

China's Horse in a Global Race - Positioning the Hong Kong Securities Market¹

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August 1998

Despite the armies of economic and financial analysts who surround us today, the forces which cause financial centres to evolve or dissolve still preserve some of their mystery. The emergence of Hong Kong as a major international financial centre in the past 20 years was not the result of far-sighted planning. Nor was it just an accident. It was a product of market forces within a certain administrative, cultural, geographic and historical framework. The result is a world-class financial centre which can reasonably claim to be the most sophisticated, and certainly the most international, in Asia.

Some of the lustre has come off this pearl in the last 12 months as a result of the financial whirlwind which has swept through Asia. Although Hong Kong avoided the mistakes in economic and financial management which afflicted some other Asian economies, it has nevertheless been deeply affected by the turmoil. In the global financial marketplace, the importance of Asia as a whole has diminished.

At such a time, it may seem idle to talk about any Asian horse in the global race between financial centres. Such a perception would, in my view, be inappropriate. The present depressed state of Asia's financial markets should not cause us to lose sight of longer-term trends in the evolution of global markets, which I do not believe have

¹ An unpublished paper by Edgar Cheng.

suddenly veered off in a new direction. The East and South-east Asian emerging economies which grew at unprecedented rates for most of the past 20 years have not lost the basic ingredients which stimulated that growth. The weaknesses in their financial market infrastructure which were a prime cause of their recent setback are in most cases being steadily corrected. Whether it takes one or two or three years for these countries to get back onto that growth trajectory, it will happen. At that time, their equity markets will recover. As these economies mature, their rate of growth may slow, but most of them will still out-pace the major economies of Europe and North America for many years yet. And one side-effect of the recent turmoil is that, within Asia, the relative weight of Mainland China, Hong Kong and Taiwan has become greater than before.

If this long-term prognosis is correct (and I believe it is) the balance in financial market terms between Asia and the rest of the world will be restored. Indeed the relative position of Asia, and particularly China, will grow again. I therefore make no apology for maintaining the optimism which is reflected in many of my past speeches about the potential for continued growth in the role of Hong Kong as an international financial centre.

Taking a trip backwards in history, I am sure nothing could have been further from the minds of the British adventurers who prised Hong Kong away from China in the last century than the thought that they were preparing the ground for one of the global financial centres of the 21st century. Even 30 years ago, such a concept would have seemed fanciful to Hong Kong's administrators. It was only in the 1970s that Hong Kong started to gather momentum as an international financial centre. The principal catalyst for this development was the openness of Hong Kong's markets to banks, brokers, fund managers and other participants from anywhere in the world, at a time when most other Asian centres were to a greater or lesser extent closed or tied up in bureaucratic red tape. This openness was supported by a legal and administrative framework which was generally seen to be fair and objective. The expansion of Hong Kong's

markets was of course fuelled also by rapid growth in Hong Kong's real economy, accelerated by even more rapid development on the Mainland in the 1980s and 1990s, unleashed by the "open-door" policies of Deng Xiaoping. Initially, the Hong Kong financial community was largely British, but in the last 20 years or so it has become highly cosmopolitan and a large body of local expertise has built up in most branches of financial services.

The institutional framework has nevertheless remained largely as constructed by the previous Administration.

Now Hong Kong is firmly launched as part of China. Can, and should, the framework remain the same?

So far it does not look much different on the surface. Despite the conditions created by the Asian financial crisis, the "One Country, Two Systems" formula has so far operated almost exactly as it was intended to do. Interference from Mainland authorities has been conspicuous by its absence. Hong Kong people are really running Hong Kong. And, at least in the securities market area, they appear to be maintaining the system much as it was before.

Therein lies a danger. Not because the system set up in colonial days was wrong at the time. But because it is wrong now in many important respects. This is only in part due to Hong Kong's reunification with China. The main reason the system is in need of overhaul now is that the international context within which our market operates has changed substantially, and we have not yet adjusted to this.

