Towards an International Financial Centre for Greater China: Hong Kong and Infrastructural Reform

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TOWARDS AN INTERNATIONAL
FINANCIAL CENTRE FOR GREATER CHINA:
HONG KONG AND INFRASTRUCTURAL REFORM

Joseph J Norton*

Introduction

1997 has been a key year in deciding whether China is successful in learning from its prior experiences and from the experiences of others, and continuing its story of growth with the necessary pattern of financial stability. Two events underlie the importance of 1997: first, the reunification of Hong Kong with China on 1 July 1997, and second, the results of the 15th Party Congress in September 1997. While the reunification of Hong Kong and China is perhaps the most important event for China since World War II, the 15th Party

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1 Since 1978, China has taken major steps in the transformation and modernisation of its economy. These reforms, starting from basic reform of agricultural relationships, have progressed towards 'socialism with Chinese characteristics' to the goal of the creation of a 'socialist market economy,' now enshrined as 'Deng Xiaopeng Theory' at the 15th Party Conference by Jiang Zemin. Not only have these changes led to impressive growth of the Chinese economy, but to a large extent have been successful in the face of Western theories of economic reform, especially as manifested in the reform processes of the transitional economies of Central and Eastern Europe and the former Soviet Union.

2 Chinese growth in many ways is reminiscent of the growth rates and patterns of other Asian economies, such as Japan, South Korea, and Thailand. In this resemblance to the other Asian economies lies another potentially serious problem for China: today, Japan, Korea, and Thailand all face severe financial crises brought about by their policies of non-transparent and non-rule of law-oriented financial growth. See eg S Sagawa, 'Market Troubles Felt Far and Wide' International Herald Tribune, 8 November 1997, p 1. The goal then is to learn both from the failures of the other Asian economies in order to avoid their present problems, while emulating their successes in economic development and at the same time solving China's own serious problems with its state-enterprise sector.

3 China's economy has grown at an average rate of 9 per cent in real terms for the past fifteen years and is now one of the ten largest economies in the world. GDP growth in 1996 was 9.7 per cent, while inflation decreased from more than 20 per cent in 1994 to 6.1 per cent in 1996. Further, economists predict that GDP growth will exceed 10 per cent in 1997. While these results are impressive, China faces a number of very serious blockages to its continued development, not the least of which is the dire economic condition of many of its state-owned enterprises and the direct and interconnected relationship of the problem to the banking and financial system and to government and the population in general. For a description of these problems, see J Norton, 'Receptivity of International and Domestic Capital Markets to State-owned Enterprises in China: Criteria and Relevant Issues' in W Ebke (ed), Festschrift for Bernard Grossfeld (forthcoming 1998).
Congress is potentially of even greater importance for the future of both mainland and greater China (ie mainland China, Hong Kong, and Taiwan). At the conference, President and General Secretary of the Communist Party, Jiang Zemin, presented his strategy for the future development of China in his Report to the 15th Party Congress. This report is significant because it details an ambitious plan of developing the Chinese economy into the next century, and provides important guidance for the resolution of the problems with its state-owned enterprises (SOEs), developing capital markets within a ‘mixed economy,’ solidifying the legal system, and assuring the stability and continued success of the Hong Kong Special Administrative Region (HKSAR). The importance of this plan is that it has solidified the confidence of both domestic and international financial markets as to the future of the HKSAR and the continued economic development of China.

As a commentator external to both China and Hong Kong, this author attempts to provide perspective and a few modest suggestions based on his experiences as a student of the role of financial law in economic development around the world and as to the future development of mainland China and the HKSAR, given the political decision to pursue a system of ‘one country, two systems’ that lies at the heart, inextricably now, of their mutual development.

With that as background, the following sections of this article will touch on a number of points in relation to China and the HKSAR, all in the context of the developing international consensus on the role of financial law in setting the foundation for and promoting financial stability which is now widely recognised as one very important aspect of economic development. The first section will address the question of what China can gain from the HKSAR in regard to its greater financial development under the structure ‘one country, two systems.’ The following section will discuss how China can maximise these advantages by maintaining and developing the HKSAR as an international financial centre, with the ultimate possibility in the next century of being of equal prominence to New York, Tokyo, and London. Then, the article will provide a summary of a few basic principles that now represent the international consensus on requirements for the role of law in creating and maintaining financial stability and growth. Finally, the last section will present a few comments and suggestions on how China and the HKSAR can develop in the future in such a way as to maximise the development of both financial systems within the single country of the PRC and in greater China.

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The importance of the HKSAR for financial development within mainland China

The reunification of Hong Kong with China offers a unique opportunity for the development of China: the handover of an important and sophisticated international financial centre with its developed infrastructure of laws and human expertise. With the reunification, China is poised to develop the HKSAR into an international financial centre of the first order, rivalling New York, London, and Tokyo in the next century. Further, under the provisions of the Basic Law, the HKSAR is to maintain its status as an international financial centre. While the HKSAR is already a significant international financial centre, following its reunification with mainland China it now has an advantage that it never had before and that has been essential to the development of other world-class financial centres: access to one of the world's largest economies and, perhaps equally importantly, to one of the world's highest savings rates. The advantages for the highly ambitious inhabitants of the HKSAR are immediately obvious.

The next question then is what might be the advantages for China as a whole of the reunification with Hong Kong, specifically in the context of financial development and stability. Beyond the long-term goal of perhaps becoming one of the world's leading financial centres and the commitments embodied in the Basic Law, the HKSAR offers more immediate benefits to China in three principal ways. First, the HKSAR can continue to act as a window for mainland China to the international financial system. Second, the experiences of the HKSAR can serve as a teacher and a laboratory for further development of the mainland's financial system. Third, the continued success of the HKSAR will serve as an example to the international financial system generally of China's commitment to financial development and stability and, more particularly, to Taiwan of the benefits of reunification with China, thus increasing the confidence that lies at the heart of financial development and stability.

