Hong Kong’s International Financial Centre: Retrospect and Prospect

Louis W. Pauly

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Established as a think-tank in 2006, the Savantas Policy Institute:

1. Conducts in-depth public policy research and analysis pertinent to the Hong Kong Special Administrative Region (HKSAR) in the political, economic and social domains;
2. Promotes greater understanding of democratic ideals, values, culture, institutions, and conditions making for the establishment of quality democracy in the Hong Kong SAR, within the framework of the Basic Law and in accordance with the principle of "One Country, Two Systems", and to formulate recommendations for the steps to be taken to achieve this end;
3. Promotes public understanding of the knowledge-based economy, and the importance of long-term investment in knowledge, innovation, technology and expertise as the motor force of sustainable growth;
4. Promotes public understanding of the effects of globalization and technological change on the structure of Hong Kong's economy, and to recommend appropriate long-term developmental strategies to leverage such effects and change;
5. Fosters economic and social partnership between the Hong Kong SAR, the Mainland of China and other countries and regions and leverage the synergy for mutual benefit and growth;
6. Promotes public understanding of and participation in the political, economic, and social development of the Hong Kong SAR; and
7. Undertakes such activities as are necessary to attain the above objectives including the organization of public education programs, speaker programs, seminars, conferences, scholarships, training and skills upgrading programs.

The Author

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# Hong Kong’s International Financial Centre: Retrospect and Prospect

**Contents**

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Executive Summary</td>
<td>4</td>
</tr>
<tr>
<td>1. Introduction</td>
<td>7</td>
</tr>
<tr>
<td>2. Analytical Background</td>
<td>9</td>
</tr>
<tr>
<td>3. Four Key Industries</td>
<td>16</td>
</tr>
<tr>
<td>4. The Productivity of Hong Kong’s Labour Force</td>
<td>24</td>
</tr>
<tr>
<td>5. Hong Kong’s Financial Centre in Comparative Context</td>
<td>28</td>
</tr>
<tr>
<td>6. Financial Sectors in Dynamic Markets</td>
<td>44</td>
</tr>
<tr>
<td>7. The Changing Role of Government</td>
<td>59</td>
</tr>
<tr>
<td>8. Regulatory Reform and the Strengthening of Hong Kong’s IFC</td>
<td>66</td>
</tr>
<tr>
<td>9. Finance, Autonomy, and the Achievement of Broader Prosperity</td>
<td>77</td>
</tr>
</tbody>
</table>
Hong Kong’s International Financial Centre: Retrospect and Prospect

Executive Summary

1. In any listing of the world’s top international financial centres, Hong Kong takes a prominent place. How secure is that place, and what factors increase the odds that it will remain in the first tier of IFCs? This study places in a larger context the contemporary challenges facing Hong Kong as it seeks to build on past success and strengthen its IFC.

2. The growing role of Hong Kong’s financial sector needs to be viewed as the consequence of a long-term transformation. Although finance has long played an important role in Hong Kong’s development, it is today only one of the four pillars of the local economy. Even though finance accounts for over 16% of Hong Kong’s GDP, however, it provides only 6% of total employment.

3. External surveys now routinely place Hong Kong third among global financial centres. In terms of overall market breadth and depth, only London and New York exceed it. A primary entry and exit point for Mainland trade and investment financing, Hong Kong has particular strengths in banking, equity markets, funds management, and, increasingly, insurance. Various activities related to the growth of offshore RMB markets are bright spots at present. Singapore remains a strong competitor, especially in foreign exchange and derivatives trading, international banking, and bonds.

4. Significant shifts can be expected as China’s system of capital controls erodes. But the associated and much-hyped eclipse of Hong Kong by Shanghai is likely decades away. In the meantime, Hong Kong has the ability to adjust and remain prosperous. Principal home base for multinational corporations with important Asian regional strategies, one of several financial gateways into China, prominent gateway out of China, connector of Chinese and foreign business networks—Hong Kong’s unique position can endure and strengthen.

5. Joint agreements to develop the Pearl River Delta as a coherent economic region, a new framework agreement on Guangdong-Hong Kong Cooperation, and plans to make Qianhai, near Shenzhen, a southern China hub for service industries pose challenges to narrowly focused strategies to defend Hong Kong’s existing advantages.

6. Keeping Hong Kong’s financial markets competitive and stable is complicated by an array of new factors. The complex interaction of new political and economic risks brings with it the need for continuous review and reform in the structures and practices of financial regulation and supervision.

7. Relative to the recent experience of the United States and much of Europe, and to its own experience ten years earlier during the Asian crisis of the late 1990s, in 2008 Hong Kong’s crisis management system proved reasonably robust. The bankruptcy of Lehman Brothers,
however, and widespread allegations that the risks and fees associated with so-called mini-
bonds bearing the Lehman name had been misrepresented by many Hong Kong
intermediaries, revealed serious flaws in governance at a number of levels.

8. Across the advanced economies of the world, including Hong Kong’s, the crisis of 2008
suggested the need for more pro-active and less reactive government. But balancing the
competitive impulses required for continuing prosperity in financial markets and durable
expectations of overall stability and safety requires subtlety. For Hong Kong it also
requires the maintenance of relative autonomy both internationally and inside greater
China.

9. At the global and regional levels, Hong Kong’s government has already proven its ability
to think strategically and act constructively as financial regulatory and supervisory policies
are adjusted. The joint work of FSTB and the HKMA during and after the crisis of 2008
suggests that to strengthen today’s IFC in Hong Kong a single entity ‘above the fray’ needs
to be in a position to think strategically about healthy financial markets in Hong Kong and
their relationship with the broader economy. It should be a permanent secretariat and long-

10. Closer to the markets, a version of the UK’s planned Prudential Regulatory Authority, as a
distinct and distinctly mandated subsidiary of the HKMA, should be considered. Under its
stability mandate, the HKMA should remain in a position continually to re-assess and
guide macro-prudential policies, especially as they apply to systemically significant banks
and the migration of systemic risks, arising, for example, from institutional scale, cross-
border links, and interconnectedness, ostensibly outside the banking system. International
comparators should also inform continuing reconsideration of the relationship between the
SFC and the HKEx. Similarly, comparative analysis should influence continuing debate
on moving beyond arbitration procedures to the establishment of a separate, cross-sectoral
agency for consumer protection.

11. There is no reason to tamper with the HKMA’s primary responsibility for managing the
Exchange Fund. But the current scale of reserves and the expansion of cooperative
facilities with China and regional partners call for reconsideration of very conservative
investment practices. A sovereign wealth fund may not need to be explicitly carved out,
but the return on a serious portion of existing and future reserves could reasonably be
benchmarked against the performance of SWFs in comparable jurisdictions.

12. Higher investment returns on the Exchange Fund would provide the government with
greater fiscal capacity. With the same goal in mind, the current low tax policy, and the
related policies associated with land use, should not be out of bounds for comparative
analysis and open debate. Fiscal flexibility would facilitate necessary investment in public
infrastructure and human resources to sustain a resilient IFC and build a more broadly
diversified economy.
13. Continuing to attract the regional head office functions of multinational firms remains important. In this regard, the role of personal tax incentives may be exaggerated, especially because of the counter-balancing implications of rapidly rising housing costs. High-quality elementary and secondary schools, new resources to upgrade the linguistic abilities (English and Mandarin) of the general labour force, better air quality, improved public health services, and the kind of cultural amenities long promised by the West Kowloon Complex—all are arguably more significant.

14. Maintaining an IFC in the top global tier will not likely generate the quantity or quality of jobs needed to ensure the future vibrancy of Hong Kong’s overall economy. New industries will be needed. Finance will remain a key piece of the economy, but none of the world’s leading IFCs are disconnected from real economies and distinct systems of industrial innovation. Deepening financial-industrial linkages between Hong Kong and the Mainland is not inconsistent with enhancing the conditions for innovation and knowledge-based development within Hong Kong itself. Continuing strategic investments are required, not least in the university system.

15. With regard to the financial sector, a two-track strategy has much to commend it. Hong Kong can offer its experience and expertise to Mainland cities seeking to build modern financial markets, while also keeping its internal focus on the challenge of continuously enhancing the globally competitive advantages of its IFC.
Hong Kong’s International Financial Centre: Retrospect and Prospect

1. Introduction

In any listing of the world’s top international financial centres, Hong Kong takes a prominent place. How secure is that place, and what factors increase the odds that it will remain in the first tier of IFCs? This study was commissioned by the Savantas Policy Institute, a think-tank committed to helping Hong Kong strengthen its society and economy.¹ As in other world cities, that economy is now clearly knowledge and service-based. In this context, the financial sector is critically important, both for the opportunities it brings and the risks it implies. It plays a key role in shaping the future of the current generation of Hong Kong residents and the generations that will succeed them.

More specific concerns are today in the minds of Hong Kong’s market participants and financial policymakers. What are the implications of recent developments in dynamic regional and international markets? What should be done to meet growing challenges from Singapore, Shanghai, Shenzhen, Guangzhou, and other cities eager to expand their financial service sectors? What policy reforms will strengthen Hong Kong’s current competitive advantages and build new ones? What impact will growing offshore RMB markets have on Hong Kong as an IFC? Should Hong Kong’s financial regulatory and supervisory systems be reformed? What lessons should be learned from past financial crises and especially from the global crisis of 2008? Do Hong Kong’s monetary, fiscal, currency, and reserve policies interact in a way that best enhances the life prospects of the majority of Hong Kong’s people?

Although such questions frame this study, an outsider can provide perspective but not definitive answers. Mindful of the risks of hubris and aware of the cascade of relevant research now pouring out of Hong Kong’s own universities, think-tanks, government agencies, and organizations much closer to the market, this study makes a modest contribution to significant policy debates already underway. I learned a great deal from the advice and frank counsel of many officials, market participants, and close observers who met with me during research trips to Hong Kong and Shanghai in June and October of 2010. Given the sensitivity of many of the

¹ I am grateful to many people, without whom this study would never have been completed. Regina Ip, founder and chairperson of the board of governors of the Savantas Policy Institute, invited me to undertake the project, and I am grateful to her for doing so. Key members of her team, in particular, Charles Wong, played a pivotal role. No one understands networks better than Charles. Vincent Yiu, Germaine Lau, and many other Savantas staff members and student interns assisted. The Hong Kong General Chamber of Commerce invited me to give two presentations that led to much valuable advice; the Chamber’s Chief Economist, David O’Rear, was a patient host. The British Chamber of Commerce organized an informative breakfast meeting. The Business and Professionals Federation held a very helpful briefing on key policy issues. Simon Xiaobin Zhao, David Dodwell, and David Meyer wrote pioneering studies on Hong Kong as an international financial centre and shared their current reflections. Doug Fuller, Frank Song, Kwok-chuen Kwok, Ming Zhang, Guoyou Song, Xunbo Yu, Zhongqi Pan, and C. Randall Henning were also most generous with their scholarly insights. Joe Wong, close friend and colleague, remains irreplaceable. Andy Filardo repeatedly provided encouragement and hospitality. Many government officials, political leaders, corporate executives, and market observers in Hong Kong and Shanghai became my teachers on the understanding that their lessons would not be directly attributed. If their student is slow, they are not to blame.
issues discussed, however, I promised not to quote any of them by name. Their views sometimes complemented and sometimes challenged my own, and they prompted me to reflect on and question conclusions drawn from earlier visits to Hong Kong as well as from many years of research on related topics.

In this regard, note at the outset that my field is political economy, with particular interests in history, international finance, international relations, comparative public policy, and economic geography. Since this study was not constrained by its sponsor, I have taken it as my main task to set the contemporary challenges facing Hong Kong as it seeks to strengthen its IFC into a larger context. That context needs to be borne in mind as useful debate continues on strategies and tactics for accomplishing that objective. My suggestions in that regard are offered with the sense of humility that any sympathetic outsider should nurture, especially when events are moving swiftly. My conviction, however, is that Hong Kong’s financial sector should be understood as firmly rooted in deep social and political foundations and not as disconnected from broader domestic and international purposes. A strong IFC is only a means to an end, not an end in itself.
2. Analytical Background

Foundations for prosperity

During my first visit to Hong Kong, the ‘in-between-ness’ of the place fascinated me. The sun had already set on the British Empire, but in that great Asian city I met officials steeped in its traditions. Richard Nixon’s historic visit to China had occurred five years earlier, and everyone was trying to discern the implications of Deng Xiaoping’s reforms. In 1977, change was in the air. Only later did I learn that the famous phrase attributed to an American baseball player, had long applied to Hong Kong. “It’s déjà vu all over again.”

Adaptability, it seems, is the essence of Hong Kong’s unique history. A commonplace refrain in business and government circles credits the British with leaving a rich legacy in ‘the rule of law.’ But law is a process of social and political accommodation. The deepest legacy of the British was a political structure resilient in the face of systemic change. That structure permitted a people mainly of Chinese descent to construct and reconstruct a distinct identity in a turbulent region. Time and again, it helped them as a society to find a middle path between hard choices. Like a well-functioning backbone in a healthy human body, it embodied spirit of pragmatic resiliency. Ultimately, that society surpassed its imperial teacher in learning also how to pass such a spirit on to succeeding generations. At its core, that structure of political decision-making revolved around a simple practice—refraining from clarity whenever difficult adjustments were required to maintain stability. Such a practice was most useful in the building of modern financial markets.

By most standard measures, Hong Kong’s financial sector provides the base for one of the world’s three great financial centres. With the significant exception of its bond market, only London and New York currently surpass it. It is already Asia’s international banking centre, a centre tested severely during the so-called Asian crises of the late 1990s and affirmed by its outstanding performance during the worst global crisis since the 1930s, which began in the United States in 2007. It is evidently also now Asia’s major centre for equities, a status that continues to be bolstered by the dynamism of China’s emerging corporations. Underpinning both is a unique approach to governance. Any analysis of the challenges Hong Kong now faces as it seeks to address remaining weaknesses in its financial industries must begin with a careful consideration of that approach.

Standard histories begin, quite appropriately, with the famous phrase associated with Financial Secretary Philip Haddon-Cave and the actual policy line crafted by his predecessor, John Cowperthwaite. “Positive non-intervention,” often misinterpreted as articulating an ideology of ‘laissez-faire,’ did shape governmental practice during the seminal twenty-year period beginning in 1961. Instead of simply letting private markets work their capitalist magic, however, the policy line provided cover for a quite activist set of steering mechanisms. As the historian Steven Tsang put it, behind the scenes “government remained the largest employer, the biggest developer of real estate, the leading constructor, the largest landlord, and the biggest
provider of education and health services.” The government’s objective, however, was to maximize Hong Kong’s autonomy, and specifically to liberate it from explicit direction by the British Treasury. By engineering a fiscal surplus and refraining from many of the direct private-market interventions so popular at the time in Great Britain, Continental Europe, Japan, and even the United States, this goal was met before the opening of the 1970s.

In fact, before Haddon-Cave succeeded Cowperthwaite in 1971, the government’s reserve fund stood at two-thirds the size of total official expenditures. To be sure, the consequences of this policy of austerity had long-term social consequences, not all of which were positive. Arguably, for example, the absence of subsidized and compulsory public education until the end of the Cowperthwaite era resulted in a social deficit that would only be addressed through the retirement of an entire generation of citizens, a generation that partly willingly and partly unwillingly sacrificed their own life-prospects for the benefit of their children and grandchildren. That same generation took advantage of opportunities presented by relatively unrestricted private markets. Unlike their cousins back in the Mainland, most people had no choice but to take care of themselves and their families in an environment permissive of both phenomenal success and catastrophic failure. Still, there is no denying the fact that the greatest successes depended on combining industrial entrepreneurship with access to financial and land resources directly or indirectly sustained and steered by government policies. Quips that survive the passage from one generation to the next contain a grain of truth. One holds that the most important people during Hong Kong’s great economic takeoff period were the Financial Secretary, the head of Hong Kong and Shanghai Bank, and the chairman of the Jockey Club. The personal histories of today’s great indigenous entrepreneurs belie that truth. One would have to be blinded by the ideology of laissez-faire not to see the deeper influence of government policies, especially when it came to questions related to the use of land. As elsewhere, however, finance and real estate are intimately connected. Before we return to that connection in Hong Kong, we need as broader sense of the history and geography of financial centres.

Financial centres

Remarkably, since its subject matter is so obviously important, the geography of finance is still a young field of study. In a seminal study, Charles Kindleberger puzzled over the fact that national credit markets tended to be spatially concentrated in a hierarchical pattern. Relative to commerce, industry, and transport systems, financial systems tended over time to become more and increasingly concentrated. Most economists have traced this tendency to the exigencies of information flows, to degrees of uncertainty, and to the necessity of transactional speed. Across the world’s major regions, therefore, there has long been a readily observable tendency for certain cities to emerge as centres for face-to-face contact. As commerce encouraged agglomerations of wholesalers, those wholesalers pulled in financial service providers. Simultaneously, the central offices of expanding corporations tended to concentrate around

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finance. Not by coincidence is it often said that banking is an industry dependent on trust and confidence. But the informational asymmetries that drive the phenomenon of agglomeration appear to reach certain natural limits. Information has a cost, and local financiers with specific informational advantages—the knowledge of local markets and time differences—exploit them. So, of course, do others in different localities. Thus far, therefore, the centralization process has been incomplete. We remain in a world characterized by increasingly centralized but geographically bounded financial markets, with those boundaries defined by “the tendency of governments and private persons to favor their compatriots over foreigners, even at the expense of higher cost or lower profit—an implicit or explicit mercantilist attitude.” Such a tendency, Kindleberger nevertheless hypothesized, might be expected to recede over time. “The continuous reduction in the costs and difficulties of transportation and communication over the last two hundred years,” he concluded, “has favored the formation of a single world financial market.”

In his own magisterial study of financial geography, Youssef Cassis more recently backed away from Kindleberger’s bold conclusion and simply began with the empirical observation that not one but several capitals of capital have emerged since the end of the nineteenth century. They include London and various smaller regional centres in various European capital cities, New York and several smaller and specialized US cities, Tokyo, Hong Kong, and Singapore. To this confined list, we might today add Shanghai, but at this moment in history such an addition would still reflect more an aspiration than an observation. As to the reasons for the emergence of these centres, Cassis emphasized the irreducible national roots of banking, debt, and equity laws, the mandates and activities of central banks, the monetary conditions conducive to the agglomeration of financial services, and finally the ebb and flow of local economic and social conditions.

In the end, it is men . . . who are the driving force behind international financial centres . . . [and] all these factors, both institutional and human, create an atmosphere that is unique to each financial centre and that is vital to its success, even if it is neither quantifiable nor always easy to detect. This expresses itself in the way that a centre’s premises are laid out, its traditions, its unwritten rules, its interpersonal relationships, its attitude towards the outside world and its unique culture. The development of these various factors, themselves [uniquely] influenced by changes occurring in the world political and economic order, explain the ups and downs in fortune of the world’s main financial centres.

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4 Ibid., p. 11.

5 Ibid.


7 Ibid., p. 5.
Turning specifically to Hong Kong, Cassis noted the remarkable boom that occurred after 1945 and the city’s capacity to make the most of favourable economic trends outside the Chinese Mainland. Hong Kong’s banking markets soon recovered from the war. Not by chance were the heirs of British overseas banks to reassert themselves after the United States and Chiang Kai-shek’s China acquiesced in Great Britain’s return to Hong Kong after Japan’s wartime occupation. Thereafter, Hongkong and Shanghai Banking Corporation and Standard and Chartered, to name the biggest, worked hand in hand with Hong Kong’s government to restore and develop sea, air, and telecommunication systems as well as to support the growth not only of traditional trading networks focused on China but also the city’s new industrial entrepreneurs. Tested by China’s civil war, by later turmoil associated with the Cultural Revolution, and finally by the uncertainties surrounding Great Britain’s final handover in 1997, those manufacturing and service networks flourished. Especially after the 1970s, they regional markets they underpinned began attracting a widening range of multinational corporations. Hong Kong enjoyed a perfect location for their regional headquarters, and their main banks naturally followed.

It would nevertheless be a mistake to imagine that Hong Kong’s postwar financial recovery and development were spontaneous. The case of Singapore during the same period throws into sharp relief the more subtle but still important role played by government policy in Hong Kong. As Cassis emphasized, the government of Singapore targeted the financial sector for rapid development just after independence was declared in 1965.8 In 1968, as the offshore dollar market was maturing in Europe, the government authorized the Bank of America to set up a currency unit. Its main competitors soon arrived, and the interbank Asian dollar market was born. The establishment of the Monetary Authority of Singapore in 1971 provided a new source of confidence in the future of that market. That same year, the government provided direct incentives for the issuance of Asian dollar bonds; the first issues included US$10 million for the government-owned Development Bank of Singapore and $100 million for the government itself.

In 1984, the government created the Singapore International Mercantile Exchange, modeled on and directly linked to its counterpart in Chicago, and thus began the organized trading of derivatives in southeast Asia. By 1990, the deposits and loans of Asian currency units of Singapore’s foreign banking community had grown to US$350 billion, while a once fledgling foreign exchange market was booking transactions valued at around one-third of that amount per day—surpassed only by London, New York, and Tokyo. By the mid-1990s, 185 foreign commercial banks and 75 investment banks had local operations.9 Wealth management, insurance, and the hedge fund industry then took their turns in the government’s plans for financial market deepening. The image of Singapore as Asia’s Switzerland took root. Some of my own friends in the banking industry held positions in Singapore during this period. Although they prospered, they were also occasionally disquieted by the sense that an overly strong state seemed omnipresent inside the society of which they were transient members.

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8 Ibid., p. 276.

9 Ibid.
Hong Kong took a different stance. More conservative and less intrusive, its government nonetheless nurtured sense of personal and professional freedom. Having successfully ridden waves generated by instability in China and by global monetary turmoil associated with the end of the Bretton Woods exchange rate system and the oil price shocks of the early 1970s, Hong Kong emerged as a centre for offshore credit operations for the region’s governments and expanding industrial corporations. Within a decade, its banks had risen to third place in this sector, just behind London and New York. Cassis was hardly alone in attributing this success to the non-interventionist stance of Hong Kong’s government, but this deserves deeper reflection. In London, relevant regulatory policies were then coming to be labeled ‘light-touch.’ But this did not mean ‘no touch.’

In fact, the government of Hong Kong created important tax advantages by dropping its previous 15% withholding tax on interest paid on foreign deposits. Through its land policies and associated incentives, moreover, it helped rapidly to develop the property and communications infrastructures required for efficient clearing and settlement systems. In addition, it moved aggressively to abolish all exchange controls and establish personal tax advantages for highly skilled managers. Indeed, as long as their firms covered high accommodation expenses, such advantages were hard to beat anywhere else in the region. Unlike Singapore, Hong Kong had the crucial advantage of an indigenous industrial base that grew up after the war. Trade remained key, but local entrepreneurs certainly did seek aggressively to utilize a large and growing labour force and, especially after China moved toward liberalization in the late 1970s, the less expensive labour force in a burgeoning hinterland. Eventually, even conservative local banks could not ignore the possibilities for new business servicing operations. Foreign corporations and their main banks, in turn, were attracted by a legal system akin to London’s and, after 1983, by a nominally fixed exchange rate system.

In a region still more turbulent than North America or Europe, the policies needed to maintain a dollar peg promised to foster a vital sense of stability. Equity markets, in particular, benefited, from the rapidly growing requirements of Chinese corporations for working capital and, in turn, from the rising interest of Chinese entrepreneurs in diversifying their own personal investment portfolios. By the late 1990s, Hong Kong had surpassed Singapore in key financial market segments, with the notable exception of bonds. Aside from London, London, it had also surpassed all other financial centres in the world in the number of foreign banks represented on its territory. By the opening of the 21st century, a prominent financial geographer could declare, “Its intermediaries of capital, who include traders, financiers, and corporate managers, have made Hong Kong the pivot of decision-making about the exchange of capital within Asia and between that region and the rest of the world.” This view is compelling, indeed it rests on a plausible image concerning the way information, trust, and competitive impulses interact in contemporary capital markets. It sensitizes us to the intimate relationship between history and geography. More specifically, it highlights Hong Kong’s enduring place at the intersection of

Chinese social networks and foreign networks as they evolved over time in Asia. At one and the same time, Hong Kong became a magnet for foreign investors in the region and a “window on the world’s economy” for China.\textsuperscript{11}

Even before the British handover in 1997, certain idiosyncrasies in Hong Kong’s financial sector had become particularly noteworthy.\textsuperscript{12} Foreign banks had an outsized role in servicing the part of the economy focused on external trade, while local banks fixated on housing loans and the financing of land speculation. This left the overall economy hostage to a boom and bust cycle in property markets. Furthermore, the opacity of China-based companies that were playing an ever larger role in Hong Kong’s financial markets raised the specter of systemic risk beyond the capacity of Hong Kong authorities effectively to monitor or control. In fact, even before trying to gauge the impact of explicit or implicit Chinese sovereign risk, Hong Kong’s supervisory systems had obviously failed in the late 1990s in the context of the Asian financial crisis.