In retrospect, the main risk to Hong Kong associated with the Handover was never subversion of the courts or curtailment of individual freedom. It was inertia in the area of public policy, flowing from an understandable desire to avoid doing anything which might "rock the boat" during the delicate transition period. Despite some admirable initiatives, such as the formation and subsequent operation of the Hong Kong Monetary Authority and the earlier establishment of the Securities and Futures Commission (SFC), there was an evident reluctance to address some longer-term strategic issues in the securities market area or to pursue initiatives to up-date Hong Kong's institutions or legislation which might

have provoked controversy. Here I must share the blame (if that is the right word) with Government, SFC and others, having been at the helm of the Stock Exchange for much of the relevant period. The harsh fact is, that, within the consensual society that we still are, fundamental changes of the kind necessary were simply not "practical politics" at that particular time. This period of partial paralysis co-incided with a time when changes in securities and derivative markets world-wide were accelerating, driven by technology and globalisation, and competition between financial centres was intensifying.

I do not claim to be an economic guru. There are, however, certain trends in the evolution of financial centres globally which have been growing for some time and are now obvious.

The first of these is that a multiplicity of "national" financial centres is steadily giving way to a handful of international centres. National boundaries are becoming increasingly irrelevant as the horizons of banks, investors, issuers and intermediaries become global. This is leading financial market activity to concentrate in the hands of a limited number of global firms and (importantly for Hong Kong) a limited number of global financial centres. What happens over the next few years is likely to determine which cities are the winners in this global race.

The second obvious trend is that electronic markets and electronic proof of ownership are making physical markets obsolete. They are also one of the factors causing markets to transcend national boundaries. Stock or futures exchanges (especially if they get caught in a "national" time-warp) will find their markets eaten away from under them by border-hopping trading systems, whether operated by other exchanges or global securities houses or information vendors or via the Internet. This process will be accelerated if exchanges cling to outdated practices such as fixed commissions, or if governments cling to forms of taxation which inhibit international competitiveness, such as stamp duty on securities transactions. Cost and efficiency determine where the business flows to. The time zone factor no longer restricts the direction from which the competition comes, as banks and dealers operate on a 24-hour-a-day basis from a single centre.

A third trend is that financial services have become a vastly more complex, competitive and sophisticated business. Commercial bankers are finding their traditional lending role usurped by securities markets. The role of simply being a stockbroker is becoming obsolete; value has to be added in some additional way to justify charging commission. Retail investors are giving way to institutions (many of them managing the collectivised funds of individuals) who pursue more complex and sophisticated investment strategies. The range and complexity of financial products increases by the day - securitisation of a wide variety of assets or cash flows; multitudinous forms of swaps; futures and options on equity, fixed income and commodity markets; "structured products" and "synthetic" securities - a vast array of instruments designed for taking or managing risk in innumerable forms. Much of this technology emanates from the USA or (to a lesser extent) Europe. Only a small part originates in Asia.

A fourth trend is that governments the world over are opening and deregulating their financial markets to make their economies more efficient and their financial centres more competitive. The recent financial crisis has accelerated this trend in Asia. Thus, one of the factors which differentiated Hong Kong from other Asian markets in the past (its openness and relative freedom from red tape) no longer represents such a competitive advantage as it did before.

It might be thought that technology, globalisation and deregulation would make the whole concept of financial centres obsolete - that investors and traders would no longer need to come to markets any more, because computers can take markets to them. But this is not what is so far happening. In practice, financial firms are continuing to congregate in a diminishing number of centres.

Why should this be? I believe the most important reason is that practitioners and firms who provide "high-tech" financial products and services thrive best when surrounded by other professionals in the same and related lines of business, with plentiful supporting professional service providers such as lawyers, accountants and IT providers. Markets thrive on innovation; innovation occurs where there are a large number of creative and intelligent people with common

or inter-related skills interacting with each other under the pressure of competition. The life-blood of such a community is information. To the extent that networked computers can transmit more information faster from further afield, those who use it are able to stay in one place - the place they find most efficient, stimulating, congenial and cost-competitive. Thus, once a sufficient "critical mass" of financial market professionals has been created, it tends to increase in size due to its own gravitational force. But, if this process goes into reverse, a financial centre can disintegrate rapidly as the gravity of other centres tears pieces off it.

