

## University of Hong Kong

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### The Future of Hong Kong as an International Financial Centre, Post-Crisis

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#### 1. *Introduction*

I want to thank Deputy Vice Chancellor Professor Richard Wong and the University of Hong Kong for the honour of giving this lecture, my first public lecture in Hong Kong since I stepped down as Chairman of the Hong Kong Securities and Futures Commission in September 2005. Thanks should also go to Mrs Teresa Tong, Chair Person of the Hong Kong University Convocation Standing Committee who suggested that I come back to the University to give my views on the Role of Hong Kong as an International Financial Centre, Post-Crisis.

I owe all my friends in Hong Kong an apology, because I have been away a long time, working in Mainland China and Malaysia, completing a book that I thought should have taken me not more than a year, but it took four. The purpose of my book was to review the Asian Financial Crisis of 1997/98, so that I could understand for myself what are the key lessons that Asians should draw from that crisis. After all, most of the authoritative books written on the Asian crisis were penned by non-Asians. Today, the same authors and critics are trying to explain why the subprime crisis happened and who is to blame for not stopping it. *Deja vu*.

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<sup>1</sup> The views expressed in this paper are solely those of the author and not those of the China Banking Regulatory Commission or any institution that the author is associated with.

My premise for writing the book was very simple – there was no way that Asia could advance to the ranks of the developed region of the world without a strong financial system. So, this book, *From Asian to Global Financial Crisis*, was an explanation to myself whether there were deeper issues that Asia needs to address before we can achieve that goal. As I delved into the research into each country case, I began to notice a broad pattern – that individual crises were not isolated but highly inter-connected, inter-dependent and interactive. It became clear that the East Asian crisis of 1997/98 should not be just confined to just four countries, Thailand, Indonesia, Malaysia and South Korea, but were part and parcel of the Japanese crisis that began with the bursting of the asset bubbles of 1989. Indeed, the origins of the Japanese crisis can be traced back to the Plaza Accord of 1985, when Japan agreed to revalue the Yen to help address the US current account deficit, setting off a chain reaction that affected not just Asia, but also the United States.

A historical pattern began to emerge. It was as if a financial tsunami was moving back and forth across the Pacific every decade – in the 1980s it was the sovereign debt crisis in Latin America, in the 1990s it swept back to Asia with overleveraged corporate sector and in the first decade of the 21<sup>st</sup> century, it returned to North America, with overleveraged household and financial sectors. One wonders whether after the deflation of the current bubbles in the West, will there be another bubble in the East?

The story I shall tell this evening therefore is the part that Hong Kong has played in the ecology of global financial markets and to make conjectures about what Hong Kong should or could do in the future post-crisis. To do this would require a dissection of the nature of the current crisis, the past crisis and perhaps the nature of financial markets itself. Hence, this evening I shall not be talking as a financial regulator, but as an academic trying to think strategically what role Hong Kong can play in Asia and the global stage to make financial markets function safely and soundly for the communal good. I shall be drawing upon

history and disciplines other than economics to explain this crisis and examine how competitors are looking at Hong Kong.

Finally, I shall present my own personal views on Hong Kong can play an important role and vital role in assisting the Mainland of China to transform into a modern economy that will become one of the most important global players in the 21<sup>st</sup> century. I wish to stress that any views and opinions expressed are solely my own and not of any institution that I am associated with, past or present.

## ***2. The Nature of Financial Markets and Financial Centres***

From my work experience in Hong Kong in the HKMA and then SFC, I became acutely aware that financial markets are networks, linked through the payment system. Financial systems are networks of banking, securities, insurance and fund management, but they in turn, are also networked with the real sector of consumers, corporations and the government. Financial systems handle money and the savings of the public, which are the lifeblood of the economy. Just as the central bank is the heart of the banking system, a financial centre is the heart of the real economy. When the financial centre, the hub of the financial network, fails, like Lehmans, the whole system suffers a heart attack.

I use a medical analogy because the issues of handling financial crises are like those for handling the SARS epidemic in Hong Kong in 2003. The reason why the best and brightest in the West did not see the current crisis coming (just as we did not see the Asian crisis coming 12 years ago) is because we were looking at financial systems as doctors looking at individual patients. The orthodoxy made the assumption that if individual financial institutions were healthy, then the whole financial system should be healthy and stable. That was exactly the problem of the IMF methodology in 1996 when it looked at individual

countries. No one was looking at the system as a whole and the interconnections and interactions between the different economies.

But the mutation of the SARS virus caused death for even healthy people and spread through contagion. So we had to look at the problem system-wide as public health specialists, tracing where the virus evolved and how it spread, before we could deal with it through diagnosis, prognosis, isolation and also long-term public health and education measures. With hindsight, we now know that treating SARS with steroids may have had short-term effects, but created long-term problems due to the fact that the immunity defences of the patients were down.

Perhaps financial regulation should deal with contagion in the same way as Chinese medicine, by strengthening the immunity system, combined with sound public health measures and instant isolation and segregation. Prevention is always better than the cure, but that was not what recent central bankers believed. Alan Greenspan believed that if you could not identify bubbles, central banks had the tools to limit the damage. Some damage.

