The Rapid Development of Foreign Currency Finance in Hong Kong: "Internationalization" of the Financial Market During a Period of Transition

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Preface

Substantial statistical data concerning currency and financing in Hong Kong finally began to appear at the beginning of the 1980's. Although some data — such as statistics on balance of payments — is still not available, and information is lacking compared to other countries, there are signs of improvement and more is expected in the future.[1)]

The bulk of land in Hong Kong is in the New Territories. Due to the impending termination of the lease on this area in 1997, the 1980's started as the period during which the future of Hong Kong would finally be determined.[2)] Negotiations which began in 1982 between the Chinese and British governments came to a conclusion two years later with the China-British Joint Declaration (December 1984) where the plan by which Hong Kong would be returned to China was made explicit.

Thus, the period from around 1980 to 1997 has become a transition period from Hong Kong as a British colony to Hong Kong as a part of China. Since the majority of those who live in Hong Kong are people who fled from China or their descendents, they are faced with the serious question of how to live through this historical shift. Many have been compelled to make a choice either to stay or to emigrate to another country. The number of those who choosing emigration has risen sharply since 1980. Also during the first half of the 1980's, instability during the transition resulted in a Hong Kong currency crisis as well as a banking crisis.

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1) Researchers have complained about the insuffciency of statistical data from as early as the 1950's. "The traditions of confidential banking make it difficult to convince the banks of the necessity of making complete statistical information public. The Government of the Colony has not thought it necessary to require them to do so. The balance sheet information is so incomplete as to be of little practical value to a Hong Kong economist .... The Exchange Fund account and a complete Balance of Payments for the Colony ought to be published ...." F.H.H. King, *The Monetary System of Hong Kong*, 1953, pp. 90–91. 39 years later, the details of the Exchange Fund were finally published.

2) Although the "restoration" was an issue to be dealt with sooner or later, public discussion of the issue took place at the Third Plenum of the 11th Central Commitee of the Chinese Communist Party held on December, 1978. At this rally the "reform and open door" policy was adopted. China's decision to "recover Hong Kong" may have taken shape at this same time.

Measures to reform and increase Hong Kong financial data have been taken because it has become necessary to understand more about the currency and monetary situation in the transition stage. Such change of statistics itself is a phenomenon of transition. Generally speaking, when the rule of the colonial government was stable, none of those who controlled Hong Kong's economy (especially bankers) felt the need to make such information puplic. Rather, their attitude was to "leave them uninformed."[3] Information became available only when their control seemed in jeopardy.

This paper aims to examine the historical significance of one of the notable trends that can be seen in the "new statistics": the sudden increase in foreign currency finance in Hong Kong. This phenomenon has been taken up in both public and private literature and is commonly treated as an index that most clearly indicates Hong Kong's "transition into an international financial market."[4] Such movement toward internationalization is now commonly noted to be one of the characteristics of the Hong Kong financial market today.[5]

However, the following two points should be considered when studying the internationalization phenomenon. First, it is necessary to place this phenomenon in the context of historical change. It is tempting to see internationalization merely as the result of an inevitable modernization process. Nevertheless, seen from the side of Hong Kong which is working on its own internationalization, the historical transition is interwoven into the process. Without recognition of this historical change, the internationalization of Hong Kong cannot be completely understood. For example, seen from the former point of view, Hong Kong's shift to a modern "international financial center" would be a further step toward modernization for the old British "international financial metropolis." However, seen from the latter point of view, one realizes that the Hong Kong Government began to promote the transformation of the territory into an international financial center only towards the end of the 1970's — the beginning of the transition period towards a Hong Kong controlled by China. Until then, the government, in consideration of the interests of colonial banks, instituted policies that impeded the advancement of foreign powers. The policy change occurred because of the change in the historical situation.

Second, the way in which historical change is recognized is at issue. As we approach 1997, discussion over this is becoming heated. Such arguments are developed mostly on the premise that Hong Kong should adjust itself to diffrent environments through changing its shape and its way of doing things. Such an image is only a borrowing of the "independent Hong Kong" image that was shaped by the compromise reached by the People's Republic of China, the U.K., and Hong Kong.

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3) "Many busy directors of banking institutions feel that the public does not need more specific information. It is enough for them to know that the management is in good hands, and, in any case, the first duty is to the stockholders. The public should not be told things they cannot hope to understand; they will only misinterpret the information and act foolishy." *ibid.*, p. 91.

4) For a representative case, see Government Information Service, *Hong Kong 1992 — A Review of 1991.*

5) In Hong Kong, the term "internationalization" implies confidence in the colony and its prosperity through its being utilized as a market by other countries. In addition, it is also used at times as a check to prevent likely hostility against Hong Kong, hinsting that those who oppose Hong Kong's interest will be reducing the profits of other countries as well. Therefore, when discussing the indices of "internationalization," it is necessary to examine the substance as opposed to the "political utilization value."

These three groups' respective interests are at odds and therefore each understands Hong Kong differently. The ruler and the system will undergo change, but the people of Hong Kong must survive the changes. Hong Kong has consistently been a British territory throughout its capitalist years. Therefore, it is possible to focus on the "changes in economic conditions" that enable or disable colonial rule.[6)]

The purpose of this paper is to focus on the increasing use of foreign currency finance as an important sign of internationalization, and to consider the increase in foreign currency finance in the context of Hong Kong's historical transformation, i.e; its return to China.

