One country, two systems: the economic integration between Hong Kong and China

Foong May Lee

2011

Bachelor of Commerce Best Business Research Papers

UVic Libraries ePublishing Services

Original citation:

Lee, F. M. (2011). One country, two systems: the economic integration between Hong Kong and China. *Bachelor of Commerce Best Business Research Papers*, *4*, 75–86.

One Country, Two Systems:
The Economic Integration between Hong Kong and China

Foong May Lee
Fall 2010

ABSTRACT

Hong Kong has enjoyed political and economic development after being ceded over to the British in 1842. Even while being a British Colony, Hong Kong has managed to maintain an intimate relationship with China, partly due to history, culture and language similarity, and geographic proximity. This also resulted in a highly integrated economic relationship between them, even if there was no governmental intervention since the beginning. The relationship never ceased after Hong Kong was returned to China, and all the while with Hong Kong preserving its political and economic system under the 'One Country, Two Systems' policy. The introduction of the Mainland and Hong Kong Closer Economic Participation Agreement (CEPA) signifies the official start of a co-operative relationship. Hong Kong's and China's economies were able to mutually benefit from the agreement, especially for businesses in both regions.
Not only was there exchange in physical goods and labour, there was also an exchange of skills and knowledge as well. CEPA was also able to bring upon a further increase in foreign direct investments into Hong Kong, benefitting the economy. Furthermore, the intention of the Chinese government in making the RMB an international currency gave Hong Kong the opportunity to further develop its position as a major international financial centre. The potential of an offshore RMB trading centre is huge and Hong Kong has been able to gain a first-mover's advantage into that market.

INTRODUCTION

On the campus of the Chinese University of Hong Kong, there stands the statue of the "Goddess of Democracy". It was at first rejected by the school authorities. However after strong student opposition towards that decision, the school authorities relented, and the statue now stands proudly in front of the University Mass Transit Rail (MTR) station. Recently, the statue received a bright red banner, congratulating Mr. Liu Xiaobo on winning the Nobel Prize. This is obviously a display of freedom of speech and democracy. Being officially a part of China, Hong Kong however has managed to preserve its political and economic system inherited from its British Colonial days. This would not have been possible were it not for the introduction of the 'One Country, Two Systems' policy.

The Hong Kong of today underwent significant transformation from the barren land it was when great kings and dynasties still ruled over Ancient China. This changed with the arrival of the Portuguese, led by Jorge Álvares, who also established a trading post in what is now Tuen Mun, Hong Kong. Even though under the rule of Emperor Qianlong during the Qing Dynasty (1644 – 1911) and the number of trading ports was greatly reduced, foreign trade still increased. It was also during that time that the Chinese view foreign trade with suspicion, thus they were reluctant to trade with the British. This also created a favourable trade balance for the Chinese, as the European market had a high demand for Chinese goods, whereas the Chinese were less interested in what the European traders had to offer. Opium was then smuggled in by the British to offset the trade situation. The Chinese government tried to curb the spread of opium within China, but failed as soon many able men were reduced to being slaves of the drug.

Tensions grew and soon the First Opium War erupted in 1839. The defeat of the Chinese resulted in the signing of the Treaty of Nanking in 1842, which is also when Hong Kong Island was ceded to the British. This will soon be followed by a number of treaties in 1860 and 1898 whereby Kowloon and the New Territories were also ceded to the British.

After being ceded over to the British, Hong Kong has benefitted a lot through the economy and political reforms introduced, becoming a major trading port for the British in the Asian Pacific region. It has also developed a significant manufacturing industry, with clothes and textile production being a major motivator of the economy. Due to Hong Kong sharing similar ancestry and roots with Mainland China, Hong Kong was highly affected by things happening in China. The economic reform in China during the 1980s opened up the Chinese market, and many manufacturing firms in Hong Kong relocated their factories to China to take advantage of the lower labour wages. Nevertheless, many still chose to have their service-related portion of the business remaining in Hong Kong. This caused the service industry to take hold of Hong Kong and to transform Hong Kong into mainly a service industry country, and also a major financial centre.

Colonial Hong Kong underwent major development, facilitated by Hong Kong's role as a main entrepôt for the Asian Pacific region. British rule in Hong Kong halted for a few years during World War II when the Japanese overtook it. This signalled the start of a miserable period that lasted '3 years and 8 months' for the Chinese in Hong Kong. Hong Kong experienced hyper-inflation under the Japanese Occupation. After the Japanese surrendered, only then did the British regain sovereignty over Hong Kong. Under British colonial rule, decisions made in London were implemented in Hong Kong through a selected British Governor.

The start of the 20th century also marked the start of the decolonisation movement by the European powers. The movement ended in 1997 with Hong Kong being returned to China. Many concerns were raised regarding the handover. After so many years of being governed by the British, Hong Kong had developed a highly dissimilar economy and political system from Mainland China. These concerns were addressed when Deng Xiaoping proposed the idea 'One Country, Two Systems', guaranteeing that Hong Kong will retain their current economy and political system after the return and it will remain unchanged for 50 years (Welsh, 1997).

