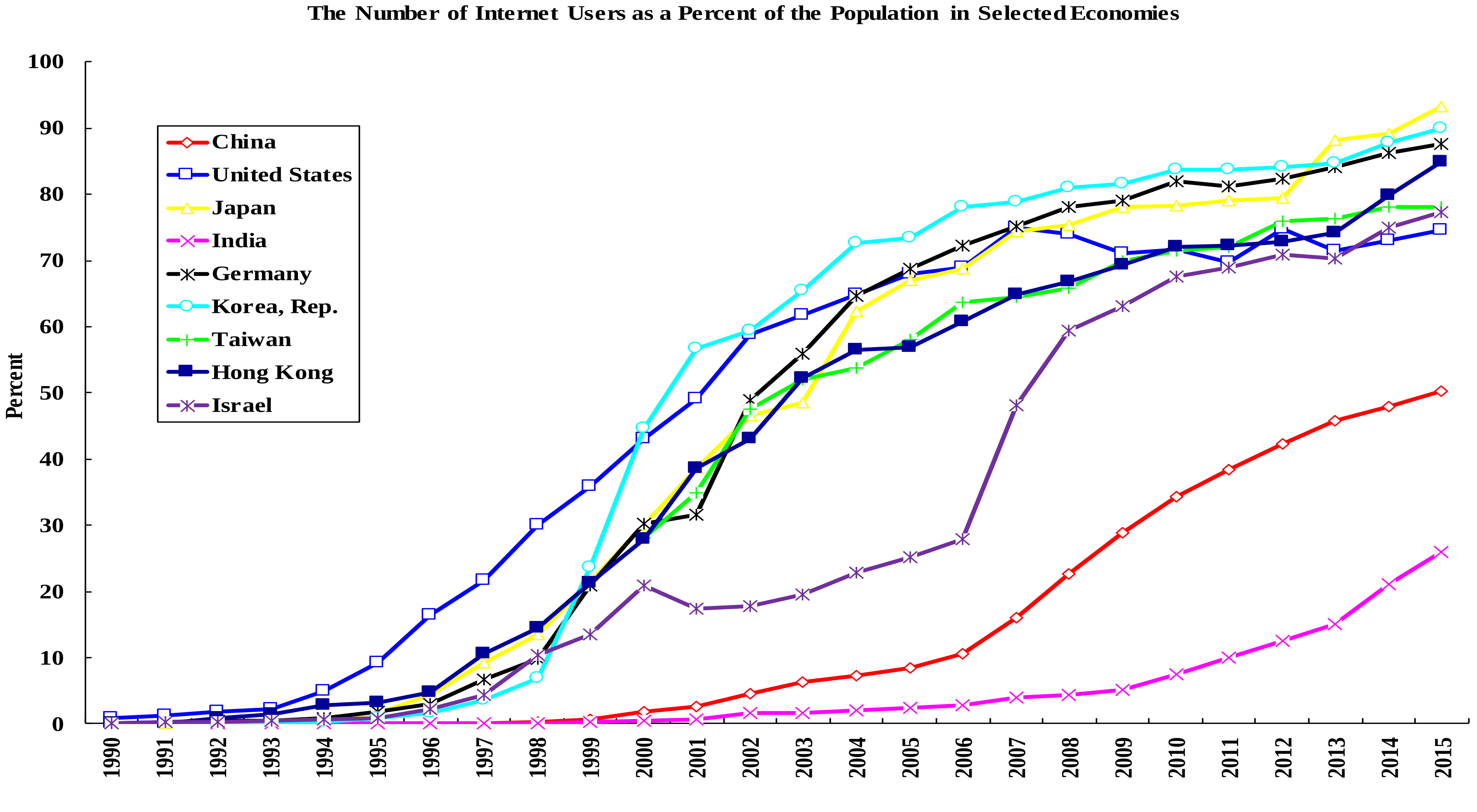
The Comparative Advantages of Hong Kong

- 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 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.

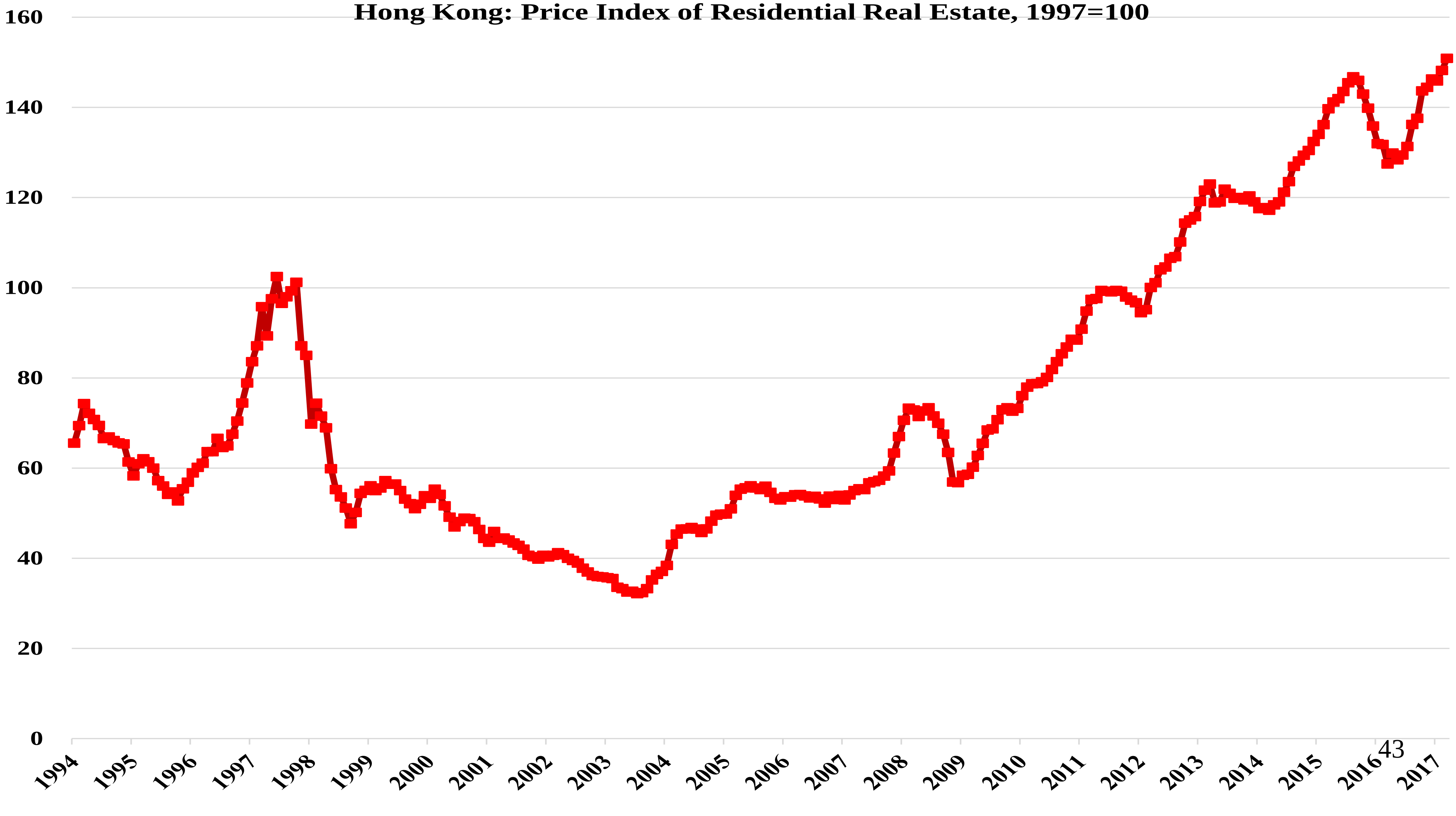
The Number of Internet Users as a Percent of the Population in Selected Economies



