Chinese University of Hong Kong

Dr. Li Dak Sum Shanghai-HK Development Lecture

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The Hon. Dr Li Dak Sum,
Professor Sung Yun-wing,
Distinguished Guest,
Ladies and gentlemen,

I am extremely honoured to be invited to give this Li Dak Sum Shanghai-Hong Kong Development Lecture. Dr. Li Dak Sum is well known as an entrepreneur, philanthropist and generous community service contributor to the development of Ningbo, Shanghai and Hong Kong, especially in his donations to the Chinese University of Hong Kong, his alma mater Fudan University and Zhejiang University.

The theme of this lecture is Shanghai and Hong Kong Development, but I want to broaden this to a wider discussion of how the two cities fit into the overall development of China within the broader picture of global development. The late Sir QW Lee, whom I count as one of my mentors, used to say that Hong Kong and Shanghai are the twin engines of the China jet plane that is taking off. He would have been proud to see Shanghai going into the next phase of development through the Free Trade Zone area, whilst China has just completed a historic Third Plenum that announced a major reform programme.

As we move out of the Year of Snake into the Year of the Horse, there has been a number of good news, despite a year of volatility. Earlier this month, the WTO negotiations came to an agreement in Bali that re-affirmed the continuation of multilateralism. This can only be good news for free trade, in which Hong Kong, Shanghai and China are so committed. The second is the successful Third Plenum, which reaffirmed China's determination to reform, and the whole series of detailed plans and programmes that are being announced and launched.

Allow me to deliver this lecture in two parts. The first assesses what the international environment and global financial reforms imply for Asia and China as a whole, including of course Shanghai, Hong Kong and the development of their financial centres. The second looks into more depth the implications of the Third Plenum reforms and see how Shanghai and Hong Kong fit into the broad canvas.

[1] I am grateful to Mr Ng Chow Soon, Ms Wang Yao, Mr Li Sai Yau, and Ms Jodie Hu for research support on this paper. All opinions and errors are personal to the author and not those of the institutions that the author is associated with.

The Post-Global Financial Crisis Landscape – Implications for Financial Markets

The Fung Global Institute has just completed its second Asia-Global Dialogue, where some of the world's leading business and thought leaders came to discuss Asian growth, jobs and opportunities. Whilst there was agreement that Asia remains a growth story, particularly after China's historic Third Plenum determination for reforms, there are still considerable roadblocks. The US is on a path of recovery, especially with the shale oil innovation and strong corporate competitiveness. Europe seems to be bottoming out, but there are considerable social tensions and major structural reforms ahead. In the words of one European participant – Europe is 10.3 per cent of population, 28.4 per cent of world GDP, but accounts for half of social expenditure. We all hope Abenomics will pull Japan out of two decades of lost growth and deflation and the rest of the emerging markets are struggling with adjustment with the prospects of QE tapering and withdrawal of hot money.

During the Asian Global Dialogue, Professor Stanley Fischer, former Governor of the Bank of Israel and Deputy Managing Director of the IMF during the Asian Financial crisis, threw a major challenge to Asians. If Asians are to make a major contribution to global issues as equal partners and global citizens, then there must be more original Asian thinking and research that needs to be as good, if not as constructive as G7 leadership.

I totally agree with Professor Fischer and humbly submit that we suffered exactly as the West during the last two financial crises – to quote Keynes as quoted by Professor Fischer, "*The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back. I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas.*"

In the 21st century, we are still haunted and blinded by the thinking of the 20th century. Nowhere was this as obvious as the intellectual basis of increasing inflation through quantitative easing. To quote Keynes again, writing in Economic Consequences of the Peace in 1918, "*Lenin was certainly right. There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose*."

Nowhere is this more obvious than in finance. In the 20th century, we have created unprecedented wealth through financial innovation, largely through leverage, but we have also created unprecedented inequality. Today, savers and surplus economies are being blamed for the ills of the deficit and debtor countries. Hard work and frugality are blamed for over-borrowing and excessive debt. Nothing illustrates for me personally the moral and intellectual bankruptcy of the Wall Street viewpoint of unfettered capitalism than Alan Greenspan's quote recently:

"*The whole period upset my view of how the world worked – the models failed at a* *time when we needed them most … and the failure was uniform," ….To me it suddenly seemed that the whole idea of taking the maths as the basis of pricing that system failed. The whole structure of risk evaluation – what they call the 'Harry Markowitz approach' – failed," ….."The rating agency failed completely and financial services regulation failed too*[2]."

What are the key lessons from the current global financial crisis?

- The first is the loss of trust – the loss of fiduciary responsibility to act as custodians of public savings.
- The second is the short-termism with bad incentives that made the system very fragile.
- The third is that economic and finance theory, on which our financial architecture is based, is deeply flawed and incomplete.

