

Especially as it is embedded in the Basic Law, the HKMA takes the goal of maintaining Hong Kong's role as an international financial centre very seriously. With the rapid financial liberalisation in the region there should be a migration of financial activity to this time zone. We are meeting these challenges by further improving our supervision and settlement systems. The impact of other factors, such as taxation arrangements, on Hong Kong's competitiveness in the region also need to be assessed. It will be important to maintain confidence in Hong Kong's free markets as we move into the era of "one country, two systems".

Introduction

I am very honoured to be invited here this morning to discuss a subject that is crucial to Hong Kong, namely, its role and future as an international financial centre. I would like to congratulate the Economic Sub-Group of the Preliminary Working Committee in addressing this issue.

We in the HKMA have been addressing this issue for some time, from the monetary and banking points of view – of course there are others both inside and outside the Government who also have a strong interest in aspects of this key topic. As a result of our consideration of this issue, we have over the past few years made a number of strategic moves which have been well reported in the press and well received. They are designed not only to increase our competitiveness, but also to ensure that by mid-1997 we comply fully with the Basic Law. Hong Kong is, of course, unique in having its status as an international financial centre actually embedded in its constitution. Article 109 of the Basic Law says:

“The Government of the Hong Kong Special Administrative Region shall provide an appropriate economic and legal environment for the maintenance of the status of Hong Kong as an international financial centre.”

Thus the Basic Law imposes a clear responsibility on the authorities. As part of the Hong Kong Government, the HKMA takes this responsibility seriously. In this connection, we have recently prepared an internal strategy paper which concluded with a list of recommendations on areas

for further intensive study. Clearly the whole subject merits attention beyond the HKMA and I am taking advantage of this occasion to have the strategy paper published to facilitate discussion. In view of the time constraint, I shall this morning only touch on a few selected points.

Hong Kong's competitiveness as an international financial centre

Hong Kong has many advantages as an international financial centre, not least of which is its strategic geographical position as a major hub and gateway to China, located in the fastest growing region in the world. Other advantages that have often been mentioned are its openness, stable environment with clear cut rules of business, low tax and market friendliness. It is important that we have a clear appreciation of the ingredients of our success in the past. This will enable us now and in the future to meet our competition and to enhance our role as the New York of the East. Our strategy paper identified a long list of these advantages, many of which are well known. Indeed, some have been the long standing philosophy of the Government and are enshrined in the Joint Declaration and the Basic Law. I do not therefore propose to go through them today.

But in this connection we need to realise that financial activities do not remain static. Circumstances change all the time. We therefore have to be acutely aware of what is going on around us in order that we can maintain, exploit and enhance our advantages. The private sector can of course be trusted to cope with changing circumstances, motivated by profits. But this

* This is the text of a speech by Joseph Yam, Chief Executive, Hong Kong Monetary Authority, to a seminar on Hong Kong's Role as an International Financial Centre held in Hong Kong on 18 May 1995.

alertness clearly needs to be extended to the authorities as well, because they do have considerable influence on the ground rules and are often in a better position to initiate a response.

If we take a close look at this region, or this time zone, defining it to be Hong Kong time plus or minus three hours, we can see an interesting phenomenon. There are of course a lot of people in this time zone, in fact, eight times that of the London time zone and four times that of the New York time zone, correspondingly defined. The GDP of this time zone is of comparable size with the other two. The growth rate of GDP of economies in this time zone is also a lot faster than any other time zone. What is even more impressive is that this time zone also has the largest concentration of the money of this world. Of the seven largest official reserve holders in the world, five are in this time zone. And I believe that the same applies to private sector money, however defined.

But the same cannot be said about financial sector activity, where London and New York still have the lead. The question to ask ourselves is perhaps why this is the case. Why, for example, do we in this time zone have sometimes to wait until the late afternoon and the late evening to pick up the phone to London or New York for financial transactions when we should really be at home with our families? And why do entities of this region prefer to issue paper in the Euro market rather than in the Asian market? The answer I think is simply one that concerns risk. Even though as a whole this time zone has the critical mass, in terms of financial clout, this is very much dispersed as different economies are still very much focused on their domestic needs, and their financial markets characterised by varying degrees of accessibility and sophistication. Furthermore, as the standards of prudential regulation in these markets vary, so consequently do the perceived degree of integrity and therefore the willingness of investors, particularly foreign investors, to participate in these markets.

But I think this is changing. In recent years there has been a rapid process of financial liberalisation in developing economies, particularly those in this region. Associated with this was the rapid development of domestic financial markets which has been helpful to channelling domestic

savings effectively to productive investment, thus spurring economic growth. And as these markets gain in sophistication, foreign capital is finding them increasingly attractive. Financial liberalisation also allowed domestic capital to be invested in foreign markets. Thus the process has generated large international flows of funds, looking for attractive investment opportunities. And regulatory standards have also been improving continuously, moving closer to standards of the established centres. I am hopeful therefore that there would be a gradual migration of financial activity into this time zone, at least to a degree commensurate with the financial and economic weight of the economies here.

