HONG KONG OUTLOOK

THE SPECIAL RELATIONSHIP WITH CHINA

Hong Kong has long enjoyed the fruits of its privileged relationship with the People's Republic of China, making the most of opportunities for offshore renminbi business and enjoying a series of cross-border market liberalizations. But has recent volatility from China put Hong Kong's own prospects at risk? John Tsang, Hong Kong's financial secretary, tells *Institutional Investor* there is no reason to fear.

By Matthew Thomas

The Chinese central bank made a historic decision in the middle of August, when officials announced they were allowing the market to have more influence on the movement of the renminbi. The move, which won kudos from the International Monetary Fund, created a breathtaking amount of discussion from economists, traders and journalists. It also allowed the renminbi to drop by almost 2 percent on August 11, the biggest one-day fall in the currency's history.

It was perhaps inevitable that the decision would have generated such a flurry of discussion. But amid the rush to figure out exactly what the move meant for China, there was less attention paid to the impact it would have on Hong Kong, a special administrative region of China and an economy that has done very well from its relationship with the mainland in the last decade.

Hong Kong investors could be forgiven for feeling an ounce of fear. The region's stock market has benefited greatly from Chinese listings. Hong Kong has reaped the fruits of the internationalization of the renminbi, in which it still remains the most important hub. Hong Kong companies and investors were also starting to feel the benefits of Stock Connect, a landmark agreement with the mainland that allowed two-way stock market flows. Does the increasing volatility of the renminbi — which came amid dramatic volatility in the value of China's A-share market — put Hong Kong's fortunes at risk?

John Tsang, the financial secretary of Hong Kong, certainly doesn't think so.

"I believe the new mechanism is an imperative step in the right direction, as it allows market demand and supply to play the key role in setting the renminbi central parity exchange rate," he says. "The more market-oriented exchange rate mechanism, together with other structural economic reforms, will contribute positively to the mainland's macroeconomic stability and ensure a more balanced economy on the mainland, with a healthy mix of consumption and services sectors."

This optimistic view echoes the response of the International Monetary Fund, which said the move "appears as a welcome step as it should allow market forces to have a greater role in determining the exchange rate." But much subsequent attention has been paid to the impact of the move: the rapid fall in the value of the renminbi.

The question of whether Beijing's depreciation was a sensible step — as well as a positive for Hong Kong — seems to hinge almost entirely on perspective. In the short-term, the increased volatility of the currency generates negative headlines, and sets pulses racing. But in the long-term, the benefits seem obvious. China is, in fact, simply moving closer to what international economists have long called for: a more market-driven currency, a

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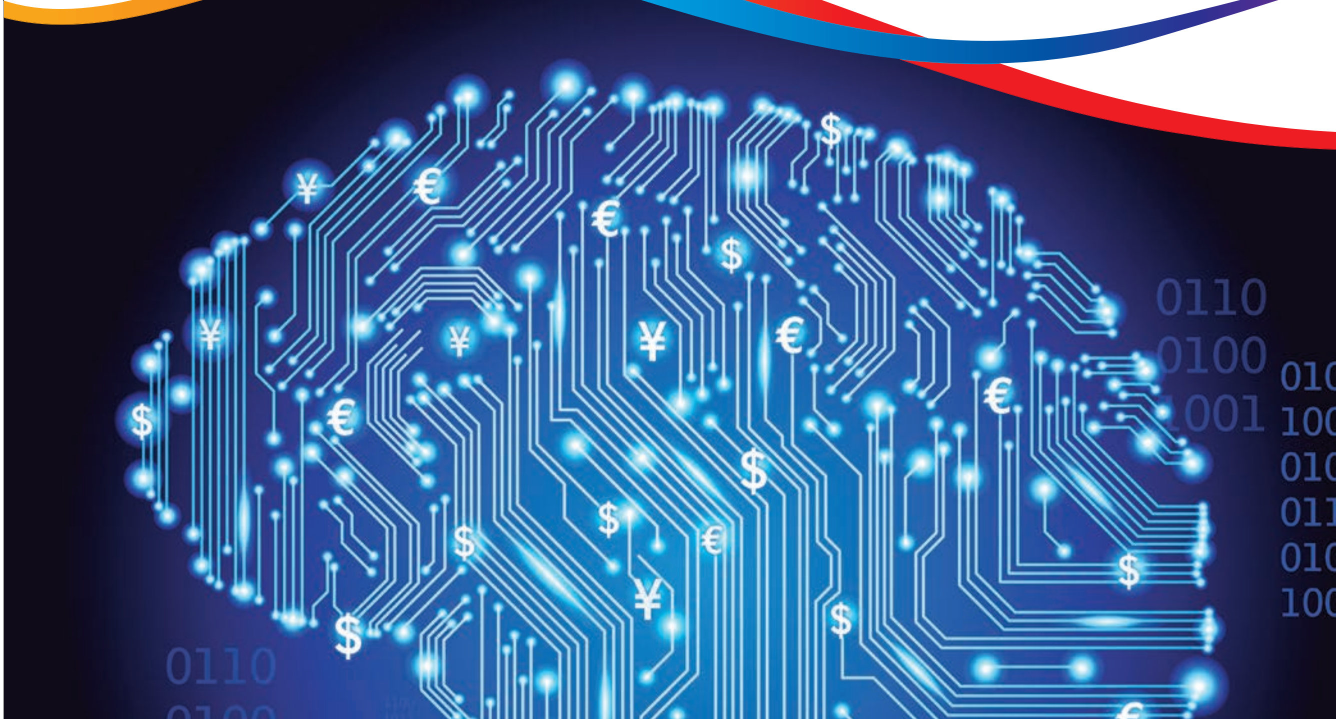

