

After 1 July 1997 Hong Kong becomes a Special Administrative Region of China with a high degree of autonomy. The Basic Law provides that the Hong Kong government will formulate monetary policy and the HK dollar will remain as a convertible currency under the “one country, two currencies” system. Arrangements are being made for cooperation between Hong Kong and the mainland in financial supervision and reform of the payments system. Hong Kong will continue to play an important role in the mainland’s economic development.

Ladies and Gentlemen,

The post-1997 financial relationship between Hong Kong and the mainland is one of the most important issues requiring attention within the general framework of maintaining Hong Kong’s status as an international financial centre. I am very pleased to have this opportunity to share my views with you on this issue. I shall try to address the issue from the following four perspectives: first, the legal basis for the financial relations between Hong Kong and the mainland and the determination of Hong Kong’s status; second, the principles for handling financial issues; third, the development of, and cooperation between, the financial markets in Hong Kong and the mainland; and fourth, Hong Kong’s status in international financial relations.

The legal basis for the financial relations between Hong Kong and the mainland and the determination of Hong Kong’s status

The Chinese government will resume the exercise of sovereignty over Hong Kong on 1 July 1997. In accordance with the relevant provisions of the Sino-British Joint Declaration and the Basic Law, Hong Kong will become a special administrative region (SAR) enjoying a high degree of autonomy. From the financial perspective, this considerable degree of autonomy is adequately reflected in the Basic Law.

The provisions governing the financial affairs of the future SAR are stipulated in Chapter V of the Basic Law as follows. First, Article 109 provides that Hong Kong’s status as an international financial centre will be maintained. Second, under Article 111, Hong Kong’s monetary and financial system

will remain unchanged and the government of the future SAR can formulate monetary policy and exercise financial supervision independently. Third, according to Article 111, the HK dollar will continue to be issued as the legal tender. Fourth, Article 112 stipulates that Hong Kong will be free from foreign exchange controls and its financial market will remain open. Fifth, according to Article 113, the Exchange Fund will be used primarily for maintaining the value of the HK dollar.

The above-mentioned legal provisions, the core of which is to maintain the present monetary and financial regime in Hong Kong, establish financial relations between the mainland and Hong Kong as “one country, two currencies” under the basic political setting of “one country, two systems” and therefore provide the legal basis for further developing the financial relationship between the two.

As the mainland and Hong Kong will keep separate monetary systems, formulate policy targets and achieve them through the employment of separate monetary policy instruments after China resumes the exercise of sovereignty, we regard the financial relations between the mainland and Hong Kong as being between two relatively independent financial systems under two different social and economic systems within one sovereign country.

Principles for handling financial issues

(a) Monetary Systems

Since 1983, Hong Kong has maintained a monetary system that links the HK dollar to the US dollar, i.e. the linked exchange rate system. I made some comments on this system at a

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symposium held by the Economic Group of the Preliminary Working Committee in Hong Kong last October.¹ We have noticed that there is widespread concern over the increasing pressure of Hong Kong's imported inflation due to the recent movements of the US dollar, which has revived the discussion on whether to terminate or retain the linked system. The recent slide of the US dollar indicates that its role in the world economy will decline somewhat in the foreseeable future. However, backed by the US domestic market and the size of the economy, the US dollar's role as a major international currency will not be fundamentally shaken. In terms of Hong Kong's trade pattern, for the future, the US dollar will remain the dominant currency for Hong Kong's trade settlement. All this will continue to support the linked system. For this reason, I would like to reiterate our view that under the special historical conditions of the transitional period, the cost of maintaining the linked exchange rate system, i.e. the constraint on using interest rates to combat inflation, is being outweighed to a great extent by the cost associated with its abandonment. We understand and endorse Hong Kong's adherence to this system.