Following the collapse of Peregrine Investments and a speculative attack against the linked exchange rate, the Hong Kong Monetary Authority took the dramatic step in August of 1998 of directly intervening to support prices in local financial markets. In an unprecedented measure, graphically displayed below, the equivalent of US$15 billion was drawn from the Exchange Fund and used to support the prices of local blue-chip stocks. Although confidence was restored, the notion that ‘light touch’ regulation adequately protected Hong Kong’s core financial interests had been discredited. At the same time, the unorthodox intervention reinforced in many minds the idea that Hong Kong’s monetary reserves, the consequence of fiscal and current account surpluses and the linked exchange rate system, should grow without limit. The opportunity cost thereby borne by the society that had grown up after the war barely figured into any subsequent debate. That cost would rise as productive industries continued moving operations to the Mainland.

\textsuperscript{11} Ibid., p. 3.

The connection between the Exchange Fund and the resiliency of Hong Kong’s financial markets is clear. Who benefits? Differences of opinion over the appropriate size and investment performance of the Reserve Fund, as well as on the direction in which those markets should evolve, ultimately turned on the answer to that question. As we discuss more fully below, another crisis ten years later made associated debate more complicated. Although Hong Kong managed the crisis of 2008 better than most countries, and certainly better than the United States and United Kingdom, the defensive tools deployed left it vulnerable to new risks. An over-valued currency, rising foreign exchange reserves, and excessive domestic liquidity creation created the conditions for asset bubbles, especially in real estate. A weaker, not a stronger, banking system became not just a theoretical possibility. At the same time and for the same reasons, dependence on the United States arguably increased. Some presumably gained from such development. But surely many in Hong Kong also became more vulnerable to the next crisis.

In the context of rising competition and periodic bouts of instability in financial markets around the world, the question of ‘who benefits’ shaped diverging views on the reform of a broad range of Hong Kong’s the policies underpinning its IFC. We assess related debates in more detail after providing a broader view of the economic terrain within which Hong Kong’s market makers are currently working.
3. *Four Key Industries*

The growing importance of Hong Kong’s financial sector needs first to be viewed as the consequence of a long-term domestic transformation. Although, as noted above, finance has long played an important role in Hong Kong’s development, it is today only one of the four industrial pillars of the local economy. The other three pillars are tourism, trade and logistics, and professional services. In the wake of the relative decline of manufacturing, or more accurately, the shifting of manufacturing facilities mainly to Mainland China during the past two decades, the four pillars now account for half of all HKSAR economic activity.

The tables below, compiled from latest available data tracked by the HKSAR Government’s Census and Statistics Department, sets the economic value and employment contributions of the four industrial sectors into comparative perspective. The first set of indicators relates to GDP and value added at current factor costs. Both highlight the important place of financial services, but they also help put that sector into context.\(^{13}\)

The second set of indicators relates to employment. They clearly demonstrate the importance of the four industries at the present time. Like the first set, however, they also demonstrate the lower employment-generating performance of finance. In this regard, trade and logistics as well as professional services are much more important. Obviously, however, that outcome reflects a myriad of direct and indirect linkages across the sectors.

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## The Four Key Industries of Contemporary Hong Kong

### Value Added

<table>
<thead>
<tr>
<th>Value added at current factor cost (HK$ MM)</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
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<td>(1) Financial services</td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Banking</td>
<td>100,500</td>
<td>107,300</td>
<td>136,500</td>
<td>180,400</td>
<td>160,200</td>
</tr>
<tr>
<td>Insurance</td>
<td>17,300</td>
<td>17,300</td>
<td>19,500</td>
<td>23,500</td>
<td>22,600</td>
</tr>
<tr>
<td>Other financial services (e.g. stock brokerage, asset management, finance leasing and investment, holding companies)</td>
<td>35,100</td>
<td>45,700</td>
<td>70,100</td>
<td>98,000</td>
<td>69,000</td>
</tr>
<tr>
<td>(2) Tourism</td>
<td></td>
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<td></td>
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<td></td>
</tr>
<tr>
<td>(A) Inbound</td>
<td>27,400</td>
<td>31,900</td>
<td>35,000</td>
<td>40,000</td>
<td>36,500</td>
</tr>
<tr>
<td>(B) Outbound</td>
<td>9,600</td>
<td>10,900</td>
<td>10,300</td>
<td>12,300</td>
<td>7,300</td>
</tr>
<tr>
<td>(3) Trading and Logistics</td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>(A) Trading</td>
<td>279,700</td>
<td>315,000</td>
<td>318,600</td>
<td>329,100</td>
<td>343,800</td>
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<tr>
<td>(B) Logistics</td>
<td>67,200</td>
<td>69,800</td>
<td>71,500</td>
<td>71,100</td>
<td>62,100</td>
</tr>
<tr>
<td>(4) Professional Services and Other Producer Services</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(A) Professional services</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Legal, accounting and auditing services</td>
<td>14,400</td>
<td>15,400</td>
<td>15,900</td>
<td>18,100</td>
<td>19,300</td>
</tr>
<tr>
<td>Architectural, surveying, project engineering services; engineering; technical services; business management and consultancy services</td>
<td>20,600</td>
<td>21,200</td>
<td>23,600</td>
<td>27,400</td>
<td>31,000</td>
</tr>
<tr>
<td>Other professional services (e.g. information technology related services, advertising services)</td>
<td>11,800</td>
<td>13,800</td>
<td>14,200</td>
<td>15,200</td>
<td>15,700</td>
</tr>
<tr>
<td>(B) Other producer services</td>
<td>85,700</td>
<td>91,800</td>
<td>96,300</td>
<td>110,200</td>
<td>121,200</td>
</tr>
<tr>
<td>Total GDP</td>
<td>1,244,800</td>
<td>1,332,800</td>
<td>1,423,300</td>
<td>1,552,000</td>
<td>1,567,900</td>
</tr>
</tbody>
</table>
### The Four Key Industries of Contemporary Hong Kong

#### Percentage Share of GDP

<table>
<thead>
<tr>
<th>Share of GDP (%)</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Financial services</td>
<td>12.3</td>
<td>12.8</td>
<td>15.9</td>
<td>19.5</td>
<td>16.1</td>
</tr>
<tr>
<td>Banking</td>
<td>8.1</td>
<td>8.0</td>
<td>9.6</td>
<td>11.6</td>
<td>10.2</td>
</tr>
<tr>
<td>Insurance</td>
<td>1.4</td>
<td>1.3</td>
<td>1.4</td>
<td>1.5</td>
<td>1.4</td>
</tr>
<tr>
<td>Other financial services (e.g. stock brokerage, asset management, finance leasing and investment and holding companies)</td>
<td>2.8</td>
<td>3.4</td>
<td>4.9</td>
<td>6.3</td>
<td>4.4</td>
</tr>
<tr>
<td>(2) Tourism</td>
<td>3.0</td>
<td>3.2</td>
<td>3.2</td>
<td>3.4</td>
<td>2.8</td>
</tr>
<tr>
<td>(A) Inbound</td>
<td>2.2</td>
<td>2.4</td>
<td>2.5</td>
<td>2.6</td>
<td>2.3</td>
</tr>
<tr>
<td>(B) Outbound</td>
<td>0.8</td>
<td>0.8</td>
<td>0.7</td>
<td>0.8</td>
<td>0.5</td>
</tr>
<tr>
<td>(3) Trading and Logistics</td>
<td>27.9</td>
<td>28.9</td>
<td>27.4</td>
<td>25.8</td>
<td>25.9</td>
</tr>
<tr>
<td>(A) Trading</td>
<td>22.5</td>
<td>23.6</td>
<td>22.4</td>
<td>21.2</td>
<td>21.9</td>
</tr>
<tr>
<td>(B) Logistics</td>
<td>5.4</td>
<td>5.2</td>
<td>5.0</td>
<td>4.6</td>
<td>4.0</td>
</tr>
<tr>
<td>(4) Professional Services and Other Producer Services</td>
<td>10.6</td>
<td>10.7</td>
<td>10.5</td>
<td>11.0</td>
<td>11.9</td>
</tr>
<tr>
<td>(A) Professional services</td>
<td>3.8</td>
<td>3.8</td>
<td>3.8</td>
<td>3.9</td>
<td>4.2</td>
</tr>
<tr>
<td>Legal, accounting and auditing services</td>
<td>1.2</td>
<td>1.2</td>
<td>1.1</td>
<td>1.2</td>
<td>1.2</td>
</tr>
<tr>
<td>Architectural, surveying, project engineering services; engineering and technical services; and business management and consultancy services</td>
<td>1.7</td>
<td>1.6</td>
<td>1.7</td>
<td>1.8</td>
<td>2.0</td>
</tr>
<tr>
<td>Other professional services (e.g. information technology related services, advertising services)</td>
<td>0.9</td>
<td>1.0</td>
<td>1.0</td>
<td>1.0</td>
<td>1.0</td>
</tr>
<tr>
<td>(B) Other producer services *</td>
<td>6.9</td>
<td>6.9</td>
<td>6.8</td>
<td>7.1</td>
<td>7.7</td>
</tr>
<tr>
<td>Four Key Industries = (1)+(2)+(3)+(4)</td>
<td>53.8</td>
<td>55.5</td>
<td>57.0</td>
<td>59.6</td>
<td>56.7</td>
</tr>
</tbody>
</table>
# The Four Key Industries of Contemporary Hong Kong

## Employment Numbers

<table>
<thead>
<tr>
<th>Employment</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Financial services</td>
<td>169 500</td>
<td>179 500</td>
<td>186 000</td>
<td>192 700</td>
<td>206 600</td>
</tr>
<tr>
<td>Banking</td>
<td>72 400</td>
<td>75 400</td>
<td>81 400</td>
<td>88 400</td>
<td>93 700</td>
</tr>
<tr>
<td>Insurance</td>
<td>39 700</td>
<td>45 100</td>
<td>42 200</td>
<td>43 000</td>
<td>43 500</td>
</tr>
<tr>
<td>Other financial services</td>
<td>57 400</td>
<td>59 000</td>
<td>62 400</td>
<td>61 200</td>
<td>69 500</td>
</tr>
<tr>
<td>(2) Tourism</td>
<td>153 600</td>
<td>163 900</td>
<td>176 300</td>
<td>193 800</td>
<td>197 400</td>
</tr>
<tr>
<td>(A) Inbound</td>
<td>128 700</td>
<td>136 200</td>
<td>144 700</td>
<td>160 600</td>
<td>164 800</td>
</tr>
<tr>
<td>(B) Outbound</td>
<td>24 900</td>
<td>27 700</td>
<td>31 700</td>
<td>33 200</td>
<td>32 600</td>
</tr>
<tr>
<td>(3) Trading and Logistics</td>
<td>796 700</td>
<td>824 900</td>
<td>839 900</td>
<td>842 200</td>
<td>832 800</td>
</tr>
<tr>
<td>(A) Trading</td>
<td>601 700</td>
<td>624 700</td>
<td>629 800</td>
<td>633 600</td>
<td>623 500</td>
</tr>
<tr>
<td>(B) Logistics</td>
<td>195 100</td>
<td>200 200</td>
<td>210 100</td>
<td>208 600</td>
<td>209 300</td>
</tr>
<tr>
<td>(4) Professional Services and Other Producer Services</td>
<td>360 600</td>
<td>371 500</td>
<td>387 000</td>
<td>406 500</td>
<td>424 800</td>
</tr>
<tr>
<td>(A) Professional services</td>
<td>132 100</td>
<td>136 900</td>
<td>144 900</td>
<td>152 300</td>
<td>163 400</td>
</tr>
<tr>
<td>Legal, accounting and auditing services</td>
<td>34 800</td>
<td>37 500</td>
<td>40 000</td>
<td>42 400</td>
<td>46 100</td>
</tr>
<tr>
<td>Architectural, surveying, project engineering services; engineering and technical services; and business management and consultancy services</td>
<td>55 300</td>
<td>57 500</td>
<td>60 300</td>
<td>63 500</td>
<td>67 600</td>
</tr>
<tr>
<td>Other professional services (e.g. information technology related services, advertising services)</td>
<td>42 000</td>
<td>42 000</td>
<td>44 600</td>
<td>46 400</td>
<td>49 700</td>
</tr>
<tr>
<td>(B) Other producer services *</td>
<td>228 500</td>
<td>234 700</td>
<td>242 100</td>
<td>254 200</td>
<td>261 400</td>
</tr>
<tr>
<td>Four Key Industries = (1)+(2)+(3)+(4)</td>
<td>1 480 400</td>
<td>1 539 800</td>
<td>1 589 300</td>
<td>1 635 200</td>
<td>1 661 500</td>
</tr>
<tr>
<td>Total employment</td>
<td>3 279 100</td>
<td>3 343 000</td>
<td>3 412 000</td>
<td>3 485 400</td>
<td>3 521 400</td>
</tr>
</tbody>
</table>
The Four Key Industries of Contemporary Hong Kong

Percentage Share of Total Employment

<table>
<thead>
<tr>
<th>Share of total employment (%)</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Financial services</td>
<td>5.2</td>
<td>5.4</td>
<td>5.5</td>
<td>5.5</td>
<td>5.9</td>
</tr>
<tr>
<td>Banking</td>
<td>2.2</td>
<td>2.3</td>
<td>2.4</td>
<td>2.5</td>
<td>2.7</td>
</tr>
<tr>
<td>Insurance</td>
<td>1.2</td>
<td>1.3</td>
<td>1.2</td>
<td>1.2</td>
<td>1.2</td>
</tr>
<tr>
<td>Other financial services</td>
<td>1.7</td>
<td>1.8</td>
<td>1.8</td>
<td>1.8</td>
<td>2.0</td>
</tr>
<tr>
<td>(e.g. stock brokerage, asset management, finance leasing and investment and holding companies)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(2) Tourism</td>
<td>4.7</td>
<td>4.9</td>
<td>5.2</td>
<td>5.6</td>
<td>5.6</td>
</tr>
<tr>
<td>(A) Inbound</td>
<td>3.9</td>
<td>4.1</td>
<td>4.2</td>
<td>4.6</td>
<td>4.7</td>
</tr>
<tr>
<td>(B) Outbound</td>
<td>0.8</td>
<td>0.8</td>
<td>0.9</td>
<td>1.0</td>
<td>0.9</td>
</tr>
<tr>
<td>(3) Trading and Logistics</td>
<td>24.3</td>
<td>24.7</td>
<td>24.6</td>
<td>24.2</td>
<td>23.6</td>
</tr>
<tr>
<td>(A) Trading</td>
<td>18.3</td>
<td>18.7</td>
<td>18.5</td>
<td>18.2</td>
<td>17.7</td>
</tr>
<tr>
<td>(B) Logistics</td>
<td>5.9</td>
<td>6.0</td>
<td>6.2</td>
<td>6.0</td>
<td>5.9</td>
</tr>
<tr>
<td>(4) Professional Services and Other Producer Services</td>
<td>11.0</td>
<td>11.1</td>
<td>11.3</td>
<td>11.7</td>
<td>12.1</td>
</tr>
<tr>
<td>(A) Professional services</td>
<td>4.0</td>
<td>4.1</td>
<td>4.2</td>
<td>4.4</td>
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<tr>
<td>Legal, accounting and auditing services</td>
<td>1.1</td>
<td>1.1</td>
<td>1.2</td>
<td>1.2</td>
<td>1.3</td>
</tr>
<tr>
<td>Architectural, surveying, project engineering services; engineering and technical services; and business management and consultancy services</td>
<td>1.7</td>
<td>1.7</td>
<td>1.8</td>
<td>1.8</td>
<td>1.9</td>
</tr>
<tr>
<td>Other professional services</td>
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<td>1.3</td>
<td>1.3</td>
<td>1.3</td>
<td>1.4</td>
</tr>
<tr>
<td>(e.g. information technology related services, advertising services)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(B) Other producer services</td>
<td>7.0</td>
<td>7.0</td>
<td>7.1</td>
<td>7.3</td>
<td>7.4</td>
</tr>
<tr>
<td>Four Key Industries = (1)+(2)+(3)+(4)</td>
<td>45.1</td>
<td>46.1</td>
<td>46.6</td>
<td>46.9</td>
<td>47.2</td>
</tr>
</tbody>
</table>

In striking contrast to the industrial economy of Hong Kong in the era before China’s opening in the late 1970s, the four key industries of the present are all in the service sector. To be sure, the main generator of employment, trading and logistics, is still linked to a manufacturing base. But that base is now on the Mainland. Finance and professional services generate less employment, but taken together they generate roughly the same economic value in GDP terms. Another way to assess the importance of both industries as they have changed over time is to examine available data for service exports. Of late, and certainly since recovery from the Asian crisis of the late 1990s, service exports from Hong Kong have been growing at a pace in excess of 10% per annum. Since 2003, exports of financial services have grown much faster than exports from any other service sector.
China is the single largest importer of services from Hong Kong, followed by the United States. If the Mainland economy doubles in size over the next decade, service exports from Hong Kong will likely account for 50% of its GDP.14 Although there is no reason to expect financial services to shrink in terms of its relative share of this activity, there is every reason to expect traditional banking services to shrink relative to other kinds of financial services, including asset management and securities trading.

As Hong Kong’s financial markets deepen, it is likely that the creation and trading of equity and other kinds of derivatives will increase. This will complement the strong contemporary performance of its equity market in the initial public offerings of Chinese companies. Based on the experience of other financial centres, especially New York and London, private equity placements, alternative investment vehicles, and other forms of wealth management will also very likely increase in importance. The fact that a rising number of non-resident investors are already looking to Hong Kong is especially suggestive of such a trend, since many resident investors are still recovering from their traumatic experience with Lehman mini-bonds. We discuss that matter more fully below.

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**Hong Kong’s Fund Management Business by Source of Investor**

![Graph showing fund management business by source of investor](chart.png)


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HKMA analysts currently project that Mainland firms and individuals will account for about 50% of the next decade’s growth in financial service exports. Together with domestic expansion, this will very likely propel total financial sector output from about 15% of GDP to over 20%, which would be comparable to the current situation in both New York and London. Given increasing competition in this sector both regionally and globally, such a performance will depend upon Hong Kong firms moving rapidly up the chain of value. The quantity of business and the quality of business are very much related. What this translates into is the need to bolster the capacity for rapid emulation of advances made elsewhere and to accelerate the pace of local innovation, which brings us back to the quality of the labour force.

Upgrading and supplementing that labour force is the key challenge in safeguarding and enhancing Hong Kong’s competitiveness in the years ahead. Again, it is a matter of investment, building, and restructuring—not least in the biggest driver of labour force quality, education.

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15 Ibid., p. 29.
The legacy of past investments is already evident. In the financial sector, it is reflected in Hong Kong’s growing reputation among international investors, service professionals, and business managers. Whether that reputation continues to grow is a function of policy, the core issue to which we return after a deeper examination of the productivity of Hong Kong’s workforce.
4. The Productivity of Hong Kong’s Labour Force

Behind aggregate sectoral measures lies the fundamental reality of a workforce still adapting to the decline of manufacturing and the rise of a modern service economy. Before anything else, Hong Kong’s economy is comprised of its people. Land, location, climate, and natural resources—none matter and none count in the absence of a working, consuming, investing population. What has actually driven the growth of Hong Kong’s economy during recent decades? The answer is clear. Hong Kong’s contemporary economy has been shaped mainly by rapid growth in the productivity of its labour force, growth mainly occurring in financial and trade-related activities.\textsuperscript{16}

In recent years, the pace of growth in labour productivity in Hong Kong of about 5% per annum from 2002 to 2007 far exceeded that of Japan (1.8%), Singapore (2.9%), Taiwan (3.1%), Korea (3.3%), the Philippines (3.5%), Indonesia (3.6%), Thailand (3.7%), Malaysia (3.9%). No advanced industrial country comes close, but one country far exceeds it. China recorded an increase of 10.1% per annum for the same period.\textsuperscript{17} The performance of China and Hong Kong are obviously related, and both were also negatively affected by the global business downturn associated with the financial crisis of 2008, but their joint productivity growth may be expected to resume as a global recovery takes hold.

More revealing than the aggregate productivity indicator for Hong Kong is the breakdown by sector, for here we see much divergence over time and a shifting sense of the future. Driving annual changes are two components: the efficiency of labour deployed and technological progress. These key investments were made over time to upgrade the quality of the labour force, but deeper analysis suggests that the basic forces necessitating change came from service exports and the growth of complementary service sectors on the Mainland.


\textsuperscript{17} Ibid., p. 4.
Annual Average Change in Total Factor Productivity for Key Sectors in Hong Kong

(1987-2007)

<table>
<thead>
<tr>
<th>Sector</th>
<th>Efficiency Change</th>
<th>Technological Progress</th>
<th>TFP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wholesale &amp; retail trade</td>
<td>-4.8</td>
<td>7.5</td>
<td>2.4</td>
</tr>
<tr>
<td>Restaurants &amp; hotels</td>
<td>-4.6</td>
<td>7.4</td>
<td>2.4</td>
</tr>
<tr>
<td>Trade</td>
<td>-3.1</td>
<td>7.2</td>
<td>3.9</td>
</tr>
<tr>
<td>Transport &amp; storage</td>
<td>-2.8</td>
<td>5.8</td>
<td>2.9</td>
</tr>
<tr>
<td>Communications</td>
<td>-2.8</td>
<td>5.8</td>
<td>2.9</td>
</tr>
<tr>
<td>Finance, except banking</td>
<td>0.5</td>
<td>7.1</td>
<td>7.7</td>
</tr>
<tr>
<td>Business services</td>
<td>-5.0</td>
<td>7.5</td>
<td>2.1</td>
</tr>
<tr>
<td>Insurance</td>
<td>0</td>
<td>6.9</td>
<td>6.9</td>
</tr>
<tr>
<td>Construction &amp; real estate</td>
<td>-6.3</td>
<td>5.1</td>
<td>-1.5</td>
</tr>
<tr>
<td>Banking</td>
<td>0.1</td>
<td>6.4</td>
<td>6.5</td>
</tr>
</tbody>
</table>

The sectoral composition of recent Hong Kong’s productivity growth underlines the long-term transformation in its economy since 1997. In essence, employment in the manufacturing sector has diminished as a share of GDP, while employment in the service sector has increased dramatically. Trading activities and transport services have led the way in the creation of new jobs. More accurately, those jobs reflect the expanding significance not of purely domestic exports but of re-exports to and from the Mainland.

As highlighted in the previous section, jobs directly or indirectly connected to financial institutions are critical to the present and future Hong Kong economy. In an overall sense, the importance of the financial sector has long been important, not only in terms of new jobs but, increasingly over time, in terms of high-wage jobs. Because of technological changes, lower-wage jobs, including in the back-offices of financial institutions, have become relatively easy to move to cheaper locations. At the same time, front-office and highly-skilled jobs have increased in volume in Hong Kong itself ever since 1997.

As confidence in the future gradually returned over the past decade and a half, Hong Kong’s financial institutions expanded their headquarters operations but also quickly followed their manufacturing clients to Guangdong and eventually further afield inside China. In 2001, Ernst & Young made a high-profile move to Guangzhou and were soon followed by the Bank of East Asia, HSBC, and Standard & Chartered. At the same time, foreign banks, private equity firms, hedge funds, and other financial service providers established regional headquarters in Hong Kong. Best estimates are that regional offices and regional headquarters operations

18 Ibid., p. 23.
increased from about 2,400 in 1997 to over 3,800 by 2007. As Meyer put it, “The reason is the centrality of Hong Kong in the business networks of Asia, especially because it is the pivotal meeting place of the Chinese and foreign networks of capital.”

