

The Future of Hong Kong as an International Financial Centre

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Outline

- ◆ Introduction
- ◆ Review of Global Trends
 1. The shifting economic centre of gravity
 2. The China-U.S. strategic competition
 3. The internationalisation of the Renminbi
 4. Multipolarisation
 5. The COVID-19 epidemic
- ◆ Hong Kong's Strengths and Weaknesses
- ◆ Some Directions for Future Expansion
- ◆ Concluding Remarks

Introduction

- ◆ Hong Kong has been a very successful international financial centre, after New York and London.
- ◆ Its productivity has been high—it employs only 7.4% of Hong Kong's labour force but generates more than 24% of Hong Kong's GDP.
- ◆ However, this also means that the rest of the population has not received enough of the benefits from Hong Kong being an international financial centre.
- ◆ The financial sector of Hong Kong should figure out some new ways of helping and supporting the real economy of Hong Kong.

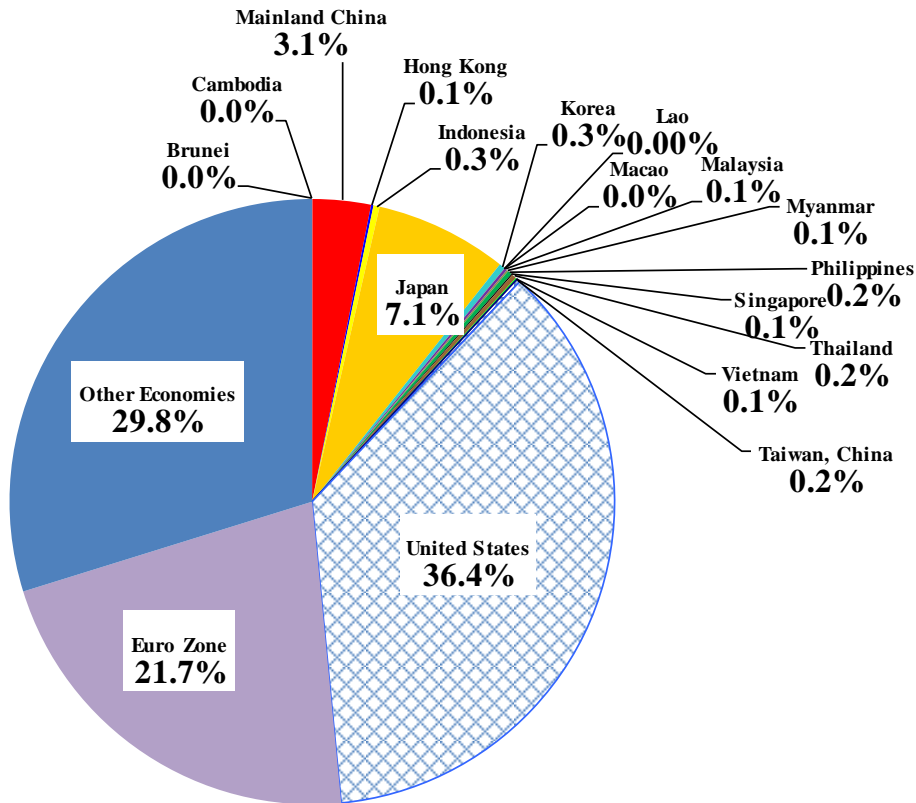
Review of Global Trends:

The Shifting Economic Centre of Gravity

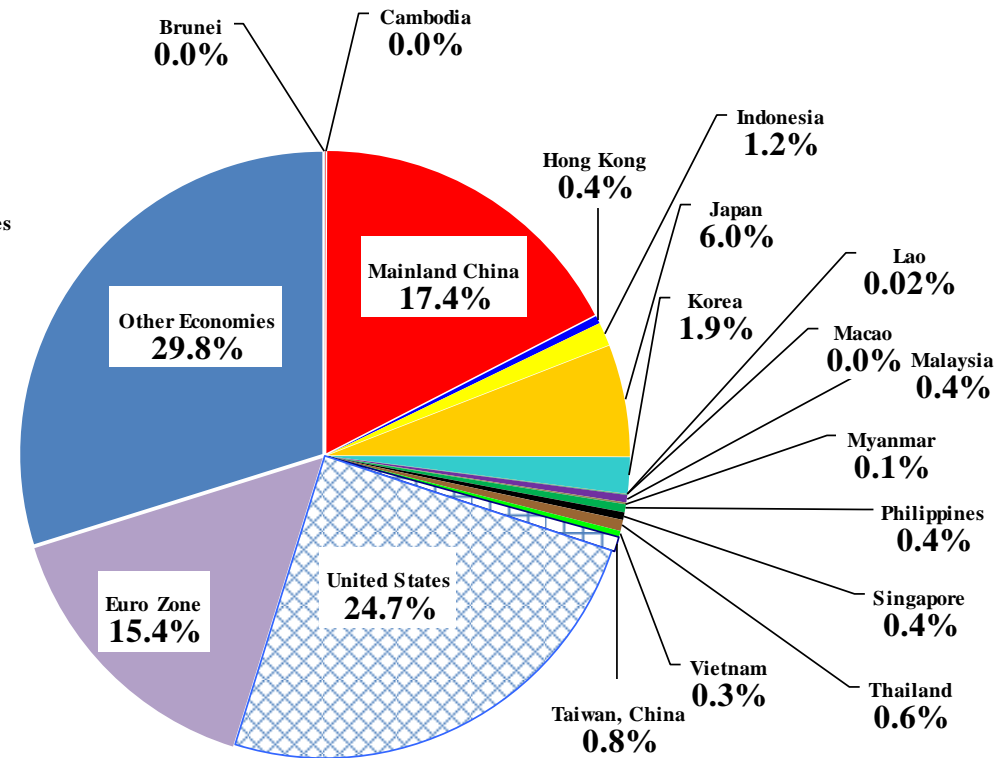
- ◆ The centre of gravity of the world economy has been shifting from North America and Europe to East Asia, and within East Asia to China in particular. And this has been happening in real GDP, wealth, international trade, manufacturing, and innovation
- ◆ The Chinese economy will be growing faster than those of North America and Europe in the next ten years. While the Chinese economy cannot continue to grow at 9%-10% per annum, its real GDP per capita is still in a range that would allow its economy to grow at an average annual real rate of 6%.
- ◆ My own forecast is that by 2030, the real GDP of Mainland China at market prices will reach parity with that of the U.S., at US\$30 trillion, in 2021 prices.
- ◆ With the growth in real GDP of 6% on average and a national savings rate in excess of 40%, the wealth of Chinese households and institutions will also grow by leaps and bounds. It is this wealth that will drive the Chinese demand for assets domestically, as well as abroad, because of the need for diversification. The savers will eventually own the world!

