

*Applying the “one country, two systems” regime after 1997 means the Hong Kong economy does not have to converge with that of the mainland. Hong Kong has over the years built up its central banking functions to support Hong Kong’s role as an international financial centre. This role is underpinned by the monetary and financial discipline in Hong Kong.*

The monetary and financial arrangements for Hong Kong after 1997 will be based on an application of the concept of “one country, two systems”. This concept is of course a new one, and there is really no precedent against which one could assess objectively the likelihood of its success. Some observers have therefore expressed reservations as to whether it is workable, citing the social, political and economic forces normally at work within a country. But the framework laid down in the Joint Declaration and the Basic Law is a comprehensive one: Hong Kong will enjoy a high degree of autonomy after 1997, except in foreign affairs and defence. We are confident that, as long as the provisions laid down in these documents are strictly observed, things will work out well for Hong Kong.

In a way, the concept of “one country, two systems” involves similar considerations as the concept of “one system, many countries” that the European Union represents, except that the former argues for maintaining the status quo in monetary segregation and the latter for making historical changes in monetary union. Both involve a great deal of political will. And human nature is such that it is always easier to maintain the status quo. So one should at least not be as sceptical to the concept of “one country, two systems” as applied to the question of Hong Kong than to the concept of “one system, many countries” as in the case of Europe. But seriously, the political will is demonstrably there and it involves just two sovereign states and not 15. And the Joint Declaration I imagine has a similar legal status to the Maastricht Treaty.

Let me be more specific in the comparison: to achieve EMU I understand there is a list of convergence criteria on price stability, public finances, interest rates and exchange rate stability, presumably to safeguard against possible disruptions

to individual countries as a result of monetary union. I think this is equivalent to saying that, without convergence, it would be better for the status quo to be maintained. In the context of Hong Kong’s future I could not agree with this more, for I cannot think of any other two economies in this world that are more different than those of Hong Kong and China. The Heritage Foundation has just named Hong Kong as the freest economy in the world and the corresponding ranking for China is 121st. And notwithstanding the rapid process of reform and liberalisation in China towards a Chinese style socialist market economy, it is still a lot different from capitalism as practised in Hong Kong.

Policy convergence is therefore rather remote, while institutional convergence is a long way into the future. The Chinese tasks of fiscal, financial and enterprise reform on the road to a socialist market economy are both monumental and historic. The Chinese leaders are fully aware of the risks and challenges involved, as well as the time it takes to achieve that goal. The philosophy of Chinese reform is gradualism, epitomised in the expression “crossing the river by feeling the stones”. Insofar as Hong Kong is concerned, that gradualism is defined realistically in the Joint Declaration and the Basic Law as autonomy for Hong Kong for 50 years after 1997.

And there is really no logical reason or desire to seek convergence. Hong Kong is a successful example of how the market works. It is essential to China’s economic transformation to keep Hong Kong as it is so as to serve as a demonstration model and perhaps also as a buffer zone during China’s own transition. It is this pragmatism and realism that stands behind the concept of “one country, two systems”. It is not a airy fairy idea. It will work.

\* This is the text of a speech by Joseph Yam, CBE, Chief Executive of the HKMA to the informal dinner at the BIS Governors Meeting on 11 December 1995.



But you will have noticed arguments every now and then about issues relating to Hong Kong in transition. Detailed as the Joint Declaration and the Basic Law may be, nothing is purely black and white. And so the interpretation of various shades of grey has been the subject of some controversy. And the Sino-British relationship has not exactly been at its best recently. Basically, out of good intentions to safeguard the interests of the future Hong Kong Special Administrative Region, China wished to get involved in important decisions taken before 1997 that may affect Hong Kong after 1997. The British side, being very comfortable with Hong Kong people running Hong Kong, before or after 1997, basically feels that this ought to be left to the people of Hong Kong, as they have been doing an excellent job. But if talking is necessary to continue to get things done, so that container terminals and airport, etc. are built for the long term benefit of Hong Kong, then talks by all means should take place, with substantial input from Hong Kong. These talks have ups and downs, and at times involved a lot of frustration and were made complicated by the need to disprove conspiracy theories; but by and large Hong Kong achieves what it wants, for after all everyone involved wants Hong Kong to be stable and prosperous after 1997. In any case, these arguments will not and cannot continue for long. After the establishment of the Hong Kong Special Administrative Region Government on 1 July 1997, it will be Hong Kong people who will be taking decisions affecting Hong Kong, other than those concerning defence and foreign affairs. We will be exercising the autonomy so clearly promised in the Joint Declaration and the Basic Law, and we will do so in much the same way as in the past under British rule.