Some of you will have noticed that I am not sounding like a regulator or economist, but more like an ecologist. This crisis has demonstrated above all that the problems we face today are systemic, inter-linked, inter-dependent and inter-active. To understand both the current financial crisis and the Asian crisis properly, one must see this multi-dimensionally from the perspective of history and from the macro and micro-dimensions. Both crises were in fact network crises, in the sense that financial markets were networked together and transmitted shocks across the network in complex manners that we have not fully understood.

For example, the Asian crisis was a crisis of the Asian Global Supply Chain, which is the manufacturing and distribution network built by the Japanese in the

1960s, expanding first to the Four Dragon economies of South Korea, Taiwan, Hong Kong and Singapore, and then to the Four Tigers, Thailand, Indonesia, Malaysia and Philippines, with lately China emerging as the core of that Supply Chain. The Asian Global Supply Chain had two major markets, the developed markets of North America followed by Europe.

For a variety of historical reasons, each of the East Asian financial systems were better linked to the international financial centres of London and New York than with each other. In this regard, Hong Kong, with her heritage of common law, excellent sea, air and telecommunications infrastructure, low taxes and a free port for trade and human talent, evolved historically to become a leading international financial centre, because geographically, she was perfectly placed in the heart of the fastest growing and exporting region in the world.

In network terminology, Hong Kong became the best hub in the Asian network economy, because she had the information, communications and payments network that were most convenient to users. It was not just the hardware of ports, airports and institutions, but also the software that comes from the entrepreneurial spirit of her people, a free press, backed up by an efficient government and her common law judiciary.

In reflection, Hong Kong's rise as a free market arose from the fact that she was a people network of trade, essentially with the Mainland, but also with the overseas Chinese and the rest of the world. In the 1970s, Milton Friedman discovered the entrepreneurial spirit of Hong Kong and the legend of Hong Kong as the freest market economy in the world was born.

After unsuccessfully experimenting with a floating rate, the peg to the US dollar in 1983 gave Hong Kong the monetary stability to become a major financial centre because the US was not only the major trading partner of East Asia, but also the dominant currency in global trading. Following the Plaza Accord in 1985,

the Japanese yen strengthened. The Japanese exported capital in large scale to establish production capacity overseas and to prevent the Yen over-appreciating. Japanese banks established branches in Hong Kong to finance Japanese trade and investment throughout East Asia. As international banks and fund managers clustered in Hong Kong to intermediate the capital flows, attracted also by the rise of China in the 1980s, Hong Kong became a true international financial centre.

In my last lecture at this University in July 2005, entitled “Free Markets and Property Rights Infrastructure: Lessons from Hong Kong”, I identified three fundamental conditions for the success of any international financial centres: the protection of property rights; low transaction costs and high transparency. Financial markets have four major functions – resource allocation, price discovery, risk management and corporate governance. The protection of the property rights of investors requires sound monetary policy, low inflation, vigilant financial regulation and free and transparent laws and courts to arbitrate property right disputes.

The real secret to Hong Kong as an international financial centre is that she possesses a property rights infrastructure (PRI) second to none in Asia. Over the years, Hong Kong has built up a modern PRI that has three categories of institutions to delineate, exchange and protect property rights. The institutions for delineation of property rights include transparent and secure central registries of property rights, such as the land registry and share registry to officially record property rights. Hong Kong has the highest concentration of international lawyers and accountants in Asia to define and verify the property rights via annual audits and right to sue to protect property rights.

Secondly, the institutions for exchange of property rights include the stock and futures exchange, the foreign exchange markets, the clearing houses and regulated financial intermediaries that conduct financial business under well defined and accepted rules.

Thirdly, Hong Kong has excellent institutions for enforcement and fine-tuning of property rights through the usage of international standards of regulation and rules. She also has a robust and free press, as well as disclosure regime to ensure that property rights can be independently verified and players are accountable. Mostly importantly, she has an independent and transparent judiciary to adjudicate disputes over property rights.

Because of low taxation, a free port status, high trading volume and ease of doing business, Hong Kong has very low marginal transaction costs. Finally, with a free media and strong disclosure regime, investors have high transparency to look after their own interests and make quick decisions.

The reason I have spent some time to explain the nature of financial markets and the functions of an international financial centre is because these financial infrastructure and reputation take years to build. They have withstood the test of time, including the financial tsunami that hit Hong Kong in 1997/98. For example, some people have argued that the Hong Kong Mortgage Corporation may be redundant because of the problems of Fannie Mae and Freddie Mac. They have forgotten that the Mortgage Corporation plays an important role to reduce the maturity mismatch of the banking system, it helps deepen the bond market and during the Asian crisis, constituted an orderly system to help banks through their temporary liquidity problems without resorting to the central bank. You do not remove fire engines, just because for a long time there are no fires.

### ***3. From Asian to Global Financial Crises***

Having dissected the nature of financial markets and financial centres, what caused the Asian crisis and the current crisis? The story that I excavated was the linkages between the Japanese deflation post-1989 and the East Asian region. When the Japanese bubble deflated after 1989, Japanese interest rates

were brought down to zero to ease the pain of adjustments. Japan still ran a current account surplus and had to export capital, which flowed after 1990 towards East Asia. Thus began a period of rapid outward direct investments and portfolio investments (in the form of bank loans and foreign aid) that brought new Japanese factories and prosperity to East Asia. Stock markets and property markets in East Asia boomed from 1990 to 1996, and after the Yen peaked at 80 to the US dollar in April 1995, the famous Yen carry trade was invented, whereby any speculator could borrow Yen at near zero interest rates and punt the Asian markets and currencies. In a situation of free capital flows, the speculator not only earned a large positive carry (the difference between Yen interest rate and say Baht interest rate), but also a depreciating Yen liability and an appreciating Baht stocks due to the booming stock market. Needless to say, when the carry trade reverses in large volumes, the emerging market suffers a large capital outflow and deflating bubble.