In fact, most of the concerns were proved incorrect, especially under the 'One Country, Two Systems' policy. For one, Mainland China was developing fast after its economic reform in the 1980s. Hong Kong was able to take advantage of this fact by still having retained its capitalistic economy. On top of that, Hong Kong's close ties with China allowed it to perform the role of 'gateway to Mainland China'. This is also partly due to the fact that Hong Kong shared many similarities with Mainland China. A majority of the population in Hong Kong are Chinese, who have their ancestry roots in China. They also share a similar language and culture, assisting the building of strong business networks between the two regions. This paper serves to analyze this relationship, with focus on the signing of the Closer Economic Partnership Agreement (CEPA) and the recent announcement by Beijing to make Hong Kong into an off-shore Renminbi (RMB) trading centre. Furthermore, the significant impacts and implications for local businesses and international firms will also be highlighted in this paper.

1. MAINLAND CHINA AND HONG KONG CLOSER ECONOMIC PARTICIPATION AGREEMENT (CEPA)

On 29 June 2003, the Mainland China and Hong Kong Closer Economic Participation Agreement was signed. This represents a momentous occasion for both Hong Kong and China. CEPA's main objective is to promote free-trade between the two regions, and it mainly covers 3 areas: 1) Trade in Goods; 2)

Trade in Services; and 3) Trade and Investment Facilitation (Trade and Industry Department of Hong Kong, 2008).

1.1 TRADE IN GOODS

Under CEPA, goods that are listed and certified as 'Made in Hong Kong' will be exempted from any tariffs upon entering China. As of 31 May 2010, there is a total of 1,592 goods listed (Trade and Industry Department of Hong Kong, 2010). For Chinese exporting firms located in Hong Kong, they will have to acquire a 'Certificate of Hong Kong Origin – CEPA' for their goods in order to enjoy the tariff preference. Those firms also have to have a 'Factory Registration' issued by the Trade and Industry Department before they can acquire the 'Certificate of Hong Kong Origin – CEPA' (Trade and Industry Department of Hong Kong, 2008).

Table 1: Hong Kong's external trade with Mainland China (HK$ Million)

Year	Imports	Domestic Exports	Re-exports
2000	714,987	54,158	488,823
2001	681,980	49,547	496,574
2002	717,074	41,374	571,870
2003	785,625	36,757	705,787
2004	918,275	37,898	850,645
2005	1,049,335	44,643	967,923
2006	1,192,952	40,268	1,115,941
2007	1,329,652	40,610	1,267,722
2008	1,410,735	34,758	1,335,687
2009	1,249,374	26,672	1,236,577

Source: Census and Statistics Department of Hong Kong

A reduction in tariffs serve as an incentive for firms to export their goods to Mainland China, for now they will have an increase in their profit margins. This is the first and most obvious benefit of CEPA. Figures provided by the Hong Kong Census and Statistics Department in Table 1 above clearly showed an increase in the total imports and re-exports to Mainland China, especially for re-export in 2003, the only exception being 2009 which can be explained by the overall decrease in global consumption resulting from 2008-2009 financial crisis. The figures also established the fact that Hong Kong has a competitive advantage in providing higher added value business activities. This can be seen from Table 2 below whereby raw materials and semi-manufactures consist of an average of 36% of its total imports.

Table 2: Hong Kong Imports by End-use Category (HK$ Million)

Year	Foodstuffs	Consumer goods	Raw materials and semi-manufactures	Fuels	Capital goods
2000	3.84%	33.91%	35.01%	2.05%	25.19%
2001	3.85%	34.30%	32.61%	1.94%	27.30%
2002	3.65%	33.54%	34.46%	1.93%	26.41%
2003	3.23%	31.89%	36.24%	1.96%	26.68%
2004	2.85%	29.93%	38.14%	2.30%	26.78%
2005	2.63%	29.10%	37.31%	2.60%	28.36%
2006	2.52%	26.82%	38.20%	2.85%	29.62%
2007	2.69%	26.58%	38.31%	3.07%	29.35%
2008	3.20%	26.80%	36.13%	3.69%	30.18%
2009	3.94%	25.63%	36.47%	3.34%	30.63%

Source: Census and Statistics Department of Hong Kong

The data in the above tables is indicative of the fact that Hong Kong imports raw materials from China, which are then processed and re-exported to China.

China undertook major economic reforms in the late 1970s. By opening its doors, it has caused a major exodus of labour intensive production processes from Hong Kong to China. This is due to the fact that firms want to take advantage of the lower labour and production costs in China. However this did nothing to decrease Hong Kong's competitive edge, and in fact led Hong Kong into transforming itself into the Hong Kong it is today. While the relocation of Hong Kong's manufacturing sector caused unemployment problems, it has also allowed firms to focus more resources on higher value added-business processes, such as accounting, finance, management, or even manufacturing activities that require higher labour skills (Tao & Wong, 2002).