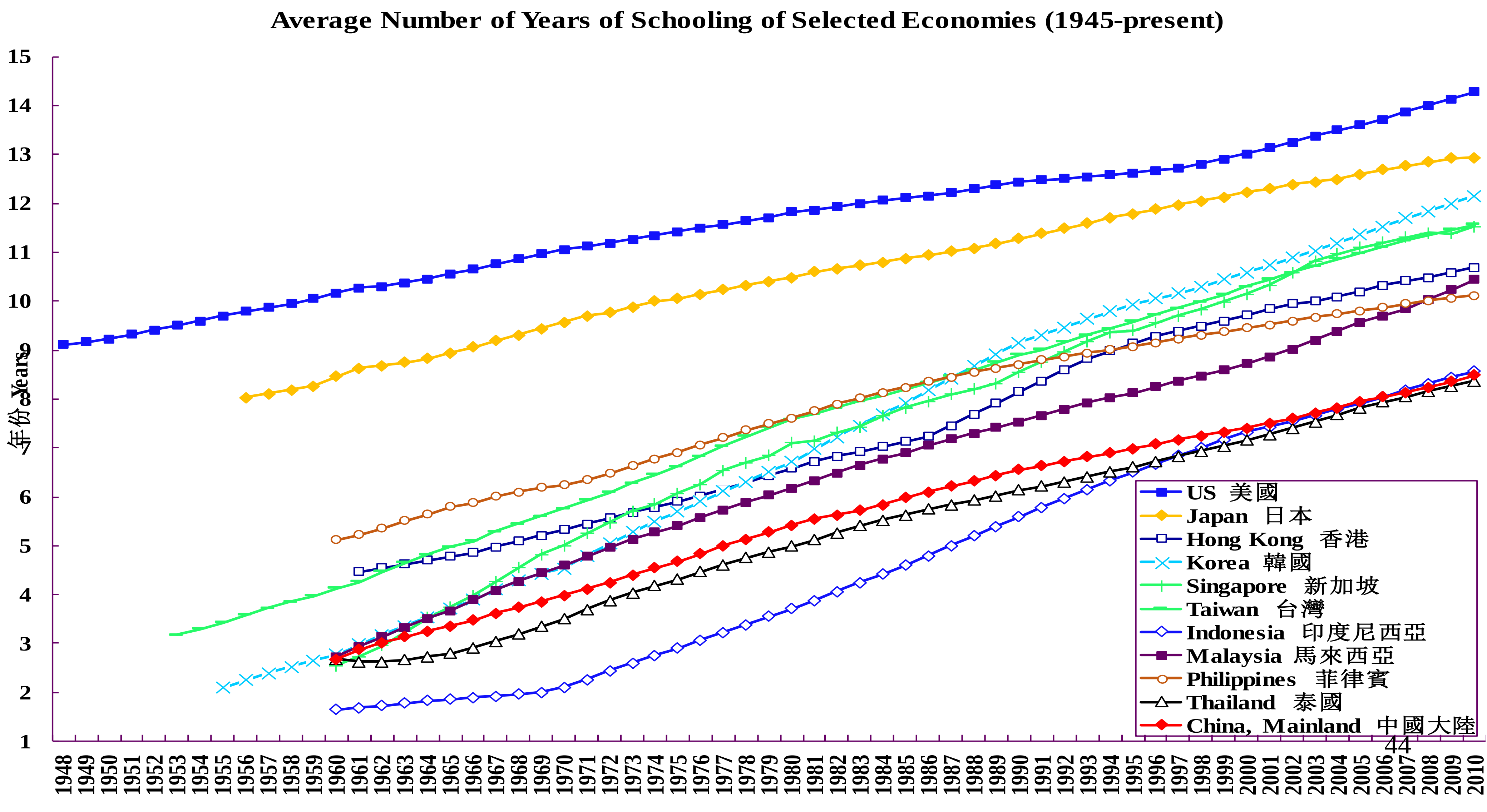
The Vulnerabilities of Hong Kong

- 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 0.76% 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).

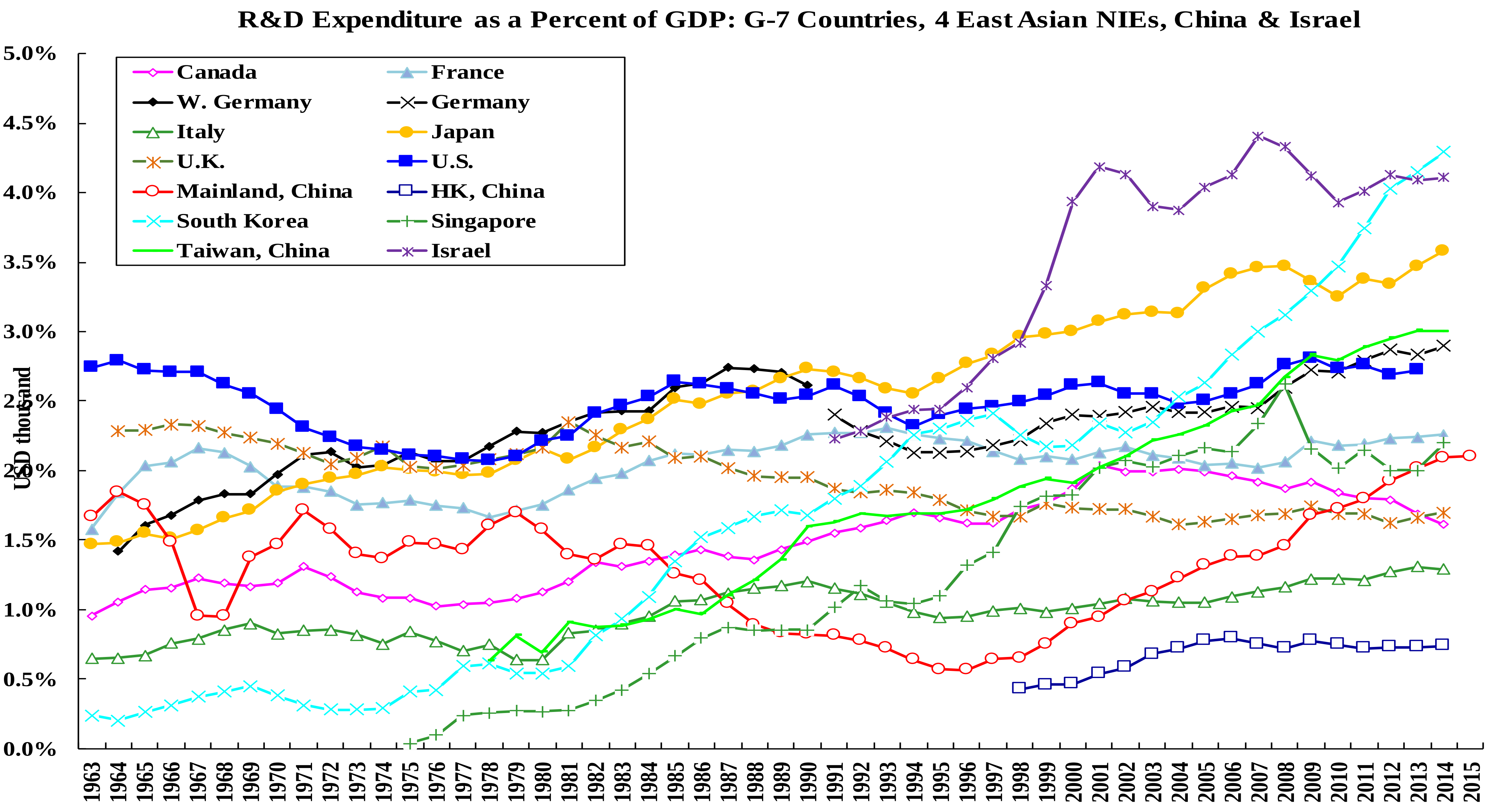
Price Index of Residential Real Estate, Hong Kong: Centa-City Leading Index (1997=100)



