OPEN AND CONNECTED: SCALING NEW HEIGHTS[1]

This speech explores the opportunities for Hong Kong presented by the three world trends of trade liberalisation, globalisation and technological advance.

Trade liberalisation, most dramatically illustrated by China's prospective entry into the World Trade Organisation (WTO), will enlarge and deepen Hong Kong's intermediary role. Globalisation brings challenges which small and open economies like Hong Kong can best address by promoting transparency, building more effective infrastructure, and maintaining a suitable exchange rate system. Technological advance allows developments such as the new US dollar payment system, which significantly lowers costs and reduces settlement risk for business throughout the region. But it also brings dangers and uncertainties that require an appropriate regulatory response.

The speech concludes that all these processes will bring opportunities as well as risks and uncertainties. But Hong Kong is well placed to respond to the challenges to deepen its role as a global city.

I am grateful, and much honoured, to have the opportunity to speak to this 7th Annual Business Summit of the Hong Kong General Chamber of Commerce. This conference is billed as a "business summit". The word "summit" always makes me think of one of my favourite hobbies - hiking. Those of you who have enjoyed - or endured - some of the more spectacular mountain trails in Hong Kong will know what I mean. I am thinking especially of the steep ranges in the remoter parts of Sai Kung, but you don't have to go far in Hong Kong before you find yourself in the middle of one of our wild and mountainous country parks. They are among the attractions that make Hong Kong such a special place. In my view, they should be included in any list of the qualities that make Hong Kong a desirable city to do business in - along with the rule of law, a low and simple tax regime, an educated workforce, and so on. If you haven't enjoyed these mountains, I recommend you take advantage of this long-awaited fine autumn weather to try them out. But if you are used to eating lavish lunches like this one every day, check with your doctor before you tackle the mountains in Sai Kung. And avoid Sharp Peak, the steepest, slipperiest and sharpest summit of the lot.

Hong Kong's economic development bears some resemblance to its mountain ranges: indeed, the dramatic ups and downs of the past decade alone form as stark a profile as anything that can be seen on the Maclehose Trail - the most daunting and relentless of all of Hong Kong's hiking trails. Go back further into Hong Kong's history, and it is possible to see, decade after decade, this same jagged landscape. The remarkably rapid reconstruction of an entrepot economy after the devastation of World War II. Then the blow to Hong Kong's entrepot position from the UN embargoes on China during the Korean War, which, far from destroying Hong Kong, helped stimulate its dramatic transformation into a major manufacturing economy. And again, in the late '70s and early '80s, when the Mainland began to liberalise its economy, and when manufacturing industries began to shift from Hong Kong to the Pearl River Delta

1 This is the text of the speech delivered by Joseph Yam, Chief Executive of the Hong Kong Monetary Authority, at the "Hong Kong: The Hub of Asia": 7th Annual Hong Kong General Chamber of Commerce Business Summit on 13 December 2000

and beyond, Hong Kong's re-creation of itself as a regional entrepot and its further development beyond into an international financial and services centre. Hong Kong has been sent more than its fair share of challenges, and there have been hardships and casualties along the way, but it has scaled each of them with the skills and the stamina of the best mountaineers. And, while pausing to enjoy the view, it has also found it possible to look beyond through the mist to the taller peaks gleaming in the distance.

WTO and Hong Kong

The most prominent of these peaks - at least among those visible to us now - is the prospective accession by China to the WTO. It is still not clear when exactly this event will take place, although the latest predictions seem to put it at some time during the second quarter of next year. Nor is it entirely clear how extensive an impact the event will have on China, on the world, on the region, or on Hong Kong - or how fast or slow the impact will be to take effect.

Some initial assessments about the impact on Hong Kong of China's WTO accession were, in fact, quite negative. A few were even alarmist. The trend of analysis now seems to be more positive. It is, however, qualified by a recognition of the challenges that Hong Kong faces, and of the standards we need to maintain, and improve on, if we are to make the most of our uniquely advantageous position. The Chamber's own detailed analysis of the implications (which has provided a solid basis for the discussion at this summit) is, in my view, an excellent example of what we need to help us understand this historical turning point in world trade relations: a rational, balanced, informed approach to a complex issue. The study focuses its analysis through another form of "turning point" - the "hub" - in positioning Hong Kong as a logistical, financial and digital centre of intermediation between the Mainland and the rest of the world. Indeed, China's entry into the WTO, along with globalisation and technological advance are the three processes that I believe will shape Hong Kong's role as such a hub over the coming years.