The British colonization enabled Hong Kong to develop a higher skilled labour pool, through modernization and exchange of knowledge. On top of that, Hong Kong has better intellectual property rights protection when compared China, again the inheritance of its British colonial ruler. Combining all of these elements, Hong Kong became the best environment for businesses that require higher skills and knowledge to thrive, for example, watchmakers (Chiu, 2006). The move of labour intensive businesses processes to China created a metaphorical 'bridge' or business network connections between firms in Hong Kong and their Mainland associates, allowing it to play the role of the intermediary between China and the world (Tao & Wong, 2002). Also, due to its history of culture and economic relationship with China, Hong Kong was able to maintain an informal network of friends and relatives that facilitate the emergence of more business relationships between the two regions. The geographic proximity of Hong Kong with China also helps to ease the transfer of resources between the two regions.

This state of affairs should not be ignored by overseas firms interested in entering the growing Chinese market. Additionally, Hong Kong's unique blend of Eastern and Western culture is another added competitive advantage for Hong Kong playing the role as 'gateway' to China. Moreover, the business environment in Hong Kong is closer to the Western model due to the long period governed by the British. For this reason alone, foreign corporations may find it more comfortable setting up in Hong Kong or partnering with a local firm, and reduce their risk. Therefore it is not surprising that Hong Kong is the top choice for foreign companies interested in setting up their Asian headquarters (Meyer, 2008). A recent study by HSBC (2010) indicated that China is the top choice by US mid-sized firms for long-term prospects. Those firms can take advantage of this bond between Hong Kong and the People's Republic of China (PRC) and also CEPA to explore further opportunities and prospects for growth in the fast-emerging Chinese market.

1.2 TRADE IN SERVICES

While the trade in goods portion of CEPA emphasizes the free trade for physical goods and manufactured products, the trade in services portion gives focus to the transfer of 'juridical persons' and 'natural persons' between Hong Kong and China. 'Juridical persons' consists of companies, partnerships and sole proprietorships, while 'natural persons' refers to any citizens of Hong Kong (Trade and Industry Department of Hong Kong, 2010). CEPA allows access to the listed service sectors shown in Table 3 (Trade and Industry Department of Hong Kong, 2010).

Beijing has goals to make the service sector a major contributor to China's GDP. Currently, the service industry contributes to only 40% of China's GDP (National Bureau of Statistics of China, 2009), whereas it is closer to 70% or more in other advanced economies (Commerce, Industry and Techonology Bureau, 2007). Therefore, it can be expected that China's service sector to grow even further in the near future. This represents a huge market potential.

Table 3: List of Service Sectors for CEPA

▪ Accounting	▪ Photographic
▪ Advertising	▪ Placement and Supply Services of Personnel
▪ Air Transport	▪ Printing
▪ Audiovisual	▪ Public Utility
▪ Banking (Updated)	▪ Rail Transport
▪ Building-cleaning	▪ Real Estate
▪ Computer and related services	▪ Related Scientific and Technical Consulting Services
▪ Construction and Related Engineering	▪ Research and Development
▪ Convention and Exhibition	▪ Road Transport
▪ Cultural	▪ Securities and Futures
▪ Distribution	▪ Services incidental to Mining
▪ Environmental	▪ Services related to Management Consulting
▪ Freight Forwarding Agency	▪ Social Services
▪ Individually Owned Stores	▪ Specialty Design
▪ Insurance	▪ Sporting
▪ Legal	▪ Storage and Warehousing
▪ Logistics	▪ Technical Testing, Analysis and Product Testing
▪ Management Consulting	▪ Telecommunications
▪ Maritime Transport	▪ Tourism
▪ Market Research	▪ Trade Mark Agency
▪ Medical	▪ Translation and Interpretation
▪ Patent Agency	

Source: Trade and Industry Department of Hong Kong

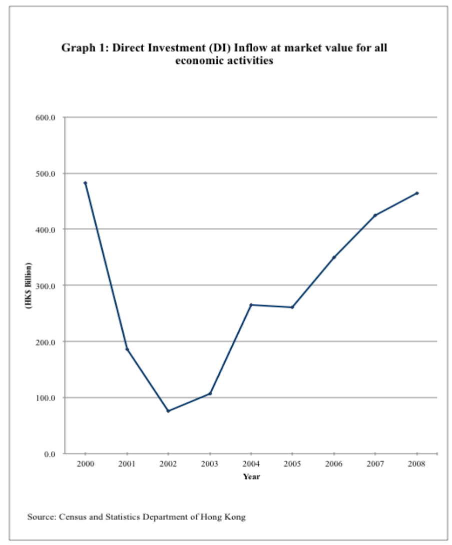
A further liberalization under this area in CEPA is the mutual recognition of professional certificates from both regions. Professionals who have already acquired the relevant certificates from their relative issuing boards in Hong Kong and is approved under CEPA, will be able to also provide their services in Mainland China, and vice versa (Trade and Industry Department of Hong Kong, 2008). Removing unnecessary steps and regulations for service providing professionals in both regions will help with the exchange of skills and knowledge between China and Hong Kong. In fact, the high level of exchange of information, human resources, and capital is unprecedented in the world, and mainly due to the unique relationship that Hong Kong and China shared (Fu, 2003). Chinese firms benefit from Hong Kong's management expertise, while Hong Kong benefits from China's growth. This is especially true in recent years as China starts to emerge as a major global economic power. Therefore foreign firms should know to take advantage of this bilateral flow of resources.