The HKSAR as a window for mainland China to the international financial system

It is widely recognised that, today, finance is no longer conducted purely on a local basis but rather is carried on within the context of a continually

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5 BL109: 'The Government of the Hong Kong Special Administrative Region shall provide an appropriate economic and legal environment for the maintenance of the status of Hong Kong as an international financial centre.'

6 For an analysis of Hong Kong's strengths and weaknesses as an international financial centre, see R Yan-Ki Ho, 'Hong Kong as an International Financial Centre' in R Ho, R Scott, and K Wong (eds), The Hong Kong Financial System (Hong Kong: Oxford University Press, 1991), p 381.
Countries and enterprises increasingly look to international and foreign markets for their financing needs, as well as for opportunities to expand markets for their own products and services. In this regard and of most direct relevance, according to recent World Bank studies, China is estimated to need US$774 billion over the next decade for the development of its internal infrastructure. While China has one of the highest savings rates in the world, it will be unable to fund these sorts of needs from entirely domestic sources in the near term.

At present, Hong Kong is one of the leading international financial centres in the world: it is the fifth largest banking centre for external financial transactions, the fifth largest foreign exchange market, the seventh largest stock market, the eighth largest trading entity, and the busiest container port.

The benefits for China are obvious on their face, but should be mentioned briefly nonetheless.

First, Hong Kong has an effectively functioning financial market infrastructure, with a large interbank market, effective payment and settlement mechanisms, and extensive market diversity and depth. All of these are essential for attracting investors and for handling large capital flows. Second, it possesses a transparent, effective, and rule-based system of financial law that inspires confidence in both domestic and international investors. For this reason, the HKSAR can be an important window for Chinese companies seeking to raise capital, from both domestic and international sources, and for international investors, including overseas Chinese, to invest in China. Third, the HKSAR is well-known for its financial innovation and can therefore provide an important source of expertise and creativity for the needs of Chinese financial undertakings. Fourth, Hong Kong has a large and experienced resource base of financial professionals and international intermediaries — a vital edge over competitors such as Singapore. Perhaps more importantly, while China is making rapid steps in the development of these sorts of infrastructure in its own markets, rather than facing an uncertain period of necessary development.


The effectiveness of Hong Kong's financial infrastructure was graphically tested and emphatically proven during the recent stock market fluctuations of October 1997. See, inter alia, 'Hong Kong: A Rubbery Sort of Economy,' *The Economist*, 1 November 1997, p 108. This is in marked contrast to the situation in 1987, when Hong Kong's markets were suspended and a HK$4 billion rescue package had to be assembled to prevent the bankruptcy of the futures market. See K Wong, 'The Hong Kong Stock Market' in Ho, Scott, and Wong (note 6 above), p 215.

See *National Treatment Study* (note 10 above).

within its own emerging financial markets, China now has immediate access to all of these systems in a fully developed format.14

Of course, this is not a new role for Hong Kong, and the HKSAR should continue to serve as a window to the international financial system for mainland China. Further, the two economies and financial systems are already inextricably linked. A few statistics show the magnitude of this involvement: according to statistics released recently by the Census and Statistics Department, China is the third largest external investor in Hong Kong, after the United Kingdom and Japan.15 At the end of 1994, China's direct investment in Hong Kong totalled US$17 billion, accounting for 18 per cent of the overall inward direct investment in the territory.16 During 1996, investment from China to Hong Kong was US$20.87 billion, out of a total Chinese foreign investment of US$54.8 billion.17 Moreover, China has had great success with securities offerings in Hong Kong, and in trading volume for foreign-listed Chinese companies the HKSAR is dominant, indicating that it has become the favoured trading market for Chinese companies.18 Once again, Hong Kong's role as a financial window for the mainland is not new, but with reunification it has the prospect of increasing its role to the greater benefit of both systems.

One example of a great success in this area has been the development of standards for the listing of Chinese companies in Hong Kong. In 1993, the Securities and Futures Commission, the Stock Exchange of Hong Kong (SEHK), the China Securities Regulatory Commission (CSRC), the Shanghai Securities Exchange, and the Shenzhen Stock Exchange signed a Memorandum of Regulatory Co-operation.19 This agreement created the regulatory framework which enables mainland enterprises to list in Hong Kong as H-shares. As mentioned above, the H-share market has been arguably a greater success than the N-share market in New York. This success demonstrates the strong role that the HKSAR can continue to play for China in its efforts to access international capital.

Lessons from the HKSAR for the financial system of mainland China

According to a Chinese proverb, 'one can use stones from those hills to polish one's gem.'20 This is an extremely apt metaphor for use in regard to the

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14 This is a topic of great importance to the regulatory officials of the HKSAR; see http://www.hksfc.org.hk (text of speeches by SFC officials regarding Hong Kong's role as an international financial centre). See generally J Norton and Y Huang (eds), Risk and Regulation in Chinese Financial Markets (forthcoming 1998) (describing China's emerging systems of financial market regulation).
16 Ibid.
17 Ibid. While recent events have caused some uncertainty in China, Hong Kong's status seems unlikely to change.
18 Hong Kong Securities and Futures Commission (HKSFC), Confidence in the Markets (Hong Kong: HKSFC, June 1997).
relationship between the HKSAR and mainland China. Under the Joint Declaration and the Basic Law, China has determined that it will maintain Hong Kong's capitalistic system for a period of fifty years, thus creating an internal structure for the PRC of 'one country, two systems.' While the ultimate goal of China's development is the creation of a 'socialist market economy' under 'Deng Xiaopeng's Theory,' achieved through the process of 'crossing the river by feeling for the stones,' the HKSAR will retain its present system until mid-way through the next century, if not longer. Obviously, one of China's intentions in the creation of this relationship was to benefit from Hong Kong, not only as a window to the international financial system, but also as a teacher and as a stone to use in its own greater development.

