

H A R V A R D | B U S I N E S S | S C H O O L

**HONG KONG COMPETITIVENESS AND
ITS FINANCIAL SERVICES CLUSTER**



**MICROECONOMICS OF COMPETITIVENESS
FINAL PAPER**

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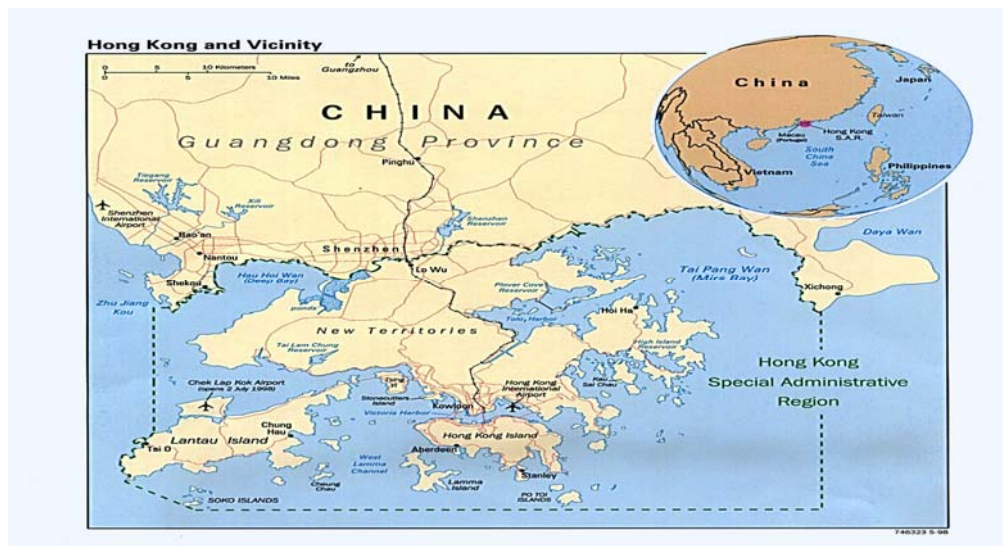
Boston, May 2008

SECTION 1: ANALYSIS OF HONG KONG COMPETITIVENESS

1.1. OVERVIEW OF HONG KONG

Hong Kong, officially the Hong Kong Special Administrative Region, is located in the eastern side of the Pearl River Delta, bordering the Guangdong Province in the north and facing the South China Sea in the east, west and south (**Exhibit 1**). Hong Kong's population is approximately 6.92 million in 2007, with 95% Chinese descendents (HKCSD: 2007).

Exhibit 1: Hong Kong's Geography



Source: *Hong Kong and Vicinity*

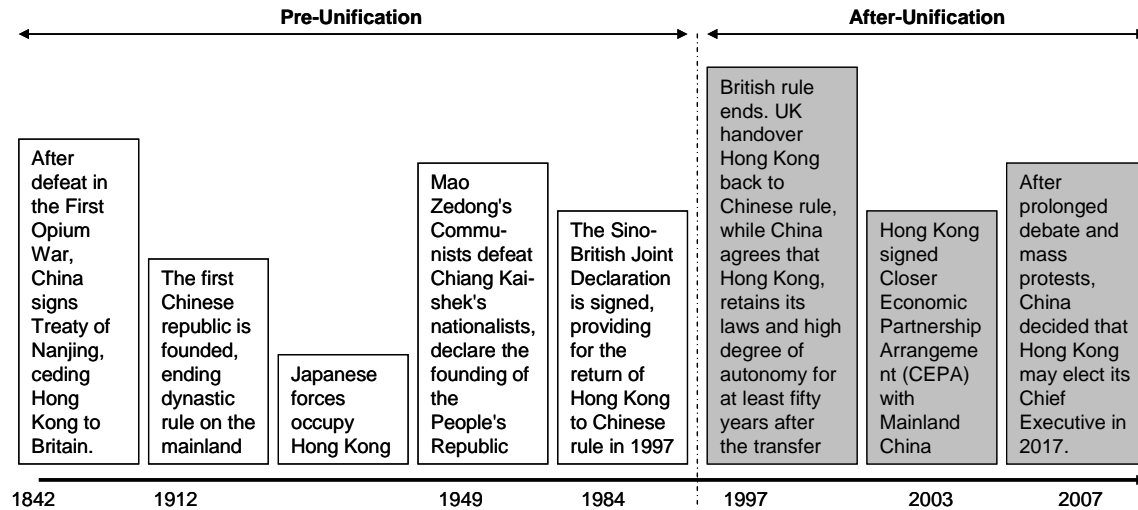
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The historical development of Hong Kong has been always closely linked to mainland China. (**Exhibit 2**). Originally a small fishing village, Hong Kong was ceded to the British Empire in 1842 after China lost the First Opium War against Great Britain. Until 1997, Hong Kong was under the British rule except occupied by the Japanese during the Second World War. The British government introduced and established in Hong Kong the rule of law and the private property right system, which laid a solid and favorable institutional foundation for modern Hong Kong.

Hong Kong's sovereignty was officially handed over to the People's Republic of China (the

PRC) in 1997 according to the Sino-British Joint Declaration signed in 1984. After the hand-over, Hong Kong remained its self-governing status under the Basic Law, the mini-constitution, which grants a high degree of autonomy except in foreign policy and defense. Such political, economic and social autonomy well preserved the institutional advantages in Hong Kong while offered Hong Kong access to the growth and resources in mainland China.

Exhibit 2: Brief History of Hong Kong



Source: *International Herald Tribune*

1.2. THE ECONOMIC DEVELOPMENT OF HONG KONG

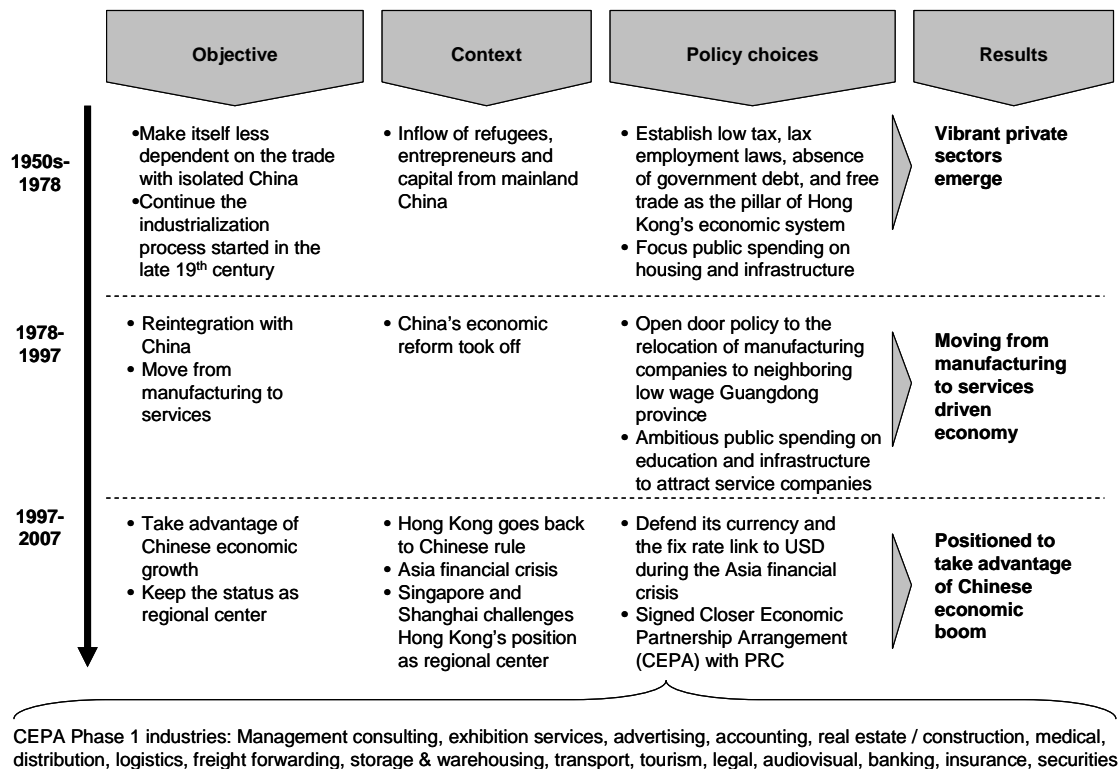
Prior to the World War II, Hong Kong served as the major trading port connecting China with rest of the world. In 1949, mainland China established the communist regime and foreign capital fled China. Hong Kong took advantage of its cheap labor and free economy status, successfully attracted foreign capital and developed local manufacturing and textile bases. In addition, by leveraging its efficient infrastructure and free port position, Hong Kong gradually evolved into a center for transportation, trade and retail.

