

HONG KONG STUDY

ANNEX I

CURRENCY AND FINANCE

HK\$10=£1
(approx)A. Present SituationRelationship with HMG in Currency and Banking

1. The Hong Kong Letters Patent and Royal Instructions, in addition to conferring general powers of control over executive and legislative matters on HMG, specifically make legislation relating to currency and the issue of bank notes subject to the approval of the Secretary of State. In practice, the Hong Kong Government runs its financial affairs quite independently of HMG. The Treasury has certain responsibilities under the Hong Kong (Coinage) Order 1936 (as amended). When a new coin is needed, or when a coin is to be demonetised, the Treasury's formal approval is required. Also, under the Order Hong Kong is required to have its coinage struck by the Royal Mint. Apart from this neither the Treasury nor the Bank of England have any specific functions in relation to Hong Kong, nor any formal relationship with the Hong Kong Government. Moreover, generally speaking HMG have no specific liability for the financial obligations of the Hong Kong Government. However, in the last resort HMG would be regarded as responsible for Hong Kong since it is a colony over which, formally speaking, they have plenary

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powers of control, both executive and legislative.

2. Hong Kong has no central bank, but normal central banking functions are undertaken through the Monetary Affairs Branch of the Government Secretariat and by the Commissioner of Banking, with appropriate assistance from the Hong Kong and Shanghai Banking Corporation (HSBC), which is, for example, the major note issuing bank.

3. Currency notes are issued by HSBC and the Chartered Bank under specific local ordinances and the Royal Charter of the Chartered Bank. Apart from small fiduciary issues (totalling HK\$95 million) which are backed by securities issued or guaranteed by the United Kingdom or Hong Kong governments, issues of currency have to be backed by interest-free certificates of indebtedness purchased from the Exchange Fund. The Fund in turn invests the proceeds either in foreign currencies or in Hong Kong dollars (as deposits with the banks). The Fund is required to maintain assets equal to 105% of its liabilities in respect of certificates of indebtedness, but there is no requirement for a specific proportion to be covered by foreign assets. The profits of the note issue accrue to the Fund. Coins are issued by the government and are also backed by assets held with the Exchange Fund. As at end-1981, total notes and coins in circulation amounted to HK\$12.3 billion. The Queen's head is used on coins and the armorial bearings (in whole or in part) on notes.

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4. The Exchange Fund is responsible for regulating the foreign exchange value of the Hong Kong dollar on behalf of the Government. In addition to assets held as currency backing, it holds all other official foreign currency reserves of the colony and the bulk of the Government's HK\$ balances. As at end-December 1982, total assets of the Fund amounted to some HK\$37.9 billion (including assets held as currency cover): external assets amounted to HK\$31.5 billion. Because of the absence of conventional domestic reserve assets in the form of Government debt in Hong Kong, the banking system also holds substantial net foreign exchange assets (HK\$11.9 billion at end-1981), concentrated mainly in the note-issue banks, particularly HSBC: foreign assets constitute the residual liquidity of the banking system as a whole.

Hong Kong Dollar

5. The Hong Kong dollar was linked to sterling until June 1972 and to the US dollar between 1972 and November 1974. Since the latter date it has floated independently according to supply and demand in the market, with the Exchange Fund intervening on occasion to moderate disorderly movements.

Balance of Payments and Debt

6. Hong Kong has a very open economy, with exceptionally high dependence on external trade and capital flows, and

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imposes no exchange controls. The current account of the balance of payments is normally in deficit (HK\$8.4 billion in 1981), offset in whole or in part by sizeable net inflows of private capital both direct and portfolio. The government itself has only very minor external debt (HK\$244m at 31 March 1982) all due to the Asian Development Bank (on which see below). This debt carries HMG's guarantee because of the United Kingdom's responsibility for external affairs. There is no internal direct Government debt outstanding, but the Government has a contingency obligation in respect of guarantees on debt of governmental agencies of some HK\$4.2 billion (Mass Transit Railway Corporation, current figure) and HK\$9.6 billion (Home Ownership Scheme, estimated for 1986). The effective (trade-weighted) index for the Hong Kong dollar stood at 85.9 (December 1972=100) at end-1981, representing a fall of 2.6% over the year.