In the context of China's financial development, Hong Kong's role as a teacher must be viewed through the glass of an important emerging international consensus on the role of financial stability for economic development. Today, scholars, governments, international institutions, and businesses recognise that one of the most important aspects of economic growth for any economy is financial stability. Financial stability is crucially based on the underlying legal and financial infrastructure in an economy, and for the first time an international consensus is developing on exactly what is necessary in the way of legal and financial infrastructure for financial stability.

This emerging financial consensus can be seen to be the result of two separate series of events since the collapse of the Bretton Woods system in 1972. These series of events can be classified along two axes, one based on the experience of the developed economies and one based on experiences within emerging economies. First, the growth of international co-operation and the establishment of minimum standards in the area of regulation of financial institutions has come to be viewed as essential in order to maintain and strengthen the confidence and integrity of the international financial system. This trend is reflected in the development of the Basle Committee on Banking Supervision as a response to various crises involving international financial institutions since the 1970s and the increasing importance and effectiveness of its pronouncements in the area of financial institutions regulation and

21 Basic Law, Preamble ('one country, two systems'), Art 5 ('The socialist system and policies shall not be practised in the Hong Kong Special Administrative Region, and the previous capitalist system and way of life shall remain unchanged for 50 years.').


23 These ideas are being increasingly formalised: see Basle Committee on Banking Supervision, Core Principles of Effective Banking Supervision (September 1997), in which both Hong Kong and the PRC were involved in the formulation. IOSCO is also presently developing its own set of general principles for securities regulation. Information regarding IOSCO documents can be found at its internet homepage at http://www.iosco.org. See J Norton and D Amer, 'International Co-operative Efforts in the Realm of Financial Crises in Developing Countries' in R Lastra and H Schiffman (eds), Bank Insolvencies in Emerging Economies (forthcoming 1998).
supervision. Further, international co-operation in this area continues to be of increasing importance to the developed economies as financial and technological innovation and internationalisation continues at a rapid rate, as demonstrated by recent intense focus on the areas of derivatives, payment, and settlement systems throughout the world.

The second strand of developing consensus is the realisation of the importance of domestic financial stability for developing countries, especially given their potential vulnerabilities to changes in capital flows within the international financial system. In many ways, this emerging consensus is the result of the 1980s debt crisis and the Mexican peso crisis of 1994-5, and is today being echoed in an all too substantial form by events in South East Asia. The consensus in this area is that, in order to develop economically, emerging markets must have in place appropriate structures to guarantee financial stability, especially given the increasing mobility of international capital and the reliance of emerging markets on that capital to fund their own development processes.

Today, these two strands are increasingly coming together as the line between developed and emerging economies continues to blur and as both are more closely integrated into the international financial system. As Japan is experiencing today, an effective financial infrastructure is as necessary to a developed economy as to an emerging economy, such as Thailand, although, as both Thailand and Mexico have experienced, it can be easier for a developed economy to successfully extricate itself from problems than for an emerging economy. Beyond this intertwining, this consensus can be seen to have developed in a similar fashion to most regulatory developments: as a response to a significant crisis that exposed the weaknesses in the then-existent system, weaknesses that generally only became evident with technological and financial innovation.

With this background, the HKSAR has three important assets as a teacher of financial stability to China. First, Hong Kong has developed its present...
system of financial law and regulation over time in reaction to the needs of its
system for development and in reaction to significant internal and external
crises.31 If China learns from Hong Kong’s experience, it may be able to avoid
certain pitfalls in relation to financial stability that other economies have
experienced on their paths to development. Second, the HKSAR bridges-the
gap between an emerging market and a developed economy. As such, it
possesses important experiences with the implementation of international
financial standards that may be very instructive for China. Moreover, the
HKSAR has played and, one hopes, will continue to play an important role in
many of the processes that lead to the formulation of international consensus
in the necessary requirements for financial stability, both domestic and
international.32 Third, Hong Kong has the human infrastructure and experi-
cence to be a teacher in a direct sense for mainland regulators to gain experience
with the workings of a developed financial system and the role of law and
regulation therein.

Experience-based system of financial law

First, the HKSAR possesses a transparent, effective, and rule-based system
of financial law that inspires confidence in both domestic and international
investors. More importantly, the HKSAR has developed its system of financial
law through the classic methodology of crisis response.33 In other words, the
HKSAR financial system has already experienced many of the crises of
development that China can expect to face in the future and has developed a
legal and regulatory structure to respond to crises. For this reason, regulators
and professionals from Hong Kong can provide important experience and
know-how for the development of Chinese financial law, and from a Chinese
perspective.

As a result of this developmental process, the HKSAR possesses an effective
and tested system of financial regulation and supervision that can be very
instructive for the mainland’s greater efforts in this regard. As recent crises from
Mexico to Bulgaria to Thailand have shown, effective financial regulation and
supervision are at the heart of the development of a stable financial system.34

31 See generally, Ho, Scott, and Wong (note 6 above). See also I Tokley, Hong Kong Banking Law and
Practice (Hong Kong and Singapore: Butterworths Asia, 1996) and T Ghose, The Banking System of
Hong Kong (Singapore: Butterworths, 1987).

32 Anthony Neoh, Chairman of the HKSCF, also serves as Chairman of the Technical Committee of
the International Organisation of Securities Commissions (IOSCO). In that position, he has played
a leading role in the development of IOSCO’s minimum standards and core principles for securities
regulation, drafted at the behest of the Group of Seven (G-7) following the events of the Mexican

33 It is anticipated that Hong Kong will put the experiences it has gained in the present climate of crisis
and volatility in South East Asia to good use as well, although from the differences in results between
1987 and 1997, the previous lessons were obviously learned and the resulting reforms well-
implemented.