The “Reform and Opening” policy in China in the 1980s brought another growth opportunity to Hong Kong, where local entrepreneurs relocated their manufacturing bases to the neighboring Guangdong Province for labor cost advantages in mainland. Meanwhile, Hong Kong’s local

economic structure shifted from manufacturing to services. Financial services, logistics, and retail became driving forces of the economy.

After the hand-over in 1997, Hong Kong's service sector went into a high-growth period by leveraging close connection with mainland China. In 2003, Hong Kong and the PRC signed the Closer Economic Partnership Arrangement (CEPA), a landmark trade pact aimed at offering preferential access to the mainland market for Hong Kong-based companies and promoting trade between the two markets. The CEPA would be implemented in phases. In Phase I, mainland China granted Hong Kong-based companies market access to 17 services industries, an access beyond China's WTO commitments, and exempted tariffs for Hong Kong-made products exported to mainland China. Broader market access and more duty-free exports to mainland China would be given to Hong Kong in the next phases under the CEPA.

Exhibit 3: Economic Development of Hong Kong



Source: HKTDC

1.3. ECONOMIC AND SOCIAL PERFORMANCE OF HONG KONG

Hong Kong is one of the wealthiest regions in the world. In 2007, its GDP per capita (PPP) is ranked 14th in the world, and 2nd in Asia. Also, Hong Kong is the 11th largest trading economy in the world (HKCSD: 2007). The average life expectancy of Hong Kong's population is 81.9 years, the second longest in the world (HKCSD: 2005).

Hong Kong's average GDP growth is around 5% from 1989 to 2007, despite two economic recessions during the Asia financial crisis in 1997-1998 and the global economic downturn in 2001-2002 (CIA: 2007). As seen in **Exhibit 4**, Hong Kong, driven by trade and services industry, has a higher growth rate than most East Asian countries.

Exhibit 4: Selected Economic Statistics of the East Asian Countries

	GDP Growth 2006	GDP Per Capita (PPP)	Agriculture Value-added (% GDP)	Industry Value-added (% GDP)	Services Value-added (% GDP)	Trade (% GDP)
Hong Kong	6.8	37,856	0.2	14.3	85.4	399.4
China	10.7	4,501	11.7	48.4	39.9	72.4
Indonesia	5.5	3,348	12.9	47	40.1	56.9
Korea	5.0	22,278	3.2	39.6	57.2	85.3
Malaysia	5.9	12,149	8.7	49.9	41.3	217
Singapore	7.9	43,328	0.1	34.7	65.2	473.5
Thailand	5.0	7,364	10.7	44.6	44.7	143.5

Source: *World Development Indicators, 2006*

In addition, Hong Kong's growth has been outpacing OECD countries. From 2005 to 2007, average GDP growth in Hong Kong is 6.8% while the forecasted growth rate is approximately 6% from 2007 to 2009 (EIU: 2007). Hong Kong's detailed economic performance indicators and key assets are summarized in **Exhibit 5**.

Exhibit 5: Key Economic Performance Indicators and Assets of Hong Kong

Economic Performance Indicators	Key Assets
<p>GDP 2007:</p> <ul style="list-style-type: none"> Total: \$206.7 billion Per capita (PPP): \$31,800 (2006) 14th in the world, 2nd in Asia Growth: 6.8%(2005~2007), forecast 4~5% (2008) <p>Productivity (2001~2006/p.a.):</p> <ul style="list-style-type: none"> Total growth: 3.6% Manufacturing growth: 1.9% Im&Export growth: 10.7% Financial Services: 11.3% <p>Wages (Real) Growth (1992~2007/p.a.):</p> <ul style="list-style-type: none"> Total annual growth: 0.9% Manufacturing growth: 0.9% Im&Export growth: 0.9% Financial Services: 1.5% <p>Employment (2007):</p> <ul style="list-style-type: none"> Unemployment rate: 4.0% Distribution: Agriculture 0.2%, industry 14.3%, Services 85.4% <p>Inflation (2005~2007):</p> <ul style="list-style-type: none"> CPI annual rate: 3.6% <p>Trade (2007):</p> <ul style="list-style-type: none"> Domestic export: \$14 billion Import:\$368 billion Re-export:\$331 billion, 11th largest trading economy in the world Major trading partners: China, Japan, ASEAN countries, USA and EU 	<p>Location</p> <ul style="list-style-type: none"> Deep water port with no frozen period In the center of Asia, less than 5 hour flight to all major Asian hubs (e.g. Tokyo, Shanghai, Beijing, Singapore, Sydney, Bangkok, Manila, Delhi, Dubai etc.) In between London and New York (8 and 12 hours time difference respectively) <p>Infrastructure</p> <ul style="list-style-type: none"> World class airport and container port, ranked Nr.1 and Nr.2 respectively by Skytrax Personal computers: 601 per 1000 people (2005) Internet user: 508 per 1000 people (2005), ranked 4th in 2007 EIU's E-Rediness ranking, 1st among Asian countries <p>Human Development Indicator</p> <ul style="list-style-type: none"> Life expectancy: 81.9 (2005), world Nr.2 Combined primary and secondary education enrollment ratio: 76.3% (2005) Ranked 21st in the HDI index (2005) <p>General Business Environment:</p> <ul style="list-style-type: none"> Efficient and clean public service (government efficiency ranked 1st in Asia, Heritage Foundation 2007) Rule of law Freedom of information and capital flow Low tax (16.5% corporate tax, no VAT, no import tax)

Source: World Bank, IMF, EIU, CIA, Hong Kong Census and Statistical Department

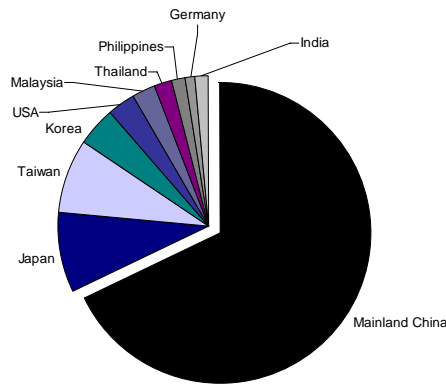
1.3.1. GROWTH DRIVERS IN HONG KONG'S ECONOMY

Capitalize on the economic integration with mainland China for trades and capital inflows

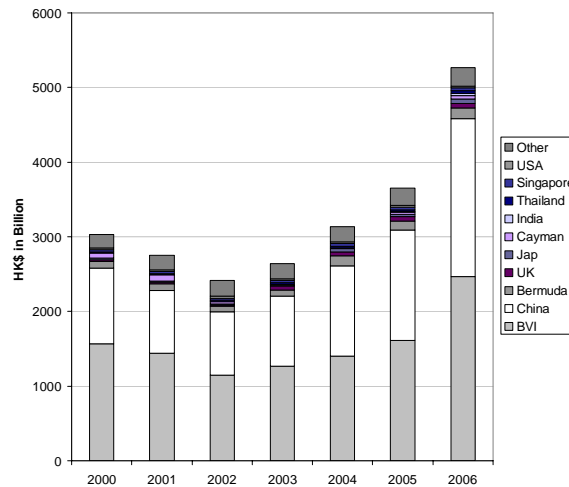
In 2007, 62% and 49% of Hong Kong's re-exports are originated from and for the PRC, respectively (HKCSD: 2007). Mainland China accounts for approximately 35% of Hong Kong's total stock of inward direct investments while British Virgin Island (BVI), a popular off-shore zone where large amount of FDIs originate from China, accounts for another 35% (HKCSD: 2006) (**Exhibit 6**). The implementation of CEPA would further accelerate Hong Kong's participation in the economic growth of mainland China. According to the World Bank, China's growth in 2008 is forecasted to be 9.6%, despite the expected world economy slow-down (China View, 2008). As China's economy growth is expected to continue, Hong Kong would remain a beneficiary of the close economic tie with the PRC.

