

THE FOREIGN EXCHANGE MARKET IN HONG KONG*

The average foreign exchange turnover in Hong Kong was US\$91bn per day in April 1995, 49% above that in 1992. As in other centres, most of the increase reflected greater use of swaps. Hong Kong has become the fifth largest trading centre in the world, up from sixth in 1992.

Introduction

The Hong Kong Monetary Authority conducted a survey on the foreign exchange and derivatives market in March and April this year as part of a global survey coordinated by the Bank for International Settlements (BIS). The global survey is conducted once every three years and this was the third time that Hong Kong has participated. Twenty five other centres also participated in the current survey.

In the previous surveys, turnover data was only collected on the foreign exchange market, including spot deals, forward contracts, options and futures. However, in view of the rapidly growing derivatives activities, BIS expanded this year's survey to cover a wider range of derivatives business. Besides currency derivatives, derivatives on interest rates, equities and commodities were covered. The data were collected from all authorised institutions and several major securities houses in Hong Kong by asking them to fill in a questionnaire.

The survey results are being released by national bodies in two parts, with results on foreign exchange market activity released in September and the second part on derivatives market activity scheduled to be released in late November or early December. BIS released a preliminary estimate for the global foreign exchange market in October and the final results for both parts will be released in 1996.

Net turnover

The foreign exchange market in Hong Kong has grown rapidly during the last three years. The net turnover of deals contracted by authorised institutions in Hong Kong was US\$91bn per business day in April 1995, equivalent to over 170 trillion HK dollars per year. This represents almost 50% growth over the figure of US\$61bn in April 1992. Net turnover refers to the figure after

elimination of double-counting among authorised institutions in Hong Kong (i.e. a sale of US dollars for HK dollars from one AI to another counts as one rather than two transactions). The gross turnover (i.e. before elimination of this double-counting) in April 1995 was US\$105bn, which represents an increase of 43% as compared to April 1992. The detailed results are shown in the Appendix.

It is encouraging to note that Hong Kong has overtaken Switzerland as the fifth largest foreign exchange trading centre in the world. As shown