34 See, inter alia, P Honohan, ‘Banking System Failures in Developing and Transition Countries:
Diagnosis and Predictions,’ BIS Working Paper No 39 (January 1997); M Goldstein and P Turner,
‘Banking Crises in Emerging Economies: Origins and Policy Options,’ BIS Economic Paper No 46
(October 1996).
The strength of Hong Kong's financial system lies in its proven financial market infrastructure, a significant interbank market, effective payment and settlement mechanisms, and extensive market diversity and depth. As reflected in the recent G-10 Report on Financial Stability in Emerging Market Economies, these are all important keys to the development of a stable financial system.\(^{35}\) China is developing these sorts of infrastructure and the experience of the HKSAR is potentially invaluable. Further, the HKSAR has extensive experience with financial innovation and can therefore provide an important example to Chinese financial undertakings.

Further, in regard to the mainland's central problem of its state-owned enterprises (SOEs), Hong Kong has an effective legal and infrastructural framework to facilitate the formation, registration, and regulation of limited liability companies.\(^ {36}\) Their expertise in this area is potentially extremely helpful as the mainland develops its own systems of corporatisation, destined to go forward following the plan presented at the 15th Party Congress. Importantly in the context of China's present difficulties with its SOEs, Hong Kong has a developed system of insolvency law that has evolved over time in order to meet the needs of domestic companies, investors, and creditors.\(^ {37}\) Not only does this provide immediate experience with insolvency administration and the mistakes that can be made, it also provides an insolvency mechanism outside of China to deal with failed companies that are registered in the HKSAR.

Financial infrastructure based on international standards

Third, the HKSAR has and will continue to play an important role in the development of international standards for financial regulatory standards, such as those by the Basle Committee on Banking Supervision, the International Organisation of Securities Commissions, and the International Accounting Standards Committee. Under the framework being established by the Group of Seven/Eight, these sorts of international financial organisations are of increasing importance in the promulgation of internationally accepted and acceptable standards for international and domestic financial stability.\(^ {38}\) As these sorts of standards are developed and implemented of necessity, either at the demands of international markets or at the hands of international financial institutions such as the International Monetary Fund or the World Bank, it will become increasingly important for emerging economies not only to understand their contents but to be able to implement their terms, both specific and general.

\(^ {35}\) See G-10 Report (note 22 above).
\(^ {36}\) See generally P Smart, K Lynch, and A Tam, *Hong Kong Company Law: Cases, Materials and Comments* (Hong Kong: Butterworths Asia, 1997).
In the area of financial regulation, Hong Kong has long been at the forefront of the adoption and use of international standards. For example, the Basle Capital Accord of 1988\(^{39}\) has been applied in Hong Kong since the end of 1989, with its internationally accepted minimum capital adequacy ratio of 8 per cent.\(^{40}\) As an indicator of the success of its implementation, at the end of December 1996 the consolidated capital adequacy ratio of all locally incorporated institutions in Hong Kong was 17.8 per cent.\(^{41}\)

Further, the Hong Kong Monetary Authority (HKMA) follows international trends for best practice in the area of financial regulation as they develop.\(^{42}\) For example, in January 1996 the Basle Committee issued proposals for applying capital charges to market risks incurred by banks.\(^{43}\) From 31 December 1996 the HKMA implemented a reporting framework on market risks, with the revised capital adequacy regime taking statutory effect by the end of 1997, in line with Basle requirements.\(^{44}\) The HKMA also follows international practice in regard to the supervision of international banking operations as embodied in the revised Concordat.\(^{45}\) In addition, the minimum standards for the supervision of international banking groups established by the Basle Committee in July 1992 have been taken into account in establishing the manner in which the authorisation criteria are to be applied to overseas applicants.\(^{46}\)

Further, the Securities and Futures Commission (SFC) is extremely active internationally, with its Chairman, Anthony Neoh, also acting as the current Chairman of the Technical Committee of International Organisation of Securities Commissions (IOSCO).\(^{47}\) As such, the SFC and Hong Kong are extremely well-placed not only to implement international standards of best practice in its securities markets, but in fact are leading the development of those standards for the rest of the world. The SFC is active in signing Memoranda of Understanding and similar co-operative agreements with

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\(^{40}\) See Tokley (note 31 above).


\(^{42}\) Hong Kong Monetary Authority (HKMA), Annual Report 1996.

\(^{43}\) Basle Committee on Banking Supervision, *Amendment to the Capital Accord to Incorporate Market Risks* (January 1996).

\(^{44}\) HKMA (note 42 above).


\(^{47}\) For information on IOSCO, see their website at http://www.iosco.org.
securities and futures regulators around the world and is actively involved in the IOSCO.48 Finally, IOSCO, along with the IASC, is in the process of developing internationally acceptable accounting standards, with the hope of uniting the international financial system with a single language.49 These standards will set the benchmark by which any Chinese company seeking to access international financial markets will be judged. Importantly, following reunification, the SFC will continue to be a full independent member of IOSCO.50

Existence of significant human capital resources within the HKSAR

Along with its developed financial infrastructure and internationally oriented system of financial law, the mainland now has immediate access to all of the human expertise that goes along with the successful running of a modern international financial system. These lawyers, accountants, businessmen, regulators, judges, etc can provide an immense source of human capital for China in its future development.

