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Hong Kong's Role in China's Financial Reform—The Era of the “New Normal”

*John Chrisman, David Richardson, and Alan Lee**

As the Chinese leadership has announced a significant change in the course of development and direction, namely to focus more on the quality—not just quantity—of growth, Hong Kong is set to assume a new role in the era of the “new normal.” This article examines what the change of direction in China means for Hong Kong.

Since adopting the Open Door Policy some 35 years ago,¹ Mainland China² has largely completed the transition from a centrally planned economy to a market-based economy, while achieving remarkable growth during the process. In the second decade of the twenty-first century, the country is seeking sustainable growth and convergence towards high-income status.³ To this end, the Third Plenary Session of the Eighteenth Communist Party of China Congress, which took place in November 2013, put forward an ambitious and comprehensive agenda of reforms to start a new chapter in Mainland China's economic development.⁴

Historically, Hong Kong has always played a pivotal role in Mainland China's economic and financial reforms. The most important *entrepôt* for Chinese trade for decades, Hong Kong is the largest capital source of Mainland China's overseas direct investment, the center for cross-border Renminbi (“RMB”) trade settlement and offshore⁵ RMB business, as well as a major overseas capital market for Mainland Chinese enterprises pursuing IPOs on the Hong Kong Stock Exchange (“HKSE”).

As the Chinese leadership has announced a significant change in the course

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¹ “Open Door Policy” means the economic policy initiated by Deng Xiaoping in 1978 to open up China for foreign investment.

² “Mainland China” in this article refers to the geopolitical area under the jurisdiction of the PRC, excluding Hong Kong, Macau, and Taiwan.

³ Press Release No. 14/260, International Monetary Fund, June 5, 2014.

⁴ *See id.*

⁵ “Offshore” in this article refers to the other jurisdiction areas of the PRC, in particular, Hong Kong; “Onshore” in this article refers to the jurisdiction of the PRC.

of development and direction, namely to focus more on the quality—not just quantity—of growth, Hong Kong is set to assume a new role in the era of the “new normal.” This article examines what the change of direction in China means for Hong Kong.

“NEW NORMAL”

The term “new normal” has become the People’s Republic of China (“PRC”)⁶ government’s favorite catchphrase⁷ of late. Within the Chinese context, “new normal” denotes the adoption of and transition towards a more sustainable economic growth model, which focuses more on quality and equity than sheer quantity. During the 35 years between 1978 and 2013, annual growth of the PRC economy averaged close to 10 percent.⁸ However, with economic growth figures decelerating to 7.7 percent in 2012⁹ and again in 2013,¹⁰ China appears to have entered a new phase of economic development, with the “new normal” being economic growth of lower quantity but higher quality.¹¹

The term “new normal” entails not only adjustment toward a slower pace in economic growth,¹² but economic reforms such as restructuring and rebalancing.¹³ In the “new normal” era, China’s GDP growth rate would no longer be the be-all and end-all factor; rather, the progress of fundamental economic reforms as resolved at the Third Plenum¹⁴ in late 2013 are set to become essential in the country’s transition from a fast-growing, developing economy based on investment in heavy industries¹⁵ and low-cost, manufactured ex-

⁶ “PRC” in this article refers to the People’s Republic of China, excluding Hong Kong, Macau, and Taiwan.

⁷ “In 2015, reform will set the tone for the new normal in China,” by Hu Shuli, *South China Morning Post*, January 1, 2015.

⁸ “GDP growth (annual %)” by The World Bank, available at <http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG>.

⁹ See *id.*

¹⁰ See *id.*

¹¹ “Adapt to a New Normal and March toward a New Stage (Study and Implement the Spirit of the Central Economic Work Conference),” by Li Wei, *People’s Daily*, December 29, 2014.

¹² “China’s Economy Realized a New Normal of Stable Growth in 2014,” National Bureau of Statistics of China, January 20, 2015.

¹³ “China media: Growth fears,” BBC, January 20, 2015.

¹⁴ Officially the 3rd Plenary Session of the 11th Central Committee of the Communist Party of China.

¹⁵ The economic slowdown was especially visible in industry, particularly heavy industry,

ports¹⁶ to a more mature economy based on domestic consumption, as well as high-value goods and services.¹⁷

“GOING GLOBAL”

In the “new normal” phase of economic development, as the pressure and urgency to upgrade its industries and restructure its economy intensify, China is becoming increasingly interested in overseas markets as solutions.¹⁸ The PRC government announced that it would increase financial support for Chinese enterprises to invest and operate overseas¹⁹ or, as an official statement on December 24, 2014²⁰ read, “going global.”