Banking

7. The monetary sector in Hong Kong comprises some 123 licensed banks and 360 deposit-taking companies. As at end-1981 total liabilities of the sector amounted to HK\$633 billion, of which HK\$272 billion was Hong Kong dollar-denominated, the remainder representing offshore business. Hong Kong dollar-deposit liabilities amounted to HK\$143 billion. Hong Kong's offshore banking business has developed rapidly in recent years, aided by the freedom

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from controls and a growing concentration of financial expertise within the colony. At end-1981, 89 foreign banks had branches in Hong Kong and a further 121 representative offices. Hong Kong is now a significant international financial centre, with a leading position in loan syndication for Asian borrowers: the financial sector's overseas earnings make a significant contribution to the colony's surplus on invisible trade.

8. The Hong Kong and Shanghai Banking Corporation (HSBC) operates the clearing for inter-bank settlement and the other banks maintain clearing balances with it. Two banks, namely the Chartered Bank and the Bank of China, are sub-clearers for 19 and 12 other banks respectively. In 1964 the HSBC and the Chartered Bank, at the Hong Kong Government's request, provided funds to avert a liquidity crisis in the banking system. This was the only occasion in which there has been a liquidity crisis and only 3 small banks were involved. Funds were subsequently provided by the Government to meet net creditors' claims. HSBC is the main banker to the Government (including of course the Exchange Fund) and because of its own position at the centre of the clearing system and its role as a note-issuing bank, HSBC is itself highly unlikely to come under purely domestic pressure with respect to its overall liquidity. Should it face difficulties, however, it would

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be the Hong Kong Government which would act as lender of last resort to the system, using the assets of the Exchange Fund.

Effects of a Crisis

9. In practice, a simple liquidity crisis in Hong Kong would be a matter affecting individual banks and containable within the established machinery. It is also possible to envisage more serious domestic economic problems involving the solvency of the banking system, such as a property collapse or other major economic upset. In practice this could be containable provided the situation arose from commercial factors and not from an actual or even anticipated change in the political situation, but it could affect external confidence too. A more serious threat to the system as a whole could result from a major shift out of Hong Kong dollars altogether such as might be stimulated by worries about relations with China. This would quickly affect, and very seriously, the exchange rate of the Hong Kong dollar. In other words, the crisis would be a foreign exchange crisis and the Exchange Fund's commitment as lender of last resort would be to act as foreign exchange dealer of last resort - standing ready to use its foreign exchange assets to purchase Hong Kong dollars. However the Exchange Fund assets are not unlimited, although they have risen substantially in recent years. At present levels of import prices the Fund's assets represent about 19 weeks

of retained imports (ie imports less exports).

10. The Fund's intervention in the exchange markets has in the past been aimed at moderating disorderly fluctuations round the perceived trend leaving the trend in the rate to be determined by market forces. In the event of a major crisis, it might be expected to react by more substantial intervention or even more radical measures. Should its resources be insufficient, the Hong Kong Government has powers to borrow abroad, on the security of the general revenue of the colony, for the account of the Fund. In normal circumstances, the Hong Kong Government, with minimal external debt and a substantial fiscal surplus, would be regarded as a prime borrower. However, should its borrowing capacity be impaired by political and economic uncertainty, it would have to apply to HMG for guarantees on its borrowing. The Bank of China is almost certainly the largest buyer of foreign currency in Hong Kong for, in China's eyes, that is the purpose Hong Kong serves. It could, therefore, temporarily lessen the impact on the foreign exchange market by holding back from buying foreign currency and even selling into the market. But it is most unlikely that the Bank could hold back, or intervene, for very long.

