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Comment Peter Nicholas Kriz

Introduction

In a rather provocative chapter, McCauley and Chan use a combination of descriptive statistics and counterfactual estimations to persuade readers of two facts regarding Hong Kong's fate as international financial center. One, Hong Kong possesses marked leadership over Shanghai in international banking, foreign exchange, derivatives, capital market development, and internationalization, and these current advantages are of importance for how one should consider their futures. Two, recent trends portend a growing rather than diminishing gap in favor of Hong Kong with respect to the relative financial strength of these two cities. In light of their findings, the authors conclude that rather than weaken in the face of China's renaissance, Hong Kong's position as the de facto center of international finance in China should strengthen, and its financial leadership over Shanghai be retained.

My comments on this chapter are organized into three sections. First, I ask a number of questions issues related to Hong Kong's strength relative to Shanghai. In doing so, I provide some needed context to the interpretation of current data and future projections. Second, I critically discuss the main analytical feature of the chapter, the counterfactual estimation. I approach their findings from four theoretical considerations, each of which offers a different characterization of future expectations and suggests a more holistic perspective on the counterfactuals. Finally, I conclude with a few parting thoughts on economic research on China and other emerging markets.

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Hong Kong's Relative Strength: A Fait Accompli?

To gain a robust appreciation of Hong Kong versus Shanghai's financial past, present, and future, one must deconstruct the myriad of facts and figures that are currently available. I suggest a three-step approach. First, develop an understanding of the economic and political processes that explain the recent past. Next, evaluate the current state of affairs based not only on the past processes but also on current forces and expectations of the future. Finally, make projections into the future based on both an understanding of processes that drive the present and also on how those processes might change going forward. Without a thorough approach to uncover the fundamental political economy that has produced the remarkable dynamism of China this past century, it would be near impossible to provide plausible projections as to the financial future of Hong Kong versus Shanghai.

To frame this analysis, I ask three sets of questions:

- One, what explains Hong Kong's current edge over Shanghai in international finance? What are the historical processes that explain the development of finance in Hong Kong and Shanghai?
- Two, is the current nature of Hong Kong finance different from that of Shanghai? Are there obstacles preventing Shanghai from matching the services offered by Hong Kong to international capital? How would Hong Kong's leadership be threatened by the developing renaissance of Shanghai finance?
- Three, what should the monetary integration of China imply for the future of finance in Hong Kong and Shanghai in both absolute and relative terms? Will economic development in China raise all boats and raise them proportionately? Is the penetration of Hong Kong-based finance into China any different from that of Shanghai? If so, how?

What Explains Hong Kong's Current Edge over Shanghai in International Finance?

Unfortunately, the authors do not sufficiently address the question of what explains Hong Kong's relative success. Yes, it is true that Shanghai is more domestically focused, more closely tied to government bonds, and has natural leadership in commodities, but the advantages of Hong Kong are largely the result of historical legacy. For both cities, domestic and international political economy have defined their historical evolution.

From 1937 to 1992, excepting brief periods of during the Second World War and the Chinese civil war, international finance in Shanghai was effectively shut down. As a communist victory on the mainland became apparent, domestic human capital, technical expertise, and the entire international financial community fled Shanghai, primarily for Hong Kong. Therefore, by edict, finance in Shanghai turned wholly public and domestic. Even the economic liberalization that began in Shenzhen (Guangdong) in 1979 bypassed Shanghai for more than a decade. Not until 1992 did international financial operations resume with the first significant boom in economic activity. From this tumultuous perspective of history, the phoenixlike rise of Shanghai's financial community has been truly extraordinary and without historical precedent.

In comparison, Hong Kong has been the beneficiary of four fortuitous historical blessings. One, as the seat of British Colonial Empire in East Asia, Hong Kong was endowed with the legal and institutional frameworks of the world's leading capitalist nation. It was also plugged into a global network of the largest players in international finance and had direct access to London, then the undisputed financial center of the world. Two, Hong Kong was the regional depository of human capital and technical expertise in international finance that poured out of China between 1945 and 1949. More than merely a technical boost, the immigration *sinified* Hong Kong's human capital and exposure to mainland business networks far more than it had been under the British. Three, with these networks firmly in place by 1979, Hong Kong was ideally positioned, geographically and operationally, to help finance protoprivate enterprises in the Special Economic Zones (SEZs) of nearby Cantonese-speaking Guangdong. The proximity of Hong Kong and the prohibition of international finance in Shanghai effectively gave Hong Kong a thirteen-year head start in Shenzhen and with private financial dealings with China. As a result, Hong Kong was ideally suited to handle a large proportion of international capital flows entering China during the boom that started in earnest in the early 1990s.

