



Hong Kong’s Role in the Movement Toward a More Integrated Greater Chinese Marketplace

Mainland China, Hong Kong and Taiwan have operated under different systems of governance for many years, preventing full economic integration across Greater China. Nonetheless, these three regions complement each other in many ways, and given their various stages of economic development, there are distinct opportunities for gains through cooperation. Following the return of Hong Kong’s sovereignty to Mainland China in 1997, the two regions have been more closely integrated; their 2003 Closer Economic Partnership Arrangement (CEPA) further boosted their relationship by reducing restrictions to economic integration and Hong Kong has enjoyed preferential treatment relative to other countries. More recently, Taiwan has moved toward increased cooperation with the Mainland, as newly elected President Ma Ying-jeou has implemented measures to heighten cross-strait business activity. Although such developments could lead to some form of preferential treatment arrangement, full economic integration is not expected in the near future. As a result, Hong Kong will continue to play a key role in facilitating cross-strait relationships, given its deep integration with both Mainland China and Taiwan. This *Asia Focus* evaluates Hong Kong’s role in the changing economic and financial connections between Mainland China and Taiwan.

Hong Kong’s Economic Relationship with Mainland China

Since the return of Hong Kong’s sovereignty to the Mainland, these two regions have taken steps to enhance economic cooperation. Most notably, a CEPA was signed in 2003, which reduced or removed “geographical, financial and ownership restraints” for companies that meet certain criteria, such as having incorporation in Hong Kong, an established operating history, liability to pay Hong Kong taxes, and a majority of staff employed in Hong Kong.ⁱ The CEPA has improved integration through increased trade and financial relationships, with both regions enjoying associated economic benefits.

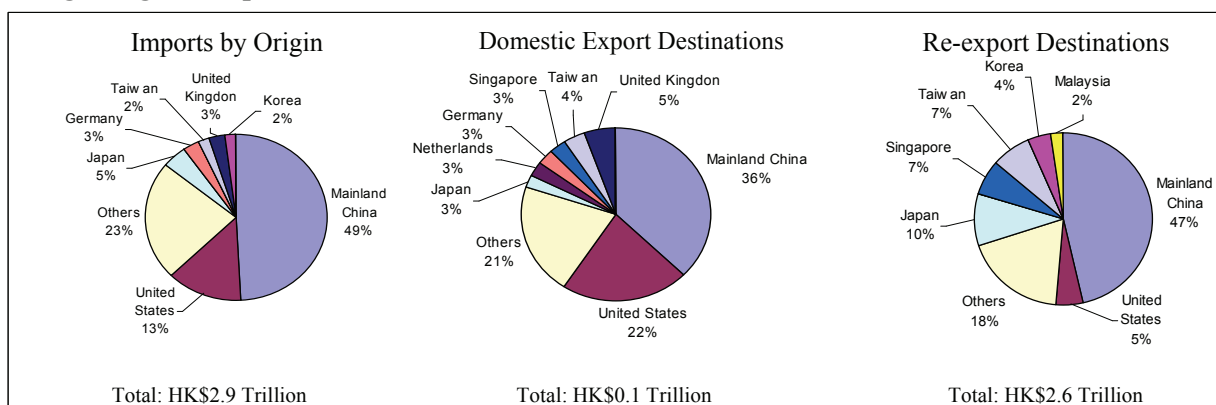
As of 2005, the Foreign Direct Investment (FDI) relationship with Hong Kong as home and Mainland China as host was valued at US\$242 billion, placing it as the second largest in the world. There is also a significant, yet smaller FDI relationship in the reverse direction. In addition to FDI, Hong Kong has been a leading host for Mainland China companies’ IPOs. According to the Hong Kong Securities and Futures Commission, Mainland China companies comprised over 60% of IPO listings and more than 80% of IPO funds that were raised in Hong Kong from January 2007 through March 2008.ⁱⁱ Apart from investment, Mainland China is Hong Kong’s largest trading partner, as shown in the following graphs.

CEPA – Primary Provisions		
Trade in goods	Trade in services	Trade and investment facilitation
“All goods of Hong Kong origin importing into the Mainland enjoy tariff free treatment, upon applications by local manufacturers and upon the CEPA ‘rules of origin’ being agreed and met.”	“Hong Kong service suppliers enjoy preferential treatment in entering into the Mainland market in various service areas. Professional bodies of Hong Kong and the regulatory authorities in the Mainland have also signed a number of agreements or arrangements on ‘mutual recognition of professional qualification.’”	“Both sides agreed to enhance co-operation in various trade and investment facilitation areas to improve the overall business environment.”