Another phenomenon that marks Hong Kong's shift to an international financial center is the "internationalization of financial institutions." While the term mainly implies the rapid increase in the number of foreign banks in Hong Kong, the Hongkong and Shanghai Banking Corporation has launched itself into the overseas market in its own drive toward "internatinalization." It is necessary, therefore, to consider the activities of these financial institutions in relation to the internationalization trend. However due to limited space, this point will be discussed in another paper.

The composition of this paper is as follows: First, in "The Development of Currency and Finance in Hong Kong," I will discuss the British establishment of Hong Kong's financial system after World War II, including the process (1970's) by which that system gradually erodes in the changing times. Next, in "The Rapid Increase in the Balance of Hong Kong's Foreign Currency Finance in the 1980's," I will show how the increased use of foreign currency finance was brought about. Finally, I will explain why I think that the increase in foreign currency finance in the Hong Kong financial market marks the end of the British Colonial-style monetary/financial system.

I The Development of Currency and Finance in Hong Kong

A. The Basic Financial Structure in Postwar British Hong Kong — Production by Chinese Labor and Financial Domination by the Hongkong and Shanghai Banking Corporation

Even after the collapse of old colonialism at the end of World War II, Hong Kong has remained to this day a British crown colony. The economic factor that enabled this political "anachronism" to survive was Hong Kong's successful transformation from a transit center for goods in and out China to a production base maintaining extraterritorial rights in China. Instead of relying upon China for capitalist production, Hong Kong began producing commodities on its own. When the United Nations instituted an embargo to counter China's participation in the Korean War, it became impossible for Hong Kong to continue its prewar-style transit trade with China. However, at the same time

6) For example, the Hong Kong Government's intervention in the general economy, particularly in the monetary sector intensified during the 1980's. Many interpret this as "a switch in policy-making from the traditional laissez-faire." Because the change reflects changes already made in developed countries, it interpreted as move toward "modernization." However in British-ruled Hong Kong, laissez-faire didn't stand alone; it had two faces, one of which was "privilege." Increased intervention in the economy means that "the privileges derived from colonial ruling are in crisis." As a result of not being able to see (or not wanting to see) this fact, the extremely realistic and important problem of the historical transition of power in politics and the economy is apt to be overlooked.

there was a rapid influx of people coming from China, which, together with the entrepreneurs and capital flowing in mainly from Shanghai, merged to form a "happy marrriage" of unemployed labor and idle capital. These factors all contributed to the transformation of Hong Kong into a production base and export center.[7] The leading factor facilitating this change was the cost of labor in Hong Kong, said to be half that in Singapore.[8]

Bankers and merchants, Hong Kong's traditional rulers, could now enjoy their share of surplus value from goods produced in Hong Kong. Bank finance played a decisive role in industrial development and the provision of its infrastructure. It is estimated that the HSBC, the largest of local banks, controlled more than half of all industrial finance in Hong Kong.[9] As the HSBC's power increased along with industrial development, confidence in bank notes — the bulk of which were issued by the HSBC — increased. Strong exports resulted in a surplus in the foreign exchange balance, strengthening the external value of the Hong Kong dollar.

Throughout the 1950's Hong Kong's economic status was on the rise, and as it retained its role as a transit center for Asia even without China, there was a gradual increase in the number of foreign banks in the territory. However, like domestic banks, the foreign banks were called "authorized banks" and were subject to exchange regulations that protected the sterling pound. This meant that foreign banks were compelled to abide by the foreign exchange rate quotation (later on, the deposit rate) set by the Exchange Banks Association, an organaization led by British banks such as the HSBC. Foreign currency deposits in "non-designated area" currencies such as the US dollar were deemed as "matters subject to approval," and almost no such deposits were actually made. In short, foreign banks were permitted to operate in Hong Kong as long as they recognized the domination of the Hong Kong dollar market by British banks. Foreign banks' operation was restricted by the exchange control law in the interest of Britain and British controlling body in Hong Kong. Hong Kong's currency and financial system and its relation with foreign banks were established in the 1950's and 60's under postwar British domination.

B. The Collapse of the Sterling Pound and the Emergence of a Euro-Currency Market

While Hong Kong prospered as a manufacturing center of goods for export, the mainland British economy continued to decline. In the late 1960's, Britain faced a serious currency crisis. As a result, the mainland currency (the pound) was devalued against the colony currency (the Hong Kong dollar). In 1972, when the pound was floated, the Sterling Area — created to protect the pound — fell apart, and the fixed exchange relation between the British pound and the Hong Kong dollar was abolished.

As a result, Hong Kong's foreign exchange controls were abolished. Hong Kong, which still had cost problems, such as taxation (corporate and interest tax) and a cartel among exchange banks over the applicable interest rates for customers, nevertheless became a place where free transaction

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7) Endacott, G.B.. *A History of Hong Kong*, 2nd edn., 1977, p. 316.

8) Yokoyama Shoichi. 「香港工業化の研究」 *(A Study of Industrialization in Hong Kong)*, 1969, p. 314.

9) Jao, Y.C.. "Financing Hong Kong's Postwar Industrialization: The Role of the Hongkong and Shanghai Banking Corporation" in F.H.H. King, (ed.), *Eastern Banking*, 1982.

between the domestic currency Hong Kong dollar market and the Euro-currency market could take place. The Euro-currency market, which had matured centrally in London, first expanded into Asia when the Singapore ACU market began to function in December, 1988. By the early 1970's, it had a strong footing in Asia.

