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Featured Article:
Role of Hong Kong as a RMB Offshore Center

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Hong Kong Sustainable Development Research Institute
Edmund Ho

Introduction

The economy of China developed rapidly after the open door policy in 1978, which eased trade barriers and allowed China to participate in international trade. Such policy has initiated the economic growth of China since late 20th century. In 2011, the GDP of China reached US$7.29 trillion and ranked the second in the world[1].

In spite of the enormous volume of foreign trade and investment, China's international trading currency is still dominated by US dollar. Such misallocation of currency distorted the trading market in China which put investors into inevitable exchange rate risk. In addition, this circumstance limited China’s international influence and constrained its globalization pace[2]. Thus the internationalization of Renminbi (RMB) is a prior task for the Chinese government in the coming decade.

On the other hand, after the return of sovereignty of Hong Kong to China in 1997, the economic integration between two economies has been growing robustly. In the past two decades, Hong Kong has several roles to enhance the economic development of China, include attracting Foreign Direct Investment (FDI) and allowing Initial Public Offering (IPO) by Mainland firms in Hong Kong stock market.

In the Twelfth Five-Year Guideline accounted by the 17th Central Committee of the Communist Party of China (CPC) in 2011, Hong Kong was emphasized the status of international financial center and supported towards the role of offshore center of RMB[3]. With respect to the macroeconomic policy, this article addresses the policy circumstance of RMB business in Hong Kong, followed by analysis of the advantages possessed and challenges faced by Hong Kong. Finally suggestions are made to maintain and perfect the role of Hong Kong as an offshore center.

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1 "China" International Monetary Fund, 18 April 2012

2 "Second Round Study and Recommendations To Speed Up Development of HK into an Offshore RMB Centre" Hong Kong Ideas Center, March 2010

3 "HKSAR's Work in Complementing the National 12th Five Year's Plan" CMAB, 16 March 2011

Development of RMB Business in Hong Kong

In fact, local banks in Hong Kong started RMB business in 2004. Yet, at the same time, a Settlement Agreement was signed in 2004 by People's Bank of China and Bank of China(Hong Kong), which put constrains in RMB interbank transaction between accounts. The agreement largely constrained the trading of RMB and controlled the pace of development of RMB financial tools market.

In 2010-2011 Government Budget, the Financial Secretary Mr. Tsang Chun-wah, John, suggested three measures to facilitate the development of offshore RMB business[4]. They included:

1) Hong Kong SAR would corporate with Mainland China to optimize the RMB settlement service and expand the circulation of RMB outside the boarder.
2) Promote RMB bonds business.
3) Develop RMB-denominated investment products.

Consequently, Hong Kong Monetary Authority (HKMA) revised Settlement Agreement in July 2010, which canceled the above restriction. Such amendment allowed the trading of various RMB products, like Exchange Traded Fund (ETF) and insurance, which was beneficial to Hong Kong becoming a RMB offshore center.

Advantages and Strengths of Hong Kong

There are several advantages and strengths of Hong Kong in taking the role of RMB off-shore center.

High Degree of Economic Freedom

First, Hong Kong has continuously been ranked the first in the Index of Economic Freedom since 1995, which is published by The Heritage Foundation and Wall Street Journal. High economic freedom does not solely represent free capital flow in market, but also promotes participation and collaboration of corporations in new projects.

[4] http://www.budget.gov.hk/2010/eng/budget21.html Budget Speech 2010-2011

Under the current situation of high demand of RMB offshore services, the firms in liberal market can create RMB related products by market mechanism efficiently, without much push and intervention from the government.

Low Tax Rate Regime

Second, when compared with OECD countries' standard, the tax rates in Hong Kong are extremely low. The standard rate of Salaries Tax is 15% while the Profits Tax for business corporations is 16.5%. Such low tax rate policy is protected by Basic Law Article 108[5]. Furthermore, many types of taxes exist in developed economies are not established in Hong Kong, included Capital Gains Tax and Value-added Tax.

The low tax business environment in Hong Kong is an attractive advantage for foreign entrepreneurs looking to expand their business into Asia. An effective tax system allows companies to conduct business without being overpowered by their tax liabilities[6].

Existed Financial Infrastructure for RMB

Third, Hong Kong is the city with the largest RMB reserve outside mainland China. Along with independent legal protection for private ownership and anti-corruption, Hong Kong possesses advanced financial hardware for RMB offshore center development.

The Clearing House Automated Transfer System (CHATS) developed by the government, which is the Real Time Gross Settlement (RTGS) system for the transfer of funds in Hong Kong, allowed four currencies transactions settlement: Hong Kong dollar, Renminbi, Euro and US dollar[7]. Such backgrounds in Hong Kong give a strong and organized basis for Hong Kong's development into a RMB offshore center and internationalization of RMB.

