Speech

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Chief Executive of the HKSAR the Honourable Donald TSANG, Dr. LAM Shan-muk, President Dr. Henry HU, Vice President Dr. CHUNG Chi-yung, Professors and Lecturers, Students, Parents and Guests,

Those who studied finance and business and are graduating today may have noticed this: the past four years you spent in this university in an international financial centre coincided with four years of unprecedented turmoil in international finance. You may think that this was a lucky coincidence for you, in that you lived through one of the most severe financial crises of the century as a university student rather than as a member of the job market in finance. Instead of having to worry all the time about the security of your job, you spent the four difficult years in the protected environment of a university, watching historical events unfold in international finance. Or you may think that this was an unlucky coincidence for you, in that there has been so much volatility in financial markets during the past four years, presenting so many attractive opportunities that, had you been working rather than studying, you could well have already made millions.

Whether it is a lucky or an unlucky coincidence, if I may offer you my views, should not matter much to you. Speaking from experience, luck in practice has very little to do with the success or otherwise of your career. But I have no doubt that this coincidence is an important one for you, and perhaps a rare one, so much that I would quite like to take this opportunity to alert you to the significance of it.

Many of you will soon be entering the job market, like many fresh graduates before you, equipped with the robust theoretical foundation that the university provided you as an academic institution, and importantly not having any experience as to how that theoretical foundation is, or is not, translated into practice in finance and business. In other words, you have not been contaminated by the all too many questionable practices that have proliferated in finance.

But, unlike the fresh graduates before you, you will be entering the job market at a time when there is a strong need for finance to go back to basics. It is a time when financial institutions have to re-adjust their behavior to come more in line with the fundamental reason for their existence in the first place, which is to serve the economy. It is a time when those employed in financial institutions have to re-learn what finance is all about, in order to ensure their long term survival in the industry. Your lack of experience and the uncontaminated nature of your existence in the industry, interestingly, put you in good stead, in that with the right attitude you can help bring about the necessary changes, perhaps even more effectively than those with experience.

I say so not to please you. I say so because I truly believe that you are the generation that could make a difference, not so much through participating in demonstrations of the "occupy Wall Street" kind, but in being inquisitive in these interesting times over the rationale of established practices, equipped with the theoretical foundation that you have acquired in university. Old habits die hard. It will be difficult for those before you – the experienced and the contaminated – to accept changes, particularly those with vested interests to maintain the status quo, let alone bring about changes.

Over the two or three decades preceding the current financial crisis, finance had regrettably been allowed to attain a life of its own, rather than a life that is defined by the sole purpose of serving the economy, matching the different risk appetites of those with surplus money with the different risk profiles of those in need of money. A fashion developed, whereby financial skills were deployed quite freely, taking advantage of the predominantly free market environment, to design opaque and complex financial arrangements that claimed to enhance financial efficiency for the public good. This fashion was cleverly named financial innovation and those engaged in it attractively remunerated. Financial institutions earned astronomical profits and the so-called investment bankers awarded sinfully high bonuses. But, as the global financial crisis erupted, it became clear that, instead of financial efficiency being enhanced, prudential standards in finance were eroded and systemic risks built up.

We all know the consequences of these financial excesses. The United States is now living with the debilitating consequences of the financial innovation that originated there – a process called credit risk transfer through securitization. Europe is, in a way, even more unfortunate, in that its financial institutions were landed with much of the toxic financial assets and, as they worked themselves out of the mess they found themselves in, were not able to provide support to the European economy. Economic recession set in, requiring heavy doses of fiscal stimuli to ease the pain, through running larger than usual budget deficits and borrowing more than usual by issuing public debt, to the extent of leading to a sovereign debt crisis.

Old habits do die hard. Vested interests mean that established practices, however questionable they are, will be defended vehemently. And, in finance, those with vested interests are in a strong position to defend their interests. They have strong political influence, with Wall Street being a clear example of the political reality of finance, particularly in a democratic society. But I am optimistic that common sense will prevail. Finance exists to support the economy. It should not have a life of its own. A highly profitable financial industry is an indication of financial inefficiency rather than financial efficiency, in that the middle man is taking or charging too much for his services when matching or transforming the needs of investors and borrowers. I look to you always to exercise this common sense, be alert to it, promote it and satisfy yourselves that what you do is consistent with it.

This is not as difficult as it sounds. Take the stock market as an example. The fortunes and the livelihoods of many, including the investors and importantly those working in that market as brokers or market makers, are derived from it. Understandably therefore there are strong vested interests in how that market is operated. I can still remember the old days, and this was before many of you were born, when the stock market had been run to promote the interests of the operators, under a self-regulatory framework. The vested interests of the operators were so strong that, in 1987, when there was a sharp global downward adjustment in stock prices that threatened the viability of brokers, a decision was taken to close the market for a week, presumably in order to protect them from bankruptcy.