With foreign networks well established during the British era, the biggest change in the contemporary period has come from the rapid development of Chinese networks. The intention on both the Hong Kong and the Chinese side was clearly affirmed in 2003 in the Closer Economic and Partnership Agreement (CEPA). In practice, FDI flows through Hong Kong, the export of trade-related services from Hong Kong, and, more recently, booming flows of Chinese portfolio investment into Hong Kong suggest the deepening of China-Hong Kong networks. In Hong Kong, those networks intersect with simultaneously expanding foreign networks. Improvements in the productivity of employed labour follow.

According to recent HKMA estimates, Hong Kong can count on capturing a minimum of 10% of portfolio investments flowing out of China in the foreseeable future. A key factor influencing Hong Kong’s growth prospects in the financial sector will therefore be the pace of change in China’s capital liberalization policies. Although less predictable, it is also quite possible that illicit flows would grow significantly if the pace of policy change in China slackens.

With the expansion in strategic-level jobs comprising the core of financial networks has naturally come growth in demand for skilled service-providers in Hong Kong. As noted above, financial, legal, marketing, business consulting and similar positions accounted for over 630,000 jobs in Hong Kong by 2008. But the biggest change in this regard was in the final destination of the services provided from that Hong Kong base. Indicative of the deepening interdependence between Hong Kong and the Mainland, the export of business services from Hong Kong rose from about HK$90 billion in 1997 to over HK$260 billion per year within the following decade. Driving much of this growth was a dramatic increase in foreign direct investment into China during the same period, investment from all over the world but not least from Hong Kong itself. In short, the trade and investment nexus is crucial in a world where intra-firm trade currently accounts for the lion’s share of exports and imports.

Behind Hong Kong’s continuing transformation to a successful service economy lies a myriad of factors. Geography and history have given it privileged access to the world’s largest and fastest growing market. History too has given it a head start in the race to develop a population capable of working both in the currently dominant language of global business, namely English, and in the language and business culture of China. With regard to the critical networks of global finance, that same history continues to link Hong Kong deeply to London.

All of these factors are vitally important, but their legacy cannot be taken for granted. Key policy drivers developed them, and they fostered the productivity of Hong Kong’s labour force today. Those same drivers will shape Hong Kong’s ability to compete in rapidly changing

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20 Ibid., p. 20.

regional and global economies in the future. They include personal and corporate tax policies and the land-use and land-transfer policies linked to them, currency and reserve policies, financial and capital market access policies, regulatory and supervisory policies, immigration policies, infrastructure development policies--from transport systems to health care, education policies, policies aimed at preserving basic political and economic freedoms, and governing and judicial structures capable of maintaining a credible commitment to the rule of law.

These factors deserve fuller examination and critical assessment in any comprehensive study focused on the future of Hong Kong. We return to a consideration of many of them below, but the best way to prepare the ground for a necessarily abbreviated analysis is to look at how the rest of the world currently perceives Hong Kong’s particular strengths as financial centre.
5. **Hong Kong’s Financial Centre in Comparative Context**

From regional to global centre

“What’s past is prologue,” claimed Antonio in Shakespeare’s *The Tempest*. But as he followed that famous phrase, “what to come in yours and my discharge.” Hong Kong’s mode of entry onto the world economic stage does not completely determine its future destiny, but the assets it possessed from the beginning continue to shape its most promising opportunities. Its harbour and its physical and human links to the heartland of China made it a trading centre. It is but a small step from trade in commodities and manufactured goods to trade in services. And when trade between nations mediated by trading companies was largely transformed by the practice of intra-firm trade within multinational corporate networks, Hong Kong’s adaptation required little detailed direction. Its natural advantages remained the same as industrial capitalism on a national scale developed into financial capitalism on a global scale. Its geographic location, its time-zone, and its openness to the movement of people made it—and, as noted above, continue to make it—a clearing house for information. There was, however, nothing inevitable about the precise path it has recently taken. Compared to other places in its region, it avoided many policy mistakes that could have undercut its natural advantages. Among other things, the result is that it is now widely recognized as among the top three financial centres in the world.

That recognition now derives from the actual practice of the intermediation of information flows, and that practice, in turn, rests on three factors: connectivity, diversification, and the quality and depth of key specialities. The most sophisticated comparative studies of financial centres now routinely utilize an instrumental and survey-based database designed and regularly updated for the City of London. Last September its Policy and Resources Committee released the seventh in its semi-annual series entitled, *Global Financial Centres*.22 The study breaks those three instrumental factors down into five simple categories: People, Business Environment, Infrastructure, Market Access, and General Competitiveness. It draws evidence, for example, concerning the fairness and justice of a business environment from a long-term set of indices measuring perceptions of corruption and regulatory opacity. Complementing such evidence, the Committee maintains an open and continuing online questionnaire completed by professionals engaged in international financial services. Regularly discounting older assessments, the latest study rests on 32,170 assessments provided by 1,690 professionals. Seventy five of the world’s great cities are rated and ranked accordingly. Of these, Hong Kong regularly finds its place among the top eight. The following table lists them in order as of September 2010.

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22 Z/Yen Group (City of London/Long Finance/Financial Center Futures), *Global Financial Centers Index 8*, London, September 2010. Although useful, such surveys of changing perceptions are of limited value in rigorously comparing the underlying forces driving the expansion and deepening of financial centres over time. More objective and regularly updated comparative studies are necessary, both to develop scholarly understanding and to assist policymakers.
At the same global level, the study lists Shanghai, Beijing, Dubai, and Geneva as “relatively deep but still specialized global centres.” At the next level down, “transnational” centres range from such “broad and deep” cities as Tokyo, Sydney, and Vancouver to the “relatively specialized” Shenzhen and Taipei.23

Hong Kong’s third place global ranking has strengthened in recent years and it rates highly across all financial sectors. Overall, Hong Kong, Singapore and Tokyo are listed in that order in terms of regional importance. During the past year and in relative terms across the Asian region, Shanghai is rising strongly, Shenzhen has weakened slightly, while Beijing has strengthened slightly. Taipei and Seoul are also improving in terms of their own regional rankings. In general, however, the gap between Hong Kong, Singapore, and Tokyo and all other regional centres remains quite wide. In reputational rankings internationally, most Asian centres have benefited from the fact that the region largely escaped the worst effects of the global financial crisis of 2008. Indeed, their recovery from the Asian crisis of a decade earlier has been dramatic.

In this context, when GFC study respondents were asked to list the cities anywhere in the world that were likely soon to become more significant, they listed Shenzhen, Shanghai, Singapore, Seoul, Beijing, and Hong Kong—in that order. Similarly, when they were asked where they expected to open new offices in the near future, they listed in rank order Shenzhen, Shanghai, Hong Kong, Beijing, Singapore, and Seoul. Finally, it is worth noting that respondents did not consider any of these cities to be ‘tax havens,’ a term they reserved for Jersey, Guernsey, the Isle of Man, the Cayman Islands, and other small island centres.

To give a sense of the relative shifts in reputational ratings over the past two years, the following table lists the raw GFC survey scores:

---

Overall GFC Ratings

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>London</td>
<td>772</td>
<td>775</td>
<td>790</td>
</tr>
<tr>
<td>New York</td>
<td>770</td>
<td>775</td>
<td>774</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>760</td>
<td>739</td>
<td>729</td>
</tr>
<tr>
<td>Singapore</td>
<td>728</td>
<td>733</td>
<td>719</td>
</tr>
<tr>
<td>Tokyo</td>
<td>697</td>
<td>692</td>
<td>674</td>
</tr>
<tr>
<td>Shanghai</td>
<td>693</td>
<td>668</td>
<td>655</td>
</tr>
<tr>
<td>Chicago</td>
<td>678</td>
<td>678</td>
<td>661</td>
</tr>
<tr>
<td>Zurich</td>
<td>669</td>
<td>677</td>
<td>676</td>
</tr>
<tr>
<td>Geneva</td>
<td>661</td>
<td>671</td>
<td>660</td>
</tr>
<tr>
<td>Sydney</td>
<td>660</td>
<td>670</td>
<td>651</td>
</tr>
<tr>
<td>Shenzhen</td>
<td>654</td>
<td>670</td>
<td>695</td>
</tr>
<tr>
<td>Beijing</td>
<td>653</td>
<td>651</td>
<td>613</td>
</tr>
</tbody>
</table>

Finally, the GFC survey data may be broken down to provide two further informative sets of rankings, the first for industry sub-sectors and the second for factors associated with relative competitiveness.

Industry Sector Rankings

<table>
<thead>
<tr>
<th>Rank</th>
<th>Asset Mgmt.</th>
<th>Banking</th>
<th>Government</th>
<th>Insurance</th>
<th>Prof. Services</th>
<th>Private Banking</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>London</td>
<td>New York</td>
<td>New York</td>
<td>Hong Kong</td>
<td>London</td>
<td>London</td>
</tr>
<tr>
<td>2</td>
<td>New York</td>
<td>Hong Kong</td>
<td>London</td>
<td>Shanghai</td>
<td>New York</td>
<td>Geneva</td>
</tr>
<tr>
<td>3</td>
<td>Hong Kong</td>
<td>London</td>
<td>Singapore</td>
<td>New York</td>
<td>Hong Kong</td>
<td>New York</td>
</tr>
<tr>
<td>4</td>
<td>Singapore</td>
<td>Singapore</td>
<td>Hong Kong</td>
<td>Singapore</td>
<td>Singapore</td>
<td>Toronto</td>
</tr>
<tr>
<td>5</td>
<td>Tokyo</td>
<td>Tokyo</td>
<td>London</td>
<td>Tokyo</td>
<td>Chicago</td>
<td>Bahrain</td>
</tr>
<tr>
<td>6</td>
<td>Chicago</td>
<td>Shanghai</td>
<td>Frankfurt</td>
<td>Tokyo</td>
<td>Chicago</td>
<td>Talinn</td>
</tr>
<tr>
<td>7</td>
<td>San Francisco</td>
<td>Zurich</td>
<td>Chicago</td>
<td>Beijing</td>
<td>Tokyo</td>
<td>Qatar</td>
</tr>
<tr>
<td>8</td>
<td>Shanghai</td>
<td>Shenzhen</td>
<td>Geneva</td>
<td>Shenzhen</td>
<td>Zurich</td>
<td>Dublin</td>
</tr>
<tr>
<td>9</td>
<td>Boston</td>
<td>Chicago</td>
<td>Paris</td>
<td>Paris</td>
<td>Toronto</td>
<td>Brussels</td>
</tr>
<tr>
<td>10</td>
<td>Zurich</td>
<td>Frankfurt</td>
<td>San Francisco</td>
<td>Chicago</td>
<td>Boston</td>
<td>Stockholm</td>
</tr>
</tbody>
</table>
### GFC 8 (2010) Rankings of Areas of Competitiveness

<table>
<thead>
<tr>
<th>Rank</th>
<th>People</th>
<th>Business Environment</th>
<th>Market Access</th>
<th>Infrastructure</th>
<th>General Competitiveness</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>London</td>
<td>New York</td>
<td>New York</td>
<td>London</td>
<td>London</td>
</tr>
<tr>
<td>3</td>
<td>Hong Kong</td>
<td>Hong Kong</td>
<td>Hong Kong</td>
<td>Hong Kong</td>
<td>Hong Kong</td>
</tr>
<tr>
<td>4</td>
<td>Singapore</td>
<td>Singapore</td>
<td>Singapore</td>
<td>Singapore</td>
<td>Singapore</td>
</tr>
<tr>
<td>5</td>
<td>Tokyo</td>
<td>Chicago</td>
<td>Tokyo</td>
<td>Tokyo</td>
<td>Tokyo</td>
</tr>
<tr>
<td>6</td>
<td>Shanghai</td>
<td>Tokyo</td>
<td>Shanghai</td>
<td>Chicago</td>
<td>Shanghai</td>
</tr>
<tr>
<td>7</td>
<td>Chicago</td>
<td>Shanghai</td>
<td>Chicago</td>
<td>Washington</td>
<td>Chicago</td>
</tr>
<tr>
<td>8</td>
<td>Zurich</td>
<td>Zurich</td>
<td>Zurich</td>
<td>Zurich</td>
<td>Zurich</td>
</tr>
<tr>
<td>9</td>
<td>Geneva</td>
<td>Sydney</td>
<td>Seoul</td>
<td>Boston</td>
<td>Toronto</td>
</tr>
<tr>
<td>10</td>
<td>Boston</td>
<td>Geneva</td>
<td>Toronto</td>
<td>Geneva</td>
<td>Sydney</td>
</tr>
</tbody>
</table>

All things considered, the compilers of the GFC surveys conclude that over the past decade, and especially over the past two years, the reputational gap between London and New York, one the one hand, and Hong Kong, Singapore, and other Asian centres, on the other, has been diminishing rapidly. Within the region, Hong Kong and Singapore are today locked in their own competition for regional leadership, but Shanghai and Shenzhen enjoy rapidly improving reputations. Comparisons are worth examining in more depth in this changing regional context.

### Hong Kong and Singapore

Although striking differences exist in the underlying political economies of Hong Kong and Singapore, they share many historical characteristics. Both entered the modern era as colonies of Great Britain, Singapore in 1819 and Hong Kong in 1842. The main legacies of relevance to both of their financial markets today are the British common law tradition and the English language. Luckily for both, the British and then the Americans built the foundation of the global economy as it has evolved since the nineteenth century upon those legal and linguistic building blocks. Chinese emigres seeking a better life for their families adapted well to those traditions and, without losing their own cultural heritage or personal networks, they built adaptable and successful societies.

Breaking from Great Britain in 1959 and from the Federation of Malaysia in 1965, Singapore became an island-state dominated by overseas-Chinese. Of its current population of 4.8 million, 75% claim Chinese roots. For its part, Hong Kong’s relative autonomy from China was guaranteed in 1997 upon the basis of a population now comprising 6.9 million, 95% of which is Chinese. By 2009, Singapore’s booming economy recorded a GDP of US$177 billion, or US$37,000 per capita, while Hong Kong expanded to US$210 billion, or US$30,000 per capita. Certainly in comparison with regional neighbours, two ‘economic miracles’ accounted
for such outcomes. But strikingly different were the political engines lying underneath those miracles.

In the history of global capitalism, comparative analysts have identified a principal distinction across economically successful societies. Some have been led by strong states—like France and Japan, while others, like England and the United States, have been led by strong societies. For present purposes, arguing over very subtle differences is beside the point. Looked at together, the evidence of experience suggests quite plausibly that contemporary Singapore would not be what it is today in the absence of central state institutions capable of pushing its society forward in a challenging external environment. In contrast, Hong Kong developed a strong society capable of adapting quite effectively with little central direction to intense political struggles constantly buffeting it from without and from within. Economic and political freedom is very hard to quantify. But even the casual observer would be hard pressed to make the argument that the average Singaporean has throughout the modern era been freer than the average resident of Hong Kong.

Matthew Harrison of the Hong Kong Exchange convincingly captured the essential difference between Singapore and Hong Kong in the character of governments that built two distinctive financial economies. In Singapore, government played the role of leader; it believed in industrial policy and it implemented such a policy through targeted tax concessions, strict regulation, and sectoral planning. In Hong Kong, government played the role of facilitator; it restrained its tax policies and kept individual and corporate taxes low across the board, it intervened directly in its economy on an ad hoc basis, mainly in response to emergencies, and it adjusted its regulatory framework as required by periodic scandals. In Singapore a centralized government promoted new industries and encouraged the development of locally based ‘off-shore’ markets. In Hong Kong, a government with widely distributed powers accommodated often opaque linkages between public and private sectors that, relatively speaking, permitted deep interaction between domestic and international markets. Until recently, the focal point of this interaction has been in the banking sector, and the following chart provides a rough sense of an important effect of policy differences over time.

Both policy paths led to sound and vibrant financial markets, but in Singapore those markets are dominated by large state-owned institutions like the Development Bank of Singapore, while in Hong Kong most major market makers are private and relatively small (with the historic exception of the Hong Kong and Shanghai Banking Corporation). Similarly, the Monetary Authority of Singapore plays the most prominent role in regulating and supervising all of Singapore’s financial sectors, including securities, futures, foreign exchange, insurance, and banking. In Hong Kong, these functions are broken up across the Hong Kong Exchange, the Securities and Futures Commission, the Office of the Commissioner of Insurance, the Hong Kong Monetary Authority, and various self-regulatory organizations. The functional constituency system in Hong Kong’s legislature may also be presumed to have a distinguishing impact in terms of both what is done by regulators and what is not done.

One fact looms very large in accounting for the way in which such differences have evolved across the two cases. Singapore’s natural economic hinterland is southeast Asia and India, and in the absence of a high degree of centralization and a strategic orientation toward global markets, it would not have developed as quickly and as autonomously as it did during the past half century. Hong Kong’s hinterland is China, and in the absence of a decentralized and adaptable system, it would not have been in a position fully to take advantage of the opportunities a booming China placed in its path since the 1970s. 25

As an excellent recent and fine-grained study on Hong Kong’s IFC underlines, however, proximity to the Mainland has been a double-edged sword in terms of shaping and constraining competitive advantages. It is true that Hong Kong’s financial sector shines brightly because of its stock market and the IPO activity taking place there, because of its longstanding regional leadership in banking, and because of its expanding expertise in funds management. When 25

25 Ibid.
Chinese and strictly regional business is excluded, however, Singapore appears to retain durable advantages in foreign exchange and derivatives trading, as well as in international banking and even equity underwriting. With China excluded, Singapore looks more like an international centre and Hong Kong more like a financial entry and exit point for greater China.

The following table provides a summary sense of the important differences between Singapore and Hong Kong.

<table>
<thead>
<tr>
<th>Singapore and Hong Kong Financial Markets Compared</th>
<th>Singapore</th>
<th>Hong Kong</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign Exchange Reserves (2009)</td>
<td>US$196 billion</td>
<td>US$259 billion</td>
</tr>
<tr>
<td>Share of Global FX Trading (2007)</td>
<td>5.8%</td>
<td>4.4%</td>
</tr>
<tr>
<td>Sovereign investment holdings (2010)</td>
<td>US$469 billion (GIC and Temasek)</td>
<td>US$139 billion HKMA Investments</td>
</tr>
<tr>
<td>Unrestricted Domestic Banks (2009)</td>
<td>6</td>
<td>23</td>
</tr>
<tr>
<td>Unrestricted Foreign Banks</td>
<td>27</td>
<td>122</td>
</tr>
<tr>
<td>Restricted Banks</td>
<td>41</td>
<td>26</td>
</tr>
<tr>
<td>Offshore Banks</td>
<td>40</td>
<td>0</td>
</tr>
<tr>
<td>Deposit-taking Companies</td>
<td>0</td>
<td>28</td>
</tr>
<tr>
<td>Merchant Banks</td>
<td>50</td>
<td>0</td>
</tr>
<tr>
<td>Asian Currency Units</td>
<td>160</td>
<td>0</td>
</tr>
<tr>
<td>Representative Offices</td>
<td>415</td>
<td>71</td>
</tr>
<tr>
<td>Total Assets of Banks (2009) as % of GDP</td>
<td>US$446 billion 740%</td>
<td>US$1,375 billion 650%</td>
</tr>
<tr>
<td>Authorized Insurance Companies of which Foreign-owned</td>
<td>158 (2009) n/a</td>
<td>175 (2008) 85</td>
</tr>
<tr>
<td>Openness to Foreign Fund Managers</td>
<td>Restricted</td>
<td>Open, under strict licensing</td>
</tr>
<tr>
<td>Domestic Market</td>
<td>Preferred and Incentivized</td>
<td>Open, under strict licensing</td>
</tr>
<tr>
<td>Overseas Markets</td>
<td>US$614 billion</td>
<td>US$754 billion</td>
</tr>
</tbody>
</table>

26 Lingnan University, Department of Economics, *Report on Hong Kong as an International Financial Center for China and for the World*, (Collaborative project (No. LU 3002-PPR-5) led by Jesús Seade and supported by The Research Grants Council under the 5th Round of its Public Policy Research Funding Scheme), Hong Kong: Lingnan University, 10 December 2010, p. 4.

27 Harrison, “The Hong Kong and Singapore Markets Compared.”
## Singapore and Hong Kong Financial Markets Compared

<table>
<thead>
<tr>
<th>Category</th>
<th>Singapore</th>
<th>Hong Kong</th>
</tr>
</thead>
<tbody>
<tr>
<td>New Stock Exchange Initiatives</td>
<td>International listings</td>
<td>International listings</td>
</tr>
<tr>
<td></td>
<td>Asian Gateway</td>
<td></td>
</tr>
<tr>
<td></td>
<td>ASEAN Link</td>
<td></td>
</tr>
<tr>
<td></td>
<td>OTC Clearing</td>
<td></td>
</tr>
<tr>
<td></td>
<td>ADR Listing</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Chi-X Dark Pool</td>
<td></td>
</tr>
<tr>
<td>Stock P/E Ratios (March 2010)</td>
<td>600%</td>
<td>800%</td>
</tr>
<tr>
<td>Stock Exchange Net Equity (2009)</td>
<td>US$.71 billion</td>
<td>US$1.03 billion</td>
</tr>
<tr>
<td>o/w domestic</td>
<td>63.2%</td>
<td>42%</td>
</tr>
<tr>
<td>foreign</td>
<td>36.8% (5.2% China)</td>
<td>58% (25.2% H shares;</td>
</tr>
<tr>
<td></td>
<td></td>
<td>22.1% Red chips;</td>
</tr>
<tr>
<td></td>
<td></td>
<td>10.7% Other China)</td>
</tr>
<tr>
<td>Equity Market Turnover (2009)</td>
<td>US$247 billion</td>
<td>US$1,502 billion</td>
</tr>
<tr>
<td>o/w structured products (Apr. 2010)</td>
<td>5.4%</td>
<td>21.7%</td>
</tr>
<tr>
<td>Initial Public Offerings (2009)</td>
<td>2</td>
<td>31</td>
</tr>
<tr>
<td>Exchange –traded Funds (Apr. 2010)</td>
<td>1</td>
<td>19</td>
</tr>
<tr>
<td>Real Estate Inv. Trusts (Apr. 2010)</td>
<td>25</td>
<td>8</td>
</tr>
<tr>
<td>Derivative Contracts (2009)</td>
<td>99</td>
<td>53</td>
</tr>
<tr>
<td>Bond Listings (April 2010)</td>
<td>1,028</td>
<td>159</td>
</tr>
<tr>
<td>o/w Govt. or Central Bank</td>
<td>38.3%</td>
<td>48%</td>
</tr>
<tr>
<td>o/w Foreign Currency</td>
<td>28.5%</td>
<td>n/a</td>
</tr>
<tr>
<td>as % of GDP</td>
<td>75%</td>
<td>43%</td>
</tr>
<tr>
<td>Quality of Market Infrastructure</td>
<td>1st</td>
<td>8th</td>
</tr>
<tr>
<td>(Mercer Report on Global Markets)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gini coefficient (income inequality)</td>
<td>43</td>
<td>52</td>
</tr>
<tr>
<td>Press Freedom (Reporters sans frontieres)</td>
<td>133rd</td>
<td>48th</td>
</tr>
</tbody>
</table>

All things considered, the competition between Hong Kong and Singapore is likely to remain enduring and deeply marked by past and present policy differences. Hong Kong’s special advantages, in turn, are likely to remain obvious as well. Principal home base for multinational corporations with important Asian regional strategies, one of several financial gateways into China,
prominent gateway out of China, connector of Chinese and foreign business networks—Hong Kong has established a unique position that is unlikely to erode but could be enhanced by diversification strategies and policy reforms.

The competition with Singapore, moreover, keeps the pressure on to enhance strengths and counter weaknesses. Hong Kong’s low personal and corporate tax system broadly compensates for targeted incentives provided by Singapore to attract certain types of financial service providers, but tax competition soon leads to a dead end. A stable currency directly tied to the US dollar encourages funds seeking safety at least to move through Hong Kong, as does a generally conservative regulatory and supervisory environment. First-class financial clearing and settlement systems comparable to and linked in with those of London and New York are more critical than ever. A general openness to the immigration of skilled professionals works in the same direction. Business services of high caliber and networked internationally underpins an unmatched locational advantage for corporate offices focused on greater China.

