Joseph Yam: Two IFC

Talk by Mr Joseph Yam, Chief Executive of the Hong Kong Monetary Authority, at the Federation of Hong Kong Industries Annual Dinner 2004, Hong Kong, 2 March 2004.

*   *   *

I am delighted to be joining you at your annual dinner this evening. Since its foundation in 1960, the Federation of Hong Kong Industries has seen enormous changes in the business landscape of Hong Kong. In 1960 Hong Kong was reaching the end of its first decade as a major centre of manufacturing. Today Hong Kong is the centre of a much larger regional manufacturing base, with some 5 million manufacturing workers employed by Hong Kong companies in Guangdong Province alone. The size and diversity of this manufacturing base makes the work of your organisation even more important and challenging. The Federation has risen to the challenges with a growing focus on the Pearl River Delta and beyond and a stress on communication and co-operation with counterparts beyond Hong Kong, in Mainland China, in Asia and across the world. As industrialists, you are in command of considerable resources, and as producers of wealth and as investors you are some of the main users of Hong Kong's financial infrastructure. My aim in this speech is to tell you something about recent and future developments in that infrastructure.

But first I should point out that "Two IFC" - the title of this speech - does not stand for the magnificent new building in which the HKMA offices are now housed. It stands for a Mach Two International Financial Centre. It stands for a new vision of what an international financial centre is like. It raises questions on how the Hong Kong Special Administrative Region Government (HKSARG) should go about discharging its responsibility under Article 109 of the Basic Law in "the maintenance of the status of Hong Kong as an international financial centre".

You may wonder why I refer to Mach Two in the description of an international financial centre. Mach is defined in the *New Oxford Dictionary of English* as "the ratio of the speed of a body to the speed of sound in the surrounding medium". Mach Two is generally used to mean twice the speed of sound. It is also used as an image for a higher dimension. I think it is a suitable description of the phenomenal, dimensional jump that we have been seeing in global finance - and in the environment in which an international financial centre has to function.

Financial liberalisation, and consequently the globalisation of financial markets, has placed new demands on an international financial centre. The information technology revolution means that the speed at which international capital travels the globe, and its volume, have increased tremendously, to the extent that the traditional topography or the key attributes constituting an international financial centre are no longer adequate. The migration of financial sector activity into cyber space has begun, whether we like it or not. When was the last time you went into a bank? You can now conduct most banking transactions through the Internet, while enjoying your vacation in Phuket or having a family reunion in Whistler. Soon it will be the financial intermediaries, or may be even the markets themselves, that will start to migrate into cyber space. Indeed, the boundaries arising from geography and time zones are breaking down for many activities, particularly those of financial markets, under the influence of globalisation and the revolution of information technology.

What then are the attributes of a Mach Two International Financial Centre? And how does the HKSARG discharge its responsibility specified clearly in Article 109 of the Basic Law? These are challenging questions and the legal responsibility is an onerous one. But before I attempt to answer these questions, I think I should, in view of the increasing emphasis in Hong Kong on accountability, first draw attention to where the functions and responsibilities of this task rest.

You may not be aware of this, but the Chief Executive of the HKSARG, on 27 June last year, issued a public statement concerning the responsibilities of the Financial Secretary (FS) and the Secretary for Financial Services and the Treasury (SFST). Specifically in relation to the status of Hong Kong as an international financial centre, the statement specifies that:

> "FS shall be responsible for determining the policy objectives at a macro level. SFST shall be responsible for formulating specific policies to achieve such objectives and for overseeing their implementation through the regulatory authorities and other organisations as appropriate".

On the same day, the Financial Secretary made a public statement concerning the macro policy objectives in relation to, among other things, the maintenance of the status of Hong Kong as an international financial centre. He said that:

> "An international financial centre is a place where financial institutions from many different jurisdictions come together to carry out financial intermediation of an international dimension. The Government should seek to maintain and enhance Hong Kong's status as a major international financial centre. Towards this end, the Government should -
>
> a. maintain an appropriate economic and legal environment for an open, fair and efficient market, including through ensuring that Hong Kong's laws continue to provide a level playing field;
>
> b. further enhance the international competitiveness of Hong Kong's financial services through promoting international financial intermediation and attracting foreign savings to Hong Kong;
>
> c. develop payment, clearing and settlement systems to facilitate the safe and efficient conduct of international and cross-border financial services in Hong Kong; and
>
> d. strengthen corporate governance standards with a view to fostering international confidence in our financial markets."

I think these macro policy objectives for the maintenance of the status of Hong Kong as an international financial centre are very appropriate. Indeed, it seems that they are so appropriate that there has not been any difference of opinion expressed publicly since their promulgation in June last year. It may be that this is a reflection of a general lack of interest in the subject. I hope not.