If this prognostication is correct, it is not difficult to see that, in order to safeguard our competitiveness as an international financial centre, one important area to which we should give special attention is our ability to provide the facilities for investors prudently to manage the risks associated with the high rate of return available in this dynamic region.

Risk management

Traditionally, bankers have concentrated on credit or counterparty risks, but increasingly they have begun to monitor more closely their market risks, liquidity risks, operational risks, legal and settlement risks. As the boundaries for banking, securities and futures markets become blurred internationally, supervisory authorities must also look closely at systemic and cross-border payment and settlement risks. As we all know, the proper management of risks will require us to devote time and resources to both the internal management and supervisory framework, with sufficient attention to the technological infrastructure.

Hong Kong has already a financial supervisory framework that ranks well with the best internationally. By and large, it is market-friendly without sacrificing the need for supervisory authorities to monitor developments and be in a position to deal with shocks to the system that can come either externally or internally. There are certainly areas which we can improve, particularly in maintaining close co-ordination between domestic regulators, and as the case of Barings revealed, greater co-operation with foreign supervisory authorities.

Financial products are essentially legal contracts involving property rights and obligations. They therefore require a complete legal framework: the more complex the financial instrument, the greater the need for comprehensive laws, regulations and codes of conduct. There also needs to be confidence that they will be fairly enforced, in particular that foreign and domestic players will be treated equally. Hong Kong's legal framework is founded on well-established British common and contractual law, on which much of international financial contracts are based. Hong Kong's courts have a good reputation for impartiality and this was given by market participants as a major plus. For this to continue to be the case, investors will need to be reassured that 1997 will not change conditions materially.

The development of global financial markets depends heavily on the availability of efficient telecommunications and a robust technological platform. Hong Kong has been successful because of its excellent telecommunications and good financial software and hardware. Hong Kong has the potential of being the first to exploit the true benefits of seamless global financial trading, where global financial products can be traded, cleared and settled at the lowest transactions costs and the lowest trading and settlement risks. To put us in a position to achieve this important niche in the global financial network, the HKMA has worked closely with the Hong Kong Association of Banks to develop our real time gross settlement (RTGS) system, in full compliance with international standards, by 1996. We are also discussing payment system linkages with China and the US. That hopefully will be the first important step for making Hong Kong a global cross-border payments hub, in line with its role as an international financial centre.

Our Central Moneymarkets Unit (CMU) Service is already an accepted paperless securities clearing and settlement system, with linkages to Euroclear and Cedel that would facilitate investor access to Hong Kong markets. CMU will be fully integrated into the RTGS system. Shortly, we will begin to look at linkages with the securities Central Clearing And Settlement System (CCASS) and other domestic and international payments and securities systems to effect delivery versus payment

(DvP) and payment versus payment (PvP). These are ambitious but absolutely vital infrastructure issues that must be addressed. As I have often said before, in the global financial network, either you are plugged in or you are cut out of the business opportunities.

A level playing field

Let me turn to the competition. Hong Kong of course does not fear competition. It thrives on competition as long as there is a level playing field. The competition to Hong Kong does not come so much from the traditional international financial centres of New York, London, Tokyo or Frankfurt, which have national interests of political significance that loom large and so may not be as focused on financial sector development as is so clearly laid down in the Basic Law for Hong Kong. They therefore may not move so flexibly. The immediate and obvious competitor is perhaps Singapore, which shares Hong Kong's advantages of being in the right time zone to complement London and New York, having a neighbouring high-growth region, and low tax. But other neighbouring centres, such as Shanghai, Sydney, Taipei, Bangkok and Kuala Lumpur are also seeking a seat at the global table, each rapidly going through a process of financial liberalisation which would enhance their competitive position.

Singapore has over the years introduced a number of measures aimed at improving its competitiveness as an international financial centre. In the foreign exchange market, it has already overtaken or is on the verge of overtaking Tokyo. It is aggressively building up its fund management strength, and through a number of tax incentives, financial institutions in Singapore pay tax at a reduced rate of 10% on the net income derived from 'offshore' transactions. In Sydney, taxable income derived from pure offshore banking transactions by an authorised offshore banking unit is also taxed at a reduced rate of 10%.

I believe that in this area of taxation on offshore financial business, we now need to consider again whether changes are needed in Hong Kong. Serious consideration should be given to levelling the playing field. This is one of our recommendations in our strategy paper. But on such fiscal matters there is obviously a need for the

Administration to consider the wider public interest and the implications for the fiscal system. I am sure this subject will receive the attention it deserves and look forward to participating in discussions on it.

Shanghai is another potential competitor, and we need to keep an eye on developments there. As many of you would agree, the development of both cities is complementary. Shanghai, despite its immense potential, probably cannot develop into a full-fledged international financial centre unless RMB is fully convertible in both the current and capital accounts. But with its comparative advantage in RMB business, its status as a national financial centre is unrivalled. Nevertheless, some businessmen are worried that Hong Kong will eventually lose business to Shanghai, though this is some years into the future.