1.3 TRADE AND INVESTMENT FACILITATION

Co-operation in ten areas of economic development were agreed upon by both parties under CEPA. One area that stood out was the co-operation of Small and Medium Enterprises (SMEs) (Trade and Industry Department of Hong Kong, 2010). SMEs are the focal point in economic development, especially for the case of Hong Kong where SMEs constitute 98% of the business establishment in Hong Kong (Trade and Industry Department of Hong Kong, 2010). This is due to the potential benefits that they bring, for example, employment opportunities, supply base for large firms, source of innovative and new industries or areas of business (Pollard, 2005). However according to Pollard (2005), it falls short in the determination of the implementation process. It is important to provide support for SMEs to ensure their viability, as they are an important source of employment opportunities.

While at first glance CEPA seems to only benefit local Hong Kong firms, especially with the requirements needed to be fulfilled to enjoy the benefits, it however opens up another new opportunity for Hong Kong as an attractive place for foreign direct investments (FDI). Firms interested in taking advantage of CEPA but do not fulfill the requirements can think of partnering with or investing in local Hong Kong firms, as CEPA is "nationality blind" and many firms seemed to have done that (Hong Kong SAR Government, 2010). As shown in Graph 1 below, the total amount of direct investment flowing into Hong Kong has increased after the introduction of CEPA in 2003. However this did not continue into 2005 due to the Severe Acute Respiratory Syndrome (SARS) outbreak in 2004. Nonetheless, FDI picked up after 2005 and has continued to increase well into the year 2008. Due to the importance of SMEs to the local economy, it is important to give more support for them, as mentioned above. CEPA will also be able to introduce FDIs into local SMEs, representing an opportunity for them to be exposed to the global economy, enhancing their competitive advantage.

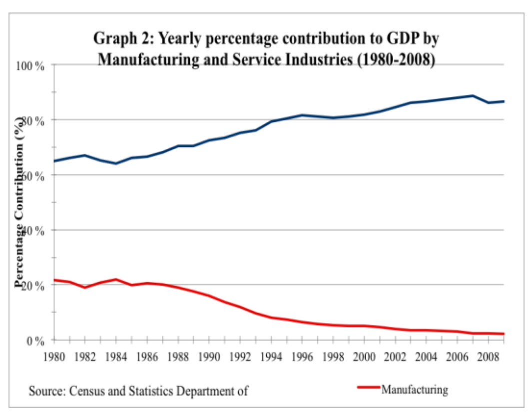
Another point to take note of is Hong Kong's logistics capabilities, especially for firms interested in manufacturing in Hong Kong to take advantage of its highly-skilled labour workforce. Hong Kong has been operating as a free port and has traditionally been an important trading port for the British. On top of that, the construction of the Hong Kong-Zhuhai-Macau Bridge will also reduce transportation time between Hong Kong, Macau and Mainland China from 3 hours to half an hour (ARUP, 2010). The Guangzhou-Shenzhen-Hong Kong Express Rail Link will also ease transportation time between Guangzhou, Shenzhen and Hong Kong (Hong Kong SAR Government, 2009). The construction of those two transportation systems is set to further increase the economic integration between Hong Kong and Mainland China. The increased flow of people into both regions will mean that there will be an increase in services demanded as well, and this represents an opportunity for the small and medium enterprises (SME) especially.



Graph 1: Direct Investment (DI) Inflow at market value for all economic activities

1.4 CEPA AND HONG KONG'S ECONOMY

Ever since China opened up its market, the close relationship with Hong Kong has with China allowed it to become a service-oriented industry. This is due to Hong Kong's relatively higher labour wages compared to China. While CEPA promotes zero-tariffs trade for 'Made in Hong Kong' goods and to also attract international manufacturers interested in selling their goods in China to produce in Hong Kong (Chiu, 2006), it did not help to improve Hong Kong's manufacturing industry. As seen in Graph 2 below, ever since the 1980s, the manufacturing industry percentage contribution to GDP has steadily decreased while the service industry increased.



