

## PROSPECTS FOR THE FINANCIAL RELATIONSHIP BETWEEN MAINLAND CHINA AND HONG KONG AFTER 1997\*

*After 1997 the Hong Kong Special Administrative Region will enjoy a high degree of autonomy under the principle of “one country, two currencies, two monetary systems and two monetary authorities”. Hong Kong will retain its currency link to the US dollar and mainland financial institutions will be treated like other international banks in Hong Kong.*

*Meanwhile, China will continue to reform its financial system, placing the large banks on a more commercial basis, improving the effectiveness of monetary policy and moving towards current account convertibility of the Renminbi. As China develops, Hong Kong will act as its international financial centre.*

Maintaining a proper financial relationship between mainland China and Hong Kong after 1997 is vital to preserving Hong Kong's status as an international financial centre. I am pleased to make some comments on this issue. I will cover three broad areas: the legal basis and principles of the financial relationship between the two sides; the economic and financial basis of future mutual co-operation; and the potential and format of such financial co-operation.

### **The legal basis and principles of the financial relationship between Hong Kong and mainland China after 1997**

The “Basic Law” and “Joint Declaration”<sup>1</sup> set out the premises for determining the laws, regulations and policies affecting the financial relationship between mainland China and Hong Kong after 1997. According to such laws, Hong Kong will become a Special Administrative Region of the People's Republic of China (PRC) after 1997, enjoying a high degree of autonomy. With regard to financial issues, this means: first, the Central People's Government will continue to do its best to maintain Hong Kong's position as an international financial centre; secondly, the existing monetary and financial system will remain unchanged and the Government of the Hong Kong Special Administrative Region (HKSAR) will, on its own, formulate and implement monetary and financial

policy; thirdly, the HK dollar will continue to be the only legal tender in the HKSAR, and the authority to issue currency and the arrangement for note issue will remain unchanged; fourthly, Hong Kong will not implement a foreign exchange control policy – thus the HK dollar will remain freely convertible and its financial markets will remain open; and lastly, the Exchange Fund, as Hong Kong's foreign exchange reserves, will primarily be used for regulating the exchange value of the HK dollar.

The core objective of the above legal principles is the maintenance of the existing monetary and financial system of Hong Kong. They establish the principle of “one country, two currencies, two monetary systems and two monetary authorities”, and lay down clearly the legal basis for the development of the financial relationship between mainland China and Hong Kong in the future. Thus, the nature of this financial relationship may be defined as a relationship between two relatively independent monetary systems under different social and economic systems within a sovereign state. Financial transactions between both parties will be implemented in accordance with the regulations and practices of international financial activities.

In order to maintain Hong Kong's status as an international financial centre, we believe that we

\* This is a translation of the speech delivered by Chen Yuan, Executive Deputy Governor of the People's Bank of China, at the “Beyond 1997” Conference on 26 October 1995 in Beijing.

<sup>1</sup> “The Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China” and “The Joint Declaration of the Government of the People's Republic of China and the Government of the United Kingdom of Great Britain and Northern Ireland on the Question of Hong Kong”, together with its annex “Elaboration by the Government of the People's Republic of China of its Basic Policies Regarding Hong Kong”.

should adhere to the following principles when dealing with specific monetary problems on both sides:

- *To retain the monetary system of Hong Kong – the linked exchange rate system – during the transition.* We believe that as Hong Kong is a small open economy, it is appropriate to link the exchange rate of its currency to that of a major trading partner. The US dollar is an obvious choice given its position as a leading international currency, and the likelihood it will remain the main currency in which Hong Kong's trade will be denominated in the foreseeable future. With the continued steady growth of the Hong Kong economy and the deepening of economic reforms and greater openness in mainland China, trade will remain an important factor supporting the growth of the Hong Kong economy. Therefore, we understand and resolutely support the view that Hong Kong should maintain its linked exchange rate system.
- *To enhance co-operation between the two monetary authorities on monetary policy.* Since the establishment of the Hong Kong Monetary Authority in 1993, the monetary policies and measures adopted in Hong Kong have been refined, and this year it successfully coped with the challenge posed by the unexpected Mexican currency crisis. In order to maintain Hong Kong's status as an international financial centre and to enhance the development of the financial industry, the two monetary authorities (that is, the People's Bank of China and the HKMA) need to maintain their existing good working relationship before and after 1997, and continue to communicate and discuss with each other on monetary issues as they arise.
- *To uphold the regulatory principles governing financial institutions.* We believe the Basle Agreement has been the standard commonly followed by monetary authorities around the world. The financial institutions of both mainland China and Hong Kong must follow

international regulations and standard practices when setting up financial institutions outside their own region. Thus, Hong Kong financial institutions will be treated and supervised as foreign enterprises in mainland China. Similarly, Chinese financial institutions operating in Hong Kong also have to abide by the laws of Hong Kong and be adequately supervised by the HKMA.

