

2: Finance Sector Trends Are Favourable to Hong Kong IFC

In this section, we start with a top-down comparison of economic statistics of Hong Kong, the two World Cities of London and New York City and the territory's Asian peer, Singapore, to set the backdrop to our research.

We elaborate on the role of finance as a highly effective enabler of efficient economic activities by virtue of its requiring extremely high standards of performance (precision and urgency) and conclude that it is not a coincidence that both London and New York City, the two acknowledged World Cities, are IFCs. The finance industry acts like the standard bearer for the entire economy. It is like thinking about the Olympic Games: while there are hundreds of medals in the Games, it is the 100m sprint and the 100m free style that catch the imagination of most watchers.

Hong Kong should learn from the evolution of London and New York City and widen and deepen its IFC capacity and capabilities in order to hasten its rise as the next World City. We also set out the six favourable factors that will propel the finance industry in Hong Kong to new heights. We will leave a more detailed discussion on the future development of the finance industry to Section 6 "More users will tap Hong Kong IFC's Deepcraft".

Finance sets the service standard and attitude of a city

Many favourable factors should help propel Hong Kong IFC to new heights

In Section 3, we will turn to assessing the quality of the non-finance service sectors and conclude that open competition and entrepreneurship remain in rude health with the 300,000 Small and Medium sized Enterprises (SME's) dominating most (some 98% of enterprises) of these sectors. As a result of this free market structure, the service quality and availability (convenience) in Hong Kong are world class. An example of this is the number of restaurants that feed a busy city. Despite a population 10% smaller than London, Hong Kong has 1.8 times the restaurants of the capital city. This suggests a far more competitive market and has led to lower prices and better overall quality.

The next section sees further improvement in the non-finance sectors

For the past two centuries, London has been the true World City – a highly successful meeting place of commerce and depository of wealth from all corners of the world, a trendsetter of global culture, a place where commercial and social ideas flow together, become refined by enterprise and discourse and impact the world. While there have been many great cities rising and fading in modern history, few, if any, compare with London when it comes to the degree of internationalization and the extent its systems of organizing business, law, knowledge, values and language have influenced the world.

London – a World City that has stood the test of time

This has remained so despite the rise of the US as the largest economy in the world in 1870 (Cassis, Youssef. "Capitals of capital: the rise and fall of international financial centres, 1780-2005". Pages 80-86, 110-116), overtaking the UK which at the time, provided nearly one-third of global production. New York City, as the commercial and financial capital of the US, ascended into the ranks of an IFC largely through the sheer scale of its economic growth. By 1914, the US GDP was already the total of UK, Germany and France, the next three largest economic powers of the day.

New York City – the World City of a superpower

Top-down Comparison Hong Kong/London/New York City – Similar Population and Land Area

2011 (unless specified)	Hong Kong	London	New York City	Singapore
Nominal GDP, 2010 (HK\$ bn)	1,744	3,385	4,966	1,737
Nominal GDP Per Capita, 2010 (HK\$)	246,000	433,000	607,000	342,000
Nominal GDP Per Capita Growth, 2000-10	25%	53%	38%	87%
GDP PPP, 2010 (HK\$ bn)	2,525	3,272	4,966	2,277
GDP PPP Per Capita, 2010 (HK\$)	357,000	418,000	607,000	449,000
Population, 2010	7,077,000	7,825,000	8,175,000	5,077,000
Population Growth p.a., 2000-10	0.6%	0.8%	0.2%	2.3%
Total Area (sq. km)	1,104	1,572	789	712
Labour Force	3,769,000	4,011,000	4,170,000	3,136,000
Mean Wealth Per Adult (HK\$)	1,088,000	2,011,000*	1,937,000 ^	2,221,000
Median Wealth Per Adult (HK\$)	223,000	950,000*	411,000 ^	788,000
Unemployment Rate	3.2%	9.6%	11.2%	2.2%
Budget Surplus as % of GDP	4.3%	-10.4%*	-9.8% ^	-1.1%

*Figures for the United Kingdom, ^ Figures for the United States
Source: HK CSD, UK ONS, NYC EDC, Dept. of Statistics Singapore,
Credit Suisse Global Wealth Databook 2011, HKGolden50

Neither of the two World Cities attained their global prominence by a history other than being the financial capital of their hinterland. Centres of agriculture, industry, commerce etc somehow all failed to develop sufficient gravity to attract talents, capital, entrepreneurs and artists from all over to elevate them above their functional excellence and transform them into World Cities. To ascend to the echelon of a World City, it seems, a city requires at least the sophistication, skills, attitudes, soft and hardware and international networks of an IFC.