A comparative analysis of their recent financial histories suggests that Hong Kong was handed enormous advantages over Shanghai by history, by the accident of war and implicitly by design. Only in the past fifteen years has Shanghai had any opportunity to regain its international stature. Rather than emphasize Hong Kong's advantages over Shanghai as a clear indication of Hong Kong's inherent superiority, perhaps the authors should have given more perspective to the distinctive influences of history. It would have been interesting to examine in detail the initial years of Shanghai's renaissance and its implications for Hong Kong's future.

Is the Nature of Hong Kong Finance Different from That of Shanghai?

The authors also fail to address this question of inherent differences. Although they do acknowledge that Hong Kong's financial leadership may be temporal, they do not provide any behavioral or structural insights into how Hong Kong's approach to international finance is any different from that of Shanghai. Understanding any differences in objectives, constraints, or culture would be essential in predicting the future success of Hong Kong in Chinese financial development.

Nor do the authors suggest the existence of obstacles preventing Shanghai from eventually offering equivalent services to international capital as Hong Kong. Should they in fact exist, they would ultimately be first-order importance. Knowledge of any barriers would affect the relative speed at which Shanghai closes the gap and whether the gap will ever be closed. Understanding these obstacles would also help us determine whether the future of China will feature one or two centers of international finance. Perhaps most important, the existence of obstacles would provide observable indicators that would help evaluate health of both centers.

To promote the supposition that Hong Kong has something special that will prevent Shanghai from eventually dominating international finance in China, the authors could have provided arguments based on either economic or institutional determinants. A short list of factors might include technical efficiency; capacity and economies of scale; human capital; the commitment of and interactions with big players; better ties to real domestic activity, product innovation and customization; and legal, political, and social institutions. Without clear determination of the processes driving Hong Kong's advantage, it is difficult to rule out that Hong Kong's advantages are historical accidents with a finite lifetime.

What Should Monetary Integration Imply for the Future of Finance in Both Cities?

Of course, with China there are two forms of monetary integration: domestic (with Hong Kong) and regional (with Asia). With both, the authors rightly point out that economic development in China thus far appears to be raising all boats. However, their analysis essentially extrapolates current advantages enjoyed by Hong Kong into the future, thereby implying that both financial centers will expand proportionately. Yet it is not likely that government policy will remain passive on such a fundamental issue as determining the center of international finance in China. It seems clear that the combination of global politics and domestic public policy more than natural economic forces has shaped the financial landscape in favor of Hong Kong. If Beijing does intervene and actively promotes one center over the other, then current trends may contain little to no predictive power going forward.

Moreover, it is not altogether obvious that Hong Kong's economic advantages will continue nor for how long. The authors understate the incredible trends in Shanghai since 1992. They leave unaddressed the question of whether the penetration of Hong Kong-based finance into China is any different from that of Shanghai. The authors do not explore the determinants of financial market penetration and expansion nor argue why Hong Kong might possess special advantages over Shanghai. As the clear financial center of Cantonese-speaking China, it remains to be seen whether Hong Kong can extend to greater China the linguistic and cultural advantages it clearly had in Shenzhen and Guangzhou.

Given the absence of any effort to explain the source of Hong Kong's advantages over Shanghai or to provide some basis for how one should predict the future development of international finance, I am left to conclude that the authors' depiction of Hong Kong's strength relative to Shanghai is somewhat of a statistical tautology, a fait accompli. That Hong Kong is clearly ahead of Shanghai in virtually every financial category and continues to leverage its advantages is not particularly interesting nor is it illuminating with respect to future expectations. To provide a more persuasive analysis, the authors should provide some accounting for how history, political economy, and market integration will shape the future fortunes of Shanghai and Hong Kong.

Counterfactual Estimation: Alternative Theoretical Perspectives

In order to estimate the size of China's international banking position and the relative share that might be expected of Hong Kong and Shanghai, the authors adopt the counterfactual estimation methodology of Lane (2000). They impose the relationship of international banking positions to income and economic openness found in Organization for Economic Cooperation and Development (OECD) countries on Chinese data. Throughout, they assume that Hong Kong's share of China's external position remains stable at 40 percent. They find that growth rates for China's cross-border banking position are expected to quintuple over seven years to half of gross domestic product (GDP). They conclude that the projections for Hong Kong suggest that Hong Kong's strength as a financial center looks stable.