Average No. of Years of Schooling per Person in the Working Age Pop., Selected Economies



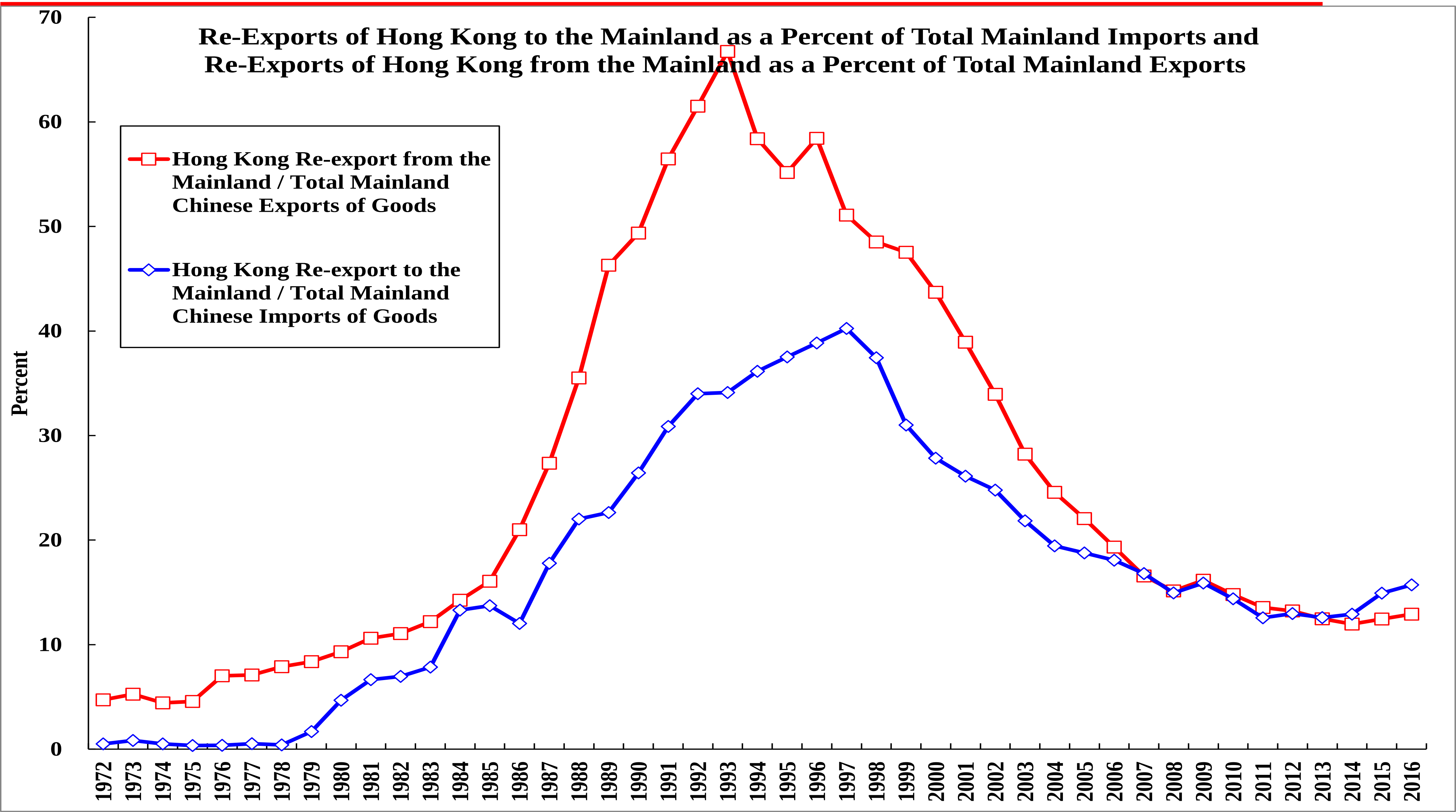
R&D Expenditures as a Ratio of GDP: G-7 Countries, 4 East Asian NIES, China & Israel