It will be helpful for China to clarify its policy on Shanghai and its relationship with Hong Kong, having regard to the concept of one country, two systems. And certainly there is a need for continued close co-operation between the monetary authorities on issues of mutual interest concerning the two financial centres. I await the comments on this by Deputy Governor Chen Yuan today.¹

Confidence

An international financial centre is a collection of markets that trade financial services or products and help to allocate resources or property rights efficiently. The market is a wondrous mechanism that matches supply and demand and determines price. To ask why Hong Kong has been so successful as an international financial centre is to ask why markets work so efficiently. As our strategy paper has emphasised, markets function well under a free and friendly policy environment, where people can trade products under a clear and equitable legal and prudential framework, using a robust technological platform. But apart from these technical considerations, confidence is of overriding importance.

There are two aspects of confidence that affect the efficiency of the market. The first is the need for political stability, without which markets cannot thrive. Hong Kong has long enjoyed political

stability and I am confident that there will continue to be political stability after the change of sovereignty. The concept of one country, two systems is without precedent historically. But the ingredients of Hong Kong's success, in particular as an international financial centre, have been enshrined in the Joint Declaration and the Basic Law. Nevertheless, there will always be those that are sceptical, maybe for good reasons. We should not dismiss them lightly. We have to understand their concerns and address them seriously. My idol, the maestro of free markets, Milton Friedman, was sceptical. And for those of us who have met and listened to him, we know that it is quite a challenge to win an argument over Milton. In much the same vein, it will be quite a challenge, for those in a position to do so, to maintain and enhance confidence in political stability, a serious deterioration of which may change what has hitherto been a positive into a negative.

The other aspect of confidence lies in the ability and freedom of the entrepreneur to make use of his own skills and judgement to act in his best interest. Hong Kong's pool of entrepreneurial talent is the envy of the world. This comes largely from the lack of self-censorship, in that creativity and innovation in the market-place knows no bounds. And in Hong Kong entrepreneurship and vision have not been limited to the private sector. A hallmark of public officers in Hong Kong has been their self-confidence and vision to take bold steps where necessary. The decisions, even against unfavourable economic and political circumstances, to adhere to fiscal discipline, to maintain strong reserves and to invest in sound infrastructure that kept Hong Kong competitive and cost-effective were not the actions of risk-averse bureaucrats. Nor have our public officers taken the seemingly easy way out by being more interventionist in the market place. In case we all forget, it takes considerable self-confidence to be non-interventionist.

It would be difficult to improve upon these freedoms. But any erosion of them would be damaging to confidence. It may cause our almost irreplaceable entrepreneurs to leave and benefit the competition. It may seriously impair the efficiency of public administration in Hong Kong. It

¹ This speech is reproduced as the preceding article in this issue of the *Quarterly Bulletin*.

may undermine Hong Kong's development as an international financial centre. To safeguard against that erosion requires dare I say, China to have confidence and trust in Hong Kong, in its entrepreneurs and in its public officers, just as those of us who have chosen to stay have confidence in China.

Market results speak louder than rhetoric. Whatever the rating agencies say, the market has its own way of monitoring confidence and our commitment to policies that would preserve Hong Kong's stability and prosperity. I am pleased to see that, by and large, the yield curve of HK dollar Exchange Fund debt paper tracks closely the yield curve for US Treasuries. This is a solid demonstration that the market does not demand a premium for the risks associated with 1997. It is also a demonstration of the credibility of our monetary policy. Long may this continue.

Conclusion

To sum up, Hong Kong has succeeded as an international financial centre because it has, by historical accident or design, followed the sound principles of the free market with minimal government intervention. Markets have a habit of

moving around artificial barriers created against them. It is this free market that has been enshrined in the one country, two systems principle. Challenges to Hong Kong do not come so much from other centres, but from the need to maintain confidence. We would not be realistic if we do not recognise that there is investor apprehension that the unique free market nature of Hong Kong may deteriorate to its disadvantage in the transition. Confidence can be ephemeral and fragile, as the recent example of Mexico has shown. Rhetoric alone will not maintain confidence. If anything, the market is allergic to rhetoric. Instead, it wishes to see concrete achievements through cooperation. It wishes to see Hong Kong Inc. getting on with it. It wishes to see that the concept of one country, two systems has meaning as well as reality.

At the technical level, there are in fact very few specific measures that are necessary to promote Hong Kong's status as an international financial centre. I have mentioned the tax aspect that merits further thought. And there are specific financial products and services identified where we could further improve the financial infrastructure, as spelt out in our strategy paper. All these may require further study, and the HKMA will continue to play an active part in it. ☺

Hong Kong as an International Financial Centre

Strategy Paper

Introduction

1. Hong Kong is unique in having its status as an international financial centre (IFC) actually embedded in its constitution. Article 109 of the Basic Law says:

“The Government of the Hong Kong Special Administrative Region shall provide an appropriate economic and legal environment for the maintenance of the status of Hong Kong as an international financial centre.”

