Mr. Yam looks at the future of Hong Kong as a financial services centre for China and the Asian region Speech by the Chief Executive of the Hong Kong Monetary Authority, Mr. Joseph Yam, JP, to Coopers and Lybrand Financial Services Conference in Hong Kong on 28/10/97.

I have been asked to speak on Hong Kong's role as a financial services centre for China and the Asian region. As you know, many of the economies of the Asian region, including of course the mainland of China, have been undergoing a rapid process of financial liberalization. This has brought tremendous benefits to the region, through providing the mechanisms for channelling savings into investments, domestically and internationally, thus promoting growth and development of the region. The process has brought substantial risks to the region as well, as clearly you have witnessed in the past few months when financial turmoil spread in the region.

2. Notwithstanding the financial problems now being faced by the region, the balance of opinion is still firmly that financial liberalization is of long-term benefit. The correct response to such problems is clearly, at least for the immediate future, to take the right medicine and implement the necessary economic adjustment programmes, prescribed if necessary by the International Monetary Fund. Indeed, this has very much been the focus of recent attention when one looks at individual economies in this region that have been subject to financial turmoil. But prevention is always better than cure. Much attention will also be required, in the fullness of time, to make sure that the financial systems through which financial intermediation takes place are robust so that the benefits of financial liberalization could be maximized and the associated risks could be minimized and prudently managed.

3. As a financial services centre which operates with a highly liberal regime, Hong Kong has important roles to play in all this. There is not enough time to go into details here on this occasion, so I shall just identify three general areas for your consideration.

4. The first area concerns financial intermediation within individual economies, in other words, the channelling of domestic savings into domestic investments. Here Hong Kong, at this stage at least, largely only plays an advisory role. The less liberalized financial systems in this region are very much dominated by domestic financial institutions, particularly in the banking market. Further, domestic politics and a desire to protect domestic financial institutions from undue competition are such that liberalization to admit foreign financial institutions to take part in domestic financial intermediation would only proceed at a pace dictated by these considerations. For example, it will, I think, take some time and patience for Hong Kong-based banks to gain a physical presence in the mainland of China, be allowed access to renminbi banking business and command a significant share of that business.

5. But Hong Kong's expertise in developing markets, in building the market infrastructure and, where necessary, in regulating markets and supervising market participants to uphold the efficiency and integrity of financial markets is there for everybody to see and tap. Furthermore, we know the region, and particularly in the case of the mainland of China, I would argue that we know a lot more than others, and so we are in an advantageous position to perform an advisory role. And the financial community of Hong Kong, including the regulators, have been actively playing that advisory role. I can speak from experience here, although it would not be appropriate for me to be too specific. In many of the Hong Kong Monetary Authority's

contacts with, for example, our counterparts in the mainland of China, the subjects for discussion are increasingly on financial affairs in the mainland rather than those in Hong Kong.

6. I believe that in performing this advisory role effectively we will open up opportunities for the financial services industry of Hong Kong. As markets are built and liberalized in these neighbouring economies, I am confident that our own financial institutions will gain access to the business in those markets through establishing a presence there, and eventually compete, I hope, on a level playing field with the domestic financial institutions. In any case, the need for a physical presence with a large branch network in the provision of financial services may soon become a thing of the past with the advancement of telecommunications and information technology. It is still early, I think, to come to a definitive view, but the prospects are that electronic money and the use of the internet for banking and other financial services are breaking down geographical boundaries. Barriers to entry and restrictive practices may lead to the diversion of business to offshore markets in locations with liberal practices.

7. The second area concerns financial intermediation in the international dimension, involving the flow of savings into investments across international boundaries. Hong Kong as a financial services centre has a business role of providing the markets, in banking, debt and equity, supported by other efficient financial services and the rule of law, to facilitate the international flow of funds in this region. Our markets have the freedom, the liquidity and the integrity to attract international investors managing institutional savings to come here and those in need of funds to raise them here. The opportunities in this region, in particular in China, are enormous, and international investors would have a preference to operate in markets in which the rules of the game are transparent and familiar to them, and are of internationally accepted standards. And that means coming to Hong Kong.

8. The banking market in Hong Kong is of course a very international one, with a total of 182 licensed banks, 151 of which are incorporated outside Hong Kong. 81 of the largest 100 banks in the world are licensed in Hong Kong. Collectively they provide a wide range of banking and other financial services, not just for Hong Kong but for the region as a whole. The banking sector of Hong Kong is reputed to be amongst the most efficient and profitable in the world.

9. Hong Kong's debt market, which has developed quite rapidly in the past eight years, is also playing a significant role in the region. Financial intermediation through the debt market is still relatively underdeveloped in the region, but the prospects are good. As the very substantial savings of the region is increasingly institutionalized through the establishment of provident funds and pension funds, the demand for debt securities would grow, perhaps much faster than that for banking and equity instruments. At the same time, the huge investments envisaged for the development of the physical infrastructure in the region will require much debt financing, thus increasing the supply of debt securities. With the first class infrastructure in our newly developed debt market, Hong Kong is in a very favourable position to take advantage of these good prospects.

10. Hong Kong's equity market is of course one of the largest and most liquid in the world, and, notwithstanding recent volatility, is the favourite market for institutional investors and for those wishing to raise funds. One popular area recently is, of course, the use of Hong Kong's stock market for raising funds by Chinese state-owned enterprises. Up to late October, 38 enterprises from the mainland of China have made their initial public offerings in Hong Kong in the form of the issue of "H" shares. These shares were bought by investors both

in Hong Kong and overseas. It is important to note that when mainland enterprises sought to be listed on the Hong Kong Stock Exchange, they are required to comply with all the listing rules and other relevant regulations in Hong Kong. No favouritism or preferential treatment has been or will be given to mainland companies. Thus, in addition to fund raising, the listing of mainland companies in Hong Kong facilitates the upgrading of corporate governance of these listed companies in line with the international standards practised in Hong Kong. Through this process, Hong Kong has also played a strategic role in the reform of the state-owned enterprises in the mainland.