The Euro-currency market, a playing field where banking capital from various nations can freely compete, is free from the internal regulations of each country. Although this market is isolated from the domestic one as an offshore market, it functions to incapacitate domestic market regulations in other countries, clearing the way for the abolition of all regulations. By utilizing offshore markets such as that of Singapore, Hong Kong depositors were able to escape taxation and arranged rates among banks at home. When Japanese financial liberation was eventually promoted with the inauguration of the Japan Offshore Market (JOM), Hong Kong (located in the same time zone as Japan), together with Singapore, provided external environments for the liberalization of the Tokyo Market.

C. Opposition and Compromise Concerning the Increased Activity of Foreign Banks — the Reissue of the Banking Licence in 1978

Since liberalization of the market also meant liberalization of foreign banks' activities, local banks — especially the HSBC, with its long history of market domination — had to react quickly to prevent the erosion of their market. The suspension on the issuance of bank licences ("the moratorium") from 1965 (the year of the banking crisis) to 1978 was a measure taken by the government to protect local banks. However, even without a "bank" qualification, it was possible to open banking businesses (as long as they did not accept small, short term deposits from individuals) in the form of finance companies; thus, the number of finance companies multiplied during this period. It is also true, however, that small finance companies were liquidated under the Deposit Taking Company Ordinances of 1976. Also, finance companies (deposit taking companies), which were gradually liquidated or upgraded to licensed banks and or restricted licensed banks, rapidly decreased in number.[10] However, the decision to reissue bank licenses (the lifting of the moratorium), was epoch-making. It opened the way for the major banks of the world to begin full-scale participation in the Hong Kong market.

It seems that the local Hong Kong banks, represented by the HSBC, made the decision to open the market to free competition on the supposition that foreign banks would not erode local banks' profits due to local banks' strong connection with local industry and the Hong Kong dollar market. However 1978 turned out to be a historical transition point for the HSBC. The end of the moratorium marks the point at which the HSBC began its drive to become a "multinational corporation" (a post-British Hong Kong strategy).[11] In other words, the lifting of the moratorium was a trade-off for the HSBC and foreign banks.

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10) The banking system of Hong Kong has taken the form of a "three-tier system" according to the revised Banking Ordinance of 1981. The system has experienced some partial revisions.

11) In the same year (1978), the HSBC announced its acquisition of Marine Midland Banks, a major U.S. bank. It then bought a 51.1% share of Marine Midland Banks, Inc., MMB's holding company. In December 1987 it bought the remaining shares — the HSBC now owns all shares.

After the moratorium was lifted, U.S. and European banks immediately rushed to obtain licenses. Japanese banks, however, got off to a slower start. On one hand this was because the Japanese Ministry of Finance firmly controlled the opening of overseas bank offices. On the other hand, at that time U.S. and European banks were much stronger when compared to later years. Japanese banks didn't begin their powerful advance into the Hong Kong market until the 1980's.

II The Rapid Increase in the Balance of Hong Kong's Foreign Currency Finance in the 1980's

The balance in foreign currency that accounts for Hong Kong financial institutions' total assets and liabilities throughout the 1980's was far greater than the balance in Hong Kong dollars. Table 1 shows the balance sheet (financial balance) of all the authorized financial institutions in Hong Kong dollars and in foreign currency. The data for 1991 shows that Hong Kong's own currency accounts for only about 20% of the total, while the remainder is in foreign currency. When we note the change in percentages of total bank assets in Hong Kong dollars and foreign currency from 1980, the rapid increase in the amount of foreign currency is apparent, especially during two periods: 1982–83, and 1986–87 (see Table 2).

There was no statistical differentiation between foreign currency and Hong Kong dollars until

Table 1 Balance Sheet for All Authorized Financial Institutions

(Unit: Billion HK$)

Liabilities at end of	HK$		Foreign currency		Total	
	1980	1991	1980	1991	1980	1991
Amount due to authorized institutions in Hong Kong	51	292	36	288	87	580
Amount due to banks abroad	5	126	163	3,193	168	3,319
Deposits from customers	111	564 (604*)	18	811 (771*)	129	1,375
Other liabilities	36	163	15	183	51	346
Total	203	1,145	232	4,475	435	5,620

Assets	1980	1991	1980	1991	1980	1991
Amount due to authorized institutions in Hong Kong	51	291	35	287	86	578
Amount due from banks abroad	7	44	96	2,292	103	2,336
Loans and advances to customers	104	724	80	1,520	184	2,244
Other assets	29	115	33	347	62	462
Total	191	1,174	244	4,446	435	5,620

*deposits adjusted to exclude foreign currency swap deposits.
Source: *Hong Kong Monthly Digest of Statistics*, various issues.

the end of 1970. Hence, by distinguishing the amount "Due to foreign banks" (deposits of or borrowing from banks abroad) which was mostly in foreign currency, and assuming other accounts to be in Hong Kong dollars, the percentages of both in the 1970's are shown in Table 3. Although the figures do not match explicitly with those of the 1980's, it can readily be seen from this table that the movement toward foreign currency finance began during the early 1970's and continued through the 1970's and 1980's.

Table 2 HK$ and Foreign Currency Assets of All Authorized Institutions in Percentages

At end of	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
HK$	43.8	41.7	36.7	31.9	29.9	28.1	23.3	18.2	19.1	20.5	19.1	20.9
Foreign Currency	56.2	58.3	63.6	68.1	70.1	71.9	76.7	81.8	80.9	79.5	80.9	79.1

Source : *Hong Kong Monthly Digest of Statistics*, various issues.