Asian corporations caught in the exuberance of rising markets made the mistake of the “double mismatch”, borrowing short to lend or invest long and borrowing foreign currency to invest in local currencies. It is amazing that Hungary and other Eastern European economies corporations repeated the same mistake a decade later.

Asian policy makers did not fully appreciate the dangers of running inconsistent macro-economic and supervisory policies, principally fixed or soft pegs against the US dollar, large volatile capital flows and asset bubbles. Just as Japan was suffering what Nomura Chief Economist Richard Koo called a balance sheet crisis, East Asia faced balance sheet inconsistencies that were only obvious when net international position (NIP) were calculated by the IMF in 2004 (Table 2.1, Page 68 of my book). In hindsight, the four crisis economies in South East Asia had net foreign liabilities of more than 50% of GDP in 1996, with the exception of South Korea, which had a net foreign position of only 9% of GDP. In essence, before 1997, roughly US\$300 billion of short-term funds flowed into East



Asia and after 1997, US\$200 billion left, causing a classic twin banking and currency crisis.

In the irrational exuberance and hubris of the first half of the 1990s, Asians and the global institutions did not notice the interconnections between Japan as the largest economy and the rest of Asia. During the period, up to 40% of the foreign debt of some of the crisis economies were denominated in Yen. In 1996, the Japanese government made the policy mistake of trying to tackle its growing fiscal deficit by raising taxes, causing the fragile economy to tank, whilst her banks began to suffer from growing post-deflation non-performing loans. It was no coincidence that the first Japanese bank failures also occurred in 1997. The Korean economy got into trouble because the overleveraged Korean corporations borrowed over US\$60 billion debt offshore and the central bank did not have foreign currencies reserves to meet the capital outflows. Hence, the Asian financial crisis was a network crisis, because the Asian Global Supply Chain was like an electrical network with two inconsistent standards, the US dollar and Japanese Yen. The large volatility of the Dollar-Yen relationship caused stresses in the system in the form of currency mismatches that created the banking and currency crisis. This was the systemic cause of the crisis, whereas many micro and macro policy mistakes were made.

What are the similarities and differences between the Asian and the current financial crises? The most obvious similarities are the excess liquidity, large capital flows, excess credit by banks, loose monetary policy and low interest rates that created the asset bubbles. In the Asian case, it was funds from Japan and other markets that flowed into East Asia that created the bubbles. In the current crisis, there is a school of thought that the savings glut in Asia (sometimes labelled self-insurance by Asians in holding large foreign exchange reserves) that financed the US deficits. Whatever the macro-economic cause, there is no doubt that in both cases there were inconsistent monetary and fiscal policies, inadequate

supervision, lack of transparency and huge moral hazard. Even the accusation of crony capitalism stained both crises.

Where are the differences? The obvious difference is that the Asian crisis was a classic retail banking and currency crisis at the regional level, whereas the current crisis is a wholesale bank crisis with a massive derivative amplification at the global level. In other words, this is a much more complex and evolved crisis and much bigger in scope, size and depth, since the epicentre was the US and it involved mainly the developed financial markets (especially Europe). Even though Asia was not that badly hurt through the financial channel, the free fall in trade was bad enough to puncture the “decoupling myth”.

Indeed, the crisis showed that investors had almost no place to hide – almost all assets declined simultaneously at the same time when Lehmans failed, with the exception of the US Treasuries and that was due to the flight to quality.

The most glaring difference was the medicine that the IMF initially recommended for Asia, namely, the raising of interest rates and the cutting of fiscal expenditure that were initially adopted and had the effect of worsening the deflation. This time round, there was almost unanimous cutting of interest rates and huge fiscal stimulus, almost replicating the Japanese solution for her deflation, namely, a zero interest rate policy (ZIRP) and large fiscal stimulus.

#### *4. What did we learn from both crises?*

One common feature was the fact that most people did not see the crises coming. Asians were warned about the impending crisis in 1996/97, but these were ignored. So did the West, despite warnings from both the IMF and the BIS. There is today an awareness that what failed us was our analytical tools and our understanding of human behaviour. My favourite author on the subject of

financial crisis, John Kenneth Galbraith, has a wonderful quote in his book, “The Great Crash 1929”: ~

“One of the oldest puzzles is who is to regulate the regulator. But an equally baffling problem, which has never received the attention it deserves, is who is to make wise those who are required to have wisdom<sup>2</sup>.”

Before I go into the challenges and opportunities facing Hong Kong as an international financial centre, it may be worthwhile to spend a few minutes on what the current crisis has uncovered in terms of what the gurus call a “paradigm shift”. For what it is worth, there are several consensus mega-trends that are already discernible.

