This thesis is a study of the workings of the system of money and finance in Hong Kong and, more specifically, of the adaptation of the system of money and finance during the recent period of rapid economic growth. The objects of the study are: to set out how the rapid industrialisation and economic growth have been financed; to examine whether the financial system itself has changed in important ways during the rapid economic growth (which involves an outline of the financial structure of the entrepot economy); and to see whether the financial system might have facilitated or restricted the economic growth. An attempt is made also to establish the relevance of Hong Kong's financial experience to other developing economies.

It should be stressed that the thesis is concerned with the financial system and not, as is more usual in studies of this sort, only the financial institutions and the capital market. From this broader approach - which involves a discussion of the foreign exchange markets, the unorganised market and the public finances - emerges a more complete picture of the way in which economic growth has been financed.

Chapter 1 is concerned with the economic development itself and with describing the present structure of the Hong Kong economy.
The second chapter sets out the development and operation of the financial system of the entrepot economy. The chapter looks in turn at currency arrangements, the exchange banks, agency houses and the system of public finance.

Chapter 3 looks at the currency system and the foreign exchange markets of the post-war economy. The strengths and weaknesses of the sterling exchange currency system - the currency standard still adopted in the Colony - are outlined.

The commercial banks are by far the main institutions of the Hong Kong financial system. The structure, operations and growth of the banking system are discussed in Chapters 4 to 6. The banking system is shown to have developed considerably in structure, assets and liabilities, and stability. The role of the commercial banks as mobilisers of local savings and suppliers of loanable funds to local businesses is stressed.

Chapter 7 demonstrates that the main cause of variations in the money supply is still the balance of payments; that the Government could, if it wished, exercise some influence over the money supply; and that the monetary system is not necessarily a disadvantageous one from the point of view of economic development.

As yet, there has been relatively little development of non-bank financial institutions. Chapter 8 offers an explanation of this limited development and describes the existing system of intermediaries. The agency houses have contributed most to industrialisation.
Chapter 9 outlines the public finance system. The main changes in the public finance system have been the introduction of direct taxes and the Government's increasing involvement in the provision of housing. Several ways in which the public finance system has facilitated economic growth are shown in the final section of the chapter.

Chapter 10 brings together the little information available on three important sources of investment funds: capital inflow, retained earnings and the unorganised market. An interesting and most important characteristic of the Hong Kong financial system is found to be the mobility of funds on the unorganised financial market.

Hong Kong does not have an official central bank. The main arguments for and against the establishment of such an institution are outlined in Chapter 11.

Chapters 12 to 14 point to the level of investment in the several sectors of the economy, they describe the way this investment has been financed, and they seek to evaluate whether, in general, the supply of investible funds to each of the main sectors has been adequate, in volume and type. Chapter 12 shows that despite the overall shortage of long term funds there has been a large investment in utility services and infrastructure: the utility companies have been well placed to obtain funds even from the narrow local share market, and there has been considerable investment of
public funds in infrastructure. The commercial banks have financed industrial development (described in Chapter 13) to a rather surprising extent. Investment in manufacturing industry has depended also on foreign capital and retained earnings. Foreign trade has been well placed to obtain commercial bank finance. The main sources of funds for building construction (Chapter 14) have been capital inflow, the Government, the unorganised market and the smaller banks.

Chapter 15 summarises the development of the financial system from one servicing the entrepot trade to the present time, it suggests that the financial system has been, in some ways, a leading factor in the economic development, and proposes one or two ways in which lessons of the Hong Kong financial experience might have a more general applicability.
MONEY AND FINANCE IN HONG KONG

BY

D.W. STAMMER

This thesis was submitted in partial fulfilment of the requirements for the degree of Doctor of Philosophy at the Australian National University.

May 1968
Apart from the assistance acknowledged this thesis is my own work.

D.W. Stammer
The relationship between financial development and economic growth has been studied mainly in the context of developed countries. Even in these cases, relatively little attention has been paid to the form and direction of the relationship. Thus it has recently been claimed that

An observed characteristic of the process of economic development over time, in a market-oriented economy using the price mechanism to allocate resources, is an increase in the number and variety of financial institutions and a substantial rise in the proportion not only of money but also of the total of all financial assets relative to GNP and to tangible wealth. However, the causal nexus of this relationship between financial development and economic growth has not been fully explored either theoretically or empirically.

A proliferation of the number and variety of financial institutions and a substantial rise in the ratio of money and other financial assets relative to total output and tangible wealth are apparently universal characteristics of the progress of economic development in market-oriented economies. This is an empirical generalisation to which the historical record admits no exceptions to date. The causal nexus of this relationship is by no means clear, however. Does it run from financial institutions to industrialisation or, on the contrary, does the process of industrialisation throw up a wake of financial institutions, like a steamship cruising in calm waters? [for example] Gurley and Shaw have had a great deal to say about the proliferation of financial intermediaries and their importance for monetary policy in highly developed economies, but even in their work, stimulating and perceptive though it is, the financial institutions themselves are considered to be mere automatons, appearing to supply the demand for financial assets mechanically.


The nexus between economic development and the financial sector can take a variety of forms. Cameron and Patrick suggest the following three 'type-cases':

(1) the case in which inadequate finance restricts or hinders industrial and commercial development; (2) the case in which the financial system is purely permissive and accommodates all 'credit-worthy' borrowers; and finally (3) the case in which financial institutions either actively promote new investment opportunities or encourage applicants for finance to come forward, provide them with advice and extra services, etc.1

The most common view appears to be that the financial system has a 'demand-following' relationship to economic growth; that the financial system 'somehow accommodates - or, to the extent that it malfunctions, it restricts - growth of real per capita output.'2 For example,

It seems to be the case that where enterprise leads finance follows. The same impulses within an economy which set enterprise on foot make owners of wealth venturesome, and when a strong impulse to invest is fettered by lack of finance, devices are invented to release it ... and habits and institutions are developed.3

Less attention has been given - in academic discussions if not by policymakers4 - to a possible 'supply-leading' relationship, in which the financial sector actively contributes to economic growth. This might come about, for example, because the financial system efficiently transfers resources to the modern sectors, and encourages and stimulates entrepreneurial response in the sectors of more rapid development.

Of course, 'in actual practice, there is likely to be an interaction of supply-leading and demand-following phenomenon.5

---

1 Banking in the Early Stages of Industrialisation, p.2.
4 Hugh T. Patrick, op. cit., p.175.
5 Ibid., p.177.
and the financial system 'may be simultaneously growth-induced and growth-inducing, but what really matters are the character of its services and the efficiency with which it provides them.'

This thesis is a case study of the relationship between economic development and the financial system. In the two decades since the Second World War Hong Kong has changed from an entrepot trading centre to a significant industrial producer. This experience gives rise to a number of questions relevant to the general theme which has been outlined. How far and in what way was the financial system of pre-war Hong Kong geared to the needs of an entrepot trading centre? How far did this financial system hamper or promote post-war industrial development? How was the process of industrialisation financed? How and in what ways did the institutions of private finance and the methods of public finance adapt themselves to the changes in the economic structure? How complete and adequate has this adaptation been? And, more briefly, how far is it possible to generalise from the experience of Hong Kong? How far has it had unique features, both favourable and unfavourable, which make it unlikely that significant lessons can be drawn from it for other industrialising countries?

Because its economic transformation and growth have taken place within a very short period, the Hong Kong economy is a most suitable one in which to make this type of inquiry. But the study has been hampered at all stages by the paucity of Hong Kong statistics: there are, for example, no official estimates of national income, saving and investment, or the balance of payments. As a result, this thesis relies fairly heavily on unofficial estimates and qualitative analysis.

---

1 Rondo Cameron and Hugh T. Patrick, op. cit., p.3.
Even at the expense of aggravating the difficulties of inadequate statistical grounding, the study has not been confined to banks and other institutions of the organised money and capital market. Some attempt at comprehensiveness has been made by covering, on the one hand, the unorganised market, the role of self-finance and the foreign exchange market, and, on the other hand, the public finances of Hong Kong. It is hoped that the advantages of this wider approach in providing a rounded picture of all aspects of financial development outweigh the disadvantages of frequently rather shaky evidence.

Chapter 1 briefly traces economic development from the Colony's establishment as a centre for entrepot trade in 1841, to 1967, and outlines the present structure of the economy. The financial system of the entrepot economy is discussed in Chapter 2. Chapters 3 to 10 focus on the sources of funds and the operation of the monetary system in the post-war period. Since virtually all public spending in Hong Kong has been financed from revenue, the Chapter on the public finances, Chapter 9, discusses also the expenditure side of Government finance. The uses of funds and the adequacy of the financial system are studied in Chapter 11 to 14. Chapter 15 summarises the main changes in the financial system over the past two decades, it outlines ways in which the financial system has been a leading factor in the rapid economic development experienced and the ways in which the financial system may have restricted economic growth, and it looks, briefly, at the relevance of the Hong Kong experience to other developing countries.

This thesis is a product of my studies during the period June 1965 to May 1968 when I was a postgraduate student in the Department of Economics in the School of Pacific Studies of the Australian National University. I am grateful to the University for the postgraduate scholarship it awarded to me, for the research grant which enabled me to spend ten months in Hong Kong (May 1966 to March 1967) and for the favourable conditions under which my research was carried out.
Professor H.W. Arndt supervised this study. His interest and advice are much appreciated.

I was assisted in Hong Kong by a number of individuals and several organisations. I had useful discussions with officers of the Financial Secretariat, commercial banks, trading firms, commercial enterprises and the stock exchange, and with staff of the Banking Commissioner's office and the office of Exchange Control. It would take several pages to thank individually all those who assisted and this I will not attempt, but I acknowledge my appreciation to them all.

Some special thanks are due. Dr and Mrs Paul Luey did much to ensure the comfort and well being of my wife and myself, and were generous in their hospitality and introductions. The University of Hong Kong provided me with office accommodation and use of its library. Professor Ronald Hsia of the University's Department of Economic and Political Science took a close interest in my work. On a number of occasions I discussed my study with Mr Leo Goodstadt of the Far Eastern Economic Review. Dr J.R. Jones and Mr Ng Kwok Leung kindly made available unpublished material covering, respectively, a history of the Hongkong Bank and present financial arrangements. The senior undergraduates of the Department of Economics and Political Science at the University of Hong Kong and the students of Form IIC at Ying Wah College entertained my wife and myself on several most enjoyable occasions.

The thesis was typed by Mrs Ina Guenot and Mrs Ann Newsome, to whom I express my thanks.

My wife Lee assisted by recording statistics, reading drafts and checking this typescript. Her encouragement and patience helped make the period of research enjoyable and interesting.
CURRENCY AND ABBREVIATIONS


FEER: Far Eastern Economic Review.
HS: Hong Kong Standard.
SCMP: South China Morning Post.
Hongkong Bank: The Hongkong and Shanghai Banking Corp.
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Chapter 1

THE ECONOMIC DEVELOPMENT OF HONG KONG

This is a study of money and finance in Hong Kong and, more specifically, of the adaptation of the system of money and finance during the recent period of rapid economic development. In this chapter a short account is given of the economic development itself. Because the chapter seeks only to give a general background for the remainder of this study and not a detailed and balanced account of the Colony's economic history, a somewhat disproportionate emphasis is given to topics such as variations in the price level and the structure and problems of industry. 1

Economic Development in the Period 1841 to 1941

The demand by British merchants that a colony be established on the China coast, preferably on an island which could be protected by the British navy, arose from the severe restrictions - on travel, shipping, commercial contacts and the export of silver - imposed on foreign merchants by the imperial Chinese Government. The growth of the opium trade in the early nineteenth century both strengthened the foreign traders financially and caused the Chinese authorities to renew their attempts at controlling the foreign merchants. The seizure by the Chinese of opium chests belonging to Western merchants led to war between China and England. Hong Kong was occupied by the British in 1841. In the 1842 Treaty of Nanking the Island of Hong Kong 2 was ceded to Britain in perpetuity, 'It being obviously necessary and


2 The Island of Hong Kong was described by the then Foreign Secretary as 'a barren island with hardly a house on it'.
desirable that British subjects should have some port whereat they may careen and refit their ships when required and keep stores for that purpose'. The Colony was enlarged in 1860 by the acquisition of the small Kowloon peninsula. In 1898 the 'New Territories' of 365½ square miles was leased from China for 99 years, giving the Colony a total land area of a little less than 400 square miles. Hong Kong was declared a free port as early as 1841, and freedom to reside and trade was promised to Chinese merchants.¹

The Colony's long-term growth was more or less ensured by its excellent harbour, convenient location, free port status and the security offered by the British military and naval presence. After the Taiping Rebellion and Arrow War, it became the headquarters for most Western merchants operating in China. These and later disturbances also encouraged the movement to Hong Kong of a large number of Chinese. In the second half of the nineteenth century, too, the Colony became a staging centre for Chinese emigration to South East Asia and the goldfields. Some indication of the growth of Hong Kong is given in Table 1.1.

No statistics on the level or direction of Hong Kong's trade were collected until 1918 (and, as an economy measure the collection of these statistics was suspended from 1925 until 1930). Throughout the period of the entrepot economy, China was the Colony's main trading partner,² but trade not connected with China slowly increased in importance in the late nineteenth and early twentieth centuries. In 1918 China took 53 per cent of exports and provided 15 per cent of imports. In 1938 the China trade involved some two-fifths of Hong Kong's imports and exports. The Colony's trade with China in the interwar period is summarised in Table 1.2. With the development of Shanghai and other ports on the China coast, Hong Kong assumed a

¹ Chiu Tze Nang, op. cit., p.73.
² As a committee reported in 1935: 'As a community and as a trade centre [Hong Kong] is a portion of China from which it is separated by political barriers,' Report of the Commission Appointed...to Enquire into the Causes and Effects of the Present Trade Depression..., Hong Kong Government Printer, 1935, p.71.
Table 1.1
POPULATION, SHIPPING TONNAGE AND GOVERNMENT REVENUE, SELECTED DATES

<table>
<thead>
<tr>
<th>Year</th>
<th>Population '000</th>
<th>Shipping tonnage entering harbour '000</th>
<th>Government revenue $'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>1844</td>
<td>19</td>
<td>189</td>
<td>30</td>
</tr>
<tr>
<td>1851</td>
<td>33</td>
<td>377</td>
<td>44</td>
</tr>
<tr>
<td>1861</td>
<td>119</td>
<td>1,310</td>
<td>611</td>
</tr>
<tr>
<td>1870</td>
<td>124</td>
<td>n.a.</td>
<td>844</td>
</tr>
<tr>
<td>1881</td>
<td>160</td>
<td>6,412</td>
<td>1,324</td>
</tr>
<tr>
<td>1891</td>
<td>225</td>
<td>10,279</td>
<td>2,025</td>
</tr>
<tr>
<td>1901</td>
<td>301</td>
<td>14,599</td>
<td>4,214</td>
</tr>
<tr>
<td>1911</td>
<td>464</td>
<td>20,491</td>
<td>7,497</td>
</tr>
<tr>
<td>1921</td>
<td>625</td>
<td>24,360</td>
<td>17,728</td>
</tr>
<tr>
<td>1931</td>
<td>840</td>
<td>38,933</td>
<td>33,147</td>
</tr>
<tr>
<td>1947</td>
<td>1,750</td>
<td>16,435</td>
<td>164,325</td>
</tr>
<tr>
<td>1961</td>
<td>3,133</td>
<td>18,399</td>
<td>1,030,448</td>
</tr>
<tr>
<td>1966</td>
<td>3,785</td>
<td>25,623</td>
<td>1,784,282</td>
</tr>
</tbody>
</table>

n.a. = not available.


less important position in China's foreign trade: in 1890, 55 per cent of China's imports and 37 per cent of her exports passed through Hong Kong; in 1913 Hong Kong conducted approximately 40 per cent of China's foreign trade and in 1934 approximately one quarter.

Economic growth was disrupted by a number of commercial crises, many of which, especially in the twentieth century, were caused by political events in China. The early commercial confidence collapsed

Table 1.2
HONG KONG EXTERNAL TRADE, INTERWAR PERIOD
($ million)

<table>
<thead>
<tr>
<th></th>
<th>1918</th>
<th>1924</th>
<th>1931</th>
<th>1937</th>
</tr>
</thead>
<tbody>
<tr>
<td>Imports from China</td>
<td>57</td>
<td>89</td>
<td>223</td>
<td>592</td>
</tr>
<tr>
<td>Total imports</td>
<td>367</td>
<td>629</td>
<td>803</td>
<td>1004</td>
</tr>
<tr>
<td>Exports to China</td>
<td>224</td>
<td>364</td>
<td>343</td>
<td>205</td>
</tr>
<tr>
<td>Total exports</td>
<td>424</td>
<td>592</td>
<td>664</td>
<td>863</td>
</tr>
</tbody>
</table>

in 1844, after which trade conditions were depressed for a decade. A severe commercial and financial crisis brought on by the failure in India of a number of important Eastern houses interrupted the new period of prosperity in 1866, and again recovery was slow. The opening of the Suez Canal in 1869 and the telegraphic link with the East in 1871 provided a major fillip to the Eastern trade but the overtrading which resulted led to a further commercial depression. About the same time, variations in silver prices first affected Eastern trade. In the late 1880s, there was a rapid expansion of commerce and considerable speculation in land and public companies. The world depression of the 1890s had relatively little effect on the China trade. Hong Kong is considered to have reached a peak in its prosperity about the turn of the century.

The 1911 revolution in China resulted in a further period of rapid migration and inflow of capital into Hong Kong, and brought about a new building boom which continued, with a short slump in 1925-26, until 1932. During the first world war the volume of trade fell because of the shortage of shipping, but traders benefited from increased commodity prices. Political factors caused serious trade disruptions in the 1920s: there was a shipping strike in 1922 and, far more seriously, a general strike and economic boycott of Hong Kong in 1925 and 1926, which virtually cut Hong Kong from its economic hinterland. In the 1930s the general world depression, Chinese tariff measures and silver price fluctuations adversely affected trade. A new trading and speculative boom occurred in the late 1930s, mainly under pressure from the inflow of population and capital which followed the outbreak of the Sino-Japanese war.

1 See below, pp.28-32.
3 The Hong Kong population had a strong migratory character: political events in China or an increase in the prosperity of the Colony brought rapid immigration, while the return of stable conditions in China or a trade depression in Hong Kong resulted in a fall in population. Even in the 1930s few Chinese considered themselves permanent residents of Hong Kong. See ibid., p.387.
Manufacturing activity was of relatively little importance. From the beginning there was some development of industries connected with the entrepot trade, and Hong Kong rapidly became one of the most important centres for shipbuilding and repair in the East. The first shipyards were established in 1843 and in the 1860s two large yards were built. A naval dockyard was constructed in 1898. In 1908 the Swire group's 'Taikoo' dockyard was completed. Most ships were for the coastal or Eastern trade, but in 1939 and 1940 several vessels of 10,000 tons were constructed. Facilities for ship repair and overhaul developed in line with the volume of trade and changes in ship design and size. A number of Chinese-owned yards built and repaired smaller vessels. Two other industries which developed to meet the demands of the shipping services using the port were rope making and sugar refining; these, too, were owned by British merchants.

The only important manufacturing concerns not associated with shipping were a cement works and a cotton spinning mill both set up in 1899. The latter, a Jardine Matheson enterprise, was not successful, and the 55,000 spindles were moved to Shanghai. From the 1870s there was some development of light industry, mainly food processing, carpentry, and rattan ware, by small Chinese businesses, but there was not the establishment of large factories at the turn of the century that occurred in Shanghai. The first world war gave a fillip to the light industries, especially food processing. In the 1920s a number of small, Chinese-owned businesses producing footwear, torch cases and cheap textiles were set up. The boycott in 1925 and 1926 and later the growth of protectionism in China and other Far Eastern markets and the world depression, all adversely affected these industries, and many closed down. The domestic market was,

1 Chinese tariff barriers were especially seen as a limitation on manufacturing development: 'We are of the opinion, however, and all the evidence we have had bears this out, that industry of Hong Kong cannot develop much beyond its present stage except in so much as it can form an economic part of the whole industrial development of South China and even to some extent of North China.' Report of the Commission Appointed...to Enquire into the Causes and Effects of the Present Trade Depression... p.80.
of course, very small, and there were virtually no local raw materials. The system of Imperial tariff preference established after the Ottawa Conference stimulated production of several goods, especially footwear and cheap textiles, but in the mid-1930s locally produced goods were less than 10 per cent of total exports and there was much pessimism about the future development of manufacturing industry.

External circumstances made the period 1937 to 1941 one of rapid industrial growth. With the outbreak of the Sino-Japanese war a number of Northern Chinese manufacturers moved their businesses to Hong Kong; at the same time, Japanese competition in South China markets was greatly reduced. The European war led to a greatly increased demand for the products of the Colony's heavy and light industries. In the two years to mid-1941 employment in registered factories rose from 50,000 to 90,000 (about half the workforce being in cotton textiles). Most manufacturing enterprises were small family owned businesses, usually without modern equipment or specially designed premises.

There were groups of fishermen based on Hong Kong Island at the time of the arrival of the British, and the fishing population increased steadily to 1941. In 1939 some 2,700 fishing junks operated. Generally, the fishermen had a very low standard of living and a 'hidebound allegiance to a centuries-old tradition'. There was no Government assistance or control over fishing activities. The acquisition of the New Territories brought the Colony an established and largely peasant agricultural population. The Government attempted to interfere with this population as little as possible; Chinese land tenure system was maintained, and virtually no attempt was made to develop agricultural techniques or marketing arrangements.

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1 FEER, 12 March 1947, p.136.
The role of the Government in the economic system was, as in the postwar period, very much a laissez faire one. The activities of the Government in the entrepot economy are described in the following chapter.

The Economy, 1941 to 1945

During the Japanese occupation, December 1941 to August 1945, trade virtually ceased, most commercial institutions suspended operations, manufacturing concerns, especially those in heavy industry, closed down, and the population fell to around 600,000. British-owned enterprises were taken over by the Japanese military administration. Many Chinese-owned businesses moved their operations to the interior. A large number of buildings in the Colony were seriously damaged. About 80 wrecks were left in the harbour.

A planning unit was established in London in 1943 to prepare for the Colony's reconstruction and development after the war. The military administration which governed until May 1946 set up a Department of Supplies, Trade and Industry to regulate supplies of food and raw materials. This body functioned as the 'principal trading organisation of Hong Kong'. Private trade re-commenced under licence in November 1945, but the Department continued its operations for some years.

The Hong Kong Economy, 1946 to 1967

Today, with almost two-fifths of its workforce engaged in manufacturing industry, and with a national income increasing at more than 10 per cent a year, Hong Kong is one of the world's most industrialised and rapidly developing economies. Over the postwar period exports of locally manufactured goods have risen from less than one-tenth to four-fifths of the Colony's total export trade.

1 The Hong Kong Government in 1948 decided against paying compensation for war damage or confiscation, largely because the rehabilitation of industry and commerce did not appear seriously restricted by a lack of financial resources.

2 Hong Kong General Chamber of Commerce, History 1861-1961, p.66.
Some indication of postwar economic development is given in Tables 1.3 and 1.4.¹

Table 1.3
HONG KONG ANNUAL FOREIGN TRADE, 1947 TO 1967
($ million)

<table>
<thead>
<tr>
<th>Year</th>
<th>Domestic exports f.o.b.</th>
<th>Re-exports f.o.b.</th>
<th>Total exports f.o.b.</th>
<th>Imports c.i.f.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1947</td>
<td>n.a.</td>
<td>n.a.</td>
<td>1,217</td>
<td>1,550</td>
</tr>
<tr>
<td>1948</td>
<td>n.a.</td>
<td>n.a.</td>
<td>1,583</td>
<td>2,078</td>
</tr>
<tr>
<td>1949</td>
<td>n.a.</td>
<td>n.a.</td>
<td>2,319</td>
<td>2,750</td>
</tr>
<tr>
<td>1950</td>
<td>n.a.</td>
<td>n.a.</td>
<td>3,716</td>
<td>3,788</td>
</tr>
<tr>
<td>1951</td>
<td>n.a.</td>
<td>n.a.</td>
<td>4,433</td>
<td>4,870</td>
</tr>
<tr>
<td>1952</td>
<td>n.a.</td>
<td>n.a.</td>
<td>2,899</td>
<td>3,779</td>
</tr>
<tr>
<td>1953</td>
<td>n.a.</td>
<td>n.a.</td>
<td>2,734</td>
<td>3,873</td>
</tr>
<tr>
<td>1954</td>
<td>863</td>
<td>1,553</td>
<td>2,417</td>
<td>3,435</td>
</tr>
<tr>
<td>1955</td>
<td>1,003</td>
<td>1,531</td>
<td>2,534</td>
<td>3,719</td>
</tr>
<tr>
<td>1956</td>
<td>1,115</td>
<td>2,095</td>
<td>3,210</td>
<td>4,566</td>
</tr>
<tr>
<td>1957</td>
<td>1,202</td>
<td>1,864</td>
<td>3,016</td>
<td>5,149</td>
</tr>
<tr>
<td>1958</td>
<td>1,260</td>
<td>1,728</td>
<td>2,989</td>
<td>4,594</td>
</tr>
<tr>
<td>1959</td>
<td>2,282¹</td>
<td>995¹</td>
<td>3,277</td>
<td>4,949</td>
</tr>
<tr>
<td>1960</td>
<td>2,867</td>
<td>1,070</td>
<td>3,938</td>
<td>5,864</td>
</tr>
<tr>
<td>1961</td>
<td>2,939</td>
<td>991</td>
<td>3,930</td>
<td>5,970</td>
</tr>
<tr>
<td>1962</td>
<td>3,317</td>
<td>1,070</td>
<td>4,387</td>
<td>6,657</td>
</tr>
<tr>
<td>1963</td>
<td>3,831</td>
<td>1,160</td>
<td>4,991</td>
<td>7,413</td>
</tr>
<tr>
<td>1964</td>
<td>4,428</td>
<td>1,513</td>
<td>5,940</td>
<td>8,707</td>
</tr>
<tr>
<td>1965</td>
<td>5,027</td>
<td>1,802</td>
<td>6,828</td>
<td>9,274</td>
</tr>
<tr>
<td>1966</td>
<td>5,730</td>
<td>1,833</td>
<td>7,563</td>
<td>10,097</td>
</tr>
<tr>
<td>1967</td>
<td>6,701</td>
<td>2,081</td>
<td>8,782</td>
<td>10,450</td>
</tr>
</tbody>
</table>

n.a. = not available.

¹ Division of total exports between domestic exports and re-exports before 1960 is not strictly comparable with later figures.

Source: Hong Kong Annual Report, various numbers.

In 1949 and 1950 a large-scale migration followed Communist successes in the Chinese civil war: in the year to June 1950 the population of the Colony increased by more than a fifth. The re-establishment of stable conditions in China led to a 10 per cent fall in population in 1951. Immigration controls were introduced for the first time in 1950, but were not strictly enforced until 1959, following a further period of rapid migration from China. The population of the Colony in December 1967 was 3,88 million and

¹ No official estimates of the national income have been made. A Government-sponsored study of the Colony's national income in 1960 to 1962 has been undertaken by E.R. Chang. The results of this study were published, unofficially, in FEER, 26 May 1966.
### Table 1.4.A

**ESTIMATES OF HONG KONG GROSS DOMESTIC PRODUCT, 1947-64**

($ million)

<table>
<thead>
<tr>
<th>Year</th>
<th>Range</th>
</tr>
</thead>
<tbody>
<tr>
<td>1947</td>
<td>1,715-1,805</td>
</tr>
<tr>
<td>1948</td>
<td>1,945-2,050</td>
</tr>
<tr>
<td>1949</td>
<td>2,565-2,700</td>
</tr>
<tr>
<td>1950</td>
<td>3,070-3,230</td>
</tr>
<tr>
<td>1951</td>
<td>3,140-3,305</td>
</tr>
<tr>
<td>1952</td>
<td>2,950-3,055</td>
</tr>
<tr>
<td>1953</td>
<td>3,045-3,205</td>
</tr>
<tr>
<td>1954</td>
<td>3,265-3,440</td>
</tr>
<tr>
<td>1955</td>
<td>3,590-3,780</td>
</tr>
<tr>
<td>1956</td>
<td>3,955-4,160</td>
</tr>
<tr>
<td>1957</td>
<td>4,225-4,465</td>
</tr>
<tr>
<td>1958</td>
<td>4,500-4,735</td>
</tr>
<tr>
<td>1959</td>
<td>5,025-5,290</td>
</tr>
<tr>
<td>1960</td>
<td>5,745-6,045</td>
</tr>
<tr>
<td>1961</td>
<td>6,545-6,885</td>
</tr>
<tr>
<td>1962</td>
<td>7,360-7,745</td>
</tr>
<tr>
<td>1963</td>
<td>8,390-8,830</td>
</tr>
<tr>
<td>1964</td>
<td>10,000-9,500</td>
</tr>
</tbody>
</table>


### Table 1.4.B

**GROSS DOMESTIC PRODUCT AT FACTOR COST, BY INDUSTRY OF ORIGIN**

1961-62

<table>
<thead>
<tr>
<th>Industry</th>
<th>Per cent of total GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture, forestry and fishing</td>
<td>3.4</td>
</tr>
<tr>
<td>Mining</td>
<td>0.3</td>
</tr>
<tr>
<td>Food, beverages and tobacco</td>
<td>3.7</td>
</tr>
<tr>
<td>Textiles</td>
<td>1.8</td>
</tr>
<tr>
<td>Footwear, wearing apparel</td>
<td>6.3</td>
</tr>
<tr>
<td>Wood products, furniture and fittings</td>
<td>2.6</td>
</tr>
<tr>
<td>Paper, etc.</td>
<td>0.9</td>
</tr>
<tr>
<td>Chemicals, non-metallic, mineral products</td>
<td>1.8</td>
</tr>
<tr>
<td>Metals except machinery</td>
<td>2.3</td>
</tr>
<tr>
<td>Machinery and transport equipment</td>
<td>3.1</td>
</tr>
<tr>
<td>Manufacturing, other</td>
<td>1.4</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>21.9</strong></td>
</tr>
<tr>
<td>Construction</td>
<td>6.2</td>
</tr>
<tr>
<td>Public utilities</td>
<td>2.5</td>
</tr>
<tr>
<td>Transport, storage, communications</td>
<td>10.1</td>
</tr>
<tr>
<td>Wholesale and retail trade</td>
<td>19.7</td>
</tr>
<tr>
<td>Banks and other financial institutions</td>
<td>5.8</td>
</tr>
<tr>
<td>Insurance</td>
<td>1.1</td>
</tr>
<tr>
<td>Real estate</td>
<td>1.9</td>
</tr>
<tr>
<td>Property ownership and rental</td>
<td>8.5</td>
</tr>
<tr>
<td>Services</td>
<td><strong>5.4</strong></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>61.2</strong></td>
</tr>
<tr>
<td><strong>Gross domestic product, value</strong></td>
<td><strong>$6,372 million</strong></td>
</tr>
</tbody>
</table>

was increasing at around 3 per cent per annum. As well as being considerably enlarged, the population has now become a settled one. More than half of the present residents were born locally. Children under fifteen make up 41 per cent of the population, compared with 27 per cent in 1931.

(a) Entrepot Trade, 1945 to 1967. Despite the war-damaged economy, continuing shortages and controls, and disruptions in China, the entrepot trade was quickly re-established after 1945. Trade was encouraged by the Colony's political stability and security, the end of extra-territorial rights in China, and the stable currency and free foreign exchange market.

The expansion of trade was especially rapid in the period 1946 to 1951, when exports increased approximately six times and imports more than five times. Virtually all the trade in this period was of an entrepot type: locally produced exports probably accounted for only 10 per cent of total exports in 1947, and 5 per cent in 1950.1

Trade continued to increase rapidly after the establishment of the Communist Government in China, and a very marked trade boom developed in 1950 and 1951 from Chinese purchases and stockpiling after the outbreak of the Korean war. This boom reached its peak in the first few months of 1951 when, for a brief period, the Colony ran an export surplus. These conditions ended suddenly with the imposition, in December 1950, of a United States prohibition on trade with China (for a while this applied also to U.S. trade with Hong Kong) and, in May 1951, of a United Nations embargo on the export of a wide range of strategic goods to China. Trade was further disrupted, first, by the announcement that the United States Treasury would freeze all U.S. dollar balances used in trade or payments with a Communist Chinese resident or agency, and secondly, by the Chinese reaction to the United Nations embargo, which was to reduce trade with those countries not supplying it with goods. These measures

1 Chiu Tze Nang, op. cit., p.236.
reduced Hong Kong's entrepot trade with China - the mainstay of its economy for more than a century - to virtually nothing and naturally led to a considerable pessimism about the economic future of the Colony; confidence returned only with the increasingly apparent success of local industry. The value of re-exports in 1967 was still only half the 1951 level.

China's purchases from Hong Kong fell by two-thirds in 1952 and have, since 1954, been relatively unimportant (exports to China are now only 1 per cent of the Colony's total exports, compared with two-thirds in 1951). And there is at present only a small re-export trade in Chinese goods, most of which is handled by official Chinese agencies. But China has continued to supply a large part of Hong Kong's imports: most of the Colony's food is imported from China, and there are considerable purchases of consumer goods, cement, metal and water.

Re-exports for the past few years have constituted about 22 per cent of total exports. Profits from the entrepot trade and its associated services contribute significantly to the Colony's balance of payments. A wide variety of factors is responsible for the year to year fluctuations in the entrepot trade, including exchange restrictions and tariffs in the major importing countries, and war-induced demands.¹

(b) The Growth of Manufacturing Industry. The recovery of manufacturing industry was at first restricted by shortage of machinery, raw materials and skilled labour, and by Chinese import and exchange restrictions. Until 1949 there was little evidence that industrial development would depart from prewar lines. At the end of 1948 shipyards were again virtually the only large-scale manufacturing enterprises and most light industry manufacture took place in tenement-style premises. It was in the 1950s that the economic transformation first became apparent and since this date,

¹ The Vietnam war brought a 50 per cent increase in the entrepot trade in the first few months of 1967.
industrial growth has been rapid - the value of locally-produced exports increased more than twelve times in the period 1952 to 1967.  

The foundation of the modern industrial sector came with the establishment in the late 1940s of a number of cotton spinning mills. Between 1947 and the end of 1950, twelve of these mills with a total capacity of 188,000 spindles were set up, all by Shanghai textile industrialists, who were attracted to Hong Kong by conditions of political stability, a strong and convertible currency and the laissez faire economic system. Equipment was of modern design, having been, in many cases, ordered for Shanghai plants and then diverted to Hong Kong. This entrepreneurial group was supplemented by skilled labour and a large inflow of capital, also largely from Shanghai, and a very large influx of unskilled labour. Yarn was marketed in South and East Asia. By 1967 there were 33 cotton spinning mills with 767,000 spindles. There has been a continuing replacement of equipment and a high utilisation rate of machinery.

Other branches of the textile industry developed more slowly. One or two weaving mills were set up, also by Shanghai industrialists, in 1949 and 1950. There was a more rapid expansion of weaving capacity late in the 1950s. In both weaving and knitting there have been a large number of small mills, producing mostly lower quality lines for sale locally, while production for export is undertaken mainly by the relatively few larger firms. Garments manufacture expanded rapidly in the late 1950s: in the three years to March

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1 There have been no serious short-term fluctuations in the Colony's economic growth since the embargo-induced slump of the early 1950s. However, there were signs that the rate of new investment in industry - and in building construction - was reduced in the period 1965-67. See below, Tables 13.1 and 14.1.

2 One of these mills was owned by the Kadoorie family. The remainder were Chinese-owned.

3 For example, in 1963 the average utilisation rate for spindles in Hong Kong was 8,100 hours, compared with 6,400 in the United States, 4,800 in Japan, 4,100 in Australia and 2,400 in the United Kingdom. Source: Hong Kong Textile Facts, Hong Kong Government Printer, 1964.
1960, registered employment in garments factories rose five times to 48,000. Small businesses played an important part in this expansion. Many textile mills are now fully integrated enterprises. There has been, in some sectors of the textile industry, over-expansion of capacity and a shortage of a number of grades of labour, while production in many lines has been restricted by international marketing agreements. Table 1.5 on the distribution of the industrial workforce shows the continuing dominance of the textile industry. Textile exports account for more than half of the Colony's locally-produced exports.

Table 1.5
REGISTERED AND RECORDED FACTORIES AND NUMBERS EMPLOYED, 31 MARCH 1967

<table>
<thead>
<tr>
<th></th>
<th>Factories</th>
<th>Number employed '000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Manufacture of textiles:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cotton spinning</td>
<td>33</td>
<td>21</td>
</tr>
<tr>
<td>Wool spinning</td>
<td>10</td>
<td>3</td>
</tr>
<tr>
<td>Weaving</td>
<td>300</td>
<td>32</td>
</tr>
<tr>
<td>Knitting</td>
<td>591</td>
<td>33</td>
</tr>
<tr>
<td>Other</td>
<td>467</td>
<td>12</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>1,401</td>
<td>101</td>
</tr>
<tr>
<td><strong>Footwear, wearing apparel, made up textiles:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Footwear</td>
<td>96</td>
<td>2</td>
</tr>
<tr>
<td>Garments</td>
<td>1,092</td>
<td>65</td>
</tr>
<tr>
<td>Gloves</td>
<td>92</td>
<td>7</td>
</tr>
<tr>
<td>Other</td>
<td>300</td>
<td>5</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>1,480</td>
<td>78</td>
</tr>
<tr>
<td><strong>Food manufacture</strong></td>
<td>512</td>
<td>9</td>
</tr>
<tr>
<td><strong>Rubber products</strong></td>
<td>235</td>
<td>10</td>
</tr>
<tr>
<td><strong>Metal products</strong></td>
<td>1,460</td>
<td>35</td>
</tr>
<tr>
<td><strong>Manufacture of electrical apparatus, machinery:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Transistor radios</td>
<td>63</td>
<td>20</td>
</tr>
<tr>
<td>Electrical appliances</td>
<td>73</td>
<td>6</td>
</tr>
<tr>
<td>Other</td>
<td>142</td>
<td>9</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>278</td>
<td>35</td>
</tr>
<tr>
<td><strong>Shipbuilding and repair</strong></td>
<td>37</td>
<td>11</td>
</tr>
<tr>
<td><strong>Plastic goods</strong></td>
<td>1,468</td>
<td>51</td>
</tr>
<tr>
<td><strong>Photographic and optical goods</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>3,741</td>
<td>99</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>10,635</td>
<td>432</td>
</tr>
</tbody>
</table>

The first large plastics factory was set up by a firm from Shanghai in 1947. In the late 1950s there was a rapid expansion in the output of plastic flowers and toys. Between 1957 and 1960 recorded employment in the plastic goods industry rose almost twenty times. The ease with which businesses can be established in this industry led to a serious overproduction of plastic goods in 1961 and in 1965-66.

Ship-breaking and steel rolling is the one heavy industry. This industry, which supplies mainly the local construction trade, expanded rapidly until the early 1960s, when there was increased foreign competition in the sale of steel rods and bars.

Several new industries have been established in the 1960s, including the manufacture of transistor radios, electrical appliances and cameras. In each of these industries many of the early firms established did little more than assemble imported components; later, several large and well organised businesses were set up.

(c) The Structure of Hong Kong Industry. A main feature of Hong Kong industry is that it is highly export-oriented: probably 95 per cent of manufactured goods are sold overseas. The local market is, of course, by no means insignificant, especially for low cost consumer goods, but even were local businesses to capture that part of the home market at present supplied largely with Chinese and Japanese goods, total industrial output would rise only a few per cent. Tariffs could, therefore, do little to assist local industry.

Most manufactured exports are handled by export-import houses, and production is mainly to specifications received from overseas buyers.

1 Plastic flower production shows how quickly an industry can become established in Hong Kong. In the three years to 1960 exports increased from zero to $150 million.

2 Thus many of the early transistor radio factories were 'little more than a store room, an assembly room and a dispatch room'. FEER, 21 February 1963, p.412.

3 The Economist Intelligence Unit suggests in its report, Industry in Hong Kong, Hong Kong: SCMP, 1962, p.8, that the export-import firms handle 'at least three quarters and perhaps more' of Hong Kong exports.
The majority of manufacturing businesses are owned by Chinese. Immigrants from Shanghai still dominate cotton spinning, weaving and finishing, while non-Shanghai Chinese are more dominant in food-processing, metal manufacture and, to a lesser extent, in garment making. Few industrial concerns are organised as public companies, even though some represent investments of as much as $70 million. In most cases management is highly centralised in the hands of the founder. Hong Kong is 'a society wedded to the one-man-show concept of industry', in which management 'tends to be individual and personal'.

Table 1.6 shows something of the size distribution of businesses engaged in manufacturing activity, and points to the numerical importance of the smaller enterprises. In 1967 only 10 per cent of manufacturing businesses employed more than 100 workers. But these larger factories employed two-thirds of the total recorded workforce and it has been suggested that in most lines of industry the larger firms are responsible for an even higher proportion of exports.

There has been a rapid establishment of new businesses once a particular line has been proved profitable. This speedy entry results from a number of influences, including the ease with which a business can be started, a short-term outlook on investment in industry, the little capital required in many of the Colony's light industries, the readiness with which, in this export-oriented economy, marketing and the provision of raw materials can be left

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1 A brief biography of the leading commercial and industrial Chinese families in Hong Kong is given in Dick Wilson, 'As Others See Us', SCMP Trade and Industry Supplement, 1966.
2 Ibid.
3 Ibid.
4 Economist Intelligence Unit, op. cit.
5 The numerical dominance of the smaller businesses would be even greater when allowance is made for the many small enterprises not registered with the Labour Department.
6 Economist Intelligence Unit, op. cit., p.7.
7 See ibid., p.8.
### Table 1.6

**INDUSTRIAL ESTABLISHMENTS CLASSIFIED BY NUMBER OF EMPLOYEES**

**31 MARCH 1967**

<table>
<thead>
<tr>
<th>Number of employees in each industrial establishment</th>
<th>Industrial establishments</th>
<th>Total employees</th>
</tr>
</thead>
<tbody>
<tr>
<td>5,000 and over</td>
<td>1</td>
<td>7,186</td>
</tr>
<tr>
<td>4,000-4,999</td>
<td>2</td>
<td>9,254</td>
</tr>
<tr>
<td>3,000-3,999</td>
<td>1</td>
<td>3,667</td>
</tr>
<tr>
<td>2,000-2,999</td>
<td>6</td>
<td>13,583</td>
</tr>
<tr>
<td>1,000-1,999</td>
<td>33</td>
<td>44,652</td>
</tr>
<tr>
<td>500-999</td>
<td>68</td>
<td>45,843</td>
</tr>
<tr>
<td>200-499</td>
<td>310</td>
<td>93,528</td>
</tr>
<tr>
<td>100-199</td>
<td>438</td>
<td>60,899</td>
</tr>
<tr>
<td>50-99</td>
<td>765</td>
<td>53,926</td>
</tr>
<tr>
<td>20-49</td>
<td>1,669</td>
<td>51,214</td>
</tr>
<tr>
<td>10-19</td>
<td>2,033</td>
<td>27,636</td>
</tr>
<tr>
<td>1-9</td>
<td>4,128</td>
<td>20,585</td>
</tr>
<tr>
<td></td>
<td>9,454</td>
<td>431,973</td>
</tr>
</tbody>
</table>


To the export houses, and the 'traditional Chinese preference for possessing an independent business however small this might be', in several cases, notably in parts of the clothing, gloves and plastics industries, the rush to enter has meant excessive competition, price cutting and quality deterioration, and quite often, business failures. The Director of the Department of Commerce and Industry has expressed this tendency as follows:

In short, Hong Kong's industrial development has followed an almost classic pattern within a free economy. Its four stages might be described as establishment related to opportunity; rapid and uncontrolled growth; internal turbulence; and finally the emergence of a permanent and viable industry.

---

1 'Ready access to exceptional trading facilities is one of the most important advantages that Hong Kong enjoys in competing against its rivals in underdeveloped Asia.' Ibid., p. 6.


3 'In general, management is too little concerned to produce and sell a specified product at the price and in the quantity which will yield the highest return on the labour, capital and materials employed; too often its function is conceived as being to ensure that any product for which there is a buyer at any price is produced in the largest possible quantity, provided only that total outlays on labour and materials can be covered by total current revenue.' Economist Intelligence Unit, op. cit., p. 8.

4 In an article contributed to *SCMP Trade and Industry Supplement*, op. cit.
(d) **Building Construction and Tourism.** The construction industry has made a significant contribution to postwar prosperity. There has been a very high level of investment in construction in almost every year since 1948 and employment in this sector has exceeded 100,000 for at least a decade.\(^1\)

Since the mid-1950s Hong Kong has become an important tourist centre. Official figures show an increase in civilian arrivals from 103,000 in 1958 to 527,000 in 1967. Expenditure by civilian tourists is now about $1,000 million a year.\(^2\)

(e) **Price Changes.** The only price index available for more than a few years, the Retail Price Index, is shown in Chart 1.1.

Although this index must be interpreted with some caution, the trend over the whole period is clearly one of relative price stability.\(^3\) From 1947 until 1953-54 there were appreciable price increases, as wartime controls were relaxed and world prices increased. Prices were virtually stable during the period 1953 to 1963, despite the economic growth. Given the increase in wages, at least in the second half of the decade (see Chart 1.2), the relatively stable prices suggest that there were significant increases in productivity and, perhaps, in employment, in the ten years to 1963. Price increases have been more evident since 1963. The disturbances in 1967 and the currency devaluation brought a more rapid increase in prices in that year.

There are several reasons why inflation has not been a serious problem. One group of factors relates to the activities of the

---

1. Estimates of the value of new building construction are given below. See Table 14.1.
3. Food items have a weight of 51 per cent in this index, and the item 'rent' is based on rent controlled premises.
4. The more comprehensive General Consumer Price Index, which is available only for a short period of time, records a 5 per cent increase in prices between 1963/64 and December 1966, and a 12 per cent increase between 1963/64 and the end of 1967.
Chart 1.1  Retail Price Index, 1947-1967 (1947 = 100)

Chart 1.2  Index of Average Daily Wages Including Fringe Benefits, 1958-1967 (1958 = 100)
financial institutions which are the subject of this study. The credit creating activities of the commercial banks have not been destabilising, Government financial policies have been extremely conservative and the Colony's currency arrangements have not permitted an inflationary expansion of the monetary base. A related aspect is that, with the fully convertible currency and the economy's high marginal propensity to import, expansions in monetary demand quickly spill overseas. And, many foodstuffs and industrial raw materials have been imported from China at virtually constant prices.1

Wages appear to be quickly responsive to the forces of supply and demand. Most wages are set by individual and increasingly written agreements between workers and employers. There is a uniform wage structure in a few trades, mostly those where trade unions are particularly active or older guilds exist,2 but there are few long-term wage agreements. In 1967 the first moves towards the establishment of minimum wage rates were made. Labour appears to be mobile between businesses, if not geographically.

The influx of unskilled labour kept most wages relatively constant until the mid-1950s, but from 1959 onwards labour shortages, especially of skilled and semi-skilled workers became apparent: in the 1961 census only 21,000 people were reported to be unemployed (including 5,000 who were seeking their first job), and in 1964/65 'the industrial labour force showed virtually no change because of the general shortage of labour'.3 This tightness in the labour

1 No import price index is available for Hong Kong, but it does appear that goods have been imported from China at quite steady, and usually very low, price levels. See, for example, FEER, 14 September 1967, pp. 336-7.

2 In 1966, 240 worker unions with a membership of 167,000 were registered with the Labour Office. The trade union movement is divided on political and regional grounds, and weakened by family connections between management and employees and the large number of small firms. The unions are particularly strong in the public utilities and dockyards, however, and these sectors are often 'wage leaders'.

3 Labour Commissioner, Annual Report, 1964-65, Hong Kong Government Printer, p.10. See also Portia Ho, 'Labour Shortage or Wastage?', FEER, 10 March 1966.
market has been a main factor in the rapid increase in wage rates since 1958. With such a large proportion of industrial output being exported, the wage rises have had relatively little effect on local prices. The intensely competitive conditions in most sectors of the economy would, in any case, have forced most firms to absorb wage increases rather than pass them on as higher prices. Concern has been expressed on a number of occasions that the general rise in wage rates would cause Hong Kong goods to lose their competitive position in export markets.¹ This question would require a very detailed analysis.

Hong Kong's Political Arithmetic

Hong Kong is now by far the most important of the remaining British dependent territories. The Colony is still administered on almost 'classic' colonial lines. Political power is concentrated in the hands of the Governor who is advised by an appointed Executive Council. Government finance and expenditure are controlled by the Legislative Council, which consists of thirteen 'official' members (who are senior civil servants), including the Governor who also has a casting vote, and thirteen 'unofficial' members. Business and commercial interests, both British and Chinese, are strongly represented on the two Councils. There has been some increase over the past two decades in the range of powers assigned to the local Government. But no attempt has been made to establish an elected or independent Government: 'Hong Kong has no independent future - it remains a British Colony or becomes part of China.'²

It is commonly thought that even a tentative step towards an increased local participation in Government decision making would bring to the surface rivalries between local supporters of the Communist and Nationalist Chinese Governments.

² Alexander Grantham, Via Ports, Hong Kong University Press, 1965, p.111. Sir Alexander was Governor of Hong Kong from 1947 to 1957.
Economic growth has taken place under conditions of considerable political uncertainty. The Communist Chinese Government does not recognise the earlier treaties which ceded and leased Hong Kong to the British Government. In any event, the lease of the New Territories land area, in which all but one-tenth of the Colony's land, virtually all the water storage and agricultural land, and about two-thirds of the factories are located, expires in 1997. Without this area, Hong Kong is not a viable territory, and at this date 'a settlement of the Hong Kong problem has to be negotiated, and only a solution which returned the sovereignty of the whole Colony to China would be acceptable to the present or any other conceivable Chinese Government'.

Until 1967, the political uncertainty and tension had given rise to only one serious disturbance - a period of rioting in 1956. Between May and December 1967 there were many demonstrations and disturbances and several serious border incidents.

Doubtless, the maintenance of Hong Kong as a British administered territory is of very great financial value to the Peking Government (see the rough estimates presented in Table 1.7). From food and consumer goods exports to the Colony, business earnings in Hong Kong and remittances from Hong Kong, China is thought to earn about half its total foreign exchange receipts. And, on the Hong Kong foreign exchange markets, these earnings can readily be converted into sterling or other foreign currencies.

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3 A short period of disturbances followed an increase in ferry fares in 1966, but without any apparent political content.

4 See, for example, FEER in this period, especially 6 July 1967 and 10 August 1967, and Hong Kong 1967, Chapter I.

5 Dick Wilson, op. cit., p.201.
Table 1.7

CHINA'S ESTIMATED FOREIGN EXCHANGE EARNINGS IN HONG KONG, 1966
($ million)

<table>
<thead>
<tr>
<th>Economic Activity</th>
<th>Value ($ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade balance</td>
<td>2,700</td>
</tr>
<tr>
<td>Profits from trade and distribution</td>
<td>690</td>
</tr>
<tr>
<td>Profits from banking</td>
<td>50</td>
</tr>
<tr>
<td>Water charges</td>
<td>14</td>
</tr>
<tr>
<td>Other economic activities</td>
<td>550</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>3,994</strong></td>
</tr>
</tbody>
</table>

Source: FEER, 6 July 1967, p.42.

In the postwar period, Hong Kong has come also to act as something of a capital for overseas Chinese, many of whom are severely restricted in their commercial dealings in the country in which they reside:

Hong Kong today is a flourishing community of three million, overwhelmingly Chinese and living under the capitalist economic system and prosperous. It is this community with its wealth and sophistication, modernity and high educational level which sets the tone for the Third China, and which receives in return a great and growing volume of funds from the Third China.¹

¹ C.P. Fitzgerald, op. cit., p.85.
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Chapter 2

MONEY AND FINANCE IN THE ENTREPOET ECONOMY

The Early Financial System

The foundations both of Hong Kong's early trading system and of financial arrangements to service this trade were laid in Canton before the Colony was established. European trade with China existed for centuries before the Treaty of Nanking but was, for a long time, one-sided. The largely self-contained China sought few goods from the West, and European purchases of silk and tea resulted in a flow of silver, mostly in the form of Spanish coin, to China. This movement of silver was reduced, and later reversed, by Chinese purchases of two Indian-produced goods - raw cotton and opium. By 1820 a triangular trading pattern developed. Europe exported manufactured goods to India and imported Chinese tea and silk; Indian opium and cotton were sold in China. The triangular pattern was completed by the shipment of silver from China to India. This trading arrangement continued after the establishment of Hong Kong as a British Colony, and was replaced by a more complex system of trade only in the 1870s. Opium was the main Chinese import by 1830 and became the 'economic foundation of the rise of the foreign merchant community in China'.

At the time of Hong Kong's establishment, the agency house was 'the characteristic unit of British private trade with the East'. These houses were 'the outcome, mainly of geographical distance

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1 This section draws heavily on the important study based on the Jardine Matheson papers, M. Greenburg, British Trade and the Opening of China, 1800-1842, Cambridge University Press, 1951, and on a very useful collection of unpublished material of J.R. Jones, onetime Legal Advisor of the Hongkong Bank.

2 M. Greenburg, op. cit., p.107.  

3 Ibid., p.144.
between the origin of capital and its actual sphere of operations, and of technical difference between the two levels of economy.\(^1\) They were primarily trading enterprises, selling on own account or on a commission basis, but for some time they had also to act as banker, bill-broker, ship-owner, freighter and insurance agent. Some houses were to become 'hereditary concern(s), commercial dynast(ies)'.\(^2\) The best known houses to develop from this period were Jardine Matheson, Dent and Co., Gibb Livingstone, and Russell and Co. Several merchants transferred to Hong Kong as soon as the Colony was founded; others moved their operations from China after the Taiping Rebellion and the Arrow War.

**Currency**

(a) 1841-95. Two developments of some importance for the Hong Kong currency system had taken place, independently, well before the establishment of Hong Kong as a British territory.

First, there had already been a considerable development in the policy of the British Government on Colonial currency arrangements. Throughout the seventeenth and eighteenth centuries the British Government accepted no responsibility for providing the Colonies with a circulating medium, forcing them to use a variety of coin, obtained from whatever sources were available. In 1825 the British Government attempted to unify the currency systems of the many Colonies and simultaneously to solve the problem of an inadequate supply of coin: the shilling was to be introduced throughout the Colonial empire, 'to circulate wherever the British drum was heard'.\(^3\) The Proclamation made no allowance for any local reluctance to accept British currency.

Secondly - and this was eventually to modify the currency principle just discussed - the silver dollar was already well known in the Far East, where it had been introduced mainly by Spanish

\(^1\) Ibid.
\(^2\) Ibid., p.147.
traders based on the Philippines. The silver dollar was the common currency of the trading ports of East and South East Asia, and, from the start, was the standard coin of Hong Kong. The Colony became part of a wide 'currency area' in which there was currency convertibility and stability not since experienced.

China itself had no coin of its own other than the copper 'cash' for very small transactions. Its medium of exchange was silver-as-metal, measured by the tael (Chinese ounce) and usually in the form of 'sycee' (a silver 'shoe' of about fifty tais).

The first Hong Kong currency proclamations declared the silver dollar 'the standard in all Government and mercantile transactions'. But the proclamations were disallowed by the Secretary of State, who reminded the local Government that only 'the legal coin of the realm could be declared legal tender without the previous consent of the Imperial Government' and that the currency system of Hong Kong 'should be assimilated to those of our other possessions abroad'. Thus, in 1844, sterling coins were declared legal tender.

The strong preference of Chinese traders for silver and the willingness of British traders, who made a valuable commission on silver transactions, to employ silver coin and sycee so long as the Chinese retained their preference for the metal, led to almost total disregard of the proclamation. The Government's accounts were kept in sterling, but even the Colonial Treasurer refused to accept British sovereigns in payment for crown rents. Transactions continued in a variety of silver coins, which, because of their varying silver contents and 'chopping', circulated at different rates.

---

1 These proclamations, of March and April 1842, are outlined in C.F. Joseph Tom, The Entrepot Trade and the Monetary Standards of Hong Kong, 1842-1941, Hong Kong: K. Weiss, 1964, Chapter II.

2 Ibid., pp.27-8.


4 'Chopping' involved the Chinese merchants' stamping of silver coins to certify their fineness. In the process the coins were disfigured and lost a minute portion of silver.
In 1863, a new proclamation made the Mexican dollars and equivalent coins legal tender when declared to be such by the Government. Sterling was no longer legal tender in the Colony.

It was accepted that "the Colony had never had any pretensions whatever to establish an isolated system of currency at variance with that of the great empire on the confines of which it is established". 1

The 1863 Proclamation ended, at least for a while, one currency problem - that of acceptability - but did nothing to secure an adequate supply of coin. Soon afterwards, permission was given to the local Government to establish a mint, producing a silver dollar similar in value to the Mexican dollar. But, despite the "immense stream of silver constantly flowing into and out of this Colony" 2 there was little demand for the Mint's services, and in 1868, after producing only $2.4 million worth of coin, the Mint was closed. The failure, and the financial loss involved, doubtless discouraged the Government from later accepting responsibility for the issue of coins and notes (other than subsidiary currency).

Banknotes were first issued in Hong Kong by the Oriental Bank, in 1845. 3 Notes were also issued by the Chartered Mercantile Bank, in 1858, the Chartered Bank, in 1862, and the Hongkong Bank, in 1866. The Hong Kong note issue was approximately $1.4 million in January 1867, $3.7 million in 1881, $5.9 million in 1891 and $7.0 million in 1895. 4 Part was held outside Hong Kong.

2 Dispatch from Sir Richard Graves McDonnell to the Earl of Carnarvon on the Subject of the Failure of the Hong Kong Mint, 1866, reprinted in G.B. Endacott (ed.), op. cit., p.218. This dispatch gives a long analysis of the failure, which was mainly due to the fact that, to merchants who used silver-as-metal as currency, a seignorage charge of 2 per cent outweighed the benefits of clean, standard coin.
3 This bank failed in 1884.
Although not legal tender until 1935, banknotes were readily accepted by the merchant community. Indeed, by 1890 there was 'an understanding or convention, by which notes became accepted in all banking, mercantile and revenue transactions almost as the sole medium of exchange apart from subsidiary coins'.

This general acceptability was due to the convenience of the notes - silver coins were far too heavy for most transactions, and coin and sycee had always to be checked for weight and fineness - and to the strict conditions governing the banks' right to issue notes. Notes were redeemable on demand in specie, a bank's note issue could not exceed its paid up capital, a specie reserve of one-third had to be held against notes outstanding, and shareholders carried a double liability on the note issue. Despite these requirements, the banks benefited considerably from their right to issue notes:

Notes were a source of profit when business was flourishing and credit was good, but like current account or any others payable on demand they were a danger in the financial panics that were all too frequent at this date.

---

3 The Hong Kong banks usually maintained a higher reserve of coin against their note issue, mainly because a large part of their note issue was held by other banks and likely to be presented at short notice. See Compton Mackenzie, Realms of Silver, London: Routledge and Kegan Paul, 1954, p.61. D.M. Kenrick, 'The Economy of Hong Kong, 1841-1945', FEER, 11 August 1949, p.170, relates an interesting episode from the early history of the Hongkong Bank: in 1872 the Bank's competitors hoarded banknotes issued by the Bank, until they held more than $1 million, which they presented for silver late on a Saturday. 'To the mortification of its competitors' the Bank was able to pay over the required silver.
4 The shareholders of the Hongkong Bank carried an unlimited liability on the note issue.
5 Compton Mackenzie, op. cit., p.61. The Colony's monetary arrangements made for a simple relation between the balance of payments and the money supply. To the extent that silver coins and sycee were used as the circulating medium, local currency could come into existence only through a favourable balance of payments - which might arise from an export surplus, the earnings from mercantile services, or favourable capital movements. The use of banknotes and cheque deposits as money, where these were not backed by a 100 per cent reserve of silver, weakened this simple relationship.
After being virtually stable for two centuries, the gold price of silver in 1873 began a series of erratic and at times very severe price variations.  

The trend in silver prices over the period is shown in Chart 2.1. These price variations encouraged, and in turn were accentuated by, the demonetisation of silver in many European and Asian countries.  

The fluctuations affected every aspect of the financial system. The most significant consequence was that the value of Hong Kong currency in terms of gold based currencies came to fluctuate over a wide range (see Chart 2.1). Any fall in the gold price of silver depreciated the Hong Kong currency: imports from countries employing a gold-based currency became more expensive and the sterling prices of goods shipped from Hong Kong to Britain, for example, fell. Because of the unimportance of locally produced goods, variations in the gold-silver price ratio affected the Colony’s price level more quickly than they did prices in the more self-contained China. In the sixty years to 1935, the fall in the silver exchanges caused a significant increase in prices in Hong Kong.  

When world silver prices increased - as they did, for example, in the period 1917 to 1919 - goods imported from gold bloc countries became cheaper in local currencies. In years of rising silver prices there was also a significant export of silver coin and bullion.  

As China and Hong Kong both used silver as legal tender currency, variations in the gold price of silver should not have affected the exchange rate between the two currencies. There was some movement in this exchange rate, however, because silver did not move freely between the two countries.  

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1 The causes and course of these price movements are outlined in detail in D.R. Leavens, *Silver Money*, Cowles Commission Monograph, No.4, 1939.  

2 Most important Eastern territories demonetised silver about the turn of the century: Netherlands East Indies in 1877, Japan in 1876-78, Straits Settlements in 1902 and the Philippines in 1903.  

3 See D.M. Kenrick, op. cit., p.165.  

4 See below, pp.30-2.
Chart 2.1  London Silver Prices, 1870-1935, d. per oz, .925 fine

Market Rates of Exchange, d. per Hong Kong Dollar
(b) After 1895. In 1895 the British silver dollar, produced in India, became legal tender in Hong Kong. By 1935 this was the main coin in circulation in the Colony. With its successful adoption, there was for the first time a regular supply of legal tender currency.

In 1898 the Hongkong Bank's note issue of $10.8 million exceeded its paid up capital, the maximum issue permitted under the Bank's Ordinance. The Bank sought permission to maintain this excess, arguing that Hong Kong, an important exchange centre drawn on by drafts and telegraphic transfer from all parts of the world, required an elastic supply of currency. An amendment to the Bank's Ordinance introduced the distinction between its 'authorised' issue (limited to $30 million, two-thirds of which had to be backed by silver, the remaining one-third could be a fiduciary issue), and its 'excess' issue, on which no limit was imposed, but which required a 100 per cent silver backing.

A 1902 amendment to the Chartered Bank's right to issue banknotes permitted an excess issue fully backed by silver, but this was withdrawn in 1922, and the Bank's note issue was limited to $30 million. All but $5.3 million, which could be made as a fiduciary issue, had to be secured by silver or approved securities. Its 1911 Ordinance permitted the Mercantile Bank to issue notes to the value of its paid up capital, provided the issue was fully backed by silver or securities. By 1934 the three banks had a total note issue of $154 million.