While it is certainly not unreasonable to expect that Hong Kong will remain a great financial center for the foreseeable future, there are a number of theoretical and empirical shortcomings to the authors' use of counterfactual estimation. A proper projection would have addressed the deeper economic and political questions that will determine Hong Kong's fate. Rather than bother with the limitations of a quantitative model, I would have preferred the authors to have laid down a qualitative road map to better forecast the fate of Hong Kong.

In the section that follows, I critically discuss McCauley and Chan from four theoretical considerations: historical legacy, institutions and nonlinearities, political economy, and strategic interactions. From each vantage point, I examine the econometric analysis of the authors and the assumptions that underlie its construction. While no single theoretical perspective owns the market on prognostication, each can contribute to the building of an analytical framework that can better contextualize future expectations for Hong Kong and Shanghai.

Implications of Historical Legacy

As presented, Hong Kong's share in China's international banking position is tautological: imposed by the authors at the recent (albeit stable) trend of 40 percent. Yet the current state of international finance in China is conditional upon its unique historical legacy. To impose an ad hoc value to what constitutes the key dependent variable in this discussion seems to undermine the point of this analysis.

Let's assume for the time being that the recent share of 40 percent is representative of some kind of steady state. If so, it would presume a constancy of underlying institutional factors. Change these factors and the steady state itself would change in virtually any economic model. Yet it is clear that China is in the process of resolving its "liberalization trilemma," that is, the challenge that financial liberalization imposes upon the macroeconomic policy framework.[1] As such, it is fundamentally restructuring its financial, legal, and regulatory institutions and has been doing so since 1979. With institutions undergoing fundamental reconstruction, it is difficult to accept the constant 40 percent assumption assigned to Hong Kong's share of China's international finance. What we may be witnessing is simply a local trend that may bear little resemblance to Hong Kong's share once the country as a whole has reached its global steady state.

Moreover, once the potential of Shanghai's financial sector is fully unlocked, the future path of Hong Kong's share is unlikely to be predictable based on past dynamics. The relative strengths of these two financial giants will be largely determined by how well each financial center can service the needs of international investors and global demands to participate in the development of China. The population data in table 1C.1 suggests that development and urbanization remain in their early stages. Where it has taken place has been in areas where Hong Kong has had natural advantages. Whether Hong Kong can continue to lead Shanghai in more neutral areas remains to be seen, particularly as the latter builds critical mass and technical know-how and the former loses its institutional advantages.

One solution to these criticisms would be use of a structural rather than counterfactual model. To properly address the content of this discussion, one needs a model that can examine how market penetration and global positioning might unfold under varying characterizations of Hong Kong and Shanghai. Such a model would be inherently dynamic, whereby structural and institutional assumptions are nontrivial.

1. The financial liberalization trilemma posits that exchange rate flexibility, openness of the capital account, and the extent of domestic financial institutional development are mutually determined: once one dimension is chosen, it endogenizes the other two. See Chow and Kriz (2007) for a complete presentation.

Table 1C.1 Population of China (2005 estimate; in millions)

Overall	
Northwest	89.8
Southwest	173.1
South Central	357.1
East	369.0
Northeast	107.3
North	148.0
Total	1,244.3
Urban	
Northwest	33.6
Southwest	50.0
South Central	107.4
East	171.6
Northeast	56.4
North	55.4
Total	474.4 (38%)

Source: China Business World.

Institutions and Nonlinearity

Given the internal dynamism of China, it is would seem essential to look more closely look at the role of institutions. However, the authors implicitly ignore institutions in both their argumentation and in the way in which the counterfactual estimation is structured. Imposition of data from OECD countries imposes a stable and advanced level of capitalistic institutional development onto China. Doing so avoids the messy although important fact that China has been undergoing a process of fundamentally reconstructing its institutions from those of Maoist Communism.

