Speech

Speech by SFST at annual autumn dinner of Hong Kong Securities Institute (English only)

Thursday, October 14, 2010

Following is the speech by the Secretary for Financial Services and the Treasury, Professor K C Chan, at the annual autumn dinner of Hong Kong Securities Institute tonight (October 14):

Distinguished guests, ladies and gentlemen,

It is an honour and a pleasure to be invited to speak at the annual autumn dinner of Hong Kong Securities Institute.

The Institute has been our active partner in driving Hong Kong's financial market forward. And thanks to the Institute's invitation, I have the opportunity today to brief you on our latest efforts in developing Hong Kong into a global financial centre.

First, let's take a look at how our financial markets are doing. Hang Seng Index is trading at around the 23,000 level. The Dow Jones Index is around 11,000. World equity markets are trading near the highest level since the global financial crisis, but there are signs that the global economic recovery is slowing down. How do we see the future for our economy and our financial markets?

To quote Dickens, this is the "best of times", but also "the worst of times". I will first talk about the unprecedented opportunities we are in, and then the challenges and risks that we face.

<u>Shifting of financial centre of gravity to the East</u>

Hong Kong has done well through the global financial crisis, and as a result, our profile as an international financial centre is higher than ever before.

The crisis has reaffirmed the strengths of Hong Kong. That list includes a simple and low tax regime; high-quality services, free flow of information and of financial and human capital, and our rule of law.

The crisis also marks a shift of economic growth opportunities from the West to the East. We now stand at a juncture where China's economy is taking off.

We have seen the strong economic performance of China through the global financial crisis, and its leadership role in reviving global demand. At a time when markets in Europe and the US are still recovering from the crisis, the centre of economic gravity seems to be moving from the West to the East.

From an importer of capital, China is becoming an exporter. From being the world's factory, China is investing heavily to boost domestic demand. From having a tight control of its currency, China is preparing to internationalise the use of the RMB. In my view, we are seeing a second opening up of China's economy.

Hong Kong, being situated in the centre of the burst of economic and financial activities of the East, will surely benefit. The only question now is how we can make the most of such opportunities.

Our regulatory structure

We can only turn opportunities into gold if we have the infrastructure in place. One core aspect is regulation. It holds all the activities in place and provides a platform for fair and orderly competition.

Our regulations are fair, transparent, predictable and most importantly, they work.

During the darkest days of the financial crisis, there was no major disruption to our markets. Our banking system remained sound. Clearing and settlement were smooth and efficient despite surge in trading volume.

Our regulations remained consistent before, during and after the crisis. Take short-selling as an example, in the eye of the financial storm, there was suspicion that short-selling was to blame for the huge volatility in the financial sector in general or individual companies, and many called for a ban on short-selling.

Hong Kong is one of the few markets in the world that did not tinker with our short-selling regime. With the benefit of hindsight, it is generally recognised that those who succumbed to pressure and banned short-selling did it for the wrong reasons.

The market respects us for not wavering, for being consistent in our interpretation of rules and having a consistent approach to making the rules.

After the global financial crisis, we in Hong Kong, and many others in the world, have witnessed a new advantage of our financial market. That is the strength of our financial regulation. While we are seeing sweeping regulatory reforms being introduced in many jurisdictions to address the short-comings exposed by the financial crisis, our regulatory structure is standing out as stable and strong.

The changes proposed elsewhere may be warranted, but they will unavoidably create uncertainties and increase the costs of capital in the short term.

Our fair, transparent, certain and predictable regulatory system has served us well. It will continue to woo financial institutions to set up shops here and provide investors with confidence to use our services and buy our products.

Capital raising centre

As to how we will develop our market, our priority should be to build on our strength, and add to the breadth and depth of our market.

For years, Hong Kong has been serving as the premium capital-raising platform for enterprises of Mainland China. We will continue to work on what we do best - helping Mainland companies raise international capital. At the same time, we will apply our expertise and connection with China to help international enterprises branch into the Mainland. The natural first step may be a listing in Hong Kong which serves to achieve the dual purpose of raising their profile in the region and funding the capital for their China operations.

Because of the access to Asian investors and consumers, and the IPO volume we are capable of handling, we have attracted an increasing number of foreign listings. And these efforts should continue.

We are growing our expertise and accumulating experience on a broad range of fund raising activities. By "we", I don't just mean our professionals such as bankers, lawyers and accountants or our regulators - the stock exchange and its listing committee and the Securities and Futures Commission, but also our investors who are getting more familiar and comfortable with the disclosure and risks associated with different companies and sectors. This growth cannot be rushed. We will take the time to get it right. I am confident that we are moving in the right direction.

Offshore renminbi business centre

As China's most important international financial centre, we will serve the financial needs of our country in more than one way. We are excited about the historic mission to assist our country to plan and execute its next phase of reform in its market opening. I am of course talking about the internationalisation of the renminbi (RMB).

The increasing use of RMB in the region is going to be a growth driver for the financial markets in Mainland China and Hong Kong. Hong Kong has the full backing of the Central Government in developing offshore RMB business.

The growth of RMB services has been significant. In 2004, Hong Kong is the first economy outside Mainland China to conduct yuan banking. Since the introduction of the pilot scheme of trade settlement in RMB a little more than a year ago, RMB trade settlement has been growing rapidly, with a large proportion of this trade being settled in Hong Kong.

We saw the development of a RMB bond market in Hong Kong. Last September, the Central Government launched its inaugural RMB sovereign bond issue, totalling RMB6 billion. This year we have seen both Hong Kong and foreign companies issue RMB bonds here. There will be more to come.