I have recently spoken in some detail elsewhere on the economic implications, and, in particular, the implications for Hong Kong's banking and financial sectors of China's entry into WTO. So I shall deal with these only briefly here, before turning to the other two processes of globalisation and technological advance. To summarise the research by the World Bank, the HKMA and other organisations: China's share in the world's external trade is predicted to double in the space of five years as a result of WTO entry - from around three-and-a-half per cent to more than seven per cent. This rapid growth in the Mainland's share of world trade, coupled with a projected growth in trade volume at the rate of 7% per annum, is likely to mean yet more Mainland-related business for Hong Kong, just as it will undoubtedly also mean a great deal more business for Shanghai and other Mainland cities as well. In other words, the business "creation effect" stimulated by WTO accession will far outweigh the "diversion effect", under which the pessimists had been predicting that Hong Kong's trade would gradually dry out and shrivel up. To put a figure on it, our estimates within the HKMA suggest that Hong Kong's annual GDP growth rate will be boosted by somewhere between half to one per cent through the increase in re-export trade resulting from China's membership of the WTO.

But that is not the end of it. For our less visible trade, in financial, technical and professional services, the outlook is even more promising. These lucrative service industries, which are increasingly taking pride of place in Hong Kong's economy, will be greatly boosted by business from Chinese enterprises seeking to expand their capabilities and improve their governance to handle increased trade and meet foreign competition. They will also be stimulated by overseas investors who need advice on how to make the best of the opportunities on the Mainland and who find Hong Kong the best place at which to obtain that advice. These trends have been in play for a long time - indeed they reflect Hong Kong's historic role as a hub of commercial, technological and cultural exchange between China and the rest of the world. But there are clear signs that these mediatory and advisory services are now receiving a boost in anticipation of WTO entry, as companies in the Mainland, in Hong Kong and overseas position themselves for new kinds of commercial relationships.

How do banking and finance fit into all of this? We expect to see two main developments over the next few years. The first is the greater demand for banking services resulting from the growing volume of business that will follow WTO accession. The second is the financial deepening, stimulated by more rapid financial liberalisation, greater banking competition, and product innovation induced by the terms of WTO accession. These developments will accelerate the reforms already in train within China's domestic banking sector - reforms that cover the whole spectrum of banking management and services from corporate governance to the professional training of staff. The developments will also progressively open China's business environment to competition from banks from outside the Mainland. In two years' time, foreign banks will be able to conduct RMB business with Chinese enterprises in Shanghai, Shenzhen, Tianjin and Dalian. Within five years, they will be able to deal with all Chinese enterprises without any geographical restriction. The advantages for banks with a base in Hong Kong are obvious. Many of them have a head start on the Mainland, with networks of branches and more than a generation of practical experience. They also have all the advantages of geographical proximity, a common language and culture, yet separate financial and legal jurisdictions that Hong Kong's unique position in China brings. Forty per cent of the Mainland's trade is routed through Hong Kong. Hong Kong is the Mainland's largest source of foreign direct investment and China's main financial conduit and funding centre. There is every reason to expect that these activities - all of which require banking services at a variety of levels - will continue to be channelled through Hong Kong.

But there are also potential diversion effects, which Hong Kong's banks will need to address if they wish to make the most out of their natural competitive advantages. Size is perhaps the greatest problem. Quite apart from the obvious economies of scale, and the momentum for expansion that larger operations can enjoy, there seems to me little likelihood in the near future of any relaxation of the size criterion of US$20 billion for entry into the Mainland's banking market. Hong Kong banks that do not currently meet this criterion will have to find a way of dealing with this. The obvious solution is consolidation, which already has many other advantages to commend it. And for those who are fortunate enough to have been admitted before the introduction of the size criterion, they can alternatively lobby and hope for a favourable outcome of Beijing's consideration of the "grandfathering" proposal that we have already put on the table on their behalf. On this I am hopeful, given that the grandfathering arrangement in relation to a change in policy is internationally accepted practice and that such an arrangement would apply to banks from Hong Kong as well as other jurisdictions. But I also do not wish to understate the complexity of the matter when considered in the context of WTO negotiations.