Graph 2: Yearly percentage contribution to GDP by Manufacturing and Service Industries (1980-2008)

The huge Chinese consumer market remains a very attractive option for businesses. However it seems that the reduction in tariffs is not enough to offset the difference between Hong Kong labour wages and productivity with China, resulting in the ever declining manufacturing sector in Hong Kong. On the other hand, for goods that require a higher level of skills, such as watches, Hong Kong still has the upper hand (Chiu, 2006). Nevertheless, the return of higher value-added manufacturing firms to Hong Kong is still not significant enough to see Hong Kong return to a pre-1980s situation.

With the eventual opening up of the vast Chinese market, foreign firms taking advantage of CEPA to enter China, using Hong Kong as a stepping stone, will now have gained some form of competitive advantages over other firms. Once China fully opens up, they would already have gained a better understanding of the Chinese market, an established presence and also valuable business networks, or a first-mover advantage. Latecomers will find it hard to compete against those foreign firms already established in China, be it through partnership or FDI investment in a Hong Kong firm.

On the other hand, according to Krugman (2009), a bigger market size implies that there will be more firms and more sales per firm. It would also mean that consumers now have a greater variety of products to choose from, and not to mention, lower prices. Comparatively, the Hong Kong market is marginally smaller when compared to the Chinese market. If we consider that the size of the population is equivalent to the size of the consumer market, then the Chinese consumer market will roughly be around 1.3 billion people, while Hong Kong has 7 million people (CIA, 2010). In other words, the Chinese consumer market is almost 190% larger. CEPA will be beneficial to the overall economic development of the two regions, for it opens up a bigger market which will support more firms. On the other hand, due to the increase in the number of firms and higher competition, consumers in both Hong Kong and China will now be able to have a greater variety of products and lower prices.

One main concern for firms interested in entering the Chinese market might be about the availability of funds. Doing business with China would mean that the preferred currency of exchange will be in RMB. However, the lack of a proper RMB settlement facility in Hong Kong could act as a deterrent. On top of that, there is a lack of RMB financial instruments for corporations to raise funds in RMB. While CEPA encourages the economic and business integration between Hong Kong and China, and that Hong Kong can benefit from inward direct investments, it is important that firms have easy access to RMB fund, which will further increase the effectiveness of CEPA.

2. HONG KONG'S ROLE AS AN OFFSHORE RENMINBI (RMB) TRADING CENTRE

Historically, there is no existing official RMB settlement channel between Hong Kong and China. Exchange of RMB in Hong Kong was limited only to cash, and most currency exchangers have to physically carry RMB cash over to Mainland China to be deposited into a Chinese bank account. The opening up of China and CEPA also encourages the flow of Chinese tourists into Hong Kong (Chiu, 2006) which would mean an increase in foreign spending in Hong Kong. The absence of a proper mechanism to redirect the RMB back to Mainland China usually discourages people from spending too much in Hong Kong. Additionally, there is an active market of RMB business in Hong Kong and the sum may be huge, but its activities are limited and it is also regarded as a 'grey market' (Fu, 2003).

In terms of trade, only 1% of Chinese trade is denominated in RMB, and given that the volume of Chinese trade is not small, that other 99% also represents a significant size. All businesses, be they international or based in Hong Kong and Macau, have to convert their local currencies into US dollars when settling import trade with Mainland China. Chinese exporters then convert those US dollars into RMB. This whole process incurs more transaction and conversion cost, representing smaller profit margins. Firms also suffer more foreign exchange risk. This also means that the Chinese traders have a stronger reliance on the US dollar as trade payments (McMahon, 2010). This is not something that Beijing wants especially when they are planning to make the RMB an international currency (Daniel, 2010). As a result in 2003, a memorandum was signed between the Hong Kong Monetary Authority

(HKMA) with the People's Bank of China (PBOC), signalling the start of a cooperative relationship between them to transform Hong Kong into a major offshore RMB trading centre.

2004 marked the beginning of a pilot RMB business program in Hong Kong. Participating Hong Kong banks are now able to offer RMB deposit, remittance, exchange and credit services for personal customers (Fan, Leung & Yim, 2010). The memorandum also established the People's Bank of China (Hong Kong) as an official settlement facility for RMB circulating in Hong Kong, and the RMB funds are deposited back into a capital account back in Mainland China. Additionally, consumers from Mainland China did not have a limit on their credit/debit card spending in Hong Kong, and the same applied to ATM withdrawals. Banks were also allowed to directly deposit RMB into a deposit account for remittances (Fu, 2003). The pilot program was further expanded in 2005 to seven designated service industries, including retail sales, beverage and transports, allowing them to open RMB deposit accounts. In 2006, another relaxation in regulation came, allowing Hong Kong residents to open RMB cheque accounts (Fan, Leung & Yim, 2010). A regulated market was established which paved the way for Hong Kong to become the first offshore RMB trading centre. This has been the case when in 2007 the Chinese government started allowing Chinese banks in Hong Kong to issue Renminbi within annual quota restrictions. While still requiring official approval for remittances back to Mainland China, it represents an opportunity for retail investors in Hong Kong to finally raise RMB funds officially (Russell-Walling, 2010).