Importantly, the HKSAR and the mainland have already begun to take advantage of the human capital element. For example, in 1995 an agreement concerning regulatory co-operation was signed between the SFC and the Chinese Securities Regulatory Commission (CSRC).51 As part of these cooperative relationships, the SFC, the Stock Exchange of Hong Kong (SEHK), and the Hong Kong Futures Exchange have a training programme for PRC regulators and exchange officials, as well as ongoing programmes for executives of H-share companies on the regulatory system, listing rules, take-overs and mergers rules, and investor relations.52 Likewise, the HKMA and the People’s Bank of China (PBC) have instituted mutual secondment programmes designed to increase understanding, co-operation, and effectiveness within both systems.53

Demonstration effect for confidence in China

Finally, China’s success in reunification with Hong Kong will have important demonstration effects, both internationally and for the future of Taiwan. First, from the perspective of the international financial system, if the HKSAR continues to be a successful financial centre, this will serve as an important demonstrative example of China’s commitment to economic development and financial stability. This will inspire confidence in China and in the HKSAR, and confidence brings financial stability and investment.

49 See IOSCO, Annual Report 1996. See also the website of the IASC at http://www.iasc.org.uk.
50 HKSFC (note 48 above).
51 Ibid.
52 Ibid.
53 HKMA (note 42 above).
Second, if the reunification of Hong Kong with mainland China is successful, then this will have an important demonstration effect for further efforts to unify greater China or to create a formal 'Chinese economic circle.' While this point is rather obvious, it is nonetheless important: if mainland China and Taiwan are to be peacefully reunified, the reunification process with Hong Kong must be successful. More importantly, Taiwan must perceive that China's commitment to 'one country, two systems' in the Joint Declaration and the Basic Law are meaningful and can be relied upon, before it will be willing to walk down the same path as Hong Kong.\(^5\)

*Maintaining and developing the HKSAR's status as an international financial centre: important issues impacting policy choices in regard to the HKSAR*

Given the potential importance of the HKSAR for China, this section will suggest several ways in which China can help to ensure that the HKSAR retains its present strength as an international financial centre and thereby enhance its contribution to China, as well as fulfilling her commitments to the HKSAR under the Basic Law.

*Effective regulation and supervision of the financial system*

As noted above, a safe and efficient financial system is absolutely essential for the functioning of the economy.\(^5\) In order to retain and increase the position of Hong Kong as an international financial centre, China must allow effective financial regulation and supervision to continue. It is in the interests of China to maintain confidence and integrity in the strength of financial institutions in the HKSAR. If effective regulation and supervision are not maintained, domestic and international confidence will suffer, weakening the financial markets not only in Hong Kong but also on the mainland.

While Hong Kong has not always had effective systems of financial regulation, it has been steadily strengthening its regulatory framework both for financial institutions and for the securities markets.\(^6\) It is because of the effectiveness of its legal and institutional regulatory framework that it has developed so successfully as an international financial centre. One example of the HKSAR's effectiveness lies in the creation of the HKMA and its provision of clear powers and responsibilities. The HKMA was established by the Hong

\(^{54}\) For a contra point, see S Cooney, "Why Taiwan is not Hong Kong: A Review of the PRC's "One Country Two Systems" Model for Reunification with Taiwan" (1997) 6 Pacific Rim Law & Policy Journal 497.

\(^{55}\) For a contemporary and far-reaching analysis in the context of the Australian financial system, see Committee of Inquiry into the Australian Financial System, Financial System Inquiry Final Report (March 1997) (Wallis Report).

\(^{56}\) See generally US Department of the Treasury (note 10 above), pp 261-98; Tokley (note 31 above); Ho, Scott, and Wong (note 6 above); and Ghose (note 31 above).
Hong Kong government on 1 April 1993.\textsuperscript{57} With effect from that date, the former Office of the Commissioner of Banking was merged with the Office of the Exchange Fund to form the HKMA, with the functions of the former Commissioner since being subsumed under the HKMA.\textsuperscript{58} Under the Banking (Amendment) Ordinance 1995 enacted on 28 June 1995, the HKMA is now responsible for all authorisation matters, including authorisation, suspension, and revocation of all three types of authorised institutions, namely licensed banks, restricted licensed banks (RLBs), and deposit-taking companies (DTCs).\textsuperscript{59}

At the end of 31 January 1996, there were 182 licensed banks, 62 RLBs, and 124 DTCs in Hong Kong.\textsuperscript{60} Of these 368 authorised institutions, 334 were owned by interests from over 30 foreign countries.\textsuperscript{61} In addition, there were 157 representative offices of foreign banks.\textsuperscript{62} There are now 35 China-related authorised institutions, of which 18 are licensed banks.\textsuperscript{63} The Bank of China Group (BoC) is the second largest banking group in Hong Kong, second only to the Hongkong Shanghai Banking Corporation (HSBC).\textsuperscript{64} Moreover, the BoC became one of the three note-issuing banks in Hong Kong in 1994.\textsuperscript{65} This increasing presence of mainland financial institutions increases the need for the HKSAR to retain its effective systems of financial regulation and supervision. Importantly, the PBC and the HKMA have been working closely together and have retained their separate responsibilities. Further, the HKMA has retained its independence and must continue to do so in order to continue to be effective. With China’s commitment now embodied in the principle of ‘one country, two currencies, two monetary systems and two monetary authorities’ that are mutually independent, the HKMA is set to maintain and strengthen its important role in Hong Kong.\textsuperscript{66}

In the area of securities regulation, Hong Kong has made a sustained effort to develop its securities legal and financial infrastructure since the world-wide market collapse of 1987,\textsuperscript{67} an endeavour which has proven relatively successful in sustaining itself through the recent financial crisis in South East Asia. While securities regulations were not always given the attention they deserved, the experience of the United States in developing its domestic capital markets after the 1929 crash suggest that such regulation in the interests of investor protection and disclosure is essential to the development of capital markets of

\begin{itemize}
\item See HKMA (note 42 above); and Tokley (note 31 above).
\item Ibid.
\item Ibid.
\item Ibid, p 91.
\item Ibid, pp 92-3.
\item Ibid, p 91.
\item Ibid, p 92.
\item Bank of China, \textit{Annual Report 1996}.
\item Tokley (note 31 above).
\item HKMA (note 42 above), p 6.
\item See K Wong, ‘The Hong Kong Stock Market’ in Ho, Scott, and Wong (note 6 above), p 215.
\end{itemize}
significant depth and liquidity.\textsuperscript{68} Efforts in this direction include the creation of the SFC and the strengthening of the regulatory effectiveness of the HKSE. These efforts have enabled Hong Kong to become the second largest stock market in Asia, after Tokyo.

