BANKING AND MONETARY LINKS BETWEEN CHINA AND HONG KONG *

The banking and monetary systems of China and Hong Kong will become closer while remaining distinct. This will be manifested in supervisory cooperation, training programmes, cross-border lending, linkages between high-value payment systems and entry of domestic banks into each other's markets. On the latter three state-owned Chinese banks have recently been licensed to set up branches in Hong Kong.

I am pleased to be here to speak to this seminar organised by the Hong Kong Management Association. The theme of this evening's discussion is the financial integration of China and Hong Kong, and I have been asked to cover the banking and monetary aspects. The whole subject of the future relationship between the financial systems of Hong Kong and the Mainland is clearly of crucial importance to the economic well-being of both territories and the Association is to be congratulated for its initiative in putting this seminar together.

Integration and autonomy

The links between the banking and monetary systems of China and Hong Kong are already close and are likely to become closer over time. But I am not sure that it is right to describe this process as one of "integration" if this is meant to imply that the two systems are becoming part of one whole. The distinguishing characteristic of the constitutional and administrative arrangements laid down by the *Joint Declaration* and the *Basic Law* is that Hong Kong shall enjoy a high degree of autonomy after 1997, and this will apply in the banking and monetary areas as in other aspects of Hong Kong affairs.

In keeping with the general principle of "one country, two systems", some of the provisions of the *Basic Law* which are relevant to banking and monetary affairs can be paraphrased as follows:

- Hong Kong shall retain the status of an international financial centre.
- The Government of the future SAR shall, on its own, formulate monetary and financial policies, safeguard the free operation of financial business and financial markets, and regulate and supervise them.
- There shall be no exchange control and the Government of the future SAR shall safeguard the free flow of capital within, into and out of Hong Kong. The markets for foreign exchange, gold, securities, futures and other similar instruments shall continue.
- The HK dollar, as the local legal tender, shall continue to circulate and remain freely convertible. It must be backed by a 100% reserve fund.
- The Exchange Fund shall be managed and controlled by the Government of the future SAR, primarily for regulating the exchange value of the HK dollar.

On the basis of this legal framework, Mr Chen Yuan, the Deputy Governor of the People's Bank, in a recent speech characterised the financial relations between China and Hong Kong as "being between two relatively independent financial systems under two different social and economic systems within one sovereign country."[1] This is an excellent way of describing the relationship since it captures the two notions of autonomy and integration. Some practical results of this are that Hong Kong banks operating in China will continue to be regarded as foreign banks after 1997 and vice versa for Chinese banks in Hong Kong. The HK dollar will also be regarded as a foreign currency on the Mainland as will the RMB in Hong Kong. In a similar vein, debt issued by Chinese entities in the Hong Kong market will be an external obligation of China.

* This is the text of a speech by David Carse, OBE, Deputy Chief Executive (Banking) of the HKMA to the Hong Kong Management Association on 28 November 1995.

1 "The Financial Relations between Hong Kong and the Mainland", reproduced in the August 1995 issue of the *Quarterly Bulletin*. See also the speech on this subject by Mr Chen Yuan reproduced in this issue.

Cooperation between China and Hong Kong

Nonetheless, the fact that Hong Kong and China will be part of one sovereign country and the closeness of the economic and financial links between them clearly means that it will be necessary for there to be close cooperation between the central banks of the two territories – in other words between the People's Bank of China and the Hong Kong Monetary Authority. This is a simple fact of life: a financial crisis in China would obviously have major implications for Hong Kong and vice versa. A spillover effect could also result from significant changes in the monetary policies or arrangements in either of the two territories. This will require the two monetary authorities to keep closely in touch and perhaps on occasions to coordinate policies. But this is a feature of central bank relationships around the world and it should not be seen as an erosion of the HKMA's autonomy. Indeed, the Chinese authorities have gone out of their way to make the point that after 1997 the People's Bank will not take over the role of the HKMA. As Mr Chen Yuan said in the speech mentioned above, "As Hong Kong will maintain its independent financial system after 1997, it will be necessary to have an independent monetary authority".