This substantial, but not insuperable, reservation aside, I am confident that, in terms of producing business for Hong Kong's banks, the creation effect of WTO entry will outweigh any diversion that will arise from the preference of some foreign banks and enterprises for dealing directly with the Mainland. There will still be factors that will encourage international businesses to use Hong Kong as a financial centre. These include the efficiency and sophistication of Hong Kong's financial markets and the financial infrastructure, the critical mass that goes with being the world's fourth largest banking centre, and all the qualities that single out Hong Kong, of which an audience such as this needs little reminder: the rule of law, the free movement of goods, capital and information, light government, and a trained and energetic workforce.

Globalisation

WTO is about globalisation. So let me turn to that subject now. Hong Kong's openness, and our connectedness to the larger world, place us in an excellent position to take advantage of the acceleration of globalisation that trade and financial liberalisation, and other forces are bringing about. Globalisation is not a new phenomenon. Our ancestors embraced the idea with the opening of trading routes, the building of canals and steamships, and the laying of railway lines and telegraph cables. And for a hundred and fifty years or more, Hong Kong has been a classic example of a global hub - a city at the crossroads of a number of regional and transcontinental trading routes. The process of globalisation is not, as we are frequently reminded, a universally benevolent force. But the process has largely ensured that international capital is allocated to where it can be most efficiently used, and that nations produce goods and services for which they have a competitive advantage. And, whatever the risks and shortcomings, the more efficient the global financial system, the more effective the process of globalisation is. As a result, global growth and development benefit.

It is possible to discuss this subject from a number of angles and for a very long time. But I should like to focus on two aspects today. One is how globalisation, as we are experiencing it today, is changing the role of governments. The other is the implication of globalisation for the choice of exchange rate regimes by individual jurisdictions.

To benefit from globalisation, national economic systems have made a distinct movement towards what Alan Greenspan has called "market-oriented capitalist structures". Fifty years or more ago, the clear trend was towards state regulation, centralisation, and - at the extreme - nationalisation. Today, it is in the opposite direction: the themes are liberalisation, privatisation and deregulation. Indeed, economies are now graded on the extent of their market orientation. Governments have become smaller relative to the economies they serve. Market competition, freed from distorting regulation or dirigiste policies, has come more fully into play, with lower transaction and information costs and increased market efficiency. There is generally greater recognition of the beneficial impact of market-oriented policies, and greater realisation that globalisation has made intervention, however desirable it might be in some cases, a great deal less effective.

We have therefore seen a sea change in the way in which governments approach economic management. In the post-war period the imperative of reconstruction and concerns about market failure predominated: so the approach was extensive government involvement in the functioning of an economy and frequent intervention. The consensus approach now, followed to one degree or another in most major economies, is government retreat from economic management, though without abdicating the responsibility for seeking to ensure that the arenas in which market forces come into play operate in a fair, equal and transparent way.

Hong Kong came into this new paradigm much earlier than most. In fact, the general view outside Hong Kong is that we are the most developed example of the paradigm. The philosophy of positive non-interventionism, coined twenty-odd years ago to describe the paradoxical but highly effective economic policy the government had already been following for some years, intersects neatly with the rise of global "market-oriented capitalist structures" of whatever size and complexity. Our free market tradition and our openness to the world have positioned us well for the new globalism.

