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Working Paper Series Vol. 2002-26
November 2002

The International Centre for the Study of East Asian Development, Kitakyushu

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Abstract

This paper surveys the continuing role of Hong Kong in China's economic development after Hong Kong's return to Chinese sovereignty in 1997. Focus is placed on three areas. First, the growing economic integration with Guangdong Province, especially the Pearl River Delta, in the development of an export oriented light industrial manufacturing platform. Figures from a recently conducted survey find that Hong Kong based manufacturing and import/export companies employ over 11 million workers in the Chinese Mainland, and is responsible for intermediating 40 percent of China's external trade and one-third of total foreign direct investment flows into the Mainland in 2000. Second, export of services account for an increasingly large share of Hong Kong's total exports and amount to one-quarter of Hong Kong's GDP. Service exports serve an important as producer services in support of the export oriented manufacturing base in Guangdong Province. The service is provided for goods that are routed through Hong Kong as re-exports or for offshore trade that does not pass through Hong Kong. Hong Kong's role as a regional headquarter for foreign businesses operating in Asia has therefore been growing. Third, Hong Kong's role as China's international financial center does not appear to have been eclipsed after its return to Chinese sovereignty. Shanghai's role as an international financial center is growing but the gap between the two cities remain considerable and Hong Kong continues to have an important role to play in managing China's financial resources and risks.

[1] This paper was presented at as a part of ICSEAD's Public Lectures on Asia Series (Ajia Kouza) on 12 November 2002.

Introduction

Hong Kong’s economic ties with the Mainland, revived in the late 1970s, have strengthened further since its return to China's sovereignty in 1997. Hong Kong's economic links with the Mainland expanded rapidly in the 1980s and the first part of the 90s, with Hong Kong becoming the most important trade and international fund raising center for the Mainland.

Hong Kong currently intermediates about 40 percent of China's external trade. As manufacturing moved across the border, Hong Kong gravitated toward intermediation, and its re-exports trade, almost all related to the Mainland of China, is now larger than its GDP at 110 percent. Entrepot trade with the Mainland and related services are thus critically important to the Hong Kong economy.

Hong Kong has been the most important source of international capital for the Mainland. Cumulative foreign direct investment (FDI) from Hong Kong was estimated at about US$171 billion as of 2000, or about 55 percent of China's total FDI. Although the share of FDI flows from Hong Kong has decreased recently, it still accounted for more than one-third of total FDI flows to the Mainland in 2000.

All but one of the 58 Chinese state-owned enterprises (SOEs) listed abroad at end-2001 were listed in Hong Kong, having raised a cumulative of US$16.6 billion. In 2000, China-related companies (both so called "red-chip" and "H-shares") raised a record US$44 billion in the Hong Kong market.

China has raised more than US$23 billion in the Hong Kong bond market (out of $28 billion placed outside the Mainland) in the last 10 years. Seven Mainland sovereign bonds were issued in Hong Kong, and 18 Mainland issues of non-government bonds were listed on the Hong Kong exchange at end-2000.

The stock of Hong Kong banks' direct lending to Mainland entities totaled some US$37 billion in 1999, or about 70 percent of total foreign bank lending to the Mainland. Lending to the Mainland by Hong Kong banks has since declined, in part due to the financial problems of some debtors.

Hong Kong banks have also been active in arranging syndicated loans and floating rate notes for use in the Mainland. At the peak in 1998, syndicated loans to the Mainland of China arranged by Hong Kong banks totaled $5.6 billion.

The growing presence of Mainland firms and capital raising activities has contributed to the development of Hong Kong's financial markets. For instance, the growing number of Mainland firms in the equity market has attracted an increasing amount of international funds to Hong Kong, with good returns: during the period 1996-2000, the "red chip" index was up 36 percent, compared to a return of 15 percent of the rest of the market.

The Mainland of China has become a major source of FDI in Hong Kong. By-end 1999, the Mainland of China had invested over US$100 billion in Hong Kong (about one-fourth of total inward FDI). Despite growing links, the financial markets of Hong Kong and the Mainland remain largely independent from each other.

Trade and Manufacturing in the Pearl River Delta

Hong Kong's economy is increasingly correlated with Mainland's external sector, though not its overall economy. Hong Kong's integration with the Mainland of China will deepen in the coming years, with the Mainland economy opening up further following WTO accession. In the next few years, Hong Kong will benefit from increased trade between the Mainland of China and the rest of the world. China’s exports still account for a relatively small share of world trade (Table 1), but are forecasted to grow to 10 percent by 2020.