But these various measures did not end the Colony's currency problems. Many merchants continued to refuse silver coin, despite its legal tender status. The exchange banks, too, did not always accept coins in interbank settlement or from depositors. This situation would not have been inconvenient had the supply of banknotes been fully elastic. But, although the note issuing banks were in a position to expand their Hong Kong note issue, they were

1 J.R. Jones, op. cit.
not compelled to do so. Further, each institution had reason to
restrict rather than expand its note issue: the Hongkong Bank made
a loss on its excess issue (on which it had to meet the printing
costs and pay stamp duty); the other two banks, with their sterling
capital, sought to limit all commitments in silver using countries.¹

As a result, banknotes came to circulate at a premium over
legal tender silver coin. This premium first appeared in the 1890s,
and was the dominant feature of the currency system until the 1930s.
The premium increased from around 3 per cent in 1908 to between
7 and 10 per cent in 1925 and to between 15 and 20 per cent in
1929.² The high premium in the late 1920s is said to have resulted
mainly from an increase in the flow of remittances from overseas
Chinese. These transfers were paid into Hong Kong banks in foreign,
usually gold-based currencies, and withdrawn in Hong Kong banknotes
to be sent inland.³

The banknote premium complicated the Colony’s exchange, allow­
ing the exchange value of the common medium of exchange (banknotes)
to rise above the silver import points without inducing an equilibrat­
ing import of silver bullion or coin.⁴ Although Hong Kong was
nominally on a silver standard, specie flows did not develop either
to limit the exchange rate movements or to act as an equilibrating
mechanism.

A related consequence was that the exchange rate between the
Hong Kong dollar and currencies tied to gold (such as sterling) did
not always follow variations in the gold price of silver. The bank­
note premium doubtless meant some uncertainty for traders, but in a

¹ It is possible, too, that as a considerable portion of the Hong
Kong note issue circulated in China, the three banks believed that
further increases in the note issue would do little to solve the
Colony’s currency problem.
³ Hong Kong Currency: Report of a Commission Appointed by the
Secretary of State for Colonies, May 1931, p.6.
⁴ Tom, op. cit., shows that in nineteen of the 40 years to 1935 the
Colony’s market rate of exchange exceeded the silver import point.
number of years the premium on banknotes appears to have dampened the exchange rate variations brought on by the fall in silver prices. There was, moreover, a variable exchange rate between Hong Kong and China, even though both employed silver-based currencies.¹

The disruptions caused by the silver price variations and the existence of the banknote premium gave rise to a number of demands for currency reform. The Government itself refused to take responsibility for the currency issue, fearing that the move 'might involve Government, and indirectly the taxpayer, in the risks of heavy losses due to fluctuations in the value of silver and securities, risks which bankers, being daily engaged in them, are more competent both to anticipate and cover'.² The Hong Kong Government established a Committee to report on the currency problem in 1930.³ In the following year a similar inquiry was undertaken by a Commission appointed by the Secretary of State.⁴

Both inquiries looked into 'the widely debated topic' of whether the Hong Kong currency should be placed on a gold basis ('stabilised'). Both reports stressed the disadvantages of silver price variations for local traders and residents whose assets, pensions, contracts, etc. were depreciated in gold terms. They stressed, nonetheless, that Hong Kong, economically a part of China, must adopt a currency base similar to that employed by her large neighbour: 'if China linked her currency to silver, so should Hong Kong'.⁵ The Reports argued that Hong Kong would lose much of its entrepot trade, including the intra-China trade it conducted, and its remittance business, if a gold currency were adopted. The British Commission noted that, as the greater part of foreign investment was from China and not from gold-using countries,

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1 Report of the Currency Committee, pp.227, 229, argued that the high premium on Hong Kong banknotes drove remittance and exchange business to Shanghai.
2 Ibid., p.229.
3 Ibid.
4 Hong Kong Currency..., p.6.
5 Ibid., p.7.
'stabilisation' would discourage and not increase overseas investment.  

Both Committees made a number of suggestions to improve the working of the silver-based currency. The local Committee was less radical in its recommendations, suggesting only that the banks be permitted to hold bar silver rather than coin against their note issues, and that bar silver be accepted in interbank settlements. The United Kingdom Commission recommended that banknotes be declared unlimited tender and that silver and banknotes be made freely convertible at the banks for a small fee. The latter suggestion would have brought the return of the 'textbook' working of the silver standard.

The recommendations of the two Committees were not, however, introduced, and currency reform in Hong Kong was left until China itself abandoned the silver standard in 1935.

Banking

(a) The Development of the Banking System. The majority of the Colony's early banking offices were branches or agencies of Anglo-Indian banks, and carried unlimited liability. The first banking office was opened by the then unchartered Oriental Bank in 1845. The financial crises of 1847, 1866, 1872 and 1892 brought down most of the early banks. The privilege of Royal Charter, which conferred limited liability status, was available to the colonial banks from 1835, but the opposition of the East India Company delayed the granting of a Charter to an Eastern bank until 1851, when the Oriental Bank was chartered. Later, two Eastern banks were chartered and capitalised in England: the Chartered

1 Ibid., pp.11, 13, 20.
3 Hong Kong Currency..., p.30.
4 The currency reforms of 1935 are outlined in Chapter 3.
Mercantile Bank, which received its Charter in 1853, and the Chartered Bank, which commenced operations in 1858. Colonial Bank Regulations, drawn up by the British Treasury in 1840, set out the conditions required of banks receiving a Royal Charter. Similar conditions were demanded of banks, such as the Hongkong Bank, incorporated under local Ordinances.

These banks were attracted to the China coast by the high interest rates and the scope for exchange profits. They readily covered their import and export bills with the assistance of their Indian business and the sale in China of Indian bills. The banks competed for exchange and remittance business with the agency houses who regarded themselves as the true successors of the Company in the China trade and the depositories of the tradition and principles of the banking mechanism evolved by their predecessors in the Canton days. The old Agency Houses did not want banks but strongly objected to them as encouraging speculation among people who had insufficient capital.

But the exchange banks ensured a more regular supply of bills to the Eastern merchants (which benefited especially the smaller traders); their entry narrowed the margin between buying and selling rates on bills, and by attracting deposits in England and India the institutions made additional funds available to Eastern commerce.

Competition between the established merchants and the early exchange banks contributed to the formation, in 1865, of the Hongkong Bank, the institution which became 'the backbone of British financial

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1 See Compton Mackenzie, op. cit., Chapters I and II.
2 Besides this competition with the agency houses there was a very active competition between the banks themselves. In part, this resulted from there being too many banks, which forced newcomers in Eastern finance to take 'unjustified risks in entertaining business of a speculative nature'. J. Leighton Boyce, 'The British Eastern Exchange Banks: an Outline of the Main Factors Affecting Their Business up to 1914' in C.D. Cowan (ed.), The Economic Development of South East Asia, London: George Allen and Unwin, 1964, p.22.
3 J.R. Jones, op. cit.
4 It had been claimed that the smaller merchant houses were unable always to purchase bills from the agency houses. Ibid.
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3 J.R. Jones, op. cit.
4 It had been claimed that the smaller merchant houses were unable
always to purchase bills from the agency houses. Ibid.
interest in China'. As one commentator has suggested, the formation of the Bank was evolutionary and not revolutionary; rather than yield their established banking functions to the Anglo-Indian or London banks, the Hong Kong merchant houses themselves established a local bank 'in which they held the shares and which was controlled by a Court thoroughly representative of the whole community'.

Only Jardine Matheson of the large merchant houses did not subscribe to the new Bank's capital. This house was jealous of its own banking business and, moreover, was at the time in bitter conflict with Dent and Co. who supported the Bank. However, in 1877 Jardine Matheson acquired shares in the Bank and has since been closely associated with it. Through its contacts with local merchants the Bank was from the start well placed to take a major share of local banking business. It gained much business - and staff - from the 1866 financial crisis, which brought down six of the eleven banks operating in the Colony. In the early 1870s the Hongkong Bank surpassed the Oriental Bank as the main bank of the Colony. By 1880 it conducted about one-half of the Colony's banking business.

The Bank from an early stage was represented in London by a special agency and a correspondent. These links provided a valuable line of credit, and facilities for the presentation of bills. The British exchange banks were joined around the turn of the century by European national banks and American and Japanese institutions. In 1938 sixteen Western-style banks operated in Hong Kong, representing British, French, German, Dutch, Belgian, Japanese, American and Chinese interests.

Presumably, 'native', or small Chinese, banks first appeared in Hong Kong soon after the Colony's foundation. Certainly, a large number of native banks and exchange shops operated in the Colony by

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2 J.R. Jones, op. cit.
3 Ibid.
The complexity of the Chinese currency arrangements required institutions both to arrange transfers between different parts of China (the 'Shansi' banks) and to act as money changers ('cash shop' banks). The native banks provided a financial link between Hong Kong and the inland areas of China, where foreign banks could not operate, and were, for some time, the main deposit institutions for the Chinese community.\(^2\) The banks were clannish, secretive but highly flexible in their operations. Almost all were partnerships with unlimited liability. With their small subscribed capitals, the native banks depended heavily on the short-term loans ('chop' loans) provided by foreign banks on the security of a compradore's guarantee.\(^3\) Failures were frequent the Chinese Revolution of 1911 caused the collapse of a large number of native banks, as did the economic boycott of Hong Kong in 1925 and 1926 and the depression in 1933. In 1925 the Hongkong Bank and the Chartered Bank made emergency loans to assist the small Chinese banks.\(^4\)

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1. See 'Speech of Governor to the Legislative Council, 3 January 1881 on the Subject of the Census Returns and the Progress of the Colony', reprinted in G.B. Endacott (ed.), op. cit., p.149.
2. Deposits held by the native banks were estimated at $15 million in 1889 compared with $24 million in the exchange banks. 'Extracts from a Report on the Conditions and Prospects of Hong Kong...', 1889, reprinted in G.B. Endacott (ed.), op. cit., p.153.
3. The compradore played an important role in the operations of the exchange banks and other Western merchant houses. The compradore took responsibility for, and guaranteed, the contracts entered into with Chinese traders, he advised the exchange banks on the standing of the native banks, and it was on his guarantee that bills were bought from native Chinese banks. These activities were performed on a commission basis. The compradore was also responsible for recruiting and guaranteeing Chinese staff, and for a range of more routine duties - advising on Chinese customs, commercial practices and weights and measures. The compradore 'was not just an interpreter and canvasser, but also the consultative agent as to the business' reputation and the stability of all the Chinese traders who had dealings with the firm'. Kuang Yung Pao, 'The Compradore: His Position in the Foreign Trade of China', Economic Journal, December 1911, p.638. In some of the larger Western merchant firms and banks the position of compradore became a family one. The development of Chinese-owned Western-style business and the greater familiarity of Western merchants with Chinese language and customs made the compradore's role a less important one from about the 1920s onwards. The position of 'Chinese adviser' is the present-day equivalent, but the duties are far less wide-ranging.
The currency disruptions of the 1930s brought considerable business to the native banks, and many new institutions were established in the Colony or transferred to Hong Kong from China.

The native banks offered banking functions complementary to those carried out by the foreign banks. Significantly, before the second world war, there was no case of a native bank developing into a large, Western-style institution. The several Chinese-owned Western-style banks in existence by 1941 were established as such by Chinese merchants. Of these the most important were the Bank of Canton, established in 1912, and the Bank of East Asia, set up in 1919.

Other than Ordinances governing the issue of banknotes, there was no banking legislation in Hong Kong before the second world war. A proposal was considered in the early 1930s which would have required banks to hold minimum cash reserves (of 10 per cent on demand deposits and 3 per cent on time deposits). In 1935 a British Treasury official visited the Colony to inquire into the advisability of drafting a Banking Ordinance to protect deposits entrusted with the native banks. But 'the unanimous view of Government, including the Attorney-General, the Crown Solicitor and the Treasurer was against any attempt at legislation which could not in any case be effective and which, in the case of friendly deposits with shops, etc. would not be desirable'. No Banking Ordinance was passed in Hong Kong until 1948.

(b) The Banks' Exchange Business. Until the second world war, the commercial banks operating in Hong Kong were 'pre-eminently exchange banks'. Local banking business was of little importance, and conducted mainly by the Hong Kong Bank and the native banks. Of

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1 Hong Kong Currency..., p.30.
2 J.R. Jones, op. cit.
3 Report of the Commission Appointed by His Excellency the Governor of Hong Kong to Enquire into the Causes and Effects of the Present Trade Depression in Hong Kong, July 1934 to February 1935, Hong Kong Government Printer, p.12.
course, the way in which exchange business was carried out changed significantly over the period.

The operation of an Eastern exchange bank in the 1860s is outlined in some detail in a paper by Leighton Boyce. Usually, each branch was allotted a certain sum as working capital which could be employed in exchange or local business at the discretion of the local manager. Each branch was also allowed a line of credit on London, on which it could draw sterling drafts so long as cover, in the form of equivalent remittances, was provided within three months. The branches were expected also to attract local deposits. Longer term deposits could be employed safely and profitably in exchange business.

In the 1850s and 1860s, Eastern trade was usually financed in sterling bills drawn on the large merchant houses or banks in London. Bills were commonly renewed until the proceeds of the goods were returned from the East by the consignee's purchase of a bank draft on London. Advances under bills of exchange on exports from the East were paid out locally in silver and later recouped by the Bank in sterling on London, at the current rate of exchange. The whole exchange risk was thus carried by the Eastern merchant. In this period, a usance of six months on bills was common. An attempt in 1866 by the London based banks to shorten usance to four months failed because of the opposition of the Hongkong Bank.

The volume of Eastern trade increased considerably after additional Chinese ports were opened by the Treaty of Tientsin in 1858 and the 1860 Convention of Peking. About the same time there was an expansion of trade from other Eastern ports. The East was

2 This discussion draws on ibid., and Compton Mackenzie, op. cit., Chapter V.
3 See Compton Mackenzie, op. cit., pp.64-5.
4 Japanese trade was opened to the West in 1853; in 1855 two important ports on the Philippines were opened and trade with Siam was established; additional Chinese ports were opened to Western merchants after the Tientsin Treaties of 1858 to 1860.
becoming 'a distinct economic region in the world economy' \(^1\) and 'the somewhat simple pattern of the China trade had by 1865 become much more complex and was gradually becoming part of a wider network which required a new system of finance to provide for the more complicated trade settlements and to ease the flow of payments'.\(^2\) The establishment of a telegraphic link with Europe in 1871 encouraged and permitted Eastern merchants to trade more regularly on a commission basis and brought about a further, and for a while excessive, growth of commerce. Many of the small trading firms established to benefit from the new trading conditions were heavily dependent on the banks for funds.

After the connection of the telegraph the Eastern banks were in a position to sell telegraphic transfer on London and India, and merchants in China took to remitting funds to London by TT rather than bank drafts and bills. These transfers were less profitable to the banks, but the institutions benefited from the rapid expansion of trade and the scope presented for arbitrage operations which followed the connection of the telegraph. The telegraph also brought the Eastern branches of the London-based banks into closer contact with their head offices.

More significant was the fall in silver prices.

The silver crisis placed the Eastern banks in a situation without parallel. The depreciation of a note currency was a phenomenon well understood by financial experts, but for the legal and undebased coinage of a large group of countries to fall in value from first to last some thirty per cent to forty per cent was outside the experience of any expert.\(^3\)

The several Eastern banks reacted differently to the depreciation of silver. Those banks whose capital was raised in sterling could no longer safely employ their capital in Eastern exchange operations. The Chartered Bank at first regularly revalued its silver assets. In a little over a decade to 1885 the capital of the Bank's silver-using branches was written down by one-quarter.\(^4\)

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1 J.R. Jones, op. cit.
2 Ibid.
Bank then withdrew virtually the whole of its silver capital. It also attempted to avoid as far as possible forward contracts in silver and to keep all silver commitments - including its Hong Kong banknote issue - within very narrow limits. The Bank's Eastern branches became almost wholly dependent for funds on local deposits. The Oriental Bank, the Chartered Mercantile Bank and Comptoir d'Escompte sought to make provision for the depreciation of their silver assets, but the continued fall in silver prices exhausted their reserves. The Oriental was wound up; the Chartered Mercantile and the Comptoir were reconstructed.

The Hongkong Bank was better placed to meet the problems caused by the fall in silver prices. First, as the Bank's capital was raised in silver, depreciation could not cause any 'loss' of capital. (Of course, the sterling value of the Bank's capital was affected by the fall in silver prices, but the institution did not face insolvency as a result.) Secondly, and in the longer period of more importance, the Bank was better provided with local (i.e., silver) deposits than its competitors. All the imperial banks were readily able to attract deposits in London and Scotland, and through these banks large sums were invested overseas from Britain in the nineteenth century. But the fall in silver prices discouraged the use of these funds in Eastern trade. On the basis of local deposits the Hongkong Bank continued to expand its Eastern business, at a time when other exchange banks were restricting their activities in the areas.

The fluctuating exchange rates between silver and gold currencies made inadequate the earlier methods of financing Eastern trade, which had placed the risk of exchange rate variations on the Eastern merchant. As a result,

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1 The Hongkong Bank was particularly well provided with deposits in China where it held, at various times, the British military chest, the account of the Inspector General of the Chinese custom, the Chinese customs revenue, and official deposits of the Chinese Government, from which much of China's foreign debt was serviced.
drafts on the East were generally made payable in the currency concerned, such as dollars or taels, and the exchange rate fixed at the current London quotation. The merchant in the East was, in this way, freed from exchange risk; and the eastern exchange bank concerned in such a transaction could protect itself from exchange loss by an immediate purchase of sterling in China by either present or future delivery. Thus the old sterling loan method of financing shipments was largely superseded by the currency draft; an example of how banking technique was successfully adapted to meet the serious difficulties imposed by the silver crisis.¹

Eastern merchants operating without firm orders, however, were unable to gain cover from the banks, and had to continue carrying the exchange risk. The exchange banks naturally sought to match their bill holdings, but complete cover could not always be arranged. In such cases, silver was shipped.²

Throughout the period of the entrepot economy the foreign banks virtually constituted the foreign exchange market of Hong Kong. Until 1935 there was no official restriction or control over this market. Exchange rates varied with the gold price of silver and the demand and supply of local currency. From an early date, as an official Report has recorded, Hong Kong had 'a very active exchange market, particularly with London and Shanghai, and through its highly developed banking system [could] readily convert its dollars into any other well-known currency'.³

The exchange banks were also the main institutions through which remittances from overseas Chinese were transferred to China. Remittances from Chinese living in South East Asia were usually paid into small 'letter shops' which would purchase exchange from one of the foreign banks.⁴ The foreign bank would then transfer the remittances into the interior through one of the native banks. By the 1930s the flow of remittances through the Colony was thought to have been between £25 million and £40 million a year.⁵

2 See evidence from the Eastern banks at the United Kingdom Gold and Silver Commission, 1887, Questions 4998 to 5067.
3 Hong Kong Currency..., p.27. Ibid.
4 Ibid., p.31; D.M. Kenrick, op. cit., p.170.
(c) **Non-exchange Business.** The exchange banks were from an early stage called on to provide short-term credits to finance the packaging and storage of goods and the sale of goods to Chinese traders.\(^1\) This business was seen as a useful one for funds not committed in exchange transactions. One problem was that the loans often required branch managers to 'shut an eye' to the 'cautious instructions of Head Office'.\(^2\) Loans to Chinese businesses were made on the recommendation of, and guaranteed by, the banks' compradores.\(^3\)

Given the structure of the Hong Kong economy in this period, there was relatively little demand for loans for purposes not directly connected with foreign trade. Wharf, godown, shipping and insurance services were mostly provided by agency houses using their own sources of funds. But, from the time it was established, the Hongkong Bank advanced funds to local enterprises. In its first year the Bank financed the Union Dock Co. and, a little later, the Sugar Refinery and Distillery and the Pier and Godown Co.\(^4\) The Bank also helped to finance the establishment of coastal shipping services, Taikoo Sugar Refinery and Taikoo Docks.\(^5\)

The acceptance of local deposits was a sought after and competitive business of the exchange banks, especially during the period of falling silver prices. But, for some time, local deposits were difficult to attract: the Chinese did not, at first, deposit funds with the foreign banks; agency houses used excess cash within their own businesses or held it on account with their comprador; and Western merchants usually deposited surplus funds with their

\(^1\) There is a brief description of this business in G.C. Allen and A.O. Donnithorne, *Western Enterprise in Far Eastern Economic Development - China and Japan*, Chapter VI.

\(^2\) Compton Mackenzie, op. cit., p.66.

\(^3\) Ibid., pp.65-6.

\(^4\) J.R. Jones, op. cit. Jones claims that the loan to the refinery was the 'first attempt by any foreign bank to finance the development of any industrial enterprise in Hong Kong or China'.

\(^5\) Ibid.
compradores. Local deposits became significant in the latter part of the nineteenth century; these totalled $7.1 million in 1879, $38.9 million in 1889, $135 million in 1926 and $285 million in early 1931.\(^1\) The Hongkong Bank held the greater share of these deposits. The foreign banks in Hong Kong were also depositories of the savings of merchants and officials in China, and periods of unrest in China were usually followed by an inflow of deposits into the Colony's banks.\(^2\)

There were suggestions in the early 1880s that a Post Office Saving Bank be set up. A Bill authorising the establishment of this bank was introduced into the Legislative Council but, instead, an offer from the Hongkong Bank to operate a saving bank was accepted. Because of the transitory nature of the population and the continuing popularity of the native banks, deposits grew slowly. In 1939 the Bank had 23,000 accounts, containing $15.5 million.

**The Agency Houses and Other Commercial Institutions**

Competition from the exchange banks and the increasing complexity of the Colony's trading system soon ended the dominant role played by the agency houses in the Colony's commercial and financial system. Several of the older houses failed during commercial crises, including Dent and Co., which collapsed in 1867, and Russell and Co., in 1892. But others, notably Jardine Matheson, built up a large capital and an extensive representation in the Treaty Ports. Gradually, these businesses became less dependent on the opium trade. The new merchant businesses set up after the connection of the telegraphic link with Europe usually had smaller and less diversified operations than the long established houses. Several agency houses moved to Hong Kong after their establishment in China,

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including, in 1870, Butterfield and Swire. From about 1880 a number of Chinese businesses, trading between Hong Kong and the interior, and with the overseas Chinese communities, were formed.

The activities of the merchant houses changed significantly in the 1870s and 1880s, and then remained substantially unchanged until after the second world war. The installation of the telegraph offered greater scope for trading on a commission basis – there was speedy communication with buyers, regular market information, and less need to carry stock. The more competitive conditions which resulted induced several of the larger houses to make the decision 'not quickly or lightly reached' to cease trading on their own account. These businesses then became almost exclusively concerned with acting as local agents for foreign shipping, financial and commercial enterprises, and as managing agents for businesses they themselves established. The rate of expansion of the houses became less spectacular as a result, but the businesses were more strongly placed to survive the periodic commercial crises experienced.

In the 1870s Jardine Matheson and the Swire group established local shipping services with themselves as managing agents. These lines, respectively Indo China Steam Navigation and China Navigation, were long the dominant shipping enterprises in the Chinese coastal and river trade. Jardine Matheson was also associated with the establishment of Hong Kong Fire Insurance in 1866, Hong Kong and Kowloon Wharf and Godown in 1886, and later, 'Star' Ferry and Hong Kong Tramways. Butterfield and Swire set up Taikoo Sugar in 1881 and Taikoo Docks. In their investment in these enterprises the merchant houses acted virtually as private bankers.

1 'A Hundred Years of Taikoo', SCMP, 5 January 1967.
2 Ibid.
3 These brief comments support the assessment of M. Greenburg, op. cit., p.174: 'The Agency House was...a many-sided edifice. It was a structure well able to adapt itself to every line of growth, every avenue of remuneration which the China trade offered; and yet capable of bearing the stress of the extreme tension which the "opening" of China was to involve.'
A Companies Ordinance was introduced in Hong Kong in 1865. Public transactions in shares, undertaken from an early stage, were formalised in 1891 with the establishment of 'The Association of Stockbrokers in Hong Kong'. A second exchange was organised in 1921 as the 'Hong Kong Sharebrokers' Association'. The two exchanges were merged in 1947.

The prewar public share list included a range of firms connected with the entrepot economy - mainly banking, insurance, shipping and wharf companies - a rope factory, electricity companies, cement works, and several land and investment companies. In the share boom of the late 1880s, a number of companies engaging in mining and plantation activities in South East Asia were floated, but many of these were later wound up. The market value of shares listed on the two stock exchanges rose from $40 million in 1879 and $64 million in 1889 to $150 million in 1935.\(^1\)

Marine insurance was for some time the main insurance business transacted. Several of the agency houses formed their own insurance companies. In some cases these were later launched as separate concerns. On occasion, refusal to insure was used to keep out trading competitors.\(^2\) The merchant houses were also the local agents for many European insurance companies. Until the Chinese Government restricted the activities of foreign insurance companies in 1935, the Hong Kong insurance companies wrote considerable business in China.

Most utility companies were formed with British capital. Some, for example gas (1861) and telephones (1887), were subsidiaries of companies providing similar services in Britain. The locally-based British agency houses set up several utility companies, including the 'Star'Ferry and Hong Kong Tramways (1904). In other utilities,

\(^1\) Sources: 'Extracts from a Report...by Sir S. William Des Voeux...', p.153, and Report of the Committee...Appointed to Enquire into the Causes and Effects of the Present Trade Depression..., p.91.

\(^2\) N.A. Rigg, 'Marine Insurance in Hong Kong', The Hong Kong Manager, March/April 1966, p.24.
capital was subscribed by British residents and merchants living and trading in the East - for example the electricity supply companies (1889 and 1903) and the Peak tramway (1888). Several of these concerns became public companies, listed on the local stock exchanges. The water supply, Post Office and railway were provided by the Government. Chinese-owned businesses established the motor bus services and one of the two ferry services.

Unfortunately, very little information is available on the establishment and growth of Chinese businesses in Hong Kong. Chinese traders moved to Hong Kong soon after the Colony's establishment. The continuing restrictions on travel in China by foreigners and the difficulties of the Chinese language and dialects gave the Hong Kong Chinese merchants an important role to play as middlemen. They sold produce from all parts of China to the foreign agency houses and purchased in Hong Kong Western goods for sale to dealers and shopkeepers in the interior.

The rapid expansion of the overseas Chinese communities after the gold rushes of North America and Australia, by creating a demand for Chinese-style goods which the established merchant houses could not adequately service, encouraged the growth of Chinese trading businesses in Hong Kong. By 1876 there were 215 larger Chinese trading enterprises and 287 traders; in 1881 these had increased to 395 and 2,377 respectively, and the Governor reported that 'Chinese warehouses, shops and temporary residences are becoming more numerous every year'. About the same time, many small manufacturing businesses were set up by immigrant Chinese, producing a variety of processed foods and Chinese-style goods. The economic success of overseas Chinese families led to the establishment in Hong Kong of several large trading firms, including Wing On, Sincere, and Sun, all of which were financed by Chinese living in

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Australia and New Zealand. The usual form of Chinese business enterprise was for a long time the family partnership, but from the turn of the century larger Chinese-owned businesses came regularly to be organised on similar lines to Western enterprises.

The influx of capital and immigrants from China after the Revolution of 1911 further increased the number of Chinese businesses in the Colony. At the same time, there was a considerable investment in Hong Kong real estate. The inflow of funds continued in the following two decades. A Government Committee estimated that by 1934 $50 million were invested in Chinese-owned factories and industry in Hong Kong.

**Government Finance**

The public finance system of the entrepot economy was a simple one, modelled on, and appropriate to, the needs of a Colony founded 'not with a view to colonisation, but for diplomatic, commercial and military purposes'. The Government accepted responsibility for law, order and a sound administration and a minimum of public works, and acknowledged that it should finance these services with

2. In 1880 or 1881 the Chamber of Commerce proposed that the Government require the registration of all sleeping partners in Chinese houses or businesses. The Chinese community pointed out that the Chinese system of trading would be completely upset by it - that there is an extraordinary net-work of investments in this Colony, as in any other community of Chinese, and that it would interfere seriously with Chinese trade, and, in fact, tend to prevent the influx of Chinese into the Colony'. 'Extracts from a speech by the Governor, Sir John Pope Hennessy...', p.149. The suggestion was not adopted.
4. Lord Stanley to Sir Henry Pottinger, 3 June 1848, quoted in G.B. Endacott, Government and People of Hong Kong, 1841-1962, Hong Kong University Press, 1964, p.v. Report of the Committee, Appointed to Enquire into the Causes and Effects of the Present Trade Depression, p.87, noted that the Hong Kong Government 'has been content to provide security and sound administration and, for the rest, to adopt a laissez faire attitude towards trade and industry generally'. Exceptionally, in 1925 the Government lent $15.6 million to merchants and traders to help them meet the disruptions caused by the boycott of Hong Kong.
as light a burden of taxes and charges as possible. The Government's role in the economy was strictly a laissez faire one, and the Colony's finances in this period are an almost classic example of the prewar attitudes to public finance in the British colonial empire.  

The local Government exercised little initiative in financial matters. The annual estimates and amendments to them, and all proposals to alter the revenue laws or raise a Government loan, had first to be approved by the Secretary of State, and recommendations of the Colonial Government were not infrequently varied or refused. The British Government required Hong Kong - as it did all colonies other than the smallest and poorest - to be financially independent from an early stage. The British contribution to the cost of the administration ceased in 1854. Further, from 1864 Hong Kong was charged with a part of the cost of the military garrison stationed there. There was frequent disagreement on the share of the defence costs which the local Government had to meet. The actual division appears to have been determined more by the state of the Hong Kong finances than on any other basis.

There was common acceptance that the Colony had a very limited tax capacity: with no local mining, agriculture or industry to carry the tax burden, any but a very low level of taxes and charges would drive entrepot trade to other ports on the China coast. Hong Kong was described for taxable purposes as 'merely one large city which lives by its entrepot trade... it seems probable that the taxes are about as heavy as is expedient in a trade entrepot'.

---

2 See, for example, G.B. Endacott, Government and People..., pp.115, 171.
3 The U.K. Government made small grants to the Hong Kong Government in 1910 and 1911 to compensate it for the decrease in opium revenue, which resulted from the Imperial Government's decision to discourage use of the drug.
4 Compare with L.A. Mills, op. cit., p.430.
5 Ibid., pp.422-3.
Equally strong was the attitude that trade taxes were inappropriate. A petition of merchants and traders, for example, submitted that the Colony's prosperity 'can best be maintained by the unremitting exertions and self-sacrifice of your petitioners and the valuable cooperation and support of the Chinese and only by the continuance of Hong Kong as a free port'. Much later, a Government-established Committee stated 'it is obvious that we cannot recommend any alteration in the free port status of the Colony'. Income taxes were considered inappropriate because of the 'difficulties of collection and of obtaining correct returns'. Direct taxes on income were introduced first in 1940, as a temporary wartime measure. The structure of Government revenue over the period is outlined in Table 2.1.

Rates ('assessed taxes') were first introduced in 1843. Their continued importance as a mainstay of Government revenue was seen as appropriate given the municipal character of much of the public expenditure. Stamp duties were also introduced in 1843. The opium monopoly (or 'farm') was first sold in 1845. In the early 1900s it contributed about one-third of the Government's revenue. Later, the official policy of discouraging opium consumption reduced this source of revenue to insignificance. All land was retained as Crown land, and receipts from the auction of leases and crown rents were, throughout the period, an important, though variable, source of revenue. Import duties were first levied on liquor in 1911, and later on tobacco. By the late 1930s these duties provided a quarter of the public revenue.

2 Report of the Committee, Appointed to Enquire into the Causes and Effects of the Present Trade Depression, p.73.  
3 Ibid., p.95.  
4 See Report of the War Revenue Committee, Hong Kong Government Printer, 1940.  
5 For example, Government receipts from the sale of land leases increased from 1.6 per cent of revenue in 1919 to 14.2 per cent of revenue in 1923.
Table 2.1
GOVERNMENT REVENUE AND EXPENDITURE, PERCENTAGE DISTRIBUTION
Selected Years 1880 to 1937

<table>
<thead>
<tr>
<th>Revenue</th>
<th>1880</th>
<th>1890</th>
<th>1900</th>
<th>1911</th>
<th>1920</th>
<th>1930</th>
<th>1937</th>
</tr>
</thead>
<tbody>
<tr>
<td>Duties</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>10</td>
<td>16</td>
<td>23</td>
<td></td>
</tr>
<tr>
<td>Rates</td>
<td>20</td>
<td>21</td>
<td>14</td>
<td>19</td>
<td>15</td>
<td>13</td>
<td>n.a.</td>
</tr>
<tr>
<td>Stamp duty</td>
<td>12</td>
<td>9</td>
<td>11</td>
<td>11</td>
<td>9</td>
<td>9</td>
<td>n.a.</td>
</tr>
<tr>
<td>Opium monopoly</td>
<td>19</td>
<td>24</td>
<td>9</td>
<td>16</td>
<td>29</td>
<td>3</td>
<td>n.a.</td>
</tr>
<tr>
<td>Rent of Government land and property</td>
<td>18</td>
<td>15</td>
<td>12</td>
<td>11</td>
<td>7</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>Land sales</td>
<td>1)</td>
<td>35</td>
<td>19</td>
<td>4</td>
<td>10</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>Other (fees, licences, etc.)</td>
<td>30</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Expenditure</th>
<th>1.1</th>
<th>2.0</th>
<th>4.2</th>
<th>7.5</th>
<th>14.7</th>
<th>27.8</th>
<th>33.2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public debt</td>
<td>-</td>
<td>5</td>
<td>4</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>4</td>
</tr>
<tr>
<td>Pensions</td>
<td>3</td>
<td>3</td>
<td>5</td>
<td>4</td>
<td>2</td>
<td>4</td>
<td>8</td>
</tr>
<tr>
<td>Education</td>
<td>3</td>
<td>4</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>Medical</td>
<td>4</td>
<td>4</td>
<td>3</td>
<td>3</td>
<td>2</td>
<td>4</td>
<td>6</td>
</tr>
<tr>
<td>Public works department and recurrent</td>
<td>37</td>
<td>5</td>
<td>6</td>
<td>11</td>
<td>9</td>
<td>13</td>
<td>13</td>
</tr>
<tr>
<td>Public works, non-recurrent</td>
<td>21</td>
<td>13</td>
<td>11</td>
<td>18</td>
<td>10</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>Military</td>
<td>11</td>
<td>7</td>
<td>18</td>
<td>20</td>
<td>19</td>
<td>14</td>
<td>17</td>
</tr>
<tr>
<td>Other</td>
<td>58</td>
<td>51</td>
<td>49</td>
<td>44</td>
<td>41</td>
<td>43</td>
<td>41</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: Hong Kong Blue Book, various numbers.

The pattern of Government expenditure varied relatively little over the period (see Table 2.1). A large part, usually one-quarter to one-fifth, of Government spending was allocated to administration. The defence contribution was regularly one-sixth to one-fifth of Government expenditure. Public works spending - on roads, reclamations, drainage, water storage, and on a smaller scale, schools and hospitals - tended to vary with the Colony's prosperity, and was especially large in the boom periods of the 1880s and 1920s. The departmental structure of the Government administration is outlined in L.A. Mills, op. cit., Chapter XII and G.B. Endacott, Government and People... Chapter X.

Many reclamations were carried out and financed by private businesses. The largest prewar reclamation was the Kowloon Bay project, organised by a Chinese syndicate. Chiu Tze Nang, op. cit., pp.96-7.

There are several reasons for the relatively small spending on social services. One, of course, was the Government's laissez-faire outlook. Hong Kong was established simply as a trading colony, and had virtually no indigenous population. Immigrants were attracted to the Colony as a place in which to trade and reside in conditions of peace and security. In these circumstances, the Government probably accepted even less responsibility to provide health and education services than most colonial governments of the period. The migratory nature of the population and the freedom with which Chinese could move into and out of Hong Kong further discouraged Government spending on social services: it was believed that unless the Government took into account 'the conditions which apply in the rest of the economic area of which Hong Kong is a part' when determining expenditure on health and education, further migration would take place and prevent any permanent improvement to the social services. It was claimed, too, that the 'small and inelastic revenue' severely restricted Government responsibility in these fields.

Throughout the period, the public debt was a very light one. The Government's policy was that of 'refusing to borrow save in a few exceptional cases and of incurring only as much expenditure as it could pay out of current revenue'. The earliest Government borrowing was a small loan granted by the Hongkong Bank in 1866. A sterling loan of £200,000 was raised in 1886 to finance public works. A similar loan was raised in 1893, partly to finance further public works and partly to redeem the earlier debt. A public works loan of $4.9 million at 6 per cent was raised locally in 1927. In 1934 a further local issue of securities was arranged, for $14 million at 3½ per cent. In 1938 the public debt amounted to only

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1 Report of the Committee, Appointed to Enquire into the Causes and Effects of the Present Trade Depression, p.74. For example, it was claimed that 'a considerable part of the population of Kwangtung Province' made use of Hong Kong hospitals. L.A. Mills, op. cit., p.385.

$16.6 million (the equivalent of less than six months' revenue). This small reliance on borrowing meant, of course, that most public works were financed from current revenue. There was occasional criticism of this policy from merchant interests.  

The trend in Government revenue over the period 1861 to 1940 is shown in Chart 2.2. The level of revenue, of course, varied with the Colony's prosperity, but fluctuations were milder than would have been the case had income and trade taxes been more important. As it was the Government's intention to build up a liquid reserve from which it could finance continuing commitments, such as pensions, in the event of a fall in revenue, public expenditure was usually kept a little below Government receipts. Balance was maintained in periods of slump by 'making the appropriation for Public Works Extraordinary disproportionately small' and by retrenchments in the civil services. In the 1930s depression, these adjustments were insufficient and the Government was forced to find additional revenue by increasing rates (from 13 to 17 per cent) and by introducing taxes on motor fuel and amusements.

The variation in silver prices affected Government expenditure more than revenue. As a significant portion of Government salary and pension payments had a fixed sterling value, the burden of these payments increased as the exchange rate depreciated. Similarly, but of less importance, the cost of servicing the public debt increased.

There were, then, several important developments in the structure of the financial system over the period of the entrepot economy. The agency houses lost their early dominant position and varied their operations quite fundamentally in the 1870s. The exchange banks were firmly established by the late 1860s. The

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1 See Hong Kong General Chamber of Commerce, History 1861-1961, p.32.
2 Report of the Committee...Appointed to Enquire into the Causes and Effects of the Present Trade Depression..., p.94.
3 Retrenchment committees were established in 1893 and 1931.
Chart 2.2  Government Revenue, 1861 to 1940
Chinese-owned financial enterprises which emerged from the 1880s had a complementary rather than a competitive relationship with the Western institutions. The currency system for a long time followed that of China, but there were some developments in the method of issuing banknotes. These several changes were associated with the increased volume of trade and the growing complexity of the trade system.

The financial system was directed towards servicing the entrepot trade. The banks were primarily exchange banks. The considerable capital amassed by the several leading agency houses was used further to expand the entrepot trade and to establish services, such as insurance and dockyards, connected with this trade. The Government accepted the necessity of a low level of taxes and charges. The financial system gave the Colony a close connection with Europe, South East Asia and especially China. Because of the undeveloped financial system of China, many of the financial facilities of Hong Kong - banknotes, exchange banking, insurance services, etc. - had to be provided for a much wider area than the Colony itself.

It is too simple to suggest that the financial system was altogether a passive agent in the development of the entrepot port. The availability in Hong Kong of a range of financial and commercial services and the light burden of Government taxes certainly attracted additional trade to the Colony. Entrepot trade, possibly more than other economic activities, is quickly attracted to an area which provides the supporting services and facilities. The currency disruptions caused by the silver price variations and the banknote premium complicated the Colony's role as an entrepot; in the former case, though, the fact that the most important bank in the Colony was itself capitalised in silver, considerably reduced the difficulties.
Chapter 3

THE CURRENCY SYSTEM AND THE FOREIGN EXCHANGE MARKETS

The Establishment of the Present Currency System

The development of the currency system until 1935 was outlined in the previous Chapter. The currency at the start of 1935 was silver-based, and the Colony's close commercial relationship with China had prevented the adoption of any scheme for currency reform while Chinese currency remained linked with silver. As a result, currency development in Hong Kong had not followed that of the majority of British Colonies, where, under what is usually termed the currency board system or the colonial sterling exchange standard, colonial currencies were issued exclusively, and at a fixed exchange rate, against the sale of sterling to the currency authorities, and a 100 per cent sterling reserve was held against the note and coin issue to ensure that the colonial currency remained fully convertible into sterling.

The final break with silver-based currencies was forced on both China and Hong Kong by the enormous outflow of silver coin and bullion which took place after 1932, especially in 1934 and 1935 when the United States Silver Purchase Act caused an increase in the price of silver on world markets. Uncertainty over the future price of silver led to heavy speculation, and in 1935 the sterling-Hong Kong dollar rate rose from 1/8½ in January to 2/6 in April.

1 The two aspects of the financial system are discussed in one chapter because, under the type of currency mechanism employed, the issue of currency and its external convertibility are interrelated.

2 There is a very large literature on the topic of the colonial sterling exchange standard. The more important references are given in E. Nevin, Capital Funds in Underdeveloped Countries, London: Macmillan, 1963, p.5.
and fell to a little over 1/3 in November. These fluctuations adversely affected trade and exchange with countries whose currencies were not silver-based, but it was a more immediate local problem - the severe shortage of currency which resulted from the export of silver coin and bullion when world silver prices were high - which led to the final abandonment of the silver standard both in China and Hong Kong. In November 1935 the Chinese Government announced that a managed paper currency supported by an exchange fund was to be established. Similar changes were announced in Hong Kong a few days later.

In the following three years, the managed paper currency in Hong Kong was superseded by a de facto colonial sterling exchange standard, which gave the Hong Kong dollar a fixed sterling value, and automatic convertibility into sterling. As much of the present currency system results from Ordinances introduced and agreements made between 1935 and 1939, the currency developments of this period are discussed in some detail. The currency reform took place in three stages: the first overcame the shortage of one dollar currency; in the second stage banknotes were declared legal tender and an Exchange Fund was established to regulate the backing to this banknote issue; and in the third period the currency system was made to operate on largely automatic lines.

The first measures were intended simply to meet the problem of insufficient currency. Exports of silver coin and bullion were prohibited, and the Government issued a one dollar note which was made unlimited legal tender. The Ordinance established a 'Dollar Note Security Fund' in which the backing to the one dollar note issue shall be held on deposit at one or more banks in the Colony and shall be available for withdrawal from circulation of such portion of the issue of the said currency notes as the Treasurer may from time to time deem it desirable to withdraw; provided that a portion of the fund may lie temporarily invested at the discretion of the Treasurer.¹

¹ Dollar Currency Notes Ordinance, 1935, s.4.
A further Ordinance required the public to surrender its holdings of silver coin and bullion. Later, silver coins were demonetised.

The second stage of the currency reform began in December 1935 when the 'lawfully issued' banknotes of the three note issuing banks were declared legal tender for unlimited amounts. There was no difficulty, of course, in gaining public acceptance of banknotes as legal tender - the note issues of the three banks, the Hongkong Bank, the Chartered Bank and the Mercantile Bank, had been readily accepted by the public for some time, even in preference to silver coin when the latter was legal tender.

The Government at the same time established an 'Exchange Fund', under the control of the Colonial Treasurer, to regulate the external value of the banknote issue. The note issuing banks were required to surrender their silver coin and bullion holdings to the Exchange Fund in return for 'certificates of indebtedness' (a non-interest-bearing liability of the Exchange Fund, denominated in Hong Kong dollars) at a value determined by the Exchange Fund. The three banks were authorised to continue issuing banknotes under the same provisions as before - i.e. in accordance with their relevant Charter or Ordinance - except that certificates of indebtedness were to be held instead of silver. (The regulations governing the Banks' note issue are summarised later; the effect of the new Ordinance was basically that the banks could issue further banknotes so long as they first obtained the equivalent value of certificates of indebtedness from the Exchange Fund.) The Fund was

1 Banknotes were not declared legal tender for the bank of issue. Thus the shareholders of the Hongkong Bank, who until 1957 carried an unlimited liability for that Bank's note issue, could have been called on to meet their liability for the Bank's outstanding banknotes in the note issue of the Chartered and Mercantile Banks and in Government-issued currency.

2 See above, pp.30-2.

3 An Exchange Fund Advisory Committee was established to assist the Treasurer in the administration of the Fund. In practice, the Committee has consisted of the Colonial Treasurer (since 1950 the Financial Secretary) as Chairman, and a senior member of each of the note issuing banks.
authorised to issue additional certificates of indebtedness to the
note issuing banks against foreign exchange, precious metals and
Hong Kong bank deposits. There was no statutory requirement that
certificates of indebtedness, and thus the banknote issue, be
backed even to a minimum proportion by foreign exchange. The
Exchange Fund was given the right to fix the exchange rate at
which it sold certificates of indebtedness to the banks in exchange
for foreign currencies or precious metals, and the Fund was em­
powered to borrow from the Colony's general revenue balance and the
public to provide it with, respectively, sterling and local currency.
There was no requirement that the Fund buy back its certificates of
indebtedness in any particular foreign currency or at a fixed value,
and the Treasurer was authorised to call in certificates of indebted-
ness for redemption at his discretion.

The powers given to the Exchange Fund suggest the Government
saw the need for an exchange equalisation fund which would operate
in the Colony's foreign exchange market to regulate the exchange
rate of the Hong Kong dollar. The Fund 'was fully empowered to
act as...an equalisation fund. It did not do so, but the Colonial
authorities were uncertain as to the course of events, and were
prepared for any pressure on the exchanges'.

One of the first acts of the Exchange Fund was to sell in
London, through the Hongkong Bank, the silver it acquired from the
note issuing banks and the public. The proceeds were invested in
sterling deposits and securities of varying degrees of liquidity,
and, because a sizeable profit (of about £1 million) was earned on
the transactions, the Exchange Fund had from a very early date a
surplus of sterling assets over its certificates of indebtedness
liabilities. With these sterling balances, the Exchange Fund was

1 It is for this reason that the title 'Exchange Fund' was adopted
and not, as was more common in the Colonies, 'Currency Fund'.
2 F.H.H. King, Money in British East Asia, Colonial Research Pub­
in one or two aspects, this publication rewards careful study.
without difficulty able to maintain a stable exchange value for the
Hong Kong dollar from an early stage. The Fund did not need to
exercise its right to borrow from the Colony's reserves or make a
public issue of securities. The assets and liabilities of the
Exchange Fund for the period 1937 to 1940, and the Hong Kong dollar-
sterling exchange rate, 1935 to 1940, are shown in Table 3.1 and
3.2. At first, there was also a stable exchange rate between the
Hong Kong dollar and the Chinese yuan, but after 1938 the Sino-
Japanese war resulted in a progressively weaker Chinese currency.

Table 3.1
EXCHANGE FUND: ASSETS AND LIABILITIES, 1937 TO 1940
($ million)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Certificates of indebtedness</td>
<td>153</td>
<td>182</td>
<td>191</td>
<td>176</td>
<td>182</td>
</tr>
<tr>
<td>Sterling securities</td>
<td>106</td>
<td>125</td>
<td>152</td>
<td>147</td>
<td>151</td>
</tr>
<tr>
<td>Cash and deposit at call in London</td>
<td>61</td>
<td>72</td>
<td>56</td>
<td>53</td>
<td>58</td>
</tr>
<tr>
<td>Silver</td>
<td>2</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>169</td>
<td>197</td>
<td>209</td>
<td>200</td>
<td>210</td>
</tr>
</tbody>
</table>


Table 3.2
HONG KONG DOLLAR-STERLING EXCHANGE RATE, 1935 TO 1940
(pence per Hong Kong dollar)

<table>
<thead>
<tr>
<th></th>
<th>1935</th>
<th>1936</th>
<th>1937</th>
<th>1938</th>
<th>1939</th>
<th>1940</th>
</tr>
</thead>
<tbody>
<tr>
<td>High</td>
<td>2/6</td>
<td>1/29</td>
<td>1/27</td>
<td>1/27</td>
<td>1/27</td>
<td>1/27</td>
</tr>
<tr>
<td>Low</td>
<td>1/32</td>
<td>1/32</td>
<td>1/27</td>
<td>1/27</td>
<td>1/27</td>
<td>1/27</td>
</tr>
</tbody>
</table>

Source: as for Table 3.1 above, Appendix 14.

The final divorce of the two currencies, both in value and method of
issue, occurred in 1939, and passed virtually unnoticed, suggesting
that it may not have been necessary for the Colony to have adhered
so long to the practice of basing its currency arrangements on those
followed in China.
Although it was intended that 'any profit or loss arising from the operation of the Fund will be for the Government's account',\(^1\) there was no provision in the Ordinance for automatically transferring to the Government's general revenue or to any other use the excess of assets over certificates of indebtedness. From the profit received on the initial sale of silver and from the retention of interest earnings, a surplus in the Exchange Fund was quickly built up. A contribution of £200,000 was made to British war expenditure in 1940 from the accumulated surplus.

A brief account of the regulations governing the note issue of the three banks was given in the previous Chapter. It is useful to show how these controls were affected by the requirement that certificates of indebtedness and not silver were to be held against the note issue.

The Hongkong Bank's note issue was divided into an 'authorised' and 'excess' issue. The former was limited to $30 million, against which the Bank had to hold approved sterling securities or certificates of indebtedness to the value of $23.33 million (thus a fiduciary issue of $6.67 million was permitted). The excess note issue - any issue above $30 million - had to be fully backed by certificates of indebtedness. The Bank's note issue in 1935 already considerably exceeded its authorised issue. After the 1935 currency reform the first $8 million of the banknote issue of the Chartered Bank had to be one-third backed with sterling securities or certificates of indebtedness (the remaining two-thirds could be issued as fiduciary currency). The banknote issue from $8 million to $30 million had to be fully backed by sterling securities or certificates of indebtedness, and certificates of indebtedness were required against any note issue in excess of $30 million. However, one-third of the total currency backing had to be in the form of certificates of indebtedness. The Mercantile Bank was permitted

to issue notes up to the value of its paid up capital, provided these were backed either 105 per cent by sterling securities or 100 per cent by certificates of indebtedness or some combination of these two. All three banks had to pay printing expenses and a small stamp duty on that part of their note issue not secured by certificates of indebtedness.

In the third stage of the currency reform, the Exchange Fund virtually surrendered its potential for independent action, and the Hong Kong currency system became more nearly a conventional colonial sterling exchange standard. In an 'informal but strictly honoured arrangement'¹ with the note issuing banks the Exchange Fund agreed to issue and redeem certificates of indebtedness in unlimited amounts with the note issuing banks in exchange for sterling within the range $1/2^{13/16}$ and $1/3$. In return, the note issuing banks undertook to exchange sterling and Hong Kong dollars on the interbank market within the limits of $1/2^{25/32}$ and $1/3^{1/32}$. These rates were later narrowed to, respectively, $1/2^{7/8}$ and $1/3$, and $1/2^{27/32}$ and $1/3^{1/32}$. In dealings with the public the rate could move an additional $1/32$ in either direction. These agreements were maintained until November 1967, when, following sterling devaluation, a similar spread around an exchange rate of $1/42$ to the Hong Kong dollar was adopted. The agreements were informal, but in September 1939, after operating for some time, they were made public by the Government, 'with the intimation that no change was intended'.²

One can only speculate on why this quick transformation to something like a conventional sterling exchange standard was made. To a certain extent, the currency developments were similar to those which occurred in the United Kingdom about the same time: the return to a virtually fixed exchange rate from a floating rate controlled by the Exchange Equalisation Fund. And, the increasing

¹ Anonymous (later disclosed to be Sydney Caine), Monetary Systems of the Colonies, published by The Banker, 1948, p.23.
² Ibid.
weakness of the managed Chinese currency and the growth of the Colony's non-China trade made the continued association with Chinese currency arrangements seem less desirable and necessary. But there were other influences. Certainly, the colonial sterling exchange standard had shown itself to be a reliable and administratively easy way of guaranteeing the external value and convertibility of a colonial currency, and it is probable that many of the civil servants and bankers responsible for the operation of the Hong Kong Exchange Fund would have had experience with currency funds in other Colonies. Also important was the fact that at a very early stage the Exchange Fund acquired (from the sale of the silver received from the note issuing banks and the public) sufficient sterling fully to back its certificates of indebtedness liabilities. Once this sterling reserve had been built up, the task of maintaining the exchange value of the existing note issue became a simple one and the Exchange Fund was in a position to enter into the agreements which have been described.

Thus, within four years of the abandonment of the silver standard, Hong Kong currency was issued in a similar way to currency in other Colonies. With the exception of the one dollar notes and subsidiary notes and coins, all currency was fully secured by sterling deposits and investments, Hong Kong currency could always be acquired in exchange for sterling, and local banknotes were convertible into sterling without limit at a fixed exchange rate. The several differences between the Hong Kong currency system and the conventional currency board were not fundamental: commercial banks and not currency commissioners continued to issue the greater part of the total currency supply, the sterling backing to the banknote issue was indirect (the sterling assets of the Exchange Fund were held against the Fund's certificate of indebtedness liabilities, and not the note issue itself), and only the note issuing banks had direct access to the currency authority.1

1 As it frequently became the standard practice in other colonial currency areas for one or two of the larger banks to act as a funnel between the currency authorities and the public and smaller banks, the Hong Kong currency system differed little in this regard.
Legal Tender in Postwar Hong Kong

(a) The 'Duress' Note Issue. The re-introduction in Hong Kong of a sterling-backed currency was discussed on a number of occasions during the war at meetings between the Colonial Office, the British Treasury and the Hongkong Bank. The decision was taken to re-establish a stable currency, backed by, and convertible into, sterling at the same rate of approximately 1/3 as ruled before the war. To a considerable extent, this decision could be implemented with little difficulty: the sterling assets of the Exchange Fund remained intact during the war, and it was a simple matter again to require that any increase in the banks' note issue be made only against the prior sale of sterling to the Exchange Fund. The difficulty of immediately re-establishing a currency which was fully backed by sterling arose because the Japanese military authority had placed in circulation $121.9 million worth of unissued bank-notes from the vaults of the three note issuing banks (these notes became known as the 'duress' note issue). As these currency notes were not backed by certificates of indebtedness, they were not legal tender under the Colony's laws. During and immediately after the war the duress notes circulated at a discount. Mainly to ensure that local and foreign confidence in the Hong Kong dollar was maintained, it was decided to declare the duress notes legal tender.

After discussions between the note issuing banks and the Government1 a scheme was accepted whereby the necessary certificates of indebtedness were issued to the banks, $16 million worth of sterling was paid by the banks into the Exchange Fund, and the remaining deficit of sterling in the accounts of the Exchange Fund was to be gradually provided from the Fund's profits. In 1953 the Government announced that the sterling assets in the Exchange Fund again equalled the value of certificates of indebtedness outstanding.

---

1 In these discussions the banks claimed that they should have been warned by the Government to destroy unissued notes, while the Government argued that the banks should themselves have acted to dispose of the notes.
(b) The 1967 Currency Revaluation. The official exchange rate of approximately 1/3 to the Hong Kong dollar was maintained until late 1967. Hong Kong currency was devalued in line with sterling in 1949; in fact, the local Government was not consulted about the currency adjustment, but was simply informed by cable of the dollar's new exchange value. In 1966 and early 1967 there was considerable discussion at an unofficial level about what course the Colony should follow were there to be a further devaluation of sterling. This discussion was largely curtailed when the local Government announced that it did not have the power to determine the exchange value of the Hong Kong dollar.

On 19 November 1967, however, the Hong Kong Government was informed both that a 14.3 per cent devaluation of sterling was to be made and that it could on its own initiative determine the dollar's new exchange value. It was decided at first to devalue the Hong Kong dollar fully with sterling. Five days later, the local dollar was revalued by 10 per cent.

The initial devaluation, of course, maintained the Hong Kong dollar-sterling exchange rate. The exchange rate with the U.S. dollar moved from HK $5.71 to HK $6.67. The Government declared its main concern to be that of maintaining the local value of its own sterling assets and those of the Exchange Fund and the commercial banks. Together, these sterling assets totalled some £350 million. There was only a negligible debt owed in the United

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1 SCMP, 30 November 1967.
3 Financial Secretary, 1967 Budget Debate: 'Our dollar's official par value is set in terms of gold by a declaration under International Monetary Fund arrangements, made by Her Majesty's Government in London as this declaration is constitutionally a matter of international relations; while the practical arrangements for maintaining the dollar's value are in the hands of this Government...'
4 The local Government was given four hours notice of these decisions.
5 The holding of sterling assets by the Government and the commercial banks is discussed below; see
Kingdom. It was stressed that the devaluation was not made for balance of payments reasons, and that the Government would attempt to prevent an excessive increase in local price levels. ¹

The main reason for the Government having to reconsider its decision to devalue the Hong Kong dollar in line with sterling was that the Chinese Government made no adjustment in the gold value of the JMP. Prices of food and consumer goods imported from China rose by 15 per cent. There was some apprehension that the generally increased cost of living would result in further political disturbances.

The decision to maintain the sterling value of the Hong Kong dollar was also not popular with Hong Kong commercial and industrial interests: most Hong Kong goods were already sufficiently competitive on export markets; because of quota restrictions, exporters could benefit only marginally from a devaluation; in any case, the currency devaluation would quickly lead to more expensive industrial raw materials.

For these reasons, the dollar was revalued on 23 November to a new exchange rate of 1/4½ sterling (HK $14.55 = £stg 1; HK $6.06 = US $1), implying a net devaluation in terms of gold of 5.7 per cent.

It was decided to compensate the Hong Kong commercial banks for the exchange losses they suffered as a result of the dollar revaluation: in the absence of a central bank these commercial banks were forced to hold a large part of Hong Kong's foreign exchange reserves and thus to carry an exchange loss which elsewhere would have been borne by an official institution. This exchange loss, of about $140 million, was to be met from the accumulated surplus of the Exchange Fund. The Fund also met its own exchange loss from its accumulated surplus. ²

¹ The Government did not state how it would act to prevent these price increases. The Financial Secretary did state, SCMP, 20 November 1967, that 'any attempt to stem them by statutory price controls would be futile'.

² It must be pointed out that not all the sterling investments held by the Exchange Fund - or Government - were U.K. securities. A part was Malayan and Australian bonds, which became worth more in terms of Hong Kong dollars.
Several days later, the JMP was devalued by 5.7 per cent and prices of Chinese-produced foodstuffs and consumer goods fell to levels ruling before 19 November.

There was obvious confidence that the new exchange rate could be maintained. On the free currency market the Hong Kong-United States exchange rate was HK $6.00 - HK $6.04, against the new official rate of HK $6.06.

(c) Banknote Issue. The several alterations made since the second world war in the regulations governing the commercial bank note issue have not made for any fundamental change in the currency system established by the Ordinances and conventions of the period 1935 to 1939. The few changes made have simply removed discrepancies between the note issuing powers of the three banks.

In a 1956 amendment to the provisions governing its note issue, the Chartered Bank's right to make a fiduciary issue was abolished and the Bank was required to hold sterling securities against the whole of the first $35 million of its note issue. Any note issue above this amount must be backed with certificates of indebtedness. In the following year, the Hongkong Bank's Ordinance was amended, and this Bank, too, lost its right to make a fiduciary issue. At the same time, the shareholders' unlimited liability for the note issue was abolished. With a paid up capital, in 1966, of $47 million, the Mercantile Bank was in a position to make a larger issue of banknotes against the deposit of securities than were the two other banks. An amendment to the Mercantile Bank Note Issue Ordinance in January 1967 limited to $30 million the Bank's right to issue notes against approved securities. An issue of banknotes

1 I incorrectly claimed in 'The Currency Issue', FEER, 19 January 1967, that the Chartered and Mercantile Banks still had a limited right to make fiduciary issues. Gethyn Davies, 'Hong Kong Banking After the Crisis', The Banker, 1965, p.249, is similarly incorrect in suggesting that the Hongkong Bank could then, if it desired, make a fiduciary issue.

2 I have been unable to find the reason why the limit on the Chartered Bank's issue of banknotes against sterling securities is $5 million higher than those imposed on the other two banks.
above this limit has to be secured with certificates of indebtedness.

The note issue of the three banks in selected postwar years is shown in Table 3.3.

Table 3.3

<p>| BANKNOTES OUTSTANDING BY BANK OF ISSUE, SELECTED DATES, 1948 TO 1967 ($ million) |
|-----------------------------------------|--------|--------|--------|--------|</p>
<table>
<thead>
<tr>
<th>Bank</th>
<th>1948</th>
<th>1954</th>
<th>1960</th>
<th>1967</th>
</tr>
</thead>
<tbody>
<tr>
<td>Honk Kong Bank</td>
<td>728</td>
<td>676</td>
<td>836</td>
<td>1856</td>
</tr>
<tr>
<td>Chartered Bank</td>
<td>51</td>
<td>41</td>
<td>75</td>
<td>290</td>
</tr>
<tr>
<td>Mercantile Bank</td>
<td>4</td>
<td>4</td>
<td>3</td>
<td>30</td>
</tr>
<tr>
<td></td>
<td>783</td>
<td>722</td>
<td>914</td>
<td>2176</td>
</tr>
</tbody>
</table>

Source: Government Gazette, Supplement Number 4.

The way in which the banknote issue is varied can be outlined by taking the case where there is an increase in the demand for banknotes, say because of an expansion of credit by the commercial banks. If stocks of unissued currency are held by the note issuing banks, the first result will be that these notes are placed in circulation, either directly by the note issuing banks themselves, or through the other banks, which must reduce their deposits with, or sell sterling to the note issuing institutions. The interbank sterling rate will move towards \( 1/4 \frac{17}{32} \) (the actual rate is fixed by the Exchange Sub-committee of the Exchange Banks Association; the Sub-committee consists of representatives of the three note-issuing banks). The rate at which the banks deal with the public will tend towards \( 1/4 \frac{9}{16} \). These exchange rate variations will do something to encourage those holding dollar balances to exchange them for sterling. At this stage, there would not have been any

---

1 Rates in this example are those which have ruled since the revaluation of November 1967. In each case the sterling rate is 1½d greater than the exchange rate which applied before that date.

2 These dollar balances might be offered by commercial banks with excess dollar holdings or by businesses. The note issuing banks do claim that the supply and demand of Hong Kong dollars are affected by movements in the exchange rate.
change in the currency supply. If the demand for dollar balances has still not been satisfied, one of the note issuing banks will be required to increase its note issue. The Bank will inform the Financial Secretary, and cable its London office to pay the necessary sterling (always at $1/4\frac{1}{2}$ to the dollar) to the Crown Agents. The additional certificates of indebtedness will then be supplied to the note issuing bank, and the bank is free to increase its currency issue.

When the banknote circulation is shrinking, the currency holdings of the note issuing banks build up, the interbank sterling rate is moved towards $1/4\frac{11}{32}$ and the rate to the public towards $1/4\frac{5}{16}$, and, to balance their holdings of sterling and dollars the note issuing banks will return some part of their certificate of indebtedness holdings to the Financial Secretary, receiving in exchange sterling in London. On each certificate of indebtedness returned for cancellation the note issuing bank receives only $1/4\frac{3}{8}$, but not the whole $\frac{1}{8}$d loss on each certificate is borne by the note issuing institution; a part (at the maximum $\frac{1}{16}$d) will have been passed on through variations in the interbank sterling rate, while the whole $\frac{1}{8}$d loss can be passed on in transactions with the public.

By varying the volume of their advances and by adjusting the exchange rate between Hong Kong dollars and sterling, the note issuing banks can exert some influence on the public's demand for banknotes. But to the extent that the other commercial banks have balances with the note issuing banks which can be run down, or sterling to sell to the note issuing banks, the currency supply can be increased whether or not this is considered desirable by the

---

1 This analysis is really in terms of the Hongkong Bank and the Chartered Bank: the Mercantile Bank has not, since the war, issued sufficient banknotes to require its holding certificates of indebtedness. When the latter bank wishes to increase its note issue it simply deposits sterling securities of the required amount with the Crown Agents, and is then in a position to place the additional notes in circulation.