The Hong Kong Monetary Authority is one of the regulatory authorities responsible for implementing the specific policies for maintaining Hong Kong's status as an international financial centre. You may have heard of an exchange of letters between the Financial Secretary and the Monetary Authority, also in June last year, which set out the division of functions and responsibilities in monetary and financial affairs between the two. In the principal letter, the Financial Secretary specifies that, in support of policies to maintain the status of Hong Kong as an international financial centre:

> "The Monetary Authority, when discharging his responsibilities for maintaining the stability and integrity of the monetary and financial systems of Hong Kong, shall, in co-operation with other relevant authorities and organisations, seek to promote:
>
> a. the development of payment, clearing and settlement systems to facilitate the safe and efficient conduct of international and cross-border financial activities in Hong Kong;
>
> b. confidence in Hong Kong's monetary and financial systems through active participation in international financial and central banking forums; and
>
> c. appropriate market development initiatives that help strengthen the international competitiveness of Hong Kong's financial services."

Against this somewhat bureaucratic but politically essential background, let me now give you my views, for what they are worth, on a Mach Two International Financial Centre.

As explained in the statement of the Financial Secretary last June, an international financial centre is a place for carrying out financial intermediation of an international dimension. This means, I think, not only the channelling of foreign savings into Hong Kong investments and Hong Kong savings into foreign investments. That would be too narrow an interpretation. In any case, the Hong Kong economy is small by international standard. Savings and investments, in national accounting terms, amount merely to HK$400 billion a year, hardly a month's turnover in the stock exchange. Financial intermediation of an international dimension is, I think, meant to include also the channelling of savings from one foreign jurisdiction into investments in another foreign jurisdiction, for example, US savings into investments in the Mainland of China, or vice versa, or German savings into Indonesian investments, and so on. To aspire to be an international financial centre, we must provide the platform whereby international financial intermediation can be conducted in Hong Kong, and for a substantial volume of the activity to be captured here. The question is: "How?"

We should not, of course, forget the traditional Mach One answers. I am sure they are familiar to you all. They include:

a. respect for the rule of law and independence of the judiciary;

b. a pool of skilled labour;

c. a robust regulatory system with a light regulatory touch;

d. a simple personal and corporate tax regime with a low tax rate;

e. a government that is responsive to financial sector concerns;

f. a stable and freely convertible currency;

g. a clean and efficient government; and

h. an attractive working and living environment.

All these Mach One attributes continue to be important. They lie at the foundation of an international financial centre, and we must all do our best to ensure their continuity, and to strengthen them in the light of changing circumstances. But, as I said earlier, the dimensional jump in global finance arising from the globalisation of financial markets and the revolution of information technology has made them inadequate on their own.

On the business side, we are now talking about, for example, the provident fund managers in a foreign jurisdiction who have access to up to the minute information on financial markets. They are nimble in making portfolio reallocations among bank deposits, debt and equity, hopping across the three different channels of financial intermediation and looking for financial arrangements and instruments that best suit their investment appetite. We are also talking about the increasing number of high net worth international citizens who carry portable computers, and who are quite capable of managing their own finances and demanding direct access to financial markets.

On the risk management side, we are talking about investors who are increasingly alert to risks and skilful in managing them. Apart from the minority who play the currency markets, the majority of them probably do not wish, for example, to incur the exchange rate risk of a second currency on top of that of the currency of the economy in which they are investing their savings. We are also talking about the increasing number of sophisticated market participants who are aware of the payment, clearing and settlement risks of financial transactions. Receiving a cheque does not necessarily mean finality of payment. Striking a deal in a bond purchase does not necessarily mean that you have immediate title over the bonds. You do not necessarily get your US dollars or euros, when you buy them in Asian time zone out of Asian currencies, at the same time as you part with your money. Many of you probably still do not care. But increasingly you will when you realise what can happen to your money in the few hours of time difference in this age of information technology. I hope the wake-up call will not take the form of a major IT scandal in international finance.

But let me offer a little comfort by telling you that the Mach Two International Financial Centre that I have in mind should go a long way towards meeting the business and risk management needs that I have just referred to. In fact, we have been quietly and effectively putting together the building blocks, plumbing and wiring to cater for those needs and enable Hong Kong to attain that Mach Two status. I think we are some way ahead of others in this effort, but quite a lot still needs to be done. And we need more time, effort, support and understanding of the community, particularly the financial community, parts of which may have a vested interest in the maintenance of the status quo.

What then are the additional attributes that qualify a Mach One International Financial Centre as a Mach Two? There are, as far as I can identify, four such attributes.