Table 3 Assumed[1)] HK$ and Foreign Currency Liabilities in 1970's in Percentages

At end of	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980
HK$	92.5	89.8	86.5	81.2	75.0	67.6	65.4	63.3	61.0	60.4	56.1
Foreign Currency	7.5	10.2	13.5	18.8	25.0	32.4	34.6	36.7	39.0	39.6	43.9

Note : 1) It is assumed that the account "Due to overseas banks" is in foreign currency and that all other accounts are in Hong Kong dollars.
Source : *Hong Kong Monthly Digest of Statistics*, various issues.

A. Views on the Rapid Increase in the Amount of Foreign Currency Financial Balance

There are many different explanations given for the increase in the amount of foreign currency finance in Hong Kong, but here, in order to gain a foothold for a better understanding of the situation, I will examine two of the most salient explanations.

According to the most popular view, the increased use of foreign currency finance is a sign that Hong Kong has become an international financial market.[12)] However, while the tendency to use foreign currency is a natural outcome of increasing financial transactions, these transactions are not always made in the market where they are booked. For example, "markets" in the Carribean, despite all their bookings of international finacial transactions, have not become international financial markets.[13)] Thus it is important to delve further into the matter without taking statements such as

12) Ho, Richard Yan-ki. "The Banking System : An Overview" and "Hong Kong as an International Financial Centre" in Richard Yan-ki Ho, Robert Hanney Scott and Ko Ann Wong (eds.), *The Hong Kong Financial System*, 1991.

13) Jiro Otsuka points out that in places where "substantial financial intermediary activity" takes place in other markets, while only the "booking" is done at the home market, such as in the Carribian offshore market, the home market is essentially a Euro market in such makets as the U.S.. The Luxembourg market is seen to have the same finction for Germany. However, Otsuka maintains that Hong Kong

"more than 60 per cent of the (banking) sectors' aggregate assets and liabilities are external, spreading over more than 100 countries"[14] at face value and to question the nature of transactions and the significance they have for Hong Kong as an international financial market. To give away the conclusion early, the bulk of Hong Kong's foreign currency assets and liabilities especially the recent rapid increase, is merely the booked balance of extended domestic financing in other countries — in this case, Japan's. The tendency to use foreign currency in finance reflects the rapidity and thoroughness of "market liberalization." But it does not necessarily reflect the active and unique role Hong Kong's market taken on as an "international financial center."

A second perspective views the move toward using foreign currency in finance as currency substitution — the substitution of foreign currency for domestic currency. According to this view, foreign currency was chosen in order to escape the Hong Kong dollar crisis which reached its peak between 1982 — 86.[15] This explanation is plausible, but only if the discussion is limited to foreign currency deposits. Since the foreign currency balance can carry different meanings, this kind of understanding may ignore important factors.

While both perspective should be appreciated for having a certain amount of truth, both have weakenesses. In order to draw a more accurate and complete picture, the move to foreign currency finance must be set within the disintegration process of the currency/financial system of Colonial Hong Kong.

B. The Japanese Finance and Foreign Currency Deposits — The Major Factor Accounting for the Increased Foreign Currency Finance

Table 1 shows that, at the end of 1991, the total amount of foreign currency liabilities was 4,475 HK$ (units are in billions of HK$). The "Amount due to banks abroad" was 71.4% of the total (3,193 HK$). If the "Deposit from customers" 18.1% (811 HK$) is added, the sum of only these two accounts reaches a high of 89.5%. As for assets, the "Amount due from banks abroad" and "Loans and advances to customers" are 51.6% (2,292 HK$) and 34.2% (1,520 HK$) respectively. The combined assets also amount to as much as 85.8% of the total. Since the combined liabilities and the combined assets at the end of 1991 (89.5% in liabilities and 85.8% in assets) are larger than corresponding figures at the end of 1980 (78.0% in liabilities and 72.1% in assets), the each of the four items increased not only absolutely in amount but also relatively as part of the total liabilities

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and Singapore decide interect rates on their own, thus differentiating themselve from those markets which do not have "financial substance." Otsuka's point of view is plausible. However, as for recent Euro-yen transactions, Hong Kong has been as a booking center for part of yen financing in Japan, similar to what Luxembourg is for Germany. Jiro Otsuka, "転換期のアジア金融市場—国際金融仲介水平分業化への視点"「調査月報」("The Asian International Financial Market in Transition: A Perspective towards the Horizontal Specialization of Intermediary Activity in International Financing," *Chosa Geppo*) (日本長期信用銀行 *The Long Term Credit Bank of Japan*), No. 266, 1990.

14) Government Information Service, *op. cit.*, p. 72.

15) Jao, Y.C., "From Sterling Exchange Standard to Dollar Exchange Standard: the Evolution of Hong Kong's Contemporary Monetary System" in Y.C. Jao and F.H.H. King, *Money in Hong Kong*, 1990, p. 119.

and assets. What is the substance of these four items?

Table 4 shows liabilities and claims classified by country. The proportion of Japanese liabilities and claims of the total (world) is shown for the end of 1980 and 1991. From this table we can see that, of all authorized institutions, the Japanese liabilities and assets increased most dramatically between 1980 and 1991. By applying these figures to the above items, the approximate Japanese share for each item can be calculated. Thus, from the 1991 share percentages 68.5, 61.5 and 76.0% and the aforementioned percentages of each account of 1991, 71.4, 51.6, and 34.2%, the Japanese share of each account is obtained as 48.9, 31.7, 26.0, respectively. This shows us that as of 1991, 48.9% of foreign currency liabilities and 57.7% (31.7+26.0) of assets were transactions with Japan.