Cooperation with the People's Bank is not however waiting until 1997. There are already frequent and fruitful contacts between the People's Bank and the HKMA on matters of common interest. For example, we have already reached a consensus with the People's Bank in the area of coordinating applications for cross-border licences by banks from our respective territories. We have also agreed that we will allow one another to conduct examinations of the cross-border operations of banks in our respective territories and to exchange information on these operations. We hope that the People's Bank will conduct regular on-site examinations of their banks in Hong Kong, as we have done and will continue to do in respect of our banks' operations in China. To assist the People's Bank to build up its capability in this area, staff from the People's Bank are regularly sent on secondment to the HKMA, and we also provide help in other areas of training, for example by speaking at seminars.

There is also considerable cooperation in monetary affairs. I shall speak later on about what we are doing in the specific area of payments systems. More generally, Chinese officials have been strongly supportive of the linked exchange rate and of the monetary reforms which have been introduced in Hong Kong in recent years. They have made it clear that they attach great importance to the continuation of Hong Kong as an international financial centre after 1997 and that Shanghai will not take the place of Hong Kong. Rather the two centres will operate alongside one another with Shanghai having a particular emphasis on domestic RMB business.

Hong Kong's continued autonomy as a financial centre after 1997 requires that it should retain its own links with monetary and financial authorities abroad in both a bilateral and multilateral context. China has been supportive of this objective, backing Hong Kong's continued membership of a number of international bodies such as the Asian Development Bank and the Asia Pacific Economic Cooperation forum (APEC) and for Hong Kong to become a member of SEANZA, an informal grouping of South East Asian, New Zealand and Australian central banks and monetary authorities. As you are all aware, with Chinese support, the World Bank/IMF Annual Meetings for 1997 will be held in September of that year in Hong Kong.

The HKMA has also been trying to build up its own contacts and cooperation with other central banks and monetary authorities in the region which was demonstrated by the gathering in Hong Kong last week at which a series of bilateral repurchase agreements were signed between central banks. China's support for this process was evidenced by the presence of Mr Chen Yuan from the People's Bank.

Banking links between China and Hong Kong

I will now discuss the strong and growing links between the banking sectors in China and Hong Kong. In doing so it is worth bearing some facts in mind. In particular, while Hong Kong's GNP is only around one-fifth the size of China's, the assets of its banking system are almost one and one half times as large. Admittedly, much of the assets of the Hong Kong banking sector are offshore in nature and held by foreign banks. But the comparison serves to show that in banking terms, Hong Kong should not be considered the junior partner.

The entry of Chinese banks into Hong Kong

It is precisely the size and international character of the Hong Kong market which have attracted Chinese banks to set up a presence here. Of course, the 13 banks which comprise the Bank of China group have been here for many years and now form the second largest retail banking group in Hong Kong. They have been joined over the years by other Chinese banks and non-bank entities which have acquired majority or minority stakes in locally incorporated banks in Hong Kong.

The latest and most significant additions to the Chinese representation are the three Chinese specialised banks recently granted banking licences in September and October 1995, namely the People's Construction Bank of China, the Agricultural Bank of China and the Industrial and Commercial Bank of China. This is the first time that Hong Kong has granted banking licences to mainland Chinese banks since 1965, when the Office of the Commissioner of Banking was established.

We took the decision to licence these banks against the background of the important changes that have been made in the legal framework for the banking system in China. The new Central Bank Law which was passed earlier this year has clarified the objectives and functions of the People's Bank. The Law lays down that the Bank will formulate and implement monetary policies using market-based rather than administrative means and exercise supervision and control over the financial industry. The primary objective of monetary policies is to maintain the value of the currency and thereby promote growth. The Bank may no longer lend to the State or local governments and is expressly declared to be free from intervention by the latter.