The Shifting Economic Centre of Gravity: Distribution of World GDP, 1970 & 2020

1970

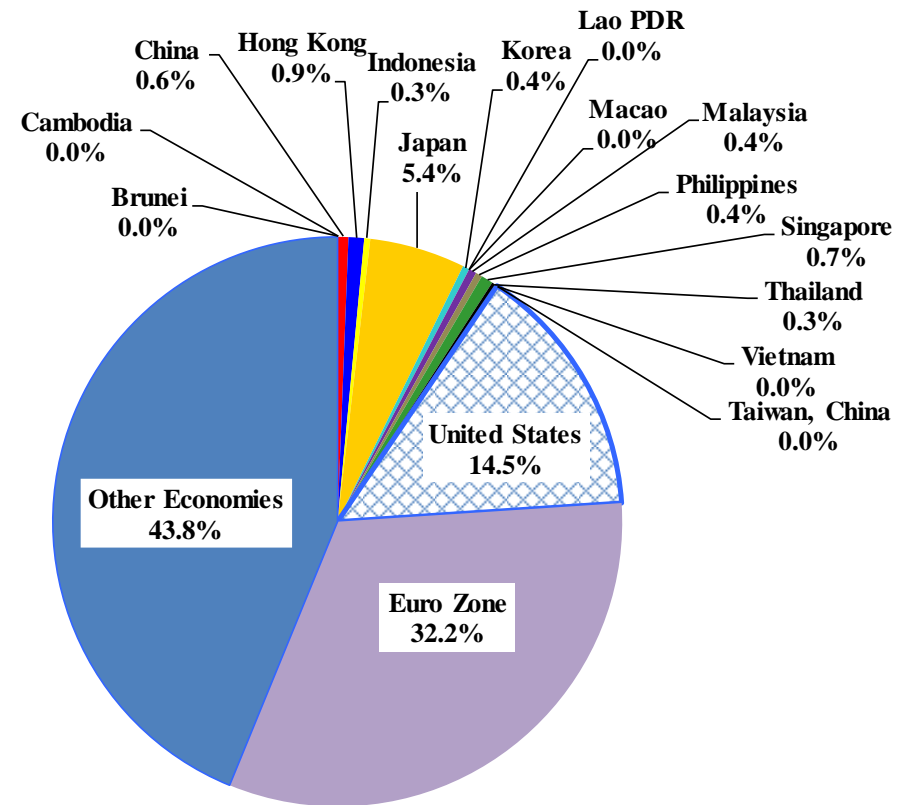


2020

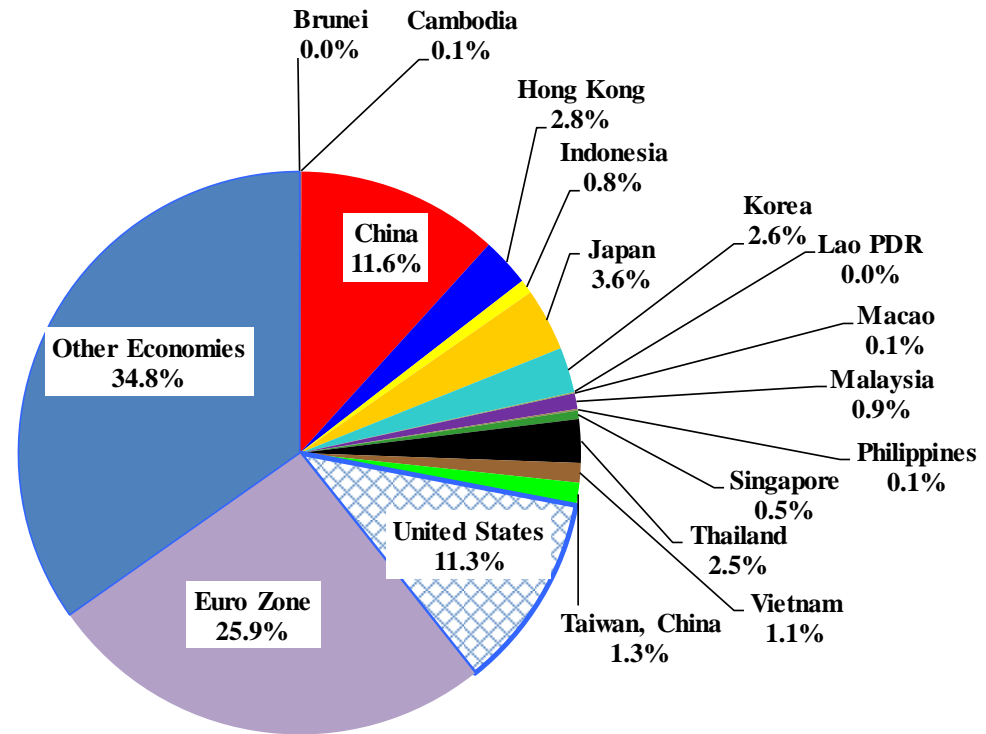


The Shifting Economic Centre of Gravity: Distribution of G&S Trade, 1970 & 2020

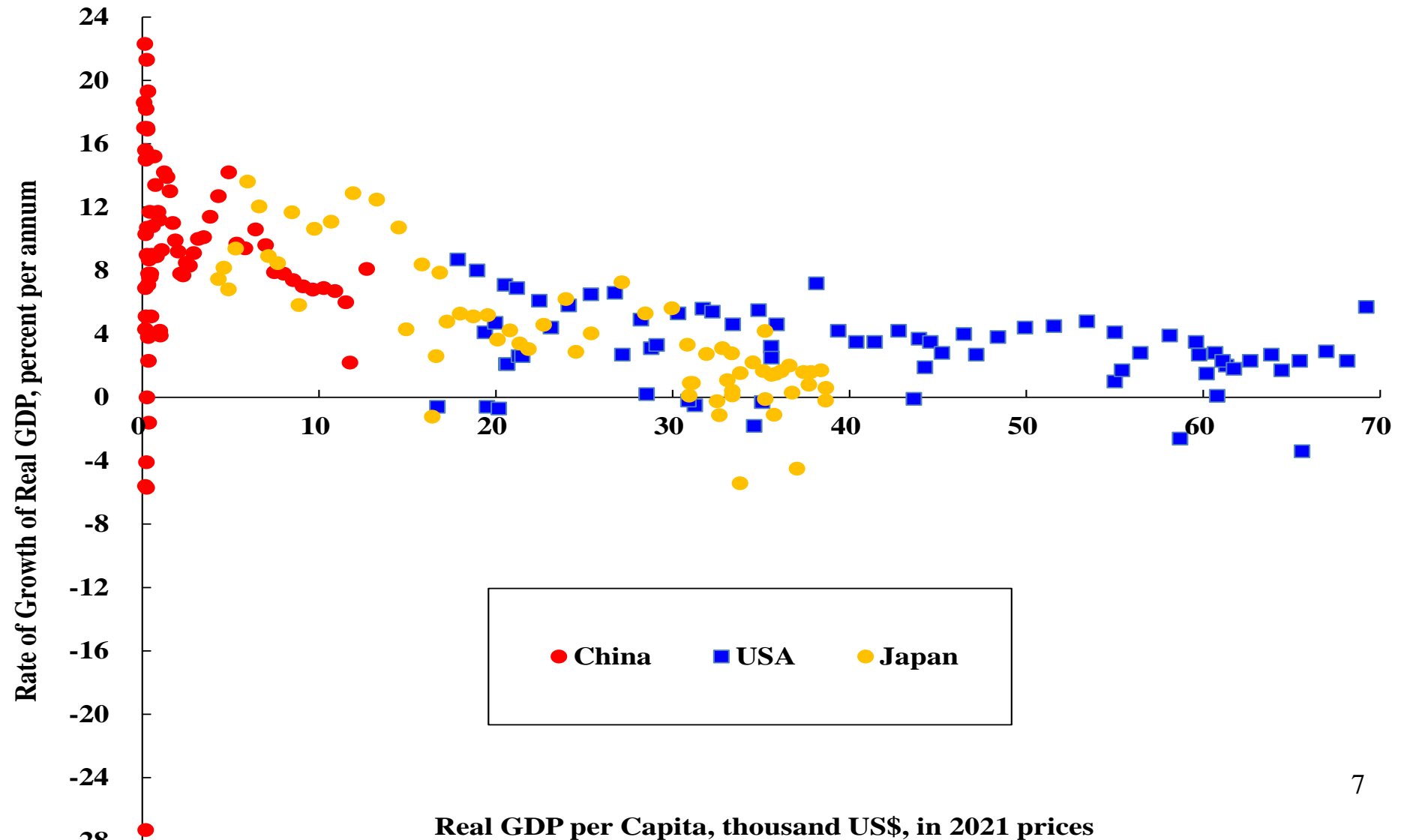
1970



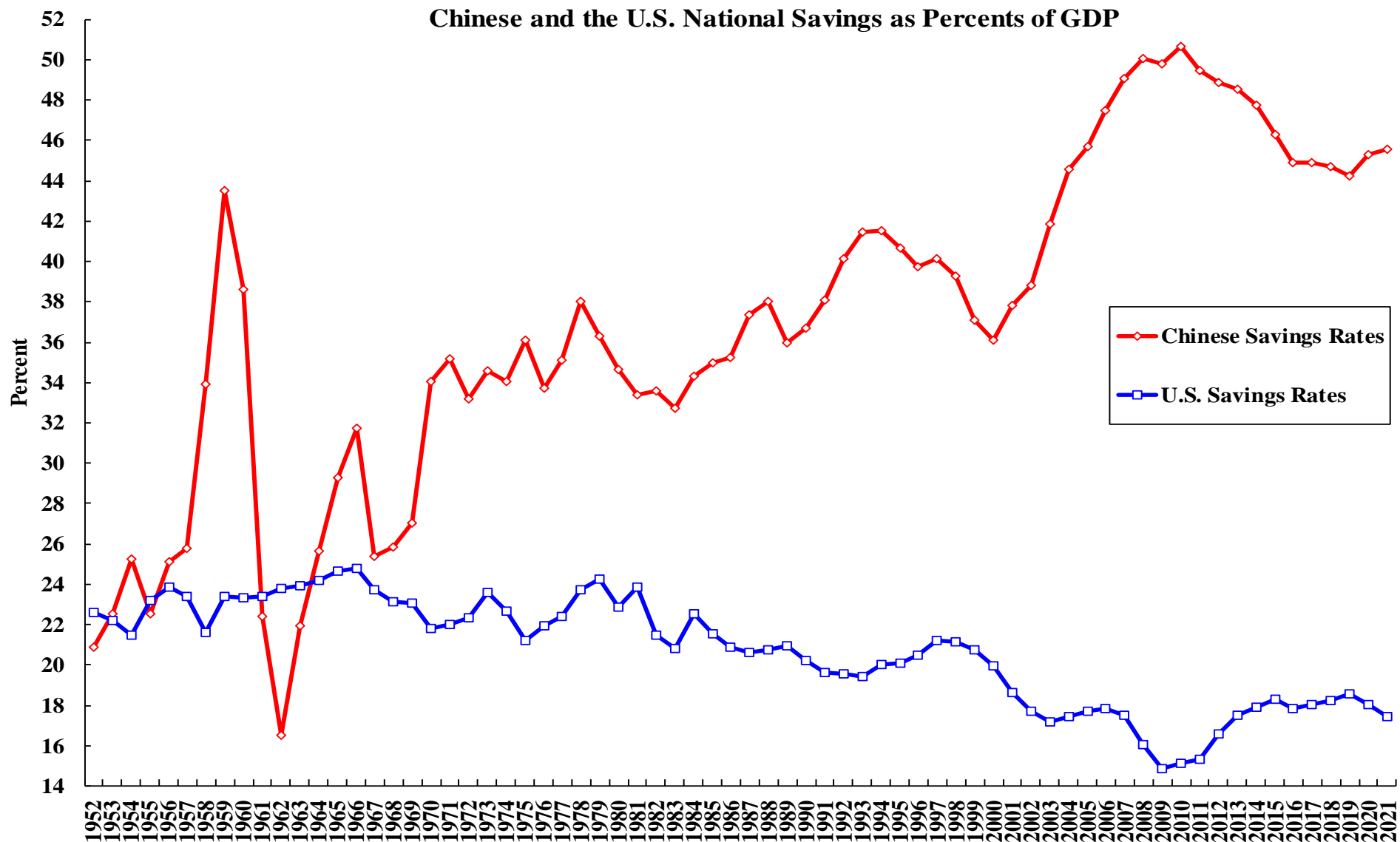
2020



The Rate of Growth of Real GDP vs. Real GDP per capita: China, Japan and the U.S.



Chinese and U.S. National Savings as Shares of GDP



Review of Global Trends:

The Shifting Economic Centre of Gravity

- ◆ From various reported surveys, there are supposedly more than six hundred known US\$ billionaires in China, more than in the United States. There may be many more unknown ones in China. The aggregate wealth of Chinese households has also been rising rapidly.
- ◆ Over the past decades, many successful Chinese enterprises, both state-owned and private, have emerged. The 2022 Fortune Global 500 list includes 145 Chinese enterprises, compared to 124 U.S. enterprises. Collectively, the revenue of the Chinese enterprises on the list exceeded the revenue of the U.S. enterprises for the first time.
- ◆ The capital needs of these Chinese enterprises will provide the basis for the supply of both equity and debt securities in the Hong Kong capital market.

Review of Global Trends:

The Shifting Economic Centre of Gravity

- ◆ China has recently become the top country in terms of (1) the total number of scientific and engineering articles published in international professional journals, (2) the total number of their citations, and (3) the total number of the top 1% most frequently cited articles, by its nationals. China has also been awarded the largest number of patents by the U.S. Patent and Trademark Office, the European Patent Office and the China National Intellectual Property Administration combined in 2021.