Exhibit 6: Trade and FDIs in Hong Kong

Origins of Hong Kong Re-Export (2007)



Hong Kong's FDI Destination

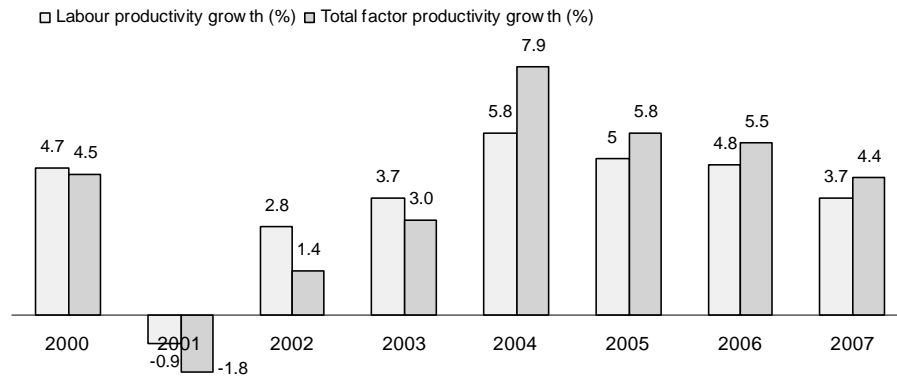


Source: EIU, Census and Statistical Department

Maintain high productivity growth while control real wage inflation

In the process of economic restructuring, Hong Kong companies have been continuously improving their productivity. The total productivity grew at 3.6% annually from 2001 through 2006. In particular, the productivity of the services sector grew at a much higher rate of 10.7% during the same period (HKCSD: 2007). At the same time, Hong Kong managed to maintain the growth of its labor cost. Real wage growth was at a modest level of 0.9% from 1992 through 2007 (HKCSD: 2007). As seen in **Exhibit 7**, Hong Kong's productivity growth recovered from the Asia financial crisis in 2001, and maintained at the pre-crisis level of 3% above in most recent years. As a comparison, the annual productivity growth of the US, EU and Japan has been 2.0%, 1.6% and 1.9% respectively from 2000 through 2007 (The Conference Board and Groningen Growth and Development Centre: 2008).

Exhibit 7: Productivity Growth in Hong Kong



Source: IMF, EIU, HKCSD 2007

Capital accumulation

Like its Asian neighbors, Hong Kong has a tradition of high savings rate. Private savings rate in Hong Kong is 24.5% GDP in 2007, significantly higher than the OECD average of 8.5% (EIU: 2007). In addition, Hong Kong government is financially disciplined. Hong Kong has approximately US\$160 billion foreign reserves in 2007, one of the highest in the world (EIU: 2007), and Hong Kong government is expected to operate at a budgetary surplus in 2008 and 2009.

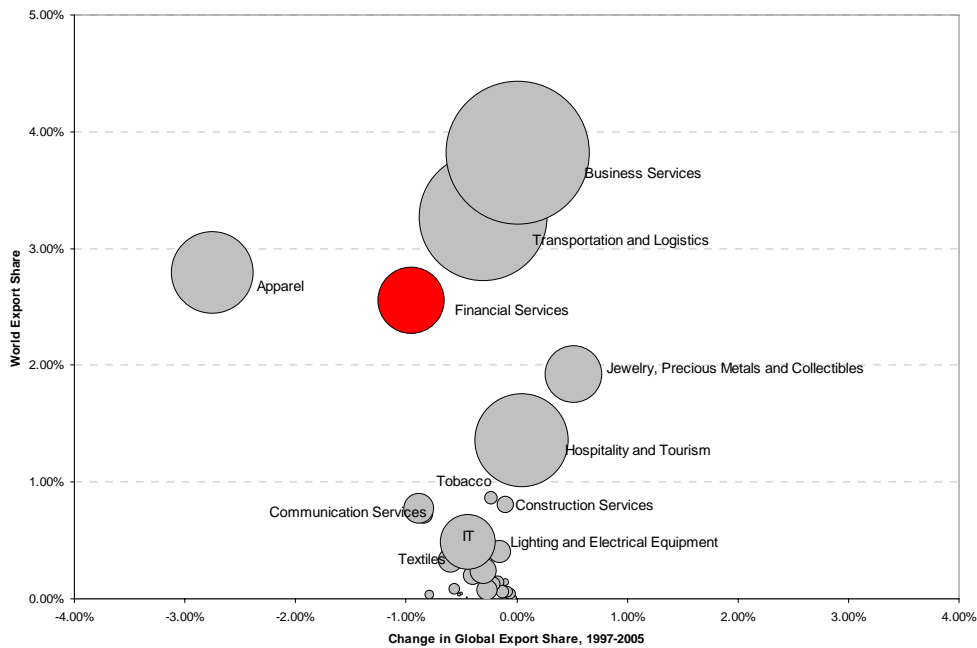
Hong Kong is also a highly attractive market for foreign direct investment, ranked the second in Asia and seventh in the world in 2006. Its FDI inflows increased by 28% to US\$42.9 billion (UNCTAD: 2007). Not only did FDI bring in capital to Hong Kong, but also management expertise and sophisticated demand to the local market.

1.3.2. CLUSTER MAP

Along with Hong Kong's economic transition from manufacturing to services, several strong service clusters have emerged (**Exhibit 8**). According to HKCSD, trading and logistics, financial services, and business services are the top three clusters in Hong Kong, in terms of contribution to GDP and employment. These clusters are also internationally competitive, accounting for the

largest part of Hong Kong's export and having the most significant world market shares.

Exhibit 8: Cluster Map in Hong Kong



Source: ICCP, 2007

1.3.3. ROLE OF GOVERNMENT IN HONG KONG'S ECONOMIC DEVELOPMENT

Hong Kong's economy is renowned for being open and free. For 13 years in a row, the Wall Street Journal and the Heritage Foundation ranked Hong Kong the freest economy in the world.

Over years, Hong Kong government established an effective framework for a functioning market economy with appropriate involvement but generally no interference. Private property rights and contractual rights are well-protected; disputes are settled by an independent court system based on British common law; no constraints are imposed on trade and capital flow. Hong Kong has the lowest corporate tax rate of 16.5% in Asia, and has probably the least taxes levied by government in the developed economies, without value-added tax, sales tax, import or export tariffs, and capital gain tax etc. (EIU: 2007). In foreign exchange policy, Hong Kong has pegged its currency to US dollar since 1983, which effectively lowered the fluctuation of Hong Kong dollar and eased the international trade in Hong Kong.

Unlike many other advanced economies, Hong Kong does not have a general competition law. Except for a number of sectors, where sector-specific regulations govern the competitive behaviors, price fixing and cartels are in general not illegal in Hong Kong. This is particularly true in transport and utility sectors, where monopolies dominate the market.

The Hong Kong government actively manages the infrastructure through ownership and operation. It has stakes in airport and subway system in Hong Kong, as well as a large number of public hospitals and outpatient clinics. It is generally believed that these state-owned infrastructures are efficiently managed in a highly professional manner. For example, Hong Kong airport is ranked 1st among 155 airports worldwide by Skytrax, a renowned aviation consulting company. However, in recently years, Hong Kong government started to privatize some of government-owned infrastructure companies. In early 2000, it sold 23% government stake in the urban underground company MTRC (EIU: 2001).

Different from other developed economies, Hong Kong government plays an active role in the local property market. Government is involved in building and selling subsidized residential properties, constructing and operating industrial estates, and developing office buildings. These government-involved real estate projects are intended to provide affordable housing to local citizens, and affordable industrial and office space to local and foreign companies. Notwithstanding government's efforts, Hong Kong's property price has continued to increase. In 2007, Hong Kong is ranked the most expensive city for rental accommodation (ECA International: 2007) and 5th among 143 cities in terms of cost of living (Mercer: 2007).

Hong Kong government established R&D fund to support local innovation activities, i.e. the Innovation and Technology Fund (ITF), and the Applied Research Council. Lastly, as a result of the check and balance through rule of law and free media, Hong Kong government is virtually free of corruption, ranked the 14th least corrupted globally, above many developed countries such as Germany, France and the USA (CPI: 2007).

1.4. NATIONAL DIAMOND ANALYSIS

Hong Kong is ranked among the most competitive economies in the world, i.e. the 12th by Global Competitiveness Report. As seen in the national diamond analysis (**Exhibit 9**), its major strengths are primarily its location, productive work force, transparent business environment, government efficiency, and world-class infrastructure. Based on these conditions, it is not surprising that a prosperous service driven economy has emerged.

