Joseph Yam: One country, two financial systems

Speech by Mr Joseph Yam, Chief Executive of the Hong Kong Monetary Authority, at the luncheon of the British Chamber of Commerce, Hong Kong, 20 October 2006.

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Ladies and Gentlemen,

Thank you for inviting me to speak to you today on the subject of "One Country, Two Financial Systems". The continuing strong British presence in Hong Kong since 1997 - in all areas of business and society – has been one of the many positive features of the "one country, two systems" policy: it is also a measure of the success of this policy. The British Chamber of Commerce in Hong Kong has played a leading role not only in representing the interests of British companies in Hong Kong, but also in promoting Hong Kong to the world. The British commercial presence in Hong Kong is a rich and diverse one, covering a vast range of economic activities. These include, of course, the ever-expanding financial services sector, which benefits both from Hong Kong's dense economic connections with the Mainland of China, as well as from the "one country, two systems" policy. It is this subject that I now wish to explore with you.

I believe it was Deng Xiaoping who first coined the phrase "one country, two systems". A study of his speeches suggested that the concept germinated at the beginning of the eighties, before Margaret Thatcher paid him a visit in 1982 at the Great Hall of the People and raised with him the question of the political future of Hong Kong. The phrase was then used, for the first time in public, by Deng Xiaoping when he received industry and business leaders from Hong Kong in June 1984[1]. Since that occasion, it has become by far the most common formula for summarising the governance arrangements for Hong Kong after the resumption of the exercise of sovereignty. It has, indeed, turned out to be a most effective political expression, capturing succinctly China's policy towards Hong Kong, emphasising that Hong Kong is to be ruled by Hong Kong people (港人治港) and that there is to be a high degree of autonomy in the governance of Hong Kong (高度自治). The policy has also been most successfully implemented, contributing further to the credibility of the formula and the unique political concept that it encapsulates.

Indeed, whenever one hears the phrase "one country, two systems", the immediate context will almost invariably be the political arrangements for the governance for Hong Kong. But I think there is much more to be said for "one country, two systems" beyond politics and governance, for the simple reason that there are many differences between the two systems within our country, on whatever dimension one chooses to examine the situation, and differences present opportunities for relative strengths to be exploited and relative weaknesses to be addressed, and synergies maximised to the benefit of all concerned. The economic system on the Mainland, described as a socialist market economy, is very different from the economic system of Hong Kong, a capitalist free market economy. The medical system on the Mainland is different from that in Hong Kong, in terms of the manner in which medical services are delivered and funded, and in terms of the types of medicine used. The tax systems are also very different, so are the labour systems, the educational systems and the transport systems (we drive on different sides of the road); and, of primary interest to me as Monetary Authority, so are the monetary and financial systems.

China is therefore probably unique in having two different systems, including two different financial systems, in one country. I believe that, beyond politics and governance – the arrangements for which have been quite well bedded down – there is perhaps a need for all concerned to pay greater attention to the opportunities presented by the differences between the two financial systems and to developing a beneficial working relationship between them. Put in another way, the relationship between the two systems within the country is a multi-dimensional one. While the governance relationship at the political level is of crucial importance, the relationships on other dimensions also require close attention. One important question that needs to be answered is whether, on any one of these other dimensions, the two systems have a working relationship that maximises the mutual benefits of the two jurisdictions and therefore is in the best interests of the country.

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1 The phrase "One Country, Two Systems" was first used in public by Deng Xiaoping when he received industry and business leaders from Hong Kong on 22-23 June 1984.

As Monetary Authority, I have certain responsibilities for the financial system of Hong Kong. These derive from the laws of Hong Kong and are clearly set out in a formal and transparent exchange of letters between the Financial Secretary and the Monetary Authority of June 2003[2]. I believe therefore that it would not be inappropriate for me to contribute to answering that important question, insofar as the working relationship between the two financial systems in the country is concerned.

Let me do so first by making a brief comparison between the two financial systems in the country. As the fundamental role of the financial system is financial intermediation, or the channelling of funds from those who have a surplus of it to those in need of it, the comparison should usefully be made in respect of the three channels of financial intermediation, namely, that of banking, equity and debt.