Table 4 Japan's Share of External Liabilities and Claims of All Financial Institutions

(Unit : Billion HK$, %)

At end of year		1980			1991		
		Japan	Total	Share	Japan	Total	Share
Liabilities to banks outside HK	Foreign C.	9.0	163.6	5.5%	2,214	3,234	68.5%
	HK$	0.1	3.9		1	127	
Claims on bank outside HK	Foreign C.	8.1	111.8	7.2%	1,475	2,398	61.5%
	HK$		8.0		2	45	
Claims on non-banks outside HK	Foreign C.	2.1	56.0	3.7%	1,102	1,451	76.0%
	HK$		1.6			15	

Source : *Hong Kong Monthly Digest of Statistics.*

Customers' foreign currency deposits also changed dramatically between 1980 and 1981. In 1980 there were 18 HK$ deposited in foreign currency as opposed to 111 HK$ in Hong Kong dollars, a ratio of 14.0% to 86.0%. In 1991, the figures were 811 HK$ to 564 HK$; the ratio of 59.0% to 41.0%. Even after adjusting the foreign currency deposits with swaps into de facto Hong Kong dollar deposits, the figures are 771 HK$ to 604 HK$, a 56.1% to 43.9% ratio. This shows that foreign currency deposits exceeded Hong Kong dollar deposits.

C. Hong Kong as a Booking Center and the Move Away from the Hong Kong Dollar — the Present Stage of Euro-Currency and Hong Kong Dollar Markets

Table 5 illustrates how the proportions of Hong Kong dollars to foreign currency changes after deleting the increase in both balances due to Japanese and foreign currency deposits between the period of 1980 and 1991. This proves that the foreign currency portion decreased from 56.2% in 1980 to 48.4% in 1991. This means the overall increase in foreign currency finance resulted from two factors: the increased Japanese balance and foreign currency deposits. If there were other factors, they played insignificant roles.

Before taking a closer look at these two key factors, we will survey the increase in the balance of claims on non-bank customers by country and region (Table 6). From the table we see that, the number of Hong Kong's external customers' transactions is steadily growing in the 1980's. Because domestic loans increased by at least six times, the growth rate for "other Asian Oceania/countries" increased a mere 4.4 times, which contrasts with the more increasing trend in the 1970's.[16] However, growth rates for China and Japan were explosive: the balances as of 1991 are 94 times and 526 times respectively of as of 1980. Since discussion of China requires much in-depth study, it shall be treated in a different paper. Here I would like to focus on the sudden rise in Japanese customer

Table 5 Foreign Currency Ratio after deducting the Japanese Finance (the Amount Borrowed from Japan by Hong Kong Financial Institutions) and Foreign Currency Deposits

At end of	HK$	Foreign Currency
1980	43.8%	56.2%
1991	20.9%	79.1%
1991 (Adjusted)	51.6%	48.4%
Adjustment of liabilities as of 1991 (Unit: Billion HK$)		
HK$	1,185[1] + 578	=1,763 (51.6%)
Foreign Currency	4,435[1] − (2,205[2] + 578[3])	=1,652 (48.4%)
Total		3,415 (100.0%)

Note: 1) Foreign currency deposits with swap are adjusted to read as HK$ deposits (Table 1).
2) 2,205 is supposed to be the increase of the Japanese Finance which is taken from the increase in 'liability to banks in Japan' in Table 4 (2,214−9).
3) 578 is the net increase in foreign currency deposits, which is heypothesized to have been converted fully from Hong Kong dollars. (Table 1) 771−1,375×18÷129.

Source: *Hong Kong Monthly Digest of Statistics*, various issues.

Table 6 Claims on Non-Bank Customers outside Hong Kong
(Unit: Billion HK$, Times)

At end of year	China	Japan	Other Asian/Oceanian Countries	Others (Europe, USA etc.)	Total
1980	0.5	21	31.9	23.1	57.6
1991	47	1,105	141	173	1,466
Number of Times' Increase	94×	526×	4.4×	7.5×	25.5×

Source: *Hong Kong Monthly Digest of Statistics*, various issues.

16) For more information on the increase of Hong Kong's external financial transactions in the 1970's, see S.Y. Lee and Y.C. Jao, *Financial Structure and Monetary Policies in Southeast Asia*, 1982. 日本銀行調査局 "国際金融市場としての香港，シンガポールの発展について—前回石油危機以降のオイル・マネー還流に果たした役割を中心に—"「調査月報」(Research Dapartment, The Bank of Japan, "On the Development of Hong Kong and Singapore as International Financial Markets: the Role They Played in the Reflux of Oil Money after the Last Oil Crisis" in *Chosa Geppo*), Vol. 31, No. 5, May, 1980.

transactions as one factor leading to the rapid increase in the financial balance for Japan — a phenomenon peculiar to the 1980's.

(1) Three Types of Hong Kong-Japan Inter-office Transactions

Previous studies have shown that the substance of the increase in the financial balance due to and due from Japan was Japanese banks' finance loaned indirectly to their customers in Japan after passing through money centers such as Hong Kong and Singapore. This trend followed the "liberation" of the "impact loan" in yen in June 1984, and the inauguration of the Japan Offshore Market (JOM) in December 1986 (interbank transaction).[17] Loans in yen from outside Japan increased notably as they were outside the scope of the Bank of Japan's "window guidance" controling banks' loans to coustomers.