- ◆ China is on the verge of a breakthrough in innovation and technology. There will be many start-ups, and many failures resulting therefrom, but a small number will manage to become “unicorns”. This provides the basis for Hong Kong-Shenzhen and the Greater Bay Area to become the venture capital and start-up hub of China and East Asia. The vast Chinese market attracts entrepreneurs, innovators and venture capitalists because of its economies of scale.

Review of Global Trends:

The China-U.S. Strategic Competition

- ◆ The China-U.S. strategic competition will be the new normal for this decade. The de-coupling of the Chinese and U.S. economies, including their capital markets, is probably inevitable in the short and medium terms, and will bring challenges as well as opportunities to Hong Kong. For example, the repatriation of Chinese enterprises currently listed abroad is good for the Hong Kong Stock Exchange; and as the risk of Chinese nationals holding U.S. assets is perceived to rise, more money will stay in Hong Kong and/or the Mainland.
- ◆ The need of Chinese enterprises for an IPO with proceeds in a convertible currency will also diminish over time as the Renminbi becomes more widely accepted internationally and early investors in Chinese start-ups are increasingly domestic.
- ◆ Hong Kong can also intensify its collaboration and cooperation with Continental Europe. To the Continental European countries, China is viewed as a most important customer, not a competitor.
- ◆ The China-U.S. strategic competition will also accelerate the use of the Renminbi as an international medium of exchange, if for nothing else but to avoid what happened to Russia, which has been cut off from transactions in the U.S. Dollar and the Euro since the Russia-Ukraine conflict. The assets of Russian nationals, both enterprises and individuals, have also been confiscated under the sanctions.

Review of Global Trends:

Renminbi Internationalisation

- ◆ The Renminbi has been current-account convertible since 1994. Its value rests on the purchasing power of the Renminbi for Chinese goods and services (and assets). For all practical purposes, the offshore Renminbi is completely convertible in Hong Kong. The Chinese capital control applies only to certain capital flows into and out of the Mainland.
- ◆ Own-currency settlement of bilateral transactions between two countries, as opposed to third-country currency settlement, actually reduces both transaction costs and exchange rate risks for both countries. It requires only one currency exchange, and incurs only one exchange rate risk, and can hence benefit both countries. If a third-country currency is used for settlement, it will require two currency exchanges, doubling the transaction costs, and also be subject to two exchange rate risks.
- ◆ More and more countries have entered into own-currency settlement agreements with China, for example, Indonesia and Russia, settling their international transactions with China in Renminbi and their own currencies. Thus, the households and enterprises of these countries will potentially hold significant Renminbi balances which can be used to purchase Chinese assets in addition to its goods and services.