All of that said, comparison with Singapore brings out some weak spots in Hong Kong’s IFC. Dependence on developments on the Mainland brings prosperity when China is booming and moving toward openness. Likewise, dependence on US monetary policy brings benefits only when that policy is on a stable path and not inclined to export inflation or deflation. Whether diversification strategies are perceived by Hong Kong’s market makers to be necessary or not depends on how one views the political economies of China and the United States over the long haul. But it also depends crucially on the capacity of government to design and implement policies conducive to diversification. Here, Singapore’s activism deserves to be a constant focal point for those committed to keeping Hong Kong’s IFC strong. Before we look at such matters in greater detail, other comparisons will be helpful.

Hong Kong, Shanghai, and Shenzhen

Comparing Hong Kong’s present and future as a financial centre to the current and likely experience of Shanghai is more difficult and more speculative. The competitive challenge Shanghai poses to Hong Kong’s regional dominance is not impossible to assess, and it could change dramatically in the future. Undoubtedly, finance in Shanghai is on the rise. But this does not necessarily mean that Hong Kong’s financial centre is in decline.

We can make a start by reviewing the situation just before the 2007-2008 global financial crisis, which generated much statistical ‘noise’ that should be discounted if we are to come to reasonable judgments about the future. The following table provides a few useful if rough indicators around the mid-decade mark.

---

### Share of Major World Financial Markets (%)

<table>
<thead>
<tr>
<th></th>
<th>Equity Turnover</th>
<th>IPOs</th>
<th>Intl Bonds Outstanding</th>
<th>Domestic Bonds Outstanding</th>
<th>Bank Fgn. Assets</th>
<th>Bank Fgn. Liab.</th>
<th>FX Turnover</th>
<th>FX / Interest Rate Derivatives Turnover</th>
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<td>23.3</td>
<td>44.6</td>
<td>8.9</td>
<td>11.7</td>
<td>19.2</td>
<td>19.4</td>
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<td>UK</td>
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<td>16.9</td>
<td>12.6</td>
<td>2.4</td>
<td>19.8</td>
<td>22.5</td>
<td>31.3</td>
<td>38.1</td>
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<td>3.7</td>
<td>0.9</td>
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<td>3.2</td>
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<td>6.0</td>
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<td>0.1</td>
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<td>N/A</td>
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<td>N/A</td>
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Shanghai’s financial markets obviously remain at an early stage of development, and it will be a long time before they account for much activity on a world scale. That said, the city plays a prominent role in raising domestic bond financing, and its market for domestic equities is vibrant and growing. Like the other main market for equities in China, namely Shenzhen, its core structure and the structure of the companies for which it raises funds are quite idiosyncratic. In short, those companies are mainly small firms focused on the domestic Chinese market or linked fairly low down in supply chains controlled by larger state-owned enterprises.

The Shanghai and Shenzhen stock markets continue to play key roles in the corporate privatization plans of the Chinese government. They began their operations with two separate kinds of listings: A-shares in local currency for domestic investors, and B-shares in foreign currency for foreign investors. Notwithstanding such new distinctions in shares, most firms entering the market already had complicated ownership structures, with much of their equity ‘non-negotiable,’ that is primarily controlled by governmental entities, and some of their equity ‘negotiable,’ that is potentially tradable. Despite some loosening of restrictions after their inaugural period, including the post-WTO accession Qualified Foreign Institutional Investor (QFII) initiative that permitted limited foreign purchases of certain A-shares, government planners continue to limit the liquidity of the Shanghai and Shenzhen markets and to subject share prices to abrupt and still unpredictable changes in policy.\(^{29}\)

\(^{29}\) Introduced in 2002, the QFII program aimed to attract longer-term foreign investors and curb speculation. It was complemented in 2006 by the Qualified Domestic Institutional Investor (QDII) program, which sought to utilize a
**Structure of Shanghai and Shenzhen Equity Markets at the end of 2006**

### Number of listed companies

- **Shanghai Stock Exchange**
  - A-shares: 832
  - B-shares: 54

- **Shenzhen Stock Exchange**
  - A-shares: 566
  - B-shares: 55

### Market capitalization (US$ billions)

- **Shanghai Stock Exchange**
  - Non-negotiable: 707
  - Negotiable: 210

- **Shenzhen Stock Exchange**
  - Non-negotiable: 118
  - Negotiable: 110

**Total**: 1,146


By 2009, and after the worst of the crisis had passed, the market capitalization of the Shanghai and Shenzhen equity markets had increased almost three-fold. As impressive as this is, the larger financial context surrounding them remains highly distorted by unacknowledged losses carried on the books of major banks, by a range of policies intended to control capital flows within China and across its borders, and by regulatory opacity and inconsistency.

In contrast to Shanghai and Shenzhen, Hong Kong’s equity markets are well developed, open, and competitive. Domestic listings do account for the lion’s share of trading activity, but a major source of growth in recent years have been IPOs for Chinese Mainland incorporated state-owned enterprises (H-shares), and intermittently, new listings for ‘red-chip’ Chinese companies incorporated outside the Mainland, albeit most of which remain under the majority control of Mainland shareholders, like provincial and municipal governments.


Structure of Hong Kong’s Equity Markets at the end of 2006

Number of listed companies

<table>
<thead>
<tr>
<th>Category</th>
<th>Domestic</th>
<th>Foreign</th>
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<tr>
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<td>Mainboard and GEM, China dimension</td>
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<td>90</td>
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Market capitalization (US$ billions)

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<tr>
<th>Category</th>
<th>Domestic</th>
<th>Foreign</th>
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<td>Total</td>
<td>1,715</td>
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After stability had returned to the Hong Kong equity market in 2009, the differences between Hong Kong and its competitors on the Mainland had become clear. Chinese authorities apparently continue to see the Shanghai (and Shenzhen) exchanges as useful mechanisms mainly for propelling domestic economic growth. Compared to Hong Kong, disclosure requirements and other standards associated with listing shares are less onerous. Accordingly, the risks, especially for outsiders lacking inside knowledge of the conditions of such firms and of associated government plans, are comparatively high. With its access to foreign capital providers and higher listing standards, on the other hand, Hong Kong continues to attract large companies from the Mainland, companies that find the ‘seal of approval’ implied by a Hong Kong listing increasingly useful not only to raise funds but to enhance the prospects of core businesses as they first venture out into international markets.

In short, Shanghai is now a national financial centre that looks set gradually to become more dominant in China’s developing financial markets. For the foreseeable future, its path may resemble that taken by Chicago today or New York during the twentieth century. Focused on burgeoning domestic markets, and subject to periodic bouts of legislative and regulatory change, Shanghai will advance to the fullest extent allowed by a political system marked by a complicated mix of centralizing and decentralizing impulses. We return to this issue below.
Hong Kong’s competitive position with regard to Shenzhen is similarly shaped by the fact that the line marking off ‘one-country, two-systems’ runs between them. But it is also complicated by the fact that both cities—together with quickly developing Guangzhou—are deeply linked culturally, but also economically, by virtue of the relocation of much of Hong Kong’s manufacturing base to Guangdong. More visibly in recent years, they have been tied together through joint agreements to develop the Pearl River Delta as a coherent economic region. On April 7, 2010, for example, a new framework agreement on Guangdong-Hong Kong Cooperation was signed in Beijing.

Among other things, the provincial authorities and Shenzhen municipal authorities pledged to build a 15-square kilometre industrial zone in nearby Qianhai at a cost of RMB 40 billion. The aim is to make Qianhai a southern China hub for service industries, including finance, logistics, transport, telecommunications, and media. The headline announcements hyped the ultimate objective by labeling it ‘South China’s Manhattan.’ But similar audacity must have been evident thirty years ago when a backward agricultural land aspired to become south China’s manufacturing centre with Hong Kong’s help. Many steps would be required to emulate that success, including most immediately the central government granting incentives similar to those granted to Pudong, Binhai, and Hengqin in eastern China. In this regard, Shenzhen and Qianhai may be in relatively unique position to play a key role in the national experiment with gradual currency decontrol. When the Qianhai initiative was first announced, it was widely reported that the People’s Bank of China might open there a branch office charged with responsibility for managing the cross-border capital flows that would be associated with moving toward RMB convertibility. In any case, Hong Kong has offered its support the development of Qianhai through the framework agreement as well as through the commitments expressed by private groups like The Greater Pearl River Delta Business Council.31 We may presume that their public-spirited leaders ultimately seek through such means to defend Hong Kong’s interests as China moves toward greater financial openness. Not illegitimate, however, is the question of whether they can speak and act for the majority of Hong Kong’s current residents.

Hong Kong in China

The question of whether the Qianhai project represents a mortal threat or a long-term opportunity gets close to the heart of the task confronting Hong Kong’s financial policymakers at the present moment. Because of global transformations now underway, Hong Kong lives at the edge of similar strategic choices facing most cities and even most countries around the world. They want the benefits of global integration—the prosperity, the peace, and the freedom promised by an open world order—without paying the full price in terms of political autonomy. But Hong Kong is now an integral part of a fast-changing China, so any discussion of its autonomy in any meaningful sense must take place along two dimensions, the global and the national. Still, as the old saying goes, money is power. So addressing the issue of how Hong

31 See, for example, Greater Pearl River Delta Business Council, Study Report in Response to the Outline of the Plan for the Reform and Development of the Pearl River Delta, Hong Kong, September 2009.
Kong’s role as a financial centre can be strengthened therefore depends on how one first conceives the ultimate political objective. In this regard, external decisions seem lately to be forcing choices.

In the financial sector, two such decisions stand out. The first was the decision by China’s State Council on March 25, 2009 to affirm the goal of transforming Shanghai into an international financial centre by 2020. The second is related, since there is no chance of even getting close to such a goal without it. Chinese leaders decided gradually to relax exchange and capital controls, to allow the emergence of offshore RMB markets, and eventually to make the RMB a fully convertible currency. Skepticism is certainly warranted, since in the end such moves are inconsistent with a system of central planning that still relies on the licensing, monitoring, steering, and bailing-out of a full range of economic activities. The ability of the Party at the core of the Chinese state to adapt to changing circumstances should not be underestimated, for it lies at the core of the economic restructuring taking place before our eyes. The challenge, however, is daunting.

A fully convertible currency would suggest fundamental change in the way China’s economy is governed. Especially if it avoided recourse to a dual exchange-rate system (a separate exchange rate for offshore RMB), intervention to guide capital flowing into and out of the economy would become more difficult, more uncertain, and more costly. Today, all legal foreign exchange transactions come through banks, typically one of the four state-owned banks (Bank of China, Construction Bank, Commercial Bank, or Agricultural Bank), which must seek specific authorization from the Foreign Exchange Department of the People’s Bank. Together with interest rate controls on domestic loans and deposits, this system steers capital in the direction desired by central planning authorities. If it were quickly liberalized, it would expose China’s banks and their main clients to the full force of external markets. The well-known bad-loan problem on the books of those banks would have to be solved quickly, and controls on interest rates would be very difficult to maintain. The effects of being forced quickly to write off bad loans and rapidly reduce reliance on hidden interest-rate subsidies would be particularly problematic for state-owned enterprises not yet ready for open competition. The effects on domestic wages and price levels would surely be dramatic and highly contentious.

For these very reasons, plans for gradualism are nothing new in this policy arena. The fact is, however, that similar plans in other countries have often proved impossible to implement. At a certain point, the pressure of freely moving capital forces the abandonment of rigid exchange rate systems. Crisis ensues and typically leads to the rapid decontrol of capital markets. Of course, nowhere in the world is capital entirely free to move, but the overall trend during the past half century is evident. The most powerful industrial and industrializing countries came to realign their politics and policies to accommodate open capital markets. Exceptions were made.

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during emergencies, but these usually passed quickly.33 They may not like all of the consequences thereby implied, but great and less-great powers have typically found themselves unwilling to bear for long the costs of alternative choices. For most, embracing capital mobility has also meant accepting exchange rate and interest rate flexibility.

One alternative choice under conditions of capital mobility is rigidly to peg an exchange rate and give up control over domestic monetary policy. This was Hong Kong’s choice in 1935, when it abandoned the silver standard and pegged the HK dollar to the pound sterling at a rate of 16 to 1. It was also its choice in 1967 when it repagged to the pound, and again in 1972 when it pegged loosely to the US dollar. In 1983, it moved decisively to the present system, which links the HK dollar tightly to the US dollar through a currency board arrangement. This exchange rate system carried Hong Kong through a turbulent period in its history. As noted above and discussed further below, it was tested severely in 1998, and it survived. Although there are opportunity costs involved and economists can argue about them, the historical facts suggest a broad political consensus within Hong Kong, one not unlike the consensus apparent in smaller countries joining the Economic and Monetary Union in Europe. If the choice is between giving up the freedom to move capital in and out of Hong Kong and giving up the ability to set domestic interest rates autonomously, then the latter choice is preferred.

In the case of Hong Kong, the specific policy instrument needed to maintain that choice and to some extent to buffer the negative effects of a passive monetary policy is a very large pool of foreign currency reserves, the Exchange Fund. At a deeper level, the link and the Exchange Fund worked together to help preserve another kind of autonomy. Both before and after July 1, 1997, when Hong Kong became a Special Administrative Region of the People’s Republic of China, the arrangement gave Hong Kong’s government room for maneuver vis-à-vis the Mainland. It did so, not least by providing to foreign and domestic investors confidence in Hong Kong’s markets, even as those markets continued the long process of integration with Mainland markets.

Shanghai’s restoration as China’s main national financial centre, and its longer term chances of regaining its place as the region’s international financial centre seems like a reasonable bet in the long run. Who knows when that day will arrive? Whenever it gets close, it will likely pose a distinct challenge for Hong Kong. If and when that day draws near, Hong Kong will already have switched its peg to the RMB or simply adopted the RMB as its home currency. How else could it flourish in such changed circumstances? Perhaps then it will take its place as a regional but still important financial centre within greater China. Until complete convertibility arrives, however, participants in Hong Kong’s financial markets will retain opportunities for arbitrage between two still-distinct systems. For its part, the Mainland will at the same time retain a most convenient channel for sending capital out, not least to ameliorate associated political pressures, and for bringing it back in as circumstances warrant.

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In this regard, it is entirely possible that reformist decisionmakers in Beijing may be stymied in their efforts to accelerate the process of RMB convertibility in the near to medium term. Internal and external developments might conspire to push the point of no return in China’s financial and capital markets into the distant future. Either way, a relatively autonomous Hong Kong stands to gain during the interim period until the RMB is fully convertible. After that, the game changes fundamentally. But the retention of a degree of autonomy differently conceived may even then give a prosperous Hong Kong and its financial centre a privileged place within greater China. To that possibility, we return after looking in more depth at the current strengths of Hong Kong financial service sector.
**6. Financial Sectors in Dynamic Markets**

As noted above, many observers in the field of international finance today perceive Hong Kong to be one of the world’s top financial centres. An alternative opinion, also already noted, accounts just as well for the particular mix of finance and professional services at the core of Hong Kong’s economy. It holds that Hong Kong is mainly a centre for the regional headquarters of multinational firms engaged in an array of businesses aiming mainly at future growth in greater China. The evidence supports both viewpoints, and in either case places commercial banking in the primary position.

**Commercial banking**

After World War II, banking quickly regained the important position it traditionally held in Hong Kong. With the government pursuing a liberal licensing policy, the sector grew naturally until 1965, when a series of bank runs began as bubbles burst in local property and stock markets. The government switched gears and promoted consolidation, including by allowing foreign banks to acquire up to 100% of the shares of existing local banks. It missed the chance to complement this policy with abolition of a withholding tax on foreign currency deposits. As noted above, this had the effect of locating the Asian-dollar equivalent of the eurodollar market in Singapore instead of Hong Kong. Still, during the 1970s much of the international loan syndication business in the region migrated to Hong Kong.

In 1978, facing stiff competition from Singapore, the government made it easier for multinational banks to establish fully capitalized subsidiaries or branches as long as it deemed the headquarters of the bank to be of sufficient size and prudently supervised in a home country offering reciprocity to banks based in Hong Kong. In 1981, in the wake of the so-called third-world debt crisis, the banking system was rationalized into three tiers: licensed banks, authorized to offer current and savings accounts, accept deposits of any size and maturity, and clear cheques through the local payments system; restricted-license banks, permitted to engage in merchant banking, operate in capital markets, and take deposits of any maturity in amounts equal to or greater than HK$500,000; and deposit-taking companies authorized to engage in consumer finance and securities activities and to take deposits of HK$100,000 or more with maturity of at least three months. Throughout the 1980s and 1990s, notwithstanding a series of local and global banking crises, the liberalization of key markets continued even as official oversight expanded in scope.

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35 See Y.C. Jao, “Shanghai and Hong Kong as International Financial Centers: Historical perspective and Contemporary Analysis,” School of Economics and Finance, University of Hong Kong, n.d.
By 2010, 145 banks operated as licensed banks, and 26 firms had restricted banking licenses. Deposit-taking companies, mainly owned by banks, numbered 28. Of all 199 institutions authorized to take deposits and operating nearly 1300 branches, 180 were beneficially owned by foreign interests. Finally, over 70 foreign banks maintained representative offices.\(^{36}\)

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Banking Institutions in Hong Kong

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Perhaps because of the turbulent financial history of Hong Kong, dating back to the 1866 crisis that saw six of eleven then-existing banks fail (including two note-issuing banks), the biggest licensed banks are now well-known for conservative management. Their traditional source of vulnerability, however, is the property sector. Even today, strong banks like Wing Hang Bank depend on rising property markets. For example, of the Bank’s total advances extended for use in Hong Kong, fully 73% are tied to property development, property investment, and residential purchases.\(^{37}\) The comparable proportion for the Bank of East Asia is 46%, and for Hang Seng Bank 71%.\(^{38}\)

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\(^{36}\) HKMA data.


Rapid increases in land and housing prices in Hong Kong but also on the Mainland, where most have rising exposures, have long been problematic. Until recently, they ushered in many emergency bank closures and reorganizations. In 1997, however, local property prices fell by 50% and no bank failures occurred. The banking system was severely tested again ten years later, and again no banks failed. Notwithstanding the positive effects of good management, strong balance sheets, adequate capital, and competent supervision, most close observers agree that greater sectoral diversification would help existing banks weather future storms.

There are plenty of opportunities. Given its continuing importance as a transportation hub in the world’s fastest growing region, past experience in shipping and aircraft financing provides a base for future expansion. The vast majority of ship financing to the present time has taken the form of bank loans. There is room for innovation here, but tax considerations are significant. The sector is inefficient in China, and Hong Kong’s banks may have much to offer in the near future. The same can be said for aircraft financing. HSBC Group, for example, recently put together an Airbus purchasing arrangement worth US$260 million for Air China that was guaranteed by three European export credit agencies. Previous deals were limited and difficult, not least because they typically required direct or indirect guarantees from the Government of China. The arrangement was therefore seen as unlocking a vast potential market. As the managing director of HSBC China summed it up, “In view of China’s fast-growing air travel market and the associated fleet expansion needs, this deal provides increased options for airlines in China. HSBC has very rich experience in overseas markets. We will fully leverage our global expertise and resources to support the further development of China’s aviation market.”

Subject to tax limitations in both Hong Kong and China, techniques like leveraged leasing, where a ship or aircraft is acquired by means of significant borrowing, and liabilities to lenders are limited to the value of the vessel alone, also hold much promise for the future.

Across the board, the Hong Kong’s commercial banking system was strengthened by two major developments in the mid-1990s. The first was the government’s decision to establish the Hong Kong Monetary Authority, with responsibility for both monetary and financial stability. In addition to managing the linked exchange rate system and the Exchange Fund, it was charged with bank supervision and oversight of the broader financial infrastructure. How this decision now looks in comparative perspective is a subject to which we return below.

The second development was the establishment of Hong Kong Interbank Clearing Limited in 1995 and the subsequent launching of a Real Time Gross Settlement System. Although they require continuous and expensive investment in new technologies, both now underpin the safety and soundness of Hong Kong’s banking markets and reduce many of the risks inherent in a modern and increasingly cross-border payments system. The particular border that matters most to Hong Kong is obviously the border with the Mainland, so this kind of infrastructural work soon came to be seen as preparatory to the significant banking business of the future involving the RMB.

39 HSBC website.
Given its strategic location and the historical fact that many Hong Kong-based businesses moved operations to the Mainland during the past three decades, both demand-side and supply-side factors gave Hong Kong banks what Alicia Garcia Herrero recently called their special niche, that is, to serve as the building blocks for China’s main “offshore” financial centre. Policy liberalization in China remains the key driver. As soon as official signatures dried on the June 2003 Closer Economic Partnership Agreement (CEPA) between China and Hong Kong, intense work programs on offshore RMB markets accelerated. In February 2004, the RMB Business Scheme was launched in Hong Kong, initially to cover basic banking services like RMB deposit-taking, remittances, and credit and debit card offerings. Hong Kong-based firms and individuals began building up RMB balances in Hong Kong banks within decreed limits (RMB 20,000 per day at present). On March 6, 2006, an RMB Settlement System was launched, including final clearing of RMB claims through the People’s Bank of China branch in Shenzhen. In July 2009, the settlement of cross-border trade accounts was authorized, permitting Hong Kong firms to settle transactions with Mainland firms directly in RMB. Throughout 2010, the HKMA worked to ensure that Hong Kong established itself as the primary centre for trade settlement in offshore RMB.

The recent expansion of the offshore RMB banking business in Hong Kong occurred simultaneously with local recovery from recession and from the severe shocks of the global financial crisis. Preceding upturns in many foreign markets, Hong Kong’s retail banks began recording significant growth in operating profits and more modest increases in returns on assets from the middle of 2008.

**Foreign exchange and related derivatives trading**

Although banks dominate the foreign exchange trading business, they are not the only players. In fact, foreign exchange markets are deep and dynamic in Hong Kong, which is, after all, one of the world’s leading centres for trade in goods and services. The financial side of that intermediating business remains a core competence, bolstered now by the confidence-generating linked exchange rate system, by the absence of exchange controls, and by the continual upgrading of professional skills in core organizations. With some justification, HSBC claims to the leading foreign exchange market maker in the world for all tradable currencies. Within Hong Kong itself, HSBC manages the settlement of US dollar claims, Standard and Chartered plays the same role for euro claims, and Bank of China (Hong Kong) is the clearing bank for RMB claims.

40 Lingnan University, Department of Economics, *Report on Hong Kong as an International Financial Center for China and for the World*, p. 65. Among the studies anticipating its findings and making well-reasoned recommendations for associated policy reforms was Business and Professionals Federation of Hong Kong, *Hong Kong 2020: The Big Picture*, Hong Kong: BPFHK, 2009.

Reinforcing Hong Kong’s performance in foreign exchange markets, once again, are robust RTGS systems, which have operated efficiently since 2000 for US dollars, since 2003 for euros, and since 2007 for RMB. Linking those systems and the HK dollar clearing system are separate payment-versus-payment (PvP) mechanisms that settle foreign exchange transactions simultaneously and eliminate risks arising from time-zone differences. In 2006, a similar mechanism was established between Hong Kong’s US dollar RTGS system and its counterpart for Malaysian ringgit payments. All things considered, this kind of infrastructure is critically important for Hong Kong’s continuing development as an IFC. Both reliability (finality of settlement) and competitive efficiency are key, and enhancing both remains central to the mandate of the HKMA.

In currencies other than the RMB, no distinctions exist in Hong Kong between onshore and offshore currency trading. Foreign exchange futures and options markets are vibrant, and there are no blanket restrictions on forward exchange trading. Restrictions on non-deliverable forward contracts began to be loosened in 2005. This successfully promoted the development of markets for a variety of derivatives and structured products, such as synthetic foreign currency loans. Although Singapore competes effectively on this same terrain, Hong Kong’s advantages are most apparent and most enduring with respect to flows to and from the Mainland. Moreover, the absence there of an RMB forward market, an interbank money market for claims with maturities beyond four months, and a liquid government bond market—all provide significant opportunities directly on the Mainland for Hong Kong-based intermediaries as planned and gradual liberalization occurs.

**Investment banking: IPOs**

After a bruising experience in 2008, investment banking bounced back as a key source of financial market growth in Hong Kong and in most other markets. Investment bankers essentially broker asset transactions. They match providers of capital with users. In the case of Hong Kong, their main business for many years now has been to bring initial public offerings to market. One particular niche is managing new equity listings for Mainland firms embarking on privatization and other fund-raising exercises.

