Introduction

The 'one country, two systems' structure established to govern the relationship between Hong Kong SAR and Mainland China was an innovative and comprehensive solution to particular economic and political challenges posed by the return of Hong Kong to the PRC in 1997. At the time of the drafting of the Basic Law, the integration of the colony into the regional economy of Southeast China through outward FDI had already begun, and from the mid-1980s this process facilitated the transformation of the Hong Kong economy from a manufacturing base to one dominated by financial and commercial services. It was recognized on both sides of the negotiations that the territory's viability and future prosperity relied on retaining independence over a range of key fundamentals, including a separate and independent currency and monetary system that was at the foundation of Hong Kong's attraction as an international financial centre for the PRC and also for the rest of the Asian region. An important credibility mechanism for the HK$ (as for the inconvertible RMB at this time) was the exchange rate link to the US$. Since this was also the anchor for the RMB after 1997, the linked rate system kept the relationship between the RMB and the HK$ stable.

While the rapid growth and development of the Mainland economy after 1999 outstripped many predictions, the relatively poor performance of Hong Kong from 1997 until 2003 has changed the context in which the one country two currencies system operates. The de-linking of the RMB from the US$ and subsequent appreciation from July 2005 has further complicated the monetary relations between Hong Kong SAR and the rest of China. Hong Kong's interest rates and monetary policy are now arguably more closely aligned with those of the USA than those of

its main trade partner. The increased use of RMB in banking and other transactions in Hong Kong SAR is further evidence of the erosion of the barriers between the two currencies. In February 2008, RMB deposits in Hong Kong had reached RMB47.8 billion, an increase of 92% over a year, although this still represented only 0.8% of total deposits in Hong Kong. Cross-border financial flows within the banking system have also accelerated with the accumulation of net liabilities in Hong Kong to banks on the Mainland since 1999.[2] Once the RMB and the HK$ reached parity against the US$ in January 2007 there was a psychological shift in attitudes about the relative merits of each currency as well real concerns over the potential impact of the appreciation of the RMB on the cost of imports into Hong Kong from the Mainland.[3] The potential for further appreciation of the RMB against the HK$ poses challenges as well as opportunities for Hong Kong consumers and producers and heightens public attention on the implications of separate currencies within a single country.

The financial, monetary and banking relations between Hong Kong and Mainland China have a long and intimate history that should be borne in mind when assessing the challenges faced by the separate monetary systems operating today. As Chan's chapter in this volume shows, due to the commercial integration of the region, the HK$ circulated widely in Southeast China both as a store of value and as a medium of exchange. This monetary integration increased during the collapse of China's monetary system in the late 1940s.[4] With the establishment of the PRC, HK$ were collected by the new government of China and their use in private transactions was prohibited in order to promote the new national Chinese currency. Banking relations between the two territories were never severed but they were put under severe strain by the nationalisation of banking and commerce in the early 1950s. Nevertheless, this article will emphasize that there was considerable continuity in the banking relations between Hong Kong and Mainland China and will explore the operations and implications of exchange rate dynamics in the 1960s and 1970s when the global fixed exchange rate system collapsed, destabilising the exchange rate between the HK$ and RMB. An important contribution is to present new data on the activities of Mainland Chinese banks operating in Hong Kong during this period, collected from official archives. This data confirm the extent of cross-border activities throughout the 1960s and early 1970s.

International banking

Hong Kong has traditionally been an important international financial centre for the Mainland, surpassing Shanghai from the mid-1930s as

military and political disturbances interrupted activity there. The monetary chaos of the 1930s also drew foreign banks into operating the exchange rate system. King recounts how during the crisis caused by the rise in the silver price in 1933–34 H.H. Kung and T.V. Soong of the Bank of China drew Henchman of the Hongkong Bank into a secret partnership to support the exchange rate of the Chinese dollar. His success earned him a gold wristwatch and the confidence of Soong and Kung that put the Hongkong Bank at the forefront of support schemes over the next few years.[5] Although the new Communist regime after 1949 severely restricted the activities of foreign banks and most extracted themselves from China during the early 1950s, the Hongkong and Shanghai Bank (HSBC) maintained its presence through these difficult years and was able to restore some of its business from the mid-1950s.

Relations between the Bank of China, the HSBC and the Hong Kong government were cordial and generally functioned well.[6] However, there were delicate political aspects of the Bank of China's role in Hong Kong. In 1961, the Bank of China requested subsidised land to build workers' accommodation but the project was delayed because the land needed to be cleared of 1500 squatters. The Political Advisor recommended to the Colonial Secretary that

> 'I feel that we should be no more or less helpful to the BoC than we would be to any other employer wishing to take similar action. What we want to avoid doing is creating the impression that for political reasons we are putting obstacles in the BoCs way.'[7]

Ten years later, however, when the question of land for workers' housing arose again, the Director of Special Branch advised that

> from an internal security viewpoint it is undesirable to allow the BoC or any other CPG [PRC] organization to build further large fortress-type buildings, especially on road junctions or other strategic locations. Hence Special Branch would wish to be consulted on any sites which may be offered to the bank.[8]

While the Bank of China was the most prominent Mainland-controlled bank in Hong Kong it was not the largest. Table 3.1 shows that by 1970 there were 13 PRC-controlled banks in Hong Kong with a total of 55 branches.[9] They included the Bank of China, other banks registered on the Mainland, and banks registered in Hong Kong but controlled by the PRC.

Table 3.1 Mainland Chinese Controlled Banks in Hong Kong 1970

	Number of Offices Jan 1970
Bank of China	2
Bank of Communications	6
China and South Sea Bank	5
China State Bank	5
Chiyu Banking Corporation	3
Hua Chiao Commercial Bank	4
Kincheng Banking Corp.	6
Kwangtung Provincial Bank	7
Nanyang Commercial Bank	7
National Commercial Bank	3
Po Sang Bank	1
Sin Hua Trust	7
Yien Yieh Commercial Bank	5

Classification based on Bank Returns to the Banking Commissioner for 1970. In 1967 Chiyu Banking Corporation was removed from the list of Mainland banks but reappeared in the list in 1969. Hua Chiao Commercial Bank was moved from local to Mainland in 1967. Branches from HKRS411/2/45.

The Bank of China was undoubtedly the most politically influential PRC bank in Hong Kong but Nanyang Commercial Bank (locally registered in Hong Kong) had the largest local deposits and advances. Figure 3.1 shows the growth in total assets and deposits of Nanyang Commercial Bank. The rate of growth was interrupted by the communist disturbances in Hong Kong in Spring 1967 that affected all PRC banks adversely, and it took several years to recover its position. In the boom of the early 1970s, however, the bank grew very quickly.