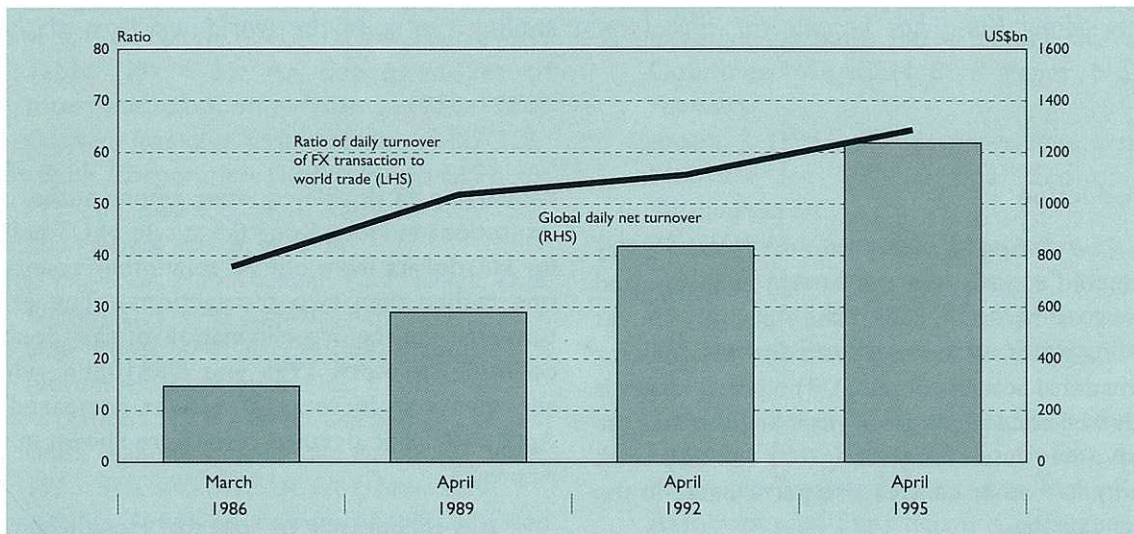
Table 1:
Net Turnover

(in US\$ bn)	1995	1992	% change
United Kingdom	465	291	60
United States	244	167	46
Japan	161	120	34
Singapore	105	74	43
Hong Kong	90	60	50
Switzerland	87	66	32
Germany	76	55	39
France	58	33	74
Australia	40	29	37
Canada	30	22	36
Denmark	29	27	11
Belgium	28	16	79
Netherlands	26	20	30
Italy	23	16	50
Sweden	20	21	-7
Luxembourg	19	13	45
Spain	18	12	49
Austria	16	4	252
Others	39	31	23
Sum of above	1573	1076	46
Global net total	1230	820	50

Note: Data based on preliminary global results released by BIS. The current comparison is made on the basis of excluding options and futures i.e. confined to spot, foreign exchange swaps and outright forwards only.

* This article is primarily the work of Kitty Lai of the Economic Division, who led the team conducting the survey in Hong Kong.

Chart I
Global Foreign Exchange Daily Turnover



Note: Survey for March 1986 included UK, US, Japan and Canada only; the global daily net turnover is estimated using the proportion of these four countries in April 1989.

from table I, most participants recorded significant growth in currency trading volume¹ and Hong Kong's growth is among the highest.

The net global turnover surged rapidly in the past decade to exceed one trillion US dollars in April 1995. The daily turnover amounted to more than 60 times world trade, much higher than 7 in early seventies. This reflects the increase in financial transactions arising from cross-border capital flows due to both direct investment and portfolio diversification. (chart I)

Type of transactions

The expansion of the foreign exchange market in Hong Kong was largely due to the increase in foreign exchange swaps². As shown from chart 2, the net turnover of foreign exchange swaps was almost double that of April 1992. Outright forwards also registered a strong increase of 59%. This is generally in line with the global pattern which also showed much of the increases in currency trading coming from swap activities (see table 2). The net global turnover for forwards (including swaps) rose 65%, based on BIS' preliminary estimate. In particular, London, the largest trading centre, had swaps contributing almost 80 percent of the

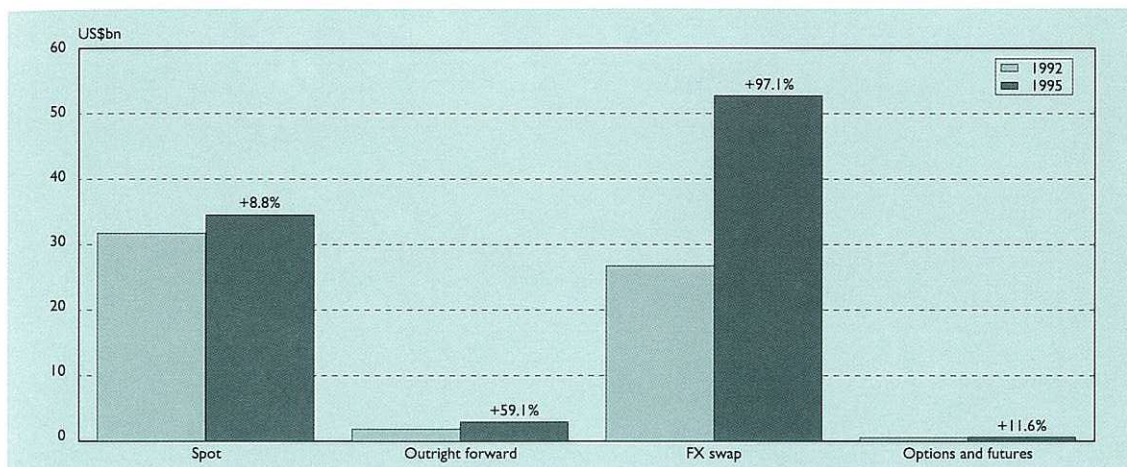
increase in turnover.