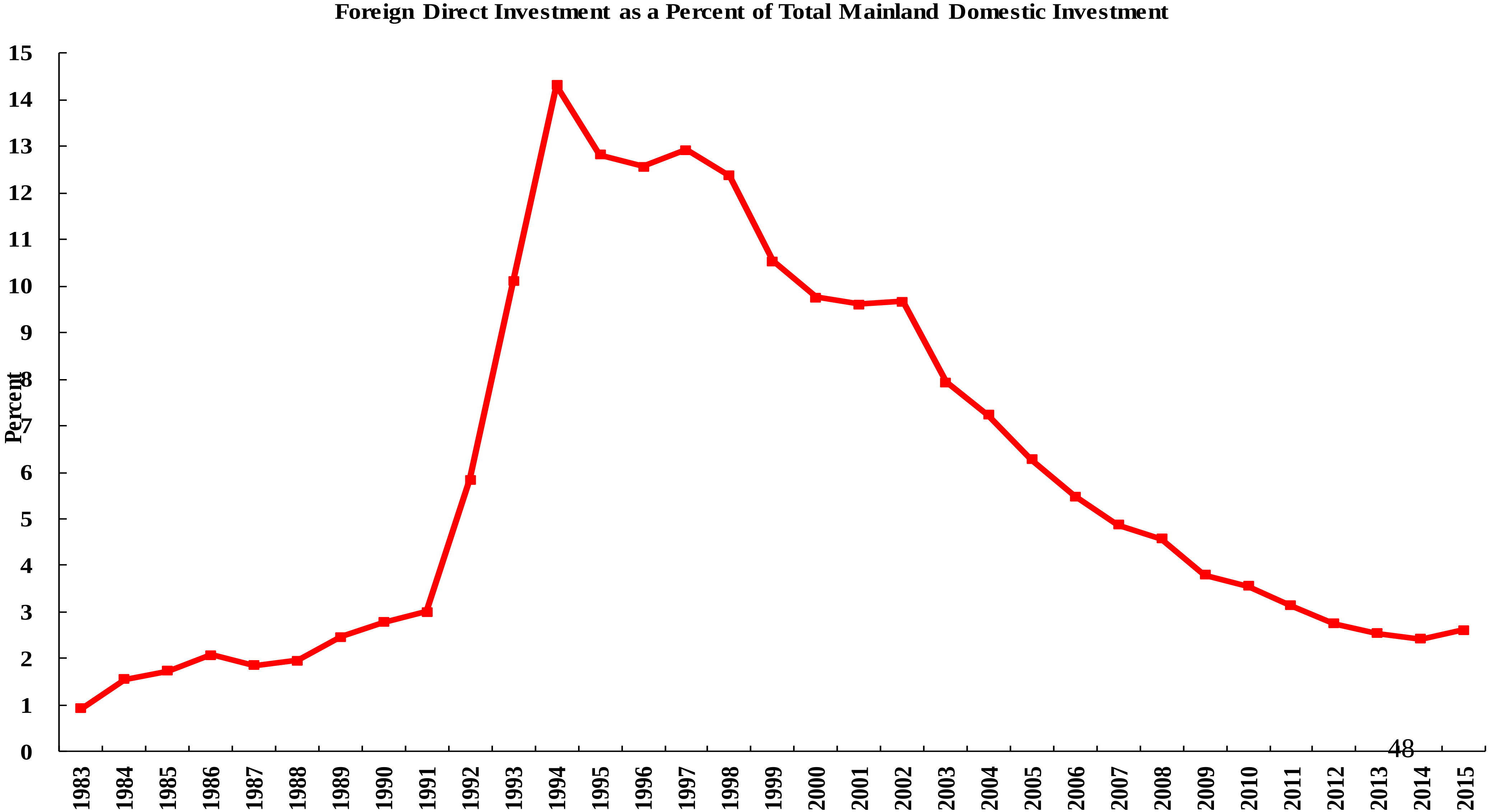
The Vulnerabilities of Hong Kong

- 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

HK Re-Exports to and from the Mainland as a Percent of Mainland Imports and Exports



Foreign Direct Investment as a Percent of Total Mainland Domestic Investment



The Economic Complementarities between Hong Kong and the Mainland

- Hong Kong has no more industry to speak of; the Mainland has strong light, heavy and high-technology industries
- The Mainland has excess savings; Hong Kong can provide opportunities for Mainland firms and households to invest the excess savings outside of China
- Hong Kong has talents but only a relatively small talent pool and relies on importation of talents; the Mainland has a huge talent pool
- Hong Kong does not have enough land and suffers from the high cost of land; there is plenty of land on the Mainland
- Hong Kong has a limited market; the Mainland's market is the world's largest
- Hong Kong is more internationalized and is useful as a gateway for not only inbound but also outbound direct investment

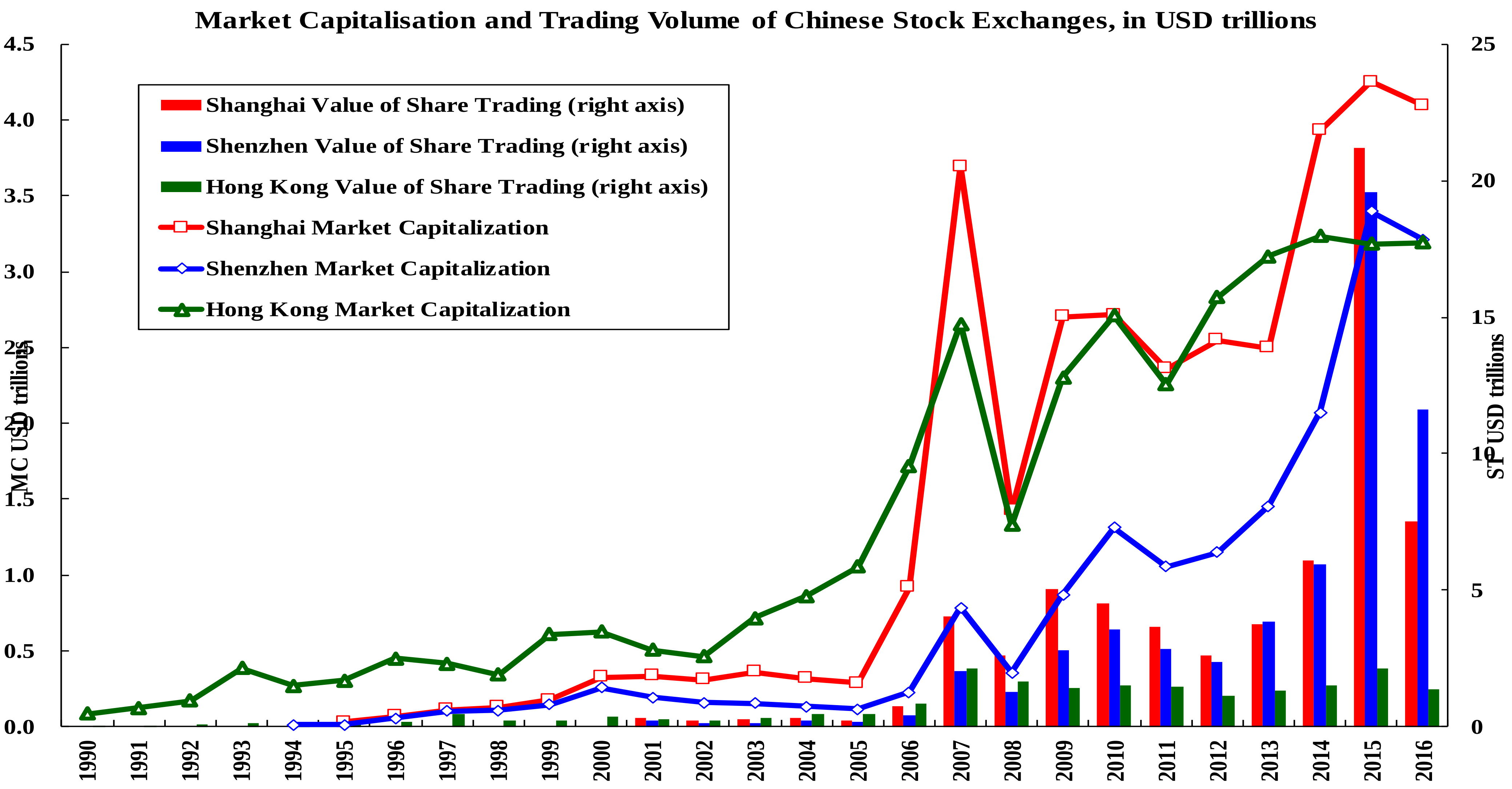
Hong Kong as the Mainland's Capital Market

- In 1891, the predecessor of the Hong Kong Stock Exchange was founded.
- In 1986, the Hong Kong Stock Exchange merged with three other stock exchanges to form a unified exchange but retain the same name.
- In 1993, Tsingtao Beer was listed on the Hong Kong Stock Exchange. It was the first Mainland company to do so, followed by many other large state-owned .
- The Hong Kong Stock Exchange was instrumental in attracting foreign portfolio investors to invest in the shares of Mainland Chinese enterprises by listing their shares. The Hong Kong Stock Exchange provided the easy access, the liquidity and the strict regulation expected by the foreign portfolio investors. Listing of Mainland enterprises on the Hong Kong Stock Exchange also helped to bring in foreign exchange, which was needed by Mainland enterprises at the time.

