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Commission on Strategic Development
Committee on Economic Development and Economic Cooperation with the Mainland

Further Development of Hong Kong's Financial Services

PURPOSE

This paper provides an overview of the latest development of Hong Kong's financial services sector and the strategic recommendations of the Focus Group on Financial Services formed under the Economic Summit on "China's 11th Five-Year Plan (FYP) and the Development of Hong Kong"[1].

Overview of Hong Kong's Financial Services Sector

(a) The current situation

2. Hong Kong has already developed into a major international financial centre. This important role was positively recognized in China's 11th FYP approved by the National People's Congress in March 2006. The Chief Executive in his 2006 Policy Address further set out that we need to consolidate and enhance our position as an international financial centre in the Asia-Pacific region. Located within the Asia time zone, Hong Kong is a prime choice for market participants where 24-hour international financial services could be provided alongside with the two global financial centres in London and New York.

3. As an important pillar of our economy, the financial services sector contributes directly around 13% of our GDP and employs more than 180 000 people. The following gives a brief overview of the performance of our financial services sector–

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[1] The Economic Summit on "China's 11th FYP and the Development of Hong Kong" was convened by the Chief Executive in September 2006. 33 personalities from the industrial and business, professional, labour and academic sectors were invited to attend the Summit. The objective of the Economic Summit was to provide a platform for the Government and the various sectors to discuss how Hong Kong should respond to the challenges and opportunities arising from the 11th FYP and come up with a set of strategic proposals and action agenda.

(i) Securities Market

- The total market capitalization of our stock market reached US$1,710 billion as at end 2006, and ranked 6^{th} in the world and 2^{nd} in Asia.

- Total equity raised in 2006 reached US$67.25 billion, ranking 3^{rd} globally and 1^{st} in Asia.

- In terms of total IPO fund raised last year, which amounted to US$42.8 billion, Hong Kong ranked 2^{nd} globally and 1^{st} in Asia, ahead of New York and Tokyo.

- As at end 2006, a total of 367 Mainland enterprises were listed on our stock exchange, representing about one third of the total number of listed companies, 50% of the total market capitalization and 60% of the average daily turnover of stocks.

(ii) Asset Management

- Hong Kong is rising fast as Asia's leading asset management centre. Our combined fund management business exceeded US$580 billion as at end-2005.

- Funds sourced from overseas investors accounted for over US$360 billion (63%) of the total fund management business in Hong Kong as at end-2005.

(iii) Banking

- We are the world's 15^{th} and Asia's 3^{rd} largest international banking centre in terms of the outstanding amount of the banking system's external transactions. Around 70 of the world's 100 largest banks are currently operating in Hong Kong.

- We are the 6^{th} largest foreign exchange market in the world in terms of total average daily net foreign exchange turnover.

(iv) Insurance

- With 181 authorized insurers as at end-2006 and total gross premiums of US$20.3 billion in 2006, we have the highest concentration of insurers in Asia.

- Our long-term insurance business has continued to attain double-digit annual growth since 1991.

(b) Hong Kong as a financial centre in the international scene

4. The encouraging performance of Hong Kong's financial services sector in recent years has gained considerable international recognition. Hong Kong was ranked 3rd after London (1st) and New York (2nd) among the top 10 international financial centres in a most recent global financial centres study published in March 2007[2] **(Annex 1)**. London and New York were ranked as the only two global financial centres[3] that possess a number of significant factors including business environment, market access, infrastructure, etc. accumulated over years and large clusters of financial institutions and skilled talents. Their comparative advantages over other financial centres are difficult to be challenged within a short period of time. However, there is considerable fluidity among Asian cities in competing for the pre-eminent status as the international financial centre of Asia. Whilst Hong Kong is, at present, the clear fore-runner; Singapore, Tokyo and Shanghai are all aspiring to assume such function.

5. In today's ultra-competitive global financial market environment, major financial centres are eagerly defending their position and trying to overtake other competitors through enhancing their competitiveness in terms of regulatory environment, taxation regime, and attracting skilled talent. The following highlights some recent notable efforts of selected financial centres that may have bearing to Hong Kong:

(i) The City of New York has just completed a study on sustaining New York's and the United States' global financial services

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[2] City of London, The Global Financial Centres Index, March 2007

[3] A global financial centre is an intense concentration of a wide variety of international financial businesses and transactions in one location. An international financial centre conducts a significant volume of cross-border transactions (Source: Corporation of London, The Competitive Position of London as a Global Financial Centre, p. 11, November 2005 and The Global Financial Centres Index, p. 14, March 2007).

leadership.[4] The study has identified that complicated regulatory and legislative frameworks, e.g. the 2002 Sarbanes-Oxley Act (SOX), the continued requirement for foreign companies to conform to United States (US) accounting standards and cumbersome legislative environment that attract frivolous litigation have considerably reduced New York's competitiveness as the global financial centre. On attracting talents, New York has been very conscious of the risk of falling behind in attracting qualified workers on financial services due to the strict immigration restrictions of the US.

In response, the Mayor of the City of New York has called for re-examining the implementation of the SOX, and to undertake reforms to eliminate inefficiencies in US regulatory system and the legal systems to reduce spurious litigation. He also appealed to the Federal Government to make it easier for talents to work and study in the US. He further suggested reforming the US's educational institutions to establish a world-class centre for applied global finance in financial engineering and global capital market to drive innovation in financial services.

(ii) On the other hand, London has been benefiting from the European Union's free movement of people and has successfully become a hub for talents. Having said that, concerns have been raised on the effect of the United Kingdom's tax regime in affecting the competitiveness of London as a financial centre as several large companies are leaving the United Kingdom to lower tax jurisdiction in Ireland and Caribbean due to tax considerations[5].