The Central Bank Law represents a move towards giving the People's Bank greater autonomy and establishing more clearly its authority over the banking and monetary system. It has been complemented by the Commercial Bank Law which provides the framework for the commercialisation of the specialised banks and the development of other commercial banks. Among other things, it bans interference in the operations of the banks by any individual or organisation; defines the permitted scope of their activities – they are not, for example, allowed to engage in real estate investment; and lays down various ratios for asset-liability management, including an 8% capital ratio and a maximum loan to deposit ratio of 75%.[2]

Within the framework provided by these two Laws, the People's Bank has been working actively to improve its supervisory approach and standards in order to bring these into line with the recommendations of the Basle Committee on Banking Supervision. Much progress has been made but some difficult challenges lie ahead. In particular, if the process of commercialisation is to succeed, solutions will need to be found to the bad debt problem of the specialised banks, and the banks will need to improve their management structures, internal control systems and credit skills. A start has been made by setting up new state policy banks which are taking over the policy lending function of the specialised banks and by allowing the banks to begin to write-off their bad debts. Moves towards the liberalisation of interest rates will also allow the banks to operate with more commercial freedom. However, a fundamental solution to the problems of the banking system will in turn require major reforms of the loss-making state owned enterprises. Only when that has been achieved will the banks be able to operate on a fully commercial basis.

In the meantime, however, we have taken the view that enough progress had been achieved to allow the three specialised banks to set up branch operations here. In doing so, we have taken account of the fact that, despite the process of commercialisation, these banks are, and will remain, state-owned. The fact that the State continues to stand behind the liabilities of the specialised banks has recently been made clear by the Governor of the People's Bank. In addition, the banks will be

2 For more information on these laws see the boxes in the articles on the "The External Environment" in the May and August 1995 issues of the *Quarterly Bulletin*.

restricted to one branch in Hong Kong like all other banks licensed after 1978, and will operate on the basis of very conservative business plans in their early years. It is essential that the banks feel their way gently into the highly competitive Hong Kong market. They should thus concentrate on getting the necessary staff and systems in place, rather than setting out to aggressively chase market share. To reinforce this point, it has been firmly agreed with both the People's Bank and the banks themselves that their branch operations in Hong Kong will adhere to local banking supervisory criteria. Of course, this cautious approach works both ways. We would equally expect Hong Kong banks to act as good corporate citizens in respect of their operations in China.

We do not consider that the entry of the specialised banks poses a threat to the stability of the banking system in Hong Kong. Indeed, we believe that Hong Kong will benefit because the setting up of these branches represents an endorsement of the importance of Hong Kong as a banking centre and as a contributor to the economic and banking reforms in China. Exposure to the competitive banking environment of Hong Kong, if prudently and cautiously handled, will help the banks to develop the modern banking skills which they need. If the specialised banks can develop on sound commercial lines, this will be to the ultimate benefit of both China and Hong Kong.

The entry of Hong Kong banks into China

The cross-border banking links are not however one way. Hong Kong banks have also been expanding into China. Of the 31 Hong Kong incorporated banks, 16 have some form of presence over the border. Together they have a total of 29 branches and 24 representative offices in the major cities of China. Their main lines of business include trade finance, mortgage lending, project financing and provision of working capital to joint ventures in China.

This seems to be a sensible approach towards overseas expansion. Conducting business in China is not without its problems and risks. The accounting and legal frameworks are still developing, and the taking of security and the recovery of loans can be fraught with difficulties. Hopefully, the new Security Law which came into effect on 1 October of this year will help in this respect. However, operating in any foreign market presents its own problems and it cannot be said for example that banks in Hong Kong, or foreign banks in general, have made a great success of their presences in the supposedly "safe" US market. At least in China, banks from Hong Kong can operate in a market which is expanding and for which they have a cultural and geographical affinity. Of course, they are to a large extent following their customers who have set up factories and other operations in China. This provides a natural customer base.

