

## Hong Kong SAR: Ten Years On

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*The next 10 years is likely to see a rapid convergence of the financial markets of mainland China and Hong Kong towards the creation of a single market.*

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Hong Kong's first 10 years following reunification with China have been economically turbulent ones. The period began with six years of deep economic adjustment in the aftermath of the Asian financial crisis. Economic confidence took a further blow in the spring of 2003 when the post-colonial city's economy plunged to its lowest point with the SARS outbreak.

By the summer, however, the threat of a full-blown SARS epidemic had faded and the signing of the Closer Economic Partnership Arrangement (CEPA) with mainland China provided a much-needed fillip to local business sentiment. In response, the economy began to show signs of what would become a sharp and sustained recovery. Four years on, this recovery has not yet lost momentum, with the stock market registering record highs in recent months. Hong Kong appears to be entering its second 10 years as a Special Administrative Region on a stronger footing. But new challenges lie ahead.

### 2007 vs 1997

It is worth taking a look at the state of the economy 10 years on from 1997 as it has passed through a deep trough into a significant upswing that has helped it recover lost ground. A look at the broadest measure of economic health – nominal GDP – suggests that the economy has recovered from the downturn: nominal GDP stood at HKD1,474 billion in 2006, up 7.8% from HKD1,365 billion in 1997. However, other economic indicators suggest a less rosy picture. At HKD215,006, per capital GDP in 2006 was only 2.2% higher than in 1997, indicating that the territory is largely at same level 10 years on from reunification.

The unemployment rate has trended up. Despite recent improvements, the current rate is still twice as high as in 1997. Property prices are still an average of 44% below the 1997 peak, although those at the luxury end have surpassed 1997 levels.

The brightest spot is perhaps the financial market. The Hang Seng Index, which slumped to 6,660 in 1998, recently surpassed 22,000, 33% higher than its peak in 1997 and 24% above the high point reached during dot-com fever in 2000. Total market capitalisation currently stands at about HKD15,000 billion, or 10 times GDP, compared with HKD4,750 billion, or 3.5 times GDP, in 1997.

On the other hand, the latest government survey



on income distribution provides evidence that as the economy becomes more dominated by financial services and increasingly knowledge-based it is also becoming more polarised. Between 1996 and 2006, the median monthly household income at current prices edged down slightly from HKD17,500 to HKD17,250. Moreover, the income gap between the rich and the poor has widened. The household income of the lowest income group is down by 20%, whereas the household income of the highest income group has gone up by over 11%.

### **Lessons: Rigidity vs Flexibility**

The lessons from Hong Kong's economic performance in its first 10 years following reunification are many. In general terms, however, the biggest lesson is how Hong Kong underwent economic adjustment when subject to certain rigidities and entered recovery when certain barriers were removed. In particular, price rigidity was a major player in the lengthy and severe down-cycle, while new arrangements for encouraging greater cross-boundary flows of funds are providing new impetus to the economy.

The currencies of many of Hong Kong's neighbours depreciated substantially during 1997-98. With the HK dollar tied to the US dollar, Hong Kong's economic adjustments needed to be made in the form of price deflation at all levels, including asset prices, general price levels and wages. These price adjustments took place at different paces, but the adjustment cycle was lengthened with the bursting of the dot-com bubble in 2000, the 9/11 terrorist attacks in the US and subsequent recession in 2001-02, and the SARS crisis in 2003. The labour market adjustment was realised through a painful rise in unemployment to 8.7%. Residential property prices slid nearly 70% before coming to a halt. Consumer price deflation lasted for 68 months.

Hong Kong has learnt not to underestimate the repercussions of asset price adjustments. The resultant wealth contraction coupled with falling wages and rising unemployment damaged confidence, causing a vicious price-wage downward spiral. Hong Kong was faced with a choice of devaluation or deflation, and opted for the latter.

Another lesson arose from the experience that when price adjustments were deep enough, an external stimulus was able to kick-start an upswing — the speed and magnitude of which surprised not only

the pessimists but also the optimists.

The external factor that began Hong Kong's economic rejuvenation in 2003 was the Mainland, or more precisely, Hong Kong's deepening economic integration with the fast-growing Mainland economy.

Phase 1 of CEPA took effect in 2004. The liberalisation of flows of trade in goods and services and in flows of people and funds were further increased in subsequent years. With opportunities in Hong Kong constrained by the size of its domestic market and internal factors unable to re-ignite its growth engine, this new flexibility, which included allowing more Mainland visitors to come to Hong Kong for leisure and business and more Mainland enterprises to come to raise funds as well as granting Hong Kong companies easier access to the vast Mainland market, has proved a powerful stimulant. The result has been a strong recovery with GDP growing above-trend for 13 consecutive quarters.

