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Free Markets and Property Rights Infrastructure: *Lessons from Hong Kong*

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1. Introduction

I want to thank Dr Timothy Hau for his kind invitation to join this Opening Ceremony. I understand that this Summer Program is to allow students from the US and Asia to learn about the principles of free market economies and political concepts such as the rule of law and the separation of powers. What better place to study this in Hong Kong, the Mecca of free markets and consistently rated as one of the freest market economies in the world?

Before I begin, I have to preface my comments today as being totally personal and do not reflect the opinions of the Hong Kong Securities and Futures Commission. These comments reflect my own experience as a practical accountant, growing up in an emerging market, who subsequently worked as a central banker before moving on to work on financial market reforms in the World Bank and then coming to Hong Kong, where I saw for myself the virtues of the free market. I began to appreciate this even more when I became a market regulator deeply involved in the issues of corporate governance. Hence, what follows is a synthesis of how free markets helped to make Hong Kong successful and hopefully has some lessons for emerging market reforms.

Hong Kong's rise as a free market arose from the fact that in the 1950s, it was a small territory that had a lot of refugees with entrepreneurial skills and a British civil service that knew that it did not know enough about markets to pick winners. In 1971, Sir John Cowperthwaite as Financial Secretary coined the policy phrase "positive non-intervention". An example of his hands-off approach was his view that there is no need for statistics, because with statistics you will use them for planning. In the 1970s, Milton Friedman discovered the

[1] I am grateful to Ms Tan Gaik Looi for research assistance in the preparation of the paper, as well as Edmond Lee and Rosetta Chiu for graphics and secretariat assistance. Thanks should also go to Ms Wang Yuan and also my former colleague Professor Xiao Geng of the University of Hong Kong for discussions that led to many of the ideas in this paper.

entrepreneurial spirit of Hong Kong as it emerged as one of the four Asian Tigers and the legend of Hong Kong as the freest market economy in the world was born.

It is unquestionably true that Hong Kong has been successful because of its energy, as reflected by its entrepreneurial, pragmatic and resilient people, their free market orientation, a low and simple tax structure, a free media and the rule of law. Its strategic position at the centre of the fast growing East Asian region, with excellent rail, river, sea and air linkages to China and the rest of East Asia, with the best deep-water port facilities in South China and one of the best airports in the world, created conditions for an efficient entrepot and international financial centre. Having a stable currency linked to the US dollar, the US being Hong Kong's major trading partner and its currency being the dominant currency in global trading, also helped.

At the same time, as any careful observer would admit, Hong Kong has features that involve considerable government intervention. Just under half of the population live in public housing, the government carefully controls land supply and there are high concentrations in utilities, public transport and other sectors. At 52.8% of the budget spent on education, health and welfare, Hong Kong is more akin to a Scandinavian social welfare economy than its image.

My purpose this morning is to give you a tour d'horizon of the lessons of free markets in recent years. In 1989, the fall of the Berlin Wall signalled the failure of central planning. Thereafter, the dominant economic philosophy was the triumphalism of capitalism, globalization and free markets, culminating with the celebration of the technology bubble in 2000. As that bubble deflated, corporate scandals emerged, social inequity and the revival of anti-globalization feelings led to recent re-thinking of the meaning of free markets. As Nobel Laureate Joe Stiglitz put it succinctly, "while markets are at the centre of the success of our economy, markets do not always work well by themselves, why they do not solve all problems, and why government will always be an important partner to them[2]".

After 1997, the pain of deflation and adjustment after the Asian crisis surfaced in public debate over the size of the fiscal deficit and the need to reduce the size of government in Hong Kong. There was also considerable soul-searching on the general direction of the Hong Kong economy and whether the government should take a more active role in the economy in order to revive economic growth and create job employment. The old free market label of the 1980s was beginning to wear thin, as growth slowed and competition from Singapore, Shanghai and Shenzhen intensified. I have always felt that there is a need for a "Free Market II" philosophy to replace the clichéd "positive non-interventionism".

What are the real strengths of the free market and rule of law model?

[2] Joseph Stiglitz, "The Roaring Nineties: Seeds of Destruction", Penguin/Allen Lane, 2004

This lecture is one of a series of papers[3] by some of us in Hong Kong who feel that the free market model needs to be explained better, so that Hong Kong can become a living example of how China can move towards the market economy, without making the mistakes in other transitional economies, such as Russia.