When Chinese authorities began favouring Shanghai in this regard, for example, by steering IPOs for firms that had earlier been authorized to form offshore subsidiaries to raise funds (‘red chips’), investment banking in Hong Kong became more diversified. To be sure, blockbuster IPOs involving state-owned enterprises, like that of the Agricultural Bank of China in the summer of 2010, still garnered the bold headlines. The largest IPO ever up to that point in time, the issue ultimately raised US$22.1 billion, but that kind of business was increasingly shared with Shanghai. By December 15, 2010, the annual volume for IPOs in Hong Kong

42 Ibid., p. 75.
exceeded US$50 billion. With 78 companies tapping the booming market, 56 of which were from the Mainland, Hong Kong ranked fifth in the world for the year.43

The market for IPOs in Hong Kong

Source: HK Exchange and SFC data; Lingnan University, Department of Economics, Report on Hong Kong as an International Financial Centre for China and for the World, p. 43.

IPOs will remain important even if the market for Mainland firms cools, but the most promising investment banking franchises also provide local expertise and global connections critical for companies contemplating mergers and acquisitions. They also sell advisory services to corporate and individual investors with investment portfolios to manage. At present, the Hong Kong Stock Exchange plays the dominant local role in making markets for those investors. It ranks eighth in the world, with market capitalization in excess of US$ 1 trillion, and it offers a full range of products, including futures and options. In this regard, Hong Kong has come a long way from 1987, when the original Hong Kong Futures Exchange was debilitated by scandal and crisis. In March 2000, it merged with the Stock Exchange of Hong Kong and the Hong Kong Securities Clearing Company to form Hong Kong Exchanges and Clearing Limited. In this sector, that private entity then became a leading self-regulatory organization, a subject to which we return below.

For risk-tolerant investors, the Exchange established a second board, the Growth Enterprise Market. (The innovation has now been emulated in Shenzhen.) At present, it is often likened to

a casino, but the hope is that it will eventually give rise to a new class of venture capitalists in the region. If so, they will be expected to champion future start-ups in high technology and other high-risk/high-reward industries.

Market participants routinely suggest that much work remains to be done to build the infrastructure of Hong Kong’s stock and bond markets, so the business of local investment bankers and financial advisors is likely to remain robust. While no one complains about the opportunities presented by IPOs and offshore RMB instruments, pressures are mounting both for further diversification and for more competitive pricing. It is worth noting here that the monopoly of the Hong Kong Exchange is frequently questioned in this regard. But so too is the sustainability of the profits of intermediaries that depend upon sales of investment products to retail investors. The Lehman Brothers mini-bond incident of 2008 shed much light on the regulatory and supervisory underpinnings of changing investment and commercial banking markets in Hong Kong, and we examine it in more detail later in this study.

One other key issue for investment banking in Hong Kong deserves to be highlighted. The sector itself is not immune from trends encouraging the outsourcing of routinized work. Often viewed as emblematic of the high value-added service-economy of the future, investment banking actually involves many analytical, production, and marketing tasks of a repetitive and basic nature. It doesn’t take a scientist, for example, to prepare most offering prospectuses. Much analytical and presentational work can, in-principle, be outsourced. As in other global financial centres, therefore, labour cost arbitrage even in this sector will push Hong Kong constantly to innovate.

In December 2010, the HKEx ruled that Mainland Chinese companies listing in Hong Kong could prepare financial statements using Mainland accounting and auditing standards.44 Although Chinese authorities considered these standards to be closely approaching the same International Financial Reporting Standards used in Hong Kong, skeptical investors worried. So too did those hoping that Hong Kong could long continue to be viewed as a global financial centre clearly distinct from China.

Derivatives and synthetic securities

Although the global crisis of 2008 prompted many market observers to question the difference between investing and gambling, the investment vehicles that caused the most trouble were not really new. Rather, the risks they represented, the scale of those risks, and the essential implications of contagion from a systemic crisis of confidence were all misunderstood and

44 Financial Times (London), 10 December 2010. “When Chinese issuers list shares on other big international exchanges – New York, London, Tokyo, Sydney – their auditors are subject to local oversight by the respective authorities. Hong Kong’s decision to rely on Chinese supervisors implies a loss of integrity, as well as a loss of legal redress should things go wrong.”
mismanaged. In the wake of the crisis, Hong Kong is collaborating with other jurisdictions around the world to improve the basic infrastructure through which various kinds of financial derivatives and synthetic securities, like synthetic exchange-traded funds, are handled.

For derivatives, the HKEx is establishing a clearing house for over-the-counter derivatives. This complements recently announced plans of the HKMA to maintain a central registry and database of OTC activity. With the latter improving market transparency and the former reducing clearing risks, since the clearing house serves as counterparty for both sides a trade, the aim is to make Hong Kong a relatively more attractive centre than its regional competitors.

Interest-rate derivatives will open the market, and equity derivatives are expected to follow. Eventually, dealers expect to be able to offer variations on such products denominated in RMB. The main securities market regulator, the Securities and Futures Commission (SFC), is consulting market participants on appropriate supervisory structures.\(^45\) Similar issues regarding appropriate disclosure of risks and data on pricing confront instruments like synthetic exchange-traded funds. Parallel work programs are therefore underway within the HKEx and the SFC.

More on this below, but it is obvious that regulators want to keep Hong Kong markets abreast with regional and global competitors without also repeating transparency-related problems like those encountered with Lehman mini-bonds in 2008.

**Overall exchange market competitiveness**

The implications of the current strength of the Hong Kong Exchange are the subject of much debate. Given recent history, Exchange leaders extol the stability that comes from its near-monopoly position. Others, aware of competitive currents coursing through analogous markets in London and elsewhere, wonder about the costs and the opportunity costs. One current issue clarifies both positions: so-called ‘dark pools’ of liquidity

There is nothing essentially new about off-exchange liquidity deployed in non-displayed trades arranged by dealers and brokers. In major international financial centres, an informal matching service has long been offered to big clients, although some observers now say that this has morphed into a system of vested interests matching, clearing, settling trades, and front-running new information. Best estimates are that some thirty active dark pools now deal in stocks on major U.S. markets, up from about 10 in 2002. They are said to account for nearly 10% of trading volumes.\(^46\) Whatever their merits or risks, such alternative liquidity systems have been rising globally in volume and in the electronic speed of their deployment across rapidly globalizing exchanges.\(^47\)

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More specifically in Asia, the demand to widen the scope for alternative forms of liquidity management has been rising as large global traders have sought to increase their exposures in the region. Trading via dark pools allows that to occur in ways that also facilitate the masking of specific traders. On the one hand, trading through dark pools can be market-stabilizing by discouraging herd behavior. On the other hand, it obviously undercuts regulatory moves to enhance market transparency. Not least, it also threatens to undercut standard brokerage and exchange pricing structures. The challenges posed by dark pools have unleashed much research and intense discussion around the world. In Hong Kong, the SFC has come to be associated with the more deregulatory position; it has already granted alternative trading system licenses to firms like Credit Suisse, Citigroup, UBS, BNP Paribas, Goldman Sachs, Morgan Stanley, Merrill Lynch, Nomura Cross, Deutsche Bank, and several agency brokers (ITG and Instinet, Liquidnet Asia). The HKEx takes the more skeptical position.

Although over a dozen off-exchange crossing networks now operate in Hong Kong, the HKEx has thus far limited the scope of their operations. The stated objections revolve around resistance to market fragmentation and opacity. Doubters point to the idea that dark pools might crack open the HKEx’s monopoly over secondary securities trading and clearing. By way of riposte, HKEx officials point out that its current dominant position in Hong Kong reflects a long and painful struggle to bring order and stability to crisis-prone markets. Again, the first phase of market consolidation occurred in 1986 by way of the merger of pre-existing exchanges and the second phase ended in 2000, when futures and clearing functions were added. Ever since then, controversy has centered on potential conflicts associated with the HKEx having both a regulatory and a commercial role and on the regulation of minimum trading spreads charged by member-brokers. Alternative liquidity systems challenge the HKEx on both counts.

Bond issuance and trading

In recent years, public entities like the HKMA and the Hong Kong Mortgage Corporation (HKMC) have issued HK dollar bonds in an attempt to accelerate local market development. The Government itself in 2009 proposed a plan to begin a systematic bond issuance program, despite the fact that it doesn’t need the funding and that interested corporations and individuals had full access to US-dollar bond markets, effective substitute for HK dollar bonds under the linked exchange rate system. The government contended that in the long run, currency mismatches in aggregate funding schemes like the Mutual Provident Fund could become more problematic and more expensive to manage in the absence of a flourishing HK dollar bond market. (Most retirees save HK dollars and expect to be paid out in HK Dollars, but the funds that hold their savings over time are widely diversified in currency and other terms. The HK dollar bond market is necessary to provide a mechanism for hedging). Even with regular issues from the Government, many observers noted that it would take some time to develop liquid secondary markets. Thus far, banks have tended to be primary purchasers, and they have not been inclined actively to trade local government bonds. Nevertheless, the Singapore case looms large in the minds of policymakers. After its government initiated its own bond issuance program in 1998, demand
expanded, volumes grew by 400% over the next decade, and a sufficiently liquid secondary market developed.\textsuperscript{48} At the start of 2009, Hong Kong dollar debt securities outstanding were valued at US$91.9 billion, or nearly 80% of the total outstanding debt instruments held locally.

Anchoring Hong Kong’s contemporary bond markets are Exchange Fund Bills with short-term maturities and Notes with maturities up to ten years, as well as interest rate swaps and options. Trades in Bills and Notes are cleared through the RTGS system (real time and end-of-day delivery versus payment) managed by the Central Money Markets Unit of the Hong Kong Monetary Authority. Bond trading among private intermediaries is mainly over-the-counter, but the Hong Kong Exchange now lists many debt instruments. Some banks and brokers also offer on-line bond trading to institutional investors and retail clients.\textsuperscript{49} To enhance the chances that Hong Kong-based intermediaries will play a greater role in underwriting Asian debt securities and marketing them to foreign investors, in 2010 the HKMA joined with regional counterparts and Euroclear in a task force to promote the development of a common platform for post-trade processing.

The most promising avenue for catching up with Singapore’s growing bond markets, however, looks set to be opened by RMB-denominated bonds. On January 10, 2007, China’s State Council authorized Mainland financial institutions to issue RMB bonds in Hong Kong. The proceeds were allowed to be remitted to the Mainland. Similarly, future interest payments were allowed to be paid in RMB directly to foreign bondholders. In addition to requiring the further liberalization of RMB banking services in Hong Kong, this development prompted the HKMA to collaborate with the operators of the interbank clearing system to build a modern RMB RTGS system, which opened in June of 2007. The next month, the first local RMB bond was issued by the Chinese state-owned China Development Bank. The equivalent of nearly US$2 billion was raised, triple the amount originally expected. The funds were to be used back on the Mainland for infrastructure projects.

Although, as noted above, bond markets in Hong Kong are starting from a low base, the promise of RMB bonds for the investment banking arms of local banks as well as for foreign firms remained attractive. In June 2009, HSBC (China) Company Limited became the first locally incorporated foreign bank to issue an RMB bond in Hong Kong. Although it did not need the funds, its declared intent was to deepen the market by establishing a pricing benchmark. The Bank of East Asia followed a month later. Then in October, China’s Ministry of Finance issued sovereign RMB bonds totalling RMB 6 billion. In February 2010, limits on types of issuers were relaxed and non-financial firms began to tap the new market. Hopewell Highway Infrastructure Limited issued the first such bond the following July, and McDonald’s Corporation sold the equivalent of US$29 million in RMB notes in August to provide working capital for its burgeoning operations on the Mainland. By June 2010, eight issuers had launched thirteen RMB


\textsuperscript{49} Hong Kong Trade Development Council website.
bond issues, bringing the total amount raised to RMB 38 billion. Six months later, China’s Ministry of Finance came back to the market and issued another RMB 8 billion in bonds, with two, five, and ten year maturities designed to establish a benchmark yield curve. The issue was significantly over-subscribed.

Islamic finance

Despite the overwhelming pull of the Mainland on Hong Kong’s investment banking industry, in both its equity and bond segments, it remains worth exploring future possibilities in Islamic finance. At its base, this involves the trading of diverse kinds of assets. As early as 2007, the HKSAR Government highlighted the prospect of developing appropriate instruments to facilitate such trading. An Islamic bond (sukuk) market in Hong Kong is surely feasible. Not only might this contribute to the volume and liquidity of Hong Kong’s overall debt markets, it would also promote prudent geographic diversification. In 2009, the Government adopted a four-part strategy to build appropriate infrastructure, raise the profile of Hong Kong’s strengths internally and externally, and prod innovation by private-sector participants through, for example, stamp duty and other tax adjustments relevant to sukuk.

More recently, the HKMA negotiated a Memorandum of Understanding with Bank Negara Malaysia to deepen technical cooperation and market awareness. Ultimately, however, real economic factors drive successful financial market structures. The conclusion of many financiers in Hong Kong today is that Hong Kong is unlikely to play a significant global role in Islamic finance any time soon. But aside from any action that could result in the long run from deepening trade linkages with Malaysia and Indonesia, surprises could come from future tax changes on the Mainland designed to promote local development in Xinjiang. As a top official from Prudential Fund Management in Kuala Lumpur puts it, "China is like Indonesia, a sleeping giant. If Islamic finance can tap Muslims, especially the 37 million in Xinjiang, then there will be a huge potential for the Islamic space in China." At that point, there may be huge potential for Hong Kong too, which at the very least justifies the early preparatory and promotional work of the HKMA.

Wealth management

At the intersection of commercial and investment banking as traditionally defined are rapidly expanding financial services organized under the banner of asset or wealth management. At the most sophisticated end of the retail market for such services are high net-worth individuals and firms open to new strategies for investing in stocks, bonds and other fixed-

50 HKMA data.

51 “Islamic Finance Set for Big China Leap,” Reuters, October 2, 2009.
income instruments, foreign-currency instruments, real estate, private equity funds, hedge funds and other types of managed funds. This clientele is obviously growing in Hong Kong itself, and many of their counterparts technically still resident on the Mainland are becoming more prominent participants in Hong Kong’s market for asset-management services. A range of similar kinds of services also exists for non-profit and for-profit institutions, as well as for financial intermediaries operating at least in part out of Hong Kong. Hong Kong’s low-tax system attracts wealth holders, and the market for high-end advisory services develops in train.

Nevertheless, given conservative banking habits, and controversial episodes associated with alternative investment vehicles like ‘mini-bonds’ issued by the ill-fated local subsidiary of Lehman Brothers, innovation in the field of wealth management in Hong Kong has not been straightforward. Real estate investment trusts, for example, were only authorized in 2005, and they attracted controversy from inception. REITs are essentially mutual funds for real estate driven partly by corporate tax advantages deriving from the requirement that 90% of associated income be distributed to investors. The Hong Kong Housing Authority launched the first one as soon as the SFC gave it permission to do so. Although it was substantially oversubscribed, groups fearful of the implications for the future availability and pricing of public housing objected. Later issues were modest and the financial performance of the trusts has been disappointing.

Despite the challenges, wealth management looks set to become a much more important source of activity for Hong Kong’s IFC. The seeds have already been sown. Private equity pools, hedge funds of various kinds, and alternative investment vehicles comprise a fast-growing sector. Bolstering their growth have been recent regulatory moves in the United States and Europe aimed at pushing riskier and more speculative activities out of banks and bank holding companies. At base, however, it is the search for yield that simultaneously seems to be pushing them out of developed markets and toward perceived new opportunities, not least in greater China. Hong Kong’s strategic position in this context is obvious. Less obvious are associated risks.

Net capital flows from the Mainland are expected to contribute significantly to the demand for asset-management services, but of those flows the HKMA estimates that Hong Kong will retain around 10%. The liberalization of the RMB will increase flows both ways, but the HKMA recently announced that RMB deposits in Hong Kong-based banks totaled RMB 279.6 billion (US$42 billion) as of November 30, 2010, an increase of 29% from the previous month and 246% from a year earlier. By the end of 2010, 67,000 Mainland firms had been authorized to settle cross-border trade accounts in Hong Kong, facilitated by an expanding currency swap arrangement between the HKMA and the PBOC. Since this growth also increased the risk that unauthorized transactions would take place, Hong Kong’s banks were directed especially to monitor transactions in large amounts by new customers or between firms known to be related to one another. In any event, even as Hong Kong-based firms continue to invest heavily on the Mainland in anticipation of continuing rapid growth and currency appreciation, the amount of

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Mainland wealth invested in and through Hong Kong will surely grow as well. Capital controls have typically had a portfolio diversification effect elsewhere, and, even when flows are perfectly legitimate, differences in tax rates can be expected to reinforce such an effect.

Insurance

The insurance industry in Hong Kong remains strong and multi-dimensional. Gross premia routinely total 11-12% of GDP, making Hong Kong the second biggest insurance market in Asia after Japan. There is a stable base for products not linked to investments, while demand for investment-linked products ebbs and flows with general market conditions. In the wake of the 2008 crisis, for example, such demand subsided.\textsuperscript{53} Especially in light of Hong Kong’s aging and relatively affluent population, however, linkages between insurance, investment, and wealth management markets are expected to deepen considerably in coming years. Keeping the sector strong is therefore a high priority. The idea of bringing the regulation and supervision of insurance to global standards by establishing an independent insurance regulatory authority, examined more fully below, must be viewed in this context.

Long-term life insurance policies, as well as health-related policies, dominate the local market, while general business insurance typically accounts for around 15%. In 2009, there were 46 long-term insurers authorized to do business in Hong Kong, 110 general insurers, and 19 composite insurers. Much of the employment associated with the sector is accounted for by 538 authorized brokers and over 33,000 registered agents. Over 1 million new life insurance policies are written annually.\textsuperscript{54} Bolstering the local market significantly during the past decade has been the Mandatory Provident Fund scheme, to which workers began contributing in December 2000. This policy instrument is expected to inject an extra of USD4-5 billion a year into general retirement accounts during the next half century. Insurance companies are major players in managing associated trusts and steering associated investment portfolios.

For many Hong Kong-based insurers not entirely focused on local business, future plans are obviously shaped by developments in China. Insurers and reinsurers are using Hong Kong as a base for regional operations, citing transport links to Europe and North America, ease of access to the Mainland, a solid legal regime, and better living conditions. China’s accession to the World Trade Organization did much to stimulate this build-up, as did the Hong Kong-China CEPA Agreement. China is already among the top ten insurance markets in the world, and industry reports routinely estimate annual premium growth rates in excess of 30%.

The leading non-life insurance companies in Hong Kong include HSBC Insurance (Asia), American Home Assurance, Bank of China Group Insurance, Ming An Insurance (Hong Kong), QBE Hongkong & Shanghai Insurance and AXA General Insurance (Hong Kong). The top life


insurers include AIA (Bermuda), Manulife, HSBC Life, Prudential UK, AXA China (Bermuda) and Hang Seng Life. Mainland insurers are also listed on the Hong Kong Exchange, including China Life Insurance, Ping An Insurance of China, and PICC Property and Casualty Company.

As in closely related fields, the latter suggests a game-changing impending development, namely the emergence of high-potential future business helping Chinese insurers invest in foreign markets. As their premium income grows, there will also grow a natural pressure to diversify reserves, maximize and protect returns, and prepare prudently for future claims. Once again, this terrain is gradually being mapped out in larger Chinese plans to internationalize the RMB. For the foreseeable future, no city on the Mainland will be able to match Hong Kong’s capability in this regard. The possibilities for joint ventures with foreign insurers based in Hong Kong, as well as for stand-alone Chinese insurance operations, are vast. Growth in this sector, in turn, may be expected to spawn new investment products, new markets, and new linkages across diverse segments of existing financial markets.

All of the world’s largest reinsurance companies have longstanding offices in Hong Kong, including Munich Re, Swiss Re, General Re (Berkshire Hathaway), and Hannover Re. Measured in terms of annual service exports from Hong Kong, reinsurance now accounts for about one quarter of the total.\(^{55}\) As in other sectors, significant regional offices are being built in Hong Kong mainly to cover the Chinese market. Recent interviews with senior executives from major European re-insurers suggest the aspiration, already within reach, not to be the largest reinsurers on the Mainland but to be the most profitable.

Hong Kong’s traditional role as base for the regional headquarters of multinationals and its position as a gateway into the Mainland position it very well to develop another sector of changing global insurance markets, namely the captive insurance sector. Partly a tax-driven business, captive insurers are typically wholly-owned subsidiaries of parent firms enabling those firms to manage risks, and retain insurance premia, in-house. In recent years, the HKSAR Commissioner of Insurance has been promoting the virtues of Hong Kong as an appropriate location for captives owned by Mainland firms. The same infrastructure and workforce strengths that attract other types of insurance businesses to Hong Kong are relevant here.

**Commodities trading**

Buying and selling commodities continues to be central to the economic life of Hong Kong. The great trading companies of the British era specialized in such activity and much of Hong Kong’s economic history was shaped by it. So the more recent idea of building new exchanges to capture more of the global commodities trading business, as well as to develop new kinds of commodity futures instruments, is hardly radical. The Chinese Gold & Silver Exchange, for example, has been in existence in Hong Kong for more than a century. Its current plans call for initiating trading in gold contracts denominated in RMB, the first of their kind

\(^{55}\) HKSAR Census & Statistics Department, *Report on Hong Kong Trade in Services Statistics*. 
outside the Mainland. At the end of 2010, the Exchange was trading 3-4 million troy ounces of gold per day, and settling nearly $5 billion per day in HK dollars. With offshore RMB business, officials predicted a near-term expansion in volume by about 20%. Of course, the accuracy of such estimates depended both upon RMB balances continuing to build up in Hong Kong and upon Mainland investors not choosing to move related activity to Shanghai, where a similar exchange exists.

Similarly, after much preparatory work, the innovative Hong Kong Mercantile Exchange recently launched its first product, a 32 troy ounce gold futures contract. Similar contracts are expected to be available soon for ferrous metals and power. On-exchange as well as over-the-counter facilities are being organized by HKMex. Participants will include end users, industrial users, professional traders, swaps desks of investment banks, arbitrageurs, and high-net worth individual investors.

In addition to drawing members from the ranks of established regional and global brokers and traders, the new HKMex is primarily targeting leading Mainland producers and users of commodities. As net buyers, these firms have traditionally had to hedge through international exchanges. If they join the HKMex, the promise is better price discovery with proximity to the home market and better management of counterparty risk. The Exchange also promises faster clearing as well as clearing-house guarantees to both counterparties involved in a transaction. Confidence is expected to be further bolstered by the fact that the Exchange is regulated by the SFC.

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7. The Changing Role of Government

Despite all the talk during the past decade about ‘globalization,’ we remain in a world mainly organized by and around states. As in other realms of policy, in the economic realm most states continue to do all they can to improve the competitive positions of their champions and the home markets. During recent periods of systemic financial stability, this has taken the form of loosening regulatory structures, intentionally leaving lacunae in supervisory nets, or providing direct or indirect financial incentives. The objective is to create new opportunities for profit-making activity, to attract new businesses, to encourage efficiency, and to stimulate job and wealth-creating innovation. During periods of instability, conversely, the focus of policy-making typically shifts to intervening in markets directly or indirectly to limit the risk of systemic failure and capital flight. In this context, and especially after 1997, the experience of Hong Kong has been distinctive in many ways.

Although not a state, as a special administrative region of China Hong Kong retains a relatively autonomous capacity to govern itself. Its government, moreover, is bound by a constitutional mandate to “provide an appropriate economic and legal environment for the maintenance of the status of Hong Kong as an international financial centre.” As in other places, that environment itself reflects the legacy of past crises. In Hong Kong’s case, the severe international shocks experienced in 1973, 1987, and 1997 were decisive.

Capital markets around the world today rest on a foundational tension between innovation and restriction. One crisis after another ever since the end of the Bretton Woods exchange rate system in 1973 implicated core banking systems and the sensitive and increasingly cross-border payments systems managed by banks. What always followed was a tightening of banking restrictions, consequent innovation outside banking systems, and, when calm returned, competition-driven moves designed to permit banks to participate directly or indirectly in new markets created by such innovation. That policy cycle itself seems an increasingly global one, that regulatory and supervisory adjustments lag the pace of market innovation but eventually rein in new ways of doing things constitutes a design feature in modern capitalism.