Spot contracts recorded only a moderate growth of 9% over three years ago, although this was higher than the 6% growth between 1989 and 1992. Options and futures showed a modest increase of 12% over three years earlier. The Barings incident in February, together with other cases of reported losses in derivatives, might have affected the trading of options and futures early this year. In addition, a reporting institution opined that since Hong Kong is a developing options market, the trading might not be very stable from month to month.

Reflecting the growth rates, the share of forwards (including both outright forwards and foreign exchange swaps) out of the total daily net turnover in Hong Kong rose significantly to 61% in April 1995 from 47% in April 1992 and 39% in April 1989. The rising share of swap activities is a continuation of the trend in previous surveys and most participating centres in the BIS survey show the same pattern. The proportion of spot deals showed a corresponding decline over the years in Hong Kong – from 61% in 1989 and 52% in 1992 to 38% in 1995. The share of options and futures remained small at 1% (see chart 3).

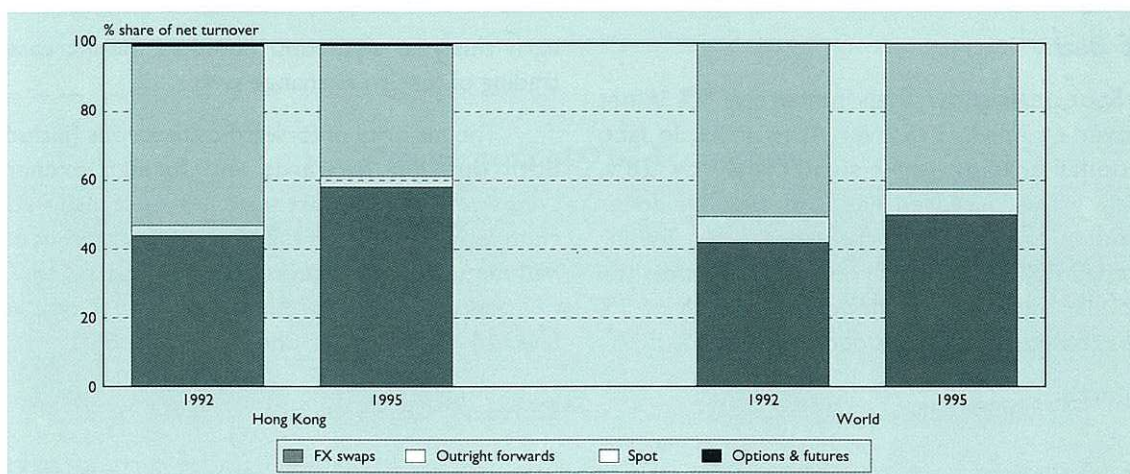
1 The growth is somewhat exaggerated by the fall in the US dollar's value over the past three years. The 50% growth in US dollar terms would be 39% in ECU terms and a fall of 6% in yen terms. The 50% growth compares with 34% growth in OECD nominal GDP and 30% growth in world merchandise trade.
2 A foreign exchange swap contract refers to a simultaneous purchase and sale of a certain amount of foreign currency for two different value dates.

Chart 2
Average Daily Net Turnover of Foreign Exchange Transactions



Note: 1992 figure on options and futures refer to gross turnover.