Moreover, it is being discovered that the Euro-yen loans, formally lent by Hong Kong but actually lent by banks in Japan, were spent on real estate and stocks in Japan.[18] However, in Hong Kong it was not only the yen impact loan that swelled the Japanese banks' foreign currency balance sheet. There are in fact three types of transactions; Type 1, the impact loans, may be the most representative. But Type 2 — diversion of a JOM fund to a general domestic fund — and Type 3 — an operation for increasing current assets, done to satisfy the liquidity ratio pursuant to the Hong Kong Banking Ordiance — are different transactions, each with a different purpose. The three together are deemed to constitute the basis of the foreign currency assets and liabilities with the Japanese banks' Hong Kong branch offices.

There can be, of course, other kinds of transactions between the head offices in Tokyo and branch offices in Hong Kong, such as the head office taking in the Euro-dollar unilaterally from Hong Kong. Also, an increased balance can be generated from transactions with other banks in Japan. Thus, I am not saying that the three types of transactions alone account for all of the foreign currency assets and liabilities with Japanese banks in Hong Kong. However, judging from the rapid increase in Foreign currency from 1986 to 1987 and the increase in both sides of the balance sheet for Japan, it can be assumed that Tipe 1 and 2 in particular were the significant factors behind the increase.[19]

Although the three transactions have different purposes, they do have the following points in common: Types 1 and 2 are Japan's and Type 3 is Hong Kong's "loophole for domestic regulations." All three types are "booking transactions," as they do not require after all an actual transfer of the

17) Okuda Koji, "ユーロ円とアジアのオフショア市場"「立命館国際研究」("Euro-yen and the Asian Offshore Market" in *The Ritsumeikan Journal of International Studies*), 5-1, May, 1992. Iwai Atsuo. "東京市場と結びつきを深める香港金融市場"「国際金融」("Hong Kong Financial Market Strengthening Its Ties with Tokyo" in *International Finance Journal*), No. 864, May, 1991. BIS, *Quarterly Review, International Banking and Financial Market Development*, 1992, pp. 16-18.

18) Yamaguchi Yoshiyuki, "「資産インフレ」の金融メカニズムについて—奥田宏司氏の所説の検討を手掛かりにして—"「名城商学」("On the Financial Mechanism of 'Asset Inflation': Using Koji Okuda's Approch as a Foothold" in *The Journal of Commerce and Economics*), vol. 41, No. 1, June, 1991 and No. 2, October, 1991.

19) See Okuda's paper mentioned above for details on the Euro-yen impact loan and the point in time at which Hong Kong and Singapore's balance for Japan increased.

funds to and from the Hong Kong branches.

Let us see how Types 1 2 and 3 can be expressed in a simple T-form. To avoid complexity, variations not related to the basic mechanism are disregarded.

Type 1 Euro-yen Impact Loan

Bank F in Tokyo		Bank F Hong Kong Branch Office	
Loan to HK Branch (JOM)	Borrowing from other banks (JOM)	Loan to customers in Japan	Borrowing from Head Office

In Type 1, Bank F Tokyo lends money to its Hong Kong branch by borrowing funds from the JOM account. The Hong Kong branch then loans the funds obtained from its head office to customers of Bank F in Japan.

Unlike cases in which the transaction is completed in Japan, this transaction frees Japanese banks from the Bank of Japan's window guidance regulating internal loans. It also enables the utilization of the JOM market as an additional supply source of funds. Furthermore, placing funds from Tokyo to Hong Kong in the above manner can also be done through a general inter-office account. If this is the case, the above "JOM" can simply be deleted.

In the case of Type 2, Bank F acquires funds from the JOM and loans them to its Hong Kong office through the JOM account. At the same time, the head office borrows the same amount from the branch office. Though the direct inflow of funds from the JOM to the domestic market is "cut off" except for certain amounts in Japan, nevertheless the JOM funds, simply by moving back and forth between the two offices, are transformed into domestically loanable funds. In type 2, the balance of the Hong Kong branch office will swell by the same amount on both sides of the balance sheet through the transactions with head office in Japan.[20]

Type 2 JOM funds to be converted into domestic funds

Bank F Tokyo		Bank F HK		Bank F Tokyo	
Loan to HK br. (JOM)	Borrowing from other banks (JOM)	Loan to Tokyo HO	Borrowing from Tokyo HO	Loan to customers in Japan	Borrowing from HK

Type 3 shows the way Bank F's Hong Kong office 'creates' its assets which fall due within one month and its liabilities over one month by dealing with its Tokyo head office. Any currency is applicable, but the yen or the U.S. dollar is most frequently used. The partner of the transaction does not necessarily have to be the Tokyo head office; it could be another overseas office, such as one in New York. However, since the head office of Japanese banks is in the same time zone as Hong

20) Furumi Kenichi, 「ビジネス・ゼミナール外国為替入門」 (*Business Seminar: a Guidebook of Foreign Exchange*), 1990, p. 191.