Since the People's Bank of China and the Hong Kong Monetary Authority revised the RMB clearing and settlement agreement in July, the interbank market in RMB is becoming active, and financial institutions are very active in introducing RMB products to our investors. An offshore market in the RMB is taking shape in Hong Kong.

What we are seeing is only a beginning. More is needed to be done to build up our offshore RMB business to support the internationalisation of the RMB. In his Policy Address, highlighting the importance of enhancing our financial cooperation with the Mainland, the Chief Executive particularly outlined four short term goals, three of which are related to RMB business.

To echo what the Chief Executive has said, I will describe the work as follows. First, we want banks in Hong Kong to promote the use of RMB in trade settlement. Because the idea of using RMB is new to many overseas corporate customers, we need to show them the benefits of switching from say, US dollar, to RMB in trade settlement, and to help them understand the rules and procedures involved.

Second, we need to develop an interbank market on RMB to increase the efficiency of bank lending to their customers. The revised settlement agreement announced in July has lifted many restrictions. Hopefully as the RMB deposits build up and as trade settlement volume increases, this will lead to an efficient local RMB interbank market. We should also seek to improve the linkage between the interbank markets in Hong Kong and the Mainland.

Third, we need to expand investment channels for RMB funds accumulated in Hong Kong. By offering investment opportunities denominated in RMB, we can help grow the demand for holding RMB assets offshore, and the expanded pool of funds will facilitate the growth of RMB trade settlement. The Chief Executive mentioned that he would like to see expansion of channels for enterprises to invest in the Mainland the RMB capital raised in Hong Kong. Foreign direct investment is one example of the investment opportunity we have in mind. Another example is for RMB funds in Hong Kong to be invested in the Mainland market through a QFII-like arrangement.

<u>Asset management centre</u>

All these exciting developments about our market will no doubt benefit our asset management industry. Although Hong Kong has already established itself as a major asset management centre in Asia, I see potential for us to do even more.

Given the Mainland's large and increasingly affluent population, Hong Kong is an ideal - and logical - wealth management centre for Chinese individuals and institutions. Don't forget, we are the Mainland's gateway to the world's financial markets. We can serve as an effective channel for orderly capital outflows from the Mainland, and Mainland financial institutions can manage their overseas investments through Hong Kong. At the same time, we can help overseas managers search for investment opportunities in China. We have the best of both worlds.

Uncharted waters

I have described some unprecedented opportunities for our financial market. But in the short term, I also see risks to our market because of the economic conditions in other parts of the world and policy responses taken in these countries.

In recent months, we have seen signs that the global economic recovery is slowing down, and troubles are flaring up. First, early this year we had the European debt crisis. It prompted quick European Union responses to the debt crisis in some EU member states. It also put the spot light on the deficits run up by many European countries, and governments there are pledging cuts in future deficits. While such policy responses are necessary to calm the financial market, they will weaken the economic recovery.

More recently, the market is concerned about talks of a currency war, with charges and countercharges of currency manipulation between countries. China is coming under Western pressure to appreciate its currency. Some countries have gone into the markets to stem the rise of the value of their currency.

There are signs that central banks in U.S. and Japan are adopting a new round of Quantitative Easing. In the so-called QE2, central banks will be purchasing long term financial assets, mainly government bonds, from the banks. The objective of this is not to increase money supply in the traditional sense. Rather, its purpose is to lower the long term interest rates, and by changing the asset mix available, induce investors to hold riskier assets.

Will QE2 work to stimulate economic growth? From Japan's experience with QE2 in the period after the Asian financial crisis, the prospect is not good. The reason for the slow growth in these economies is the lack of demand, rather than a lack of bank lending.

Will QE2 lead to inflation in these countries? In my view that is not likely, because QE2 is not likely to lead to economic expansion in these countries.

What QE2 could do, and if it works according to plan, is to free up liquidity invested in government securities and push it to riskier assets. This could push up asset prices, such as stock and corporate bond prices. And this liquidity may affect the emerging markets the most, as emerging markets have higher economic growth potential. As a result, the excess liquidity could result in asset bubbles in the emerging markets.

Two years after the global financial crisis, we are finding ourselves in uncharted waters. Economic growth will be slow in many Western economies, with unemployment staying at a high level. Because of the deficit concern as well as lack of political consensus, expanded fiscal stimulus is not a practical option. Monetary policies pursued by major reserve currency countries could lead to asset price bubbles in emerging markets. Currency market responses to this mix of macroeconomic and monetary conditions may result in wide swings of exchange rates. Not only is that a source of risk to our financial markets, large changes in the exchange rates can have political implications and increase tension among nations.

For many countries, the task of managing the fragile economic recovery in the face of these risk factors is no less daunting than dealing with the near collapse of the financial system two years ago. For Hong Kong and other emerging markets, surges in our asset prices are posing increasing risks to financial and economic stability.

For financial practitioners as well as investors, we should not forget the lessons from the global financial crisis. That is, loose monetary policies have produced asset bubbles, and our global financial system provides fast transmission of liquidity between markets. Capital flows that go into a market because of excess liquidity can take a reverse course when the global financial conditions change. We need to bear in mind that the current asset prices may not truly reflect the state of the real economy. We should not underestimate the risks before us.

I have touched on both risks and opportunities to our market. These two ideas are of course not strange to finance practitioners in our audience. It is my hope that you can use these opportunities to create value and manage risks for your clients, and together we create lasting developments in our financial market.

Thank you.

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