HONG KONG'S EXTERNAL CLAIMS AND LIABILITIES VIS-À-VIS MAINLAND CHINA

Mainland China has become a net supplier of funds to Hong Kong's banking sector in recent years. Banks in Hong Kong as a whole have run significant net liabilities vis-à-vis Mainland banks and non-bank Mainland corporations, attributable mostly to placements by Mainland banks. While such funds formed a small proportion of total Hong Kong dollar funding of our banking system, their changes were often a significant driver for changes in total funding.

The marked rise in cross-boundary liabilities reflected a combination of factors, including active fund-raising activities of H-share enterprises and surplus foreign currency liquidity in the Mainland's banking system. The latter was in part attributable to a policy change in the Mainland in 2000, which allowed exporters to retain more foreign exchange earnings than before. Increased cross-boundary spending and foreign banks' cautious lending attitude towards the Mainland following the failure of Guangdong International Trust and Investment Corporation might have also played a role.

I. Introduction

Alongside an expansion of Hong Kong's bilateral trade and investment links with the Mainland, external liabilities and claims of Hong Kong's banking system vis-à-vis Mainland China rose steadily in the past decade. In respect of the Hong Kong dollar, our banks have had a net external liability vis-à-vis the Mainland, which saw a notable rise in 2000, before moderating in 2001 (Table 1). In respect of foreign currency, our banking system has changed from a net supplier to a net recipient of funds from Mainland China since mid-2000.

Table 1

Banks' External Claims and Liabilities vis-à-vis Mainland China

HK$ bn

	At the end of the period				
	1997	**1998**	**1999**	**2000**	**Oct 2001**
Claims and liabilities vis-à-vis Mainland China					
Hong Kong dollars claims	79	81	53	46	22
Foreign currency claims	329	243	193	175	175
Total claims	408	324	245	221	197
Hong Kong dollar liabilities	140	148	117	182	119
Foreign currency liabilities	167	143	145	211	226
Total liabilities	306	291	262	393	345
Net claims (+) / liabilities (-)					
Hong Kong dollar	-60	-67	-64	-136	-97
Foreign currency	162	100	47	-35	-51
Total	**102**	**34**	**-17**	**-172**	**-148**

Source: HKMA

These developments have raised questions about the stability and importance of such funding sources to our banking system. In particular, sharp fluctuations in the Hong Kong dollar positions held by Mainland entities may have an impact on our money and exchange markets. To examine these issues, this paper looks into the factors behind the movements in external claims and liabilities, and assesses their implications for our monetary and banking system. It is structured as follows. Section II briefly explains how external claims and liabilities arise. Section III gives an overview of recent developments of external banking transactions with Mainland China, followed by a discussion of the contributory factors in Section IV. The implications of these developments are discussed in Section V, and the last section concludes.

II. How Do External Claims and Liabilities Arise?

An external liability of a bank refers to an obligation to a non-resident entity abroad. This includes deposits from customers abroad, borrowings from abroad, as well as non-residents' holdings of equities, securities and capital instruments issued by a resident bank. An external asset is a claim on a non-resident. Such claims include foreign currency banknotes, loans and other credits to non-resident entities, holdings of equities, debt securities, and capital instruments issued by non-resident entities.

External liabilities and claims are generated from an economy's current account, and capital and financial account activities. Suppose Hong Kong runs a current account surplus with the Mainland, and assume that the payments are arranged via the banking system. In accordance with the double-entry principle of the balance of payments account, a credit entry is shown in the current account representing the surplus, while a debit entry is shown in financial account representing an increase in Hong Kong banks' claims on a Mainland entity.[1] In short, external claims of Hong Kong's banking sector on the Mainland rise when there is a current account surplus, or when there are autonomous capital flows from the Mainland to non-bank entities in Hong Kong.[2]

III. Recent Developments of External Banking Transactions with Mainland China

Banks' external liabilities vis-à-vis the Mainland rose significantly in 2000, following relatively steady increases in the previous ten years (Charts 1 and 2).[3] Such liabilities moderated slightly in 2001. On the other hand, external claims have declined since 1997, amid banks' cautious lending stance following the Asian financial turmoil and the failure of Guangdong International Trust and Investment Corporation (GITIC).[4] Reflecting these developments, net liabilities (all currencies) rose appreciably to HK$172 bn at end-2000, about ten times the figure in 1999. Net liabilities eased to around HK$148 bn in the first ten months of 2001.

An overwhelming proportion of the transactions is conducted between banks, rather than directly with Mainland non-bank entities, although our external liabilities to non-bank customers doubled in 2000.[5] Specifically, most of the transactions, especially those denominated in the Hong Kong dollar, are placements between banks in Hong Kong and their head offices (or branches) in the Mainland. This reflects partly the role of Hong Kong in intermediating the foreign currency liquidity of the Mainland banking system.