Chart 3
Composition of Foreign Exchange Turnover by Types of Transactions



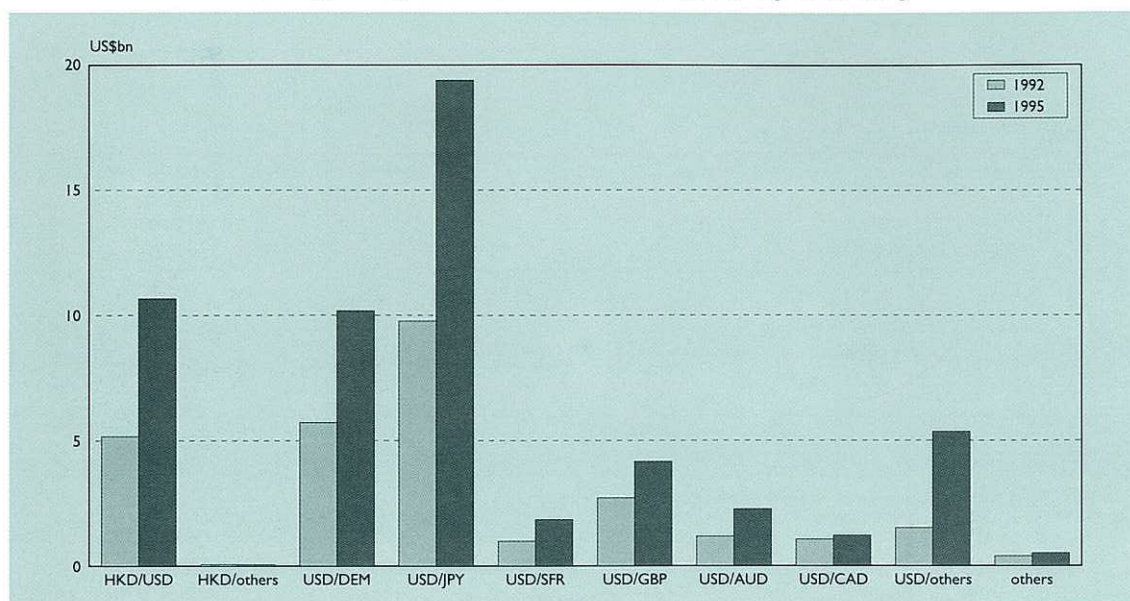
Note: Global figures for options and futures are not available.

Table 2:

Foreign exchange transactions	Average daily net turnover in HK (US\$bn)			Average daily net global turnover (US\$bn)		
	1995	1992	% change	1995	1992	% change
Spot	34.5	31.7	8.8	535	400	34
Forwards	55.7	28.6	94.6	695	420	65
Of which:						
Outright forwards	2.9	1.8	59.1	N.A.	N.A.	N.A.
Foreign exchange swaps	52.7	26.8	97.1	N.A.	N.A.	N.A.
Options and futures	0.6	0.6	11.6	N.A.	N.A.	N.A.
Total	90.8	60.9	49.1	1230	820	50

Note: Figures may not add up to total due to rounding.

Chart 4
Average Daily Net Turnover of Forwards by Currency



Spot deals

Spot deals showed an increase of 9% in net turnover of April 1995 over April 1992. In fact, HK dollar trading grew significantly by 28%, reflecting the increased need for the HK dollar for both business and financial transactions. Trading of the US dollar against currencies other than the HK dollar registered a moderate growth of 9% while cross-currency deals declined by 7.5%.

Forwards

Forwards (including both outright forwards and foreign exchange swaps) recorded an average daily turnover of US\$56bn in April 1995, almost twice that in April 1992. The increase in turnover was mainly contributed by transactions in the US dollar against Japanese yen, HK dollar and Deutschemark (chart 4). This reflects banks' increased use of swaps in their daily currency management. Coupled with the growth in foreign trade, cross border portfolio flows and direct investment abroad, banks' increased exposure to foreign currencies led to more frequent use of swaps for hedging. In addition, foreign banks short of HK dollar funds temporarily can lend their foreign currency funds and borrow HK dollar funds through the use of foreign exchange swaps. Some authorised institutions commented the higher than usual interest rate and exchange rate volatilities

early this year also contributed to the increase in trading of foreign exchange swaps.