Hong Kong as the Mainland's Capital Market: The Stock Market

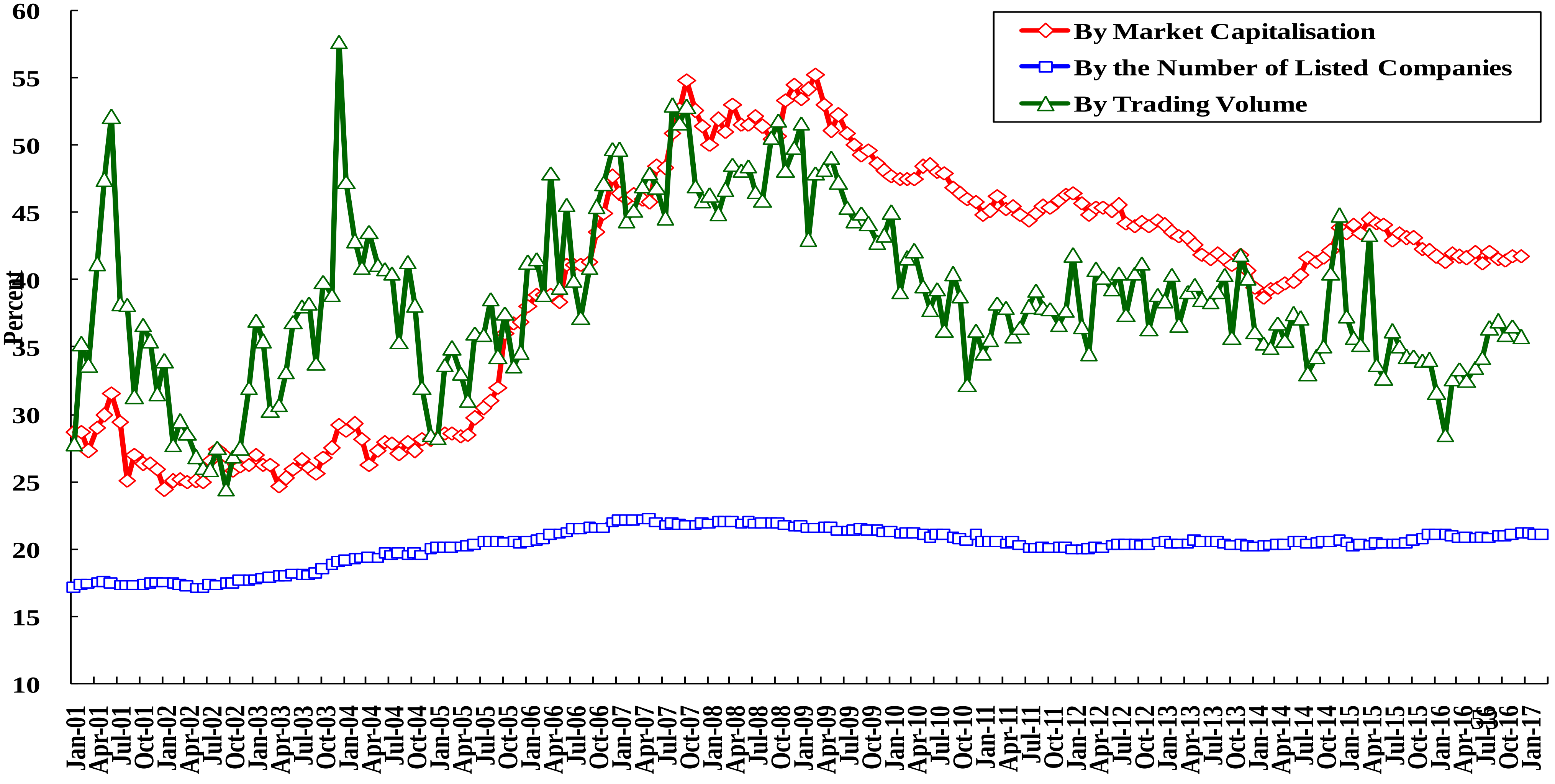
- Stock exchanges on the Mainland were first established in early 1990s, much later than the Hong Kong Stock Exchange (although there was a Shanghai Stock Exchange before 1949). However, in terms of total market capitalization—the total value of all the companies listed on the stock exchange at the prevailing share prices of the market—both the Shanghai Stock Exchange and the Shenzhen Stock Exchange are now separately larger than the Hong Kong Stock Exchange in terms of market capitalization.
- Mainland firms now constitute more than 50% of the Hong Kong Stock Exchange by market capitalization but less than 20% by the number of listed firms—indicating that the Mainland firms listed on the Hong Kong Stock Exchange are on average much bigger than the other firms listed there.
- Mainland firms also constitute one half of the fifty publicly listed enterprises comprising the Hong Kong Hang Seng Index.
- Recently, Shanghai-Connect and Shenzhen-Connect have been introduced to allow investors inside China to invest in shares listed on the Hong Kong Stock Exchange and investors outside of China to invest in shares listed on the Shanghai and Shenzhen Stock Exchanges.

The Market Capitalization and Value of Share Trading of Chinese Stock Exchanges, US$ tril.