### **The Next 10 Years: Financial Services Increasingly Dominant**

It is now generally accepted that the economic future of Hong Kong rests on continuing to deepen its economic relationship with the Mainland. The future growth of Hong Kong's various service industries will rely in large part on successfully tapping the huge Mainland market to look for new markets and customers. But this moving out of business activities will put the Hong Kong economy at risk of losing business to the Mainland, even in the financial services sector in which Hong Kong still enjoys a clear leading edge.

As an important international financial centre (IFC), Hong Kong is already highly experienced in providing cross-border financial services. During the next 10 years and beyond, the largest market and greatest demand for financial services is highly likely to centre on the Mainland. Hong Kong is well positioned to meet this demand. Thus, Hong Kong's primary objective should be to ensure that it is the preferred provider.

The introduction of various kinds of renminbi financial services in Hong Kong (including the upcoming renminbi bond issues) is vital — irrespective of the initial size of such activities. Schemes that facilitate fund flows between Hong Kong and the Mainland benefit both markets.

There is little doubt that the Qualified Foreign Institutional Investor (QFII) and Qualified Domestic Institutional Investor (QDII) schemes will continue to expand in the years to come as the Mainland will further de-regulate its financial markets and relax its capital controls. Hong Kong needs to position itself to capture the surge in related financial business that will accompany these developments.

Hong Kong should also step up preparations for when the renminbi becomes fully convertible. This may or may not take place during the next 10 years depending on how “full convertibility” is defined, but there is little question that the renminbi will grow increasingly accessible to foreign investors and that the renminbi exchange rate will become more flexible over time. As this happens, the rigidity and barriers between the Hong Kong and Mainland financial markets will further decrease. The two markets may increasingly come to operate as one.

### **Predictions: One Market, One System**

It is far too early to make a cast-iron prediction that Hong Kong and the Mainland will eventually have a single financial market that operates on the basis of one system. However, all indications are that the efforts and measures currently being put in place in Hong Kong and on the Mainland will help facilitate such a reality. The QFII and QDII schemes — which allow funds to flow between the two markets — are one example. Allowing renminbi deposits and the issuance of renminbi bonds in Hong Kong are others. And the recent discussion on price equalisation of A-shares and H-shares of the same company arguably offers an even more vivid illustration of moves towards integrating the two markets.

The Mainland and Hong Kong stock markets currently play different roles for Mainland enterprises and are treated as two separate markets by investors. At present, there are 45 Mainland companies that have dual listings of H-shares and A-shares, which are traded in Hong Kong and on the Mainland respectively. Although these two classes of shares are essentially the same — carrying equal equity and voting rights in a company — they are traded in different currencies, cater for different investors, and are subject to different supervisory and regulatory requirements.

Without an effective arbitrage mechanism between

the two markets, the fact that these shares trade at different prices is not illogical because they are two different products in two separate markets. Share prices are determined by the supply and demand conditions in the respective jurisdictions.

The existence of two different prices for A-shares and H-shares reflects the existence of two different markets. Any efforts to narrow or even eliminate such price differentials are effectively efforts to bring the two markets closer to becoming one.

If A-shares and H-shares eventually become freely exchangeable between the two markets, the markets will operate as one and prices will become equal. Any scheme that is capable of generating such a reality would currently only affect the very small number of companies that are cross-listed in the two markets. Longer term, however, the growing number of companies that are undertaking dual listings could make such a development more significant.

If the two markets effectively operate as one, one of the markets will most likely take up a leading role. Companies and investors will generally choose to transact in the most efficient market, i.e., the one that provides the best price and the lowest transaction costs.

For Hong Kong, the biggest challenge will be how to ensure that it benefits from an integrated market. When shares are traded at the same price on the Mainland and in Hong Kong, which market will get the bigger slice of the trading? Who will choose to trade on which market and why? These questions will not be limited to the stock markets. Other financial service sectors will face similar challenges.

### **Conclusion**

The next 10 years is likely to see a rapid convergence of the Mainland and Hong Kong economies. For the financial services industry, integration of the two financial markets is likely to take place rapidly as financial transactions are highly mobile in nature, generally occurring where the market is most efficient — providing the best price and the lowest transaction costs. Hong Kong needs to address this issue now, making any changes necessary to ensure that it remains the preferred choice for the region. This challenge applies not only to the financial sector, but also to many other sectors.