Before I launch into this discourse, I want you to bear in mind three pieces of advice. The first is from Keynes, the second from Swedish Nobel Laureate Gunnar Myrdal, and the third is simply a reality check.

In his famous book, the General Theory, Keynes said, "The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist[4]." In other words, don't always believe dead economists, nor living ones.

Second, in his magnum opus, Asian Drama, Myrdal had this to say about economists: "Economic theorists, more than other social scientists, have long been disposed to arrive at general propositions and then postulate them as valid for every time, place and culture[5]." In other words, the conclusions of economic theories are only as good as their assumptions. If the assumptions are false, the conclusions are false.

Third, as economists we all need reality checks, because common sense is not common. There is a famous Chinese historical tale about how sophists argued before a weak Chinese emperor that a horse was a deer in order to please a powerful Minister. One must therefore check perception or theory against objective facts. In China, this is called "seek truth from facts" [實事求是]。

The beauty of the free market goes back to Adam Smith, where the entrepreneur "in such manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases led by an

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[3] See Reference. An earlier paper examined the development experiences in the Asian economies and will be published by Stanford University Press, (Sheng, 2003). In the same book, another chapter reviews China's need for a property rights infrastructure as a pre-condition for efficient capital market development and good corporate governance, drawing particularly on lessons from Hong Kong's experience. Another paper analysed the property rights disputes in China from the perspective of new institutional economics, emphasizing particularly the role of property rights infrastructure in resolving property rights disputes and commercial crimes (Sheng, Xiao and Wang 2005). An unpublished paper examines the historical reasons why China did not evolve its own property rights infrastructure (Sheng, Xiao and Wang 2004). An overview of the role of property rights infrastructure and the function of efficient markets was presented recently in Beijing (Sheng, 2004).

[4] John Maynard Keynes, "The General Theory of Employment, Interest and Money", Macmillan, 1942, pp 383

[5] Gunnar Myrdal, "Asian Drama: An Inquiry into the Poverty of Nations", Vol. 1, "The Beam in Our Eyes", Penguin, 1968, pg 17

invisible hand to promote an end which was no part of his intention[6]". In other words, capitalism is the belief that the combined individual acts of greed by market participants end up through the invisible hand of the market to create the greatest good for all.

This naïve version of capitalism and free markets was adopted for former Soviet economies when the Berlin Wall fell. As Milton Friedman himself admitted of the disaster: "What do these ex-communist states have to do in order to become market economies? And I used to say: "You can describe that in three words: privatise, privatise, privatise." But, I was wrong. That wasn't enough. The example of Russia shows that….It turns out that the rule of law is probably more basic than privatisation.[7]"

We are today witnessing the greatest march to markets the world has ever seen. China and India, nearly 40% of mankind and both former planned economies, are embracing market philosophy par excellence. So how does the rule of law and the market fit in?

2. The Truth about Markets

There is a wonderful book that must be required reading of all young economists. London Business School Professor John Kay's book, called "The Truth about Markets[8]", is basically an attack on market fundamentalism or what he calls the American Business Model that believes interference with the functioning of free markets is almost never justified[9]. Its real contribution is the insight that the embedded market is an institution of institutions, and economic institutions function only as part of a social, political and cultural context[10]. Indeed, his key insight on why some nations are rich, but most remain poor is the difference in the quality of governance.

In other words, success in economic development does not only befall countries richly endowed with natural resources, capital or even cheap labour. Success is the result of competition between institutions of governance – the higher the quality, the more prosperous. Hong Kong and Singapore are the two city economies with no natural resources, but amongst East Asian economies, they have been the fastest to reach OECD levels of per income growth. Those of you who have studied development economics would know that the word "governance" never appeared in its literature in the post-war era until roughly

[6] Adam Smith, "The Wealth of Nations", The Glasgow Edition of the works of Adam Smith, Oxford, 1976, pp 454

[7] See Milton Friedman, "The Hong Kong Experiment", Hoover Digest, 1998 No. 3 available on http://www.hooverdigest.org/983/friedman.html

[8] John Kay, " The Truth about Markets: why some nations are rich, but most remain poor", Penguin, 2004. see also http://www.TheTruthAboutMarkets.com

[9] op.cit. pp 8

[10] op.cit. pp19

the Asian crisis. This paralleled the emergence of management science, which was not known until the Second World War[11].