(iii) In Asia, Singapore has announced in their recent Budget a series of financial incentives to promote their financial services sector, including tax incentives relating to over-the-counter financial derivatives and Qualifying Debt Securities, reduction of corporate tax rate by 2 percentage points to 18% by 2008, tax incentives for asset management services, etc.

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[4] The City of New York and United States Senate, Sustaining New York's and the US' Global Financial Services Leadership, 2007

[5] City of London, The Global Financial Centres Index, p.50, March 2007 and p.7, Special Report on Britain, The Economist, February 3rd 2007.

(iv) Over the past decade or so of economic gloom in Japan, Tokyo has been losing its competitiveness as an international financial centre, increasingly in danger of being threatened by its Asian neighborhood. For instance, the growth of Tokyo's stock market in capitalization as compared with other international financial centres has slowed down, and the number of foreign companies traded on the Tokyo exchange has decreased significantly. A high-level committee, chaired by the Prime Minister, is preparing a series of proposed actions on financial sector reform, including Japan's financial standard, regulatory system, tax regime, financial product innovation, etc. for the government's consideration this year[6].

(v) In the Mainland, a number of cities are striving to develop their financial services :

- Shanghai is becoming a major financial centre for securities, insurance, foreign exchange and funds in the Mainland. The stock exchange transaction in Shanghai has surpassed Hong Kong[7]. Its bond issuing activities are also very active. About 45% of the commodities futures trading in the Mainland are carried out in Shanghai. The financial services development of Shanghai is supported by the growing strong economic base of the Changjian Delta region. The People's Bank of China set up its first regional branch in Shanghai in 1998 and many multinational companies, the financial institutions in particular, have set up their China headquarter there.

- As the capital of China, the development potential of Beijing, where the country's financial policy-making authorities, (i.e. The People's Bank of China, China Banking Regulatory Commission, China Insurance Regulatory Commission, and China Securities Regulatory Commission) and the headquarters of many financial institutions are located, should not be overlooked.

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[6] "Market failure – Why Tokyo is losing ground to New York and London", Financial Times, 8 May 2007

[7] During the first quarter of 2007, the average daily turnover of the Shanghai Stock Exchange was US$14.2 billion, while the average daily turnover of the Hong Kong Stock Exchange was US$6.8 billion.

- The rapid development of Shenzhen's financial industry is worth noting. In 2006, the value-added of the financial industry of Shenzhen reached RMB 37.6 billion, ranked third among the major cities in the Mainland. In its 11th Five-Year Plan, Shenzhen targets to develop into a top-tier regional financial centre in the Mainland and to enhance its capital financing, financial innovation, financial information, and related supporting services.

- In May 2006, the State Council approved the Tianjin Binhai District as the country's comprehensive financial reform pilot zone. Nevertheless, its potential development is too early to assess at this stage.

In the short term, it would be difficult for Mainland cities to replace Hong Kong's position as an international financial centre in view of the convertibility of Renminbi (RMB) issue, their current scale and experience of operation, particular with respect to experience at international level, etc. However, their longer term potential, in particular Shanghai, to emerge as the Mainland's major financial centre(s) should not be overlooked. A terse note on the recent development of Shanghai, Beijing, Shenzhen and Tianjin on financial services and their implications to Hong Kong is at **Annex 2** for members' reference.

Challenges Faced by Hong Kong's Financial Services Sector

6. Financial services is one of our most important and promising industries. It is of paramount importance to preserve our competitiveness vis-à-vis other places in the region so as to provide the crucial impetus for Hong Kong's continued development. As the Mainland is moving towards financial reform and liberalization, we should not overlook the challenges as well as opportunities. The ensuing paragraphs discuss the challenges faced by our financial services sector, as well as the opportunities arising from the 11th FYP, which is an important document outlining the blueprint for China's economic and social development from 2006 to 2010.

7. The recent development of Hong Kong as an international financial centre has largely been related to Mainland's international financial intermediation activities. Compared with other international financial centres such as New York, London and Tokyo, Hong Kong is relatively small in

terms of our domestic economy. In terms of market capitalization and turnover, Hong Kong's stock market is still relatively modest by global standards. Compared with other financial centres, the breadth and depth of our financial services and products in the bond trading, currency futures, and commodities futures markets are considerably behind other major financial centres. To catch up with New York, London or Tokyo, apart from improving our own credentials and strengthening our international exposure, an important strategy for Hong Kong is to strengthen our integration with the Mainland economy and to serve the financial intermediation needs of the Mainland economy in a more significant scale.

8. The 11th FYP has set out policies for expediting the financial reform in the Mainland. Going forward, there are three main areas of the Mainland's financial system that would have particular implications to Hong Kong: (i) improvement of financial intermediation to ensure sustainable economic growth; (ii) the move towards RMB capital account convertibility; and (iii) internationalization of RMB.

9. As these developments of the Mainland's financial system take place, they present challenges to Hong Kong as an international financial centre. We should not take for granted that the Mainland enterprises would continue to make use of Hong Kong as their fund-raising platform. When RMB becomes fully convertible, international investors can enter the Mainland market directly and it would not be necessary for them to use Hong Kong as a springboard for their Mainland investments. It is also possible that when the Mainland financial market becomes fully liberalized, market activities may shift to the larger and more liquid Mainland market such as Shanghai and other Mainland cities, leading to the gradual fading-out of Hong Kong's function as an international financial market. Other financial centres in the region will also become Hong Kong's competitors in the provision of RMB-denominated financial products and related services.