To facilitate the “going global” strategy, official approvals required for overseas investment will be made easier to obtain,²¹ and procedures governing public listing, mergers and acquisitions, as well as banks setting up overseas branches, will also be simplified. China will strengthen financing support for exports of capital goods, encourage commercial banks to finance the entire industrial chain of equipment manufacture and promote the use of foreign exchange reserves.²²

“Going global” is an increasingly important objective not only for Chinese enterprises, but also for the government itself. The Central Economic Work Conference’s final statement promised to encourage Chinese enterprises to both invest overseas and expand their operations in other countries. In addition, the

which was jolted by the real estate downturn in 2014, *see supra* note 12.

¹⁶ In 2014, the total value of exports was RMB 14,391.2 billion (equivalent to US\$2,319.1 billion), up by 4.9 percent, *see supra* note 12.

¹⁷ In 2014, the total retail sales of consumer goods reached RMB 26,239.4 billion (equivalent to US\$4,228.41 billion), a nominal annual rise of 12 percent, *see supra* note 12.

¹⁸ “China seeks to forge foreign demand for its industrial output,” by Lucy Hornby, *Financial Times*, January 26, 2015.

¹⁹ “China’s overseas direct investment is projected to rise at least 10% annually for the next five years, a trend that will soon make the country a net capital exporter,” said a senior commerce ministry official, reported in “China overseas direct investment seen rising 10% a year,” by Gerry Shih and Matthew Miller, Reuters.

²⁰ “China stresses finance for companies ‘going global,’” Xinhua, December 24, 2014; 国部署金融支持企业“走出去”升级版, December 24, 2014.

²¹ China’s Ministry of Commerce revised its rules to reform the regulatory approval process in order to promote greater outbound investment on September 6, 2014, reported in “China: Rules Revised to Facilitate Overseas Investments,” by Laney Zhang, the Library of Congress, October 31, 2014.

²² *See supra* note 20.

conference said that China would continue to promote the RMB as an international currency.²³

HONG KONG'S UNIQUE ADVANTAGES

In comparison with other cities in Mainland China, Hong Kong enjoys a unique advantage in financial services thanks to free trade, an open and flexible market, a freely convertible currency and free flow of both information and capital. More importantly, Hong Kong has an independent judiciary and a business-friendly environment. These comparative advantages will be conducive, if not crucial, to Chinese enterprises and capital in “going global.”²⁴

International Securities Market

Possessing an active international securities market, Hong Kong has consolidated its position as one of the top IPO markets in the world,²⁵ consistently ranked in the top five globally for IPO fundraising. Much of the success of Hong Kong's equity market is attributed to Mainland China. Among the US\$29 billion in IPO funds raised last year on the HKSE, some 85 percent were from Chinese enterprises.²⁶

In addition to an outstanding securities market which helps Chinese enterprises raise necessary funds, Hong Kong also provides a platform for Chinese enterprises to enhance transparency and corporate governance standards, thereby promoting their international reputation.²⁷

In 2014, a total of HK\$227.8 billion (equivalent to²⁸ US\$29.39 billion) was raised, representing an increase of 33 percent on the HK\$171.3 billion (equivalent to US\$22.1 billion) raised the year before. In line with the Chinese “new normal” and “going global” strategies, retail, consumer goods and services dominated with 46 percent of new listings, followed by financial services (including real estate) at 16 percent. It is estimated that 120 new companies will

²³ “China Sets Economic Reform Targets for 2015,” by Shannon Tiezzi, *The Diplomat*, December 12, 2014.

²⁴ “HK's financial hub role constantly refined,” Hong Kong Government News, September 17, 2014.

²⁵ Hong Kong Pulls Into Second in IPOs, by Prudence Ho, *The Wall Street Journal*, December 16, 2014.

²⁶ “Speech by CE at Asian Financial Forum 2015,” Hong Kong Government Press Releases, January 19, 2015.

²⁷ “Speech by SFST at Hong Kong Institute of Chartered Secretaries Annual Dinner 2015,” Hong Kong Government Press Release, January 14, 2015.

