Volume Title: Financial Sector Development in the Pacific Rim, East Asia Seminar on Economics, Volume 18

Volume Author/Editor: Takatoshi Ito and Andrew K. Rose, editors

Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-38684-8

Volume URL: http://www.nber.org/books/ito_07-2

Conference Date: June 22-24, 2007

Publication Date: February 2009

Chapter Title: Comment on "Hong Kong and Shanghai: Yesterday, Today and Tomorrow"

Chapter Author: David Cook

Chapter URL: http://www.nber.org/chapters/c0407

Chapter pages in book: (37 - 42)

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## Comment David Cook

### Introduction

The authors have written a compelling case arguing that Hong Kong will continue to thrive as an international financial center even as the further development of the People's Republic of China could result in the growth of a rival financial center in Shanghai. Certainly, current trends are very positive. The finance, insurance, and business services (FIRE and business services less real estate) sector made up less than 10 percent of Hong Kong's economy in 1990 but had grown to more than 17.5 percent in 2005. This indicates both that integration into the mainland economy has not, in fact, dampened the financial industry in Hong Kong but also that continued performance of the sector is crucial for the overall macroeconomic performance of the Special Administrative Region (SAR).

The authors make three basic points based on past historical data, present trends, and a structural forecast of the future. First, in the prewar era, both Shanghai and Hong Kong were measured as significant international financial centers. Second, by many recent measurements, the depth and breadth of Hong Kong's financial markets continue to exceed that of Shanghai's. Third, China's international banking assets are likely to grow dramatically in the future as the economy develops. If Hong Kong's share of China's international banking continues to hold steady, rapid expansion of Hong Kong's banking will continue.

A central contribution of the chapter is a well-founded prediction of the size of China's external banking assets. The authors estimate a statistical

David Cook is an associate professor of economics at the Hong Kong University of Science and Technology

model of a country's external banking assets as a function of its level of development and some other macroeconomic variables using cross-country data. Capital controls have inhibited the acquisition of nonofficial foreign assets by Chinese banks. This model can then be used to predict what will happen to China's external banking assets as it normalizes its integration with world financial markets and continues to develop economically. The authors predict dramatic growth in China's external bank lending. This seems reasonable and may even underestimate financial flows from China. China has acquired a large positive net international investment position relative to its level of development. It would be interesting if the authors could test how a history of positive net flows will increase the positive gross flow of funds by including the net international investment position or average of current account surpluses as an explanatory variable. It may also be useful to evaluate how well the model works for Taiwan, which is another economy that developed with large surpluses.

The authors conclude by noting that if Hong Kong's share of China's external banking assets stays constant, then Hong Kong's financial sector will also enjoy dramatic growth. Given the relative growth rates in the two economies, continued growth in Hong Kong's financial sector of this sort will require the further development of Hong Kong as a financial entrepôt for China as a whole or as a *Chinese* domestic financial center. The following discussion will focus on this aspect of Hong Kong and China's future development.

## Financial Markets

The authors present evidence that along many dimensions, financial markets in Hong Kong are more developed than those in Shanghai. While their case is compelling, there are some caveats as to whether this implies that Hong Kong can continue to develop its role as a financial entrecôte. These caveats might be examined sector by sector.

### Commercial Banking

Banks located in Hong Kong are much larger in aggregate than are the banks in Shanghai. At present, Beijing is the geographical center of commercial banking in China, not Shanghai. As reported in Bowers, Gibb, and Wong (2003), 60 percent of the domestic deposits in the Chinese banking system are held at the four top banks, all of which are majority controlled by the central government. The big four state-owned banks were spun off of the People's Bank of China at the outset of China's reform process and are still headquartered in Beijing, not in Shanghai.

The authors also note that there are large gross international financial flows that are channeled through Hong Kong's banking system. A large fraction of the assets of Hong Kong banks are categorized as Due from

Banks Abroad. The demand for foreign currency deposits in Hong Kong has been much larger than the demand for foreign currency loans leaving Hong Bank banks with an overhang of foreign currency. Prior to 2001, the Hong Kong Association of Bankers set legally enforced ceilings on interest rates on Hong Kong dollar deposits while foreign currency deposits were competitive (see Schenk 2003). As the dominant deposit taking banks in Hong Kong are part of multinational conglomerates, shipping the excess foreign currency to overseas branches is an effective way to eliminate currency mismatch. A large fraction of the assets of Hong Kong banks are, thus, Due *from* Banks Abroad. There are also a large number of foreign multinational banks operating in Hong Kong that have been prevented, in the past, from building branch networks by regulations (since repealed) referred to as the "One Building" rule. Borrowing from overseas branches can be a key source of funds for these banks. Therefore, a large fraction of Hong Kong banks' liabilities are Due to Banks Abroad.