The increasing sophistication of financial products and services is contributing to this concentration of financial centres. Small firms are being driven to specialise and big firms to organise themselves along product, rather than geographic, lines. The product is generally managed from a global centre where the product expertise (including risk management capability) is concentrated. The financial centres which accumulate such product expertise become the hubs of the global market. Geographic units may still be needed by the product manager to help him reach his clients, but the product centre is the real "brain" of the business and, as communications improve, geographical outlets will tend to become leaner.

The product-driven focus of international securities firms is accentuated by the tendency of global investors to look at sectors or industries on a world-wide basis, rather than at geographical divisions of the market.

A key factor influencing the development of such global "hubs" is the supply available in the local labour market of individuals with the educational background, training and experience to contribute to the process of product development and management. Experienced and creative individuals may be routinely poached by one firm from another, but they tend to stay in a centre where they can remain at the forefront of financial market technology.

Another factor with a major effect historically on the evolution of financial centres is the size of the "home" market enjoyed by a particular centre. If demand in the domestic market is large and sophisticated, the

firms that meet that demand develop the skills and economies of scale to become highly competitive in international markets. This is one of the main reasons for the increasing domination of world markets by firms with a strong base in North America.

Moving to the world of stock and futures exchanges, there are certain other global trends which have been evident for several years but have gathered pace recently.

The first of these is that exchanges, which originated as "clubs" of brokers with rules designed to protect the interests of their members, are having to become businesses operating in a competitive environment, responding to the needs of their clients (investors and listed companies). There is an inherent conflict between the interests of the organisation as a business (to provide cost-competitive, innovative services) and the interests of many of its members (to preserve restrictive pricing or trading practices and to limit competition). This conflict lies at the heart of the recent strategic malaise of both the London Stock Exchange (LSE) and the London International Financial Futures Exchange (LIFFE). Exchanges with less of a historical incubus, such as the Deutsche Borse in Frankfurt, have found it easier to adopt a modern governance and management structure. This has enabled them to set and maintain competitive corporate strategies. The need to do this has led numerous exchanges in Europe (such as the French MATIF, the Amsterdam, Stockholm and Milan stock exchanges) and further afield (including Australia) to "demutualise" - i.e. to separate ownership and management of the exchange from trading rights.

Facilitated by this process is another trend, which has become apparent more recently, towards mergers between derivative exchanges and those which operate the cash market. Factors driving this trend include the need to offer integrated services to clients (including cross-margining facilities) and efficiency gains in clearing and settlement. Such mergers have been particularly prevalent in Europe - for example in the Netherlands, France, Germany, Sweden, Austria and Switzerland, all fairly recently. Malaysia has also just merged its stock and equity futures exchanges.

A third trend in stock and derivative exchange organisation is now emerging forcefully - cross-border consolidation of exchanges. This process had already started (inter alia) between Frankfurt and Paris, when it was dramatically accelerated by the recent link-up between the London and Frankfurt stock exchanges. Stockholm and Copenhagen had already agreed to merge before all this. Numerous "alliances" had also been formed between exchanges in Europe, with a view to expanding remote membership.

What were and are the implications of these various global trends for Hong Kong? What is it that we need to change in order to remain competitive as a financial centre?

First and foremost, we have to maintain and increase Hong Kong's "critical mass" of sophisticated professionals. Here the Asian financial crisis has hurt us. Hong Kong may have retained or improved its relative position within Asia but, in the global context, Asia has become a less important part of the world. There has been some consequent outflow of expatriate personnel, in fields where financial market activity has declined. But, generally speaking, such fields are those of the more "plain vanilla" variety (such as agency brokerage) which add less relative value. The most sophisticated product specialists are mostly still here and some new ones have arrived with the skills to take advantage of new kinds of opportunity - for example, corporate restructurings, mergers and acquisitions, and private equity investment.