The Share of Mainland Enterprises on the Hong Kong Stock Exchange

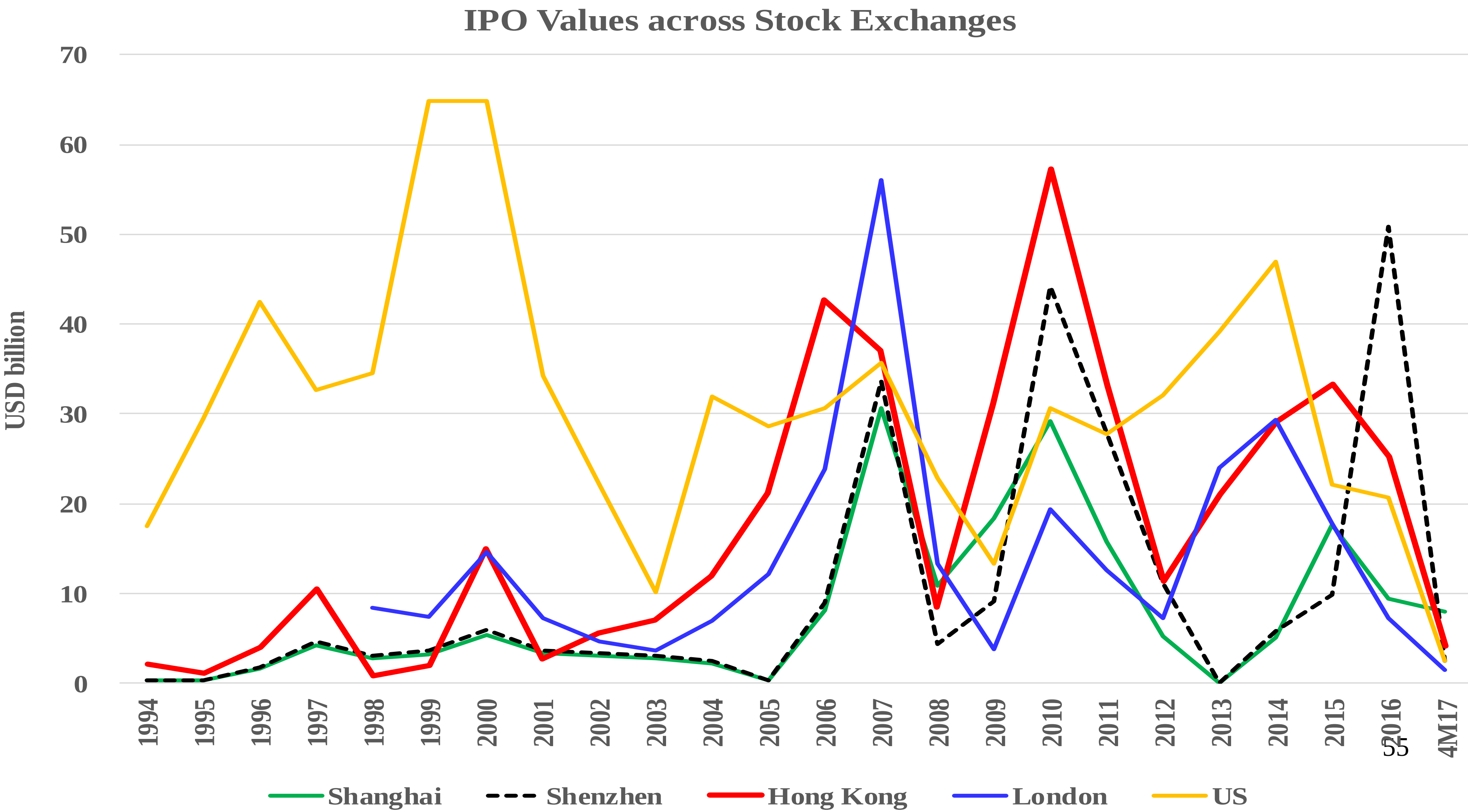
The Share of Mainland Enterprises on the Hong Kong Stock Exchange by Market Capitalization, Trading Volume and the Number of Listed Enterprises



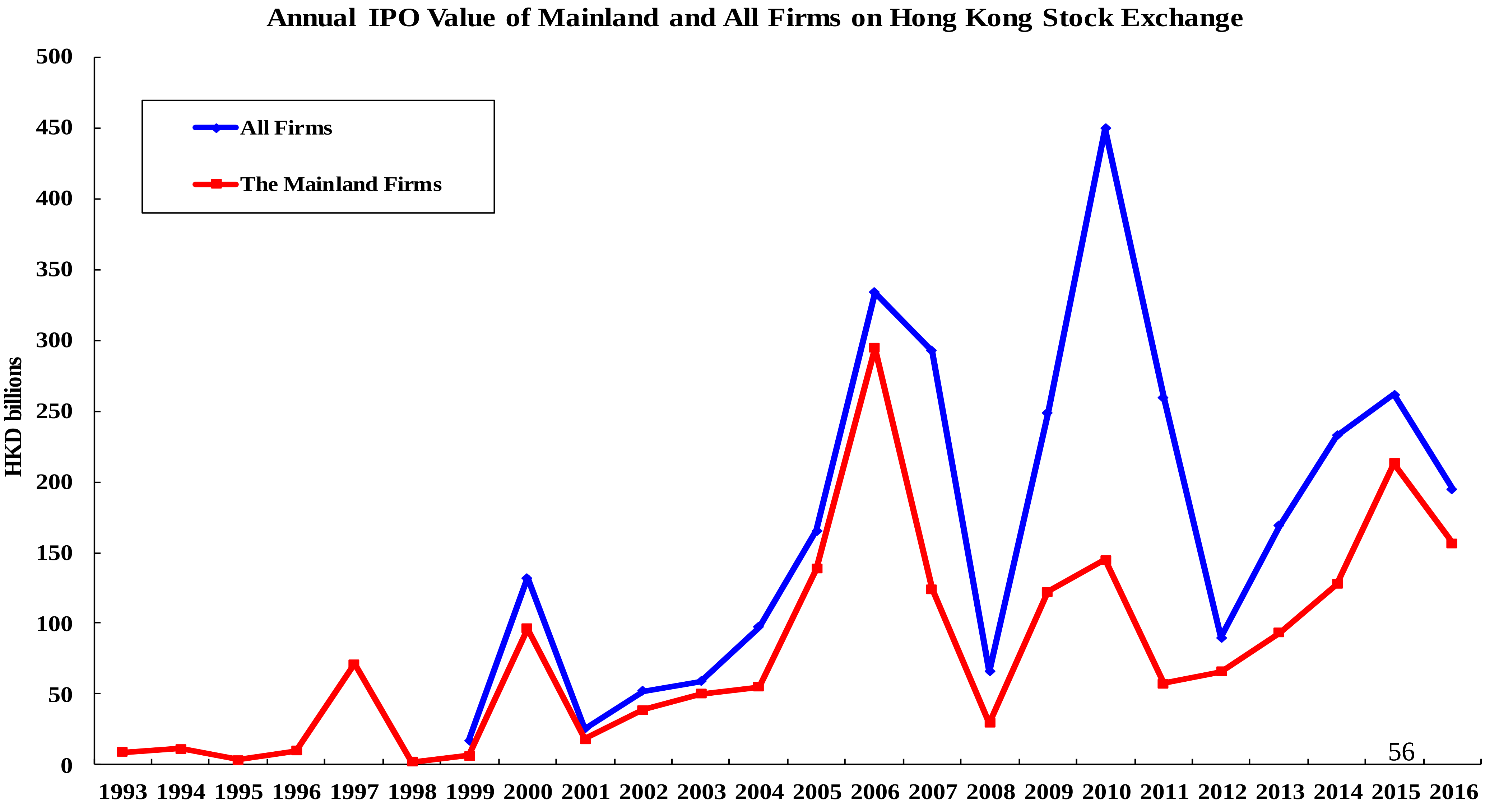
Hong Kong as the Mainland's Capital Market: The Stock Market

- In terms of initial public offerings (IPOs), that is, the first-time sales of shares by firms to public investors on the stock exchange, Mainland firms have been the mainstay of the Hong Kong Stock Exchange, accounting for most of the value of its IPOs, except in the global financial crisis years of 2009-2011 when firms from other countries came to Hong Kong to raise money because of the lack of activities in New York and London.
- Increasingly, however, Mainland enterprises may find listing on the Shanghai Stock Exchange much more attractive because there is substantial domestic investor demand and the enterprises need to raise Renminbi rather than foreign exchange. The Mainland, with foreign exchange reserves exceeding US$3 trillion, does not need any more inflow of foreign exchange. Moreover, funds raised offshore cannot be automatically remitted to the Mainland for use on the Mainland. Specific approval from the People's Bank of China is required. However, there is a long queue of firms at the Shanghai Stock Exchange waiting for their turns for IPO.
- That is also why Hong Kong has to begin to seek successful firms from other countries and regions to list their shares on the Hong Kong Stock Exchange, perhaps as a secondary listing.