- *To continue strengthening the Exchange Fund.* The steady growth of the Exchange Fund is vital to the stability of the HK dollar exchange rate and the maintenance of market confidence in the linked exchange rate system. We hope that the pre-1997 British Hong Kong Government will guarantee continued growth in the assets of the Exchange Fund to enhance Hong Kong's ability to withstand external pressures and to provide a firm foundation and guarantee for the smooth transition of Hong Kong.
- *To treat any claims and liabilities existing between mainland China and Hong Kong after 1997 as foreign claims and liabilities.* That is to say, mainland Chinese entities will enjoy in Hong Kong the same treatment, without any special privileges, as other international and local market participants. At the same time, mainland Chinese entities will continue to live up to their international reputation to meet all obligations to Hong Kong and support the development of the Hong Kong debt market.

### **The economic and financial foundation of future financial co-operation between mainland China and Hong Kong**

As everybody knows, with mainland China's implementation of economic reform and market opening for more than ten years, economic ties between China and Hong Kong have developed and grown so close that they share both weal and woe. At present, Hong Kong is the largest foreign investor in mainland China. Hong Kong and mainland China are one another's largest trading partner. There is no doubt that the economic and financial development of mainland China has

provided a positive motivation for the steady growth of Hong Kong's economy, and has laid a solid foundation for future financial co-operation.

**(a) The current economic and financial situation in mainland China**

China's economy continues to respond to the macro-economic adjustment policies. As a result, all macro-economic indices continue to improve. This is shown by the strong but moderating economic growth, a fall in the growth of fixed asset investment; the stabilisation of retail prices with an inflation rate this year of about 15%; the steady growth of external trade; and the deepening reform of state-owned enterprises. These factors have created a favourable environment for further financial reforms.

In December 1993, the "Decision Relating to the Reform of the Monetary System" issued by the State Council indicated that a new phase of reform of the monetary system had begun. The reform aims at establishing a system under which the central bank, under the leadership of the State Council, can implement an independent monetary policy through macro-economic controls; policy-related banking operations are separated from commercial banking operations; the state-owned commercial banks are supplemented by other types of financial institutions; and there is a co-ordinated opening of the financial market with orderly competition and proper supervision. Over the past year, the monetary system reforms have been smoothly implemented and have basically achieved the expected results and ensured the healthy operation of the finance industry. This year, the financial sector in mainland China is developing steadily under macro-economic control.

- *The central bank further strengthened its role in stabilising the value of the currency, improving the operation of monetary policy instruments and improving prudential supervision of financial institutions.* Due to the ongoing moderately tight monetary policy this year, the rate of increase of money supply has been further reduced.
- *The commercialisation of state-owned specialised banks has continued to progress.* Asset-to-liability ratio management and loan ceilings have been applied to the state-owned commercial banks. We have

also instituted centralised funds allocation, capital cost and profit-analysis, loan quality monitoring and risk management systems and are gradually increasing the capital adequacy ratio.

- *A smooth reform of the foreign exchange system.* Following the successful unification of the dual exchange rate system in 1994, a market-based, unified and managed floating exchange rate system has been formulated. Sale and purchase of foreign exchange was done through banks and a unified foreign exchange market was established to give full play to the effect of market forces in determining the distribution of foreign exchange resources.
- *Progress on greater monetary openness to foreign countries.* At the end of August this year, 24 cities have been approved for the establishment of foreign financial institutions; approval was given to set up a total of 466 representative offices and 134 operating branches in mainland China, of which 115 are banks and their branch offices with total assets amounting to US\$16.1 billion and four are subsidiaries of foreign insurance companies. At the same time, 508 financial institutions or subsidiaries have been established outside China by state-owned commercial banks.