In short, Wall Street finance failed to serve the real sector and there is a whole raft of reforms that try to deal with this, including QE and new laws and rules like Dodd-Frank, Basel III, Liikanen, Vickers etc that affect not only the crisis countries but also the rest of the world.

The flaws in finance theory have considerable consequences on the future landscape of Asian finance. Fortunately, thanks to the Asian financial crisis of more than 15 years ago, Asian finance turned out more cautious and prudent, so that financial centres did not flirt that much with financial innovation and leverage, both on the buy (investor) and the sell (marketing) side. But partly because of the caution, the capital market was not as well developed and the Asian financial system remains by and large very bank-dominated[3].

The future of Asian finance will depend on how the real economy looks like. Several features of the Asia real economy are fairly robust and will not change despite short-term uncertainties:

- Asian economies will rebalance by promoting domestic consumption as the second engine of growth. There are signs that China is already moving in that direction;
- Asian economies will attempt to solve three major objectives – first to promote growth and jobs for the labour force from favourable demographics; second to address the social inequalities through wage increases, improvement in social welfare, and fiscal transfers; and thirdly, to address the environmental challenges of clean air, water, energy and resource conservation and a better environment.
- Asian demographics will be both favourable and unfavourable. The younger population in ASEAN and South Asia will have to invest heavily in education, infrastructure and job creation; the older population centres in North Asia will have to provide higher social benefits for the aged, such as healthcare, social insurance and pensions.

[2] Gillian Tett, Interview with Alan Greenspan, 25 October 2013, Financial Times, available at http://www.ft.com/intl/cms/s/2/25ebae9e-3c3a-11e3-b85f-00144feab7de.html#axzz2mrYWzLOi

[3] For a survey of the issues, see Andrew Sheng, Chow Soon Ng, and Christian Edelmann, Asian Finance 2020, available at http://www.funglobalinstitute.org/en/asia-finance-2020-framing-new-asian-financial-architecture

- Urbanization and moving into middle-income will generate considerable wealth and therefore opportunities for the financial sector to undertake wealth management and deploy excess savings more efficiently.
- To increase productivity, Asian economies will have to use innovation, technology and reforms more effectively, increasing Research and Development as Percentage of GDP and compete more vigorously with each other.

The bottom line is that Asia will still remain the major source of new growth globally, accounting for more than half of global GDP growth. The HSBC has projected that 11 out of 26 fast growing economies globally in 2050 would be from Asia[4]. McKinsey Global Institute estimated that out of the 136 new cities that enter the top 600 in the world by 2025, all of them will come from the emerging markets, of which China will account for 100 and India 13[5].

Asia today is home to nearly two-thirds of humanity, and accounts for 40 percent of world trade, one-third of world GDP and one-quarter of global financial assets. Asian financial sector will have to serve this transformation along the following lines:-

- To create jobs, trade and growth, Asian financial markets will have to help provide trade finance, fund SMEs in both equity and working capital, provide long-term infrastructure and project funding and also manage wealth better for their investors.
- The insurance, pension and asset management industries should be supported in order to reduce the maturity mismatch in the financial sector and provide long-term funding and stability to the system as a whole. Insurance and pension funds can help improve social security, hedge risks in the system and add risk capital for innovative industries.
- On the whole, the financial sector must improve financial inclusivity, reduce the level of financial repression, and inject capital to strengthen the robustness of the private sector to absorb risks.
- Furthermore, the financial sector should use technology to improve product and service delivery and restore trust in its fiduciary role.

What does this mean for Shanghai and Hong Kong as international financial centres (IFCs)?

Firstly, the competition for international financial centres is increasing. According to a survey by the Financial Times in March this year, Hong Kong, Shanghai and Beijing were the top three IFCs in terms of inward foreign direct investment (FDI)[6], relegating London to fourth place. But in reality, it will not be easy to topple New York and London as the top two in the whole range of financial services.

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[4] HSBC, The World in 2050, available at www.hsbc.com/~/media/HSBC-com/about-hsbc/...in-%202050.ashx

[5] R. Dobbs, J. Remes, J. Manyika, C. Roxburgh, S. Smit, F. Schaer, *Urban world: Cities and the rise of the consuming class,* McKinsey Global Institute, June 2012

[6] The Banker. 2013. *Hong Kong tops inward financial services FDI ranking*. http://www.thebanker.com/Banker-Data/International-Financial-Centres/Hong-Kong-tops-inward-financial-services-FDI-ranking

Secondly, many regional financial centres are competing against Shanghai and Hong Kong as IFCs, including Beijing, Shenzhen, Seoul, Taipei, Tokyo, Singapore, Sydney and Mumbai. According to the Global Financial Centres Index, compiled by the Z/Yen Group, as at October 2013, the most competitive financial centres are London, New York, Hong Kong and Singapore, followed by Tokyo (5) Seoul (10), Sydney (15), Shanghai (16), Shenzhen (27), and Beijing (59).