1 Balance of payment statistics are based on the double-entry principle. In other words, a surplus in the current account is matched by a deficit in the capital and financial account.

2 When there is a capital inflow from the Mainland to Hong Kong, on the balance sheet of our banking system, there will be an increase in bank deposits, representing the funds held by the recipient of the capital inflow. This will be matched by an increase in the balances due from Mainland banks on the asset side.

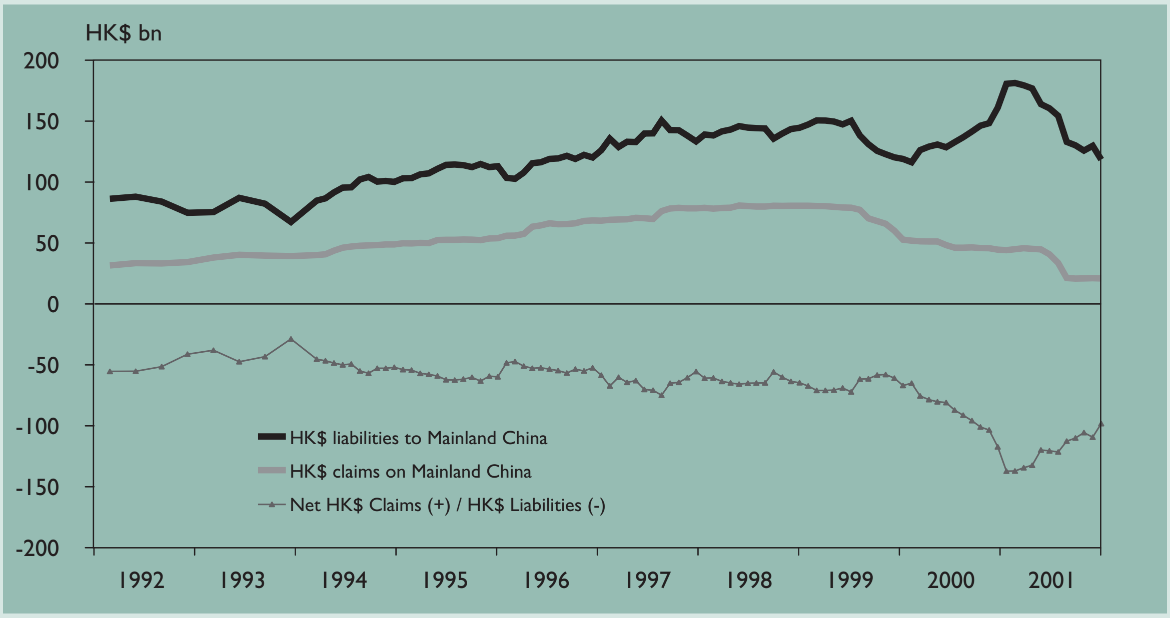
3 Total gross external liabilities vis-à-vis Mainland China rose by an average annual rate of 11% during 1990-99.

4 The People's Bank of China (PBoC) ordered the closure of Guangdong International Trust and Investment Corporation (GITIC) in early October 1998 following its failure to repay debts. This incident led to banks' re-assessment of their lending stance towards Mainland entities, which used to be based on the assumption of an implicit guarantee by the state or provincial government on the borrowings of state-owned enterprises.

5 Interbank activity refers to activity between banks, including inter-office activity. While breakdowns by the nature of claims and liabilities vis-à-vis the Mainland are not available, anecdotal information suggests that the bulk of them are in the form of interbank lending and borrowing.