Table 1. Selected Global Export Shares in Percentage, 2000

China	4.0
Japan	7.7
Asia NIEs*	7.7
France	5.2
Germany	8.8
United Kingdom	4.5
United States	12.4

Source: IMF, direction of Trade Statistics.
(*): Korea, Singapore, Taiwan province of China, Hong Kong. Re-exports of Hong Kong are excluded.

Hong Kong's efficient port facilities, trading experience, global network, and agglomeration of trading activities are hard to rival in the near future. Nonetheless, Mainland port facilities are improving, and the economy of the Yangtze River Basin is gaining importance. As China continues to liberalize trade and investment, direct access between the Mainland and rest of the world will increase, potentially bypassing Hong Kong. Therefore, Hong Kong's role as a traditional "middleman" for Mainland trade will likely diminish over time. Increasingly, entrepot trade will shift to offshore trade (Table 2), or by-pass the Hong Kong connection altogether. Nevertheless it is expected that the initial increase in Mainland trade will dominate the trade diversion effects, but this is unlikely to be sustainable in the long run.

Table 2. Survey of Traders on Prospects of Different Shipping Arrangements

(views expressed, in percent of total)

	Growth	No change	Decline
Re-exports	18.5	32.5	49.1
Transhipments via Hong Kong	37.2	36.8	26
Direct shipment	76.7	17.9	5.4

Source: Hong Kong Trade Development Council

Where China is Efficient?

However, it is important to recognize that Hong Kong's role in Mainland trade goes far beyond entrepot trade as a traditional "middleman". A close examination of the recent trade statistics points to Hong Kong's critical role in China's development and in export trade in particular. Recent figures from China's customs showed the relative contributions to exports from domestic enterprises and foreign-invested enterprises (FIEs). In 1Q02, the total value of exports produced by FIEs exceeded exports of the entire domestic industrial sector for the first time since 1992.

In other words, the FIEs are the main driving force in generating exports for China, and data shows that they saw exports grow by 25 percent per annum between 1993 and 2001. Contrast this with domestic enterprises, and compound growth has only been at about 7.8 percent (Table 3).

Table 3: China's export value in US$bn 1992-2001

Year	Domestic enterprises	Foreign-invested enterprises
1992	68	17.357
1993	67	25.237
1994	86	37.713
1995	102	46.876
1996	90	61.506
1997	108	74.900
1998	103	80.962
1999	106	88.628
2000	130	119.441
2001	133	133.235
Jan-April 2002	44.083	47.300

Source: Customs, China

The largest investors in China FIEs are from Hong Kong. The Hong Kong Trade Development Council estimated that at the end of April 1999, there was 180,653 Hong Kong funded investment projects in China, representing nearly 55 percent of all foreign-invested projects in the country. The vast majority of the projects were in manufacturing for export. The amount of each investment was relatively small, and thus did not attract much media attention. Investments in import/export projects were also closely related to production.

The largest portion of investments was made in Guangdong Province. In 2001, Guangdong received US$15.7 billion in FDI. Investments from or those that came via Hong Kong accounted for 60 percent of the total in 2001. In past years, Hong Kong's contribution was even higher at 70 percent to 80 percent. The proportion is now lower because Guangdong's economy has become larger and more funds from other parts of the world flow in at a faster rate.

What China's customs figures indicate is that the FIEs form the most vibrant part of China's production ability with much of it in light industries. Hong Kong and the overseas-Chinese community by-and-large own these FIEs. To date, these FIEs have been able to grow without a "home market" – i.e., selling to the domestic Chinese markets - and they have had to deal with bureaucratic hassles as well as poor transportation infrastructure.

In other words, the FIEs have been able to achieve dramatic growth despite China's inefficiencies. Indeed, Hong Kong money has gone into investing in transportation infrastructure for essential improvements, such as in the ports in Shenzhen, where Hong Kong companies have a direct interest in efficiency gains.

Hong Kong's Manufacturing Investment in the Pearl River Delta Region

A recent survey of 123,000 manufacturing and import-export companies based in Hong Kong conducted in April 2002, found that an estimated 63,000 companies (or 53 percent) have manufacturing operations on the Chinese Mainland. These 123,000 companies engaged a total of 477,000 workers in Hong Kong. The 63,000 companies with manufacturing operations on the Mainland employed a total of 389,000 workers in Hong Kong.