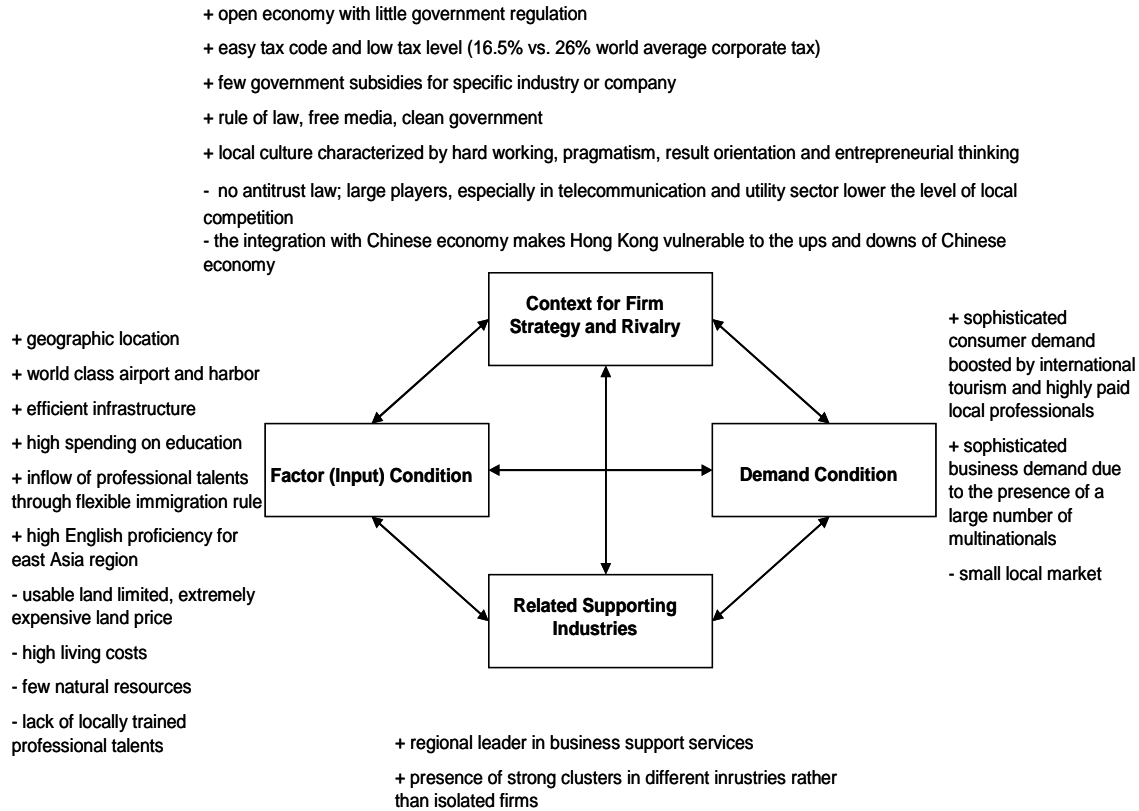
Due to the increased affluence and the limited land availability, Hong Kong's living cost has become prohibitively high. The monopoly in certain sectors, e.g. utilities, further drives up the living cost. Recently, issues such as air pollution, epidemic diseases of SARS and Bird Flu, all lowered the life quality in Hong Kong and resulted in the relocation of some high-paid professionals to neighbor countries, i.e. Singapore.

Hong Kong's close economic tie with mainland China accelerated its growth. However, some are concerned that Hong Kong's economy is over-dependent on China and Hong Kong companies don't pay enough attention to investing in the rest of Asia. Although it remains a favorite trade hub for its Asian neighbors, Hong Kong needs to capitalize on the growth of other Asian countries to diversify the risk of potential slow-down of China's growth.

Also, Hong Kong is facing creditable threats from big cities in mainland China and regional economic centers in Asia. Traditionally, multinational companies consider Hong Kong the stepping stone to enter China market. In the past decade, mainland China has advanced fast economically. Many coastal cities, such as Shanghai and Shenzhen, have been improving their infrastructure and establishing more foreign investor- friendly policies to attract foreign capital, resulting in a number of multinational firms relocating their China headquarters from Hong Kong to mainland China, i.e. BASF, International Paper, Ernst&Young. In Asia, Hong Kong is not a member of ASEAN, the major trading block in the region. However, Singapore, as Hong Kong's arch rival, is actively driving the integration of ASEAN and positioning itself as a hub for

ASEAN economies. Many multinational companies targeting ASEAN markets would like to invest in Singapore rather than Hong Kong.

Exhibit 9: Hong Kong National Diamond



Source: Team Analysis

Innovation is a potential area for improvement in Hong Kong's economy. In terms of the number of patents filed in the US, Hong Kong stands far behind the other advanced economies. For example, although it has 50% higher population than Singapore, Hong Kong consistently fell behind Singapore, between 2000 and 2006, in the number of patents filed, While the number of patents filed by Singapore and the PRC increased at 20% and 21% per year respectively, between 1993 and 2006, Hong Kong's patent filing grew at a moderate 13% during the same period (US Patent Office: 2007). One could argue, however, that Hong Kong's economy is driven by services rather than manufacturing or technology. And innovation in business services is hard to measure,

let alone patent.

1.5. POLICY RECOMMENDATIONS

We believe that Hong Kong should be focused on two major challenges at the macro economy level: decreased quality of life and over-dependence on mainland China.

1.5.1. IMPROVE QUALITY OF LIFE

Increase competition in utilities and infrastructure sectors to lower the living cost

Hong Kong's utilities sector is monopolized by a few private or government-owned companies, resulting in high water, electricity and gas costs to residents in Hong Kong. Introducing competition, particularly in the utilities sector, would directly lower the living cost. Hong Kong legislature needs to pass the long-awaited anti-trust law to encourage local competition. In addition, Hong Kong government should loosen its control of the infrastructure sector and open the market to foreign companies, especially those in the neighboring Guangdong Province. Given the huge fixed-investment required in infrastructure sector, large-scale utility companies in the Guangdong Province, for example, are in a better position to capture the economy of scale by offering services to Hong Kong residents and thus lowering the utility costs in Hong Kong.

Coordinate with neighboring Chinese provinces to address sanitary and pollution problems

To address the issue of pollution and epidemic diseases, Hong Kong needs policy coordination with neighboring Chinese provinces. Unlike London where air pollution is mostly a result of local congested traffic, Hong Kong has pollution originating from the manufacturing companies based in the neighboring Guangdong Province, now the global manufacturing base for electronics products. In the short term, Hong Kong government needs to coordinate the industrial zoning plan with Guangdong government, and jointly assess the environmental impact in

Guangdong's industrial planning. In the long run, Hong Kong needs to develop a systematic approach to help mainland China address the environmental issues. For example, Hong Kong government can establish funds sponsoring companies to introduce applied environmental technologies to mainland China. Local commerce associations can organize international environmental technology fairs focused on China's environmental protection market. Similar approach applies to the disease control. In 2003, information exchange between China's and Hong Kong's public health authorities eventually helped control the fast-spreading SARS, which proved the benefits of close coordination at government level between Hong Kong and mainland China.

Develop high-speed transportation with and affordable housing in adjacent Chinese cities

Hong Kong government can coordinate with adjacent Chinese cities in urban planning to encourage the development of affordable housing projects. The physical distance between Hong Kong and the much cheaper neighboring Chinese cities, i.e. Shenzhen and Zhuhai in the Guangdong Province, is comparable to the distance between Connecticut and New York. If high-speed transportation were built between Hong Kong and these cities, professionals working in Hong Kong can easily commute to live in Shenzhen or Zhuhai. However, as of now there are only a small number of highways in between and the waiting time to pass the "border" control is too long. Hong Kong and Guangdong should jointly streamline the border control measures and construct high-speed intra-city transportation projects for mutual benefit.