Based on archival data, Figure 3.2 shows the rise in deposits and advances for all PRC banks in Hong Kong from 1964–72. After growing quickly at the beginning of this period, deposits and advances declined in 1967 due to political disturbances in Hong Kong arising from the Cultural Revolution on the Mainland. It took two years for the Mainland banks to recover the 1966 level of deposits but the rate of increase then recovered quickly and by the end of 1972 Mainland banks in Hong Kong held over HK$2b (US$354m) of deposits. The fastest growing banks after 1967 in terms of deposits were Sin Hua Trust and Kwangtung Provincial bank, both of which (along with Nanyang Commercial) had significant branch networks in the colony. In 1964 and in 1972 these three banks accounted for over 40% of total Mainland banks' deposits in Hong Kong, although their share dipped below 40%

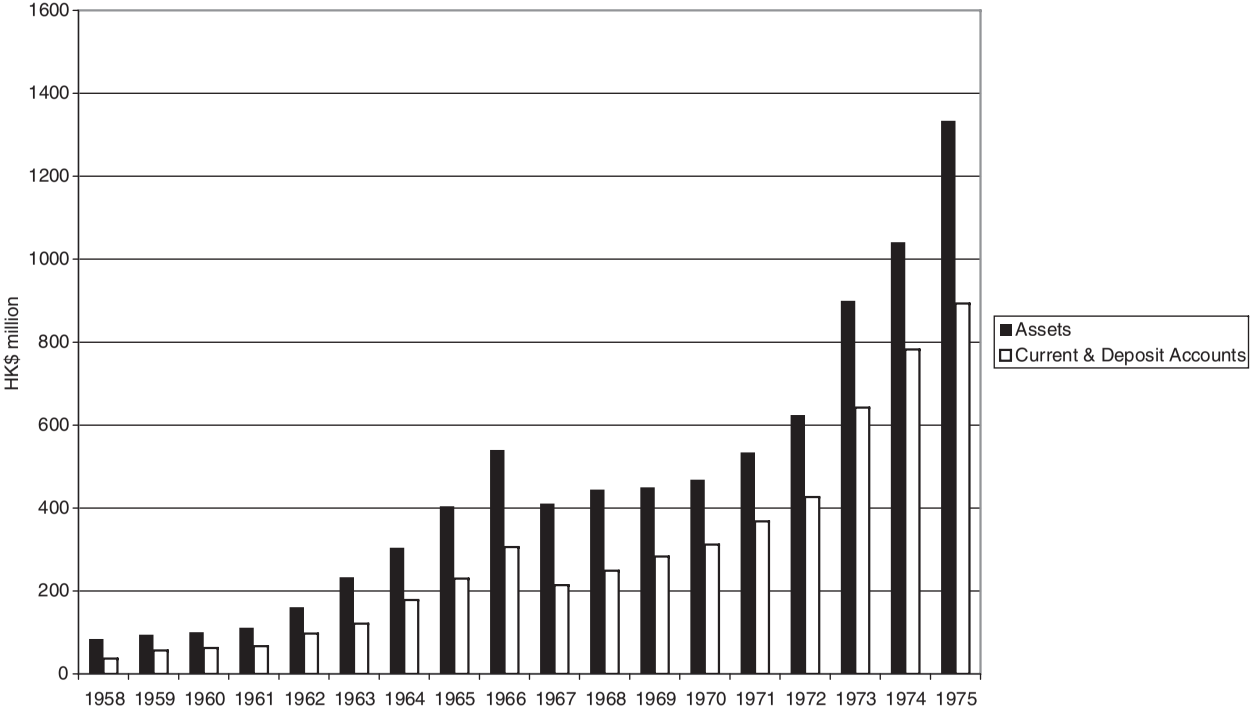

Figure 3.1 Nanyang Commercial Bank: Total Assets and Deposits

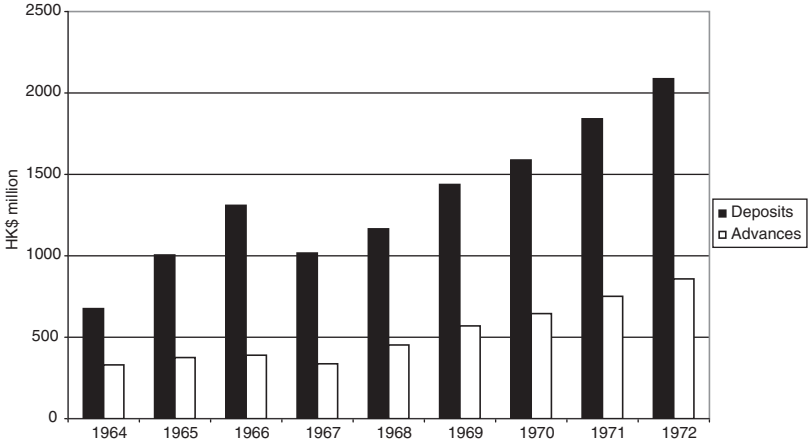

Figure 3.2 Mainland Chinese Controlled Banks in Hong Kong

in the intervening years. In terms of local advances, Sin Hua Trust and Nanyang Commercial Bank together accounted for about one third of advances by Mainland banks.

Despite an impressive overall performance, Figure 3.3 shows that the Mainland banks did not keep pace with the growth of Hong Kong banking during this boom period. After peaking in 1966 at 14% before the political troubles of 1967, their share of deposits declined steadily to

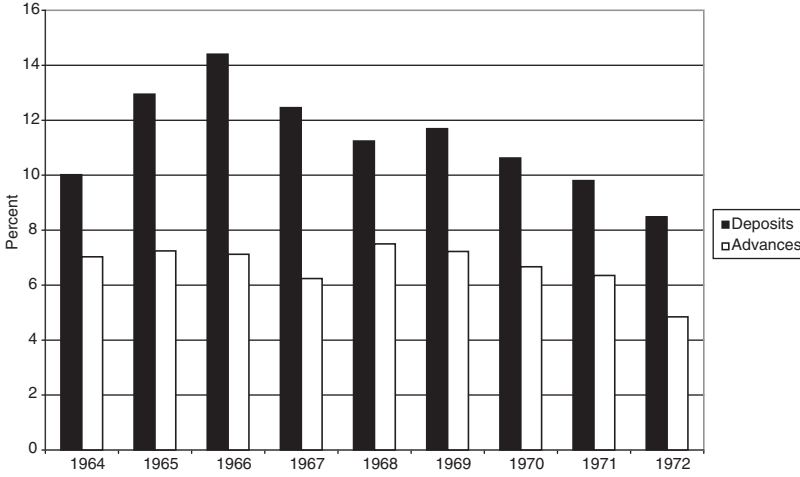

Figure 3.3 PRC Banks in Hong Kong: Market Share

below 9% by the end of 1972.[10] After making significant initial progress, confidence among depositors in the Mainland-associated banks never recovered from the disruptions of 1967 and the ensuing political strife on the Mainland. By 1981, after the Open Door policy was in operation, Mainland controlled banks restored their share of deposits to 14% and increased their share of advances to a historically high level of 15%.[11]

While the growth of deposits was sustained at the same rate as for the banking system as a whole through most of 1969, there was an absolute fall in the level of deposits from May to July 1970. The value of deposits then recovered, but no longer grew at the same pace as the banking system as a whole.

Another feature of the Mainland Chinese banks was the low ratio of local advances to deposits, which led to high liquidity ratios. Figure 3.4 shows that most PRC banks were not engaged in substantial lending to customers in Hong Kong but mainly collected deposits for other uses, particularly to be channelled overseas. Only three small PRC banks met the average ratio of loans to deposits of locally incorporated banks. When deposits were rising quickly in the years before 1967, advances lagged well behind.