The further freeing up of regulations in July 2009 came as further good news for participating banks and businesses in Hong Kong. They were able to perform RMB transactions with businesses located in Shanghai and four other Chinese cities in Guangdong without needing approval of the Chinese government. Then in February 2010, banks in Hong Kong were allowed the freedom of determining the use of their RMB funds with the condition that the funds will now flow back to Mainland China (Fan, Leung & Yim, 2010). What this means now is that any party eligible to issue bonds in Hong Kong will now be able to issue RMB denominated bonds, so long as the funds raised will not be sent back to a Chinese account. More recently in June 2010, the plan introduced in July 2009 expanded to include 20 provinces in China and international banks. What is more is that the scope was also extended to include services and current account items when it previously only allowed cross-border transaction in goods (Russell-Walling, 2010). This came as good news to businesses and banks that were interested in participating in the Chinese market. Despite the fact that CEPA encourages economic integration, it is still lacking in the finance area. The freeing up of offshore RMB regulations attempts to cover this area.

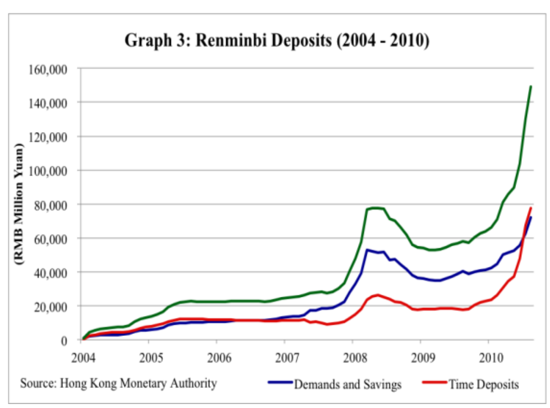
One might ask, what will be the purpose of raising RMB funds when they are not able to utilize it in the Chinese market, referring to the relaxation of regulations introduced in February 2010. However, this step should be viewed as an experimental step Beijing is taking. China would not want to run the risk of liberalizing the RMB too soon and too fast, or even before the financial system is fully developed to handle the kind of risks and shocks that come with freeing up a currency. In the views of the Chinese government, it would ideally be the best to only take small steps and see how the market reacts to it before taking the next step. It will also allow the domestic financial market more time to adapt to the increase in market demand. On the other hand, for firms to be able to utilize this fund back in the mainland is not at all that hard. All it needs is governmental approval for remitting those funds back to China. Once a firm is able to gain the approval from the central government, it will be good for them to use that fund for business activity in China (Russell-Walling, 2010). It can also be predicted that once the RMB becomes fully convertible, it will be a less troublesome process, and the full convertibility of the RMB is only a matter of time. It will be better for firms to take advantage of this right now, when the market is still in the beginning stages.

2.1 CHINA, HONG KONG AND THE RENMINBI

Beijing is determined to raise the RMB's status to a level equivalent to the US dollar, a major international currency. However, it is also important that this process is not happening too fast, as it will overwhelm the market, and could potentially cripple the market should it not have the proper facilities and preparation to handle such a sudden surge in demand. Hong Kong is in fact acting as a testing facility for Beijing, taking advantage of the unique 'One Country, Two Systems' policy that allowed Hong Kong to retain its capitalistic market. The world in its entirety is a capitalist market, while China is operating under a socialistic system. By using Hong Kong as a testing ground, Beijing can keep a close eye on market developments and respond to issues effectively, making any necessary adaptations to their policy. Conversely, as long as the 'One Country, Two Systems' policy is in effect, Hong Kong still does not have full control over its destiny. No matter what, Hong Kong is still considered part of the sovereignty of China, and what is more, the intimate relationship both shared results in Hong Kong having most of its political and economic development highly influenced by China. Beijing's determination in being a true participant in the global market is undeniable. Even now, China is already a formidable global economic power, unlike its status pre-reformation. Once again, as with the economic integration under CEPA, this relationship is a mutually beneficial one. The growing Chinese market however represents a threat to Hong Kong's position as a leading international financial centre as well. Financial analysts are predicting the rise of Shanghai and Shenzhen that will come to compete with Hong Kong as the leading financial centre in the Asian Pacific region. In fact, it is the goal of China's State Council to develop Shanghai into a global financial centre by 2020 (Cheng, 2010). Still, as Hong Kong financial institutions gain more experience in this area, the regulators in Beijing are also gaining experience at the same time (Cheng, 2010).

Hong Kong is a well-established international financial centre, and China would stand to benefit to utilize this in their plan of making the RMB a major international currency. To begin with, Hong Kong is a well-known international financial centre, and it has recently been ranked third on the Global Financial Centre Index, after London and New York (Z/Yen, 2010). Secondly, Hong Kong has the necessary knowledge and workforce in the financial sector. Hong Kong also stands to benefit from China as well. In fact, the Hong Kong Hang Seng Index enjoyed the fastest comeback post-financial crisis in 2008 to 2009, raising 52 percent (Cheng, 2010).