**(b) Current financial co-operation between Hong Kong and mainland China**

- *Establishment of financial institutions.* 16 Hong Kong-based banks have established 29 branches in mainland China. Similarly, increasing number of mainland Chinese financial institutions are establishing operations in Hong Kong. Besides the original 13 members of the Bank of China Group, Chinese enterprises have stakes in some local banks in Hong Kong and have set up a few dozen non-bank financial institutions. The representative office of the People's Construction Bank of China has been approved to be upgraded to a branch. Two other state-

owned specialised banks with representative offices in Hong Kong have also applied for upgrade.<sup>2</sup>

- *The linking of the settlement systems in China and Hong Kong.* At present, both the People's Bank of China and the HKMA have begun to establish their own "Real Time Gross Settlement" payment systems, which will comply with international standards. The HK dollar settlement system will link with the Renminbi settlement system when the time is appropriate. To achieve this, we have set up a joint working group on payments systems to study the issue. The linking of the two systems will greatly promote the financial development and economic activities of both mainland China and Hong Kong.
- *Co-operation in the syndicated loan market and capital market.* Hong Kong is the syndicated loan centre of the world. 90% of syndicated loans for use in mainland China are arranged in Hong Kong. The Hong Kong stock market is one of the largest in the world, and at present, there are 17 state-owned enterprises listed in Hong Kong. Over 40% of the companies listed in Hong Kong have participated in almost one thousand investment projects in mainland China, with a total investment of about HK\$500 billion. The total market value of Chinese enterprises listed on the Hong Kong stock market is almost HK\$100 billion.
- *Co-operation in the foreign exchange market.* Hong Kong has surpassed Switzerland to become the world's fifth largest foreign exchange market with a daily turnover of US\$91 billion. At present, a considerable portion of the mainland's US\$70 billion in foreign exchange reserves is traded through the Hong Kong market. With regard to regulation and development of the foreign exchange market, a good working relationship is being developed between the regulatory

authorities and the foreign exchange market community.

### **(c) The potential and format of future financial co-operation between mainland China and Hong Kong**

After 1997, Hong Kong will serve as the international financial centre of China, while Shanghai will mainly assume the role of China's domestic financial centre. Hong Kong is now experiencing a period of economic restructuring and its financial services industry will continue to play a pivotal role. On the other hand, the financial industry in mainland China is gradually becoming more internationalised. Financial services will no doubt play a very important part in the closer economic inter-relationship between Hong Kong and mainland China.

Throughout the implementation of the "eighth five-year plan", the reform to provide greater openness and the development of the economy have achieved great success. On this foundation, the central government of China recently formulated its "ninth five-year plan" and a guidance document setting out the long-term objectives for the year 2010. The plan is to achieve a reasonable level of prosperity within the coming 15 years and lay the foundation for doubling the gross national product between 2000 and 2010. The implementation of this strategic objective will have a significant and far-reaching impact on the economic and social development of mainland China, and put greater demands on the successful reform of the financial sector.

The reform of the financial sector in mainland China, as envisaged in the "eighth five-year plan", was fully implemented and achieved great success. However, monetary reform is a difficult and long-term commitment involving systemic changes and the full realisation of the fundamental goals takes time. Financial sector reform will be continued under the "ninth five-year plan" in accordance with long-term objectives for the year 2010 to maintain the basic equilibrium between demand and supply. It will be carried out alongside enterprise reforms and reform of the taxation and investment systems. Such reforms will proceed on a firm legal basis and will focus on three aspects of the financial sector:

2 Approval was subsequently given to these two banks – the Agricultural Bank of China and the Industrial and Commercial Bank of China.

the central bank, the commercial banks and the foreign exchange management system and the opening up of the financial sector.

- *The central bank will shift from direct control to indirect control.* There is a gradual shift from controlling the volume of loans and the amount of cash issued towards controlling the money supply by indirect means. Another area is to refine and improve monetary policy instruments. Next year, the central bank will make use of open market operations (trading in government securities) to regulate base money. Meanwhile, overall reform of the interest rate regime is under further study.
- *Commercialisation of state-owned specialised banks.* Reform of the specialised banks is conducted in accordance with the requirements of a socialist market economy, reference to international practices and China's Commercial Banking Law. The reform aims to align the commercial banking operations and management with international standards. The four state-owned specialised banks, namely, the Industrial and Commercial Bank of China, the Agricultural Bank of China, the Bank of China and the People's Construction Bank of China, will be transformed into large-scale commercial banks whose management and operations are up to international standards. This will facilitate these specialised banks playing a leading role in the banking system of China. Reform will take place in two stages. In the first stage, to be completed next year, the operation and management standards of the four commercial banks will be significantly enhanced. The second stage, to be completed at the end of this century or on a longer time scale, will see a full implementation of international practices by the specialised banks regarding asset-liability management, risk management and operating standards. To this end, a group of professional bankers will be trained up urgently to manage the state-owned commercial banks.