Ironically, these gross international financial flows through the banking system have been encouraged by regulations that have limited competition in the domestic banking sector in Hong Kong. Whether international flows of this type can be a sound basis for believing that Hong Kong will act as a financial entrepôt for China is questionable. The possibility certainly exists. In 2005, about 20 percent of Hong Kong banks' liabilities to banks abroad are to mainland banks, a fact attributed to mainland banks acquiring Hong Kong dollars and lending them back in the Hong Kong money market (Hong Kong Yearbook 2005, chapter 4). In addition, about 8 percent of obligations of banks abroad to Hong Kong banks overseas assets are from mainland banks. As the mainland banking system liberalizes, Hong Kong banks are likely to have a comparative advantage and, perhaps, a regulatory advantage as well in penetrating that market.

As the authors argue, Hong Kong's well-developed commercial banking sector is likely to benefit from an expanding Chinese market. However, given the dominance of banks in China's financial system, decisions about the future geographical location of commercial banking are likely to be decided for public policy reasons. Looking at the U.S. example, we can recall that the Glass-Steagall act was passed to deliberately shape the geography of banking power in the United States. Decision making about the shape of the banking sector in China is likely to be no less political in China.

### Equity Markets

Both Hong Kong and Shanghai have large equity markets. According to the World Federation of Exchanges, in May 2007, both markets had capitalizations of slightly larger than US$1 trillion. Between 1993 and 2005, mainland firms raised more than $100 billion in equity offerings in Hong Kong (Hong Kong Yearbook 2005, chapter 4). In 2005 and 2006, three of the Big Four Chinese state-owned banks had large initial public offerings

(IPOs) in Hong Kong though in 2007 initial offerings have been concentrated in Shanghai (see Kwong, Tucker, and Gangahar 2007). In the immediate term, central government policy is likely to drive the location of equity business in China.

In the longer term, thick market externalities (see Diamond 1982) may be a more dominant factor in moving China's equity markets to a single geographical location. Substantial time series evidence (see Amihud 2002; Pastor and Stambaugh 2003; and Acharya and Pedersen 2005) has shown that the degree of aggregate market liquidity has strong effects on equity prices. If market locations also benefit in the long run from being very liquid, then the increasing returns to scope and scale that would come from concentrating all listings in one market might make it more efficient to have a single major equity market in China, whether that would be in Shanghai or Hong Kong.

### Bond Markets

It can definitely be said that Hong Kong is an international center for bond issuance. Compared to some other developed anglophone countries, the Hong Kong dollar international bond market is relatively large. In 2005, the outstanding stock of international Hong Kong dollar bonds was 38 percent of Hong Kong's gross domestic product (GDP) compared to the Canadian dollar international bond market being 14 percent of Canada's GDP, the Australian dollar market being 21 percent of Australian GDP, and New Zealand being 35 percent.[1] At that same point in time, the renminbi international bond market was negligible.

It is not clear, however, that this implies that Hong Kong can generate a significant fraction of its GDP by being a bond issuing center for China as a whole. Hong Kong's better standards of corporate governance would give it a comparative advantage in issuing corporate bonds rather than public-sector bonds, which might be more easily traded in Beijing. However, neither Hong Kong nor China's domestic corporate bond markets are particularly well developed. Eichengreen and Luengnaruemitchai (2004) report that in 2003, the ratio of domestic credit provided by the banking sector relative to outstanding domestic debt securities issued by the corporate sector was above 150 to 1 in China and above 45 to 1 in Hong Kong. In a market so dominated by banking, the corporate debt market may continue to be less significant.

### Derivative Markets

In the 2004 data cited by the authors, forex and interest rate derivative trading was much larger in Hong Kong than in Shanghai. However, a more

1. These figures are calculated using data on the stock of bonds from the Bank for International Settlements (2007) and from data on GDP from the World Bank's World Development Indicators.

global comparison may offer some perspective. For example, the authors report that in April 2004 that the monthly average of the over-the-counter trading in interest rate derivatives in Hong Kong was approximately US$11 billion. On a good month in 2006, the trading in interest rate products at the Hong Kong Futures Exchange (see Hong Kong Exchange and Clearing 2007) was about HK$1 billion. As a comparison, on any given day in 2006, about 2 million interest rate contracts with a total notional value of US$2 trillion were traded on the Chicago Mercantile Exchange. The point is not to compare Hong Kong's market negatively with the longest existing financial derivatives markets. However, in comparison with the ultimate size of China's needs in terms of trading interest rate risk, Hong Kong's current lead may not prove decisive.

## Conclusion

To help us further understand Hong Kong's future role as an international financial center, specific discussion of the SAR's role as an intermediary for the flow of funds between the mainland and foreign countries would be useful. As the authors note, both Hong Kong and Shanghai operated as symbiotic banking centers in the prewar era. Clearly, that was the product of a specific series of historical circumstances. Hong Kong's relatively sophisticated economy, well-regulated market, and liberal international policies have granted the region a very well-developed financial system with a great deal of participation by multinational financial companies. However, given the early stage of development of China's own financial markets, Hong Kong's real existing advantages are insufficient to guarantee a continued role in the future equivalent to the current day. Much will depend on policy decision made in Hong Kong and Beijing. Current developments provide grounds for optimism. Up to the current day, policy changes are being made that should make it easier and more profitable for Hong Kong's financial sector to act as a financial entrepôt.

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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.

Peter Nicholas Kriz is an assistant professor of economics at Singapore Management University.