Kong, the head office is usually chosen.[21)]

Type 3 Producing liquid assets that satisfy the liquidity required by the Hong Kong Banking Ordinance

Bank F HK office		Bank F Tokyo	
Loan to Tokyo Term: within one month	Borrowing from Tokyo Term: over one month	Loan to HK Term: over one month	Borrowing from HK Term: within one month

As stated above, these transaction types increase the balance of assets and liabilities in the Hong Kong branch office of Japanese banks. While in Type 1 (Japanese) coustomers are on the assets side and banks are on the liabilities side, in type 2 and 3 the banks are on both sides. Thus, the transaction will appear on the balance sheet for all authorized financial institutions in Hong Kong as shown in Table 1 in the following manner: Funds "Due to banks abroad" (contributed by Types 1, 2 and 3) are applied partly to "Loan and advance" (loans to customers, contributed by Type 1), and the rest of funds is applied to "Due from foreign bank" (contributed by Type 2 and 3).

(2) Foreign Currency Deposits and Decreasing Confidence in the Hong Kong Dollar

As shown in Table 7, foreign currency deposits increased faster than Hong Kong dollar deposits before experiencing a brief interruption in September 1983. The increase in foreign currency deposits outpaced Hong Kong dollar deposits in 1984 before becoming relatively stabilized toward 1990. As stated below, this movement was, directly or indirectly, closely related to that of Hong Kong dollar exchange rates. And the Hong Kong dollar exchange rate fluctuated in different patterns in the two periods before and after the currency reform in October 1983. The currency reform was enacted in

21) According to the Hong Kong Banking Ordinance, every authorized institution must maintain a liquidity ratio of not less than 25% in each calendar month. The ratio is calculated from between the institution's liquefiable assets and qualifying liabilities for each working day of the calendar month. If a foreign bank takes funds from its overseas head office in the term of over one month (to be not counted as qualifying liabilities) and places them for a term within one month (to be counted as liquefiable assets) this set of transactions will greatly improve the overall liquidity ratio of the bank. This kind of inter-office operation has been done actively by foreign banks since the liquidity ratio requirement was instituted by the Banking Ordinance in 1964. Until the Banking Ordinance was revised in 1986, banks were obliged to maintain an average balance of liquid assets in the current month of not less than 25% of the deposit balance at the end of the previous month. The aggregate amount of each month's liquid assets was made public by the Government. However in the current system (after 1986) no data is available in the Government publications concerning liquidity rations, such as the sum of the liquefiable assets and actual liquidity ratio. It is therefore impossible to distinguish the amount of liquefiable assets from the inter-office operation of foreign banks. However it is believed that a substantial amount is still involved because foreign banks remain dependent on this operation to satisfy the requirement. "It will still be possible for an authorized institution to 'manufacture' liquidity to comply with the requirements of section 102 by mismatching the periods of receivables and payables from and to a foreign branch. Although this may involve incurring an interest cost, this will be squared up when the accounts are consolidated in the book of its head office." Ghose, TK., *The Banking System of Hong Kong*, 1987, p. 271.

response to the currency and banking crisis which peaked in the previous month.

Table 7 Customer Deposits of All Financial Institutions

(Unit: Million HK$, %)

At End of Year	HK$	Foreign Currency	Total	Percentage of HK$: Foreign C.
1980	111,125	17,729	128,854	86.2 : 13.8
1981	134,359	29,266	163,625	82.1 : 17.9
1982	135,384	98,688	234,072	57.8 : 42.2
(Sept., 1983[1])	133,627	146,785	280,412	47.7 : 52.3
1983	153,401	138,849	292,250	52.5 : 47.5
1984	193,190	175,198	368,387	52.4 : 47.6
1985	212,132	236,837	448,968	47.2 : 52.8
1986	245,103	317,426	562,529	43.6 : 56.4
1987	309,543	394,066	703,609	44.0 : 56.0
1988	346,744	498,776	845,520	41.0 : 59.0
1989	387,640	620,017	1,007,658	38.5 : 61.5
1990	452,382	778,889	1,232,271	36.7 : 63.3
1991	563,927	813,679	1,374,606	41.0 : 59.0

Note: 1) Figures at the end of September, 1983 — when the currency crisis peaked — were specifically shown.

Source: *Hong Kong Monthly Digest of Statistics*, various issues.

Before October 1983

The period before October 1983 is characterized by the fall in the exchange value of the Hong Kong dollar. It fell with increasing speed until bottoming out at US$1 to HK$9.5 on September 24, 1983.[22] During this period of tension due to the negotiation between China and Britain, serious anxiety prevailed inside and outside the territory over the future of Hong Kong. This anxiety resulted in the currency crisis, exasperating the ongoing banking crisis.

Meanwhile, the US dollar was on the rise elsewhere in the world at this time. US dollar exchange rates were firmed by the high interest policy consciously pursued by the Reagan administration. In Hong Kong, however, the 1997 problem made the US dollar rise even higher. The 1997 problem is classified by many as a political factor and therefore irrelevant to decide the level of the exchange rate. It was a political factor, however, in this case it was a critical factor determining the acceptance of paper money by the people. As the fate of the power of the state which circulates Hong Kong dollars was placed in doubt, confidence was lost in Hong Kong currency.

In this period foreign currency deposits increased sharply. This increase was not only due to the abolition of interest tax on foreign currency deposits (February 1982) and the firmness of the US dollar. Foreign currency deposits were preferred as an instrument for the flight of money out of Hong Kong currency. There were other flows of money out of Hong Kong and into overseas deposits for the same reason, however, with the lack of balance of payment data (mentioned above[2]) it

22) Government Information Service, *Hong Kong 1983*, p. 46, *Hong Kong 1984*, p. 51. According to other sources, the lowest point for the Hong Kong dollar is 9.65.

is difficult to estimate the scale of the whole movement.[23)]

Accordingly, the period from 1982−3, (with the 1986−87 period when Japanese balance especially increased) is one of the two remarkable periods when the amount of foreign currency in Hong Kong finance sharply increased.