Currently, however, the business that can be undertaken by Hong Kong and other foreign banks in China is confined to foreign exchange. The RMB market is likely to be opened up to foreign banks in due course as part of the moves towards liberalisation and convertibility of the RMB. Progress towards this goal will partly depend on how quickly the specialised banks can commercialise and prepare themselves to withstand foreign competition. However, when it does come, the opening up of the RMB market to foreign banks will not be without strings attached - it will likely carry a quid pro quo, in that the tax treatment of foreign and domestic banks will be made more equal. At present, Chinese domestic banks are subject to 55% profits tax in addition to a 5% business tax on business turnover, while foreign banks have to pay only 15% tax on their profits. The price for being allowed to do RMB business is likely to be a higher tax rate for foreign banks. In the meantime, it is arguably no bad thing for the foreign banks to be kept out of the domestic currency market since it insulates them from potential problems while that market is still evolving and legal and accounting standards are still developing.

A further stumbling block in the operations of Hong Kong banks in China is that the rules on foreign entry were tightened in April 1994. Now foreign banks which wish to establish a branch must have total assets of at least US$20 billion. If strictly applied, this would make it impossible for most of the Hong Kong banks to establish new branches in China. We have taken this up with the People's Bank and argued the case for Hong Kong banks to be treated with flexibility under the entry requirements. This is a difficult issue since it is part of the autonomy of Hong Kong after 1997 that banks from Hong Kong should be regarded as foreign financial institutions in China. I realise that we are open to the accusation that we are trying to have it both ways. And yet I think that our position is a reasonable one. Given the knowledge and long experience of Hong Kong banks in China business, we consider that their presence in China would be of mutual benefit to both financial systems and that they would be well placed to contribute to the development of China's financial sector. In addition, it is natural that they should want to be able to service the needs of their Hong Kong customers in China.

The principle of China's asset size criterion cannot be faulted – in Hong Kong we apply a similar rule to foreign banks wishing to establish branches here, though the amount is set at a lower level of US$16 billion. However, in Hong Kong's case we are prepared to relax the size criterion if to do so would help to promote the interests of Hong Kong as an international financial centre. Moreover, we offer an additional element of flexibility by allowing foreign banks to operate as restricted licence banks or deposit-taking companies, for which there is no asset size criterion. We hope that the Chinese authorities will therefore consider whether some means could be found to provide similar flexibility for Hong Kong banks in China.

Cross-border banking transactions

Apart from branching into China, banks in Hong Kong can also conduct banking business with China from their offices in Hong Kong. This sometimes gives rise to fears that banks in Hong Kong are building up a substantial cross-border exposure to China. However, the figures do not bear this out, at least so far as HK dollar transactions are concerned. In August 1995, the Hong Kong banking system's HK dollar claims on banks in China totalled $51 billion, but this was far outweighed by liabilities to banks in China of $113 billion. In other words, banks in Hong Kong were net borrowers in HK dollars from banks in China of about $62 billion. This represents the HK dollars which have been transferred, for example, from Hong Kong importers to Chinese exporters and which are deposited in banks in China. These banks thus end up with claims on banks in Hong Kong. In fact, the HK dollars have never left the banking system here – all that has happened is that the ownership of the deposits has changed. The effect on the liquidity of banks in Hong Kong is not significant.

Cross-border HK dollar claims on non-banks in China are small at only about $2 billion. This shows that the local banks are not heavily exposed. Claims in foreign currencies are much larger at around $61 billion, showing the importance of Hong Kong as a source of syndicated loans for infrastructure and project financing in China. However, most of this business is in the hands of foreign banks based in Hong Kong.