Much to the regret of economic liberals, a seemingly inexorable political logic in free societies with open capital markets leads not always to freer markets, with the main source of discipline coming from shared understandings of the doctrine of ‘caveat emptor.’ Instead, in moves quite understandably deplored by liberals but always acquiesced in by pragmatists, that logic has led to larger and larger core banks, reinforcement of the idea that they and now other institutions with which they collaborate are ‘too big or too interconnected to fail,’ the extension of official nets to save them during perceived emergencies, the closing of regulatory lacunae, and

57 Basic Law, Article 109.

58 For an outstanding overview, and one that has shaped my own thinking in this section, see D.W. Arner, B.F.C. Hsu, and A.M Da Roza, “Financial Regulation in Hong Kong: Time for Change,” Asian Journal of Comparative Law, Volume 5, Issue 1, Article 8, 2010, pp. 1-47.
the bolstering of supervision by agencies directly or indirectly tied to governments. That such a logic undercuts traditional attractions to Hong Kong’s financial markets is, quite simply, true. The critical reaction is clear and compelling from those who believe that freer markets prevailed during the British ascendancy.\footnote{For an articulate, passionate, and important local expression of this critique, see David Webb’s well-known blog: www.webb-site.com. I have considerable sympathy for his admiration of markets but remain skeptical about the practical political possibilities of breaking up globe-spanning firms capable of exposing distinct polities to systemic risks. Together with the fact that all factors of production are not always mobile, this seems necessarily to imply that governments are sometimes acting entirely responsibly when they intervene in markets to defend broader social interests.} Perhaps someday, some state or group of states will make the dramatically novel move to break up the banks they regulate and supervise. Perhaps such a move would create small enough, numerous enough, and competitive enough firms in specialized market segments, firms that may routinely be allowed to fail when they get into trouble. For better or for worse, the probability of such developments appears today to be approaching zero. Since 1997, Hong Kong has adjusted accordingly.

Even before the handover, Hong Kong had joined the global movement. I introduced the context at the outset of this study. Between the two oil price shocks of 1973 and 1978, a perceptible shift began in Hong Kong’s financial markets. Haddon-Cave’s famous addition of the adjective “positive” to a traditional non-interventionist stance came just after the March 1973 stock market crash and just before the HK dollar exchange rate was permitted to float. After a decade of economic turmoil, not coincidentally associated with a tremendous increase in international capital flows, in 1981 the Financial Secretary announced the adoption of a new system of bank regulation. Henceforth, his office would explicitly be responsible for setting overall financial policies and reconciling them with their ultimate base, that is, with fiscal and monetary policy. Officials reporting to him, today organized as the Financial Services and Treasury Bureau, would be responsible for overall policy implementation, most importantly with regard to the three tiers of banks: licensed banks, licensed deposit-taking companies, and registered deposit-taking companies. They would eventually be joined by commissioners for insurance and for securities and commodities trading. Two years after the stock market crash of 1987, the latter would be replaced by the Securities and Futures Commission. As in the Anglo-American governing tradition, it would remain an agent of the government but one with ‘independent’ statutory authority.

In April 1993, albeit without the same kind of statutory base, the HKMA became the regulator and supervisor of banks and banking. After 1998, the HKMA, the SFC, and the Insurance Commissioner were joined by the Mandatory Provident Fund Schemes Authority (MPFA), a new monitor for the pensions industry. Finally, industry associations in each segment of the financial markets held onto varying prerogatives aimed to enhance self-discipline in line with overarching expectations of official accountability. Other bodies, reflecting various official agencies or public-private partnerships, also played roles designed to stabilize the system as a whole. These included the Hong Kong Deposit Protection Board, the Companies Registry, the Financial Reporting Council, the Independent Commission Against Corruption (first established in 1974), the Consumer Council, and the Joint Financial Intelligence Unit of the Hong Kong
Police Force and the Hong Kong Customs & Excise Department. This basic structure was not dissimilar to analogous structures across the British Commonwealth or the United States.

As the boundaries around different financial market segments were permitted to erode in Hong Kong as well as elsewhere, the need for better coordination among these agencies became apparent. In the face of exogenous shocks, it is no coincidence that the past decade featured one policy experiment after another in establishing and adjusting various official oversight and compensatory mechanisms. A Cross-Market Surveillance Committee, comprised of the FSTB, HKMA, SFC, OCL, HKEx, and MPFA, was replaced in 2003 by two committees. The Council of Financial Regulators (CFR), chaired by the Financial Secretary, was charged with responsibility for overseeing ‘efficient’ markets in Hong Kong and promoting their development. Although the CFR was also to be mindful of the need to maintain market stability, a separate Financial Stability Committee (FSC) led by the Secretary of the FSTB was assigned primary responsibility for the stable functioning of the system overall and of coordinating responses to systemic risks. In practice, this subsumed but did not replace the post-1993 assignment of the key banking-market stability mandate to the HKMA. Now anchoring these regulatory and supervisory missions in the private sector are an array of Memoranda of Understanding between the relevant official agencies and the various industry SROs. For the biggest market segments, the functional constituency system of the Legislative Council also aims to connect public and private sector interests. Whether it succeeds or not, the complexity of the current system of financial regulation and supervision at the executive level cannot be fully appreciated without considering the evolving role of the legislature.

During every crisis since 1973, in Hong Kong and elsewhere among the world’s more advanced and open jurisdictions, systems of financial regulation and supervision attracted controversy and heightened scrutiny. Again, most governments, including the government of Hong Kong, responded by acquiescing in the consolidation of local intermediaries and then by subjecting those intermediaries to more extensive official oversight. Soon thereafter, they found themselves facing increasing demands from those same intermediaries for ‘level’ playing fields with their foreign and domestic competitors. Simultaneously, following crises that invariably hurt some consumers of financial services, they could rarely ignore demands for protection from the possibility that those same intermediaries would forget traditional fiduciary obligations. With reference to the challenge of securing Hong Kong’s future as an IFC, let us deal with each of these issues in turn.

**Financial stability**

Before the global crisis of 2008, external reviews of Hong Kong’s financial regulatory and supervisory system underlined its adequacy but also its notable complexity. In its regular surveillance reports, for example, the International Monetary Fund emphasized the need for an improved division of responsibilities between the SFC and the HKEx (including perhaps taking

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60 Arner, Hsu, and Da Roza, p. 2.
listing authority away from the HKEx and assigning it to the SFC or an affiliate of the SFC). It called for greater legislative or regulatory clarity on the mandates of the HKMA and the Commissioner of Insurance. It also advocated improvements in corporate governance and in financial data collection and monitoring. Finally, it underlined the need for stronger information-sharing arrangements with other jurisdictions, especially with the Mainland. Some progress was made on these issues, but the depth and extent of the 2008 crisis did more to highlight deficiencies than any IMF assessment could.

Certainly relative to the experience of the United States and much of Europe, and relative to its own experience ten years earlier during the Asian crisis, Hong Kong’s crisis management system proved robust. In particular, the HKMA’s liquidity management tools were effective, swap arrangements with the Mainland reinforced confidence in the adequacy of reserves, emergency extensions of deposit insurance calmed the local banking market, and selective injections of capital from official sources into private institutions came in a timely fashion. In retrospect, the most disruptive shock as well as the most constructive emergency response both emanated from the same source, namely the United States government. Although historians will long argue about the most basic roots, the emergency-precipitating shock was the decision to allow the Lehman Brothers investment bank to file for bankruptcy and inadequately to take account of the cross-border implications of such a filing. The constructive response came in the decision effectively to nationalize the insurance giant, AIG, and to compensate in full its credit-default swap counterparties, regardless of nationality.

What both events suggested, of course, was not strength but weakness—the weakness of a globalizing financial system without a fully shared and legitimate arrangement for decision-making or burden-sharing. That Hong Kong authorities are fully cognizant of this weakness is today indicated in their full and active participation in the post-crisis work programs of the Financial Stability Board and other international agencies. The HKMA in particular has taken a higher profile role on the world stage.

Less overtly but perhaps even more passionately, the crisis seems to have reinforced another lesson of the Asian crisis, not only in Hong Kong but also among its neighbours in the region. Despite the now-evident need for solidarity in the face of global financial crises, the most important crisis-prevention measures seem to be evolving in the opposite direction. In Hong Kong’s case, the crisis proved once again that the Exchange Fund managed by the HKMA under the ultimate authority of the government served not only as the foundation for the linked exchange rate system, but also as the reliable defence against financial contagion. From the highly unusual stock market interventions of August 1998 to the broader explicit and implicit stabilization efforts of 2008, the Exchange Fund was perceived to be crucially important. The main implication for future policy, at least according to some officials, was that it should be bigger. We return to this issue and its global as well as regional consequences later, but now

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62 Arner, Hsu, and Da Roza, p. , 20.
focus on the other financial policy issue requiring work after the crisis, namely the issue of consumer protection.

**Consumer protection**

The fundamental challenge is hardly novel or unique. In a world of free and more open financial markets, does the responsibility of governmental authorities extend beyond the most basic matters of licensing, establishing and adjudicating property rights, and otherwise ensuring that competition in those markets takes place on a level playing field? The current answer everywhere in the world where capital flows relatively freely is ‘yes.’ That, however, is where full agreement stops. The follow-up question has necessarily normative cast. Where should we draw the line between governmental responsibility and the responsibility of individual market participants? Answers vary, both across national borders and within them.

Certainly before the handover in 1997, the traditional answer in Hong Kong was that the role of government should be as limited as possible. As long as the society in which a relatively free and unrestricted financial market is embedded is flexible and capable itself of adjusting quickly to internal or exogenous economic shocks transmitted through those markets, then financial openness and minimal official interference should produce prosperity. As noted above, several decades ago something like such an expectation might have guided official decision-makers in Hong Kong. Nevertheless, the actions taken by their successors during each major financial crisis since 1973, and certainly the actions taken during the crisis of 2008, strongly suggest quite another expectation and quite another understanding of Hong Kong’s society.

The saga of the Lehman Brothers mini-bonds in Hong Kong well illustrates the point. Its observable conclusion is an evident social and political consensus to support a more interventionist set of financial regulatory policies, including policies designed to protect the consumers of financial services (from unclear risks and excessive fees) and to impose fiduciary

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63 Michael Bordo and Barry Eichengreen “Crises Now and Then: What Lessons from the Last Era of Financial Globalization” in Paul Mizen (ed). Monetary History, Exchange Rates and Financial Markets: Essays in Honor of Charles Goodhart, Vol 2. London: Edward Elgar Publisher 2003, pp. 52-91. Consistent with this experience is the historical evidence that suggest a correlation between freely moving capital flows and shorter recessions. Note, however, that studies making this point are often necessarily based on limited case material; we only have the late nineteenth century experience, the inter-war period, the post-1945 period, and the post-1973 period to compare. The actual, not the idealized, workings of exchange rate regimes also complicate analysis when very different countries and regions are compared over time. Be that as it may, the observable fact since the Great Depression and certainly since 1973, when countries at the core of contemporary international financial markets gave up their commitment to the gold-exchange standard agreed at Bretton Woods, is that most contemporary societies are not flexible and capable of adjusting quickly to internal and exogenous economic shocks. In practice and in very practical terms, such flexibility and adaptability means that the financial losers of the moment have limited capacity to mount an effective political reaction, that is, they cannot credibly demand a bailout either from the public purse or from private sources acting under official duress. Nor can they plausibly expect such demands to be met.
legal obligations on intermediaries selling such services. The surrounding events also suggest a new understanding that such obligations rest not simply on the shoulders of private intermediaries but also on government. In short, it repudiates traditional notions of *caveat emptor*. Together with the evolution of such practices as mandatory insurance coverage for bank deposits, governments in Hong Kong will in the future likely find it more difficult not to respond to social demands for protection from sudden or widespread financial losses, even when such losses do not threaten overall market stability. Again, to some observers and participants who valued the freedom they once found in Hong Kong, this is a matter of some regret. For present purposes, the main point is that Hong Kong has joined most other advanced economies in this regard.

Lehman mini-bonds and similar instruments were sold in many countries, but their unwinding cast a particularly harsh light on the limits of Hong Kong’s rules governing the selling of financial products to retail investors. The same lesson had been learned elsewhere during earlier crises. Transparency, or full disclosure, in the selling especially of complex products by banks is not enough. Light-touch regulation to discourage mis-selling by institutions the public typically sees as insured or at least closely watched by government is not enough. Traditional understandings of the fiduciary obligations of banks to their customers are now reinforced with the threat of penalties or enforcement efforts designed to elicit ‘voluntary’ compensation. In a new era of structured financial products with tempting returns and vague risks, especially to investors hardly qualified as ‘professionals,’ the idea of ‘self-regulation’ rang hollow.

The fact that Lehman Brothers itself was ultimately at risk in the event of a default on the mini-bonds sold by Hong Kong institutions with permission of the SFC was not entirely clear at the point of sale. Even if it had been, investors may well have imagined that the Lehman name was undoubted. The truth is that no one expected the firm to be permitted to go into bankruptcy in 2008, and even if they had, certainly no one should have expected its American overseers to be so cavalier in their consideration of liabilities not domiciled in the United States. When that bankruptcy nevertheless did occur, contagion spread across borders like wildfire in a dry forest. Under British law, for example the London subsidiary of Lehman ceased business immediately. The holders of Lehman Brothers mini-bonds in Hong Kong suddenly found themselves facing staggering losses. Having authorized their sale, under the Securities and Futures Ordinance and the Companies Ordinance, the SFC in turn found itself the target of intense political reaction. As the main regulator and supervisor of banks selling the Lehman instruments, the HKMA was drawn into the ensuing controversy as well.

In short, some 44,000 investors bought nearly HK$16 billion in mini-bonds guaranteed by Lehman Brothers. They might well have turned out to be low-risk, high-yield investments. With the unexpected collapse of the firm, however, they in fact turned into under-valued claims at the tail-end of a long and complicated unwinding process. With the HKMA and SFC awash in complaints from the holders of those claims, and the government under mounting pressure from the LegCo, the sixteen banks that had distributed the mini-bonds eventually agreed to repurchase them. They ‘voluntarily’ bought most of them back at prices varying between 60 and 70% of
their nominal value, depending on the age of the bond-holder, plus an additional payment
reflective of any recoveries the banks themselves were eventually able to make in the Lehman
bankruptcy process.64 For the time being, at least, the cause of diversifying the financial
holdings of most Hong Kong citizens was set back. The local development of wealth
management services promised long to be marked by the experience.

At the same time, a precedent had been set to extend outward the implicit safety net under
banks licensed to do business in Hong Kong. Public consultations during 2010 on the idea of
establishing an insurance authority at arm’s length from the government covered some of the
same terrain. Turning the clock back to the days of non-interventionism—positive or not—
seemed entirely unrealistic. Likewise, future reliance on the ad hoc management of markets
during crises seemed imprudent. As has happened elsewhere, therefore, following in train from
the crisis of 2008 was a fully justified debate on a new and more effective system of financial
oversight. The questions that inevitably followed focused on the modalities of that system.

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64 SFC Press Release, 22 July 2009. For the background studies, see SFC, “Issues raised by the Lehman minibonds
crisis: Report to the Financial Secretary, December 2008; HKMA,”Report of the Hong Kong Monetary Authority
on issues concerning the distribution of structured products connected to Lehman Group companies,” 31 December
2008; ; FSTB, “Action Plan on Recommendations in the Reports prepared by the HKMA and SFC on the Lehman
Brothers Mini-bonds Incident,” 2 February 2009.
8. Regulatory reform and the strengthening of Hong Kong’s IFC

The challenge Hong Kong faces in reforming its financial market infrastructure after the crisis of 2008 is hardly unique. All advanced economies are facing it. How should, and how can, the impulse to preserve the maximum feasible space for competition and innovation be brought into better balance with the need for stability and prudence, both for consumers and producers of financial services and for the system as a whole? Clearly the onus has to remain on the private sector continuously to upgrade and improve internal risk-management systems. But the primary responsibility of official authorities for driving important adjustments in regulatory and supervisory systems cannot be denied.

The crisis of 2008 and its aftermath revealed three main issues for Hong Kong’s financial policymakers: the need for clearer mandates and better coordination among regulators, especially the HKMA and the SFC; the need to reconsider the range of responsibilities and the policy targets assigned to the HKMA and the Exchange Fund it manages; and the need for a more strategic approach to managing the interaction between ‘two systems’ in greater China.

Across much of the developed world, the crisis of 2008 suggested the need for more proactive and less reactive government. In Hong Kong, as in other jurisdictions, a clearer division of regulatory and supervisory responsibilities promised just such an outcome. Balancing the competitive impulses required for continuing prosperity in Hong Kong’s financial sector and durable expectations of overall stability and safety requires subtlety. The mantra of the moment for achieving this balance is ‘disclosure, transparency, and accountability.’ While no one can disagree in-principle, this mantra obscures the real challenges of the moment. Those challenges demand political imagination, strategic thinking, and a sense of realism. At the level of Hong Kong’s leadership, they require casting off any notion that modern financial markets are apolitical mechanisms that, once set, must be left alone.

I am all too aware that the issues at hand are sensitive. They are subject to much disagreement on the grounds of both ideology and material interest. They cannot be fully analyzed and resolved in a few short pages. In the rest of this section, I therefore take it as my task to help establish the terms of deeper debate on regulatory and supervisory reforms aimed at strengthening Hong Kong’s IFC. In the previous sections of this study, I set out the local context of that debate, and in this section I emphasize the additional context provided by evolving global reactions to the crisis of 2008. In the section after this one, I return to the third issue mentioned above, namely, options for defending the autonomy of Hong Kong’s IFC within greater China.

Financial market governance

As often noted, confidence is the key factor in attracting the positive aspects of participation in global financial markets as well as in avoiding the negative aspects that can

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65 In Hong Kong, perhaps the best reminder occurred in September 2008, when a two-day run on the Bank of East Asia prompted prominent shareholders to shore up the bank’s stock price with confidence-building purchases and the HKMA to flood the interbank market with the equivalent of half of billion US dollars in liquidity.
contribute to dilemmas of various kinds. Regulatory and supervisory systems that are functional, adaptable, and reliable build such confidence. Extreme circumstances, such as those witnessed in the autumn of 2008, shed light on the most basic psychological foundations of modern financial markets. The initiator of a financial transaction must continually assess the risk that his/her counterparty will not be able to settle when required. If the counterparty is perceived to be well-regulated, or if it is perceived to be entirely backstopped by an undoubtedly creditworthy supporter, then perceptions of risk are reduced and confidence bolstered. To this idea of credit risk must be added various other kinds of risks: liquidity risk, interest rate risk, and foreign exchange risk, to name the most common. The underlying question seems straightforward. Who will pay up at the full value expected if a counterparty cannot or will not do so? The ideal answer in a free-market environment should be, “no one.” From hard experience, however, we have learned that sometimes, in some circumstances, the ideal answer cannot be given. The lender of last-resort function developed as a partial alternative answer. But assigning that function to central banks, as is typical today, was a way of avoiding having to be clear about the final answer.

That final answer responds to a more practical question. Who will be in investor of last-resort if a counterparty cannot be allowed to fail? The dramatic experiences we just lived through have us the answer with blinding clarity. The cases of Lehman Brothers and AIG frame it. All clearing banks, investment banks, and even insurance companies that survived the crisis were forced by those cases to acknowledge that answer. Who knows if in the future the potential failure of a gigantic hedge fund might suggest the same. If systemic circumstances will not allow their orderly winding-up in accordance with the laws governing their establishment and their operations, no matter how far-flung, their investor of last-resort is the fiscal authority of their homeland. It is true that sometimes branches or subsidiaries outside their homelands might be salvaged by local monetary or fiscal authorities, but they in turn would likely seek redress. In the end, the fiscal capacity of governments, whether exercised alone or collaboratively, is the ultimate generator of confidence. If it proves inadequate during a true systemic emergency, then markets we commonly now depict as global simply fail.

With its low-tax regime, its commitment to a fixed exchange rate, and, after 1997, its long-term integration with the Mainland, Hong Kong faces certain limits on its fiscal capacity. Could it burst through those limits in an emergency? Of course it could, albeit not immediately, elegantly, or without constraint. Until the point at which its fiscal accounts are fully merged into the accounts of the Mainland, those limits may be sensed if not precisely measured. We can be certain that governments and financial institutions around the world do indeed make dynamic calculations concerning them.

Given those fiscal limits, what can Hong Kong’s government do to reassure the actual and potential counterparties of financial institutions under its primary or secondary jurisdiction, that is, the firms at the core of its present and future IFC? Most evidently, it can, and often does, run fiscal surpluses. It also can, and does, encourage the expansion of the confidence-generating foreign-exchange reserves. But excessive fiscal surpluses and excessive foreign exchange reserves can actually undermine confidence, not least by increasing the prospect of
compensatory or retaliatory actions by other jurisdictions or by leading to under-investment in the real economies that support stable financial sectors. So the practical question becomes, how can Hong Kong’s policymakers find the optimal policy mix that sustains confidence?

The question begs answers that extend beyond the arena of finance. To the extent it can be carved out to clarify the terms of practical policy debate, however, two answers suggest themselves. The most obvious answer is internal. Hong Kong’s policymakers can improve, and make even less susceptible to breakdown at moments of maximum stress, the systems through which they regulate and supervise the intermediaries in their charge. The less obvious answer has a necessarily external dimension. Those same policymakers can work with their regional and international counterparts to reduce systemic risks and improve collaborative safety nets.

Both inside FSTB and inside the HKMA, work is actually now underway to flesh out those two answers. That work is not taking place in an international vacuum.

Changing markets

At present, Hong Kong has in place a mixed and overly complex system of financial market governance. The Lehman mini-bonds incident shed light on only the most obvious implications. Systems of financial regulation and supervision are both highly technical and highly political. They evolve over time and in unique local circumstances. They are difficult to change, and they usually do so in the wake of, not in anticipation of, actual crises. Before the latest crisis, Hong Kong’s system was typically viewed as a segmented or traditional-institutional system. That is, the overall system was taken to be durably split along sectoral lines. Banks were regulated by one institution, securities companies by another, and insurance firms by a third. Specifically, the three main institutions were the HKMA for banks, the SFC for securities companies, and the Commissioner of Insurance for insurance firms. Generally speaking, this is the most common model in place around the world. Moreover, with the exception of the fact that it has located the bank regulatory function not in the central bank but in a separate agency, this is also the system that has evolved recently in China.

The main contemporary problem with this model is that the sectoral boundaries around various types of financial markets have rapidly been eroding, especially in advanced economies. That erosion has been driven partly by deliberate policy changes, for example, to enhance competition in concentrated banking markets or to attract firms into newly opened markets. Once such changes began, dynamic market forces kicked in. Financial institutions and their clients naturally pushed all kinds of boundaries in the search for profits or for enhanced security. Despite many questions and much debate over its meaning and impact, the consequent process in Hong and elsewhere now bears the name ‘financial innovation.’ Boundaries around previously distinct segments dissolve. This process of de-segmentation opens regulatory gaps, creates overlaps and confusion among regulators, and otherwise disturbs basic structures of market governance. As it occurs, intermediaries like it for obvious reasons, and they can be counted on

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66 There are many ways to label, compare, and contrast such systems. For a convenient, clear, and concise orientation directly applied to the case of Hong Kong, see Arner, Hsu, and Roza, 2010, pp. 41-47.
to defend their interests in its continuation. But officials like it too, for they live in a political but also bureaucratic environment that rewards blame-shifting when things go wrong and infrequently and inadequately rewards decisiveness when things go right. To stop the process of de-segmentation entirely would be difficult, costly, and arguably unwise. The resulting dilemmas are inherent in contemporary capitalism, where most financial structures incline toward openness and integration, while most political structures remain confined and local.

Such gaps and overlaps became only too obvious during the Lehman mini-bonds incident. The biggest gap was a global one, and beyond the capacity of Hong Kong alone to fix. The decision to let Lehman fail was made by US authorities, who were not fully aware of what the legal, political, and economic fallout would be abroad.\(^67\) It was, however, the regulatory overlaps and confusion that quickly became clear after the Lehman bankruptcy, and here is the terrain where near-term reform seems most likely within Hong Kong. In short, the mandates of the HKMA and the SFC need to be clarified. Before looking in detail at that issue, however, a couple of other items need to be put on the table.

