Hong Kong – New opportunities as an international financial centre

A speech delivered by Joseph Yam, Chief Executive of the Hong Kong Monetary Authority, at a seminar organised by the Hong Kong Economic and Trade Office in Tokyo on 8 May 2007.

Joseph Yam spoke on the relationship between the Hong Kong and the Mainland financial systems, and how they could complement each other to their mutual benefit. He also spoke on the roles Hong Kong can and should play in the development of the financial markets of China as a whole.

Let me first thank you for giving me the honour of speaking to you today on a subject that is of enormous importance to Hong Kong – the status of Hong Kong as an international financial centre. Many of you may already be aware that the maintenance of Hong Kong as an international financial centre is a requirement laid down in the **Basic Law** of the Hong Kong Special Administrative Region of the People's Republic of China. It is unusual for a policy of this kind to be written into a constitutional document. But there are sound historical reasons for doing so; and I will not go into them today. I draw your attention to this legal requirement merely to underline the strong commitment to this policy regarding Hong Kong by the People's Republic of China and the seriousness with which we in Hong Kong take this policy.

And I am happy to be discussing this subject with you today in the context of the **tenth anniversary** of China's resumption in the exercise of sovereignty over Hong Kong. The past ten years have been eventful, particularly in financial affairs, for both the Mainland and Hong Kong. They included, of course, the Asian financial crisis, which had consequences that took quite a few years to sort out. During this decade China has also continued with great confidence in its challenging programme of reform and liberalisation. This programme has placed a clear emphasis on financial development, very much in accordance with Deng Xiaoping's dictum that "finance is the nucleus of a modern economy". As China's international financial centre, Hong Kong has both participated in and benefited from this process. The Hong Kong Special Administrative Region Government has recently developed a strategy to help position Hong Kong in the best possible way in this process: it is this strategy that I would like to focus on in my talk today.

Let me begin with the principle of **"one country, two systems"**. It is natural that the political and governance dimensions first spring to mind whenever this term is mentioned. But there is a lot more to it. The one country, China, embraces two economic systems – one, described as the socialist, market economy of the Mainland, the other the capitalist, free market economy of Hong Kong. China also maintains two financial systems – one on the Mainland, which is relatively closed yet developing, and the other in Hong Kong, which is rather more open, developed, competitive and efficient, by virtue of its long history of market freedom. There are also two educational systems, two transport systems, two social systems, two legal systems, and so on.

This arrangement is quite unique. Other countries may have their own regional variations in governance and economy, but I am not aware of any where the differences are so pronounced, or offer such opportunities. What this unique arrangement means, very simply, is that China has two financial systems to serve its needs. There are considerable differences between the two financial systems, given their different histories, even to the extent that different currencies are used. We all know that **differences present choices** for the users, and differences enable relative strengths to be exploited, relative weaknesses to be addressed and synergies to be maximised in the national interest. However, financial controls, for example, those on the Mainland relating to international capital flows, which are justified by special circumstances, do limit the freedom to choose. And so complete reliance on the free market in the making of rational choices of which system to use in the provision of financial services is not possible; nor is complete reliance on the free market in the associated maximisation of comparative advantages and specialisation between the two systems. Realistically, these will need to be achieved by the creation of special channels to facilitate the mobility of funds, financial instruments and financial institutions between the two systems, and the architecture of the special channels designed to suit the special circumstances of the Mainland.

I am happy to say that there is now increasing recognition of the need for these special, financial mobility channels or, put simply, the need for strengthening the co-operative relationship between the two financial systems within the country. Let me refer to the statements made by Premier Wen on 19 January this year at the **National Finance Working Meeting** held in Beijing and later in a published article. This is quite an important meeting. If I remember correctly, it is only the third such meeting ever held in the history of the People's Republic of China. Premier Wen identified six areas in finance in which special efforts are to be given in the period ahead. One of these (the fifth) concerns the promotion of financial openness. There he laid down clearly the need:

> **"To continue to advance financial co-operation between the Mainland and Hong Kong".**
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> **"To further develop a mutual-assisting, complementary and inter-active relationship between the two financial systems of the Mainland and Hong Kong" and**
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> **"To strengthen and promote the status and utility of Hong Kong as an international financial centre."**

As far as I am aware, this is the first time the Central People's Government has been so specific about the relationship between the two financial systems. And those are unambiguous words, at least in what they say about the spirit of the co-operative relationship. **Mutual assistance** means that where the need arises to address shortcomings in the financial system, whether in supervision, regulation, standards, technology, or whatever, there should be a readiness on both sides to provide assistance. I will not bother you with the details; suffice it to say that we in the Hong Kong Monetary Authority spend a considerable amount of time providing assistance, in training and in technical support, to our counterpart regulators on the Mainland. We also benefit in turn from the skills and expertise of our colleagues from the Mainland.

