

January 2008

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Recommended Citation

Song, Q. (2008). Analysis of Hong Kong to be an offshore financial center of RMB. *Lingnan Journal of Banking, Finance and Economics*, 1. Retrieved from <http://commons.ln.edu.hk/ljbfe/vol1/iss1/3>

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Analysis of Hong Kong to be an Offshore Financial Center of RMB

Qichao SONG

Abstract

In this article we aim to discuss the possibility and feasibility as well as the disadvantages and barriers for Hong Kong to be an offshore financial center of RMB. As the most biggest financial center in China, Hong Kong need to develop the RMB business for strengthening its position in the international competition. And we think that to become an RMB offshore financial center is not only an opportunity but also a responsibility for Hong Kong. We also give some suggestions on this issue.

Introduction

Generally speaking, the financial institutions of one country only engage in the deposit and loan business in local currency. But after World War II, the business dealing with foreign currencies gradually emerged, as financial institutions of some countries became the deposit and loan centers for foreign currencies. Those activities are known as offshore finance. The Euro dollar market is just a typical offshore financial center market.

The appearance of offshore financial centers stems from the development of world trade. Efforts to evade financial regulation and political considerations of regulation are among the most important reasons. The formation of offshore financial centers is not a result of human force but a consequence of international political and economic factors.

The growth of offshore centers can be traced back to the restrictive regulatory regimes in many advanced countries in the 1960s and 1970s. Roberts (1994) studied the emergence of the offshore financial centers. As large financial institutions shifted financial activity offshore, the euro dollar market was established with financial activity denominated in a currency other than the currency of the jurisdiction in which the institution is located. These activities, begun in the financial centers of Europe (mostly London), soon spread to other offshore centers.

Some expected that the activities of OFCs would diminish when the industrial countries pursued financial liberalization in the 1980s and 1990s. However, many of these centers have adapted to increased competition from the major onshore financial centers and continue to account for a significant volume of global financial flows (Roberts, 1994). And after the 2000, the offshore financial centers has continuously developed but the recent crisis brought great criticism about them.

After the development in decades, there are a large number of offshore financial centers in the world in the list given by IMF [1]. Among them, the leading ones include Bermuda, which is market leader for captive insurance and also has a strong presence in offshore funds and aircraft registration, and Luxembourg, which is the market leader in Undertakings for Collective Investments in Transferable Securities and is believed to be the largest offshore Eurobond issuer, although no official statistics confirm this.

Along with the fast development of China in the past thirty years, there is a goal for RMB towards internationalization. It results mainly from the fast growing foreign trades between China and other countries. To set up an offshore financial center in Hong Kong is under discussion and expectation. We analyze that issue in detail in this paper.

Feasibility analysis

1. Sufficient conditions of Hong Kong

In developing an offshore financial market, there is a comparably fixed mode over the world that Hong Kong is able to fulfill. To become an offshore financial center there are many conditions. According to Robert (1994) and Li (2005), we give the analysis on Hong Kong as below. Firstly, Hong Kong enjoys political stability and sustained economic development. Secondly, Hong Kong has excellent geographical location and convenient transportation. Thirdly, the regulatory and legal systems are well established so as to adapt to the demand of offshore financial markets. Lastly, in the financial services industry, Hong Kong has

advantages not only in taxation and in regulation policies, but also in training of financial professionals, and in communication infrastructure.

2. Economic interactions between Mainland China and Hong Kong

Now we discuss one of the most feasible conditions in two aspects. For one thing, the transit trade of Hong Kong has benefited from the frequent interactions between Hong Kong and mainland China. As an important transit harbor of mainland China, Hong Kong's economy depends highly on commercial trade with the significant character of transit trade. After transfer of the sovereignty, Hong Kong experienced an increasing trend in dependence on trade with the transit trade ratio from the mainland nearly 60% per year [2].

For another thing, homogeneity in the exchange rates calls for a new composition exchange rate mechanism in the two economies. The homogeneity relationship is shown prominently in exchange rate regimes, that are setting the exchange rate, directly or indirectly, fixed on US dollars. In Hong Kong, the linked exchange rate system was established from 1983, with a pegged exchange rate to US dollars. While in the mainland, now the exchange rate regime in practice is a managed floating rate system in which RMB is linked to a basket of currencies with most weighted in US dollars. Under the framework of CEPA (Closer Economic Partnership Arrangement), the cyclical fluctuation among Hong Kong and mainland China cannot coordinate with the business cycle in the United States which constantly makes Hong Kong suffer. So some arrangement may be carried out to deal with that.

3. Implementation of CEPA

CEPA encourages the cooperation in financial industries of the two sides. Banks in the mainland could move their international capital and foreign exchange trading centers to Hong Kong for the purpose of using the financial resources of Hong Kong. This kind of cooperation enhances Hong Kong's position as a capital managing center. The human capital in the financial services industry also can flow between the mainland and Hong Kong under CEPA, which is propitious to the internationalization of the RMB. Moreover, mainland China and Hong Kong could share information on financial supervision and cross boarder crime. CEPA creates a good environment for the offshore financial business undertaken in Hong Kong.

Advantages and Opportunities

1. The control of circulation of RMB offshore

To permit the circulation of RMB in Hong Kong, the supervision authority in the mainland can get an important benefit, that is, it could take the RMB circulating abroad into the banking system as to control the scale of RMB circulating outside of the mainland China. Because the circulation of billions of RMB in Hong Kong is out of the commercial system, the setting up of an offshore financial market will facilitate RMB currency flow back to the mainland (Zhang, 2004).