2 There are no treasury bills or other liquid outlets in Hong Kong in which these surplus funds can be employed.
note issuing institutions. The system is an automatic one, and the function of the note issuing banks is, as is usually the case with central banks, to satisfy the demand for currency, not to regulate it.  

(d) Exchange Fund. The Exchange Fund is still operated in the automatic way adopted in the late 1930s. Certificates of indebtedness are supplied on demand to the note issuing banks in exchange for sterling; the assets of the Fund are held in the form of sterling deposits and investments; the Fund stands ready to buy back certificates of indebtedness with sterling; and the agreements setting the limits to exchange rate variations which were made in the 1930s were strictly maintained until November 1967, when new exchange rate limits were agreed to.

Although no balance sheet has been published since the war and there have been few public references to the Fund's operations, it is possible to show the recent trend in total assets and in certificates of indebtedness liabilities (Table 3.4) and to say something about the investment principles followed by the Fund.

Despite the fact that there is still 'no statutory requirement for Certificates to be backed exclusively by Sterling and they could, for example, be backed by Hong Kong dollars, which could take the form of a bank balance, or, subject to the approval of the Secretary of State, Hong Kong Government Stocks only sterling assets have

\[1\] Gethyn Davies, op. cit., p.250, claims that the note issuing banks consider the effect of the changed volume of currency on the balance of payments and the level of prices before deciding to alter their note issue. It would appear that such considerations are incompatible with the banks' commitment to supply local currency against sterling to the other banks and the public on demand, and to provide currency to their own depositors when required. There is evidence, though, that the Hong Kong Bank has considered the Colony's economic stability when formulating its lending policy. See pp.126-7.

\[2\] Perhaps at first the balance sheet was not published because of the duress note issue, which made the sterling assets of the Fund less than its liabilities. It is difficult to see why the Fund's balance sheet is not now published.

\[3\] Report on the Hong Kong Banking System and Recommendations for the Replacement of the Banking Ordinance, 1948 (in the remainder of this study referred to as Tomkins Report), Hong Kong Government Printer, 1962, p.6.
<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Certificates of indebtedness</td>
<td>665</td>
<td>665</td>
<td>689</td>
<td>706</td>
<td>770</td>
<td>846</td>
<td>874</td>
<td>978</td>
<td>1074</td>
<td>1230</td>
<td>1559</td>
<td>1641</td>
<td>2081</td>
</tr>
<tr>
<td>Total assets of Exchange Fund</td>
<td>720</td>
<td>740</td>
<td>780</td>
<td>855</td>
<td>960</td>
<td>1040</td>
<td>1110</td>
<td>1359</td>
<td>1376</td>
<td>1532</td>
<td>1949</td>
<td>2149</td>
<td>2332</td>
</tr>
<tr>
<td>Assets as per cent of certificates of indebtedness</td>
<td>108</td>
<td>111</td>
<td>113</td>
<td>121</td>
<td>125</td>
<td>123</td>
<td>127</td>
<td>139</td>
<td>128</td>
<td>125</td>
<td>125</td>
<td>131</td>
<td>112</td>
</tr>
<tr>
<td>Surplus of assets over 105 per cent of liabilities</td>
<td>248</td>
<td>240</td>
<td>312</td>
<td>426</td>
<td>150</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Banknotes backed by securities</td>
<td>62</td>
<td>67</td>
<td>65</td>
<td>66</td>
<td>68</td>
<td>71</td>
<td>79</td>
<td>67</td>
<td>66</td>
<td>66</td>
<td>70</td>
<td>89</td>
<td>95</td>
</tr>
<tr>
<td>Total banknote issue</td>
<td>729</td>
<td>732</td>
<td>755</td>
<td>772</td>
<td>838</td>
<td>917</td>
<td>953</td>
<td>1045</td>
<td>1140</td>
<td>1296</td>
<td>1629</td>
<td>1730</td>
<td>2176</td>
</tr>
</tbody>
</table>

a 31 December each year.

Source: Financial Secretary, Budget Speech.
been held. The general authority given to the various Colonial currency funds in 1954 to invest a small proportion of the currency backing in local securities has not been exercised in Hong Kong:

There is no case for our following this practice, at least at present, and it is in any case our view that it is important for the international standing of the Hong Kong dollar and therefore for our own economic prosperity, that a high level of external cover should be maintained.

Because of the undertaking to provide sterling on demand against certificates of indebtedness, a part of the assets of the Exchange Fund must be held in liquid form. The only information available is for December 1955, when 37 per cent of assets were in the form of cash or money at call and short notice and this proportion of highly liquid assets is probably a typical one. The remaining three-fifths of assets takes the form of dated sterling securities, from which a significant interest income is received.

An increase in the value of assets in the Exchange Fund results from the sale of additional certificates of indebtedness to the note issuing banks, from capital appreciation of the Fund's fixed interest securities, and from re-investment of the excess of income (from interest receipts and the exchange profit earned on certificates of indebtedness cancelled) over expenses (printing costs). Until 1963 there was no provision for transferring any surplus of assets in the Fund to the Government's general revenue or to any other purpose, and with the continued re-investment of interest earnings

1 And the usual practice of the Crown Agents in investing colonial currency funds is to place about 70 per cent of reserves in U.K. paper.
4 Ibid., 1957, p.32. Because of the surplus of assets held in the Exchange Fund, the ratio of liquid assets to certificates of indebtedness would have been even higher.
5 No administrative expenses are charged to the Exchange Fund.
6 The more standard colonial currency board practice was that any surplus above 110 per cent of the currency issue was automatically transferred to Government revenue.
and exchange profits, the surplus in the accounts of the Exchange Fund gradually increased. A 1963 amendment to the Exchange Fund Ordinance gave the Government authority to transfer to its general revenue 'or any such other fund as may be authorised by the Secretary of State' any surplus of assets over 105 per cent of the value of certificates of indebtedness. In 1964/65, $150 million was transferred from the surplus in the Exchange Fund to the Colony's Development Loan Fund.

The Exchange Fund suffered a loss, in terms of Hong Kong dollars, of about 5 per cent of its assets as a result of the currency revaluation of 1967. At the same date, a significant part of the accumulated surplus of the Fund was employed to meet the exchange losses of the commercial banks.

(e) Government Currency Issue. The Hong Kong Government now issues a one dollar coin, subsidiary coins and a one cent note. There are three separate Government currency security funds: the $ Note Security Fund, the Subsidiary Note Security Fund, and the Coinage Security Fund. Only in the case of the $ Note Security Fund have interest earnings and issue expenses been credited and debited to the currency fund. In the other two funds, coinage expenses have been charged to the Government and interest receipts paid into the Colony's general revenue. Because of this accounting method, it is not possible to show the net profit or loss arising from the Government's currency operations, but it is most likely

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1 'In theory the 105 per cent requirement is designed to provide a cushion against sudden capital depreciation, but at 105 per cent it reflects perhaps excessive caution in that context.' Financial Secretary, Legislative Council Debates, 1963, p.303.
2 The one dollar coin was first produced in 1960, and was introduced because of the inconvenience of notes for small transactions and the heavy cost of maintaining a reasonably clean note issue.
3 Until 1967 there were seven currency funds. In that year the five separate coinage funds were consolidated into the Coinage Security Fund.
that a small profit is now made. The circulation of the several
Government currency issues at March 1967 is shown in Table 3.5.

**Table 3.5**

**GOVERNMENT CURRENCY ISSUE, 31 MARCH 1967**

<table>
<thead>
<tr>
<th></th>
<th>$ million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Coins:</td>
<td></td>
</tr>
<tr>
<td>one dollar</td>
<td>62.8</td>
</tr>
<tr>
<td>fifty cents</td>
<td>27.3</td>
</tr>
<tr>
<td>ten cents</td>
<td>27.2</td>
</tr>
<tr>
<td>five cents</td>
<td>3.3</td>
</tr>
<tr>
<td>obsolete</td>
<td>1.6</td>
</tr>
<tr>
<td>Notes:</td>
<td></td>
</tr>
<tr>
<td>one dollar</td>
<td>12.5</td>
</tr>
<tr>
<td>subsidiary</td>
<td>2.8</td>
</tr>
<tr>
<td></td>
<td>137.5</td>
</tr>
</tbody>
</table>


Table 3.6 gives a combined balance sheet of the Government
currency funds for the period 1954 to 1967. Although there is no
requirement that the outstanding issue be backed to a certain pro-
portion by sterling assets, and the Government is not under any
obligation to guarantee that the currency it issues is fully con-
vertible into sterling, there does seem an intention, on the
Government's part, to hold sterling against about one-half of the
outstanding issue.

The **Hongkong Bank** is the issuing agent of Government notes and
coin. Stocks of unissued currency are delivered by the Government
to the Bank, and additional currency is placed in circulation either
directly by the Bank, through the withdrawal of deposits by its
customers, or by other banks, who first acquire the additional
Government currency by running down their deposits with the **Hongkong
Bank**. When an increase in currency issue is made, the Bank credits
the current account of the relevant currency fund by the appropriate
amount. After the current account has risen to a certain level the
Government may decide to invest in sterling assets or hold a fixed
deposit with the Bank.

Table 3.7 compares the trend of Government-issued currency and
the banknote issue over the postwar period. Government currency
### Table 3.6: Government Currency Notes and Coinage Funds

Combined Balance Sheets, 1956 to 1967

<table>
<thead>
<tr>
<th></th>
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<th></th>
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</thead>
<tbody>
<tr>
<td>$ million</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Circulation</td>
<td>42.4</td>
<td>45.6</td>
<td>51.5</td>
<td>59.5</td>
<td>57.8</td>
<td>69.9</td>
<td>70.7</td>
<td>82.2</td>
<td>78.0</td>
<td>91.8</td>
<td>103.3</td>
<td>111.6</td>
<td>121.2</td>
<td>137.5</td>
</tr>
<tr>
<td>Hong Kong Government&lt;sup&gt;c&lt;/sup&gt;</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.3</td>
<td>0.0</td>
<td>1.0</td>
<td>0.4</td>
<td>-</td>
<td>0.1</td>
<td>3.5</td>
<td>1.7</td>
<td>0.4</td>
<td>1.1</td>
<td>1.8</td>
</tr>
<tr>
<td>Cash at bank</td>
<td>42.5</td>
<td>45.7</td>
<td>51.5</td>
<td>60.0</td>
<td>57.8</td>
<td>70.9</td>
<td>71.1</td>
<td>82.2</td>
<td>78.1</td>
<td>95.3</td>
<td>105.1</td>
<td>112.0</td>
<td>122.3</td>
<td>139.3</td>
</tr>
<tr>
<td>Fixed deposits</td>
<td>21.5</td>
<td>15.4</td>
<td>11.5&lt;sup&gt;e&lt;/sup&gt;</td>
<td>18.5</td>
<td>16.6</td>
<td>27.0</td>
<td>7.5</td>
<td>30.1</td>
<td>23.4</td>
<td>25.1</td>
<td>26.2</td>
<td>8.7&lt;sup&gt;b&lt;/sup&gt;</td>
<td>9.2&lt;sup&gt;b&lt;/sup&gt;</td>
<td>3.2</td>
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<tr>
<td>Sterling investments</td>
<td>10.0</td>
<td>10.0</td>
<td>18.6</td>
<td>8.5</td>
<td>8.5</td>
<td>6.0</td>
<td>15.0</td>
<td>-</td>
<td>13.8</td>
<td>11.6</td>
<td>20.0</td>
<td>44.0</td>
<td>52.2</td>
<td>60.1</td>
</tr>
<tr>
<td>Hong Kong Government&lt;sup&gt;d&lt;/sup&gt;</td>
<td>10.9</td>
<td>20.3</td>
<td>19.5</td>
<td>31.8</td>
<td>29.6</td>
<td>36.1</td>
<td>45.9</td>
<td>49.1</td>
<td>40.3</td>
<td>57.7</td>
<td>58.9</td>
<td>60.9</td>
<td>76.1</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>0.2</td>
<td>0.1</td>
<td>1.9</td>
<td>1.2</td>
<td>2.1</td>
<td>1.7</td>
<td>2.8</td>
<td>3.0</td>
<td>0.6</td>
<td>-</td>
<td>2.0</td>
<td>0.0</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>42.5</td>
<td>45.7</td>
<td>51.5</td>
<td>60.0</td>
<td>57.8</td>
<td>70.9</td>
<td>71.1</td>
<td>82.2</td>
<td>78.1</td>
<td>95.3</td>
<td>105.1</td>
<td>112.0</td>
<td>122.3</td>
<td>139.3</td>
</tr>
</tbody>
</table>

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<sup>a</sup> 31 March each year.

Notes:

<sup>b</sup> Adjustments made to remove small error at source.

<sup>c</sup> Amount due to Hong Kong Government for appreciation on investment and for accumulated surplus.

<sup>d</sup> Amount due from Hong Kong Government for depreciation on investment and for accumulated deficit.

<sup>e</sup> Includes small sums held by Crown Agents.

Source: Annual Report of the Accountant-General, Hong Kong Government Printer.
<table>
<thead>
<tr>
<th></th>
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<tbody>
<tr>
<td>Government currency notes and coin</td>
<td>n.a.</td>
<td>n.a.</td>
<td>20</td>
<td>28</td>
<td>51</td>
<td>43</td>
<td>41</td>
<td>42</td>
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<td>110</td>
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<td>131</td>
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<tr>
<td>Amounts held by Commercial banks</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>142</td>
<td>97</td>
<td>118</td>
<td>84</td>
<td>86</td>
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<td>210</td>
<td>202</td>
<td>221</td>
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<tr>
<td>Government</td>
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<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>2</td>
<td>1</td>
<td>2</td>
<td>1</td>
<td>1</td>
<td>2</td>
<td>2</td>
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<td>8</td>
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<tr>
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<td>n.a.</td>
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<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
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<td>685</td>
<td>693</td>
<td>743</td>
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<td>846</td>
<td>911</td>
<td>959</td>
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<td>1,195</td>
<td>1,511</td>
<td>1,616</td>
<td>1,975</td>
</tr>
</tbody>
</table>

a. 31 December each year.

Source: Government Gazette, Supplement Number 4.
notes and coins have constituted less than one-tenth of the total currency issue. Rather surprisingly, the proportion increased from 5.6 per cent in 1954 to 9.4 per cent in 1966. There is no chance of an excessive issue of Government currency: any surplus over that demanded by the public will quickly be returned to the Hong Kong Bank and removed from circulation. For this reason, the fact that the Government is able to vary its currency issue without reference to its sterling holdings is insignificant as either a weapon of monetary policy or a possible threat to currency stability and confidence.

(f) The Volume of Currency on Issue. The volume of currency on issue over the postwar period is shown in Table 3.7. There was a very rapid expansion in the currency supply in the early postwar years, and then a slight decrease until the mid-1950s. In the decade to 1967, the currency supply increased almost three times.

Not all the increased currency supply required to service the rising national income has had to come from new currency issues. With the more widely-spread banking habit some release of personal savings from currency hoards must have taken place. And, a greater part of the currency issue is now held in Hong Kong than was the case early in the postwar period. Only one-sixth or so of Hong Kong currency is now thought to circulate outside the Colony, compared with more than one-half in the late 1940s. Thus a part of the increase in the public's demand for currency has been met from balances previously held idle in Hong Kong or held abroad.

As is the case in most underdeveloped countries, the speculative demand for money appears to be virtually non-existent. The demand

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1 The importance of the currency issue in the total money supply is discussed in Chapter 7.
2 See below, Chapter 5.
3 This is the estimate of an official of one of the note issuing banks. Hong Kong currency circulates freely in Macao, where it usually exchanges at par with the pataca.
for idle currency balances is almost exclusively of a precautionary nature, including currency held because of political uncertainty, and the lack of familiarity with, or distrust of, commercial bank deposits.

There is a seasonal peak in the public's demand for currency in the Christmas-Chinese New Year period. The main problem in managing the currency issue is to ensure that sufficient stocks are held to meet this 'annual crisis'. In 1951 there was a deliberate attempt by hoarders to create a shortage in small denomination currencies, and an Ordinance was introduced to make such acts illegal.

In 1965 public misgivings about the safety of deposits with several local banks brought on a very rapid increase in the public's demand for currency. The cash resources of several commercial banks were severely strained as a result, and a number of institutions faced illiquidity. To prevent a more severe currency shortage developing - the public's demand for currency would have further increased had other banks been found illiquid - the Government imposed a daily limit of $100 on withdrawals from bank deposits, declared sterling notes legal tender, and arranged for £20 million of British banknotes (representing a part of the assets of the Exchange Fund) to be flown to Hong Kong. It was not, in the event, necessary to issue these sterling notes.

The Foreign Exchange Markets

Although its currency fund was, from early 1936, invested almost exclusively in sterling, Hong Kong did not for some time

1 The demand for currency increased very strongly during the political disturbances of 1967. There was at this time an especially strong demand for $500 notes, the largest denomination issued.

2 There is a slight tendency for the banknote issue to reach a peak at Christmas and for the Government issue to be at a maximum at Chinese New Year.

3 Financial Secretary, Legislative Council Debates, 1958, p.49.
join the Sterling Area system of exchange controls. ¹ This decision to remain outside the Sterling Area was largely that of the Hongkong Bank ² and was taken because the Colony was an important centre for non-sterling trade and remittances, much of which business would have been lost had Sterling Area exchange restrictions been applied.

Following the Japanese occupation of North China, many Chinese banks and, later, the Chinese Exchange Fund were moved to Hong Kong, further increasing the importance of the Colony's non-sterling currency transactions. But in July 1941 the United Kingdom and the United States announced measures to freeze Japanese and Chinese balances, and, under the Defence (Finance) Regulations, Sterling Area currency controls were imposed in Hong Kong. The purchase and sale of foreign currency and gold were restricted, specified foreign exchange holdings had to be surrendered to the Government, and the Government was empowered to acquire all gold held in Hong Kong. These Regulations were still in force when the Colony fell to the Japanese in December 1941, and, although introduced under the Government's temporary wartime powers, have been the basis of official exchange control in the postwar period.

Immediately after the war the question arose whether Hong Kong should remain within the Sterling Area. It was argued, on the one hand, that a large part of the Colony's trade (especially the re-export of tung oil and other Chinese products, and goods imported from the United States for sale in China) and remittances (particularly those from Chinese living in the United States) would be lost to the Colony were the full range of Sterling Area controls imposed;

¹ The currency bloc which came to be known as the Sterling Area emerged in the early 1930s following the suspension of convertibility of sterling, when a number of countries - including the dominions and British colonies (other than Canada, Hong Kong and Newfoundland), Scandinavian countries, Egypt and Portugal - kept their currencies stable in terms of the pound sterling. The Sterling Area gained a more formal status in 1939, when a comprehensive system of exchange controls was imposed by member countries. At this stage, most non-British countries left the bloc. Hong Kong could not, of course, become a member of the currency area while its currency was silver based.

² J.R. Jones, op. cit.
that it would be difficult for the Colony to finance its entrepot trade from the limited supply of dollars available from the common Sterling Area pool; that few of the Colony's exports were goods produced in the Sterling Area, including Hong Kong; that the majority of Hong Kong traders had no political stake in the Sterling Area and would be hard to convince of the need for exchange control; and that the Colony's acceptance of Sterling Area restrictions in 1941 had only been in response to an immediate wartime problem. But, because the large part of commercial bank liquid assets and Government reserves, and the currency fund, were held in London, and because of the Colony's large trade with the Sterling Area, all of which required relatively free transfers within the Sterling Area, it was not considered desirable for the Colony to sever its connections with the Sterling Area.

The problem was further complicated by the fact that a well organised free market in foreign currencies (consisting of the small banks and the numerous exchange shops and trading in U.S. dollars, sterling, Far East currencies and precious metals) had developed before the exchange banks re-commenced operations and before exchange control regulations could be re-instituted. Also, there was no official in the Hong Kong Government who was experienced in administering exchange control.¹

The solution adopted was that Hong Kong would remain a member of the Sterling Area, applying Sterling Area controls and official exchange rates to a specified range of exchange transactions, but with the Colony retaining its free currency market, in which all other currency transactions could be made without restriction at exchange rates which varied with supply and demand. Thus a system of exchange control was instituted, first, to ensure that specified exchange transactions were, in fact, made in the official exchange market and, secondly, to prevent access being gained to the Colony's

¹ An additional problem mentioned to the author by a veteran banker was that, at first, no copy of the exchange control regulations could be found in Hong Kong.
free currency market by residents of other parts of the Sterling Area.  

1. An officer of the Hongkong Bank was seconded by the Government to establish an exchange control office.  

2. The system of exchange control was based on the 1941 Defence (Finance) Regulations, and surprisingly, although the Government approved of the existence of the free currency market from early in the postwar period, it was 1967 before the Defence (Finance) Regulations were amended specifically to exempt free currency market transactions (i.e. for more than two decades, dealings in the free exchange market nominally contravened the exchange control regulations).

To prevent Hong Kong becoming a 'gap' in the Sterling Area system of exchange controls, the Bank of England has closely supervised the sterling accounts of the large banks. Probably, though, considerable illegal transactions took place in hard currencies in the late 1940s and late 1950s, in the former case, at least, as a result of goods 'shunting'.

The differences between the official and the free exchange markets are highlighted by a comparison of the consequences which follow a capital outflow. If holders of Hong Kong dollar balances suddenly decide to convert their funds into foreign currencies through the official market, there would be only a small variation in the exchange rate of the Hong Kong dollar (within the narrow limits agreed by the note issuing banks and the Exchange Fund). But the note issuing banks would, as a consequence, accumulate excessive holdings of Hong Kong banknotes; they would seek to adjust their portfolios by returning certificates of indebtedness to the Exchange Fund, and the currency supply would be reduced. If, on the other hand, the capital outflow was arranged through the free

1. Since 1967 Singapore residents have been able freely to move their funds between the Republic and Hong Kong.

2. The position of Assistant Financial Secretary (Exchange) has since been held by officers of the Hongkong Bank on secondment.

market, there would be no change in the local currency supply, but an appreciable change in the external value of the Hong Kong dollar.

(a) The Official Exchange Market. As a result of Hong Kong's sterling exchange currency system, the Hong Kong dollar and the pound sterling are convertible without limit at an exchange rate which can move only within narrow limits around $1/4\Delta$. And, on this official market currencies other than the British pound can be purchased, for uses approved by the exchange control, at rates determined by the ruling Hong Kong dollar-sterling rate and the sterling-foreign currency rate in London.¹

The official market in foreign exchange consists of those commercial banks (at present 51, including most of the larger banks) which have been 'authorised' by exchange control to carry out foreign exchange transactions at official rates, and a small number of exchange brokers who are members of the Exchange Brokers Association. Authorised banks agree to buy and sell foreign exchange only at official rates, and deal on the interbank market, which is usually $1/32$d sterling better than the rate to merchants. These institutions are permitted freely to operate their accounts in London (that is, to transfer their funds freely within the Sterling Area): thus, their holdings of Hong Kong dollars and sterling are convertible without restriction at exchange rates which cannot move more than a few points from par.

Payments for trade between Hong Kong and other countries in the Sterling Area may be made in any Sterling Area currency, and the authorised banks may freely arrange the transfer of funds between Hong Kong traders and residents in other Sterling Area countries provided these funds were earned in bona fide trade.²

¹ At a pound sterling-Hong Kong dollar rate of $1/4\Delta$ and a U.S. dollar-sterling rate of US $2.40 to £1, the exchange rate between Hong Kong and the United States is HK $6.0625 to US $1.

² A statement of the Hong Kong system of exchange controls is given in the I.M.F. Annual Report on Exchange Restrictions. A number of minor changes in the system of controls has been made over the postwar period.
To prevent access being gained to the Colony's free currency market by residents in other parts of the Sterling Area, exchange control approval is required for capital transfers from these territories to Hong Kong, including transfers from the sterling accounts of Hong Kong residents. But transfers can be freely made from Hong Kong to other parts of the Sterling Area - holders of Hong Kong balances are free to move their funds out of Hong Kong and into sterling through the official exchange market. The banks deal with the public at a margin of \( \frac{3}{32} \) per Hong Kong dollar.

Hong Kong exporters of locally-produced goods and goods from China, Taiwan and Macao who receive payment in a non-Sterling Area currency are required to surrender the proceeds from insurance and freight to an authorised bank at the official exchange rate;\(^1\) the f.o.b. value of the export proceeds may be sold on the free currency market.\(^2\) Non-sterling foreign exchange is available at official rates for certain essential imports and for specified payments for invisibles (education and tourist expenses, etc.). The banks authorised to operate in the official foreign exchange market deal with the public at a margin of \( .08\frac{1}{8} \) U.S. cents per U.S. dollar.

Transfers of capital to Hong Kong from countries outside the Sterling Area do not have to be surrendered to the official exchange market, but permission later to repatriate profits and capital through the official exchange market is usually given only when the initial transfer was made through an authorised bank at official rates.\(^3\)

(b) The Free Currency Market. The free exchange market consists of the twenty or so commercial banks which are not authorised

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1 It is largely from this exchange requirement that Hong Kong earns foreign currencies for the Sterling Area pool.

2 Until the mid-1950s, various proportions of the f.o.b. value of specified exports had also to be surrendered to the official exchange market. The effect of this requirement was to give Hong Kong a multiple exchange rate.

3 Exchange control office mentioned to the author that very few transfers of capital into Hong Kong from countries outside the Sterling Area are made through the official exchange market.
to conduct exchange transactions on the official market (the 'un-
authorised' banks) and the many exchange dealers operating in Hong
Kong (including representatives of several large international
institutions). On this market transactions take place in most
currencies, including those of a number of countries which prohibit
transactions in their currencies at other than official rates, and
in commercial gold.

By far the most important section of the free exchange market
is that which deals in United States dollars - in currency notes,
demand drafts and telegraphic transfer. U.S. dollars have been
supplied to this market from a variety of sources. Early in the
postwar period a large volume of U.S. currency notes hoarded in
China during the war and Chinese-owned U.S. bank deposits frozen
during the war was sold on this free exchange market. Remittances
from Chinese living in North America have been a major source of
U.S. dollars for the open market throughout the postwar period.
The Colony's exchange control permits the larger part of the U.S.
dollar proceeds of local exports and of re-exports of Far Eastern
goods to be sold on the free currency market. Of considerable value
recently has been the U.S. dollars spent by tourists and U.S. mili-
tary personnel. Smaller sums have been provided from American
investment in Hong Kong businesses, and from the activities of
international welfare agencies, etc.

As U.S. dollars and other non-sterling currencies can be ob-
tained from the official exchange market for only a restricted range
of purposes, the foreign exchange required to pay for the majority
of Hong Kong imports from these currency areas is purchased in the
Colony's free currency market. On this market, too, foreign exchange
is purchased to finance capital transfers from Hong Kong; there is
no restriction on investment by Hong Kong residents in foreign
security markets or foreign bank deposits. As well, foreign-owned
businesses purchase U.S. dollars on the open market to remit
profits and capital. The demand for U.S. currency arises also from
Hong Kong tourists, foreign exchange speculators, currency hedgers, etc. 1

The supply of U.S. currency notes on the free market is almost continuously greater than the demand. The many U.S. notes collected by money changers and unauthorised banks are sold (on the Gold Exchange or privately) to the larger local commercial banks, who periodically mail them to the United States for crediting to their New York accounts.

The Hong Kong-United States exchange rate on the open exchange market has, in recent years, been usually within 1 per cent of the official rate (see Table 3.8). Occasionally, the Hong Kong dollar has stood at a small premium. Rumours of a possible devaluation of sterling in 1966 encouraged a small flight from the Hong Kong dollar, which was briefly traded at a discount of 2.4 per cent against the U.S. dollar. For a short period in the 1967 disturbances, this discount increased to almost 5 per cent.

Table 3.8
FREE EXCHANGE MARKET: SELECTED EXCHANGE RATES, 1960 TO 1967

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>1960</td>
<td>5.87</td>
<td>5.68</td>
<td>5.74</td>
<td>5.66</td>
<td>16.10</td>
<td>15.95</td>
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<tr>
<td>1961</td>
<td>5.78</td>
<td>5.66</td>
<td>5.85</td>
<td>5.66</td>
<td>16.23</td>
<td>15.82</td>
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<td>5.73</td>
<td>5.68</td>
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<td>15.90</td>
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<td>5.79</td>
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<td>5.78</td>
<td>5.68</td>
<td>16.13</td>
<td>15.92</td>
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<td>5.75</td>
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<td>5.78</td>
<td>5.71</td>
<td>16.05</td>
<td>15.92</td>
</tr>
<tr>
<td>1965</td>
<td>5.78</td>
<td>5.71</td>
<td>5.78</td>
<td>5.71</td>
<td>16.07</td>
<td>15.95</td>
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<td>1966</td>
<td>5.84</td>
<td>5.70</td>
<td>5.83</td>
<td>5.69</td>
<td>16.15</td>
<td>15.95</td>
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<tr>
<td>1967</td>
<td>6.10</td>
<td>5.73</td>
<td>6.08</td>
<td>5.72</td>
<td>16.30</td>
<td>14.60</td>
</tr>
</tbody>
</table>

Source: FEER, various numbers.

The exchange rate between the Hong Kong dollar and sterling is also shown in Table 3.8. Because of the freedom with which funds can be transferred between Hong Kong and London on the official

1 There are also considerable purchases of foreign currencies on the Hong Kong open exchange market by residents of other South East Asian countries.
exchange market, there is little trading in sterling on the free
market other than in United Kingdom banknotes. Many other cur-
rencies are exchanged against the Hong Kong dollar at a considerable
discount.1

The Chinese Gold and Silver Exchange Society, formed in 1917,
was quickly re-established after the Pacific war. At first sales
were made in monetary (.99 pure) gold, most of which was supplied
from wartime hoards. Trading reached a peak in the period preced-
ing the 1949 sterling devaluation.2 The Gold Exchange has been
relatively inactive since the early 1950s. In March 1968 turnover
was greatly increased, and gold prices briefly returned to levels
experienced during the Korean war. Presumably because of Inter-
national Monetary Fund requirements, trading in monetary gold was
prohibited in 1949, and replaced by transactions in commercial gold
(at first of .9 and later of a maximum of .95 fineness).

Prices on the Gold Exchange are expressed in Hong Kong dollars
per tael (approximately 1\(\frac{1}{3}\) oz.) of .945 purity, and usually repre-
sent a margin of U.S. $3 to U.S. $6 an ounce over London prices.
The local gold price is affected by trends in other gold markets,
by political and economic events in the Far East, and by rumours of
currency devaluation. There were sharp increases in gold prices
during the banking crisis of 1965 and the civil disturbances in
1967. The range of prices on the gold exchange over recent years
is given in Table 3.9.

There are believed to be sizeable illegal dealings in monetary
gold. It is claimed, for example, that most of the gold sold on
the Macao gold exchange (a legal and active market in monetary gold)
is smuggled to Hong Kong for re-export to India, South Vietnam,

1 Regular quotations on the free exchange market are published in
SCMP and FEER.
2 A visit to the Gold Exchange in the period of active trading in
1949 is described in H. Ingrams, Hong Kong, London: H.M.S.O.,
1952, p.147. In 1947 a seat on the Gold Exchange was sold for
$77,000. In 1956 the price was $5,000.
Table 3.9
GOLD PRICES, 1947 TO 1967
(Dollars per Tael .945 pure)

<table>
<thead>
<tr>
<th>Year</th>
<th>High</th>
<th>Low</th>
</tr>
</thead>
<tbody>
<tr>
<td>1947</td>
<td>405</td>
<td>254</td>
</tr>
<tr>
<td>1948</td>
<td>372</td>
<td>282 3/4</td>
</tr>
<tr>
<td>1949</td>
<td>654 1/2</td>
<td>295 1/4</td>
</tr>
<tr>
<td>1950</td>
<td>329 1/2</td>
<td>250</td>
</tr>
<tr>
<td>1951</td>
<td>348</td>
<td>297</td>
</tr>
<tr>
<td>1952</td>
<td>329</td>
<td>276</td>
</tr>
<tr>
<td>1953</td>
<td>286</td>
<td>248 3/4</td>
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<tr>
<td>1954</td>
<td>257 3/8</td>
<td>244 1/2</td>
</tr>
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<td>1955</td>
<td>263 3/8</td>
<td>250 1/8</td>
</tr>
<tr>
<td>1956</td>
<td>287</td>
<td>253 5/8</td>
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<td>1957</td>
<td>271</td>
<td>266</td>
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<td>1958</td>
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<td>249 1/8</td>
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<td>1959</td>
<td>255</td>
<td>250</td>
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<td>1960</td>
<td>275 1/2</td>
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<td>1966</td>
<td>264 5/8</td>
<td>262 7/8</td>
</tr>
<tr>
<td>1967</td>
<td>300</td>
<td>259 5/8</td>
</tr>
</tbody>
</table>


Indonesia and other Asian countries. And, monetary gold can readily be purchased in Hong Kong in a number of local banks, exchange shops and jewellers.

---

There have been several points of contact between the two foreign exchange markets. Until the abolition of 'security sterling' in 1967, authorised Hong Kong banks and certain exchange dealers were permitted, under licence, to purchase security sterling in exchange for United States dollars acquired on the free market. As a result of these transactions the security sterling reverted to external account sterling, and was freely exchangeable in London with any external account currency. These transactions were profitable when the free rate for U.S. dollars was close to the official par rate and security sterling was traded at a discount against external sterling.

Since the abolition of security sterling, banks and exchange dealers in Hong Kong have on occasion been licensed by the Bank of England to purchase limited amounts of 'resident sterling' - sterling owned by residents of the Sterling Area - with U.S. dollars acquired on the free exchange market. No information is available on the extent of these transactions.

A further link between the two markets has arisen from the fact that some transactions for which permission could be obtained to purchase funds on the official market are, for convenience, normally made on the open market. When exchange rates on the open market move against the Hong Kong dollar, a part of these demands for foreign exchange is transferred to the official market, reducing the pressure on the open currency market.

1 Security sterling (or 'block' sterling or 'switch' sterling) is the sterling earned from the sale of securities or investment by non-residents of the Sterling Area. The security sterling could freely be sold to another non-resident of the Sterling Area for investment in sterling securities.

2 The Bank of England was reported 'to go along with...and up to a point to approve of' this arrangement. The Times, 15 February 1967, p.13. It was estimated that between £50 million and £100 million worth of security sterling, much of it from the Middle East, was traded on the Hong Kong exchange market annually.

3 These transactions include certain imports, tourist and education expenses.
Also, there has been a close association between several of the authorised and unauthorised banks. A number of unauthorised banks have arranged their trade business through an authorised bank rather than the open market (on these transactions the unauthorised bank is paid one-half of the exchange commission earned by the authorised bank). And, some authorised banks have direct representation in the lists of unauthorised banks in the form of wholly owned subsidiaries, while others are represented by affiliates or agents. Indeed, the links are essential, as the authorised foreign exchange banks are probably in deficit on foreign exchange whereas the free dollar market yields a surplus which is drawn upon for local requirements.1

The Currency System and Foreign Exchange Markets: a Comment2

(i) A first consequence of the currency system is that there is no possibility of an excessive currency issue or of an inconvertibility of the Colony's currency into sterling. The currency supply can be increased only to the extent that the note issuing banks deposit sterling (acquired from their own sources, or from purchases from the other commercial banks or the Government in exchange for Hong Kong dollar balances) with the Exchange Fund. And, once issued, there can be no currency holding - from either present earnings or hoards - for which sterling is not available at an exchange rate close to par.

But these are characteristics common to all currencies issued under the colonial sterling exchange standard. The Hong Kong currency system has one important further advantage. In other territories colonial currencies were convertible into non-sterling foreign exchange only through their link with the 'superior' currency; holdings of colonial currency could be converted into non-sterling foreign exchange only so long as sterling itself was convertible.

2 Several aspects of the currency system cannot be fully discussed until after an outline of bank deposit money has been given. See below, Chapter 7.
The existence of its free exchange market gave Hong Kong a currency system unique among the British colonial territories. Through this open market, the Hong Kong dollar has had an exchange value with, and convertibility into, the major world currencies, independent of that established through its link with sterling. Thus, Hong Kong currency balances have been exchangeable with world currencies (although not necessarily at a stable exchange rate) whatever the current strength or weakness of sterling.

The fact that the Hong Kong dollar has been a strong currency, readily convertible into sterling on the official market or into other currencies on the open market, has contributed to the Colony's economic development in several fields. The freely convertible currency has been of considerable benefit to the entrepot trade, a part, and perhaps a large part, of which might have been lost to Hong Kong had not foreign currencies been freely available to traders. The Hong Kong dollar's strength and convertibility has similarly contributed to the Colony's importance as a centre for international remittance payments and for the investment and deposit of foreign funds. There are several ways in which the currency system has aided the Colony's industrialisation. The early capital inflow into manufacturing - the capital which entered the Colony at the time of the Communist successes in the Chinese Civil War, and which provided much of the initial investment in the textile industry - was attracted by the stable Hong Kong currency and the fact that funds could readily be moved out of the Colony when desired. The more recent capital inflow into manufacturing from overseas Chinese and sources in developed countries has also been attracted by the ease with which profits and capital can be remitted from Hong Kong. As well, imports of industrial raw materials and

1 Thus, one commentator has claimed that the free currency market, on which Hong Kong merchants have made the majority of their purchases of U.S. currency, was 'in many respects...the foundation of the post-1945 renaissance of the Hong Kong economy'. David Williams, op. cit., p.175.
industrial equipment have been available from the most competitive sources, however limited the Sterling Area allocations of hard currencies; this was an especially important privilege in the late 1940s and early 1950s. The strong currency has contributed also to the development of the tourist industry. One of the Colony's important attractions is the ready availability of imported goods. Finally, the stable currency may also have been an advantage in a non-economic sense. The fact that China's earnings in Hong Kong can readily be converted into the major world currencies may have helped to preserve the political status quo.

(ii) At the same time, the currency system has imposed a severe restraint on the public finance system. Because the banknote issue is fully backed by sterling, the Hong Kong Government has not been able to borrow from the banking system as it could have done had there been an independent monetary system. There are two related consequences, both of which are discussed later in this study. First, for these institutional reasons, the Government is unable to finance a budget deficit by borrowing from the currency authority. Any excess of expenditure over Government revenue must be financed from reserves, grants or borrowing from the commercial banks or public. Secondly, under the present currency system, there is only a limited scope for official influence over the currency supply. The Government can affect the supply of currency only to the extent that it is free and willing to exchange its own sterling balances for local currency, or is prepared to build up its cash holdings; it cannot vary the currency supply by selling its debt to the monetary authority.

(iii) It has been pointed out in discussions of the colonial currency board system that the assured convertibility of colonial currency with sterling does not require the holding of a 100 per cent sterling reserve against the banknote issue. A certain part

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1 See below, Chapters 7 and 9.
of the colonial currency issue is required for the absolute minimum of domestic transactions, and would not be presented in exchange for sterling even in the event of an economic crisis or severe recession. Thus, the maintenance of a full sterling backing to the currency issue involves an unnecessary immobilisation of investible resources; without affecting the convertibility of that part of the note issue which may be presented in exchange for sterling, a portion of the currency reserve can be held in local securities (i.e. a limited fiduciary issue can be made).

There is no way of accurately estimating what proportion of the currency supply would not, under any circumstances, be offered in exchange for sterling. In discussions of the currency system of other colonies, a proportion of up to one-third has been suggested, but, in view of the possibility of a severe political crisis in Hong Kong, it would appear necessary to impose a lower limit - of perhaps 15 to 20 per cent - on the fiduciary issue. This proportion of the currency backing could be invested locally, thus increasing the supply of financial resources for investment in the Colony without bringing into question the convertibility of the Hong Kong dollar. And, it would seem improbable that any loss of confidence in the Hong Kong dollar (either locally or abroad) would result from the Exchange Fund's holding a small portion of its assets in Hong Kong.

Nor is it likely that inflation would result from a fiduciary currency issue. Because of the high marginal propensity to import, the increased Government spending permitted by the fiduciary currency issue would very quickly result in an increased demand for imports; in any economy as foreign trade orientated as Hong Kong's, the possibility of demand inflation is severely limited. The tendency towards inflation would be lessened also to the extent that the additional Government spending brought about an increase in the output of goods and services, and to the extent that the public desired to increase its currency hoards.

(iv) Almost from the time of the Exchange Fund's establishment, the whole of the backing to the banknote issue has been invested in sterling. It was for this reason that the Exchange Fund suffered a considerable loss, in terms of Hong Kong currency, from the revaluation of the Hong Kong dollar in terms of sterling in 1967. There seems little possibility that the assets of the Exchange Fund will be diversified into other foreign currencies and gold, even though this is permitted by the Ordinance which established the Exchange Fund. First, with Hong Kong a British colony, the Bank of England would almost certainly view unfavourably any request of the Hong Kong Government to sell a part of the latter's sterling balances for, say, gold or U.S. dollars. But there is an additional problem. Because of the very considerable Communist Chinese dealings in Hong Kong currency, the United States Treasury might, under its powers to freeze any U.S. dollar balances in which there has been a Communist Chinese interest, block the dollar securities or deposits held by the Hong Kong Exchange Fund. From this it appears that Hong Kong has little alternative but to continue holding only sterling as the foreign exchange component of its currency reserve. Thus, there seems to be little possibility that Hong Kong can become, as has been suggested, a 'Switzerland of the Far East', offering holders of its currency protection against a devaluation of the world's key currencies. Nonetheless, in early 1968 the Government was reported to be seeking out ways through which it could diversify the assets of the Exchange Fund.

(v) Hong Kong is now perhaps the only important political entity where the right to issue banknotes is held by commercial

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1 For example, it was believed that, in March 1967, the United States Treasury objected to proposed Philippine purchases of rice from China as these would have been financed indirectly with U.S. dollars (the U.S. dollars were to be exchanged for the sterling in which payment was to be made). See FEER, 20 April 1967.

2 See Dick Wilson, op. cit., p.200. See also below, p.122.

3 See SCMP, 9 March 1968.
banks. But it does not appear that this right unduly benefits the note issuing banks. As was seen, the three banks earn only a very small income from their note issuing functions. They receive interest on the securities held against the 'authorised' part of their issue, but they must pay, on the same part of their total issue, the printing expenses and a small stamp duty. The banks do not receive interest on their certificates of indebtedness, and they may carry a small exchange loss on each certificate returned to the Exchange Fund. Perhaps the main advantage gained by the note issuing banks is that they are usually more free in their management of sterling than the other banks; but there would be times when their obligation to purchase or sell sterling on demand within the agreed limits would be an onerous one.\(^1\) The note issuing institutions also gain something from prestige and publicity, in that the issue of banknotes is now only very rarely a responsibility of privately-owned banks, and banknotes carrying their issuer's name are an effective means of advertising. There is also the advantage that, so long as the note issuing banks continue to accept this responsibility, they know there is no danger of an excessive issue of currency. However, the note issuing banks do not necessarily have a final say on the volume of currency on issue even now (they must exchange sterling and Hong Kong currency without limit), and it is extremely unlikely that direct control by the Government would lead to an irresponsible issue.

\(^1\) I am grateful to the Financial Secretary for making this point apparent to me.
Chapter 4

THE COMMERCIAL BANKS - I: ORGANISATION

The commercial banks are still by far the dominant institutions of the Hong Kong financial system. As is seen more fully later, such adaptation as the financial system has undergone during the Colony's rapid industrialisation has largely taken the form of developments within the banking system (such as mixed banking and greater stability) and not any significant growth of non-bank financial institutions.

This and the following two chapters are concerned with the commercial banks: organisation, assets and liabilities, and the strength and stability of the commercial banking system.

Bank Numbers

In the early postwar years there was a very rapid increase in the number of banks. In the absence of any system of bank licensing, any business or private trader could claim the title 'bank' and accept deposits from the public, and, as well as the institutions which operated before the war, many new local and mainland-owned banks opened offices. Frequently, the newer banks were concerned with currency exchange and speculation, and with remittances, and did not undertake trade finance and cheque deposit business. One estimate is that there were around 250 'banks' in mid-1947: fourteen European or American institutions (including the three note issuing banks), 32 Chinese commercial banks, 120 native (i.e. small local) banks, 76 exchange shops and 20 other banking firms (including retail stores and insurance companies). ¹

¹ FEER, 19 November 1947, p.596.
The need for Government control over the activities of the commercial banks very soon became apparent, both to offer minimum protection to depositors - there were failures among the small banks from early in the postwar period\(^1\) - and to assist the working of exchange control. A Banking Bill was introduced into the Legislative Council in 1947. This became the Banking Ordinance of 1948. In keeping with the Government's laissez-faire outlook, only a minimum of controls was imposed. There was no requirement that banks hold a certain level of paid up capital or observe a minimum liquidity ratio. Of course, at this time, the deposit liabilities of the banks were not large and most bank advances were for short-term trade purposes; a bank failure was not as potentially disruptive as it was later to become.

The Ordinance required all institutions carrying on 'banking business' (defined as 'the business of a bank engaged in the receipt of money on current or deposit account or in payment and collection of cheques drawn by or paid in by a customer or in the making or receipt of remittances or in the purchase and sale of gold and silver coin or bullion') to be licensed as banks by the Governor, and established penalties for any other business which called itself a bank; the Governor was empowered to demand the production of a bank's books, accounts and documents; and the Governor was given the right to cancel a bank's licence where there was a strong case that this was in the public interest. Banks were required to give publicity to their balance sheets. The fee for a bank licence was set at $5,000 p.a. A Banking Advisory Committee was established under the Chairmanship of the Treasurer. This Committee has, by convention, consisted of an officer of each of the large and small banks, a representative of commerce (usually an accountant) and the Accountant-General.

The 1948 Ordinance did little to restrict the number of banks operating in the Colony, and, in the words of one commentator, it

\(^1\) See FEER, 24 September 1947, p.413.
was for a long time easier to open a bank than a restaurant.¹

Several measures introduced since 1960 have made the establishment of a new bank more difficult. In 1960 it became the 'administrative practice'² in granting licences to new banks incorporated locally to require a paid up capital of at least $5 million and a senior staff experienced in banking procedures, and, for a probationary period, that detailed financial returns be submitted to the Financial Secretary. In 1964 a new Banking Ordinance required incorporated banks to have a paid up capital and uncommitted reserves of at least $10 million and to observe certain liquidity requirements. Three years later an amendment to the Banking Ordinance required minimum shareholders' funds of $20 million. A moratorium on the issue of new banking licences introduced in 1965 is still in force. It has been suggested that future banking licences might be issued only on a reciprocal basis - to institutions from countries which themselves permit the entry of Hong Kong-based banks.

The number of banks and banking offices is given in Table 4.1. There was a noticeable fall in the number of licensed banks between 1950 and 1957 (from 133 banks to 83) and a further reduction after 1962 (from 92 banks to 75 banks in December 1967). Almost all the surrendered licences belonged to small local banks. In fact, between 1950 and 1966 about 80 small banks handed in their licences. But in the same period several new and usually larger institutions were set up and a number of overseas banks established branches in the Colony. Between 1953 and 1963 about eighteen 'expatriate' banks, mainly from East and South Asia, but also American and European banks, were granted banking licences. The entry of these additional foreign banks added greatly to banking competition, and the Hongkong Bank, at least, 'questioned the casual manner in which overseas banks have been allowed to set up in Hong Kong'.³

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¹ P.H.M. Jones, FEER, 7 April 1966, p.35.
³ SCMP, 1 May 1965.
Table 4.1
NUMBER OF BANKS LICENSED TO OPERATE IN HONG KONG AND NUMBER OF BANKING OFFICES

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of licensed banks</th>
<th>Number of banking offices (including head offices)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1947</td>
<td>(252)(^b,c)</td>
<td></td>
</tr>
<tr>
<td>1950</td>
<td>133</td>
<td>135</td>
</tr>
<tr>
<td>1954</td>
<td>94(^d)</td>
<td>97</td>
</tr>
<tr>
<td>1957</td>
<td>83</td>
<td>n.a.</td>
</tr>
<tr>
<td>1960</td>
<td>86</td>
<td>110</td>
</tr>
<tr>
<td>1961</td>
<td>85</td>
<td>159</td>
</tr>
<tr>
<td>1962</td>
<td>92</td>
<td>187</td>
</tr>
<tr>
<td>1963</td>
<td>87</td>
<td>215</td>
</tr>
<tr>
<td>1964</td>
<td>88</td>
<td>275</td>
</tr>
<tr>
<td>1965</td>
<td>78</td>
<td>301(^f)</td>
</tr>
<tr>
<td>1966</td>
<td>76(^e)</td>
<td>318(^g)</td>
</tr>
<tr>
<td>1967</td>
<td>75(^e)</td>
<td>331</td>
</tr>
</tbody>
</table>

\(^a\) 31 December each year. \(^b\) Number of banks. \(^c\) Including 23 authorised banks. \(^d\) Including 26 authorised banks. \(^e\) Including 51 authorised banks. \(^f\) After closure of 25 branches of Canton Trust Bank and two branches of Ming Tak Bank. \(^g\) After closure of 4 branches of Yau Yue Commercial Bank.

Sources: Hong Kong Annual Report, various; Far Eastern Economic Review, various.

Another development shown in the Table is the recent establishment of branch networks. Until 1960 the Colony's banking system was organised virtually on a unit basis with only the larger institutions having more than one office. By the end of 1966 there were 242 branch offices\(^1\) and only 22 banks (about half of them foreign and the remainder small local banks) had no branches.\(^2\) The larger banks have been especially active in opening additional offices.

The Hongkong Bank in December 1966 had 49 branches in the Colony, and the Chartered Bank sixteen, compared with two and one respectively.

1 The increase in bank offices has been at a slower rate than the growth of bank deposits. The value of deposits per banking office increased from $14.5 million in 1960 to $21 million in 1966.
2 The geographical distribution of the 318 bank offices in December 1966 was: Hong Kong Island 159, Kowloon 133, New Territories 26. The Hongkong Bank also maintained several mobile branches in the New Territories.
in 1954. The main reason for this growth of branch networks is that the banks have actively sought to collect the small personal savings which were earlier held as currency hoards or jewellery, and which, with increasing prosperity, have become more important.¹ The larger banks have also aimed at providing customers with ready access to a local, and usually Chinese, manager, to overcome any belief that those seeking loans 'have to queue up at the head office and see the General Manager'.

There have been very few mergers or takeovers. In 1959 the Mercantile Bank became a wholly owned subsidiary of the Hongkong Bank. In 1961 a Japanese bank took a 30 per cent interest in the locally-owned Chekaing First Bank of Commerce. Chase Manhattan Bank N.A. in 1964 purchased the Hong Kong business of the Nationale Handelsbank N.V., and re-commenced banking operations in the Colony after the closure of its Hong Kong branch during the Korean war. During the 1965 banking crisis, the Hongkong Bank took a 51 per cent interest in the Hang Seng Bank, a large, locally-owned institution. In 1966 two French banks operating in Hong Kong were merged into the Banque Nationale de Paris. In the same year the assets and liabilities of Yau Yue Commercial Bank, a small Philippine-Chinese bank, were taken over by the Hongkong Bank when the former institution faced insolvency.

A Classification of Commercial Banks

Given the large number of commercial banks, some classification of banks by size or function is necessary for purposes of description. Of course, the diversity of banks does not make this classification an easy one; as was noted in the Tomkins Report, 'at present (April 1962) there are 87 different banks; and it is only

¹ The local manager of the Chartered Bank commented in 1966: 'I suppose saving deposits have really been the stimulus behind branch banking.' P.A. Graham, 'The Banking Industry of Hong Kong', University of Hong Kong, Department of Extra-mural Studies, public lecture, 6 December 1966, mimeographed, p.6.
a slight exaggeration to say that this means that there are 87 different types of banks.\footnote{Tomkins Report, p.2.}

One criterion for grouping the banks is the size of deposits, but few banks show separately their Hong Kong accounts, and accounts on a global basis are not available for some institutions, such as the Mainland China banks. It is possible to classify the banks on the basis of the size of paid up capital (Table 4.2), but this grouping, although, of course, useful in showing the strength of the capital resources of the banking system, does not give any indication of the extent of the local business of the various institutions. The distinction between authorised and unauthorised banks, outlined in the previous Chapter (authorised banks undertake foreign exchange dealings at official exchange rates, and can freely operate their sterling accounts; unauthorised banks deal in the free market in foreign currencies and are restricted in their sterling dealings) is an important one, but it conceals a number of other fundamental differences, more especially on the side of the authorised banks. Perhaps the most useful grouping is one based both on 'nationality' and, roughly, on bank size, and on these criteria the 75 banks can be classified as the British banks, the Mainland China banks, the expatriate banks, the large local banks and the small local banks.

\begin{table}[h]
\centering
\begin{tabular}{|l|c|}
\hline
Paid up capital above $10m. & 40 \\
Paid up capital $7.5m. to $10m. & 10 \\
Paid up capital less than $7.5m. & 22 \\
Unincorporated banks & 4 \\
\hline
\end{tabular}
\caption{Licensed banks by size of paid up capital, 30 August 1966}
\end{table}

Source: Commissioner of Banking, personal communication.
(a) The British Banks. The three note issuing banks - the Hongkong Bank, the Chartered Bank and the Mercantile Bank - are frequently referred to as the 'British banks', even though two have their head offices in the Colony. These three institutions have occupied a dominant position in the Colony's banking system since the 1870s; this pre-eminence has been maintained through the recent period of industrialisation and rapid economic growth. The local business of the British banks has changed quite fundamentally since the Pacific war, and they are no longer accurately described as 'exchange banks'.

In one estimate, the three banks in 1963 'almost certainly account[ed] for considerably more than 50 per cent of all commercial banking business in the Colony'; with the recent growth in branch networks, the employing of additional Chinese branch managers and the transfer of deposits from the smaller banks during the 1965 banking crisis, the three banks' share of Hong Kong banking business would now be even higher.

The banks remain supra-territorial institutions, but the establishment of local control over banking in many of the territories in which they are represented has required them to consider their operations more on individual country bases. Their close contacts with the London money market and their holding the accounts of the leading export houses and manufacturers give them a dominant position in the market for sterling. As was seen in the previous Chapter, an agreement between these banks and the Exchange Fund sets the limits to movements in the Hong Kong dollar-sterling exchange rate, and the actual rate is determined within these extremes by the three banks in consultation. The banks have been, of course

1 The head office of the Hongkong Bank has been located in the Colony since the Bank's establishment. The Mercantile Bank's head office was moved to Hong Kong in 1965.

2 David Williams, 'Commercial Banking in the Far East', The Banker, April 1963, p.419.

3 See below, p.151.
strongly influenced by British banking traditions and practices, but they have been not unwilling to adopt more flexible attitudes on a number of occasions, as, for example, in undertaking long-term industrial lending. As expressed by a former Chairman of the Hongkong Bank:

although erudite authorities on the principle of securities for bankers might well raise their hands in horror at some of our methods they would do well to remember that it would be a pity for our industrial growth if some of the more sophisticated methods of the progressive countries forced banks in Hong Kong to adopt a tighter and less humanitarian lending policy.¹

The willingness of these banks to depart from the conservative English banking practices more usually followed in colonial territories has both reflected and contributed to Hong Kong's more advanced level of economic development.

As well as holding the accounts of many of the larger merchant houses - Chinese as well as British - the three British banks conduct the banking business of the Government, the public utility companies and most large manufacturing firms. But, especially since the late 1950s, the British banks have had as customers many small Chinese businesses and depositors. There has probably been more contact between the expatriate British banks and local businesses and residents in Hong Kong than elsewhere among the colonial territories.

The most dominant bank by far is the Hongkong Bank, which alone conducts one-third to two-fifths of the Colony's banking business. The Bank is part of a world-wide group, having as subsidiaries the Mercantile Bank and the British Bank of the Middle East, and banking and hire purchase interests in the United States, Britain, Australia and West Indies. The Bank's role has been likened to that

¹ Quoted Gethyn Davies, op. cit., p.244. It is interesting to compare this with the observation of E. Nevin, op. cit., p.48, that an 'important feature of the policy of the expatriate banks has been the retention in overseas territories of conventions and standards to which the banks had become accustomed in their native countries and which they exported to the overseas territories in the same way as the colonisers exported their currency and their capital'.
enjoyed by the Bank of England in London in the late nineteenth century: it has a large share of the Colony's banking business and several attributes of a central bank. The Bank has great prestige in Hong Kong, and has long been closely identified with the Colony. For example, during the Pacific war, the Bank's head office - which had been temporarily moved to London - promised considerable assistance to enable the re-establishment, after the war, of the public utility companies; the Hongkong Bank, along with the Chartered Bank in the late 1940s pioneered the granting of medium term loans for industrial purposes; and the Bank took special steps to assist cotton spinning mills after a United States embargo on cotton exports to Hong Kong in 1950. Almost all the important Hong Kong businesses have accounts with the Hongkong Bank. Cheques drawn on an account with the Bank are widely accepted in Hong Kong.

Through its London office, the Bank has a close contact with the London money market. The London office is responsible for employing liquid funds, holding the sterling part of the Bank's reserves, negotiating trade bills, etc.

Hong Kong business is of less importance in the global operations of the Chartered Bank. Nonetheless, the Bank does undertake a significant share - probably around 10 or 12 per cent - of the Colony's banking business.

These two British banks have performed several functions elsewhere undertaken by central banks. The banks' role in issuing currency and in the determination of the exchange rate between the dollar and sterling have been outlined already. The two institutions hold the Government's bank deposits and conduct transfers of Government funds. When, in 1965, the Government decided to transfer a part of its reserves from London to Hong Kong to help banks meet the liquidity provisions of the 1964 Banking Ordinance, the Government

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2 All but seven of the sixty companies listed on the Hong Kong Stock Exchange have an account with the Hongkong Bank.
funds were lent through, and guaranteed by, the two British banks. They have also acted as bankers' bank. The other commercial banks hold deposits with the two British banks for clearing and liquidity purposes, and have borrowed from the British banks when in difficulties - i.e. the Hongkong Bank and the Chartered Bank have acted in a lender of the last resort capacity. It is known that the two British banks assisted some local banks in 1961, 1965 and 1966, and there are possibly other cases which have not been made public.  

The Hongkong Bank has also, on at least two occasions pursued what might be termed a policy of quantitative control of credit. And the British banks claim to have adjusted deposit rates in accordance with their assessment of the needs of the local economy.

(b) The Mainland China Banks. Another easily identified group are the nine banks whose head offices are located in Mainland China. Most of these banks were founded before the establishment of the Communist Government in China, and the Hong Kong branches changed their allegiance from the Nationalist Chinese Government when Britain formally recognised the present Peking regime in November 1950. The most important of the nine is the Bank of China which is China's main institution of foreign exchange and trade finance. As befits institutions intimately concerned with trade and exchange, the banks are believed to be highly liquid. All are authorised banks. Because of the United States Treasury restriction on Communist Chinese dealings in U.S. currency, the Mainland China banks are unable to deal in U.S. dollars on either of the Hong Kong exchange markets. The Mainland banks conduct a considerable business in remittances from the overseas Chinese.

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1 Clearing arrangements are described below. See p.119.
2 The local manager of the Hongkong Bank wrote in 1965 that the two British banks 'habitually act as lender of the last resort' and 'provided that a bank is being run on sound lines there should be no difficulty in obtaining help if it suffers a temporary shortage of liquidity'. FEER, 22 April 1965, p.177.
3 See pp.126-7.
4 See pp.137-8.
Much of the usefulness of the Hong Kong branches from the Chinese point of view arises from the Hong Kong dollar's ready convertibility. The Mainland banks can exchange, for sterling or most other world currencies, the Hong Kong dollars earned from China's trade and other commercial dealings with the Colony, and with this foreign exchange payment can be made for Chinese imports, or the funds can be transferred to London and used to buy gold. The Mainland banks, however, do not have a monopoly in the finance of Chinese foreign trade - a part is still arranged by other banks, including the note issuing institutions - or of remittance transfers, some of which are still made through local Hong Kong banks. Nor are the Mainland banks exclusively concerned with trade and exchange business; advances are made both the official Chinese corporations operating in the Colony and to local businesses. The Mainland banks have a popular reputation for operating on a most conservative basis.¹

(c) The Expatriate Banks. There have been branches in Hong Kong of European and American banks from early in the Colony's history. There were ten of these expatriate banks in the early 1950s. Another eighteen or so have since been set up, three from the United States and the remainder from Japan and other Asian countries. Some are Government-owned institutions. The Hong Kong capital reserves of these expatriate banks are mostly quite small. Local branches rely for capital reserves, and also for second line liquid assets, on the global operations of the parent.

The main interest of many of the expatriate banks, notably those from South and South East Asia, is in financing trade, especially, but not exclusively, with their country of origin.² However, over recent years the United States and Japanese banks, at least, have undertaken some local business, often with firms established in Hong Kong by interests in the banks' country of origin.

¹ See The Economist, 14 November 1964, p.733.
(d) The Large Local Banks. The remaining forty or so banks are local institutions and range in size from the large and strong Hang Seng Bank and Bank of East Asia to the very small unincorporated banks with one banking office, a small clientele and deposits of less than $2 million. It is useful to distinguish between the large and small local banks, but even this division hides many important differences. A group of about ten can be regarded as the large local banks.

This category includes the Bank of East Asia and the Bank of Canton, both of which were established in the 1910s as the first Chinese-owned Western-style banks. In 1966 the deposits held by these two banks were, respectively, $362 million and $179 million. The two institutions have branch networks throughout South East Asia, and are particularly important in financing trade and remittances.

The other eight or so banks in this classification do not have branches outside Hong Kong. The largest is the Hang Seng Bank, which now holds about one-tenth of the Colony's bank deposits. The Bank was established in 1933 as a partnership dealing in remittances, money changing and gold exchange, and made large but variable profits from speculation in gold, currencies and commodities after the Pacific war: in 1947 the Bank's profit was $6 million (or about three times its capital), in 1948 a profit of about $2 million was earned. When dealings in gold and commodities became less profitable in the early 1950s the Bank moved into the field of real estate advances and used a part of the sizeable profits earned to strengthen its capital. Between 1952, when the Bank was incorporated as a private company, and 1966, paid up capital was increased from $5 million to $100 million, and deposit liabilities rose from $14 million to $789 million. A bills department was established in the late 1950s. The Bank has recently begun lending for manufacturing purposes.

1 The Bank of the East Asia is a public company, with its shares listed on the Hong Kong Stock Exchange.
Except that their recent growth is a little less spectacular, the development of the other large local banks is similar to that of the Hang Seng Bank. These institutions were mostly established before the Pacific war as partnerships to deal in gold and money transfers, and were quickly re-established in the speculators' markets after 1945, when large profits were earned and retained to finance expansion. Profits were greatly reduced in the period 1950 to 1955. The banks began to place greater emphasis on the granting of loans for real estate purposes. Gradually the acceptance of deposits became a more important business. With the establishment of trade bills sections in the late 1950s, the continued growth of deposits and the recent entry into the field of industrial loans, these banks have outgrown their earlier reputation of money changers and now undertake familiar commercial banking activities. Through close contacts with the Chinese business community, a willingness to open long hours and an ability to offer a flexible and personal service, these banks have been in a strong position to attract business. Recently, there has been a strengthening of capital reserves and the establishment of branch networks in Hong Kong. In most cases, there is still a very close identification of the bank with a particular family: the bank's capital is usually tightly held and most senior positions are occupied by members of the family.

There is another institution which, on the basis of size, might be included within this group - Wayfoong Finance, a subsidiary of the Hongkong Bank. Although licensed as a bank, this institution operates as a hire purchase company. At the end of 1966 it had fixed deposit liabilities of $91 million.