The first is the consensus that this crisis is extremely complex and that there are no simple answers. Most commentators agree that we should have a system-wide view of the financial system, instead of focusing on parts or being institution-based. The fashionable phrase is macro-prudential regulation, meaning a holistic view of what macro-economic trends are having on micro-institutional risks and vice versa.

The second point of consensus is that the developed economies will definitely slow due to the deleveraging effect, as banks have to increase capital and because the debt-strapped consumers will have to cut back on consumption to rebuild their balance sheets. This is why export growth is still in negative territory.

The third point of broad consensus is that emerging markets will continue to grow faster than the developed markets. Just as India, China, Brazil and Indonesia seem to be back on track for growth above 5% annually, growth in the

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<sup>2</sup> Galbraith (1954, reprinted 1975) p. 51.

US, Europe and Japanese markets seem to be stalled at lower levels of not more than 2%. There is broad agreement that China, Japan, the oil-producing Middle East and Germany will remain surplus economies, although the global imbalance will narrow as the US dollar begins to depreciate.

The fourth point is more controversial. Environmental scientists seem to agree that Global Climate change will have a major impact on the global economy over the medium and long-term, although before the UN Conference in Copenhagen in December, no one can agree whether we have gone beyond the point of irreversibility in terms of Global Warming. Nevertheless, I remain convinced that over the next decade, there will be major changes in government and individual spending patterns as we all become more green – using alternative energy, energy and resource saving products and life-styles. This in turn will mean that old “smoke-stack” polluting industries will be phased out, whilst more green investments will increase. Inevitably, this will increase risks for financial systems as the real sector undergoes a major structural transformation.

The fifth point is that the role of many offshore financial centres is now under threat, after the G20 Summit decided to bring all offshore financial centres under greater scrutiny, namely into black lists if they do not comply with anti-money laundering and tax rules.

Finally, there is awareness that the neoclassical “free market fundamentalist” economics will be superseded by more complex behavioural economics, but it is not clear that it will be replaced by Keynesian economics. Nevertheless, government intervention is now the norm, so Hong Kong’s intervention in the foreign exchange market in 1998 will no longer be controversial and may even be admired as a pioneering step in crisis management. The only point of dispute is whether the government is intervening too much and whether we are creating “nanny economies” in which everything must be solved by the state.

Nobel Laureate Paul Krugman has famously said, “much of the past 30 years of macroeconomics was spectacularly useless at best, and positively harmful at worst.” If this is true, what should guide our strategic analysis of what to do in the future?

We should have realized that the key failure of economic thought was the attempt to create a quantitative science resulted in specialization fragmentation of academic disciplines that resulted in silos or narrow compartments of thinking. For example, neo-classical economics uses unrealistic assumptions about human behaviour, perfect information and zero transaction costs that turned out to be false. The leading example of this failure in financial modelling is to assume that default risk and liquidity risk can be measured separately and are mutually exclusive, when under certain conditions of stress, they become the same risk.

Similarly, global financial markets have become one world, but we regulate markets and institutions in segmented jurisdictions. HSBC is a global institution, but your local bank is regulated in over 150 countries by no less than 4-5 regulators in each, whilst HSBC’s total assets are larger than many countries in size. Bank of England Governor Mervyn King has famously said, “Banking is Global in Life and National in Death”. What he means is that banks profit globally, but the funerals are paid for locally. Perhaps he also meant that regulators are not necessarily the best undertakers.

It is because at the national and global levels, too many different agencies are in charge of different parts of the same animal that there are overlaps, gaps, turf fighting and non-cooperation to solve complex social issues. As financial institutions grow larger and more complex, they engage in regulatory and tax arbitrage, leading to the present “tragedy of the commons” – selfish behaviour by individuals and individual institutions creating huge public loss.

In other words, the world is facing a massive collective action problem. If we have difficulty cooperating at the local level, we face even more complicated problems at the regional and global level. We seem to be able to cooperate only in the face of downright disaster.

The issues of systemic and collective action are at the heart of the dilemma facing each and every economy at the strategic and global level. We all appear to be in a collective action trap – if we do not cooperate, there is a race to the bottom, because the pervading self-interest, “we want it now” greed of free market fundamentalism is creating economic, political and ecological gridlock.

It would appear that globalization has created an increasingly complex, interdependent, inter-connected and interactive world, where collective behaviour seem to be moving in highly irrational and non-linear manner. So what should we do?

In 1982, the Californian physicist and system-thinker Fritjof Capra had already identified this blind spot in our fragmented, linear thinking. He argued that current economics thinking is still Newtonian, whereas modern physics and bioscience had already moved past Einstein. The current partial and linear thinking has limited our capacity to react to complex system-wide problems, forcing us to re-think our next steps at the policy and institution level (Table 2).

In essence, we need an integrative approach to the solution of our modern problems, because partial solutions often end up being the wrong solutions – what the Chinese call, if you got a problem in the head, you fix the head, and if you have a pain in the leg, you fix the leg. No one seems to be happy. Isn't that the most common complaint about our world today?

##### ***5. How others see Hong Kong as an International Financial Centre***

Before I launch into an analysis of options for Hong Kong, I looked at the City of London's excellent research on London's position relative to its competitors<sup>3</sup>. Their studies suggested, "Asia is now amongst the most important sources of liquidity, credit and investment capital within the global financial system". But they note that "Asian investors have continued to recycle most of their surpluses through traditional centres such as London and New York rather than through the region's own financial centres - reflecting the fact that the region's financial centres appear not to be able to offer the levels of surety, sophistication, innovation and scale that differentiates London and New York as the world's only truly global financial centres" (my underlining).