But globalisation has brought challenges of a scale and immediacy that we have not seen before, and our very openness has at times been our vulnerability. The most difficult of these challenges have been in the financial market, where problems from outside can rapidly escalate into crises that threaten the integrity of our whole system. Capital flows, particularly those that are boosted by high leverage, have become large, fast, volatile and sometimes quite destabilising. Large economies with deep markets may have been able to withstand the volatility without their stability being seriously undermined. Yet, even then, government intervention in one form or another has been necessary: witness the LTCM episode in 1998, or the more recent interventions in support of the euro. For small and open economies, such as our own, the challenge is even harder to meet, and the measures necessary to prevent market failure have been even more dramatic. We faced our own episode here in Hong Kong in 1998, when the shock waves from highly mobile and volatile international capital flows threatened our markets with collapse. Our intervention in the stock market in August 1998 to keep our markets working earned us a great deal of vilification at the time, and - for the wrong reason perhaps since we did not go in to make a profit - a great deal of praise since. But let's leave the last word on this - at least for the time being - to Alan Greenspan. He said, in his post mortem earlier this year on the Asian financial crisis, the following words:

> Official safety nets and interventions cannot be eliminated entirely. There are limits to the size and extent of the shocks that the private sector can manage, at least in the short run, without official assistance.

Looking ahead, to minimise the need for government intervention aimed at heading off market failures induced by large and volatile capital flows, we need to build bigger markets and to strengthen the markets we already have. The challenge here - in an age when grandiose government schemes are no longer palatable or feasible - is to find ways of doing this without too much government, including regulatory, involvement. Among the more significant developments in the international efforts to deal with this issue are codes of practice, rather than regulatory impositions, and the promotion of transparency. Increasingly, the focus is not so much on architecture - building something grand and visible to replace the now defunct Bretton Woods system - but on infrastructure: laying down the connections and making sure they work properly rather than building walls and barriers. I shall say more about this in a few minutes.

A crucial element in the management of international capital flows is, of course, the question of exchange rate systems, which were a special target of large speculators looking for short-term profit opportunities during the Asian financial crisis. Where there is an exchange rate target against which bets can be laid, the pressures that build up can be quite formidable. Even when the exchange rate is freely floating, and therefore theoretically free of any precise exchange rate target, when sentiment is one-sided, which is often the case in financial markets, exchange rate overshooting can be quite common.

Largely against the background of financial crises in the 1990s, in which the choice of exchange rate regime has been a prominent issue, there has been a clear trend in thinking on what constitutes an effective and credible choice. This choice boils down to two options, in what is now commonly referred to as the two corner solutions: either an exchange rate target that is perceived to be impregnable or a regime that does not involve any exchange rate target, as in a free float. Neither solution is, admittedly, immune to crisis, particularly in the case of open and liquid markets. And the precondition has to be that any exchange rate regime, if it is to be credible, is built upon sensible economic policies, strong institutions and robust market infrastructures.

Clearly, no exchange rate regime can be perfect, and no simple regime can suit all. The present trend is towards floating regimes, though these seem to work best for the larger economies, whose foreign exchange markets are big enough to absorb voluminous capital flows, and for the smaller economies where controls and restrictions are practised. For Hong Kong, we have in our linked exchange rate system the most extreme case of an exchange rate target that is perceived to be impregnable - and has been proved to be impregnable under the most adverse of conditions. The link, in combination with sound fundamentals and well managed banks, has helped us through the recent crisis: not without hardship, it must be acknowledged, but with considerably less damage and uncertainty than we would have experienced had it not been in place. The tight discipline it exerts on our economy is helping to propel improvements in productivity, an important element in our current robust recovery. Indeed, the evidence to date suggests that Hong Kong experienced one of the fastest rebounds in productivity growth in the region. Labour productivity, measured in terms of GDP per person employed, registered the strongest gains of 10% in the post-crisis period, well above other Asian economies, whose gains were in the range of 5 to 8%. Because the exchange rate link suits an externally oriented, entrepot economy, it will continue to serve Hong Kong well in its expanding role as a regional and international hub, as China enters the WTO. And this applies, it should be added, regardless of the path taken by the renminbi - a path that will likely involve careful and controlled experiments with greater exchange rate flexibility in the not too distant future, and cautious and considered moves towards currency convertibility in the fullness of time.