Chart 1

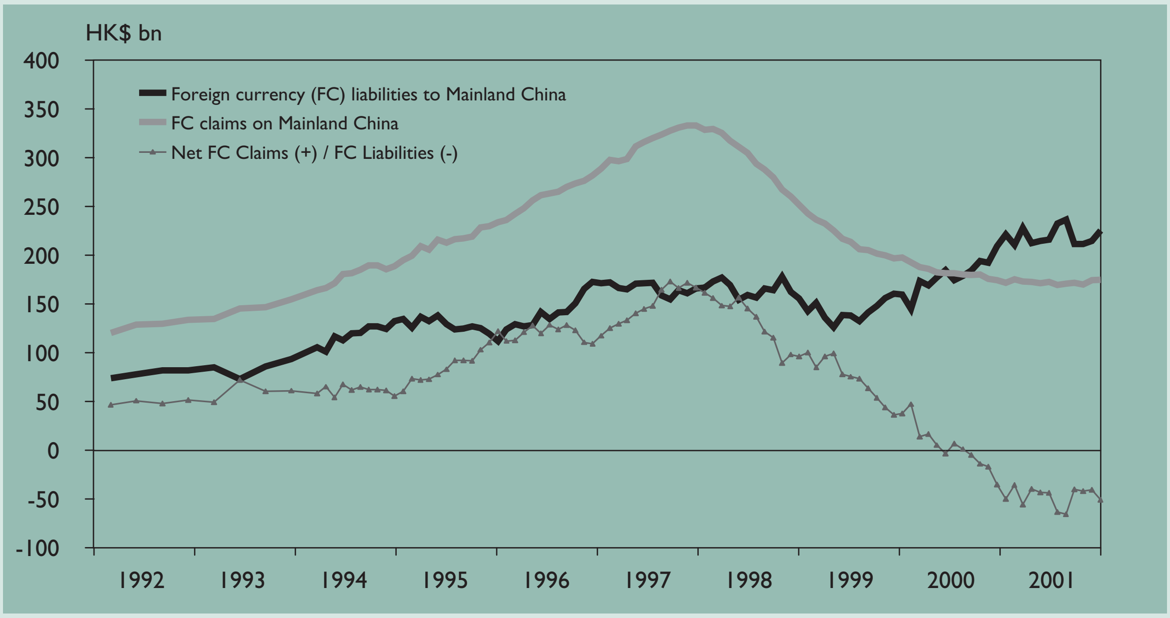
Hong Kong Dollar External Claims and Liabilities vis-à-vis Mainland China



Source: HKMA

Chart 2

Foreign Currency External Claims and Liabilities vis-à-vis Mainland China



Source: HKMA

IV. Factors Underlying Changes in External Claims and Liabilities vis-à-vis Mainland China

External transactions between Hong Kong and the Mainland arise from various sources, including bilateral trade and investment, Hong Kong's residents' cross-boundary spending, Mainland enterprises' fund raising activities, and other factors affecting Mainland banks' foreign currency liquidity, etc. In the following paragraphs, we will, as far as possible, quantify the impact of these factors.

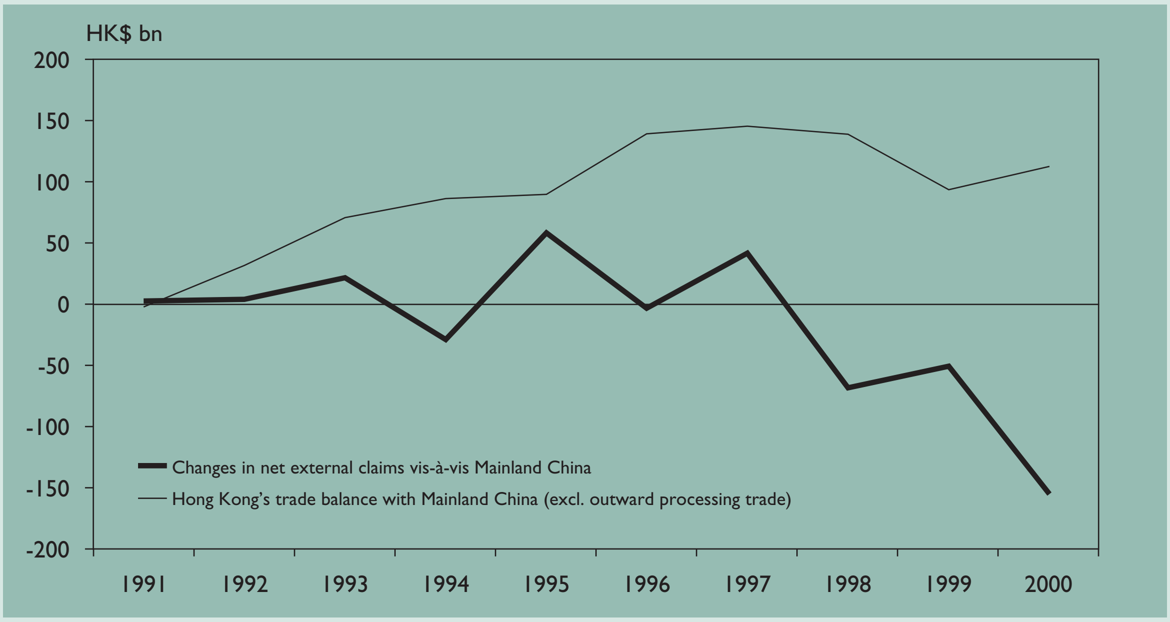
Bilateral trade

Hong Kong has been running a bilateral trade surplus vis-à-vis the Mainland (adjusted to exclude outward processing trade), which should have contributed to an accumulation of net claims on the Mainland (all currencies).[6] However, while we maintained a surplus, albeit a smaller one, in the past few years, net claims started to decline sharply in 1997 (Chart 3). There are two possible explanations. First, the relationship between the trade surplus and such financial claims is less straightforward. As discussed in the last part of this section, how Mainland importers arrange their payments may have influenced the flows of funds. Secondly, investment and other activities may have exerted a more pronounced influence on cross-boundary financial transactions over the past few years.