Figure 3.5 shows the high levels of liquidity in Mainland Chinese banks compared with other foreign or locally registered banks. Information on the specific nature of the liquidity is available only for December 1966 when it was calculated that 80% of the overall liquidity of Chinese Mainland banks was held overseas. The other 20% was held in cash and net

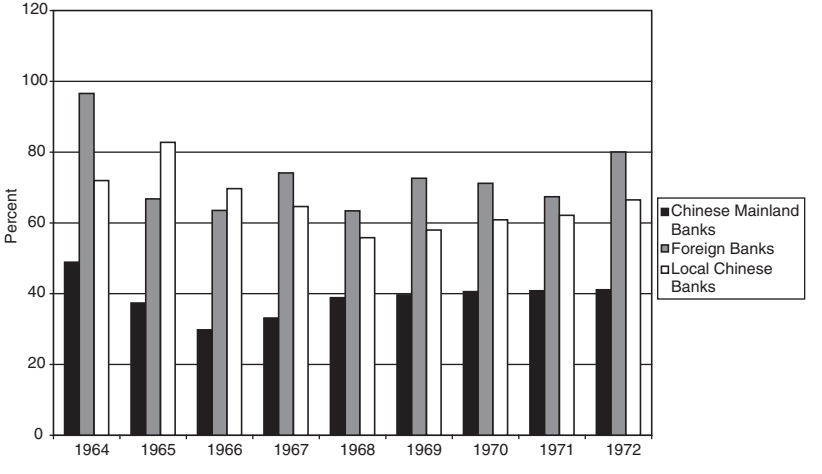

Figure 3.4 Ratio of Advances to Deposits

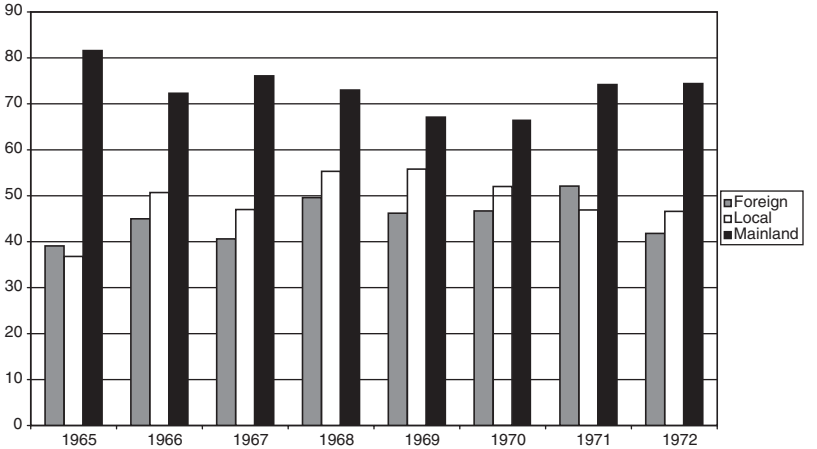

Figure 3.5 Hong Kong Banks' Liquid Assets as a Percent of Deposits

bank balances in Hong Kong. About 70% of these overseas liquid assets were held in China, and the rest in London.[12] As China's foreign trade bank, the Bank of China predictably held the largest balances on the Mainland, accounting for about 35% of the total and over half of Mainland banks' assets in the UK. While the Nanyang Commercial Bank was more heavily involved in local lending, it was also the next largest holder of overseas balances, accounting for 15% of the total held in China and 21% of the total balances in the UK. In all, 87% of Main-

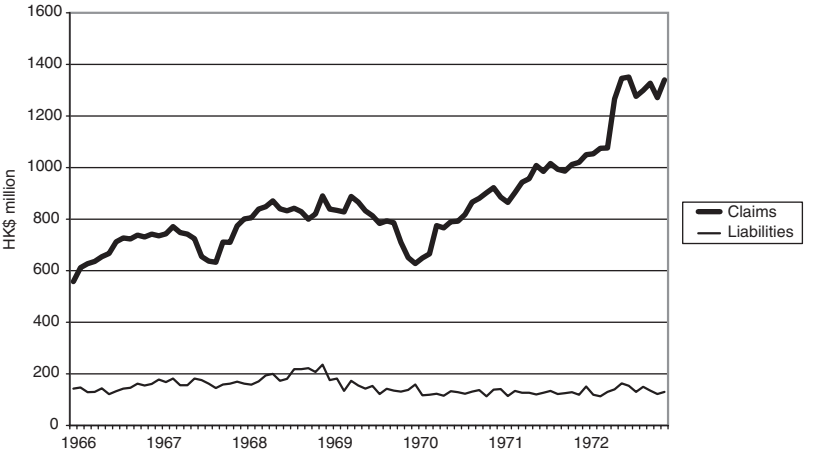

Figure 3.6 Hong Kong Banks' Balances with Banks in Mainland China

land banks' assets in China were bank deposits and money at call and only a small proportion were commercial bills.

Figure 3.6 shows that claims on banks in the Mainland represented a substantial proportion of the deposits collected in Hong Kong. PRC banks were the only group that held net claims on banks in China, while other banks held small net liabilities. Hong Kong banks' net claims in China declined temporarily during the political unrest in Hong Kong in the Summer of 1967, but then recovered until the last quarter of 1969. The decline in the claims on banks on the Mainland in the second half of 1969 was just as severe as during the May riots of 1967, but from the beginning of 1970 a steadily rising amount of funds was held in the Mainland, amounting to HK$1b (US$177m) by mid-1971 and HK$1.3b (US$230m) in 1972. Figure 3.7 shows the half-yearly data for PRC banks only.

In May 1967, the Economic Secretary noted that '[T]he money due from China amounts to an illegal (but countenanced) keeping of funds outside this Colony by the Mainland banks. Other banks which wish to keep their money outside the colony comply with the regulations by keeping it in London. The PG [PRC Government] is enabled by this to use the assets of Hong Kong banks for whatever purpose it likes in the medium of Hong Kong dollars or transferable sterling. A useful working capital.'[13] To put this into perspective, the value of HK$ held in China averaged 30% of exports to Hong Kong from 1965–72, and amounted to about one month of China's total import bill in 1968.

Figure 3.8 shows the relative magnitude of the net balances compared to the value of total deposits in PRC-controlled banks in Hong Kong. The rise in this ratio in the early years reflects the slower growth of deposits after the riots of 1967 up to 1970. From the start of 1970, an increasing proportion of PRC banks' liquidity was being channelled to the PRC, peaking at a net balance equivalent to 60% of total deposits by the end of 1972.

These cross-border balances can be compared with more recent experience. Since 1999 Hong Kong's current surplus with the Mainland has been offset by outward flows of capital that have led to accumulations of net liabilities by Hong Kong banks to the Mainland. In the 1960s, in contrast, investment from Hong Kong in the Mainland was prohibited so the trade surplus led to an accumulation of claims on banks in China. From 2000–07 net liabilities of Hong Kong banks to the Mainland amounted to an average of 3.7% of total HKD deposits. Figure 3.9 shows that net cross-border balances were much higher relatively in the 1950s. Even in the 1960s and 1970s, these balances amounted to at least 5% of