Technological advance

I made reference earlier to the emphasis in international financial reform on laying down connections, rather than on raising up walls and restrictions. So let me turn to the process of technological advance, my final topic today. This is intricately linked with the question of globalisation, particularly in the case of information technology. Indeed, without it, globalisation as we understand it would not be taking place. Again, this is not a new trend: over the centuries new navigation aids, railways and steamships, the telegraph, the telephone, and later radio, television and satellites have all boosted the speed and quantity in which information travels around the world. Now the internet and other electronic channels have vastly expanded that capacity.

In the field of financial services, recent advances in information technology have played an enormous role in determining the speed and manner in which money circulates and the nature of the competitive landscape. Money, which was once solid, heavy and difficult to shift around, turns into electronic pulses, which can be sent around the world at the touch of a button in a matter of seconds. At the consumer end of the industry many of us now rarely enter a bank, but carry out our transactions on cash machines, over the telephone, and increasingly through computer terminals, and, no doubt in time, over WAP telephones. The little plastic cards, of which we all have at least one in our pockets, have seen a growth in business by more than thirty times in the past thirty years. Technology does not only manifest itself in web and wires, but also in the rarefied area of financial engineering, with advanced mathematical models and complex equations developed to price new derivative products. These have become useful instruments for hedging purposes and for offloading and allocating risks to those who have the appetite and capacity to take them on.

But these developments have brought dangers and anxieties as well as benefits and convenience. The Y2K episode - though it was well managed and ultimately uneventful - underlined how dependent we have become on the technology created over the last decade or so, and how irreversible that technology is. More recently, and now that the Y2K anxiety has been overcome, the rapid development of e-banking has underlined other concerns about privacy, security, risk management, customer protection - even about the very nature of banking - in a borderless world. The dangers posed by innovative financial products hardly need to be laboured in a place that has been very much at the brunt of their more destructive forces in recent years.

What can a monetary authority do in the face of such difficulties? I have referred already to the drastic measures taken in 1998, and more than enough has been said on that matter elsewhere. In the field of regulation and supervision, we need to ensure that we keep pace with the rapid developments going on, so that anxieties about e-money and e-banking - real or imagined - are properly addressed. In this area, Hong Kong has been one of the first regulatory authorities to issue guidelines that, among other things, require banks to ensure that their internet security platforms are airtight and that risk management systems are properly in place. We have strengthened our supervisory skills and resources to enable us to check that this is being done. This is not going to be an easy process. No-one can predict what directions technical innovation, customer behaviour, or latent practical problems will take. The challenge for regulators like the HKMA is to seek a balance between not allowing these developments to bring unmanageable risk and not stifling the application of useful new technology by holding back innovation. It is a difficult balance to achieve. Too great an interest by the regulator in new initiatives by the bank can often be misunderstood as heavy-handed over-regulation. The answer to the dilemma, clearly, is for regulator and industry to work hand in hand in a constructive way. Our policy in this, as in other areas, is to consult with - and listen to - the industry organisations as well as to the public at large and its representatives.

In other areas of its work, the HKMA has itself become something of a pioneer and is currently a clear leader in this time zone. Of particular importance here is our work on financial infrastructure. This is how we look at the matter. It is now possible to trade globally over the telephone or over the net from anywhere in this world - and no doubt, with the right equipment, from out of this world as well. But those who trade have to come down to earth to effect settlement and, very simply, Hong Kong is where we would like them to be when they land. To serve as a financial centre in a world connected in this way means primarily having the capability and infrastructure to capture these deals and provide safe, efficient and inexpensive settlement and clearing services. This is why we in the HKMA have, since our establishment in 1993, been paying particular attention to building financial infrastructure as the foundation of our strategy in developing Hong Kong as the financial hub of Asia.