Source: Hong Kong Trade and Industry Department

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Hong Kong – Composition of Trade in 2007



Source: Hong Kong Census and Statistics Department

Taiwan's Economic Relationship with Mainland China

Due to historic political considerations, Taiwan's economic integration with Mainland China has been more limited than with Hong Kong. Nevertheless, economic cooperation has improved with increasing levels of trade in recent years. For example, in 2007 more than 25% of Taiwan's direct exports were to Mainland China, up from only 7.6% in 2002.ⁱⁱⁱ Meanwhile, exports from Taiwan to Hong Kong, including those which were re-exports to Mainland China, dropped to 15.4% from 23.6% over the same period, suggesting a heightened level of direct trade between Taiwan and the Mainland. The December 2008 restoration of "Three Direct Links"—direct trade, postal services, and transportation—should further enable heightened cross-strait business activity and underscores improvement in economic cooperation.

Such cooperation gained momentum in 2008 under Taiwan's recently elected President Ma Ying-jeou, who has pledged to reduce cross-strait investment restrictions in an effort to improve Taiwan's economy. In August 2008, Taiwan's cabinet eased restrictions on investments in Mainland China for Taiwanese companies and individuals. Additionally, policymakers and market participants have discussed opening Taiwan to investors in Mainland China.

These developments come alongside other measures aimed at improving cross-strait cooperation, such as adding direct charter flights between Mainland China and Taiwan, beyond those previously restricted to Chinese holidays, and opening Taiwan to tourists from Mainland China. Previously, flights had to stop in a third region, such as Macau or Hong Kong, significantly extending trip durations. In September 2008, Chinese officials proposed "further integration" between the two regions, including the possibility of signing a CEPA, similar to the agreement that Mainland China has with Hong Kong.^{iv} In response, a spokesperson at Taipei's Straits Exchange Foundation, a quasi-official body tasked with handling China-related negotiations, stated that such negotiation should be on an equal footing and aimed at reaching deals that benefit both regions.^v While Taiwan may be reluctant to sign a CEPA that includes any reference to Taiwan being part of Greater China, some form of preferential arrangement is possible. For example, Sean Chen, Chairman of Taiwan's Financial Supervisory Commission, recently expressed interest in working toward an agreement to liberalize cross-strait banking. However, political differences could make the discussions sensitive and lengthy.

Taiwan's Restrictions on Investment in Mainland China [‡]			
Net Worth (NW) in US\$ millions			
Pre-August 2008		Post-August 2008	
Category	Limit	Category	Limit
Companies with NW > \$334	20% of NW	All Companies [†]	Higher of: 60% of NW or \$2.6
Companies with \$167 ≤ NW ≤ \$334	30% of NW		
Companies with NW < \$167	40% of NW		
Individuals	\$2.7/year	Individuals	\$5/year

‡: Exchange rate: NT\$33.4 = US\$1

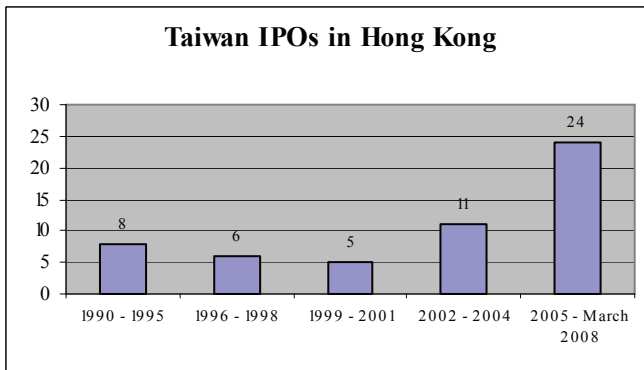
†: Companies with annual revenue of at least \$16 million and at least 50 employees may have no investment restriction. In addition, restrictions only pertain to funds raised locally, as those raised abroad have no restriction.