As mentioned before, the SFC and other HKSAR regulatory entities have developed close working relationships with their mainland counterparts. Further, the HKSAR securities regulators must remain independent and effective in their efforts. As experience in other markets has shown, the quickest way to destroy the confidence built up over time is to allow the regulators to weaken and the system to be seen as corrupt or unfair. As is shown again and again, capital can move out of a market just as quickly, if not quicker, than it moved in. In this regard, China's demonstration during October 1997 of its commitment in regard to the separation of responsibility for the HKSAR financial system from that of China is significant.

**Maintenance of a culture of financial innovation**

One of the strengths of Hong Kong as an international financial centre has been a tradition of financial innovation. In many ways, this is a cultural trait of common law legal systems in that if something is not prohibited then it is presumed to be allowed. In the area of finance, this is an important attitude to allow to continue. If this attitude is destroyed, then financial innovation is stifled and Hong Kong would lose out to competitors like Singapore. Further, regulators must be prepared to face the possible threats that may be posed by financial innovation, but they should not be directed to prevent the development of new products and risk-sharing techniques.

Presently, the HKSAR possesses a sophisticated and effective system of securities regulation. Such a system is vital to the continued success and development of capital markets in the HKSAR. Present systems of accounting, disclosure, transparency, and enforcement must not be softened. While it may be tempting to do so in the face of pressure from mainland companies desiring to access these capital markets, the experience of the United States in this respect is most instructive: with the strictest standards and enforcement in the world, the United States also has the most successful capital markets. Today, rather than weakening standards, Japan and Europe are increasing their own standards in an effort to increase investor confidence and hence investment.\textsuperscript{69}

\textsuperscript{68} For development of this hypothesis, see J Seligman, *The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance* (Boston: Northeastern University Press, 1982).

\textsuperscript{69} For a discussion of this trend in the context of Europe, see B Steil et al, *The European Equity Markets: The State of the Union and an Agenda for the Millennium* (London: Royal Institute of International Affairs, 1996).
As the people of Hong Kong have shown throughout their history, if given the opportunity they will succeed and prosper.\(^7\) While financial regulation is necessary to set the boundaries of the game, it should not restrict the development of that game beyond the need to cure market inefficiencies and reduce potentially systemic risks. Once again, HKSAR regulators have shown themselves to be up to the task and should be allowed to remain independent and market-enhancing. In fact, this is central to the missions of both the SFC and the HKMA.

**A strong rule of law**

The emerging international consensus is that a transparent, predictable, and enforceable legal regime underlies successful economic development.\(^7\) The Basic Law of the HKSAR provides for a stable starting point from which the presently existing legal regime of Hong Kong can continue to operate. It is important for investors and businesses to feel that their investments are safe, and can be protected in order to provide the necessary confidence in the financial system. The recent exodus of companies from the HKSAR registers to those of foreign jurisdictions clearly illustrates this point.\(^2\) While this point is often made, it is important to realise that it is necessary not to undermine the legal order allowing small derogations, since a great flood is the product of many single raindrops.

Hong Kong has an effective legal tradition and infrastructure, developed to meet its needs for financial development. As instructed by the Basic Law, these structures must be allowed to continue effectively and to adjust as necessary to the needs of the HKSAR marketplace. Without moving into complex questions of interpretation raised by the status of the Basic Law within the Chinese legal system and in relation to the Chinese Xianfa, it is simplest to say that Hong Kong people are effective at policing themselves and should be allowed to continue to do so, with minimal interference.\(^7\) Despite this general principle, increased contact and interlinkages between law schools and scholars between the HKSAR and the mainland should be encouraged. After all, many difficulties can be avoided in the future if the two systems are able to understand the respective legal language and tradition of the other.\(^7\)

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\(^{70}\) See A Neoh, 'Hong Kong's Future: The View of a Hong Kong Lawyer' (1992) 22 California Western International Law Journal 309.

\(^{71}\) See G-10 Report (note 22 above).


\(^{73}\) See eg Zhao (note 20 above) and A Jordan, 'Lost in the Translation: Two Legal Cultures, the Common Law Judiciary, and the Basic Law of the Hong Kong Special Administrative Region' (1997) 20 Cornell International Law Journal 335.

\(^{74}\) See Zhao (note 20 above).
Effective administrative and judicial enforcement

The 'rule of law' as to economic or other societal regulation is of little practical value unless fair and effective enforcement can be attained and sustained. As such, the HKSAR regulatory authorities will require adequate personnel and technological capabilities to ensure effective enforcement. The enforcement must also be fair, both substantively and procedurally; this will require transparent and judicially reviewable administrative processes. Also, administrative enforcement cannot be entirely fair and effective without an independent, well-educated, and non-corrupt judiciary. Further, effective enforcement will require vigorous and non-politicised cross-border co-operation among the HKSAR and mainland authorities, and ongoing co-operation with other key financial institutions/markets regulators on a global basis. The current state of Hong Kong's banking and securities regulatory structures and judiciary, if maintained and further enhanced, undoubtedly will prove the 'linchpin' for future success in these efforts.