²⁸ Exchange rate as of April 2015.

list in Hong Kong in 2015. Total funds raised are projected to reach HK\$200 billion²⁹ (equivalent to US\$25.81 billion). Small-and-medium-sized companies are expected to dominate the HKSE in 2015. Meanwhile, the retail, consumer products, services and financial services sectors are also expected to take up a large share of new listings in 2015.³⁰ Below are two representative examples to illustrate the changing trends in the new era.

Case Study I: WH Group Limited

The Chinese food industry has come to realize that the era of the “new normal” has arrived.³¹ Insofar as food prices in the domestic market are concerned, grains went up by 3.1 percent, oil and fat, pork and fresh vegetables went down by 4.9 percent, 4.3 percent, and 1.5 percent in 2014,³² respectively. In this “new normal” phase of economic development, Chinese enterprises are seeking overseas markets as propellers for growth.

WH Group Limited (“WH Group”), the world’s largest pork producer, acquired Smithfield Foods, Inc., the largest pork producer in the United States, by way of merger in September 2013.³³ WH Group subsequently listed on the HKSE in August 2014 and raised HK\$18.31 billion (equivalent to US\$2.36 billion) to refinance its debt. The global headquarters of WH Group is located in Hong Kong, overseeing its business operations in the PRC, United States and other countries.

Chairman and CEO of WH Group, Wan Long, concluded that “listing in Hong Kong has always been consistent with our goal to establish a platform to support WH Group’s global growth strategy. This move is also in line with our stature as the world’s largest pork company, with an increasingly global reach. Being a listed company in a major financial center such as Hong Kong will raise our standing and enable us to attract more resources and talent, reinforcing our lead in the global pork and packaged meat market.”³⁴

Case Study II: CGN Power Co., Ltd.

On January 28, 2015, during the State Council executive meeting, Premier

²⁹ “Hong Kong expects to see over 100 new listings in 2015,” *PWC*, 2015.

³⁰ *See id.*

³¹ In 2014, the consumer price went up by 2.0 percent. Specifically, the price went up by 2.1 percent in urban areas and 1.8 percent in rural areas. Grouped by commodity categories, prices for food rose by 3.1 percent. *See supra* note 12.

³² *See supra* note 12.

³³ Prospectus of WH Group Limited, dated April 15, 2014, *available at* <http://www.hkxnews.hk/listedco/listconews/SEHK/2014/0415/LTN20140415117.PDF>.

³⁴ Press Release—WH Group Announces Details of Proposed Listing on Main Board of the HKEx, July 23, 2014.

Li Keqiang stated that China intended to create a competitive edge for its nuclear industry, which would become an integral part of its high-tech export. Within the general “going global” strategy, China clearly has an eye to export domestically produced nuclear power plants.³⁵ In 2014, the energy consumption per unit of GDP decreased by 4.8 percent compared with 2013.³⁶ CGN Power Co. Ltd. (“CGN Power”), China’s largest nuclear power producer, raised HK\$28.21 billion (equivalent to US\$3.64 billion) in its initial public offering on the HKSE in December 2014. In its prospectus, CGN Power stated that it is considering investment in projects in foreign countries in accordance with its business development strategy.³⁷

On January 29, 2015, in the presence of Premier Li Keqiang and French Prime Minister Manuel Valls, CGN Power and EDF Energy, a British energy company, signed a cooperation agreement. On December 14, 2014, in the presence of Premier Li Keqiang and his Kazakh counterpart Karim Massimov, CGN Power and a Kazakh state-owned nuclear company signed a cooperation agreement. Both sides planned to set up a joint venture in Kazakhstan to fabricate nuclear fuel assemblies, ensuring nuclear fuel supply security for the sustainable development of Chinese nuclear power enterprises.³⁸

Testing Ground

One of the unique roles of Hong Kong is acting as a testing ground for the PRC’s financial market liberalization.

Although Mainland China is the world’s largest exporter, the U.S. dollar remains the main settlement currency for global trade. PRC authorities set out the policy direction for freer cross-border capital flow and higher degree of convertibility of RMB in the *Financial Development and Reform Plan for the 12th Five-Year Plan Period (2011–2015)* published in September 2012.

Hong Kong is playing a vital role for the RMB in “going global.” As the RMB is increasingly used outside Mainland China, Hong Kong continues to build upon its role as the testing ground for the PRC’s financial reforms, and the place in which international use of RMB as a settlement, investment and funding currency is being tested. Hong Kong’s mature and stable financial

³⁵ “李克强部署加快铁路核电等中国装备“走出去”, 东方财富网, January 28, 2015.