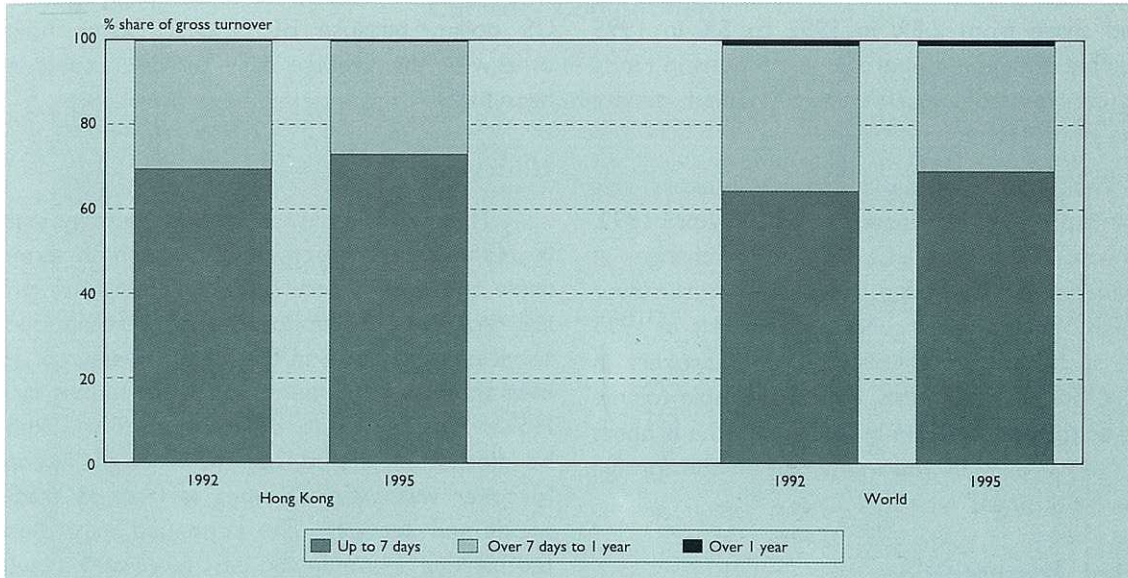
The majority of forward transactions (including both outright forwards and foreign exchange swaps) were very short term in nature, as in other centres. Nearly three quarters of the transactions had maturity under seven days, compared to 72% of London and 66% of New York and Tokyo. Very few had maturity over one year (chart 5).

Currency analysis

The most commonly traded currency pairs in Hong Kong were the US Dollar against Japanese Yen (29% of daily net turnover) and the US Dollar against Deutschemark (25%). The share of HK dollar against US dollar transactions ranked third at 16%. The volatility of the Japanese yen in April 1995 might have spurred the trading of the currency such that the share of US\$/yen trading rose slightly when compared with April 1992. The dominance of US\$/yen and US\$/mark transactions is also found in most other centres.