Freedom from legal and political restrictions on capital movement

In the late 1950s, the United States instituted certain currency controls that led in part to the development of the Euromarkets in London. This development was buttressed in the 1960s and 1970s by fears among some Middle Eastern countries that investments in New York might not be safe from US political decisions. Essentially, this indicates that, if China seeks to develop the HKSAR as a world-class international financial centre, (1) currency movements should not be restricted in and out of the region, and (2) investors must feel that their investments in Hong Kong (and China as a whole) are in fact safe from government political decisions. While this is generally applicable to the entire role of law in the HKSAR, it is especially important in the context of financial controls. At present, the HKSAR is viewed as an open and safe port for capital movements. The Basic Law states that this situation is to be maintained. If the status of Hong Kong as an international financial centre is to be maintained and enhanced, this must remain the case. Importantly, despite being presented with a significant occasion on which it might have sought to curtail capital movements into and out of the HKSAR, during October 1997, the mainland took no such action.

76 BL112 provides: 'No foreign exchange control policies shall be applied in the Hong Kong Special Administrative Region. The Hong Kong dollar shall be freely convertible. Markets for foreign exchange, gold, securities, futures, and the like shall continue. The Government of the Hong Kong Special Administrative Region shall safeguard the free flow of capital within, into, and out of the Region.'
Underlying Issues

Several issues are important to everything that has been discussed so far, namely:

- transparency;
- accounting standards;
- prevention of corruption; and
- the creation of a favourable international investment environment.

Transparency is necessary so that all the various players understand the rules of the game, so that the game can continue successfully. Hong Kong has a developed and tested system that ensures transparency and inspires confidence in international investors, including overseas Chinese. At present, mainland China is in the process of developing its own financial regulatory infrastructure. As the recent experiences of Japan, South Korea, and Thailand have shown, legal and financial transparency is of the utmost importance in the long-term successful development of an effective financial system. The legal and financial system of Hong Kong, as well as the emerging international consensus on the requirements for financial stability, is built on the principle of transparency, and for this reason, the financial and legal infrastructure of the HKSAR must remain transparent. Moreover, Hong Kong can teach mainland China much about the advantages of transparency as a baseline for financial and legal development and resulting financial stability and economic success.

Accounting standards clarify relationships and encourage investment, both domestic and foreign because they provide an understandable common language for businessmen to communicate about their businesses and finances. In addition, internationally accepted accounting standards encourage investment because they provide transparency and comprehensibility. For these reasons, consistent accounting standards are absolutely essential for the success of continued financial stability and development in China. The HKSAR has a sophisticated and experienced accounting profession applying internationally accepted accounting standards that should not be compromised. Further, as the mainland increasingly uses Hong Kong as a window to the international financial system, its own companies will gain greater experience and confidence with accounting systems and practices, thereby increasing their own role in the international financial system. Perhaps more importantly, mainland

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77 See eg L Lowenstein, 'Financial Transparency and Corporate Governance: You Manage What You Measure' (June 1996) 96 Columbia Law Review 1335 (discussing the importance of transparency in the US financial system).
78 See eg Sugawara (note 2 above), p 1.
79 See eg D Mercado, 'Evolving Accounting Standards in the International Markets,' Practising Law Institute, Corporate Law and Practice Course Handbook Series, No 84-7166 (October 1996).
businessmen will find that clear systems of accounting are not only useful for encouraging foreign investment, but also for their own internal management purposes and maintenance of profitability in the long term.

Corruption can undermine the reform process by reducing public confidence. Hong Kong possesses a respected and effective bureaucracy and judicial system that buttresses confidence in its financial system. Through the efforts of the Independent Commission Against Corruption (ICAC), it has acted to maintain the rule of law and to fight corruption in both public and private sectors. Unfortunately, reports of corruption in Hong Kong have increased in recent years. This is not an encouraging development because as corruption increases, confidence in the fairness and openness of the financial system decreases, causing investors to move to other shores. The HKSAR must be allowed to continue its anti-corruption efforts in order to maintain its status. This is an area where Singapore can be especially instructive: while its legal system is viewed as very strict, it is also viewed as extremely uncorrupt. Thus, if the HKSAR were to be viewed as a less fair and open place for business, then business will increasingly move to Singapore, with its strict but fair and non-corrupt system. Moreover, this is an area where the mainland and Hong Kong must be committed to one another. If the HKSAR seeks to combat corruption within its region, then mainland authorities must help them. Not only will this shore up confidence in its legal system, but also that of China's, which admittedly could use a public relations boost in this significant area. Importantly, this idea was supported in the Report to the 15th Party Congress.

International investment encourages growth and the transfer of know-how; however, as shown by the experience of other countries (eg Mexico), it can also hold danger. Given its unique developmental standpoint and position within the PRC, the HKSAR has a unique opportunity to encourage international investment in China and perhaps to become one of the leading financial centres in the world, rivalling London, New York, and Tokyo in the next century. As stated previously, the HKSAR is viewed as having all the traditional advantages required of important international financial centres. Further, following its reunification with China, it now has the one advantage that it previously lacked: access to one of the largest economies in the world. If allowed to continue in its present direction, the HKSAR will develop its reputation and ability to serve as an international financial centre for China,

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80 For detailed information on the impact of corruption and international efforts to combat it, see the homepage of Transparency International, an organisation formed to monitor and encourage international efforts against corruption, at http://www.transparency.de/.
82 Ibid.
83 Ibid.
allowing the mainland to continue to grow at its own pace, without the need to open up its financial system at a time before it was ready, as has arguably occurred in certain nations of the former Soviet Union.