Yet a major obstacle that must be solved beforehand is the issue of RMB liquidity in Hong Kong. So far all those measure introduced by the HKMA and the People's Bank of China should be able to raise the level of RMB liquidity in Hong Kong, which should then facilitate Hong Kong's role as an offshore RMB trading centre. Being a Special Administrative Region of the People's Republic of China, Hong Kong is allowed to have its own currency, the Hong Kong dollar. The increasing importance of the RMB and Hong Kong's role as an off-shore RMB trading centre might slowly erode the importance of the HKD in Hong Kong, as many believe. However it is important to note that the RMB will gain popularity in Hong Kong due to increase trade between China and the preferences of businesses in using RMB as the main trading currency to decrease transaction costs. In fact, ever since Beijing started loosening up on off-shore RMB regulations in Hong Kong, the amount of RMB deposits in Hong Kong increased significantly towards the end of 2007 (see Graph 3). This was however slowed down by the global financial crisis in the second half of the year 2008. Slowly in 2009 and 2010, it has picked up its pace, increasing evermore after the change in regulations in June 2010.



2.2 FURTHER RMB MARKET DEVELOPMENTS IN HONG KONG

On August 19, 2010, a change in regulation came again, and now participating banks in Hong Kong were allowed to invest their RMB in both the on-shore and off-shore bond markets (Wright, 2010). This move had big implications, especially for businesses in Hong Kong. What was previously limited only to retail investors now became open to the bigger corporations. Furthermore, this also acted as an encouragement for businesses in Hong Kong to accept RMB as well, making RMB less of a one-way trade settlement instrument. This is because corporations in Hong Kong now have more options in using their RMB besides saving it in a RMB deposit account. They are now able to invest that money and gain some return on it. In October, ICAP and Thomson Reuters started to allow the RMB to trade on their electronic-trading platforms, only limited by the size of RMB pool circulating in Hong Kong (McMahon, 2010). This move represented another step in making the RMB a major international currency, and with the entry of ICAP and Thomson Reuters, it meant that interest rates and trading amounts were now to be freely available. The more information the market has, the more efficient it becomes.

The next obvious step for Hong Kong and China to take advantage of this fledging offshore RMB trading centre is to further relax regulations on the use of the RMB, especially in Hong Kong. This will allow banks and financial institutions the freedom to offer more variety of RMB denominated securities and investment products, attracting more investors. CEPA acts as encouragement for foreign firms to set up in Hong Kong and trade with the Mainland Chinese market. However, should the number of MNCs increase its presence in the region, there will also be a rise in demand for better financial management strategy, especially for the RMB which will be a major currency used. This represents a business opportunity for banks in Hong Kong to start coming up with innovative and efficient financial instruments for the increasing number of corporate clients.

CONCLUSION

The relationship between Hong Kong and China has come a long way, so has the political and economic development of both regions. It has gone off into separate directions at the beginning, but has slowly come together ever since China's economic reform. Hong Kong, while being a major international financial centre, is still highly affected by China. The financial crisis of 2008-09 shows this exactly. The overall decrease in global consumption affected Hong Kong greatly for it is a major entrepôt of the world. However, the decrease was offset by the economic growth in China that shows no signs of slowing down, having being only marginally affected by the downturn.

The introduction of CEPA, China's entry into the World Trade Organization (WTO) and most recently, the move to make Hong Kong into a major RMB offshore trading centre, indicates the desire of the Chinese central government to slowly transform China into a global economic power. Further loosening up of regulations can be expected, and if recent trends are indicative of the future, the pace is likely to pick up as well. Therefore, it is important that businesses in the Asian Pacific region, or even all over the world, to realize this and take advantage of it. By gaining first-mover advantage, firms will be able to unlock the hidden potential of the emergent Chinese market.

REFERENCES

ARUP. (2010). *Hong Kong-Zhuhai-Macau Bridge*. Retrieved November 16, 2010, from http://www.arup.com/Projects/Hong_Kong_Zhuhai_Macau_Bridge.aspx

Cheng, AT. (2010, April). *Hong Kong Takes Steps to Become Asia's Leading Financial Hub.* Retrieved November 16, 2010, from Institutional Investor: http://www.institutionalinvestor.com/Article.aspx?ArticleID=2473426

Chiu, PY. (2006, May). 'CEPA: A Milestone in the Economic Integration between Hong Kong and Mainland China.' *Journal of Contemporary China,* 15(47), pp. 275-295.

CIA. (2010, November 9). *The World Factbook*. Retrieved November 16, 2010, from https://www.cia.gov/library/publications/the-world-factbook/index.html

Commerce, Industry and Techonology Bureau. (2007, June). *Impact of the First Three Phases of CEPA on the Hong Kong Economy.* Retrieved November 18, 2010, from http://www.legco.gov.hk/yr06-07/english/panels/ci/papers/ci0612cb1-1849-4-e.pdf

Daniel, F. (2010, September) 'Hong Kong's Race to Raise Renminbi Flows' *Asiamoney,* 21(8), pp. 56.