First an IFC, then, a World City?

Having come under British rule for 155 years, one of the longest periods of colonial histories in the world, Hong Kong has inherited a comprehensive system of Common Law and some of the best market practices of the developed West. It therefore shares the same international system of business conduct with the developed world and should head the race as the preeminent hub of financial and high credibility business (eg healthcare, product certification, valuable goods) in Asia, where service standards are often lower. For example, while the service sector accounts for some 93% of Hong Kong's GDP, the highest in the world, it is only 43% in China and around 60% in Shanghai and 72% in Singapore.

Hong Kong shares the best practices of UK/the West and is the service capital of the World

It is to be expected, therefore, that the service intensity of Hong Kong and the unfettered competition inherent in the system, will continue to sharpen the quality and reliability of this industry and keep costs low. Together with the city's cultural affinity and geographical proximity to its Asian customer base, these two aspects should attract more and more customers from its hinterland and enable Hong Kong to share in the growth momentum of a fast developing Asia.

With competition so intense, customers always come first in Hong Kong

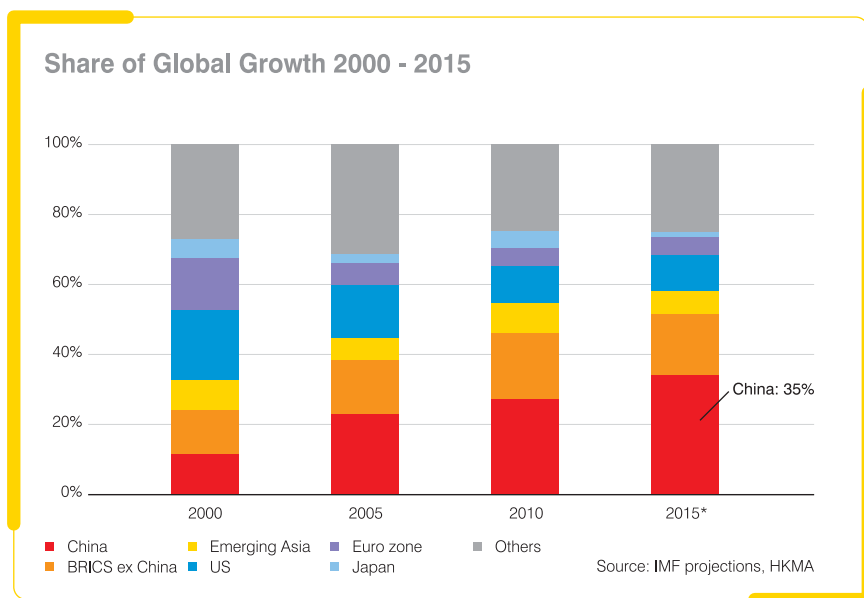
Six Favourable Factors to Propel Hong Kong IFC to New Heights

As an IFC, Hong Kong is set to scale new heights. This is so due to a number of favourable factors including: (1) the shifting of the global economic growth focus from the West to the East (2) the growing recognition, globally, of the sophistication and "deepcraft" of the city's finance industry (3) the immediate hinterland of a young and fast-growing Guangdong province that will increasingly utilize the service platform of Hong Kong for multiple services (4) growing talent pool of finance practitioners (5) One-Country, One-Market – development of the offshore Rmb market, the increasing freedom given to mainland individuals and business to come to Hong Kong (6) a non-finance sector that delivers quality services at good value for money.