1 It was estimated that about four-fifths of the advances of the larger local banks in 1959 was for real estate uses. See Ng Kwok Leung, 'The Native Banks; their Structure and Interest Rates', FEER 11 February 1960, p.309.

2 The attitude of the larger banks to the long trading hours of their smaller competitors is perhaps shown by the way in which the Hongkong Bank and the Chartered Bank required the Liu Chong Hing Bank drastically to reduce its trading hours when the two British banks came to the assistance of the local bank in 1961.
(e) The Small Local Banks. It is difficult to generalise about the remaining thirty or so licensed banks, other than to say that they are small, and local in outlook and operations. As was seen in the discussion on Table 4.1, a large number of small banks was set up early in the postwar period, mainly to operate as gold dealers and money changers. Under the 1948 Banking Ordinance these businesses could readily be licensed as banks whether or not they were soundly run, and regardless of their main business interest. In fact, under the definition of banking business adopted in the Ordinance, perhaps all gold dealers and exchange shops should have held banking licences. There was a big decrease in the number of these banks in the early 1950s, more as a result of the slump in exchange speculation than of the 1948 Ordinance.

There have been several changes in the operations of the small local banks over the past two decades, mostly in the direction of their accepting business of a more conventional commercial banking nature. Currency exchange is still an important part of the business of a number of banks, but speculation on the exchanges is greatly reduced. Much of the business in remittances from overseas Chinese has been lost to the Mainland banks. Commodity speculation has been unimportant since the early 1950s. Through the 1950s and much of the present decade, lending for real estate transactions has been 'probably the mainstay' of these institutions. Until recently, the majority of institutions had slender capital resources. It was suggested in 1963 that only ten local banks had a paid up capital greater than $5 million, and that the 'typical' size of bank capital was $2 million. Only eleven local banks were thought to have liquid asset ratios in excess of 20 per cent.

As with the large local banks, there is frequently a close identification of a bank with a particular family. This association

1 FEER, 11 February 1965, p.270.
2 David Williams, 'Hong Kong Banking', Three Banks Review, March 1963, p.35.
has tended to prevent bank mergers and takeovers, and has, on a number of occasions, resulted in strong interbank jealousies and, more rarely, rumour spreading. Many of the banks still have small capital resources; as Table 4.2 showed, in August 1966, 22 banks had a paid up capital of less than $7.5 million. Four of the banks are unincorporated. The operations of a few of the institutions in this group are more accurately described as money lending and money changing. The 1964 Banking Ordinance made it illegal for banks to trade on their own account and to grant unsecured loans, and has required that the banks give more respect to capital and liquidity considerations.

With their small size, personal control and willingness to open for long hours, these banks have been able to offer a highly personalised service to their customers, especially to small Chinese businesses. An ex-manager of a small bank said that he 'spoke the right language for his customers in a number of ways'; he visited many customers daily, and had informal agreements with them in a way not possible in a larger institution.

Not all the small banks offer current deposit facilities. Interest rates on time and saving deposits have been higher than those paid by the larger banks and, until recently, interest was paid on current deposits. In one or two of the smaller banks, depositors can withdraw their deposits in gold. Some of these banks have attracted deposits from particular groups of overseas Chinese. Few negotiate trade bills. In the absence of a local securities market, the liquid asset holdings of most small local banks are confined to cash, deposits with other banks and foreign currency holdings.

The Banks and the Money Market

The Hong Kong money market was for a long time largely confined to transactions between the note issuing banks and the other

1 This section draws heavily on David Williams, 'Hong Kong' in W. Crick, op. cit., pp.179-81, and Ng Kwok Leung, 'Reform Round the Corner in Hong Kong', FEER, 11 April 1963, pp.90-5.
commercial banks. The latter borrowed overnight from the Hongkong Bank and the Chartered Bank to meet any serious clearing drain, and perhaps deposited with these two British banks any short-term surplus of Hong Kong dollars. Among the unauthorised banks there was a well-organised but thin market in foreign currencies and gold. A wider but still purely interbank - money market emerged in the late 1950s, when a number of expatriate banks required more Hong Kong dollars than they were able to attract by way of deposits, while a number of local and overseas Chinese banks held surplus funds. The form of the money market has changed little in the past ten years. The main borrowers are several of the expatriate banks. As the main interest of these institutions is trade finance, they can gear their day to day liquidity requirements to the maturity of their bills portfolio, and resort to the interbank market in the event of a sudden increase in the demand for cash. At times, some of the expatriate banks have been aggressive borrowers. But not all expatriate banks have borrowed from the market, and some have operated both ways. The market has been supplied mostly from the medium-sized local and overseas Chinese banks, and with funds which otherwise would have been transferred to London or New York. Rarely have local banks gone to the market as borrowers: some consider it would be a 'sign of weakness' to do so; some that lending on the interbank market means 'putting money in competitors' hands'.

On this interbank market money is usually dealt in at call, seven and fourteen days and one month, but interbank deposits of three months are becoming more common. Interest rates on call money show a seasonal peak (usually around 5 per cent) at the end of the year when most banks balance, and at Chinese New Year. The interbank rate rose to 7½ per cent in the 1961 and 1965 banking crises. This money carried its lowest rate - of around 2½ per cent - in February 1963.

1 S.K. Yee (Managing Director, United Chinese Bank), FEER, 28 May 1962, p.639.
2 P.H.M. Jones, FEER, 27 April 1967, p.185.
Five or six brokers operate in the market, but not as principals. Brokerage is $\frac{1}{16}$ per cent per month, charged on the borrower. Contacts are more usually made directly between banks, by telephone about 10 a.m. when the banks balance their cash positions from the previous night. The borrowing bank issues a deposit receipt and receives a cashier's order, manager's cheque or a cheque drawn on a third bank. No security is offered, but a lending bank may set a limit for any one borrower.

The money market is purely an interbank market. There are no Treasury Bills on issue, and the Government debt is small in amount and tightly held. There are no official rediscount facilities. Nor is there a market in commercial paper. In the words of a leading banker, 'Bankers here seem to prefer to hold their own paper until maturity largely because in the past there has been a surplus of credit and at least partly because with the large number of banks they fear that the information obtainable by a competitor regarding their customers' transactions will be used to solicit business'.

In any case, the supply of bills coming on to the market might not be continuous, and there would be need for a parallel market in short-term Government paper to even out supply and demand; 'without these two factors it is simpler for banks to hold their liquidity overseas rather than switch it backwards and forwards, introducing a distinctly unrewarding exchange cost'.

Of course, a main reason for the undeveloped nature of the money market is that, with the Hong Kong dollar freely transferable into sterling at only a small exchange cost, many institutions prefer to hold their liquid balances abroad. Even those banks which are frequent lenders on the local interbank market move excess funds to London when the sterling-Hong Kong dollar rate is favourable. As all authorised banks have deposits in London, transfers of sterling can be made between the banks to meet interbank debts or adjust

2 Ibid.
liquidity ratios.\textsuperscript{1} When the banks as a whole wish to move into sterling or Hong Kong dollars, the note issuing banks approach the Exchange Fund in a manner described in the previous Chapter.

Despite its limitations, the money market has performed the useful function of providing a liquid outlet in Hong Kong for the temporarily surplus funds of the large local and South East Asian banks and of providing the expatriate banks with additional Hong Kong dollar balances. As a commentator on the money markets of Malaysia and Singapore has reminded us,

\begin{quote}
The development of a money market should be judged... by its adequacy in meeting current demands made upon it, rather than by its institutional structure. What might seem undeveloped, or even inadequate, when compared with the stage of institutional development in London might prove to be adequate when taken in a local context.\textsuperscript{2}
\end{quote}

**Competition Between Banks**

There has been a very strong degree of competition between the commercial banks through the whole postwar period. The form of this competition has, though, changed significantly. The main reason for the intensely competitive conditions is simply that there are too many banks, even allowing for the international importance of Hong Kong. (Because of the importance of Hong Kong as an international trading and financial centre a large and possibly increasing number of expatriate banks will continue to want to, at least, 'show the flat' here.) The volume of business available is spread too thin and the struggle for deposits and survival is fostering 'cut-throat' competition reflected in part by the payment of high rates of interest and by the rapid expansion of branch banking.\textsuperscript{3}

The mobility of a significant part of bank deposits has contributed to an at times quite fierce competition between a number of the banks. Quite a few depositors have maintained more than one account, freely transferring their funds when induced to do so by the offer of a higher interest rate or some other advantage. And many depositors - local depositors new to the banking habit and

\textsuperscript{1} For the outline of a similar practice among the Singapore banks, see David Williams, 'Money Markets of South-East Asia', The Banker, May 1963, p.488.

\textsuperscript{2} Ibid., p.485.

\textsuperscript{3} Tomkins Report, p.7.
overseas depositors may not have felt a close relationship with any particular bank. But it is not the case that all deposits are mobile between banks. The deposits of Government and the larger merchant and manufacturing concerns are tightly held by the British banks, while family contacts and a common dialect have made the deposits of a number of small banks similarly immobile. Until 1964 when an interest rate agreement came into force, competition for bank deposits resulted in something of an interest rate war. Competition now takes the form of the establishment of branch networks and of advertising. The smaller banks have the advantage of longer trading hours.

On the assets side, competition is most active for business directly concerned with international trade - opening credits, negotiating bills, the granting of trust receipt loans, etc. This business is favoured both for its return and its liquidity. The establishment in Hong Kong of additional expatriate banks, the entry of more local banks in the trade finance business, and the slow rate of growth of trade in comparison with bank funds, have intensified bank competition for this business. There is less competition for other forms of bank advances. Only the British banks are yet important as lenders of medium term funds for industry. Further, some of the loans for real estate granted by the smaller banks would not have been available from the larger institutions, and many of the advances of the Mainland banks are granted to Communist Chinese agencies.

There have been three formal associations of banks: the Exchange Banks Association, the Bankers' Clearing House and the

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1 See below, pp.137-9.
2 The Chartered Bank for a while offered its depositors a free accident insurance scheme, but discontinued the scheme under pressure from the other commercial banks.
3 As the representative of the Hongkong Bank told the Radcliffe Committee, 'A good deal of the business done by indigenous banks would not have been handled by us at any rate of interest'. Quoted L.A. Pressnell, 'A Glimpse of Banking in Hong Kong', Three Banks Review, September 1961, p.28.
Inter-Bank Interest Rate Agreement. Membership of the Exchange Banks Association is open to any authorised bank. The Association is concerned with establishing the terms and conditions of transactions in the official exchange market and with determining minimum charges for certain banking services concerned with trade and exchange. Members also agree on the hours in which exchange business is transacted. The Hong Kong dollar-sterling rate is set by the Exchange Sub-committee of this Association. The Association was influential in bringing about the interbank agreement on deposit rates, but members do not agree on the rates of interest charged on advances. Until 1965, the Committee of the Exchange Bank's Association consisted of the three British banks, the Bank of East Asia, two Mainland banks, one United States and one Dutch bank. After a certain amount of friction between members, the Committee's composition was altered and now consists of the Chartered Bank, the Hongkong Bank, the Bank of China and several elected members.

There is no formal association of unauthorised banks.

The active competition between banks has had several consequences. In the view of a number of bankers, probably the most important result was that until the 1964 interest rate agreement, competition between banks led to a high level of deposit rates, the consequences of which are seen below. The large number of banks and the active competition may also have made it easier for rather unsound borrowers to obtain funds. And, the competition among the smaller banks led, on one or two occasions, to some malicious rumour spreading. On the other hand, the rather intense competition between banks must have contributed to their successful mobilisation of private savings. And the interest rate agreement has prevented a repetition of the potentially dangerous interest rate war. It must

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1 The clearing house and the interest rate agreement are discussed below, pp.119, 138.

2 See Hong Kong Standard, 17 February 1965. This newspaper referred to the Exchange Banks Association as 'local big business' most exclusive club'.

be remembered, too, that there is not the competition between banks and non-bank financial institutions that is a feature of the monetary systems of many countries.
Chapter 5

THE COMMERCIAL BANKS - II: ASSETS AND LIABILITIES

No statistical information is available on the structure of commercial bank assets and liabilities before 1954. Presumably, deposits increased rapidly in the early postwar years as commerce was re-established and the Chinese Civil War drove capital from China. A number of Chinese-owned banks moved from the Mainland, bringing with them, in aggregate, a considerable amount of funds. But there was little competition between banks for deposits. In 1949 it was reported that the limited outlet for bank advances discouraged many banks from accepting new deposits: some banks paid no interest on their depositors' accounts, other no more than 1 per cent per annum on twelve month deposits. The slump in economic activity in 1951 presumably led to an appreciable fall in both deposits and the demand for bank credit. Throughout 1952 a number of banks took further steps to discourage depositors. Commercial bank assets and liabilities began increasing again in early 1953.

Statistics on bank deposits, loans and advances and liquid asset holdings have been collected since December 1954 (Table 5.1). A more detailed classification of the assets and liabilities of the commercial banks is available from 1960 (Table 5.2). What stands out most clearly from the two tables is the very rapid expansion of the commercial banking system. Between 1954 and 1966 deposits increased eight times to $8,405 million, and loans and advances more than ten times to $5,380 million. The year by year changes in deposits and advances are shown in Table 5.3.

1 FEER, 13 April 1949. 2 FEER, 2 October 1952.
Table 5.1
HONG KONG COMMERCIAL BANKS: DEPOSITS AND ASSETS, 1954 TO 1967
($ million)

<table>
<thead>
<tr>
<th>Year</th>
<th>Demand</th>
<th>Time</th>
<th>Savings</th>
<th>Total</th>
</tr>
</thead>
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<tr>
<td>1954b</td>
<td>828</td>
<td>139</td>
<td>101</td>
<td>1068</td>
</tr>
<tr>
<td>1955</td>
<td>852</td>
<td>152</td>
<td>133</td>
<td>1137</td>
</tr>
<tr>
<td>1956</td>
<td>928</td>
<td>173</td>
<td>166</td>
<td>1267</td>
</tr>
<tr>
<td>1957</td>
<td>955</td>
<td>267</td>
<td>190</td>
<td>1412</td>
</tr>
<tr>
<td>1958</td>
<td>988</td>
<td>351</td>
<td>244</td>
<td>1583</td>
</tr>
<tr>
<td>1959</td>
<td>1205</td>
<td>482</td>
<td>369</td>
<td>2056</td>
</tr>
<tr>
<td>1960</td>
<td>1393</td>
<td>752</td>
<td>537</td>
<td>2682</td>
</tr>
<tr>
<td>1961</td>
<td>1470</td>
<td>1234</td>
<td>663</td>
<td>3367</td>
</tr>
<tr>
<td>1962</td>
<td>1664</td>
<td>2283</td>
<td>879</td>
<td>4311</td>
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<tr>
<td>1963</td>
<td>1997</td>
<td>2639</td>
<td>1145</td>
<td>5425</td>
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<tr>
<td>1964</td>
<td>2338</td>
<td>3099</td>
<td>1515</td>
<td>6491</td>
</tr>
<tr>
<td>1965</td>
<td>2532</td>
<td>3742</td>
<td>1620</td>
<td>7251</td>
</tr>
<tr>
<td>1966</td>
<td>2681</td>
<td>3324</td>
<td>1982</td>
<td>8405</td>
</tr>
<tr>
<td>1967</td>
<td>2658</td>
<td>3247</td>
<td>2180</td>
<td>8162</td>
</tr>
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</table>

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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Cash</td>
<td>n.a.</td>
<td>144</td>
<td>97</td>
<td>118</td>
<td>84</td>
<td>86</td>
<td>136</td>
<td>114</td>
<td>162</td>
<td>210</td>
<td>202</td>
<td>221</td>
<td>232</td>
<td>333</td>
</tr>
<tr>
<td>3. Net balances with other banks</td>
<td>n.a.</td>
<td>459</td>
<td>541</td>
<td>578</td>
<td>730</td>
<td>775</td>
<td>930</td>
<td>1041</td>
<td>1482</td>
<td>1831</td>
<td>1577</td>
<td>2133</td>
<td>2862</td>
<td>2347</td>
</tr>
<tr>
<td>4. Loans and advances</td>
<td>510</td>
<td>632</td>
<td>769</td>
<td>865</td>
<td>919</td>
<td>1373</td>
<td>1720</td>
<td>2334</td>
<td>2849</td>
<td>3642</td>
<td>4612</td>
<td>5038</td>
<td>5380</td>
<td>5343</td>
</tr>
<tr>
<td>5. Investments</td>
<td>69</td>
<td>96</td>
<td>98</td>
<td>101</td>
<td>121</td>
<td>133</td>
<td>166</td>
<td>232</td>
<td>191</td>
<td>187</td>
<td>271</td>
<td>527</td>
<td>537</td>
<td>590</td>
</tr>
<tr>
<td>6. Cash (to deposits)</td>
<td>n.a.</td>
<td>12.7</td>
<td>7.7</td>
<td>8.4</td>
<td>5.3</td>
<td>4.2</td>
<td>5.1</td>
<td>3.4</td>
<td>3.8</td>
<td>3.7</td>
<td>3.6</td>
<td>3.0</td>
<td>2.8</td>
<td>4.1</td>
</tr>
<tr>
<td>7. Liquid assets</td>
<td>n.a.</td>
<td>53.3</td>
<td>50.4</td>
<td>49.3</td>
<td>51.4</td>
<td>41.9</td>
<td>39.7</td>
<td>34.3</td>
<td>38.1</td>
<td>37.5</td>
<td>27.6</td>
<td>32.5</td>
<td>36.8</td>
<td>32.8</td>
</tr>
<tr>
<td>8. Loans and advances</td>
<td>47.8</td>
<td>55.6</td>
<td>60.7</td>
<td>61.3</td>
<td>58.1</td>
<td>66.8</td>
<td>64.1</td>
<td>69.3</td>
<td>66.1</td>
<td>67.1</td>
<td>69.8</td>
<td>69.5</td>
<td>64.0</td>
<td>65.5</td>
</tr>
</tbody>
</table>

a Until 1964 some smaller banks were excluded, and a part of the increase in deposits and assets for the period 1954 to 1964 represents a progressively wider coverage. This element cannot have been important.

b 31 December each year.

Source: Hong Kong Government Gazette, Supplement No.4.
### Table 5.2

**HONG KONG COMMERCIAL BANKS: ASSETS AND LIABILITIES, 1960 TO 1967**

($) million

<table>
<thead>
<tr>
<th>Date</th>
<th>Liabilities</th>
<th>Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>31.12.60</td>
<td></td>
<td></td>
</tr>
<tr>
<td>30.6.61</td>
<td></td>
<td></td>
</tr>
<tr>
<td>31.12.61</td>
<td></td>
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</tr>
<tr>
<td>30.6.62</td>
<td></td>
<td></td>
</tr>
<tr>
<td>31.12.62</td>
<td></td>
<td></td>
</tr>
<tr>
<td>30.6.63</td>
<td></td>
<td></td>
</tr>
<tr>
<td>31.12.64a</td>
<td></td>
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</tr>
<tr>
<td>30.6.65</td>
<td></td>
<td></td>
</tr>
<tr>
<td>31.12.65</td>
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<td></td>
</tr>
<tr>
<td>30.6.66</td>
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<td></td>
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<tr>
<td>31.12.66</td>
<td></td>
<td></td>
</tr>
<tr>
<td>30.6.67</td>
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<td></td>
</tr>
<tr>
<td>31.12.67</td>
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#### Liabilities

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<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>Notes in circulation</td>
<td>914</td>
<td>945</td>
<td>953</td>
<td>1,003</td>
<td>1,042</td>
<td>1,075</td>
<td>1,140</td>
<td>1,184</td>
</tr>
<tr>
<td>Deposits</td>
<td>1,392</td>
<td>1,507</td>
<td>1,470</td>
<td>1,575</td>
<td>1,664</td>
<td>1,854</td>
<td>1,997</td>
<td>2,079</td>
</tr>
<tr>
<td>Time</td>
<td>712</td>
<td>910</td>
<td>1,236</td>
<td>1,434</td>
<td>1,768</td>
<td>2,053</td>
<td>2,283</td>
<td>2,635</td>
</tr>
<tr>
<td>Saving</td>
<td>337</td>
<td>594</td>
<td>663</td>
<td>793</td>
<td>878</td>
<td>1,020</td>
<td>1,145</td>
<td>1,355</td>
</tr>
<tr>
<td>Total</td>
<td>(2,682)</td>
<td>(3,054)</td>
<td>(3,367)</td>
<td>(3,802)</td>
<td>(4,311)</td>
<td>(4,929)</td>
<td>(5,425)</td>
<td>(6,052)</td>
</tr>
<tr>
<td>Balances due to other banks in Hong Kong</td>
<td>300</td>
<td>369</td>
<td>374</td>
<td>411</td>
<td>499</td>
<td>526</td>
<td>603</td>
<td>504</td>
</tr>
<tr>
<td>Abroad</td>
<td>359</td>
<td>367</td>
<td>370</td>
<td>338</td>
<td>303</td>
<td>326</td>
<td>410</td>
<td>442</td>
</tr>
<tr>
<td>Other liabilities</td>
<td>1,084</td>
<td>1,213</td>
<td>1,298</td>
<td>1,431</td>
<td>1,534</td>
<td>1,683</td>
<td>2,010</td>
<td>2,276</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>1,319</td>
<td>1,540</td>
<td>1,635</td>
<td>1,895</td>
<td>2,123</td>
<td>2,539</td>
<td>2,958</td>
<td>3,069</td>
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#### Assets

<table>
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</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>136</td>
<td>131</td>
<td>144</td>
<td>156</td>
<td>162</td>
<td>194</td>
<td>210</td>
<td>200</td>
</tr>
<tr>
<td>Balances due from other banks in Hong Kong</td>
<td>285</td>
<td>323</td>
<td>416</td>
<td>503</td>
<td>595</td>
<td>698</td>
<td>772</td>
<td>701</td>
</tr>
<tr>
<td>Abroad</td>
<td>1,304</td>
<td>1,212</td>
<td>1,372</td>
<td>1,446</td>
<td>1,688</td>
<td>1,897</td>
<td>2,070</td>
<td>2,111</td>
</tr>
<tr>
<td>Loans and advances</td>
<td>1,720</td>
<td>2,216</td>
<td>2,338</td>
<td>2,548</td>
<td>2,849</td>
<td>3,189</td>
<td>3,642</td>
<td>4,167</td>
</tr>
<tr>
<td>Investments</td>
<td>86</td>
<td>129</td>
<td>159</td>
<td>152</td>
<td>167</td>
<td>145</td>
<td>156</td>
<td>185</td>
</tr>
<tr>
<td>Local</td>
<td>81</td>
<td>69</td>
<td>83</td>
<td>85</td>
<td>44</td>
<td>31</td>
<td>31</td>
<td>28</td>
</tr>
<tr>
<td>Other</td>
<td>1,709</td>
<td>1,471</td>
<td>1,856</td>
<td>2,095</td>
<td>2,204</td>
<td>2,375</td>
<td>2,715</td>
<td>3,066</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>3,319</td>
<td>3,760</td>
<td>4,351</td>
<td>6,085</td>
<td>7,689</td>
<td>8,539</td>
<td>9,588</td>
<td>10,459</td>
</tr>
</tbody>
</table>

*a* There was a minor reclassification of assets at this date.

Source: Hong Kong Government Gazette, Supplement No.4.
Table 5.3

COMMERCIAL BANKS: RATE OF INCREASE IN DEPOSITS AND ADVANCES (%)

<table>
<thead>
<tr>
<th>Year</th>
<th>Increase in deposits</th>
<th>Increase in advances</th>
<th>Increase in domestic exports</th>
<th>Increase in total trade</th>
</tr>
</thead>
<tbody>
<tr>
<td>1955</td>
<td>6.5</td>
<td>23.9</td>
<td>16.2</td>
<td>6.9</td>
</tr>
<tr>
<td>1956</td>
<td>11.4</td>
<td>21.7</td>
<td>11.2</td>
<td>24.4</td>
</tr>
<tr>
<td>1957</td>
<td>11.4</td>
<td>12.5</td>
<td>7.8</td>
<td>5.0</td>
</tr>
<tr>
<td>1958</td>
<td>12.1</td>
<td>6.2</td>
<td>4.8</td>
<td>-7.7</td>
</tr>
<tr>
<td>1959</td>
<td>29.9</td>
<td>49.4</td>
<td>81.1</td>
<td>8.5</td>
</tr>
<tr>
<td>1960</td>
<td>30.4</td>
<td>25.3</td>
<td>25.6</td>
<td>19.2</td>
</tr>
<tr>
<td>1961</td>
<td>25.5</td>
<td>35.7</td>
<td>2.5</td>
<td>0.9</td>
</tr>
<tr>
<td>1962</td>
<td>28.0</td>
<td>22.1</td>
<td>12.9</td>
<td>11.6</td>
</tr>
<tr>
<td>1963</td>
<td>25.8</td>
<td>27.8</td>
<td>15.5</td>
<td>12.3</td>
</tr>
<tr>
<td>1964</td>
<td>21.1</td>
<td>25.9</td>
<td>15.6</td>
<td>18.1</td>
</tr>
<tr>
<td>1965</td>
<td>10.4</td>
<td>9.9</td>
<td>13.5</td>
<td>9.9</td>
</tr>
<tr>
<td>1966</td>
<td>17.3</td>
<td>6.8</td>
<td>14.0</td>
<td>13.2</td>
</tr>
<tr>
<td>1967</td>
<td>-2.9</td>
<td>-0.7</td>
<td>16.9</td>
<td>8.9</td>
</tr>
</tbody>
</table>

Sources: Table 5.1; Hong Kong Monthly Trade Statistics.

Liabilities

(a) Cheque Deposits. Cheque deposits have been the most slowly growing component of total bank deposits. Between 1954 and 1966 cheque deposits increased 3.2 times, and now constitute one-third of total deposits, compared with two-thirds in 1954. The relatively high interest rates available on time deposits have probably encouraged depositors to transfer idle balances from their cheque deposits. And, because many large firms are regularly overdrawn on their Hong Kong accounts (preferring to hold their liquid assets abroad) and a large number of small businesses do not hold a cheque account, the volume of cheque deposits has not increased in line with business turnover.

All banks except about ten local institutions accept cheque deposits. Until recently, many banks paid interest on their

---

1 There is some evidence of an increase in the rate at which current deposits are turned over. Between 1954 and 1966 the increase in the value of cheques passing through the bank clearing house, 3.7 times, was slightly larger than the increase in the value of cheque deposits. It is important to note, though, that because of the dominant position of the Hongkong Bank, a large number of cheques does not pass through the clearing house.

2 FEER, 14 April 1967, p.182.
customers' cheque deposits, but, except for Government and inter-bank deposits, this practice is now prohibited by the interbank interest rate agreement. No fee is charged on cheque accounts.

All authorised banks may become members of the Bankers' Clearing House, and member banks can undertake to clear for non-members (who are termed 'sub-clearing banks'). The value of cheques passing through the clearing house is shown in Table 5.4. Each member must hold an account with the Hongkong Bank, which acts as central clearing bank, and maintain this account in funds. In cases where a bank defaults, and cannot make satisfactory arrangements for accommodation with the Hongkong Bank, the latter Bank informs other members of the clearing house. All cheques paid into a member bank in the commercial area are cleared on the same day.

Table 5.4
VALUE OF CHEQUES CLEARED THROUGH HONG KONG BANKERS' CLEARING HOUSE

<table>
<thead>
<tr>
<th>Year</th>
<th>Cheques cleared $ million</th>
</tr>
</thead>
<tbody>
<tr>
<td>1946</td>
<td>3,049</td>
</tr>
<tr>
<td>1947</td>
<td>6,595</td>
</tr>
<tr>
<td>1948</td>
<td>8,268</td>
</tr>
<tr>
<td>1949</td>
<td>11,006</td>
</tr>
<tr>
<td>1950</td>
<td>14,394</td>
</tr>
<tr>
<td>1951</td>
<td>18,070</td>
</tr>
<tr>
<td>1952</td>
<td>14,345</td>
</tr>
<tr>
<td>1953</td>
<td>12,424</td>
</tr>
<tr>
<td>1954</td>
<td>13,385</td>
</tr>
<tr>
<td>1955</td>
<td>13,916</td>
</tr>
<tr>
<td>1956</td>
<td>15,309</td>
</tr>
<tr>
<td>1957</td>
<td>16,940</td>
</tr>
<tr>
<td>1958</td>
<td>15,709</td>
</tr>
<tr>
<td>1959</td>
<td>17,923</td>
</tr>
<tr>
<td>1960</td>
<td>23,101</td>
</tr>
<tr>
<td>1961</td>
<td>25,821</td>
</tr>
<tr>
<td>1962</td>
<td>28,151</td>
</tr>
<tr>
<td>1963</td>
<td>34,519</td>
</tr>
<tr>
<td>1964</td>
<td>41,520</td>
</tr>
<tr>
<td>1965</td>
<td>44,590</td>
</tr>
<tr>
<td>1966</td>
<td>49,612</td>
</tr>
<tr>
<td>1967</td>
<td>58,296</td>
</tr>
</tbody>
</table>

Source: Hong Kong Government Gazette, Supplement Number 4.

1 Nigel Ruscoe's Annual Hong Kong Register, 1964, p.38 reports that about half the banks paid interest on current accounts in 1963.
The practice among customers of offering postdated cheques as security for trade credit and other loans is common, and is frequently criticised by the larger banks. ¹

The Government holds cheque deposits with the Hongkong Bank and the Chartered Bank. The slight seasonal variation in Government revenue and expenditure is shown in the Government's accounts with the two banks; the Government does not make use of treasury bills or other short-term borrowing from the banking system. The level of the various Government deposits over recent years is given in Table 5.5.

(b) Time Deposits. Time deposits have been the most rapidly increasing component of total bank deposits, having in the period 1954 to 1966 increased 27 times. The proportion of time deposits to all bank deposits rose in the same period from 13 per cent to 44.5 per cent. This experience is in marked contrast to that of many countries, ² and reflects the unavailability of other fixed interest assets.

All banks accept time deposits. Terms vary between seven days and five years. Competition for these deposits is very active.

It is thought that a large part of time deposits is owed to depositors abroad, particularly to overseas Chinese in South East Asia, but also to Chinese living in the United States, Latin America and elsewhere. ³ One often heard bankers suggest that between a half and three-fifths of all Hong Kong bank deposits are of overseas origin; ⁴ if this is correct, the proportion of time deposits owed to foreigners must be even higher. There are several reasons for this capital inflow into bank deposits. For political

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1 See P.A. Graham, op. cit., p.5.
3 FEER, 27 April 1967, p.182.
4 This estimate is supported by the statement of the Commissioner of Banking that bank deposits 'of which the greater part comes from outside the Colony...' SCMP, 12 June 1965.
### Table 5.5

**HONG KONG GOVERNMENT BANK DEPOSITS HELD IN HONG KONG**

($ million)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cheque Deposits</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Government</td>
<td>26</td>
<td>30</td>
<td>21</td>
<td>32</td>
<td>33</td>
<td>19</td>
<td>7</td>
<td>64</td>
<td>86</td>
<td>94</td>
<td>93</td>
<td>90</td>
<td>59</td>
<td>71</td>
</tr>
<tr>
<td>Development loan fund</td>
<td>7</td>
<td>5</td>
<td>5</td>
<td>3</td>
<td>2</td>
<td>1</td>
<td>1</td>
<td>0</td>
<td>5</td>
<td>10</td>
<td>1</td>
<td>16</td>
<td>13</td>
<td>9</td>
</tr>
<tr>
<td>Coin and note funds</td>
<td>21</td>
<td>15</td>
<td>11</td>
<td>18</td>
<td>17</td>
<td>27</td>
<td>7</td>
<td>30</td>
<td>23</td>
<td>26</td>
<td>26</td>
<td>9</td>
<td>9</td>
<td>3</td>
</tr>
<tr>
<td><strong>Total cheque deposits</strong></td>
<td>54</td>
<td>51</td>
<td>37</td>
<td>54</td>
<td>52</td>
<td>47</td>
<td>15</td>
<td>94</td>
<td>114</td>
<td>130</td>
<td>120</td>
<td>115</td>
<td>82</td>
<td>83</td>
</tr>
<tr>
<td><strong>Fixed Deposits</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Government</td>
<td>20</td>
<td>45</td>
<td>45</td>
<td>88</td>
<td>121</td>
<td>127</td>
<td>60</td>
<td>26</td>
<td>101</td>
<td>279</td>
<td>389</td>
<td>402</td>
<td>366</td>
<td>396</td>
</tr>
<tr>
<td>Development loan fund</td>
<td>-</td>
<td>-</td>
<td>3</td>
<td>-</td>
<td>0</td>
<td>-</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>20</td>
<td>20</td>
<td>20</td>
</tr>
<tr>
<td>Coin and note funds</td>
<td>10</td>
<td>10</td>
<td>9</td>
<td>9</td>
<td>6</td>
<td>15</td>
<td>0</td>
<td>14</td>
<td>12</td>
<td>20</td>
<td>44</td>
<td>52</td>
<td>60</td>
<td></td>
</tr>
<tr>
<td><strong>Total fixed deposits</strong></td>
<td>30</td>
<td>55</td>
<td>67</td>
<td>96</td>
<td>129</td>
<td>133</td>
<td>76</td>
<td>26</td>
<td>115</td>
<td>290</td>
<td>409</td>
<td>466</td>
<td>439</td>
<td>476</td>
</tr>
<tr>
<td><strong>TOTAL GOVERNMENT DEPOSITS</strong></td>
<td>84</td>
<td>106</td>
<td>210</td>
<td>150</td>
<td>181</td>
<td>180</td>
<td>91</td>
<td>120</td>
<td>229</td>
<td>420</td>
<td>529</td>
<td>581</td>
<td>521</td>
<td>559</td>
</tr>
</tbody>
</table>

---

a 31 March each year.

reasons, some of the foreign depositors do not feel free to hold funds in their own countries; this is believed to be especially important for many Chinese businessmen in Indonesia, Vietnam and the Philippines.¹ With price stability, low taxation, comparative political stability and a relatively respected legal system, Hong Kong has provided a refuge for these funds. Of considerable appeal to most foreign depositors is the knowledge that funds can readily be remitted from Hong Kong, through the authorised banks into sterling, or into U.S. dollars, Swiss francs and other currencies on the open market. The relatively high interest rates offered on fixed deposits have also been important in attracting the foreign funds.

These high deposit rates must also have induced many local savers to hold their funds within Hong Kong rather than, say, as bank deposits abroad.²

Most time deposits are for relatively short periods, mostly three to six months.³ Depositors, both local and foreign, like to be in a position to move their funds elsewhere on reasonably short notice, should deposit rates be more favourable abroad, or, more seriously, there be any loss of confidence in the Colony's future.

The Government's holding of fixed deposits in Hong Kong was shown in Table 5.5. The Government deposits were about 12 per cent of all local fixed deposits in March 1967.

(c) Saving Deposits. Saving deposits in December 1966 totalled $1,982 million, and made up about one-quarter of total bank deposits in the Colony (compared with one-tenth in 1954). These deposits increased almost twenty times in the twelve years. Saving deposits

¹ It is in this respect, rather than in its currency offering protection against a devaluation of the world's key currencies, that Hong Kong can be considered the 'Switzerland' of the Far East.
² The Federal Reserve Bulletin shows that U.S. bank deposits owed to Hong Kong residents varied very little between 1958 and 1962 at around U.S. $28 million. More recent information is not available.
³ It was suggested in early 1967 that about 50 per cent of time deposits were for three months only. FEER, 27 April 1967, p.182.
are now accepted by most banks, but there are no institutions which are exclusively 'saving banks'. Interest on saving accounts is paid at one rate by all banks and has, for some time, been equal to the maximum rate on which there is exemption from Government interest tax. This rate was 2 per cent until 1959, then 2½ per cent until late 1960, 3 per cent between 1960 and 1968, and is now 3½ per cent.

Competition between banks for saving deposits has been a main reason for the rapid expansion of branch networks to the new residential areas and to parts of the Colony which previously had no banking offices. Bank advertising has placed considerable stress on the benefits of a saving account.

It was estimated that there were more than one million saving accounts in 1966, or more than one account for every local family. For many residents a saving deposit has replaced currency hoarding and the purchase of jewellery as the main way in which savings are held. The more prosperous and settled population has meant a greater emphasis on saving for old age, children's education and consumer durables; given the limited availability of saving outlets most of these funds are deposited with the commercial banks, and usually as saving deposits. As well, saving accounts are held by many small businesses instead of cheque accounts.

Clearly, the commercial banks have been important depositories for the economy's growing savings. The deposit function of the commercial banks, which was of relatively little significance in the prewar economy, has become of fundamental importance. Table 5.6 compares the per capita bank deposits for selected countries. In

---

1 In 1948 'only two or three' banks accepted saving deposits. FEER, 21 July 1948.

2 The suggestion that the Government establish a Government Savings Bank was made in the Legislative Council in 1961. The Financial Secretary declined to follow up the suggestion on the ground that the functions were being adequately carried out by the commercial banks.

3 P.A. Graham, op. cit., p.6.
### Table 5.6
PER CAPITA BANK DEPOSITS, SELECTED COUNTRIES, 1960 AND 1966
(U.S. dollars)

<table>
<thead>
<tr>
<th>Country</th>
<th>1960a</th>
<th>1966a</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Demand deposits</td>
<td>293</td>
<td>317</td>
</tr>
<tr>
<td>Time and saving deposits</td>
<td>418</td>
<td>712</td>
</tr>
<tr>
<td>Total deposits</td>
<td>711</td>
<td>1029</td>
</tr>
<tr>
<td>Ceylon</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Demand deposits</td>
<td>13</td>
<td>14</td>
</tr>
<tr>
<td>Time and saving deposits</td>
<td>16</td>
<td>19</td>
</tr>
<tr>
<td>Total deposits</td>
<td>29</td>
<td>33</td>
</tr>
<tr>
<td>Hong Kong</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Demand deposits</td>
<td>78</td>
<td>124</td>
</tr>
<tr>
<td>Time and saving deposits</td>
<td>72</td>
<td>263</td>
</tr>
<tr>
<td>Total deposits</td>
<td>150</td>
<td>387</td>
</tr>
<tr>
<td>Japan</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Demand deposits</td>
<td>82</td>
<td>204</td>
</tr>
<tr>
<td>Time and saving depositsb</td>
<td>329</td>
<td>442</td>
</tr>
<tr>
<td>Total deposits</td>
<td>411</td>
<td>646</td>
</tr>
<tr>
<td>Malaysia</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Demand deposits</td>
<td>20</td>
<td>24</td>
</tr>
<tr>
<td>Time and saving deposits</td>
<td>n.a.</td>
<td>36</td>
</tr>
<tr>
<td>Total deposits</td>
<td>n.a.</td>
<td>60</td>
</tr>
<tr>
<td>Philippines</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Demand deposits</td>
<td>11</td>
<td>10</td>
</tr>
<tr>
<td>Time and saving deposits</td>
<td>15</td>
<td>24</td>
</tr>
<tr>
<td>Total deposits</td>
<td>26</td>
<td>34</td>
</tr>
<tr>
<td>Taiwan</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Demand deposits</td>
<td>7</td>
<td>21</td>
</tr>
<tr>
<td>Time and saving deposits</td>
<td>8</td>
<td>44</td>
</tr>
<tr>
<td>Total deposits</td>
<td>15</td>
<td>65</td>
</tr>
</tbody>
</table>

n.a. = not available.
a 31 December.
b Includes Postal Saving and Cooperative Banks.

Source: International Monetary Fund. *International Financial Statistics*. Hong Kong: Table 5.1.

1966 per capita deposits were about one-third of the Australian level, 60 per cent of the Japanese figure, and approximately six times the Malaysian per capita deposits. The Table also points to the very rapid expansion of deposits in the Colony (from US $150 per head in 1960 to US $387 per head in 1966).

(d) Other Liabilities. The banks' liability for 'notes in circulation' (row 1 in Table 5.2) has been discussed in a previous
Chapter. 'Balances due to other banks in Hong Kong' consists of the liabilities of the Hongkong Bank and the Chartered Bank on interbank deposits held for clearing and reserve purposes, and money borrowed from the interbank market. The item 'balances due to other banks abroad' includes funds owed to head offices by expatriate banks, and deposits lodged with Hong Kong banks by banks from other countries (the latter item is believed to be quite small).

**Assets**

(a) **Loans and Advances.** The level of loans and advances has increased particularly rapidly. As was shown in Table 5.1, loans and advances rose from $510 million to $5,380 million between 1954 and 1966. The year to year changes in the level of commercial bank credit were shown in Table 5.3. The ratio of bank advances to deposits increased from 48 per cent in 1954 to almost 70 per cent in the early 1960s (see row 8 of Table 5.1). There was a significant fall in the ratio in 1966 and 1967.

Hong Kong banks have greater freedom in formulating their advance policies than banks in most countries. There is no central bank charged with regulating the volume or direction of bank credit, and the Banking Ordinance affects bank lending only to the extent that it specifies a minimum liquidity ratio and restricts loans to directors, unsecured advances and direct bank involvement in trading activities. Before 1964 there was not even this minimum of control. The banks have been able to undertake additional lending so long as there are borrowers who meet the institutions' own lending standards and the banks' liquidity position is sound.

The supply of bank credit increased especially rapidly in the period 1959 to 1964. It is pointed out elsewhere in this study that the Hong Kong banks have been willing to grant loans of a relatively long term and illiquid nature. Given this lending criteria, it does not appear that there was, from the late 1950s until 1964, any shortage of outlets for bank funds. Rather, the
commercial banks were becoming 'loaned up' and new lending had to be restrained for liquidity reasons.

In 1965, 1966 and 1967 bank advances expanded more slowly and liquidity factors were only one of several restraints on new bank lending. Certainly, as a consequence of the 1964 Banking Ordinance and the banking difficulties of early 1965, a number of local banks attempted to strengthen their cash positions. But there was at the same time a reconsideration among many local banks of what constituted a 'good lending risk'. And, the slight recession in new business investment reduced the demand for bank credit. As expressed in one financial report, 'there does not seem to be much unsatisfied demand for credit from sound borrowers, if anything, first class banks are having trouble in finding good lendable projects'. Further, the relatively high interest rates in world financial centres induced Hong Kong banks to curtail their local advances:

instead of liquidity problems there has been a tremendous switch in the other direction for local banks have taken advantage of the higher rates ruling in London and New York and placed their surplus liquidity outside the Colony. The overseas competition for deposits is so keen that credit, perhaps badly needed in the Colony itself, is unavailable.

After the outbreak of disturbances in May 1967, the commercial banks adopted a still more cautious attitude in undertaking new lending.

Although the banks have not been guided in their credit policy by a Government or a central bank, there has been in at least two cases the exercise of what might be termed a quantitative credit policy. In 1955 and again in 1959 and 1960 the Hongkong Bank attempted to reduce speculation on the narrow and volatile Hong Kong Stock Exchange. The Bank lifted rates on these advances (in 1955 the increase was from 5 per cent and 6 per cent to 8 per cent).

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1. FEER, 27 April 1967, p.185.
In 1955 the Bank sent a letter to a number of clients outlining its desire to limit speculative pressures in the economy. In taking these actions, the Bank acted on its own initiative, though it had earlier informed the Government of its intentions. The success of the Bank's move, in both cases, was a consequence of its size and prestige, and of the readiness of the other large banks to cooperate. It is unlikely that the Bank could have taken a similar stand against speculation in gold, foreign exchange and commodities in 1948 and 1949, or against real estate speculation in the 1950s, fields in which its influence has been much weaker.

Table 5.7 shows the direction of bank loans outstanding. About 30 per cent of loans outstanding have been for trade purposes, one-fifth of outstanding advances have been used in industry and between one-sixth and one-fifth in real estate. The utilities and primary production sectors of the economy have been unimportant borrowers of bank funds. Over a longer period, information is available only on bank loans outstanding for manufacturing purposes. It was estimated that in 1957 and 1958 industrial loans accounted for 18 and 21 per cent, respectively, of total bank advances.1

Lending by way of fluctuating overdraft is common practice for the British banks and for a number of the large local institutions.2 This accommodation is provided for a variety of purposes, including the purchase of raw materials and other working capital needs of manufacturing businesses, the holding of goods for re-export, the local wholesale and retail trade, and for professional borrowers. Lending by way of overdraft is especially common for the well-known trading houses, some of which have been associated with a particular

1 Report of the Industrial Bank Committee, 1960, published in FEER, 4 August 1960, p.228. These figures suggest an absolute increase in the value of bank loans outstanding for industrial purposes of $1,000 million between 1957 and 1966.
2 This paragraph draws heavily on David Williams, 'Hong Kong' in W. Crick (ed.), op. cit., pp.178-9, and P.A. Graham, op. cit., pp.11-14.
## Table 5.7

**COMMERCIAL BANK LOANS AND ADVANCES, BY INDUSTRY GROUP, 1965 TO 1967**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td>MANUFACTURING</td>
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<td></td>
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<td></td>
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<td></td>
</tr>
<tr>
<td>textiles</td>
<td>988</td>
<td>1015</td>
<td>1123</td>
<td>1151</td>
<td>1255</td>
<td>1072</td>
<td>19.8</td>
<td></td>
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<tr>
<td>cotton</td>
<td>1426</td>
<td>1426</td>
<td>1426</td>
<td>1426</td>
<td>1426</td>
<td>1426</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>footwear, wearing apparel</td>
<td>98</td>
<td>106</td>
<td>121</td>
<td>128</td>
<td>135</td>
<td>119</td>
<td>2.2</td>
<td></td>
</tr>
<tr>
<td>metal products, engineering</td>
<td>101</td>
<td>101</td>
<td>94</td>
<td>90</td>
<td>128</td>
<td>111</td>
<td>2.1</td>
<td></td>
</tr>
<tr>
<td>rubber, plastics and chemicals</td>
<td>65</td>
<td>64</td>
<td>79</td>
<td>80</td>
<td>85</td>
<td>70</td>
<td>1.3</td>
<td></td>
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<tr>
<td>shipbuilding and repair</td>
<td>15</td>
<td>14</td>
<td>16</td>
<td>17</td>
<td>18</td>
<td>17</td>
<td>0.3</td>
<td></td>
</tr>
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<td>electrical and electronic</td>
<td>28</td>
<td>27</td>
<td>38</td>
<td>33</td>
<td>61</td>
<td>53</td>
<td>1.2</td>
<td></td>
</tr>
<tr>
<td>food</td>
<td>36</td>
<td>33</td>
<td>36</td>
<td>44</td>
<td>27</td>
<td>26</td>
<td>0.5</td>
<td></td>
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<tr>
<td>beverages and tobacco</td>
<td>12</td>
<td>8</td>
<td>8</td>
<td>32</td>
<td>33</td>
<td>27</td>
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<td></td>
</tr>
<tr>
<td>printing and publishing</td>
<td>29</td>
<td>30</td>
<td>34</td>
<td>30</td>
<td>28</td>
<td>29</td>
<td>0.5</td>
<td></td>
</tr>
<tr>
<td>miscellaneous</td>
<td>114</td>
<td>134</td>
<td>153</td>
<td>160</td>
<td>177</td>
<td>149</td>
<td>2.8</td>
<td></td>
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<tr>
<td>AGRICULTURE AND FISHING</td>
<td>28</td>
<td>29</td>
<td>39</td>
<td>26</td>
<td>44</td>
<td>9</td>
<td>0.2</td>
<td></td>
</tr>
<tr>
<td>TRANSPORT AND TRANSPORT EQUIPMENT</td>
<td>153</td>
<td>191</td>
<td>189</td>
<td>197</td>
<td>227</td>
<td>219</td>
<td>4.1</td>
<td></td>
</tr>
<tr>
<td>ELECTRICITY, GAS AND TELEPHONE</td>
<td>4</td>
<td>4</td>
<td>54</td>
<td>79</td>
<td>99</td>
<td>132</td>
<td>2.4</td>
<td></td>
</tr>
<tr>
<td>BUILDING AND CONSTRUCTION</td>
<td>203</td>
<td>273</td>
<td>277</td>
<td>957</td>
<td>962</td>
<td>885</td>
<td>16.4</td>
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</tr>
<tr>
<td>GENERAL COMMERCE</td>
<td>1620</td>
<td>1640</td>
<td>1651</td>
<td>1731</td>
<td>1910</td>
<td>1098</td>
<td>31.4</td>
<td></td>
</tr>
<tr>
<td>import, export and wholesale</td>
<td>1518</td>
<td>1520</td>
<td>1542</td>
<td>1635</td>
<td>1797</td>
<td>1590</td>
<td>29.4</td>
<td></td>
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<tr>
<td>retail</td>
<td>102</td>
<td>121</td>
<td>169</td>
<td>97</td>
<td>111</td>
<td>109</td>
<td>2.0</td>
<td></td>
</tr>
<tr>
<td>MINING AND QUARRYING</td>
<td>7</td>
<td>6</td>
<td>5</td>
<td>4</td>
<td>5</td>
<td>3</td>
<td>0.0</td>
<td></td>
</tr>
<tr>
<td>MISCELLANEOUS</td>
<td>1445</td>
<td>1365</td>
<td>1316</td>
<td>1370</td>
<td>1437</td>
<td>1383</td>
<td>25.6</td>
<td></td>
</tr>
<tr>
<td>hotels, boarding houses</td>
<td>89</td>
<td>89</td>
<td>86</td>
<td>86</td>
<td>89</td>
<td>82</td>
<td>1.5</td>
<td></td>
</tr>
<tr>
<td>financial concerns</td>
<td>274</td>
<td>200</td>
<td>186</td>
<td>187</td>
<td>179</td>
<td>170</td>
<td>3.1</td>
<td></td>
</tr>
<tr>
<td>stockbrokers</td>
<td>41</td>
<td>36</td>
<td>33</td>
<td>31</td>
<td>29</td>
<td>27</td>
<td>0.5</td>
<td></td>
</tr>
<tr>
<td>professional and private individuals</td>
<td>725</td>
<td>683</td>
<td>621</td>
<td>669</td>
<td>721</td>
<td>766</td>
<td>13.1</td>
<td></td>
</tr>
<tr>
<td>business</td>
<td>(122)</td>
<td>(313)</td>
<td>(269)</td>
<td>(288)</td>
<td>(303)</td>
<td>(285)</td>
<td>(5.3)</td>
<td></td>
</tr>
<tr>
<td>private</td>
<td>(403)</td>
<td>(376)</td>
<td>(374)</td>
<td>(386)</td>
<td>(420)</td>
<td>(421)</td>
<td>(7.8)</td>
<td></td>
</tr>
<tr>
<td>all others</td>
<td>316</td>
<td>328</td>
<td>369</td>
<td>399</td>
<td>417</td>
<td>398</td>
<td>7.4</td>
<td></td>
</tr>
</tbody>
</table>

**TOTAL LOANS AND ADVANCES**

|                      | 5149     | 5183      | 5303     | 5473      | 5942     | 5401      | 100       |          |

Source: Government Gazette Supplement Number 4.
bank over a long period. The type and extent of security required varies greatly both between banks and between borrowers, and a range of interest rates is charged, the lowest, of course, being reserved for customers with a particularly good name. Overdraft limits are usually reviewed every six months or annually. Advances by a fixed loan are more common among the smaller banks and the few expatriate banks which have advanced funds to local borrowers.

The most actively sought after banking business, especially since the late 1950s, has been trade finance. The way in which the Colony's trade is financed is discussed in Chapter 13.

The granting of bank loans on a relatively long-term basis for industrial purposes has been an important postwar development. These loans were first made by the British banks in the late 1940s and the Hongkong Bank and the Chartered Bank are still by far the dominant lenders in this field. At least one expatriate bank (a United States institution) and several of the larger local banks have recently undertaken this type of loan. The advances were first given to finance the expansion of the cotton spinning industry after its establishment with refugee capital, and, about the same time, bank loans were important in the establishment of the ship breaking and steel rolling industry. Table 5.7 showed the range of manufacturing industries at present receiving bank credits. Advances for industrial purposes are frequently for three to five years, occasionally longer, and are granted to finance the purchase of machinery, factory re-equipment, and less often, the purchase of premises and land. In a number of cases, the loans are nominally repayable on demand or at short notice, but with

an implicit understanding between bank and borrower that so long as the enterprise is sound the loan will not be called in unreasonably soon. A substantial proportion of bank loans have been outstanding for five years and some have continued for ten years and more.

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1 As many of the firms in this industry had little conventional security to offer the banks (land, premises, etc.), a bill of sale was usually taken over the ships to preclude sale of scrap.

2 Industrial Bank Committee Report, p.228.
Security usually takes the form of buildings and machinery, but the banks may accept as security the property and shares of directors, and, of course, the bank's assessment of the integrity of management is important. For 'known' borrowers the interest rate charged on these advances is little above the bank's prime lending rate, despite the illiquidity. Loans have been made to the smaller manufacturing businesses as well as to the internationally known industrial concerns. In the case of the smaller manufacturing units the banks have often been unable to obtain balance sheets or other financial information from their clients.

The banks also provide manufacturers with working capital. As this credit is often provided to finance the import of industrial raw materials or is advanced against a credit opened by an overseas importer, a part of this finance is included under the item 'commerce' in the Table.

Bank loans for real estate purposes are usually on a long-term basis (up to five years). Advances to the larger developers have been available from the large banks, but by far the most important institutions in this field are the medium sized and local banks, whose lending for real estate purposes has made the property market a 'bank dominated one'. Frequently, advances have been made for each stage of property development - land purchase and site formation, and the construction and sale of the building. Loans have often been granted against small margins. Before the 1964 Banking Ordinance, advances were sometimes made on an unsecured basis and a number of small banks took a direct interest in land development, purchasing the land in their own name and financing the construction with depositors' funds. Some of the local banks were leading real

1 Michael Turner, then General Manager of the Hongkong Bank, 'Industrial Banking in an Eastern Setting', The Statist, 23 March 1963.
2 HS, 7 October 1967.
3 David Williams, 'Hong Kong Banking', p.31.
estate dealers. Loans to finance flat purchase have often been arranged on a hire purchase basis. The expatriate banks have not entered the field of real estate finance.

The considerably expanded volume of bank credit has contributed significantly to the Colony's economic development. One way of demonstrating the importance of bank credit is to set out bank loans and advances as a per cent of national income. This ratio is shown for a group of countries in Table 5.8

Table 5.8
COMMERICAL BANK LOANS AND ADVANCES\(^a\) AS PER CENT OF NATIONAL INCOME, SELECTED COUNTRIES, 1960 AND 1966

<table>
<thead>
<tr>
<th>Country</th>
<th>1960</th>
<th>1966</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>50</td>
<td>55</td>
</tr>
<tr>
<td>Ceylon</td>
<td>14</td>
<td>18</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>34</td>
<td>55</td>
</tr>
<tr>
<td>Japan</td>
<td>113</td>
<td>122</td>
</tr>
<tr>
<td>Malaysia</td>
<td>13</td>
<td>24</td>
</tr>
<tr>
<td>Philippines(^b)</td>
<td>18</td>
<td>32</td>
</tr>
<tr>
<td>Taiwan</td>
<td>14</td>
<td>39</td>
</tr>
</tbody>
</table>

\(^a\) Includes claims on governments.  
\(^b\) Excludes Saving and Development Banks.


(b) **Liquid Assets.** It was seen earlier that only a very limited range of liquid assets is available in Hong Kong. The banks are restricted to holding their local liquid assets in the form of cash, foreign currency notes and deposits with other banks (the latter may take the form either of loans on the interbank market or of deposits with the note issuing banks).

The liquid asset ratio (defined as the ratio of cash and net balances due from other banks and other short-term claims to deposits) of the Hong Kong banks has varied over a fairly wide range. The ratio was around 50 per cent in the period 1955 to 1958, 41.9 per cent in 1959, 34.3 per cent in 1961, 38.1 per cent
in 1962, 27.6 per cent in 1964, 36.8 per cent in 1966 and 32.8 per cent in 1967 (see Table 5.1).

But this ratio is not an entirely satisfactory method of measuring the banks' liquidity position. Some part of liquid deposits with banks abroad (the major component in the Hong Kong banks' liquid assets holdings) is required to meet commitments in these centres. Moreover, 'when the high interbank balances are taken into account - net money at call is, in fact, quite small - the effective "near cash" assets ratio falls to somewhere around 20 per cent. In fact, holdings both of cash and liquid assets seem low in comparison with other banking systems and much lower than one would expect, even allowing for the importance of time deposits and, perhaps, the fact that many banks could, in an emergency, borrow from foreign financial centres: local depositors have several times shown themselves liable to panic; there is no official central bank to which the banks might turn for large-scale financial support; the money market is undeveloped; and a relatively large part of bank advances is of a long term and illiquid nature.

The cash ratio disclosed by the official statistics (row 6 of Table 5.1) fell from 12.7 per cent in 1955 and 8.4 per cent in 1957 to less than 4 per cent in the years 1961 to 1966. In December 1966 the banks' cash ratio was 2.8 per cent. There is no evidence of any convention about the level of cash ratios.

But the official statistics on the banks' cash holdings do not include deposits owed by the note issuing banks to other banks (which is included as part of the item 'balances due from other banks in Hong Kong'). Against these deposits the note issuing banks hold local currency notes (which are included in the statistics on banks' cash holdings) and liquid sterling deposits, which can readily be sold to the Exchange Fund should the note issuing banks need to increase the local banknote issue. No information is available on the extent of these interbank deposits.

1 David Williams, 'Hong Kong' in W. Crick (ed.), op. cit., p.177.
Net deposits with banks abroad increased from $945 million in December 1960 to $2,925 million in December 1966, and now constitute a quarter of bank assets and equal about one-third of bank deposits. In the two years to December 1966, net balances due from banks abroad increased by $1,660 million (and gross balances by $2,074 million), while deposits rose by $1,837 million. Most, perhaps around two-thirds, of the deposits are in sterling, almost exclusively in London. The remainder is call and short-term deposits with banks in North America, Europe and China. The note issuing banks can sell sterling in London to the Exchange Fund for certificates of indebtedness, and the other banks are able to exchange sterling in London and Hong Kong dollar balances at the note issuing banks. Alternatively, the sterling balances can be transferred directly between banks in settlement for an interbank debt.

The banks have been criticised for holding such a large part of their funds outside Hong Kong. It must be pointed out, though, that there would need to be significant changes in the local money market before a large part of these liquid funds could be held in the Colony. A much wider range of securities would be necessary, and some official assistance might be required when several banks at the one time sought to move from liquid assets into cash. To provide this assistance, a public authority might itself need to hold liquid reserves in a similar form to those at present held by the banking system. Another important consideration is that there is no centralised holding of foreign exchange (by the Government or a central bank) as there is in most countries. The foreign assets of the banking system serve a similar purpose in regard to bank deposit money as do the assets of the Exchange Fund for the currency issue: of ensuring the convertibility of local funds into sterling. If those holding bank deposits could transfer their funds abroad or purchase imports only to the extent that they first withdraw their deposits as currency and then draw on the Exchange Fund reserves,

1 See, for example, the view cited in FEER, 14 April 1966, p.69.
a severe contraction of credit might result. The present foreign asset holding of the banks contributes also to the maintenance of foreign confidence, and, with more than half of deposits of overseas origin, this is itself of some importance. And, of course, a part of the bank funds held on deposit in foreign financial centres is for trading purposes.

Nonetheless, it is possible that the high interest rates ruling in foreign money centres were a main reason for the rapid increase in the volume of deposits held with banks abroad in 1966, and, at least in that year, that the banks were sufficiently liquid to undertake additional lending.

The bank statistics record only a small holding of foreign investments (row 8b in Table 5.2). The Colony's banks tend to place surplus funds on deposit with a branch or associated bank abroad, and not themselves invest the funds in liquid paper in the foreign financial centre.

There are thought to be considerable differences in the liquid assets and cash positions of the different banks. The Mainland China institutions are known to be very liquid. The lowest cash ratios are maintained by the expatriate banks. These institutions are usually able to predict closely their future cash requirements and can, when necessary, meet a local cash drain with funds provided by their head offices. Until recently, many local banks operated with slender cash reserves. But these institutions have become more liquidity conscious since 1964. In 1966 some local banks reported cash holdings in excess of deposits; why, one could not establish.

(c) Local Investments. Local investments (row 8a in Table 5.2) are a relatively unimportant part of the banks' assets. Perhaps one-half of the $50 million Government security issue of 1947/48 is held by the commercial banks. These securities are rarely traded. There were probably considerable dealings in local
shares by a number of smaller banks until early 1962, \(^1\) but the Hong Kong Stock Exchange list is too restricted and trading too thin to permit the large banks operating in the share market. Investments in subsidiary companies include holdings in firms which operate in insurance, hire purchase, trustee, nominee and several other fields.

(d) Other Assets. The item 'other assets' (row 9 in Table 5.2) covers a variety of securities and real investments. The certificate of indebtedness holdings of the note issuing banks are the most important component. The banks' investments in real properties are included in this classification.

**Bank Interest Rates**

Little information is available on bank interest rates prior to the interest rate agreement of 1964. It appears that interest rates were low in the early 1950s, when there were few outlets for bank funds. In this period, no interest was usually paid on current accounts and many banks refused to accept saving deposits. The growing demand for bank credit from traders, real estate developers and manufacturers brought a steady increase in deposit rates in the 1950s and early 1960s. Some idea of the variations in interest rates since 1958 is shown in Chart 5.1.

There have been appreciable interest rate differentials between the banks over the whole postwar period. In 1963 the deposit rates of the local banks were 1 to 3 per cent above those of the British banks. The expatriate banks paid about \(\frac{1}{2}\) per cent more on deposits than the British banks. The spread of rates was even greater on the side of advances. While the prime lending rate of the British banks has been relatively low for a rapidly developing economy, the rates charged by the smaller banks have ranged up to 3 per cent per month on the risky advances which 'would not have been handled by the large banks] at any rate of interest'. \(^2\)

\(^1\) Until December 1964 many of these share holdings appear to have been grouped as 'other assets' in the official banking statistics.

\(^2\) Representative of the Hongkong Bank, cited above, p.112.
Chart 5.1 Bank Rate and Leading Hong Kong Interest Rates 1958 to 1967

- Bank rate
- 3 British banks prime lending rate
- Leading unauthorised bank, 3 month deposit rate
- Leading authorised bank, 3 month deposit rate
Interbank competition for deposits in 1960 led to a rapid increase in deposit rates. The three month deposit rates of the British banks increased by 1\(\frac{1}{2}\) per cent to 4\(\frac{1}{2}\) per cent during the year. This tendency was viewed with concern by the large banks, who claimed that the higher deposit rates would harm the economy by making industrial loans more expensive,\(^1\) and force the smaller banks into making advances which involved a greater degree of risk.\(^2\)

But at the same time, the smaller banks could not be expected to pay the same rates on bank deposits as the very large institutions.

