Anthony Neoh

The Financial Markets of Hong Kong: Opportunities and Challenges of the Future

9

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Being new to the position of Chairman of the Securities and Futures Commission, I believe that probably the most useful thoughts that I can express, at this stage of my learning curve, are a few thoughts of the future. It was, after all, thoughts of the future that prompted me to accept this appointment.

When one speaks of the future, there must be some point in the past that we anchor upon as a landmark to compare both where and how far, we might go in the future. If I were to choose such a landmark, I would certainly choose the signing of the Sino-British Joint Declaration in 1985 and the market crash of 1987. The first event enabled hopes for the future to be built. The second, was a rude shock to Hong Kong's securities and futures markets and which resulted in many people losing a great deal of money, in some cases their life savings. But this event gave Hong Kong the impetus to build sound institutions for the future.

The Sino-British Joint Declaration created certainty, whereas until, 1985, there had been uncertainty. The Joint Declaration is, of course, important from a historical perspective but when one sees the great strides made in the reform of China's economy, and the continuing integration of Hong Kong's economy into that of China, there can be no doubt that the resumption of sovereignty by China over Hong Kong promises exciting possibilities for the future.

Let us look at the economic facts.

In 1993, the total value of visible trade between Hong Kong and China amounted to $740 billion. China is the largest market for, as well as the largest supplier of, Hong Kong's re-exports. Hong Kong has always been and will continue to be, an important gateway to China. In 1993, 23 million trips were made by Hong Kong residents to China. To this, should be added 1.9 million trips by foreigners. With the completion of the new airport, this traffic is expected to increase. Hong Kong accounts for two-thirds of all direct external investments in China. This is increasing with the establishment of investment funds both privately and through publicly listed vehicles. Fifteen Chinese State enterprises have so far listed in Hong Kong raising a total of $19 billion. Concurrently, China is investing heavily in Hong Kong and its banking links in Hong Kong are fast rivalling the largest international banking groups operating in Hong Kong. These statistics, coming nine years after the Joint Declaration, can only serve to prove the continuing economic inter-dependence between the Mainland and Hong Kong.

It will not be lost on those assembled here today that prices of Hong Kong securities are affected by the economic fundamentals both within Hong Kong's borders and within the borders of the Mainland. Some would no doubt feel that the winds of politics have also a part to play in this process. I would not venture to give investment advice to anyone nor do I feel that it is properly the role of a regulator to do so. However, as professionals in investment, you no doubt have a practiced eye to discern "truth from facts" and to judge the true emerging trends. I would suggest a few, from personal experience and from published sources.

In 10 years of teaching law and advising on new legislation in China, I have personally seen much encouraging change. When I started lecturing to Chinese lawyers at Shenzhen University in 1985, there were fewer than 10,000 lawyers in China. Today, the figure is now close to 100,000. Then, the first law school that resumed after the Cultural Revolution, Beijing University Law School, was about to graduate its third class of graduates. Now, every province has a law school, some with more than one. Then, China was beginning to send trainees abroad to study law. Today, law graduates return in droves to China. In every major city, you will find law firms with returned law graduates specialising in commercial legal work involving foreign parties. There is now a definite movement towards self-regulation of the legal profession.

When I first started to read Chinese law, there was only a "thin" ten-volume set of published legislation. Now Chinese legislation fills a shelf and to be manageable, needs to be stored in digital form. The computer database provided by the National People's Congress to the Securities and Futures Commission fills about 60 megabytes of space in a personal computer. It is updated quarterly, each time, in multiple disks.

In 1985, there were few legally qualified judges in the Chinese courts; now the preponderant number of judges in the Economic Chambers of Intermediate Courts (the level of court that deals with economic disputes of any significance and with foreign parties involving any amount) have university level legal qualifications, obtained in the past ten years. All judges are required to attend continuing legal education. International arbitrations in China have increased tenfold since 1985. The China International Economic and Trade Arbitration Centre (CIETAC) now has many well-known international arbitrators on its panel and since 1987, China has accorded to the Convention for Recognition and Enforcement of International Arbitrations Awards.

