

SHANGHAI IS RISING BUT DOES HONG KONG CARE ENOUGH?

By Dong Tao
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Hong Kong's status as a financial center is in danger. In my view, the Special Administrative Region (SAR) is China's New York today but may in the future may become China's Florida.

A few months ago, the State Council announced its decision to develop Shanghai as an international financial center by 2020, a move which could endanger Hong Kong's future status as a global financial center. Yet Hong Kong officials in charge of financial affairs appeared relaxed despite this news. They may think the city has nothing to worry about with regard to the coming Shanghai competition, but I think they are either trying to act calm for the sake of maintaining public confidence, or are not facing reality—and are making a wrong judgment about the challenge they face. In fact, the State Council's decision has grave implications for Hong Kong's economy in the long run.

There have been many weaknesses in that economy during recent years, but these have been covered by its remaining strengths. The four industrial pillars of the past – financial services, trading and logistics, tourism, manufacturing – have dwindled down to only one and a half over the past two decades. Tourism is still doing relatively well thanks to a boost from mainland tourists, but tourist arrivals from other countries are not particularly strong. For example, visitors from Japan, the highest-paying customers before 1997, have declined sharply. In my view, the only Hong Kong economic pillar left fully intact is financial services, consisting mainly of the stock market where share trading and initial public offerings (IPOs) of Chinese equities have been its lifeline during recent years.

Last year, the *Economist* magazine rated Hong Kong as the world's third financial center, after New York and London. This was a notable honor for a city whose greatest ambition previously had been merely to become a regional center. However, the rise of the Chinese economy has given Hong Kong a golden opportunity, helped by the persistent bearishness of the Shanghai A-share market and the immediate need for China to implement banking sector reform. Under the direction of then-Premier

Zhu Rongji, the Hong Kong stock market thus became the launch site for Chinese banking reform by helping the issue of equities for the country's largest banks, followed by the infrastructure sector and property sector. China even launched its Qualified Domestic Institutional Investor scheme through Hong Kong, which lets Chinese institutional and retail investors invest in the SAR through certified mutual funds. All these triggered a virtuous cycle in the Hong Kong economy, pushing the Hang Seng index higher. Hong Kong's IPO launchings have been among the world's top three consistently over the past decade. The market cap of Hong Kong now dwarfs that of long-term rival Singapore and equals that of the Asian economic power house, Japan.

The Hong Kong Advantage

Hong Kong possesses the environment needed for creating a first-class global capital market. Its rule of law, basic infrastructure, investment banking sector and regulatory governance have all evolved naturally over time. In prior years, the condition of the Chinese economy and the sluggishness of its domestic equity market were the two main factors pushing Hong Kong into becoming a global financial center. Nevertheless, the most important point is that Hong Kong was ready, and was able to seize the opportunity.

But with the exception of the stock market, Hong Kong's financial sector has not made many other breakthroughs to support its claim to be a global financial center. For example, the development of its bond market has been slow. There has not been much worth mentioning in this area other than the launch of a few renminbi-denominated bonds as advocated by China. Even the establishment of a government bond-yield curve has been delayed. Although Hong Kong is called a window into China, which is one of the world's major raw material purchasers, the development of Hong Kong's commodities, gold and energy trading markets have not been successful. There have been some positive developments in the private banking sector, yet overall in this area Hong Kong now trails Singapore. The huge losses incurred by a faulty derivative product called the "accumulator" have greatly hampered the sector and have been a major setback.

There have been other disappointments. The handling of the share block trading period by the Hong Kong Stock Exchange's listing committee has revealed management deficiencies; it backed away from its own plan to restrict company insiders ability to deal in their own shares just before public announcements about corporate results. Also, despite obvious

flaws in the process of selling shares after the close of normal trading hours, the Hong Kong Stock Exchange did not make any corrections until the share price of HSBC was manipulated, creating a shock that hit markets around the world. The Lehman Brothers “minibond” incident also revealed a regulatory blind spot, for these risky instruments were often misrepresented by sellers and not understood by buyers, bringing large investor losses and public protests against the government. Although shortcomings exist in every regulatory regime, it is puzzling why key policymakers did not admit their mistakes readily but instead claimed that they knew about these problems in advance. Under the “one country, two systems” framework, it is hard for Beijing to interfere directly in Hong Kong’s financial and regulatory affairs. Although its officials have treated policymakers in Hong Kong with great courtesy, we think they are seriously concerned about complacency and the underlying risks in Hong Kong’s financial system.

Of course, the policy of turning Shanghai into an international financial center basically reflects a strategic decision about the Chinese economy. China is rising and its influence over the rest of the world is likely to increase. It is natural and necessary to seek development of an international financial platform that can serve the country’s growing needs. As the world’s greatest commodity importer, China also requires a greater say in global commodity markets. In addition, the credibility of the US dollar has been damaged and the risk of continued depreciation has greatly increased. As the world’s largest holder of foreign exchange reserves, China must expedite the internationalization of its currency.

Is There Room for Two?