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[5] http://www.basiclaw.gov.hk/en/basiclawtext/chapter_5.html Basic Law Chapter V

[6] http://www.healyconsultants.com/articles/hong-kong-company-formation-options-foreigners.html "Hong Kong Company Formation - Options for Foreigners", Healthy Consultant.

[7] "Financial Services" Information Services Department, Hong Kong SAR. November 2007.

Capital Control of PRC Government

Lastly, the current accounts in China allow conversion of RMB, but not the case of capital accounts. Chinese residents are limited from owning foreign assets, and vice versa. The effect of capital control could be reflected by the stock price differentials of A share and H share from the same listed company[8].

While this limitation does not apply to Hong Kong, it offers Hong Kong a special opportunity towards internationalization of RMB. The middleman role of Hong Kong, promotes the internationalization of RMB on one hand, allows Chinese Government to continue its capital control policy on the other hand.

Challenges Encountered

Until 2012, compared to the international trades settled in US dollar, the amount of settlements in RMB is still relatively small. Not many corporations select RMB as clearing currency. The main reasons are as follow.

Lack of Incentive for Changing Clearing Currency

First, majority of multinational corporations have constructed a traditional clearing system using US dollar. Complex procedures are required if they change the clearing currency to RMB. Without sufficient incentives, RMB is unlikely to be adopted as trade medium in the short run.

Exposure to Exchange Rate Risk

Second, while US dollar is still the dominating currency for trade, not every trader is willing to bear the exchange rate risk. The expected appreciation of RMB, due to its continuous undervaluation[9], generates resistance for corporations to pay using RMB.

[8] "Mainland China Financial Market Reformation and Opening" Open University of Hong Kong, March 2011

[9] "Law of Yuan Price: Estimating Equilibrium of the Renminbi". Lipman, Joshua Klein (April 2011).

High Cost of Debt

The loan interest rate of RMB[10] is significantly larger than that in Hong Kong Dollar and US Dollar. Corporations which seek financing services would not prefer RMB due to its high cost of debt.

Suggestions

To enhance internationalization of RMB, increasing the rate of circulation of RMB and liquidity of RMB products in markets are essential. The following suggestions are possible measures to consolidate the status of RMB offshore center of Hong Kong.

Considering of Linking HKD to RMB

The exchange rate of HK dollar is currently linked to the US dollar. In the current background of depreciation of US dollar due to Quantitative Easing, Hong Kong's economy is heavily affected. It leads to low interest rates and inflation.

As an offshore center of RMB, Hong Kong has the role to internationalize RMB. At the same time, Hong Kong should then link its exchange rate with RMB, while remaining linked to US dollar. There will be two benefits. First, HK dollar's exchange rate can be more stable by linking to RMB also. It can ease the current "hot money" coming from mainland China to Hong Kong financial market. Second, RMB can further be internationalized through linking to Hong Kong dollar which is an internationalized currency.

Development of Various RMB Derivatives

Along with the traditional investment tools like bonds and Non-deliverable Forwards (NDF), products which could hedge investment risk are essential to promote the circulation of RMB. Hong Kong Exchange and Clearing Limited (HKEx) can participate as the leading role for such hedging products. Derivatives, like Interest Rate Swap and Forward Rate Agreement, could secure investors from interest rate risk and thus offer confidence to corporations in settle trading by RMB.

[10] Financial information from ICBC, until Oct 2012

Promotion of RMB as International Foreign Exchange Reserve Asset

Depreciation of US dollar creates the global threat in terms of foreign exchange reserve in US dollar and Treasury Bill. Under such financial environment, Hong Kong Monetary Authority (HKMA) should consider increasing the proportion of RMB bonds in Foreign Exchange Fund and act as a leading demonstration to the world in holding RMB.

Deepening the Communication and Cooperation with Mainland China

The growth of economic integration between Hong Kong and Mainland China was rapid in the past decade. Hong Kong's economy received substantial supports and push from the Central Government which played a major role in saving Hong Kong from the economic crisis in 2003 and 2008. If Hong Kong can sustain and fully performed as a RMB offshore center, the communication between Hong Kong and Shanghai will be enhanced. Shanghai, which is the RMB onshore center, is a prospective partner to Hong Kong in the near future. Both cities can coordinate closely and utilize the comparative advantages of each other.

Conclusion

Under keen global competition, the path towards international RMB offshore is not smooth. To maintain a leading position among other competitors, like Singapore, Hong Kong should continue to utilize its advantages, stand firmly on "One Country, Two System" Policy. On the other hand, Hong Kong SAR Government should retain good communication with Mainland China, as well as to optimize its policy step by step to promote internationalization of RMB.

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CONTACT US

SDRI
Hong Kong

Address：Room 2608, China Resources Building, 26 Harbour Road, Wan Chai, Hong Kong

Tel：(852) 3678 8817 **Fax：(852) 3005 4326** **Email：info@hksdri.org**

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