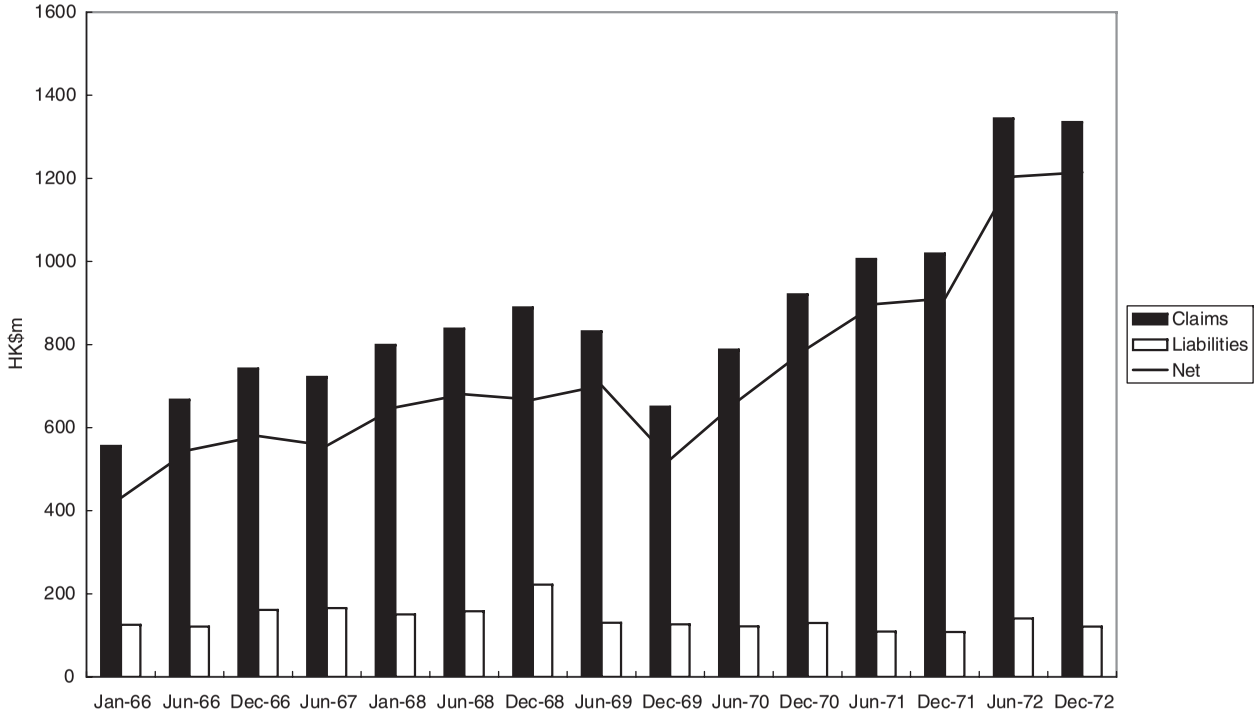

Figure 3.7 Mainland Banks in Hong Kong: Balances with Banks in Mainland China

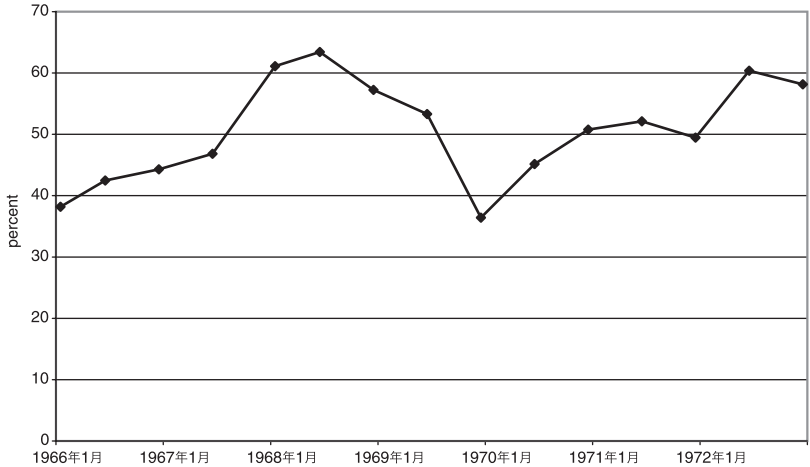

Figure 3.8 Mainland Banks net claims on Banks in China as Percent of Deposits in Hong Kong

HK$ deposits. Unlike the 2000s, however, changes in the net cross-border balances were not more volatile than overall deposits so they did not threaten monetary stability in the colony.[14]

The financial links between Hong Kong and the Mainland also operated through branches of Hong Kong banks there, but on a much smaller scale. From 1955 the Bank of China agreed to channel enough business through the Shanghai office of HSBC to allow it to cover its overheads in order to keep the office open. Chartered Bank also continued to operate in Shanghai on this basis (in premises below the HSBC). Both banks processed documents for exports to various countries, but not for imports. Business was very limited, both by the number of staff and by the amount of business directed to them by the Bank of China. Profits were only allowed to be remitted to head office from 1962 and revenues were taxed heavily.[15] Chartered Bank had a larger turnover than the HSBC office at this time and, indeed, the HSBC Board considered shutting the Shanghai Office in March 1962, but decided to remain open in expectation of long-term advantages.[16] Figure 3.10 shows the increase in business passing through the HSBC Shanghai branch on a half-yearly basis. From about 10,000 bills per year (worth £6m) in 1966, the number fell to a low of 5,500 in 1970, recovering to 7,700 (worth £7m) by the end of 1971. This pattern of business resulted in a rise in the pre-tax profit of the Shanghai branch from RMB108,000 in 1968 to RMB288,000 in 1971.

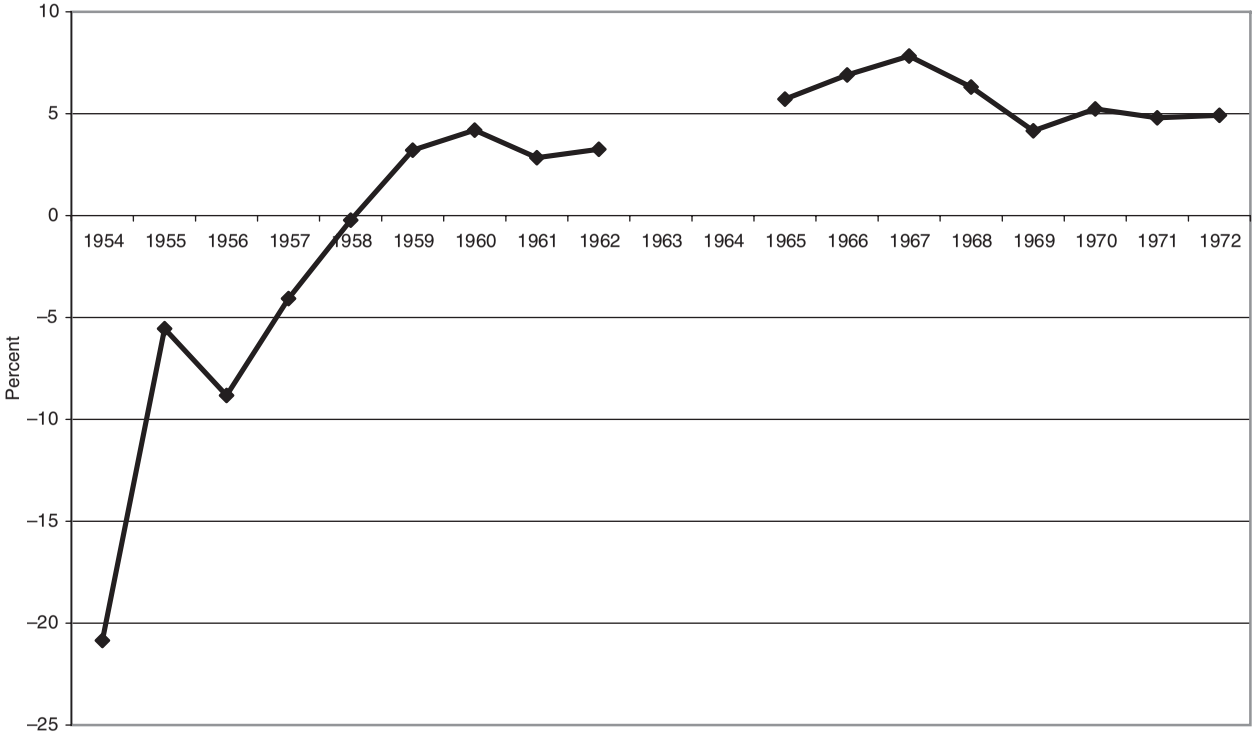

Figure 3.9 Net Claims of Banks in Hong Kong on Banks in Mainland China: Percent Total HKD Deposits