In contrast to a number of other jurisdictions that share the same basic regulatory model, the role of the HKMA with regard to the banking sector stands out. Although hardly unique, the fact that bank supervision and monetary policy are located under one institutional roof is noteworthy. A similar situation exists in Singapore and elsewhere in Asia, but in the United States, the United Kingdom, Canada, Germany, Japan, and many other places, including, as just noted, China, the central bank retains a deep interest in banking matters but defers to separately mandated institutions for detailed supervision. After the crisis of 2008, it is true that the central banks in those latter jurisdictions were more assertive in trying to expand their domains. But there is less here than meets the eye, and that is what is relevant to post-crisis debates over structural reform in Hong Kong.

**Comparing systems**

Before 1997, the UK did combine monetary policy and bank supervision in the Bank of England. With the dividing line between bank lending and securities underwriting already becoming more difficult to see, the government of Tony Blair and Gordon Brown carved out from the Bank detailed responsibility for bank supervision, combined it with responsibility for the supervision of functionally similar firms in the securities markets, and gave the full mandate to a new Financial Services Authority (FSA). Because monetary policy continued to be implemented through the banking system and responsibility for ‘monetary stability’ was left to the Bank of England, the move was controversial from the outset. But it was hardly unprecedented. Many of the UK’s European partners maintained one or more separate agencies for financial supervision.

\(^{67}\) For a detailed account, see Andrew Ross Sorkin, *Too Big to Fail*, New York: Viking, 2009.
Immediately following the crisis of 2008, however, a partial reversal is taking place in the UK. Macro-level responsibilities for financial supervision are moving back to the Bank and to its Financial Policy Committee. Still not clearly defined, the increasingly common term ‘macro-prudential’ suggests a mission keyed on systemic stability. In addition, the government has decided to abolish the FSA and divide its remaining cross-sectoral supervisory functions between two new agencies: the Prudential Regulatory Authority, which will be a subsidiary of the Bank, and the Consumer Protection and Markets Authority. If all goes according to plan, the former will continue the detailed work of the FSA entailed in examining banks and other intermediaries delivering still-comparable services. The latter will serve as the guardian of fairness and the ‘integrity’ of markets across all financial sectors. In the financial press, such a division of labour has come to be called a ‘twin peaks’ approach.

Something comparable but not identical is taking place in the United States, where the monetary and financial stability mandates of the Federal Reserve are being enhanced, as is its role as supervisor of large, complex financial institutions, whether they are incorporated as bank holding companies or not. Simultaneously, however, the regulatory responsibilities of the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, the Federal Insurance Office (newly established in the Treasury Department), and other agencies in a complicated federal system of government are not being taken away or consolidated. Instead, given the now-widely perceived need for greater cross-sectoral coordination, three new entities were established: the Financial Stability Oversight Council, chaired by the Secretary of the Treasury, the Office of Financial Research in Treasury, and a new agency for consumer protection. Although this complicated structure can hardly be recommended in all its details as a new model for Hong Kong or anywhere else, it does tend in the same direction as the UK in its attempt to close regulatory gaps and reduce overlaps by focusing attention on the same ‘twin peaks,’ consumer protection across the board and prudential supervision of intermediaries defined more by what they do than how they are legally constructed.

Although the US and the UK have obviously not wholly abandoned sectoral regulation and supervision, their reform efforts suggest the wisdom of moving in a more functional direction. Australia, Canada, and Japan have taken similar steps to differentiate and coordinate regulatory tools across various missions like systemic stability, safe conduct by intermediaries, and consumer protection. At the national level in Europe, some governments (France and the Netherlands) have moved to combine such missions under a single structure separate from the central bank. What they continue to share with other member-states of the euro-area is a reluctance to place responsibilities for financial regulation and supervision inside the European Central Bank.

These structural choices are obviously complicated, difficult, and tied to deeper factors in their unique settings. Before drawing out the potential implications for Hong Kong, however, that complexity should not be allowed to obscure two conclusions unchanged by the crisis of 2008.
First, governments across the advanced economies remain committed to concentrating the mission of the central bank on monetary stability, that is, to avoiding excessive inflation or deflation. Although central banks need deep knowledge of how banks and now bank-like institutions react to changes in monetary policies, there are other social values embedded in financial markets. Central bank dogma aside, although the monetary stability mandate may need to be protected from everyday political pressures, it is nowhere viewed as always deserving of the first place in the ranking of a given society’s ordered preferences. For this very reason, wise central bankers have long understood that accretions to their monetary mission bring with them political complications. In 2008, for example, the leaders of the Federal Reserve clearly understood that everything they did to stabilize financial intermediaries in crisis would come back to haunt them, and potentially to undercut the degree of political independence they need to maintain a sound monetary policy in the long run. They therefore insisted that Congress be asked to authorize, and the US Treasury to complement, its direct or indirect injections of liquidity into banks, bank holding companies, and insurance companies. And when it became necessary to buy the equity of some of those firms, Fed leaders were only too happy to stand in the shadow behind the Treasury Secretary.

The second conclusion not changed by the crisis of 2008 or by the crises that preceded it relates to the basic interests of fiscal authorities like the one represented by that same Treasury Secretary. In modern democracies, the ultimate fiscal authority is typically shared by the legislature and the executive. With the possible exception of times of war, when that authority has to be used their overriding objective is to solve the immediate problem facing them but also to limit claims on the public purse. Bailouts are financially and politically costly, and they are accountable for those costs. Moreover, if expectations of bailouts become built into markets, moral hazards become engrained and proper risk management by the private sector becomes impossible. In extreme but imaginable circumstances, the private capital-markets based system becomes corrupted and crisis-prone.

Across countries and across regions, both conclusions continue to push financial regulatory and supervisory reform efforts toward what might plausibly be called the messy middle. In any given political context, the policy space for financial regulatory and supervisory reform may expand, contract, or shift. But there remain excellent reasons not to place too much power or responsibility in central banks and equally excellent reasons to keep the ultimate fiscal authority of governments disciplined, separated from financial regulation and supervision, and reserved for emergencies. The task now is to assess current developments in Hong Kong in light of that logic.

Planning for the future

Even the casual observer cannot fail to be impressed by the Hong Kong Monetary Authority and the quality of its staff. A uniquely complicated set of circumstances set the stage for its establishment, including most obviously the adoption of the linked exchange rate system
in October 1983 and the signing of the Sino-British Joint Declaration in December 1984. Financial crises preceded its creation, and financial crises pushed it to new heights in 1998 and again ten years later when it stepped into the limelight with the Financial Secretary and once again restored confidence in Hong Kong’s banking system. (It used the Exchange Fund to guarantee customer deposits not only in core authorized institutions, but also in banks with restricted licenses and other deposit-taking companies. It initiated a Contingent Bank Capital Facility to inject new capital, if necessary, directly into financial intermediaries. It introduced temporary measures to allow liquidity to be provided to licensed banks. As noted above, in 1998 it also used HK$118 billion to buy a range of non-financial stocks in a successful bid to stabilize markets and discourage activity deemed excessively speculative.)

From the beginning, then, the HKMA was assigned many responsibilities: for maintaining the linked exchange rate system and managing associated reserves, safeguarding monetary and banking stability, for developing the financial infrastructure necessary to support a resilient international financial centre, for investing surplus cash generated by government, and for resolving financial emergencies. Over time, without complete or clear statutory foundations beyond those required for the linked exchange rate system, it became a quasi-central bank. From the point of view of a Chief Executive or a Financial Secretary, one can see the attractions of this one-stop, and not independent, shop. In fact, it has proven to be a generally successful instrument of executive power. It has also been well led.

As in the similar case of the Monetary Authority of Singapore, at its inception the government agreed to executive compensation levels in the HKMA in excess of those prevailing in the civil service. In later years, second thoughts about some aspects of that agreement may have occurred to senior officials, but they have typically been assuaged by calculations of political utility. To the extent it is perceived to be more than the manager of a currency board, indeed, to be a central bank and primary financial supervisor, the HKMA provides the government with a useful political buffer and an effective instrument for steering a modern market economy and, in a pinch, for managing financial crises.

The question now naturally arises. Why change anything? The linked exchange rate seems secure. Hong Kong’s financial system has proven itself to be resilient. The current circumstances do not, in fact, suggest the need for root-and-branch reform of the HKMA. But both recent events and the prudent anticipation of changing circumstances do suggest the need for open minds capable of thinking strategically. At the very least, the Lehman mini-bonds incident reflected some weaknesses in the supervision of financial institutions at the point-of-sale. Having shed harsh light on the gap between prudential oversight and the regulation of products not necessarily suitable for most non-professional investors, some were likely tempted to extend the HKMA’s remit into the area of consumer protection. But all bureaucracies have limits. To assign such responsibilities to the HKMA would have been to risk continuing success in its core missions. Moreover, the products that would conceivably have to be regulated under such a rubric will likely continue to be difficult to differentiate from similar products sold by non-banks. After all, the global processes of securitization and de-
segmentation, slowed down but not stopped by the crisis of 2008, look set to add many new products and much new complexity to the financial marketplace in the years ahead.

Beyond the responsibilities noted above, the mission of the HKMA at the moment even covers the Hong Kong Mortgage Corporation. Incorporated as a public company in March 1997 and modeled directly Fannie Mae, the HKMC is owned by the government through the Exchange Fund. This is not the place for a full analysis of its role in Hong Kong’s housing market, or to debate the benefits and costs of its operations for the private sector. The overarching point to note here, however, is that too much already seems loaded into the mandate of the HKMA.

In connection with continuing efforts to ensure that Hong Kong’s financial regulatory and supervisory systems are optimally structured to sustain and build a resilient global financial centre, the government needs continuously to review the mandates of individual regulators. The high-level Council of Regulators, convened by the Financial Secretary, was a step in the right direction in terms of coordinating those mandates to meet the requirements of a changing global system. But especially when comparable structures governing competing centres are undergoing substantial reform, it is important for the Council also to lean against the natural tendency of particular agencies to protect their turf. ‘Best practices’ in this regard are very much contested in the United States, the United Kingdom, Japan, and in Europe, so this is obviously not the time to import a wholly different regulatory and supervisory model.

Again, the HKMA in particular has lived up to many of the expectations of its founders. But the road ahead looks bumpy. Rapidly rising local real estate prices, international economic and political uncertainties, the promising but uncertain future of the offshore RMB, the possibility that the exchange rate peg may at some point in the not too distant future be shifted from the US dollar to a basket of currencies or to the RMB, the rise of new sources of contagion from booming financial markets elsewhere, the sheer complexity of financial innovation at home and abroad, and the now-obvious moral hazards that exist in crisis-prone local and international markets—all of these factors suggest the wisdom of at least studying and debating the optimal mandate of the HKMA. Carving out specific functions and assigning them to new agencies should not be ruled out without careful consideration.

68 The Mortgage Insurance Programme of HKMA, offered through HKMC, extends mortgage insurance cover for approved mortgage originators for credit losses of 25-30% of the value of properties financed by loans with loan-to-value ratios below 95%. See HKMA, Annual Report, 2009, p. 188. The HKMC is one of six “public sector entities” authorized by the government; others include the Hospital Authority and the Airport Authority.

69 Undoubtedly, the catastrophe that struck Fannie Mae and Freddie Mac in the United States in 2008 stimulated work in the government and in the HKMA to see if any lessons needed to be learned or changes made in the current structure of the HKMC. When Fannie Mae went down, its leverage ratio was roughly double that of the HKMC. Moreover, good arguments can be made to support or oppose the HKMC’s work in stimulating secondary markets for residential mortgage. With a lower cost of funds available to it because of its sovereign backing, it can undercut bank lending during good times or it can support banks when they need liquidity during tough times.
Since there is such an intimate connection with monetary policy, might it make sense to leave macro-prudential responsibilities for banking, securities, and insurance markets to the HKMA, but then to carve out a more focused agency for detailed supervision of all firms serving analogous functions in a dynamic marketplace? The subsidiary form planned for the UK’s new Prudential Regulatory Authority might ensure that such an agency would remain closely linked to the HKMA. The HKMA could continue to set major banking policies and manage Hong Kong’s IFC strategy. The separate agency, in turn, could operate closer to markets with the aim of preventing problems from developing.70

In the wake of the Lehman mini-bonds incident, moreover, continuing debate is warranted on the idea of establishing an agency separate from both the HKMA and the SFC specifically charged with responsibility for consumer financial protection, much like the new agency being set up in the United States. Aside from reducing the risk of task overload, a key plausible source of regulatory failure in modern financial markets, such distinct agencies can play a fundamental role in healthy democracies. They can champion policy objectives related to efficiency and fairness, help render difficult policy choices clearer, and make more transparent the process of policymaking.71 Perhaps the December 2010 decision of the government to establish under the SFC an Investor Education Council and Financial Dispute Settlement Centre will prove to be steps in this direction. The fact that claims brought to that Centre can end on binding arbitration is positive, but with the line between securities markets and banking markets continuing to blur, the case for a stronger official agency should not be considered closed.

Other rationales for separating out such agency mandates, including the mandate for an insurance supervisor one step removed from central government, also suggest themselves. Given

70 An recent collaborative economic study concludes: “Tighter restrictions on bank activities are negatively associated with bank efficiency while greater capital regulation stringency is marginally and positively associated with bank efficiency. In addition, a strengthening of official supervisory power is positively associated with bank efficiency only in countries with independent supervisory authorities. Independence coupled with a more experienced supervisory authority tends to enhance bank efficiency. Financial transparency is also positively associated with bank efficiency,” Lingnan University, Department of Economics, Report on Hong Kong as an International Financial Center for China and for the World, 2010, Chapter 2.2.

71 Arner, Hsu, and Da Roza (2010) disagree. They propose a “twin peaks” structure, with the HKMA responsible for monetary and financial stability, prudential regulation of all financial institutions—including banks, securities firms, and insurance companies, and with the SFC or a successor institution responsible for the regulation of securities market conduct regulation as well as of all financial products across all sectors. They would also leave the HKEx with responsibility for listing rules but subject it to the enhanced enforcement powers of the SFC. They would split the prudential and consumer protection functions of the Mutual Provident Financial Authority and the Office of the Commissioner of Insurance and move them respectively into the HKMA and the SFC under the twin peaks structure. Finally, they would render more equivalent and transparent the bank deposit insurance scheme and the evolving scheme for consumer compensation in securities markets and merge associated agencies into the HK Deposit Protection Board. My own view, again, is that this would all load too much into the mandate of the HKMA in particular. There are good reasons, especially good political reasons in a democracy, to resist the supposed imperatives of bureaucratic efficiency implied by such a plan. Not least, the increasing concentration of powers and authorities in the central bank would render the HKMA into even more of a political target that it already is. A less politicized central bank, with buffering agencies between it and the government, would reduce moral hazards in good times and provide more policy options during bad times.
the vital importance of monetary stability to the future of Hong Kong’s IFC, clarifying that as the main mission of the HKMA could be constructive. The separate agencies, in short, would provide a political buffer for monetary and currency policy changes in the future.

Similarly, and in the context noted above, such agencies would create new and useful buffers for future governments committed to limiting perceptions that fiscal resources will always be available to support troubled financial institutions. In extremis, the messy business of winding up such institutions is best left to agencies that are at arm’s length from the Financial Secretary and also from the Chief Executive of the HKMA.72 For not dissimilar reasons, even when market conditions are calm, assigning the task of protecting consumers of financial products to an official agency a step removed from both monetary and fiscal politics would seem politically wise. Of course, it could be overridden under crisis conditions, but such an assignment might help deflect pressures for market interventions or tax concessions that could become more routine in the wake of the Lehman mini-bonds incident.

The mission of the SFC is being widened to cover more than ‘fairness, efficiency, competitiveness, transparency and orderliness’ in Hong Kong’s securities and futures markets. But the rationale for giving it primary responsibility for consumer protection is still not clear. Given the need for Hong Kong’s IFC to develop deeper markets for a full range of equity, debt, and derivative instruments, the borderlands between the HKMA, the SFC, and the HKEx will need continuing scrutiny. The main task should be clear: to keep regulation, supervision, and consumer protection on par and competitive with regimes prevailing in New York and London. Among other things, this means ensuring that brokers and dealers feel under constant pressure to compete on price, speed, service, and quality. The merger of unstable exchanges into a stable, efficient, and unified exchange was a signal and necessary success. Openness to ideas and competition is now particularly vital if the HKEx is to retain its key position in Hong Kong’s IFC. Even if self-regulation were not an oxymoron, it would seem unwise to count on it ushering in that kind of openness.

That essential notion of openness also makes it necessary to recall that internal reform issues are directly connected to the issue of the optimal size and quality of the Exchange Fund. Dysfunctional markets, poorly regulated and supervised, and inadequately prepared for externally generated shocks require bigger reserves behind them. Efficient, safe, and stable markets are unlikely to need bailouts or other forms of official intervention. The authorities can economize on reserves, and they can also be more amenable to holding some reserves in less liquid, high-yielding form. Hong Kong’s financial policymakers are fully aware of the trade-off. Their constituents have every reason to keep them focused on getting regulatory and supervisory structures right.

72 This is a key lesson coming out of the 2008 crisis in the United States, where the Fed and the Treasury were very widely perceived to be too close to the big commercial and investment banks. Other agencies will likely play ever more prominent role in the years ahead when it comes to winding up failing intermediaries, while the Treasury and the Fed will be more prominent in the general oversight of systemic risks.
The LegCo has a continuing responsibility to ensure that regulatory reform does not simply occur in the immediate aftermath of crises. It needs to be complemented by a robust strategic planning capability inside the executive. In recent years, the FSTB has set the groundwork and established key precedents. Since the ideology of ‘positive non-intervention’ is now obsolete, the government would be well-served in this complicated area of policy by a high-caliber, internal think-tank capable of keeping abreast of the challenges now being thrown up regularly by dynamic global financial markets. Realistic options developed in an open-minded manner need to be placed in front of decision-makers. The large, complex financial institutions now dominating global financial markets are not being broken up. Nor are they becoming less complex. Laissez-faire therefore no longer marks a feasible track for policy planning. Likewise, overly concentrating power in any particular agency of government is both imprudent and inconsistent with building a solid foundation for a dynamic and diversified IFC of the future.

A similar logic brings us back to the other theme raised at the beginning of this section. Self-help is an unreasonable and inadequate guide for macro-prudential policymaking and for associated reserve management in contemporary IFCs. Safety nets, emergency planning, and effective crisis prevention efforts should be multilateral. When financial markets are still tending toward openness and key intermediaries are still scaling up, collaboration across political boundaries makes sense. It allows for economies in the size of liquid foreign exchange reserves and it promises effective, lowest cost responses to emergencies. But collaborators are not acolytes. Sustainable cooperation derives from negotiations on the basis of mutual interest. Negotiators, in turn, need ‘room for maneuver.’ In the case of Hong Kong, that room must be carved out at two levels, at the international level and within greater China. To that complicated operation, we now turn.
9. **Finance, Autonomy, and the Achievement of Broader Prosperity**

Hong Kong and its IFC have a huge stake in the continuing global experiment in economic and financial openness. If we take as our starting point the strategic view noted above that financial services and professional services are and will for some time remain two of its four pillar industries, then we must conclude that a world that moves toward closure or narrow regionalism would be a very bad one for Hong Kong.

Today, despite doubts spawned by the crisis of 2008, Hong Kong’s bet on continuing systemic openness for the foreseeable future seems still to be sound. At the same time, HKSAR remains on a political and economic trajectory leading toward ever-deeper integration with the Mainland. In the great scheme of things, 36 years is not very long at all. Thus, any strategy for Hong Kong’s IFC guided by the idea of independence—global or local—would rest on an illusion. It could not succeed. So what should the objective be? In other words, to what ends should the strengthening of Hong Kong’s IFC be directed?

It is hardly worthy of the distinguished history of the place, nor of the sacrifices of previous generations of its residents, to hold that the objective should be to make Hong Kong’s rich even richer and to defend their ability to move their wealth out if the need arises. Surely a better objective, one with a higher chance of being realized, would be to ensure widening and sustainable prosperity for all of the people who reside in Hong Kong. To the extent one agrees with such an objective, and not just as a matter of empty sentiment, then one must conclude that it is and will remain possible for those people to act as a collectivity. That is, through leaders whose legitimacy derives from their sincere sharing of the common objective, the people of Hong Kong will retain the ability to act like a community.

On the basis of that assertion, we can then argue that if there is agreement that the end is general prosperity and the means is collective action, then the terms of debate on specific measures to strengthen Hong Kong’s IFC will be clarified. Specific policy ideas will elicit natural disagreements, but at least a basic standard will exist for the rational consideration of options. The prior agreement that a community exists and will sustain itself creates a zone for the making of reasonable and practicable choices, a political zone in between complete integration in a larger collectivity and complete independence for the smaller community or for any individuals within it. We might call it a zone of relative autonomy.

The challenge is actually to design and implement policies on that basis. Given its size, its location, and the constitutional arrangement with the Mainland that already binds it, Hong Kong’s actual powers must remain limited. The federal analogy is an imperfect one, but it is roughly suggestive of a likely future. Hong Kong is now in some senses more and in some senses less than a province within a federation, but it is also on a path that could lead to a prominent place in a vital economic and political union. Under either the present scenario or the likely future scenario, relative autonomy in integrating economic and social environments does demarcate a feasible route to the common objective noted above—as long as one absolutely key resource is in place. That resource is not necessarily a strong government, not necessarily a large
government, and not necessarily an intrusive government. It is a smart government with a fiscal capacity adequate enough for the circumstances of the time. A smart government, in short, is essential if any deliberate strategy aimed at strengthening Hong Kong’s IFC as a step toward the broader common objective is to stand a chance of succeeding.

**Autonomy and the capacity to manage global challenges**

At the global level in regard to the financial sector, Hong Kong’s government has already proven its ability to think strategically and act constructively. The FSTB and the HKMA participate in and contribute to many forums and organizations charged with the twin tasks of stabilizing global markets and keeping them competitive. The Basel Committee, the Financial Stability Board, the OECD, and the IMF come quickly to mind.

Typically, Hong Kong’s role at the international level, though positive and constructive, has been low-profile. Occasionally, however, an opportunity for a more prominence presents itself. In 2009, for example, in the context of international controversy on the issue of tax havens, the OECD ultimately singled Hong Kong out as an exemplar of an international financial centre that had built itself upon a base of free markets, low tax rates, and transparency in its tax system. Although reports at the time suggested that China helped Hong Kong successfully make its case to the OECD, the HKSAR government subsequently led the region in new efforts to exchange tax information and prepare the ground for a significant expansion in bilateral agreements to avoid double taxation. Arguably, the most fundamental challenge to sustaining free and open financial markets in the wake of the crisis of 2008 follows along the same line, namely the challenge of reaching cross-border agreements on burden sharing aimed at preventing crises or managing them when they nevertheless occur.

A few months ago at a conference organized by a central bank, I heard a senior official from a European country, an official with much direct experience in the very difficult business of bailing out banks that were too-big-to-fail, say the following. “It used to be that whenever I had to do this in the past, we never worried about the taxpayers. Any political resistance or anxiety could be very simply handled by reminding them that by bailing out the bank and preventing chaos in their financial system, we were bailing them out. There was never a problem. But in this last crisis (2008), the taxpayers saw that we were using their money at least in part to bail out foreigners. That is a different thing, and from now on we will be very mindful of the new politics surrounding this issue. Next time, we might not be able to do it.”

As American taxpayers discovered during that same crisis, and very specifically in the case of AIG, in an emergency their government may need to invest in large, complex, cross-border financial institutions, whether they like it or not, whether they believe in free markets or not, and whether it benefits foreigners or not. Their leaders may say they will never do so. Their leaders may be ideologically opposed to doing so. But in recent decades in emergency circumstances,

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73 *OECD Observer (on-line)*, no. 273, June 2009.
they have always done so. For competitive reasons, reinforced by domestic pressures from large, complex financial institutions themselves, they have continued to acquiesce as those institutions become larger and more complex. That particularly difficult political dilemmas therefore now confront them should surprise no one. In this light, then, all the more significant is Hong Kong’s recent and novel agreement to participate in the deepening of crisis-management arrangements at the regional level.