1.5.2. MITIGATE OVER-DEPENDENCE ON CHINA

Promote trade with and investments from the ASEAN economies

Hong Kong needs to participate into the growth of other regional economies to mitigate its over-dependence on China. We believe the South East Asia region would offer Hong Kong another great growth opportunity. In history, Hong Kong exported its large amount of human

resources to the South East Asia countries. Today, many leading entrepreneurs in Singapore, Malaysia, Indonesia, Thailand and Philippines have their family origins in Hong Kong. These entrepreneurs share the common dialect and cultural heritage with Hong Kong residents. Hong Kong government should sign a Free Trade Agreement with ASEAN to accelerate trade growth between Hong Kong and ASEAN countries. According to the Basic Law and WTO regulation, Hong Kong government has the freedom to sign bilateral trade agreement with other countries.

Develop broad economic relationships with the South East Asian countries

To further draw the attention of local and foreign companies towards Hong Kong's connection with the South East Asia, Hong Kong government and the business associations may establish trade promotion offices in selected overseas locations; universities and research institutions should be encouraged to research on the South East Asia region; and government may joint force with its ASEAN counterparts to introduce the business opportunities in ASEAN to Hong Kong companies.

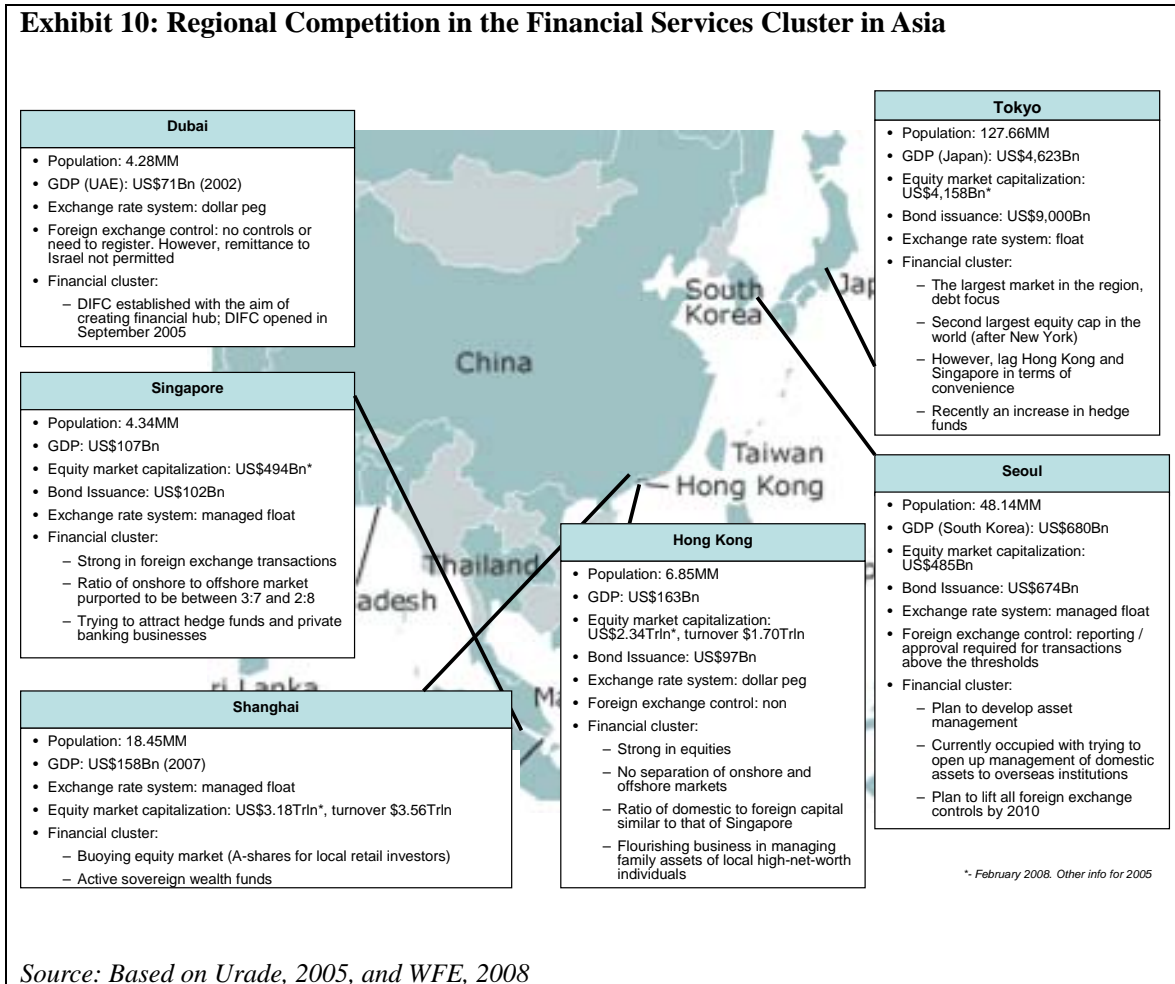
SECTION 2: FINANCIAL SERVICES CLUSTER IN HONG KONG

2.1. HISTORICAL EVOLUTION OF THE CLUSTER

The various facets of financial services industry - including commercial and investment banking, insurance, financial markets and alternative assets - have been historically dominated by two global centers, New York and London. As previously noted, Hong Kong was a trading port in the 19th century and established itself early on largely as a regional financial center focused on trade and shipping financing, insurance and deposit taking (Leung, Unterobderdoerster: 2008).

Development of the PRC has changed the global financial services landscape with Hong Kong positioned perfectly to capitalize on its growth. Driven mainly by buoying demand for Chinese stocks and currency, Hong Kong is now ranked 3rd most competitive financial center in

the world by GFCI (Singapore nr 4). Hong Kong faces significant regional competition (**Exhibit 10**), yet we argue that only Shanghai and Singapore pose most direct threats. Currently, Singapore is still incomparable in terms of market liquidity, while Shanghai is mostly geared towards local investors (e.g. A-Shares vs, Hong Kong's easily accessible H-Shares).

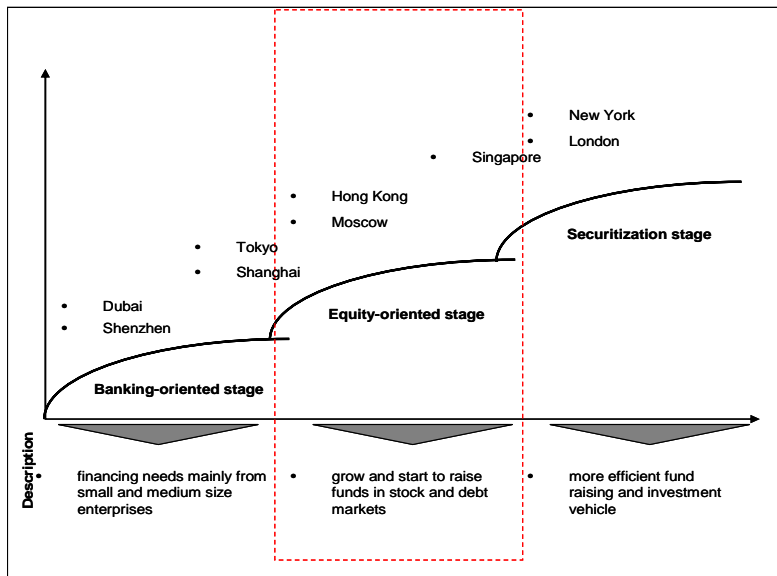


For financial industry participants, Hong Kong today is characterized by a strong emphasis on the rule of law and open market mechanism. As noted above, there are no barriers for access to the market by foreign businesses and no restrictions on capital flows into and out of Hong Kong (as well as no exchange controls), which differentiates Hong Kong from the peers.

As **Exhibit 11** shows, in terms of cluster development Hong Kong is in the equity oriented

stage. It is important to know that successful clusters can operate in any stage and do not necessary have to move up; we address this question in our strategic issues and recommendations parts.