Whether they succeed will depend on a whole host of factors. Hong Kong, Singapore and Sydney have advantages because of the common law, strong regulatory record and the active, liquid markets in foreign exchange and stock markets.

Furthermore, Hong Kong and Shanghai have advantages because of the rise of the RMB as an international currency. This is an area that deserves more discussion, to which I shall now turn.

Third Plenum Reforms – Implications for Shanghai and Hong Kong

Currently, Hong Kong is already an international financial centre, whereas the Central Government has the stated objective of making Shanghai an international financial centre. To do so would require the opening of the capital account for the RMB. In this regard, the Third Plenum reform decisions had many reform measures that would affect the position of Shanghai. I quote a comment on the historical significance of the Third Plenum by Dr. Qin Xiao[7]:

"The 18th Third Plenum Decision has given the most important and historic reform roadmap for deepening reform following the Eleventh Third Plenum of the late 1970s. The Decision has responded to the needs of Chinese economy and society, clarified the direction, objective and timetable, and created an authoritative leadership and implementation structure. This roadmap lays out how to upgrade China to the next level of reform, with high hopes, but the journey will not necessarily be smooth."

The decision pointed out (correctly in my view) that the core problem of reform is to sort out the relationship between state and market, allowing the market to undertake the decisive role in resource allocation.

If this is the case, then there will be interest rate, exchange liberalization towards market forces and ultimately, the opening up of the capital account, which will move China fully into global financial, trade and investment integration.

It has now been two decades since I came to work at the Hong Kong Monetary Authority in 1993. At that time, Hong Kong was clearly an international financial centre, but Shanghai was a national financial centre. Hong Kong had $109.6 bn in GDP, one sixth that of China's $613.2 bn, but Hong Kong had foreign exchange reserves of $43 bn, double that of the foreign reserves of China of $21.1 bn. Two decades years later, the GDP of Shanghai by 2012 was already 2 trn yuan ($321.2 bn), much higher than that of Hong Kong's GDP of $263 bn. Mainland China's GDP in

[7] Caijing Magazine, Issue 35, 2013. Translated by author, Chinese version available at http://magazine.caijing.com.cn/2013-12-08/113663152.html

2012 was \$8.23 trn, 33 times that of Hong Kong, while Hong Kong's foreign exchange reserves are at the end of 2012 was \$317.4 bn, one tenth that of Mainland China's \$3.3 trn. Of course, Hong Kong had \$36,763 in per capita GDP, compared with \$6,091 for China and \$13,434 for Shanghai. But Hong Kong has high income per capita because the population of Hong Kong has remained relatively stable at 7.2 million, whereas the Shanghai population was 23.7 million at the end of 2012.

Of course, Shanghai's land area at 2448 sq. miles (6,340 sq.km) is six times larger than that of Hong Kong, at 426 sq miles or 1,104 sq. km. By comparison, Singapore has 275.8 sq. miles or 714.3 square km, with a population of 5.4 million.

Instead of projecting Shanghai and Hong Kong's financial development in terms of flow projections, I intend to look at the potential from a global wealth perspective. The latest projections for Hong Kong GDP growth in the medium term are roughly 3.5-4 per cent per annum, whereas the Chinese Mainland's GDP growth range is roughly 7 per cent per annum. Growing at double the speed means that China's real income and wealth will become larger relative to Hong Kong and therefore the role of the RMB will become even more important in the coming years.

According to the Credit Suisse Global Wealth Report 2013[8], which measures mainly personal and household wealth, the most wealthy country is the US (\$72.1 trn), followed by Japan (\$22.6 trn) and China (\$22.2 trn). However, counted as a group, Europe had gross wealth of \$76.2 trn. Global wealth has reached an all-time high of \$241 trn in 2012, up 4.9 per cent since last year and 68 per cent since 2003, with the US accounting for 72 per cent of the latest increase. Average wealth per adult reached a new all-time high of \$51,600, with wealth per adult in Switzerland returning to above \$500,000.

The Credit Suisse report expects global wealth to rise by nearly 40 per cent over the next five years, reaching \$334 trn by 2018. Emerging markets are responsible for 29 per cent of that growth. China will account for nearly 50 per cent of the increase in emerging economies' wealth.

