Joseph Yam: The WTO - China's future and Hong Kong's opportunity

Speech by Mr Joseph Yam, JP, Chief Executive of the Hong Kong Monetary Authority, at a conference co-sponsored by the Cato Institute and the Hong Kong Centre for Economic Research on "Globalisation, the WTO, and Capital Flows - Hong Kong's legacy, China's future", held in Hong Kong, on 4 September 2000.

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I feel honoured to be invited to deliver the keynote address at today's conference on the implications of China's prospective entry into the World Trade Organisation (WTO). This is a timely conference for, although the arrangements for China's entry into the WTO are not yet signed and sealed, it looks very likely that they will be agreed soon. The Cato Institute takes a special interest in the relationship between economic change and government policy throughout the world, and it is appropriate that it should be following this historic event closely. The Hong Kong Centre for Economic Research - now, I note, more than 20 years old - has established a solid reputation for independent research into public policy and economic affairs: it is therefore well positioned to provide the Hong Kong and regional perspective. It also seems right to me - despite the heavy rainfall we've been having this summer - that Hong Kong should be the venue for this conference. The reasons, I hope, will become clear in this address. On behalf of the Hong Kong SAR Government, I extend a warm welcome to all of you who are visiting Hong Kong from overseas, particularly those who are here for the first time: I hope that this will be an enjoyable and memorable stay.

The broad implications of China's accession to the WTO

What will China's accession to the WTO mean for China and the rest of the world? For China - which is already the world's ninth largest trading entity - it will mean more external trade, and external trade of a better quality. There will be substantial tariff reductions among China's existing trading partners and there will be access to more trading partners for China. At the same time, China will be cutting its tariffs on a broad range of products, from agricultural to industrial. Tariff reductions allow comparative advantage greater play. They will help eliminate trade distortions and facilitate more efficient allocation of resources among the trading partners, thus further promoting economic growth globally. The World Bank's estimates give an indication of the growth potential of China's trade on its accession to the WTO. China's share in world exports will double in the space of five years: from the present 3.7% to around 7.3% by 2005. China's share in world imports is expected to rise marginally faster than its share in exports: from the present 3.4% to 7.2% in five years' time.

This doubling in China's share in the world's external trade will be complemented by an opening to the world of large sectors of the economy that have hitherto been closed to external investors: the telecommunications, financial services and distribution industries, for example, and a variety of technical and professional services. These are all areas with enormous potential in China. They have already, over the past decade, seen dramatic change and expansion through the - still raging - revolution in information technology. WTO entry will give them a further boost by breaking down restrictive barriers and opening the channels for direct investment and technology transfer from outside. Increased foreign competition in these areas will force Chinese enterprises to speed up their reforms to meet the challenges. From a larger and longer perspective, further economic liberalisation and integration into the global economy will undoubtedly be a stimulus to regulatory, institutional and cultural change within China: I note that this is an important theme in today's conference, although it seems to be a matter of some considerable debate what path, or paths, that change will follow. The general view, nevertheless, is that WTO entry will mean growth, integration and globalisation for the mainland's economy.

The implications for Hong Kong

The view on the implications for Hong Kong are, on the other hand, somewhat divided. At the extreme end of the spectrum there are those who believe that China's WTO entry will be one more nail in the coffin, one more noose around the neck, for Hong Kong: that the diversion of business that will result from the now well-advanced infrastructural development in China's coastal cities and the direct access provided through WTO membership heralds the demise of Hong Kong's historical role as intermediary between China and the rest of the world. In support of this, the impressive physical developments in Shanghai, the readiness - and the skill - with which our colleagues on the mainland are embracing the English language and the internet, the important regulatory reforms are all cited as if it will only be a matter of a couple of years or so for all the business now going on in Hong Kong to be lifted up and poured into the millions of square feet of gleaming new office space now waiting in Pudong.

The outlook is, I think, somewhat more complicated, and a great deal more positive, than this scenario suggests. And it is worth adding that we have seen so many nails hammered into Hong Kong's coffin that the coffin is now more metal than wood. According to some, in the past few years alone Hong Kong has been diagnosed with a whole collection of terminal diseases brought by the handover in 1997, the recent regional financial crisis, the "threat" not just from Shanghai but also from Seoul, Singapore and Sydney, the high cost of doing business, declining educational standards, worsening pollution and, believe it or not, too stable a currency as well, and a whole host of other factors. The impending "catastrophe" of China's entry into the WTO is the latest spectre on the horizon, and no doubt when that one passes without incident more demons will be conjured up. Yet, in this moribund state, we are still managing to struggle along with GDP growth - projected for this year - of 8.5% and export growth at double-digit rates in recent quarters.

