

Facts versus Frictions: a role for Hong Kong in the Sino-US economic relationship?
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Ladies and Gentlemen: good afternoon. Before I begin I want to acknowledge two people. First, let me say thank you to Richard for the invitation to speak today. It is indeed a privilege to be asked to take part in your Luncheon Talk Series. Second, I would like to thank a certain University of Hong Kong alumnus for opening up Hang Seng's dining rooms for this luncheon. Although Raymond is out of town and therefore unable to be with us, I want to acknowledge his kind hospitality.

That said, I must admit it does feel somewhat strange to be back here. I wasn't even sure they would remember me downstairs. I was pretty sure, however, that my old employee pass would not still work!

As for my speech today, you may have noticed on the original invitation that the title raises a question. Namely, does Hong Kong have a role to play in the Sino-US economic relationship? The short answer to this question is: yes, we do. As for our precise role, I will come to that later.

First, however, I want to talk about the Sino-US economic relationship in general. And remind you of some of the frictions of this relationship as well as some of the underlying facts.

It is actually quite timely to be speaking on this subject. In part, because of last week's agreement resolving - at least for now - the friction between the United States and China over textiles. And in part, because of this week's visit by President Bush to China. But mostly, it is timely because the relationship between the United States and China is at a critical juncture. The relationship could continue down the preferred road of increased levels of economic cooperation. Or it could just as easily veer off on to a more bumpy path, with politically influenced bouts of confrontation.

By most accounts, the single most significant friction in the Sino-US relationship seems to centre around this . . . the RMB.

When I was in New York a month and a half ago, I was asked several times about the revaluation of the RMB. About the accusations of some special interest groups that China is: "subsidizing its currency on an unprecedented scale" in a blatant effort to make its exports cheaper. A so-called 'manipulation' which is driving up the US trade deficit and costing American jobs. In particular, most people seemed to be concerned about the potential impact of the threatened 27.5 per cent tariff on Chinese goods. Most

also seem to realise that such a tariff will not be good for either country's economy nor, for that matter, for Sino-US relations.

Then when I was in Beijing a week and a half ago, I listened to various senior Chinese officials openly acknowledge that a flexible exchange system is in the country's long-term interests. That July's 2.1 per cent revaluation and adoption of a currency basket was just a first step. That the country is not seeking a trade surplus intentionally. And that in the interests of macroeconomic stability, moving to a more flexible exchange rate regime needs to happen at a slow and measured pace.

Against this backdrop of American political rhetoric and Chinese economic realities, it is perhaps important to be mindful of certain facts.

First, there is the fact that China is not the sole source of US current account imbalances. As a recent report by two European economic think tanks noted: while the US current account deficit grew by more than 500 billion US dollars between 1997 and 2004, China was responsible for less than 7 per cent of the growth. Meanwhile, Russia and the Middle East - as exporters of oil - were the source of 30 per cent of the deterioration.

Also, there is the fact that China's large trade flows are in reality a reflection of the rise in global production sharing. In addition to China's increased participation in the assembly, processing and other labour-intensive stages, it has also become in many cases the final stop in the production chain. China is, in effect, selling its low-cost labour services to the global market by assembling and processing exports. Assembling and processing largely imported components into products which, when exported, translate into a gross exaggeration of China's export value.

And yes, there is the fact that the current value of the RMB is not - at the moment - determined by fundamentals alone. Rather, China's currency policy is based on gradual change with an emphasis on maintaining monetary and economic stability.

Finally, there is the fact that American trade deficits have existed since the mid-1970s. Today's deficit is actually a reflection of trends in global trade rather than the value of the RMB. In other words, as Alan Greenspan has pointed out, there is no evidence to suggest that any increase in the RMB will necessarily translate into any corresponding increase in American manufacturing activity and jobs. The reason being that although a significant change in the value of the Chinese currency might cause some manufacturers to move their operations, they would likely move to other low-cost markets and not back to the United States.

A second significant friction in the Sino-US economic relationship relates to access to China's markets.

As you may recall, when US Treasury Secretary John Snow was in Beijing recently, he boldly suggested China should opening up even further and even faster than it had agreed to under WTO membership. He kindly presented a blueprint for the wholesale opening of everything from banking to insurance to fund management. Urging China to consider dropping caps on foreign ownership and eliminating barriers for foreign investment in locally traded shares.

As you may expect, the view of Beijing on the appropriate pace is somewhat different. For example, the *People's Daily* has referred the steady stream of recent foreign investments in the banking sector as: "a spree of grabbing" and a "financial feast." Meanwhile, the vice-chairman of the CBRC has been citing the dangers of China's financial sector being opened up too quickly. Dangers which have prompted officials to set limits on the total number of strategic investments by individual foreign banks and on the minimum tenure of such investments.

From my perspective, anyone who accuses China maintaining a 'one-way street' for foreign investment is once again choosing to overlook certain facts.