The total assets of the **banking system** of Hong Kong are equivalent to 21% of those of the Mainland. You may think that this is not high; but if you put this along with similar comparisons for population, which is only 0.5%, or gross domestic product, which is 8%, you can appreciate the significance of the banking system of Hong Kong in the context of the country as a whole. What is more, the quality of assets in the banking system of Hong Kong is superior and the efficiency in financial intermediation, in mobilising savings in the form of deposits into the hands of borrowers who are credit-worthy, is also a lot higher.

Capitalisation of the **equity market** of Hong Kong is 2.6 times that of the Mainland. The amount of funds raised in the past ten years in Hong Kong, through Initial Public Offerings (IPO) and other fund-raising activities, is nine times that on the Mainland. The turnover value in 2005 was about 1.5 times that on the Mainland, and Hong Kong also has an active derivatives market, which traded 25 million contracts in stock futures and options last year. The high liquidity helps price discovery, and attracts fund raisers and investors to our market. This is shown by the listing of the large state-owned banks this year, including what is expected to be the largest IPO ever in the world - the listing of the Industrial and Commercial Bank of China. The efficiency of our equity market is underpinned by a combination of fundamental strengths, including a sound legal and regulatory framework and an advanced financial infrastructure. In particular, the high standard of disclosure required in Hong Kong promotes market transparency and good corporate governance.

The size of Hong Kong's **debt market** is equal to 24% of that of the Mainland, and liquidity is a lot higher. Despite the significant progress made in recent years, the development of the Mainland bond market has been constrained by over-regulation (partly reflecting concerns about corporate governance and credit culture), a narrow investor base, and lack of instruments for pricing and risk management. Hong Kong has built up an efficient financial infrastructure for debt market development over the years. The Exchange Fund Bills and Notes (EFBN) programme has created a yield curve for the Hong Kong dollar of up to 10 years, providing a benchmark for debt issuance by other entities. A multi-currency and multi-product payment and settlement platform serves local and overseas investors to facilitate their fund transfers and delivery versus payments when they buy and sell debt instruments. More broadly, the developed financial markets, including derivatives for managing interest-rate and exchange-rate risks, a critical mass of financial institutions and a large investor base, support the growth of the debt market.

This brief comparison will, I hope, bring out quite clearly the size, sophistication and efficiency of Hong Kong's financial system in the context of the country as a whole. It should also give some indication of the actual and potential utility of the financial system of Hong Kong to the country, in contributing to sustainable economic growth and development on the Mainland. It was also Deng Xiaoping who coined another memorable phrase. He said that: "finance is very important; it is the nucleus of a modern economy"[3]. Indeed, the future path of the economy of China depends crucially on how matters concerning money and finance, currency and exchange are organised. To sustain the current rapid pace of economic growth and development, what China needs now is an effective mechanism for financial intermediation for the Mainland – a mechanism to mobilise the huge amount of savings

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2 The responsibilities of the Monetary Authority are laid down in the exchange of letters between the Financial Secretary and the Monetary Authority on 25 June 2003. The letters can be found on the HKMA website. (http://www.info.gov.hk/hkma/eng/press/2003/attach/20030627e3a1.pdf).

3 The phrase was used by Deng Xiaoping during a visit to Shanghai in the spring of 1991, when the central government decided to develop Pudong into a modern financial centre. The phrase is included in the article "the Speech during the Shanghai visit" in *the Selected Works of Deng Xiaoping*, Volume 3. ("视察上海的谈话"，《邓小平文选》第三卷)

(now equivalent to over 40% of GDP) into the hands of those who need funding to finance consumption, investment and other economic activities.