The survey found that an estimated 35 percent of the manufacturing firms reported that they have activity in the Mainland, whereas an estimated 55 percent of the import-export firms reported having so. Superficially the finding that a lower proportion of manufacturing firms than import-export firms reported having manufacturing operation in the Mainland may appear to be surprising. But it is quite likely that many of the import-export firms are classified as such in Hong Kong simply because their manufacturing operations are across the border. They are thus traders in Hong Kong and manufacturers in the Mainland. For this reason it is not appropriate to think of these import-export firms as pure traders.

It is estimated that 22 percent (or 27,000 companies) of the manufacturing and import-export firms have invested in factory facilities in the Mainland, 26 percent (or 32,000) have management and operation control of factory facilities, and 23 percent (or 28,000) have made sub-contracted processing arrangement with factories in the Mainland (Tables 4 and 5).

Table 4: Estimated Numbers of Firms by Activities on the Mainland

	Established factory facilities		Made sub-contracted processing arrangement with foreign invested or local enterprises	Had some economic activity on the Mainland	Had no economic activity on the Mainland
	Invested in factory facilities	Had management and operation control of factory facilities			
All Firms	27,000	32,000	28,000	63,000	60,000
Manufacturing	3,000	3,000	3,000	7,000	13,000
Import/Export	24,000	29,000	25,000	56,000	47,000

Note: The first three columns are not mutually exclusive because a firm can be engaged in more than one type of economic activity on the Mainland.

Out-sourcing of production is not the dominant mode of production. Only 23 percent of the firms are estimated to have made sub-contracted processing arrangement with factories in the Mainland. Both manufacturing and import-export firms are engaged in out-sourcing activities and some of them may have invested in factory facilities in the Mainland and/or have management and operation control of factory facilities there as well.

Table 5: Estimated Percentage of Firms by Activities on the Mainland

	Established factory facilities		Made sub-contracted processing arrangement with foreign invested or local enterprises	Had some economic activity on the Mainland	Had no economic activity on the Mainland
	Invested in factory facilities	Had management and operation control of factory facilities			
All Firms	22.2	26.2	23.2	52.0	48.0
Manufacturing	13.9	17.1	16.9	35.0	65.0
Import-Export	23.7	27.9	24.4	55.0	45.0

Note: The first three columns are not mutually exclusive because a firm can be engaged in more than one type of economic activity on the Mainland.

The first three columns depicted in Tables 4 and 5 are not mutually exclusive. Table 6 depicts the various configurations of economic activity and their percentages that Hong Kong based companies are engaged in manufacturing operations on the Mainland.

Table 6: Economically Active on the Mainland

	Percentage of Firms
Invested in factory facilities only	17.4 percent
Had management and operation control of factory facilities only	23.5 percent
Made sub-contract processing arrangement only	27.3 percent
Invested in factory facilities & had management and operation control of factory facilities only	14.1 percent
Invested in factory facilities & made sub-contract processing arrangement only	4.5 percent
Had management and operation control of factory facilities & made sub-contract processing arrangement only	6.2 percent
Invested in factory facilities & had management and operation control of factory facilities & made sub-contract processing arrangement	7.1 percent
Total	*100 percent*

Manufacturing and import-export companies with manufacturing operations in the Mainland together hire a total of more than 11 million workers. An estimated 2200 of these companies had set up operations in the Mainland before 1976. The process has been on going ever since. At its peak, about 7500 companies set up operations in the year 1992 alone. Since 1997, a cumulative total of about 7400 companies have set up operations in the Mainland.

In 2001, the gross output of the median firm produced HK$18 million in the Mainland. The cumulative investment in the Mainland by these companies has a median value of $8 million. Approximately 71 percent of the output of these companies was exported, 19 percent was transferred to other facilities for further processing, and only 10 percent were for domestic sales.

An estimated 87 percent of the firms that exported their output made in the Mainland transported those exports via Hong Kong. In terms of the value of exports, the median percentage of output transported via Hong Kong was 80 percent in 2001.

On average, 50 percent of the raw materials used in Mainland factories with connection to Hong Kong were imported, 17 percent were transferred from other factories in the Mainland and the rest comprising 34 percent were from other domestic suppliers.

An estimated 78 percent of the firms that imported raw material used in Mainland factories imported through Hong Kong. In terms of value, the median percentage of such imported materials transported via Hong Kong was 50 percent in 2001.