Opportunities Arising from the 11th FYP

10. While facing the various challenges as mentioned above, the rapid economic development and the reform of the financial services sector of the Mainland during the 11th FYP period have, on the other hand, provided enormous opportunities to Hong Kong's financial services sector. The 11th FYP unequivocally supports the development of financial services in Hong Kong. At the same time, the rapid development and gradual integration of the Asian economies have also brought new opportunities, in particular in developing asset and wealth management in the Asian region. Hong Kong

can seize the opportunities brought by the 11th FYP by strengthening and developing further our role in the financial intermediation between Mainland and the rest of the world, participating in domestic financial intermediation activities in the Mainland, and providing a testing ground for RMB internationalization.

Strategic Recommendations of the Focus Group on Financial Services

11. In response to the above-mentioned challenges and opportunities, the Chief Executive convened in September 2006 an Economic Summit on "China's 11th FYP and the Development of Hong Kong", and formed, among others, a Focus Group on Financial Services to formulate strategic proposals and practical Action Agenda to enhance Hong Kong's status as an international financial centre. The Focus Group adopted two complementary approaches in its deliberations: a macro, strategic perspective and a micro, market-specific perspective; and recommended a series of strategic proposals on how Hong Kong can contribute to the economic development and financial reform of the country in a more significant manner.

Macro, strategic perspective

12. From an institutional perspective, the Focus Group considered that China is unique in having two financial systems in the country under the "One Country, Two Systems" principle. The two financial systems should establish a complementary, cooperative and interactive relationship :

- Complementary relationship - Through exploiting the respective strengths of the two financial systems, both Hong Kong and the Mainland could complement and bring mutual benefit to each other. For instance, accessing international markets through Hong Kong can help reduce direct exposure of Mainland's financial systems to external financial risks in the course of its reform;

- Cooperative relationship - The two financial systems can benefit from closer collaboration in areas such as financial supervision, financial infrastructure, risk management, through technical transfers, information exchange, qualification recognition and harmonization of standards; and

- Interactive relationship - The two financial systems should interact with a view to enhancing the role of China as a country in the setting of international financial standards and policies, and in promoting financial intermediation efficiency and the development of financial markets within the country.

The above relationship is of mutual benefit to the two financial systems and to the interest of the country in its rapid economic transition as a whole. It will allow better use of Hong Kong's financial system in enhancing the financial intermediation efficiency and in implementing financial reform in the Mainland. In parallel, it will also strengthen Hong Kong's status as an international financial centre of the country. In this respect, Hong Kong has the responsibility to assist in ensuring the country's economic and financial stability and in strengthening the country's resilience to risks.

13. From a practical perspective, the Focus Group considered that Hong Kong could contribute to the Mainland's financial reform and development in three aspects. First, by offering diversified financial services to the Mainland, our established financial platform can help raise the efficiency of financial intermediation and support the financial system reform and development in the Mainland. Second, Hong Kong as an international financial centre can facilitate two-way cross-boundary fund flows of the Mainland, which will help address the increasing concern of external imbalances in the economy. Third, Hong Kong is also well positioned to serve as a testing ground for RMB to become fully convertible.

14. Specifically, the Focus Group recommended a five-pronged strategy to pursue the policy direction:

- to enhance the presence of Hong Kong financial intermediaries in the Mainland to provide financial services on location;

- to enhance the outward mobility of Mainland investors, fund raisers and financial intermediaries;

- to allow financial instruments issued in Hong Kong to be marketed in the Mainland;

- to enhance the capability of Hong Kong's financial system in handling financial transactions denominated in RMB; and

- to strengthen financial infrastructural linkages between the Mainland and Hong Kong.

15. From a strategic perspective, the Focus Group proposed to further develop Hong Kong as China's international financial centre of global significance. Strategically, this policy direction is of national interest to China as her economy has become one of the largest in the world. The Focus Group considered that developing Hong Kong into an international financial centre of global significance would help enhance China's status and competitiveness in the world. It is also a natural development of Hong Kong's existing status as a premier international financial centre in Asia. Through the policy, Hong Kong will also complement the development of other financial centres in the Mainland. Different financial centres can play their own role based on their respective comparative advantages.

Micro, market-specific perspective

16. From a micro, market-specific perspective, the Focus Group proposed to strengthen high level liaison with the Mainland to facilitate continuous capital formation for Mainland enterprises. As an international financial centre, the Focus Group viewed that we should further facilitate overseas quality issuers to list in Hong Kong. Efforts should be made to establish a more flexible regulatory and operational infrastructure for local, Mainland and overseas financial intermediaries and investors. It is also necessary to ensure the smooth and efficient operation of the markets.

17. As the Mainland is moving towards achieving RMB convertibility for capital account transaction in a gradual manner, the Focus Group also considered that the development of RMB futures and options market could consolidate Hong Kong's lead in offshore RMB trading and expand the range of non-deliverable RMB products. This would also consolidate our lead in offshore RMB trading, and our position as an RMB hedging and derivatives centre.

18. The Focus Group also considered the development of a commodities futures market in Hong Kong a worth pursuing initiative, as the Mainland is one of the world's largest consumers and suppliers of commodities, precious metals and other raw materials. As a first step, the Group proposed to conduct an independent consultancy study on the market potential, conditions and requirements; and make concrete proposals for developing the commodities market.

19. Finally, an effective insurance market and asset management sector would provide the necessary risk management, financial intermediation, and wealth preservation tools for the sustainable development of the Mainland economy. The Focus Group proposed that liaison be made with the Mainland to enable Hong Kong insurance institutions meet the needs of the Mainland. At the same time, the Focus Group considered that we should promote the development of international captive insurance market in Hong Kong, further the training of insurance practitioners, and foster the development of Hong Kong's asset management business.