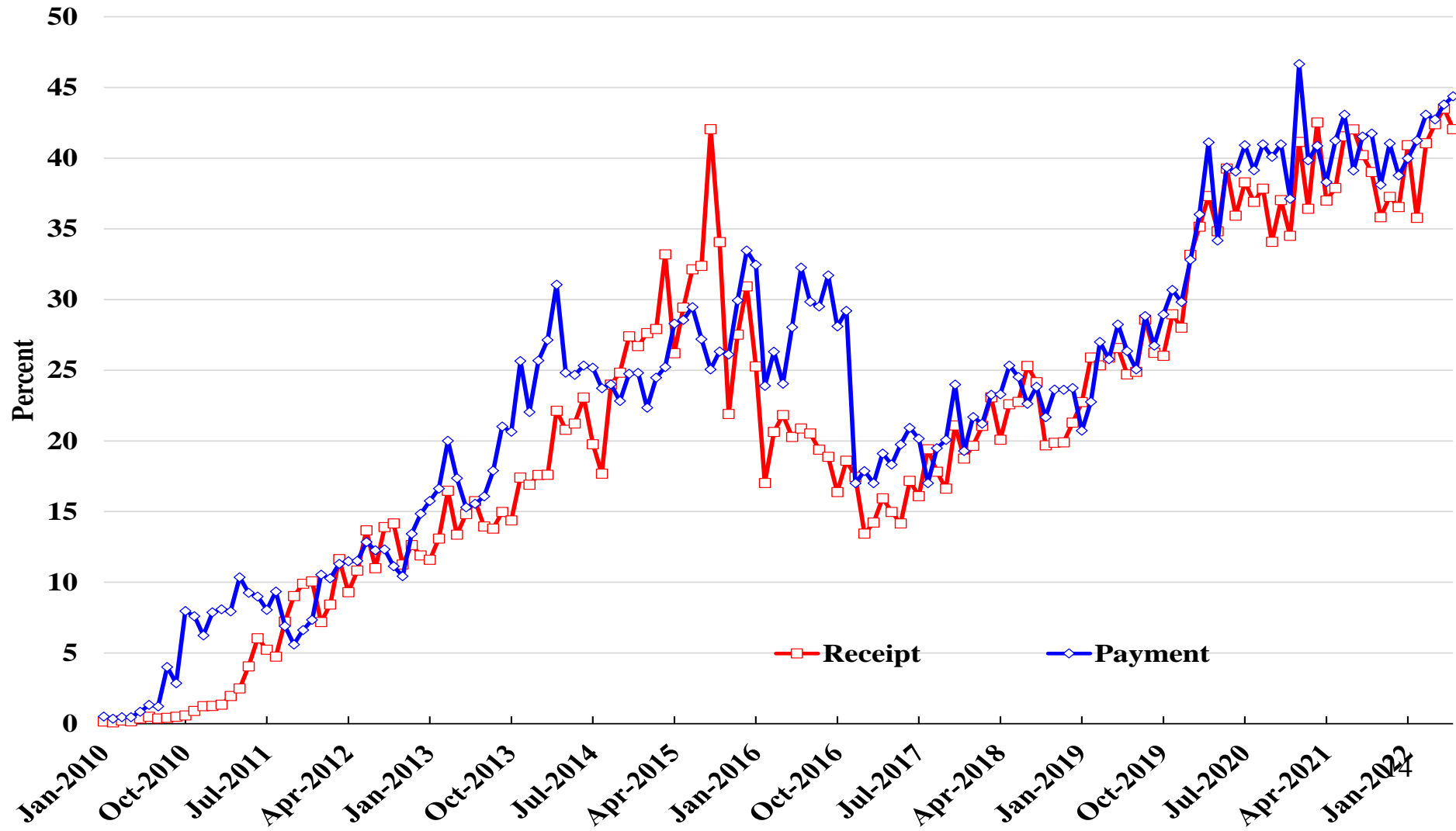
Review of Global Trends:

Renminbi Internationalisation

- ◆ Infrastructural projects in ASEAN and Belt and Road countries which use Chinese contractors and equipment may require long-term Renminbi financing. They can be funded in Hong Kong in the form of Renminbi-denominated bonds and bought and sold directly in Renminbi.
- ◆ Hong Kong is clearly the global centre for offshore Renminbi. It should ride the wave of Renminbi internationalisation and actively promote the use of the Renminbi.