Cross-boundary spending of Hong Kong residents

Increased cross-boundary spending by Hong Kong residents has contributed to a rise in Hong Kong dollar receipts in the Mainland. To the

Chart 3
Hong Kong's Bilateral Trade Balance with Mainland China and Change in Net External Claims vis-à-vis Mainland China



Source: HKMA and CEIC

6 Outward processing trade refers to arrangements made between Hong Kong companies and manufacturing entities in the Mainland under which the companies concerned sub-contract the whole or part of the production of their products to the Mainland entities. Raw materials and semi-manufactures are normally exported to the Mainland for such processing. Both exports and imports are adjusted to exclude outward processing activity, as such activities only involve payments of processing fees rather than the value of products or materials involved. As a result, external claims and liabilities between both economies will reflect only processing fee payments.

extent that they are subsequently recycled back to Hong Kong through the banking system, our net liabilities to the Mainland increase. However, while cross boundary trips by Hong Kong residents have grown at a double-digit rate each year since 1997 (Chart 4), Hong Kong residents' expenditure incurred during personal travels in the Mainland showed only a modest increase, from HK$24 bn in 1995 to HK$29 bn in 2000.[7] Thus, this factor could not be a major reason behind the recent surge in net external liabilities.

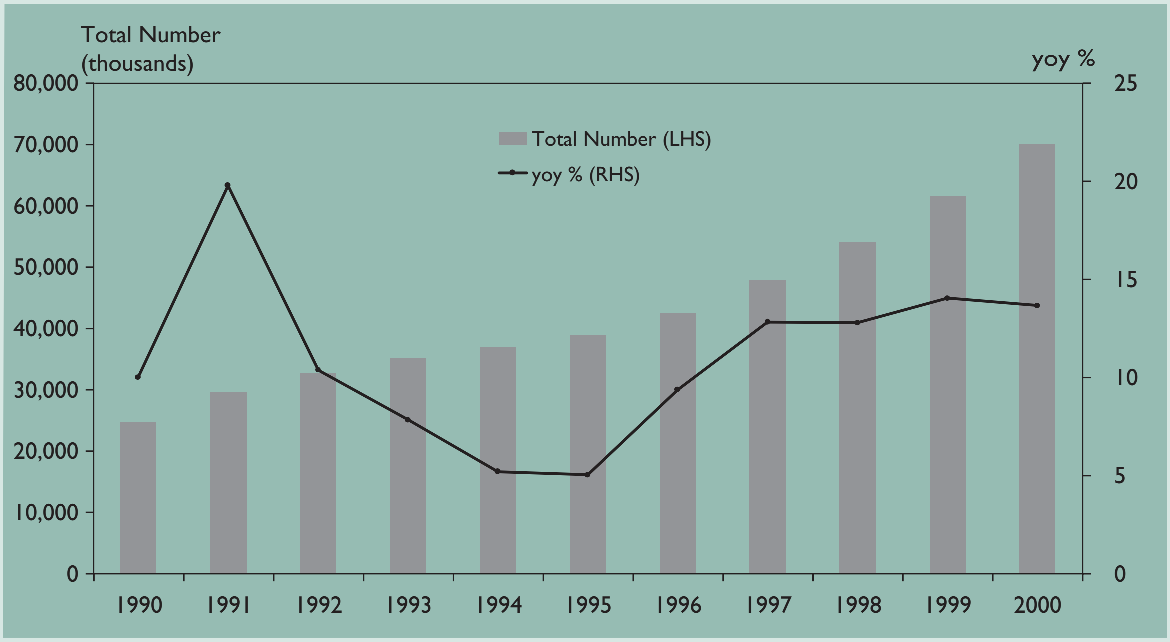
Foreign investment and fund-raising activities of Mainland enterprises

Part of the rise in our cross-boundary liabilities was probably due to increased fund-raising by Mainland enterprises in Hong Kong, particularly H-share companies.[8] In the aftermath of the Asian financial crisis, actual foreign direct investment (FDI) to the Mainland, including that from Hong Kong, showed a moderate decline (Chart 5). Nonetheless, there was a notable rise in fund-raising activity by Mainland enterprises in Hong Kong in 2000. H-share companies alone raised HK$52 bn in Hong Kong's stock market in 2000, as against HK$4.3 bn in 1999 (Chart 6). According to anecdotal information, some of these proceeds were placed with our banking sector, increasing our external liabilities vis-à-vis the Mainland, particularly against non-bank customers.