2. This paper discusses what we see as steps that may be desirable if we are to maintain, and indeed enhance, this status.

Hong Kong's Advantages as an IFC

3. The main advantage of Hong Kong is her strategic geographical position, but the other advantages include, in no particular order:—
 - Good clear and predictable legal system.
 - Good accounting practices.
 - Free press, leading to transparent information.
 - Sound and modern infrastructure and offices.
 - Educated workforce with good English language skills.
 - Freedom from unnecessary regulation.
 - Attractive tax system for both individuals and companies.
 - Freedom of entry for companies and freedom to do business.
 - Good quality of life, respect for law and order, safe streets etc.
 - Connections with China.
 - Excellent air, sea and telecommunication links.
 - Easy entry for professional expatriate staff.
 - Stable currency with no exchange controls.
 - Critical mass of other financial institutions.
 - Political stability.
4. Hong Kong's proximity to China remains a major attraction, but in some areas other centres are catching up with Hong Kong (quality of infrastructure, freedom of entry for companies, critical mass of other financial institutions). This is not something we should be too surprised at, as it is part of the enrichment and development of the whole region.
5. The competition to Hong Kong does not come from the traditional international financial centres of New York, London, Tokyo or Frankfurt. These, including Shanghai, are hampered because they are also national financial centres, and therefore more subject to national taxation and other considerations. They cannot move flexibly. Tokyo is a good example of how financial centre development and de-regulation have been delayed because of disagreements over policy and pace of change.
6. The most immediate competitor is Singapore, which shares Hong Kong's advantages of being in the right time zone to complement London and New York, having a neighbouring high-growth region, and low tax. It is making a bid for the top slot with major changes in policy, especially in the tax and asset management area. However, meeting the competitive challenge from Singapore or elsewhere is part and parcel of the overall strategy to keep Hong Kong's position as the leading Asian IFC.

7. This paper discusses some of the issues in developing Hong Kong as an IFC, drawing on available studies and our discussions with key market participants. The paper is organised around the Five 'P's that constitute the key elements of a financial market. Markets function well under a free and friendly **P**olicy environment, where **P**eople trade **P**roducts under a clear and equitable legal and **P**rudential framework, using an efficient and robust technological **P**latform, such as the payment and settlement system.

Policy

8. Hong Kong is widely perceived as the most free economy in the world along with Singapore and followed by Bahrain and the United States, measured according to the US Heritage Foundation's "Index of Economic Freedom" in respect of ten key policy areas:—
- Trade Policy
 - Taxation Policy
 - Government Corruption
 - Monetary Policy
 - Capital Flows and Foreign Investment
 - Banking Policy
 - Wage and Price Control
 - Property Rights
 - Regulations; and
 - Black Market
9. It would be difficult to improve on Hong Kong's freedoms, but any erosion of these free and liberal policies may cause investors to leave. Top of this list for the investors is their fear or uncertainty that Hong Kong would change its unique character as a free market. Any major changes in the above policy areas would be viewed as very negative indeed. Thus, the **Confidence** factor is critical, and it would be important that this Confidence is maintained through 1997. For example, investors feel that if the present currency stability was to disappear, it would be very difficult to maintain such a major centre here. They do not argue that the Link itself is essential to their peace of mind, merely that currency stability is - they would be (and are) just as content to do business under the sort of currency regime that prevails in Singapore or Bangkok as they are here.
10. A second strongly held view is that any deterioration in the legal system would be a big negative. Obviously corruption and lack of fair and independent judicial judgement is uppermost in their minds here, but even if the system stayed clean it could still deteriorate, for example by becoming much slower, more expensive or less predictable.
11. On the regulatory front, two dangers were highlighted. The first is the perception that the Government is increasing the burdens of regulation and supervision. As regulations become more complex with new products and situations, there is a danger that the application of rules becomes less flexible, and overlaps will occur, leading to delays in decision making.
12. The second danger is the observation that the Government is more vulnerable to measures that could increase costs of doing business. The proposed Old Age Pension Scheme was the example they hit upon mainly, viewed as adding to labour costs and increasing the social burden. The Scheme itself, had it come into effect as planned, was also a negative for fund managers, as it would remove some of their fund management business. On the other hand, a mandatory fully funded provident fund scheme with private sector management would have been seen as a boost for the local fund management industry.