The World Bank projections on the effects of WTO entry - a doubling in the space of five years of China's share in international trade (which is itself projected to grow at the rate of about 6% per annum) - suggests that the business "creation effect" stimulated by WTO accession will far outweigh the "diversion effect". There should, in brief, be more than enough work to keep both Shanghai and Hong Kong busy for a long time to come, and more than enough skill and enterprise available in both cities to enable each to focus on the opportunities that WTO entry will bring. There will be some similarity in functions, but there will also be scope for each city to develop its own characteristics as a financial centre. The logical trend in financial services, given the continuation of exchange controls on the mainland, in contrast to the free flow of capital in and out of Hong Kong, as enshrined in the Basic Law, seems to be for Shanghai to develop as China's domestic financial centre and for Hong Kong to develop as its international financial centre. But there is no reason why they should be deliberately constrained to these roles. China has room for at least two global cities. Nor is there any reason why, in the event the mainland attains the financial and other freedoms enjoyed in Hong Kong, Shanghai should not have a go at the business of international finance, or why Hong Kong, with its highly sophisticated financial infrastructure, to facilitate efficient international as well as domestic financial intermediation, should not have a go at the RMB business. A little competition is no bad thing, as long as it is fair competition, and Hong Kong's free enterprise is very good at it. The only residual worry is that the playing field might be a tilted one, involving subsidies and other forms of support or protection from the authorities. But WTO entry is thankfully conditional upon the removal of many of these obstacles to free and fair competition, to the advantage of those that are good at this game and are prepared to embrace it.

The broad implications of China's WTO entry for Hong Kong are perhaps best divided into the near-term impact and the longer-term impact. The near-term impact is, I think, unequivocally positive for Hong Kong. For general trade our estimates within the HKMA suggest that, although our domestic exports to the mainland will be largely unaffected by the WTO terms, our re-export trade, involving the movement of goods to and from the mainland through Hong Kong, will be considerably boosted, and should raise our annual GDP growth rate by somewhere between 0.5% to 1%. In terms of financial, technical and professional services, which are increasingly taking centre stage in Hong Kong's economy, the near-term outlook is even more encouraging. These industries will be considerably boosted - and enriched - by the Chinese enterprises that are seeking to upgrade their capabilities and governance methods to handle increased business and meet foreign competition, and by overseas investors who need advice on how to make the best of the opportunities on the mainland. There are clear signs that this boost is already in progress, in anticipation of WTO accession.

The longer-term impact (let's say beyond the five-year horizon) is less clear. It is quite reasonable to expect that Hong Kong's intermediary role in many areas will be eroded, as traders on the mainland deal directly with the rest of the world. Yet, the view from the market seems to be that, while a declining proportion (but not a declining amount) of China's goods will physically pass through Hong Kong, Hong Kong companies will continue to play an important intermediary function in sourcing the products and identifying the markets. Beyond this, it is likely that Hong Kong's role will gradually change from one of intermediary into one of proprietor. The further liberalisation of China's economy offers immense opportunities for Hong Kong investors, who, apart from possessing the necessary wealth, have a number of distinct advantages. They have a common language and culture with their counterparts on the mainland. They have an immense and very detailed knowledge of the mainland business landscape, and a great deal of practical experience. They also have proximity and well-established connections. This will no doubt be a profound change in role for Hong Kong. But I also have no doubt that Hong Kong will be able to cope well, just as it did over its history of economic development, from entrepot to manufacturing centre to international business centre.

Those of you who speak with businessmen and women in Hong Kong - who are the backbone of our economy - will probably hear that many of them are already establishing or reinforcing their links, or opening branch offices across the border in anticipation of China's WTO entry. This trend is already quite evident in the larger companies. The Hong Kong-based company that operates our container port facilities is expanding its operations into the newly modernising ports of the mainland. In new sectors, such as internet services, Hong Kong companies have been among the first to grasp the opportunities on the mainland. The outlook for Hong Kong investment on the mainland is one of both sectoral and geographical diversification: from the mainly manufacturing activities that grew up in the Pearl River Delta in the 1980s, to a variety of activities spread over a much larger region. And, like the establishment of the Special Economic Zones close to Hong Kong nearly a quarter of a century ago, China's entry into the WTO will underline the truism that the more China opens to the world, the more Hong Kong benefits.