Exhibit 11: Financial Cluster Development Stages

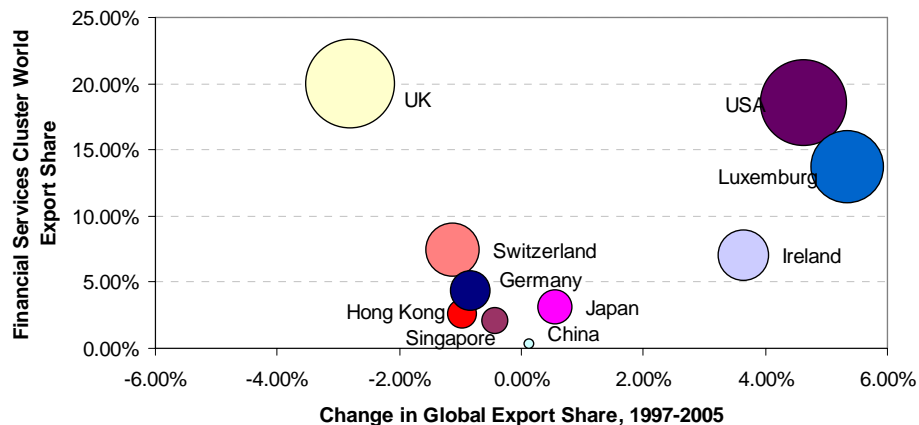


Sources: Team analysis based on Tse Kwok, 2007

Hong Kong competes internationally on relatively less sophisticated services such as IPO’s and foreign exchange trading (**Exhibit 12**). Despite recent government focus on attracting alternative asset managers and financial sponsors, Hong Kong remains a relatively small player in this field.

Exhibit 12: Performance of International Financial Clusters

<u>% Global Share</u>	<u>UK</u>	<u>US</u>	<u>Japan</u>	<u>France</u>	<u>Germany</u>	<u>Singap.</u>	<u>H. Kong</u>
Cross-border bank lending (Mar 2007)	20	9	7	9	10	2	2
Foreign equities turnover (Jan-Sep 2007)	53	36	-	-	4	-	-
Foreign exchange turnover (Apr 2007)	34	17	6	3	3	6	4
Exchange-traded derivatives turnover (Jan-Jun 2007)	6	38	2	1	13	-	1
Over-the-counter derivatives turnover (Apr 2007)	43	24	4	7	4	3	1
Marine insurance net premium income (2006)	24	10	11	6	8	1	1
International bonds - secondary market (2006)	70	-	-	-	-	-	-
Fund management (as a source of funds, end-2006)	8	52	7	6	3	-	1
Hedge funds assets (2006)	21	66	2	1	-	1	2
Private equity - investment value (2006)	14	60	2	4	1	1	-
IPOs (Jan-Sep 2007)	15	26	-	-	-	1	8
Securitisations - issuance (2006)	6	79	2	-	1	-	-

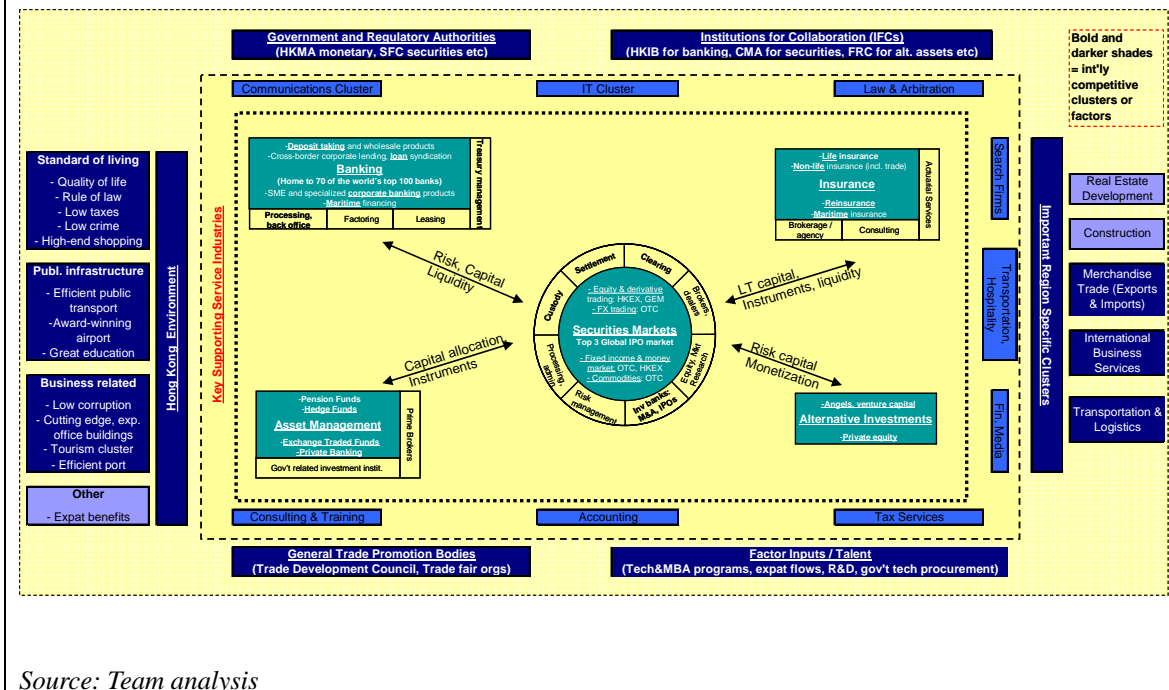


Sources: IFSL, ICCP

2.2. MAPPING THE CLUSTER

Today's financial services cluster in Hong Kong is centered on securities markets (**Exhibit 13**), particularly equities, money market and foreign exchange. Hong Kong Stock Exchange (HKSE) is a top 3 global IPO market, claiming in 2006 the highest total proceeds at US\$46.1 billion and the two largest global IPOs by Bank of China and ICBC. Mainland companies account for 30% of the 1,100 traded companies on the HKSE, representing 45% of total market capitalization. (Ernst & Young: 2007) Hong Kong dominated East Asia in 2005 by number and value of IPO's, secondary offerings and overall market capitalization. Yet it was way behind in the bond market size and bond trading volume, e.g. in 2005, only 46 different government bonds were outstanding in Hong Kong versus 66 in Singapore, 605 in South Korea and 8,858 in Japan (Urade: 2005). Commodities markets are also significantly underdeveloped, with small exchanges such as Chinese Gold and Silver Exchange Society providing basic functions. On the other hand, foreign exchange OTC market is well developed and serves as a key hub for purchasing RMB.

Exhibit 13: Hong Kong Financial Services Cluster



Strong banking sector in Hong Kong is mostly a legacy of its former dominance in manufacturing and regional trading. In September 2007 there were 142 licensed banks, 29 restricted license banks and 30 deposit-taking companies; these institutions include 70 out of the world's 100 largest banks. In 2005, Hong Kong had 108 foreign banks versus just 72 in Japan. (Urade: 2005) Relatively simple activities such as deposit-taking, trade financing, corporate finance, treasury activities, precious metal trading and securities broking define the banking sector (ISD: 2008).

Hong Kong is home to sophisticated, world-class supporting clusters, such as law and arbitration, IT services, communication, consulting and accounting services. The financial services cluster also benefits from Hong Kong's strong infrastructure and strong relevant clusters, such as real estate (financing services and potential for securitization in the future) and tourism and hospitality (financing, transactions processing).

In terms of regulation, financial services companies are governed by separate authorities for each sector group, including Securities and Futures Commission (SFC), Monetary Authority (HKMA), Office of the Commissioner of Insurance (OCI) and others. Despite these numerous regulatory bodies, Hong Kong's pragmatic, transparent and easy to understand approach to regulation has helped to provide international investors with comfort in investing in Chinese companies. Compared to mainland China, Hong Kong is seen as a location providing investors with greater transparency, investor protections and enforcement (E&Y: 2007).