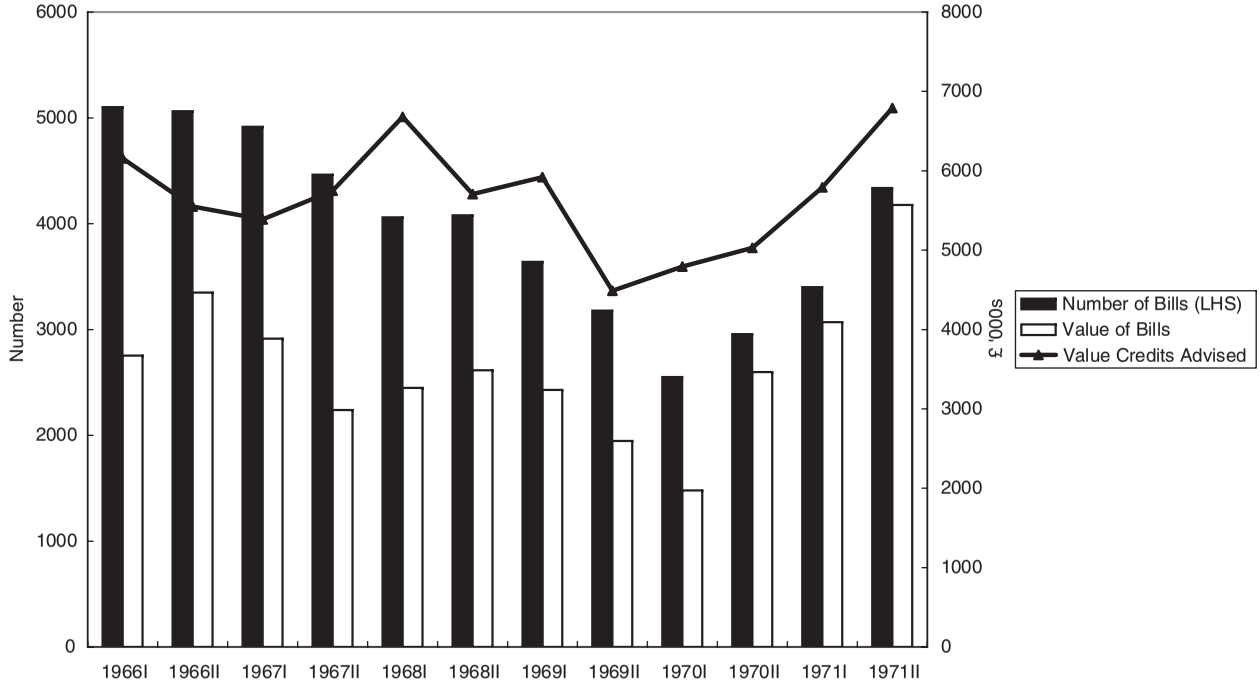

Figure 3.10 HSBC Shanghai Office Business 1966–71

Mostly, however, the Shanghai office was burdened with small and unprofitable Demand Debit (DD) and Mail Transfers. In 1974 the HSBC estimated that total remittances by individuals to the Mainland via Hong Kong was HK$1.9b (US$380m), rising to HK$2.13b (US$426m) in 1975.[17] By November 1978, the office was processing about 800 export bills per month, which was not much greater than the 700 per month in the second half of 1971. In September 1978 the General Manager Overseas Operations visited the Shanghai office and found it 'depressing', 'old fashioned and rather gloomy' and he recommended that the office should not engage in any further correspondent business (mainly low value DD and Mail Transfers).[18]

Despite the increase in bill business from the 1970s, the Shanghai office continued to be constrained by staff shortages and was unable to increase it business. The local staff was aging and new staff appointed by the Bank of China had limited English. Indeed, in November 1978 on the eve of the announcement of the Open Door policy the Shanghai Manager wrote to Head Office asking to reduce the volume of documents referred to his office.[19]

The evidence presented here shows the integration of Hong Kong with the Mainland from the 1950s through to the advent of the Open Door Policy. Also evident is the continuity of this link throughout the period, and that it operated mainly from the branches of Mainland banks in Hong Kong rather than through the residual offices of foreign banks on the Mainland.

Exchange rate policy

As in the current context, the exchange rate between the HK$ and the RMB was fundamental to cross-border economic relations between the two territories from the late 1960s. Throughout most of this period the PRC operated a managed floating regime but from January 1974 the regime changed to a *de facto* crawling band around the US$ with fluctuations of +/–2%.[20] The HK$ was pegged to sterling until July 1972, two weeks after sterling floated. At this point, anchor currency was changed to the US$. The HK$ was depreciated slightly in November 1967 after the devaluation of sterling in that month (although not by as much as sterling was devalued). Both currencies appreciated against the US$ from December 1971 when the USA devalued the US$. With the collapse of the Bretton Woods system in the Spring of 1973, the HK$ re-pegged to the US$ at just over HK$5 (an appreciation of 17%). The RMB was also stabilised against the US$ and the premium on the

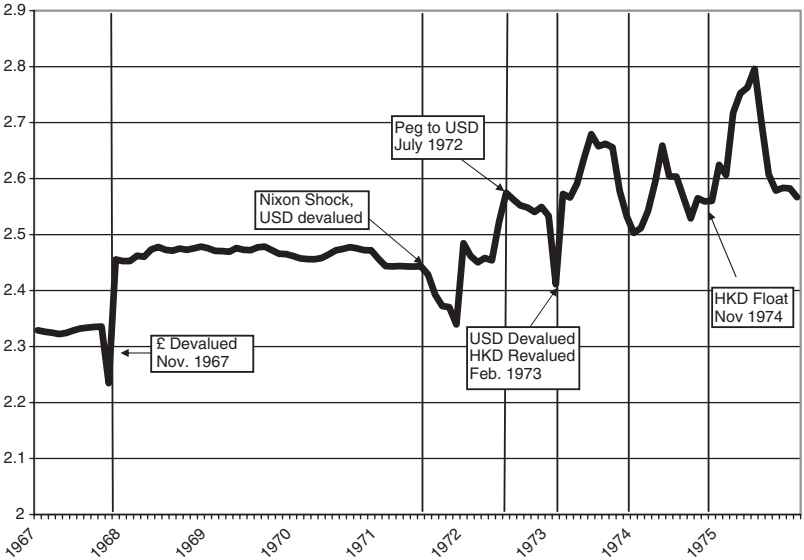

Figure 3.11 HK$ per RMB 1967–75

black market contracted. Figure 3.11 shows the monthly cross rate between the HK$ and the RMB.

Hong Kong's decision not to follow sterling in November 1967 owed much to the public sensitivity to the RMB/HK$ exchange rate at this time. London informed the Hong Kong government of its intention to devalue the pound at 1:30am on Sunday 19 November and an Executive Council meeting was convened that evening to determine Hong Kong's response. A Bank of England representative described the meeting as quite heated, with strong indignation expressed by the representative from HSBC in particular who objected to the lack of consultation and the loss in the foreign currency value of sterling assets. Malaysia and Singapore had already declared that they would not follow sterling, which surprised those in Hong Kong who now understood that there was a choice to make and they groped for an assessment of Hong Kong's own interests. The Executive Council debate was 'a struggle between the banking group and some official and the Chinese members who were particularly concerned with the prospects of rising costs' so the impact of increased prices from devaluing the HKD against its trading partners was clearly in the minds of legislators.[21] However, after only 45 minutes the Council agreed to follow sterling, in a decision pushed through by British official members of the Council (Ronald

Holmes, acting Colonial Secretary and later Secretary for Chinese Affairs, was the only one to vote against devaluation) while all the Chinese representatives voted against devaluation. This decision proved hugely controversial as food prices immediately increased. The following day the Communist influenced Hong Kong papers were all vehemently against the devaluation of the HKD, although the other press reaction was more mixed.[22] The Bank of China announced that they would not follow sterling, so the RMB appreciated 14.3% against the HKD and food prices in Hong Kong immediately increased, leading to intensifying political pressure on the Financial Secretary to reverse his decision. By Tuesday 22 November, Cowperthwaite was re-considering the Executive Council's decision and a 10% revaluation was announced the following day. A survey of 720 people from all walks of life conducted by the Department of Chinese Affairs noted that most people did not understand why any devaluation was necessary and they were especially concerned by the impact on the cost of living.[23]

Figure 3.11 shows that after the RMB appreciated in 1967, the exchange rate was stable until the suspension of US$ convertibility in the Nixon Shock of August 1971. Until the US$ was re-pegged at the end of 1971, the RMB was allowed to depreciate against the HK$. Once the US$ was stabilised the RMB began again to appreciate against the HK$. Of course the RMB was not convertible during this period so that the exchange rates were centrally determined rates rather than market rates. However it is clear that the rate between the HK$ and the RMB and the use of Hong Kong as China's international financial centre during the 1960s and 1970s had important implications for Hong Kong's own exchange policy.