The implications for banking and financial service

Physical trade and the less visible trade in services require a financial infrastructure in the same way that new buildings need plumbing and electrical wiring. We expect that the "creation effect" of WTO entry will result in a surge in banking business on the mainland. There are two main elements in this process. The first is the greater demand for banking services, resulting from the growth induced by the effects of WTO accession. The second is the financial deepening, stimulated by more rapid financial liberalisation, greater banking competition, and product innovation induced by the terms of WTO accession. These processes have positive implications for domestic banks incorporated in the mainland and for foreign banks, including banks incorporated in Hong Kong.

For the domestic banks, expanding business and the challenge of foreign competition provide an impetus for reform and innovation. The banking reforms currently in progress in China are proceeding well. These include, among other things, the establishment of asset management companies to carve out the bad assets inherited from the days of policy lending. They also include the full introduction of commercial principles and market-based credit policies, and improvements in accounting standards. There will also be a profound impact on the governance and culture of the commercial banks, in terms of much better transparency and accountability, especially if these banks are to be floated as intended. To meet foreign competition, they will also put much more emphasis on recruiting good people, including those studying abroad, and giving them proper training. A good example is the recent joint venture between Qinghua University and Harvard Business School to provide extensive training for bank managers in the mainland. They will also need a much clearer business and IT strategy, which could include the need for consolidation. WTO entry will mean a phased opening of China's banking market to foreign banks. Restrictions on foreign banks' operations, in terms of the scope of business, clients and geographical coverage, will be gradually relaxed. There is therefore a strong need for China's banks to gear up and gird themselves for the challenges that will be posed by their sophisticated foreign competitors.

For foreign banks, the opportunities brought by financial liberalisation on the mainland, in the context of WTO, are immense. In two years' time, foreign banks will be able to conduct RMB business with Chinese enterprises in Shanghai, Shenzhen, Tianjin and Dalian. Within five years, they will be able to deal with all Chinese enterprises without any geographical restriction. The obvious advantages for Hong Kong's banks in this process are the same advantages that have taken Hong Kong's other industries into the mainland. Hong Kong's banks were among the first to open branches on the mainland, especially in the southern cities: they know China well, speak the language, have extensive branch networks, and maintain strong relationships, some of which have grown up over more than a generation. There are niches in which Hong Kong's banks should maintain and extend their competitive advantage. For example, they should be able to continue to derive substantial business from the extensive involvement of Hong Kong companies in the manufacturing and retail sectors in China, in the form of private or joint venture enterprises. Given also that about 40% of the mainland's trade is routed through Hong Kong, Hong Kong's banks will have an unrivalled advantage over other banks in capturing the increased demand for trade and related financing services. As the largest source of foreign direct investment in the mainland, and as China's main financial conduit and funding centre, Hong Kong will stand to benefit considerably from the increased demand for banking services in China.

There are, however, potential diversion effects that Hong Kong, and in particular Hong Kong's banks, will have to consider and address if they wish to make the best out of their competitive advantages. Size will be an issue for banks wishing to enter the banking market on the mainland. Although size is not necessary a good indication of quality, it is a convenient regulatory tool, and I do not see, at least in the foreseeable future, any likelihood of relaxation in the size criterion of USD 20 billion. I have been in regular dialogue with the People's Bank of China on this, and I can understand and appreciate the constraints imposed by the terms of the WTO negotiations on any relaxation which may facilitate the consideration of entrance by smaller Hong Kong incorporated banks, along with foreign banks of similar size. So the question of consolidation - which already has other advantages to commend it - arises again. It is also quite natural that foreign banks will find it attractive to deal directly with the mainland, rather than through Hong Kong. But there should still be factors that encourage them to continue to use Hong Kong as a base. For example, given economies of scale, it is much cheaper for foreign banks to cover their China operations through their Hong Kong offices, rather than incurring the additional costs of setting up a new office in, say, Shanghai. Also, contrary to the established wisdom, the cost advantages are not always on Shanghai's side: corporate tax, for example, is twice what it is in Hong Kong. Other positive inducements include the efficiency and sophistication of Hong Kong's financial markets, and the critical mass that goes with being the world's fourth largest banking centre and seventh largest foreign exchange centre.