First, the fact that the cumulative total of American foreign direct investment in China is - at last count - over 48 billion US dollars as of the end of 2004. A rather large sum which means the United States is second only to Hong Kong as the largest foreign investor in the Mainland.

They are also overlooking the fact that there are already a significant number of American companies currently operating in China. Some 50,000 according to one senior Chinese official. Including many which are doing quite well in the profits column.

And they are overlooking the fact that China's self-described 'gradualist' approach has been anything but over the last couple of years. In the banking sector for example, billions of dollars in capital have been injected into China's largest banks. Billions of dollars of nonperforming loans have also been transferred to specialised asset management companies. And billions of dollars in foreign investment have and still are being welcomed.

Ultimately, such critics are choosing to overlook the fact that China has been consistently and methodically opening up its economy to foreign investment for the last 25 years. And in the process, it has accomplished in a few decades what other countries have taken generations to achieve.

Moving on. A third source of current and quite likely future friction, is the desire of some Chinese companies to acquire some US assets.

If you flip through the business section of a US newspaper or three, you will likely see ominous references to China. Headlines declaring ‘The Chinese are coming.’ Articles talking about a “Chinese assault” on corporate America. Commentators declaring China sees the United States simply as “a treasure trove of technology that can be easily plundered.”

Meanwhile in China - in the wake of the rejection of CNOOC’s higher offer for Unocal - some say the United States is clearly not as free of an economy as it claims to be. The takeover was not allowed to go proceed due to “bogus fears and hidden interests” they maintain. Others were left wondering why American politicians cannot seem to understand the distinction between being state-owned and not state-run.

In actual fact, most Chinese companies do not have designs on going global. Or even buying American for that matter. A recent survey by the Economist Intelligence Unit confirms as much. The survey of more than 175 Chinese companies found that 9 out of 10 see mainland China as their main target market. The only reason it seems most Chinese companies look aboard is to find new suppliers. Or to buy an international name to strengthen their own brand in the domestic market.

As for the small number of Chinese companies that are interested in acquiring assets in America, it is a natural consequence of China’s growth. Natural because as companies in China continue to expand they may seek to diversify their distribution capabilities beyond their home market. One could even argue - and I have - that allowing Chinese companies to invest in American assets is desirable. Desirable because the United States needs to continue to attract foreign capital to maintain current standards of living. And also desirable because such incoming capital will be vital in helping to maintain US equity prices after the baby-boomer generation has retired.

There are, of course, a number of other frictions that seem to surface regularly.

American complaints that China is not doing enough to protect intellectual property for example. Accusations that crackdown are only occasional and when they do happen they are more about periodically appeasing trade partners than seriously enforcing intellectual property rights.

Meanwhile, Chinese authorities respond that it is unrealistic to expect China to reach - in one great leap - the same level of intellectual property rights protection as developed nations. They also maintain the country is making more progress than many of its critics acknowledge.

There is even friction about how to address the frictions. Some US officials talk about how they don’t want to be seen as bullying China. But then they designate arbitrary deadlines for movement on the RMB - such as before President Bush arrives in Beijing.

Not surprisingly, Chinese authorities - at least the ones I talk to - are less than impressed with such approaches.

Ultimately, these and other frictions come down to one central issue. The re-emergence of China as an economic superpower and how the country's rise is viewed in the political corridors and corporate boardrooms in America.

And once again, certain facts are being overlooked. First, the fact that China and the United States are already economically intertwined. China clearly depends on American companies for further foreign investment. And much of the country's exports depend on American consumer spending remaining robust. The United States, meanwhile, benefits from Chinese investment in US bonds and American consumers benefit from a steady supply of lower-cost goods.

Then there is the fact that both China and the United States share certain common interests. Access to stable global energy supplies for example. It is also in the interests of both to have stability here in Asia, economic and otherwise. Both want to prevent trade protectionism.

All of which brings me back to my initial question: does Hong Kong have a role to play in the complex Sino-US economic relationship?

As I said at the outset, the short answer is yes. A more important question, however, is what role should Hong Kong play? From my perspective, there are several.

First and foremost - and you might expect me to say this - Hong Kong needs to maintain its role as the preferred banker.

Recent and upcoming 'red chip' IPOs have solidified Hong Kong's blue-chip status as Asia's leading international financial centre. The place when mainland companies come when they want capital. However, we are only as good as our last IPO. To maintain our position as the logical and preferred choice of Chinese companies seeking to tap international markets, we must persistently look for ways to enhance our efficiency. We must frequently introduce new and innovative financial products and services. We must continue to regularly upgrade our financial infrastructure. We must maintain integrity in our financial system - our rule of law, our transparency and our reputation are vital.

Just as an aside, another thing we must do if we want to retain the 'international' part of the title is also serve other high-potential economies in Asia beyond China. Economies such as a re-emerging India, a rebounding Korea and even a rejuvenated Japan.