(1) The Shifting of the global economic Growth Focus from the West to the East

In their study to identify the new “Global Growth Generators”, Economists Willem Buiter and Ebrahim Rahbari (2011) et al. forecast that 11 economies will power global growth for the next 40 years – nine of these in Asia and two in Africa. An IMF study covering the bulk of the Golden 5 Years shows that China and Emerging Asia (excluding India) accounted for/will account for 36% and 42% of global economic growth in 2010 and 2015, respectively, some 7 times and 9 times that of the Eurozone which forms the immediate hinterland of London over the same period. Clearly, the lower income base and strong cash positions of developing Asia are conducive to growth while the significantly higher private and public sector debt loads of Europe detract from growth and the growth differential between the two regions are likely to persist beyond 2015 for some time.

Developing Asia (ex-India) will grow at nine times the speed of Euro zone in 2000-2015



(2) The Growing Recognition, globally, of the Sophistication and “Deepcraft” of the city’s finance industry

Hong Kong – an IFC with proven “Deepcraft”

In assessing whether Hong Kong has the essential skills (technology) to be the preeminent IFC in Asia, we refer to a book by W. Brian Arthur, a professor at the Santa Fe Institute and Professor of Economics at Stanford University. In “The nature of technology: what it is and how it evolves” 2009, he says “One thing very noticeable about the buildout of new bodies of technology is that *their leading edge is highly concentrated in one country or region...*” (Pages 156-165) “Real advanced technology ...*issues not from knowledge but from something I will call deepcraft... it is a set of knowings. Knowing what is likely to work and what not to work.* Knowing what methods to use, what principles are likely to succeed, what parameter values to use in a given technique. Knowing whom to talk to down the corridor to get things working, how to fix things that go wrong, what to ignore, what theories to look to. *This sort of craft-knowing takes science for granted and mere knowledge for granted. And it derives collectively from a shared culture of beliefs, an unspoken culture of common experience...A knowing that again becomes part of a shared culture...To any problem or difficulty ... there would surely be an answer somewhere in the [location]...*

We will put our examples, in brackets, within the paraphrasing of the book, to illustrate Hong Kong's deep craft in financial markets: [Shared knowings] **take time to build up, and do not transfer easily to other places.** And *they cannot be fully written down...the real expertise resides largely where it was created, taken for granted, shared, and unspoken... It follows that once a region...gets ahead in an advanced body of technology, it tends to get further ahead. Success brings success, so that there are positive feedbacks or increasing returns to regional concentrations of technology. Other locations can contribute, to be sure.* (eg. For the past 18 years, Hong Kong has competed with other stock markets in China, Singapore, Japan and US in providing financial services to mainland Chinese and other global companies, including raising funds for these firms through Initial Public Offerings (IPOs). In the past five years, Hong Kong's excellence in this area has become increasingly recognized, and this will lead to bigger concentration of servicing by IFC Hong Kong.).

They can manufacture and improve the technology, but they will not be initiating it on a large scale because the detailed knowings needed to push the edge are not resident there (eg Investor base in Hong Kong's peer markets is not deep enough to provide liquidity to listed stocks, thus depressing valuation of the stocks listed in these markets compared with those listed in Hong Kong. As a result, Hong Kong is entrenching a belief that its market offers the highest valuation and liquidity in Asia for China/Asia businesses. Despite rocky market conditions for most parts of this year, Hong Kong still managed to raise US\$25bn (HK\$195bn) through IPO's in first three quarters, the highest in the world. Out of these, 70% came from overseas with the balance from mainland China.)

All this of course has consequences for national competitiveness. Technology proceeds out of deep understandings of phenomena, and these become embedded as a deep set of shared knowings that resides in people and establishes itself locally—and that grows over time... *The process is not one that can be easily controlled from the top down...* From what I have said in this chapter, it should be clear that *domains develop in a different way than individual technologies do*. The process is not so much like the development of the jet engine: focused, concentrated, and rational. **It is more like the way a system of legal codes forms: slow, organic, and cumulative.** **With domains, what comes into being is not a new device or method, but a new vocabulary for expression**—a new language for “programming” new functionalities in.