The US will remain the leader in terms of aggregate wealth, with total net worth of \$100 trn by 2018. China will overtake Japan as the second wealthiest economy in the world, probably around 2016, with total wealth of around \$34.7 trn. The Eurozone, currently accounting for 24 per cent of global wealth, will likely see its share decline a little to 23 per cent (\$76.8 trn). In other words, by 2018, Shanghai will definitely become an important manager of Chinese wealth, but even with fast growth, the main financial centres will still be in the US and Europe, since Chinese wealth will still be half of that of Europe and roughly one third that of the US.

By comparison, in mid-2013, Hong Kong personal wealth was \$0.9 trn, whilst Singapore wealth was \$1.1 trn, and Chinese wealth was \$22.2 trn.

Because of the rise in GDP, China's wealth would be around \$34.7 trn by 2018, 56.7 per cent higher than in 2013. Unless Singapore, Hong Kong, Australia and others were to match the GDP growth and attract overseas funds and banking to manage, it

[8] Available at https://publications.credit-suisse.com/tasks/render/file/?fileID=BCDB1364-A105-0560-1332EC9100FF5C83

is likely that other financial centres would be smaller relative to Chinese financial centres, particularly Shanghai, but Beijing, Shenzhen and other centres will also compete for leadership role in Chinese finance.

In sum, China will continue to build up wealth in the next five years as the economy continues to power ahead. Therefore, there will be huge opportunities for both Hong Kong and Shanghai.

So far, I have not gone into detail on what Shanghai and Hong Kong should be doing in order to help Chinese financial development. The details are being mapped very carefully by the People's Bank of China and the Third Plenum reform decisions, so there is very little need for me to elaborate.

Of course, the RMB will play a key role, as the internationalization of the RMB and the opening of the capital account, which is expected by 2020, will give a boost to both Shanghai and Hong Kong. According to the BIS 2013 Triennial Survey of Foreign Exchange, the role of the RMB in global FX trading has surged, with RMB turnover soaring from $34 bn daily in 2010 to $120 bn in 2013. Although it holds the position of ninth most actively traded currency in 2013, with a share of 2.2 per cent in global FX volumes, it is still distant from challenging even Sterling, Australian dollar, Swiss Franc and Canadian dollar in activity. Most of the turnover is also offshore RMB trading.

What is significant is that HSBC estimates that 30 per cent of China's total trade flows (or around 50 per cent of bilateral trade with emerging market countries) will be settled in RMB within the next three years. Nearly $2 trn worth of cross-border trade flows could be settled in RMB by 2015, making it one of the top-three currencies used in global trade.

To support this, since June 2010, the People's Bank of China (PBOC) has concluded over RMB 2.6 trn ($426 bn) of bilateral swap arrangements with over 20 central banks worldwide. Recent swap agreements with the Bank of England, Bank Indonesia and the European Central Bank would facilitate trade finance and greater acceptance of RMB as official foreign exchange reserves.

The willingness of central banks to use bilateral currency swaps to support trade is encouraging because it means that trade finance need not be disrupted during crises (as happened in 2008) and central banks can play a useful role as lender of last resort for trade finance.

In sum, both Shanghai and Hong Kong would continue to play important roles in helping China "go out", particularly in finance, trade and investments.

I cannot conclude without saying a few words about the Shanghai Pilot Free Trade Zone (FTZ). The Shanghai FTZ comprises only 28 sq.km, but as a pilot project, it is a bold step in regulatory reform.

On 2 December, the People's Bank of China (PBOC) released the "Opinions on Leveraging the Role of Finance in Supporting the Construction of China (Shanghai)

Free Trade Zone."[9] The opinions explored ways to facilitate investment and financing remittance, and promote the convertibility of capital account; promote the cross-border use of RMB within the FTZ more flexibly; allowing market-oriented reform of interest rate; and deepen foreign exchange reform and streamline an appropriate foreign exchange control system.

These implications mean that FTZ is "Hong Kong in Shanghai." In fact, China is already beginning to build different Hong Kong's in Qianhai, Hengqin and Nansha, respectively, which means that the role of Hong Kong need to change to respond to the new competition. That is the subject of another lecture.

Conclusion

From the above analysis, I am convinced that the prospects for the Shanghai-Hong Kong financial development are bright, because of the Third Plenum decisions on market reforms and the growth in Chinese income and wealth, as well as Asian regional economic growth. The next decade offers tremendous opportunities for both Hong Kong and Shanghai to reform the markets to serve the real economy better. There are areas where Hong Kong complements Shanghai, whereas there are areas where Hong Kong can go a different direction to serve the market in different niches. There is no reason for both markets to have similar structures and patterns of development.

Thank you for your patience and I shall be happy to answer any questions on the above.

Hong Kong,
17 December 2013.

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[9] Available at
http://www.pbc.gov.cn/publish/goutongjiaoliu/524/2013/20131202094934794886233/20131202094934794886233_.html