Action Agenda

20. The Focus Group considered that the window of opportunity for realizing the strategic direction to establish Hong Kong as an international financial centre of global significance within China will not remain open forever. It is important for us to act quickly so as to build up a critical mass of financial businesses and talents to gravitate within Hong Kong instead of going to other financial centres. This is not only important for Hong Kong's own economic development but is also strategically important for China's long-term development as well.

21. To put the strategic direction into concrete action, the Focus Group has proposed an Action Agenda setting out 80 specific recommendations covering a range of macro, strategic and micro, market-specific proposed actions for the Government's consideration[8]. Separately, the Focus Group on Trade and Business set up under the Economic Summit has also proposed a range of actions to strengthen our talent pools, including financial services, etc., to support the long-term development of Hong Kong[9].

WAY FORWARD

22. Immediately following the release of the action agenda in January this year, the Government, financial regulators and other stakeholders have been studying the Action Agenda in depth and actively pursuing the implementation of the recommendations. The Government will continue to consult the stakeholders and relevant Mainland authorities, as

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8 The Report (include Action Agenda) on Economic Summit on "China's 11th Five-Year Plan and the Development of Hong Kong" could be accessed from http://www.cpu.gov.hk.

9 The Focus Group on Trade and Business set up under the Economic Summit has proposed 6 action items to attract talents and nourish local talents to support the development of Hong Kong, including financial services, logistics, tourism, information services, creative industries, information technology, etc.

appropriate. The Financial Secretary is tasked to coordinate and oversee the implementation of the Action Agenda. Major progress of action is highlighted below –

- Adjustment of position limits of Hang Seng China Enterprises Index futures and options contracts have been implemented;

- A joint policy statement was published by Hong Kong Exchanges and Clearing Limited and the Securities and Futures Commission in March 2007 to facilitate the listing of overseas companies. The statement clarifies requirements in the Listing Rules and provides a clear roadmap for potential issuers and their advisers to refer to regarding key shareholder protection matters;

- A supplementary memorandum of co-operation was signed in January 2007 between The People's Bank of China and the Hong Kong Monetary Authority regarding the cooperative arrangements on the issuance of RMB-denominated financial bonds in Hong Kong by financial institutions in the Mainland; and

- The China Banking Regulatory Commission announced in May the expansion in the scope of investment for offshore wealth management services provided by commercial banks on the Mainland to include equity investments, subject to certain conditions.

23. Looking ahead, the Government will steadfastly develop Hong Kong as the international financial centre of global significance in the Asian time zone, serving our nation's financial development and reforms with a view to enhancing our country's financial security in increasingly-globalised financial markets. In parallel, it is also important to continue our efforts rigorously to attract more overseas companies to Hong Kong in order to sustain our international exposure.

ADVICE SOUGHT

24. In developing Hong Kong as an international financial centre, the five-pronged strategies and the 80 recommended measures in the Action Agenda of the Economic Summit will form the basis to take the matter

forward. Against the above background and information, Members are invited to -

(a) note the 80 recommended measures; and

(b) apart from the recommendations in the Action Agenda, advise whether there are any other measures that should be taken to further enhance Hong Kong's competitiveness as the international financial centre of global significance.

Secretariat to the Commission on Strategic Development
May 2007

Annex 1

Table 1 – The Top 10 Financial Centres

City	Ranking	Remarks
London	1	Most key success areas are excellent – London is in the top quartile in over 80% of its instrumental factors. Especially strong on people, market access and regulation. The main negative comments concern corporate tax rates, transport infrastructure and operational costs.
New York	2	Most areas are very strong – New York is also in the top quartile in over 80% of its instrumental factors. People and market access are particular strengths. Our respondents cited regulation (particularly Sarbanes-Oxley) as the main negative factor.
Hong Kong	3	Hong Kong is a thriving regional centre. It performs well in all of the key competitiveness areas, especially in regulation. Headline costs are high but this does not detract from overall competitiveness. Hong Kong is a real contender to become a genuinely global financial centre.
Singapore	4	Most areas are very good and banking regulation is often cited as being excellent. It performs well in four of the key competitiveness areas but falls to 9th place on general competitiveness factors alone. Definitely the second Asian centre just behind Hong Kong.
Zurich	5	A very strong niche centre. Private banking and asset management provide a focus. Zurich performs well in three of the key competitiveness areas but loses out slightly in people factors and in general competitiveness.
Frankfurt	6	Despite a strong banking focus, suffers from inflexible labour laws and skilled staff shortages. Market access, infrastructure and business environment are strong but Frankfurt falls outside the top ten GFCI rankings for people and general competitiveness.
Sydney	7	A strong national centre with good regulation, offering a particularly good quality of life. Sydney is strong in four of the key competitiveness areas but falls outside the top ten for people – many financial professionals leave for larger English-speaking centres.
Chicago	8	Number two centre in the US. Hampered by the same regulatory regime as New York. It scores highly for people but is let down by its infrastructure and market access rankings. Unlikely to overtake New York, it remains a powerful regional and specialist centre.
Tokyo	9	Does not fare well in terms of regulation and business environment, but the size of the Japanese economy means Tokyo has good liquidity. It fares poorly on people but has good infrastructure and market access.
Geneva	10	A strong niche centre similar to Zurich. Private banking and asset management continue to thrive. Geneva is strong in business environment and general competitiveness but let down by infrastructure.