After October 1983

The currency reform of October 1983 obliged the issuing banks to surrender US dollar to the Govenment at the rate of US$1=HK$7.8 in exchange for a certificate of indebtedness which had been necessary to issue bank notes (to recover bank notes from circulation, the opposite procedure is followed). As a result of this act, the exchange rate in the market stays near 7.8. The market rate, allowed to fluctuate and depart from 7.8, is kept around 7.8 by arbitration. Since the currency reform, the exchange rate for Hong Kong and US dollars has remained at a stable 7.8.

The attractiveness of foreign currency deposits in US dollars during the period after October 1983 was due, not to any appreciation in the exchange rate, but to the relative higher interest rates for US dollars. Although there is no official data, it is believed that the proportion of all foreign currency deposits made in US dollars decreased relative to the other currencies, while that of European currencies increased sharply. In the case of non-US dollar deposits, even if the US/HK dollar is stable, the foreign currency risk remains. Thus attractiveness of non-US dollar deposits remained the same as in the period before 1983. In the period before and after 1983, there was a significant amount of foreign currency deposits with swap (see Table 1), which were actually HK dollar deposits. These deposits, made in order to be free from the agreed interest rate (on HK dollar deposits) set by the Bankers Association, obtained higher interest rates than the one agreed on.

As is obvious, especially in the first period, the increase in foreign currency deposits is remarkable sign of confidence lost in the Hong Kong currency and an escape from it. It is to be noted, however, that the foreign currency deposits in Hong Kong reflect only a part of such movement; they refer only to those deposits converted from Hong Kong dollars to foreign currencies which stayed in Hong Kong, but not those which went out of it.

III Conclusion: An End to British Currency and Financial Order in Hong Kong

As we have seen, the increasing amount of foreign currency characterizing Hong Kong finance in the 1980's means that (a) Hong Kong has become a booking center and (b) confidence in the Hong Kong dollar is decreasing. The two features seem contradictory: (a) looks positive for Hong Kong and (b) negative. However, the facts show that both are negative phenomena for the British

23) Though lacking balance of payment statistics to prove it, many agree with the assumption that capital was flowing out of Hong Kong after 1983. Another interpretation of the movement of capital is as follows: "What is more likely is that there was substantial outflow of local capital, which was largely, and possibly entirely, offset by a substantial inflow of foreign capital." "Capital Flows in Hong Kong," *Hongkong Bank Economic Report*, April, 1990.

Hong Kong Financial order.

The development of Euro-currency markets gives leading banks in the world the opportunity to pursue their interests in a broader area where domestic regulations cannot reach them. The number of Euro-currency transactions in Hong Kong has grown since the 70's based on the demands of the trade. By the 80's, almost 80 percent of the total balance of all financial institutions were in foreign currencies; half of that foreign currency balance consisted of booking of de facto domestic finance in Japan, one of the biggest users of the Hong Kong financial market. In this way, Hong Kong has come to be a booking center for Japanese domestic finance.

This development is the inevitable result of a series of events such as the floatation of the sterling pound and the abolition of exchange regulation, the lifting of the 'moratorium' on issuing banking licenses, and the increase in the number of foreign banks in the Hong Kong marketplace. However, for the leaders of traditional Hong Kong finance such as the HSBC, this is a fatal compromise and a retreat from competition with strong foreign banks. Those who controlled Hong Kong finance left the foreign currency market (which made its appearance in 70's) at the disposal of foreign banks.

The confidence lost in the Hong Kong dollar translated into confidence lost in the Hong Kong banking system which has been depending on Hong Kong dollar finance. This was shown in the early 80's when the Hong Kong dollar crisis occured along with the banking crisis. Of the three factors that keep nonconvertible notes effective — the volume of money in circulation, the legal force of the state, and the confidence of the people — measures controlling the volume of money have developed remarkably since the monetary reform of 1983. However, the latter two factors will be decided in the future under Chinese administration, which means at present it is difficult to speculate on the currency's stability.

Hong Kong's use as a booking center and the lost confidence in the Hong Kong dollar illustrate, therefore, the irreversible weakening or retreat of the monetary and financial order of British Hong Kong. This order will completely disappear at some stage under Chinese rule, a process is already happening during the present period of transition.

Table 6 shows that Hong Kong financial institutions' external assets to China increased through the end of 1991 — to almost 100 times the amount at the end of 1980 which was negligible. This shows that there is an unprecedented demand of money to satisfy the capitalist method of production in the area of China surrounding Hong Kong. Such production has been initiated by Hong Kong companies, first in the form of outward processing arrangements. These arrangements soon created a huge demand for money to build the infrastructure for more production in future. Figures in Table 6 show just the tip of iceberg, since they reflect those flows of money through Hong Kong banks only.

As the production center moves out of Hong Kong into China and productive activity increases rapidly there, the financial order of British Hong Kong led by British banks and based on production inside Hong Kong, an order that dominated the Hong Kong dollar market — even to the point of issuing Hong Kong dollar notes by themselves — is now 'out of date'. At the same time, banks in Hong Kong are expected to play a new role, supplying money to satisfy the increasing demand created in China. The process of historical change from a British Hong Kong to a Chinese Hong Kong monetary and financial order becomes more clear when we investigate the respective roles taken on by the various players in finance.