Guangdong Province has received the lion's share of this investment from Hong Kong based companies. And within Guangdong almost all of it is concentrated in the Pearl River Delta region. Hong Kong's manufacturing operations are also located in areas in the Mainland outside Guangdong. The Yangtze River Delta region had an estimated

2,600 factories working for Hong Kong, while the number in the other provinces is estimated to be around 3,000.

In Guangdong, 53,000 Hong Kong based companies have manufacturing operations there. They are divided into two main types of operations: foreign funded enterprises and factories under some other contractual forms (including sub-contract processing arrangements and management and operation control arrangements).

Approximately 21,000 companies in Guangdong are foreign funded enterprises and 32,000 companies are under some other contractual forms. Foreign funded enterprises in Guangdong employ about 4.75 million workers and companies under some other contract forms engage 5.59 million workers. Together they are responsible for generating total employment in excess of 10 million workers in Guangdong.

The companies that we surveyed were all registered in Hong Kong and are therefore considered as Hong Kong based companies. It is believed that some fraction of these companies might be foreign owned even when registered in Hong Kong. The present study has not identified their ultimate ownership. The Pearl River Delta is clearly the base for manufacturing operations of Hong Kong based firms, regardless of whether the Hong Kong based companies are classified as manufacturers or importers-exporters.

The region continues to grow despite the onset of the Asian Financial Crisis in 1997 and the subsequent regional and global economic slowdown. Since 1997, new Hong Kong based companies have continued to invest in manufacturing operations across the border. The 63,000 companies based in Hong Kong employ less than 400,000 workers in Hong Kong but is responsible for generating more than 11 millions jobs on the Mainland, with over 10 million in Guangdong alone.

Hong Kong's trade story is tied to manufacturing. Most of the production now takes place across the border. When China's exports do well, Hong Kong manufacturing-cum-trading companies make money. Hong Kong's recent economic data shows that growth is coming from external drivers in both the trade of goods and services. The region is arguably the world's most efficient light-manufacturing center and its lead could increase in the years to come if the public and private sectors in Hong Kong and Guangdong Province can continue to enhance the region's supply-chain efficiency in a sustainable manner.

Over the past two decades, Hong Kong industrial manufacturers have helped to turn China into a substantial production base for all kinds of products for the world market. It is instructive to note that China's foreign invested enterprises (FIEs) have become most competitive in light-industrial consumer products, where Hong Kong has played the most influential role. China is the world's sixth largest exporter today, selling US$266 billion in 2001, the bulk of which were consumer products.

Hong Kong's manufacturing companies are specialists in a range of consumer products including consumer appliances, toys and games, textiles and garments, jewelry as well as accessories - the bulk of which are made in Mainland China for the international markets.

Hong Kong's best companies in these areas are the top producers and managers of production capacities in the world. As managers of global production capacities, they are very much a part of multinational companies' global assembly processes.

Export of Services

For cities that are part of a metropolitan area operating an increasingly global world, for example, Hong Kong, London or New York, a critical feature is flow of all kinds - people, information, ideas, knowledge, goods, services, capital as well as technology. Growth comes from seeking greater flow in every possible area.

It is useful to consider producer-services "flow" to illustrate the power of services as an engine for growth. It will be seen that Hong Kong is doing well in these areas, despite the headache of weak private consumption and property prices.

The link between manufacturing and services needs to be much better understood, because they are intimately bound together in the Hong Kong context. When the China market is seeing strong export growth, Hong Kong makes very good money because it supplies the services support for China's light industrial exports and a substantial chunk of light-industrial products are controlled by Hong Kong SMEs.

Hong Kong provides the higher-end value services and does not compete with China in land and labor. Its entrepreneurs supply the capital and know-how in order to exploit the production inputs across the border. It is the perfect marriage and can only get better if the Pearl River Delta can become an even more efficient supply-chain system for light industries. This vision is being gradually articulated in Hong Kong as will be seen in subsequent chapters. How the Pearl River Delta develops as a whole, will be fundamental to Hong Kong's own continued development in the longer term.

It must also be noted that in the supply of services to support manufacturing in China, Hong Kong has no competition. This is especially true in the trade-related services, since much of the services are often provided by the parent company in Hong Kong to its subsidiaries, affiliates and sub-contractors in China. To understand how this works, we take a look at Hong Kong's offshore merchanting trade below.