And this happens by slow emergence (eg. It has been 18 years since the IPO of the first mainland Chinese corporation in Hong Kong. Over this period, new laws, market practices acceptable to global investors have evolved and a new “vocabulary” was developed by a growing band of analysts and professional investors to appraise the opportunities that have emerged from such new offerings.) *A domain crystallizes around a set of phenomena loosely understood or around a novel enabling technology, and builds organically upon the components* (eg the grouping of mainland stocks have grown to such a significant extent that special market indices were made to represent these. A few weeks ago, the Hong Kong Stock Exchange entered in to alliance with the exchanges in Brazil, Russia, India, and South Africa for the development of futures and index related products. Shanghai and Shenzhen Exchanges are likely to join in future.) *products, practices, and understandings that support these. And as the new domain arrives, the economy encounters it and alters itself as a result...* (Hong Kong IFC is also a tourist and convention city – functions that encourage exchange of information, ideas and experiences with all the good support services eg culinary sector, to match, absorbing all the labour released from its old manufacturing base.)

In fact, we can see that **innovation has two main themes. One is this constant finding or putting together of new solutions out of existing toolboxes of pieces and practices** (eg the decision by the Hong Kong Stock Exchange (HKEx) to invite non-Chinese overseas companies to list in the IFC – eg Prada, Samsonite and Russal etc. This was a “leap” in geographic catchment for Hong Kong which hitherto serviced companies in Asia time zone. The “knowing” that this new and bold initiative “will work” demonstrates deep understanding of global processes; eg the giant IPO of China Mobile on 23rd October 1997 raising HK\$32bn – it involved the same listing procedures but the “knowing”, without there having been a precedent, that the market could absorb a “new industry” with such a “huge size”, and which was successfully executed, demonstrated deep insight of “what works”. The **other is industries constantly combining their practices and processes with functionalities drawn from newly arriving toolboxes** (eg The first listing of H-shares (Tsingtao Brewery) in Hong Kong in 15th July 1993; ETF’s of H-shares and other groupings of such shares) - **new domains**.

This second theme, like the first, is about the creation of new processes and arrangements, new means to purposes (eg Rmb deposits in Hong Kong, Rmb-bonds and Rmb-listings in Hong Kong in 2012). But it is more important. This is because a new domain of significance (think of the digital one) is encountered by all industries in an economy. As this happens, the domain combines some of its offerings with arrangements native to many industries. The result **is new processes and arrangements, new ways of doing things, not just in one area of application but all across the economy** (eg the move towards One-Country, One-Market and more mainland investors to come to Hong Kong and buy products based on mainland corporate or debt instruments).

(3) The Immediate Hinterland of a Young and fast-growing Guangdong Province that will increasingly utilize the multiple service platform of Hong Kong

Hong Kong and London both have populous immediate hinterland with sizeable economic influence. For Hong Kong it is Guangdong Province, which is the province with the largest GDP in China, and for London it is the entire country of UK.

The Hinterlands – Guangdong Province vs. the UK

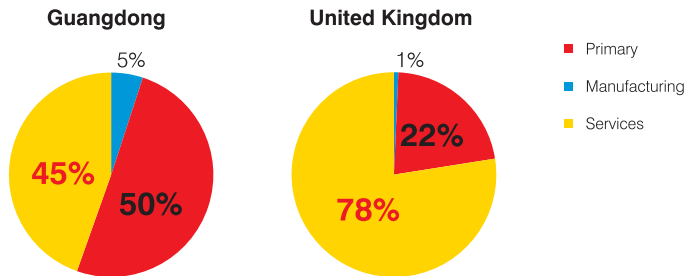
In 2010	Guangdong	United Kingdom
Population	104,303,000	62,262,000
Total Area (sq. km)	178,000	242,000
Population Density (population/sq. km)	586	257
Dependency Ratio	31%	52%
Nominal GDP (HK\$ bn)	5,219	17,480
Nominal GDP Per Capita (HK\$)	50,000	281,000
Nominal GDP Growth p.a., 1990-2010 (Local Currency)	18.4%	4.8%
Service Intensity	45%	78%

Source: Statistics Bureau of Guangdong Province, UK ONS, CIA World Factbook

While Guangdong has 104m people, the most of any province in China and over 65% more than the UK's 62m, its current nominal GDP is still less than one-third of that of UK. Although Guangdong lags the UK in income, it is growing fast (from 1990 to 2010, its nominal GDP has grown 28 times) and its young population (20% lower dependency ratio than the UK) should remain a significant economic growth engine for Southern China for many decades to come.