Fan, I., Leung, B., and Yim, J. (2010, July 19). *Hong Kong's Development as an Offshore Reminbi Centre.* Retrieved November 22, 2010, from http://www.hangseng.com/ermt/eng/fxmv/pdf/ecof_e_2010july.pdf

Fu, HW. (2003, December 1). *Hong Kong's Prospects as an Offshore Renminbi Centre.* Retrieved November 10, 2010, from http://info.hktdc.com/econforum/boc/boc031201.htm

Fung, HG. and Zhang, J. (2007) 'An Assessment of the Closer Economic Partnership Arrangement between China and Hong Kong' *The Chinese Economy,* 40(2), pp. 36-50.

Hong Kong SAR Government. (2009, October 20). *ExCo Approves Implementation of High-speed Rail Link*. Retrieved November 16, 2010, from http://www.info.gov.hk/gia/general/200910/20/P200910200166.htm

Hong Kong SAR Government. (2010, October 20). *Hong Kong is Best Business Partner in Asia, US ExecutivesTold.* Retrieved November 11, 2010, from http://www.info.gov.hk/gia/general/201010/20/p2010200104.htm

HSBC. (2010, June 28). *HSBC Study: More US Mid-sized Companies Bolster Plans to Expand International Revenues.* Retrieved November 14, 2010, from http://www.hsbcusa.com/ourcompany/pressroom/2010/news_06282010_hsbc_international_business_survey.html

Krugmaan, PR. and Obstfeld, M. (2009). *International Economics: Theory and Policy* (8th ed.), Pearson Addison Wesley, Boston.

McMahon, D. (2010, October 8). 'Yuan Goes Electronic in Global Market Bid' Retrieved November 16, 2010, from *The Wall Street Journal Online*: http://online.wsj.com/article/SB10001424052748704011904575537754269611906.html

Meyer, D. (2008). 'Structural Changes in the Economy of Hong Kong since 1997' *The China Review, 8*(1), 7-29.

National Bureau of Statistics of China. (2009). *China Statistical Yearbook 2009.* Retrieved November 18, 2010, from http://www.stats.gov.cn/tjsj/ndsj/2009/indexeh.htm

Pollard, D. (2005, September). 'CEPA and Pan Pearl River Delta Economic Integration: A Comparative Business Development Perspective' *Global Economic Review,* 34(3), pp. 309-320.

Russell-Walling, E. (2010, September). 'Opening up Renminbi possibilities' *The Banker*.

Tao, Z. and Wong, RY. (2002, May). 'Hong Kong: From an Industrialised City to a Centre of Manufacturing-related Services' *Urban Studies,* 39(12), pp. 2345-2358.

Trade and Industry Department of Hong Kong. (2008, November 6). *CEPA*. Retrieved November 16, 2010, from http://www.tid.gov.hk/english/cepa/cepa_overview.html

Trade and Industry Department of Hong Kong. (2008, December 3). *CEPA - Trade in Goods*. Retrieved November 16, 2010, from http://www.tid.gov.hk/english/cepa/tradegoods/tradegoods_intro.html

Trade and Industry Department of Hong Kong. (2008, November 4). *Mutual Recognition of Professional Qualification and other issues relating to professional services under CEPA*. Retrieved November 20, 2010, from http://www.tid.gov.hk/english/cepa/mutual/mutual.html

Trade and Industry Department of Hong Kong. (2010, July 5). *Definition of "Hong Kong Service Suppliers" (HKSS)*. Retrieved November 16, 2010, from http://www.tid.gov.hk/english/cepa/tradeservices/hkss_def.html

Trade and Industry Department of Hong Kong. (2010, May 31). *Goods entitled to CEPA Zero Tariff Preference - Mainland 2010 Tariff Codes, Product Description and Rules of Origin.* Retrieved November 16, 2010, from http://www.tid.gov.hk/english/cepa/tradegoods/files/mainland_2010.pdf

Trade and Industry Department of Hong Kong. (2010, June 2). *Summary of Trade and Investment Facilitation*. Retrieved November 21, 2010

Trade and Industry Department of Hong Kong. (2010, July 2). *Support to Small and Medium Enterprises*. Retrieved November 16, 2010, from http://www.tid.gov.hk/english/smes_industry/smes/smes_content.html

Trade and Industry Department of Hong Kong. (2010, June 21). *Trade in Services - Frequently Asked Questions.* Retrieved November 16, 2010, from http://www.tid.gov.hk/english/aboutus/faq/files/trade_in_services.pdf

Welsh, F. (1997). *A History of Hong Kong.* HarperCollins.

Wright, C. (2010, October). 'Chinese Reform: Renminbi Moves to a Sweeter Spot. *Euromoney*.
Z/Yen. (2010). *The Global Financial Centres Index 8.* London: City of London Corporation.