A more serious concern is the fact that Hong Kong's cost base is still high by the standards of major international centres, even after the reductions in staff costs, property prices and rental rates which have occurred in the last 12 months. This matters *vis-à-vis* other Asian centres such as Singapore, particularly in the key area of fund management. It matters equally in relation to global centres such as London and New York, which now threaten (more than other Asian centres do) to grow at Hong Kong's expense in global activities such as putting together complex corporate finance transactions, packaging and floating debt and equity issues in the international markets, constructing and selling derivative products and trading international

bonds and other OTC securities. Relative costs are an important factor influencing the decisions of global financial institutions about where to locate different activities. Hong Kong may (at this stage) have few rivals as a centre for China-related business. But Hong Kong's value in this context, as well as its future weight as a financial centre generally, will be profoundly affected by the extent to which we achieve a position as one of the major "poles" of global market activities. Hong Kong's position in this context is far from assured. Cost competitiveness will influence the extent to which Hong Kong is used as a base for the "high-tech" activities of international banks, fund managers, information vendors, trading systems, securities houses, investment banks and others. This lies at the heart of the "critical mass" phenomenon.

Also essential to the establishment and maintenance of "critical mass" is the availability of relevantly skilled people in the local labour market. This is an area where Hong Kong is also skating on thin ice. Although a considerable number of Hong Kong people have in recent years acquired the skills and product knowledge to participate in sophisticated, global market activities, the main source of such practitioners is still the "Anglo Saxon" financial centres. To create a larger indigenous supply of individuals with the right educational background and training calls for a directed and sustained effort by Government, supported actively by the industry.

The constitutional and organisational structures of Hong Kong's financial market institutions, notably the Stock and Futures Exchanges, also look increasingly outdated and inappropriate in the global context (as I have argued publicly a number of times). The most urgent need is for a separation of ownership from trading rights, to prevent the vested interests of exchange members from obscuring or distorting the organisation's strategic vision and blocking or retarding the implementation of measures which would make the Hong Kong market more competitive and efficient. Constitutional change of this nature may be a necessary prelude to closer integration of the cash and derivative markets, the need for which is also likely to be ultimately inescapable. I am well aware of the controversy which reforms of this

nature may arouse. But our local brokerage community has also become more sophisticated in recent years and I believe there is now a wider recognition that change is necessary. Nevertheless a clear strategic vision and determined lead from Government is essential to bring about such reform. If we fail in this area, Hong Kong's exchanges will be seriously hampered in implementing strategies to help them emerge in a strong position from the inevitable consolidation of markets which will take place in Asia, as it is already doing in Europe.

In the regulatory area, Hong Kong retains the advantage of a relatively unburdensome regime which is still perceived as being reasonably effective. Nevertheless, there are weaknesses in our investor protection framework which have been evident for many years and which will matter increasingly as investors compare Hong Kong with more tightly regulated developed markets. One of the top priorities in this context (as I have also argued publicly on a number of occasions) is the introduction of more effective means of enforcing rules designed to protect minority shareholders against abuse by controllers or managements of listed companies; these would include basic statutory obligations for directors of listed companies and statutory penalties for serious breaches of Listing Rules or the Takeover Code. Our present systems for dealing with insider trading and company investigations are also out-moded and cumbersome. And our systems for dealing with cross-border and inter-market abuses, including new and more sophisticated forms of market manipulation, need to be strengthened (though this is part of a wider and necessary international effort).

These are only some of the areas in which I believe Hong Kong needs to become fitter if it is going to keep up in the global race. Most of the actions required lie within our own capabilities, though they call for considerable effort and commitment from the top to implement.

Hong Kong's success as a global centre in the long term will, however, be closely bound up with our success in becoming not just a "window on China and China's window on the world", but the main

international financial centre of a China which will be part of the world market. For reasons of history, Hong Kong is still an "offshore" financial market as far as the Mainland is concerned. The absence at this stage of full RMB convertibility limits the extent to which the Hong Kong market can intermediate between Mainland enterprises and international investors, or help to channel Mainland savings to productive use. The potential synergies between Hong Kong and the Mainland in the financial market area are vast, but at this stage they can only be exploited to a very limited extent. This is not to belittle the considerable achievements of Hong Kong and the Mainland, working together in this area over the past five years, including development of the "H" share market, and expansion of Hong Kong's Red Chip sector. Despite the fact that such counters have been caught severely in the Asian downturn, these foundations are still in place. But where do we go from here? What are the next steps which will allow the financial market skills accumulated in Hong Kong to play a larger role in restructuring the Mainland economy and simultaneously give Hong Kong what it still lacks - a real financial market hinterland?