The economic development debate until recently was all about the need for capital, savings, balance of payments, planning and import-substitution or closed/open market strategies. For example, the intellectual basis of IMF analysis is the Polak two-gap model, in which balance sheets don't feature prominently and all economic ills can be traced to either a balance of payments [flow] gap or a fiscal gap. Entrepreneurship, legal and public institutions were all part of the assumptions of these growth models, based primarily on the classical theory of perfect competition, perfect information and comparative advantage[12]. Most of these development economic theories and models suffered from the missing assumptions problem highlighted by Myrdal – if there are few entrepreneurs, if the legal and commercial institutions that protect property rights do not work, then all these theories of economic development prove to be deficient. Which again proves Keynes' point that you should not always believe dead (or even living) economists.

Kay's insights are useful for an analysis of how the market works and also the role of government. Markets possess certain characteristics, which are, very briefly: -

- Information Asymmetry – market participants do not have equal information, and therefore incur different risks and transactions costs in searching, analysing and trading property rights
- Incentive Compatibility – markets work because they match market participants' incentive compatibility (supply and demand)
- Adaptive – markets are adaptive and have feedback – behaviour is influenced by incentives and enforcement of rules and laws
- Disciplined Pluralism – market economies succeed because disciplined pluralism is more innovative and more responsive to customers than centralized decision-making
- Spontaneous Order – no one designs the market: it evolves
- Path Dependent – where you go depends on where you start from (historical legacy and conditions)

Kay says that we cannot discuss economic systems in a vacuum, because it is a complex, interacting set of institutions that evolved over time – no single person created the market. Therefore, reforms are complex and changes in the system need to recognize that changes involve not only institutions, but covers

[11] Peter Drucker, "The Essential Drucker", Harper Business Books, 2001, said that "When Karl Marx was beginning work on Das Kapital in the 1850s, the phenomenon of management was unknown".
[12] For a survey of economic development theory, see Gerald M Meier and Dudley Seers, "Pioneers in Development", World Bank/Oxford University Press, 1984

structure, objectives, processes, standards, rules of the game, outcomes and individual behaviour. Hence, policy-makers who believe in simple, naïve and grand theories that bear little relation to the realities of ground conditions often come to grief. At the same time, people who beaver away at the detail without a sense of direction very often lose the way.

Consequently, understanding how successful markets work would give better insights on how the reform process can succeed or fail.

The Kay insight that markets are embedded in their social, cultural and institutional history is an important one. Markets cannot be created overnight and the best example is how difficult and long it has proven to develop a successful pan-Asian bond market, despite all the political goodwill and the fact that all the technology and skills exist within Asia to create this.

So what is the definition of a market? It can be defined as a system that delineates, transfers and protects property rights of its participants over the whole demographic cycle. Who are the participants? They are consumers, savers, investors, borrowers and governments (including regulators) and they interact with each other everyday through either the market or a centrally planned system.

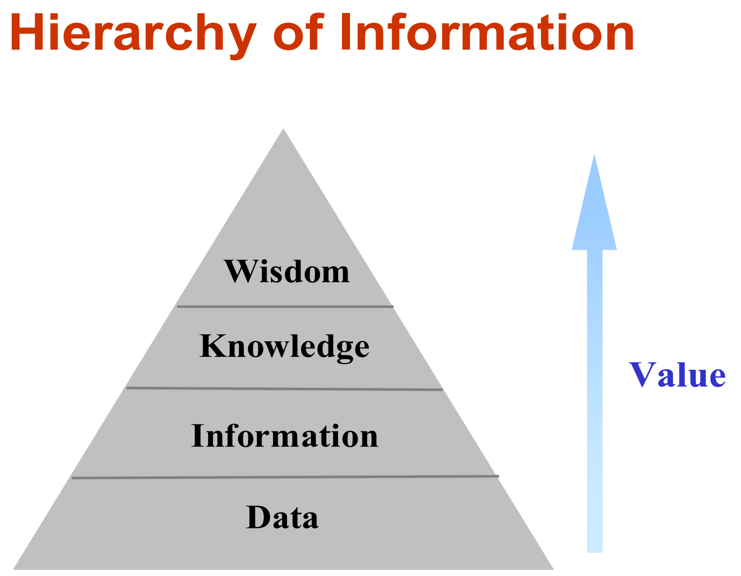
Why is the market more efficient than central planning? Because it resolves incentive incompatibility and has disciplined pluralism. In other words, it resolves conflict in exchange through matching supply and demand and through the exercise of individual choice, it localizes mistakes and does not concentrate mistakes in an arbitrary manner, which is the fatal flaw of central planning. In every market transaction, the participant (buyer or seller) makes a transaction decision and continuously adapt to situations where he or she feels cheated or disadvantaged. My first teacher in Hong Kong free market economics, Mr Joseph Yam of the Hong Kong Monetary Authority, pointed out that the market simply flows around any obstacles built by regulation or policy. The market is first and foremost pragmatic and therefore limits the damage because of loss-avoidance behaviour of market participants.