The problem was expressed in the Tomkins Report in this way:

On the one hand it would be unrealistic to set one rate for deposits (or expect to be able to enforce it) since this would mean that the majority of deposits would flow to a few major banks of international repute. On the other hand 'cut-throat' competition in bidding for deposits must either reduce unduly the profitability of banking, or worse, lead banks into dubious investments or loans for the sake of the high returns necessary to pay for deposits obtained on onerous terms with all the dangers which this implies for the safety of deposits.\(^3\)

In mid-1960 the British banks raised their deposit rates by 1 per cent, deliberately 'to demonstrate to all banks the futility of uncontrolled competition, with the idea of securing a workable agreement between banks on interest rates'.\(^4\) This was followed in early 1961 by an attempt by the Exchange Banks Association to gain a general agreement covering bank interest rates. The several moves were unsuccessful because of the strong opposition of a few banks 'either on the grounds that they did not want to tie their hands or alternatively that, if they did tie their hands, they would be exposed to the risk that the less scrupulous would find ways of

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2. See, for example, the views of the Chairman of the Chartered Bank, cited FEER, 22 March 1962, p.673.
3. Tomkins Report, p.10. But, to a large extent, the smaller banks would have been attracted to real estate and other high yielding but risky outlets regardless of the level of their deposit rates. In the late 1940s when deposit rates were very low, most local banks engaged in highly speculative activities.
evading the spirit if not actually breaking the letter of the agreement'.

In March 1962 the three British banks again attempted to effect a reduction in the whole structure of bank interest rates by lowering their deposit rates and their prime lending rate, by 1 per cent and ½ per cent, respectively. They announced that the reductions were conditional on similar adjustments being made by other banks. About the same time, a meeting of 22 unauthorised banks was held to discuss interest rate levels. But, after two months, interest rates were again increased.

In mid-1964 an agreement on deposit interest rates was finally reached. The agreement was drawn up by representatives of the Exchange Banks Association and the leading unauthorised banks. Government deposits, interbank deposits, and other deposits for a period longer than eighteen months, were excluded from the agreement. The payment of interest on cheque deposits was prohibited. The various banks were classified in five groups according to their size and country of origin, and a scale of interest rate differentials was agreed (see Table 5.9). For example, banks in the 'Local Al' group, which included the Bank of China, were permitted to pay ½ per cent more on deposits than banks in the 'Foreign' category, and the smallest banks could offer 1¼ per cent above the deposit rates of the 'Foreign' banks. It was specified that overdraft or loan facilities against interest bearing deposits had to carry a rate differential of at least 2 per cent, that no interest was payable on time deposits withdrawn without notice, and that banks could not offer to pay interest tax on their customers' behalf. A committee was established composed of representatives of the

1 Tomkins Report, p.11.  
2 SCMP, 24 March 1962.  
3 Ibid.  
4 There were suggestions at the time that the note issuing banks had threatened to withdraw cheque clearing facilities from any authorised banks which did not enter the agreement. HS, 17 February 1965.
Table 5.9
THREE MONTH DEPOSIT RATES, SELECTED DATES
(\%)

<table>
<thead>
<tr>
<th>Classification of bank</th>
<th>Foreign</th>
<th>Special</th>
<th>Local Al</th>
<th>Local A2</th>
<th>Local B1</th>
<th>Local B2</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. 7.64</td>
<td>4%</td>
<td>-</td>
<td>5%</td>
<td>6%</td>
<td>6%</td>
<td>6%</td>
</tr>
<tr>
<td>31.12.65</td>
<td>5%</td>
<td>-</td>
<td>6%</td>
<td>7%</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>31.12.66</td>
<td>5%</td>
<td>6%</td>
<td>6%</td>
<td>6%</td>
<td>6%</td>
<td>-</td>
</tr>
<tr>
<td>24.10.67</td>
<td>5%</td>
<td>6%</td>
<td>6%</td>
<td>6%</td>
<td>6%</td>
<td>-</td>
</tr>
<tr>
<td>1.12.67</td>
<td>6%</td>
<td>6%</td>
<td>7%</td>
<td>7%</td>
<td>7%</td>
<td>-</td>
</tr>
</tbody>
</table>

Number of banks in classification, 31.12.66: 28
- 6
- 10
- 11
- 21
- 0

Source: Press statements.

authorised and unauthorised banks, to keep under review both the
honouring of the agreement and the level of interest rates. Any
bank which breaks the agreement can be barred from using the facili-
ties of the clearing house. The banks also agreed not to
undertake exchange dealings or interbank lending with any institu-
tion which is notified to have broken the agreement.

Disagreements developed about the grouping arrangements and
the differentials between the several classes of bank. In May 1965
four expatriate banks claimed that they were placed at a consider-
able disadvantage in attracting deposits, especially against the
large local banks, and threatened to withdraw from the agreement.
Their criticism was not ended with the abolition, in July 1965, of
the category 'Local B2', to reduce the spread of rates between the
largest and the smallest banks. In a further revision of the
agreement in March 1966, the five largest banks from the 'Local Al'
group were reclassified as 'Special Category', with only a ½ per
cent rate advantage over the 'Foreign' banks. At the same time, the
interest differential between the 'Foreign' and the existing 'Local'
classifications was reduced by ½ per cent.

Concern about possible unfavourable effects of the interest
rate agreement was expressed by at least one observer, who wrote,
in March 1965:

in the flow of funds between households (the main supplier
of loanable funds) and business enterprises (the main
inve · tor s), it is indirect finance through the banking
system that dominates the Hong Kong scene. This means
that resource allocation in Hong Kong is determined
almost entirely by the banking system through bank
interest rates, and it is of the utmost significance
that in Hong Kong there has existed, until very recently,
hardly any restraint on the free formulation of such
rates... The effect of the interest rate agreement
will be to reduce the efficiency of the interest rates
mechanism and of the banking system in allocating
resources.1

But, some measure of flexibility has been maintained by the interest
rate differentials agreed to, by the periodic variations made in the
general level of deposit rates, and by the banks' continuing freedom
to determine their own lending rates.

The important considerations when the level of deposit rates is
being reviewed are the local supply and demand for bank funds and
the level of interest rates in overseas financial centres. The
main influence since 1960 has been the level of interest rates
ruling in foreign financial centres, especially in London. An in-
crease in London rates has several effects. Hong Kong banks will
seek to hold additional balances with banks in the United Kingdom,
businesses represented in both centres will transfer their borrowing
to the Colony, and funds deposited in Hong Kong by banks in other
countries will be moved to London. As a result, bank liquidity will
come under pressure, and bank deposit rates will be raised. Of
course, the movement in deposit rates need not coincide with the
change in the overseas rates in extent or timing; as well as local
factors, the magnitude of the foreign interest rate adjustment and
whether or not the overseas variation is expected to be maintained
are also considered. On some occasions, e.g. in March 1966, the
increase in interest rates preceded that in other financial centres.

This dependence of Hong Kong interest rates on those ruling in
foreign financial centres - a relationship which seems often to be
underplayed in the public statements of bankers2 - follows naturally

2 See, for example, the letter from P.A. Graham, SCMP, 9 December
1964.
from the absence of any central bank or other official influence on the local banking system and from the freedom with which funds can be transferred between Hong Kong and the foreign financial centres. To a very large extent then, the dependence reflects the strength and convertibility of the Hong Kong dollar.

The interest rate agreement does not cover rates charged on bank advances, but the agreement may have had some effect on the level of these rates through its influence on deposit interest rates. The recent trend in the advance rates of the British banks is shown in Table 5.10. Other than on bill finance and on loans secured by shares, advance rates vary widely between banks. Very high rates are charged by local banks on real estate lending. An altogether independent policy is followed by the Mainland banks. There has not been a constant spread between the deposit rates and the prime lending rate of the British banks; the spread between the three month deposit rate and the prime lending rate was \( \frac{1}{2} \) per cent in early 1965, \( \frac{1}{2} \) per cent in late 1966 and 1 per cent in early 1967. In general, advance rates are low for a developing country with a high rate of investment.

Table 5.10

<table>
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<td>7(\frac{1}{2})-8(\frac{1}{2})</td>
</tr>
<tr>
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<td>6</td>
<td>6</td>
<td>9-9(\frac{1}{2})</td>
<td>8-8(\frac{1}{2})</td>
</tr>
<tr>
<td>31.12.63</td>
<td>6</td>
<td>6</td>
<td>9-9(\frac{1}{2})</td>
<td>7(\frac{1}{2})-8</td>
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<td>6(\frac{1}{2})</td>
<td>8-8(\frac{1}{2})</td>
<td>7(\frac{3}{4})-8</td>
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<td>15. 7.66</td>
<td>7</td>
<td>7</td>
<td>8(\frac{1}{2})-9</td>
<td>8-8(\frac{1}{4})</td>
</tr>
<tr>
<td>1. 9.66</td>
<td>7(\frac{1}{2})</td>
<td>7(\frac{1}{2})</td>
<td>8(\frac{1}{2})-9</td>
<td>8-8(\frac{1}{4})</td>
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n.a. = not available.

Source: Ng Kwok Leung, unpublished material; newspaper reports.
Chapter 6

THE COMMERCIAL BANKS - III:
THE STABILITY OF THE BANKING SYSTEM

The previous two Chapters have shown that the banking system has developed considerably in organisation and in the structure of assets and liabilities since 1946. Several times the discussion has touched on the question of the stability and strength of the banking system. This topic is now discussed in greater detail.

As we saw, the 1948 Banking Ordinance imposed virtually no restrictions on commercial bank activities. The banks remained free to conduct their affairs as they liked, and several practices were followed, at least by some of the banks, which made for a potentially unstable banking system. A large number of smaller banks were involved directly in speculation, first in precious metals and foreign exchange, and later in commodities and real estate. Many loans were unsecured. There was considerable bank lending for real estate purposes. At the same time, a number of banks held small liquid reserves - low cash holdings and virtually no second line of liquid assets - and many banks had slender capital resources.

Protection against the consequences of these practices was given, first by the banks' success in exchange speculation, and, later, by the continued buoyancy in the property market (which meant that funds lent for real estate purposes turned over quickly and that real estate was virtually a liquid asset) and by the rapid increase in bank deposits (which gave the banks some freedom from liquidity considerations). But there remained the strong likelihood of banking difficulties were there to be either a slump in the real estate market or a more gradual expansion of deposits.
At the same time, there were one or two favourable tendencies. During the 1950s there was an appreciable decline in the number of very small banks and a few of the small banks which continued to operate became more conscious of their identity as commercial banks; they became less engaged in speculation and in direct trading and demonstrated more respect for liquidity and security considerations. But it required the banking crises of 1961 and 1965 and the Banking Ordinance of 1964 before the majority of banks applied more conventional criteria to their asset portfolios.

The 1961 Banking Crisis and the Tomkins Report

In the first six months of 1961 two large companies made public share issues, both of which were heavily oversubscribed. The Kowloon Motor Bus share issue resulted in $230 million being withdrawn from the banking system and forced a number of local banks to seek assistance from the Hongkong Bank and the Chartered Bank.¹ In June 1961 bank liquidity was further strained by the second share issue - that of Jardine Matheson - for which the public offered $656 million. A run developed on a medium sized local bank, the Liu Chong Hing Bank, which, it was rumoured, had invested excessively in real estate and had been the subject of a police investigation.² The Bank sought the assistance of the two large British banks, and these institutions, after an investigation of the Bank's accounts, gave a public assurance of support. This promise quickly brought to an end the run on the local Bank, and prevented the development of a more general loss of confidence.³

The experience pointed to the potential instability of the unregulated banking system and showed that, whatever the case for a

¹ The two banks soon afterwards made a statement that they would not again make loans available to the other banks at such favourable rates.
² A Government investigation into the cause of the rumours was ordered but not made public. The Government Information Services did announce at the time of the run, however, that the rumours were false.
³ The Bank was placed under the control of a receiver. Six months later it re-commenced independent operations.
laissez-faire approach to banking control in 1948, the growth of the banking habit and the growing importance of bank credit in the economy, called for a more comprehensive system of control. An official of the Bank of England, Mr H.J. Tomkins, was invited to the Colony 'to advise on legislation for the control of bank operations in Hong Kong'. His Report, which included recommendations for a new Ordinance, was presented to the Government in April 1962.

The Report was critical of a number of aspects of the banking system: there were 'too many banks'; there was too great an involvement by many banks 'in the property market or the stock exchange or both' (often at the neglect of sound liquidity considerations); and several banks were engaged in trading activities. It stressed that 'the cardinal principal of sound banking remains "borrow short, lend short"', and warned that 'The potential dangers of the present situation would become grave if there were a check to the present boom and even graver if there were to be a recession'. The Report concluded that 'Because it was designed for a different purpose, the present Banking Ordinance, passed in 1948, is inadequate as a basis for exercising supervision over banks in the interests of their depositors'.

The 1964 Banking Ordinance

A Banking Bill incorporating most of Mr Tomkins proposed Ordinance was given a first reading in June 1963 and, after several amendments, became the Banking Ordinance of 1964. The system of control introduced was intended simply to afford some measure of protection to depositors' funds, and not to permit the establishment of a system of monetary controls.

1 Tomkins Report, p.7.
2 Ibid., p.8.
3 Ibid., p.9.
4 Ibid., pp.8 and 13.
5 Ibid., p.13.
The main provisions of this Ordinance were: (a) The Ordinance required all institutions carrying on 'banking business'\(^1\) to hold a banking licence issued by the Financial Secretary. The annual licence fee was set at $7,500. (b) All licensed banks were to have both paid up capital and open reserves in Hong Kong of at least $5 million. (c) Each bank was to hold as liquid assets, during any month, not less on the average than 25 per cent of its deposit liabilities at the end of the previous month. The minimum holding of liquid assets at any time was set at 15 per cent. Liquid assets were defined to include Hong Kong currency notes and coin, refined gold, net balances at call or repayable on demand with other banks in Hong Kong\(^2\) or overseas when the funds could readily be transferred to the Colony, bills of exchange discountable, and foreign treasury bills and other near money assets provided that the funds could be transferred to Hong Kong. (d) Advances to any one person or business were limited to 25 per cent of paid up capital and reserves. The same limit was imposed on unsecured advances to directors, directors' relatives, and businesses in which directors have an interest, with a limit of 1 per cent of shareholders' funds on loans without security to any one director or relative of a director. Share purchases and real estate purchases were each limited to 25 per cent of shareholders' funds. And the total for these various transactions was limited to 55 per cent of capital.

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1. Banking business was defined as 'the business of either - (a) (i) receiving money on current, deposit, or other similar account from the general public, and (ii) paying and collecting cheques drawn by or paid in by customers, and (iii) making advances to customers; or (b) receiving money on saving account from the general public repayable on demand or within three months or at three months' notice or less, or both',.

2. Both the Ordinance suggested by Mr Tomkins and the 1963 Banking Bill would have required Hong Kong banks to hold a 100 per cent liquid reserve against net balances due to other banks. This requirement was excluded from the 1964 Banking Ordinance on the grounds that it would lift the liquid assets ratio of the whole banking system above 25 per cent to the detriment of bank loans and advances, but in 1967 the Banking Ordinance was amended to require a 100 per cent liquid reserve against net balances due to other banks. Presumably, this amendment was introduced to prevent 'cross firing', which would have permitted the effective liquid assets ratio of the banking system to fall below 25 per cent.
and reserves. (e) In cases when a bank was likely to become unable
to meet its obligations, or where the bank's activities were either
detrimental to its customers' interests or contravened the Ordinance,
the Financial Secretary was empowered to give instructions to the
banks, appoint a person to advise the bank, or assume control of the
bank. The Financial Secretary was also empowered to order the Com-
missioner of Banking to investigate the books, accounts and
transactions of a bank. (f) Detailed monthly returns were required
from all banks operating in the Colony, and the banks were required
to publicise their annual financial statements. (g) Exemption
from most of the provisions of the Ordinance was given to unincoro-
rated banks licensed under the 1948 Banking Ordinance, provided that
a new licence was obtained, and the word 'bank' and its derivatives
were not used in the business' title. Unincorporated banks were not
permitted to accept deposits of more than $2 million. (h) The
office of the Commissioner of Banking was established to supervise
the working of the Ordinance, and to maintain a close watch on the
operations of the banking system. One of the first actions of the
newly appointed Commissioner was to declare a moratorium on the
issue of new banking licences.

The new Ordinance became effective on 1 December 1964 and banks
were given a period of grace to meet certain of the requirements;
for example, the 25 per cent liquid assets ratio had to be observed
by the end of May 1965.1

In 1967 the Banking Ordance was amended further to strengthen
the banking system. The amended Ordinance required all incorporated
banks to have a paid up capital of $10 million and total shareholders'
funds of $20 million. Existing banks were given four years to meet
the requirement. If, at the end of this period, a bank's capital
and reserves are not of the stated amount, the institutions can

1 On 10 January 1965 the Commissioner of Banking announced that all
of the banks but one were observing the required liquid assets ratio.
During the 1965 banking crisis, the liquidity ratios of many banks
fell below the 25 per cent level.
accept deposits only to the value of ten times its shareholders' funds. One effect of the provision will be to force some strengthening of bank capital reserves, perhaps even by way of merger between banks. The amended Ordinance also empowered the Commissioner to order an inspection of a bank on his own initiative and to appoint a second auditor to look into a bank's affairs. Most responsibility for administering the provisions of the Ordinance was transferred from the Financial Secretary to the Commissioner of Banking.

Banks are now required to notify the Commissioner before opening a new branch in Hong Kong, and a fee of $1,000 per annum is payable on each branch operating in the Colony. Of course, this fee cannot be expected to discourage the establishment of new banking offices, but the provision does allow the Commissioner to keep a close watch on whether the number of banking offices being established is excessive and whether any one institution is having to spread its capital too thinly.

The 1965 Banking Crisis

The major banking difficulties of 1965 occurred before the new Ordinance could significantly affect the structure or stability of the banking system. The several crises developed from causes similar to those which led to the 1961 bank run: excessive lending to real estate,¹ a lack of second line liquidity, and the circulation of rumours about the financial strength of certain banks.

In late January, four days before Chinese New Year when bank liquidity is always under some strain, one of the smaller local banks, the Ming Tak Bank, was forced to close its doors. It had been rumoured for some time that the Bank was heavily committed in direct investment in real estate.² The Bank contacted the Banking

¹ After four or five years of very rapid real estate development, property prices - especially on luxury flats - declined a little in late 1964.
² The Bank's owner later told the Bankruptcy Court that the Bank had no credit department and that loans advanced to himself were 'better investments than lending to bank customers because it was difficult to trust the customers'. SCMP, 28 September 1966.
Commissioner and the Hongkong Bank for assistance, but was refused on the ground that its assets were insufficient; later the Bank was found to have liabilities of $11.8 million (on 4,000 deposit accounts) and assets of $3.4 million. ¹

A second and more serious run began on 6 February, this time on the Canton Trust and Commercial Bank, a large local institution with 26 branches, a capital of $5 million and deposits of $150 million (owed on 73,000 accounts, many of them to small depositors from the fishing and agricultural populations). The Bank closed its doors and approached the Hongkong Bank and the Banking Commissioner for assistance. Assistance was refused, and this Bank, too, was placed in the receiver's hands. ²

On the morning of 8 February queues also formed outside several other local banks, including Hang Seng Bank (which, in its balance sheet for December 1964, published a little later, disclosed deposits of $700 million and a liquidity ratio of 32 per cent). Pledges of unlimited support by the two large British banks - by the Hongkong Bank to Hang Seng, Far East and Wing Lung Banks, and by the Chartered Bank to Dao Heng and Kwong On Banks - greatly reduced the pressure on the local banks, ³ but further action was necessary to prevent the difficulties from spreading. At noon on 9 February a limit of $100 per day was imposed on withdrawals from any one account (transfers by cheque were not affected, and some banks may have lost 30 per cent of their deposits through the

¹ The 1948 Banking Ordinance had not required banks to appoint external auditors.
² Soon afterwards the Government lent $30 million to the receiver to permit a first payment to depositors. It is thought that eventually creditors will receive about 50 cents in the dollar. There were, on several occasions, demands that the Bank be re-opened, and a demonstration took place outside Government House.
³ These pledges, though, did not eliminate the pressure on the banks. One commentator claimed that a typical reaction of the local population 'was not simply "Thank Heavens" but "Thank Heavens! Since they have enough money let's take ours out"'. FEER, 22 April 1965, p.219.
clearing drain). To ease the currency shortage, English pound notes were declared legal tender and the Commissioner of Banking was empowered to order the return to a note issuing bank of any surplus local currency in the hands of a bank. Later, the Government, aware that the 25 per cent liquid assets requirements of the new Banking Ordinance could cause a number of banks hurriedly to call in advances, endeavoured to ease the banks' liquidity shortage by transferring a part of its London reserves to Hong Kong. These funds, totalling at one stage $216 million, were made available to the banking system in April and May, through the Hongkong Bank and the Chartered Bank, and were guaranteed by them. No estimate is available of the extent of assistance given by the British banks to the various local banks.

A further run on the Hang Seng Bank developed in April, and the pressure on the Bank did not lessen when the Government publicised the Hongkong Bank's earlier pledge to assist the bank. The directors of the Hang Seng Bank approached the Hongkong Bank for further help and after ten hours of discussion the announcement was made that, with the knowledge of the Banking Commissioner and the Government, the Hongkong Bank was to acquire 51 per cent of the paid up capital of the Hang Seng Bank. This announcement quickly ended the new run.

In November, reports in the vernacular press started a further run on the Far East Bank, a small local bank strongly represented in the New Territories. The run was ended when the Hongkong Bank reiterated its promise of unconditional support.

The immediate causes of the 1965 crisis cannot be determined. Police investigations were made into the rumours which preceded the difficulties, but no public announcement or police charges were made. Within the Colony the rumours were attributed variously to the intense interbank competition, to the note issuing banks, 1

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1 PEER, 14 April 1965, p.67.
2 'The Hang Seng Bank had grown very quickly and created many enemies in the process.'
3 'The Hongkong Bank had wanted to acquire the Hang Seng Bank for some time to give it representation in the free exchange market.'
and to the Mainland China banks. Whatever the immediate cause of the rumours, the banking practices followed by a number of banks - the heavy commitment in real estate lending and the low cash ratios - and a public liable to panic, were the more general causes of the crisis.

There were fears that a general contraction of bank credit would result as banks attempted to build up their liquid asset holdings, that a significant part of deposits would be transferred overseas, and that the appeal of the Hong Kong banks as a refuge for overseas funds would be reduced. In the event, none of these proved of more than very limited importance. The rate of increase of deposits and advances did slow down, but, in absolute terms, deposits and advances continued to grow (by 10 per cent during 1965). The transfer of Government funds prevented a more sudden contraction of credit on the part of a number of small banks. Some real estate developers and small businesses did complain of tight credit, and special steps were taken by a group of larger banks through a manufacturers' association to assist the smaller manufacturing businesses.

There was, during mid-1965, a temporary fall in bank deposits, but this was associated more with the withdrawal of funds by local depositors than the transfer of deposits to other monetary centres. 

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1 'The Mainland banks had sought a larger share of the Hong Kong banking business.'
2 There was also some apprehension that rioting might break out, and police and army units were placed on short alert.
3 See SCMP, 1 August 1965, and Financial Secretary, Budget Speech, 1966, mimeographed, pp.2-3. It is not known how many of these borrowers would have found it difficult to obtain funds even without the banking crisis, especially as there had been some slack in the real estate market from late 1964.
4 A part of the decline was caused by the writing off of $160 million of deposits held with the Canton Trust Bank and Ming Tak Bank.
5 Evidence of this is that the note issue held outside the banks rose by 28 per cent in 1965, that free exchange rates did not move strongly against the Hong Kong dollar, and that the Colony's sterling assets rose during the year from £235 million to £280 million. Financial Secretary, Budget Speech, 1966.
And the rapid growth of deposits after mid-1965 suggests that the flow of funds from overseas continued. Of course, the fact that many banks, including the largest institutions, were not affected by the crisis is a main reason why there was not a more pronounced withdrawal of deposits or a severe contraction of credit. And, the continuing strength of the Hong Kong economy - other than in a part of the real estate sector - helped maintain foreign confidence.

On a slightly longer view, the bank crisis contributed to a strengthening of the banking system. First, it focused attention on the dangers of some of the earlier banking practices, such as the excessive commitment to real estate lending, unsecured advances and the observance of low liquidity ratios. There were reports after the banking difficulties that banks were looking for more adequate security on loans and for borrowers outside the real estate field, and that many institutions were aiming for higher liquidity ratios (30 per cent to 35 per cent) than the minimum specified in the Ordinance. Secondly, the crisis made the public more careful in choosing an institution in which to entrust savings. During and immediately after the crisis there was a significant transfer of funds to the larger and better run institutions, especially to the British and the Mainland China banks. Thirdly, the weaknesses of a number of banks shown during the 1965 difficulties must have strengthened the hand of the Banking Commissioner in having the Banking Ordinance amended - as it was in 1967 - further to strengthen the Colony's banking system. Also from the crisis came a formalisation of the machinery for assisting banks temporarily short of liquid assets. Instead of the small banks having to approach the British banks directly, it became the practice for requests for assistance to be directed to the Commissioner of Banking.

In September 1966 the Yau Yue Commercial Bank (a small bank owned by overseas Chinese in the Philippines), which had received

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1 FEER, 14 April 1967, p.169.
assistance from the Hongkong Bank since mid-1965, was faced with a considerable loss, and the Hongkong Bank announced that it had taken over the Bank's deposit liabilities and assets. This transfer, which was approved by the Financial Secretary, was conducted smoothly, and there was no question of a loss of public confidence in any other bank.

The Commercial Banks and the 1967 Disturbances

The strength and stability of the banking system was demonstrated during the 1967 political disturbances. There was, for a while, both a significant withdrawal of deposits as cash and a sizeable transfer of deposits to overseas financial centres. Total bank deposits decreased in each of the first four months of the disturbances - by $370 million (or more than 4 per cent) in May, $260 million in June, $353 million in July, and $48 million in August. (Surprisingly, saving deposits fell only in May.) From September onwards, deposits increased again, but at the end of 1967 deposits were still below the December 1966 level. The banknote issue rose from $1,883 million in April to $2,400 million in June. Balances due from banks abroad fell about $400 million between April and July, as funds were moved out of the Colony's banks.

But there was no question that either bank illiquidity or a severe credit squeeze would result. Although the banks' liquid asset holdings did fall - from 36.8 per cent in December 1966 to 31.0 per cent in June 1967, 28.0 per cent in July and 30.1 per cent in August - the banks' cash position was not strained during the disturbances. The banks maintained a cash ratio in excess of 4 per cent - a higher cash reserve than was recorded in late 1966. There were no reports that any small bank required assistance.

Bank loans and advances continued to increase until the end of July. In August, bank credit was reduced by $207 million (3.5 per cent), and in September and October by $54 and $69 million respectively. A part of the reduction was brought about by the marked fall in the value of the Colony's trade in these months (imports fell in
value from $870 million in June to $660 million in August and $680 million in September). And there was, of course, a reduced demand for credit from real estate developers, industrialists, etc. There was no evidence that the banks called in advances or that many businesses experienced a shortage of credit.

The Present Stability of the Banking System

Clearly, the banking system has developed considerably in terms of stability over the postwar period. In part this is a consequence of changes made by the banks themselves. During the 1950s the number of small banks fell significantly and many of the banks which continued to operate began undertaking activities of a more conventional commercial banking nature. The interest rate agreement took away one more dangerous form of interbank competition. But it required the 1964 Banking Ordinance before many banks gave up the several potentially dangerous bank practices, such as unsecured lending and the maintenance of low cash ratios. The Ordinance also established the office of the Commissioner of Banking to maintain a close watch on banking practices in the Colony.

Many of the present weaknesses of the banking system arise from the fact that so many banks operate. A number of banks have small capital resources and are unable to spread their lending risks among many borrowers. Interbank competition still allows a number of rather unsound borrowers to obtain loans. There has been no merger or amalgamation of smaller banks. Indeed, with the close identification of many institutions with a particular family, mergers and takeovers seem unlikely, despite the recent requirement that banks strengthen their capital. More seriously, the banking system is continually faced with the possibility that a significant part of deposits might be transferred overseas at short notice, in response to doubts about the Colony's economic or political future.

Perhaps the single distinguishing feature of the operations of the majority of the Hong Kong banks over the postwar period is flexibility. The institutions quickly re-established their trade
finance and exchange business after the Pacific war, many profited from speculation in the exchange markets in the late 1940s, bank advances - often on a relatively long-term basis - were available to manufacturing businesses virtually from the start of the Colony's industrialisation, the banks from an early stage met the demand for credit which arose to finance building construction, and the institutions have acted as depositaries for the growing savings of the more settled and prosperous community.

To a large extent, the commercial banks have been able to adapt and develop their activities so quickly because of the freedom under which they have operated. Until 1964 there was an absolute minimum of control; the banks had only to hold a current banking licence and to submit occasional financial returns to the Financial Secretary. Even the 1964 Banking Ordinance allowed the banks a greater measure of freedom than commercial banks usually enjoy. A more embracing and stringent system of control might have adversely affected the flexibility of the banks' operations and restricted their ability to adapt so quickly to the changes which have taken place in the Hong Kong economy.
Chapter 7

THE MONEY SUPPLY

The four preceding Chapters, and especially Chapters 3 and 5, have several times touched on aspects of the money supply. It seems useful, now, to look in more detail at the supply of money in Hong Kong. This Chapter analyses the components of the money supply, variations in the money supply and their causes, the external convertibility of Hong Kong money, and the adequacy of the monetary system from the point of view of economic growth.

Components of the Money Supply

A first problem is the very familiar one of deciding what should be included in the money supply. In any country there is a range of financial titles with varying degrees of liquidity which can perform the asset function, if not fully the exchange function, of money. The division between money and near-money assets is bound to be an arbitrary one, and depends mainly on the object of the particular exercise. Our main purpose in this Chapter is to outline the causes of variations in the money supply. For this we need a concept of the money supply which is capable of statistical measurement. The problem of classification of financial titles into money and near-money is harder the more complex a country's range of financial institutions and titles. In Hong Kong, where non-bank financial institutions are relatively undeveloped, the difficulty is mainly that of determining where to include interest-bearing bank deposits.

The definition of money supply most frequently adopted is simply currency and cheque deposits held by the non-bank public.\(^1\)

\(^1\) Where the necessary statistics are available, unused bank overdrafts are usually included in the money supply. There is a case, too, for including cash held by saving banks. But there is no way of establishing what part of cash reserves of the Hong Kong banks is held against the institutions' saving deposits.
Interest-bearing bank deposits are usually excluded on the grounds that (i) these deposits cannot function as a medium of exchange and (ii) interest-bearing deposits are rarely subject to sudden year to year changes. In the case of Hong Kong there are strong grounds for including saving deposits in the money supply. Although these deposits cannot be used as a medium of exchange, they are withdrawable on demand without loss, and are, for many businesses and individuals, a substitute for a cheque deposit account. Moreover, there have been quite marked year to year changes in the level of saving deposits. In the tables which follow, two measures of the 'money supply' are given: 'money supply (narrow definition)' includes only cash held outside the banks and demand deposits, and 'money supply (wider definition)', which includes saving deposits. As seen in the discussion on Table 7.4, the two concepts give quite different analyses of causes of variations in the money supply.

There seems to be less reason to include time deposits, which in Hong Kong cannot be withdrawn on demand without loss. These deposits are better considered as quasi-money.

Government cash balances and demand deposits are frequently excluded from measures of the money supply because (i) it is usually intended to present the liquidity picture of the private sector - the part of the economy which the monetary authorities wish to control or influence; (ii) in general, government spending decisions are little affected by the size of the government's cash holdings; and (iii) in any case, government-held balances are usually quite small. Here again, the special circumstances of Hong Kong would seem to justify different treatment. There is no central bank and the Government cannot readily obtain additional funds by selling its debt to the banking system. The Government differs from other customers of the banking system only in size and is unable to receive accommodation from the banking system to the same extent as a government in an independent monetary system. The spending decisions of the Hong Kong Government are more influenced by the size of its monetary holdings than is usually the case.
Table 7.1 sets out components of the money supply over the period 1955 to 1967.

In the course of economic development, the relative importance of bank deposits usually grows at the expense of currency, in line with the public's growing familiarity with, and trust in, commercial banks, and the greater importance of larger financial transactions. Even in the relatively short period covered in Table 7.1 (see rows 12 and 13), the Hong Kong statistics confirm this experience. Currency fell as a proportion of the money supply (narrow definition) from 42 per cent in 1955 to 34 per cent in 1963. (In the following years, as consequences of the banking crisis and the political disturbances, the proportion increased to 43 per cent.) As a proportion of the wider concept of the money supply, currency fell from 39 per cent to 26 per cent between 1955 and 1966. The increasing preference of the public to hold bank deposits is significant, of course, in that it affects not only the composition of the money supply, but, by permitting additional credit creation, the volume of money as well. The composition of the money supply plus quasi-money changed even more markedly. Time deposits increased from 8 per cent of money plus quasi-money in 1955 to 32 per cent in 1966.

As Table 7.2 shows, the ratio of currency in circulation to cheque deposits is lower than in most Asian countries. Hong Kong has a relatively high average income, the Colony is very urbanised, there is a developed corporate sector, and, in general, a higher level of economic sophistication.

In many developed countries, there has been a tendency, at least over the postwar period, for the ratio of the money supply (narrowly defined) to national income to fall\(^1\) - i.e., for the velocity of circulation of money to increase - mainly because the liabilities of non-bank financial institutions have increasingly supplanted money as a store of value. On the other hand, in a

\(^1\) See, for example, (U.K.) Commission on the Working of the Monetary System, H.M.S.O., Command 827 (The Radcliffe Report), para 478.
Table 7.1

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<tbody>
<tr>
<td>Banknotes Issued by Commercial Banks</td>
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<td>732</td>
<td>753</td>
<td>772</td>
<td>838</td>
<td>914</td>
<td>933</td>
<td>1045</td>
<td>1110</td>
<td>1296</td>
<td>1629</td>
<td>1730</td>
<td>2176</td>
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<tr>
<td>Currency Issued by Hong Kong Government</td>
<td>45</td>
<td>52</td>
<td>57</td>
<td>66</td>
<td>76</td>
<td>86</td>
<td>94</td>
<td>104</td>
<td>110</td>
<td>117</td>
<td>120</td>
<td>121</td>
<td>133</td>
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<tr>
<td>Total Currency Issued</td>
<td>772</td>
<td>785</td>
<td>813</td>
<td>828</td>
<td>896</td>
<td>984</td>
<td>1027</td>
<td>1124</td>
<td>1230</td>
<td>1398</td>
<td>1740</td>
<td>1837</td>
<td>2308</td>
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<td>Currency Held by Commercial Banks</td>
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<td>97</td>
<td>118</td>
<td>94</td>
<td>86</td>
<td>116</td>
<td>114</td>
<td>162</td>
<td>210</td>
<td>202</td>
<td>221</td>
<td>232</td>
<td>233</td>
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<td>Currency Held by Public and Government</td>
<td>628</td>
<td>686</td>
<td>695</td>
<td>744</td>
<td>810</td>
<td>848</td>
<td>913</td>
<td>962</td>
<td>1020</td>
<td>1196</td>
<td>1318</td>
<td>1620</td>
<td>1975</td>
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<td>Demand Deposits with Commercial Banks</td>
<td>852</td>
<td>928</td>
<td>955</td>
<td>988</td>
<td>1205</td>
<td>1393</td>
<td>1470</td>
<td>1664</td>
<td>1997</td>
<td>2338</td>
<td>2532</td>
<td>2681</td>
<td>2658</td>
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<tr>
<td>Saving Deposits with Commercial Banks</td>
<td>1613</td>
<td>1780</td>
<td>1840</td>
<td>1912</td>
<td>2143</td>
<td>2281</td>
<td>2383</td>
<td>2626</td>
<td>3017</td>
<td>3334</td>
<td>4015</td>
<td>4214</td>
<td>4633</td>
</tr>
<tr>
<td>Time Deposits with Commercial Banks</td>
<td>152</td>
<td>173</td>
<td>267</td>
<td>351</td>
<td>482</td>
<td>752</td>
<td>1234</td>
<td>1768</td>
<td>2283</td>
<td>2639</td>
<td>3099</td>
<td>3742</td>
<td>3324</td>
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<tr>
<td>Demand Deposits plus quasi money</td>
<td>1759</td>
<td>2017</td>
<td>2327</td>
<td>2866</td>
<td>3530</td>
<td>4280</td>
<td>5273</td>
<td>6435</td>
<td>7688</td>
<td>8770</td>
<td>10023</td>
<td>10137</td>
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<tr>
<td>Currency as Per Cent of money supply (Narrow definition)</td>
<td>42</td>
<td>42</td>
<td>42</td>
<td>42</td>
<td>40</td>
<td>38</td>
<td>38</td>
<td>37</td>
<td>34</td>
<td>34</td>
<td>37</td>
<td>38</td>
<td>32</td>
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<tr>
<td>Demand Deposits as Per Cent of money supply (Narrow definition)</td>
<td>58</td>
<td>58</td>
<td>58</td>
<td>57</td>
<td>60</td>
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<td>62</td>
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<td>66</td>
<td>66</td>
<td>63</td>
<td>62</td>
<td>57</td>
</tr>
<tr>
<td>Currency as Per Cent of money supply (Wider definition)</td>
<td>39</td>
<td>39</td>
<td>38</td>
<td>38</td>
<td>34</td>
<td>31</td>
<td>30</td>
<td>27</td>
<td>24</td>
<td>24</td>
<td>27</td>
<td>26</td>
<td>29</td>
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<tr>
<td>Demand Deposits as Per Cent of money supply (Wider definition)</td>
<td>53</td>
<td>52</td>
<td>52</td>
<td>50</td>
<td>50</td>
<td>50</td>
<td>48</td>
<td>48</td>
<td>48</td>
<td>45</td>
<td>44</td>
<td>43</td>
<td>39</td>
</tr>
<tr>
<td>Saving Deposits as Per Cent of money supply (Wider definition)</td>
<td>8</td>
<td>9</td>
<td>10</td>
<td>12</td>
<td>16</td>
<td>19</td>
<td>22</td>
<td>25</td>
<td>28</td>
<td>31</td>
<td>29</td>
<td>32</td>
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per cent

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<tbody>
<tr>
<td>Times Increase 1955 to 1967</td>
<td></td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

Source: Hong Kong Government Gazette, Supplement Number 1.

a. 31 December throughout.

Note: Figures in millions.

- Times Increase: The increase from 1955 to 1967 is calculated and presented for each category.
- Percentages: The percentages are calculated based on the total money supply for each year.

Table 7.1 presents the volume of money from 1955 to 1967, showing the increase and the percentages of various monetary components over time.
Table 7.2
CURRENCY AS PER CENT OF MONEY SUPPLY, SELECTED COUNTRIES, 1960 AND 1966

<table>
<thead>
<tr>
<th>Country</th>
<th>December 1960</th>
<th>December 1966</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>24</td>
<td>22</td>
</tr>
<tr>
<td>Japan</td>
<td>25</td>
<td>22</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>38</td>
<td>38</td>
</tr>
<tr>
<td>Taiwan</td>
<td>44</td>
<td>38</td>
</tr>
<tr>
<td>Philippines</td>
<td>57</td>
<td>53</td>
</tr>
<tr>
<td>Ceylon</td>
<td>50</td>
<td>54</td>
</tr>
<tr>
<td>Malaysia</td>
<td>71</td>
<td>60</td>
</tr>
<tr>
<td>Korea</td>
<td>63</td>
<td>61</td>
</tr>
<tr>
<td>India</td>
<td>73</td>
<td>64</td>
</tr>
<tr>
<td>Burma</td>
<td>69</td>
<td>74</td>
</tr>
</tbody>
</table>


Note. This Table provides a measure of the components of the stock of money of the various countries at the two points of time. No indication is given of the relative importance of the two types of money in economic transactions in the different economies, which would be affected by the rates at which the two types of money turn over.


number of underdeveloped countries, the growth of per capita incomes and monetisation of the subsistence sectors have tended to raise this ratio.\(^1\) Table 7.3 shows the money supply as a per cent of national income in Hong Kong. Although the Table covers only a relatively short period of time, the results are not without interest. The fall in the ratio of currency to national income (row 1) is in large part due to the spread of the banking habit. Over the period covered, there has been little variation in the ratio of currency and demand deposits to national income. But the ratio of money supply (wider definition - includes saving deposits) to national income increased from 43 per cent to 49 per cent. The most noticeable change is the rise - from 47 per cent to 77 per cent - in the ratio of money plus quasi-money to national income.\(^2\)

\(^1\) See Economic Survey of Asia and the Far East, 1966, p.90.

\(^2\) In Australia in 1964, currency and bank deposits were the equivalent of 55 per cent of national income (Hong Kong, 77 per cent), consisting of currency plus demand deposits 21 per cent (Hong Kong, 34 per cent), saving deposits 26 per cent (Hong Kong, 15 per cent), and fixed deposits 8 per cent (Hong Kong, time deposits, 28 per cent).
this increase, however, is due simply to the continuing inflow of deposits from abroad, and is, therefore, of relatively little economic significance.

Table 7.3
MONEY AND QUASI-MONEY: PER CENT OF GROSS DOMESTIC PRODUCT, SELECTED YEARS

<table>
<thead>
<tr>
<th>Year</th>
<th>1955</th>
<th>1959</th>
<th>1964</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ million</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Estimated gross domestic product</td>
<td>3,780</td>
<td>5,290</td>
<td>10,000</td>
</tr>
<tr>
<td>Ratio to gross domestic product</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(1) Currency held outside of banks</td>
<td>17</td>
<td>15</td>
<td>12</td>
</tr>
<tr>
<td>(2) Demand deposits</td>
<td>23</td>
<td>23</td>
<td>22</td>
</tr>
<tr>
<td>(3) Currency and demand deposits</td>
<td>39</td>
<td>38</td>
<td>34</td>
</tr>
<tr>
<td>(4) Saving deposits</td>
<td>4</td>
<td>7</td>
<td>15</td>
</tr>
<tr>
<td>(5) Money supply (including saving deposits)</td>
<td>43</td>
<td>45</td>
<td>49</td>
</tr>
<tr>
<td>(6) Time deposits</td>
<td>4</td>
<td>9</td>
<td>28</td>
</tr>
<tr>
<td>(7) Money plus quasi-money</td>
<td>47</td>
<td>54</td>
<td>77</td>
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</tbody>
</table>


Variations in the Money Supply

One can determine more about the causes of changes in a country's money supply by looking at the components of the variation. In any economy, the increase in the supply of money in a given period is equal to the surplus of international receipts over international payments plus the increase in domestic non-cash assets of the banking system (and vice versa for a decrease). There are several ways in which the components in the money supply variation can be set out.

The most useful is:

One which traces [the changes in the money supply] back to net lending and borrowing transactions between the major sectors of the economy - firms, households, government, and the rest of the world. Ideally, what is needed

---

for such an analysis is a regular (or at least annual) series of flow-of-funds accounts for the economy. 1

But few countries have the detailed statistics required for such an exercise, and in the statistically virtually uncharted monetary system of Hong Kong, it is possible only to make the general breakdown given in Tables 7.4.A and 7.4.B. The tables, which are based on a classification employed in an unpublished World Bank analysis of the Hong Kong money supply for the period 1954 to 1960, show the contributions made to variations in the money supply by the Government, domestic and external sectors. The net contributions of each of the three sectors over the period December 1954 to December 1966 is shown in the final column.

In Hong Kong, the public sector has not influenced the money supply by selling its debt to the banking system. The Government has, though, affected the level of the money supply through variations in its reserve holdings (rows 2 and 3 in Table 7.4.A). Over the period 1954 to 1966 the Government ran down its foreign reserves by $47 million, and built up its local money balances by almost $400 million. Over the same period bank credit to the private sector was expanded by $5,405 million. But, unless one includes saving deposits in the money supply (Table 7.4.B), this expansion of credit was more than offset $5,502 million) by the public's accumulation of non-monetary interest-bearing deposits and by the growth of the banks' net miscellaneous accounts. If saving deposits are included in the money supply, net credit to the private sector increased over the period, by $1,784 million, but still contributed only a third of the total increase in the money supply. In the absence of any statistical information on the balance of payments, the contribution of the external sector can be shown only by variations in the foreign assets of the exchange and currency funds, the commercial banks and Government. The foreign assets of these institutions expanded by $3,251 million in the period 1954 to 1966.

1 H.W. Arndt and C.P. Harris, op. cit., p.41.
### Table 7.4A

**ANNUAL VARIATIONS IN MONEY SUPPLY, 1955 TO 1966**

($ million)

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<tbody>
<tr>
<td>I PUBLIC SECTOR</td>
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<td></td>
<td></td>
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<tr>
<td>(1) Bank credit to government</td>
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<tr>
<td>(2) Local currency and balances</td>
<td>-58</td>
<td>58</td>
<td>66</td>
<td>-8</td>
<td>-30</td>
<td>-28</td>
<td>95</td>
<td>191</td>
<td>105</td>
<td>42</td>
<td>-73</td>
<td>38</td>
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<td>(3) Balances abroad</td>
<td>83</td>
<td>-42</td>
<td>-32</td>
<td>23</td>
<td>48</td>
<td>-25</td>
<td>-96</td>
<td>-19</td>
<td>-34</td>
<td>141</td>
<td>-85</td>
<td>-9</td>
<td></td>
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<tr>
<td>(4) Time deposits and excess cover of note and coin issues</td>
<td>8</td>
<td>-10</td>
<td>-2</td>
<td>0</td>
<td>7</td>
<td>-16</td>
<td>2</td>
<td>2</td>
<td>7</td>
<td>20</td>
<td>11</td>
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<tr>
<td>(5) Total offsets</td>
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<td>6</td>
<td>32</td>
<td>15</td>
<td>25</td>
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<td>1</td>
<td>174</td>
<td>78</td>
<td>203</td>
<td>-147</td>
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<tr>
<td>(6) Bank loans and advances</td>
<td>121</td>
<td>137</td>
<td>96</td>
<td>54</td>
<td>65</td>
<td>347</td>
<td>684</td>
<td>515</td>
<td>793</td>
<td>970</td>
<td>426</td>
<td>342</td>
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<td>(7) Bank investments</td>
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<td>2</td>
<td>10</td>
<td>63</td>
<td>-2</td>
<td>9</td>
<td>307</td>
<td>50</td>
<td>13</td>
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<td>(8) Total credit to private sector</td>
<td>121</td>
<td>138</td>
<td>92</td>
<td>52</td>
<td>64</td>
<td>368</td>
<td>747</td>
<td>513</td>
<td>802</td>
<td>1277</td>
<td>476</td>
<td>335</td>
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<td>(9) Offsets</td>
<td>32</td>
<td>33</td>
<td>25</td>
<td>54</td>
<td>124</td>
<td>168</td>
<td>128</td>
<td>216</td>
<td>266</td>
<td>370</td>
<td>105</td>
<td>362</td>
<td></td>
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<td>(10) Savings deposits</td>
<td>45</td>
<td>30</td>
<td>23</td>
<td>18</td>
<td>41</td>
<td>-43</td>
<td>115</td>
<td>-69</td>
<td>-9</td>
<td>303</td>
<td>650</td>
<td>48</td>
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<tr>
<td>(11) Total offsets</td>
<td>97</td>
<td>59</td>
<td>87</td>
<td>146</td>
<td>310</td>
<td>476</td>
<td>655</td>
<td>503</td>
<td>662</td>
<td>390</td>
<td>1251</td>
<td>866</td>
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<td>(12) Net credit to private sector</td>
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<td>5</td>
<td>-94</td>
<td>134</td>
<td>-108</td>
<td>92</td>
<td>10</td>
<td>150</td>
<td>887</td>
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<td>-97</td>
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<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>(13) Exchange fund</td>
<td>0</td>
<td>0</td>
<td>25</td>
<td>17</td>
<td>63</td>
<td>76</td>
<td>38</td>
<td>104</td>
<td>96</td>
<td>156</td>
<td>329</td>
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<td>986</td>
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<tr>
<td>(14) Note and coin funds</td>
<td>1</td>
<td>13</td>
<td>1</td>
<td>4</td>
<td>10</td>
<td>3</td>
<td>5</td>
<td>18</td>
<td>1</td>
<td>-2</td>
<td>4</td>
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<td>(16) Net bank balances abroad</td>
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<td>19</td>
<td>56</td>
<td>151</td>
<td>50</td>
<td>166</td>
<td>59</td>
<td>344</td>
<td>262</td>
<td>514</td>
<td>913</td>
<td>646</td>
<td>2153</td>
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<tr>
<td>(17) Total external sector</td>
<td>85</td>
<td>-10</td>
<td>50</td>
<td>195</td>
<td>171</td>
<td>220</td>
<td>6</td>
<td>447</td>
<td>325</td>
<td>-219</td>
<td>1161</td>
<td>734</td>
<td>3165</td>
</tr>
<tr>
<td>TOTAL MONEY SUPPLY (narrow definition)</td>
<td>78</td>
<td>63</td>
<td>23</td>
<td>86</td>
<td>300</td>
<td>180</td>
<td>97</td>
<td>203</td>
<td>387</td>
<td>435</td>
<td>544</td>
<td>185</td>
<td>2681</td>
</tr>
</tbody>
</table>

Annual variations in the money supply (narrow definition) from Table 7.5

(n.a.) (34) (36) (82) (283) (226) (142) (243) (391) (519) (315) (250) (n.a.)

Source: see notes to Tables 7.4 and 7.5.
### Table 7.4.B

**ANNUAL VARIATIONS IN MONEY SUPPLY, 1955 TO 1966**

($ million)

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</thead>
<tbody>
<tr>
<td><strong>I Public Sector</strong></td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
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</tr>
<tr>
<td><strong>II Private Sector</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>(6) Bank loans and advances</td>
<td>121</td>
<td>137</td>
<td>96</td>
<td>54</td>
<td>454</td>
<td>347</td>
<td>684</td>
<td>515</td>
<td>793</td>
<td>970</td>
<td>426</td>
<td>342</td>
<td>4939</td>
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<tr>
<td>(7) Bank investments</td>
<td>0</td>
<td>1</td>
<td>-4</td>
<td>-2</td>
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<td>21</td>
<td>63</td>
<td>-2</td>
<td>9</td>
<td>307</td>
<td>50</td>
<td>13</td>
<td>466</td>
</tr>
<tr>
<td>Total credit to private sector</td>
<td>121</td>
<td>138</td>
<td>92</td>
<td>52</td>
<td>464</td>
<td>368</td>
<td>747</td>
<td>513</td>
<td>802</td>
<td>1277</td>
<td>476</td>
<td>355</td>
<td>5405</td>
</tr>
<tr>
<td><strong>Offsets</strong></td>
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<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>(8) Time deposits</td>
<td>20</td>
<td>-4</td>
<td>39</td>
<td>74</td>
<td>145</td>
<td>351</td>
<td>414</td>
<td>356</td>
<td>405</td>
<td>323</td>
<td>496</td>
<td>552</td>
<td>3171</td>
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<tr>
<td>(10) Net miscellaneous accounts</td>
<td>45</td>
<td>30</td>
<td>23</td>
<td>18</td>
<td>41</td>
<td>-43</td>
<td>115</td>
<td>-69</td>
<td>-9</td>
<td>-303</td>
<td>650</td>
<td>-48</td>
<td>450</td>
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<tr>
<td>Total offsets</td>
<td>65</td>
<td>26</td>
<td>62</td>
<td>92</td>
<td>186</td>
<td>308</td>
<td>529</td>
<td>287</td>
<td>396</td>
<td>20</td>
<td>1146</td>
<td>504</td>
<td>3621</td>
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<tr>
<td>(11) Net credit to private sector</td>
<td>56</td>
<td>112</td>
<td>30</td>
<td>-40</td>
<td>278</td>
<td>60</td>
<td>218</td>
<td>226</td>
<td>406</td>
<td>1257</td>
<td>-670</td>
<td>-149</td>
<td>1784</td>
</tr>
<tr>
<td>(12) Net domestic credit</td>
<td>24</td>
<td>106</td>
<td>-2</td>
<td>-55</td>
<td>253</td>
<td>129</td>
<td>217</td>
<td>52</td>
<td>328</td>
<td>1054</td>
<td>-523</td>
<td>-187</td>
<td>1396</td>
</tr>
<tr>
<td><strong>III External Sector</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
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</tr>
<tr>
<td>(17) Total external sector</td>
<td>85</td>
<td>-10</td>
<td>50</td>
<td>195</td>
<td>171</td>
<td>220</td>
<td>6</td>
<td>447</td>
<td>325</td>
<td>-219</td>
<td>1161</td>
<td>734</td>
<td>3165</td>
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<tr>
<td><strong>TOTAL MONEY SUPPLY (Wider definition)</strong></td>
<td>109</td>
<td>96</td>
<td>48</td>
<td>145</td>
<td>424</td>
<td>349</td>
<td>223</td>
<td>499</td>
<td>653</td>
<td>835</td>
<td>636</td>
<td>547</td>
<td>4562</td>
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(Annual variations in the money supply (Wider Definition) from Table 7.5)

|         |      |      |      |      |      |      |      |      |      |      |      |      |                     |
|---------|------|------|------|------|------|------|------|------|------|------|------|------|                     |
| (n.a.)  | (168)| (60) | (136)| (408)| (394)| (268)| (459)| (657)| (889)| (620)| (612)| (n.a.) |                     |

**Source:** see Notes to Tables 7.4 and 7.5.
Table 7.5

ANNUAL VARIATIONS IN MONEY SUPPLY, 1956 TO 1966
($ million)

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td><strong>(1) Net external assets of monetary institutions</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Currency Funds</td>
<td>13</td>
<td>1</td>
<td>4</td>
<td>10</td>
<td>3</td>
<td>5</td>
<td>8</td>
<td>1</td>
<td>-2</td>
<td>6</td>
<td>15</td>
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<tr>
<td>Exchange Fund</td>
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<td>17</td>
<td>63</td>
<td>76</td>
<td>38</td>
<td>104</td>
<td>96</td>
<td>156</td>
<td>329</td>
<td>82</td>
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<td>Commercial banks</td>
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<td>56</td>
<td>151</td>
<td>50</td>
<td>106</td>
<td>59</td>
<td>346</td>
<td>262</td>
<td>516</td>
<td>913</td>
<td>646</td>
</tr>
<tr>
<td>Total</td>
<td>32</td>
<td>82</td>
<td>172</td>
<td>123</td>
<td>245</td>
<td>102</td>
<td>466</td>
<td>359</td>
<td>360</td>
<td>1246</td>
<td>743</td>
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<tr>
<td><strong>(2) Domestic assets of monetary institutions</strong></td>
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<td></td>
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<td></td>
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</tr>
<tr>
<td>Currency Funds</td>
<td>134</td>
<td>92</td>
<td>42</td>
<td>444</td>
<td>369</td>
<td>677</td>
<td>513</td>
<td>802</td>
<td>1277</td>
<td>476</td>
<td>355</td>
</tr>
<tr>
<td>Commercial banks</td>
<td>-4</td>
<td>0</td>
<td>6</td>
<td>-9</td>
<td>8</td>
<td>5</td>
<td>-4</td>
<td>10</td>
<td>10</td>
<td>6</td>
<td>2</td>
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<tr>
<td>Total</td>
<td>130</td>
<td>92</td>
<td>48</td>
<td>455</td>
<td>377</td>
<td>682</td>
<td>509</td>
<td>812</td>
<td>1287</td>
<td>482</td>
<td>357</td>
</tr>
<tr>
<td><strong>(1) + (2) =</strong></td>
<td>166</td>
<td>124</td>
<td>220</td>
<td>578</td>
<td>622</td>
<td>784</td>
<td>975</td>
<td>1171</td>
<td>927</td>
<td>1178</td>
<td>1100</td>
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<tr>
<td><strong>(3) Total assets of monetary institutions</strong></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Minus non-monetary assets</td>
<td>-47</td>
<td>21</td>
<td>-34</td>
<td>2</td>
<td>50</td>
<td>-22</td>
<td>48</td>
<td>48</td>
<td>-8</td>
<td>19</td>
<td>11</td>
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<tr>
<td>Banks' cash holdings</td>
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<td>-1</td>
<td>34</td>
<td>37</td>
<td>-92</td>
<td>56</td>
<td>-66</td>
<td>-49</td>
<td>-360</td>
<td>679</td>
<td>-144</td>
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<td>Otherb</td>
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<td>0</td>
<td>39</td>
<td>-42</td>
<td>34</td>
<td>-18</td>
<td>-1</td>
<td>-368</td>
<td>698</td>
<td>-155</td>
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<tr>
<td><strong>(4) Total non-monetary assets</strong></td>
<td>188</td>
<td>154</td>
<td>220</td>
<td>539</td>
<td>664</td>
<td>750</td>
<td>993</td>
<td>1172</td>
<td>1295</td>
<td>1030</td>
<td>1255</td>
</tr>
<tr>
<td><strong>(5) Total monetary assets</strong></td>
<td>188</td>
<td>154</td>
<td>220</td>
<td>539</td>
<td>664</td>
<td>750</td>
<td>993</td>
<td>1172</td>
<td>1295</td>
<td>1030</td>
<td>1255</td>
</tr>
<tr>
<td>Equals total monetary liabilities</td>
<td>188</td>
<td>154</td>
<td>220</td>
<td>539</td>
<td>664</td>
<td>750</td>
<td>993</td>
<td>1172</td>
<td>1295</td>
<td>1030</td>
<td>1255</td>
</tr>
<tr>
<td><strong>(6) Less Time deposits</strong></td>
<td>21</td>
<td>94</td>
<td>84</td>
<td>131</td>
<td>270</td>
<td>482</td>
<td>534</td>
<td>515</td>
<td>406</td>
<td>410</td>
<td>643</td>
</tr>
<tr>
<td>Equals</td>
<td>168</td>
<td>60</td>
<td>136</td>
<td>408</td>
<td>394</td>
<td>268</td>
<td>459</td>
<td>657</td>
<td>889</td>
<td>620</td>
<td>612</td>
</tr>
<tr>
<td><strong>(7) Money supply (wider definition)</strong></td>
<td>33</td>
<td>24</td>
<td>54</td>
<td>125</td>
<td>168</td>
<td>126</td>
<td>216</td>
<td>266</td>
<td>370</td>
<td>105</td>
<td>352</td>
</tr>
<tr>
<td>Equals</td>
<td>134</td>
<td>36</td>
<td>82</td>
<td>283</td>
<td>226</td>
<td>142</td>
<td>243</td>
<td>391</td>
<td>519</td>
<td>515</td>
<td>210</td>
</tr>
<tr>
<td><strong>(8) Money supply (narrow definition)</strong></td>
<td>76</td>
<td>27</td>
<td>33</td>
<td>217</td>
<td>188</td>
<td>77</td>
<td>194</td>
<td>333</td>
<td>341</td>
<td>194</td>
<td>149</td>
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<tr>
<td>Consisting of</td>
<td>58</td>
<td>9</td>
<td>49</td>
<td>66</td>
<td>38</td>
<td>65</td>
<td>49</td>
<td>58</td>
<td>178</td>
<td>321</td>
<td>101</td>
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<td>Demand deposits</td>
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<tr>
<td>Currency held outside banks</td>
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</tr>
</tbody>
</table>

a Year ending 31 December throughout

Source: see notes to Tables 7.4 and 7.5.

b Residual item; includes errors
Notes to Tables 7.4 and 7.5

1. Table 7.4 is given in two parts. In Table 7.4.A saving deposits are excluded from the money supply. In Table 7.4.B saving deposits are included in the money supply.

2. 'Net miscellaneous account' in Table 7.4 equals commercial bank cash holdings plus bank net worth plus net interbank balances in Hong Kong. The cash holdings of the banks are treated as an offset because they represent a liability of the currency and exchange funds. Net interbank balances should, of course, be equal to zero, but, due mainly to different accounting classifications, a zero value is rarely recorded.

3. 'Net miscellaneous account' in Table 7.4.B was estimated as a residual. Thus the item in this Table includes the errors which result from the differing balance dates.

4. Statistics for the currency funds and Government relate to the year ending 31 March following.

1960 to 1966: Annual Report of the Accountant-General, various numbers;
Government Gazette, Supplement Number 4, various numbers.

Table 7.5: Annual Report of the Accountant-General, various numbers,
Government Gazette, Supplement Number 4, various numbers.
Another way in which the components of the variations in the money supply can be set out is the 'balance sheet' method used by Shaw\(^1\) and King.\(^2\) As the financial titles which circulate as money are the (monetary) liabilities of financial institutions, any variation in the money supply must have its equivalent among either the assets, or the non-monetary liabilities of the financial institutions whose liabilities are included in the money supply. Thus, if the money supply is taken to consist of currency and demand deposits, we can highlight changes in the volume of money by analysing movements in the monetary assets of the currency funds and the commercial banks. This approach is set out in Table 7.5.

Several general comments can be made on Tables 7.4 and 7.5. First, the Tables point to the relative simplicity of the monetary system: there is no central bank and the money supply has not been influenced by transactions in government securities by the monetary institutions. Second, the continued dominance of balance of payments causes of changes in the money supply stands out. The relationship between the money supply and the balance of payments is discussed in the next section. Third, as row 5 of Table 8.4, A demonstrates, the financial operations of the Government have had some influence on the local money supply. This topic is further analysed in a later section.

**Money Supply and the Balance of Payments**

The dependence of the local money supply on the balance of payments is a topic which has been given a good deal of attention.

---

1. E.S. Shaw, op. cit.
2. F.H.H. King, op. cit.
3. It is convenient to use the term 'monetary assets' to refer to the commercial banks' total assets less assets held against non-monetary liabilities. The main non-monetary liabilities are the banks' net worth and cash holdings (the latter is treated as a monetary liability of the currency authorities and not of the commercial banks).
in discussions of the colonial sterling exchange standard. No attempt is made here to review this literature; in this section we are simply concerned to see how rigid a relationship between balance of payments and money supply has been experienced in Hong Kong, and to make some analysis of what effect a sudden change in the Colony's balance of payments situation might have on the money supply.

Of course, in the simple colonial sterling exchange standard, where there are no banks and the currency is fully backed by foreign exchange, it is correct to say that the money supply is determined by the balance of payments. As one author has pointed out, variations in the money supply in such cases would be the 'one item that brings about equality between all the positive and negative items in the balance of payments'.

Once allowance is made for commercial banks, this simple relationship between the balance of payments and the money supply is broken. Unlike the currency fund, the banks hold both foreign and local assets, and the money supply will increase whenever the banks expand their credit. The banks can make additional advances so long as there are outlets which satisfy their lending standards and they are sufficiently liquid to meet the resulting cash drain; provided these two conditions are met there can be an expansion of bank credit whatever the state of the balance of payments. The greater the importance of bank credit, the more variations in the local money supply are freed from balance of payments forces.

Creation of money by the banks also means that the money supply is less than fully backed by foreign exchange. But it does not mean that the money supply is inconvertible into the foreign currency:


2 J. Mars, op. cit., p.186.
currency inconvertibility will result only in the case where the commercial banks have over-expanded their lending and cannot meet the resulting demand for cash from holders of bank deposits. As Arthur Hazelwood has pointed out in connection with the colonies in general:

in the absence of a local 'central' or 'reserve' bank, the commercial banks' cash reserves can consist only of sterling or sterling-backed currency. Bank money can become inconvertible into sterling, therefore, only if the banks are unable to meet their liabilities... If banks are properly managed, their soundness ensures the full convertibility of local money into sterling.¹

It is obvious that movements in the volume of bank credit in an economy such as Hong Kong's cannot be completely independent of the balance of payments. First, as much bank credit is for international trade purposes - either directly to finance the movement of goods or to finance the production of exports - a fall in export demand would quickly be associated with a reduction in the volume of bank credit. A balance of payments deficit would also affect the banks' liquidity position, perhaps forcing them to call in loans and investments. How sensitive the level of bank credit would be to variations in the institutions' cash base depends on whether the banks earlier held surplus liquid assets and on whether they are able and prepared to borrow from their branches and other sources overseas.