I do not have ready-made answers to this question. These lie to a large extent in the hands of Mainland leaders. However, I would like to suggest certain directions in which some of the answers might be sought.

The first of these is the area of derivatives. As the management of Mainland enterprises becomes more sophisticated, they will seek more sophisticated ways to manage their financial risks. Some enterprises have already for years been making extensive use of derivative markets in the USA and elsewhere to protect against international risks. However, many of the risks faced by these enterprises, as well as by foreign investors in China, are of a domestic nature - RMB interest rate movements, for example. The present limited convertibility of the RMB should not be an insuperable obstacle to the creation in Hong Kong of instruments to hedge such risks. Expertise in this area is plentiful in Hong Kong, in addition to a regulatory framework with considerable experience in managing market risk. Over

time, demand for such instruments will grow. If a market does not develop within China, it will eventually do so elsewhere.

A more significant contribution to the development and efficiency of Mainland markets would be made if Hong Kong-based financial institutions could participate more extensively in Mainland securities markets - for example in the area of managing mutual funds, provident and pension schemes, life assurance and other forms of contractual savings. This would assist Mainland markets to establish an institutional investor base, thereby hastening their maturation and simultaneously providing a mechanism for directing savings to economically productive use. Similarly in the investment banking field - structuring and underwriting domestic issues of securities and providing advisory services on corporate financial transactions. The principle of foreign participation through joint ventures in this area has been established. Much of the expertise assembled in Hong Kong in these fields of activity resides in internationally-controlled firms. But the personnel are increasingly local. Surely it is better to import such expertise from Hong Kong than from elsewhere.

As partnership between Hong Kong and the Mainland develops in the financial market area, linkages between stock exchanges should also be extended. Although there is some rivalry between Hong Kong and Shanghai (which I will revert to later), each will have an eventual interest in selling the other's products. Both geography and complementarity of products should bring Shenzhen and Hong Kong closer. Hong Kong has the expertise in "high-tech" financial services, as well as the developed market infrastructure. Shenzhen has established access to the Mainland investor base. It may not at this stage be possible to link up these highly complementary elements, but the ground needs to be laid now for what is a natural future partnership.

I do not under-estimate the difficulties of attaching an established international financial centre to a still immature emerging market. We have seen some of these already in the Red Chip sector. But the learning process has been started and has already recorded some

successes. The only way to narrow the cultural gap is to increase steadily the intermixing of markets, while co-operating closely in the regulatory field to pre-empt or deal with market abuses. There is a risk that Hong Kong standards will get diluted in some sectors of the market. But it is a risk that must be taken in the interests of both Hong Kong and China as a whole. The Mainland market will also benefit from increased exposure to the standards demanded by international markets. Hong Kong itself had to work its way gradually up this learning curve. International investors may initially shy away from less established Mainland counters. But the potential rewards will eventually tempt them, as their level of comfort with the market gradually grows and the volume on offer increases. This may sound optimistic in the present depressed state of the market, but I believe it will look like a glimpse of the obvious in a few years' time.

While all this is happening, the global markets will not be standing still. Asia may not quickly acquire a common currency, in the way that Europe is doing, but the linkages between markets will nevertheless increase fast. Alliances will be formed between exchanges in Asia, and (perhaps more importantly) between Asian exchanges and their counterparts in Europe and North America, to sell each other's products or jointly develop new products. Hong Kong exchanges will need to be on their toes to identify and link with the most desirable strategic partners. These might include the operators of supra-national electronic trading systems. Volume and liquidity will be the name of the game. The extent to which Hong Kong is seen as having access (actual or potential) to the investor base on the Mainland will influence our leverage in this mating game. If our exchanges are run as businesses, without the historical incubus of membership-based governance structures, we will have a much greater capability to be proactive in anticipating market trends and taking the initiative, as opposed to adopting a reactive posture while exchanges in other financial centres make the strategic running.