Source: City of London, The Global Financial Centres Index, p. 9, March 2007

Annex 2

Development of Mainland Financial Centres - Shanghai, Beijing, Shenzhen and Tianjin Binhai New Area and its implication to Hong Kong

(Translation)

I. Shanghai gaining speed in its development into an international financial centre

As the financial hub of the country, Shanghai has all along accorded top priority to the development of its financial services. Since the Central Government's announcement of developing Shanghai into "one of the international economic, trading and financial centres" as a national strategy in 1992, Shanghai has been vigorously promoting its financial sector development in phases progressively from a domestic financial centre, regional international financial centre and moving to a global international financial centre. After more than a decade's effort, Shanghai has become the largest trading market in the Mainland for securities, insurance, foreign exchange and funds. The city has been growing in size and scale, technical skills, clustering capacity and radiating functions. Its status as the financial centre in the Mainland has been established and is becoming more pronounced:

- Shanghai has become a major cluster for domestic and foreign financial institutions in the Mainland. As at the end of last year, there were a total of 563 financial institutions in Shanghai, including 109 banking institutions, 281 insurance institutions, and 90 securities institutions[1]. On banking institutions, 19 commercial banks have set up their headquarters in Shanghai. Shanghai has replaced Beijing as the city with the greatest number of bank headquarters in the Mainland. The People's Bank of China set up its first regional branch in Shanghai in 1998. Furthermore, many foreign financial institutions have established their presence in Shanghai. At present, more than 300 foreign financial institutions have located their Mainland headquarters or branches in Shanghai, of which there are over 80 foreign-funded bank business offices and about 100 representative offices, with the total assets valued at US$65.2 billion, accounting for 56% of the total assets of all

[1] Source: "Statistical Communique of City of Shanghai on the 2006 National Economy and Social Development Shanghai Statistical Bureau."

foreign-funded banks in the Mainland. Also, 27 foreign-funded banks have appointed their Shanghai offices as reporting banks for their business in the Mainland. They account for about 80% of the total assets of all foreign-funded banks in the Mainland. In addition, Shanghai is also home to 56 foreign representative offices of securities and funds and 25 foreign-funded or joint-venture insurance companies.

- A robust financial market system has been established in Shanghai. Ten major nationwide financial markets dealing with credit, interbank funding, bills, securities, bonds, foreign exchanges, insurance, futures as well as equity rights, have taken shape in Shanghai and become increasingly efficient. According to the Shanghai Financial Stability Report (2006) published by the Shanghai headquarters of The People's Bank of China, the trading volume in Shanghai's financial markets reached up to 35 trillion yuan in 2005, in which the trading volume of securities and futures accounted for 5 trillion yuan (79% of the national total) and 6.5 trillion yuan (49% of the national total) respectively. In 2006, the volume of capital raised in the securities market was 171.4 billion yuan, while the volume of market trading was 5.8 trillion yuan and the total market value was 7.2 trillion yuan by the end of last year, representing respectively 75%, 64% and 80% of the national total. The volume of spot and repo trading of the government bonds was 961.6 billion yuan, representing 90% of the national total. Besides, Shanghai is a leading market of foreign exchange, gold exchange and equity trading in the Mainland. The successive establishment of financial institutions such as the Shanghai Petroleum Exchange, China Financial Futures Exchange and the Personal Credit Information Database of The People's Bank of China over the past year has allowed Shanghai to gain increasing sway in the transaction pricing of the Mainland's financial market.

2. Shanghai has long established its financial services as the core of its economic development and city-function. All financial indicators now rate Shanghai ahead of any other cities in the Mainland. Last year, the value-added of Shanghai's financial sector reached 79.9 billion yuan, accounting for 8.2% of the GDP. The financial depth (normal loan volume/GDP) reached 1.8, a proportion elevating Shanghai to the top in the Mainland. At present, the Lujiazui Finance and Trade Zone has become home to the densest network of financial institutions in the Mainland, boasting with the widest range of key elements of the market and the greatest

capital-raising capability. It plays a complementary role to the Financial Street at Shanghai's Bund on the opposite bank of the Huangpu River, announcing to the world that China's "London financial hub" is in the making.

3. During his visit to Shanghai in July 2004, President Hu Jintao clearly stated his support for Shanghai to sustain its vigorous efforts in taking forward the city's development into an international economic, financial, trade and shipping centre. The Shanghai Municipal Government responded promptly by unveiling in the same month the "Action Agenda for Taking Forward the Development of Shanghai into an International Financial Centre". In the Agenda, the ambitious target of developing Shanghai into an international financial centre by 2020 was put forward. A strategy was formulated to carry out in phases a schedule of "laying the foundation in 5 years, building the framework in 10 years and striving for basic completion in 20 years". It is clear that Shanghai has expedited the pace in its development into an international financial centre.

4. In early 2006, Shanghai formally published the "Planning Study on Developing Shanghai into an International Financial Centre in the 11th Five-Year Plan" (the Planning Study), which is the first of its kind for the financial sector in Shanghai since its founding as a city. The Planning Study sets out clear targets to develop Shanghai into an international financial centre during the 11th Five-Year Plan period. It seeks to achieve by 2010 the following: the direct fundraising volume in Shanghai's financial market will account for about 25% of the national total; the trading volume in the city's financial market will total around 80 trillion yuan, up from 35 trillion yuan in 2005; the combined assets of the city's financial institutions will be about 10% of the national total; and the deposit and loan balances will reach 4.5 trillion yuan and 3.2 trillion yuan respectively. In light of the macro economic environment in China, it is believed that certain targets outlined in the Planning Study can be reached before 2010.