Surplus foreign currency liquidity in Mainland's banking system

Another possible contributory factor was the fact that renminbi interest rates were below foreign currency interest rates, leading to an

Chart 4
Hong Kong Visitors to Mainland China *



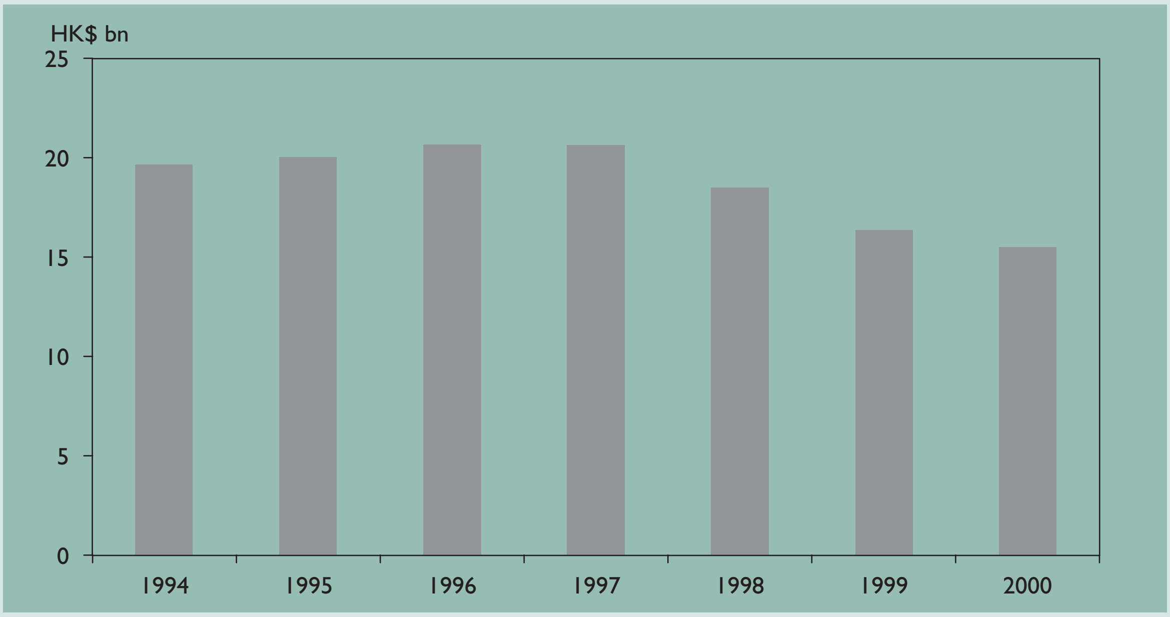
** Including visitors from Macau.*
Source: CEIC

7 Based on figures collected by the Census and Statistics Department, the estimated amount refers to spending on goods and services by Hong Kong residents in respect of personal travels. Business travels are not covered.

8 H-shares refer to Mainland state-owned enterprises listed in Hong Kong stock market. Since they are non-resident foreign companies, their deposits with banks in Hong Kong form part of our external liabilities.

Chart 5

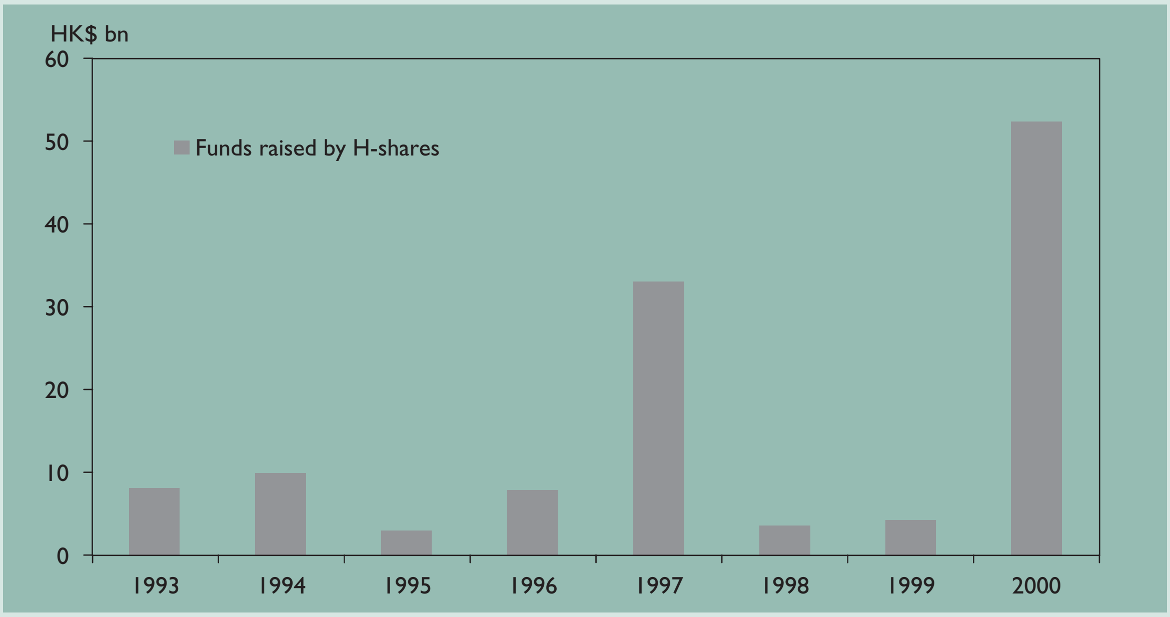
Foreign Direct Investment from Hong Kong to Mainland China



