

WILL 2020 BRING THE DEATH OF HONG KONG?

By Nicholas Kwan

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Back in 1995, Hong Kong was declared dead by Fortune Magazine. The reason: the introduction of "one country, two systems"—a creation of China's then-paramount leader Deng Xiaoping designed to extend Hong Kong's colonial prosperity into the future—was seen as the beginning of the end for its free market economy.

The reality: the prediction almost came true, but for a totally different reason. Hong Kong suffered one of its worst post-war recessions in the immediate aftermath of the 1997 handover of sovereignty due to an unrelated Asian financial crisis, which resulted from the creation of asset bubbles across the region over many prior years. Ironically, to the doomsayers' surprise, the recession ended partly because of accelerated economic integration between Hong Kong and mainland China, a process boosted by the implementation of "one country, two systems".

The End of the Beginning

Today, some analysts predict Hong Kong will die in 2020. Their reason: an expected ending of "one country, two systems" now that Beijing has declared its intention to turn Shanghai into China's leading international financial center by that year. Many see that role as one that should be exclusively preserved for Hong Kong under the "one country, two systems" arrangement, and that Hong Kong cannot thrive without it. However, I believe nothing will prove to be further from truth than this harsh prediction of Hong Kong's pending death.

"One country, two systems" is an important institutional arrangement for Hong Kong's post-handover development, but its introduction did not mark the beginning of an inevitable demise of Hong Kong as a major world financial center. There are more important factors why Hong Kong has instead continued to survive and be prosperous. In terms of its status as a global financial center, the keys to its success are competition, adaptation and credibility: the first helps identify challenges, the second helps tackle

those challenges and the last helps it excel while meeting those challenges. As long as these three factors continue to prevail, there is no reason to believe Hong Kong's crucial international status will not survive long after the year 2020.

No Competition Means No Progress

In the aftermath of the present global financial crisis, some basic aspects of international financial systems and their operations are likely to experience fundamental changes in the coming years. Severe setbacks suffered by the traditional centers like London and New York, plus the ascendance of China in the global economy, present both threats and opportunities for Hong Kong as it continues to develop its own financial industry. Growing competition from Shanghai in the area of international finance—either as a natural development of China's economic ascendance or as part of a Beijing grand design—is only one of the many challenges that Hong Kong will face in its continued effort to live up to its official slogan as "Asia's world city".

Exactly how Hong Kong can and will respond as it faces various challenges to this status is hard to predict. But compared to the threats presented by the impending overhaul of the global financial system, competition from Shanghai appears relatively more predictable and manageable—given the established channels of communication with mainland authorities and China's own interest in maintaining Hong Kong's prosperity. Yet this is not the most important factor behind my faith in Hong Kong's continued success. To the contrary, it is the very factor of growing and continuing competition, either from Shanghai or other new contenders, which will make Hong Kong click.

Competition is good for Hong Kong, the more the better, and history proves it. Its initial development as a world financial center was the result of competition among the growing number of international banks that were allowed to establish themselves in Hong Kong in the late 1970s. The city's current success as the prime offshore listing center for new shares issues by mainland Chinese companies over the past two decades came despite intense competition from the financial centers of New York, London and Singapore; this is shown by examining the relatively small listings of N- (New York), L- (London) and S- (Singapore) shares as compared to the rapid development of an H-share market in Hong Kong. In addition, the growth of

a local fund management industry—the second largest in Asia—was achieved while experiencing constant competition from Singapore.

Flexibility is Essential

Competition exposes problems in the marketplace, and forces industry participants and regulators to behave and sharpen their edges. But how well they respond to competition depends upon their ability to understand, adapt and change. Very often, the problem results less from the ability to understand but from an inability to adapt, especially when changes run against existing vested interests. Here, Hong Kong's track record in adapting to changes should give us comfort.

From its beginnings as a small fishing village in the 19th century, the city has repeatedly transformed itself to meet challenges of a changing environment; it evolved from serving as an *entrepot* in the 1950s into an export manufacturing and tourist centre in the 1970s, into a trading hub for China in the 1980s and into an international financial center since the 1990s. On top of the usual benefits gained from having a migrant society and a small open economy, the core of the city's flexibility relies upon its vibrant free market system. It is therefore essential that this competitiveness be preserved, especially amid growing aspirations for social development and broader political participation.

Credibility is an Asymmetric Asset

Competition and adaptability are keys to development in all economic activities, but unique to the success of global financial centers is their need for credibility which is at the center of modern day finance, especially international finance. Nowadays, billions of dollars move across borders by electronic messages, often completed without the backing or physical movement of any product or service. At the center of these transactions is a series of trading, payment and clearing systems regulated and facilitated by a large number of regulatory and intermediary institutions. The credibility of these institutions, instruments and systems is therefore crucial to their success, above all in a city that strives to be an international center. More interestingly, credibility is an asymmetric animal: it is hard to build but easy to destroy. A system or institution can take years, if not decades, to establish its credibility but a major mistake can destroy it in seconds, as happened in the ongoing financial crisis. In this respect, Hong Kong's success over the

past decades in building itself a respected regulatory regime, reliable financial trading and payment systems, relatively corruption-free administration and, more importantly, an independent judiciary give it a significant edge in maintaining its international status, especially against Shanghai—which lags behind in those elements.

Of course, there is no guarantee of future success, especially if Hong Kong fails to keep up its lead in those vital areas. However, ten years seem too little time for Shanghai to catch up or overtake it, especially with regard to building the essential regulatory and judicial institutions needed to support creation of an international financial center with global credibility.

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