One outcome of this form of exogenous imposition is that econometric fit will likely overpredict strength during early years of weak institutions and underpredict the same fit in later years of the forecast. I suggest two solutions. One, the authors should capture the effect of evolving institutions. Doing so would address the issue of nonlinearities presently in their estimations. Two, the authors can find data from emerging markets that have successfully reached an advanced level of financial development. The growth dynamics would be a better model for China than that of countries whose capital market development has always been at a relatively high and constant level.

Political Economy

The study of international finance in China *is* the study of domestic and international political economy. As we have noted, the relative financial strength of Hong Kong and Shanghai was heavily shaped by colonization, war, and Beijing's own domestic policies. If the past century is any guide, China's political economy will continue to evolve. Going forward it would seem safe to assume that Beijing will continue to heavily influence the growth and emphasis of both financial centers.

Political prudence dictates that Beijing play Shanghai off Hong Kong in order to avert an asymmetric dominance of one. Although the authors note the tension between Shanghai and Beijing, they do not offer us any insights into how differences between Beijing and Shanghai or the ambivalence in Hong Kong toward the rule of Beijing might influence political control from Beijing.

The authors also fail to address the possible implications of how Hong Kong will be treated once the Basic Law ceases to be. Most assuredly, markets will move in anticipation of signals from Beijing as to its intentions for Hong Kong. Therefore, by not addressing the question of Beijing's intentions, the counterfactual estimation implicitly assumes no change in political economy going forward. Their analysis assumes further that monetary integration with Hong Kong will not play a role in Hong Kong and Shanghai's fate as financial centers.

A solution to the issue of political economy would be a structural model that allows for an exogenous mechanism that can shift both shares and composition. Such a model would generate a wider range of forecasts and produce a more robust sense of market share given Beijing. Only then can we understand how the economic determinants of financial sector development will interplay with the domestic and international political economy.

Strategic Interactions

The authors present a straightforward discussion that assumes away any strategic interplay between these two financial giants. But presumably these two cities with their historical claims to fame as great centers of Asian finance may have something to say. One would imagine that Shanghai will be leveraging its domestic advantages for a greater share of international financial markets. It would be interesting to learn what form that plan might take. Similarly, it would be interesting to know how Hong Kong will continue to present itself as the financial center for China as Shanghai continues to scale and the competitive landscape turns to new markets in China and Asia.

As we alluded to, Beijing will probably have a direct influence on this game, as it has a major stake in the outcome. What are Beijing's plans? Beijing's preferences (not yet revealed) might include market specialization and two international financial centers. Doing so would facilitate political control and improve national security. Its intervention need not be based on purely economic reasons. Counterfactuals remove any such interaction but instead freeze economic relationships at a point in time. As such, the analysis in the chapter biases the results against Shanghai in a way not too dissimilar to a linear extrapolation.

In light of these criticisms, I am somewhat skeptical with respect to both the point of the counterfactual exercise and the interpretation given to its outcome. That China's financial market potential under capitalism would be huge and that Hong Kong will have a major stake go without saying. But as economists, I feel our efforts should be focused on understanding how the financial markets will develop and through what mechanisms. Borrowing institutional relationships from the OECD, imposing them on China, and fixing the relative share of Hong Kong removes the most interesting and important features of financial market development in China. Bringing the historical, political, institutional, and strategic features back in this discussion would provide a much deeper perspective to what is a deliciously complex topic.

Parting Comments

I offer two concluding comments on this thought-provoking chapter. One, this chapter reminds me that institutional and economic dynamism represents two of the final frontiers in macroeconomic and monetary research. The New Keynesian and new open economy macroeconomics (NOEM) revolutions have only recently begun to address what has been the living reality of policy making in emerging markets, particularly those countries undergoing postsocialist transition. The profession needs to introduce more evolutionary political and institutional mechanisms as well as evolving economic structure into mainstream research on emerging markets. In my research work with the ASEAN + 3, I am repeatedly struck by the need for economics to reach back to its intellectual roots in political economy. We should always reflect upon the deep institutional and political assumptions that underlie our elegant models. If we were to take a more holistic approach in emerging markets, then perhaps our record in emerging markets to date would be more enabling than it has been in the past thirty years.

Two, I am left mesmerized by the questions of whether Hong Kong will be able to effectively compete with Shanghai once Shanghai's gloves are off and how Hong Kong will manage their *raison d'être* as a part of the People's Republic of China. I simply do not know the answer to either. However, as a market socialist economy, it is certain that China will continue to direct its development from Beijing. Time will tell how Hong Kong will fit into her plans.

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