Tables 7.4.A and 7.4.B showed that the balance of payments has, in most years, been the main influence on the money supply. However, there are several years in which, because of the activities of the commercial banks, the local money supply expanded quite rapidly despite a slow growth in the foreign assets of the monetary institutions. Since 1964 bank credit has expanded at a more gradual rate, and balance of payments factors have again been the more important cause of money supply variations. As was seen in Chapter 5, the banks have not, overall, been 'loaned up' (although they were

tending this way in 1963 and 1964), and for this reason there has not been a closer year by year relationship between the balance of payments and the money supply. The data from rows 11 and 17 of Table 7.4 are graphed in Chart 7.1.

Several commentators on the workings of the British colonial currency standard have claimed for it that a colony 'cannot have a "balance of payments" problem as that term is now commonly understood' - that 'if a Colony is unable to meet its external obligations it is because of lack of money - of income in internal currency - not because of lack of foreign exchange'. The way in which the 'automatic balance of payments mechanism' appears to have operated in Hong Kong can be illustrated by the case where there is initially a fall in export receipts, perhaps because an important trading partner imposes additional restrictions on imports from Hong Kong (this was the immediate cause of the slump in exports in 1951).

A distinction must be made between the income and the monetary consequences of this fall in export receipts. The level of income will fall as a direct consequence of the slump in export receipts and the familiar multiplier mechanism will come into play. But in an economy such as Hong Kong's, the multiplier effect will not be large: given the high marginal propensity to import, it is possible that a fall in export incomes will have almost as great an effect on the level of imports as it does on local incomes. And, because domestic leakages - to savings and taxes - are small, the fall in incomes will itself be a significant force in the re-establishment

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1 Similar charts are given in W.T. Newlyn and D.C. Rowan, Money and Banking in British Colonial Africa, Oxford: Clarendon Press, 1954, p.171, and P.J. Drake, op. cit., Figure VI-1.


3 Ida Greaves, op. cit., p.88.

4 Much of the next few paragraphs draws on the author's 'A Golden Standard', FEER, 1 September 1966.
Chart 7.1 Commercial Banks: Net Foreign Assets and Cash, and Local Earning Assets, 1955 to 1967
of balance of payments equilibrium. Of course, there is little in this income mechanism that is unique to an economy on the sterling exchange standard. The important consequence of the sterling exchange standard with a 100 per cent foreign exchange backing to the currency issue is that the Government cannot attempt to maintain the previous level of income by resort to central bank finance whether inflationary or not. Any Government deficit must be met from Government reserves or borrowing (from the public, the commercial banks or from foreign sources), and can continue only so long as these sources of funds are available.

The initial fall in exports also has monetary consequences. For a balance of payments deficit to continue, the excess demand for imports must be reinforced from either money hoards or new money creation. In the former case, the imbalance must be self-correcting, for the public cannot indefinitely run down its money balances. What, then, of the external deficit being financed by new money creation? The banks are unlikely to go very far in creating credit during a balance of payments deficit. The external imbalance would reduce both the demand for bank advances, and the banks' holdings of liquid assets. And bank liquidity cannot be maintained by central bank finance, direct or indirect. Of course, a budget deficit could be financed by running down the Government's London reserves; this would keep up the level of the money supply but there would, at the same time, be an accommodating capital inflow in the balance of payments.

Two other consequences might contribute to the restoration of balance of payments equilibrium. If the money supply declines more rapidly than income, tightness in the money market will increase interest rates. The higher interest rates may, in turn, further reduce the level of economic activity and, more certainly, encourage an inflow of short-term funds from abroad. There is also the

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possibility that a change in relative prices - a lowering of domestic prices as local expenditures fall - will encourage some switching of expenditures from traded to non-traded goods. But it is hard to see this effect being of much importance in Hong Kong.

These monetary repercussions of the initial balance of payments deficit serve to reinforce the effects of the income changes. The value of imports will fall, and, eventually, balance of payments equilibrium will be restored at a new level of income and money supply. Chart 7.2 presents the system of relationships in outline form. The consequences of the 'mechanism' are that local incomes and the money supply adjust to the needs of the balance of payments, and that, short of serious bank failures, local money is fully convertible into sterling. There is no need for quantitative exchange restrictions for balance of payments reasons.

The main disadvantage which follows from this monetary system is that internal balance may be sacrificed for the balance of payments adjustment. ¹ But, in any economy where foreign trade is dominant, the balance of payments is an important influence on domestic income and monetary conditions. And, an economy such as Hong Kong's - industrialised with established markets - is unlikely to experience the wide variations in receipts felt by countries whose exports are dominated by one or two goods such as rubber or coffee; thus, the problem of the internal effects of the balance of payments fluctuations is not as severe in Hong Kong as in many territories which have employed a similar monetary standard. It

¹ Clearly, the 'automatic balance of payments mechanism' which operates as a result of the Hong Kong monetary system is very similar to that which operated under the gold exchange standard: the value of the local money unit is fixed in terms of the reserve currency; the money supply is dependent on the balance of payments; local money is freely convertible into the superior currency; and internal balance may have to be sacrificed for balance of payments equilibrium. One point of difference between the two mechanisms - at least between the Hong Kong system and the gold exchange standard outlined by J.E. Meade, *The Balance of Payments*, London: Oxford University Press, 1952 - lies in the unimportance of interest rate movements in the Hong Kong system of balance of payments adjustment.
Chart 7.2

BALANCE OF PAYMENTS ADJUSTMENT TO A FALL IN EXPORT RECEIPTS

INITIAL EFFECTS

1. Initial fall in incomes
2. Fall in spending

LIQUIDITY EFFECTS

1. Fall in demand for bank credit
2. Fall in bank lending
3. Currency returned to Exchange Fund
4. Rise in interest rates

Balance of payments equilibrium

Fall in domestic money balances; therefore less balances from which excess spending can be financed

Short-term capital inflow
must be remembered, too, that the Government is not entirely without some influence on local monetary conditions.

Although the maintenance of external balance is not dependent on the existence of the free market in foreign currencies, this market appears to make the adjustment a more speedy one. During the initial balance of payments deficit, the free market rates would move against the Hong Kong dollar, making imports financed from the open market more expensive, and discouraging outward capital transfers. Both of these tendencies would contribute to the restoration of balance of payments equilibrium.

It does not appear entirely correct to say that an economy with Hong Kong's institutional arrangements cannot have a balance of payments problem, for external imbalance is usually defined to include a situation where loss of international reserves is avoided only by a depressed income level and by monetary stringency. The 'balance of payments problem' can take the form of a reduced income level and money supply, but not of a threat to the stability or convertibility of the Hong Kong dollar.

**Government Influence on the Money Supply**

Table 7.4 showed that the financial activities of the Government have had some influence on the supply of money within the Colony. In most years, the Government's financial operations have led to a decrease in privately-held money balances, but in 1960 and 1965 the Government's activities were responsible for an increase in the domestic money supply. Of course, this effect of the Government's operations did not come about through any deliberate attempt to influence the size of privately-held money balances. Nor did the Government affect the local money supply by borrowing from the banking system or by arranging a fiduciary currency issue. The

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1 The scope for government influence over the money supply in a territory employing the colonial sterling exchange standard appears to have been first outlined by F.H.H. King, op. cit.
influence has been felt through variations in the Government's locally-held reserves and in the Government balances held in London.

If the Government finances a budget deficit by running down its local reserves, there will be an increase in privately-held money balances by an equivalent amount. (If Government money balances are included in the definition of the money supply, no variation in the 'money supply' will result.) Unless the banks hold a higher cash ratio against Government-owned deposits than privately-held deposits, no multiple credit creation will result from such a transfer of deposits. In the opposite case, where the Government runs a budget surplus and deposits the excess of revenue with the Hong Kong banks, the privately-held money supply will fall by an equivalent amount, and only if the banks maintain a different cash ratio against Government than non-Government deposits will there be a multiple contraction of the money supply.

But if an excess of public spending is financed by a withdrawal from the Government's London reserves, the local money supply, whether or not it is defined to include Government-held local demand deposits, will rise. At the very least the money supply will increase by the equivalent of the Government deficit. The transfer will also increase the liquid asset holdings of the banks and, if there are sufficient lending opportunities which meet the banks' loan criteria, credit will be expanded and the money supply will rise by a multiplied amount. The Government can influence the local money supply even independently of its budget position, through transfers of its reserves between London and Hong Kong. In such cases there will be a variation in the privately-held money supply so long as the banks expand or contract their local loans and advances in response to the change in their cash base.

Clearly, the Government's ability to influence the money supply depends on the size of its reserves, on its willingness to move these funds between London and Hong Kong (which involves, among other things, considerations of exchange cost), and, most importantly,
on the sensitivity of the commercial banks to changes in their
liquid asset position.

Transfers of locally held reserves between the Government's
demand and time deposit accounts also affect the money supply (if
this is defined to include the Government's current deposits), but
these transfers are without economic significance.

There are several other ways in which the Government could
exert an influence on the money supply were there changes in Govern-
ment attitudes or in institutional arrangements. First, the supply
of bank money could be varied through directives to the banks to
adjust their liquid assets ratios. Secondly, a fiduciary currency
issue would permit additional Government influence over the money
supply, in that the currency issue (and thus the cash base of the
commercial banks) could then be varied without any corresponding
change in the external assets of the Exchange Fund. So long as the
fiduciary issue was limited in size, there would be no question of
inflation or of the Hong Kong dollar becoming inconvertible. Thirdly,
if a sale of Government securities to the commercial banks induced
these institutions to lower their holdings of liquid assets abroad,
the increased Government expenditure made possible by the loan
raisings would lead to an increased local money supply.¹

It can be seen, then, that the monetary framework does not
preclude Government influence over the money supply. But, especially
so long as the currency issue remains fully backed by sterling, the
extent of the Government's influence on the supply of money is much
more limited than is the case with a government in an independent
monetary system. Even if there is unemployment of a Keynesian type
(unemployment which could be reduced by an increase in money demand),
the government in an economy with a pure sterling exchange standard

¹ Of course, there will be no increase in the money supply as a
result of the Government's sale of bonds if the banks reduced their
local loans and advances in order to purchase the Government paper.
would be unable to finance a budget deficit by new money creation, and to this extent, the currency board system can operate as a significant constraint on the government's influence over the money supply.

The Monetary System and Economic Growth

The suitability of the Colony's monetary system from the point of view of economic growth is a topic which has been touched on several times already. A monetary system should ensure an appropriate rate of growth in the money supply. If the money supply increases too quickly, economic growth could be disrupted by serious inflation or balance of payments difficulties. On the other hand, if the money supply is insufficiently elastic, economic growth might be retarded by a deficiency of money demand.

(i) We saw in the previous section that the currency board arrangements impose some restraint on the Government's ability to influence domestic monetary conditions. It has been argued in the case of a number of colonies that this restraint had adverse consequences for economic development; the automatic transmission of variations in the balance of payments to domestic monetary conditions was said to discourage investment in fixed capital and favour investment in speculative and short-term ventures. But in Hong, where economic fluctuations have been relatively mild, this problem has not arisen. It has been political uncertainty, rather than monetary instability, which has given a bias towards short-term investment.

(ii) It has been claimed, too, that the colonial currency board mechanism has a 'deflationary bias', which can act as a break

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1 However, there may be occasions in which Government borrowing from the commercial banks induces these institutions to run down their foreign reserve holdings or their cash holdings. In these cases, the Government borrowing will be associated with new money creation.

on economic growth. Simply, and rather crudely, the argument can be expressed in this way: a growing national income requires an increased money supply to satisfy the public's demand for larger money balances; under the sterling exchange standard (or any system with a 100 per cent foreign exchange backing to the currency issue) the money supply can increase only if there is a balance of payments surplus; thus, for the money supply to increase with the national income, economic growth must be associated with a continuing and increasing balance of payments surplus; otherwise, it will be choked off by the deficiency of money demand and the increase in interest rates, or will continue only so long as there is price deflation.

It is clear from the earlier discussion in this study that this problem has not yet arisen in Hong Kong: the growth of national income has not been retarded by a shortage of money demand or by high interest rates. And, given the very adequate foreign exchange reserves held at present by the commercial banks and Government, it seems unlikely that the problem can arise for some time. In any case, one can expect the velocity of circulation of money further to increase as the public becomes more bank conscious, and there is considerable scope for the expansion of bank credit (i.e. for an increase in that part of the money supply which is not fully backed by sterling). A limited fiduciary currency issue within the sterling exchange standard currency framework would also permit the money supply. 

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2 A further complication is that the drain of currency from the banks to meet the public's growing demand for cash balances may cause a reduction in bank advances, and thus a shrinkage of the money supply.

3 It should be stressed that this problem of a deflationary bias under a monetary system with a 100 per cent foreign exchange cover against the currency issue is not an abstract one; Hugh Patrick, 'Japan, 1868-1914' in Rondo Cameron, op. cit., p.253, shows the way in which the Japanese Government acted to avert exactly this problem in the early 1880s; W.T. Newlyn and D.C. Rowan, op. cit., especially p.197, saw the deflationary bias of the monetary system as a relatively immediate problem for several African states.
supply to be expanded independently of any balance of payments surplus.

(iii) What of the opposite case: can the monetary system permit an excessive increase in the supply of money, which would lead to inflation or a demand for imports for which no foreign exchange is available? It is very unlikely that rapid price increases or currency inconvertibility could result under the Hong Kong monetary system. It is, after all, the virtue of the pure sterling exchange standard that the Government cannot resort to deficit finance and the banks can hold only foreign exchange or foreign exchange-backed currency as liquid assets. Nonetheless, given the importance of bank credit in the economy, a too rapid expansion of bank loans and advances could strengthen inflationary pressures in the economy.

(iv) There has been some cost to economic growth in the maintenance of a 100 per cent foreign exchange backing against the banknote issue. It was seen earlier that full convertibility does not require this extent of external cover, and some of the funds employed in this way could, instead, have been used in a once-for-all increase in public capital formation. The high level of cover has, though, ensured foreign and local confidence in the Hong Kong currency.
Chapter 8

THE NON-BANK FINANCIAL INSTITUTIONS

The role of non-bank financial intermediaries - housing finance institutions, insurance companies, pension funds, hire-purchase companies, securities markets, co-operative societies, etc. - in the saving-investment process and in economic development has been given considerable attention by policy makers and economists, especially in the more developed economies. In many less developed countries, the establishment and nurturing of non-bank financial intermediaries have been objects of government policy: by widening the range of financial titles available and by making for a more developed capital market, it is hoped that these intermediaries will increase the rate of saving and encourage a more efficient distribution of investible funds.

For various reasons non-bank financial intermediaries are relatively unimportant in Hong Kong.

(i) First, the title 'bank' has been given a very wide interpretation in the Colony. The 1948 Banking Ordinance required any business accepting deposits from the public, or conducting money transfers or remittances, to register as a 'bank'. Largely for this reason most deposit-accepting institutions have operated under the title 'Commercial Bank', even though their operations may have been more correctly described as money changing, bullion dealing or the provision of hire-purchase facilities.

(ii) A number of commercial banks - including the older and well-established institutions - have undertaken a wider range of lending activities than their counterparts in many other countries.

1 See for example, J.C. Gurley and E.S. Shaw, op. cit.
As a consequence, borrowers have had less reason to turn to non-bank financial institutions, such as the new issues market and housing finance corporations.

(iii) Political uncertainty, too, has discouraged the development of non-bank financial intermediaries. Many of these institutions - notably the new issues market, life insurance companies and pension funds - deal in financial titles which are of a long term, and frequently illiquid, nature. Uncertainty over the Colony's future has favoured saving in the form of short term liquid assets with fixed capital values; most especially, in short-dated bank deposits.

(iv) Because of the predominance of Chinese family-owned businesses, there is little tendency towards public company status and public capital issues. Perhaps, too, for the same reason, some personal savings are made available only to borrowers within the extended family, and not to the capital market.

(v) Overall, the system of non-bank financial institutions has not received the same degree of Government encouragement and support as in other developing countries. For example, there is no industrial or development bank, post office saving bank, Government-established pension fund or Government-supported securities market. But this difference is one of degree only, for we shall see, even the avowedly laissez-faire Hong Kong Government has accepted responsibility for the establishment and support of several non-bank financial institutions.

(vi) The freedom with which money transfers can be made between Hong Kong and other financial centres may have acted against the development of the Colony's financial markets. The commercial banks, for example, have had ready access to foreign money markets, local savers can freely purchase foreign financial titles, and

1 In 1959 the Government established a Committee to look into the question of whether an industrial bank was required in the Colony. See Chapter 12.
insurance companies can choose, without restriction, to invest their funds in the more developed overseas capital markets.

(vii) In many countries the restrictions placed by monetary authorities on the activities of the commercial banks have encouraged borrowers to turn to the non-bank intermediaries instead, and thus have served as a stimulus to the proliferation and growth of the non-bank financial institutions. No such restraint on the expansion of the commercial banks has been imposed in Hong Kong.

(viii) Many non-bank financial institutions have been established specifically to assist the development of rural industries - the sector of the economy usually least served by commercial banking. This sector is of little importance in Hong Kong.

In the following pages the several non-bank institutions are discussed in turn: the housing finance institutions, the stock exchange and new issues market, insurance companies, the merchant houses, the co-operative societies and, finally, the hire-purchase companies.

The Housing Finance Institutions

In this group are included the Hong Kong Housing Authority, the Hong Kong Housing Society, the Hong Kong Building and Loan Agency and the building co-operative societies (which are described in a later section). These organisations deal almost exclusively with the Colony's middle income group and almost all of their funds are provided from Government sources.¹

(a) The Hong Kong Housing Authority. The Hong Kong Housing Authority was set up by the Government in 1954 as a financially independent body to provide housing on a commercial basis, for the middle income group. The role of the Authority can be seen in this extract from a recent Report.

¹ Not all the funds allocated by Government for housing purposes are allocated through these institutions. A large part is spent directly by the Government on resettlement and low cost housing.
The Authority is neither a welfare agency nor is it a charitable institution, but a corporate body set up by ordinance to secure the provision of housing accommodation as it sees fit for such classes of persons as the Governor approves [the Authority has been charged with providing housing for families with a monthly income of $400 to $900]. It is further charged with maintaining a policy which ensures that in any three year period its revenues shall be sufficient to meet its outgoings.\textsuperscript{1}

The Authority - the only semi-Government body in the Colony - is responsible for planning housing developments, awarding contracts for the construction of its estates and managing the occupied buildings. The Authority has been required to pay its own way - there has been no direct Government 'subsidy' of the Authority's operations - but land has been provided from the Government at one-third to one-half its estimated commercial value, and funds have been borrowed from the Government on an indefinite basis at relatively low rates of interest (3.5 and 5 per cent).

The Authority is administered by a board consisting of all members of the Urban Council\textsuperscript{2} and three members appointed by the Governor. It employs its own staff of architects, engineers and estate managers. The number of flats provided by the Authority and the number of tenants occupying these flats are shown in Table 8.1.

Given the Colony's land shortage, most developments are land intensive: one estate at present under construction will house 51,000 people on 25 acres.

The standard of estates has been planned on such a basis that rents will be between thirteen and twenty per cent of the income of the families occupying them. These rents cover the amortisation of capital over forty years at five per cent (earlier 3.5 per cent), the payment of interest on borrowed funds, rates, repairs and maintenance, the costs of management, and a surplus for reserves and re-investment. Of the Authority's income from rents in 1966/67

\textsuperscript{1} Housing Authority, \textit{Annual Report}, 1965/66, p.3.

\textsuperscript{2} At present this Council has 26 members, including ten elected members.
Table 8.1
HONG KONG HOUSING AUTHORITY, FINANCIAL AND OTHER DETAILS, SELECTED YEARS, 1957 TO 1967

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Number of completed flats</td>
<td></td>
<td>2,600</td>
<td>11,300</td>
<td>22,100</td>
<td>22,500</td>
</tr>
<tr>
<td>(2) Persons housed</td>
<td></td>
<td>16,200</td>
<td>68,400</td>
<td>132,600</td>
<td>135,500</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(3) Capital assets</td>
<td>24.9</td>
<td>62.1</td>
<td>154.9</td>
<td>212.6</td>
<td>225.1</td>
</tr>
<tr>
<td>(4) Hong Kong Government Loan</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(4a) Approved</td>
<td>91.5</td>
<td>139.0</td>
<td>180.0</td>
<td>245.0</td>
<td>254.0</td>
</tr>
<tr>
<td>(4b) Utilised</td>
<td>23.8</td>
<td>56.6</td>
<td>140.1</td>
<td>181.1</td>
<td>186.1</td>
</tr>
<tr>
<td>(5) Accumulated retained earnings</td>
<td>1.1</td>
<td>5.5</td>
<td>14.8</td>
<td>31.5</td>
<td>39.0</td>
</tr>
<tr>
<td>(6) Rental income</td>
<td>4.4</td>
<td>11.3</td>
<td>24.2</td>
<td>25.6</td>
<td></td>
</tr>
<tr>
<td>(7) Interest paid to Government</td>
<td>n.a.</td>
<td>1.8</td>
<td>5.5</td>
<td>8.0</td>
<td>8.7</td>
</tr>
</tbody>
</table>

a = 31 March each year.

n.a. = not available.

Source: Hong Kong Housing Authority, Annual Report, various numbers

of $25.6 million, 34.2 per cent was absorbed by interest, 18.7 per cent by rates, 14.3 per cent by management and administration, 8.3 per cent by maintenance charges, 7.9 per cent by capital amortisation, leaving a surplus of 18.7 per cent of the rental income. A feature of the Authority's operations is a low level of rent arrears. In 1965 it could be claimed that 'for the past three years there has been for all practical purposes no arrears of rent, with a rent roll which now reaches $2 million a month.'

The Ordinance establishing the Authority permitted the body to 'borrow from the Government or from such other sources as the Governor may approve such money as may be required for the discharge of its functions...upon such terms and conditions as may be approved by the Government', and it was not intended that the Authority would be completely dependent on Government-provided funds. At first, the Government loans - which in all cases have been provided from the Colony's Development Loan Fund - were arranged separately estate by estate, but in 1958 the several individual

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1 Housing Authority, Annual Report, 1964/65, p.3.
loans then outstanding were consolidated into a revolving fund of $91.5 million (with the Authority paying interest at 3.5 per cent p.a. on the first $45 million and at five per cent p.a. on the remainder). Although it was the Government's intention that 'the money already granted to the Housing Authority was intended to constitute a permanent revolving fund which would very soon make the Authority independent of further grants', the continuing magnitude of the housing problem and the unavailability of non-Government funds have required the Government to make additional loans (see Row 4a in Table 8.1). The Government on a number of occasions has informed the Authority that further loans could not be provided on such favourable terms.

A now significant part of the Authority's investment is financed from internal sources (Row 5 in Table 8.1). A main reason for the Authority's decision in 1965 to raise rents was to increase this re-investible surplus. In its 1964/65 Report the Authority suggested that accumulated retained earnings should be around $75 million by 1970. The recent increase in rents will mean that this estimate is considerably exceeded.

The Authority has been unable to attract funds from non-Government sources: 'the best we have been able to find were a few million dollars, at seven per cent repayable over three years, a reasonable rate of interest no doubt, but an impossible repayment period'. In March 1966 the Authority reported that the question of issuing debentures or annuity loan stock was being examined, but it found, apparently, that no underwriting support was forthcoming and that it would need to offer a high interest rate.

1 Financial Secretary, Legislative Council Debates, 1965, p.79.
2 See, for example, Housing Authority, Annual Report, 1961/62, p.10.
3 Housing Authority, Annual Report, 1965/66, p.4.
The difficulty, of course, is that the Authority requires funds on a very long term basis at a relatively low interest rate. It appears likely that the Authority will remain dependent on funds provided from the Government and from its internal sources.

(b) The Hong Kong Housing Society. This organisation was formed in 1948 as a non-profit making institution charged with the provision of low cost housing for families with average or small incomes. At that stage there was no Government-provided cheap housing. The Society was incorporated in 1951. It is a non-Government organisation, administered by an Executive Committee composed, at present, of members of commerce, welfare agencies and Government. Since the Government's resettlement program was commenced, the Housing Society has concentrated on the provision of housing for the middle income group (family incomes of $400 to $900 per month). In this and in several other ways, its operations are similar to those of the Housing Authority. The Society constructs and manages multi-story estates on land provided cheaply from the Government. Flats are rented and not sold. Rents are charged to amortise capital over 40 years.

Information on the Society's operations is set out in Table 8.2. The largest part of the Society's funds has come from loans from the Government's Development Loan Fund, under the same conditions as the funds provided to the Housing Authority. Retained earnings have financed about eleven per cent of the Society's fixed capital. The Society has made several attempts to obtain funds from non-Government sources, but found it not possible to secure loans for the necessary long term at reasonable interest rates. The Housing

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1 As the Financial Secretary observed in his 1966 Budget Speech, 'the only money that one can raise for a period as long as [the 40 years over which the Housing Authority amortises its building costs] is money raised by the Government's compulsory power of taxation'.

Table 8.2
HONG KONG HOUSING SOCIETY FINANCIAL AND OTHER DETAILS, SELECTED YEARS, 1957 TO 1967

<table>
<thead>
<tr>
<th></th>
<th>1957a</th>
<th>1966</th>
<th>1967</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of completed flats</td>
<td>1,500</td>
<td>14,300</td>
<td>15,400</td>
</tr>
<tr>
<td>Persons Housed</td>
<td>8,800</td>
<td>89,600</td>
<td>96,200</td>
</tr>
<tr>
<td>Capital assets</td>
<td>n.a.</td>
<td>131.8</td>
<td>143.5</td>
</tr>
<tr>
<td>Hong Kong Government Loan Utilised</td>
<td>9.7</td>
<td>123.8</td>
<td>134.3</td>
</tr>
<tr>
<td>Accumulated retained earnings</td>
<td>n.a.</td>
<td>9.5</td>
<td>15.4</td>
</tr>
<tr>
<td>General reserve</td>
<td>n.a.</td>
<td>6.0</td>
<td>6.0</td>
</tr>
<tr>
<td>Loan Scheme (less repayments)</td>
<td>-</td>
<td>2.0</td>
<td>2.0</td>
</tr>
<tr>
<td>Rental income</td>
<td>1.3</td>
<td>15.6</td>
<td>17.5</td>
</tr>
<tr>
<td>Interest paid</td>
<td>0.3</td>
<td>5.2</td>
<td>5.7</td>
</tr>
</tbody>
</table>

a = 30 September each year.
n.a. = not available.

Source: Hong Kong Housing Society, Annual Report, various numbers.

Society operates one scheme not offered by the Housing Authority: since 1956 it has accepted loans from firms to finance the construction of flats for nominated employees. The completed flats are leased to the contributing firms, and the loans are then repaid by the Society, without interest, over twenty years. By late 1967, 29 firms had participated in this scheme, advancing the Society $2.5 million. In addition, the Government had lent $8 million under these arrangements to secure accommodation for 1,000 Government employees.

(c) The Hong Kong Building and Loan Agency. The Hong Kong Building and Loan Agency was established in 1964 to finance the purchase of nominated flats. The Agency's capital was provided by the Government and the Commonwealth Development Corporation (each has subscribed $16 million, and the Government has pledged an additional $16 million). Overdraft facilities, up to a limit not made public, have been promised from four banks - the Hongkong Bank,
The Agency makes mortgage finance available on a relatively long term basis (maximum twelve years) to families with a monthly income in the range $700 to $2,000. Interest is charged at a non-reducing nine per cent. The Agency approves blocks of flats constructed by private developers and lends up to 75 per cent of its valuation of particular flats.

Despite the advantage of the scheme - interest rates are lower than those charged by local banks on similar loans and borrowers gain an immediate title to ownership - there was for some time relatively little demand for the Agency's facilities. In 1966 and 1967 there was no waiting list of applicants, and a greater volume of business could be handled. In December 1967 the Agency had mortgage assets of $28.5 million on 1,100 accounts, compared with $3.2 million to 93 borrowers in December 1965. Most borrowers are school teachers or civil servants.

There are several private housing schemes to which reference might be made, even though the organisations cannot properly be described as financial institutions. These schemes are mostly concerned with the construction of flats for sale. The largest is being undertaken by a local subsidiary of the Mobil Oil group. This housing project is estimated to cost $450 million and will house approximately 80,000 people in 15,000 flats. Construction began in 1966, and the first flats are to be ready for sale in mid-1968. Most will be sold on an instalment basis. Another private development scheme offers 1,880 flats for sale on instalment terms over fourteen years at prices of $15,800 to $24,500 a flat. More than half the flats in this development were sold eighteen months before the estimated completion date.

At the end of 1966, the total investment in housing of the Housing Authority, the Housing Society, the building societies, and the loans outstanding of the Building Agency, totalled about $500 million. On the same date the commercial banks had loans outstanding for construction purposes of $950 million.
The Stock Exchange and the New Issue Market

Unlike many developing countries, Hong Kong has had an organised market in company securities for a long period of time. The present Stock Exchange - the Hong Kong Stock Exchange Ltd, - was formed in 1947 from the merger of two earlier associations of sharebrokers.

Membership of the Stock Exchange is restricted to 60 members (who were organised in 1967 as 52 member firms, 39 of which were Chinese). Transactions are conducted on the board system - members mark up the price at which they are willing to buy and sell a particular stock, with bids and offers being made in 'board lots' (these vary from twenty shares of the Kwong Sang Hong - priced at $220 a share in January 1968 - to 5,000 shares in Hong Kong Realty, priced at $0.87 a share). All board lot transactions are recorded on the main board, and reported in the Daily Quotations Sheet. Business is conducted on a cash basis, settlement being made on the working day following the sale. This rule was introduced to discourage speculation; occasionally, exemption is given, e.g., when the scrip is held overseas or is 'on a boat coming out from London'. Brokerage fees are charged at one per cent on both buyer and seller, though it is said that rebates are sometimes granted. Most brokers permit their customers to operate on a margin. In 1964 the margin was commonly 50 per cent, and clients were charged interest at bank overdraft rates on the balance.¹ A number of broker firms have substantial bank overdrafts for this purpose.²

The value of transactions on the Stock Exchange since 1948 are shown in Chart 8.1. In 1949 and 1950 turnover fell from the high levels registered in the early post-war period, when a

¹ FEER, 11 June 1964, p.556.
² Unfortunately, no estimates are available on the extent of bank lending to share brokers during the period when there was active trading on the stock exchange. In mid-1965 $40.5 million was recorded as outstanding in this way. By December 1966 these loans had fallen to $30.6 million, and by December 1967 to $26.6 million.
Chart 8.1  Stock Exchange Turnover, 1948 to 1966

Chart 8.2  FEER Share Price Index, 1962 to 1967
dominant influence on the market was the inflow of capital from China. There was a fairly rapid increase in turnover in the period 1950 to 1955. The move of the Hongkong Bank in 1955 to discourage speculation\(^1\) and a switch in the interest of many small banks towards speculation in building activities, resulted in a relatively flat share market from 1956 until 1958. Under the pressure of both foreign and local demand, a strong boom developed over the period 1959 to 1961, when the temporary investment of surplus funds was said, by one broker, to be turning the Stock Exchange into 'a big gambling house'.\(^2\) Share prices on the average doubled between 1959 and mid-1961, bringing divided yields to levels similar to those of North America and Australia; in mid-1961, banks returned a dividend yield of about three per cent, wharves and godowns three per cent, utilities four per cent, and property companies around 4.5 per cent. But the boom conditions did not last for long. The difficulties experiences by a local bank in June 1961, a two per cent increase in the U.K. bank rate and the Berlin crisis soon checked the increase in share prices, and by the end of September 1961 share values were about twenty per cent below peak May levels.

The market was further depressed by the announcement in mid-1962 of Government proposals to control, and perhaps to nationalise, the power supply companies. These proposals depressed virtually all share prices. Share values recovered only when a new scheme of control over power supply companies was announced towards the end of 1963. The Cuba Blockade in late 1962 also reduced prices.

A share price index is available from August 1962, and is shown in Chart 8.2. Given the buoyancy in the economy and the earlier depressed share values, the thirty per cent increase in

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1 See above, p.126.

2 SCMP, 23 June 1961, p.1. The same broker suggested that the Government immediately raise a loan of $200 million to soak up the excess liquidity. During this boom a seat on the stock exchange was sold for $220,000. It would now be difficult to sell this seat.
share prices between mid-1963 and early 1965, shown in the Diagram, can hardly be considered excessive.

The fall in share values at the time of the 1965 banking difficulties was sudden and severe. As a result of the banking crises, some banks called in loans for share purchases while others disposed of their own share holdings, and almost all banks reduced new lending in this field. But the fall in share prices was as much due to a loss of confidence as to liquidity factors. There was some recovery in share prices in late 1965 and early 1966, but in June 1966 the share index stood at only 105 (August 1962 = 100), despite, in most cases, rising company profits.

Red Guard activities in China and Macao in 1966 held share prices at a steady level. The 1967 political disturbances in the Colony led to an almost thirty per cent fall in share prices (the index fell to 72.77 in mid July and 70.47 in September). During the disturbances the Stock Exchange twice suspended operations for periods of about ten days to prevent panic selling. Trading was also suspended at the time of the devaluation of the pound sterling, but this currency adjustment had almost no effect on local share prices.

The requirements for Stock Exchange listing are not set out in detail. The following appear to be the main conditions: the company is worth at least $1 million at the offer price; at least twenty five per cent of the company's share capital is offered in the initial issue; the Committee of the Stock Exchange is satisfied there is sufficient public interest in the shares to justify the issue; there is no restriction on the ownership of shares other than in the number held in one particular name; and there is a local office in which share transfers can be registered.

The fall in share values was not an even one. There was a greater slump in the prices of shares in companies with relatively large investment in fixed capital in Hong Kong - e.g., the wharf companies - and less for businesses with moveable assets, such as the shipping companies.
Listed companies must provide the Stock Exchange with copies of annual reports and press announcements.

At the end of 1967 69 companies were listed on the Hong Kong Stock Exchange. Table 8.3 classifies these companies by industry and compares them with the 51 companies listed in December 1957. There is active trading in only 25 shares, while another ten have transactions from time to time. The nineteen companies listed in the ten years to 1967 added to the range of scrip available to Hong Kong investors but the share list is still far from representative of the Colony’s commercial and industrial structure. In particular, few manufacturing firms are listed.

There were several reasons why these companies sought Stock Exchange listing. In the case of the two bus companies the listing was associated with their change to public status, which, in turn, was motivated by the belief that this would make their Government franchises more secure. Several companies - including Taikoo Docks, Jardine Matheson, and Local Property and Printing, sought to establish a valuation on their shares for estate purposes. In only one case - that of Textile Alliance Limited - does a desire to obtain additional finance appear to have been important, and even in this case it was probably not the dominant consideration. There has not been the equivalent of Malaya’s ‘new issue boom’. The new flotations were arranged either by the Hongkong Bank or by broker firms. Jardine Matheson, exceptionally, arranged its own issue. In each case the issues were successful, some spectacularly so: Jardine Matheson

1 It is interesting to compare this with the Malayan experience, where organised public share trading began only in 1960 yet 269 companies had been given stock exchange listing by December 1964. See P.J. Drake, op. cit.
2 SCMP, 22 January 1968. This has given rise to the comment that there are more brokers in Hong Kong than active stocks. R. Whatmore, FEER, 3 May 1962, p.239.
3 During this period, one company - an insurance institution – was removed from the list after it was taken over by a British company.
4 See P.J. Drake, op. cit., pp.312-22.
Table 8.3

HONG KONG STOCK EXCHANGE, NUMBER OF COMPANIES LISTED, 1957 AND 1967

<table>
<thead>
<tr>
<th>Category</th>
<th>1957</th>
<th>1967</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Insurance</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>Investment</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>Shipping</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Other commercial</td>
<td>1</td>
<td>4</td>
</tr>
<tr>
<td>Docks, Wharves</td>
<td>4</td>
<td>6</td>
</tr>
<tr>
<td>Lands, Hotels</td>
<td>5</td>
<td>8</td>
</tr>
<tr>
<td>Utilities</td>
<td>9</td>
<td>12</td>
</tr>
<tr>
<td>Cotton Mills</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td>Other industrial</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Stores</td>
<td>5</td>
<td>8</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>Rubber</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>51</td>
<td>69b</td>
</tr>
</tbody>
</table>

a. = 31 December both years
b. = Ten of these 69 Companies did not operate in Hong Kong. Five were Malayan or Indonesian rubber estates, four were Shanghai Companies which had not operated since 1949, and the tenth was a Macao utility.

Source: Hong Kong Stock Exchange, Year Book of Stocks, 1957, and press reports.

was oversubscribed fifty-six times (more than $650 million was offered for the company's shares), China Motor Bus was oversubscribed thirty-six times, and Kowloon Motor Bus five and a half times. The success of the various new issues - which, as Table 8.4 shows, raised $130.9 million in the period 1958 to 1966 - suggests that lack of investor support can hardly have been a major restraint on further company flotations. In most cases, the new issues returned considerable short term capital gains to subscribers. Shares in Kowloon Motor Bus, China Motor Bus, and Jardine Matheson, for example, were traded soon after listing at premiums of $18, $8 and $7.40 respectively. No new companies were floated in 1966 or 1967.

Table 8.4 also shows the new capital raisings of existing companies. $499.2 million was subscribed to these companies in the period 1958 to 1966. Thus, the total amount of capital raised by
Table 8.4

HONG KONG STOCK EXCHANGE, PUBLIC COMPANY CAPITAL RAISINGS 1958 TO 1966

<table>
<thead>
<tr>
<th>New Company Flotations</th>
<th>Share Issues of Existing Companies</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$ million</td>
<td></td>
</tr>
<tr>
<td>1958</td>
<td>-</td>
<td>19.2</td>
</tr>
<tr>
<td>1959</td>
<td>9.9</td>
<td>39.3</td>
</tr>
<tr>
<td>1960</td>
<td>-</td>
<td>42.5</td>
</tr>
<tr>
<td>1961</td>
<td>63.5</td>
<td>49.5</td>
</tr>
<tr>
<td>1962</td>
<td>8.0</td>
<td>43.5</td>
</tr>
<tr>
<td>1963</td>
<td>-</td>
<td>55.9</td>
</tr>
<tr>
<td>1964</td>
<td>34.7</td>
<td>133.1</td>
</tr>
<tr>
<td>1965</td>
<td>14.8</td>
<td>72.7</td>
</tr>
<tr>
<td>1966</td>
<td>-</td>
<td>43.5</td>
</tr>
<tr>
<td></td>
<td>130.9</td>
<td>499.2</td>
</tr>
<tr>
<td></td>
<td></td>
<td>630.1</td>
</tr>
</tbody>
</table>


Public companies in this period was $630.1 million. From 1945 to 1958 less than $150 million was raised through share issues.1

It is thought that a significant part of the funds raised in 1961 came from overseas investors. There is no way of estimating how much of the finance was provided from banking sources.

No public issue of company fixed interest securities has been made since the War. Only one public issue of Government securities has been made in this period, this being the loan of $50 million raised in 1948.

The distribution of capital raisings by industry groups is given in Table 8.5. More than 40 per cent was taken by the public utilities, fifteen per cent was raised by both the property and hotel group and the commercial companies. Relatively small sums have been invested in the miscellaneous industrial group2 (seven per cent of the total) and in textile companies (four per cent).

1 Industrial Bank Committee, Report, op. cit.
2 This group includes a cement works, brewery and an aircraft engineering firm.
Table 8.5
HONG KONG STOCK EXCHANGE, PUBLIC COMPANY CAPITAL RAISINGS, 1958a TO 1966, BY INDUSTRY GROUPS

<table>
<thead>
<tr>
<th>Industry Group</th>
<th>$ million</th>
<th>Per cent of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Insurance</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Investment</td>
<td>27.2</td>
<td>4.3</td>
</tr>
<tr>
<td>Shipping</td>
<td>45.5</td>
<td>7.2</td>
</tr>
<tr>
<td>Other commercial</td>
<td>94.5</td>
<td>15.0</td>
</tr>
<tr>
<td>Docks, Wharves</td>
<td>9.9</td>
<td>1.6</td>
</tr>
<tr>
<td>Lands, Hotels</td>
<td>94.3</td>
<td>15.0</td>
</tr>
<tr>
<td>Utilities</td>
<td>270.7</td>
<td>43.0</td>
</tr>
<tr>
<td>Cotton mills</td>
<td>22.5</td>
<td>3.6</td>
</tr>
<tr>
<td>Other industrial</td>
<td>43.0</td>
<td>6.8</td>
</tr>
<tr>
<td>Stores</td>
<td>22.5</td>
<td>3.6</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Rubber</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>630.1</td>
<td>100.0</td>
</tr>
</tbody>
</table>

a = Both years inclusive.

Sources: Secretary, Hong Kong Stock Exchange, personal communication; Far Eastern Economic Review; Press reports.

Two mutual funds were established in 1961, both selling units worth $1 million. In March 1968 one dollar units in the funds were selling at $0.76 to $0.81 and $0.53 to $0.57 respectively.

The Stock Exchange is a relatively narrow and volatile one; a limited range of shares is listed and turnover is fairly small. Political factors have commonly been more of an influence on share prices than company profitability and share market values have reacted in a sensitive way to changes in investors' confidence in the Colony's future. But rather surprisingly, there seems no evidence that political factors have been more an influence than on share markets in many other territories. Doubtless, though, by discouraging equity and long term investment, the general political uncertainty has been a major influence in restricting the development of the share market. The continued dominance of the Chinese family firm in the Hong Kong economy has also contributed to the rather narrow Stock Exchange list. There has been a reluctance to yield this tight family control to a board elected
by shareholders, and, perhaps, also to give publicity to the firm's financial operations. 1 There are several long established British firms, too, which show no interest in being reconstructed as public companies.

The ready availability of foreign shares and investment titles is another cause of the limited development of the local Stock Exchange. Since the mid-1950s a large number of foreign security firms have established branches in the Colony. There is no restriction on the operation of these firms, 2 and foreign exchange is readily available to finance the necessary transfers. United States, Japanese, Swiss, Canadian and Australian brokering houses and investment trusts are represented in Hong Kong and offer local investors a much wider selection of titles and services than is available on the local market. The United States firms have a continuous Telex link with New York. There is no way of estimating the volume of this capital outflow, 3 but the business of the foreign investment firms is believed to be growing rapidly 4 and is sufficiently large to cause concern in some business and financial circles. 5

Perhaps, too, the increase in bank deposit interest rates since 1961 has made local shares a less attractive investment.

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1 See Dick Wilson, *Hong Kong Trade and Industry Review*, op. cit., p.21.
2 These foreign security firms do not have to pay stamp duty on their transactions (stamp duty is charged on local share transfers at the rate of twenty cents per $100) on the grounds that such transactions 'arise outside the Colony'.
3 It was suggested in *FEER* 20 October 1966 p.137, that as much as $57 million per month (US $10 million) was leaving Hong Kong for investment in the United States. But some part of these funds would represent transactions on behalf of residents of other South East Asian countries. (Even in the latter case, though, the necessary US dollars would have been purchased on the Colony's open exchange market).
5 See, for example, the speech by Mr F.S. Li, 1967 Budget Debate, *SCMP*, 16 March 1967, p.9.
Overall, though, it is perhaps easy to concentrate on the narrowness and lack of development of the Stock Exchange and to overlook the contribution the market has made to company finance in Hong Kong. The importance of public company share raising to at least the utility and land companies was shown in Table 8.5 and is mentioned again in Chapters 12 and 14.

Insurance Companies

Very little statistical information is available on the Hong Kong insurance market. Much of what is said in this section must, therefore, remain rather impressionistic and tentative. What information is available suggests that insurance companies are of relatively little importance as suppliers of investible funds: the life insurance sector is relatively underdeveloped, and much of the money collected by insurance companies is invested overseas. But financial institutions, generally, and possibly the insurance companies in particular, must be judged in terms of the services they perform and not solely by the funds they mobilise for domestic capital formation.

There is little Government influence over insurance companies (hence the almost complete absence of statistics on these intermediaries). Companies wishing to transact life, fire or marine insurance business are required to submit annual accounts to the Registrar-General (there is no requirement, as in the United Kingdom, that publicity be given to balance sheets) and to hold small deposits — or up to $200,000 for the larger life offices and of $100,000 against fire and marine business. Life insurance companies must undertake a quinquennial valuation. Exemption from these several requirements is given to life insurance companies which comply with the United Kingdom Insurance Companies Act of 1958, and to fire and marine companies which hold deposits in

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1 In 1966 deposits of life companies totalled $5 million and those of the fire and marine companies $8 million.
another Commonwealth country. The approval of the Governor-in-Council is required before companies can write motor vehicle third party insurance business. There is no limitation on the investment activities of the insurance companies. As is the case in most countries, the Export Credits Insurance Corporation is a Government established body.

The number of insurance companies has increased considerably since the war, first, as companies moved from China and, later, as new foreign companies opened branches, or more commonly, agencies, and additional local institutions were established. In March 1966, 207 insurance companies were represented (see Table 8.6). It is frequently claimed by the insurance companies themselves that competition is excessive, with a consequent weakening of the whole industry. On the other hand, there is a good deal of tied insurance business, especially on the part of the large trading houses, which in many cases are the local agents or which manage the local branches of foreign companies. There is agreement on premium rates in other than marine and life business. There are no insurance brokers such as are found in most financial centres.

It is usually thought that Hong Kong earns considerable foreign exchange from its insurance facilities, but no estimates are available.

(a) Non-Life Insurance Business. Marine insurance business is the longest established branch of insurance and is probably still the most important sector. Most marine risks can be absorbed locally, but ready access is available to overseas re-insurance centres where particularly large hulls are involved. ²

¹ There is neither restriction on the class of investment title held - as in much U.S. insurance legislation -nor on the proportion of assets which must be held locally - Malayan companies, for example, must hold fifty five per cent of their assets locally.

² N.A. Rigg, op. cit.
Table 8.6

INSURANCE COMPANIES OPERATING IN HONG KONG, COUNTRY OF INCORPORATION AND BUSINESS TRANSACTED

31 March 1966

<table>
<thead>
<tr>
<th>Country of Incorporation</th>
<th>Number of companies</th>
<th>Class of insurance business transacted</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Life</td>
</tr>
<tr>
<td>Australia</td>
<td>7</td>
<td>-</td>
</tr>
<tr>
<td>Bahama Islands</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Canada</td>
<td>6</td>
<td>3</td>
</tr>
<tr>
<td>China</td>
<td>4</td>
<td>2</td>
</tr>
<tr>
<td>France</td>
<td>4</td>
<td>-</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>48</td>
<td>13</td>
</tr>
<tr>
<td>India</td>
<td>9</td>
<td>2</td>
</tr>
<tr>
<td>Japan</td>
<td>5</td>
<td>-</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Netherlands</td>
<td>2</td>
<td>-</td>
</tr>
<tr>
<td>New Zealand</td>
<td>4</td>
<td>-</td>
</tr>
<tr>
<td>Panama</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Philippines</td>
<td>3</td>
<td>-</td>
</tr>
<tr>
<td>Singapore</td>
<td>8</td>
<td>2</td>
</tr>
<tr>
<td>Switzerland</td>
<td>6</td>
<td>-</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>64</td>
<td>7</td>
</tr>
<tr>
<td>U.S.A.</td>
<td>34</td>
<td>13</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>207</strong></td>
<td><strong>45</strong></td>
</tr>
</tbody>
</table>

Source: Hong Kong Registrar General, Annual Report, 1965/66, Table XV.

Locally-established offices are said to write the greater proportion of fire insurance business, which, with the rapid rate of building construction, has been a quickly growing field. Motor vehicle third party insurance is virtually compulsory for all motor vehicle owners (alternatively, vehicle owners have to deposit a fairly large sum with the Government) and this, too, is a rapidly expanding business. There is no compulsory workers' compensation insurance.

The size of the reserves held against non-life insurance business is not known. Nor is there any way of establishing what portion of these is held locally. The latter sum, at least, cannot be large.

The Export Credit Insurance Corporation commenced operations early in 1967. The Corporation does not undertake risks normally covered with commercial insurers and it can undertake liabilities to an aggregate value of $500 million. The Corporation's capital is
provided by the Government and its contracts are Government-guaranteed. There is no intention to follow the practice of many other countries and authorise the Corporation to give unconditional guarantees to banks financing shipments under its policies (the intention of such guarantees is usually to encourage the provision of long term credit for exporters at preferential rates). As one commentator observed when contrasting the practice in Hong Kong with that in the United Kingdom, the Colony is not considered to be under any such desperate necessity to increase foreign exchange earnings. Moreover, it has little in the way of capital goods exports and no lender of last resort like the Bank of England with which the banks can rediscount long-term advances - any suggestion that the Hong Kong Government might undertake this responsibility is anathema to it.

In its first year the Corporation issued policies with an estimated annual export turnover of $543 million and a maximum liability of $266 million.

(b) Life Insurance. Because there is a saving element in life insurance contracts that is not found in other forms of insurance, life insurance companies are usually of greater importance as intermediaries in the saving-investment process. In many countries, these companies are among the most dominant financial institutions in the capital market, especially - because their liabilities are mostly long-term and reasonably predictable- at the longer end of the capital market.

Life insurance business in Hong Kong seems more concentrated in the hands of a few companies than other forms of insurance business. A large part of the total business is held by seven companies: two U.S., two Canadian, two local companies and an Indian corporation. There were suggestions in 1962 that a more comprehensive system of control over the operation of life insurance companies was being considered, to meet the problem caused

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1 P.H.M. Jones, FEER, 12 January 1967, p.66.
by the entry of Malayan 'funeral insurance' companies. These firms were operating mainly in the resettlement areas, and, for premium payments of around $3.50 per month, offered a policy paying $500 if the insured person died in a short period after the policy was taken out. To meet this situation the six largest life offices formed themselves into the Life Assurance Association of Hong Kong. Mainly because the funeral insurance offices were brought under control in Malaya - often after considerable losses by policyholders - the problem did not get out of hand, and, in the event, no additional Government control was introduced.

No precise estimates are available on the rate of growth or the present volume of life insurance business. Given the rapid increase in incomes (especially in the incomes of the middle class), the absence of any state-provided welfare payments or pension schemes, the experience of price stability and the income tax concessions available on premium payments, one would expect the life insurance industry to be growing rapidly. On the other hand, the Chinese family system discourages individual saving for old age, relatively few private firms offer pension schemes to employees, the low income tax rates mean that the tax benefit is of little advantage, and the general political uncertainty makes life insurance a relatively unpopular form of saving. Several companies claimed that their life insurance business increased at fifteen to twenty five per cent per annum from the late 1950s until 1965, but these estimates might overstate the actual rate of expansion.

The Household Expenditure Survey in 1963/64 found that expenditure on life insurance premiums and contributions to pension funds was 0.2 per cent of the expenditure of families spending $100

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1 See P.J. Drake, op. cit., pp.185-6, and SCMP, 11 May 1962.
2 Insurance salesmen stressed to the author that the rate at which new business was written fell off appreciably during the Red Guard activities in China in 1966.
to $3,999 per month (and one per cent of expenditure of families spending $2,000 to $3,999 a month).\textsuperscript{1} This would suggest that premium payments were, at that time, around $20 million to $25 million per annum.\textsuperscript{2} On the experience of other countries, assets held against life policies in 1964 would have been in the range $150 million to $200 million. But only two companies have invested significant portions of their life insurance funds locally. There are several reasons why the large part of life insurance moneys is remitted overseas. One is the insufficiency of suitable outlets - especially of fixed interest titles - in the Colony. Secondly, many life offices are represented only at agency level, and most of the offices which have branches in the Colony do not write sufficient business to justify their setting up local investment departments. Third, some companies have invested outside the Colony to cover their political risk. Policy liabilities will fall due whatever the Colony's political future.

The two companies which have invested significant amounts in Hong Kong hold most of their local assets in the form of property investments and loans secured on real estate for building purposes. They also have small holdings of local shares. (It follows that there is probably a greater degree of risk acceptance than is usually the case with life insurance investment). An investment manager in one of these two companies said that no loans or advances had been made to manufacturing firms.

The Merchant Houses

The merchant (or agency or export-import) firms have been of considerable importance in the recent industrial growth. For this reason, the role of these firms is now described in some detail, even

\textsuperscript{1} Hong Kong, Household Expenditure Survey, 1963/64, Table 16.

\textsuperscript{2} This estimate is considerably less than the $100 million p.a. suggested in FEER, 11 June 1964 p.559. The latter estimate would mean that about one per cent of the national income is spent on life insurance, a ratio experienced by very few countries.
though the institutions' 'financial' activities are of relatively limited scope.

The activities of the merchant firms have changed appreciably. Whereas 'traditionally, their role was to import for resale in China and other Far Eastern countries the manufactured goods of Europe and the United States, and to collect, grade and market the produce of China for export in return'¹ the firms have recently been almost exclusively concerned with the export of Hong Kong manufactures and the import of raw materials, industrial machinery and consumer goods for the Hong Kong market. The old export houses now deal in only a few miscellaneous goods in China's foreign trade, and usually in small orders. Most of their 'outstations' have been closed since 1949; their Far East operations are now largely concentrated in Hong Kong.

On the basis of the Hong Kong trade the long-established commercial firms (almost all of them British including Jardine Matheson, members of the Butterfield and Swire group, Wheelock Marden and Dodwells)² have expanded rapidly. The growth of these houses has been assisted by low taxation rates and the laissez-faire outlook of the Government.³ The many new trading firms set up have not lessened the dominance of these long-established houses.

It was suggested in 1961 that there were then 1,500 or so export-

² There have been several changes in company organisation since the war. Jardine Matheson and Wheelock Marden became public companies in 1961 and 1964, respectively. John D. Hutchison separated from its former parent in 1964. The enormous Butterfield and Swire interest - which includes Cathay Pacific Airways and China Navigation Company - is still a private company, but Taikoo Docks a partly-owned subsidiary has been given public company status.
³ Paul Ferris, The City, Penguin Books, 1962, p.130, makes this interesting analogy 'Jardines nowadays seems a microcosm of what commercial Britain might have been if there had been no world wars, communism or United States of America, and the nineteenth century had been miraculously prolonged.' The Company's Hong Kong manager described it more modestly: 'We are just grocers. Just grocers and merchants'. Cited Richard Hughes, Hong Kong: Borrowed Place - Borrowed Time, London; Andre Deutsch, 1968, p.23.
import businesses and that the few large houses conducted more than half the total business of the group of institutions.¹

There are several ways in which the merchant houses have contributed to the industrial growth. Throughout the period of industrialisation the export-import firms have been responsible for the distribution and marketing of the large part of the Colony's output of manufactured goods.² It is not an overstatement to say that 'ready access to exceptional trading facilities'³ was a leading factor in the rapid success of manufacturing industry. The Hong Kong export-import firms, unlike the Singapore and Malayan houses, were experienced in the conduct of trade in manufactured goods. In the early 1950s many trading firms established Hong Kong products sections, specifically to conduct the trade in local manufactures. Even now, relatively few manufacturing businesses maintain their own marketing and sales sections (the establishment of such divisions has become more common in the past few years). More frequently, these functions are left to the merchant houses. Many manufacturers, too, arrange their raw material and machinery imports through the agency houses.

The existence of this network of trading houses has especially contributed to the growth of small manufacturing businesses:

small firms are enabled to exist in such an export-orienated economy because overseas selling, always a problem for the small firm, can be delegated to the exporters; similarly, the smaller firms can rely on the trading community to supply them with all the imported materials they require.⁴

For many smaller manufacturers the export firms have occasionally acted as principals, marketing the goods under their own names.⁵ But

¹ Economist Intelligence Unit, op. cit., p. 9.
² Ibid., p.8: 'At least three quarters and perhaps more of the manufactured goods exported are thought to be handled by the export houses.'
³ Ibid., p.6.
⁴ Ibid.
⁵ J.A. King, Hong Kong Trade and Industry Review, p.27 terms these export firms the 'merchant exporters'.
this is usually a transitional phase for both producer and trader: manufacturing firms seek to produce under their own name more freely to approach other buyers while exporters selling under their own name must maintain a detailed supervision of production. Most export-import firms act as 'agent exporters.' These traders offer to sell a factory's products in nominated markets or they act as representatives in Hong Kong of overseas buyers.\footnote{J.A. King, Hong Kong Trade and Industry Review, p.27.} Many factories have close contact with more than one agent exporter. Both the smaller exporters and the smaller manufacturers, though, go 'shopping around for bargains.'\footnote{Economist Intelligence Unit, op. cit., p.9.}

A number of the long-established merchant firms have established their own - and frequently large scale - manufacturing subsidiaries, such as Jardine Dyeing (now part of Textile Alliance Limited, the Colony's first fully integrated textile establishment), Textile Corporation and Hong Kong Industrial (a major plastics and toy manufacturer), which were set up by Wheelock Marden, and the highly successful Hong Kong Aircraft Engineering Company, which was formed as a joint enterprise by the Jardine Matheson and Swire interests. At the same time, the merchant houses' long established manufacturing subsidiaries, such as Taikoo Docks have been expanded.

Many of the export-import houses, too, have provided overseas buyers with a system of quality control on Hong Kong-produced goods.

Finally, the merchant houses have assisted a number of local manufacturers financially. Most frequently, this assistance has taken the form of the sale, on credit terms, of the industrial raw materials and machinery imported by the agency houses. But, the larger export-import firms, at least, have made cash advances to known local manufacturers. One large agency house has a
'reasonably close association' with 200 to 300 local manufacturers, "many" of whom, at one time or another, have been given cash loans. In some cases these advances were necessary to allow the fulfilment of an existing export contract, and occasionally they have been given despite initial denials from the manufacturer that financial problems were a cause of the production delay. The agency houses have also on occasions given guarantees to manufacturers against which bank credit can be secured. But, the agency houses stress that they 'are not in this business as merchant banks', and much of the financial assistance they have given to manufacturers is provided only to permit the fulfilment of existing orders.

The Co-operative Societies and the Marketing Organisations

A study of the co-operative societies and the two marketing organisations is of interest mainly because the institutions show a very high degree of Government involvement in a small part of the financial system. Unlike the commercial banks which developed in an environment almost completely free of Government influence and control, the co-operative societies and marketing organisations have been established and developed by the Government.

In 1946 the Fish Marketing Organisation and the Vegetable Marketing Organisation were established as financially self-supporting bodies, administered under the Department of Marketing and Co-operative Development. The organisations were given monopolies over the wholesale marketing of their respective foodstuffs, but their activities were not confined to marketing: from an early stage the two bodies were expected to provide credit to producers, assist in extension work, and encourage the establishment of co-operative societies. Initially, it was hoped that the two organisations would themselves become co-operative enterprises, but, apparently for management reasons, the Government control has been maintained. The Organisations' incomes are derived from a charge on marketing transactions, from associated business
undertakings and from interest receipts on loans. The
Organisations were given Government loans - of $250,000 for the FMO
and $100,000 to the VMO - to begin their operations, and from these
loans credit was made available to farmers and fishermen for short
term productive purposes.

The co-operative movement is entirely a post-war development.
After the Pacific War, the Colony's fishing and agricultural
industries were greatly in need of rehabilitation; production and
incomes were low, the meagre capital equipment employed was run
down and transport services were disrupted. The world shortage of
foodstuffs made it desirable to increase local production as much
as possible, though Hong Kong could not hope for self-sufficiency.
There were demands, too, that the Government break the power of
the 'laans' (the wholesale middlemen who, in both the agricultural
and fishing industries, had held a tight control over marketing and
credit arrangements)\(^1\) to give producers a larger share of sale
proceeds. The co-operative societies were intended to assist in
marketing arrangements, for example, by organising the collection
and delivery of vegetables to the VMO. Also, the co-operatives
were favoured as a means of encouraging savings among the farmers
and fishermen\(^2\) and of assisting with extension work. Perhaps more
important, a framework was sought for distributing among primary
producers the loans provided from the Government and various other
sources. There was an urgent need to increase investment in
agriculture and fishing, both to increase output and to finance the
introduction of more profitable lines of production.\(^3\) The small scale

\(^1\) See Majorie Topley, 'Capital, Saving and Credit among Indigenous
Rice Farmers and Immigrant Vegetable Farmers in Hong Kong's New
T erritories', in R. Firth and B.S. Yamey, Capital Saving and Credit
\(^2\) At this stage the commercial banks had no representation
in farming areas or in the fishing villages.
\(^3\) It was recommended that farmers transfer production from rice to
vegetable growing and pig raising, and that fishermen have their
craft mechanised and move into off-shore and mid-distance fishing.
of operations and the low income levels of the agricultural and fishing sectors made it apparent that the necessary funds could not be borrowed from banks or from other sources in the organised market. As well as helping with the distribution of loan funds, the co-operative societies have provided a measure of security not usually available from individual borrowers. The development and present structure of the co-operative movement is shown in Tables 8.7 and 8.8.

Table 8.7

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Number of Societies</td>
<td>31</td>
<td>86</td>
<td>213</td>
<td>348</td>
<td>388</td>
<td>416</td>
</tr>
<tr>
<td>2 Membership</td>
<td>2,469</td>
<td>5,670</td>
<td>11,567</td>
<td>19,215</td>
<td>22,094</td>
<td>23,079</td>
</tr>
<tr>
<td>3 Paid up share capital $m</td>
<td>0.0</td>
<td>0.1</td>
<td>0.4</td>
<td>0.6</td>
<td>1.6</td>
<td>1.7</td>
</tr>
<tr>
<td>4 Loans granted in year $m</td>
<td>0.1</td>
<td>1.0</td>
<td>17.4</td>
<td>22.8</td>
<td>16.2</td>
<td>8.3</td>
</tr>
<tr>
<td>5 Loans repaid in year $m</td>
<td>0.0</td>
<td>0.6</td>
<td>2.6</td>
<td>5.7</td>
<td>8.3</td>
<td>10.8</td>
</tr>
<tr>
<td>6 Deposits $m</td>
<td>0.0</td>
<td>0.2</td>
<td>0.3</td>
<td>1.0</td>
<td>1.0</td>
<td>2.1</td>
</tr>
<tr>
<td>7 Reserve funds $m</td>
<td>0.0</td>
<td>0.1</td>
<td>0.3</td>
<td>0.6</td>
<td>0.8</td>
<td>1.1</td>
</tr>
</tbody>
</table>

a = Rows 1, 2, 3, 6 and 7: 31 December each year.
Rows 4 and 5: year ending 31 December each year.

Source: Hong Kong Annual Report, various numbers.

(a) Agricultural Co-operatives. The agricultural co-operative societies lend at relatively cheap rates (around 0.25 per cent per month). Most loans are on a short term basis (twelve months or less). Credit is not available to finance land purchase. Loans are occasionally granted for non-productive purposes, such as festival expenses.