Some people think that an expanding China could well have two major financial centers within its borders. In my view, due to the rapid development of information technology and globalization, several of the world’s existing exchanges already are being marginalized. In Europe, stock trading is increasingly concentrated in the London Stock Exchange, while some other exchanges in continental Europe see a diminishing role in the globalized market. Further, with the exception of the American NASDAQ, there are no successful examples of a secondary board anywhere. NASDAQ succeeds in part because it is the trading platform for shares of technology companies—giving it a distinct characteristic. However, the nature of the Shanghai and Hong Kong stock exchanges is largely similar; the only wall between them is China’s restrictive exchange rate policy, which probably will be eased over the next five to seven years.

In the past, China lacked capital, was in need of foreign exchange for imports but did not want to liberalize its capital account. The existence of Hong Kong thus became a useful platform for raising foreign funds. Now, however, the Chinese have become the world's biggest savers and overseas sources are no longer the only available channel for fund-raising. Today China has many companies that need capital but it also has a great deal of domestic capital looking for investment opportunities. This has prompted many talented international financial workers to seek jobs in Shanghai.

In my view, Shanghai and Hong Kong each have a major strength and an important weakness. Shanghai's weakness is in its "soft" environment. In that city, establishing the rule of law, creating a regulatory regime, finding human capital and achieving efficiency are even more difficult than building a commercial tower. These cannot be resolved overnight by passage of a few favorable policy measures. Hong Kong has a big advantage in this "soft" environment yet Shanghai is catching up. Its government is working hard every day to develop the city as a global financial center.

Hong Kong's disadvantage is that its government is doing nothing, or at least not enough. The entire system has become overly bureaucratic, inefficient and uncreative. It lacks the courage to reform, a sense of urgency, a forward-looking strategy and, most seriously, has little executive efficiency. Former premier Zhu Rongji once criticized the SAR government for "making no decision from a meeting, and taking no action after a decision is made". Ten years have passed, but little has changed.

Whenever I urge Hong Kong to prepare for the future and develop new financial products to exploit changes in the financial market, there always are Hong Kong government officials who explicitly or implicitly suggest that, due to China's closed capital account and the lack of RMB convertibility, there is little Hong Kong can do on its own.

But how could Singapore capture tens of billions of dollars worth of Swiss private banking business while Hong Kong did not? China's sovereign funds and major corporations face all kinds of difficulty in investing overseas, so why cannot Hong Kong offer more help proactively and become the springboard for such overseas investments? Other than becoming an offshore RMB center, for which the Hong Kong government took a rather reactive approach, it appears to me that its

officials have not really put much thought into how to promote their city in such promising areas.

The Need for Better Brains

The Hong Kong civil service is a well-functioning machine. But it lacks a brain and is deficient in independent and proactive strategic planning. In the past that did not matter, as the British took the lead and made decisions on strategic issues. Since the 1997 handover, because the British were gone and mainland China did not actively interfere in Hong Kong affairs, the setting of policy direction has become inefficient. In the early years, the public blamed Tung Chee Wah, the first chief executive, for faulty leadership but the subsequent surge of mainland tourism and bank IPOs covered the problem temporarily. But now the entire system is engaged in busywork without effective results. Restraints from both the bureaucracy and the Legislative Council have paralyzed the Hong Kong government and prevented it from doing enough forward-looking strategic work. Instead, it mainly seeks policy support from Beijing whenever it has a difficult time.

After Beijing announced its decision to develop Shanghai into an international financial center by 2020, Hong Kong seemed to care more about the bad conduct of certain Legco members. For the most part, officials responsible for financial matters have only made some meaningless comments regarding Beijing's decision. In the beginning, I thought this reflected policies of the central and Shanghai governments, but later realized that, internally, the Hong Kong government really did not view it as a crisis. I think many officials hoped mainly to "do less and make fewer mistakes," rather than face the challenge. This may be because civil service pensions have given the greatest weight to their salary schemes, and they didn't want to put them at risk. As a result, too few are willing to think ahead or take responsibility for hard decisions. Rather, they often try to push responsibility onto others. Policy assessment has become a mere ritual among a small group of people, procrastinating about decisions and the execution of strategically important policies. Yet without a robust financial sector, I wonder what can support Hong Kong's high rent and property prices. And what can support the high salaries paid to government officials?

The economic rise of China is the greatest global event of the past 20 years and possibly for the next 20 years as well. For Hong Kong, this presents both an opportunity and a challenge. The rise of China means a surge of demand, capital and business opportunities. For these, Hong

Kong has an important initial advantage, that of being the most advanced economy in the crucial Pearl River Delta region, and of having many financial services that Shanghai cannot match at the moment. However, most of these advantages are not being used effectively; doing so would require greater innovative thinking and a tireless pursuit of opportunities as they arise, plus more cooperation across the border and demonstrating greater initiative.

Before the RMB can become an international currency and China opens up its capital account, the Hong Kong stock market may still have some fantastic years. And if Hong Kong can participate in the structural transition of the Pearl River Delta region and become its financial window on the world, it could still grow despite new competition from Shanghai. But if it does not move ahead with newly acquired strength, then not only will Chinese companies list in both Hong Kong and Shanghai but also Hong Kong companies like HSBC and Cheung Kong will list in Shanghai. When that happens, Hong Kong's financial sector may well face the risk of being marginalized.

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