Hong Kong's economy continues to be driven by external demand. The thing to watch is Hong Kong's export of services. Hong Kong is already the most service-oriented economy in the world. Over the past 10 years, Hong Kong has already undergone a remarkable restructuring. Services contribution to Hong Kong's GDP rose to 85.6 percent in 2000 from 74.5 percent in 1990. In the year 2000, services exports were doubled that of domestic goods exports. That same year, the value of Hong Kong's services exports was US$41.4 billion (HK$323 billion), and for goods exports, the value was US$19.6 billion (HK$153 billion).

The value of total exports of services rose by 13.8 percent to US$40.72 (HK$317.6 billion) in 2000, compared to 1999. The value of service imports grew by 4.1 percent to US$24.55 (HK$191.5 billion). Taking them together, Hong Kong had an invisible surplus of more than US$16 billion (HK$126 billion) in 2000, or 10 percent of GDP. Between 1997 and 2001, trade-related services exports grew annually by 10.9 percent.

The major service groups are transportation (31.3 percent of total value), trade-related services (30.7 percent), travel (19.7 percent), financial services (6.6 percent), and insurance services (1.1 percent). Other services shared the remaining 10.8 percent. As for imports of services, travel accounted of 59.9 percent of total value in 2000, followed by transportation (25.4 percent), trade-related services (5.8 percent), financial services (2.9 percent) and insurance (2.1 percent). Other imported services accounted for 12.9 percent.

Among the major service groups, trade-related services contributed most significantly to the overall invisible trade surplus, at US$11 billion (HK$86.4 billion) in 2000. This was followed by transportation at US$6.5 billion (HK$50.9 billion), then financial services at US$2 billion (HK$15.3 billion) and other services at US$1.24 billion (HK$9.7 billion).

Hong Kong's offshore trade

The point to bear in mind is that by and large Hong Kong's SMEs control the production capacities in light industries in the Pearl River Delta. They have no competition in the provision of these service exports because a substantial chunk is provided by the parent company in Hong Kong to its subsidiary, affiliates and sub-contractors across the border. Thus, when China exports do well, the level of production-related services go up accordingly.

Some of the goods, which used to pass through the city as re-exports are now diverted to offshore trade without having to pass through Hong Kong. This category covers the services of both "merchanting" and "merchandising for offshore transactions". Merchanting is defined as services associated with the trading of goods, which are purchased from a party outside Hong Kong and then sold to another outside Hong Kong, without the goods ever entering or leaving Hong Kong. Also included are transactions of goods made through sub-contracting and sold directly to a party outside Hong Kong without the goods coming through the city.

Merchandising services for offshore transactions are defined as services of arranging on behalf of buyers/sellers outside Hong Kong the purchase/sale of goods according to their specifications (e.g., multiple sourcing, marketing, contract negotiation, procurement, shipment, inspection, etc.) Unlike in merchanting, the Hong Kong party acts as an agent or broker and does not take ownership of the goods involved.

Earnings from offshore trade include the gross margin from merchanting and the commission from merchandising services for offshore transactions. In 2000, Hong Kong's earnings from offshore trade grew by 21.2 percent over 1999 to nearly US$11 billion. Within that, the gross margin from merchanting surged 31.6 percent to US$9 billion, while commission from merchandising services clocked US$1.78 billion. In terms of sales value of goods involved in merchanting, it totaled US$106 billion in 2000. Re-exports totaled US$178 billion. China activities contributed most to gross margin earning, accounting for 35.8 percent of the total gross margin earned in 2000, followed by the USA (23.5 percent) and Japan (8 percent).

Hong Kong as a Regional Headquarter

The attraction of Hong Kong as a business center for managing the regional activities continues to grow (Table 7). The number of regional headquarters and offices in Hong Kong increased by 20 percent in 2000 to over 3,000, and the presence of Chinese firms, falling in 1998-99, has started to grow again.

Table 7. Hong Kong as a Regional Headquarter for Multinational Companies

	1997	1998	1999	2000	2001
Number of regional headquarters and offices in Hong Kong	2,514	2,449	2,490	3,001	3,237
o/w with Mainland incorporated parent	243	205	205	229	242
Number of persons engaged (in thousand, excl. those not responded)	n.a.	136	114	133	173
o/w with Mainland incorporated parent companies		7.6	7.3	9.2	7.2

Source: Hong Kong: Census and Statistics Department.

As foreign business expands in Mainland China their China related operations might move more of their operations away from Hong Kong across the border. But certain functions will be retained in Hong Kong and these are typical of those performed by regional headquarters (Table 8).