3. Information, Governance and Markets

Because a modern economic system is a complex of interacting institutions, it has a certain hierarchy or architecture. Indeed, technology has taught us that markets are networks, across which information and property rights flow. Indeed, information and language are the lifeblood of markets, because information and language define property rights. As information scientist Robert Lucky said, "information itself is best described in terms of *organisation*[13]" with a pyramidal hierarchy, escalating from low-value data to high-value wisdom

[13] See Robert W Lucky, "Silicon Dreams: Information, Man and Machine", St Martin's Press, 1991.

(Fig. 1). The higher the order of information that requires judgement, analysis and evaluation, the more valuable the information.



•Robert W Lucky, "Silicon Dreams: Information, Man and Machine", St Martin's Press, 1991.

As any MBA student will tell you, the key to a knowledge-based institution is the quality of its governance. And since the larger modern market participants comprise corporations, corporate governance plays a key role in the preservation, growth or destruction of corporate value. Corporations operate in the market under market rules and regulations that are determined and enforced by the state. And so corporate governance is also shaped by the quality of public sector governance. Consequently, from the micro-foundations of information and property rights, we come to the realization that social wealth or value has a governance structure or hierarchy that can be pretty complicated and sophisticated. Development economists of the classical school assumed away the role of institutions, taking them as a given. Only when the market went into a bubble because of corporate scandals did people begin to focus on the importance of corporate and social governance.

4. Markets and the Property Rights Infrastructure (PRI)

In recent years, the emergence of information technology and computers have led to a better understanding of how systems or institutions function. Any IT system comprises its hardware of computers and software of operating systems. For example, a highway network comprises a set of traffic rules, standards of operation and the hardware infrastructure of the physical highways, bridges and intersections. The traffic rules, standards of operations and their enforcement can be described as the software infrastructure. In other words, whether the highway network functions efficiently or not is not just dependent on how well the hardware infrastructure is built (e.g. no potholes), but also how well we enforce the traffic rules, the quality of street lighting and traffic signs and overall traffic management to prevent accidents and bottlenecks.

Similarly, traditional development economics policymaking has concentrated on the need for tangible or hardware investments through building roads, bridges, utilities and the like. Basic hardware has its architecture of mainframe, servers, networks and communication nodes. But as most IT experts will know, the hardware is only as good as the software, and even the software has an architecture of operating system driving modules of sub-system software that must be compatible or interoperate with each other seamlessly. Failures in compatibility, low fault-tolerance and weaknesses in both software and hardware designs and operations will cause low system efficiency. The same analogy applies to market systems, because markets function depending on very important software, which I call the property rights infrastructure (PRI).

Most free market economists assume that the PRI works as in mature or developed markets, forgetting that not only does it not work well in many emerging markets, part of the PRI may not exist at all, causing incomplete markets and market failure. This fatal flaw in analysis has resulted in many policy-makers completely ignoring or under-estimating the difficulties and complexities of reforming or building the intangible PRI, because acquiring tangible fixed assets provides so much more visible icons of development. In other words, markets cannot function because PRI is weak. Why is the PRI weak? Because the incentives in the present governance structure do not push for stronger and more efficient PRI. Let me explain.

Using the IT analogy again, we can describe how financial systems define, exchange, and enforce property rights:

- First, a financial system comprises a set of *hardware* (networks of computers and other platforms) across which *participants* transact and exchange financial products (e.g. property rights), according to a set of agreed standards and rules of the game (i.e. *software*).

- Secondly, these financial products are transacted and then settled and cleared through various *processes* (such as trading software and clearing, payment and settlement software), which used to be paper-based but are now increasingly digital.

- Third, global markets are a network of local market networks. The robustness and efficiency of global markets would depend on the robustness and efficiency of the weakest links in these local networks. In other words, financial systems are subject to local shocks and contagion, which could spread risks across the global networks.