Source: Government Information Office, Republic of China (Taiwan)

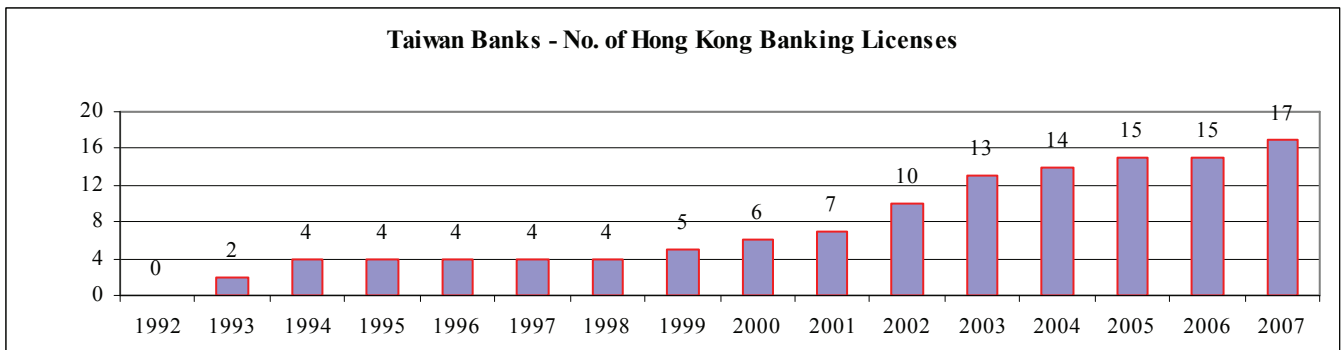
A Role for Hong Kong

Hong Kong has long been one of Asia's most open and international marketplaces, given its relatively developed regulatory system and few restrictive investment policies. In 2007, the number of IPOs in Hong Kong for domestic and international companies nearly doubled to 84, collectively raising US\$37 billion.^{vi} In addition, Hong Kong ranks as one of the leading destinations for FDI. According to the United Nation's *2007 World Investment Report*, Hong Kong attracted US\$43 billion in FDI in 2006, and the region was second in a global ranking of two indices that evaluate relative levels of FDI: "Inward Performance Index" and "Outward Performance Index."^{vii}

Hong Kong is ideally positioned to facilitate cross-strait business, not only because of its prominence in the international marketplace, but also because of its physical proximity to both Taiwan and Mainland China. In addition, Hong Kong and Taiwan have maintained strong business relations for many years. According to a recent research publication by the Hong Kong Securities and Futures Commission, a total of 54 Taiwanese companies held IPOs in Hong Kong from the 1990s through March 2008, which was double the combined total of Taiwanese companies' IPOs issued in Singapore, Paris, and New York over the same period.^{viii} During the most recent period January 2007 through March 2008, ten Taiwanese IPOs in Hong Kong collectively raised HK\$20.6 billion (US\$2.6 billion).^{ix}

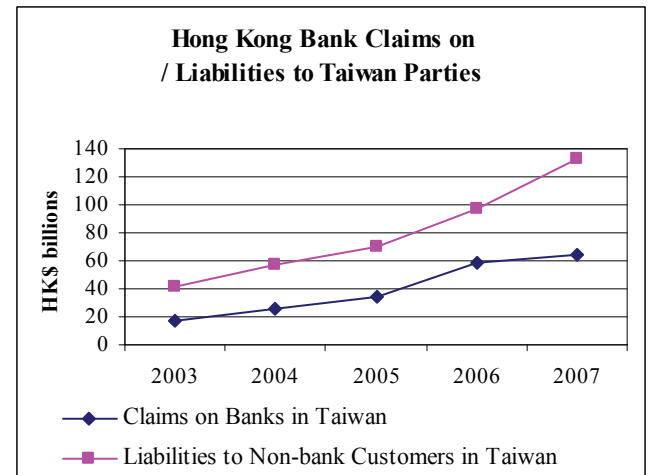


Source: Hong Kong Securities and Futures Commission



Source: Hong Kong Monetary Authority

The integration between Hong Kong and Taiwan extends beyond public issuances, as increased banking sector activity has improved the offering of financial products and services across the regions. Specifically, the composition of aggregate claims on and liabilities to Taiwan-based parties in Hong Kong's banking sector has risen during recent years. For example, Hong Kong banks' total claims on Taiwanese banks nearly quadrupled in the four years ending December 31, 2007, to HK\$65 billion (US\$8.3 billion).^x



Source: Hong Kong Monetary Authority

Over the same period, Hong Kong banks' liabilities to Taiwan non-bank customers more than tripled to HK\$133 billion (US\$17 billion). Supporting this trend is a rising number of Taiwanese banks operating in Hong Kong, as shown in the graph below. As of August 31, 2008, Taiwanese banks maintained 17 banking licenses and two local representative office licenses in Hong Kong.

While banking between Taiwan and Hong Kong has been rising, Taiwanese banks face challenges in expanding into the Mainland China market. Taiwanese banks can improve their access to the financial services market of Mainland China by establishing licenses in Hong Kong. Once in Hong Kong, Taiwanese banks are better positioned to develop links with

the Mainland since under their CEPA, the banking sectors of Hong Kong and Mainland China have become increasingly integrated. For example, five Hong Kong banks had established nine branches or sub-branches in Mainland China as of December 31, 2007. Moreover, several new measures under CEPA Supplement IV effective from January 2008 have further reduced barriers and should encourage more integration of these banking sectors.