The **first attribute** is the more obvious one and this is the existence of financial intermediation channels that are characterised by stability, integrity, diversity and efficiency. I believe our financial intermediation channels of banking, equity and debt, and their derivatives, already enjoy these characteristics. For many years after the series of banking crises in the eighties, the banking system has been serving as a reliable conduit for absorbing domestic as well as international savings, and channelling them to those who borrow funds. Greater competition, particularly after interest rate liberalisation, has increased efficiency and benefited borrowers. The many mortgagers of Hong Kong, for example, are now enjoying a mortgage interest rate, relative to prime, that is four percentage points less than six years ago. And greater depositor protection is on the way with the planned introduction of deposit insurance. The sharing of commercial as well as consumer credit information also helps those with good credit standing to have ready access to funds, and at favourable interest rates. As banking supervisor we attach great importance to promoting “the general stability and effective working of the banking system” - a requirement that is clearly stated in the preamble of the Banking Ordinance. We take this responsibility seriously and have been able to work with the banks to ensure that confidence in this traditional and essential financial intermediation channel remains high, even against most unfavourable circumstances, such as those of the past few years.

Similar progress has been made in the regulation of the equity market by the Securities and Futures Commission. Long gone are the days when the equity market was run by, and primarily for, the financial intermediaries rather than as a channel for financial intermediation. Long gone are the days when the market can be closed for days and this important financial intermediation channel brutally disrupted because the financial intermediaries got into difficulties. There is greater realisation now of the role of the stock exchange as a secondary market that provides the bedrock for the primary IPO market, which channels savings into investments to promote economic growth and development. There is now much greater appreciation that this public interest is of importance that overrides the private interest of financial intermediaries. Improvements seen in that market in the past decade have gone way beyond the governance of the market place to greater market transparency, which has enabled it to meet the best international standards.

But in the diversity of financial intermediation channels, Hong Kong is still behind because the flow of funds through the debt channel remains, relatively speaking, small. This is notwithstanding our considerable efforts since 1990 to bring debt issues to the market, principally in the form of Exchange Fund paper, which now has an outstanding amount of HK$120 billion. We have also established a reliable benchmark yield curve for Hong Kong dollar debt of up to ten-year maturity to assist private sector issuers in their pricing and built an efficient, paperless debt clearing system for the market as a whole. Perhaps a long period of low and sometimes negative real interest rates in the nineties was a disincentive for debt issues by the private sector. Indeed, the significantly positive real interest rates of the past few years and low nominal interest rates seem to have made a difference in both the number of and the amount involved in debt issues brought to the market. We need to sustain our efforts in the development of the debt market. The diversity of financial intermediation channels is not only an important attribute of an international financial centre: it is also essential to the maintenance of financial stability. Diversity reduces dependence on a particular financial intermediation channel, which in turn reduces the risk of systemic problems that seriously disrupt the normal conduct of economic activities in the event of a crisis in that channel.

The **second attribute** that makes a Mach Two International Financial Centre is the existence of a platform for financial transactions to be conducted in the major foreign currencies as well as in the domestic currency. Foreign savings, particularly those with institutionalised management, tend to have a small appetite, if any, in the assumption of currency risks in seeking investment opportunities overseas. Hedging currency risks, when exposed to a relatively minor currency like the Hong Kong dollar, notwithstanding the exchange rate stability it has demonstrated over the past twenty years, can be expensive, to the extent of undermining the attraction of those investment opportunities. Currency hedging is even more difficult for investments in a jurisdiction with a non-convertible currency. I believe foreign investors’ interests in the many financial products available in Hong Kong, not least those allowing participation in the rapid development in the Mainland, may be considerably enhanced if there is a choice in currency denomination for those products. This would also reduce the large capital flows into and out of our currency, which we get for example whenever there is a large IPO, and strengthen currency stability.

Furthermore, from when New York goes to bed and before London wakes up the next day, there are quite a few working hours in which activity in the markets for financial instruments denominated in the US dollar and the euro traditionally goes into a lull. But financial globalisation will increasingly demand 24-hour markets, not only those with over-the-counter trading but also those with a physical market place in the form, for example, of a stock exchange. Jurisdictions in our time zone collectively are a net lender to those in the other two time zones, and much of such lending takes the form of holdings of foreign assets denominated in the two large currencies. About 60% of the world’s foreign currency reserves are held by jurisdictions in this time zone. Some of us would obviously welcome, and may even demand, the facility for managing our foreign assets in our time zone, not just to avoid having to stay up late, but also to avoid unnecessary delays to the execution of investment decisions. Events do occur in our time zone that move financial markets denominated in the US dollar and the euro.