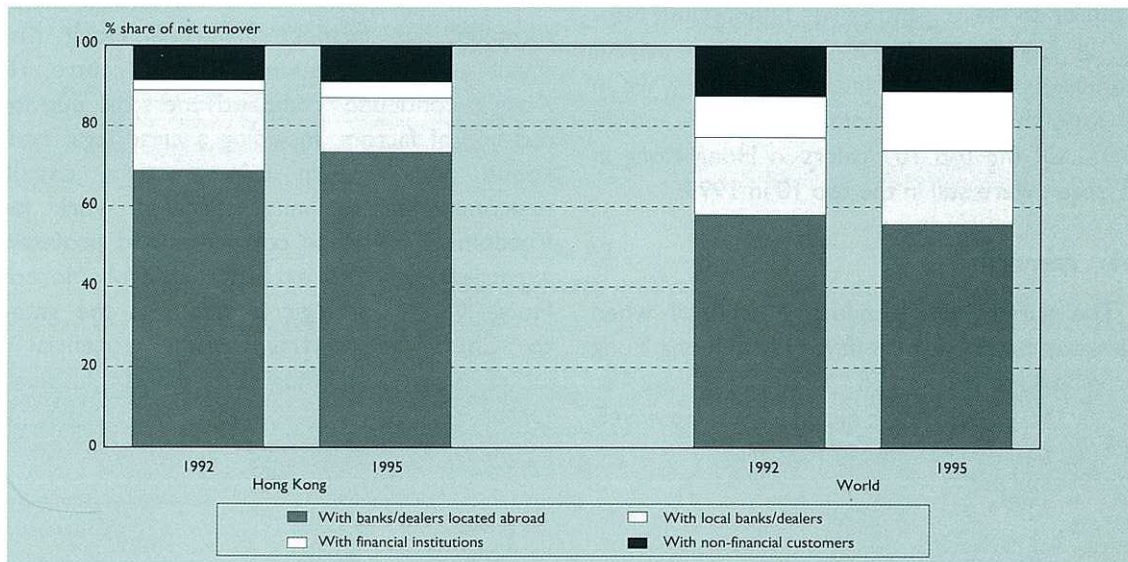
Transactions involving the US dollar (other than for HK dollars) accounted for over three quarters of the total while those involving the HK dollar accounted for less than 17%. This reflects Hong Kong's role as an international financial centre with a large volume of foreign currency trading.

Chart 5
Maturity of Forwards



Note: 1995 figures for world are estimated based on national releases of data from major centres including UK, US, Japan, HK, Switzerland and Australia, which altogether accounted for 69% of global trading of forwards. The global results on maturity composition are yet to be released by BIS.

Chart 6
Counterparty of OTC Transactions



Note: 1995 figures for Hong Kong include OTC options.

Counterparty analysis

Similar to the other centres, the majority of the transactions in April 1995 in Hong Kong were conducted with overseas banks (71% of net turnover), as compared to 69% in April 1992. The figure was higher than the global figure of 55%,

reflecting Hong Kong's status as an international financial centre as well as the strong presence of multinationals. Transactions involving local counterparties accounted for 25% of the total, below 30% in 1992. In particular, 15% were transactions between authorised institutions in

Hong Kong, 2% with other local financial institutions and 8% with local non-financial customers. In Hong Kong, trading with other financial institutions gained share from 2.5% in 1992 to 5% in 1995 while that between authorised institutions in Hong Kong contracted from 20% to 15%. This is similar to the global trend. (chart 6)

The volume of deals through brokers was 35% in April 1995, compared to 31% in April 1992. However, this may just reflect a change in procedures for collecting this data. The turnover through brokers were collected from AIs in 1995 while such data were collected from brokers in 1992. Notwithstanding this, the considerable volume of trade through brokers indicates that the brokers continue to play an important role in the foreign exchange business.

Market concentration

Overseas incorporated banks accounted for 85% of gross turnover, about the same as in April 1992. The concentration of foreign exchange trading was also little changed. The top 10 players accounted for slightly over 50% of gross turnover and the top 20 for 70%. The level of concentration was similar to major centres like London and New York. In London, the 10 most active players accounted for 44% share and 20 for 68%, while in New York, the top 10 accounted for 47% and 20 for 70%. Of the top 10 dealers in Hong Kong in 1992, seven were still in the top 10 in 1995.

Other remarks

The survey was conducted in April when there were fewer business days (17) in Hong Kong than in other centres. It is more proper to compare the turnover per business day. However,

some market participants commented that Hong Kong missed one particularly heavy trading day, when the yen reached its all-time high against the US dollar, because of a local Easter holiday; otherwise the average daily turnover could have been higher.