5. The rise in the value-added contribution of Shanghai's financial sector to its GDP from 7.5% in 2005 to 8.2% in 2006, coupled with the total liberalisation of the financial sector after the transition period upon China's entry to the World Trade Organisation, signifies that the promotion of Shanghai as an international financial centre has reached a new stage. Since the beginning of this year, leading financial institutions have established their presence in Shanghai. A number of foreign-funded banks, including, inter alia, the Hongkong and Shanghai Banking Corporation, Citbank, Hang Seng Bank, Standard Chartered Bank, etc. have applied for registration as locally incorporated banks. More and more foreign banks are also setting up sub-branch offices in Shanghai. In terms of the current scale and radiating

capacity of its financial sector, Shanghai is China's undisputed financial centre. Leveraging on the fast growing Mainland economy, its strong historical and cultural background, well-established diversified industrial structures, fast-track expansion of the total economic volume and growing cooperation network with foreign partners, Shanghai has all the necessary qualities to develop into an international financial hub in Asia.

II. Beijing to break through bottlenecks of financial development

6. As the capital of China, Beijing enjoys unrivalled edges over other Mainland cities in terms of financial policy making and resources deployment. Its development potential should not be overlooked. Beijing is home to The People's Bank of China, China Banking Regulatory Commission, China Securities Regulatory Commission and China Insurance Regulatory Commission (commonly known as "One Bank and Three Commissions") which are the country's financial policy making authorities, as well as the headquarters of some 50 financial institutions with about 80% of China's monetary resources at their disposal. By the end of last year, over 400 different financial institutions made their presence in Beijing, including some 160 banks, 55 insurance companies and around 300 securities houses. The four leading state-owned commercial banks as well as the China Life Insurance Company have established their decision-making and management centres in Beijing. Beijing is also a hub of foreign financial institutions. By the end of 2005, Beijing had 29 operational foreign-funded banks, 78 foreign bank representative offices, 17 wholly foreign-funded and Chinese-foreign joint venture insurance companies as well as 87 foreign insurance company representative offices. Many domestic state-owned and large enterprises are also headquartered in Beijing.

7. With these competitive advantages that have provided strong momentum to the rapid expansion of the financial industry, Beijing has already developed into another financial powerhouse of the country. Last year, the value-added of Beijing's financial services sector reached 96.3 billion yuan, accounting for 12.5% of the GDP and 17.8% of the total income of the tertiary industry, while its total RMB/forex deposit amounted to 3.38 trillion yuan and its total premium income to approximately 41.15 billion yuan. For these specific areas, Beijing has surpassed Shanghai to rank first among the Mainland cities. Beijing's financial institutions are mainly clustered in the Financial Street, Central Business District and Financial Corridor. Financial Street is home to the headquarters of national financial management authorities and large state-owned financial institutions. For Central Business District, it is where over 80% of Beijing's foreign-funded banking institutions are located, whereas the Financial Corridor in the Haidian District of Beijing is established to facilitate an integration of

financial and high-tech industries. All these bear witness to the growing success of Beijing's financial infrastructure and development environment. After years of development, Beijing has consolidated its status as the country's financial management centre and hub of headquarters of financial institutions, while its capacity in pooling and mobilising domestic financial resources has also been further strengthened.

8. As a whole, Beijing's financial market structure development is however not well-balanced. In particular, it pales next to Shanghai which boasts a number of nationwide capital market platforms; it is still not efficient enough to turn financial capital into capital for businesses; and it is yet to leverage on its advantages in financial resources effectively for its business development (Beijing's total transaction of different kinds of securities last year was below RMB2 trillion, less than 40% of that of Shanghai). Moreover, Beijing is not as well placed as Shanghai in view of the latter's inherent financial strength and culture, and Beijing's hinterland of financial services is smaller in economic scale when compared with the Yangtze River Delta. In a nutshell, Beijing is still not well equipped to earn its name as the financial centre of China.

9. To turn around this passive position, Beijing has in recent years been working proactively to promote the development of its financial services sector. In February 2005, the Beijing Municipal Commission of Development and Reform released the "Opinions on Promoting Development of Beijing's Finance Industry", in which clear signals have been given regarding the plans to fine-tune its financial policies, develop the city into a financial centre and adopt enhanced measures to make the city attractive to financial institutions. In July last year, Beijing took a step further by formulating the "Development Plan for Beijing's Financial Services Sector During the Eleventh Five-Year Plan Period" on the basis of the "Beijing City Master Plan (2004-2020) " approved by the State Council and the "Outline of the Eleventh Five-Year Plan in Beijing". The overall objective is to identify in the next five years a way forward for the development of the capital's financial services sector in line with its economic and social development characteristics as well as its positioning, while supporting regional and nationwide economic developments. On the basis of the above development plans, Beijing will seek to achieve breakthroughs in the following areas:

- To accord priority to the development of the capital market, by substantially enlarging the market share of direct financing business, working towards a more developed bond market and achieving a breakthrough in the building of market infrastructure for over-the-counter securities transactions. In this connection, in the "Opinions on Promoting the Opening-up and Stable Development of the Capital Market" recently released by the Beijing Municipal Government, eight initiatives have been introduced, which include, among others, establishing a multi-level capital market, enlarging the scale of capital financing, improving the quality of listed companies, enhancing the presence of institutional investors, and above all, developing China Beijing Equity Exchange into a nationwide equity market and fostering the establishment of business investment funds and venture funds.

- To promote the application and development of bank cards to a world-class level while making improvements to its banks in respect of their internal control mechanism and assets quality and quantity. At present, over 50 million bank cards have been issued in Beijing and bank card transactions account for approximately half of the city's total retail sales of consumer goods, making Beijing a nationwide leader in this regard.

- To develop Beijing into a more sophisticated insurance and reinsurance market centre on a national scale, and strive to promote the insurance intermediary market and rural insurance market. The objective is to establish the insurance industry as one of the capital's modern financial pillar industries.

- To actively create a favourable environment for Olympic-related businesses, such as infrastructural construction, tourism, culture, real estate, sports and insurance in order to foster an integrated development of Olympic-related and financial-related businesses.