Currently, domestic savings on the Mainland are mostly trapped in the banking system earning fairly low rates of interest and as a result sustaining or even increasing a savings rate that is already far too high. There is a serious lack of diversity in investment opportunities. The ability of the banking system to allocate funds in accordance with the credit-worthiness of the borrower, although improving, is still not quite efficient in view of the relatively low degree of market orientation in credit allocation. Thus, the overall effectiveness of the financial system on the Mainland in the important task of financial intermediation is not high. There is, of course, room – and there are concrete plans – for improvement. But meanwhile the financial intermediation needs are there and have to be satisfied. This is where, quite clearly, the other financial system of the country can come in.

As reform and liberalisation of the financial system on the Mainland continue, allowing the greater play of market forces, there is a need to conduct experiments in specific areas of activity in finance, including currency convertibility. The free market environment of Hong Kong provides the ideal laboratory for conducting such experiments.

So, what about the question I raised earlier on about whether the two financial systems of the country have a working relationship that maximises the mutual benefits of the two jurisdictions and therefore is in the best interests of the country? If you want an honest answer from me, it would I am afraid not be one in the affirmative. There seems to me considerable scope for a co-operative, complementary and interactive working relationship between the two financial systems, in which, as I said earlier, relative strengths are exploited and relative weaknesses addressed, and synergies maximised. The further question then is how such a working relationship should best, and realistically, be developed.

It is quite natural to think that developing such a relationship between the two financial systems could be left to the market. While this is theoretically possible, it assumes that market forces are allowed to work freely across the two financial systems, which is not always the case. In merchandise trade, this is by and large true, and as a result the two economic systems specialise in areas in which they have respectively comparative advantage in producing. But in the provision of different services, as in the case of financial services, there are restrictions limiting the working of market forces, for example, restrictions on access of service providers to the other system and restrictions on the mobility of the user of services across the two systems. On top of these, there are the restrictions in the mobility of factors of production, notably labour and capital, with the asymmetry in capital mobility between the Mainland and Hong Kong presenting the most obvious obstacle. These restrictions may well be there for good reasons, but they do not mean that the development of a working relationship that is beneficial to both financial systems and to the country as a whole can just be left to market forces. There is a clear case for the involvement of the authorities responsible for these policy areas.

To be sure, there have been notable co-operative efforts between the two financial systems, both between the authorities and between the private sectors of the two financial systems, and these have been quite obvious since the resumption of the exercise of sovereignty. These efforts have arisen simply out of need, particularly where the free play of market forces has been possible, and through the initiatives of the authorities concerned, where a common understanding can be arrived at concerning the common benefits that could flow from the removal of restrictions. But I think it is fair to say that the process has not always been a smooth one. Neither has the outcome been as productive as it could be, at least when assessed, narrowly some say, against the fundamental objective of making the two financial systems work together for their mutual benefits and in the best interests of the one country.

It is not hard to understand the obstacles to developing a mutually beneficial relationship between the two financial systems. Naturally, with financial restrictions much more prevalent on the Mainland than in Hong Kong, relationship-building between the two financial systems, to the extent that it involves relaxation of financial restrictions, invariably requires policy decisions on the Mainland. In making such decisions, the Mainland authorities have to weigh carefully the benefits of financial liberalisation with the over-riding need to avoid doing anything that will destabilize such a large and complex economy. This need for balance and careful sequencing of the reforms that are introduced is, I believe, well understood by the Mainland authorities. It is something that we in Hong Kong, in our desire for rapid change, need to approach with understanding and patience.

One thing remains clear: the utility of the financial system of Hong Kong to the country as a whole. The mutual benefits of financial co-operation are also clear – on the one hand greater efficiency of financial intermediation and therefore greater sustainability of economic growth and development on the

Mainland and on the other hand the successful maintenance of Hong Kong as an international financial centre in accordance with the requirement laid down in Article 109 of the Basic Law. Both are very desirable objectives that are clearly in the national interest. The financial conditions on the Mainland also present, in my opinion, a golden opportunity for the liberalisation of restrictions to facilitate the greater use of Hong Kong's financial system and for the associated risks to be prudently managed. With nearly US$1 trillion, the Mainland is now the largest foreign reserve holder in the world: it is running a fairly large balance of payments surplus and its savings rate is probably the highest in the world.