Conclusion

The expansion in the foreign exchange market in Hong Kong reflects both growth in external trade and the financial sector in Hong Kong. The fast growth of the trade value of merchandise and services, nearly 60% in the March quarter of 1995 over three years earlier, is one contributing factor. However, the majority of transactions are likely to be financially driven as the foreign exchange turnover was over 60 times as large as trade in goods and services. The continued expansion in the banking sector in the past few years, resulting from the growth in portfolio and direct investment in the region has led to the increased volume of foreign exchange transactions. The foreign currency assets of authorised institutions, which amounted to US\$770bn at end April 1995, rose by almost 40% over three years ago.

The high growth rate of the foreign exchange turnover has further reinforced Hong Kong's status as an international financial centre. Hong Kong's continued competitiveness is due to a number of factors, including a clear legal system, sound and modern infrastructure, excellent telecommunication links, educated work force, freedom of entry for companies and professional expatriates, and no exchange control. Moreover, Hong Kong's strategic position as the gateway to China offers tremendous potential for future growth of Hong Kong's financial services sector. ☺

Appendix : Net turnover in foreign exchange by authorised institutions in Hong Kong

Table A1:
Currency Composition

(US\$ equivalent, billion)

Currencies	Average daily net turnover ⁽¹⁾			% share	
	Apr 1992	Apr 1995	% change over 1992	Apr 1992	Apr 1995
HK dollar against:					
– US dollar	8.2	14.3	73.4	13.5	15.7
– Others	0.6	1.0	79.3	0.9	1.1
Subtotal	8.8	15.3	73.8	14.5	16.9
US dollar against:					
– Deutschemark	16.3	22.8	40.0	26.8	25.2
– Japanese yen	15.7	26.1	66.6	25.7	28.7
– Swiss franc	2.8	3.6	29.5	4.6	4.0
– Pound sterling	6.2	6.1	-0.5	10.1	6.8
– Australian dollar	1.5	2.7	84.6	2.4	3.0
– Canadian dollar	1.9	1.5	-23.3	3.2	1.6
– Others ⁽²⁾	2.4	7.6	220.4	3.9	8.3
Subtotal	46.7	70.5	50.9	76.7	77.6
Cross currencies ⁽³⁾ :					
– Japanese yen / Deutschemark	1.4	2.2	57.3	2.3	2.4
– Pound sterling / Deutschemark	2.0	1.0	-50.5	3.4	1.1
– Others	1.9	1.8	-5.6	3.2	2.0
Subtotal	5.4	5.0	-6.4	8.8	5.5
TOTAL	60.9	90.8	49.1	100.0	100.0

Note: (1) The net turnover figure is obtained after adjusting for double reporting between authorised institutions.

(2) For Apr 1995, "Others" include Malaysian Ringgit, the average daily turnover of which amounted to US\$1.3 Bn and accounted for 1.4% share. Corresponding figures for 1992 are not available.

(3) Direct trading between two currencies not involving the US dollar or the HK dollar.

(4) Net turnover by currency composition was not available for 1989.

(5) Figures may not add up to total due to rounding.

Table A2 :
Counterparty analysis

(US\$ equivalent, billion)

Counterparty	Average daily net turnover ⁽¹⁾					% share		
	Apr 1989	Apr 1992	% change over 1989	Apr 1995	% change over 1992	Apr 1989	Apr 1992	Apr 1995
With authorised institutions in Hong Kong	10.9	12.1	11.1	13.7	13.4	22.2	20.1	15.1
With foreign exchange market dealers abroad	32.8	41.5	26.4	64.4	55.2	66.8	68.8	70.9
With other financial institutions	0.8	1.5	80.7	4.5	199.6	1.7	2.5	5.0
With non-financial customers	4.6	5.2	14.0	8.2	56.3	9.3	8.7	9.0
TOTAL	49.1	60.3 ⁽³⁾	22.8	90.8	50.5	100.0	100.0	100.0

Note: (1) The net turnover figure is obtained after adjusting for double reporting between authorised institutions.

(2) Figures may not add up to total due to rounding.

(3) Figure for 1992 did not include options and futures contracts which were not classified by counterparty in the questionnaire.