HK dollars are of course also held across the border in the form of bank notes. It has been estimated that around $20 billion of HK dollar notes are circulating in China – about 25% of the total amount in circulation. While China has attempted to prohibit the circulation of foreign bank notes, massive and abrupt repatriation of HK dollar cash from China is unlikely. But even if it did happen the HKMA would have no difficulty in meeting the demand for redemption of these HK dollar notes for US dollars since the amount involved would be less than 5% of the foreign currency assets held by the Exchange Fund. Any impact on the exchange rate of the HK dollar would therefore be only minimal. Having said this, it is important to have the opportunity to discuss with People's Bank officials policy changes which might affect the HK dollar. An example is the proposal to introduce convertibility of the RMB for current account transactions. This might weaken demand for HK dollars in Southern China and thus lead to some repatriation. Again, however, this would be unlikely to create any problems for monetary management in Hong Kong. Indeed, convertibility should boost trade and investment in China which would benefit Hong Kong.

Links between the payment systems of China and Hong Kong

The circulation of HK dollars in China is an example of a monetary link which has happened because of natural market forces. Other links have been more consciously planned. A key example is the intended link between the payment systems in China and Hong Kong. As you may know, the HKMA has been working in close cooperation with the banking community to improve the existing payment system in Hong Kong. As a result, it has been decided to introduce a new Real Time Gross Settlement (RTGS) system which is designed to achieve finality of settlement between banks across the books of the HKMA. This will bring about a major improvement in the stability of the payments system and hence in the stability of the monetary system as a whole.

RTGS in Hong Kong is scheduled to begin full operation before the end of 1996. We also intend that the new payment system should be linked up with similar payment systems in other financial centres, in particular those in the US and China which are Hong Kong's largest trading partners. The use of the RMB to settle transactions between Hong Kong and China is likely to increase as the RMB attains freely convertible status, and this will increase the need for a robust framework for cross-border payments between the two territories. The China National Automated Payment System (CNAPS) for the RMB is targeted for completion in 1997 and is also designed on a RTGS basis. We have therefore, in consultation with the People's Bank, taken the strategic decision to work towards linking our RTGS with the CNAPS system.

The role of Hong Kong's debt market

The development of the RTGS payments system will further strengthen the infrastructure of Hong Kong's debt market by eventually allowing real time delivery against payment on the HKMA's Central Moneymarkets Unit Service. This will promote the development of the debt market here. The continued issuance of Exchange Fund paper, now with a maturity of up to 7 years, will further assist that process by establishing a firm benchmark for HK dollar debt securities. This will increase the attractions of the Hong Kong debt market to both domestic and foreign issuers, including those from China. In the speech I have already quoted, Mr Chen Yuan said that China would make increasing use of Hong Kong's debt market for fund raising, and that this would further boost the development of the market.

Already, in October 1995, the People's Construction Bank of China has successfully issued $1.2 billion of 7-year floating rate notes. This was the first HK dollar bond issued by a state-owned enterprise. The fact that it was over-subscribed is an encouraging start. It has since been followed by an issue of floating rate certificates of deposit by the Agricultural Bank which was also well received. China's future economic development and the associated financing needs mean that more and more Chinese enterprises will tap the Hong Kong debt market for funds. Indeed, the potential growth of the debt market is huge if one also looks at the financing requirements for infrastructural projects in the rest of Asia. This is why the HKMA has been working hard to develop the local market so that Hong Kong can fully benefit from this demand. It is good to know that we have China's support in this endeavour.

Closing remarks

In conclusion, we have been talking to a number of bankers and academics recently on how best to promote Hong Kong's banking services. When we came to the question of future opportunities, almost all fingers pointed to the North. This is worth bearing in mind when we read some of the more pessimistic comments about the future of Hong Kong and of its financial system after 1997. The success of all financial centres depends on comparative advantage and Hong Kong's most obvious advantage is its geographical proximity to China. The existing links between the two banking and monetary systems will strengthen after 1997 and our task will be to maximise the advantages from this while retaining Hong Kong's special character and attractions as part of China but distinct from it. We in the HKMA are confident that this can be achieved.