Relationship with International Financial Organisations

11. Hong Kong is not a member of the IMF or IBRD (World /Bank

Bank) - for which responsibility for one's own external relations is a condition of membership - but is a member of the Asian Development Bank (ADB) for which it qualifies by virtue of being an associate member of the UN Economic and Social Commission for Asia and the Pacific (ESCAP). Because Hong Kong is not responsible for its external relations, its membership of the ADB is conditional on HMG assuming responsibility for all its obligations to the Bank, including financial guarantees on project loans and capital (on-call) subscriptions to capital stock. Guarantees of loans and callable capital are authorised under Section 7 of the Overseas Development and Co-operation Act 1980 within a present limit variable by Statutory Order of £90 million. This limit may soon need to be increased (see below). Hong Kong is currently in receipt of four loans from the ADB, worth a total of US\$72.2 million; in addition there is currently a contingent liability in respect of callable capital of US\$45.7 million. A General Capital Increase (GCI) is presently under discussion at the ADB, which would increase this contingent liability (possibly by up to US\$60 million).

ECGD Exposure

12. ECGD's current commitments in Hong Kong amount to about \$3 billion. They do not expect to be able to scale down this figure during the period up to 1997 - indeed, commitments

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are expected to grow. If claims arose on commitments of this magnitude, they could wipe out ECGD's accumulated reserves and threaten the viability of their whole insurance function, with major consequences for the Exchequer.

B. Possible Changes

13. Hong Kong's prosperity until now and, in particular, the growth of manufacturing industry which employs the bulk of the labour force, and the development of a flourishing regional financial centre, have owed much to feelings on the part both of the resident Chinese population and of overseas business interests, that an internal political regime conducive to the continued favourable growth of business would prevail at least for the time taken to recover the initial outlay on most investments. While many industrial investments can be paid off in short periods concern has grown partly because the period of Crown land leases in the New Territories is now less than the customary 15-year mortgage. Between now and 1997, however, uncertainty about the future status of the territory - for so long as no clear-cut solution emerges - or perceptions about the implications of any agreement which may be reached between HMG and the PRC are likely to have an increasing impact on business sentiment and hence on new investment and the disposition of capital already invested in Hong Kong or generated from now onwards. While therefore there are

no strong grounds for anticipating significant modification to the institutional arrangements already described, in the years up to 1997, it is much less certain that the buoyant and expansionary climate for business which has prevailed for so long can be maintained untouched by the prospect of political changes of the kind examined below or, possibly, even more radical. Particularly if the process of negotiation is slow, confidence can be expected to become increasingly shaky.

(i) Recognition of Chinese Sovereignty with Continuing British Administration

14. If Chinese sovereignty over Hong Kong were to be recognised by HMG but full British administration continued, there would be no need for substantive change in banking legislation or the powers and responsibilities of the Hong Kong Government in financial matters.

15. However, there could be a political need to change the emblems on the currency but this would be a practical problem (and relating to new issues only) of no major significance. The Treasury's (and the Secretary of State's) responsibilities in relation to the coinage might be judged a political anachronism and so require repeal. The same applies to the references in the Exchange Fund Ordinance relating to the requirement to seek the Secretary of State's authority for the purchase of securities and the borrowing

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powers of the Fund. Apart from this, however, relationships with the Treasury or the Bank of England (or with other central banks with which the Exchange Fund holds deposits and securities) would not need any different basis.

16. It is possible that a formal change in sovereignty might create difficulties for Hong Kong's continued membership of the ADB. (The PRC is not a member of the ADB but Taiwan is). If there is a change in or ambiguity over responsibility for external relations, responsibility for the financial guarantees in paragraph 11 above would be affected.

17. Provided that agreement could be reached with China on full ultimate administrative control by HMG over the territory there should be no change in the existing pattern of relationships with HMG, reducing the possible adverse effects on confidence in Hong Kong as an international banking centre. Acceptance by HMG of less than this would place the Government in an untenable position.

(ii) Hong Kong as a Special Administrative Region (SAR)

18. The features of Special Administrative Regions have been only loosely defined, but provide that 'the rules and regulations in force shall be stipulated by law according to specific conditions'. This would appear to allow the

/PRC

PRC to stipulate, as one extreme, that those rules and regulations should be the enactments and regulations of the Hong Kong Government prior to the acknowledgement of Chinese sovereignty - including the retention of an independent currency and banking system.