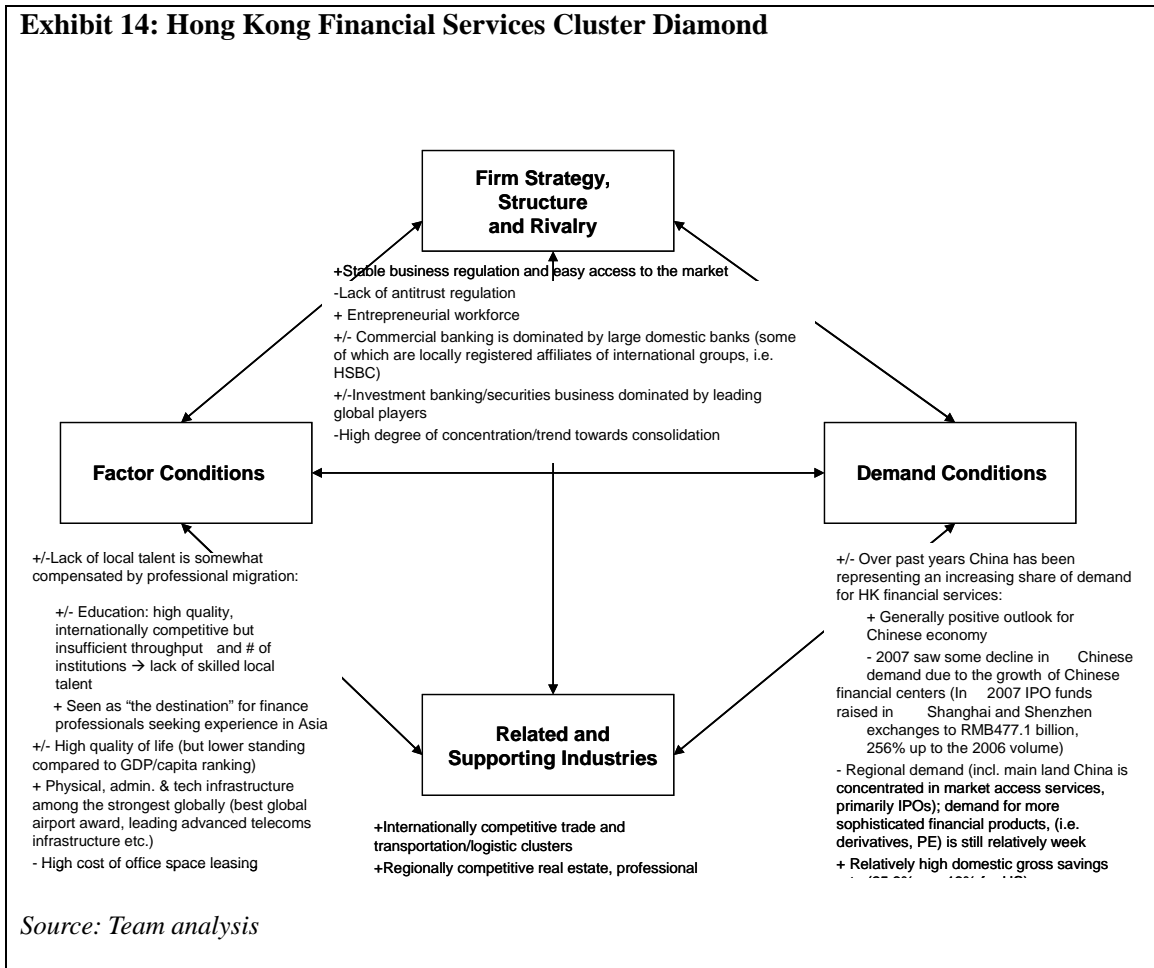
In terms of cooperation, Hong Kong boasts dozens of IFC's that provide substantial cluster support functions such as statistics and trade promotions. For example, Hong Kong Trade Development Council has become the leading body for information gathering and dissemination for financial institutions operating in Hong Kong. Most IFCs, as well as government agencies are organized along sector groups.

2.3. THE CLUSTER DIAMOND

We look at Hong Kong's success to date from the cluster diamond lens (**Exhibit 14**). First, geographical location and status as a SAR of China allows Hong Kong to play a dual role: be a gateway to China without the risks associated with actually investing in China (such as government regulations, restrictions, limited investor protection etc.) For example, the capital account in China is closed and the RMB is not freely convertible - both restrictions are non-existent in Hong Kong. Second, favorable time zone enables traders in Europe and US to achieve 24h market access if so desired, something highly important for e.g. forex markets.

From the factor conditions perspective, skilled labor is a key asset required for sustaining competitive advantage. Hong Kong's lack of local talent (due to insufficient university throughput and inadequate language skills whereby most locals speak Cantonese but not Mandarin or English) is compensated by immigration from mainland China and elsewhere. Salaries for finance professionals are comparable to those in Germany and Japan, and about

400% higher than in Shanghai (CFA: 2007). EIU ranks Hong Kong nr 18 globally in its Quality of Life index, but as previously discussed, pollution and high living costs are raising concerns about finance professionals moving out to e.g. Singapore (which ranks 11 in that same index).



Compared to other centers in Asia, Hong Kong attracts financial institutions and investors due to its low political interference, world-class liquidity of the market (but not breath) and corporate governance standards. Such a setting attracts issuers who seek listing, which creates larger market capitalization, higher trading volume and, in turn, more liquidity - what Paul M.Y. Chow, CEO of HKSE calls “a virtuous circle.” (E&Y: 2007) Risk management mechanism and strong infrastructure (clearing, settlement, information dissemination) provide additional stability and transparency to the market. As noted above, extremely favorable tax regime - no VAT, no tax

on interest, dividends and capital gains - is among the most attractive globally.

On the firm strategy and rivalry side, Hong Kong exhibits two notable weaknesses: lack of antitrust law and high concentration of players as a result. Until recently fixing of deposit interest rates was a common practice in Hong Kong and today top 10 banking institutions account for 94% of banking assets in the country, compared to 60% in the UK and 33% in the US (IUE, 2007).

Related industries are world-class, and provide a huge support to the financial sector cluster from all sides of the business as mentioned previously. Demand for financial services in Hong Kong is not very sophisticated. Due to small domestic market of only 7 million people, the demand is predominantly driven by Chinese institutions.

Among the recent developments, it is important to note Mandatory Provident Fund (MPF) system was introduced in 2000 and generated significant amounts of retirement assets, adding further growth to financial market development. MPF also contributes to greater stability in the financial markets. In August 2007, total accrued MPF assets reached HK\$240.23 billion or US\$31 billion (ISD: 2008).

2.4. STRATEGIC ISSUES

The combination of unique demand for financial services due to the Hong Kong's special status within China and strong supply-side factors has propelled an impressive growth of the Hong Kong financial services cluster over the past decade. To preserve its success going forwards the cluster needs to continue building on existing and arising opportunities as well as to deal with some issues that may potentially undermine its strength.

2.4.1. BALANCE CLUSTER'S RELATIONSHIP WITH MAINLAND CHINA

On one hand, the proximity and special access to the Mainland has been one of the major drivers of cluster's success. PRC companies accounted for a major share of IPOs on Hong Kong Stock exchange, peaking in 2006 at 77.6% (HKEX: 2008). In 2007 China also accounted for over 30% of investments into Hong Kong based investment funds (CEIC: 2008). Growth of Chinese economy is expected to continue, helping the growth of Hong Kong financial cluster. Therefore Hong Kong should go on with its strategy of building up on its unique relationships with PRC.

One of the opportunities for future deepening of the relationships with PRC is to attract more of the mainland's investors. Recent regulatory changes create a perfect environment for achieving this goal: CEPA already gave PRC fund management companies a permission to establish subsidiaries in Hong Kong; while Qualified Domestic Institutional Investor program is being expanded to allow Chinese investments in the overseas stock market (in addition to fixed income products previously), Hong Kong becomes an attractive destination (IMF: 2008). Another opportunity for expanding portfolio of products offered to China is issuance of Renminbi-denominated bonds, which have been already launched even though on a small scale (IMF: 2008). Expanding the portfolio of product offerings to China will not only contribute to the continued growth of the cluster, but will also allow to strengthen Hong Kong's relationships with mainland and preserve its competitive edge versus emerging Chinese domestic financial centers.

It is important to keep in mind that Hong Kong's traditional strength vis-à-vis mainland financial centers, such as Shanghai and Shenzhen, base will inevitably decline over time in terms of infrastructure and skill. The growing importance of mainland financial hubs can be already seen in the latest IPO statistics: 2007 was the first year when the share of mainland IPO's in overall IPO volume of HKEX declined. Reaching the peak of 77.6% in 2006, in 2007 it dropped dramatically to 42.7%. At the same time in 2007 IPO funds raised in Shanghai and Shenzhen exchanges reached RMB477.1 billion (256% increase to 2006 level), while in February 2008

Shanghai's stock exchange market cap exceeded that of Hong Kong by 35% (WFE: 2008). Coming up with more and more expanded and sophisticated portfolio of product offerings for the Mainland solves the potential overdependence problem, but only partly. To insure its future sustainability, Hong Kong needs to diversify geographically and enhance its position as a pan-Asian, as well as global financial center. To do so it needs, first, to develop an attractive value proposition for other markets – i.e. “a world-class IPO center for all Asian countries” or “a gateway for investment into Asia for a global investor” as described in the recommendations part.