## MAJOR ECONOMIC INDICATORS

| INDICATORS  |                      |           | YOY Change (%)    |        | YOY Change (%) |       |
|---|----------------------|-----------|-------------------|--------|----------------|-------|
|   | May 07               | Apr 07    | May 07            | Apr 07 | 2006           | 2005  |
| <b>REAL GDP (HKD Mn)</b><br><b>(at constant (2000) market prices)</b> | 432,234#             | 468,477** | +5.6#             | +7.3** | +6.9           | +7.5  |
| <b>CONSUMER PRICE INDEX</b><br><b>(2004/05=100)</b>                   |                      |           |                   |        |                |       |
| Composite CPI   | 103.4                | 103.3     | +1.2              | +1.3   | +2.0           | +1.0  |
| CPI(A)  | 102.5                | 102.4     | +0.7              | +0.7   | +1.7           | +1.1  |
| CPI(B)  | 103.5                | 103.4     | +1.3              | +1.3   | +2.1           | +1.0  |
| CPI(C)  | 104.1                | 104.0     | +1.7              | +1.9   | +2.2           | +0.8  |
| <b>EXTERNAL TRADE (HKD Mn)</b>  |                      |           |                   |        |                |       |
| Domestic Exports  | 9,242                | 8,611     | -19.9             | -16.1  | -1.1           | +8.0  |
| Re-exports  | 207,349              | 203,994   | +14.1             | +14.3  | +10.0          | +11.7 |
| Imports   | 230,868              | 233,203   | +11.1             | +14.7  | +11.6          | +10.3 |
| Trade Balance   | -14,277              | -20,598   | —                 | —      | —              | —     |
| <b>EMPLOYMENT AND WAGES<sup>@</sup></b>                               |                      |           |                   |        |                |       |
| Unemployment Rate (%)   | 4.3 <sup>^</sup>     | 4.3       | —                 | —      | —              | —     |
| Underemployment Rate (%)  | 2.2 <sup>^</sup>     | 2.1       | —                 | —      | —              | —     |
| Labour Force ('000)   | 3,631.6 <sup>^</sup> | 3,618.3   | +2.4 <sup>^</sup> | +2.0   | +1.3           | +0.6  |
| Real Wage Index   | 115.7**              | 115.3*    | +0.1**            | +0.3*  | -0.3           | -0.4  |
| <b>MONEY AND BANKING (HKD Mn)</b>                                     |                      |           |                   |        |                |       |
| Money Supply  |                      |           |                   |        |                |       |
| Total M1  | 516,592              | 511,623   | -20.4             | +14.5  | +13.1          | -10.3 |
| HKD M1  | 390,955              | 392,073   | -29.3             | +9.4   | +11.4          | -15.6 |
| Total M3  | 5,359,371            | 5,261,455 | +9.5              | +13.0  | +15.7          | +5.2  |
| HKD M3 <sup>§</sup>   | 2,979,279            | 2,897,351 | +6.8              | +14.8  | +19.2          | +5.7  |
| Deposits  |                      |           |                   |        |                |       |
| Total   | 5,056,985            | 4,936,770 | +11.1             | +14.4  | +17.1          | +5.2  |
| In HKD <sup>§</sup>   | 2,753,736            | 2,670,161 | +7.4              | +16.0  | +20.5          | +5.6  |
| Loans and Advances  |                      |           |                   |        |                |       |
| Total   | 2,642,269            | 2,586,491 | +3.3              | +9.3   | +6.7           | +7.2  |
| Trade Financing   | 162,437              | 155,598   | +10.1             | +9.9   | +7.4           | +8.9  |
| Other Use in HK   | 2,078,403            | 2,038,918 | -2.8              | +4.3   | +2.3           | +7.7  |
| Best Lending Rate (% pa)  | 7.75                 | 7.75      | —                 | —      | —              | —     |
| <b>EFFECTIVE EXCHANGE RATE INDEX</b>                                  | 92.7                 | 92.8      | -3.1              | -3.5   | -4.2           | +2.5  |
| <b>TOURIST ARRIVALS (NUMBER)</b>                                      | 2,202,343            | 2,176,854 | +12.6             | +2.3   | +8.1           | +7.1  |
| <b>HANG SENG INDEX OF STOCK PRICES</b><br><b>(31/7/64=100)</b>        |                      |           |                   |        |                |       |
| High  | 20,995               | 20,789    | —                 | —      | —              | —     |
| Low   | 20,294               | 19,810    | —                 | —      | —              | —     |
| Close   | 20,634               | 20,319    | +30.1             | +22.0  | +34.2          | +4.5  |

@ Monthly figures refer to the three-month period ending in the stated month

\* 3rd quarter, 2006

§ Adjusted to include foreign currency swap deposits

\*\* 4th quarter, 2006

^ Provisional figure

# 1st quarter, 2007

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