- Fourth, increasingly, the *standards* and *rules relating to operations in financial systems* are being globalized and formalized given the competitive pressures on each local market. These include accounting, legal, operational and regulatory standards, such as International Accounting Standards, IOSCO Principles, and Basle Capital Accord Requirements etc. Such standards allow comparability which reinforce accountability.

- Fifth, property rights are described by information and language. Hence, disclosure and transparency is crucial in making good decisions and ensuring accountability [and hence right incentives] in market systems.

The essential elements of a modern PRI include the following institutions grouped by three broad categories:

1. Institutions for delineation of property rights:

   - Central Registry of property rights [e.g. land registry, share registry] to officially record property rights. This is crucial for transparency of property rights and in reducing the costs of enforcement.
   - Accounting and legal process to define and verify the property rights [annual audits and right to sue to protect property right].

2. Institutions for exchange of property rights:

   - Trading process [such as stock exchange trading platform to enable transparent trading of property rights, and public auctions].
   - Clearing, settlement and payment infrastructure [clearing house and payments system operated by the banking system to enable transfers to be cleared and settled in final form through the delivery of property rights].
   - Regulated intermediaries [intermediaries who help the transfer process should be sanctioned if they do not perform according to the rules of the game].

3. Institutions for enforcement and fine-tuning of property rights:

   - Rules of the Game: norms, standards, codes, regulations, and law that help protect the property rights of participants against abuses of the system.

- Enforcement infrastructure: there must exist regulators to enforce the rules but enforcement costs should not exceed benefits to markets.
- Robust media and disclosure regime to ensure that property rights can be independently verified and players are accountable [e.g. disclosure rules and mandatory publication of financial statements, as well as financial/economic news services].
- Independent and transparent judiciary to adjudicate disputes over property rights.

5. How PRI Works to Allow Markets to Function Efficiently

Peruvian economist Hernando de Soto[14] has questioned why capitalism works well in the West but failed everywhere else. His answer is that the basic market functions do not work well in emerging markets because poor people do not have land or collateral rights that are well protected by the legal system. Information is difficult to access and the poor are over-taxed and impeded from entering markets because of monopolies, rent-seeking and excessive regulations. In other words, the PRI does not function well in many developing or emerging markets.

Most development economists intuitively assume that there is a natural progression from primary industries (agriculture, natural resources and mining) to secondary industries (manufacturing) and finally to tertiary industries (services, including financial services). This model of linear or sequential progression pervades Asian policy-makers who have tried to move out of agriculture into manufacturing by using cheap surplus labour to push for exports. This export-led manufacturing flying geese model in Asia, based on the success of Japan, has one serious weakness. The tendency to protect the services sector has led to under-developed financial systems that are still bank-dominated.

The Latin American experience shows that weaknesses in the PRI give rise to a system that is not transparent, not accountable, not fungible, with no network benefits, high transaction costs and low market liquidity. Ultimately, the poor are disadvantaged because the costs of entry into business are overwhelmingly high for small enterprises and poor people, while large enterprises can engage in regulatory capture to protect their vested interests against competition. When the PRI is defective, transactions costs are high due to high risks or rent-seeking activities.

Even the World Bank has now recognized that helping the poor to help themselves through the market requires an improvement in the investment climate, which goes beyond reducing business costs. The World Development

[14] De Soto, Hernando (2000), "The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else", New York: Basic Books.

Report 2005 admits that the gap between policies and their implementation can be huge, so that "governments need to tackle corruption and other forms of rent-seeking, to build credibility with firms, to foster public trust and legitimacy, and to ensure their policy interventions are crafted to fit local conditions[15]."

6. Lessons from Hong Kong

Let us now use Hong Kong's experience to examine how a functioning PRI ensures that markets function well with high transparency, liquidity and low transaction costs.

Hong Kong has a complete PRI arising from its history. As a free port, property rights were initially defined through foreign trade and exchange. Goods can be traded and exchanged more efficiently through hard currencies and a mutually accepted set of rules of trade and exchange. Primitive bartering systems are inefficient because of lack of transparency, standards and high transactions costs. The common law jurisdiction under which Hong Kong operated in came with a complete set of property rights infrastructure: land and stock registers, warehouse registers, accounting, commercial and financial law, courts, various specialized tribunals, arbitration centres, free media, stock exchanges, and commercial and financial intermediation services. All of these institutions operate together in an integrated system to transfer and protect property rights in Hong Kong. Property rights in Hong Kong can be transacted with great legal certainty, transparency and accountability and ultimately low transaction costs. Three examples suffice to demonstrate Hong Kong's PRI.