Comparison of Annual Values of IPOs Across Stock Exchanges



Annual IPO Value of Mainland and All Firms on Hong Kong Stock Exchange



Hong Kong as the Mainland's Capital Market: The Stock Market

- In 2014, the Hong Kong Stock Exchange lost the IPO of Alibaba, the largest global IPO ever, to the New York Stock Exchange because it would not allow any shareholder for any new enterprise to be listed in Hong Kong to have "super voting rights". Alibaba would like to maintain a two-class share ownership structure which implies that some shares will carry more voting power than others.
- While this may appear inequitable, it is not uncommon. Hong Kong Stock Exchange actually permitted such structures before the 1990s. Swire and quite a few other public listed firms in Hong Kong still have such structures. Similarly, Ford Motor Company, listed on the New York Stock Exchange, also has such a structure.
- The motivation of such a structure is to enable some shareholders (usually the founding shareholders and the senior management) to maintain control of the firm with less than a majority of the shares.
- However, it is possible that not only these controller shareholders, but also the other shareholders, may prefer such an arrangement because they are comfortable with and want to ensure the continuation of the existing senior management and their policies and strategies.

Hong Kong as the Mainland's Capital Market: The Stock Market

- As long as there is full disclosure, and certain safeguards as discussed below to be put in place, there is actually no compelling reason not to allow two classes of shares.
- The possible safeguards include:
- (1) Once the original shares with super-voting power are sold or transferred by the original owners, they will case to have super-voting power (there is a sunset clause); and
- (2) These shares can only be sold with advance notice, for example, 1 month, so that the other shareholders can have a chance to decide whether they should exit first.

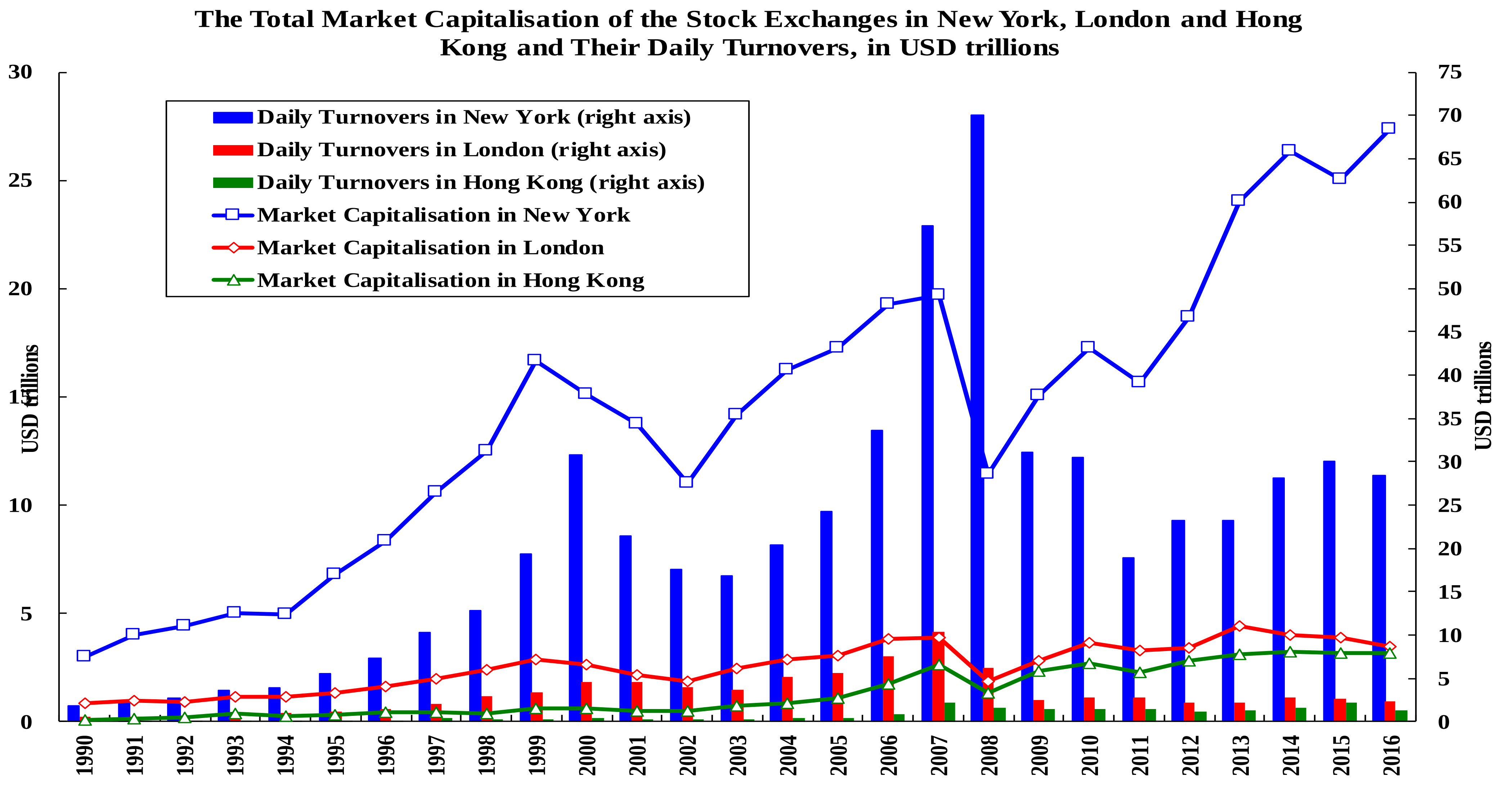
Hong Kong as the Mainland's Capital Market: The Stock Market

- Moreover, many more IPOs such as Alibaba are likely, as many privately owned enterprises on the Mainland will want to raise capital for their expansion. These prosperous private Mainland enterprises are still run by their relatively young founder-owners, and quite a few of them may wish to continue to control and manage them even after their IPOs. In fact, potential investors may also prefer that these founder-owners continue to hold their stakes and remain in charge after IPO.
- Hong Kong cannot afford to lose all of these potential listings to other stock exchanges. Hong Kong should welcome these entrepreneurs and their enterprises by allowing two-class ownership structures provided that there are full and proper disclosure and appropriate safeguards as discussed above.
- Then with full pre-IPO disclosure of the super-voting rights and the additional obligations of the “controlling shareholder”, as long as investors are still willing to buy the shares at the IPO, it should not be considered unfair.

Hong Kong as the Mainland's Capital Market: The Stock Market

- In terms of the annual value of IPO, Hong Kong has come a long way and is comparable to New York and London. Together with Shanghai and Shenzhen, the Chinese stock exchanges are way ahead of the stock exchanges in New York and London.
- However, in terms of market capitalization, Hong Kong lags far behind the U.S. and is also behind London. This reflects that the value of IPOs in Hong Kong has become significant in only the past decade. Total market capitalization is related to the cumulative value of annual IPOs over time.
- Hong Kong is also far behind the U.S. in terms of market turnover. While this is partly related to the total market capitalization, it is also due partly to the fact that the typical float of an IPO stock is no more than 30 percent, and much of it is held by "cornerstone investors" which are restricted from selling their shares for a certain period. Thus, the market for many listed stocks is not very liquid. Moreover, a thin float also makes a stock more susceptible to manipulation.

The Total Market Capitalization of New York, London and Hong Kong and Daily Turnovers



Hong Kong as the Belt and Road Capital Market

- 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 (71 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.