A **complementary** relationship implies a willingness to use the financial services provided by the other system when such services are, for one reason or another, found lacking in the domestic system. This enables the specialisation in the provision of financial services where there is comparative advantage in their provision. The consequence is greater efficiency in the use of scarce resources and higher productivity. There will inevitably be some who are disadvantaged for lack of comparative advantage. Their interests will have to be taken into account in considering initiatives to strengthen co-operation between the two financial systems. There will also, quite understandably, be differences of opinion about how co-operation should be pursued. These will have to be sympathetically appreciated, and reforms patiently taken forward, although the public interest of effective financial intermediation should always be of over-riding importance.

The **inter-active** relationship between the two financial systems promises to be an important and interesting one, in both the national and the international dimensions. At the national dimension, if the two corresponding financial markets on the Mainland and in Hong Kong, for example the equity markets, are suitably connected and the investor base on the Mainland is able to interact with that in Hong Kong, then clearly the China market, however one looks at it, will be much bigger, possibly bigger than the sum of the two individual markets. With a much larger investor base of a higher degree of sophistication, benefiting from the presence of international investors, there will be greater liquidity and the price discovery mechanism of the market will be more efficient, thus making the equity market a more attractive channel of financial intermediation. A bigger market also reduces market concentration and the scope for market manipulation that are, regrettably, common features of smaller financial markets. All this will mean greater financial stability. On the international dimension, an inter-active relationship between the two markets will mean that domestic investors, and not just fund raisers, on the Mainland will have more ready access to an international market in which to invest their savings, achieving a higher rate of return, even after adjusting for exchange-rate changes. Perhaps then consumers on the Mainland will feel more comfortable about spending more money. This would help lower the very high savings rate that now prevails on the Mainland, achieve more balanced and sustainable economic growth, and reduce the large balance of payments surplus that has become such a political issue internationally.

While these principles of co-operation between the two financial systems and the theoretical benefits are simple and clear, the devil is of course in the details. A strategy to take co-operation forward will realistically have to take into account **sensitivities** and relevant circumstances in both the Mainland and Hong Kong. For Hong Kong it is a little easier, given the long history of market freedom. Where there are rules and regulations they are designed to be market-friendly and with clear objectives of upholding market integrity and providing a measure of protection to depositors and investors. For the Mainland it is more complicated, given the preponderance of controls and therefore the invariable need to seek approvals from the relevant authorities and to justify reform proposals. The invisible hand does not work in so uninhibited a manner on the Mainland as in Hong Kong. Even so, with the Mainland economy becoming more and more market oriented, the rate of progress will naturally increase. What is important is that, in tackling the devil when working out the details of these special financial mobility channels between the two financial systems, all concerned should be clear about what is in the best long-term interest of the country.

On these, there is comprehensive **guidance**, outlined in the Eleventh Five-Year Plan approved by the People's Congress in March 2006. Chapter 33 of the Plan in particular deals with financial reform. And as I mentioned earlier, there is also the National Finance Working Meeting of January this year in which priority areas in financial reform have been identified by Premier Wen. I will not bother you with the details in these documents. What I would like to say here is that, in response to the directions identified in these documents, we in the Hong Kong Special Administrative Region have recently developed a strategy whereby the country can make greater use of the financial system of Hong Kong in enhancing financial efficiency on the Mainland while at the same time consolidate the status of Hong Kong as an international financial centre in accordance with the Basic Law. Our Chief Executive Mr Donald Tsang organised an **economic summit** last year and tasked a Focus Group on Financial Services to map out our way forward. The Report of the Focus Group, which contained a total of eighty comprehensive proposals, was published in January this year.

Having regard to the priorities of financial reform on the Mainland, the Report articulated three roles that the financial system of Hong Kong can and should play. The **first** role concerns **financial intermediation between the Mainland and the rest of the world**. The financial system of Hong Kong has been an important conduit for the channelling of foreign savings to Mainland fund raisers. Indeed, in recent years, insofar as the raising of funds through the equity market is concerned, Hong Kong has become the largest funding source of Mainland enterprises, surpassing London and New York. H-shares have become so popular that international investors are now quite willing to come to the stock market of Hong Kong to participate in an offer, rather than expect Mainland enterprises to list shares in New York or other financial centres. This is encouraging, and every effort is being made to sustain this role of the stock market of Hong Kong as the premier fund raising centre for Mainland enterprises.

But meeting the financial challenges confronting the Mainland now also requires attention to how domestic savings on the Mainland might better be mobilised, including increasing their outward mobility. Indeed, as convertibility for capital account items is gradually implemented and the investment in foreign currency assets overseas allowed, capital flows will become increasingly two-way. Hong Kong is trying to open doors and create channels to facilitate the outward mobility of capital from the Mainland, to position itself as the first port of call, if not the final destination, for the much-anticipated capital outflow that will come.