"Nevertheless, the long-term challenge for financial centres in the region is not to become Asia's London (or New York) but rather more immediately, to develop the technical and human capacities to meet the needs of financial services consumers in the region's rapidly growing economies."

Specifically, the study concludes, "there does not appear to be any prospect of Hong Kong, Singapore or Tokyo challenging London's pre-eminence as the world's leading financial centre in the near-term. Indeed, Asia's lack of financial (as opposed to trade) integration will mean that much of region's surplus reserves will continue to be invested through financial institutions based in London (and New York) until regional financial centres in Asia can begin to match the depth and diversity of products on offer in these former centres."

The reason for this conclusion is political. The study suggests quite perceptively that "The future for all of Asia's financial centres will be determined by the capacity of political elites to negotiate the often deep historical ambivalences and tensions that mark the region's geo-political landscape. More

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<sup>3</sup> City of London research reports, see [cityoflondon.gov.uk](http://cityoflondon.gov.uk), on The Global Financial Centres Index, September 2009, [www.cityoflondon.gov.uk/NR/rdoonlyres/.../BC\\_RS\\_GFCI5.pdf](http://www.cityoflondon.gov.uk/NR/rdoonlyres/.../BC_RS_GFCI5.pdf), the Future of Asian Financial Centres, [www.cityoflondon.gov.uk/NR/...53B0.../BC\\_RS\\_AsiaFC\\_ES.pdf](http://www.cityoflondon.gov.uk/NR/...53B0.../BC_RS_AsiaFC_ES.pdf)

than anything else, the emergence of China and India as the region’s two major sources of long-term growth is having (and will continue to have) an enormous impact on the long-term development of all financial centres in Asia.”

Quoting Bill Emmott, former editor of the Economist, “politics will shape tomorrow’s Asia, an Asia of great power rivalry, of suspicion and of strategic maneuvering, the beginnings of which can already be seen.”

All in all, the rise of the Asian financial centres will depend on the prospects of the capital account convertibility of the Indian Rupiah and the Chinese Renminbi, which will impact on the viability of these two currencies as major internationally traded currencies. Regional financial integration will hinge on the prospects of Sino-Japanese relations, the global debate on trade imbalances and the undervaluation of Asian currencies, as well as the liquidity of Asian debt markets and the reality of “decoupling”.

**Table 3: The Global Financial Centres Index**

<b>Table 1</b>					
The Global Leaders	Centre	GFCI 6 Rating	GFCI 6 Rank	Change in	Change in
				Rating since GFCI 5	Rank since GFCI 5
	London	790	1	9	0
	New York	774	2	6	0
	Hong Kong	729	3	45	+1
	Singapore	719	4	32	-1

There is a wonderful book that must be required reading of all yo



How does Hong Kong fare in the global financial centre index? The latest (September 2009) GFCI published by the City of London places London as number 1 with 790 points, New York at 774 and Hong Kong as third at 729, ten points ahead of Singapore (Table 3). It says “Hong Kong SAR remains the pre-eminent portfolio investment centre in Asia, and is also the region’s dominant centre for institutional investment. It also offers by far the region’s most sophisticated pool of professional services talent. After a period of uncertainty following handover, Hong Kong SAR has prospered as a semi-independent entity in relation to the Mainland. Here, Hong Kong SAR is able to draw on its socially entrenched commercial networks (including those of capital) into the Mainland. This gives it an enormous social, cultural and political advantage over Tokyo and Singapore. Its future growth is likely to be driven by the growing liberalisation of portfolio flows from the Mainland and it will, in the short term at least, enjoy “first mover” advantage as China seeks to further integrate into the world economy.”

What is interesting is that after the crisis, the GFCI has moved closer, because in 2007, London and New York were in the 800 points area and Hong Kong and Singapore nearer 700. This is clearly due to the financial crisis that hurt London and New York more, whilst Hong Kong and Singapore benefited from the better economic fundamentals and growth prospects of the Asian region.

This does not mean that Hong Kong can be complacent. Since the index is drawn upon a questionnaire survey of leading financial services personnel, it is remarkable that Shenzhen has been listed as number 5 in the global rating, above Tokyo (7) and Shanghai (10). The rise of Shenzhen may be due to the fact that it is viewed “as a natural mainland partner to Hong Kong” and is likely to be the centre where new offices will be opened.

To sum up, there is international recognition that Hong Kong remains the third most competitive international financial centre, just behind London and New York. This does not mean that the leaders are standing still. In May this year, the

UK financial services leaders published an important strategy paper entitled “UK international financial services – the future<sup>4</sup>”. The Wim Bischoff report, named after the Citigroup Europe chairman, was commissioned in July 2008 in response to the financial crisis to examine how to keep UK financial services competitive for the next 10 to 15 years. Financial services in the UK contribute to 15% of GDP and there is ample recognition that the City of London has been hurt, not least by the differences in treatment of investors due to the failure of Lehman Brothers in September 2008. As some of you may know, investors who dealt with Lehman’s New York may receive different treatment with those who dealt with Lehman Brothers International Europe, based in London, as the latter may be classified as unsecured creditors. This means that the insolvency law and processes would in the future play a critical role in the protection of investor property rights.