Conclusion

As mentioned above, the reunification of Hong Kong with China is one of two events in 1997 that will be of great significance to the future of China. The second major event is the 15th Party Congress in September. The importance to China of the reunification for the 15th Party Congress lies in the confidence levels of the international financial system. The results of the 15th Party Congress have been extremely encouraging for China’s continued economic success and development. Important outlines for progress were made in relation to all significant problems that China is currently facing, and the directness of the approach to these problems is significant. Overall, the future of China in the legal and economic spheres looks bright. Further, China demonstrated its commitment to the financial independence of the HKSAR very effectively and convincingly during October 1997.

With this prognosis, this final section will make a few comments and recommendations for encouraging the future financial stability and economic development of both mainland China and the HKSAR in four specific areas of mutual interest, beyond what has already been said: first, competition between Hong Kong and Shanghai; second, suggestions for possible arrangements between the mainland and Hong Kong in regard to capital movements; third, the development of Hong Kong as an international debt market; and fourth, the role of Hong Kong in the area of financial innovation.

Competition between the HKSAR and Shanghai

First, Shanghai is clearly setting its sights on regaining its status as the leading financial centre of China. In terms of political advantages, Shanghai will certainly be able to out-manoeuvre the HKSAR. However, China is a huge country and competition is good for competitors such as the HKSAR and Shanghai. Let the two compete and find their own niches: there is certainly room for both. Further, if Hong Kong is politically shunted in order to make room for Shanghai, China loses an important advantage in the short run: an already existing international financial centre. In the long run, it will lose out because if Shanghai were truly better suited, then it would have won without the unfair advantage (as for instance New York won over Boston, or London

86 See 'HSBC Executive Displays Confidence In Territory's Future After Reversion to China' (22 May 1996) 10:12 Int'l Secs Reg Rep.
over Amsterdam) and would have gained from travelling the road to success. Besides, competition can be very interesting as well as quite beneficial to an economy. Importantly, this echoes an important principle of Deng Xiaopeng’s theory: ‘letting a hundred flowers blossom and a hundred schools of thought contend.’

**Financial movement between the HKSAR and the mainland**
Among the most important financial relationships that must be structured between the HKSAR and mainland China are those determining the flow of capital between the two. Under the present arrangement of one country, two currencies, two monetary systems and two monetary authorities, the system should be fairly straightforward: capital can freely flow into and out of the HKSAR, while the mainland retains its current restrictions on convertibility and foreign capital. However, as time progresses and both seek to increase their financial relationship for mutual benefit, this relationship will have to be restructured. The arrangements for this should be carefully considered, structured, and implemented. While it is beyond the scope of this article to suggest how this could best be achieved in the medium term, it must be stated that the relationship should be formal and precisely adhered to in order for it to be successful, without compromising the respective integrity of either system. Once again, the events of October 1997 and the differences in the needs of the two regions (the mainland and the HKSAR) underline the importance of carefully nurturing the process of currency liberation.

**Development of the HKSAR as an international debt market**
Hong Kong has the potential to develop into an important international debt market and has already taken important steps in this direction. In 1990 the Hong Kong government launched an Exchange Fund Bills Programme as the starting point for the development of a more extensive debt market. The Mortgage Development Corporation commenced operations in 1997. Ten-year Exchange Fund Notes have now been launched. While the HKSAR has no need to issue government debts for fiscal reasons, the issuance of such a debt provides an essential benchmark for corporations and others seeking to issue debts in the HKSAR. Further, the Mortgage Corporation is now set to begin operations in the area of securitising HKSAR mortgage obligations. This signals an important step in the development of repackaging techniques such

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87 See Jiang Zemin (note 4 above).
89 See HKMA (note 42 above) and Tokley (note 31 above).
90 Ibid.
91 Ibid.
92 Ibid.
as securitisation that allow the development of secondary markets in debt obligations, thereby allowing risk transfer and profit maximisation. Finally, the fact that the Hong Kong dollar is linked to the US dollar provides an important source of stability.93

At the moment, Hong Kong has put into place the basis for this development. First, this should not be impeded, as has been previously stated. Second, if the mainland were to use the HKSAR for the issuance of its own government obligations there, this would not only strengthen the HKSAR's position, but provide a perfect window for the Chinese government to raise funds.

Centre for financial innovation
As mentioned previously, the HKSAR has a legal culture of acting unless prohibited in the financial sphere. This is an asset to both systems and should be cultivated. Importantly, this is already occurring with the HKSAR's increasing development of derivatives capabilities related to the mainland markets.94 The continuation of such an arrangement is key to the success of both economies, given Hong Kong's prominence in understanding and dealing with financial innovation, from the business, legal, and regulatory standpoint. In fact, this is a key area where the HKSAR may have a competitive advantage over Shanghai, certainly in the short term, and it should be allowed to cultivate financial innovation, but with the necessary regulatory protections to ensure the soundness and integrity of not only the institutions and products involved, but also its financial system as a whole.

As has been stated many times, laissez faire economic policies, complete freedom of capital movement, low taxes, modern infrastructure, and a well-understood regulatory and legal environment have propelled Hong Kong's economy to its present state.95 Hong Kong's role as an entrepôt to mainland China has also been key. As is often said, 'as goes China, so goes Hong Kong.' While China is booming, so is the HKSAR, but Hong Kong has always succeeded best when simply left to its own resources. Clearly, this has been an effective solution and should remain so for its future as a special administrative region within the PRC.

93 While this assertion may be challenged by the events in October 1997, in fact the peg forces the Hong Kong economy to adjust rapidly to underlying problems and market bubbles in a way that the economies of other South East Asian countries have not had to do, until the problems were of crippling severity. See 'Hong Kong: A Rubbery Sort of Economy' (note 11 above).
95 US Department of the Treasury (note 10 above), p 262.