<u>Firstly, information and transparency</u>: Ready access to high quality market information is a market fundamental. Such information is readily accessible in Hong Kong because it has 24,000 qualified accountants, preparing and auditing according to international accounting standards[16]. Corporate disclosure standards are already at international levels, with a free media to comment on the quality of such information. In addition, any investor or consumer can readily access public registers on property and share ownership to verify for himself or herself such information. If information is false or misleading, there are listing rules and securities laws to punish offenders. The integrity of information is checked both by the banking system as lenders, the tax authorities who depend on audited accounts and a media that questions the information.

In some emerging markets, it is common knowledge that auditors have to start work by asking for different sets of books: one for the tax authorities, one for the bank, one for the partners and one for the person running the business. How

[15] James D Wolfenson, Foreword, "World Development Report 2005" World Bank/Oxford University Press, 2005.

[16] If China and India had the same accountant to population ratio as Hong Kong, they would need to train another 7.5 million qualified accountants. See Andrew Sheng, "The View from Hong Kong: Managing the Cultural Divide", The Institute of Chartered Accountant of Scotland, October 2004.

can auditors even begin to certify accounts when they cannot even rely on banks to provide them with independent and accurate bank statements?

Secondly, property and entity registries: In Hong Kong, any prospective buyer can check the legality of the title to an asset, such as real estate, through ready access to the public land registry, which would give official information on the exact features of the real estate, whether there is clear title or whether there are liens and caveats on title. For example, World Bank investment climate indicators suggest that it takes 11 days in Hong Kong to register a business, compared with 198 days in Laos (average for East Asia & Pacific being 72.9 days). It takes 56 days to register property in Hong Kong versus 956 days in Croatia (average for East Asia & Pacific being 59.4 days) [17].

These public registries do not work well in many emerging markets, because title deeds are paper-based, processes are obsolete and there could be forgery or liens or caveats that are not registered. Hernando de Soto gives examples on how such title registries are corrupt or inconvenient for access by poor rural farmers or entrepreneurs. Squatter areas exist because there is no legal title to assets, so that the poor or small entrepreneurs cannot access bank credit. Informal markets are inefficient because they are opaque and can result in exploitative behaviour. In other words, the poor have dead assets that prevent them from raising finance.

Thirdly, functioning judiciary and rule of law: In Hong Kong, having a tested and tried common law system that is broadly understood and trusted in major markets is a huge advantage. Not only are disputes in property rights transparently adjudicated by the independent courts, there also exist considerable administrative law and independent tribunals to deal with administrative complaints or disputes against the bureaucracy or statutory bodies. All legal disputes are adjudicated in a transparent manner, since judgements are public information and must be based on legal precedent and principles that could be challenged in higher courts.

The effective functioning of courts to protect property is important for market efficiency. As markets become more complex with technology and innovation, the law and the judicial system must be able to cope with such change. For example, World Bank data shows that it takes 211 days in Hong Kong to enforce a contract, compared with 1459 days in Guatemala (average of 373.8 days for East Asia & Pacific) and 1.1 years in Hong Kong to resolve insolvency, compared with 10 years in India and an average of 4.2 years in East Asia & Pacific. Justice delayed is also justice denied.

I use the three examples above not to show that Hong Kong is perfect, but to illustrate that the PRI in Hong Kong is a pretty sophisticated system that works

[17] World Development Report 2005, pg 248. Comparatives are shown using the longest time taken.

well together to protect and transact property rights. Even though services, such as law, accounting and finance, are not cheap, the high level of transparency, liquidity and certainty of property rights results in low marginal transactions cost. Hong Kong is proud, for example, of its Independent Commission against Corruption, which has kept an effective check against corrupt activities at bay. The World Development Report 2005[18] showed that for a sample survey of 53 emerging markets, as high as 84.5% of companies surveyed in Albania reported bribes are paid and the highest average bribe paid for Algeria was as high as 8.6% of sales. In Zambia, 79.7% of firms reported loss from crime and the average loss from crime in Armenia was as high as 14.1% of sales.

7. How does PRI help in Market Reforms?

I have so far illustrated the importance of the PRI for an effective functioning market. One critique of the PRI concept is that it is tautological and obvious. Of course we need a good PRI, but what is the policy sequencing and what concrete proposals should be done to build an effective PRI?