13. In terms of tax policy, Hong Kong has an attractive low personal and corporate tax regime. However, in the promotion of offshore financial business, Hong Kong offers no tax incentives. In Singapore, financial institutions pay tax at a reduced rate of 10% on the net income derived from 'offshore' transactions including loan syndication, trading in commodity and financial futures, providing managerial and support services to overseas affiliates, international treasury operations and funds management, economic research and corporate advice. In Sydney, taxable income derived from pure offshore banking transactions by an authorised offshore banking unit is taxed at a reduced rate of 10%.
14. Tax rates may well fall further in Singapore, which recently introduced a value-added tax of 3%. This tax reform is designed to broaden the tax base and to lower company and income tax rates to levels closer to Hong Kong (currently 16.5% versus 27% for Singapore). Hong Kong may have to consider some tax incentive to even the playing field.
15. It is important that land and labour policies are sufficiently flexible to ensure that costs of doing business in Hong Kong are competitive. In discussions with market participants, high rents and staff wages consistently emerged as the main disadvantages Hong Kong faces. However, the market adjusts to the costs and there is no call for the government to undertake specific measures to address cost levels, other than the land supply measures which seems to have worked in deflating the property bubble so far.

Products

16. The strength of an IFC depends on the range of products traded and the liquidity of such markets. London and New York, for example, offer both range, depth and liquidity of financial services and products relative to say, Frankfurt or Tokyo. It would be useful if Hong Kong has a full range of financial products that will serve her customer base, but Hong Kong cannot be totally a "one stop financial shop". There are eight broad classes of products to be considered: banking, equity, debt, foreign exchange, derivatives, commodities, asset management and insurance.

(a) Banking

17. Hong Kong has possibly the largest representation of international banks in the world, including over 80 of the top 100. There are also 70 Japanese financial institutions in Hong Kong, the highest concentration outside of Tokyo. So far Hong Kong leads Singapore in the banking field (**Table 1**). Banking business will remain strong, as the Chinese economy and its financing needs develop. Private and corporate banking should develop further, while the scope for infrastructure financing remains high.

Table 1:
Banking Market

	Hong Kong	Singapore
Foreign banks	171	119
Representative offices (March 94)	156	50
Foreign assets (US\$ bn) (end 94)	615	366

Sources: SEACEN financial statistics, HKMA, IMF

(b) Equity Market

18. The Hong Kong equity market is already the largest in non-Japan Asia (**Table 2**). A factor assisting its growth in the last few years has been the listing of Chinese 'H-shares'. This trend is likely to accelerate.

Table 2:
Equity Markets

	Number of Listed Stocks	Market Capitalisation (end 1994) US\$ bn	Annual Turnover (1994) US\$ bn
New York	3,150	4,232	2,454
Tokyo	1,785	3,592	860
London	5,136	1,143	1,015
Hong Kong	541	267	126
Taiwan	354	247	733
Australia	1,579	219	95
Korea	1,089	192	287
Singapore	n.a.	135	77
Thailand	398	131	83

Source: Stock Exchange of Hong Kong (1995)

19. It would also assist Hong Kong's development if the shares of other major international companies were listed in Hong Kong. In the same way that London trades Hong Kong shares in London time, there is no inherent reason why Hong Kong cannot trade New York, Frankfurt and London shares in the East Asian time zone.

(c) Debt Markets

20. There are three debt markets in Hong Kong: the domestic HK dollar debt market; the non-HK dollar debt market issued and traded in Hong Kong, and the Eurodollar debt market.
21. As is the case in most of non-Japan Asia, domestic currency bond markets have been slow to develop in Hong Kong. In part this reflects consistent fiscal surpluses, which meant there was no need for large issues of government bonds. The HKMA is contributing to developing the bond market by providing market infrastructure (see section on technological platform), such as the CMU Service, and issuing progressively longer term Exchange Fund paper as a benchmark for debt issues. The airport project should broaden the debt market and mortgage-backed securities have also emerged recently, raising over HK\$2 bn in 1994. The Floating Rate and Fixed Rate CD market has jumped dramatically in size and volume.
22. A major potential for growth is the borrowing in HK dollar by the Chinese government and Chinese enterprises for infrastructure development. There are figures such as US\$500 bn cited for infrastructure projects over the next decade, a significant proportion of which will need to be financed in international markets. These HK dollar instruments have to be issued, arranged and traded in Hong Kong.

23. The non-HK dollar debt market is divided into two components. The **Dragon bond market** is the non-Asian currency debt market in non-Japan Asia. The investors are mainly Asians and the issues are priced, launched and underwritten in Asia. Although the market is growing in Hong Kong (US\$2.9 bn was raised through 11 issues in 1993), the business is shared with other regional centres. The same is true of the **Euro convertible bond market** which is equity-related bonds issued by Asian corporates for the European or American markets. The development of this market would depend on the critical mass of investment banks and the location of investors. (Table 3).

Table 3:
International Bond Issues

Outstanding issues by country of residence as at end 1994; US\$ bn

	Issues by financial institutions	Other issuers	All issuers
Japan	21	240	261
United States	86	104	190
United Kingdom	106	66	172
Australia	18	30	48
Korea, South	7	10	17
Hong Kong	10	5	15
China	3	9	12
New Zealand	0	6	6
Malaysia	0	4	4
Thailand	1	3	4
Indonesia	1	3	4
Philippines	0	2	2
Singapore	0	1	1

Source: Bank for International Settlements (1995) Appendix Table 13.