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John Tsang
Financial Secretary of Hong Kong

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more open capital account and a more hands-off approach by the central bank.

These moves will not just yield long-term benefits for mainland China. They will also benefit Hong Kong, says Tsang, who argues China's foreign currency reserves and current account surplus ensure "there is no basis for persistent depreciation of the renminbi." He sees the equation as simple: The more sustainable China's development is, the better the prospects are for Hong Kong.

The relationship is not just one-way. The Chinese government's willingness to allow its currency to trade more widely can, in fact, be seen as a sign of the benefit it got from using Hong Kong as a laboratory to explore, among other things, greater volatility in the renminbi. That is a role that Hong Kong looks set to fulfill for many more years to come.

Reaping the benefits

The rise of offshore renminbi bond issuance is perhaps the clearest example of Hong Kong's role as the "testing ground of pilot initiatives that aim to develop renminbi assets and financial product markets with greater depth and breadth," as Tsang puts it. The special administrative region was given a crucial concession in January 2007, when the Chinese government announced it would allow a limited issuance of renminbi bonds in Hong Kong.

Eight years later, the offshore renminbi bond market is worth Rmb648 billion ($101.3 billion), according to *Global RMB*. Financial centers are falling over themselves to grab a piece of the action, and the question of when the renminbi will challenge the dollar's global reserve currency status is a major talking point among economists across the globe. The success of the internationalization effort means that Hong Kong faces intense competition from markets such as Singapore, London and Taipei, which are each trying to develop their own robust renminbi centers. But it is clear Hong Kong is still in the driver's seat.

"More and more channels for the circulation and use of renminbi funds have been introduced in Hong Kong in the past few years, including the launch and expansion of portfolio investment schemes like renminbi qualfied foreign institutional investor program, Shanghai-Hong Kong Stock Connect, as well as the recent Mutual Recognition of Funds Arrangement," says Tsang.

The Stock Connect program, which allows Hong Kong investors to buy Chinese shares and vice versa, should be a boon for Hong Kong stocks, according to HSBC economists, who argue that "Hong Kong remains in a sweet spot to benefit from a series of China's efforts in capital markets liberalization." The mutual recognition of funds, which allows Hong Kong and mainland funds to market to each other's retail investors, also presents serious opportunities for Hong Kong fund managers.

Hong Kong's efforts to expand the use of the renminbi, its growing number of agreements with the mainland government, and even its recent attempts to win a share of the Islamic finance market will stand it in good stead in the years to come. Still, it is macro developments that could really make a difference to Hong Kong over the coming decades.

The bigger picture

China's government has shown an increasing appetite for engaging with the world over the last few years. The creation of the Asian Infrastructure Investment Bank (AIIB), a Beijing-based multilateral lender, is one clear example. The Belt and Road initiative is another. Both of these should provide clear benefits to Hong Kong, says Tsang.

The AIIB, which will start operating next year, hopes to address the mammoth infrastructure financing needs in Asia over the coming years. Meeting those needs will rely, at least in part, on involvement of the financial markets, and Hong Kong could prove a key launching pad. The Belt and Road strategy—a broader initiative that aims to further economic ties between China and its regional peers, and which also hinges in large part on infrastructure development—could expand those benefits for Hong Kong even further.

"One of the major elements of the Belt and Road initiatives is the massive investment to upgrade infrastructure connections among countries," says Tsang. "Hong Kong's highly efficient capital markets and the wide range of financing options, from public offerings and loan syndication to private equity funds and raising capital through Islamic finance, can help countries in the relative regions, in particular those emerging economies, to raise the necessary funds for infrastructure and business development at reasonable cost."

Hong Kong's privileged position in the effort to internationalize the renminbi will play into these advantages. The increasing importance of the AIIB, and the successful implementation of the Belt and Road strategy, will lead to more demand from corporations and governments alike for China's currency. That is one area where Hong Kong has proved its savvy in the past.

It is clear that the recent events surrounding China have raised alarms among some international investors unused to volatility coming from the Chinese market. But the long-term outlook still looks positive for China—and for the special administrative region that has long been the market dynamo of the Chinese project. ■