CEPA Supplement IV - Liberalization Measures for Banking

1. The minimum total assets of a Hong Kong bank applying for equity investment in a Mainland bank is lowered from US\$10 billion to US\$6 billion at the end of the year prior to application;
2. A bank that has been operating as a branch in Hong Kong for at least 2 years or as a locally incorporated entity for at least 3 years is considered as “a Hong Kong service provider” in the banking area as defined by CEPA;
3. A fast track (“green lane”) is established for applications from Hong Kong banks for branching in the central, western and north-eastern areas of the Mainland. Hong Kong banks are encouraged to set up village and township banks in the rural areas of the Mainland; and
4. Mainland banks are supported to open operational entities in Hong Kong.

Source: China Banking Regulatory Commission 2007 Annual Report

The first two measures noted in the table above permit banks incorporated in Hong Kong to receive status as “Hong Kong service providers” and will ease requirements for their acquisition of equity shares in Mainland banks. Under the third measure, Mainland China authorities will expedite the processing of applications from Hong Kong banks to establish branches in certain regions on the Mainland. The fourth measure will facilitate increased investment in Hong Kong banks by Mainland counterparts. On September 30, 2008, Mainland-based China Merchants Bank announced that it had completed a HK\$19.3 billion (US\$2.5 billion) investment in Hong Kong’s family-run Wing Lung Bank, resulting in its retention of a 53% ownership stake. The investment will assist China Merchants Bank in expanding its deposit base of and offering of financial products to Hong Kong customers. This acquisition has sparked speculation by some market participants that other family-run banks in Hong Kong also could be partially or fully acquired by Mainland banks, which would result in further banking sector integration across these regions.

These developments enable Taiwanese banks to access the Mainland through Hong Kong. In May 2008, Tai-

wan’s Financial Supervisory Commission granted permission for Fubon Financial Holding Co., the parent of Fubon Bank, to establish retail banking operations in Mainland China via a 20% ownership stake in Xiamen Bank. The investment is being facilitated through a Fubon Bank subsidiary based in Hong Kong, and was permitted under the CEPA, because the subsidiary was Hong Kong incorporated and capitalized, rather than a branch. The deal was completed in December 2008, and comes after comments by the China Banking Regulatory Commission in March 2008 that Mainland China is “open” to Taiwanese banks investing in their Mainland counterparts. Although this was the first of its type, such relationships will enable Taiwanese banks to access the Mainland and are increasingly likely in the absence of a cross-strait agreement related to the banking or financial sectors.

Conclusion

Although positive steps have been taken to improve relations between Taiwan and Mainland China, existing restrictions, such as those associated with investment for Taiwanese companies and individuals in Mainland China, continue to present barriers to potentially optimizing financial relationships. In addition, political considerations amongst leaders in the region may hinder other steps toward further integration, such as the signing of a formal preferential treatment arrangement. Hong Kong will continue to be an important player in facilitating cross-strait financial relations, given its unique relationship with Mainland China and its business ties with Taiwan.

ⁱ Invest Hong Kong <http://www.investhk.gov.hk/>

ⁱⁱ “Hong Kong Consolidates its Role as a Fund-raising Platform for the Greater China Region with Increased Listing of Taiwanese Companies,” Securities and Futures Commission, Research Department, Supervision of Markets Division, Research Paper No. 40, May 2008

ⁱⁱⁱ *The Consensus Forecast, July 2003 and July 2008*

^{iv} September 8 – 11, 2008 articles in *China Economic News Service*, *The Standard* (Hong Kong), and *China Times*

^v *Taiwan News* “Taiwan’s Top China Negotiator Values Agreement Content Over Name,” September 12, 2008.

^{vi} Invest Hong Kong <http://www.investhk.gov.hk/>

^{vii} *2007 World Investment Report*, the United Nations Conference on Trade and Development (UNCTAD)

^{viii} “Hong Kong Consolidates its Role as a Fund-raising Platform for the Greater China Region with Increased Listing of Taiwanese Companies,” Hong Kong Securities and Futures Commission, Research Department, Supervision of Markets Division, Research Paper No. 40, May 2008

^{ix} Exchange rate is as of December 31, 2007: HK\$7.8 = US\$1

^x Hong Kong Monetary Authority www.info.gov.hk/hkma