19. Such an arrangement would appear little different, for practical purposes, from the simple recognition scenario at (i) though, psychologically, the appearance of a closer and more formal relationship with Peking might worry bankers more. If, however, Hong Kong were not to retain its separate exchange rate regime (and particularly free movement of capital) a significant part of the basis for the establishment of a banking centre in the territory would disappear.

20. A move to SAR status would make it less likely that Hong Kong could remain a member of the ADB. At the very least, since HMG would not presumably have any responsibility for the territory's external relations, responsibility for guaranteeing future loans and/or capital obligations would fall to the PRC. If Hong Kong were to continue, as an SAR, with a separate currency and exchange rate, this might raise problems for China in relation to the IMF - although, in such special circumstances, the arrangement might be countenanced.

/C. Liability

C. Liability for Pensions and Compensation for Public Officers and their Dependants

Present Position

21. The Hong Kong Government is under a liability to pay pensions and other retirement benefits granted to members of the Hong Kong public service and to their widows and other dependants under Hong Kong pensions legislation. It is responsible for paying pensions etc already granted to or in respect of retired officers and as pensions etc are granted to or in respect of serving officers or their retirement, it will be responsible for paying these also. HMG have no legal liability at present for paying these pensions. Pensions etc are calculated and paid in Hong Kong dollars except that SPOS payments for HMOCS officers are converted into sterling at the rate of exchange prevailing at the relevant date of retirement and paid accordingly. In the event of the complete collapse of the exchange rate of the Hong Kong dollar, HMG might be obliged to fix upon an arbitrary rate of exchange for the conversion of Hong Kong dollar pensions into sterling payments.

Maintenance of Existing Arrangements

22. So long as the United Kingdom retains its present responsibility for the government of the colony, HMG will be able to ensure that pensions etc granted to retired Hong Kong public officers and their widows and dependants will continue to be paid from Hong Kong Government funds.

/Constitutional

Constitutional Change

23. In the event of constitutional changes under which the Secretary of State is no longer responsible for the public service of Hong Kong, HMG will no doubt wish the new constitutional arrangements to include provisions designed to ensure that payments of Hong Kong pensions will remain the liability of the Hong Kong Government and will continue to be paid from Hong Kong funds.

Compensation Scheme

24. At the stage when the Secretary of State relinquishes his present responsibility for the Hong Kong public service, it will be necessary to introduce a compensation scheme for serving members of the Hong Kong public service who are members of HMOCS. The scheme may also need to cover some permanent and pensionable officers who are not members of HMOCS but who are either expatriates or are local officers in senior posts whose career prospects have been adversely affected by constitutional change.

Liability to Pay Compensation etc

25. Payment of compensation and other benefits under the compensation scheme should, if possible, also become the liability of the Hong Kong Government, in which event they too will be payable from Hong Kong Government funds.

/Pressure

Pressure on HMG

26. In recent years, however, HMG have assumed the liability to pay the pensions etc of HMOCS officers and their dependants that previously rested with the Governments of many dependancies or former dependencies. No such arrangements have so far been envisaged with the Government of the colony of Hong Kong, but in the event of constitutional change HMG may be pressed to take over this liability in respect of Hong Kong. So long as HMG has effective powers in relation to the territory, it may be possible to resist this pressure.

Contingent Liability of HMG

27. If, however, constitutional changes in respect of Hong Kong take place and HMG are unable to make satisfactory arrangements for the payment of pensions etc by the government of the territory, or if that government subsequently defaults on payments, HMG may be obliged to assume liability for the HMOCS pensions and also perhaps for some other pensions as well.

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THE FUTURE OF HONG KONG

A SPECIAL STUDY

BY THE FOREIGN & COMMONWEALTH OFFICE

AUGUST 1982

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FUTURE OF HONG KONG

SPECIAL STUDY

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- P. Illustrative Questions and Answers following the Prime Minister's Visit to China



PRIME MINISTER
FIRST LORD OF THE TREASURY

FUTURE OF HONG KONG

SPECIAL BRIEFING

To Be Retained

Do Not Destroy

FUTURE OF HONG KONG

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