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FINANCE

All About the Money: Why Hong Kong Matters So Much to China

Hong Kong's attachment to Western-style values has drawn Beijing into a political crisis, but the city is a valuable gateway into the global financial system

By Natasha Khan and Yasufumi Saito

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HONG KONG—Since China resumed control of Hong Kong in 1997, the city has served as a conduit for trillions of dollars in fundraising, trade and investment.

Having a separate system—sealed off, yet under Beijing's thumb—caused a raft of social and political concerns that gave rise to this year's protests, now in their fifth month. But the city also enabled China's rise.

Today, Hong Kong makes up a much smaller part of China's overall economy than it did 22 years ago. Its role as a gateway, though, remains undiminished, meaning China faces a substantial financial cost for any crackdown.

George Magnus, an economist and the author of "Red Flags: Why Xi's China Is in Jeopardy," said Hong Kong stands out from its mainland rivals for its rule of law, competent regulators, low taxes, free movement of capital and use of English.

Neither Shanghai nor China's free-trade zones "can really compete with what Hong Kong is and does," he said.

> **Hong Kong is still China's financial window on the world, and the rest of the world's financial window on China.**
>
> —George Magnus

Here's why Hong Kong matters financially to China.

It's a Center for Raising Equity

Since 1997, mainland Chinese companies have raised $335 billion by floating in Hong Kong, tapping a broader range of shareholders than they could onshore.

Over the years, the pool of capital available at home has gotten much larger. But since the Hong Kong dollar is pegged to its U.S. equivalent, and the city has no capital controls, a listing there can generate hard currency for foreign takeovers and investments. It would be harder to use a Shanghai stock sale for the same goal.

For technology firms and others, New York has been another favored listing destination, but worsening U.S.-China relations could make this more problematic. Hong Kong offers a convenient way to tap many investors who are familiar with China.

For global investors, Shanghai and Shenzhen have become more accessible. But investors typically prefer Hong Kong's legal protections, and they have other concerns about mainland markets, including the difficulties of moving money out.

...And Debt

Chinese entities also borrow liberally through Hong Kong, both via bank loans and through bond issues.

Hong Kong is by far the largest offshore center for bond sales by Chinese firms. Companies can borrow for longer than they can onshore and, crucially, can raise funds in hard currency, said Alicia García Herrero, chief Asia economist at investment bank Natixis.

When it comes to dollar bonds, big state-backed banks and industrial companies even prefer to sell these in Hong Kong, said Victor Shih, a scholar of China's politics and financial system at the University of California, San Diego. U.S. deals would be overseen by American regulators and would require greater disclosure.

Trust Is High

Hong Kong is a preferred location for Chinese and international financiers or business people to conduct transactions because it has a Western-style legal and regulatory system that is seen as fair and nonpolitical.

For now, that is a big competitive advantage over Shanghai or Shenzhen. Hong Kong's now-scrapped extradition bill, which sparked this year's protests, had raised fears that the two legal systems would grow closer together.

Hong Kong Is Also a Gateway for Direct Investment

Foreign companies and state investors have long used Hong Kong as a staging post for investing in companies or building facilities in mainland China. As it grows richer, China is also deploying larger sums abroad through foreign direct investment, which rose from $2.6 billion in 1997 to $143 billion last year, according to data from China's Ministry of Commerce. Much of this outbound FDI goes through Hong Kong.

In some cases, Chinese money is "round-tripped" out through Hong Kong and back onshore, perhaps to take advantage of preferential terms for foreign investment.

Ms. García Herrero, the Natixis economist, says China-related FDI flows through Hong Kong partly because of an economic partnership deal between the two that offers preferential tax terms on trade and investment.

...And a Venue for the Offshore Yuan

While Beijing retains tight capital controls, Hong Kong serves as the main offshore hub for yuan loans, bonds and trading.

"China can more easily influence the offshore exchange rate in Hong Kong than abroad," said Mr. Shih, the China scholar. That means it can prop up the currency if necessary, helping head off capital flight. For example, Beijing can direct state-owned Chinese banks to buy the currency, or the People's Bank of China can issue bills to drain funds from the system.

—Frances Yoon and Nathaniel Taplin contributed to this article.

> **In China's effort to internationalize the RMB, there is no replacement for Hong Kong.**
>
> —Victor Shih, a scholar of China's politics and financial system at University of California San Diego

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