By the end of the mid-1960s the USA was the largest market for Hong Kong's exports and Japan was the largest source of imports. These two trade relations suggested that a peg to the US$ would have made more sense for the Hong Kong dollar than a peg to sterling. Nevertheless, despite the falling proportion of sterling trade, Hong Kong's foreign exchange reserves remained 99% invested in sterling assets and sterling was the intervention currency. This was to some extent a legacy of historic trade patterns, but was also encouraged by contemporary circumstances including the market price of these British government securities, high interest rates on short-term sterling assets (by 1972 Hong Kong earned about £30m per year in interest on its sterling assets[24]), and the important role that Hong Kong played as a financial intermediary for China. Most importantly for this chapter, Hong Kong needed to be able to convert China's substantial HK$ earn-

ings into sterling, which was China's preferred international currency. After sterling floated in 1972 and relations between China and the USA warmed, the supply of sterling through Hong Kong became less important to China and Hong Kong accelerated its diversification away from sterling.

Figure 13.12 shows Chinese banks' purchases of sterling through Hong Kong. Sales by HSBC alone accounted for slightly less than half on average. The total amount fell slightly in 1967 due to a shortage of sterling caused by local monetary conditions in Hong Kong after the riots of May-September of that year.[25] In 1968 and 1969 sales of sterling to the PRC recovered and then increased sharply in 1970 when China ran its first substantial trade deficit since 1960.[26] In the same year, purchases of sterling amounted to over a third of China's total import bill. By 1973 Hong Kong banks sold over £500m to the Bank of China, amounting to 25% of China's total import bill for that year.[27] Given this evidence of substantial purchases of sterling through Hong Kong, a stable exchange rate between the HK$ and sterling was particularly important for China.

Following losses sustained from the devaluation of sterling against the US$ in 1967, in 1968 China began to insist that its export contracts be denominated in (overvalued) RMB and conducted through foreign banks' RMB accounts with the Bank of China.[28] Moreover, between 1967 and 1968, Mainland banks reduced their net assets in London from HK$1.7b to HK$33m. By the end of 1973 the Bank of China claimed that over 60 countries used RMB in commercial transactions with the PRC.[29] Settlement took place through foreign currency accounts opened by the Bank of China with a wide range of correspondent banks, and RMB denominated accounts opened by correspondent banks at the Bank of China. Because of the dispute over frozen US$ assets from 1950, there were no direct correspondent relations with American banks, although the Bank of China had correspondent relationships with foreign banks located in the USA.

Exchanging RMB to hard currency was only possible for transactions related to an official export contract, which restricted the transferability and convertibility of RMB surpluses. Because the RMB was not convertible to US$, proceeds had to be converted first to sterling and then to the trader's domestic currency. Forward markets in some European currencies such as SwFr, DM and £ were created through Chinese banks in Hong Kong and through appointed correspondent banks. But China's largest trading partner, Japan, needed to exchange their RMB to sterling or change sterling for RMB to complete their trade contracts.

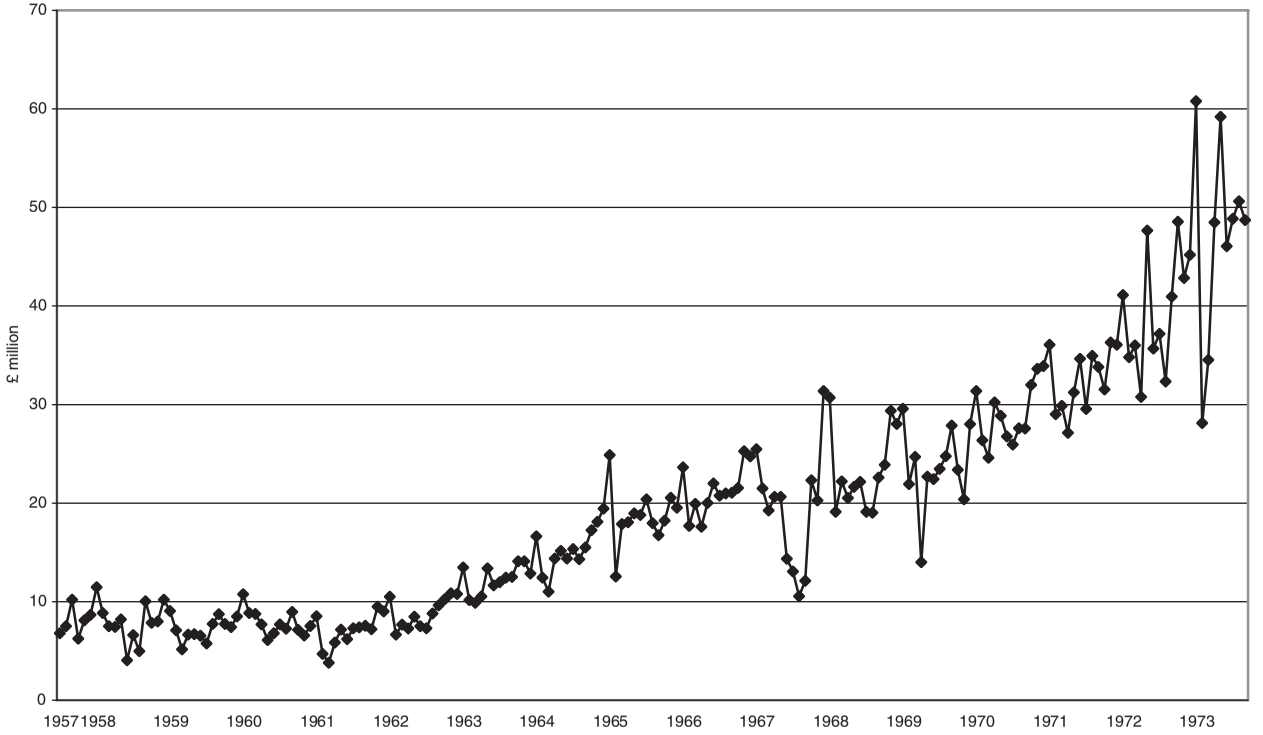

Figure 3.12 Sterling Sold to China against HK$ Monthly June 1957–September 1973

Until 1975 sterling was formally the final currency of settlement for trade contracts between Japan and China, a restriction that proved costly to Japanese exporters as Japan's trade surplus mounted and sterling weakened against the yen. Japan was China's largest non-socialist trading partner by 1969 and the largest supplier of iron and steel, exporting over 1 million tons per annum from 1968 which accounted for over 40% of Japan's exports to China in the early 1970s. In April 1973, China also signed a contract to supply Japan with crude oil from the Daqing oil field, just in time for the oil crisis that began in the autumn.