Even though I am trained as an economist, I am critical of the fact that classical development economists are so engrossed in the elegance of their market models that they forget the obvious, which is that markets are social institutions that are adaptive, path-dependent, inter-active and therefore messy. It is so much easier, conceptually to talk about sweeping capital-output models, trade, fiscal and monetary policies than to deal with the difficult question why policies cannot be implemented because of ineffective bureaucracies, market vested interests, crime and corruption. But these political economy questions cannot be avoided because they are central to reforming the market and delivering prosperity, stability and growth to the citizens.

I must confess that I did not arrive at this level of understanding of markets until I became a securities regulator because I had to deal with the tough issue of conduct regulation. The securities regulator's job is to enforce the law and to change market behaviour in such a way as to minimize damage to investors. We have to deal with market misconduct, corporate governance and financial crimes. This brings us to the realization that institutional behaviour is all about three disciplines: self-discipline, regulatory discipline and market discipline. Asian policy makers have focused largely on the first two and not enough on the third.

What the Kay insights brought into focus are that markets comprise competing and cooperating institutions that are checks and balances against each other. For example, a well-functioning financial sector should reward good firms by reducing their cost of capital. Conversely, it should impose appropriately high costs of capital for bad firms either through credit rationing or risk provisioning.

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[18] World Development Report 2005 Table A1.

Through its lending and fund-raising function, the financial sector plays an important role in disciplining the corporate sector and hence is crucial to corporate governance performance. And the media checks that the banks and corporations are behaving properly.

It is when vested interests collude to unfairly treat the less-privileged, such as consumers, the poor, SMEs and the like from having access to fair and transparent markets, that the whole economy is prevented from moving towards greater efficiency, wealth and prosperity. Consequently, just as providing water, sewage and road facilities (hard infrastructure) can address poverty and provide opportunity, it must be just as important that governments pay attention to PRI (soft infrastructure) in making markets work better. In the real world, an array of sub-systems of supporting institutions have been integrated over time and eventually formed what is collectively called PRI. If parts of the subsets do not function properly, the whole may not be effective.

Consequently, the right sequencing of reforms in PRI reform is to detect which parts of the PRI are defective. Harvard Professor Malcolm Sparrow, who wrote the book on the Regulatory Craft, has the right dictum in prioritising: "Pick Important Problems, Fix Them and Tell Everyone[19]." Increasingly, the reform of the bureaucracy, which the Clinton Administration called "Re-inventing Government", involved growing awareness that bureaucracy, obsolete laws, rules and processes stand in the way of competition, innovation and efficiency. Hence, there is always need for public sector agencies and bodies to focus on their objectives and outcomes, getting them to ensure that the regulatory benefits always outweigh the regulatory costs of government intervention. Equally important is that the policies do not create unintended consequences.

For example, there is now awareness that corruption, excessive bureaucracy and crime are not just inconvenient symptoms of weak administration, but are often the root causes why there is no growth or at least despite growth, there is huge rent seeking and inequities. Consequently, special task forces to study the root institutional reasons for such bad behaviour would yield much greater insight into how to reform the system, rather than purely discussing macro-economic policies and issues. In other words, the missing assumptions are the problem, not the body of economic theory.

There is a growing literature on the close interaction between the legal and economic aspects of the integrated modern market system as reviewed in Lars Werin (2003). Indeed, it is not just law and economics that are coming together. Management science, information theory and decision-making, sociology and the regulatory craft are all being used to try and understand how institutions can and should be changed for greater efficiency and accountability. What is happening

[19] Malcolm Sparrow, "The Regulatory Craft: controlling risks, solving problems, and managing compliance", The Brookings Institution Press, 2000.

is that in trying to make economics a science, the art of political governance has been lost. After all, government was a specific subject taught even by Greek and Chinese philosophers until Western ethics felt that Machiavelli was too devilish and immoral in expounding political governance techniques.

Since PRI is a public good that requires great political will and resources, including time to establish, it competes with the easier and more visible [and perhaps politically more palatable] public action such as building more physical hardware, or giving more tax incentives and subsidies. The investments in physical infrastructure or grand macro-economic policies have greater headline impact than the tough issues of dealing with PRI structural problems of bureaucratic weaknesses, slow courts and fighting crime and corruption that often tend to be protracted and circuitous but do not easily yield positive outcomes. In other words, which do you prefer – a wonderful modern court house or a court in an old building that delivers justice?