What the Bischoff Report sets out is what the UK needs to do in a clear and constructive manner. There are essentially three things that must be done:

- Establish a clear direction for the UK international financial services industry in partnership with the wider economy and overseas markets – specifically recognizing that the UK’s status as an international financial centre depends on the maintenance of an open economy and cooperation with other financial centres.
- Reaffirm the UK’s reputation for competence, responsibility and trustworthiness, and
- Ensure effective delivery of these recommendations.

In other words, “the UK’s future success must be based on partnership between the financial services industry and the wider domestic economy; and between the UK, emerging economies and their financial centres.”

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<sup>4</sup> available at [www.hm-treasury.gov.uk](http://www.hm-treasury.gov.uk).

## *6. Hong Kong's Role as International Financial Centre and the Rise of China*

To sum up, Hong Kong is currently viewed as the number 3 global financial centre in terms of competitiveness in terms of people, business environment, market access, infrastructure and general competitiveness. This is a proud record but leaves no room for complacency, as Singapore is a close fourth in almost the same areas<sup>5</sup>.

Everyone seems to be asking me (slightly nervously I might add) what are the implications of Mainland's plans to make Shanghai the international financial centre for China by 2020. My simple answer is that whether a city becomes an international financial centre or not depends ultimately not just on the policy environment, but also the market place. The reason why the top 4 global financial centres remain London, New York, Hong Kong and Singapore, is because they are used and trusted by the marketplace. Anyone of them can lose their place if they lose their reputation, trust and market-friendliness.

There are few doubts that China will play a major role as a leading economy in the world in the next decade or so. Some analysts are already forecasting that at the current rate of Chinese growth, China may overtake the US as the largest economy in the world within 10 to 20 years. By that time, there is no doubt that Hong Kong and Shanghai, as well as Shenzhen and Beijing, would become important financial centres. But which will emerge as the leading international financial centre will be a matter of competition, as well as cooperation.

To me, the issue is relatively straight forward, although your guess is as good as mine. As long as the Renminbi remains non-convertible on the capital account, Shanghai remains the leading Renminbi financial centre, but not yet an

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<sup>5</sup> GFCI Report (September 2009), Table 10, p.23

international financial centre. The minute the Renminbi capital account is open, and I have no crystal ball as to when that will be, any city in China will have an opportunity to play that role. Thus, the real issue is how during the interim period, Hong Kong plays to her advantages and work with the Mainland to prepare for that competition.

In other words, the heart of the issue is how Hong Kong engages both the Mainland and her partners and competitors around the world to prepare not just Hong Kong for her transition to the next phase of growth, but more important, how to assist the Mainland to become one of the leading financial markets in the world.

To put it bluntly, if Hong Kong wants to be the world's leading financial centre, she must put the interests of the Mainland and global investors before her own interests. Let me explain what I mean by reference to the current global crisis and the basic principles of financial centres.

The financial system is first and foremost a service industry. It is useful and prosperous as long as the real sector prospers. A financial sector exists to protect the property rights of the investors and savers, reduce transaction costs and have high transparency. By these standards, I am frankly appalled at what I am seeing in Wall Street. After being rescued by the public, the shareholders and the taxpayers, some of the leading bankers are set to pay themselves US\$20 billion or more in bonuses and pay in a year when governments are running double digit fiscal deficits to bail their banks out. Somewhere along the line, Wall Street bankers have lost the moral plot. Speaking for myself, I personally would never deal with a bank where I know the bankers look after their own interest more than mine. Service means that the interests of the client come first. We now know where some Wall Street bankers put their priorities.

This unfortunate negative example has clear lessons for Asia and Hong Kong. To succeed as an international financial centre, Hong Kong has to play to her strengths, her excellent connections to the Mainland, but above all, her excellent connections to the rest of the world. Note that the regulatory authorities in New York and London are already addressing these issues as a matter of priority, and I am sure, they are fully aware of the reputational implications of not maintaining these cities as a place where property rights are fully protected.

The current crisis has also hit Hong Kong and Singapore because of the failure of Lehman Brothers has impacted on retail investors holding what is now commonly called “mini-bonds”. This controversial matter is still under the investigation of a Select Committee and also legal disputes, so my comments will have to take these factors into concern. Nevertheless, I cannot discuss the role of Hong Kong as an international financial centre without drawing some key lessons from this experience. The incident raises questions of disclosure, product approval, sellers’ conflicts of interest and due diligence, client suitability, classification, internal controls, staff training and consumer education.

What is the appropriate level of investor protection? There is the complex balance between the principle of “Caveat Emptor” or buyer beware and “Moral Hazard”, the risk that if the insurer (in this case the state) protects the insured from all losses, the insured person will not take due care to protect his or her own interests.

Traditional financial regulation involves two types of regulation – prudential regulation, which is the oversight over the sound and prudent financial management of the financial institutions and disclosure or conduct regulation, which places onus on the proper disclosure and conduct of financial business. The former broadly covers the approach of bank regulators and the latter the remit of securities regulators. With the growth of universal banking,

the two approaches have converged. An important premise of financial markets is “buyer beware”, but that actually depends on the proper standards of conduct and sound and prudent business practices among the financial institutions; the absence of illegal, dishonourable or improper business’ and in particular, that reasonable steps were taken to ensure that selling of financial products were carried out with integrity, prudence and professional competence. Instead of relying solely on “caveat emptor”, the seller must have proper disclosure of risks, and due care and diligence that the product meets the client suitability test. To do so requires proper client classification procedures to differentiate between retail and professional clients.