Hong Kong as the Belt and Road Capital 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.

Directions for Enhancement

- The Financing of Infrastructure Projects
- The Development of a Long-Term Bond Market
- The Organization of Large Infrastructure Bond Funds
- The Development of "Sukuk (Sharia-Compliant)" Bonds
- Expansion of the Number of Double-Taxation Agreements
- The Development of a Belt-and-Road-Wide Stock Market
- Hong Kong as an International Asset Management and Headquarters Center
- Hong Kong as an International Re-Insurance Market
- Hong Kong as an International Professional Services Center

Directions for Enhancement: The Financing of Infrastructure Projects

- Infrastructure building is the indispensable first step of B&R. China's own economic development experience confirms that both infrastructure and openness are indispensable for success. 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.

Directions for Enhancement: 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.

Directions for Enhancement: 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.

Directions for Enhancement: 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.

Directions for Enhancement: 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.

Directions for Enhancement: 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).)

Directions for Enhancement: 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.

Directions for Enhancement: 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.

Directions for Enhancement: 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.

Directions for Enhancement: 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.

Directions for Enhancement: 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$-denominated bonds such as "green" bonds and corporate bonds can be issued based on their own individual credit ratings.
- US$-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 opportunity to promote long-term, fixed rate bonds and mortgages.

Directions for Enhancement: 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.

Directions for Enhancement: The Development of a “Sukuk (Sharia-Compliant)” 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 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.

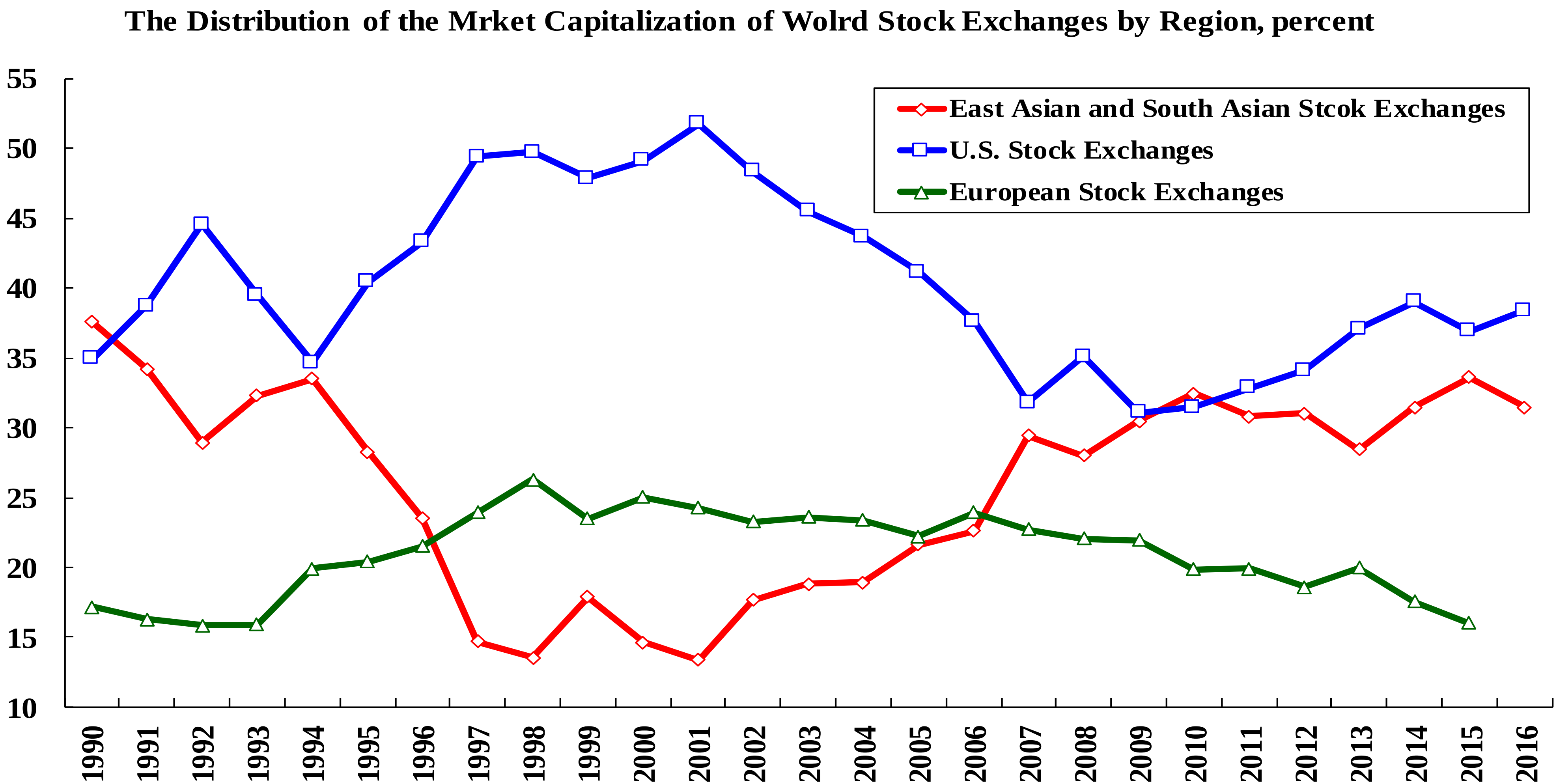
Directions for Enhancement: Expansion of the Number of Double-Taxation Agreements

- Hong Kong also needs to continue to expand its double taxation agreement (DTA) network. Double tax agreements facilitate trade and investment, and in particular infrastructure financing. Currently, Hong Kong has DTAs with only 19 out of the 71 countries involved in B&R.
- 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.

Directions for Enhancement: 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 daily 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 daily 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



Directions for Enhancement: 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).

Directions for Enhancement: 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.

Directions for Enhancement: 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.

Directions for Enhancement: Hong Kong as an Int’l Innovation and Venture Capital Center

- Hong Kong, together with Shenzhen, can also develop into an international center for innovation and venture capital, a “Silicon Valley/Route 128 ” cum NASDAQ for the entire Belt and Road region, specializing 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)”.
- This will involve a four-pronged complementary approach: increasing investment in human capital, specifically in tertiary and post-graduate education; increasing investment in research and development (R&D); creating a nurturing eco-system for venture capital; and facilitating the IPO and M&A markets for successful start-up firms so that they can raise the additional capital needed.
- 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.

Directions for Enhancement: Hong Kong as an Int'l Innovation and Venture Capital Center

- 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.

Directions for Enhancement: Hong Kong as an Int'l Innovation and Venture Capital Center

- 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.

Directions for Enhancement: Hong Kong as an Int’l Asset Management and Headquarters Ctr.

- 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 treasury operations of major multinational financial and non-financial corporations.
- Global and regional financial institutions such as banks, insurance companies and asset management companies will be more likely to establish their 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.

Directions for Enhancement: 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.

Directions for Enhancement: 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.

Directions for Enhancement: 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.

Directions for Enhancement: Hong Kong as an International Professional Services Center

- 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.

Concluding Remarks

- Hong Kong should capitalize on the opportunities provided by the "Belt and Road (B&R)" Initiative.
- 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

- 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.