Guangdong's low service intensity of 44% implies a lower level of sophistication and quality compared with Hong Kong's 93% and the UK's 78%. The opening of the Guangzhou/Shenzhen/Hong Kong Express Rail Link in 2015 should put the provincial capital within 48-minute reach of Hong Kong, further facilitating two-way flows and use of Hong Kong services.

Distribution of GDP Across Sectors, 2010

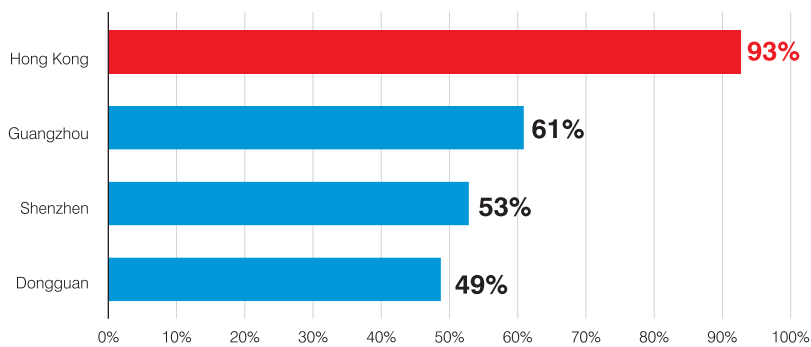


* Figures not adding up to 100% due to rounding

Source: Statistics Bureau of Guangdong Province, UK ONS

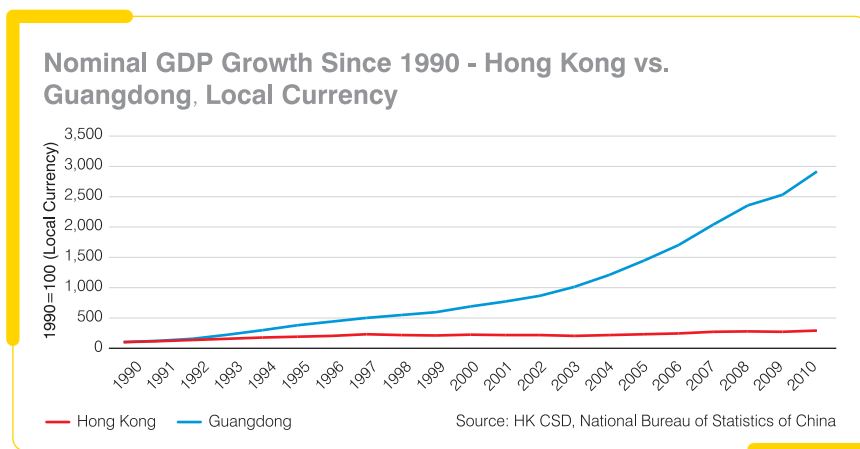
While some may argue that other cities in the Pearl River Delta may rival Hong Kong as a service centre for the region due to their lower costs and proximity to production, the GDP composition figures of other major cities suggest there is still some way to go before they can become all-rounded service centres.