We built over ten years ago a fully computerised and paperless debt clearing system as part of our efforts to develop the domestic debt market. We have since linked that system with similar debt clearing systems in a number of other jurisdictions to facilitate cross border and cross currency investments in debt markets. We are about to develop our debt clearing system further into what we call an ICSD or an international central securities depository in an attempt to pull debt issues in the region into our system. In respect of the safety and efficiency in the movement of money, we built almost five years ago a state-of-the-art Real Time Gross Settlement system for the full range of Hong Kong dollar financial transactions. This RTGS system has a seamless interface with our debt clearing system - the first of its kind in Asia. We have just replicated that payment system for the US dollar, enabling US dollar transactions to be settled real time in our time zone rather than having to wait for New York to open. The US dollar payment system is also linked up with the Hong Kong dollar payment system and in September this year we achieved the first payment versus payment (PvP) transaction in world financial history between two different currencies. This arrangement makes it possible for Herstatt risk - the risk that money might get lost during transactions between different time zones - to be eliminated. If payment systems for other currencies in this region are also linked up with our US dollar payment system, then most foreign currency transactions involving the US dollar conducted in this region can benefit from this risk reduction service. There is a standing invitation from us to central banks in the region running real time payment systems for their currencies. I hope they will take up this offer. And five days from now, the final phase of the system, which will allow paper cheque clearing and delivery versus payment settlement of debt securities denominated in US dollars in Hong Kong, will fall into place. Those among you with responsibility for corporate treasury functions should consider making use of this system, which will lower costs and considerably reduce settlement risks.

Technology changes our lives fundamentally. We are somewhat lucky to be living in an age of rapid technological revolution, and are perhaps luckier than our ancestors who experienced similar revolutions, because the revolution now going on is directed largely towards the arts of peace rather than of war. I say 'lucky' because, despite all the uncertainties and disruptions it brings, this technological revolution has the potential to change people's lives for the better. But it also brings about pain, and, if not applied with skill, can accentuate inequalities of geography, education and wealth. Labour is displaced by machines and software, and labour requirements turn away from the purely physical to the more knowledge-based - witness the slowness in the improvement of our unemployment rate. The workforce will need to adapt. And our economy will need to adapt to accommodate the kind of knowledge-based industries that are concentrated into a logistics, financial and digital hub. And technology itself, in the understandably confused state of revolution, is awfully difficult to price in financial markets, particularly when the highly uncertain nature of future earnings in respect of technologically intensive companies has to be taken into account, typically in the equity market, not to mention derivatives thereof. There has therefore been an additional, micro dimension of technology induced financial market volatility and this could well be manifested in enormous creation or destruction of wealth possibly to the extent equivalent to a substantial proportion of the GDP. Investors and the regulators of markets and of institutions providing credit will also need to adapt.

Conclusion

But Hong Kong and its people have been always good at adapting in the past: this is a super-flexible and super-adaptable city. There is every evidence now - after a flicker of self-doubt in the late 1990s - that the vigour, the creativity that brought us through the last 50 years is still in full flow. We shall need all of that vigour and creativity if we are really to make the most of the opportunities and ride out the volatilities of the coming decades. As with most things in life, these opportunities and volatilities come tangled together: we cannot just say yes to the opportunities without exposing ourselves to the volatilities. In my speech today, I have explored what I see as the three main opportunities for Hong Kong in the coming few years. Trade liberalisation, in its most far-reaching manifestation - China's prospective entry into the WTO - brings enormous opportunity for Hong Kong to enlarge and deepen its intermediary role. Globalisation is transforming the way in which government and business relate to each other, and Hong Kong is in an excellent position as an open, lightly governed city to take advantage of the process. Technological advance offers new tools to realise the practical benefits of globalisation, particularly in the field of financial services, and Hong Kong is in the vanguard of the innovative work that is going on.

But these processes also carry risks and uncertainties, which can be reduced, through hard work and vigilance, but never eradicated. How much business will be diverted from Hong Kong to other cities after China enters the WTO? How should small, open markets like Hong Kong safeguard themselves against the shocks and threats which are transmitted more quickly, more sharply and more forcefully through globalisation? And how, when we frankly have very little idea of where innovation is taking us or of where the dead ends may be, do we cope with the volatilities and unknowns - not least in the financial projections of technology-led companies - of a white hot technological revolution? These are among the many challenges of living in a logistics, financial and digital hub. As one of the world's most open and connected of cities, Hong Kong is better placed than most to respond to these challenges and to deepen further its role as a global city. We can certainly look forward to an interesting and exciting few years ahead.