Source: CEIC

Chart 6

Funds Raised by H-shares in Hong Kong

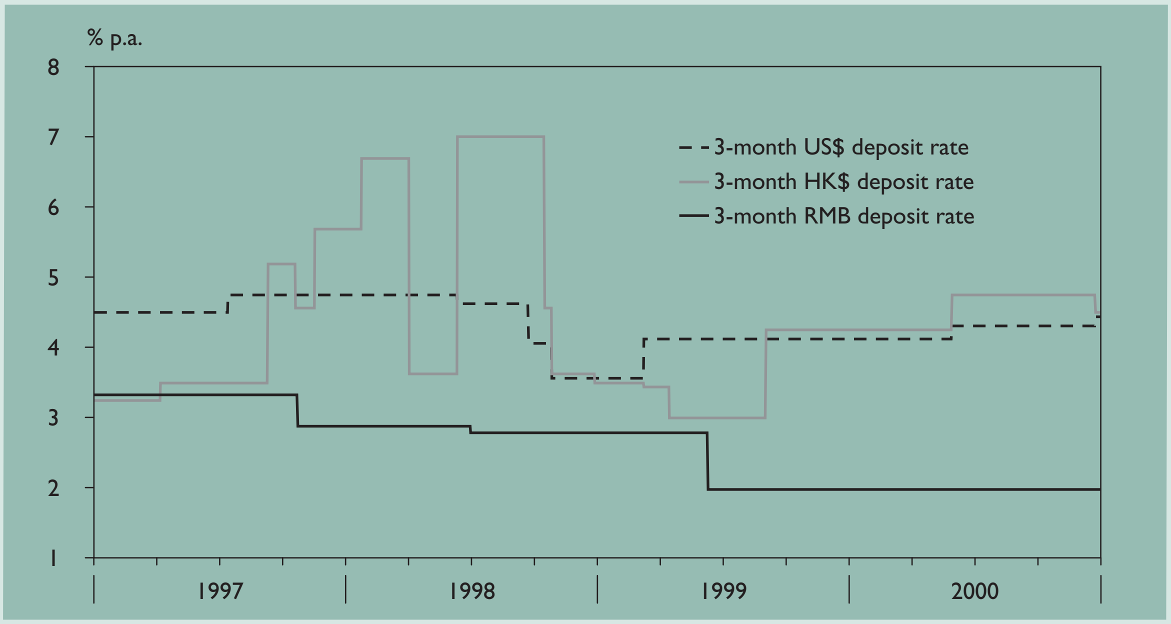


Source: Hong Kong Exchanges and Clearing Limited increase in surplus foreign currency liquidity in Mainland's banking system. Amid a widening in the differential between renminbi interest rates and their foreign currency counterparts, Mainland banks saw a rapid rise in foreign currency deposits and weak demand for foreign currency loans. Chart 7 shows that the negative spreads between renminbi and foreign currency deposit rates widened from late 1999, and stayed at around 250 basis points in terms of 3-month money at end-2000. As a result, foreign currency deposits with banks in the Mainland registered strong growth of 24% in 2000 to US$128 bn (or HK$998 bn), while foreign currency loans declined by 10% to US$61 bn (or HK$476 bn). This left Mainland banks with considerable surplus foreign currency liquidity, some of which was placed with banks in Hong Kong, including their branches here. According to Bank for International Settlements (BIS) statistics, BIS reporting banks' total liabilities vis-à-vis Mainland China rose appreciably by around 50% to US$102 bn at end-2000, of which around half were reported by banks in Hong Kong.[9] Such liabilities remained high at US$105 bn at end-June 2001.

Cautious lending stance of foreign banks

Aside from lower renminbi interest rates, growth of external claims on the Mainland has been checked by the continued cautious lending stance of foreign banks towards Chinese-related entities. Following the Guangdong Enterprise Holding incident and the closure of GITIC, there was a sharp reduction in claims on the Mainland in 1998-2000, attributable in part to a write-off of bad loans. Notwithstanding the subsidence of the Asian financial turmoil and China's impending entry to the World Trade Organisation, there is no sign of a significant rebound of foreign bank lending to Mainland entities yet.[10]

Chart 7
Deposit Rates in Mainland China



Source: People's Bank of China and CEIC.