In doing so, those concerned had forgotten the fundamental reason for the existence of the stock market. The stock market is a secondary market for the shares of companies that have raised money through the issue of those shares. The market is there crucially to provide liquidity for the listed shares, so that whoever owns them can buy or sell conveniently whenever they want to do so. This makes the stock market an attractive channel for financial intermediation, matching the needs of investors and fund raisers, through bringing new issues to the primary market in the form of IPOs or Initial Public Offerings. Without secondary market liquidity in the shares, investors would have much less interest in subscribing for the new shares in the primary market. Efficient financial intermediation is of course important for promoting economic growth and development. This is where the public interest lies. This is the fundamental reason for the existence of the stock market. But many seem to be so mesmerized by the ups and downs of stock prices that this is often forgotten or ignored. And when unusual stress developed in 1987, the private interests of the operators of the stock market were allowed to override the public interest of providing liquidity and sustaining confidence in the use of the stock market as an effective channel of financial intermediation.

Thankfully we all learn lessons from the past, regrettably more often than not when there is a financial crisis. But we must try and prevent financial crises from occurring by simply remembering what the public interest is regarding the functioning of the financial system and acting always with that in mind, whether you are the financial supervisor or the financial intermediary being supervised. I firmly believe that the world then will be a better place to live in. Those working in the financial industry will also then be earning less, but at least they will enjoy more sustainable employment. This is particularly important for an international financial centre like Hong Kong. I also believe that you can contribute to making the world a better place to live in, if you help to promote this financial culture that I am preaching, by simply remembering what you learned in university, asking questions as to why certain things are done in particular ways and reminding others in the industry, for example the "rogue trader to be" sitting in the next desk across the trading floor, of the fundamental reason for his existence.

But this will not be easy. As head of the Hong Kong Monetary Authority before I retired in September 2009, I often asked such questions of my fellow central bankers and financial regulators as, for example, why CDOs, CDSs, ABSs, ABCPs, etc, or what I collectively called the alphabet soup, were necessary for financial intermediation, or how they worked to enhance financial efficiency. I also specifically asked the question that, if mortgages were considered sub-prime, why lend? I will not tell you the answers I got to those questions, or who provided the answers, other than to tell you that I was simply brushed aside. I am sure you will have the same experience, if you dare to ask those embarrassingly difficult but fundamental questions. Perhaps you will be given the answer that there are attractive profits to be made, which of course is the short term legitimate answer that is not sustainable in the long term. Please persevere and help promote the sustainable culture for finance. Finance has to go back to basics.

There are other macro trends developing, much as the result also of the two financial crises in the last fifteen years, and they may be relevant to you in shaping your career as you enter the job market. But there is not enough time to go into them in any meaningful way on this occasion. Perhaps I should just briefly draw your attention to two of them. While I have been asking you to make good use of what you learned from university, I have to add that you should also not be dogmatic about it. One area that has become a subject of controversy is how market freedom is serving or not serving the public interest. We have seen, in Hong Kong and in other jurisdictions, clear cases of market failure that have led to debilitating consequences for the community. While such failures have so far not significantly undermined the credibility of the free market philosophy in organizing economic affairs and producing the best results for society, there have been frequent occurrence of government intervention and involvement in the market, some very well justified, including dare I say our intervention in the stock market in 1998. While it was a successful move in terms of maintaining monetary and financial stability, I must add that I was not proud of it. Rather, and particularly at the time of the intervention, I felt badly betrayed by my good friend the free market. But since then I have come around to accepting that markets do fail; and when they do the authorities have a responsibility to protect the public interest by putting them right. Many of our critics in 1998 have recently engaged in market intervention that is a lot more extensive than what we did. Put simply, the invisible hand of Adam SMITH cannot always be relied upon to transmute individual acts of selfishness into desirable collective outcomes for all. I do hope, however, that this macro trend of greater government involvement in the market could level off to an optimal degree; but, meanwhile, for those joining the job market, the public sector may offer interesting opportunities and hopefully the intellectual challenge as well, notwithstanding the peculiar political environment of Hong Kong. In this connection, interestingly, we see clearly the contrast in terms of the success in maintaining monetary and financial stability in the socialist, market economy of the Mainland of China, where there is a much higher degree of government involvement in the functioning of the economy, vis-à-vis the capitalist, free market economies of the developed world. But I hasten to add the opposite contrast in terms of the efficiency in the allocation of scarce resources. Again, there is a balance to be struck.

The other macro trend is an obvious one and this is the rising of China, of which Hong Kong is an integral part. In order to take advantage of this, you need to appreciate the role that Hong Kong can play under "one country, two systems", identify and seize the opportunities associated with Hong Kong playing that role. This involves first understanding China – the second largest economy in the world that is undergoing reform and liberalization, and embracing globalization. It is also the largest foreign reserve holder in the world and, for reasons that I have articulated elsewhere, China has to take steps to internationalize its currency, the renminbi. Hong Kong's advantage lies in its status as an international financial centre, and the maintenance of that status is mandated in the Basic Law. Where else in the world does a country have two financial systems at its disposal, enabling synergies to be maximized, relative strengths to be exploited and relative weaknesses to be addressed? With that understanding, the people of Hong Kong, whether as policy makers or as private sector citizens, whether as seasoned bankers or as fresh graduates, should correspondingly position themselves, if they are to benefit from, and contribute to, the rising of China.

I have taken up too much of your time already. It is a day for celebrating your graduation, not a day for sermons. And I am glad to be celebrating with you the award of the degree of Doctor of Business Administration, *honoris causa* so kindly bestowed on me by this university. I feel greatly honored and I wish you all the best in whatever you will be doing in the years to come. For me, I shall continue to attempt to "hea" in retirement. Thank you.