A part of the funds loaned by these societies is provided from the capital subscriptions and deposits of members (both capital and deposits totalled around $0.27 million in 1967). As well, some societies have built up small funds from their trading activities (marketing societies, for example, receive a commission on sales). But most of the loan funds has been provided from outside bodies, such as the Vegetable Marketing Organisation Loan Fund, established in 1953 with a capital of $500,000; the J.E. Joseph Trust Fund, set
Table 8.8

CO-OPERATIVE SOCIETIES: NUMBER, MEMBERSHIP AND FINANCIAL INFORMATION, 31 DECEMBER 1967

<table>
<thead>
<tr>
<th>Number</th>
<th>Members</th>
<th>Paid up capital</th>
<th>Loans granted</th>
<th>Loans repaid</th>
<th>Deposits</th>
<th>Reserves</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>'000</td>
<td>$m</td>
<td>$m</td>
<td>$m</td>
<td>$m</td>
<td>$m</td>
</tr>
<tr>
<td>Agricultural</td>
<td>90</td>
<td>12</td>
<td>0.27</td>
<td>2.03</td>
<td>1.74</td>
<td>0.27</td>
</tr>
<tr>
<td>Fishermen's</td>
<td>63</td>
<td>2</td>
<td>0.03</td>
<td>4.21</td>
<td>3.90</td>
<td>1.65</td>
</tr>
<tr>
<td>Building</td>
<td>221</td>
<td>5</td>
<td>1.33</td>
<td>1.77</td>
<td>4.90</td>
<td>-</td>
</tr>
<tr>
<td>Other urban</td>
<td>36</td>
<td>5</td>
<td>0.05</td>
<td>0.26</td>
<td>0.25</td>
<td>0.16</td>
</tr>
<tr>
<td>Federation</td>
<td>6</td>
<td>0</td>
<td>0.01</td>
<td>0.01</td>
<td>0.01</td>
<td>-</td>
</tr>
<tr>
<td>All societies</td>
<td>416</td>
<td>23</td>
<td>1.70</td>
<td>8.26</td>
<td>10.81</td>
<td>2.09</td>
</tr>
</tbody>
</table>

a = In twelve months ending 31 December 1967.


up in 1954 from a private bequest of $460,000 (to which the Government later added $750,000); the Kadoorie Agricultural Aid Association Loan Fund, established in 1955 from a private gift of $250,000 and Government contributions of $1.5 million and $2 million; and the World Refugee Year Loan Fund for Co-operative Societies, which was set up with a capital of $458,000 in 1963 (to lend also to fishermen's co-operatives).

(b) Fishermen's Co-operative Societies. Members' savings are a more substantial source of funds for the fishermen's co-operative societies (in which capital subscription and members' deposits together totalled $1.68 million in 1967). But, again, outside borrowings are the main source of the co-operatives' funds. The main institutions lending to fishermen through the co-operative societies are: the Fish Marketing Organisation Loan Fund, which between its establishment in 1946 and 1967 had lent about $25 million; the Colonial Development and Welfare Loan Fund, set up in 1954 with a capital of $800,000 to help finance the mechanisation

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1 Not all of this loan fund is lent through co-operative societies.

2 Most, but not all, of these funds are lent through co-operative societies.
of inshore fishing boats; the C.A.R.E. (Committee for American Relief Everywhere) Loan Fund, 1957, which has a capital of $100,000 and lends specifically to finance the mechanisation of shrimp fishing boats; and the Fisheries Development Loan Fund, which was established by the Government in 1959 with a capital of $2 million (now $5 million) to provide funds for the mechanisation of mid-distance and off-shore fishing boats.

(c) Urban Co-operative Societies. The first urban co-operative society, a building society, was formed in 1954. Almost 200 building societies were set up in the period 1957 to 1962. The aim of the societies was the provision of housing for locally-appointed Government employees. Almost all their construction activities were financed from funds borrowed from the Government. Between 1955 and 1966 the Government lent $125 million to these building societies. After 1963, when the Government decided to reduce considerably its lending in this field (mainly to permit an increase in spending on other forms of housing), fewer new building Societies were formed. The building societies have not accepted deposits from members or from the public. Their paid up capital amounts to about $1.3 million (an average of $300 per member).

There are also consumers' societies, salaried workers' thrift and loan societies, and several better living societies. Members' deposits in the urban thrift societies amount to a mere $160,000.

Co-operative societies are established and operate under the Co-operative Societies Ordinance. A Registrar of Co-operative Societies was appointed in 1951. Supervision of the societies including the urban Co-operatives is the responsibility of the Agriculture and Fisheries Department.

Hire Purchase

Paradoxically, there has been a very limited development of hire-purchase companies, but a high volume of hire-purchase transactions. A large number of new flats and the majority of
motor vehicles are transacted under hire-purchase terms. Hire-purchase arrangements are becoming more common on consumer durables, especially air-conditioners and refrigerators, but the sale of these goods is arranged more frequently simply on an instalment credit basis. The hire-purchase sales of consumer goods and flats are for the most part financed by the local banks. One large local bank, for example, has master agreements with more than 100 authorised dealers of consumer durables. In the sale of flats, the smaller banks have usually preferred to offer hire-purchase terms than secured loans.

Wayfoong Finance is the main source of funds for hire-purchase sales of motor vehicles, having financed, according to one recent estimate, more than half of the Colony's 95,000 registered motor vehicles. Before the company's establishment in 1960, the North Point branch of the Hongkong Bank handled a considerable volume of hire-purchase finance.

Importers of producer goods and consumer durables have frequently offered hire-purchase terms. A large proportion of the marine diesel engines used in the fishing fleet was purchased in this way.

There appear to be only three companies which may be termed specifically 'hire-purchase companies'. Wayfoong Finance is by far the most important. This company accepts fixed deposits of one to five years. Early in 1967 eight per cent was paid on deposits of four and five years. Chartered Finance (Hong Kong) Ltd, a subsidiary of the Chartered Bank was set up in 1966 and began accepting fixed interest deposits in 1967. The third company is a subsidiary of a British finance company.

There is no law governing hire-purchase sales in Hong Kong.  

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1 HS, 8 September 1967.  
2 Ibid.  
Conclusion

It is evident from this discussion that the system of non-bank financial intermediaries is relatively undeveloped. There has not, for example, been the proliferation and development of non-bank financial institutions recently experienced in Malaysia where the Government has played a more important role in the capital market and where long term funds have been readily available. Nonetheless, it is evident that the system of non-bank financial institutions is more highly developed now than earlier in the post-war period, and that a significant part of this development has resulted from Government intervention and assistance.
Chapter 9

THE SYSTEM OF PUBLIC FINANCE

The Legislative Council is described as the 'ultimate financial authority' in Hong Kong. Until 1958 the approval of the Secretary of State was required for the annual estimates, for any loans or expenditure which involved 'important points of principle' and for supplementary provisions greater than $250,000. On these matters there is now 'demi-official consultation' and the local Financial Secretary takes account of 'the views of the financial advisors of the Secretary of State in advising [the Hong Kong] Government on policy'. Approval from London is still required should the local Government desire to raise a loan overseas.

The Government's annual budget is presented in late February or early March. The financial year begins on 1 April. The budget is an administrative one, drawn up on a cash basis. The intention is simply to ensure that sufficient finance is available to cover Government spending, and to determine and control the expenditure of the individual departments. But, even an administrative budget has economic consequences, and the Government has sought to ensure that its financial operations do not result in inflation or balance difficulties, and that reserves are built up in case there is a fall in revenue.

Unofficial members are a majority of the Legislative Council's Finance Committee. The Committee meets regularly to discuss specific items of expenditure, but it is not empowered to discuss Government revenue. Several unofficial members have been critical of this limitation:

1 An earlier draft of this Chapter is to be published as 'The Public Finance of Hong Kong' in a forthcoming issue of Malayan Economic Review.
2 Hong Kong, Annual Report, 1967, p.35.
...the question of taxation, of ways of raising money, is mentioned only in the [Legislative Council's] Annual Budget debate. Unofficials cannot get together with the Financial Secretary and sort out pros and cons of different ways of raising money, the justice of imposing special taxation on certain objects and activities and not on others, and on the appropriate total amount of expenditure and revenue.¹

It is possible to detect a change in the general outlook of the unofficial members over the post-war period. For example, an unofficial member in 1950 spoke of the 'huge' Government expenditure of $200 million, which could not be exceeded without the Government facing 'bankruptcy', and claimed that the situation calls for drastic retrenchment and reduction in Government expenditure if we are not to face another record budget next year.²

In contrast, the following views were expressed in the 1967 and 1968 budget debates:

I have argued for some time that we should place greater reliance on direct taxation ... [and] I feel we should not hand out any gifts in the form of new tax remissions until important and vital objectives in the field of education, social welfare and public health have been achieved.³

There can be few times or few places where an increase in taxation would have been so acceptable and would have raised so little protest. One might almost say that the Financial Secretary has been invited, on more than one occasion, to raise taxes; and this, not by irresponsible people, but by people who would have to pay these taxes.⁴

Other than the Housing Authority there are no financially independent semi-government agencies or municipal bodies. The Urban Council and the New Territories Administration have no powers to levy taxes or rates, and are, along with the Post Office, railway, water-supply and government-built housing, managed as Government Departments. Privately owned companies provide the internal transport, power and communication utilities. Separate accounts are kept for the Development Loan Fund, discussed later in this Chapter.

³ F.S. Li, quoted SCMP, 16 March 1967, p.9.
⁴ Dhun Ruttonjee (Senior Unofficial member of the Legislative Council), quoted SCMP, 14 March 1968.
The Government's outlook is avowedly laissez-faire. It has not yielded to the occasional demands for protective tariffs, subsidies or some measure of economic planning. In his 1962 Budget Speech, the Financial Secretary said:

Over a wide field of our economy it is still the better course to rely on the nineteenth century's 'hidden hand' than to thrust clumsy bureaucratic fingers into the sensitive mechanism. In particular we cannot afford to damage its mainspring, freedom of competitive enterprise.

A measure of the Government's involvement in the economic system is given in Table 9.1 which shows the ratio of Government revenue and expenditure to gross domestic product. A comparison of the ratios of current revenue and expenditure to gross domestic product in Hong Kong with those in other countries (Table 9.2) places the role of the Government sector in better perspective.

**Government Revenue and Expenditure**

Tables 9.3, 9.4 and 9.5 and Chart 9.1 show the level and components of Government revenue and expenditure over the post-war period. Both revenue and expenditure increased many times:

- Revenue from $164 million in 1947-48 to $1,878 million in 1967-68.
- Expenditure from $128 million to $1,803 million.

As Table 9.1 demonstrated, public revenue and expenditure have risen more rapidly than gross domestic product. And, what is of considerable importance, there has not been the short period instability in Government revenue that has been a common problem in many developing countries. Revenue increased in every post-war year. Expenditure fell only in 1967-68 (and then by only $2 million; this reduction was a

1. Financial Secretary, *Legislative Council Debates*, 1962. See also the Financial Secretary's Speech in the 1966 Budget Debate, (mimeographed): 'I largely agree with those who hold that Government should not in general interfere with the course of the economy merely on the strength of its own commercial judgement ... For I believe that, in the long run, the aggregate of decisions of individual businessmen, exercising their individual judgement in a free economy, even if often mistaken, is likely to do less harm than the centralised decisions of a Government; and certainly the harm is likely to be counteracted faster.'

Table 9.1
GOVERNMENT REVENUE AND EXPENDITURE AS PROPORTIONS OF GROSS DOMESTIC PRODUCT, SELECTED YEARS, 1950-51 TO 1964-65

<table>
<thead>
<tr>
<th></th>
<th>1950-51</th>
<th>1953-54</th>
<th>1959-60</th>
<th>1964-65</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>9.0</td>
<td>12.4</td>
<td>12.5</td>
<td>15.2</td>
</tr>
<tr>
<td>Expenditure</td>
<td>7.8</td>
<td>10.9</td>
<td>13.4</td>
<td>14.4</td>
</tr>
</tbody>
</table>


Table 9.2
GOVERNMENT CURRENT REVENUE AND CURRENT EXPENDITURE AS PROPORTIONS OF GROSS DOMESTIC PRODUCT, 36 COUNTRIES GROUPED BY PER CAPITA INCOME, AND HONG KONG, 1950 TO 1959

<table>
<thead>
<tr>
<th></th>
<th>36 Countries by per Capita income US $</th>
<th>Hong Kong (per capita income approx. US$ 280)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>&gt;1200</td>
<td>501-1200</td>
</tr>
<tr>
<td>Current Revenue</td>
<td>27.3</td>
<td>29.1</td>
</tr>
<tr>
<td>Current Expenditure</td>
<td>24.3</td>
<td>24.0</td>
</tr>
</tbody>
</table>


### Table 9.3
GOVERNMENT REVENUE AND EXPENDITURE 1947-48 TO 1967-68

<table>
<thead>
<tr>
<th></th>
<th>Budget Estimates</th>
<th>Actual financial results</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th>Surplus</th>
<th>Current Account Surplus</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Revenue $m</td>
<td>Expenditure $m</td>
<td>Current Revenue $m</td>
<td>Capital $m</td>
<td>Total $m</td>
<td>Expenditure $m</td>
<td>Capital $m</td>
<td>Total $m</td>
</tr>
<tr>
<td>1947-48</td>
<td>110</td>
<td>110</td>
<td>153</td>
<td>12</td>
<td>164</td>
<td>120</td>
<td>8</td>
<td>128</td>
</tr>
<tr>
<td>1948-49</td>
<td>151</td>
<td>150</td>
<td>185</td>
<td>10</td>
<td>195</td>
<td>138</td>
<td>22</td>
<td>160</td>
</tr>
<tr>
<td>1949-50</td>
<td>180</td>
<td>180</td>
<td>255</td>
<td>9</td>
<td>264</td>
<td>143</td>
<td>40</td>
<td>182</td>
</tr>
<tr>
<td>1950-51</td>
<td>204</td>
<td>201</td>
<td>280</td>
<td>12</td>
<td>292</td>
<td>173</td>
<td>79</td>
<td>252</td>
</tr>
<tr>
<td>1951-52</td>
<td>248</td>
<td>235</td>
<td>293</td>
<td>16</td>
<td>309</td>
<td>188</td>
<td>88</td>
<td>276</td>
</tr>
<tr>
<td>1952-53</td>
<td>291</td>
<td>289</td>
<td>370</td>
<td>15</td>
<td>385</td>
<td>209</td>
<td>103</td>
<td>312</td>
</tr>
<tr>
<td>1953-54</td>
<td>349</td>
<td>328</td>
<td>383</td>
<td>14</td>
<td>397</td>
<td>253</td>
<td>103</td>
<td>355</td>
</tr>
<tr>
<td>1954-55</td>
<td>389</td>
<td>388</td>
<td>393</td>
<td>42</td>
<td>434</td>
<td>256</td>
<td>118</td>
<td>378</td>
</tr>
<tr>
<td>1955-56</td>
<td>414</td>
<td>449</td>
<td>420</td>
<td>35</td>
<td>455</td>
<td>282</td>
<td>121</td>
<td>403</td>
</tr>
<tr>
<td>1956-57</td>
<td>450</td>
<td>493</td>
<td>448</td>
<td>62</td>
<td>510</td>
<td>312</td>
<td>157</td>
<td>469</td>
</tr>
<tr>
<td>1957-58</td>
<td>508</td>
<td>561</td>
<td>518</td>
<td>66</td>
<td>584</td>
<td>360</td>
<td>172</td>
<td>533</td>
</tr>
<tr>
<td>1958-59</td>
<td>554</td>
<td>648</td>
<td>567</td>
<td>62</td>
<td>629</td>
<td>394</td>
<td>196</td>
<td>590</td>
</tr>
<tr>
<td>1959-60</td>
<td>601</td>
<td>693</td>
<td>616</td>
<td>48</td>
<td>665</td>
<td>504</td>
<td>206</td>
<td>710</td>
</tr>
<tr>
<td>1960-61</td>
<td>712</td>
<td>938</td>
<td>771</td>
<td>88</td>
<td>859</td>
<td>568</td>
<td>277</td>
<td>845</td>
</tr>
<tr>
<td>1961-62</td>
<td>914</td>
<td>1075</td>
<td>911</td>
<td>119</td>
<td>1030</td>
<td>625</td>
<td>329</td>
<td>953</td>
</tr>
<tr>
<td>1962-63</td>
<td>1062</td>
<td>1226</td>
<td>1006</td>
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Note: figures do not add because of rounding. n.a. = not available

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a Revised estimates.
b Excludes excess stamp duty.
c Includes car registration fees and betting tax.
d Includes estate duty.
na Not available.
Note: Totals do not add because of rounding.

*South China Morning Post*, 29 February 1968.
Table 9.5: Government Expenditure, Selected Years, 1947-48 to 1967-68

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a Revised estimates.
b Excludes World Refugee Year Schemes and Colonial Development and Welfare Schemes.

Note: Totals do not add because of rounding.

Definitions: Government expenditure is recorded on a cash basis, in most cases by departments. The distribution of expenditure given in this Table is based on the following classifications:

Administration: Governor's Establishment; Departments of Audit Census and Statistics, Colonial Secretariat and Legislature, Immigration, Information Services, Inland Revenue, New Territories Administration, Rating and Valuation; the Public Services Commission; Treasury; Urban Services; New Territories Administration.

Defence: All Defence categories.

Economic Services: Departments of Agriculture and Fisheries, Civil Aviation, Commerce and Industry, Fire Services, Labour Marine, Registrar-General, Resettlement; Kowloon-Canton Railway; Post Office; Radio Hong Kong; Registry of Trade Unions; Royal Observatory; Urban Services; Urban Services; Housing.

Education: Department of Education; Universities.

Health and Medical: Medical and Health Department; Subventions: Medical.

Pensions: Pensions.

Police and Judiciary: Judiciary; Legal Department; Police Force.

Public Debt: Public debt.

Public Works - Department: Public Works Department.

Public Works - Recurrent: Public Works Department.


Other: Miscellaneous Expenditure; Stores; Urban Services; City Hall.

Source: Accountant-General, Annual Report, various numbers.
Chart 9.1  Government Revenue and Expenditure 1947-48 to 1967-68

<table>
<thead>
<tr>
<th>Year</th>
<th>Revenue (m)</th>
<th>Expenditure (m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>50-1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>60-1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>60-1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>65-6</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

---

Government Revenue

(A) Income Tax

There are no significant issues for this chart. The income tax has remained relatively constant over the years, with minor fluctuations. The trend is upward, indicating an increasing reliance on income tax revenue.

(B) Customs and Excise

The customs and excise revenue has seen a steady increase, with fluctuations due to changes in import and export duties. The trend shows a consistent rise, reflecting changes in economic activities and policy changes.

(C) Direct Taxes

Direct tax revenue has also increased steadily, with a notable rise in recent years. This is due to increases in personal and corporate income tax rates.

(D) Other Taxes

Other taxes, including sales tax and property tax, have contributed to the overall revenue, with gradual increases over the years.

(E) Grants

Grants to states and local authorities have shown a consistent increase, reflecting government's support for social services and infrastructure.

(F) Debitee's Interest

Interest paid to debitees has remained relatively stable, with minor fluctuations due to changes in interest rates.

(G) Other Revenue

Other revenue, including miscellaneous sources, has contributed to the overall government revenue, with small but significant increases over the years.

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Note: The chart is a line graph showing the trend of government revenue and expenditure from 1947-48 to 1967-68. The y-axis represents revenue/expenditure in millions ($m), while the x-axis represents the years from 50-1 to 65-6.
consequence of lower construction costs on the public works program and of building delays brought on by the 1967 disturbances). 1

Table 9.3 also shows the difference between budgeted and actual revenue and expenditure. In most years actual revenue has considerably exceeded estimated revenue. Realised expenditure has usually been appreciably below the budgeted figure.

(a) Government Revenue.

(i) Income Taxes

There is no comprehensive income tax in Hong Kong. Instead tax is charged separately on a number of specified sources of income: profits, salaries, property and interest. Individuals, however, can elect for an assessment on their total income from all the specified sources if this would lead to a lower tax liability. Income which arises outside the Colony is free from tax. 2 There is no tax charge on capital gains. These income taxes, first introduced as a wartime measure in 1940, became permanent charges in 1947. Until 1950 the standard rate of tax was ten per cent. In 1950 it was increased to 12½ per cent and maintained at this level until 1966 when it was raised to fifteen per cent. These direct taxes now return about one quarter of total Government revenue.

Profits Tax, which is subdivided into Business Profits Tax and Corporation Profits Tax, is charged at the standard rate on any person or company carrying on business in Hong Kong. 3 From 1947 until 1955

---

1 The difference between budgeted and actual spending on these two counts was greater than the additional Government spending made necessary by the riots and demonstrations (on police bonuses, staff overtime, etc.). The disturbances had no apparent immediate effect on Government revenue, except for their depressing effect on land prices, and thus on Government receipts from the sale of new leases. As Government receipts from internal revenue usually relate to profits and salaries received in the previous fiscal year, the effects of the disturbances on Government revenue is more likely to be seen in the 1968-69 financial period.

2 For this reason the Government has not entered into any double tax agreements.

3 Thus, unincorporated companies do not pay tax at a higher rate than incorporated companies.
an initial investment allowance equal to ten per cent of capital expenditure on buildings could be claimed. The concession was re-introduced in 1966 at the higher rate of twenty per cent. Apart from the normal wear and tear allowances, there are no investment incentives and no tax holidays. No tax is levied when the profits of an unincorporated business are less than $7,000 in any one year. A single assessment is made on the aggregated profits of all businesses controlled by the one taxpayer. Table 9.6 shows the number of cases of profits tax dealt with by the Inland Revenue Department over recent years, and the net profits tax charged. Table 9.7 gives a distribution of the profits tax demand notes by trade groupings.

Salaries Tax is charged on all wages, salaries, pensions, rent free accommodation and other emoluments, less personal deductions (which are $7,000 each for the taxpayer and his wife, $2,000 for each of the first two children, $1,000 for each of the third to sixth children and $500 each for the seventh, eighth and ninth children) and the value of life assurance premiums of up to one sixth of taxable income over $7,000. Tax is charged at graduated percentages of the standard rate: tax is 2½ per cent of the first $5,000 of taxable income, 5½ per cent on the next $5,000, rising to 30 per cent of that part of taxable income which is in excess of $45,000. However, there is a proviso which limits the maximum tax payable by an individual to the standard rate on his gross income. Table 9.8 shows that the burden of salaries tax is a light one.¹ As an annual income of $18,000 is considered to be within the top ten per cent of incomes in the Colony,² the tax base is very narrow. There are no pay-as-you-earn deductions, but tax reserve certificates, carrying 4.2 per cent tax-free interest, are available.

¹ The light burden of salaries tax is shown also in the 1963-64 Household Expenditure Survey, op. cit. Income tax payments made up only 0.2% of expenditure of households with a monthly expenditure of $2,000 or more.
² Financial Secretary, Budget Debate, 1966 (mimeographed).
### Table 9.6

PROFITS TAX: CASES ASSESSED AND NET TAX CHARGEABLE, SELECTED YEARS, 1950-51 TO 1966-67

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of cases assessed</td>
<td>n.a.</td>
<td>39,600</td>
<td>32,000</td>
<td>34,400</td>
<td>41,900</td>
<td>46,800</td>
<td>48,800</td>
</tr>
<tr>
<td>Number of profits tax assessments issued</td>
<td>3,300</td>
<td>6,800</td>
<td>4,300</td>
<td>5,300</td>
<td>6,700</td>
<td>9,300</td>
<td>10,200</td>
</tr>
<tr>
<td>Net profits tax charged $m</td>
<td>35</td>
<td>87</td>
<td>60</td>
<td>82</td>
<td>138</td>
<td>245</td>
<td>278</td>
</tr>
</tbody>
</table>

Table 9.7
PROFITS TAX: DEMAND NOTES BY TRADE GROUPINGS, SELECTED YEARS
1961-62 TO 1966-67

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Corporations</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Distribution, Wholesale, Retail, Export &amp; Import</td>
<td>19</td>
<td>34</td>
<td>37</td>
<td>51</td>
</tr>
<tr>
<td>Banking</td>
<td>10</td>
<td>12</td>
<td>21</td>
<td>25</td>
</tr>
<tr>
<td>Other Finance and Investment</td>
<td>12</td>
<td>19</td>
<td>42</td>
<td>49</td>
</tr>
<tr>
<td>Manufacturing:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Clothing and textiles</td>
<td>8</td>
<td>6</td>
<td>9</td>
<td>8</td>
</tr>
<tr>
<td>- Other</td>
<td>13</td>
<td>20</td>
<td>25</td>
<td>26</td>
</tr>
<tr>
<td>Shipping</td>
<td>5</td>
<td>9</td>
<td>7</td>
<td>11</td>
</tr>
<tr>
<td>Hotels, Restaurants</td>
<td>4</td>
<td>6</td>
<td>7</td>
<td>9</td>
</tr>
<tr>
<td>Utilities</td>
<td>15</td>
<td>22</td>
<td>37</td>
<td>26</td>
</tr>
<tr>
<td>Other</td>
<td>10</td>
<td>14</td>
<td>25</td>
<td>30</td>
</tr>
<tr>
<td><strong>Total Corporations</strong></td>
<td>96</td>
<td>142</td>
<td>192</td>
<td>235</td>
</tr>
<tr>
<td><strong>Unincorporated Businesses</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Professions, Amusements</td>
<td>7</td>
<td>10</td>
<td>13</td>
<td>13</td>
</tr>
<tr>
<td>Export-Import, Wholesale, Retail</td>
<td>7</td>
<td>10</td>
<td>14</td>
<td>19</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>3</td>
<td>4</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Other</td>
<td>11</td>
<td>22</td>
<td>28</td>
<td>20</td>
</tr>
<tr>
<td><strong>Total unincorporated businesses</strong></td>
<td>28</td>
<td>46</td>
<td>59</td>
<td>56</td>
</tr>
<tr>
<td><strong>All Businesses</strong></td>
<td>124</td>
<td>188</td>
<td>241</td>
<td>291</td>
</tr>
</tbody>
</table>

**Note:** Totals do not add because of rounding.

**Source:** Commissioner of Inland Revenue, *Annual Report*, various numbers.
Table 9.8

SALARIES TAX PAYABLE BY A MARRIED MAN WITH TWO CHILDREN

<table>
<thead>
<tr>
<th>Gross Income</th>
<th>Salaries tax payable</th>
<th>Average rate of tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>$</td>
<td>$</td>
<td>%</td>
</tr>
<tr>
<td>18,000</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>24,000</td>
<td>192.50</td>
<td>0.8</td>
</tr>
<tr>
<td>36,000</td>
<td>1,155.00</td>
<td>3.2</td>
</tr>
<tr>
<td>80,000</td>
<td>11,475.00</td>
<td>14.5</td>
</tr>
<tr>
<td>100,000</td>
<td>15,000.00</td>
<td>15.0</td>
</tr>
</tbody>
</table>

The number of cases assessed for Salaries Tax and the net Salaries Tax payable are shown in Table 9.9.

Property Tax is charged on the net rateable value of all land and buildings at the standard rate, other than on property occupied by the owner as a residence, which is free of tax, and land in the New Territories and pre-war buildings subject to rent control, which are charged at concessional rates. There is a repairs and maintenance allowance of twenty per cent of the net rateable value.

Interest Tax is charged at the standard rate on interest receipts which arise in Hong Kong. Interest received by companies, receipts of bank interest at rates of 3½ per cent or less, and interest on tax reserve certificates, are all exempt from tax. There is no tax charged on dividend receipts.

The introduction of a comprehensive income tax - one charged on the taxpayer's aggregate income rather than separately on different sources - has been suggested by several members of the Legislative Council, as a means of increasing tax revenue (since some taxpayers would be moved into higher tax brackets and avoidance would be more difficult) and of relating tax payments more closely

1 Alternatively, of allowing a reduction in the rate of tax.
2 It is claimed that avoidance would be reduced because tax payments could be more nearly related to apparent wealth. However, if some forms of income - such as income arising abroad, and capital gains - remained tax free, this advantage would not follow.
Table 9.9
SALARIES TAX: CASES ASSESSED AND NET TAX CHARGEABLE, SELECTED YEARS 1950-51 TO 1966-67

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of cases assessed</td>
<td>8,700</td>
<td>21,500</td>
<td>16,200</td>
<td>19,700</td>
<td>32,900</td>
<td>44,100</td>
<td>47,100</td>
</tr>
<tr>
<td>Number of Salaries tax assessments issued</td>
<td>6,800</td>
<td>9,100</td>
<td>9,700</td>
<td>13,300</td>
<td>23,500</td>
<td>31,200</td>
<td>32,700</td>
</tr>
<tr>
<td>Net Salaries tax charged $m</td>
<td>7</td>
<td>10</td>
<td>11</td>
<td>14</td>
<td>27</td>
<td>46</td>
<td>57</td>
</tr>
<tr>
<td>Average per assessment $</td>
<td>971</td>
<td>1,075</td>
<td>1,166</td>
<td>1,083</td>
<td>1,148</td>
<td>1,489</td>
<td>1,741</td>
</tr>
</tbody>
</table>

Source: Commissioner of Inland Revenue, Annual Report, various numbers.
to ability to pay. In his 1962 Budget Speech, the Financial Secretary referred to "the compelling need to make an early change to a system of full income tax", and added, later in the debate, that "it is the intention to set up a special committee to consider the matter". There was strong opposition to this suggestion from the unofficial members, one of whom argued:

Such inquisition is particularly objectionable to the Chinese people; by nature and custom the Chinese people resent it. Apart from the objection that it will cause untold irritation, annoyance and inconvenience to the taxpayers, the administration of such a tax is a difficult one and requires a large staff to function... Such a system will create more opportunities for corruption... Foreign investors have come to this Colony principally because there is no full income tax here and because our rate of tax is low... To change the present system of taxation by one of full income tax is therefore attended by the danger and risk of a flight of capital from the Colony...2

In the event, realisation that 'an orthodox full income tax would not command the support of a substantial part of [the Legislative] Council' forced the Financial Secretary to drop the proposal, even though he expressed 'difficulty in wholly accepting' the case against full income taxation.3

There is general agreement on the necessity for low taxes. Early in the post-war period the view was put that because of 'Hong Kong's peculiar position as an entrepot, and not in the main, as a producer', there was little scope to increase taxes without 'doing permanent injury to Hong Kong as an entrepot'.4 More recently, it seems to have become the accepted view that, for political reasons,

3 Financial Secretary, 1966 Budget Speech, (mimeographed).
the ceiling for direct taxes is about twenty per cent - or around half the rate levied in many countries.¹

(ii) Other Recurrent Revenue

The few import charges levied - these are imposed on liquor, tobacco, hydrocarbon oils, table water and methyl alcohol - are purely for revenue purposes and, despite several increases since the war, are generally light.² Excise duties are charged on the same goods if these are manufactured locally. Revenue from duties has gradually become a less important part of total Government receipts (contribution 31 per cent of Government revenue in 1947-1948 and 17 per cent in 1967-68).

The income from the Government's commercial operations - Post Office, railway, water, lands and housing - is recorded on a gross basis. Charges for the various services are fixed on the basis of covering 'commercial costs';³ for example, rents on low cost housing estates are charged at levels which cover reimbursement of the capital cost over forty years at five per cent per annum compound interest. Fourteen to twenty per cent of Government revenue has consisted of receipts from its several undertakings.

¹ See H.M.D. Barton, 1962 Budget Debate, and Financial Secretary, Budget Speech, 1966 (mimeographed) p.29. As well as the political factor, of course, there is the Government's laissez-faire outlook: 'I am confident, however old fashioned this may sound, that funds left in the hands of the public will come into the Exchequer with interest at the time in the future when we need them.' Financial Secretary, Legislative Council Debates, 1962.
² In 1966 the charge on liquor ranged from $1.60 per gallon on locally-produced beer to $73 a gallon on imported spirits (a concession is allowed on imports of liquor and tobacco from Commonwealth countries). On tobacco the range was $2.50 a pound on Chinese-prepared tobacco to $11.25 a pound on Commonwealth cigars. On motor spirits the duty was $1.80 a gallon.
³ On the ground that commercial costs 'measure the true cost to the community in terms of the choice between competing use of scarce resources.' Financial Secretary, Legislative Council Debates, 1964, p.50. However, land for low cost housing purposes is priced below market value, and no charge is made for land provided for housing purposes.
Other sources of recurrent revenue are a first registration tax and a Commonwealth Preference Tax on motor vehicles (included in the Government's accounts as a part of internal revenue) and rates, which are charged at seventeen per cent of rateable values on land and buildings in the city and at eleven per cent in parts of the New Territories. The urban development and increase in property values have led to a rise in receipts from rates from $10 million in 1947-48 (six per cent of total revenue) to $282 million in 1967-68 (fifteen per cent of total revenue).

(iii) Capital Revenue

The Government's intention of reducing the maximum rate of estate duty (the maximum rate applies to estates worth $15 million) to the same level as the standard rate of Salaries Tax was announced in the 1967 Budget. As a first step, the maximum rate was reduced from 40 per cent to 25 per cent. The concession was given for economic not social reasons - it was said to be encouraging a capital outflow.

All land in Hong Kong is crown land. Leases, which in the urban area are usually for 75 years, are sold at public auction. Revenue from the sale of leases is, for obvious reasons, variable and difficult to predict. Increasingly, though, land for industrial purposes and re-grants of existing leases are sold on instalment terms (a cash payment of ten per cent and the balance over twenty years at ten per cent interest). This has made for a more regular flow of revenue from Government's land transactions.

Table 9.4 shows the unimportance of loans and grants in comparison with tax and other revenues. And, what little borrowing there has been is counterbalanced many times by the accumulation of reserves. The only public issue of securities since the War was the $50 million Rehabilitation Loan raised locally in 1948 (this is not shown in Table 9.4 because the proceeds were used to repay previous advances from surplus balances). An interest free loan of

1 See Table 9.12.
$48 million was received from the United Kingdom Government in the late 1950s, specifically to finance development of the airport. This loan is being repaid in fifteen annual instalments of $3.2 million. Several small loans and grants have been received from the Colonial Development and Welfare Fund, and other small grants have come from World Refugee Year Sources. The public debt is shown in Table 9.10.

(b) Government Expenditure. The distribution of Government spending over the post-war period was shown in Table 9.5.

Defence expenditure is regulated by an agreement with the United Kingdom. A 1958 Agreement committed the Colony to pay $24 million a year towards its defence costs. To this was added in 1964 a promise to make available an additional $96 million over six years to finance a defence capital works program. A revision to the Agreement in 1966 required the Colony to contribute $80 million per annum.

Public service wages and salaries take about two fifths of total Government spending (in 1967-68, $678 million out of $1,804 million).

The larger and more settled population has meant a greater demand for education and health services, and thus for increased Government spending in these fields. It is now the Government's intention to provide, by 1971, a subsidised primary school place for every child of primary school age and subsidised secondary school places for fifteen to twenty per cent of primary school leavers. In a program for the development of medical and health services adopted in 1960 the Government accepted responsibility for providing hospitals and clinics for that part of the population which could not afford to pay economic rates (a Government statement suggested that this would involve 50 per cent of the population for outpatient care and 80 per

---

1 See Hong Kong 1966, Chapter 1, 'The Social Services'. It should be pointed out that about half the school places and about one-tenth of the hospital beds are provided by private bodies with no Government assistance, and that the majority of the remainder is Government assisted and not Government-provided.
Table 9.10
PUBLIC DEBT, SELECTED YEARS, 1948 TO 1967

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Public debt</td>
<td>70</td>
<td>65</td>
<td>56</td>
<td>73</td>
<td>94</td>
<td>90</td>
<td>79</td>
<td>75</td>
</tr>
<tr>
<td>less sinking fund</td>
<td>3</td>
<td>8</td>
<td>13</td>
<td>14</td>
<td>17</td>
<td>21</td>
<td>25</td>
<td>28</td>
</tr>
<tr>
<td>Expenditure on public debt \textsuperscript{b,c}</td>
<td>67</td>
<td>56</td>
<td>43</td>
<td>59</td>
<td>77</td>
<td>69</td>
<td>54</td>
<td>47</td>
</tr>
</tbody>
</table>

\textsuperscript{a} = 31 March each year
\textsuperscript{b} = Year ending 31 March
\textsuperscript{c} = Includes repayments

Note: Totals do not add because of rounding.

Source: Accountant-General, Annual Report, various numbers.

At first, emphasis was placed on the provision of clinics. A more comprehensive program was adopted in 1963, to increase the number of hospital beds (including those in private hospitals) per thousand of population from 2.91 in 1963 to 4.25 by 1972. The field of social welfare, the Government considers its role to be that of co-ordinating the work of the various private bodies and of providing certain basic and emergency relief services. There is no likelihood that a system of general welfare payments will be introduced.

A most important part (in recent years, a third) of Government spending has been on non-recurrent public works. A breakdown of this item of Government spending is shown in Table 9.11.

The largest single item of public works spending has been, in most years, expenditure on the Colony's water supply. The large

\textsuperscript{1} Hong Kong 1966, p.10.
\textsuperscript{2} Ibid., p.11.
\textsuperscript{3} The White Paper Aims and Policy for Social Welfare in Hong Kong, 1964, p.7, stated that '...in planning for future developments, it would not be realistic to envisage comprehensive services or to introduce any further elements in a social security programme beyond the provision of relief services based on strict need, without very careful consideration of the potential effect on the economy.'
### Table 9.11

**PUBLIC WORKS, NON-RECURRENT EXPENDITURE, \( ^a \) SELECTED YEARS, 1950-51 TO 1966-67**

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Civil engineering</strong></td>
<td>45</td>
<td>40</td>
<td>30</td>
<td>26</td>
<td>18</td>
<td>24</td>
<td>25</td>
</tr>
<tr>
<td><strong>Education</strong></td>
<td>9</td>
<td>8</td>
<td>3</td>
<td>4</td>
<td>3</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td><strong>Medical and health</strong></td>
<td>6</td>
<td>10</td>
<td>2</td>
<td>9</td>
<td>8</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td><strong>Resettlement and low cost housing</strong></td>
<td>-</td>
<td>-</td>
<td>11</td>
<td>16</td>
<td>17</td>
<td>21</td>
<td>25</td>
</tr>
<tr>
<td><strong>Police and Prisons</strong></td>
<td>19</td>
<td>12</td>
<td>6</td>
<td>6</td>
<td>3</td>
<td>4</td>
<td>2</td>
</tr>
<tr>
<td><strong>Social Welfare</strong></td>
<td>-</td>
<td>1</td>
<td>0</td>
<td>-</td>
<td>0</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td><strong>Water Works</strong></td>
<td>6</td>
<td>2</td>
<td>32</td>
<td>24</td>
<td>31</td>
<td>32</td>
<td>30</td>
</tr>
<tr>
<td><strong>Other</strong>(^c)</td>
<td>16</td>
<td>27</td>
<td>15</td>
<td>14</td>
<td>21</td>
<td>16</td>
<td>14</td>
</tr>
<tr>
<td><strong>Total expenditure</strong></td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

**Note:** Totals do not add because of rounding.

- \( ^a \) Excludes expenditure financed from the Development Loan Fund.
- \( ^b \) Includes airport.
- \( ^c \) Includes works, etc., for the services.

**Source:** Accountant-General, *Annual Report*, various numbers.
population and the demands of industry, on the one hand, and the
Colony's small land area, lack of rivers and a seasonal and unreliable
rainfall on the other, make the provision of an adequate water supply
an expensive one. The accounts of the Water Authority are discussed
below. 1

It is for its investment in utilitarian, low cost housing that
the Hong Kong Government is probably most widely known. The
Government entered the housing field on a large scale in 1954, when
it was becoming evident that immigrants were not returning to China
as had been earlier expected, and is now landlord to almost one-third
of the population. About one-quarter of the Colony's population is
now housed in 'resettlement' estates (accommodation provided to
families from 'squatter' areas). By 1971, more than 1.5 million will
be housed in such estates. 2 To accommodate the small factories which
have been set up in squatter areas, the Government's Resettlement
Department has constructed blocks of flatted factory space near to the
resettlement estates.

The separate category of 'Government Low-Cost Housing' was
established in 1964 to provide housing of a minimum standard for
families whose income was too low to qualify for Housing Authority
accommodation but who, not being squatters, could not seek
accommodation in resettlement estates. It is planned to house 220,000
people in Low-Cost Housing estates by 1970. 3 Government spending on
resettlement and Low-Cost housing is expected to be about $1,000
million in the six years to 1970.

The very large spending on public housing by this most laissez-
faire of governments has resulted from the magnitude of the housing

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1 See Chapter 12.
2 The magnitude of the squatter problem hardly needs to be stressed.
   Despite the resettlement program, the number of squatters increased
   from around 260,000 in 1954 to 580,000 in September 1963. Review of
   Policies for Squatter Control, Resettlement and Government Low Cost
   Housing, 1964, p. 2.
3 Hong Kong Annual Report, 1966, p. 135.
shortage and, to a lesser extent, from the unwillingness of private
capital to make the necessary large and very long term investment.

**Budget Balances**

Over the twenty-one years covered by Table 9.3 budget surpluses
have been returned in all but two years (in both of which new salary
awards, for which no allowance was made in the Budget, were granted
to Government employees). The Table also showed that there have been
very wide differences between budget predictions and recorded
financial results. An extreme case was 1962/63, when an anticipated
deficit of $164 million became an actual surplus of $140 million.

Estimates of likely revenue have been made on what appear to be
excessively conservative assumptions,¹ while actual expenditure,
especially on capital projects, has frequently been less than
authorised. Five year forecasts of revenue and expenditure have been
made periodically since 1951, but with wide margins of error,
especially on the revenue side.² (The fact that the expenditure
projections have been reasonably correct makes the five year
forecasts of some use, as, for example, in planning the staff needs
in the Public Works Department).

In the period shown in Table 9.3 the surplus on current account
has been about one-third of current revenue³ and by far the main
source of funds for Government capital formation.

The surplus on current account has also been considerably in
excess of the deficit on capital account. From the resulting
surpluses large reserves have been built up. These have been held

---

¹ Frequently, the level of revenue forecast has been less than actual
revenue in the previous year.

² For example, the five year prediction given in the 1954 Budget
Speech estimated that revenue in 1958/59 would equal $358 million;
actual revenue in that year was $629 million.

³ Current revenue is defined in the Government's accounts as total
revenue less estate duty, land sales, excess stamp duty, and loans
and grants.
as a Revenue Equalisation Fund (set up in 1953 specifically 'for the
purpose of meeting any serious shortage of revenue for a particular
year, or for meeting any non-recurrent increase in expenditure in
any particular year') and a General Revenue Balance. Variations
in the levels of the two reserves and the assets held against them
are shown in Table 9.12. Since 1960 an increased proportion of
the Government's reserves has been held within the Colony; by March
1967 more than half of the Government reserves was held as deposits
with Hong Kong banks.

As a result of the devaluation of sterling in November 1967,
$38 million was written off the sterling assets held against the
Government reserves.

The building up of sizeable reserves and the holding of these
largely in the form of liquid assets abroad have been deliberate
acts of Government policy. The Government has sought to accumulate
a reserve from which it can maintain public spending in the event
of a fall in revenue. A large part of the reserves are held as
liquid deposits and investments in foreign financial centres
because

Reserves are of little use unless they are in reasonably
liquid form so that they can readily be drawn on when
required ... for this reason a substantial proportion
of them must be held abroad; for there is no reasonably
liquid form in which sums of this magnitude can be held
in Hong Kong ... A potentially difficult position could
arise were we to deposit very large sums in the banks

1 Financial Secretary, Legislative Council Debates, 1953, p.36.
2 The transferable surplus in the Colony's Exchange Fund (see
Chapter 3) is not included in the Government's reserves.
3 In his 1966 Budget speech, mimeographed, the Financial Secretary
stated 'I am now more than ever convinced that it is essential in
our economic interest that the Government's reserves should be
substantial and be held to a great extent abroad'. The Government's
intention to build up its foreign reserves suggests that, at least
in most years, it was confident the budgeted deficit would not
eventuate.
Table 9.12
GOVERNMENT LIABILITIES AND ASSETS, SELECTED YEARS, 1948 TO 1967

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$ million</td>
<td>$ million</td>
<td>$ million</td>
<td>$ million</td>
<td>$ million</td>
<td>$ million</td>
<td>$ million</td>
<td>$ million</td>
</tr>
<tr>
<td>Liabilities</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue Equalisation Fund</td>
<td>-</td>
<td>-</td>
<td>137</td>
<td>138</td>
<td>138</td>
<td>138</td>
<td>138</td>
<td>138</td>
</tr>
<tr>
<td>General Revenue Balance</td>
<td>37</td>
<td>193</td>
<td>242</td>
<td>358</td>
<td>407</td>
<td>659</td>
<td>688</td>
<td>710</td>
</tr>
<tr>
<td>Other, incl. deposits</td>
<td>36</td>
<td>127</td>
<td>63</td>
<td>69</td>
<td>43</td>
<td>66</td>
<td>78</td>
<td>87</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>73</td>
<td>320</td>
<td>443</td>
<td>565</td>
<td>588</td>
<td>863</td>
<td>904</td>
<td>935</td>
</tr>
<tr>
<td>Assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and current deposit</td>
<td>73</td>
<td>61</td>
<td>87</td>
<td>57</td>
<td>27</td>
<td>102</td>
<td>71</td>
<td>76</td>
</tr>
<tr>
<td>Fixed deposit</td>
<td>-</td>
<td>70</td>
<td>20</td>
<td>88</td>
<td>60</td>
<td>279</td>
<td>420</td>
<td>409</td>
</tr>
<tr>
<td>Investments</td>
<td>-</td>
<td>102</td>
<td>246</td>
<td>415</td>
<td>497</td>
<td>429</td>
<td>400</td>
<td>430</td>
</tr>
<tr>
<td>Other</td>
<td>-</td>
<td>87</td>
<td>89</td>
<td>5</td>
<td>5</td>
<td>53</td>
<td>12</td>
<td>11</td>
</tr>
<tr>
<td>Total assets</td>
<td>73</td>
<td>320</td>
<td>443</td>
<td>565</td>
<td>588</td>
<td>863</td>
<td>904</td>
<td>935</td>
</tr>
<tr>
<td>Cash, deposits and investment:</td>
<td>63</td>
<td>132</td>
<td>155</td>
<td>174</td>
<td>205</td>
<td>238</td>
<td>272</td>
<td>305</td>
</tr>
<tr>
<td>held in Hong Kong</td>
<td>49</td>
<td>82</td>
<td>50</td>
<td>123</td>
<td>71</td>
<td>380</td>
<td>426</td>
<td>469</td>
</tr>
<tr>
<td>held in sterling</td>
<td>24</td>
<td>151</td>
<td>303</td>
<td>437</td>
<td>512</td>
<td>430</td>
<td>466</td>
<td>457</td>
</tr>
</tbody>
</table>

Note: Totals do not add because of rounding

Source: Accountant-General, Annual Report, various numbers.
in Hong Kong for them to lend in the normal course, and we were then to find it necessary for some reason to run them down quickly.¹

This need to build up reserves in anticipation of future budget deficits reflects the Government's very restricted ability to finance a budget deficit by borrowing from the banking system. There is no central bank, the currency issue is fully backed by sterling, and any borrowing from the commercial banks would probably be only for a small amount and on a short term basis. Under these institutional arrangements, the Government can run a budget deficit only to the extent that it has reserves or can obtain new funds from borrowing or grants. It cannot directly 'create new money' to finance a deficit.

A smaller part of the reserves is committed to the payment of pensions, and to the repayment of the few loans received from outside sources.

There has been no attempt to use budget balances as a weapon of stabilisation policy. Thus, the budget surpluses recorded over almost all the post-war period were not intended as deflationary measures and the budget deficits in 1959/60 and 1965/66 were not aimed at stimulating the level of demand in the economy. In any case, as was shown in Chapter 7, one would have to look at what is done with the surplus funds or at the source from which the excess of spending is financed. If, for example, the budget surplus is left on deposit with the Hong Kong banks (as was the case in

¹ Financial Secretary, Budget Speech, 1967 (mimeographed). There has been a good deal of criticism of the decision to maintain large reserves, especially about that part which is held outside Hong Kong. For example, it has recently been asked 'What are these RESERVES reserved for? For the needs of Hong Kong and its people? Have they ever been drawn and for what? It seems to me these so-called reserves are more like a life insurance fund held in the name of Hong Kong and its premium payments being the responsibility of the Hong Kong people, but in the event of death - Hong Kong Government not being immortal - the beneficiaries will surely be the British Government or the Hong Kong expatriates, who constitute less than 1% of the population.' Dr T.P. Wu, letter to FEER, 24 August, 1967.
1963/64), the excess of Government revenue over spending need not be deflationary. Similarly, a budget deficit financed from the Government's locally held reserves would not necessarily be expansionary.

**Government Borrowing**

The unimportance of borrowed funds was apparent from Tables 9.4 and 9.10. The nominal public debt in March 1967 stood at only $75 million, or $20 a head, and against this a sinking fund at $28 million was held. In his 1961 Budget Speech, the Financial Secretary announced that an issue of treasury bills with a maturity of three months was to be made. It was stressed that, as well as providing the Government with funds, the proposed issue would constitute a first step in the establishment of a Government securities market and would give some indication of the yield which the market expected of Government securities. The Government, apparently, was willing to provide re-discount facilities for at least a part of the security issue. However, the continued buoyancy of revenue made it unnecessary to proceed with the issue. As the new Financial Secretary pointed out in late 1961, with the strong revenue there was little that could be done with the funds raised by the bill issue other than to deposit them with the Hong Kong banks; this might be useful to the banks but it would not benefit the Government.

In the following year, the Financial Secretary disclosed that an Ordinance authorising a short term loan raising of $50 million to $100 million was under preparation. Again, however, the continued increase in revenue made it unnecessary to issue the Government scrip.

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2. Ibid., p.271.
To some extent, the neglect of borrowing reflects a Gladstonian approach to public finance - a view that Government spending should be limited to that level which can be financed from revenue. The Financial Secretary in 1966 discussed the Government's attitude to borrowing in some detail:

In the first place, except in the event of borrowing abroad, borrowing does not throw the cost of development on future generations, as some believe; it tends merely to redistribute the burden; not that, I feel, we today in Hong Kong have any very clear moral right to try to pass capital costs on to the future if that were possible, the assets handed on to us being almost wholly free of debt. Much of the strength of our economy today derives from the prudently orthodox policies we have pursued in the post-war years.

Secondly, there are strong grounds for attempting if one can, not to mortgage the future. It is certainly cheaper in aggregate terms not to do so and it secures one from the temptation of assuming too heavy a burden of debt...

Again, one of the dangers about governmental borrowing is that there is a temptation to borrow for investment in capital projects which can never generate adequate income to redeem the debt or which do so at too slow a rate; and the burden of debt and the problem of its refinancing grows rapidly.1

But there have been other considerations. Until 1965, the rate of increase in Government spending - especially on water storage and housing - was held back by real factors (such as the long time taken to prepare plans and difficulties of site formation). Further, there has been a limited market for fixed interest securities, especially those of the longer term. Most long term investment is discouraged by political uncertainty. There is no central bank to support a public issue of securities. And, as commercial banks have free access to foreign money markets, a local issue may need to match foreign securities in liquidity (which could involve the Government in the provision of re-discount facilities) before receiving strong bank support. The problem is to some extent a circular one: there is little appetite for fixed interest securities in part because of the negligible supply of fixed interest securities. But there would almost certainly have been

---

1 Financial Secretary, 1966 Budget Speech, (mimeographed), pp.25-6.
in most post-war years, sufficient demand to absorb a short term (five to ten years) issue. 1

The Government has been especially unwilling to accept the proposal that it make an issue of bonds which the commercial banks might count as liquid assets for purposes of the Banking Ordinance:

I am afraid that I totally disagree with this idea. It is potentially inflationary, in the bad sense, as it will tend to build up the supply of credit to undesirable levels and put a strain on our external resources... Furthermore, and this is a facet of the first objection, Government's consent to its loans being treated as liquid assets would involve it in an obligation to discount or repurchase these loans on demand, should banks run short of liquidity for any reason - as they might under the very impetus of Government borrowing, and its effect on our balance of payments. 2

Despite the Colony's financial respectability, it has been very difficult to obtain funds from overseas. Borrowing from the London market has been prevented by the United Kingdom balance of payments difficulties and the priority given to other Commonwealth borrowers. The World Bank, to which the Colony applied for credit in 1961, and 1966, considered that the Colony was not sufficiently in need of outside funds.

It is difficult to say which of these various influences has contributed most to the limited use of borrowing. It seems probable though, that if revenue were ever to be less than adequate in the future, the whole question of borrowing would be reconsidered.

The Development Loan Fund

In 1951 the Government announced the establishment of a Development Fund to finance 'revenue-producing projects, and such other development and welfare projects as do not commit Government to increase recurrent expenditure to be financed from general revenue.' 3 The Fund was initially allocated the proceeds of former

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1 For example, the Financial Secretary said in 1966, Budget speech, 'We ... may be able to borrow, at not unreasonable rates of interest, for periods of say, ten years.'

2 Ibid., pp.27-8.

enemy property and the profits from the Government's trading account. A small Local Loan Fund was set up in 1956 to make interest free loans to schools. In 1958 the Development Loan Fund was established to take over these two funds.

Table 9.13 shows the growth of the Development Fund and the Development Loan Fund in the period 1953 to 1967. On several occasions the Fund has received appropriations from the Colony's general revenue. A significant transfer from the accumulated surplus of the Exchange Fund was made in 1965. It was announced in the Financial Secretary's 1967 Budget Speech that another, sizable transfer was under consideration, but this transfer had to be delayed because of the losses suffered by the Exchange Fund in the 1967 sterling devaluation. Interest on the Fund's own loans is now a significant source of revenue.

The greater part of the Development Loan Fund's assets in 1967 was in the form of loans outstanding - $528 million - most of which ($434 million) was to the credit of the Housing Authority, the Housing Society and the building co-operative societies. Loans to schools stood at $50 million. Earlier, the Fund directly financed a reclamation scheme which provided land for industrial purposes. For many years, a significant part of the assets of the Fund was held in liquid form, largely in sterling investments.

Originally, the Fund was not empowered to make grants or to take an equity interest in business corporations. In 1966 the scope of the Fund's operations was widened to include investment in the equity capital of 'viable schemes of development', such as the Export Credit Insurance Corporation, and the cross harbour tunnel. Loans and investment must be approved by the Legislative Council's Finance Committee.

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1 The Fund did, however, underwrite two share issues of the local telephone company in the early 1950s.
### Table 9.13

DEVELOPMENT FUND AND DEVELOPMENT LOAN FUND, ASSETS AND REVENUE ACCOUNT, SELECTED YEARS, 1957 TO 1967

<table>
<thead>
<tr>
<th></th>
<th>1957&lt;sup&gt;a&lt;/sup&gt;</th>
<th>1960</th>
<th>1963</th>
<th>1967</th>
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<tr>
<td><strong>$ million</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reclamation at cost</td>
<td>3</td>
<td>7</td>
<td>8</td>
<td>1&lt;sup&gt;b&lt;/sup&gt;</td>
</tr>
<tr>
<td>Loans:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Housing</td>
<td>44</td>
<td>138</td>
<td>289</td>
<td>434</td>
</tr>
<tr>
<td>Education</td>
<td>-</td>
<td>18</td>
<td>25</td>
<td>50</td>
</tr>
<tr>
<td>Medical</td>
<td>-</td>
<td>6</td>
<td>5</td>
<td>4</td>
</tr>
<tr>
<td>Fisheries</td>
<td>-</td>
<td>-</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td>Other</td>
<td>1</td>
<td>-</td>
<td>2</td>
<td>26</td>
</tr>
<tr>
<td>Total loans</td>
<td>45</td>
<td>163</td>
<td>322</td>
<td>528</td>
</tr>
<tr>
<td>Investments:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hong Kong</td>
<td>1</td>
<td>1</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Sterling</td>
<td>10</td>
<td>0</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Advances</td>
<td>0</td>
<td>3</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Total assets</td>
<td>137</td>
<td>227</td>
<td>358</td>
<td>579</td>
</tr>
<tr>
<td><strong>Revenue Account</strong>&lt;sup&gt;c&lt;/sup&gt;</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Interest on loans</td>
<td>1</td>
<td>4</td>
<td>10</td>
<td>20</td>
</tr>
<tr>
<td>Bank interest</td>
<td>3</td>
<td>2</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Transfers from Trading Reserve Fund, etc.</td>
<td>-</td>
<td>13</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Appropriation from general revenue</td>
<td>0</td>
<td>5</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Transfer from Exchange Fund</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Total revenue</td>
<td>4</td>
<td>24</td>
<td>13</td>
<td>22</td>
</tr>
</tbody>
</table>

**Note:** Totals do not add because of rounding.

<sup>a</sup> = 31 March each year.

<sup>b</sup> = Premia outstanding from sale of land.

<sup>c</sup> = Year ending 31 March each year.

<sup>d</sup> = A transfer or $150 million was made in 1965.

**Source:** Accountant-General, Annual Report, various numbers.
Post-War Developments in the Public Finance System

It is perhaps surprising to see how little the system of public finance has changed over the post-war period, other than simply in terms of the volume of revenue and expenditure, which has increased greatly.

The fact that revenue has increased more rapidly than the national income while tax rates have remained fairly steady suggests that the tax-system is income-elastic. It is this characteristic of the tax system which perhaps explains why there has been little need to alter the revenue system despite the growth of public spending. Had there been the dependence on income-inelastic trade taxes that is a feature of many developing countries, it would have been more necessary to change the level or system of taxes (or the reliance on borrowing) as Government expenditure increased.

Possibly, too, the tax system is now better administered. Businesses and salary earners are more familiar with the regulations governing direct tax; the population is a more settled one; and the Department of Inland Revenue seems better placed to limit tax avoidance and evasion: a tax payments investigation section has been established, and the Department has built up its holdings of marginal tax files. On the other hand, the absence of a system of full income tax, the prevalence of unincorporated businesses and partnerships and the fact that many businesses do not maintain audited accounts, probably mean that there is still considerable tax avoidance.1 It is believed too, that a number of transfers of property are signed in Macao to avoid stamp duty.

The distribution of Government expenditure over the post-war period was set out in Table 9.5. Much of the change in the pattern of expenditure evident in the Table is due to a reduction in expenditure on Government stores (included in 'other expenditure' in the Table) after the restocking of the early post-war years. Other

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1 See, for example, Financial Secretary, Legislative Council Debates, 1961, p.56.
than increases in the proportion of expenditure allocated to public works (i.e., Government investment in infrastructure and housing) and of spending on education, there has been little alteration to the pattern of Government expenditure, despite the economic and demographic changes which have taken place over the past two decades.

The Public Finance System: An Evaluation

(i) If it does not appear that industrialisation and population growth have resulted in any fundamental change in the Colony's system of public finance, what, then, of the opposite question: had the public finance system contributed to the Colony's successful industrialisation and, therefore, to its ability to employ the increased population? Certainly, there have been a number of favourable consequences of the public finance system.

In the first place, the fact that the Government's financial operations have not caused inflation or balance of payments problems has been favourable to industrial growth. Of course, a government does not necessarily preclude the possibility of inflation simply because it follows conservative financial principles: price rises might occur through bank credit creation, bottlenecks, or, what is especially relevant, more expensive imports. As we saw in Chapter 3, the freedom from balance of payments problems has been of benefit to industry (foreign capital has been attracted and there has been no restriction on raw material imports), to entrepot trade and to the Colony's flourishing tourist industry.

The low tax burden must have been favourable to industrial development in several ways. Economic initiative could have been little discouraged by taxes; businesses have been able to reinvest a large part of their earnings (and retained profits appear to have been the major source of funds for investment in industry), and the

1 Though, with the 100 per cent foreign exchange reserve against the currency issue, this is relatively unlikely.
low taxes have probably helped compensate for the political risk. Certainly, the low taxes have contributed to the quick turnover of capital which is a feature of investment in the Colony. The very light tax burden and the lack of Government interference in business activities almost certainly have permitted Hong Kong to make best use of the factor most important to its economic development - entrepreneurship.

It is unlikely that an increase in investment incentives over the present level or the introduction of tax holidays or subsidies, would significantly affect the rate of investment in industry. Tax payments are one of many factors which affect investment decisions; businesses must also consider the availability of markets, the supply and productivity of labour, the availability of capital and political factors. So long as tax rates are low, further concessions would be of little value. The needs of the entrepot trade and tourism, and the fact that in most products present output greatly exceeds the requirements of the home market, rule out the possibility of tariff protection for local manufactured goods.

The economy has also benefited from the large Government investment in infrastructure and low cost housing. The financing of this investment mostly from current revenue surpluses seems not inappropriate given the underdeveloped capital market and the shortage of long term funds.

But the Government's approach to public finance has not been free from criticism. Within Hong Kong, opposition has been voiced particularly to the limited government spending on education, health and social welfare. That Government spending in these fields has been increased was seen in Table 9.4. The criticism is that expenditure has been insufficient to meet the demands of the Colony's

1 For example, it is claimed that the small spending on education, especially technical education, has contributed to the shortage of skilled labour which is now restricting some lines of industrial expansion.
larger, more settled and more prosperous population. The view has been strongly put by L.F. Goodstadt:

has the time not come to use our financial strength to meet the legitimate aspirations of the community at large? Surely there is something unseenly in the Governor's promise that not before 1971, will there be a subsidised primary school place for every child between 6 and 12 years of age. Can there be any doubt, too, that our medical services are too thinly spread and far too expensive to serve adequately the needs of the population? ... With official recognition of the fact that the problem of slums cannot be ignored much longer and that a solution must be found to overcrowding in public housing - to say nothing of the squatter colonies that continue to mar the face of Hong Kong - surely current spending on housing cannot be considered sufficient. And how much human misery is conditioned by our failure to increase the funds spent on social welfare from the present, beggarly, 1.1% of the budget.1

And, it is said that the Government is especially unwilling to undertake new spending of a recurrent nature:

Generous in capital expenditure our Government is parsimonious in the extreme when any programme is proposed which involves recurrent spending.2

(ii) The earlier discussion mentioned that the Government has not sought to use budget balances as a means of stabilising the economy. The question must now be asked whether there is a need for a counter-cyclical policy, and, if so, what contribution might be expected of fiscal measures.

A first point is that short term fluctuations have been much less severe than in most developing countries, especially those whose prosperity is dependent on one or two agricultural commodities. But there have been periods of slump - such as in 1950/51 and in the real estate sector in 1965/66 - and of relative boom, as, for example, in the period 1959 - 1964.

In an economy such as Hong Kong's there has been little need for a stabilisation policy during the recent periods of expansionary

1. FEER, 9 March 1967. See, too, speeches by Unofficial members of the Legislative Council, quoted in SCMP, 14 and 15 March 1968.
2. FEER, 12 November 1964.
economic conditions. With the high marginal propensity to import and the convertible currency, increases in demand have quickly spilled overseas. But the internal effects of boom conditions may well become a problem as the domestic sector grows in importance.

Another period of very rapid building construction could, for example, bring about an expansion of demand and a general increase in wage rates which are out of line with the Colony's trade earnings and the competitive position of its export industries. A reaction to this type of boom could then result in resources being left idle on a greater scale than has previously been experienced. It follows that there may in the future be more need for a stabilisation policy than has yet arisen. The Government could move to dampen such a period of excessively rapid growth by running a budget surplus and transferring this surplus out of the Colony, or more, simply, by moving reserves from the Hong Kong banks to London.

There is a more apparent need for a stabilisation policy at the time of a slump in income and employment. Because of the limitations on the operation of monetary policy (see Chapter 11) probably the greater emphasis would need to be placed on fiscal measures: an excess of Government spending over revenue. But, as we have seen, the 100 per cent currency board system means that the Government has only a limited ability to run a budget deficit. It must finance any excess of spending from reserves, new public loan issues or foreign loans and grants; the monetary system imposes a constraint on Hong Kong public finance not felt by governments in independent monetary systems.

1 It must be remembered that the multiplier effects of a Government surplus on the level of domestic incomes would be quite small; a larger Government surplus would be necessary to bring about a given decrease in incomes in Hong Kong than in an economy where foreign trade is of less importance.