9 The data are based on residence of the reporting institution and therefore measure the activities of all banking offices residing in each reporting economy. BIS reporting banks include banks in Hong Kong.

10 According to BIS statistics, BIS reporting banks' total claims on the Mainland saw a decline of 12% to US$60 bn in 2000, and contracted further to US$58 bn at end-June 2001.

Mainland's foreign exchange policy

Mainland's foreign exchange policy may also have a significant effect on external banking flows. To highlight a few of the policy changes: since July 2000, qualified exporters are allowed to retain foreign currency earnings equivalent to 30% of their annual foreign trade volume, compared with 15% before. This might have contributed to an increase in foreign currency proceeds placed with banks in the Mainland.

Empirical Findings

The above analysis suggests that the sharp increase in net liabilities of Hong Kong's banking system vis-à-vis the Mainland was probably related to economic factors, rather than a sudden portfolio shift on the part of Mainland banks. In order to quantify the impact of these factors, we have conducted some regression analysis on gross liabilities and claims (see Box A for details). Our findings suggest that Hong Kong's exports to the Mainland, and the differentials between foreign currency and RMB deposit rates are two key determinants of the liabilities of Hong Kong's banking system to Mainland China. The positive relationship between exports and external liabilities is somewhat puzzling. A number of Mainland companies maintain bank accounts in Hong Kong to facilitate payment for their imports. We would expect such deposit balances to be drawn down as these companies pay for the imports. In other words, the relationship between Hong Kong's exports to the Mainland entities and our liabilities should be negative. However, it may well be that, along with an increase in exports, Mainland companies have been placing more funds in their deposit accounts in Hong Kong to meet transactions needs.

In respect of external claims on the Mainland, we could not establish a stable quantitative relationship with its possible explanatory variables. This is likely due to the difficulty in statistically accounting for the abrupt change in investor sentiment following the GITIC incident. Also, the on-going structural changes in the Mainland, such as diversification of fund-raising channels and the development of domestic equity market, might have affected the demand for foreign currency borrowing.

Box A

Quantitative Analysis on External Claims and Liabilities vis-à-vis Mainland China

Regression analysis was conducted to quantify the relationship between Hong Kong's gross external liabilities to Mainland China and their possible explanatory variables. Similar analysis was also conducted on external claims. However, we could not find a stable relationship on the latter. This was probably due to the statistical difficulty in accounting for a sudden drop in claims as foreign banks cut back their lending to the Mainland following the GITIC incident. The estimation results for gross liabilities are as follows.

An Empirical Model for Hong Kong's Liabilities to Mainland China

We employ an error-correction model (ECM) to estimate the relationship between gross liabilities and their determinants. The advantage of ECM is that it allows us to capture the long run relationship as well as the short-run dynamics. The findings suggest that apart from two lagged variables of liabilities to the Mainland, Hong Kong's exports to Mainland China and differentials between foreign currency and renminbi deposit rates are also statistically significant. Other explanatory variables, such as number of Hong Kong visitors to Mainland and total deposits in the Mainland also included in preliminary regressions, but were insignificant. The ECM form is as follows.

(1) $\Delta L_t = \alpha_1 + \alpha_2 \Delta L_{t-1} + \alpha_3 \Delta L_{t-2} + \beta_1 (L_{t-1} + \delta_1 X_{t-1} + \delta_2 DIR_{t-1}) + \alpha_4\ DMRMB_t + \nu_t$

Where
ΔL_t = Quarter-on-quarter percentage change of Hong Kong's external liabilities to the Mainland,
L_{t-1} = lagged external liabilities to the Mainland,
X_{t-1} = lagged Hong Kong exports to the Mainland (adjusted to exclude outward processing trade),
DIR_{t-1} = lagged differential between 3-month Libor and 3-month RMB deposit rate,
$DMRMB_t$ = a dummy variable for policy changes and
ν_t = error.

The variables in the bracket of equation 1 are the long run relationship and β_1 is the error correction term. All variables are in logarithmic form except the interest rate spread. Quarterly data from 1Q 1991 to 1Q 2001 were used in the estimation. Exports were adjusted to exclude outward processing trade, and three-month Libor was used as a proxy for foreign currency deposit rate in Mainland China. The ADF test statistics suggest that all variables are integrated of order one (I(1)), and the explanatory variables and dependent variable are also co-integrated. Chow test statistics, a test for structural break, suggest that there is a structural break in the first quarter of 1994. This probably reflects the unification of the dual foreign exchange rate system and the beginning of convertibility for current account transactions in Mainland China, from the beginning of 1994. Thus, a dummy variable (DMRMB) was used to capture the impact of such policy changes.