A second role for Hong Kong is to be a good host to people from all directions. Let me explain what I mean by this.

For companies and people going West to East - from the United States and elsewhere - Hong Kong has historically been an obvious choice. The number of offices and regional headquarters still setting up here confirms as much. This is in part because of our close proximity and geographic and economic connections to the world's largest emerging market. But it is also in part because of the differences between Hong Kong and mainland cities.

The same applies to about companies and people going East to West. Hong Kong is now attracting an increasing number of professionals from the Mainland, if visa numbers are anything to go by. As more and more mainlanders are granted visas to work or study in Hong Kong, more Hong Kong companies - and universities - are eagerly tapping into this pool of talent.

In recent years, Hong Kong has become an increasingly popular destination for people going East to East. By this, I mean the young Chinese professionals who are returning from overseas with a degree or three in hand. Again, they are attracted to Hong Kong for various reasons - the opportunities on offer to refine their skills and to make a little money in the process for example. But also because of Hong Kong's internationalism.

Interestingly, many of the latter two groups seem to see Hong Kong as a temporary stopping point. At least many of the ones I talk to! They see Hong Kong as a place to wait until the right opportunity arises in China.

While some may lament this short-term commitment, I personally think it is something that Hong Kong should embrace and exploit. After all, such transient talents also bring a steady supply of new perspectives, new ideas and new energy to our economy and our city. All good things.

The third role I believe Hong Kong should play is that of a strong advocate for China. Or perhaps, I should say a strong advocate for the better understanding of China.

One of the reasons I spent time earlier highlighting certain facts - about the value of the RMB, the causes of the US trade deficit and so forth - is that such facts are often overlooked. Sometimes unintentionally, sometimes not. Indeed many of the frictions in the Sino-US relationship are based on misconceptions about China's rise. Misconceptions that need to be challenged - and not just by officials in Beijing, but by all of us who know better.

A good example of the role I am referring to occurred a few weeks ago. You may remember certain comments by the Chairman of the US Securities and Exchange Commission while he was in China. In particular, suggestions by Mr Christopher Cox that Chinese companies could raise investor confidence simply by listing in New York and they would be better off because of it.

It was refreshing to see that such generalisations did not pass unchallenged here in Hong Kong. Indeed the rebuttal by one Hong Kong U honorary degree recipient – Mr Charles Lee - was swift and straightforward. He dismissed such suggestions, saying many Mainland companies are choosing to list closer to home - i.e. Hong Kong - because of the fondness for litigation in the United States. And because of high regulatory costs of a listing in New York. Not, as Mr Cox suggested, because they are afraid of American regulatory requirements. As Charles noted: some mainland companies which have listed on both stock exchanges in the past have recorded higher trading volumes in Hong Kong.

The fourth and final role I believe Hong Kong needs to play is the role of informal diplomat.

By this, I do not mean Hong Kong should somehow become involved in China's international affairs. That is clearly beyond this city's remit. What I am suggesting, however, is that Hong Kong can play an active role in building China's international relationships and in particular Sino-US relations.

That said, by definition being diplomatic means being tactful. And being tactful means being skillful in developing relationships. And being skillful in developing relationships means all relationships, not just those with existing friends.

Again, there is a recent example of what I am talking about. And again, it involves a recent recipient of an honorary degree from Hong Kong U. This time I am referring to Hong Kong's Chief Executive and his trip to Washington DC. Amidst the headlines and articles about the trip back here in Hong Kong, one thing that was seemingly overlooked by most was the fact that several of the people the Chief Executive met with are not - how shall I put this politely - are not known for being particularly pro-China.

Subsequent reactions suggest these discussions with the unconverted - for lack of a better term - went well. The *Washington Post*, for example, referred to the Chief Executive's approach as: "a marked change." In fact, one *Post* columnist was downright gushing with his comments about the 'unlikeliest leader of Hong Kong' and his ability to politely address difficult topics. One commentator even went as far as to suggest that the Chief Executive's visit was a lesson on "how to deal with Americans."

Perhaps it was. At the very least, it is an example of what Hong Kong can and should be doing more of.

One final comment.

Earlier I said that the economic relationship between China and the United States was at a critical juncture. The relationship could continue down the road of increased levels of economic cooperation. Or it could veer off on a more bumpy path.

Although I do not normally make predictions, I think it is safe to say that in the next 12 months or so there will be a number of rough patches in the Sino-US relationship.

In the short term we can expect renewed friction over China's trade surplus, which is forecast to rise in the final months of 2005 due to higher Christmas-related export volumes. We can also expect to see increased political rhetoric coming out of the United States in the lead up to next year's mid-term elections. Finally, we can expect to see a rise in complaints that China is not doing all it said it would as we approach end-2006 deadlines for some WTO related commitments.

I also expect such bumps to come and go because of the simple fact that the United States and China both have significant stakes in each other's continuing prosperity. As do all of us.