Whether it is to facilitate the management of currency risks by investors, or our management of currency stability, or to complete the 24-hour trading loop for global financial instruments, there is a growing need for a liquid platform in our time zone for conducting financial transactions in foreign currencies. However, it has not been easy to acquire this particular attribute of a Mach Two International Financial Centre. The difficulty lies in the understandable resistance against any intrusion into the proprietary rights over the market place of individual jurisdictions. The origins of, and the justifications for, financial markets are invariably domestic in nature. While markets have become global, market structures have remained largely domestic. There are not a lot of incentives for the largest markets to go global in terms of crossing time zones and denominating products also in foreign currencies. The hitherto high degree of domestic orientation of those markets means that they can afford such an attitude, but the high savings rate of Asia and its rapid accumulation of foreign reserves will force a change in that orientation, if this has not already taken place. Last year the net purchase of US Treasuries by ten Asian economies amounted to US$193.2 billion: this is almost 60% of the net increase in the supply of such paper. So far, there has been some progress in the form of the global harmonisation of standards and "strategic" linkages between equity markets in different jurisdictions, and Hong Kong has been at the forefront of these developments. We remain alert to further opportunities.

The platform for the conduct of financial transactions in foreign currencies has to be supported by robust payment, clearing and settlement systems. This is the **third attribute** of a Mach Two International Financial Centre. The revolution in information technology has sped up the transmission of information tremendously. This also means a much higher speed in the movement of international capital and much higher settlement risks for financial transactions. Fortunately, information technology can also be applied to the prudent management of settlement risks. The question is whether the authorities responsible for the financial infrastructure are adequately tuned in. When you are living comfortably at home, you seldom notice the importance of the proper functioning of the plumbing, electricity and gas systems, until a failure occurs. A failure in the financial infrastructure can be quite damaging to the integrity of and confidence in the financial system, and if this occurs in an international financial centre the implications can be quite serious.

In this age of information technology, the payment, clearing and settlement systems, particularly of an international financial centre, should be structured in a manner that minimises the risks of failure in the settlement of financial transactions. Let me make four brief points about the nuts and bolts of these systems. **First**, these systems should be designed to achieve real time gross settlement (RTGS) at least for large financial transactions, delivery versus payment (DVP) for the trading of financial instruments and payment versus payment (PVP) for foreign exchange transactions. **Secondly**, we have already made significant progress in building such a financial infrastructure. We are clearly ahead of other financial centres in this, with operating RTGS systems for the US dollar, the euro and of course our domestic currency the Hong Kong dollar, and these systems are all linked up to provide PVP. **Thirdly**, we intend, as the next step and as you might have guessed, to include the renminbi in this infrastructure as soon as circumstances permit, a move that will cement our position as the international financial centre of China. Our experience in building these systems puts us in a strong position to do so. We need a lead-time of only six to nine months to include an additional currency in our payment infrastructure. **Fourthly**, I urge all of you as significant users of financial services to use these systems and manage the settlement risks of your financial transactions. Your bankers should be able to help you to obtain the comfort of getting what you have bought at the same time as you paid for it.

The **fourth attribute** of a Mach Two International Financial Centre is the availability of multidimensional and direct access to all that I have talked about just now **-** the channels of financial intermediation, the platforms for the conduct of financial transactions and the payment and settlement systems. Direct access to financial services should be available at the wholesale and retail levels, to financial intermediaries and principals, including issuers and investors, regardless of geographical boundaries. There is increasing demand for greater convenience and more direct access, given that modern information technology is quite capable of accommodating such demands. The market place for finance no longer requires a physical location. The need for financial intermediaries is also decreasing. Technology also promises finer bid-ask spreads for your trades; lower transaction, settlement and custodian costs; and instant access to your computerised account holding your deposits, debt securities and stocks of various currency denominations. Even as a borrower, you should, on the basis of your established credit rating and your credit history that are available to banks, be able to get onto your computer screen competitive offers for money. This is not too far-fetched. We are almost there for residential mortgages, except for the need to access a multiple of bank web-sites rather than a single one.

There is, understandably, some resistance against progress in this direction. It is natural, for example, that the intermediaries would resist disintermediation, even though it promises greater efficiency in the intermediation of funds to the benefit of the economy. Institutional rigidities, whether or not arising from the passage of time or from technological innovation, are always difficult to resolve to the satisfaction of the affected parties, particularly when some are enshrined in legislation. So the achievement of multidimensional access to financial services is likely to take a little more time than the achievement of the other three attributes of a Mach Two International Financial Centre. One helpful initiative may be to develop greater appreciation of the public interest among all concerned. But I am confident that market forces will assist in promoting the necessary changes, with or without the involvement of Government or the supervisory authorities.

Ladies and Gentlemen, I hope this conducted tour of Two IFC has not been too boring to you. My aim has been to offer some views on how Hong Kong is developing as an IFC and what we need to do to maintain the edge that we undoubtedly have in our financial infrastructure. As users of that infrastructure, you will probably have views and perspectives of your own, and I would be most happy to discuss these and answer questions. Thank you.