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Event Report

The Hong Kong Exchange: A Small Player in China's Great Economic Reform

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On October 13th, a group of Columbia Business School (CBS) students, alumni, professors, and industry practitioners gathered at the Columbia Club in midtown Manhattan to hear Lawrence Fok '76 speak about the Hong Kong Exchange's role in China's economic reform. Mr. Fok is the executive vice president and head of the Issuer Marketing Division of Hong Kong Exchanges and Clearing Limited (HKEx), and is responsible for promoting the role of the exchange to potential issuers. After giving the audience a brief history of securities exchanges in China and Hong Kong over the past forty years, Mr. Fok outlined the contributions and benefits of the Hong Kong Exchange to China's impressive economic growth since the early '90s. The crux of Mr. Fok's argument revolved around the HKEx's strategic positioning as a bridge between mainland China and the rest of the world, providing Chinese enterprises with a liquid market for foreign capital. The Chazen Institute hosted the talk as part of the Sir Gordon Wu Distinguished Speaker Forum.

Mr. Fok's speech centered on the connection between mainland China's impressive economic growth over the past fifteen years and the development of the HKEx as an international market with access to the otherwise closed Chinese economy. Since Deng Xiao Peng took office in the 1970's, China's economy has been gradually liberalizing. By 1993, industrial development had reached the point where many Chinese firms were capital-starved and needed access to international markets. The international investing community as well as Chinese powerbrokers had confidence in Hong Kong to act as a conduit between them. In this way, the HKEx provided a mechanism for Chinese firms and foreign capital providers to access one another. As a result, the exchange underwent a period of rapid growth and emerged as one of the world's leading and largest exchanges.

As China's economy grew rapidly in the early 1990s, manufacturing and industrial companies from the mainland were forced to look outside China for the funds that would allow them to continue to expand their operations. For example, Mr. Fok pointed out that Chinese foreign currency reserves were only $30 billion at the time – nowhere near the more than $2 trillion surplus that exists today. At the time, China had no modern corporate and securities law. The way to resolve this situation was to enshrine additional shareholder protection provisions into corporate constitutions of the companies from mainland China seeking listing in Hong Kong. With this regulation taking shape, China opened international capital markets to its corporations through HKEx. Since the regulatory reforms of 1993, the number of mainland Chinese firms listed on the HKEx has grown by a factor of ten.

The HKEx was a natural partner due to its familiarity with Chinese businesses and with Western financial markets. Mr. Fok stressed the Exchange's role since the early '90s in China's remarkable economic growth over that period. The HKEx is strategically positioned as a bridge between mainland China and the rest of the world and offers the most liquid market for offshore trading in shares of mainland China enterprises. Through opening Chinese businesses to outside capital and shareholders, Western influences have transferred professional knowledge and international management practices to enterprises in mainland China. In addition, through listing on the Hong Kong exchange, Chinese companies have also opened themselves up to liquid derivatives products derived from Chinese-related equities and, consequently, an even broader set of investors with differing risk profiles.

The Rise of HKEx

Mr. Fok traced the beginning of China's opening to 1993, when the Tsingtao Brewery became the first mainland State-Owned Enterprise (SOE) to list on the HKEx. He contends that, since the 1993 opening, the benefits of international listing and ownership have transformed Chinese SOEs into competitive commercial entities on an international scale. The HKEx has allowed Chinese firms to raise $280 billion in equity capital since 1993, and these listed companies are now worth roughly $1,200 billion. Additionally, the ease with which international investors have been able to enter and exit the Chinese market through the HKEx has increased international recognition of mainland Chinese enterprises, further buoying company growth and, ultimately, China's economic performance. Trading volume has increased 700% in the past ten years, and the market cap of listed firms in Hong Kong has grown by 35 times over the past 23 years.

Thanks in large part to its connection to the mainland Chinese market, the HKEx is one of the fastest-growing exchanges in the world. In terms of market capitalization of companies, the Exchange is now the seventh largest in the world and the third largest in Asia, at an equity value of just over $2 trillion. By way of comparison, the NYSE Euronext is the world's largest exchange at a value just under $10 trillion. The Shanghai exchange is already the fourth-largest exchange, and Mr. Fok feels it is fair for the Chinese government to develop a large domestic exchange. The HKEx has seen its market capitalization increase by a factor of six since 1998 to move it into its current position in the global marketplace.

Key Reasons for Success

Mr. Fok attributes the HKEx's success and competitiveness to several factors. Most important, Hong Kong has an established tradition of rule of law and an independent judiciary due to its history as part of the British Empire. This allows for a free flow of people, technical and managerial information and, of course, capital. In addition, Hong Kong has a stable currency that has been pegged to the U.S. dollar since 1983, plus a relatively attractive tax regime. Thus, with adequate regulation and a supportive legal and tax structure, the environment is conducive to a strong business environment. The investing community recognizes Hong Kong as an international financial center, and – because of its geographical location and the cultural and lingual similarities with the mainland (Hong Kong is the only financial center with two official languages) – Chinese SOE's are able to reap the benefits of Hong Kong's business environment.

Hong Kong (and the HKEx) has the cachè that goes along with its position as respected financial center as well as the confidence of investors worldwide. Many top intermediaries and professional service firms maintain a presence in Hong Kong; consequently, the Chinese firms that list on the Exchange benefit from the ample supply of local and international support services available as well as the developed and regulated banking system. Another reason for success is that listed firms have adopted globally accepted standards in accounting, disclosure, corporate governance, and valuation. Other countries and exchanges, particularly Shanghai, have also moved in the direction of tighter standards in these areas, mitigating some of Hong Kong's advantage. However, these benefits were instrumental over the past fifteen years and have bestowed a "first mover" advantage on the HKEx. More importantly, Western investors are comfortable deploying their capital in firms that are listed on the HKEx and are still unable to move funds freely in the mainland.

Despite growing competition from national exchanges throughout Asia, Mr. Fok believes the future remains bright for his firm. China publicly announced a Qualified Domestic Institutional Investor program (commonly known as QDII) several years back, giving Chinese investors access to foreign markets through qualified financial institutions. Some of this business has flown through the HKEx, and with $2 trillion in foreign currency reserves, there is substantial business to be done. In addition, ongoing RMB internationalization and a higher degree of convertibility are likely to increase demand for Chinese securities from the international market and vice versa. Many economists expect Chinese economic performance to continue to pace the global economy, which alone should drive increased trading demand on the HKEx, but there remains potential for urbanization of the mainland, increased domestic consumer demand, service sector growth, and an increase in Chinese retail investors seeking international securities. Taking all of this into account, Mr. Fok's prognosis would seem to be right on the money.

JAMES WALSH MBA '10
Columbia Business School