11. The third area concerns the management of systemic risks arising from but not limited to financial liberalization in this region. There is clearly identified a need for much greater monetary cooperation in this region, and here Hong Kong has been actively playing, and hopes to continue to play actively, a promotional role. We have been instrumental in promoting greater Asian monetary cooperation, not just in the more visible efforts to deal with the financial turmoil we all are facing, in one way or another, but also the upgrading and standardization of supervisory practices, and the building of the financial infrastructure of this region to facilitate safe and efficient international financial intermediation in this region. Our ability to play this role no doubt enhances Hong Kong's status as an international financial centre, which is consistent with the requirement laid down in the Basic Law.

12. We took the initiative on the wake of the Mexican crisis in early 1995 to draw the central banking fraternity of this region together to talk about Asian monetary cooperation, which led first to a set of bilateral agreements for the provision of liquidity to each other in case of need. This was followed by the establishment of three working groups to share knowledge and expertise on financial market development, central bank operations and banking supervision issues. Separately, we are also promoting the establishment of linkages of the financial infrastructures of economies in this region, such as payment systems and debt clearing systems, to facilitate the efficient and safe flow of funds amongst ourselves. These efforts will have long-term benefits for the region, both in terms of the maintenance of financial stability and the development of the financial sector.

13. While important progress is being made, this has recently been overshadowed by financial turmoil in the region, and the focus of attention has as a consequence been diverted to the provision of credit to assist Asian economies in need in making structural adjustments. We had the financial package for Thailand, and there have since been many ideas put forward for a general facility of some sort. These are being actively considered and we are taking an active part in the discussion, although there are currently still quite significant differences of opinion. The position that we are taking is that whilst regional solidarity is highly appropriate for a region with increasing economic, trade and financial integration and increasing interdependence, any regional financial arrangement must be structured with regard to international standards and practices. It would not be appropriate, for example, for a regional institution, if there is to be one, to prescribe medicine, along with financial assistance, that is different from those prescribed by the International Monetary Fund. It would immediately be seen as a soft window for financial support, thus creating moral hazard problems. I am hopeful that well-structured arrangements will emerge in due course. Certainly the climate is right and the momentum is there.

14. Perhaps I should take this opportunity to put the recent financial turmoil in Asia in a global perspective. First, the world is in very good economic shape. World economic output is estimated by the IMF to expand by 4-4½% in 1997 and 1998, the strongest pace in a decade. In the OECD countries, especially in the US, there is solid growth with low inflation,

while we are seeing signs of broad-based recovery in Europe. Only in Asia have we seen a slowing of growth, but the growth rates have still been high by world standard and last year Japan grew by 3.6%, the fastest since the late 1980s.

15. Second, because of high global liquidity and low inflation, asset markets around the world are at record levels. Capital flows have increased with globalization, and added to record high stock and bond prices. The fact that Europe has recently raised interest rates, and the Fed is considering whether to pre-emptively raise rates to prevent wage-push inflation, has made the financial markets much more nervous despite the growth environment. This explains why the financial volatility in Asia has become global in nature. It is very flattering to know that Hong Kong can move even the mighty US and European markets, as much as the other way around.

16. Third, Asian fundamentals, and especially Hong Kong fundamentals, are strong. But there have been different degrees of strength in Asia with respect to the fundamentals. The adjustments in exchange rates of currencies in this region reflect partly the market perception of fundamentals. But as I said recently at the Per Jacobsson lecture, there is no perfect exchange rate regime. Some economists think that a shift from a rigid exchange rate regime to a free float would result in lower interest rates to ease the interest rate pain. However, recent experience in Asia has shown that the market demands even higher interest rates than before under a floating rate regime due to the need for hedging, since there is a perception of higher credit risks and exchange rate risks.

17. I interpret the currency turmoil in the region not as exchange rate volatility, but as a painful but necessary adjustment in the real economy (manifested through the financial system and markets) to the new world of greater competition. In essence, we must all work harder to get greater productivity gains to meet the new challenge. No one can afford to be complacent in this global world. To the extent that the free market is demanding higher interest rates because there is a reverse flow of capital from Asia to the OECD markets, we will all have to bear the pain and adjust accordingly.

18. And not all interest rate pain is bad. Higher interest rates would increase savings in Hong Kong and bring inflation down further, thus increasing our competitiveness. To the extent that higher interest rates would reduce house prices, they would also make housing more affordable.

19. The currency board system with a fixed exchange rate is appropriate for a small and highly externally-oriented economy like Hong Kong. It further imposes a strict discipline on public finances. Hong Kong runs budget surpluses, not deficits. On the other hand, a floating exchange rate adds huge volatility to the businesses of the external sector of the economy, requiring further costs in terms of hedging. A volatile exchange rate by contrast does not have quite such serious implications for a large and relatively less externally-oriented economy like Japan, where external trade accounts for less than 20% of GDP. In Hong Kong, with external trade accounting for 285% of GDP, a volatile exchange rate creates huge uncertainties for much of our livelihood, thus undermining our fundamental competitiveness.

20. Hong Kong has always understood that there is no free lunch. We have built up our strengths and our savings through sheer hard work. If there is greater competition out there, we will adjust our quality and our skills accordingly. As accountants in a service economy, you know very well that you cannot price yourselves cheaply in order to compete. Our reputation depends on our ability to deliver quality service that is value for money. This is the strength for Hong Kong. Let

me conclude by merely giving you the assurance that our linked exchange rate system, which has served us so well in the past 14 years, is here to stay.