10. Under the Beijing City Master Plan, Beijing will, in the next decade or so, endeavour to strengthen its functions as a capital and develop itself into a world city. In parallel, it will make sustained efforts to elevate its position and roles within the hierarchy of world cities. It is envisaged that one of its key functions is to become a cluster of the country's financial policy-making and regulatory authorities as well as major financial and insurance institutions. Furthermore, Beijing has in effect unveiled its strategies and policies of establishing itself as a financial city. It will take a complementary approach and seek to make inroads first into sectors such as equity exchange, venture capital, industrial investment funds, bank cards and insurance market. As there is little overlap between Beijing Municipal Government's financial strategy and Shanghai's direction of financial development, it seems that a division of labour between the two places has been established with Beijing to be the policy maker on financial matters and

Shanghai the largest financial trading centre.

III. Shenzhen to develop into a regional financial centre

11. Modern financial and logistics industries are the two mainstays of Shenzhen's services sector with strategic significance. Last year, the value-added of Shenzhen's financial services sector reached 37.6 billion yuan, trailing closely behind those of Beijing and Shanghai, and ranking third in the Mainland. By the end of last year, the Shenzhen Stock Exchange had 597 listed companies, with a total market capitalization of 1.78 trillion yuan and an annual trading volume totaling 3.87 trillion yuan. It is the second largest securities market in the Mainland after Shanghai. As at the end of 2005, Shenzhen had over 150 financial institutions employing about 70 000 workers. Its banking sector had total assets worth 1.2 trillion yuan and its deposit and loan volumes ranked fourth among the Mainland cities. Indeed, Shenzhen has become an important financial market in southern China[2].

12. Under its 11th Five Year Plan, Shenzhen will take active measures in the next five years to complement the country's financial institutional reform. It will give top priority to the development of its monetary, securities and insurance markets, and encourage innovations in the realms of financial products, institutions and technologies, upon which the financial industry as a pillar industry could be further consolidated and strengthened. The objective is to develop Shenzhen into a premier regional financial centre supporting industrial development, financial innovation centre, financial information centre and financial supporting services centre in the Mainland. By 2010, the value-added of Shenzhen's financial services sector is expected to account for over 15% of the GDP with its total asset value worth 1.8 trillion yuan[3]. Specific measures are as follows:

- To vigorously develop the banking and insurance sectors and foster new lines of financial business and products like assets securitisation, off-shore financial services, foreign currency commercial paper and intermediary business, etc.

- To build a multi-tier capital market framework, including the development of derivative markets for assets securities, and index options and futures, as well as trading platforms and issuing/circulation markets for corporate bonds for financial product transactions, while expediting the development of

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[2] 'The development plan of Shenzhen's modern services sector under 11th Five-Year Plan'.《深圳市現代服務業發展“十一五”發展規劃》，March 2007

[3] Same as footnote 2

markets and turning the city into a venture capital centre in the Mainland.

- To support the country's reform of the foreign exchange regulatory regime, work towards developing Shenzhen into Asia's largest manufacturing base of precious metal coins, and achieve an annual production target of more than 70 billion yuan worth of gold and jewel ornaments by 2010.

13. However, the financial development of Shenzhen is clouded by some negative factors, which mainly arise from the formidable competition from Shanghai and Beijing, Guangzhou's drive to develop into a regional financial hub, and the problems related to the positioning of the Shenzhen Stock Exchange that has led to a widening gap between the city and Shanghai. These add up to put Shenzhen under great pressure. In view of the above, Shenzhen, in mapping out its plan for the development of its financial services, has attached great importance to its collaboration with Hong Kong. Shenzhen has stated that it would look to the international financial centre in Hong Kong for support in the development of its modern financial services sector. Among other things, it has called on the banks of Hong Kong to extend their business into Shenzhen, and explored the feasibility for members of the gold exchange in Shenzhen to join the Chinese Gold and Silver Exchange in Hong Kong. It is also worth noting that both the Small and Medium Enterprises Board in Shenzhen and the Growth Enterprise Market in Hong Kong have so far been unable to deliver encouraging results since their inception, and there is indeed room for collaboration between the stock exchanges of the two places.

IV. Tianjin Binhai New Area - Pilot Zone for Major Financial Reforms

14. In June 2006, the State Council announced in the report, "Opinions on Pushing Forward the Development and Opening Up of Tianjin Binhai New Area (TBNA)", to give its blessing for the TBNA to introduce financial reforms and new initiatives. Major reforms initiated by the country in respect of financial enterprises and business, financial market as well as financial liberalisation measures can first be, in principle, put on trial run in the TBNA. Along with its current thinking, items high on Tianjin's recent work agenda are as follows:

- To develop the capital market and expand the channels for direct financing. (1) Industrial funds will be developed. At a time when there is an absence of a well-defined legislation governing the industrial funds in the Mainland, the State

Council approved in late 2005 the TBNA as a pilot zone for launching the industrial investment funds. Building on the success of the pilot Bohai Industrial Fund, Tianjin is expected to facilitate the development of all kinds of industrial funds and venture capital investment funds. Real estate investment trusts will also be introduced on a trial basis to develop the mass capital trust business, with a view to shaping Tianjin into an issuance, management and transaction centre of industrial funds in the Mainland. (2) Pilot reform of corporate bonds and short-term financing bond issuance system will be carried out to facilitate eligible enterprises in the TBNA to issue corporate bonds. (3) Tianjin is now vigorously seeking the approval of the China Securities Regulatory Commission for the establishment of a nationwide stock exchange market for unlisted public companies. The success of which will mean a significant breakthrough for the Mainland's capital market.