2. The complete marketization of interest rate system for RMB

Along with the fast development of financial markets in China, an interest rate index system based on a market is needed for references in making monetary policy. Similar to LIBOR (London InterBank Offered Rate), a complete marketization system for RMB interest rates can be formed with the offshore RMB financial center in Hong Kong. The improvement towards

marketization in mainland China is limited for considering the tolerance ability of commercial banks and domestic companies. At that point, though we can choose by developing a bond market in the mainland actively, using the market condition of Hong Kong is a better choice to form a market index for the RMB through absorbing the RMB circulating abroad.

3. The internationalization of RMB

Founding the offshore market for RMB in Hong Kong can provide an experimental base for RMB in its free exchange and internalization. These are among the final goals of the reformation of the monetary system in China. In this progress, China can gain experience on stabilizing exchange rates and financial supervision. The Hong Kong dollar can perform as a currency intermediary in the reformation of the monetary system of the mainland. Moreover, it can provide reference for adjustment of foreign exchange rates in the mainland. The foreign exchange market in the mainland is still not well developed now given the policy of control of the capital account, absent of financial instruments for hedging from foreign exchange risk. This makes the offshore financial center serve as an indicator for the policy-making of the central bank.

4. Opportunities for Hong Kong

In the short run, carrying out personal RMB business in Hong Kong offers a limited contribution to Hong Kong's economy. At present the business in RMB permitted for banks in Hong Kong only contains four categories: deposit, remittance, exchange and credit card, with area limitation in the scope of Hong Kong SAR. But in the long run, it can provide a base and platform by strengthening the financial infrastructure for Hong Kong in becoming the RMB offshore financial center. After the fast economic growth in China, and the intensive international economic activities, the offshore business of RMB should be bigger with an increasing market volume and business opportunity.

The balance statement of foreign trade of China also offers an advantage for Hong Kong to be the offshore financial center of RMB. The role of world factory and the increasing foreign trade of China will support a continuous need for offshore financial market of RMB.

After the Asian financial crisis, the importance of Hong Kong as an international financial center has faded especially on international banking business as mentioned in Hu (2007). One reason is the offshore business competitiveness among various Asian cities. Becoming the offshore center for RMB can increase the scale of offshore financial business as well as the attractiveness to banking institutions which could help Hong Kong in developing towards a major international financial center and improve its financial influence. In all, we believe that once Hong Kong establishes its position as the offshore financial center of RMB, the financial industry and economy of Hong Kong will have an excellent opportunity to become an international financial center like London and New York.

Challenges

1. Disparities in financial systems

There are many differences on the level of system in financial sectors between mainland China and Hong Kong that discourage Hong Kong from becoming the offshore center of RMB. Hong Kong is an open free harbor with a relative loose regulation, while mainland

China is comparatively a closed and incomplete financial system with an internal financial market for RMB.

The exchange rate regime and control of capital account is the biggest barrier for the formation and development of an RMB offshore market. Unable to free convertibility of RMB is one important limitation faced by Hong Kong to set up the offshore market of RMB. Meanwhile, the control of RMB limits the use of RMB capital by banks in Hong Kong such as issuing loans in RMB.

2. Shock on monetary policy and exchange rate of RMB

The rise of an offshore market for RMB will have impact on domestic monetary policy and the exchange rate of RMB. Essentially offshore RMB performs as world currency with its interest rate and exchange rate affected by world economy. The fluctuation of world economy will have an influence on the interest rate and exchange rate of offshore RMB more than domestic monetary policy. In extreme cases, if the RMB becomes fully convertible and freely floating in the offshore market, the domestic monetary policy of mainland China could lose its effectiveness when the business cycles depart from each other. For example, under the extreme circumstance, speculators could accumulate RMB positions via offshore market transactions for later use in attacking the RMB in corresponding markets. Such a case, however, may not be realizable due to (1) the overwhelming size disparity among the two economies and (2) the fact that an offshore trading center is, itself, made necessary by capital control issues. According to theory, nevertheless, there may be a shock sourcing from the offshore RMB on domestic monetary policy and exchange rate of RMB.

3. The coordination of regulation

The openness level is far different between the mainland China and Hong Kong in financial markets. With different regulation systems and market rules, the desynchrony takes form in exchange rate regime and control of foreign currencies. After building up the offshore financial center, the balance of two different markets and two different monetary systems is an important problem for regulation authorities. Under the current control of capital account in the mainland, the creation of an offshore center for the RMB will stimulate the short run capital flows by financial instruments using RMB. For one thing, the capital circulation transferring between offshore and domestic markets will challenge the supervision. For another, the international hot money may attack the RMB in offshore markets which makes the capital account control implemented in mainland China ineffective.

Suggestion

To become an offshore financial center of RMB, Hong Kong has its advantages and challenges as we discussed above. And there is still a long way to go as we can imagine. Here, we give some suggestions.

Firstly, the banks that could carry out business on offshore RMB should be well chosen. For the recent financial crisis let us know the importance of risk control. Secondly, the regulation should be taken strictly on RMB business operating in financial institutions in Hong Kong by the HKMA(Hong Kong Monetary Authority) to confirm the stabilization of the exchange rate and offshore market of RMB. For we must take care of the speculative activities on the offshore RMB. Thirdly, cooperation on dealing with cross boarder illegal financial activities

should be strengthened by the regulation authorities. The financial crimes become more complicated with the advanced technologies.

Recently the news came out that the pilot program of setting up the offshore clearing regime of RMB would be carried out in some cities including Hong Kong. And we think Hong Kong will definitely become the offshore financial center of RMB.

Notes:

[1]. IMF list of OFCs

<http://www.internationalmonetaryfund.com/external/np/mae/osshore/2000/eng/back.htm#table1>

[2]. http://www.censtatd.gov.hk/hong_kong_statistics/index_tc.jsp

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