The International Monetary Fund, in a recently published occasional paper entitled "Economic Reform in China: A New Phase", produced a very handy summary of the structural reforms that have taken place or are about to take place. A thread that links all of these reforms is the acknowledgement for the need for greater transparency in Government. Rules and regulations, previously unpublished, have been rewritten and published, important examples of which, were foreign exchange rules, and foreign trade and tax regulations. Important infrastructural reforms have been the enactment of the Company Law, establishment of the central banking system, soon to be put on a statutory basis, the establishment of the China Securities Regulatory

Commission, the establishment of a National Tax Service which will collect revenue on the basis of a tax law (previously taxes were collected by local Governments who remit contracted amount to the Central Government), and steps taken in the privatisation of state-owned enterprises.

For someone who is supposed to speak for Hong Kong, I seem to be spending an inordinate amount of time on China. I have done this firstly, because the border that separates Hong Kong with the Mainland does not really exist in an economic sense. It has been suggested that Hong Kong is in a uniquely advantageous position of being a developed market in an emergent economy. Secondly, I do so to demonstrate that the legal and structural reforms in China are part of the institutional building which was a necessary part of the economic development that has taken place. As economic development continues, China will build more institutions. Thirdly, as you can see, China has not sought to "reinvent the wheel" with the institutions so far in place. Many of these institutions are already in place in developed economies. There is therefore a sound basis, as China builds its institutions into the 21st century, for common dialogue and understanding with the international community. Herein lies, in my view, the key to Hong Kong's success in the future.

The continuing acknowledgement on the part of China's leaders for the need to build lasting institutions is the best assurance that the institutions already enshrined in the Basic Law of Hong Kong will be respected. Hong Kong has stood, and will continue to stand, as a shining example as to how transparent legal and regulatory systems, consistently and fairly administered, can maintain a thriving economy.

As many of you know, the Basic Law ensures that the present legal and judicial system will continue into 1997 and beyond (except in the case of the right of final appeal, which in future will be reserved to the Special Administration Region (SAR), the present right of final appeal being to the Queen in Council). The SAR is given specific responsibility to ensure that Hong Kong continues to be an international financial centre:

Article 109 states that: *"The Government of the 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".*

Article 110 states that: *"The Government of the Hong Kong Special Administration Region shall, on its own, formulate monetary and financial policies, safeguard the free operation of financial business and financial markets, and regulate and supervise them in accordance with law".*

Article 112 states that: *"No foreign exchange control policies shall be applied in the Hong Kong Special Administrative Region. The Hong Kong dollar shall be freely convertible. Markets for foreign exchange, gold, securities, futures and the like shall continue. The Government of the Hong Kong Special Administrative Region shall safeguard the free flow of capital within, into and out of the Region."*

While the Basic Law preserves, and in some cases extends our present institutions, the reforms in the securities and the futures markets instituted from the aftermath of the 1987 market crash now form the building blocks of the future.

In 1989, the Securities and Futures Commission was formed by statute. I have the great privilege to have been appointed the third Chairman of this organisation. Hong Kong has much to owe to the first two Chairmen, Mr Robert Owen and Mr Robert Nottle.

In the past five years, we have seen the establishment of many important landmarks in our market institutions. To start with, the Stock Exchange was fundamentally re-structured with a professional staff and a Council made up of members of large, middle and small sizes of brokerage as well as lay members representative of market users and professionals. The rules for listing have been radically revised to enable Hong Kong to set on the one hand, a level of shareholder protection as well as a level of market conduct expected of an international market and on the other, to enable companies incorporated in other jurisdictions (principally Bermuda and the People's Republic of China) to list in Hong Kong and thus, use Hong Kong as a place for capital formation. In the secondary market, state-of-the-art clearing houses and risk management systems have been put in place in both the Stock and Futures Exchanges. The Hong Kong Stock Exchange has established an electronic order driven trading system which automatically matches orders of up to 200 board lots. This system has a capacity of up to 300,000 transactions a day. At the height of the market in January 1994, when the index was touching the 13,000 mark, the highest daily trading volume exceeded $17 billion with the system easily handling over 110,000 transactions a day. The risk management systems in place have enabled Hong Kong's markets to withstand the volatility seen in the last few months. New financial products, particularly, financial derivatives, have come onto the market. This year, the Futures Exchange will be launching stock futures and currency contracts and the Stock Exchange will be launching traded options. This is a market which is constantly changing, thus constantly testing the skills and resourcefulness of our intermediaries and regulators.