As Hong Kong will have an independent monetary system, its system of currency issuance and management will also be independent. This is stipulated clearly in the Basic Law. The designated note-issuing banks will continue to issue HK dollar notes and deliver to the Exchange Fund an amount in foreign exchange that is equivalent to the local currency issued, as backing for the HK dollar note issues. After 1997, the HK dollar and the RMB yuan will remain the respective legal tender in the two areas with their different social and economic systems in one sovereign country. The monetary authorities governing the two currencies will issue and manage their currencies in accordance with their respective regulations. To be specific, the HK dollar will be regarded as foreign currency on the mainland. At present, the RMB yuan is not a freely convertible currency, but even when it becomes so, it will serve no more than an additional currency for transactions on the HK market. As for the cross-border circulation of the two currencies, we believe that it is a natural extension

of the currency circulation accompanying increasing contacts between Hong Kong and the mainland. We do not think it will influence the legal status of the currencies.

(b) The monetary authority and monetary policy coordination

The linked exchange rate system is both a monetary system and a policy target of the Hong Kong Monetary Authority. As we all know, for a monetary system to be successful it must suit the needs of economic development. More importantly, it requires a powerful monetary authority to safeguard the system and provide necessary conditions and instruments for the system's smooth functioning. As Hong Kong will maintain its independent financial system after 1997, it will be necessary to have an independent monetary authority. Since the HKMA came into being in 1993, the monetary policy instruments have been improved continuously as illustrated by the establishment of an open market operation mechanism dominated by the transactions in Exchange Fund Bills and Notes, and the Liquidity Adjustment Facility functioning as the lender of last resort. Successful interventions conducted by the HKMA at the beginning of the year to insulate the Hong Kong market from the Mexican financial crisis indicate that their monetary policy instruments are approaching maturity. We have good reason to believe that Hong Kong's current monetary system will continue to function effectively after 1997.

The increasingly close economic ties between Hong Kong and the mainland are bound to be reflected in all kinds of financial activities and links. Therefore, close cooperation between the monetary authorities is necessary. Hong Kong is the mainland's largest trade and investment partner. The mainland's policies, especially monetary policy adjustment, will have direct impact on the Hong Kong market. In the same vein, with the increase of the mainland's HK dollar claims on the Hong Kong banking system and the growth of total assets held by the mainland in Hong Kong, the movements of the HK dollar exchange rates will affect the value of the financial assets of the mainland. In view of this, the two monetary authorities, namely the People's Bank of China (PBoC) and the HKMA, must

¹ This speech appeared as "A Linked Exchange Rate and a Smooth Transition" in the February 1995 issue of the *Quarterly Bulletin*.

maintain the present sound cooperation, and in the meantime, avoid any negative impact resulting from the lack of policy coordination.

(c) The cross-border establishment of financial institutions and supervisory principles

Since the onset of reform and opening policies, over 120 branches or subsidiaries have been established in China by more than 50 financial institutions from 14 countries and regions. Among those, nine are from Hong Kong, which, like other foreign funded financial institutions, enjoy preferential treatment in certain areas, such as taxation and business scope. In the meantime, affiliates in Hong Kong set up by mainland financial institutions have also been increasing over the years. In addition to the 13 affiliates of the Bank of China Group, mainland financial institutions also participate in the equity of some Hong Kong based banks, such as Ka Wah Bank Ltd, Union Bank of Hong Kong Ltd, Hong Kong Chinese Bank Ltd, International Bank of Asia Ltd, First Pacific Bank Ltd, and Jian Sing Bank Ltd. A dozen mainland-owned finance companies and non-bank financial institutions such as insurance companies have been established in Hong Kong. Three specialised banks on the mainland have established representative offices in Hong Kong and applications for them to be upgraded to branches have been submitted. In the near future, with the deepening of the reform and opening policy, the momentum of setting up financial institutions across the border will continue.