2.4.2. DIVERSIFY PRODUCT OFFERINGS WITH MORE BREADTH AND DEPTH

As mentioned earlier, Hong Kong is currently in an ‘equity-oriented’ stage of financial cluster development: it holds an internationally strong position in equity offerings and foreign exchange trading; while playing a relatively insignificant role in debt markets, private equity investments and derivatives trading. Overall, successful financial services clusters can be found in any of the three stages (banking, equity-oriented and securitization). Therefore, the fact that Hong Kong is currently in a ‘security-oriented’ stage does not automatically imply that it needs to move further to the ‘securitization stage’. Still, the stage of the financial cluster development should correspond to the changing external environment. I.e. Tokyo has a successful financial service cluster that has been traditionally banking-oriented and which is supported by a strong and stable domestic demand for debt products. Situation around Hong Kong is however changing dramatically. Once financial centers of mainland China are becoming more competitive in simple equity products, in our opinion, Hong Kong will need to use its factor advantages to develop more sophisticated product offerings, i.e. derivatives, alternative investment vehicles, etc., and thus move to the securitization stage of financial services cluster development as noted above.

It is important to understand the potential impediments of Hong Kong's transfer towards securitization stage. First, current demand, especially in Asia, is skewed towards simple debt and equity products (IPO), which in turns limits Hong Kong's incentive to innovate. Also, Hong Kong

is significantly underrepresented in the bond market (only 2% of the global turnover), while vibrant debt market is a pre-requisite for most of the structured products.

2.4.3. ADJUST TO THE COMPETITIVE DYNAMICS IN THE ASIAN REGION

As mentioned above, Asian region contains a number of other established as well as emerging financial centers. To maintain its leading position in the region Hong Kong needs to develop a strategy for competing/cooperating with each of them. I.e. when it comes to the relatively young financial centers, such as Dubai and Shanghai, Hong Kong can leverage its existing expertise and links with global financial system and position itself as a link between the later and the world financial markets. In the case of traditionally debt-oriented financial centers, such as Tokyo and Seoul, Hong Kong can become a destination location for equity and (in the future) innovative structured products. Hong Kong also needs to reconsider its position relative to its most fierce competitor, Singapore, which is also interested in claiming a position of the Pan-Asian center for investment management.

2.5. POLICY RECOMMENDATIONS

2.5.1. VALUE PROPOSITIONS AND VISION

We believe that, compared with other financial centers in Asia, Hong Kong has its unique value propositions as follows:

- Hong Kong is a truly Asian financial hub for intra-Asia trade flows, portfolio investments, and holdings of financial assets, differentiating itself from emerging domestic-oriented financial centers i.e. Shanghai, Dubai and Seoul.
- Hong Kong serves as a financial services gateway for China, one of world's largest and fastest-growing economies, standing out among developed financial centers of either small or slow-growing economies i.e. Singapore and Tokyo.

Based on its unique value propositions, Hong Kong can develop a vision of becoming the

financial hub integrating Asian financial markets and linking them to the global financial markets through complete and innovative financial offerings.

2.5.2. SHORT-TERM POLICY RECOMMENDATIONS (2-3 YEARS)

Establish public-private partnership for financial services cluster development.

As regional competition among financial centers in Asia is becoming intensifying, it is critical for Hong Kong to develop a holistic approach to the development of its financial services cluster based on a public-private partnership. Hong Kong government needs to consider the cluster development as a top priority on its agenda and play a leadership role in the formulation and implementation of the development plan. We would recommend the government to establish a Financial Services Cluster Development Committee (“FSCDC” or the “Committee”) led by Chief Executive of Hong Kong SAR and consisting of major cluster participants such as chief officers of key regulators, CEOs of domestic and foreign financial institutions, industry associations, universities and research institutes. The Committee should develop actionable initiatives for the financial services cluster in Hong Kong through a bottom-up approach, based on opinions from and aligned interests of all cluster participants.

Promote Hong Kong as the primary equity market for Asian companies to raise capital

Hong Kong needs to proactively expand geographically into non-China markets in Asia while maintains its position as the primary international listing location for Chinese companies. First, Hong Kong government should launch a marketing campaign to Asian companies, promoting Hong Kong’s established track record for financial stability, sound corporate governance, transparent regulatory environment, and world-class infrastructure as well as its advantages in proximate location and shared culture. Second, Hong Kong needs to aggressively develop its Growth Enterprise Market (GEM), the NASDAQ-equivalent market for small- and mid-sized fast-growing companies. GEM should introduce the best practices in NASDAQ, streamline the

listing procedures, and lower the listing costs, functioning as a stepping stone for these companies to upgrade to the Main Board later on. Lastly, the Hong Kong Stock Exchange (HKSE) can make equity investment in the Shanghai Stock Exchange (SHSE) to establish a long-term strategic alliance and share the growth of mainland equity market indirectly.

Attract international and mainland investors with large and sophisticated demand

Listed companies and public investors are equally important for the development of equity market. Hong Kong needs to develop a large and sophisticated institutional and retail investor base as more companies come to Hong Kong for listings. First, Hong Kong government should capitalize on the CEPA and QDII program to attract mainland fund management companies, who raised significant capital from mainland retail investors during the stock market boom, to operate and invest in Hong Kong market. In addition, Hong Kong can closely cooperate with mainland China to expand the pilot project, under which Chinese retail investor can invest non-mainland securities, to broader regions. These initiatives can effectively increase the demand and liquidity in Hong Kong stock market. Second, Hong Kong government can provide incentive packages to encourage asset management companies and hedge funds to set up their Asian operation in Hong Kong. Hong Kong can emulate Singapore by offering these companies tax exemptions, fast approval of license, and flexible regulations. Their participation in the market can bring in more sophisticated demand and push forward financial innovation.

Accelerate immigration of qualified financial and supporting professionals to Hong Kong

As demand for financial services from Chinese companies has been growing fast in Hong Kong financial market, Hong Kong has a significant shortage of qualified Mandarin- and English-speaking professionals in financial services and supporting businesses i.e. accounting, legal, media and IT. In 2003, Hong Kong government adopted a special policy to offer work permits to talents from mainland, who can obtain Hong Kong citizenship if continuously working in Hong

Kong for seven years. Hong Kong government can consider adopting a more flexible policy for financial and supporting business professionals with easier approval of work permit and faster grant of citizenship. Meanwhile, similar programs can be launched for talents from other countries when Hong Kong gradually diversifies its geographic market base. Hong Kong government should also make immigration of the talent's family members easy, fast and convenient.

2.5.3. LONG-TERM POLICY RECOMMENDATIONS (3-5 YEARS)

Establish a large and sophisticated debt market and complete fixed-income products

In the past decade, the Hong Kong Monetary Authority, the central bank, has developed a government bond market through regular issuance of treasury bills and notes, and created a representative yield curve up to 10 years. However, Hong Kong still has a less developed debt market compared with other leading financial centers in Asia, particularly in government bond market, in terms of size and product offerings. Under the QDII and retail investor pilot programs with mainland, Hong Kong is presented with huge and growing demand for fixed-income securities from Chinese insurance companies, pension funds, asset management companies, and retail investors. Therefore, in government bond market, Hong Kong needs to provide sufficient liquidity, offer bonds with more maturities, and issue new products, i.e. inflation-protection bonds. In addition, Hong Kong has to upgrade its infrastructure for bond trading operation, i.e. the multi-currency and multi-product payment and settlement platform, and the bond pricing information system. Meanwhile, Hong Kong needs to capture a new growth opportunity of issuing RMB-denominated bonds in Hong Kong market although the size of such issuance is limited due to small deposit base of RMB in Hong Kong.

Develop regulatory context, collaborated institutions, and talents for financial innovation

To promote financial innovation, Hong Kong government needs to be focused on building a

robust and flexible regulatory context that can enable experienced and well-trained talents to innovate, and facilitating the collaboration among financial institutions, research institutes, and training organizations. First, Hong Kong government needs to update existing regulations and develop new rules in anticipation of changing financial innovations, i.e. securitization products, option-type derivatives, and swaps. As debt, equity and derivative markets become more inter-linked; regulators in Hong Kong should develop a coordination mechanism for more responsive decision making to market changes. Second, government in Hong Kong may encourage universities and training organizations to design specialized financial training programs based on inputs from financial institutions. Government, research institutions and companies can jointly establish independent entities to grant certification to graduates from these programs and monitor the quality of the training offered.

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