The disputes over mis-selling of complex financial products are not unique to Hong Kong. The issues are now generic to all financial centres, because throughout the world, the state has intervened to rescue financial institutions from their own mistakes. In the more litigious countries, many of the mis-selling disputes will be fought for years in the courts. At the heart of the issue is the accountability of the buyer, the seller and the state, namely, the Principal-Agent Problem.

Economists have realized that the two core problems of financial markets are the Principal-Agent Problem and Transparency. The first is the recognition that the interests of the principal (the depositor or investor) and the interests of the seller (the financial intermediary) are not the same. The second is the premise that with greater transparency and disclosure, the principal can protect his or her own interests and make the seller more accountable. These are the primary foundations of disclosure regulation. I need to spend some time on this because it goes into the heart of the issues of being a successful financial centre.

I had earlier stated that the four key functions of a financial system are to help the real sector (the users of the financial sector) to have proper resource allocation, price discovery, risk management and corporate governance. During

the Asian crisis, the Asian financial system failed these four tests. During the course of this global crisis, as a former central banker and regulator, I am seriously concerned about the current macro- and micro environment in the developed financial markets. The macro level is the sum of micro behaviour.

Resource allocation has become increasingly distorted because modern society is being founded on a premise of instant gratification – consume today tomorrow’s resources, a world built on rising debt. Short-term profits and bonuses are more important than long-run stability. Price discovery has been totally distorted when the price of money, the unit of measurement of all value, is now zero under the zero interest rate policy. Risk management is cock-eyed when products that you buy to hedge your risks end up with adding to your risks. And corporate governance is a joke when bank management pays itself more than the shareholders and the taxpayers.

Consequently, the key question that Hong Kong and all other Asian financial centres need to ask is whether we can follow the trend in the West or go back to basic principles – namely, the agent (the financial system) must serve the needs of the real sector (the consumer, saver or investor), not the other way around. A financial sector can never forget that it is a service industry.

But I cannot complete this lecture without addressing the complex issue of transparency. Financial centres thrive on the free flow of information, because transparency enables the investors to judge for themselves and to protect their interest.

I am a great supporter of greater transparency in financial markets, because I co-chaired with Mervyn King (then Deputy Governor) the 1999 G20 Working Group on Transparency that urged greater global transparency standards in financial markets. But I now realize that transparency is not just the transmission of information, but as Fritjof Capra pointed out, the alignment of behaviour.

Advertising clearly is designed to influence buyers because they disclose the attractiveness of products, not the full risks. Hence, what has happened is that financial product sellers have learnt that if you disclose so much complex information, the chances are the buyer may ignore the details and rely on your reputation instead. The December 2008 HKMA report rightly points out that “For disclosure to be successful in making risks clear to investors and assisting them to make informed investment decisions, it should be clear, concise and comprehensible<sup>6</sup>”. It should also be relevant, not buried in fine print.

Unfortunately, if the seller is more concerned about his or her own commission and bonuses rather than the buyer’s interests, then the tragedy is that both will ultimately lose. One buys a shonky product and the other gains a shonky reputation.

This is the basis of Wall Street economics, which works on the “greater fool theory” that I personally must reject as the model for Asian financial systems. If buyers of accumulator products had been told that at certain prices, when the products are marked-to-market on a daily basis, that his or her total net worth would not be sufficient to meet the margin calls, so that the chances of losing all would be quite high, would they have bought the products? This is a question that can only be settled in courts. But for the principle of disclosure to work properly, there must be proper accountability if poor disclosure is practiced, which is why the regulators must enforce the sellers’ due diligence and conduct behaviour with great vigilance.

## ***7. Concluding Thoughts***

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<sup>6</sup> Section 8.9, REPORT OF THE HONG KONG MONETARY AUTHORITY ON ISSUES CONCERNING THE DISTRIBUTION OF STRUCTURED PRODUCTS CONNECTED TO LEHMAN GROUP COMPANIES, Hong Kong Monetary Authority, 31 December 2008. Page 62.



Finally, let me wrap up. This book “From Asian to Global Financial Crisis” addressed the question what model should Asia follow to create sustainable long-term prosperity. Because greed and fear is built into the human genome, we perhaps cannot avoid financial crises. But I am personally convinced that the Wall Street model that works on “more greed than fear”, that is ultimately subsidized by Main Street, is not the model for Asia.

There is no doubt in my mind that Hong Kong will continue to play a major role as an international financial centre. But we must be realistic and clear-eyed. The competition for the leading international financial centre will be fierce, as it is not just Shanghai, but Shenzhen, Singapore, Sydney, Seoul and others are contending for the role in the East Asian time zone.

The question of who wins is not a question of quantity, but quality, because the favourite questions of when and how Renminbi becomes convertible and how Hong Kong can get into the game are technical and tactical questions. The strategic question to ask is the value game. How can Hong Kong help Mainland and global customers manage their risks better, protect their property rights better and help educate them to greater heights at better value than other competitors?