We have in Hong Kong a pool of professional expertise trained in all facets of international business: a skilled local workforce, which is well educated, computer-literate, productive, disciplined and highly trainable; in addition to a foreign expertise attracted by rich business opportunities and an international, cosmopolitan orientation, with English as the business language. Without wishing to labour the elements that make up a free economy - which the Cato Institute has set out so well - I think it is worth highlighting the point that Hong Kong scores extremely high on all of them. It enjoys the rule of law and the free movement of information, capital and human resources. It has efficient and clean government, a market-oriented economic policy, a non-intrusive but effective regulatory system, and a low and simple tax regime. It treats domestic and overseas companies on equal terms and has a liberal policy on employing foreigners with expertise. In short, Hong Kong possesses almost all of the conceivable favourable economic, legal and political attributes for attracting banks and other organisations to set up their regional headquarters here.

Our estimate, within the HKMA, is that, for Hong Kong's banking sector, as for trade generally, the "creation effect" of China's entry into the WTO will significantly outweigh the "diversion effect". Hong Kong's banking sector stands to benefit substantially from the increased demand for banking services in China. This will have a boosting effect on Hong Kong's lending business to China, provided that Hong Kong can continue to improve its infrastructural framework and its regulatory regime so that the diversion effect is minimised. Developments in these areas, including the recently opened US dollar clearing system and the substantial regulatory reforms currently in progress, suggest that we are on the right track.

Monetary implications

Turning to the implications for monetary policy, I am happy to observe that we have moved some way beyond the misunderstandings that have often clouded the view from outside of Hong Kong's monetary relationship with the mainland. The old myths that 1997 would mean that the renminbi would replace the Hong Kong dollar or that Beijing would take control of Hong Kong's extensive foreign reserves are now dead and buried after three highly successful years of experience of "one country, two monetary systems". More recently, the current issue of speculation surrounding the renminbi - and one which is far more grounded in reality - is the question of whether its exchange rate will be given greater flexibility in the near future. This revives the old question of how far the Hong Kong dollar will be affected by movements in the renminbi, which has some connection with China's prospective WTO accession, and it is therefore worth examining the rationale behind it, and the implications.

First, however, since there is some confusion on this point, it is helpful to clarify the difference between flexibility and convertibility. Convertibility means the ability of a currency to be freely exchanged into foreign currencies, either for trade (current account convertibility) or for investment (capital account convertibility). The renminbi enjoys current account convertibility but is not freely convertible for capital account transactions. Flexibility means the degree to which the exchange rate is allowed to fluctuate before there is intervention by the central bank. At present, there is flexibility in the exchange rate of the renminbi, in that the exchange rate is determined by "market" supply and demand, although the central bank remains the ultimate banker in the market. The renminbi has indeed been trading within a very narrow band in the past few years. The narrowness I think reflects China having acted responsibly, against the background of financial turmoil in Asia, in not allowing greater flexibility in the renminbi exchange rate to add destabilising volatility to Asian currencies. However, a number of observers, including the IMF, now believe that there is scope for more flexibility. But, while most observers regard full convertibility as a desirable long-term goal, few believe that any significant moves will be made in that direction in the near term. This means that, even if the renminbi were to be given more flexibility, it would probably still be subject to the existing exchange rate controls.

The immediate consideration for policymakers on the mainland and markets is whether, with greater flexibility, the renminbi would go up or down. China's persistent current account surpluses suggest that it should appreciate. But the market does not seem to feel this way. The non-deliverable forward exchange rate for the purchase of US dollars is continuously at a significant premium. The difference in views may have two explanations. One is the large amount of negative errors and omissions in the balance of payments, which many presume to indicate unidentified capital outflows. The second is the concern that many have that WTO accession will precipitate, at least initially, a surge in imports that is greater than the surge in exports.

Why, then, should flexibility be a matter for consideration? There could be a number of advantages from the perspective of the mainland. For example, allowing more interaction of supply and demand of foreign exchange for current account transactions may serve as a kind of market smoothing mechanism, especially as the short-term volatility of trade flows may increase with the WTO accession. The renminbi exchange rate should also be able to respond more to the underlying trends in external trade. Greater flexibility may also permit exchange rate adjustments in pursuit of other macroeconomic objectives. Should greater flexibility in renminbi be pursued, I believe that there would be advantages, in the interests of transparency and market confidence, for the mainland to set out clearly what it expects to achieve by the measure, especially in the absence of any move towards fuller convertibility. If the benefits are in doubt, or if the underlying motivation is misunderstood, there could be an adverse impact on general sentiment, which would be manifested in the financial markets.