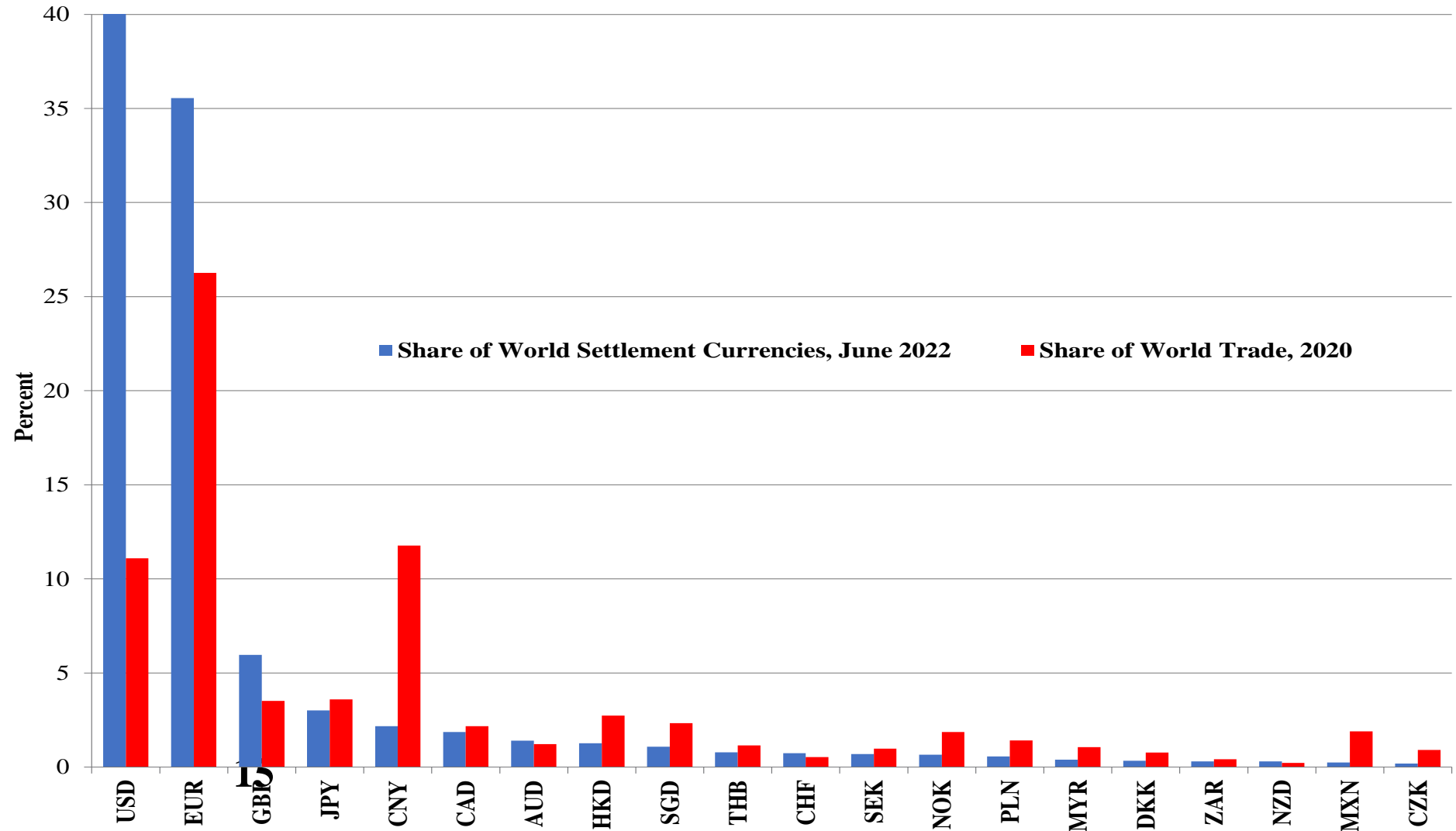
Renminbi Internationalisation: Share of Settlement in China's Foreign Transactions

Share of Renminbi Settlement in China's Foreign Related Transactions



Renminbi Internationalisation: Share of World Settlement by Currency and Trade

Share of World Settlement Currencies, June 2022



Review of Global Trends:

Renminbi Internationalisation

- ◆ The Hong Kong Dollar and the Renminbi already circulate freely and widely in Macau even though only the Macanese Pataca is legal tender there, that is, can be used to pay taxes and fines in Macau.
- ◆ Within the Greater Bay Area (GBA), it is expected that the Hong Kong Dollar, the Macanese Pataca, and the Chinese Yuan will circulate in parallel. However, the three currencies will remain the sole legal tender of respectively Hong Kong, Macau and the GBA ex HK&M.
- ◆ The direct use of the Renminbi in the Hong Kong capital markets should not only be allowed but also facilitated, given the significant offshore Renminbi deposits in Hong Kong financial institutions. For example, it should be possible to buy and sell securities on the Hong Kong Stock Exchange with Renminbi, with settlement in accordance with the closing exchange rate of the day.
- ◆ Similarly, it should be possible to buy and sell securities on the Shenzhen Stock Exchange with Hong Kong Dollars, again with settlement in accordance with the closing exchange rate of the day.
- ◆ With the introduction of the digital Central Bank currencies such as e-CNY and e-HKD in the Greater Bay Area, parallel circulation of the two currencies should pose no technical problem.

Review of Global Trends:

Multipolarisation

- ◆ De-globalisation and de-coupling
- ◆ The emergence of multiple, parallel, independent supply chains and trading blocs
- ◆ The resurgence of protectionism
- ◆ Global economic welfare will decline and slower global economic growth will result
- ◆ The decline of the U.S. Dollar as an international medium of exchange

Review of Global Trends: The COVID-19 Epidemic

- ◆ The COVID-19 epidemic, which broke out in Hubei in late 2019, is still on-going. However, the Mainland has actually done very well in controlling the COVID-19 epidemic, despite the fact that it first broke out there.
- ◆ As of 30 June 2022, cumulative COVID-19 infections per million population was 158 for the Mainland, 260,171 for the U.S., and 84,458 for the world ex China. As of the same date, cumulative COVID-19 deaths per million population was 3.7 for the Mainland, 3,019 for the U.S., and 977 for the world ex China. (The comparable figures for Hong Kong are 166,226 and 1,254 per million.) If China were to have the same death rate as the U.S., the cumulative total deaths would have increased from 5,226 to 4.3 million.
- ◆ The cumulative rate of growth of real GDP over the ten quarters since 2020 has been reduced by 7.5% on the Mainland compared to the ten quarters before. For the U.S., the reduction has been only 4.2%. There appears to be a trade-off between the reduction in the growth of GDP and the COVID-19 cumulative death rate.
- ◆ COVID-19 will eventually subside but there may be other epidemics.¹⁸ One must remain vigilant.