Estimation Results

All of the estimated coefficients were of correct signs and most were statistically significant.

$$\Delta L_t = \underset{(1.07)}{1.057} + \underset{(1.14)}{0.138}\Delta L_{t-1} + \underset{(2.53)^*}{0.319}\Delta L_{t-2} - \underset{(-5.68)^*}{0.611}(L_{t-1} - \underset{(-6.07)^*}{0.84}X_{t-1} - \underset{(-6.02)^*}{3.51}DIR_{t-1}) + \underset{(3.55)^*}{0.127}DMRMB_t + \nu_t$$

Adjusted R^2 = 0.48 DW = 2.04
*The t-statistics are given in parentheses and * denotes significance at the 5% level.*

The estimates show that in the long run Hong Kong's liabilities to Mainland China relate positively to Hong Kong's exports to Mainland China and spreads between foreign currency and RMB deposit rates. Other things being equal, a 1% increase in Hong Kong's exports to Mainland (i.e. Mainland's imports from Hong Kong) will lead to a 0.84% increase in Hong Kong's liabilities to Mainland. This suggests that some of the deposits from Mainland in Hong Kong are for transaction purpose, particularly to effect payments for imports.[11] One percentage point (100 basis points) increase in interest rate spread between foreign currency and RMB deposits will lead to a 3.51% rise in Hong Kong's liabilities to Mainland China.

11 Instead exports, our imports from Mainland China were also used as an explanatory variable. The coefficient is of right sign but was statistically insignificant.

Table 2

Source of Hong Kong Dollar Funds

HK$ bn

	At the end of the period				Change during			
	1998	1999	2000	Oct 2001	1998	1999	2000	Oct 2001[4]
Source of HK$ funds of the banking sector:	**2149**	**2200**	**2324**	**2332**	**56**	**51**	**124**	**8**
Deposits and negotiable CDs held by the public[1]	1789	1847	1923	1921	35	58	76	-2
Net balances due to banks abroad[2]	45	19	63	26	25	-27	45	-38
Capital, reserves and other liabilities[3]	315	334	337	385	-5	19	3	48
Net HK$ funds from Mainland China	**67**	**64**	**136**	**97**	**6**	**-2**	**72**	**-39**
as % of total source of HK$ funds	**3.1**	**2.9**	**5.9**	**4.2**				

1 Adjusted to include swap deposits booked locally as well as Hong Kong dollar and swap deposits booked offshore, which are off-balance sheet items.

2 Adjusted to exclude Hong Kong dollar deposits booked offshore.

3 Changes in "capital, reserves and other liabilities" have been adjusted for the effect of market makers' short positions in Exchange Fund paper.

4 October 2001 change over December 2000.

Source: HKMA

V. Implications

The surge in cross-boundary liabilities raises a concern about the significance of this funding source, and the implications, if any, on our money and exchange markets.

While net Hong Kong dollar liabilities to the Mainland contributed to only about 6% of the total Hong Kong dollar funding of our banking system (end-2000 figure), their increase in 2000 accounted for about 60% of the increase in total Hong Kong dollar funding sources (Table 2). To the extent that the rise reflected increased preference for Hong Kong dollar assets on the part of Mainland entities (banks and non-banks), it might have contributed to the soft Hong Kong dollar interest rates. Hong Kong dollar interbank interest rates for 12 months and below stayed below their US dollar counterparts for most of 2000. During 2001, banks' total Hong Kong dollar funding decreased, reflecting in part the moderation in the net Hong Kong dollar liabilities vis-à-vis the Mainland.

The change from a net claim to a net liability position vis-à-vis the Mainland in foreign currency reflects mainly reduced lending to Mainland entities, and surplus foreign currency liquidity among Mainland banks. As a funding source, net outstanding foreign currency liabilities to the Mainland represented only a very small share of the total foreign currency funding sources of our banking sector. Nevertheless, the increase partly offset the decline in other foreign currency funding in Hong Kong in recent years.

VI. Conclusion

The rise in Hong Kong's external liabilities vis-à-vis the Mainland in 2000 reflected a number of economic and structural factors. The increased holdings of Hong Kong dollars by Mainland entities may have in turn contributed to a softening of the Hong Kong dollar interest rates. In 2001, the rise in net liabilities moderated, along with narrowed interest differential between renminbi and foreign currency, some slowdown in the bilateral trade between Hong Kong and the Mainland, as well as reduced fund raising activities by Mainland enterprises. Nevertheless, given continued economic and financial integration between Hong Kong and the Mainland, close monitoring of these cross-boundary flows is warranted.

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