³⁶ See *supra* note 12.

³⁷ Prospectus of CGN Power Co., Ltd., dated November 27, 2014, *available at* <http://www.hkexnews.hk/listedco/listconews/SEHK/2014/1127/LTN20141127047.pdf>.

³⁸ Press Release—CGN plans to setup a joint venture in Kazakhstan to fabricate nuclear fuel assemblies, dated December 15, 2014, *available at* <http://en.cgnp.com.cn/n658564/n678421/c901866/content.html>.

markets, as well as regulatory mechanisms within the framework of “one country” allows Hong Kong to serve as a “firewall” for China’s financial system, reducing systemic risk during the gradual opening of China’s capital market.

As of late September 2014, a total of 149 authorized institutions in Hong Kong carried out RMB businesses, with a total amount of RMB deposits and certificates of deposit worth more than RMB 1.1 trillion³⁹ (equivalent to US\$177.24 billion), accounting for a quarter of the total deposits of non-Hong Kong authorized institutions in Hong Kong. In late September 2014, the balance of RMB loans increased to HK\$170 billion⁴⁰ (equivalent to US\$21.93 billion). RMB offshore bonds also developed rapidly, a total of 462 RMB-denominated bonds were issued in Hong Kong as of late October 2014, amounting to RMB 600 billion⁴¹ (equivalent to US\$96.67 billion).

Stock Connect Pilot Program

The Shanghai-Hong Kong Stock Connect (“Stock Connect”) was officially launched in November 2014,⁴² connecting the Hong Kong and Shanghai securities markets, allowing individuals and institutional investors of both places to participate in cross-border trade in each other’s market directly. This pilot program, through enhancing mutual stock market access between Hong Kong and Shanghai, accelerates and facilitates the gradual opening up of capital accounts in Mainland China, as well as the internationalization of RMB. It will also reinforce Hong Kong’s position as an international financial center and strengthen Hong Kong’s role as an offshore RMB business center. In the same month, the RMB conversion limit for Hong Kong residents of RMB 20,000 (equivalent to US\$3,222.48) per day was removed,⁴³ making it easier for Hong Kong residents to participate in the Stock Connect and other RMB-denominated financial transactions. This was conducive to the launch and sales of RMB investment products by financial institutions in Hong Kong.

Following the launch of the Stock Connect, Premier Li Keqiang said in January 2015⁴⁴ that a stock link with Shenzhen should be established. Hong

³⁹ Statistics of Renminbi Deposits and Cross-border Settlement, *available at* http://gia.info.gov.hk/general/201412/31/P201412310618_0618_139861.pdf.

⁴⁰ 财政司司出席「2014央视财经论坛香港」致辞全文, December 15, 2014.

⁴¹ *See id.*

⁴² “HKEx celebrates the launch of Shanghai-Hong Kong Stock Connect,” HKEx New Release, Hong Kong Stock Exchange, November 17, 2014.

⁴³ “Removal of RMB conversion limit for Hong Kong residents,” Hong Kong Monetary Authority, November 12, 2014.

⁴⁴ “Hong Kong-Shenzhen stock connect next, says Li Keqiang,” by Enoch Yiu and He

Kong's top finance official and regulator said in February 2015⁴⁵ that preparations were under way to complete a direct stock exchange link-up between Hong Kong and Shenzhen.

Adding Shenzhen to the stock connect scheme will allow Hong Kong to provide access to Chinese equity markets without completely liberalizing the capital accounts. All orders must pass through broker-members of the HKSE, using RMB situated in Hong Kong to buy Chinese stocks. When a stock is sold, the RMB proceeds are delivered back to Hong Kong. This keeps the currency inflow for the purchase of Chinese stocks to be sealed off from the rest of the Chinese economy.

CONCLUSION

Hong Kong's financial services industry should be in an ideal position to assist Chinese capital and enterprises to "go global," within the context of China's financial reform in the "new normal" era. Hong Kong is also poised to retain established strength by continuing as the leading offshore RMB center in the RMB internationalization.

Huifeng, *South China Morning Post*, January 5, 2015.

⁴⁵ "Hong Kong-Shenzhen stock through train on track," by Enoch Yiu, *South China Morning Post*, February 2, 2015.