There may not be many precedents of any great significance, in the history of economic development in other countries, of having access to two financial systems in one country, and so we need to be cautious, as always, as we venture into something new. Deng Xiaoping, when giving guidance to the drafting of the Basic Law on 16 April 1987, also recognised that "one country, two systems" is "a new thing" and that "there are many matters we cannot predict"[4].

The important thing is to be clear about the principles behind what we are trying to do. The basic principle, as far as the financial system is concerned, has always been very clear, regardless of the characteristics of the political, economic and social systems, and this is the effective mobilisation of savings into the hands of those in need of funds to finance consumption, investment and other economic activities[5]. In any jurisdiction, this is a matter of national interest and its importance surpasses that of the vested, private interests of whoever is involved in the financial system, and in whatever capacity. This basic principle of the financial system has recently been articulated in the form of policy statements in the eleventh five-year plan of China, notably in Chapter 33 and in a most encouraging paragraph towards the end on Hong Kong, reiterating, among other things, the determination to maintain the status of Hong Kong as an international financial centre.

These policy statements, read together, suggest to me that there is, at the policy making level on the Mainland, recognition of the utility of the financial system of Hong Kong to the country's development. I also believe that this is an open invitation to us to build a working relationship between the financial systems in Hong Kong and on Mainland for achieving the objectives underlying those policy statements. Indeed, our Chief Executive has seized the opportunity presented by the eleventh five-year plan to launch an extensive and intensive work programme, starting with the Economic Summit held on 11 September and following through with the continuing work of four Focus Groups that will, by the turn of the year, result in a response to be put to the Central People's Government. One of the four Focus Groups, chaired by my knowledgeable friend Dr the Hon. David Li, deals exclusively with financial services. As a member of that Focus Group, I am happy to be in a position to contribute to this important and promising cause.

I have already outlined elsewhere and in a different context a five-prong strategy developed in the Hong Kong Monetary Authority to further co-operation between the two financial systems, which will have the desirable dual effect of enhancing the effectiveness of financial intermediation on the Mainland and maintaining the status of Hong Kong as an international financial centre[6]. The strategy comprises:

First, opening doors through CEPA and other forums so that Hong Kong financial institutions can provide the much needed financial services (and competition) on location in the Mainland;

Secondly, sustaining the flow of fund raising activities from the Mainland to Hong Kong, not just in the IPO of H-shares but also in bank syndication and debt issuance, and creating channels, for example through QDII schemes, to facilitate the flow of investment funds from the Mainland;

Thirdly, creating a mechanism for the marketing of suitable financial instruments (for example CDR of H-shares) on the Mainland to satisfy the enormous investor demand there;

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[4] The guidance was given to the Drafting Committee for the Basic Law of the Hong Kong Special Administrative Region when Deng Xiaoping addressed the Committee on 16 April 1987.

[5] This principle was explained in the viewpoint article "*A Basic Law of Finance*", which can be found on the HKMA website. (http://www.info.gov.hk/hkma/eng/viewpt/20060810e.htm).

[6] The five-pronged strategy was outlined in the speech that I delivered at the Financial Services Forum for delegations from Pan-Pearl River Delta Region in Hong Kong on 23 March 2006, and in the discussion paper prepared for the Economic Summit on "China's 11th Five-year Plan and the Development of Hong Kong" on 11 September 2006.

Fourthly, enhancing the capability of the financial system of Hong Kong to handle financial transactions denominated in the RMB, with a view to facilitating in Hong Kong financial intermediation of the Mainland, the conduct of experiments in financial liberalisation and the management of the associated risks; and

Fifthly, connecting the financial infrastructures (the payment, clearing, settlement and custodial systems) of the Mainland and Hong Kong, to facilitate the orderly flow of money and financial instruments across the two financial systems.

We are now working hard on the specific proposals under each of these five strategic headings. These, together with other proposals from a market-specific perspective, will form quite a rich menu on what we, the financial system of Hong Kong, can do for the country and on the benefits the country can derive from the arrangement of "one country, two financial systems".