Service Intensity of Major Cities in Guangdong Province



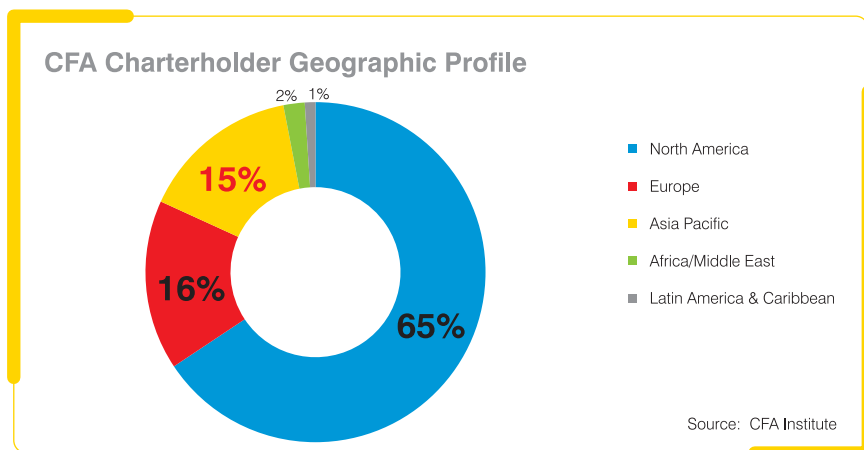
Source: Regional Government Statistics

From 1990 to 2010, the nominal GDP of Guangdong has grown 28 times, albeit off a low base, while that of Hong Kong has only increased by 180%. Increasing porosity of the economic border between Hong Kong and Guangdong, including the recent adoption of the e-Channel system that speeds up the immigration process should ensure higher demand for Hong Kong services.

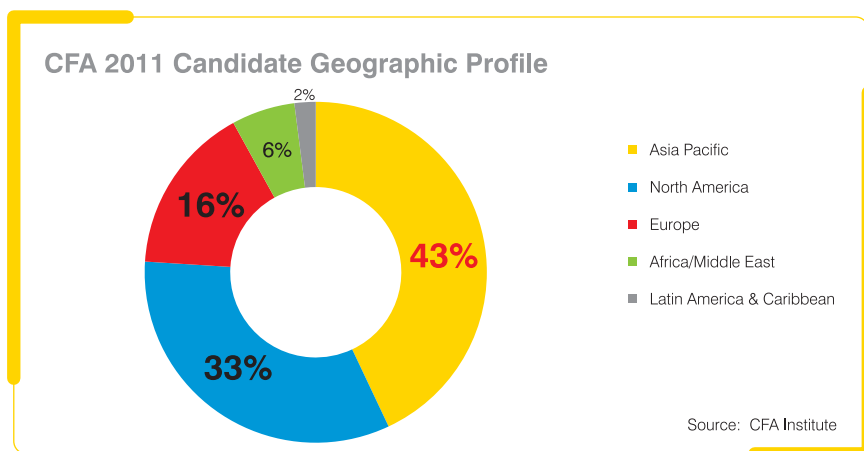


(4) A Fast-swelling Talent Pool of Finance Talents

A proxy to the existing talent pool of financial professionals is membership of the CFA Institute. While the existing pool of Chartered Financial Analysts (CFA) is heavily skewed towards the West, with Europe and North America accounting for 16% and 65% respectively, while Asia Pacific accounting for only 15%, it is the changes at the margin that suggest the size of talent pool to come.



In terms of candidates sitting for the CFA examinations, Asia Pacific takes the lion's share, contributing 43% of students. This is some three times the proportion in the existing pool of qualified practitioners.



(5) One-Country, One-Market – development of the Offshore Rmb market, the increasing Freedom given to Mainland Individuals and Business to Come to Hong Kong

The key to Hong Kong becoming a World City hinges to a large extent, the freedom given to mainland people and businesses to choose to use Hong Kong's comprehensive service platform, especially in the finance sector where the city has a clear edge. We have discussed this subject in earlier section and in our first research report.

(6) A Non-Finance sector that delivers Quality Services and Good Value

The success of an IFC does not stem from financial expertise alone but requires myriad support sectors. Cost of living is a major consideration in talents' decision to come or go. A high salary can easily be offset by expensive utilities, food, housing and entertainment costs. While London's average wage level nearly doubles that of Hong Kong, adjusting for the significantly higher cost of living there, London's purchasing power is only 26% higher than Hong Kong.

Among the components making up cost of living, the gap between Hong Kong and London is widest in the infrastructure areas. For example, London Underground's average ticket price is nearly four times that of Hong Kong's MTR and the average spending on basic household utilities is also 73% higher. Even London taxi fares are 165% more expensive for a typical 5km journey. Hong Kong offers better value for money in all major components of cost of living except rents.