With the increasing integration of international financial activities, cooperation among monetary authorities of countries and regions around the world will be strengthened constantly. In the area of financial supervision, the Basle Agreement has become a code of conduct respected by financial authorities of countries and regions throughout the world. Since Hong Kong has the advantage of an international financial centre, about 100 large international banks operate there. Exercising supervision of financial institutions in Hong Kong according to international criteria is therefore necessary for maintaining and further improving its status as an international financial

centre. Meanwhile, with the improvement of the relevant financial laws and regulations of the mainland, the practices adopted for licensing, approval and supervision of financial institutions are moving closer to international standards. A consensus has been reached between the monetary authorities on the mainland and Hong Kong in the areas of licensing procedures for financial institutions as well as supervision, despite differences in business and management skills. The consensus reached, among other things, includes the following: coordinating in licensing and supervision of financial institutions between the two monetary authorities; the financial institutions in Hong Kong with their head offices incorporated on the mainland will be supervised by the HKMA according to the same local banking supervision criteria; the financial institutions on the mainland with their head offices in Hong Kong will continue to enjoy the same preferential treatment accorded to foreign funded financial institutions. All these principles will be further refined after 1997.

(d) Development of an interface between the payment systems

The evolution of international trade and financial markets has led to the trend of developing a payment systems network among countries as well as financial markets. The different stages of advancement of the systems, however, might erode such efforts and handicap the development of local financial markets in terms of speed, scale and stability. Hence, managing and improving payment systems has become one of the most important tasks of central banks of countries and regions. At present, both the PBoC and the HKMA are in the process of payment system reform. It is expected that within two years both will replace the present system with the internationally standardised Real Time Gross Settlement system. In updating the general design of the system, we should take into account of future needs of the clearing business between the RMB and the HK dollar. To this end, a joint working group on payment systems has been set up, and research work has been conducted regularly. Successful cooperation in this area, I believe, will play a positive role in boosting future financial contacts between Hong Kong and the mainland.

(e) Further strengthen the Exchange Fund

The HKMA's successful intervention in the market to stabilise the HK dollar at the beginning of the year has been unanimously favoured. We think that the success of the intervention can be attributed to four elements. First, the HKMA's prompt and correct measures; second, the deterrent power of foreign exchange reserves; third, the support and cooperation of local banks; and fourth, the market's confidence in the linked system. Among the four elements, the deterrent power of foreign exchange reserves is very important. Therefore, I would like to reiterate our desire for the Hong Kong and British authorities to strengthen steadily the Exchange Fund to increase Hong Kong's resilience to external shocks. We are pleased to see that the HKMA, in its two-year history, has been able to cope with the speculative attacks promptly and successfully, therefore stabilising the value of the HK dollar. All these factors indicate that the HKMA is wasting no time in improving itself to reach maturity. We have full confidence in the HKMA's ability to stabilise the Hong Kong financial market. Meanwhile, I would also like to take this opportunity to express our view that, after 1997, the central government will continue, as always, to extend its full support to the HKMA in its endeavours to stabilise the financial market and maintain Hong Kong's status as an international financial centre.

Cooperation between and development of financial markets in Hong Kong and on the mainland

(a) The development and use of capital markets

Since the beginning of China's reform and opening to the outside world, Hong Kong's stock market has made a favourable contribution to the mainland's economic development. Up to 40% of the companies listed in Hong Kong have participated in nearly 1000 investment projects on the mainland with the total value of investment amounting to about HK\$500 bn. On the other hand, the market value of the red chip shares directly held by mainland companies has reached nearly HK\$100

bn, accounting for 5% of the total market value of listed shares. The red chip shares are shares offered by Chinese enterprises in Hong Kong, and H shares offered by state-owned enterprises.

The increase of Chinese shares on the Hong Kong stock market has provided the mainland with a significant source of financing for economic development. In the meantime, by transforming enterprises into joint-equity ventures to be listed, the mainland has also gained experience in enterprise reform. For the Hong Kong stock market, the increased share of infrastructure and manufacturing has made the market increasingly diversified. In addition, by holding more shares on the Hong Kong's stock market, both investors in Hong Kong and other countries can benefit from China's strong economic growth.