The **second** role concerns assisting **domestic financial intermediation** on the Mainland. Financial intermediation on an international dimension, while important, is probably only a small part of the financial activity needed to support the economy of the Mainland. This is evidenced by the sheer size of that economy, its relatively low degree of external orientation of the financial sector, and its very high savings rate. The domestic financial intermediation needs on the Mainland are enormous, and making domestic financial intermediation more effective is a formidable challenge. With a sophisticated financial system, Hong Kong is in a position to play a large role in meeting this challenge.

The **third** role is for Hong Kong to be the **laboratory** for capital account convertibility of the RMB and the increasing international use of the currency. The Mainland of China is now the fourth largest economy and the third largest trading entity in the world. In terms of the Asian region, it is the second largest economy and the largest trading entity. The renminbi is attracting increasing attention in international finance, although it still is not a freely convertible currency. Indeed, the renminbi is now a popular currency for the settlement of border trade in the southern part of China. The declared policy of gradually achieving full and free convertibility suggests the possibility of the renminbi, in the fullness of time, achieving the status of an international currency and possibly a reserve currency – even an anchor currency. Hong Kong is obviously the ideal, free-market laboratory for conducting experiments in these areas.

Let me recapitulate before I go on. We have a good understanding of the financial needs of China, as articulated in the Eleventh Five-Year Plan of 2006 and the statements from the National Finance Working Meeting earlier this year. We have, in this connection, explored in detail the possible roles for the financial system of Hong Kong in addressing these needs. There is also the ongoing, legal requirement on the maintenance of the status of Hong Kong as an international financial centre. What then should our **strategy** be from a practical point of view?

There are five key elements. The **first** is for us to open doors on the Mainland to facilitate the expansion of **presence** there by our financial institutions. With a savings rate of about 45% and rapid economic growth, there is enormous demand for financial services in China. Many of these services, especially the basic ones like retail deposit taking and lending, need to be provided on location. Hong Kong financial institutions are highly efficient and, more importantly, their linguistic and cultural affinity with the Mainland enable them to understand its financial needs – the services needed and the credit-worthiness of fund raisers – much better than institutions from overseas. They also have greater financial strength than institutions from many other jurisdictions – I am talking about capital adequacy here, not just the absolute amount of capital. We have been working on removing or lowering the restrictions on ownership, on management control and on the capital and other thresholds for establishing a presence on the Mainland, whether in the form of branches or subsidiaries. No doubt the Mainland authorities will want to manage the impact of greater competition on domestic financial institutions. This explains the gradual approach to relaxing restrictions that they have taken up to now. But the benefits that competition will bring in the transfer of know-how in areas like product development, risk management, corporate governance and financial innovation are equally obvious, not to mention the increase in efficiency that competition will bring about. Entry restrictions are gradually being relaxed, although obstacles remain in the form of controls on foreign ownership and limits on the scope of business that can be undertaken. I believe that the pace of relaxation could be increased quite considerably without creating undue risks to the position of domestic institutions or to financial stability.

The second key element involves working with the Mainland authorities to increase the **outward mobility** of Mainland investors and fund raisers, and the associated funds, and of financial institutions and instruments. The build-up of savings means that investors on the Mainland are in need of investment opportunities. Allowing them to invest in Hong Kong would offer them a wider range of instruments, including those issued by Mainland fund raisers, thus completing the process of domestic financial intermediation by making use of the advanced financial platform that Hong Kong has and the Mainland lacks. Investors will also achieve higher rates of risk-adjusted return, which will eventually stimulate consumption and lower that very high savings rate, leading to more sustainable growth for the Mainland economy. Greater mobility of fund-raisers into Hong Kong will give them access to more diverse sources of funds, again including Mainland funds. This is especially important for the many that are credit-worthy but have experienced difficulty raising funds through the Mainland's underdeveloped financial intermediation channels: the small and medium-sized private-sector enterprises are good examples. At the same time, exposure to the scrutiny of the free market in Hong Kong and to international standards will force borrowers to become more efficient and transparent. Greater mobility of Mainland financial intermediaries into Hong Kong will similarly expose them to our free market and international practices, which will in turn help them in the development of existing or new international businesses. At the same time, Hong Kong will learn more about Mainland needs and practices. The high level of co-operation between Hong Kong and Mainland regulators that has developed in recent years will allow us to ensure effective supervision of these intermediaries, in much the same way as already happens with other jurisdictions.