But in getting the market economy functioning well, the government has a responsibility in building a well-functioning PRI as soon as possible. Its role in the process of establishing PRI can be summarized as follows:

- Setting standards, rules, and legislations for a well functioning PRI;
- Defending property rights of citizens against non-citizens [national defence and foreign affairs functions];
- Enforce and protect private property rights by resolving disputes between citizens and citizens [adjudication and anti-crime functions];
- Creating mechanisms to constrain abuses of state power and resolve property rights disputes between citizens and the state [anti-corruption and human rights protection function].

Expressed in Coasian institutional economics, the role of government in a market economy is to reduce the total costs, including transaction costs and regulatory costs, of exchanging and protecting property rights. If property rights are subject to huge costs of exchange and protection, such as excessive taxation, corruption, risks of confiscation, theft, and erosion through inflation, then capital flight and prevalence of mafia are likely to occur.

8. Concluding Thoughts

I have perhaps taken a long and winding road to explain what free market economists assumed as obvious. But, what I have tried to demonstrate today is that what is obvious is not that obvious. Indeed, it is too easy to take a well-functioning PRI for granted. Many former British colonies, which inherited strong PRIs, allowed them to deteriorate after independence and paid the price in terms of growth and development. This is not to say that the common law tradition is the best in the world and that we cannot improve on these systems.

But the realization that common law evolved through over 1,000 years of case law is the best empirical evidence that the laws, principles and structures have been well tested by time. The legal and regulatory structures that evolved with transparency, due process and accountability to the public are there for good reason. This "learning by doing" pragmatic approach in common law structures are very much in the present Chinese pragmatic approach towards reform called "crossing the river by feeling the stones".

Free markets do not mean "do-nothingism". As I have tried to clarify, markets and governments should be in partnership, without one dominating the other. The old Asian model of government-led growth was perhaps useful when the private sector was weak and less sophisticated. In today's complex world, markets are so complicated that it would be impossible for a few elite policymakers, however brilliant, to anticipate which way the market will lead, especially globally, nor deal with all problems, large and small. Modern markets will naturally involve the corporate sector, the public sector and also civil society, such as non-governmental organizations.

Hence, the recommendation that policymakers should focus on better PRI instead of grand public sector initiatives in "leading industries" imply that policy-makers cannot by definition outwit the market. Focusing on the PRI means that the public should facilitate the market to grow by concentrating less on hard infrastructure, but more on improving the soft infrastructure. No one disputes that the government should spend more on education, health and welfare, but improving the delivery systems of government services, maintaining level playing fields, tackling the areas of corruption, obsolete rules, promoting competition – these are already big enough jobs for the public sector than trying to pick winning industries.

In this sense, I think the public sector should be like the gardener for the market garden – one must get the drainage right, put in the right fertilizers and prune away dead and rotting leaves and branches. Creating an environment where the garden can adapt in this complex world of intensive competition, through disciplined pluralism of different voices within a transparent and fair legal system, is already a huge job. In thinking about the rule of law within the Chinese context, I am reminded of the Legalist School, which preached the same principles of equality before the law 2000 years ago. Han Fei Tzu, whom I admire as one of the first Chinese philosophers to address more objectively the subject of political governance had this to say on law and national competition: "No state is forever strong or forever weak. If those who uphold the law are strong, the state will be strong. If those who uphold the law are weak, the state will be weak[20]." [國無常強， 無常弱。 奉法者強， 則國強。奉法者弱，則國弱。]

[20] Han Fei Tzu, "Basic Writings – On Having Standards," translated by Burton Watson, Columbia University Press, New York, 1964

An interesting feature of history is that Chinese civilization evolved for more than five thousand years without embracing the market as a concept or officially acknowledging its existence. There is no doubt the market functioned throughout history in China and local magistrates administered local markets but the central government relied more on administrative measures rather than market forces to guide the economy. All this made the Chinese bureaucracy historically more dominant than the market.[21] Deng Xiaoping was the first Chinese leader to use the market to promote economic development. After a quarter century of reforms, China has reached the stage of economic development where the macroeconomic conditions provide a favourable opportunity for the next stage of reform: construction of a robust PRI to allow more efficient and orderly exchange and protection of property rights.

Since Hong Kong is already an international financial centre with a PRI that is both competitive and transparent by world standards, Hong Kong can bring in a wealth of market experience in building the PRI to facilitate the Mainland's transition to a fully competitive market economy that operates on global standards.

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[21] It is an irony of history that reforms in the British civil service were modelled in the 1850s on the Chinese mandarin bureaucracy.