At present, the mainland stock market is still in its infancy. Thus, the Hong Kong stock market will serve as a channel for financing. More importantly, it will be a channel for cooperation and contact between the securities supervision and administration bodies on the two sides, which in turn will facilitate the sound development of the mainland market. Since the Memorandum of Cooperation on Supervision was signed, cooperation among the two sides' five securities institutions has been proceeding smoothly. This has been favourable to the two sides' financial market development. It is our intention to continue such cooperation.

(b) Development of the foreign exchange market and its administration

Hong Kong's foreign exchange market ranks the sixth in the world, and plays a significant role in Asia. Since implementing the regulations on leveraged selling and buying of foreign exchange last year, supervision by Hong Kong's supervision administration on the foreign exchange market has been strengthened, making the market more standardised and stable. At present, the cooperation between Hong Kong and the mainland in the area of the foreign exchange market is reflected in the following four areas. First, due to the convenience of being in the same time zone, the management of foreign exchange reserves on the mainland has been conducted partially through the Hong Kong

market. Second, demand for foreign exchange resulting from trade and investment activities in Hong Kong and the mainland is basically satisfied by the Hong Kong foreign exchange market. Third, in the area of supervision, initial cooperation has been established between the supervision administration and the interbank foreign exchange market. Due to the fact that the mainland foreign exchange market was not long ago established and has been constrained by the inconvertibility of the RMB yuan, the scale and variety of transactions is limited, and so is experience. We believe that contacts and exchanging ideas with Hong Kong's supervision and administration professionals will provide us with helpful experience which will be conducive to the development of the mainland's foreign exchange market. Every effort will be made to continue this contact.

(c) The bond market and debt obligations

Although we have gained some experience on the Hong Kong stock market, we have not so far participated in Hong Kong's debt market. This is mainly because the HK dollar debt market has historically been slow to evolve. In recent years, however, the HKMA has taken steps to promote the debt market through the issuance of Exchange Fund Bills and Notes which has not only served as its own monetary policy instrument but also provided a five-year benchmark yield curve index for HK dollar debt. In addition, the HKMA has developed a debt instrument clearing and custody system run by the Central Moneymarkets Unit. This system provides a safe and effective mechanism for the development of the debt market. Therefore, market conditions for the HK dollar debt market have been improved. I believe that, with increasing demand for funds in Asia and the rest of the world, the Hong Kong debt market will become increasingly attractive. The mainland will also make increasing use of Hong Kong's debt market for fund raising, and this will, in turn, further boost the development of this market.

On this occasion, I would like to stress particularly that, after 1997, the mainland's debt obligation to Hong Kong will remain an external one. That is to say, we will continue to consider ourselves equal participants with those from other

countries and the Hong Kong locality, and will not seek any privileges in Hong Kong. Meanwhile, we will, as always, honour our debt obligations to Hong Kong.

As to the concerns of the international community over the 1997 transition-related factors for the Hong Kong market, I would like to mention that we are pleased to see that the HKMA's first issuance of the Three-Year Exchange Fund Notes maturing after 1997 was well received by the market last July despite the 1997 transition-related concerns.

(d) The relationship between Hong Kong and Shanghai

As is well known, Shanghai used to be China's financial centre. With the deepening of reform and opening policy, Shanghai has increasingly exhibited its vitality and tremendous potential. Judging from its vast hinterland, developed infrastructure, tremendous economic strength, and advanced science and technology, as well as the high quality of its education and human resources, Shanghai undoubtedly boasts the advantages and favourable conditions that point to bright prospects of an international financial centre. The Chinese Government has never hesitated to point this out. Nevertheless, I would like to address the doubts and concerns as to whether Shanghai will replace Hong Kong as an international finance centre.