The pace of change is, as always, dictated by the economic conditions of the region and, of course, of the world at large. Financial markets operate without regard to frontiers and herein, perhaps, lies the ultimate challenge of the future. Let us now look at the regional position as regards the need for capital.

The Asian Development Bank has estimated that at Asia's current level of physical infrastructure and assuming the current rate of GDP growth of 5% per year, some US$130 billion will be required annually. By the year 2000, some US$1 trillion (in 1993 money terms or US$1.2 trillion in money of the day terms factoring in inflation) will be required. And this is only for physical infrastructure. Add to this the thirst for housing and for social spending in the region. Fixed investment in housing has been estimated in an advanced economy as the United

States as 3% to 4% of GDP. In faster growing economies, the rate is almost certainly going to be higher. There is thus easily another US$1.2 trillion by the year 2000 needed for housing. Add to this too, the thirst for social spending for countries with ebullient economies and high aspirations. All this could add up realistically to some US$3 trillion of capital which is waiting to be raised by the year 2000. In this area, China's Government has in fact only set modest goals: the Chinese Finance Minister, in a recent speech in Hong Kong, announced that China intended to tap the international capital markets for US$500 billion in the next decade. As China probably figures for one third of the need for capital in the region, I would venture to suggest that the Finance Minister, true to the teachings of the ancient philosophers, and thus, a paragon of caution and master of understatement, has come in, at 50% under the mark!

Add to this equation too, the rate of savings in the Asian economies. Gross domestic savings in Asia has averaged 23% of GDP, with the faster growing economies attaining over 30% (Singapore 42.5%, China 34.4% and Hong Kong 31%). This means that the thirst for capital can in good part be quenched domestically if there are systems of intermediation which can enjoy public confidence. The thirst for capital and the corresponding willingness to quench this thirst has resulted in the fast growth of the securities markets of the region. Equally, the very high volatility of the regional securities markets have pointed to problems of liquidity and confidence, and generally of the need for adequate market regulation.

Add also to this equation, the potentially liberating force of the General Agreement on Trade and Tariffs (GATT) and the accompanying General Agreement on Trade in Services (GATS). The general principles of Most Favoured Nation status to all contracting parties and the consequent falling away of trade barriers and the requirement for transparency in domestic laws and their administration will liberate emerging economies by making increasing demands on their Governments for transparency of their rules and regulations and consistency in their enforcement which will serve to enable both their constituents and their foreign partners to find greater confidence. I see China joining as a retrospective founding member of the WTO in the not too distant future. The application of the principles of the GATT and the GATS in China will act as a fillip to the transformation which we are already seeing there.

Coming to the local scene, the increasing sophistication of the financial markets will continue to test the skills of our intermediaries. There are now many choices in the market and these choices are increasing as the market develops. The need for timely information and good research is greater than ever before. It is therefore no coincidence that more investors are turning to fund managers. Since 1987, when the number of authorised funds stood at 504, there are now 978. In 1978, there were only 46 authorised funds. From some 30 approved fund management companies in 1987, these are now over 100, including subsidiaries and affiliates of many of the world's major financial institutions.

The increase in the number of fund management companies is recognition by some of the largest institutions of what Hong Kong has to offer in terms of its legal and regulatory system, its infrastructure, its workforce, its proximity to China, and the sheer volume of funds requiring management. Hong Kong's monetary and fiscal reserves amount to over HK$300 billion. On 1 July 1997, in addition to accretion to the present reserves, there will be added the entire SAR Land Fund which presently stands at HK$60 billion. It is estimated that the SAR Land Fund will stand at, at least HK$100 billion on 1 July 1997. Add to this the many public and private pension or provident funds requiring professional fund management. The implementation of the Occupational Retirement Schemes Ordinance will make professional fund management even more important. Compulsory private retirement schemes, if they do come, will add another important source of work for fund managers.

It is my duty as Chairman of the Securities and Futures Commission to facilitate the development of the local markets so that they play their full part in the process of investment. In the coming months I hope to speak to as wide a circle of people both in and out of the industry to see what policies I should recommend to the Commission. I hope you will give freely of your advice to me.