We all know how sensitive financial markets can be, and this sensitivity somewhat blurs the Hong Kong response to the prospect of greater flexibility in the renminbi's exchange rate, in particular its impact on the Hong Kong dollar exchange rate. Together with the confusion between the convertibility of a currency and the flexibility in an exchange rate, this sensitivity perhaps explains the rather excited off-the-cuff response given earlier this year by the group of Hong Kong businessmen to Premier Zhu Rongji when the subject was raised in a meeting among them. As a result, there was this message to me that we in the HKMA should examine the matter carefully. We have since done so and I have, in July, provided Premier Zhu with a response, through Governor Dai Xianglong of the People's Bank of China. The gist of the response is that, on the basis of economic fundamentals, there is no reason why the Hong Kong dollar should be impacted by changes in the renminbi exchange rate. But things get a little more complicated when market sentiment enters the picture. During the Asian crisis, the market perceived a strong correlation between the Hong Kong dollar and the renminbi. This was partly attributable to misconceptions about the economic - and perhaps the political - relationship between Hong Kong and the mainland, and partly due to the market's practice of regarding the Hong Kong dollar as a proxy hedge for the renminbi. Over the past year or so, however, the renminbi and the Hong Kong dollar have become substantially decoupled in the eyes of the market. This decoupling can be most easily read by comparing the Hong Kong dollar forward spread and the renminbi's non-deliverable forward exchange rate, which tracked each other very closely until the end of 1998, when they began to diverge. The decoupling suggests that the market has drawn the obvious conclusion from the fact that, since the linked exchange rate was introduced in 1983, the renminbi has depreciated by more than 70%, while, during the same period, the Hong Kong dollar has remained rock solid. And this was confirmed by the calmness with which the market took the raising of the possibility of greater flexibility for the renminbi exchange rate by Premier Zhu.

Our own study further suggests that, contrary to popular intuition, a devaluation of the renminbi might actually provide a stimulus to the Hong Kong economy: this is because the positive impact on demand arising from the complementarities between the two economies would outweigh the negative impact of any loss of competitiveness in those relatively few activities where the two economies remain in competition with each other. Such complementarities are in part reflected in Hong Kong's role as a major entrepot for mainland exports. For any renminbi devaluation, while Hong Kong's own direct trade balance with the mainland will deteriorate, our re-exports of mainland origin should rise. Indeed, with the surge in mainland re-exports activities since the early 1980s, the margins earned on such re-exports are now larger than all other components of Hong Kong's trade with the mainland combined.

Conclusion

I have suggested in this address that China's accession to the WTO will bring benefits to Hong Kong on a number of fronts. WTO entry will see a vast and rapid increase in China's external trade. Not all of this additional trade will go through Hong Kong, but nor will it all avoid Hong Kong. More important still, the stimulus to liberalisation, globalisation and better corporate governance will expand and deepen Hong Kong's well-established role as a fund of professional expertise, a centre of international experience and a source and channel of investment. Hong Kong's banking sector, with its strong reputation and long involvement in mainland business, stands to benefit greatly from the liberalisation in this area, providing that it can position itself to make the best out of the opportunities. In the monetary sphere, the various predictions about the future development of the renminbi in the light of WTO membership - which include the possibility of greater exchange rate flexibility - would most likely have positive implications for Hong Kong's economy as a whole, and should create no difficulties for Hong Kong's entirely separate and soundly based currency.

The role for Hong Kong in the context of a WTO that includes China, would, I believe, give even fuller scope for the qualities that, in the assessment of the Cato Institute, make Hong Kong the freest economy in the world. All of this therefore leaves a small question in my mind about the title of this conference, and I hope the organisers will forgive me for raising it. The phrase “Hong Kong’s Legacy, China’s Future” has a bit of a morbid ring about it. It suggests that we in Hong Kong are bequeathing something to China before we breathe our last, and that you are assembled here for a funeral, or at least a deathbed scene. This cannot, surely, be the intention behind the conference. The programme suggests otherwise, and I am confident that, as the day unfolds, you will be hearing plenty of evidence to show that there is a great deal of life left in this city and in the people who inhabit it. Step outside of this building and you will see it for yourself. I have tried to suggest in this address that both Hong Kong and the mainland stand to gain much from China’s accession to the WTO. Like most new developments on the mainland, WTO entry presents enormous opportunities for Hong Kong, providing that we prepare and position ourselves to make the best out of them.