- *Foreign exchange management system and the opening of the financial sector.* Mainland China is currently implementing a system under which Renminbi can be convertible on the current account subject to certain conditions being fulfilled. The Chinese Government has officially pledged to the International Monetary Fund that free convertibility on the current account will be realised by the year 2000. To achieve this, reforms to the foreign exchange system encompass
  - ◇ the improvement of the exchange rate policy and foreign exchange reserves policy;
  - ◇ the co-ordination of the exchange rate policy, the foreign exchange reserves policy and the domestic credit policy so as to improve the effectiveness of macro-economic adjustment by the central bank;
  - ◇ continued refinement of the foreign exchange trading system. It begins with speeding up the timetable for Renminbi convertibility and the refinement of the policy of greater openness to gradually incorporating the foreign exchange trading of the Sino-foreign joint ventures and solely foreign-funded enterprises into the inter-bank trading system. This will resolve the question of according national treatment to such enterprises;
  - ◇ the refinement of the foreign exchange reserves management system.

With regard to achieving greater openness, the restrictions faced by foreign financial institutions seeking approval to enter the China market will be further relaxed, the transparency of the legal framework will be enhanced, the investment environment will be improved, the disparity in national treatment between local and foreign capital will be eliminated, and more attention will be directed to the study of international capital flows.

The gradual alignment of the financial market in mainland China with the international market will help strengthen Hong Kong's position as an international financial centre. The financial services offered by Hong Kong to mainland China will continue to be indispensable. Financial co-operation between mainland China and Hong Kong has great potential. I believe that, in the foreseeable future, Hong Kong will further strengthen its position as an international financial centre, and will play an important role in the global financial market.

Here, I would like to express my views on the following two areas:

**(i) The co-ordination of economic policies**

The upturn of the global economy and major international markets, and the rapid growth of the economies of China and the rest of the Asia-Pacific region will together provide new opportunities for the economic and financial development of Hong Kong. I believe that the future economy of Hong Kong will focus on the provision of services and technology. Both China and Hong Kong need to study how to enhance co-operation and complementarity between them. Both sides also need to co-ordinate where necessary on economic policies.

Separately, Hong Kong is now encountering more intense competition from burgeoning Asian markets such as Singapore and Malaysia, though it is beyond doubt that Hong Kong is still one of the most competitive markets in the world. However, certain unfavourable factors, such as increased operating costs faced by banks, surging office rentals and an outflow of skilled workers still exist. In the long run, such phenomena will be harmful to Hong Kong's status as an international financial centre. Under the linked exchange rate system, monetary measures alone are not sufficient for solving these problems. We also need to work hard on other economic policies, especially fiscal policy. We also hope that the relevant departments in Hong Kong will continue their study and research so as to maintain Hong Kong's steady economic growth.

**(ii) The development of the bond market**

A mature Hong Kong bond market will have the effect of attracting and absorbing funds and

capital. It also contributes to the stability of the exchange rate and helps develop other financial markets in Hong Kong, thereby enhancing Hong Kong's position as an international financial centre. At the moment, Hong Kong's bond market is still in its infancy. According to a World Bank report, Hong Kong's bond market is equivalent to 9% of Hong Kong's GDP and ranks behind Singapore, Malaysia, South Korea, the Philippines and Thailand in the East Asia region. The World Bank expects that in the coming ten years, the total value of the East Asian bond market will increase sharply from US\$338 billion at end 1994 to around US\$1,000 billion.

In recent years, the HKMA has adopted various measures to improve and deepen Hong Kong's bond market, such as the introduction of the Exchange Fund Bills and Notes, the extension of the benchmark yield curve for the development of the HK dollar debt market, profits tax exemption for paper issued by supranational bodies, the launching of Central Moneymarkets Unit services, and the promotion of mortgage securitisation and assets securitisation as the major direction for bond market development. All these measures have helped in promoting the development of the Hong Kong bond market. Currently, Hong Kong's massive infrastructure project financing needs also support the growth of the bond market.

The issuance of HK\$1.2 billion of notes in Hong Kong by the People's Construction Bank of China reflects an expectation of rapid economic growth and the enormous need for infrastructure development in mainland China after 1997. Many institutions and enterprises in mainland China will continue to seek financing from the Hong Kong capital markets. Long-term infrastructure development in Asia and regional economic growth also create a need for financing in the international bond market. As an international financial centre, Hong Kong has the capability to play an important role in this process.

I would like to conclude my speech with the following reaffirmation. As the economy of mainland China continues to prosper and Hong Kong continues to develop, the future of mutual financial co-operation is very promising. Together with our counterparts in the financial sector in Hong Kong, we will endeavour to maintain Hong Kong's status as an international financial centre. ☉