China earned a substantial surplus in foreign exchange from exports of price inelastic products such as food and water to Hong Kong.[30] The trade balance averaged HK$2.5b per year from 1966–69 but then increased sharply during the early 1970s to HK$5.4b in 1973. Moreover, the proportion of these exports that were consumed in Hong Kong rather than re-exported remained at about 75% until 1976. The exchange rate between the Hong Kong dollar and other currencies was therefore of vital interest to China since the surplus with Hong Kong was used to pay for imports from elsewhere. The proceeds of exports to Hong Kong were determined by the state-set RMB prices of exports to Hong Kong and by the exchange rate between the RMB and HK$. In common with other Comecon countries, to improve foreign exchange earnings China used a combination of exchange rate appreciation and price manipulation. Raising food prices generated friction between Hong Kong and China so the management of the balance between the two countries was a delicate matter.

Hong Kong's exchange rate policy and reserves policy was further complicated by relations with the UK. In July 1968 Hong Kong signed one of the first Sterling Agreements with the UK, by which they agreed to hold 99% their reserves in sterling (a proportion known as the Minimum Sterling Proportion [MSP]) in return for an exchange rate guarantee (for the value of £ against the US$) for 90% of those balances.[31] By the end of March 1970 Hong Kong held £422m in sterling and the colony was largest single holder of sterling reserves in the world.[32] In August 1971 after the re-negotiation of the three-year agreements, the British government (HMG) offered a reduction in Hong Kong's MSP by 10% to 89%, and this was accepted, but the high interest rates available in London encouraged the Hong Kong government to delay diversification.[33]

The re-emergence of China into the international economy co-incided with the collapse of the international monetary system. In August 1971 after a run on the US$, Nixon suspended convertibility to gold and

threatened to impose a 10% surcharge on all imports into the USA unless other countries adjusted their exchange rates to ease the US balance of payments deficit. After frantic negotiations, the Smithsonian Agreement was signed in Washington that re-established the fixed exchange rate system at adjusted parities in December 1971. These new rates proved impossible for some countries to defend and from June 1972 sterling floated. Finally, in February 1973 the US$ was devalued again prompting most countries to break their pegs from March 1973 and the era of floating exchange rates began. The Chinese government viewed the collapse of the international monetary system as an example of the weakness of US hegemony, but it also created serious problems for China's trade links.[34]

This uncertainty and the changing paradigm of the international monetary system posed major challenges for Hong Kong as an important industrial exporter, a major regional financial centre, as a financial entrepot for Mainland China, and also as a colony linked to an imperial metropole. If the HK$ were pegged to a sinking currency (either sterling or US$), China would adjust their exchange rate or raise the price of exports to Hong Kong to protect the hard-currency value of its HK$ earnings. As Leo Goodstadt, then Deputy Editor of the Far Eastern Economic Review put it in 1972:

> Peking in the end decides which parity is correct for the colony. If the US dollar weakens, Peking will signal its desire for new arrangements for the colony's currency by devaluing the Hongkong dollar against the RMB. Unlike other economies, Hongkong cannot simply choose its own rate of exchange, or its links with other countries, on the basis of its export interests alone. Hongkong, to survive, must maintain its value to China.[35]

When the US$ was devalued against gold in December 1971, the HK$ continued at the same peg to sterling (a revaluation of 8.57% against the US$), citing the dangers to the cost of living posed by higher import prices if the HK$ were devalued against sterling, and therefore the RMB. The Financial Secretary revealed publicly that a lesser revaluation of perhaps 6% only had been considered by was rejected because of the projected rise in the import bill of 3.5%.[36] In January 1972 the RMB followed to keep in line with the HK$.

On 23 June 1972, sterling floated, launching a new round of problems and negotiations. When London told Hong Kong about the sterling float on 23 June (without any advance notice) they advised rather

brusquely that 'HMG's action does not bind non-metropolitan territories. Your government should consider whether to follow the UK or to peg to the dollar. We shall need to inform the IMF [International Monetary Fund] of your decision'. Hong Kong's governor, Sir Murray MacLehose asked if the HK$ could be allowed to float freely, separate from sterling, but was told firmly that 'independent floating by HK dollar would not (repeat not) be appropriate, since present speculative pressure does not apply to Hong Kong'.[37] The IMF could be persuaded that sterling had to float in response to speculative pressure but a breach in the Bretton Woods rules for Hong Kong could not be justified. A week after sterling floated, the Governor of Hong Kong wrote to London 'we are veering to the view that our interests would best be served during the period of the sterling float (and only during that period) by pegging on the US$, at about the previous cross rate'. Hong Kong banks wanted to avoid the uncertainty of floating. Also, the Bank of China was unsettled by the floating pound and this undermined Hong Kong's traditional role as a supplier of foreign exchange for China. The HSBC reported difficulty selling sterling to the Bank of China because of conflicts over the rate quoted against the HK$. This enhanced the anxiety about the HK$ exchange rate and the continued usefulness of Hong Kong to China.[38]

The Governor insisted that 'I would of course deplore anything which appeared to reduce the link with the UK, but such a move could be presented as a purely temporary measure pending the return of sterling to a new fixed parity, and I feel sure it would be seen, just as the float is seen, as something ephemeral'.[39] The HSBC's view was that once the link to sterling had been broken, the government's stated intention to revert to sterling once that currency had stabilised was 'most illogical'.[40] The British Treasury and Foreign Office tried to persuade MacLehose to maintain the link to sterling but were not successful.[41] The Bank of England believed that the Hong Kong authorities would have preferred to keep the link with sterling, but were persuaded that if sterling floated down too low then this would cause inflation because of the rise in the cost of imports from China. Clearly the China factor was important.

China was the largest supplier of the imports that directly affected wage rates – food and water. From 1967–80 Hong Kong imported about 50% of its domestic food consumption from China alone.[42] China accounted for 80–85% of live animal imports at this time and Chau has argued that Mainland food products were particularly important for working class Chinese diets.[43] Figure 3.13 shows that the price of foodstuffs was rising in 1970–72 faster than the overall Consumer Price Index for

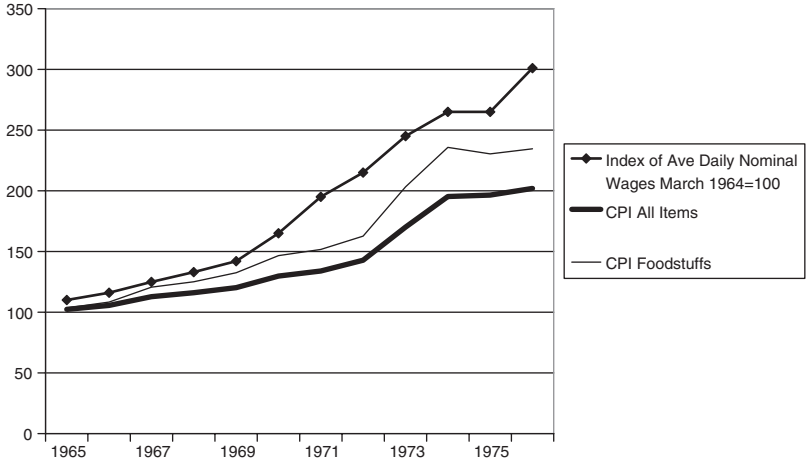

Figure 3.13 Hong Kong Indices: Wages and CPI for Low Income Households

low-income households, although the sharpest increase did not come until world prices rose in 1973.[44] Nominal wages, however, had reached an inflection point in 1970 to a higher rate of growth. These developments help to explain the enhanced sensitivity of the government and employers to the cost of living, although Chau did not detect a direct relationship between wages and prices.