Table 8. Location of Major Operations of Hong Kong Companies in the Next Five Years (Business location, in percent of total respondents)

	Hong Kong	Mainland China	Other
Trade financing/documentation	90.1	16.1	4.4
Regional headquarters/offices	85.4	18.8	5.0
Insurance	84.9	19.5	6.9
Business negotiation	72.4	39.7	18.5
Arbitration	71.5	35.0	9.6
Marketing	58.1	37.6	30.5
Freight forwarding & consolidation	55.3	58.5	9.0
Production development/design	53.4	46.6	16.2
Testing/certification	46.2	59.1	12.0
Material sourcing	38.3	71.9	20.2
Warehousing/inventory control	30.6	77.8	5.9
Sample-making/prototyping	27.2	73.4	11.0
Quality control	25.9	78.0	10.5
Manufacturing/packaging	14.4	86.3	10.8

Source: Trade Development Council.

Hong Kong as China's International Financial Center

With the Mainland opening up its financial sector, some foreign financial institutions will likely relocate their China-related activities from Hong Kong to the Mainland, especially Shanghai. Nonetheless, Hong Kong has advantages that will likely preserve its role as a center for China's international capital raising for the foreseeable future:

- sound legal framework, and independent and efficient judiciary - while the Mainland's legal system remains in need of development;

- free flow of capital and information - while the Mainland will maintain capital controls for the foreseeable future;

- a mature financial market and sound banking system - while China's financia1 market is at a much earlier stage of development, with a financially weak banking system.

These factors will make it difficult for Shanghai or other cities in the Mainland to rival Hong Kong's position as a major international financial center in the near future. Growing financing needs in the Mainland will likely benefit Hong Kong as an international financial center, especially in the following areas:

- Increasing placements by large Chinese SOEs and private firms in the Hong Kong stock market;

- Restructuring and infrastructure projects in the Mainland should help boost Hong Kong's debt market (a 1997 World Bank report estimated that China's infrastructure-related spending could exceed $700 billion over ten years, and preparation for the 2008 Olympics may require additional infrastructure spending);

- Growing *corporate debt financing* by Mainland firms (if China's corporate debt to GDP ratio were to reach 4 percent - the level in Thailand before the crisis - by 2010, corporate bonds outstanding could total over $120 billion (from the current $10 billion);

- *FDI* to China will likely increase with WTO-related liberalization of services sectors and the elimination of textile export quotas in 2005. Some of the FDI should continue to be channeled through Hong Kong.

Hong Kong firms could benefit from the opening up of China's financial sector, although they will face entrance barriers and competition from international firms.

As integration progresses, policy makers and regulatory authorities will have to increasingly look beyond developments in Hong Kong to ensure effective surveillance.

Hong Kong authorities will need to monitor closely economic developments in the Mainland of China, and as Hong Kong financial institutions become ever more involved in the Mainland economy, supervision will need to pay further increasing attention to cross-country risk.

To ensure stability and further development of Hong Kong's financial markets, market infrastructure and the regulatory framework need to be continuously upgraded. As a regional financial and commercial center, HK must maintain a smooth flow in both directions of economic activity with its neighboring areas, in particular the Mainland.

There was a time when the rapid growth in the stock markets in Shanghai and in Shenzhen led many people to question HK's future as a financial center. However, such views have quietly disappeared as major problems in Mainland China's stock markets (false company accounts, lack of transparency, administrative interference, very immature investors with strong casino mentality, etc,) revealed themselves in the past year. Indeed, it is becoming increasingly clear that the Shanghai and Shenzhen stock markets are still very immature and will take a long time before they could function as efficient capital markets.

Meanwhile, despite talks about banking reform for the past 2 decades, China's banks have yet to live up to what is expected of them. There is a huge pool of savings in China that is looking for a home. Money supply growth averaged 20 percent a year in the past 2 decades. This rapid increase in personal savings threatens to ignite inflation during the early 1990s. In recent years, such rapid growth in savings threatens to produce financial bubbles. The authorities in Beijing are aware of the potential dangers to social stability if financial market risks are not well managed.

There is therefore a lot of potential for the financial markets in Hong Kong to help China manage the country’s financial resources and risks. But to achieve this, the flow of funds between Hong Kong and the Mainland has to be liberalized gradually and managed well. At the same time, however, Hong Kong will probably have to pay a price in terms of having to manage the increased volatility spilled over from the Mainland to Hong Kong.