(d) Foreign exchange market

24. Japan, Singapore and Hong Kong dominate foreign exchange trading in the Asian time zone. However, all indications are that Singapore is moving rapidly ahead of Hong Kong in this market. Singapore has always had an edge because of active trading in her neighbourhood, such as Brunei and the rest of ASEAN. Several investment banks have been attracted to base their foreign exchange centres in Singapore for business reasons, despite the preference not to internationalise the Singapore dollar. As the Chinese renminbi (RMB) moves towards full current account convertibility by 2000 (at the latest) and full capital account convertibility later, trading in it is likely to increase and Hong Kong should attract a share of this, particularly by acting as a bridge between the nascent forex markets in China and those in the rest of the world.

Table 4:
Foreign Exchange Market Turnover

% of total: April 1992

United Kingdom	27
United States	18
Japan	12
Singapore	6
Switzerland	6
Hong Kong	6
Germany	5
France	3
Australia	3

Source: Bank for International Settlements (1993)

25. The HKMA, working closely with the Hong Kong Association of Banks, has worked at levelling the legal playing field by issuing the International Foreign Exchange Master Agreement (IFEMA), Hong Kong version, that would harmonise the legal agreement and framework for forex trading. This is because London, New York and Tokyo have their own IFEMA versions. Using their IFEMAs would imply that contracts and disputes would be settled outside of Hong Kong. There is potential to attract forex business to Hong Kong if the clearing and settlement infrastructure is better. The HKMA is beginning to study this in depth.

(e) Derivatives market

26. The derivative market comprises two components: over-the-counter trading and exchange trading. Exchange-traded derivatives markets are much less developed in Hong Kong. The most developed financial futures markets in Asia are the Tokyo International Financial Futures Exchange (TIFFE) and the Singapore International Monetary Exchange (SIMEX). The latter is linked to the Chicago Mercantile Exchange through a mutual offset system which allows contracts executed in one exchange to be offset in the other.
27. It was suggested by some market participants that an actively traded futures contract in 3-month HIBOR would be useful in developing other HK dollar derivatives and swaps, and add depth to the HIBOR market. At present HIBOR futures are inactive.
28. Exchange-traded options markets are relatively underdeveloped in Asia as a whole. The largest are Osaka and Singapore. The latter is encouraged by the exemption from stamp duties of trading in options on securities listed on SIMEX.
29. While it is clear that Hong Kong is lagging in developing traded derivatives markets, policy implications are less clear. Discussions with market participants do not suggest that government charges or regulations are holding back activity in any of these markets. The problems that have delayed the introduction of stock futures trading suggest better coordination and consultation is needed.

30. Until the results of the 1995 BIS survey are available, it is hard to assess the size of the total derivatives market in the Region. Discussions with market participants suggest that over-the-counter derivatives transactions could be almost ten times as large as exchange-traded transactions. In the total derivatives market, Hong Kong seem to be at least matching Singapore, although well behind Tokyo.
31. A possible market niche is the market for RMB derivatives. These are generally unavailable so far. Market participants mentioned three factors holding back development. The first is there are far more institutions wanting to hedge RMB than willing to be on the other side. The second factor is that most exporters to China invoice in US dollar. The third factor is that the RMB is not fully convertible. More work is needed before this area can move forward.

(f) Commodities market

32. Hong Kong is already believed to be the fourth largest gold trading centre. While some areas, such as oil, grain and mineral markets may be of relevance to China, there are no reasons why Hong Kong should have any pecuniary advantage over Chinese cities in the development of these markets, other than the present low tax regime.

(g) Asset Management

33. The absence of a public pension scheme in Hong Kong should mean a potential large demand for pension funds and other managed funds. Some corporate pension schemes exist on a voluntary basis in Hong Kong, with contributions of 5-15% from employers and 0-5% from employees. However, Russell (1995) estimates that at end-1993 Hong Kong's retirement funds had total assets of US\$15 bn, compared with US\$37 bn in Singapore and US\$24 bn in Malaysia.
34. Hong Kong has a large asset management industry, with 903 mutual funds and unit trusts managing assets of US\$46 bn as at March 1994. Singapore's funds management industry has grown very rapidly. Harrison (1994) estimates there were 112 funds managers with US\$61 bn at the end of 1992.

(h) Insurance

35. Hong Kong has one of the most competitive insurance markets in Asia. 228 insurance companies operate here, compared with 142 in Singapore. The gross insurance premiums amounted to HK\$28.0 bn (US\$3.6 bn) in 1992, compared with S\$4.3 bn (US\$2.6 bn). However, because these insurance companies have been free to invest their assets, many of the insurance company assets are managed at the foreign headquarters level, rather than through local asset management expertise based in Hong Kong. Possible areas of development include the re-insurance business, but this needs to be studied in depth.