I should add however that in the areas of my responsibility, the Joint Declaration and the Basic Law have already laid down a clear and comprehensive framework and there are not many grey areas. Where there is a perceived need to develop these areas, not so much for the purpose of the transition, but for the purpose of more effectively achieving monetary and banking stability, and to ensure that Hong Kong strengthens its position as an international financial centre, important changes have been introduced. As many of these changes have implications beyond 1997, there have been consultations with my counterparts in China. Over the years and with the strong

support personally of Deputy Governor Chen Yuan, we have conducted our consultations professionally and developed a high degree of trust and understanding between ourselves. As a result, we were able to develop Hong Kong's monetary arrangements for the long term benefit of Hong Kong.

You may not be aware of this, but it was only in 1988 that we as monetary authority in Hong Kong managed to put onto the liability side of our balance sheet the clearing or reserve balance of the banking system. A consequence of this is that we have acquired the powers to influence the supply or the price of base money, which is an essential feature of a central bank. But the purpose of doing so was not to control the money supply as we operate a currency board system with a fixed exchange rate. However, if that part of the monetary base other than bank notes was undefined because clearing balances of banks were previously held with a commercial bank and not the currency board, the currency board system was arguably defective and its effectiveness in delivering exchange rate stability could be impaired. At the time, this stimulated an interesting debate in academic circles, with Milton Friedman accusing me of dangerously introducing discretion to a rule-based monetary system. This of course is not true. I am happy to have Alan Greenspan determining our monetary policy. This has a tranquillising effect on confidence on the Hong Kong dollar as we move through the next 568 days to 1 July 1997 and beyond.

We have also, over the years, built up and reorganised our central banking functions. This eventually led to the establishment of the Hong Kong Monetary Authority in 1993. We are now responsible for all the functions of a central bank, with the exception of the issue of bank notes and the role as banker to the government. Bank notes are issued in Hong Kong by three commercial banks, but the US dollar backing for any bank notes issued under our currency board system is of course held by ourselves as part of Hong Kong's substantial foreign currency reserves which is now about five times the amount of bank notes in circulation. On the role as banker to the Government, I am against ourselves assuming that role for the obvious reason of safeguarding ourselves against possible pressures for creating money to finance budget deficits, even though as a matter of



strict fiscal discipline we rarely run budget deficits in Hong Kong.

Our monetary and fiscal discipline is underpinned by our non-interventionist approach to policies and small government expenditure which is kept at below 20% of GDP. It is therefore not difficult to appreciate why Hong Kong has been successful. I have confidence that it will continue to be successful through the political transition. The transitional arrangements for Hong Kong laid down in the Joint Declaration and the Basic Law do give a clear framework for objectively understanding the possible risks. It is of course prudent to be risk averse. But risks are to be managed and not eliminated because one tends to eliminate the opportunities as well.

And the opportunities for Hong Kong are enormous. The Asian region has been for some time the fastest growing area in the world. With strong basic economic fundamentals and sound market oriented policies, I expect the region to continue to be the fastest growing area in the world for some time to come. In the region China is of course a very important factor. Anybody who has set foot in China in recent years will agree that the process of reform and liberalisation in China is irreversible. And Hong Kong sits right in the middle of the Asian region, with ready access to China. In fact it will be part of China after 1 July

1997. The prospects of being able to do business with a huge but largely untapped market in the free environment of Hong Kong, I imagine, should be very attractive to businessmen.

Furthermore, with the high savings rate and the huge infrastructural investment needs in the region, the business of intermediation is in great demand. Hong Kong's role as an international financial centre will contribute to this process and benefit greatly from it, if we play our cards right. This means generally that we should ensure a high degree of integrity and liquidity in our financial markets, meeting international standards, and provide a reliable mechanism for the minimisation and management of risks associated with the high rate of return the region promises. This requires the Hong Kong Monetary Authority to do a good job in building such an environment and maintaining it, focusing specifically on currency stability, banking stability and market infrastructural issues such as the payment systems and the development of the debt market. I think we have so far done a reasonable job, drawing rather shamelessly from the experience and expertise available in the central banking fraternity who has been exceedingly kind in providing assistance to this new member. And so let me conclude by thanking you all for your kindness and looking forward to continuing to play our part as a responsible monetary authority in the global financial community. ☺