The Chiang Mai Initiative dates back to a series bilateral reserve swaps negotiated between ASEAN+3 (China, Japan, and South Korea) central banks during the Asian crisis of the late 1990s. Late in 2009, an important step was taken toward a more comprehensive regional organization. In addition to confirming larger commitments to a now-multilateral emergency pool of liquidity, members agreed to create a regional secretariat (ASEAN+3 Macroeconomic Research Office, or AMRO), with responsibility for independent surveillance of national and regional economies. For the first time, Hong Kong was included. Its contribution to the reserve fund of $4.2 billion was counted as part of China’s total contribution of $38.4 billion. (Japan and China put in equal shares and South Korea contributed the equivalent of half of one of those shares; together the three accounted for 80% of the total subscribed). Finance ministers serve as governors of the organization, and Hong Kong is represented in the Ministerial Level Decision Making Body by the finance minister of China. Actual lending decisions, however, will be taken by weighted votes of the Executive Level Decision Making Body, which consists of twenty-seven members—a deputy finance minister and deputy central bank governor from each of the ASEAN+3 members plus a deputy from the HKMA. This structure makes vivid the very idea of Hong Kong’s autonomy within the ‘one country, two systems’ configuration. In any event, this is precisely the way the HKMA presented it to the LegCo. Given changing perceptions in the region during the crisis then still roiling markets, the government’s decision to participate on these terms simultaneously signaled a willingness to help the Mainland achieve important regional goals, an effort to avoid the sidelining of Hong Kong’s IFC, the potential enhancement of HKMA flexibility during a future crisis, and a practical commitment to evolving plans for regional burden sharing. Interesting to watch will be its future potential role in helping to link these regional arrangements to existing global arrangements managed, for example, by the International Monetary Fund.

Hong Kong’s key financial policymakers are obviously well aware of the dilemma posed by the conflicting impulses of economic integration and political self-help. They are concerned

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about it, and they are playing a constructive role at the global and regional levels in trying to address it. They are also aware of the implications of the logical response to the dilemma currently driving much strategic thinking inside large, complex financial institutions, including banks that play a key contemporary role in Hong Kong itself. After each cross-border crisis since the early 1970s, most have become even bigger and even more complex. After all, as the events of 2008 surely suggested, this is the most reliable way for them to surmount the next crisis. Indeed, to paraphrase the response of one senior executive to my own probing along this line, ‘In the event political authorities decide that they cannot or will not assist us, we need to be so big and so global that we ourselves could cut off a diseased limb without concern that the rest of the body would be compromised.’ For Hong Kong, of course, the issue is to ensure that it is not the location where such surgery actually takes place, which bring us back inevitably to the problem of monetary and, ultimately, fiscal burden sharing.

Once again, I have only a question and not a definitive answer. That question, though, begs for more thorough and open-minded debate within Hong Kong. It points back to the need for a robust strategic capability inside the central fiscal and monetary agencies of government. The task cannot be left to the private sector.

**Autonomy and the capacity to maneuver within Greater China**

The global crisis of 2008 is now in the past. In the United States and Europe, prominent financial institutions disappeared. The survivors are now larger, but they still compete in markets that remain quite open. Vis-à-vis one another, the United States, the European Union, Japan, still the home bases for most large banks and investment vehicles, have returned to the same basic macro-policy choices that they preferred before 2008. They remain open to inward and outward capital flows; they assign a high priority to the autonomy of their internal monetary policies, that is, to their ability to increase or decrease interest rates mainly in light of domestic circumstances; and they maintain flexible exchange rate regimes. In other words, this is how

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76 Barring an economic catastrophe, my personal view is that we must acknowledge that we are likely to continue living in a world of LCFIs. Breaking them up, re-segmenting them, and rendering their possible failure in ‘free’ markets easy to contemplate might be wise, but it is not likely to happen in the near future. Thus the logic of burden sharing must be extended now to the global level. There is no practical means of escape from the necessity of deeper monetary and fiscal cooperation during emergencies. We must, then, learn to live with the uncomfortable reality of moral hazard at the global level. We can try to limit it. But no matter how hard we try, we cannot eliminate it entirely. Perhaps history can give us some hope. That same logic led us after 1945 to try and adapt the International Monetary Fund as a burden-sharing instrument in a trade and eventually investment-centered systemic economic order. Some say, a better and more feasible objective now is to adapt earlier experiments that centered on networks of central banks. That would be fine if we had ultimately only to contemplate temporary liquidity facilities to stabilize an increasingly complex system. But it would be to deny the truth that we witnessed with our own eyes in 2008. In a global financial system, we must sometimes confront solvency problems that can only be addressed by cooperative monetary and fiscal responses. In the end, integrating markets mean integrating politics. For further analysis along this line, see my “Managing Financial Emergencies in an Integrating World,” *Globalizations*, vol. 6, no. 3, September 2009, pp. 353–364.
they collectively ‘solve’ the monetary and financial trilemma long ago made famous by the economist Robert Mundell.

Inside the Economic and Monetary Union of Europe, another choice was made both before and after the latest crisis. With capital mobility and exchange rate fixity as the highest collective priorities, the monetary autonomy of individual members has been surrendered, or perhaps more accurately, rendered subordinate to the preferences of Germany. Hong Kong made a similar choice in October 1983, when it linked the Hong Kong dollar to the US dollar at a fixed rate. It thereby accepted the fact that its monetary aggregates would be heavily influenced by changes in US policy as long as it also kept its capital markets free and open. Hong Kong’s contemporary IFC, its success and its resilience, is the consequence.

Much of the current discussion about carefully and cautiously improving and enhancing Hong Kong’s IFC assumes the maintenance of that macro-policy status quo. It also assumes that China’s transition to currency convertibility and openness to freer capital movements will take quite some time. In the meantime, Hong Kong’s IFC can continue to prosper as a dynamic as well as resilient gateway, as a privileged zone where arbitrage can thrive between open global markets and a massive and internally focused Chinese economy.77

Because they understand this fundamental logic, the market participants routinely surveyed in studies of Hong Kong’s IFC now report their expectation that within ten years Shanghai will return to its historic place as the financial centre of China and Hong Kong will likely be relegated to a lesser place, at best.78 That is certainly possible. Another possibility is that China’s transition will take a very long time. Observers who believe this, for example, expect political control by a single party to be most difficult to sustain inside an economy where capital flows freely through markets rendered resilient by clear, transparent, and enforceable rules. They therefore expect capital decontrol to be a slow process. If they are right, then Hong Kong’s current macro-policy choices and the IFC they underpin hardly seem fragile. Moreover, the gradual development of offshore RMB markets in Hong Kong looks set to remain promising and lucrative.

Such a view, nevertheless, deserves careful and continuing scrutiny. Analytical debates on the nature of party rule in China and the strength, centralization, and coherence of the party itself are highly relevant. Diametrically opposed positions often appear plausible. In light of the discussion above on the experience of capital decontrol in other countries is also therefore relevant. Depending upon internal political circumstances on the Mainland, the process could move much more quickly than currently anticipated.

77 In this regard, a careful study by HKMA economists concludes as follow: [Our findings indicate] “that Hong Kong financial markets appear to be more aligned with US markets in turbulent times, but relatively more integrated with the Mainland during the tranquil periods.” See Dong He, Zhiwei Zhang, and Honglin Wang, “Hong Kong’s Financial Market Interactions with the US and Mainland China in Crisis and Tranquil Times,” HKMA Working Paper 10/2009, 16 June 2009.

78 See, for example, Lingnan University, Department of Economics, Report on Hong Kong as an International Financial Center for China and for the World, 2010, Chapter 1.8.
If China’s transition goes smoothly and full currency convertibility comes reasonably soon, Hong Kong’s macro-policy settings could still be broadly maintained but the key currency in the linked exchange rate mechanism would be the RMB and not the US dollar. Even after Hong Kong is fully integrated into greater China, its IFC could and should retain some ‘room for maneuver,’ some relative autonomy within an evolving union. Its continuing success would depend on developing certain niches, certain sub-specialties within more complex global and national financial markets. It would depend on developing durable linkages between financial intermediaries that remain based in Hong Kong and greater China’s real economy.

Another way to imagine this most plausible future is to go back to Mundell’s trilemma. The smoother and the more rapid China’s transition to currency convertibility and an open capital account, the faster Hong Kong’s IFC will have to adjust away from the traditional notion of a simple gateway into and out of a relatively closed Mainland. Since it is implausible to imagine that in a post-transition environment the Hong Kong dollar would be freely floating vis-à-vis the RMB or that Hong Kong’s capital markets would be less open, then its monetary policy would have to be fully subordinated to Beijing’s. At that point, the idea that Hong Kong would be the London of the region also becomes implausible. What then might be the sources of any competitive advantages that could promise a high degree of prosperity?

The logic leading to such a question poses a deep challenge—because its answer is so obvious. Perhaps there was a time, say, in the decade before the crisis of 2008, when some may have imagined a ‘global’ city disconnected from a diversified economic base and building a secure prosperity on the specialized foundation of a super-efficient financial sector serving markets around the world. The crisis and its continuing resolution, however, reminded us all that durable competitive advantages, as well as adequate fiscal backstops, rest on ‘real’ economies and strong-enough polities. Such economies, like the North American one on which New York depends or the European one on which London, Frankfurt, Zurich, and Paris depend, include a diversified industrial base, large consumer markets, and long-term investors unable or unwilling to flee in an emergency. Not coincidentally, such an economy is the source of fiscal capacity, the kind of capacity absolutely required during a financial crisis. To prove the point, think about the recent experience of Iceland. A financial sector disconnected from a robust real economy can thrive only in the short run.

Much of the early literature on Hong Kong as an international financial centre implicitly rested on the assumption that the world economy was inexorably moving ‘beyond borders.’ Perhaps such a belief will once again become plausible. I hope so. But today it seems a risky guide for policy. Certain images of Hong Kong’s future, drawn imaginatively from the history cited in the opening pages of this study, seemed quite believable ten years ago: images of the city as a laissez-faire financial metropolis, as a durable global meeting point resting on a fluid and entrepreneurial culture, or as a secure centre for the regional headquarters of corporations based elsewhere in the world. Such images deserve intensive and skeptical scrutiny today. They justified ultra-low tax policies, ever higher foreign exchange reserves, unusual patterns of land ownership and land use, and constrained social, public health, technology, and education
policies. With such images and such policies in the background, it is no wonder that many expatriates found Hong Kong a paradise, at least for a time. But today many officials, current residents, and friends of Hong Kong harbor deep-seated, often unspoken, doubts. At root, they are concerned that all now depends on decisions made elsewhere.

Hoping for the best but planning for the worst—for good historical reasons, these features are deeply embedded in Hong Kong’s culture. Now well into the second decade after the British handover, many are asking whether Hong Kong must simply resign itself in the near term simply to serving as a laboratory for Mainland experiments in financial and other types of policies, for example, those policies allowing the development of offshore RMB markets. They are wondering if in the longer run, Hong Kong can aspire at most to helping Shenzhen, Guangzhou and the greater Pearl River Delta attain and maintain a prominent and prosperous place within a burgeoning China. Perhaps some even find themselves contemplating a shift in their own centres of gravity within the region as they see municipalities on the Mainland quickly duplicating Hong Kong’s advantages, like its airport, its seaport, and its internal transportation systems.

In such a context, strengthening Hong Kong’s IFC must come to be seen as a key element in a larger project aimed at preserving as much autonomy as possible for Hong Kong as an essential part of a future China. For the benefit of all of Hong Kong’s residents, this must mean thinking more strategically—in pursuit of the realizable objective of keeping Hong Kong in a prominent and prosperous position within the stable and sustainable union China should become. Thus, the immediate goal inside Hong Kong must be to build adequate-enough private and public structures capable of defending and bolstering Hong Kong’s distinctive place within greater China. Deepening the trade and investment linkages between Hong Kong and the Mainland through, for example, the growing settlement facilities in Hong Kong’s IFC must be conceived of as part of a much larger and mutually beneficial project. Among other important tasks, Hong Kong’s leaders must work to ensure that the project has sympathetic supporters inside China’s Politburo, and especially inside the Standing Committee. Neither markets nor governing institutions set on auto-pilot are likely to be clever enough, constructive enough, or durable enough to position the majority of Hong Kong’s people at what we might call the ‘sweet spot’ between integration and autonomy within greater China.

A resilient IFC in a complex political economy

Powerful global and regional forces now impel the government of Hong Kong to develop the strategic capacity to design nuanced policies and the fiscal capacity to implement them. The task of strengthening its IFC should be seen as a key element in a larger agenda.

Hong Kong retains a number of highly useful assets or, to use another terms, policy instruments that for the time are capable of providing buffers between the ‘two systems’ operating within ‘one country.’ We have discussed them all above. They include: a geographic
location that remains attractive for international firms; a confidence-inspiring and institutionalized commitment to the rule of law that, among other vital things, should sustain a robust regime for the protection of intellectual property rights; the HKMA and the foreign currency reserves it manages, efficient and liquid systems for clearing and settling local and cross-border payments, an expanding network of bank branches and related businesses that have already followed key clients to the Mainland, openness to inward and outward-bound capital flows, well-developed links to external financial markets, a pool of skilled financial managers and professional service providers, modern transportation networks capable of moving people very efficiently locally and into and out of China, increasingly strong universities, the tactical flexibility that comes from deep knowledge of business culture and practices on the Mainland, the capacity to remain useful to Chinese authorities as a test-bed for economic and political innovation, a transparent financial regulatory and supervisory system, a prominent position in global media networks, and the foundations for a democratic political culture capable of rendering long-term policies legitimate and enduring.

Taken together, all of these assets can translate into a collective capacity both to profit from a perhaps lengthy transition period in Chinese economic history and constructively to assist Chinese authorities facing difficult internal trade-offs during that transition period. Recommendations for reform touching on all of these assets need to be assessed in light of their potential to enhance or undercut that collective capacity.

Whether explicitly articulated this way or not, these assets underpin the current version of Hong Kong’s traditional role as an investing and trading gateway to and from the Mainland. But that role has lately become more complex and sensitive. Hong Kong’s contemporary IFC allows Chinese authorities to release internal social pressures; for example, via Hong Kong channels, individuals and companies wanting to hedge their bets can ever more easily exercise an exit option and move capital out. Likewise, Hong Kong’s IFC remains an open structure for facilitating capital imports into the Mainland and for hosting Chinese policy experiments.

Maintaining room for maneuver and remaining flexible enough to take opportunities as they come along appear to suit Hong Kong’ society as it currently exists. Strong private interests, especially those based in the property sector or represented at the pinnacle of its financial markets, seem content with accommodating policies. At the same time, by design or by virtue of the inheritance of history, Hong Kong’s government often seems capable of delivering little else. Its executive remains constrained by the Basic Law and the realities of power in Beijing and in neighboring provinces. Its legislature remains dominated by functional constituencies, and citizens kept distant from decision-making, understandably, have come to understand only what government should do for them and not what they must do to make that possible. Its administration remains cautious and caught up in a generalist civil service culture that may have served British interests well but is not always suited to the demands on contemporary government. Its officials are not often able to make and implement decisions quickly, which now often contrasts notably with the ability of their counterparts on the Mainland. All of this reinforces a traditional focus on immediate problem-solving in Hong Kong. In just
such a context, the range of financial market issues amenable to discussion and debate is defined, often too narrowly.

Let me end by drawing out several plausible policy implications from the assessment set out above. Not all of them can or should be entirely separated from the broader economic context, but all of them flow naturally out of my analytical narrative. Food for thought offered humbly by an outsider and not a fully digested meal, they nevertheless seem to me ripe for open deliberation and debate.

To strengthen today’s IFC in Hong Kong, a single entity ‘above the fray’ needs to be in a position to think strategically. FSTB is a logical place to lodge it. The best of its high-quality staff members need to be deployed for longer than usual terms of civil service postings. In a sense, they need to act as a permanent secretariat and strategic think-tank for the Council of Financial Regulators. Their main task would be to help the Council balance and rebalance the stability and competitiveness imperatives pushing and pulling Hong Kong’s IFC in new directions. Since the agenda necessarily crosses many policy arenas, with fiscal policy at the core, the alternative idea of shifting even more power and responsibility to the monetary authority should be resisted.

Closer to the markets, a version of the UK’s Prudential Regulatory Authority, as a distinct and distinctly mandated subsidiary of the monetary authority, should be considered. Such an agency might provide a useful buffer for both the HKMA and the government in an era of global finance that looks to remain crisis-prone. Under its stability mandate, the HKMA should remain in a position continually to re-assess and guide macro-prudential policies, especially as they apply to systemically significant banks, cross-border banks, and large bank-equivalents at or near the core of the payments system. In this regard, it needs to maintain its excellent research capabilities and its relationships with important central banks around the world. It should also continue to be responsible for ensuring that the technology of settlement and clearing in Hong Kong’s IFC meets world standards. It does not, however, need directly to handle responsibilities for day-to-day financial supervision. Like most of its counterparts abroad, it should stand one step removed from future problems akin to the Lehman mini-bond problem. International comparators should also inform related reconsideration of the relationship between the SFC and the HKEx and the continuing debate on establishing a separate, cross-sectoral agency for consumer protection. The ad hoc response to the Lehman crisis provided a vivid example of what needs to be avoided in the future.

There is no reason to tamper with the HKMA’s primary responsibility for managing the Exchange Fund. But it is reasonable for the government to insist that reserves not likely to be needed to maintain the integrity of the linked exchange rate system or the liquidity of the payments system be invested more aggressively. A sovereign wealth fund does not have to be explicitly carved out, but the return on a serious portion of existing and future reserves could reasonably be benchmarked, not simply against the guideline set by the Financial Secretary, but also against the performance of SWFs in comparable jurisdictions. The HKMA’s move to
rigorously accountable external managers to handle a portion of the Fund should be reinforced by more detailed and more comparative reporting.\footnote{A compound annual investment return over the period 1994 to 2009 of 6.1\% is certainly respectable, especially when it is compared to a compound annual increase in the consumer price index of 1.5\%. (HKMA, Annual Report, 2009, p. 94-95). One problem is that CPI may understate the effects of asset price inflation, especially in property markets. Another is that international comparators are needed to help policymakers assess whether overall annual performances are optimal or not.}

Higher investment returns on a significant share of the Exchange Fund would provide the government with greater fiscal capacity. With the same purpose in mind, the current exceedingly low personal and corporate tax policy should not be immune to comparative analysis and open debate. At a time when the government is generating annual revenue surpluses, such debate might seem unnecessary. There are two main reasons to disagree. The first has to do with the distortions potentially harmful for the long run development of Hong Kong’s IFC resulting from the current land transfer and development system. The second has to do with the expenditure side, and most particularly with expenditures that might wisely be made to build the infrastructure and human resources capable of sustaining a resilient IFC and the more broadly diversified economy supportive of long-term autonomy.

Continuing to attract the regional head office functions of corporations, including domestic firms building Mainland operations, remains vital. A priority of government should be to ensure Hong Kong retains its international attractiveness, stays competitive with alternatives developing on the Mainland and elsewhere in the region, and addresses current structural weaknesses. In this regard, the importance of personal tax incentives may be exaggerated, especially because of the counter-balancing implications of rapidly rising housing costs. Tax competition, moreover, is a short-run game. Already, Shanghai and other jurisdictions across the region are reportedly willing to make special deals if necessary to match Hong Kong’s tax advantages. High-quality elementary and secondary schools, new resources to develop technical skills and upgrade the linguistic abilities (English and Mandarin) of the general labour force, better air quality, improved public health services, great universities, and the kind of cultural amenities long promised by the West Kowloon Complex—all are much more significant elements in any long-term strategy. And all of these contributors to the kind of open, knowledge-based economy supportive of a durable IFC are capable of being addressed within Hong Kong itself. Conversely, that IFC should help generate more public and private revenues for such investments. Investing in those areas, frequently mentioned in surveys of expatriates in Hong Kong, would be entirely justifiable in strategic terms. Although the scale may be different, New York, London, and Shanghai are relevant and appropriate comparators.

In fact, debates on long-term strategic investments in Hong Kong are already underway. Mindful of the intimate connection that should be in place between Hong Kong’s present and future IFC and a broader knowledge-based economy, Hong Kong’s leaders are ahead of many of their counterparts in the region by focusing attention on post-secondary institutions of higher learning. The results of pioneering efforts to attract and support outstanding faculty and students from the Mainland and elsewhere are already being reflected in widely noted annual
surveys of universities and their reputations. The Times Higher Education Supplement now
ranks the University of Hong Kong as the top in Asia and the Hong Kong University of Science
and technology as sixth among the top ten. In 2010, QS Asian University Rankings placed
HKU, HKUST and the Chinese University of Hong Kong in the first, second, and fourth
positions respectively. Other respected surveys are less generous, and all advanced economies
are now struggling with the questions of what constitutes promising research and how it should
be supported. It is clear, however, that policymakers in Hong Kong do understand and care
about the heightening competition across the region and around the world to nurture the
brainpower required to keep Hong Kong competitive, prosperous, and again relatively
autonomous. This should lead them to increase long-term investments in a vibrant university
system.

With regard to the financial sector, a two-track strategy has much to commend it. Hong
Kong can offer its experience and expertise to Mainland cities seeking to build modern financial
markets, while also continuously enhancing the globally competitive advantages of its IFC.
Regularly benchmarking against New York, London, and Singapore should spur the latter effort
along.

More broadly, it remains important to remember that all four pillar industries of Hong
Kong’s contemporary economy are not static, nor should they be seen as reflective of final
strategic choices. It is true that most governments around the world are not good at picking the
specific firms that might become winners in the future. But they are very good, indeed
irreplaceable, at funding and shaping the environment within which basic and applied intellectual
work can flourish and sow the seeds for new industries. Fair competition in markets open to the
fruits of that work must also be ensured by pro-active policies. To sustain Hong Kong’s
position in vital information-based industries like commercial banking, investment banking, and
insurance, but certainly for broader reasons as well, present and future governments must take
seriously the challenge of nurturing a competitive innovation system.

As the data arrayed above indicate, maintaining an IFC in the top global tier will not
generate the quantity or quality of jobs needed by the next generation of Hong Kong’s residents.
New industries will be required. Finance should remain a key contributor to future prosperity,
but none of the world’s leading IFCs are disconnected from real economies. Certainly Wall
Street and the City of London are not disconnected from markets where a widely diversified set
of goods and services are actually produced. If some of their financial leaders thought otherwise
before 2008, their views were thoroughly discredited by events. In the end, the fiscal resources
ultimately generated by substantial and substantially productive real economies were all that

80 Although the process has been drawn out, the Competition Bill moving toward final action was designed to
address the failings of voluntary compliance with competitive norms and to ensure efficient markets. Of the many
issues relevant to a healthy IFC under consideration, competitive conditions among brokers and dealers in the
HKEx, among mortgage providers, among land developers, and among providers of telecommunications services
deserved scrutiny. For background, see HKSARG Competition Policy Review Committee, Report on the Review of
Hong Kong’s Competition Policy, June 2006; Legislative Council Brief: Competition Bill, CITB CR 05/62/43, July
2, 2010; Mark Williams, Competition Policy and Law in China, Hong Kong and Taiwan, Cambridge: Cambridge
stood between their institutions and oblivion. Hong Kong’s IFC is ever more deeply connected to the real economy of greater China. It can continue the process of integration while simultaneously strengthening itself for the benefit of all of Hong Kong’s residents.

Such strengthening should include measures to promote industrial diversification domestically, again in the overarching interest of maintaining the relative autonomy of Hong Kong’s society, even after 2047. Deepening financial-industrial linkages between Hong Kong and the Mainland is not inconsistent with promoting industrial innovation and development within Hong Kong itself.81 Considerations along this line surely underpinned strategic investments in the New Territories’ Science and Technology Parks, in the spectacular Chek Lap Kok international airport facilities, in efficient internal transport systems, and in the university system. Similar considerations justify expanding such investments. Creative political and business leaders can surely demonstrate that the continuing distinctiveness of a vibrant and open Hong Kong enhances its long-term role as a positive contributor to sustainable economic and political development throughout the Mainland. Hong Kong’s history suggests that the broader society within which its IFC remains embedded is resilient and quite capable of supporting a complex political and economic strategy. Now is the time to bolster the governing capacity required to implement it.

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81 The Savantas Policy Institute sponsored an outstanding long-term study that speaks directly to this theme. Its main papers were recently synthesized and published in Douglas B. Fuller, ed., Innovation Policy and the Limits of Laissez-faire: Hong Kong’s Policy in Comparative Perspective, London: Palgrave Macmillan, October 2010.