People

36. Financial services need to tap large pools of specialised skilled labour. The success of London is primarily accounted for by the large pool of skilled professionals in the financial services field (Table 5).

Table 5:
Approximate financial services labour force

London	800,000
New York	400,000
Hong Kong	350,000

Sources: City Research Project (1992), HK Government (1994)

37. A factor encouraging financial firms to cluster together is reliance on a variety of supporting services such as accounting, actuarial and legal services, specialised printing, information services and computing and other technical support. Hong Kong has this critical mass of expertise, but may still be short in terms of quality and quantity relative to demand.
38. Educational standards in Hong Kong are high, but there is concern expressed that standards are slipping, especially in English language skills, of particular relevance to international finance. With the status of English likely to be scaled back after 1997, this is an area which needs to be kept under review.
39. More specialised skills are also relevant. There may be some scope for the financial sector to help develop the curricula for the universities so that course content is more practical than academic. The development of a practical Graduate School of Finance affiliated with one of the existing universities, which can upgrade skills in the financial products discussed above, and with a particular specialisation in the Chinese market, would be a useful development here. It could develop asset and risk management and actuarial skills, currently in short supply.

Staff Costs

40. The rapid increase in financial sector staff salaries indicates the supply shortages relative to demand. At the higher levels, low tax and more relaxed immigration rules have increased supply. A recent study on Hong Kong versus Singapore costs suggests that labour cost growth rates have been roughly the same, at 12% per annum. On the other hand, housing and office costs are exceptionally high in Hong Kong. In spite of this, overall costs for senior staff may not be too different between Hong Kong and Singapore because car costs and personal taxes are almost double in Singapore.
41. Junior staff do not have the same international mobility. One reason why London stays ahead as the leading European IFC is perhaps that the UK has lower labour costs than for comparable staff in Germany. There are no good data available comparing the cost of clerical labour across countries, but using data on manufacturing labour costs as a proxy (**Table 6**), Hong Kong's wages are still low compared to other IFCs and the contribution of taxes to labour costs is very low. However, our discussions with market participants found that competition is keen for good back office, support and administrative staff, and turnover rates are high (averaging 22% annually).

Table 6:
Hourly Costs of Manufacturing Workers

	US\$ per hour 1992	% change 1975-1992	Taxes as % of total 1992
Hong Kong	3.89	419	3.2
Singapore	5.00	495	15.3
Australia	12.94	132	15.3
United Kingdom	14.69	336	16.5
Japan	16.16	439	13.1
United States	16.17	154	22.6
Switzerland	23.26	282	16.4
Germany	25.94	309	22.8

Source: US Department of Labour (1993)

Prudential Framework

42. Financial products are essentially legal contracts involving property rights and obligations. They therefore require a complete legal framework: the more complex the financial instrument, the greater the need for comprehensive laws, regulations and codes of conduct. There also needs to be confidence that they will be fairly enforced, in particular that foreign and domestic players will be treated equally. British commercial and common law is well-established and is the basis for most international financial contracts. Hong Kong's courts have a good reputation for impartiality and this was given by market participants as a major plus. For this to continue to be the case, investors will need to be reassured that 1997 will not change conditions materially.
43. Hong Kong maintains international standards of prudential supervision, but is considered more flexible than other regional centres. Asked to rate the impact of regulation of financial institutions on competitiveness, two surveys of chief executives both rated Hong Kong ahead of Japan and Australia.³ The approach in Hong Kong has been to place more trust in the markets. Some market participants are worried this is changing as the Hong Kong administration is becoming more responsive to pressure, political or otherwise, requiring more intervention through regulation.
44. On the regulatory front, strategies could include measures to:–
 - Upgrade staff expertise, particularly on new products, such as derivatives;
 - Continue emphasis on self regulation;
 - Establish clear regulations in line with Basle Committee recommendations;
 - Maintain close co-ordination between domestic regulators to avoid overlaps;
 - Maintain close co-operation with foreign supervisory authorities;
 - Prevent money laundering activities;
 - Maintenance of high capital standards;
 - Improve financial disclosure and transparency.

Platform (Technology)

45. The development of global financial markets depends heavily on the availability of efficient telecommunications and a robust technological platform (the basic infrastructure). London, Hong Kong and Singapore have been highly successful as IFCs, because of excellent telecommunications and good banking software and hardware. The global financial market only emerged when national markets became "wired together" through better telephone and fax facilities.
46. While 24-hour global financial markets are fast becoming a reality, no IFC has yet been able to exploit the true benefits of **seamless** global financial trading. Currently, the global markets are still segmented into different time zones, different national markets, different instruments (eg forex versus debt versus equity) and non-harmonised telecommunications and trading systems. Thus, a truly global investor who wishes to switch investments between countries and instruments has to face segmented markets, traders, dealers and currencies, and clear and settle with multiple systems under different time zones and tax regimes. This implies high transactions and time costs, as well as higher risks. The first financial centre to reduce these transactions costs and lower risks will be a truly global leader that taps into various regional and national markets. Hong Kong has this potential.