The difficulties facing banks and objections from London were overridden by the importance of stable links with China and the threat to the cost of living in Hong Kong. Concern in the local press focused on rising prices of imported food and vegetables from China; on 29 June the wholesale price of imported vegetables from China increased from HK$53.79 per picul to $70 per picul.[45] On 6 July 1972 the Governor reported that after consultation with the Executive Council, the HK$ was to be pegged *temporarily* to the US$ at HK$5.65 = US$1 with a 2.25% margin either side of parity. This rate was 1.22% below Smithsonian rate of HK$5.5821 set in December 1971 and represented a revaluation against sterling of 5.2%.[46] A day later the Chinese revalued the RMB just over 1% against the HK$ to RMB39.73/HK$100 and 2.2% higher against the US$. As the Governor stated, 'in other words, their response to our announcement that we were temporarily pegging the HK$ to the US$ has been exactly as we predicted'.[47] He estimated that the revaluation of the RMB would raise import prices by 6% causing a 1.5% rise in the cost of living.[48] In 2007, Hong Kong imported about 70% of food from the Mainland, exaggerating the potential impact of RMB

appreciation on the cost of living for lower income earners. It was estimated that a 5% appreciation of the RMB against the HK$ would generate a 1% increase in the Consumer Price Index (CPI).[49] There is, therefore, continuity in the sensitivity of Hong Kong's economy to exchange rate policy on the Mainland.

As July 1972 progressed the HK$ slumped to the bottom of its band against the US$ but Hong Kong did not have reserves of US$ to defend the rate. Instead, the Hong Kong government was forced to sell sterling for US$ to then buy HK$ to support the rate. At this point the Hong Kong government reported that they were running out of sterling cash and would soon need to liquidate sterling securities. Sandberg of HSBC believed that Haddon-Cave had picked the exchange rate of HK$5.65/USD 'arbitrarily' and that the rate was too high from the outset. He advised Haddon-Cave that

> Cutting ourselves off from sterling, however, tempting it might seem to set the HK$ up as an independent currency instead of merely an adjunct of sterling which it has always been, was taking a risk when practically all of Hong Kong's reserves were in sterling. Secondly with the almost total lack of exchange control regulations here speculation against the HK$ (whether as an over or an under valued currency) could be a gnome of Zurich's dream and a Financial Secretary's nightmare.[50]

At the end of August 1972 the banks agreed that HSBC would have a monopoly on market intervention to support the exchange rate and discretion over when to intervene.[51] By mid-September Haddon-Cave was in London where he advised the Bank of England and UK Treasury that 'we are trying to explain to Hong Kong banks that the Hong Kong government runs the place, but it is rather difficult'.[52]

In February 1973 the US$ was further devalued by 10% but the HK$ was kept at its gold parity (revalued against the US$ to HK$5.085 = US$1) in order to maintain parity with the RMB. By July 1973 the HK$ was being dragged down against sterling partly by the continued devaluation of the US$ and partly due to the outflow of capital from the colony after the end of the stock exchange boom.[53] The Bank of England wanted to advise Hong Kong to float its currency or at least to revalue against the sinking US$ but the UK Treasury disagreed.[54] During the summer the RMB was appreciated against the HK$ and the US$ and at the same time RMB-denominated prices of Chinese exports rose dramatically, putting double pressure on Hong Kong's food costs.

At the beginning of August 1973, the Hong Kong government finally attempted to end the historic commitment to sterling reserves, announcing to the Bank of England that if a new sterling guarantee was not forthcoming within a week, it would diversify official sterling assets down to 50% of total reserves. At this point Hong Kong's sterling assets were £660m amounting to 88.6% of total reserves.[55] MacLehose remarked that 'we have held on out of loyalty and in the expectation of definite proposals from HMG, and required the banks to do so too. Because the guarantee itself is now of so little value we have long passed the point of commercial prudence.'[56] The reply from the British government was categorical that 'we cannot endorse any diversification of your own official reserves' because of the threat to the global sterling exchange rate arising from the sale of such large sterling balances. MacLehose and Haddon-Cave set out for London to take on their imperial leaders.[57] They left again empty-handed to the dismay of the legislative council, who wrote to the Acting Governor in strong terms that they were 'gravely dissatisfied with the attitude of the British government over a matter which is of vital importance to the economy of Hong Kong'.[58]

A week before all the sterling agreements were due to expire at the end of September 1973, sterling came under pressure in foreign exchange markets as traders worried about what would replace the Sterling Agreements. This prompted the British government to offer a unilateral agreement to guarantee sterling balances at a new slightly higher rate. Leo Goodstadt reported in the *Far Eastern Economic Review* that 'A sweaty hand pushed a tatty piece of paper at Hong Kong Financial Secretary Philip Haddon-Cave when he stopped at Bahrain recently on a flight back from London'.[59] This was the final offer of a sterling agreement to compensate Hong Kong if sterling should fall below US$2.4213 averaged out on the exchange rates that would prevail up to the end of March 1974. This was a slight improvement on the $2.40 threshold but nowhere near the $2.60 that Hong Kong had first claimed. In addition the guarantee was to be for official balances only with no consideration of commercial bank balances. At the end of December 1973, 76% of Hong Kong's official exchange reserves were still denominated in sterling.[60]

During 1974 there was further pressure on the HK$/US$ rate and the price of US$1 fell below HK$5.05 in July. From the 20–26 November 1974 the HK$ came under considerable pressure and was finally floated free from its link to the US$ on 27 November. The General Manager of HSBC was very aggrieved not to have been consulted formally in advance, although he had met with Haddon-Cave the night before the announcement.[61]

This paper has described in new detail the banking and monetary links between Hong Kong and Mainland China from the 1960s until the eve of the Open Door Policy. Hong Kong acted as a vital external partner throughout this period both in terms of sales of foreign exchange to the Bank of China, and also as a source of funds channelled through Mainland-controlled banks registered in the Colony. Indeed these cross-border balances were larger relative to total deposits than they are today. This paper has also shown how the disarray in foreign exchange markets complicated the delicate relationship between Hong Kong and Mainland China and affected Hong Kong's ability to adapt to the emergence of China into the international economy. Supplies of food from China were essential, particularly to the labour force in Hong Kong's rapidly growing industrial sector and this put Hong Kong at the mercy of China's exchange rate and pricing policy. Meanwhile, Hong Kong was caught by the legacy of colonial links to the UK and substantial sterling assets, without the independence to diversify its reserves once sterling was less important to China. The sterling link had been vital to Hong Kong's usefulness to Mainland China throughout the 1960s but with the collapse of the international monetary system, the complicated and prolonged extrication from sterling presented new problems for the colonial administration, both internally and externally as China diversified its own trade and payments.

Hong Kong's economic relations with the Mainland are now much more complex and comprise not only essential imports, but also processing trade, exports of services and flows of investment. The impact of the strengthening RMB on the Hong Kong economy, therefore, will be more widely distributed than in the 1960s and 1970s and the increased competitiveness of Hong Kong's exports of goods and services may well outweigh the increase in import prices. Nevertheless, this chapter has shown that the exchange rate between the HKD and the RMB first became an important policy issue forty years ago and promoted the further economic estrangement of the colony from the UK. Along with the rise in cross border bank balances, the disarray in exchange markets led to a closer realization of the continued importance of the Mainland to Hong Kong's longer-term economic viability even when China was relatively closed to the rest of the world. This reality is at the basis of the one-country, two currencies system that has sustained the relationship between Hong Kong SAR and the Mainland since 1997 and will continue to be fundamental to future changes in the currency arrangements between these territories.

Notes

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