The **third** element of our strategy is to develop channels whereby **Hong Kong financial instruments,** including the H-shares issued by Mainland enterprises in Hong Kong, are made available to investors on the Mainland. This would help satisfy investor demand on the Mainland and, inasmuch as many of these instruments are issued by Mainland fund raisers, it would again contribute to domestic financial intermediation through the use of the financial system of Hong Kong. It would also help to address the concerns of some on the Mainland that the best Mainland assets are being marketed to foreigners through H-share IPOs in Hong Kong instead of being made available to Mainland investors. These financial instruments could be traded on Mainland stock exchanges, in the inter-bank market or over the counter. They could take the form of simple derivative products of the underlying securities in Hong Kong, for example depository receipts certifying the holding in trust of those assets. There are of course technical issues involved in this type of schemes: these include the need to ensure that the derivative products and the underlying securities are convertible; the need to ensure price equalisation between them; and the treatment of the associated foreign currency transactions. But none of these issues is too difficult to resolve. We are working on and exploring with the Mainland authorities on some specific proposals. I am hopeful of positive results.

The **fourth** element of our strategy is to strengthen Hong Kong's ability to handle **financial**

transactions denominated in the renminbi, very much in anticipation of the rising role of the renminbi as an international currency. If Mainland investors and fund raisers are to be brought together in the financial system of Hong Kong, there may come a time when the preferred currency denomination for financial intermediation becomes the renminbi rather than the Hong Kong dollar, in order to avoid foreign exchange risk. As I argued earlier, it is essential that Hong Kong should develop its ability to facilitate financial transactions denominated in the renminbi, as indeed we currently possess the financial infrastructure to facilitate financial transactions denominated in the US dollar and the euro and of course the Hong Kong dollar as well. I am talking about, for example, state-of-the-art, real-time gross settlement payment systems, which achieve payment versus payment, and finality of settlement in our time zone without settlement risks. We have just extended this sophisticated financial infrastructure to include the renminbi, in anticipation of the development of a renminbi debt market in Hong Kong – a matter that has just received the go-ahead from the Mainland authorities. In fact, we made a start in developing this renminbi capability of our financial system back in 2004, experimenting with a modest scope of banking business in renminbi, including the taking of renminbi deposits, foreign exchange transactions, remittances and credit cards. We have gained valuable experience from this and are ready to expand the scope, pending the green light from the Mainland authorities on quite a number of proposals now on the table, including for example the use of the renminbi in trade finance and settlement between the Mainland and Hong Kong.

The **fifth** element of our strategy is to strengthen **linkages of the financial infrastructures** of the Mainland and Hong Kong. I have mentioned a few times the need to enhance the mobility of the funds of investors and fund raisers, the mobility of financial instruments and financial institutions between the two financial systems, through modifications of policies and relaxation of controls. There is of course a need to make sure that the financial traffic is safe and efficient, just as we need to ensure that the land, sea and air traffic for our citizens is safe and efficient, and this means effective linkages of the financial infrastructures of the Mainland and Hong Kong. There is also scope for specialisation in the provision of financial infrastructural services. Hong Kong already has a world-class, multi-currency financial infrastructure that can cater for most of the Mainland's payment and settlement needs. There are already a number of links between our systems and the Mainland's, so it makes sense, on cost and efficiency grounds, for the Mainland to make more use of our foreign-currency payment systems to settle its foreign-currency transactions in Hong Kong or to access other international payment systems through Hong Kong. Better links will also help proper monitoring and management of risks. And beyond linkages of payment and settlement systems, there are the all-important market linkages that should be explored, notably the possible linkage between the stock exchanges in Hong Kong and Shanghai, not only for market efficiency purposes that I mentioned earlier when talking about the inter-active relationship between the two financial systems, but also for competitive purposes vis-à-vis developed overseas markets in New York, London and indeed here in Tokyo.

In **conclusion**, I think you will agree that this is an ambitious strategy. There is no doubt that it will mean breaking new ground in a number of areas, both for Hong Kong and the Mainland. There are bound to be those who, understandably, worry about their established businesses and operations and how they will be affected by shifts in liquidity and where business is carried out. I firmly believe, however, that the specific proposals falling within the five elements of the strategy will benefit China as a whole, and will specifically benefit the Mainland in its financial development and Hong Kong in the maintenance of its status as an international financial centre. And, sustainable and rapid economic growth of China, well served by the two financial systems in co–operation, will benefit our neighbours in the region and the global economy. For, although I have focused almost entirely on the relationship between Hong Kong and the Mainland of China during this talk – as befits the occasion – the processes have a regional and a global dimension. As an international city, Hong Kong is the home and place of business of many people from around the world. Not least among them is the very large and settled Japanese community, whose members have played an important part in developing Hong Kong's strengths as a financial centre. The strategy I have described will provide still greater opportunities for international participation in Hong Kong's finance and trade, and I warmly encourage you all to come and make the most of them. Seeing the strategy through to fruition will take time, and there will be setbacks along the way – there always are. But China's integration into the global economy is inevitable and will benefit us all. Hong Kong can and will make an important contribution.

Thank you.