The relationship of Hong Kong to Shanghai will be somewhat schizophrenic. On the one hand, there is a high level of

complementarity. Both centres will benefit from growth of China's securities industry. Shanghai is at present China's main domestic centre; Hong Kong its main international centre. But the barriers between domestic and international markets must eventually disappear. Shanghai has made no secret of its international ambitions. Hong Kong should not be squeamish about eventually seeking to play an important domestic role. That is a natural and necessary evolution, and will strengthen Hong Kong's position in the international race. There is nothing wrong with having two competing financial centres in a big market - witness New York and Chicago. The important thing is that they compete on the basis of their efficiency and the benefits they bring to market users, rather than in trying to exercise political influence to get the evolution of markets directed in their favour by the hand of government. Successful financial centres are those which are created by markets. The role of government should be confined to providing a sound and objective legal and regulatory framework.

But competition between Hong Kong and Shanghai is not the major issue in the context of the race between financial centres for position in the global market of the future. For Shanghai to create the critical mass which already exists in Hong Kong of international firms, practitioners, product knowledge and financial market activity would require many years, as well as significant cultural changes. The global race between financial centres did not start yesterday. It has already run several laps. Hong Kong has an established position - well behind New York and London, but ahead of most continental European markets in terms of the volume of international business transacted. Within Asia, we face determined competition from Singapore, which is now trying hard to make its regulatory regime more user-friendly and to take advantage subtly of concerns among investors and depositors about Hong Kong's political future. In the commercial banking field, Singapore is running Hong Kong close. In the faster-growing securities markets, Hong Kong still has considerably greater critical mass.

Tokyo's position is different and complex. Having missed the opportunity presented to it on a plate in the 1980s to become one of three dominant world financial centres, Tokyo has now belatedly embarked in earnest on a programme of de-bureaucratisation and market opening. Foreign banks, securities houses and fund managers are flooding in, bringing with them new ideas and financial products. But their main target is the domestic Japanese market, in particular the huge volume of household savings. The extent to which Tokyo is likely to become a base for managing business in China and South-east Asia appears limited - partly due to the cultural gap between Japan and the rest of Asia and partly to the high cost of operating from Tokyo. Thus, the Japanese horse has somehow veered off the track into a different direction.

That leaves Hong Kong as still the leading Asian horse in the global race. Being now part of China, and having shown that the transition has not undermined our market institutions or legal framework or the free flow of information, Hong Kong's position should be stronger than ever. We have a new and growing dimension to our market, which will eventually evolve into a true hinterland for the financial skills assembled in Hong Kong. The extent to which we are able to realise the benefits of this new position will depend on four things in particular: First, whether we can modernise our market institutions to make them competitively fit. Second, whether we can enhance our critical mass of financial market professionals by increasing their local supply and maintaining Hong Kong's attractiveness to highly qualified expatriates. Third, whether we can maintain our costs at a level comparable to those of competing global centres. And fourth, perhaps most important of all, whether we can mobilise the full support of China's leadership for the Hong Kong horse by allowing Hong Kong to take fuller advantage of its natural, expanded "home" market.

Postscript (August 2001)

Looking back over the three years since this was written, it is remarkable how much history can be compressed into such a short period. The evolution of China's domestic securities markets has been so rapid that it is already possible to envisage their acquiring a scale and self-sufficiency analogous in a manner to the USA. Such scale is derived mainly from the size of the pool of domestic savings, and China's improving ability to mobilise it, which make the importation of capital through the equity market decreasingly essential to China's growth. We can now clearly foresee a world in which China is the dominant securities market in Asia. Thus China as a whole will have won the "horse race".

But what will Hong Kong's role be within China? That is the issue facing policy-makers in Hong Kong today. They can determine the outcome to a limited extent by succeeding (or failing) to keep Hong Kong in the vanguard of international securities market development. But the crucial factor, which is outside their control, is the timing of the arrival of full RMB convertibility. When this happens, Hong Kong will become an integral part of China's market, able to play a full role in re-cycling the enormous pool of domestic savings - both within China and from China to the outside world.