- To set the stage for integrated financial business operations. In other words, existing restrictions governing the separation of operation with regard to various financial business will be removed and specific measures include: (1) to allow qualified commercial banks to set up offices in Tianjin to run securities, insurance and financial leasing business; (2) to allow insurance enterprise groups to set up offices in Tianjin to run banking and securities business; (3) to consolidate the equity of the various existing local financial enterprises in Tianjin and set up financial holding companies and other financial enterprises, such as holding/equity participation banks, insurance companies and securities firms.

- To introduce innovative measures, and optimise the financial institution system. Tianjin is going to leverage on the opportunity presented by the current reform on the existing financial institutions to set up housing credit banks, with a view to putting in place a housing credit system featuring a partnership of commercial banks providing mortgage services and the centres for housing provident fund.

- To reform the regulatory regime for foreign exchange. (1) Pilot reform on the regulatory measures governing the foreign exchange under current accounts will be carried out in Tianjin to modify the mandatory foreign exchange settlement system; progressively abolish the associated system of verification and cancellation; and allow voluntary foreign exchange settlement and free purchase of foreign exchange by individual Mainland residents and enterprises. (2) Regulatory measures governing foreign exchange under capital account will be relaxed and the idea of allowing the convertibility of renminbi under capital account within the confines of certain districts and amounts explored. (3) The scope of the use of foreign exchange will be expanded and the limits on the purchase of foreign exchange with renminbi relaxed. (4) Renminbi will be allowed to be converted into foreign currency through qualified investments institutions so as to expand external investment. (5) Offshore financial business will be introduced.

15. Tianjin has a relatively small financial market and does not have a nationwide financial market. In 2005, the value-added of Tianjin's financial sector was merely 16.06 billion yuan, accounting for less than a quarter of that in Shanghai and only 4.4% of its GDP. Judging from the prudent attitude adopted in taking forward financial reforms, it would be unlikely for the Mainland to carry out pilot reforms in Shanghai in view of the scale and size of the city's financial base. However, it will be quite logical if the reforms are carried out in Tianjin, a city now mayored by an ex-governor of The People's Bank of China. If the pilot reforms are proved successful, it is envisaged that they would then be introduced to Shanghai and other areas.

V. Implications to Hong Kong

16. Hong Kong has the comparative advantages over other Mainland cities in terms of its free and open society, high degree of internationalisation, sound legal system, simple and low tax regime, free flow of information, robust financial market regime, together with the larger pool of financial talents, its wealth of knowledge, internationally recognised financial regulatory system and comprehensive range of financial supporting services. These make other Mainland cities difficult to replace Hong Kong's financial services sector. Mainland cities are gradually reforming their financial systems, and there is also room for improvement in their financial infrastructure in areas like accounting system, information transparency, corporate performance assessment and regulatory regime.

17. Shanghai's development as a financial centre is still restrained by the pace of the Mainland's financial reform. In the short run, Shanghai has yet been able to pose a threat to Hong Kong's status as an international financial centre. While its financial sector is a leader in the country, Shanghai still apparently lags behind Hong Kong. The gap between the two cities in respect of foreign exchange trading and financial derivative products

is even wider.

18. That said, we have to take notice of the development potentials of Shanghai's securities market. The Shanghai Stock Exchange has recently surpassed Hong Kong in terms of the trading volume by a large margin. Another example is bond trading. Owing to the size of government bonds issued, the trading volume of the Shanghai's bonds market is so large that it would make it difficult for Hong Kong to catch up in the foreseeable future. Furthermore, in view of its close ties with its economic hinterland, Shanghai's physical commodity futures market is well ahead of that of Hong Kong, not to mention its financial futures market that has now been in operation and will be a rival to the yet-to-be-developed financial futures exchange market in Hong Kong.

19. In the medium to longer term, we cannot afford to overlook the development potential of Shanghai's financial sector. Firstly, Shanghai's total economic output is growing at a breathtaking rate. Last year, its aggregate GDP exceeded 1 trillion yuan. It is expected that Shanghai will catch up with or even overtake Hong Kong in terms of total economic output by 2012 and become the largest economic centre of China. Its economic clustering and radiating capacity will then be further enhanced. Shanghai's diversified industrial structures will also go a long way towards promoting its financial sector's development as it is a magnet for enterprises, capital and talents from all over the country. Secondly, the seamless collaboration between Shanghai and its economic hinterland, particularly regarding the enormous productivity and spending power of the Yangtze River Delta, gives strong backing to Shanghai's financial services sector. Thirdly, the development of Shanghai into an international financial centre is a national strategy, which will continue to gain full support from the Central Government. On the other hand, Shanghai is well aware of its inadequacies and is now taking measures to strengthen its weaknesses.

20. In terms of their present conditions and economic strengths, Beijing and Tianjian present no real challenge to Hong Kong for the time being or in the foreseeable future. Nevertheless, Beijing, where the country's financial policy-making and management centre and the headquarters of major financial institutions are located, is irreplaceable in terms of its functions and comparative advantages. Tianjin's development into an innovation base for financial reform in the Mainland also merits our attention, as it signifies the way forward for China's financial development. The main objective of Shenzhen's financial services is to support the development of high-tech and new technology, and small and medium enterprises. It will move first towards innovation of financial services. This would provide a basis for developing a complementary relationship between Hong Kong and Shenzhen. The two

cities should further explore the details on the mode and priority of cooperation.

21. London and New York owe much of their success as the international financial hubs to the enormous size of total economic volume of their respective economic hinterlands. Since both Hong Kong and Shanghai are capitalising on the Mainland's economic growth to develop their financial sectors, the two places are bound to be faced with the question of how to coordinate the competition and cooperation between them to give play to their respective advantages, with the ultimate objective of facilitating the Mainland's economic development.