First, Hong Kong and Shanghai will mutually reinforce their roles, rather than substituting for each other. In my opinion, as an established international finance centre, Hong Kong, in the foreseeable future, will continue to benefit from its international advantages. Second, as is made clear in the Basic Law, China will continue to maintain Hong Kong's status as an international financial centre; concrete provisions have been formulated for this purpose and have become national policy. Third, according to the Basic Law, Hong Kong will be an SAR enjoying a high degree of autonomy after 1997 and the government of the future SAR can exercise control over all matters except foreign relations and defence. This will contribute to maintaining the efficiency and vitality of Hong Kong. Fourth, Hong Kong's current capitalist system will remain unchanged which is conducive to maintaining and promoting its economic ties

with leading developed countries and regions. Fifth, the economic basis and financial strength of Hong Kong have ensured the maintenance and enhancement of its status as an international financial centre.

In the short run, and before the RMB becomes fully convertible, it will be some time before Shanghai becomes a comprehensive international financial centre; and therefore, in the short run it will by no means take the place of Hong Kong. In the medium and long run, the economic relations of mutual support and cooperation between Hong Kong and the mainland will be further strengthened when China resumes the exercise of sovereignty over Hong Kong. By the same token, Hong Kong and Shanghai will become two complementary and mutually reinforcing central financial cities that will develop together with their own unique features under one sovereignty. I believe that, from the long-term perspective, the role of Hong Kong as an international financial centre will serve to expedite the development of Shanghai into a financial centre with the vast hinterland as its cornerstones and RMB transactions the major business. At the same time, Shanghai will support Hong Kong's further development as an international financial centre, and gradually become an international financial centre itself. The relations between the two financial centres will be complementary and mutually reinforcing rather than being mutually substitutable.

Hong Kong's status in international financial relations

In accordance with Article 109 of the Basic Law, as of 1 July 1997, Hong Kong will enjoy or continue its special status in the area of international financial business and relations. This can be seen from the following:

- (a) According to the Basic Law and with the authorisations of the central government, Hong Kong may maintain and develop financial relations with other countries, regions and relevant international organisations independently in the name of "Hong Kong, China", for instance, to enter into and to implement multilateral

and bilateral financial agreements; and establish, as necessary, official or semi-official financial representative institutions abroad, but the central government should be notified of such activities.

- (b) As for the international financial organisations of which the membership is restricted to sovereign countries, the central government will represent Hong Kong or, in an appropriate way, enable Hong Kong to participate in the activities of such organisations as a member of the delegation. As for the international financial agreements of which the signatory is restricted to sovereign countries, the central government, after hearing the views of Hong Kong will, at its discretion decide whether or how these agreements will be observed in Hong Kong.
- (c) As to the current relations between Hong Kong and the international and regional financial organisations, the following principles will be adopted to deal with such relations.
 - For those international financial organisations of which China is already a member and Hong Kong also participates in a certain mode, the central government will adopt necessary measures to enable Hong Kong's continuous participation in an appropriate way. For instance, allowing Hong Kong to continue its membership or quasi-membership in the name of "Hong Kong, China". In the case where Hong Kong is a member or adviser of the British delegation, the central government will consult with the government of the future SAR as to whether a similar position for Hong Kong will be retained in the future.
 - For those international organisations or treaties of which China is already a member or signatory, but Hong Kong is not, the central government will, in consultation with the

government of the future SAR, decide whether and how Hong Kong will participate in these organisations or treaties.

- For the international organisations of which Hong Kong is already a member, but China is not, central government will enable Hong Kong to continue its participation in an appropriate way, as necessary.

Besides concluding, I would like to say the following particularly to the financial community of Hong Kong and through it to the international financial community at large. We wish to share with you the prosperity and development of Hong Kong and China's mainland economy. Hong Kong needs you, and so does China. Finally, I hope the financial community of both Hong Kong and the mainland will endeavour to maintain Hong Kong's status as an international financial centre. ☉