47. The global technological platform has two major implications:
- (i) Trading will move to those centres with the most efficient (fast and low-cost) transactions, and the most robust infrastructure. In other words, trading will avoid those centres where the payment and settlements of transactions are slow, uncertain or unreliable;
 - (ii) Other than regulatory restrictions, there is no economic necessity for trading on established exchanges, since the bulk of transactions can be screen-based, over-the-counter trading. For example, the forex market is totally over-the-counter and can switch centres rapidly.
48. Hong Kong has been making important progress in this area. Building on the modern telecommunications base in Hong Kong, the efficient clearing and settlement system run by the Central Moneymarkets Unit (CMU) of the HKMA has been an important platform on which the debt market can be built, efficiently and soundly. Since 31 January 1994, when the book-entry computerised CMU service was extended to private sector HK dollar paper other than Exchange Fund Bills and Notes, the service has now over 170 members, with over 130 issues lodged valued at HK\$80 bn. The CMU service is hooked up with both Euroclear and Cedel, rendering overseas investors easy access to HK dollar debt market.
49. In addition, to ensure that Hong Kong's payment system will compete with the best in other IFCs, so that financial flows will continue to flow through Hong Kong, the HKMA has worked closely with HKAB to move the interbank payment and settlement system onto the real time gross settlement basis. The second stage is to link the Hong Kong payment system with other countries, such as the US and China, so that transactions in securities can achieve delivery-versus-payment and other financial transactions can achieve payment-versus-payment.
50. By a direct linkage with the US Fedwire, for example, Hong Kong will be able to develop the US Treasuries market in the Asian time zone, without the settlement risks that are associated with different times of trading, clearing and settlement. Similarly, trading and clearing in HK dollar or other Asian currency financial instruments can be achieved in European and US trading hours. With the CMU, the beginnings of an Asian securities clearing system, similar to Euroclear/Cedel (which together accepted and settled transactions valued at US\$14.5 trillion in 1992 or US\$55 bn per business day), have been established. Considerable research and development will have to be undertaken to attain that strategic goal. Fortunately, the Hong Kong banking system is aware of the benefits of these developments and the HKMA will be working closely with the Hong Kong Association of Banks to attain this vision.

The Way Forward

51. To maintain Hong Kong's leading position as an IFC will require us to maximise her strengths and ameliorate the weaknesses identified. This review of the strategic issues facing Hong Kong as an IFC suggests the following:—
- (i) The “secret” of Hong Kong's success has been the free market, within a framework of low taxes, sound regulations, a level playing field and an efficient and sound platform (financial infrastructure). The major threat is an erosion (or even a perception of erosion) of investor confidence that Hong Kong's leading and unique free market character will change through 1997. Clearly, everyone must appreciate this critical point as 1997 draws closer and greater efforts to ensure the maintenance of confidence are critical.

- (ii) Market results speak louder than rhetoric. The fact that the HK dollar Exchange Fund Bills and Note yield curve tracks closely the US Treasuries yield curve is a solid demonstration that the market does not demand a premium for the risks associated with 1997. We should consider extending the maturity of our EF Notes to 7-year and 10-years at the appropriate time in the light of market demand.
- (iii) With other regional centres also giving significant tax incentives, there may be a case to bring the “offshore financial business” tax rate down.
- (iv) There are specific financial products, particularly in the debt market area, that can be developed with the close co-operation of the private sector. Most of these require no subsidies or major regulatory changes, but may need some investment in the financial infrastructure, such as the clearing, settlement and payment system area. Examples are the Eurodollar and bond repo market in the Asian time zone. Developments in the debt market area will bring with it associated transactions in forex, inter-bank transactions and derivatives. More research and development will enable these products to be brought onstream in the near future.
- (v) Some institutional strengthening measures could be helpful in boosting market confidence. For example, a private sector owned secondary mortgage corporation á la Fannie Mae could help develop the secondary mortgage market in a sound and structured manner, helping both first time home-buyers and stabilising residential mortgage flows.
- (vi) There are specific areas, such as asset management, derivatives, equity and insurance and re-insurance products that require significantly more study by the other regulatory agencies on future developments. The HKMA would be prepared to work with these agencies to study these in detail. Selected expertise can be drawn from other central banks and multi-lateral agencies to work on different products.
- (vii) Other areas for improvement identified, such as education and training, use of English, international schools and other facilities will require a concerted effort by the relevant parts of the Administration and the Universities to tackle in depth.
- (viii) An ad hoc Advisory Committee, or Task Force on IFC Strategy, could be formed to discuss strategy and issues with the HKMA serving as secretariat to undertake major studies identified above. This Task Force could also keep in view the impact of regulations on competitiveness.

Hong Kong Monetary Authority

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