Hong Kong's Strength: The Confluence of the Demand for and Supply of Assets

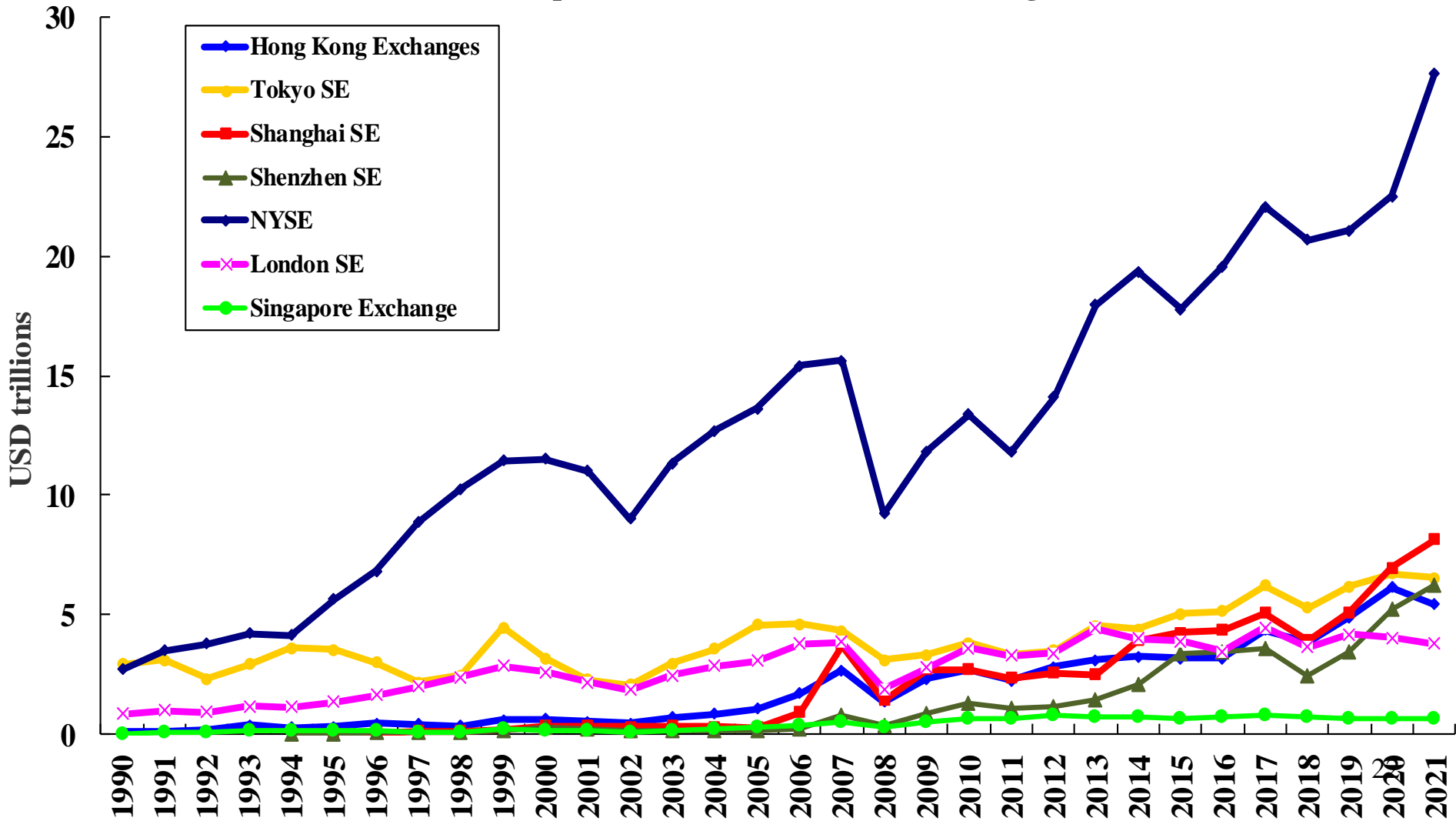
- ◆ As an international financial centre, Hong Kong has many strengths and weaknesses that are well-known—low tax rate, no capital control and rule of law, high housing cost, etc., and I shall not repeat them here.
- ◆ The fixed HK\$/US\$ peg used to be an anchor for the Hong Kong economy, but could become its Achilles heel because of potential U.S. sanctions. One way to hedge against the effects of any change in the peg is to promote the greater use of the Renminbi in the capital markets and in everyday transactions.
- ◆ However, Hong Kong's unique and most important comparative advantage is the confluence of the large demand for and large supply of assets emanating from the Mainland. Already, Mainland enterprises account for more than half of the annual IPO volume and turnover on the Hong Kong Stock Exchange.
- ◆ The immense and growing wealth of Mainland China provides the backstop for Hong Kong as an international financial centre. Moreover, the wealth holders on the Mainland need to diversify their expanding portfolios by geography and Hong Kong can provide an easy way to accomplish it.

