

Possible Medium to Long-Term Initiatives

1. Strengthening Hong Kong's Role as an International Financial Centre

a. Development of Hong Kong as the stock market of East Asia

There is no single market in which the stocks of all major firms in East Asia are traded. The result is that the markets are individually quite small and fragmented. Investors have to invest in separate national markets and in different national currencies, greatly increasing the transactions costs of cross-border investors both inside and out of East Asia.

A unified East Asian Stock Market, in which the stocks of all major East Asian firms, such as Sony, Toyota, Samsung Electronics, LG Group, Baosteel, China Mobile, Petro-China, Taiwan Semiconductor Manufacturing Corporation, Cheung Kong, HSBC, San Miguel, Siam Cement, and Singapore Airlines can all be traded in addition to the individual national markets, will bring significant benefits to Hong Kong by enlarging the total market, enhancing the overall liquidity and increasing the demands for the stocks of the individual firms. For example, an investor who wishes to track the MSCI East Asia Index only needs to be actively investing and trading in this one single market. Asset management firms only need to set up operations in a single location.

The trading in this unified market should be conducted in a single currency, e.g., the U.S. Dollar or the Renminbi, and in the form of "Depository Receipts." The use of "Depository Receipts" minimizes the frequency and volume of cross-border capital flows due to the buying and selling of the cross-listed shares. It also simplifies the problem of prudential regulation and supervision by mostly relying on home country regulators for compliance with laws, disclosure, governance, etc. and on the regulator of the unified market to monitor market behaviour, such as insider trading, market manipulation, etc.

The existence of trading in a single international market in addition to trading in the national markets enables the gradual equalization of Price/Earning Ratios (P/Es) across national markets, enhancing the efficiency in the allocation of capital. This is especially true with the possibility of arbitrage within the same or nearly the same time zone. Historically, the East Asian stock markets tend to move together, more or less, so that a unified market makes sense.

b. Development of Hong Kong as the insurance market of East Asia

Insurance and re-insurance business, especially casualty and property insurance business, are now typically conducted in either London or Zurich, for historical reasons. However, since East Asia itself now has ample risk capital, and East Asia itself also generates sufficient insurance business (aviation, shipping, property, construction, casualty, life, etc), it makes sense to develop a market serving all of East Asia, relying on East Asian risk capital, in Hong Kong. Hong Kong has the great advantage that it is a cosmopolitan city welcoming everyone and that its commercial courts are perceived to be fair, consistent and reliable. This is an ideal situation for an insurance market, when fair, fast and certain resolution of insurance claims is absolutely essential.

c. Development of Hong Kong as the headquarters city of East Asia

Hong Kong has many advantages as a headquarters city for internationally oriented East Asian firms and for multinational firms with significant business in East Asia,—low tax rates, bi-lingual (Chinese and English) and bi-cultural, easy access to the rest of the world, ethnic and religious toleration, low crime rate, the rule of law, industrious and well-educated labour force, excellent medical care, etc. Its advantages can be further enhanced with a number of supporting measures to be described below.

## 2.Measures Supporting the Development of Hong Kong

### a.Environmental Quality

Hong Kong must improve the quality of its environment, notably the quality of its air, and the degree of traffic congestion, the availability of primary and secondary schools for students from around the world (including students from Mainland China who need a curriculum compatible with the schools on the Mainland), and availability of urban cultural amenities such as galleries, museums, opera houses (Chinese and Western), so that it becomes a city where people enjoy living and staying.

### b.Internationalisation

Hong Kong's future lies in maintaining and enhancing its strong connections with both the developed economies of the West and the Mainland of China. Without either, Hong Kong has no economic future. Without the connections to the West, Hong Kong will be just another Chinese city, but with much higher costs of labour and land. Without the connections to Mainland China, Hong Kong alone cannot survive economically. In order to maintain and promote internationalisation, the citizens of Hong Kong must be encouraged to be bi-lingual and bi-cultural, to be more interested in world affairs, and to actively cultivate relations with both people in the West and on the Mainland.

### c.The System of Taxation

Hong Kong already has low tax rates and no tax on cash dividends and on capital gains. But that may not be sufficient to attract the listing of shares in Hong Kong by enterprises in different East Asian economies. In order to facilitate the creation of this single unified East Asian stock market, Hong Kong must enter into double-tax agreements (DTAs) with other East Asian economies. This will essentially allow the investors in the Hong Kong unified stock market at least the same tax treatment as if they invest directly in the national market concerned. It is, however, not essential, but helpful, that the tax treatment of cash dividends and capital gains be rationalized across countries and regions.

Moreover, as a potential headquarter city, Hong Kong should have as many double tax agreements (DTAs) with as many tax jurisdictions as possible. The basic idea is to minimize the total tax burden to the parent company that has established its headquarters or its international headquarters in Hong Kong. To this end, Hong Kong must conclude double tax agreements with not only other East Asian economies but with major economies worldwide. Hong Kong currently has only 5 full DTAs compared to more than 90 for Mainland China.

For example, recently Chinalco (Aluminum Company of China) proposed to invest almost US\$20 billion in Rio Tinto, an Australian company. But Chinalco may locate its subsidiary holding the Australian stakes in Singapore instead of Hong Kong because Hong Kong does not have a DTA with Australia whereas Singapore has one. For another example, if CNOOC Limited, which is domiciled in Hong Kong, were to enter into a joint venture with China Petroleum Corporation in Taiwan to explore oil and gas in the Taiwan Straits, the lack of a double tax agreement between Hong Kong and Taiwan might necessitate the location of the subsidiary holding the Taiwan investment in Singapore instead. Hong Kong must therefore move quickly to conclude DTAs with other economies.

DTAs can also lower taxation on individuals and therefore can lower the cost of employment of an internationally mobile workforce, making Hong Kong more attractive as an East Asian headquarters location.

The importance of reform of the system of taxation, and in particular of DTAs has already been emphasized by Ms. Ayesha Macpherson, a fellow member of the Task Force, in her various papers prepared for the Task Force.

### 3. Conclusions

Hong Kong is potentially an ideal location to host this unified East Asian stock exchange and to become a headquarters city for international firms, because it itself does not tax cash dividends nor capital gains. Hong Kong also has the further advantage that it has a very stable currency and there is no restriction on the movement of capital into or out of Hong Kong. It is therefore also ideal as the location of an East Asian insurance market. If Hong Kong can improve the quality of its environment, enhance its degree of internationalisation, and enters into more DTAs with countries and regions around the world, it will have few competitors within the East Asian region.

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