In other words, how can Hong Kong continue to add value to China and global markets?

The Hong Kong financial sector must remember that the free markets, free media and rule of law are enormous competitive advantages that will not be easy to replicate and replace. The hardware is easy to buy and build, but the software takes time. At the same time, the software is also easy to lose, because financial markets are founded on trust and reputation. Hong Kong’s great strength is that she is strategically located in the best growth neighbourhood in the world and that she is part of China, the fastest growing market in the world. The potential is

terrific, but the risk is that a minority of unscrupulous intermediaries practicing the “greater fool” theory will hurt Hong Kong’s reputation as the trusted market. Once fooled by shonky sales practices, investors will go elsewhere. The Hong Kong financial community and the regulators have to safeguard Hong Kong’s reputation against such risks.

To conclude, the leading position as an international financial centre in the Asian time zone is for Hong Kong’s to lose. Hong Kong should not fear competition from anywhere. But I must be constructive. What can be done to reinforce that role?

There is a Chinese saying that to do anything, one must have geography, timing and cooperation. There is no doubt in my mind that Hong Kong has geography and timing on her side, but getting everyone to cooperate seems to be a bit of a problem. This is not unique to Hong Kong. This year’s Nobel Laureate in Economics, Elinor Ostrom, is the first woman and political scientist to win the prize in economics. Her work is timely and valuable, because she deals with the serious problem of how to achieve Collective Action. The problem of economics and modern financial markets today is that we have built our social behaviour on the basis of the self-interested egoist. The crude version of Adam Smith free market ideals is that self-interested greed adds up to a public good via the Invisible Hand. What the current crisis has demonstrated is that if highly concentrated greed captures the guardians of the public good, then the public pays for it big time. Elinor Ostrom is saying that the issue of the Tragedy of the Commons, where self-interest destroys the public commons, cannot be solved just by the state, by privatization or markets alone, but also requires self-governance through civil society. It takes cooperation between the state, the markets and civil society together to achieve long-term sustainable prosperity. That cooperation requires reciprocity, reputation and trust and thus leadership and responsibility by all citizens.

To conclude, what are the lessons to be drawn in practical terms for Hong Kong? The real competition for the long haul will be on the question of values. Once we begin to think system-wide, we realize that we need to switch our thinking and values from quantity to quality, from short-term to long-term, from domination to partnership. Old fashioned banking is about relationship banking, which is not to take profits at the expense of the clients, but to grow with the clients.

Partnership means the building of long-term relationships, of more give than take, so that all will win. Hong Kong cannot aspire to become the leading financial centre of China or the region, without greater participation and partnership from leading academics, opinion-makers and thinkers from the Mainland and the region. My simple suggestion is to do what the Mainland has done very well – invite international experts and advisers to share their views on what is the best practice and model to adopt, pick the one that best fits Chinese realities, implement and then review very carefully and objectively what has gone right and wrong, and then move forward.

In other words, we cannot be the market leader if we do not follow and listen what the market wants. An international financial centre for China means that it must be done in partnership with Mainland and the international community. This point was already realized by City of London, which is why they have engaged in the research studies and perspective vision statement which I have described.

I have a second suggestion. The failure of Lehmans demonstrated that the bankruptcy law and processes for large complex financial institutions is outdated globally. Just as London is struggling with this problem, Hong Kong must look at this complex area of insolvency law and processes as a matter of priority. No one will want to have to spend years in courts due to the failure of a large financial institution.

I have no magic bullets to offer, except to repeat what every Hong Kong person born under the Lion Rock understands – that success comes from hard work and good reputation. I used to think that Hong Kong should be the Wall Street of Asia. Now I am sure that Wall Street is not the right model to follow.

Allow me to end with a quotation from the Legalist school, which I used in my 2005 lecture in this University, which 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<sup>7</sup>.”

[國無常強，無常弱。奉法者強，則國強。奉法者弱，則國弱。]

In the years to come, as Asia continues to rise, Hong Kong has much to offer China and the region through its living example of the rule of law and its true vocation as an international financial centre to manage risks, not to add risks. This is the systemic question that boils down to a Collective Action problem of how we can work in partnership for long-term prosperity and stability. Collective action, like charity, begins at home.

I must end, as all Asian speeches do, with an apology for being too long, too idealistic and perhaps too vague. To answer all the questions that you will surely have is another story and perhaps another book.

Thank you once again for your patience.

Hong Kong.

3 November 2009

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<sup>7</sup> Han Fei Tzu, “Basic Writings – On Having Standards,” translated by Burton Watson, Columbia University Press, New York, 1964

**Table 2: From Partial to System-wide Thinking and Values**

(Source: Fritjof Capra, Web of Life, 1997, Flamingo Press, page 10)

<b>Self-assertive</b>	<i>Integrative</i>	<b>Self-assertive</b>	<i>Integrative</i>
<b>Rational</b>	<i>Intuitive</i>	<b>Expansion</b>	<i>Conservation</i>
<b>Analysis</b>	<i>Synthesis</i>	<b>Competition</b>	<i>Cooperation</i>
<b>Reductionist</b>	<i>Holistic</i>	<b>Quantity</b>	<i>Quality</i>
<b>Linear</b>	<i>Non-linear</i>	<b>Domination</b>	<i>Partnership</i>

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