Hong Kong's Potential Competitors

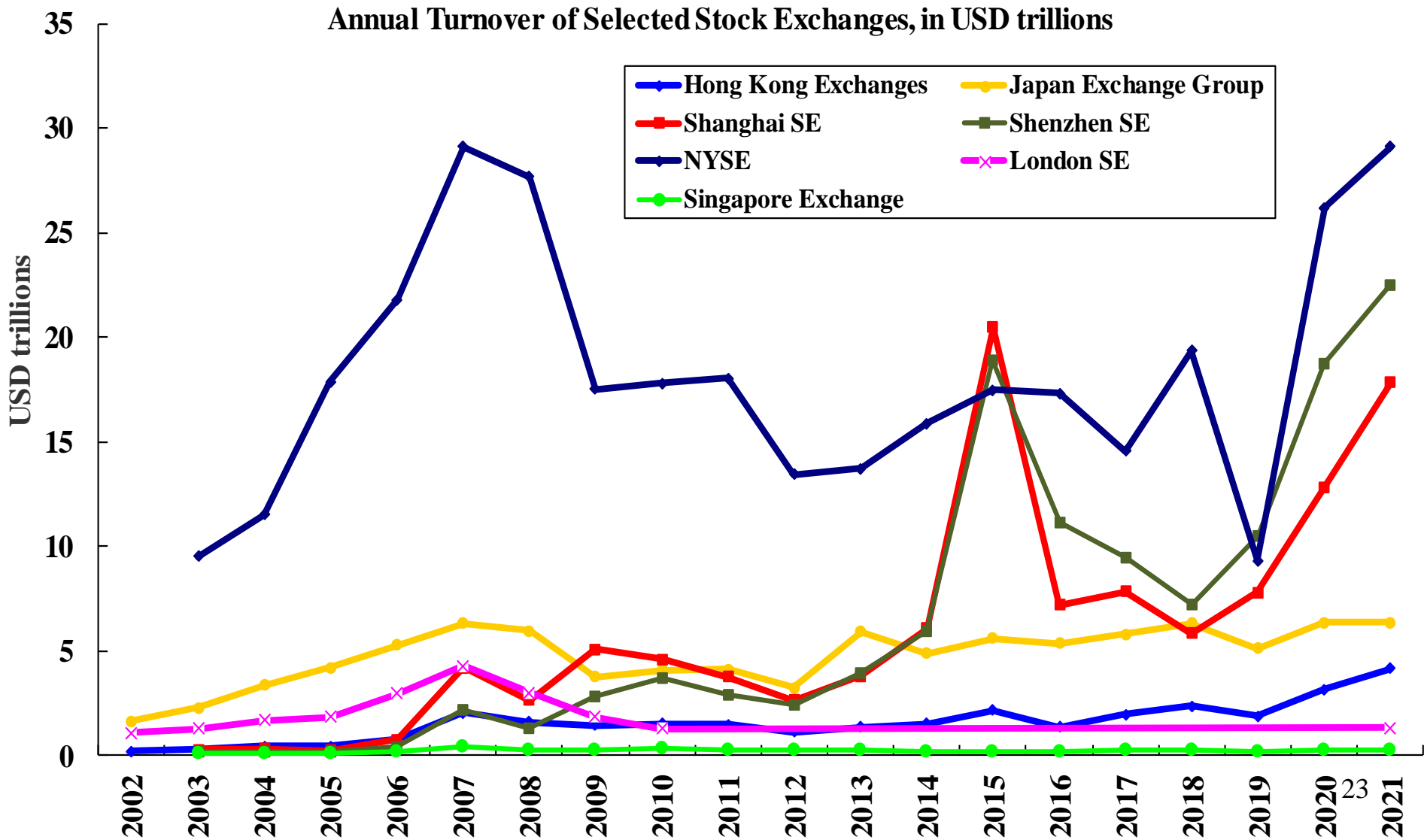
- ◆ Singapore has neither the standby buying power (demand) nor sufficient domestic supply. Saudi Arabia and the United Arab Emirates have the standby demand but cannot provide the supply. Tokyo is the only city in Asia that has both the standby demand and supply. But Tokyo does not seem to want to become an international financial centre, and Japan has shown no interest for the Yen to become a significant international medium of exchange.
- ◆ Shanghai is a potential competitor to Hong Kong, but China is large enough to have two (or even more) financial centres. (Currently, Shanghai is still subject to Chinese capital controls.) There can also be an appropriate division of labour between Hong Kong and Shanghai. For example, one can focus on the domestic economy, and the other can focus on the international economy.
- ◆ Both Hong Kong and Shenzhen are part of the Greater Bay Area and their economies complement each other. They should intensify their collaboration and cooperation and perhaps one day the two stock exchanges can merge into a single entity.

End of Year Market Capitalisation of Selected Stock Exchanges

End of Year Market Capitalisation of Selected Stock Exchanges, in USD trillions



Annual Turnover of Selected Stock Exchanges



Some Directions for Future Expansion

- ◆ The Hong Kong Stock Exchange should actively recruit successful enterprises in Hong Kong, Macau and the Mainland that have not yet been publicly listed; for example, DJI, the world's premiere drone manufacturer.
- ◆ It should also try to expand its geographical footprint and actively recruit successful enterprises outside of China and Hong Kong for a secondary listing, for example, Saudi Aramco, the world's most profitable company, Airbus, Samsung, and perhaps even Apple. More generally, it should strive to provide a marketplace for all successful East Asian enterprises in the form of secondary listings.
- ◆ Hong Kong badly needs to develop a deep, wide and liquid long-term fixed income market in both Hong Kong Dollars and Renminbi. Both the demand for and supply of Renminbi-denominated bonds should be rising over time. Renminbi-denominated infrastructural and green bonds issued by the Mainland central and local governments and by ASEAN and Belt and Road countries should be well received in Hong Kong.
- ◆ On the strength of the enormous backstop wealth of the Mainland, Hong Kong has the potential of becoming one of the few global re-insurance centres.
- ◆ Above all, Hong Kong should try to nudge its investors to take a more long-term view.

Concluding Remarks

- ◆ The future of Hong Kong as an international financial centre is excellent. With the buying power of the Chinese investors on the demand side, and the successful Chinese enterprises on the supply side, the Hong Kong Stock Exchange cannot help but prosper.
- ◆ Hong Kong should capitalise on the fact that it is the global centre for offshore Renminbi and promote the wider use of Renminbi in financial transactions.
- ◆ The economies of Hong Kong and Shenzhen together can eventually rival the success of Silicon Valley-Route 128-NASDAQ combined in the U.S.
- ◆ In the longer run, the overseas Chinese communities in the ASEAN countries may wish to re-establish their connections with their home regions on the Mainland, which were severed after 1949. Hong Kong may be able to play an important intermediary role for them, as it did in the late Nineteenth and the first half of the Twentieth Century.