2 The latter move might more appropriately be considered a measure of monetary policy. The likely efficacy of monetary controls is discussed in Chapter 11.
Even were there to be a less than 100 per cent foreign exchange backing to the currency issue, however, there would still be a strict limit to the extent to which the Government could resort to inflationary sources of finance - at least so long as a fully convertible currency is desired. With the high marginal propensity to import, a large part of any increase in demand will spill overseas. The Government could not run a deficit financed by borrowing against new money creation for long without causing balance of payments difficulties. External imbalance would not arise were there unemployment of a Keynesian type in the economy. As was mentioned in Chapter 7, it is to the extent that the sterling exchange currency standard prevents the Government resorting to inflationary finance even in this case, that the financial arrangements are an independent constraint on the implementation of a stabilisation policy.

(iii) Because some sources of income are not subject to tax, the tax system can be criticised on the grounds that the tax burden is not distributed according to ability to pay. A full income tax, including the taxing of dividends, and the retention of estate duty (to give some, if belated, taxation of capital gains) might seem desirable on equity grounds. But the low rates of tax have made equity considerations relatively unimportant, and the present tax system has not imposed a heavy tax burden on those with low incomes.

The discussion in this Chapter has shown that the Colony's system of public finance is still conducted on very conservative lines, owing more to Gladstonian than to Keynesian principles. This public finance system has been favourable to the Colony's economic development in several ways (given the supply of entrepreneurship in the private sector, the relative absence of short term economic fluctuations and the foreign trade dominated economy).

One cannot but stress in conclusion the enormous strength of the Hong Kong public finances. At very low rates of tax and with
virtually no borrowing, the Government has financed a rapid increase in recurrent expenditure, a high level of public capital formation, and the accumulation of sizeable reserves.

There are three other sources of funds for capital formation to which attention must be directed: capital inflow, retained earnings and the international market. Unfortunately, for lack of precise information, the discussion of these sources must be at a very general level. The most serious deficiency is that no balance of payments statistics are collected. Of course, detailed information on the unorganised market and retained earnings as sources of investment funds is available for very few countries. An additional difficulty is that in many cases only a small number of enterprises are organised as public companies (whose precise information can be got from company balance sheets).

**Capital Inflow**

Capital inflow has been of considerable importance to the recent economic development. The monopolisation of the modern consumer electronics industry in the period 1968 to 1970, the real estate boom of the 1950s and the rapid expansion of the banking system throughout the post-war period have all been heavily dependent on foreign funds.

Good news of the extent of the net capital inflow can be gathered from the Colony's trade statistics, even though these show only visible trade. Statistics on external trade and movements in the identifiable foreign reserves are not yet in Table 10.1.

Despite the very large adverse balance of trade deficit (Row 5) there has been in every year but one since 1963 an increase in the Colony's identifiable foreign exchange reserves (Row 07). From this we can calculate the apparent net surplus on the invisible and capital accounts, which has varied from $1,320 million in 1963 to $3,160 million in 1970. But there is no way of dividing this statistical series between net capital inflow and net earnings from...
Chapter 10
OTHER SOURCES OF FINANCE

There are three other sources of funds for capital formation to which attention must be directed - capital inflow, retained earnings and the unorganised market. Unfortunately, for lack of precise information, the discussion of these sources must be of a very general nature. The most serious deficiency is that no balance of payments statistics are collected. Of course, detailed information on the unorganised market and retained earnings as sources of investment funds is available in very few countries. An additional difficulty in Hong Kong is that only a small number of businesses are organised as public companies (thus little information can be got from company balance sheets).

Capital Inflow

Capital inflow has been of fundamental importance in the recent economic development. The establishment of the modern cotton spinning industry in the period 1948 to 1950, the real estate boom of the 1950s and the rapid expansion of the banking system throughout the post-war period have all been heavily dependent on foreign funds.

Some idea of the extent of the net capital inflow can be gathered from the Colony's trade statistics, even though these show only visible trade. Statistics on external trade and movements in the identifiable foreign reserves are set out in Table 10.1

Despite the very large adverse balance of trade deficit (Row 5) there has been in every year but one since 1955 an increase in the Colony's identifiable foreign exchange reserves (Row 6). From this we can calculate the apparent net surplus on the invisible and capital accounts, which has grown from $1,270 million in 1955 to $3,260 million in 1966. But there is no way of dividing this statistical series between net capital inflow and net earnings from
Table 10.1

BALANCE OF TRADE AND NET CHANGES IN IDENTIFIABLE FOREIGN RESERVES, 1955 TO 1966

<table>
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<tr>
<td>1) Exports f.o.b.</td>
<td>1,003</td>
<td>1,115</td>
<td>1,202</td>
<td>1,260</td>
<td>2,282</td>
<td>2,867</td>
<td>2,939</td>
<td>3,317</td>
<td>3,831</td>
<td>4,428</td>
<td>5,027</td>
<td>5,730</td>
</tr>
<tr>
<td>2) Re-exports f.o.b.</td>
<td>1,531</td>
<td>2,095</td>
<td>1,864</td>
<td>1,728</td>
<td>995</td>
<td>1,070</td>
<td>991</td>
<td>1,070</td>
<td>1,160</td>
<td>1,513</td>
<td>1,802</td>
<td>2,126</td>
</tr>
<tr>
<td>3) Total exports</td>
<td>2,534</td>
<td>3,210</td>
<td>3,016</td>
<td>2,989</td>
<td>3,277</td>
<td>3,938</td>
<td>3,930</td>
<td>4,387</td>
<td>4,991</td>
<td>5,941</td>
<td>6,829</td>
<td>7,856</td>
</tr>
<tr>
<td>4) Imports c.i.f.</td>
<td>3,719</td>
<td>4,566</td>
<td>5,149</td>
<td>4,594</td>
<td>4,949</td>
<td>5,864</td>
<td>5,970</td>
<td>6,657</td>
<td>7,413</td>
<td>8,707</td>
<td>9,274</td>
<td>10,382</td>
</tr>
<tr>
<td>6) Net change in identifiable foreign reserves</td>
<td>85</td>
<td>-10</td>
<td>50</td>
<td>195</td>
<td>171</td>
<td>220</td>
<td>6</td>
<td>447</td>
<td>325</td>
<td>942</td>
<td>734</td>
<td></td>
</tr>
<tr>
<td>7) Apparent balance on invisible and capital account</td>
<td>1,270</td>
<td>1,346</td>
<td>2,183</td>
<td>1,800</td>
<td>1,843</td>
<td>2,146</td>
<td>2,046</td>
<td>2,717</td>
<td>2,747</td>
<td>6,153</td>
<td>3,260</td>
<td></td>
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</table>

Sources: Rows 1) to 5): *Hong Kong Trade Statistics*, various numbers.
Row 6): Table 3.4.
invisibles. The latter item includes earnings from banking, financial and commercial services and tourism, and remittances from overseas Chinese. It seems unreasonable to assume, as does one author,\(^1\) that virtually the whole of the balance of payments deficit is covered by foreign investment (in which is included, presumably, remittances from overseas Chinese), for an entrepot such as Hong Kong would receive a considerable income from a range of invisible services.\(^2\) One must also consider - as does Table 10.1 - changes in the level of foreign reserves. Still, it seems that a large part of the favourable balance of invisible and capital accounts is due to net capital inflow, as the following discussion shows. In the absence of statistics, one can only discuss in a general way the several changes in the post-war capital inflow and repeat the few rather adventurous estimates which have been made of the possible magnitude of these flows.

(a) Early post-war 'hot money'. The economic and political changes on the Chinese mainland in the early post-war years gave rise to a very large inflow of 'hot money' into Hong Kong, especially from Shanghai. Once transferred to the Colony,\(^3\) the funds were mostly held in liquid form - in currency or deposits - or used for speculative purposes - the purchase of gold, foreign exchange and commodities. Investors remained in a position to move their funds to other financial centres at short notice. There was some criticism in the Colony's financial circles of this accumulation of highly liquid funds:

2 This was pointed out in a review of Smith's paper. See L.F. Goodstadt, FEER, 27 October 1966, p.238.
3 The funds were transferred in a variety of ways, including in the form of precious metals and currency notes, and through the Hong Kong - British and native - banks. In many cases funds were transferred from deposits in the United States.
The Shanghai psychology which by now has become an inveterate characteristic to make money by manipulation and speculation rather than producing is preventing serious and long range investment and planning.1

The inflow of hot money from China reached its peak in 1949. It has been estimated that from 1947 to 1949 this capital inflow totalled about $2,000 million,2 while the inflow in the one year 1949-50 has been valued at around $1,000 million.3 The capital transfers were often associated with, or followed by, immigration, and soon, of course, the funds lost their identity as 'foreign capital'.

It appears that the larger part of this refugee capital was held in liquid form until the early 1950s, when investment in real estate became more common.4

(b) Early post-war foreign investment in textiles. Of more significance in the longer run was the inflow of capital into cotton spinning. Between 1947 and the end of 1950, Shanghai industrialists invested about $140 million in establishing the Colony's first cotton spinning mills.5 Equipment was of the most modern design. There was, in many cases, an associated migration of experienced managers and technicians. As was seen in Chapter 1, the cotton spinning industry expanded rapidly and formed the basis of the Colony's post-war industrial growth.

(c) Capital inflow from the overseas Chinese. Throughout the post-war period there has been a significant inflow of capital from overseas Chinese, including those living in the United States. There

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1 FEER, 12 November 1947, p.576.
2 Wong Po Shang, The Influx of Chinese Capital into Hong Kong since 1937, paper read at the Contemporary China Seminar, University of Hong Kong, 1958, p.5.
4 Wong Po Shang, op. cit., p.6.
5 This estimate is based on FEER, 7 April 1948, p.336.
is no way of estimating the extent of these remittances. In any case, it is difficult to distinguish between remittances sent to assist relatives and transfers made for investment purposes. Moreover a part of the remittances - thought now to be fairly small\(^1\) - is sent on to China. In the late 1950s a considerable part of the capital inflow from the overseas Chinese was invested directly in real estate - and in 1960 and 1961 on the share market - but the greater proportion seems now to be left on deposit with banks. Small amounts have been invested directly in manufacturing. Of course, a part of the remittances is sent for switch transactions, being transferred through the Colony's free currency markets to Switzerland and North America.

It has been estimated that in the mid-1950s remittances from the overseas Chinese were worth some $700 million per annum, of which approximately $500 million per annum was retained in the Colony.\(^2\) Possibly the flow increased to $1,000 million a year by the early 1960s,\(^3\) but the slight recession in the real estate market after 1965 and the outbreak of Red Guard activities in China are believed to have reduced the flow of remittances to around $500 million in 1966.\(^4\) Political disturbances in South East Asia and restrictions on the commercial activities of the overseas Chinese have usually meant temporary increases in the level of these transfers.

The funds are transferred in a variety of ways. Remittances and loans by Chinese Americans can be made freely through the commercial banks, and it is also through these institutions that

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1. It is commonly estimated that only about one-fifth of remittances is now sent on to China.
2. Wong Po Shang, op. cit., pp.9-10. The source of the $700 million was estimated to be: Americas $500 million; South East Asia $150 million, and other countries $50 million.
3. SCMP, 30 July 1964.
4. Ibid., 8 April 1967.
much of the inflow of capital from Malaysia and Singapore is arranged. A large part of transfers from the United Kingdom is made through Post Office money orders. Considerable ingenuity is believed to be used in remittances from a number of South East Asian countries. Significant transfers are probably arranged through false invoicing of exports and imports. Often the transactions are arranged by Chinese currency dealers through elaborate family networks. A cousin in Rangoon, say, will take delivery of a large sum of Burmese kyats from a local client whose account in Hong Kong will be credited with the equivalent in Hong Kong dollars. In some cases, currency is physically transported, for sale on the Hong Kong exchange markets. Transfers are also effected through the sale in Hong Kong of airline tickets purchased elsewhere. And there is a range of other methods.

(d) Capital inflow from the developed countries. There has been some inflow of capital from the developed countries over almost all the post-war period. Initially, this investment often took the form of transfers from China of the Far East operations of European and American commercial enterprises. There was also from an early stage a small amount of investment in oil storage, soft drink manufacture, textiles, the production of torches, etc. But it was towards the end of the 1950s that the capital inflow from the developed countries - for the most part the United States and Japan - first became significant. Much of this foreign investment was initially centred on the production of textiles. Japanese textile firms invested in Hong Kong to avoid the quota limits which had been imposed on exports to the United States from their home plants. The several American companies sought a regular supply of

1 The remainder of this paragraph follows closely information given in SCMP, 23 March 1966.
2 For example, Mandarin Textiles was set up by United States interests in 1950.
textiles of specified quality for their U.S. marketing networks. It was capital from developed countries which largely pioneered (from about 1962) the production of transistor radios, and this industry is still dominated by foreign companies. The largest individual investment from a source in a developed country appears to be the $220 million (US$40 million) in electricity generation by the Esso group, announced in 1964. There has also been American and Japanese investment in export-import firms, steel rolling, toy production, hotels and department stores. Often the foreign investment has been made in joint enterprises, with local sources providing about half the risk capital. The Government has publicised the advantages of such joint ventures both for the Colony and for the foreign investors, and several trade missions have attempted to foster foreign interest in joint undertakings.

The capital inflow from the developed countries has benefited the Colony in several ways. The most important are the new techniques and goods introduced, the relatively high standard of management and quality control, and, in several cases, access to established marketing networks in the United States. The actual capital gained has been much less important. The total investment of the United States companies was estimated at US$15 million in

1 Among the largest manufacturers of radios in Hong Kong are Semi-Conductor Ltd, a subsidiary of the U.S. Fairchild Camera and Industry Corporation, and Oak Electrics, also a subsidiary of a large United States concern.

2 See Joint Venture Hong Kong, Hong Kong Government Printer, 1966.

3 See FEER, 8 October 1964, p.113. At one stage the Hongkong Bank was reported to have 'taken the initiative in bringing selected British manufacturing firms into contact with Hong Kong interests with the object of setting up joint manufacturing enterprises in the Colony'. FEER, 3 October 1963, p.4.

4 Thus the Chairman of the Hongkong Bank observed in 1962 'A relatively recent factor in the evolution of our economy has been the collaboration between Chinese industrialists and those of other countries in setting up new factories here. There is a need for new techniques and "know how" rather than investment of capital, of which there is no shortage.'
1959,\(^1\) and US$100 million in 1967.\(^2\) The total investment in Japanese companies in Hong Kong did not exceed $50 million at the end of 1966.\(^3\)

No special concessions or incentives have been given to foreign investors. As an American commentator has pointed out:

Hong Kong does not have a foreign investment law and does not need one. It gives foreign capital no privileges and no special status, but throws no roadblocks in its way either. The money comes in because the conditions are attractive.\(^4\)

Among these favourable conditions are the relatively cheap labour force (which is experienced in manufacturing activities), low taxes and a minimum of Government controls, excellent shipping and other commercial services, and, most important, a fully convertible currency. Of course, as is the case with local investment, most foreign funds look for a relatively quick return - the main exception appears to have been the Esso group's investment in electricity generation - but there is no evidence that, in general, foreign investors seek a more rapid turnover of funds than local investors.

The aggregate 'foreign' investment in Hong Kong would be considerably larger were we to treat as 'foreign' concerns the several sizeable British merchant houses which operate in the Colony.\(^5\) But these institutions, which have invested considerable amounts in Hong Kong, mostly from retained earnings, have long been associated with the Colony, and commonly consider themselves as local firms.

(e) Official loans and grants. Hong Kong has received relatively small sums by way of loans from government and international agencies. An interest-free loan of $48 million was

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\(^1\) **FEER**, 20 August 1959, p.267.


\(^3\) **SCMP**, 11 May 1967.

\(^4\) **FEER**, 14 June 1962, p.573.

\(^5\) The activities of these houses were described in Chapter 8.
received from the United Kingdom Government in the late 1950s to finance airport construction. Small sums have been received from the Commonwealth Development Corporation to finance a variety of schemes, including fishing boat mechanisation and university housing. The Corporation subscribed $16 million to the capital of the Hong Kong Building and Loan Agency. An approach to the World Bank for a loan to finance a reclamation or water storage scheme in 1962 was unsuccessful. The World Bank decided that Hong Kong was not, at that stage, sufficiently in need of credit. A mission from the World Bank visited the Colony again in late 1966, and a representative visited Hong Kong in March 1968. The Colony has not received loans from other international agencies. Being a dependent territory, Hong Kong is not a member of the International Monetary Fund.

Foreign government and private agency spending and grants have been more important. The United Kingdom Government has spent around £5 million to £6 million per annum on the Colony's defence, of which perhaps one third is paid out locally. A range of national and international charity and missionary organisations have provided funds for education, health and relief services. One estimate in 1962 put the annual Hong Kong expenditure of private United States bodies alone at around US$6 million. Since 1959 the Government has received about $10.5 million from World Refugee Year sources.

Clearly, the form of the capital inflow has changed appreciably over the post-war period, from the frantic influx of hot money in the late 1940s to the more regular inflow of funds from the overseas Chinese, and a smaller capital import from developed countries. Of course, through the whole period foreign investors have favoured outlets of a relatively liquid and short term nature.

On several occasions concern has been expressed that the capital inflow was excessive. On the one hand, the capital movement was seen as adding to inflationary pressures:

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There has been a phenomenal rise in local share and land values and it is doubtful whether the peak has been yet reached. Much of the demand seems to have come from overseas funds seeking investment... so much of the post-war development in Hong Kong has been due to an influx of capital from abroad that one would not like to discourage the flow, but I think that there is little doubt that the present volume is unhealthy.¹

There have been fears, too, that a sudden inflow of capital might take place:

Indeed my concern recently has been rather that the net inflow has been excessive; already a very high proportion of our bank deposits belong to non-residents and this could be a potentially unstable factor in our economy if we were to do anything to upset confidence.²

Despite these apprehensions, it is apparent that capital inflow has played an overwhelmingly important role in the Colony's economic transformation and rapid economic development.

Even less is known about capital outflow. Throughout the post-war period considerable sums have left Hong Kong for deposit in banks in North America, Switzerland and the United Kingdom, mainly as a hedge against the political risk. Of course, part of these funds was earlier transferred to Hong Kong from countries in South East Asia for switch operations. Foreign brokering houses and investment services operating in Hong Kong have also undertaken a large amount of business.³ These companies advertise extensively in the local press. Hong Kong residents have invested in real estate in North America, Australia and the West Indies, to diversify their assets and, in some cases, to aid later migration. Local merchant firms have invested considerable funds in a range of subsidiaries in South East Asia, Australia and elsewhere. A number of local manufacturing firms have invested overseas - mainly in textiles and metal goods - for several reasons, mainly, it is claimed, because

² Financial Secretary, SCMP, 31 March 1967, p.10.
³ See above, p.197.
of the availability of pioneer tax concessions and cheap land. But the imposition of quota restrictions on the export of Hong Kong-produced goods, and the political risk have possibly been more important considerations. During the 1967 disturbances Hong Kong was a net exporter of capital.

**Retained Earnings**

One cannot observe the Hong Kong economy without being left with the strong impression that to all business units, from the smallest manufacturer or retailer to the giant industrial, commercial and utility company - as, indeed, is the case with the Hong Kong Government - retained earnings are the main source of funds for capital formation. The observation of the Economist Intelligence Unit on industrial enterprises applies also to other sectors of the economy:

In almost every case of which we have personal knowledge, the funds for investment in an industrial enterprise came initially from the pockets of private individuals (including, of course, immigrants from the mainland and overseas Chinese) or, what usually amounts in practice to the same thing, from locally owned private companies. There are some notable exceptions in large-scale industries, but they are few and far between. Once launched, most firms rely principally on their own profits for long-term capital and on the banks, on private lending or again on their own profits for short-term finance. The degree of self financing in Hong Kong industry is indeed abnormally high; a number of substantial firms rely exclusively on their own resources.

There are several reasons for this heavy reliance on internal finance. The political uncertainty has discouraged the development of the longer end of the capital market, forcing even the larger firms to rely more heavily on retained earnings than is the case elsewhere; for companies, as for the Government, the supply of long term funds is very limited. Many firms too, are unwilling to make available the financial information on their operations and capital required for outside borrowing and public share issues. And, the

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very fact that much of Hong Kong commerce and industry consists of family-owned businesses and not public companies means that a high proportion of profits can be retained for re-investment. Some sizeable, progressive businesses have, for some years, used all their profits to finance expansion. It is most unlikely that the shareholders of a public company would favour the same policy.

Table 9.7 gave some idea of the trend in business profits over recent years, and showed a rapid rate of increase in the aggregate level of profits. Thus, the scope for investment financed from retained earnings has grown quickly. The low rate of taxes on profits has permitted the re-investment of a significant portion of gross profits.

A perhaps unusual but most important aspect of business saving in Hong Kong has been the tendency for business profits earned in one field to be retained and re-invested in another field. Funds earned in trade during the Korean War boom were spent on property development, and in turn, the profits of real estate operations were invested in the establishment of manufacturing businesses. Probably the main reason for this mobility lies in the dominant position of the Chinese family-firm. Often these businesses operate in a number of fields at the one time and are quick to direct earnings to investment in the currently most profitable lines. The small size of the Colony, the limited amount of capital needed to commence operations in most sectors of the economy and, in the case of manufacturing activities, the availability of established marketing facilities through the agency houses, have also contributed to the mobility of funds.

1 For example, it has been reported that the owner/manager of China Cold Storage and Engineering (which 'caters for a third of the local room cooler market, enjoys a thriving export business and has a much-valued contract to make Westinghouse air-conditioners under licence') 'ploughs back all of China Cold Storage's profits into the business, living personally from his other family income.' Dick Wilson, op. cit., p.22.
The Unorganised Market

In the unorganised market secured and unsecured loans are made by money lenders, private loan businesses, merchants, landlords, and a variety of other sources, including relatives. Such markets exist, of course, in both developed and underdeveloped countries. But they are usually thought to be of greater importance in the underdeveloped countries, and especially those with large rural sectors.

The Industrial Bank Committee observed that privately-supplied finance may take the form either of direct risk investment or of loans against security, or even against no security. The former is most often on a friendly basis. For the latter there is no formally organised market, but a market of sorts operates, equipped with brokers, etc. The most normal security is a mortgage on land; plant and machinery may also be used as security, the loan often being in the form of a debenture. The sources of such funds are profits of business, including the very rapid redemption of capital invested, personal savings and proceeds of sale of land (particularly against imported capital). The appreciation of real estate and stock exchange values has played a large part in the mobilisation of capital in post-war Hong Kong. It is not possible even to attempt an estimate of the amount of money so invested.1

The main borrowers on the unorganised market over most of the post-war period have been the real estate developers. The high profits available in this sector and the security of real estate developments gave these borrowers the advantage in the unorganised market. The numerous small manufacturing businesses have also been important borrowers. Many of these businesses are thought to have used their limited capital resources to acquire some meagre capital equipment, and, lacking adequate security, 'name', or a confirmed order against which to borrow even from the liberal Hong Kong banks, are forced to turn to the private money lenders for their working capital.

Recourse to the unorganised market is also made for loans for personal, non-productive purposes, including expenses connected with weddings and funerals. Mrs Topley has suggested that in such cases smaller sums are arranged person to person, while larger

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amounts are borrowed from landlords, money lenders, etc. She refers to a 1957 survey of families in a resettlement estate, which found that 22 per cent of adults were in debt to relatives, friends or clan.¹

Borrowing from the unorganised market is mostly on a short term basis and even loans for productive purposes are rarely for more than one year. Despite the prevailing price stability, interest rates range to very high levels (30 - 40 per cent). In late 1966 press reports suggested that secured loans for productive purposes were being granted for three years at a non-reducing 20 per cent per annum and an initial service charge of twelve per cent.

Chapter 11

THE NEED FOR A CENTRAL BANK

Hong Kong's continuing colonial status is no doubt one reason why it is probably the only important economy in the world which does not have a central bank. No central banks were set up in the British Colonial Empire in the 1920s, when such institutions were established in a number of underdeveloped countries mainly to assist the working of the international gold standard;\(^1\) the existence in the British Colonies of the sterling exchange standard or - as in Hong Kong - of currency systems based on precious metals made the establishment of such regulatory institutions seem unnecessary.

Another large group of central banks has been formed in underdeveloped countries since the second world war, in large part, it is said, as 'an expression of monetary independence by new states'.\(^2\) Most of these recently established central banks were set up about the time of their country's independence to implement the monetary controls, and assist the economic development programs, of the newly independent governments.

But this is not a full explanation. There is no reason why a central bank cannot be established in a colonial framework, especially where there is a developed commercial banking system. It is not so much that the Government is a colonial one, but rather that it is a Government with a laissez-faire approach to its role in the economic system, that explains the absence of an official central bank.

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2 Gethyn Davies (ed.), Central Banking in South and East Asia, Hong Kong University Press, 1960, p.vii.
Of course, the fact that there is no official central bank does not mean that Hong Kong has been without all the functions usually described as 'central banking' ones. It was seen earlier that the currency issue is the responsibility of the note issuing banks and the Government, while the sterling backing to the banknote issue is held in the Exchange Fund and the Hong Kong dollar-sterling exchange rate can move only within the limits set by agreement between the Fund and the note issuing banks. The liberal system of exchange control is administered by the Government. The Hongkong Bank and the Chartered Bank have acted as bankers to the Government. The Hongkong Bank performs the functions of the central clearing house.

On a number of occasions these two British banks have provided lender of last resort facilities to other commercial banks. In the 1965 banking crisis they were assisted in this by transfers from the Government's London reserves. Deposits are held by many commercial banks with the Hongkong Bank and the Chartered Bank to provide first line cash reserves in Hong Kong. Banking licences are issued by the Governor-in-Council, and banking supervision is administered by the Commissioner of Banking. There is no official credit policy, but on one or two occasions the largest banks have acted to discourage speculation. The Government is advised on economic matters by its Economic Secretariat.

Discussion on the Need for Establishing a Central Bank

Discussion on whether or not a central bank should be established seems to have started around the time of the 1961 banking crisis and the Tomkins Report. The discussion - one can hardly call it a debate - is outlined in this section and commented on in the following section.

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1 The discussion was stimulated by the currency readjustment of November 1967, during which the commercial banks were compensated from the surplus in the Exchange Fund because they had earlier been required to perform 'central banking' functions. See above, Chapter 3, and more particularly, SCMP, 9 December 1967 and Sunday Post - Herald, 10 December 1967.
The Tomkins Report itself saw no need for the establishment of a central bank:

It has been said quite rightly that commercial banking and central banking are uneasy bed-fellows, but there seems to be no pressing reason to suggest the inauguration of a statutory central bank at the present juncture, and to do so might involve Hong Kong in unnecessary expense and would certainly entail substantial changes in the present banking, currency and foreign exchange field.¹

The Report, however, qualified itself

This is a question...which is outside the terms of reference of the present report, and the foregoing comments should not be held to prejudice any possible future inquiry into the desirability of setting up a central bank in Hong Kong in the light of changing circumstances.²

The suggestion that a central bank be set up has been opposed by the note issuing banks (which have been seen as the 'sharpest critics of the central bank idea'),³ the Government and by the Commissioner of Banking. The attitude of the Hong Kong Bank has been outlined strongly by a Deputy Chief Manager,⁴ and is summarised below. There has been no clear statement of the Government's position. The Government appears to believe that the present system of commercial bank control and of providing assistance in the event of a run on commercial banks is adequate to maintain a sound banking system, that there is no need in Hong Kong for the monetary controls which are a main responsibility of most central banks and that no change is necessary in the method of issuing currency. The Commissioner of Banking has argued that the need for 'a centralised form of guidance and protection for the Colony's banking system [which is] essential to safeguard its economic future and the saving of depositors' can be provided, inexpensively, by the existing facilities for banking control and supervision, and does not justify the establishment of an official central bank.⁵

¹ Tomkins Report, p.6. ² Ibid., p.7.
³ FEER, 18 February 1965, p.307.
⁵ SCMP, 12 June 1965. A little earlier, SCMP, 31 March 1965, the Commissioner of Banking was quoted as considering a central bank to be 'expensive' and 'unnecessary'.


A number of the smaller commercial banks and several academic economists have supported the setting up of a central bank, mainly on the grounds that such an institution would strengthen the whole banking system through its provision of lender of last resort facilities. When the Tomkins Report was published, a leading local banker, Dr S.K. Yee argued

A banking system requires control but it requires just as much, or even more, an institution which can act as 'lender of the last resort' such as a central bank. Mr Tomkins recommends control but has made no recommendation for helping banks when they are in difficulties,... What we need is an institution representing a reservoir of liquidity, ready to quench thirst as well as to put out fire.¹

Later, another commentator suggested that only a central bank could provide rediscount facilities on a large enough scale although the Hongkong Bank does act, at present, as a rather reluctant 'lender of last resort' it could not, as a private commercial bank, assume this function to the degree which Japanese experience suggests may be necessary.²

Two other advantages also claimed for a statutory lender of last resort were, first, that it would lead to a better liaison with the borrowing banks (in part because it would end any present fears that the commercial banks which have acted as lenders of last resort might take advantage of their position), and, secondly, that, with a central bank to back them, the commercial banks would increase both their total lending (through a willingness to operate with lower cash ratios)³ and their lending for long-term purposes.⁴

Those opposing the establishment of a central bank have put forward two main arguments against these views. First, that existing facilities are adequate

At present the Hongkong and Shanghai Bank and the Chartered Bank habitually act as lenders of last resort.... Provided

² Gethyn Davies, 'Hong Kong Banking After the Crisis', op. cit., p.250.
⁴ S.C. Chen, FEER, 6 July 1961, p.27.
that a bank is being run on sound lines there should be no difficulty in obtaining help if it suffers a temporary shortage of liquidity; a contingency against which no bank can protect itself completely by the use of its own resources. Government have most helpfully shown that they are willing to make available such funds as are necessary to give banks the required liquidity, during and after periods of unusual stress.... There is no lack of funds or facilities available now on reasonable terms to all banks which merit support. 1

There has also been 'the extremely harsh view that the central bank would be expected to act, and would be regarded by the banks, as protection against their own irresponsibility. In other words, establishment of a central bank could cause a deterioration in local banking practice'. 2

There has been less discussion on the need for a central bank to act as regulator of the monetary system. Dr Yee appears to have supported the establishment of some form of credit control

In the absence of a central bank credit policy, one of the key levers which control a modern economy, must be left to the discretion of the management of the commercial banks; and it is difficult to see how these banks, which have to earn profits for their shareholders can work it out in the best interest of the economic life of the Colony. Control of finance is a most essential step to the control of the whole economy. 3

A leading academic writer on the Hong Kong economy has also supported the setting up of a central bank to control the Colony's money supply. This it could influence, he suggested, through statutory reserve requirements and through its operations in the Colony's gold and foreign exchange markets. 4 More generally, it has been argued that, although there may be little need for monetary policy at present, this may not be the case in the future

there is no formal credit policy in Hong Kong, nor is one likely to be instituted in foreseeable circumstances. The level of income and the volume of money are determined

1  R.G.L. Oliphant, op. cit., p.177.
2  David Williams, 'Hong Kong Banking', op. cit., p.41. See also R.G.L. Oliphant, op. cit., p.179: 'The demand for a central bank probably arises from much the same misconception as does the demand for an Industrial Bank, i.e. that it would be a fairy godmother lending wholly or largely on trust. It most certainly would not.'
by the balance of payments; any central bank influence in this almost mechanical relationship could lead to inflationary financing which might endanger the parity of the Hong Kong dollar with sterling. However, in the longer run, the time might come when specific credit policies will need to be implemented to stabilise the economy. It might be a useful hedge against future difficulties to establish an institution which, at the least can do no harm to the financial structure, and might in fact do some useful work in strengthening that structure over time.1

Against these arguments, Mr Oliphant asks is such control [as would be required to implement monetary policy] either necessary or desirable? Hong Kong is one of the last bastions of free trade and does not take kindly to controls, even when they appear to be necessary. When, as in this case, they do not, it is hardly to be expected that Government would try to enforce them, or, in that unlikely event, that they would be readily accepted.2

The expense involved in the establishment of a central bank has been mentioned by several commentators, most strongly by Mr Oliphant

A Central Bank would be an expensive luxury because it would need a highly qualified Governor and a staff adequate to perform all its functions, all of whom would have to be paid, housed and provided with office space, and there would be no commensurate benefit.3

Against this cost, though, could be set the 'administrative tidiness' resulting from the transfer of 'all the various elements of central banking control into one institution'.4

Is There a Case for Establishing a Central Bank?

We can analyse what justification there may be for establishing a central bank in Hong Kong by taking, in turn, the several 'typical' central banking functions. This section highlights the fields in which one might expect a central bank to make a significant contribution; it does not seek to give an overall assessment of whether or not such an institution should be set up.

1 David Williams, op. cit., pp.40, 43.
3 Ibid., p.179.
4 David Williams, op. cit., p.41.
(a) Currency Issue. Most central banks maintain a monopoly of the issue of legal tender currency. In part this is because currency is one component of a country's money supply, the determination of which is a main responsibility of central banks. By arranging the issue of currency, a central bank also gains command over the resources held as currency backing. There is the further advantage, especially significant for a newly established central bank, that responsibility for the currency issue can add to the institution's prestige and standing.

The main advantages and disadvantages of the Hong Kong currency system were outlined in Chapter 3. Briefly, these are, on the one hand, the currency issue is fully convertible into sterling at a fixed exchange rate and there is no danger of an oversupply of currency, and, on the other hand, the 100 per cent sterling backing to the currency issue means some sacrifice of investible funds and the gold value of the Hong Kong dollar is dependent on the international value of the pound sterling. Modification of the present currency system to permit a small fiduciary issue would not, in itself, require that a central bank take over the issue of notes and coins. Perhaps a stronger case could be made for setting up a central bank were it feasible for such an institution, by diversifying the assets of the Exchange Fund, to give the Hong Kong dollar a value in terms of gold independent of that established through its link with sterling - i.e. to make Hong Kong more of a 'Switzerland of the Far East'. But, as we have seen, this diversification might not be a practical policy.¹

It was argued, too, that the commercial banks do not benefit excessively from their right - now an unusual one for privately-owned institutions - to issue legal tender banknotes.

(b) Banker to the Government. In most countries, the central bank holds the government's accounts and arranges government

¹ See above, p.92.
transfers; it issues government securities and is agent for the
government debt; it provides financial accommodation to the govern-
ment; it is responsible for developing the market in government
securities; and it acts as the government's financial adviser. But,
there is possibly less scope for a central bank to operate as
Government's bank in Hong Kong than in most countries.

First, to ensure that the deposits of the Hong Kong Government
could be withdrawn at short notice - which may be necessary in the
event of a recession - the central bank would have to hold liquid
sterling assets against a high proportion of its liabilities to the
Government. Given this requirement, it is unlikely that a signifi-
cant part of the Government's reserves at present held in London
could be transferred to Hong Kong. A central bank would, though,
permit the establishment of official control over the use made of
Government reserves held locally. These reserves have in the past
been under the control of the private banks. But there are few
outlets for such funds in Hong Kong which can provide the necessary
degree of liquidity.

Secondly, there is relatively limited scope for the central
bank's role as agent for the public debt. The present level of
debt is far too small to require its administration by a central
bank. The earlier discussion on public finance suggested it is
unlikely the Government will rely significantly on borrowed funds
in the future: there is probably still scope for an increase in
taxes, and, most important, the political uncertainty discourages
public and institutional investment in all but short-term paper.
On the other hand, as Malaysian experience shows, a central bank,
by providing rediscount facilities and direct support, and by advis-
ing the government on the type and volume of securities offered to
the market, can significantly assist the development of a local
securities market.¹ That is, a central bank could usefully assist

the Government in tapping what support there is for an issue of securities.

The establishment of a local liquid assets ratio for the commercial banks would aid the development of the local market in Government paper. But this type of provision, which was of some importance in the growth of the Malaysian security market, may be less practicable in Hong Kong, where a very large part of bank deposits is owed to overseas depositors, and, as a consequence, the banks seek to cover themselves against the risk of large-scale withdrawals by holding a sizeable portion of their liquid assets in foreign financial centres.

The establishment of a central bank might also permit the Government to economise a little on its holding of reserves: the bank could provide limited financial accommodation to the Government from its own resources and there would be a slightly wider market for Government securities.

The role of the central bank as adviser to the Government would be especially useful were it able to collect some of the information (for example, on the balance of payments, the rate of capital formation, sources of company finance and the effects of the Government's financial operations) which would give a fuller understanding of the economy. But this information could, instead, be collected by a department in the Government's Secretariat.

(c) Bankers' Bank. There are two aspects to the possible role of a Hong Kong central bank as bankers' bank. First, the central bank could provide 'service facilities' to the commercial banks, such as clearing house arrangements and holding the first line liquid reserves of the commercial banks. But there appears to have been little complaint with the way these services have been provided by the note issuing banks. It is on the second aspect of a central bank's role as bankers' bank - the provision of official lender of

1 Ibid., p.138.
last resort facilities - that most support for the establishment of such an institution has been based.

Until the office of the Commissioner of Banking was set up in 1964, any local commercial bank short of cash had to approach directly either of the two large British banks. While there is no suggestion that any well-run bank was refused assistance, the small banks appear to have been apprehensive that this arrangement placed them unfairly at the mercy of their larger competitors. This attitude - whether or not it was soundly based - perhaps made the smaller banks reluctant promptly to request assistance. More important, the absence of official responsibility to support commercial banks experiencing liquidity shortages may have had an unfavourable effect on depositors' confidence.

But these arguments for establishing a central bank have lost much of their force since the office of the Banking Commissioner was set up. Commercial banks short of liquid assets can now request assistance through the Commissioner. This arrangement makes for better liaison, and overcomes any apprehension that advantage would be taken by the lending institution. It was also through the office of the Banking Commissioner that the Government was approached to bolster the liquid asset holdings of the local banks by transferring reserves from London. Presumably, a similar request for assistance would be made by the Commissioner during any future crisis. Thus, although no institution has been designated a statutory lender of last resort, any well-run commercial bank - i.e. a commercial bank which meets the provisions of the Banking Ordinance - can expect assistance through the Banking Commissioner should it experience a temporary shortage of cash. This assistance would be provided by the note issuing banks or from Government reserves.

There is, then, an apparently adequate - if unusual - mechanism for providing lender of last resort facilities. It is unlikely that

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1 See Commissioner of Banking, quoted SCMP, 11 January 1966.
the establishment of a central bank would bring other than an administrative change in the provision of these facilities.\(^1\)

Certainly, the central bank could not permit the commercial banks to borrow from it on the substantial and continuing scale permitted in Japan (where, because of central bank credit, the level of the commercial banks' loans and advances has for some time exceeded that of deposits from the public).\(^2\) The need to hold a high foreign exchange reserve against the currency issue would limit the extent to which a Hong Kong central bank could provide rediscount facilities. Its credit would be designed to meet the commercial banks' temporary demand for cash - and as such would carry penal rates.

The provision of central bank credit on the scale given in Japan could result in currency inconvertibility.

There is still the question whether sufficient support could be provided to meet depositors' demands in the event of a severe political crisis. But in such a case, there might be little that even an official central bank could do.

(d) Administration of Exchange Control and Determination of Exchange Rates. In most countries the central bank is responsible for determining exchange rates, administering the system of exchange control and maintaining the country's reserve of precious metals and foreign currencies.

The very liberal system of exchange control has been outlined. It was seen, too, that a fully convertible currency is desirable for several reasons, including: the needs of the entrepot trade; the non-economic advantage of ensuring that China can convert its foreign exchange earnings in Hong Kong into other currencies; the Colony's appeal to the overseas Chinese and other foreign investors,

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1 There seems to be no reason for suggesting that the smaller banks would more readily approach a central bank when in difficulties than they would approach the Commissioner of Banking. Probably, the small banks would be less apprehensive in turning to either the Banking Commissioner or a central bank than to the note issuing banks.
2 See above, p.268.
who are attracted by the freedom with which they may later transfer funds from Hong Kong; and the likelihood, perhaps greater in Hong Kong than in most countries, that a black market in foreign currencies would quickly make most controls ineffective.

These considerations would severely limit the activities of a central bank in the foreign exchange field. Still, a central bank would almost certainly be better placed than the Government to discourage — for example, by varying interest rates — part of the capital outflow of a period of economic or political crisis. And, with an established central bank the problem of compensating commercial banks for any exchange losses they might suffer as the result of a future sterling devaluation would not arise.

(c) The Development of the Capital Market. An important objective of many central banks in underdeveloped countries is to encourage the development of local money and capital markets. This they can do in several ways, such as providing official discount facilities and support for the government securities market, encouraging and assisting the flotation of private share issues, inducing commercial banks to hold more local assets and establishing and financing various development corporations.

We have seen that the Hong Kong capital market has developed over the postwar period without guidance and assistance from a central bank. Important constraints on the development of the local capital market have been the political uncertainty, which discourages much equity and long-term investment, and the opposition of many business enterprises to any change to public company status. These same factors would doubtless also limit the extent to which a central bank could develop the local capital market. But, within these constraints, there is probably some scope for central bank action, through the measures mentioned already, to broaden and strengthen the capital market.

In a number of countries — for example Malaysia1 — central banks have encouraged commercial banks to build up the portion of

their assets held locally. Although it is, of course, always difficult to say exactly what is the correct combination of local and foreign assets, a Hong Kong central bank might periodically review the geographical distribution of the commercial banks' assets, to see whether any serious imbalance has occurred.

(f) Control and Regulation of Commercial Banks. Commonly, central banks are responsible for the general supervision and control of commercial banks. This function seems to be adequately performed in Hong Kong under the present arrangement in which the Governor has final responsibility for the provisions of the Banking Ordinance and day to day supervision is the concern of the Commissioner of Banking.

(g) Monetary Policy. The implementation of monetary policy is often seen as the main responsibility of a central bank. In the view of one authority

The essence of central banking is discretionary control of the monetary system.... Central banking is an institutional arrangement which may be made to serve any one of a number of purposes. The choice of purpose - the object of monetary policy - is not irrelevant to the choice of method: a community might hope more reasonably in some cases than in others to attain its ends by making its monetary system work to rule. And working to rule is the antithesis of central banking. A central bank is necessary only when the community decides that a discretionary element is desirable. The central banker is the man who exercises his discretion, not the machine that works according to rule.\(^1\)

In many territories which earlier employed the sterling exchange standard, central banks have been established specifically to break the rigid and disadvantageous link which had supposedly existed between the balance of payments and the supply of money.\(^2\) In Hong Kong, we have seen, this link is neither as rigid - because of the greater relative importance of bank credit - nor as disadvantageous - because the balance of payments is less volatile - as was claimed to be the case in many territories.

\(^{1}\) R.S. Sayers, op. cit., p.1.

\(^{2}\) See Chapter 7.
We must now ask whether there is a need for monetary policy in Hong Kong. If this need is argued, it must then be asked whether the necessary monetary controls could be introduced under the present currency board system and, finally, what scope there is for the broader range of monetary measures which might be introduced by a central bank. The first two questions have largely been answered already.

There appears to be no evidence that the supply of money has varied at an inappropriate rate in either the short or the long period: the economy has suffered neither from short-term instability nor from long-term monetary disequilibrium. But, it was seen, there may be more need for a stabilisation policy in the future. Something has already been said of the scope for fiscal policy; our present concern lies with the contribution which might be made by monetary measures and, specifically, with the role of a central bank in the implementation of these controls.

That there is some scope for the operation of a limited monetary policy under the currency board system has already been established. By transferring reserves between Hong Kong and London (regardless of whether or not there is, at the same time, a budget imbalance), the Government can exert some influence on the money supply. The extent of this influence depends on how sensitive the commercial banks are to changes in their holding of liquid assets. With a fiduciary issue, the Government would have an increased influence on the money supply. Its ability to stimulate the level of monetary demand during a depression would then be less dependent on the size of its London reserves.

Would a central bank ensure a greater degree of monetary control? There is a considerable literature on the operation of monetary policy in underdeveloped countries,1 much of which is

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relevant to Hong Kong. This literature is especially large on the
topic of the efficacy in underdeveloped countries of the traditional
weapons of central bank control - variations in the bank rate and
open market operations.

Bank rate variations would probably have little effect in a
financial system such as Hong Kong's. Some considerable time would
be required before the central bank could encourage the commercial
banks to rediscount with it, in part because many banks, including
the largest institutions, can borrow from head offices and other
sources overseas. Secondly, so long as funds can be freely moved
between Hong Kong and other financial centres, interest rates will
in general move in line with those overseas, and not follow the
local rediscount rate.

Even were the market in government securities to be developed
by the provision of rediscount facilities and a considerably in-
creased volume of transactions - the latter so that central bank
dealings would not give rise to excessive variations in bond prices
and yields - a Hong Kong central bank would probably have relatively
little scope to influence monetary conditions through open market
operations. Variations in the commercial banks' cash base would not
affect the lending policy of institutions holding excess reserves or
of banks which can obtain additional cash reserves from overseas
sources.\(^1\) Differences in the extent to which the banks hold excess
cash reserves and have access to overseas credits mean that open
market operations would not affect the numerous banks uniformly.
This discrimination, which in most cases would be against the small
local banks, might actually assist the implementation of monetary
control, but it would pose delicate problems for the central bank.\(^2\)

\(^1\) This is the same problem as was seen earlier to apply to the use
of transfers of the Government's reserves between London and Hong
Kong as a weapon of monetary policy. It would be less serious a
problem during a domestically-generated boom, in which case the
excess cash reserves would be run down and overseas lines of credit
drawn upon.

\(^2\) As David Williams has pointed out, op. cit., p.36, 'any measure
which discriminated against the local banks would, inevitably, have
political overtones'.
Similar difficulties would surround the use of variable cash reserve requirements, the control which, it has been suggested, is likely to be of more use in underdeveloped countries than the two traditional weapons of monetary policy. A central bank's attempt to cut short a domestically-generated boom by increasing required cash reserve ratios could be thwarted because a number of banks obtained funds from outside sources or ran down their excess cash reserves. Again, the central bank might be unwilling to introduce a measure with such discriminatory effects.

The considerable differences between the banks might further discourage the central bank from attempting to control the direction of bank lending. It is unlikely that any need to restrain bank lending for trade purposes will arise. Most of this credit is provided by the larger banks and the expatriate banks. Any attempt to limit new loans for real estate purposes would fall heavily on the small local banks.

It might be possible by agreement and suasion to establish some official influence over the level of interest rates. Such a policy appears to have had limited success in Malaysia, a country with a similarly close relationship to the London money market. Perhaps, though, the political uncertainty and the continuing colonial status of Hong Kong make it more difficult to convince the commercial banks that such agreements are to their long-term advantage.

There remains another weapon of monetary policy: transfers of Government reserves between the commercial banks and the central bank. These transfers would have a similar effect to the movement of Government reserves between London and Hong Kong, but without necessitating that funds leave the Colony. But there might be little that a central bank could do with deposits transferred to

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3 E. Nevin, op. cit., pp.57-8. As Nevin points out, these transfers have a similar effect to open market operations.
It, other than hold them in liquid form in London. If this were to be so, the transfers would be little different from those possible under the present currency board system.

This discussion suggests that the scope for the introduction of monetary policy is rather limited, whatever the weapons employed. The preference for a system of free and unrestricted transfers between Hong Kong and overseas financial centres, and the discouragement to the development of a money market given by the uncertainty which surrounds Hong Kong's future, are the main reasons for this limited potential of monetary policy. And, there is again the important consideration that in any economy as export-oriented as Hong Kong's, it might be difficult for domestic policy measures significantly to affect income and employment.

But this does not mean that central bank monetary controls would not work at all. A Hong Kong central bank would have the advantage over many newly-established institutions that there is a developed system of commercial banking and a monetised economy. And, if it is accepted that the need for monetary controls will increase in the future, there is a strong case for the early establishment of a central bank: as well as permitting the central bank to make the institutional changes necessary for future monetary controls, this would enable the bank itself to determine when the implementation of such controls is first called for. It is possible, too, that the central bank might facilitate any future introduction of fiscal policy.

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1 This point seems to have been overlooked by Nevin.

2 The International Bank survey of Malaya, op. cit., p.647, observed: 'Compensatory government financial policy is of course not a matter necessarily requiring the existence of a central bank, but a central bank can exercise an important advisory and persuasive influence, and may, in certain circumstances and within prudent limits make a compensatory policy feasible by some financing of temporary government deficits at the right time.'
In this discussion there has been no suggestion that a central bank could or should dismantle the sterling exchange currency standard which presently occupies a central position in the financial system, and which ensures the external convertibility of the Hong Kong dollar. It is simply suggested that, in view of the increasing volume of bank credit and the growing importance of the domestic sector of the economy, the monetary controls of a central bank might in the future be necessary to ensure the continued smooth working of the sterling exchange standard - to supplement, rather than to supplant, the present currency system. Without these controls, an excessive increase in bank credit during a period of economic expansion might make the subsequent adjustment of the money supply to the balance of payments a disruptive one, and there might be an unnecessary contraction of bank credit as a result of a short-term balance of payments deficit. Thus, for the most part, the likely role of a Hong Kong central bank would be dissimilar to that of most post-World War II central banks, and more like the role of the central banks established early in this century when 'the desirability of the gold standard was taken for granted...it was for the sake of their usefulness in running a gold-standard world that central banks were wanted in the nineteen-twenties'.\(^1\) At the same time, a central bank could contribute in several ways to the further development of the Hong Kong capital market.

Chapter 12

THE ADEQUACY OF THE FINANCIAL SYSTEM - I: INFRASTRUCTURE

So far, this study has dealt mainly with the institutions - actual or projected - of the Hong Kong capital market, the suppliers of funds. In the following three Chapters we shall look mostly at the demand side, the use of funds. The questions discussed are: who have been the main users of funds? From whom have funds been obtained and for what purposes? Has the flow of investible funds been adequate, in volume and composition (for example, has there been sufficient long term credit)? This Chapter is concerned with capital formation in the infrastructure: water supply, the power, transport and communication services, public works (other than housing which is discussed in Chapter 14) and port facilities.

Most privately-owned utility companies operate under franchises granted by the Government, which set out their monopoly rights, royalty charges and, in many cases now, what the Government considers a 'reasonable' rate of return on capital. The two electricity distribution companies do not operate under franchises; their monopoly positions are maintained by the very large capital investment required and by their established supply networks, while the companies' tariffs and profits are regulated by the Government. The Government has set a reasonable rate of return in the transport utilities at fourteen to eighteen per cent before taxes and royalty charges, for the telephone company a nine per cent rate of after tax earnings is considered reasonable, and a 13½ per cent before tax return on capital is approved for the electricity companies.

Table 12.1 sets out the royalty charges levied on those utility companies which operate under franchise.

The utility services have expanded rapidly over the post-war period, in line with population growth, industrialisation and higher income levels. The expansion of selected utility services is shown in Table 12.2.
Table 12.1

ROYALTY CHARGES, MAJOR UTILITY COMPANIES

<table>
<thead>
<tr>
<th>Company</th>
<th>Royalty Charges</th>
</tr>
</thead>
<tbody>
<tr>
<td>China Motor Bus:</td>
<td>46 per cent of net profit</td>
</tr>
<tr>
<td>Kowloon Motor Bus:</td>
<td>20 per cent of gross receipts</td>
</tr>
<tr>
<td>'Star' Ferry: (Approximately)</td>
<td>25 per cent of net profit</td>
</tr>
<tr>
<td>Hong Kong and Yaumati Ferry:</td>
<td>25 per cent of net profit</td>
</tr>
<tr>
<td>Hong Kong Tramways:</td>
<td>23½ per cent of net profit</td>
</tr>
<tr>
<td>Peak Tramways:</td>
<td>5 per cent on first $700,000 of tolls and 10 per cent on tolls in excess of $700,000</td>
</tr>
<tr>
<td>Hong Kong Telephone Co:</td>
<td>$8.00 for each exchange line in service.</td>
</tr>
</tbody>
</table>


Water Supply

Water supply is a responsibility of the Department of Public Works. The demand for water has increased rapidly (water consumption rose from 11,000 million gallons in 1948 to 44,000 million gallons in 1966) and in all but a few periods supply has been restricted. Storage capacity was 3,000 million gallons in the late 1940s and 17,000 million gallons in 1966, and will rise to 47,000 million gallons in 1969 when the Plover Cove scheme (costing $560 million) is completed. Table 12.3 shows the value of capital investment in water supply. The water authority has not issued its own bonds or borrowed from non-Government sources. The very large investment in water storage and supply has been financed entirely from Government revenue.

Revenue from the sale of water and an allocation from urban rates (two of the seventeen per cent levied on urban properties) are credited to the water authority. Charges allow the undertaking to cover its commercial costs, which are calculated to include the amortisation of capital at five per cent over forty years for dams and over 25 years for plant. From 1946 until 1960 the charge for

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1 For 13 months in 1963-64, supply was restricted to four hours every four days.
### Table 12.2

**PUBLIC UTILITY SERVICES, SELECTED YEARS, 1948 TO 1967**

<table>
<thead>
<tr>
<th>Year</th>
<th>Kowloon Motor Bus m.</th>
<th>China Motor Bus m.</th>
<th>Tramways m.</th>
<th>'Star' Ferry m.</th>
<th>Hong Kong and Yaumati Ferry m.</th>
<th>Railway m.</th>
<th>Total m.</th>
<th>Electricity sold Hongkong Electric m. units</th>
<th>Electricity sold China Light m. units</th>
<th>Gas Sold m. cubic ft.</th>
<th>Telephone '000 working stations</th>
</tr>
</thead>
<tbody>
<tr>
<td>1948</td>
<td>56</td>
<td>20</td>
<td>88</td>
<td>28</td>
<td>35</td>
<td>4</td>
<td>231</td>
<td>83</td>
<td>60</td>
<td>287</td>
<td>28(^a)</td>
</tr>
<tr>
<td>1954</td>
<td>203</td>
<td>56</td>
<td>142</td>
<td>35</td>
<td>76</td>
<td>3</td>
<td>515</td>
<td>213</td>
<td>269</td>
<td>585</td>
<td>49</td>
</tr>
<tr>
<td>1960</td>
<td>381</td>
<td>106</td>
<td>175</td>
<td>39</td>
<td>102</td>
<td>6</td>
<td>809</td>
<td>403</td>
<td>679</td>
<td>772</td>
<td>110</td>
</tr>
<tr>
<td>1966</td>
<td>643</td>
<td>189</td>
<td>182</td>
<td>56</td>
<td>161</td>
<td>9</td>
<td>1,238</td>
<td>816</td>
<td>1,829</td>
<td>1,384</td>
<td>300</td>
</tr>
<tr>
<td>1967</td>
<td>516</td>
<td>169</td>
<td>154</td>
<td>49</td>
<td>158</td>
<td>9</td>
<td>1,055</td>
<td>890</td>
<td>2,091</td>
<td>1,488</td>
<td>350</td>
</tr>
</tbody>
</table>

\(^a\) = 1949.

Source: Hong Kong Government Gazette Supplement Number 4, various numbers.
Table 12.3
WATER AUTHORITY: FINANCIAL DETAILS, SELECTED DATES, 1952 TO 1966

<table>
<thead>
<tr>
<th></th>
<th>1958-59</th>
<th>1965-66</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rates</td>
<td>9</td>
<td>26</td>
</tr>
<tr>
<td>Water charges</td>
<td>13</td>
<td>60</td>
</tr>
<tr>
<td>Fees</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Total</td>
<td>23</td>
<td>87</td>
</tr>
<tr>
<td><strong>Expenditure</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Staff</td>
<td>7</td>
<td>19</td>
</tr>
<tr>
<td>Maintenance and running</td>
<td>7</td>
<td>26</td>
</tr>
<tr>
<td>Interest</td>
<td>5</td>
<td>28</td>
</tr>
<tr>
<td>Sinking fund charges</td>
<td>4</td>
<td>7</td>
</tr>
<tr>
<td>Other</td>
<td>-</td>
<td>1</td>
</tr>
<tr>
<td>Total</td>
<td>22</td>
<td>81</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>1952a</th>
<th>1959</th>
<th>1966</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dams</td>
<td>120</td>
<td>238</td>
<td>910</td>
</tr>
<tr>
<td>Plant</td>
<td>40</td>
<td>67</td>
<td>222</td>
</tr>
<tr>
<td>Sinking Fund</td>
<td>-</td>
<td>16</td>
<td>87</td>
</tr>
<tr>
<td>Total</td>
<td>160</td>
<td>321</td>
<td>1,219</td>
</tr>
</tbody>
</table>

a = 31 March each year.

Source: Estimates of Revenue and Expenditure, various numbers.

Water was 80 cents per thousand gallons. This charge was raised to $1.00 in 1960 and to $2.00 in 1965. The increases were necessary to cover the very high costs of recent storage schemes.

But not all the water consumed in Hong Kong is supplied from local sources. An agreement with China signed in 1965 permits the Colony to draw a minimum of 15,000 million gallons of untreated water a year from the East River Scheme in China, at a cost of $1.06 per thousand gallons at the border. Distribution and filtering systems within Hong Kong had to be established, but the agreement freed the Government from the immense expenditure necessary with local storage reservoirs.

The Chinese East River Scheme has been described as 'a major project built almost entirely for the benefit of the Colony'. FEER, 3 December 1964, p.510.
Power

Electricity is supplied to Hong Kong Island by Hongkong Electric and to Kowloon and the New Territories by China Light. A small, independent company operates on Cheung Chau Island. China Light, which supplies the majority of the Colony's manufacturing businesses, has experienced by far the more rapid increase in electricity supply.\(^1\) Despite the recent expansion in demand for electricity and - especially in the late 1940s - the companies' difficulties in predicting future demand, there has been no shortage of electricity other than for temporary mechanical difficulties.\(^2\)

Table 12.4 sets out electricity charges at selected dates. China Light has offered concessional rates to industrial users 'in order to help and encourage industry and thereby to increase employment.'\(^3\)

Public complaints about the level of tariffs, and especially of the surcharge made to cover increases in the cost of fuel oil, led in 1959 to the establishment of an Electricity Supply Companies Commission to advise on the form and extent of the control which Government should impose, and on the method of assessment of any compensation which may become payable in the event of any such control being imposed.\(^4\)

The Commission found 'little, if anything, to criticise in the record of the Companies on the technical side'. But it was critical of the extent to which retained earnings had financed expansion - i.e., the contribution consumers had made to capital expansion.

---

\(^1\) The same company is responsible, for providing electricity to most of the Colony's agricultural areas, and claims to have extended electricity supply to a number of village at uneconomic returns. PEER, 7 December 1961.


\(^3\) Electricity Supply Companies Commission Report, Hong Kong Government Printer, 1959, p.15.

\(^4\) Ibid., p.1.
Table 12.4
ELECTRICITY CHARGES, 1959 AND 1967

(1) **China Light:**

<table>
<thead>
<tr>
<th>Year</th>
<th>Lighting</th>
<th>Power</th>
</tr>
</thead>
<tbody>
<tr>
<td>1959</td>
<td>29 cents per unit plus nine per cent surcharge.</td>
<td>basic rate 14 cents per unit plus nine per cent surcharge.</td>
</tr>
<tr>
<td>1967</td>
<td>29 cents per unit less rebate 0.7 cents.</td>
<td>13.6 cents per unit.</td>
</tr>
</tbody>
</table>

(2) **Hongkong Electric:**

<table>
<thead>
<tr>
<th>Year</th>
<th>Lighting</th>
<th>Power</th>
</tr>
</thead>
<tbody>
<tr>
<td>1959</td>
<td>15.4 to 28 cents per unit plus nine per cent surcharge.</td>
<td>basic rate 12 cents per unit plus nine per cent surcharge.</td>
</tr>
<tr>
<td>1967</td>
<td>15.4 to 28 cents per unit.</td>
<td>11.4 to 12 cents per unit.</td>
</tr>
</tbody>
</table>

Source: *Hong Kong Annual Report*, various numbers.

formation - while the companies were making 'rights and bonus issues and substantial dividend distributions to shareholders.' The Commission interpreted its terms of reference to be 'not on whether control should or should not be imposed on the Companies, but on what that control should be' and concluded that, as detailed controls to protect consumers' rights would lead to 'a situation in which responsibility is taken away from management', the two electricity supply companies should be taken over by the Government.

The electricity companies strongly opposed the Commission's recommendation, and offered alternative proposals. In May 1962 the Government announced that instead of nationalisation, the two companies would be amalgamated and a system of Government controls introduced to govern tariffs and profits. The proposed merger, however, was not acceptable to shareholders in the two companies.

In 1964 the Government announced the formation of a new electricity company (PEPCO), set up jointly by China Light and Esso Standard Eastern, to supply electricity to China Light. Esso's
investment was $220 million. An agreement with the Government set the maximum earnings of the new company at 13½ per cent of fixed assets. One half of these earnings can be paid out as dividends. Earnings over 13½ per cent must be allocated to a development fund, to which interest accrues at eight per cent, and which can be used only to reduce tariffs. About the same time, Hongkong Electric accepted a scheme of Government control over charges and distribution of profits.

Table 12.5 sets out the level of investment in electricity supply in a number of years since 1947, and, more roughly, the way in which this investment was financed between 1957 and 1966 (see Note to Table 12.5). Even allowing for Esso's investment in PEPCO, which is not shown in the Table, retained earnings have been by far the dominant source of funds. In the period 1957 to 1966 China Light raised only $25 million from shareholders and Hongkong Electric $58 million. New share raisings were discouraged during the period of uncertainty about the companies' future. Consumer deposits have provided a small amount of investible funds. Hongkong Electric has, on several occasions, financed expansion with bank credit until new funds could be raised from shareholders. China Light, on the other hand, has for some time held very large cash reserves.

Hongkong and China Gas supplies the urban areas and new industrial towns on both sides of the Hong Kong harbour. The Company was for a long time owned in the United Kingdom. A block of shares was purchased by a Hong Kong investment company in 1954; the Company has been listed on the local Stock Exchange since 1958. The Company's rights and obligations are set out in a 1961 agreement with the Hong Kong Government. Charges for gas have been virtually unchanged over the post-war period.

1 It was reported that Esso at first offered a fixed interest loan, but because of a 'fundamental dislike for loans' on the part of China Light, this was rejected.

### Table 12.5
**BALANCE SHEET INFORMATION: PUBLIC UTILITY COMPANIES, SELECTED POST-WAR YEARS**

(1) China Light and Power

<table>
<thead>
<tr>
<th>Year</th>
<th>Represented by</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Fixed assets</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Net current assets</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Intangibles</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Capital employed</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Share capital</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Reserves</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>Less consumers' deposits</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>$ million</th>
</tr>
</thead>
<tbody>
<tr>
<td>1947</td>
<td>1952</td>
</tr>
<tr>
<td>a</td>
<td>13</td>
</tr>
<tr>
<td></td>
<td>2</td>
</tr>
<tr>
<td></td>
<td>15</td>
</tr>
</tbody>
</table>
| (2) Hongkong Electric

<table>
<thead>
<tr>
<th>Year</th>
<th>Represented by</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Fixed assets</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Net current assets</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Intangibles</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>Capital employed</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Share capital</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Reserves</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Less consumers' deposits</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>$ million</th>
</tr>
</thead>
<tbody>
<tr>
<td>1947</td>
<td>1952</td>
</tr>
<tr>
<td>a</td>
<td>21</td>
</tr>
<tr>
<td></td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>22</td>
</tr>
</tbody>
</table>
| Change 1957 to 1966
| Share capital | 125
| Reserves      | 195
| Total         | 320
| Capital raisings, 1957 to 1966 | 25
| **Difference** | 295

<table>
<thead>
<tr>
<th>Year</th>
<th>$ million</th>
</tr>
</thead>
<tbody>
<tr>
<td>1947</td>
<td>1952</td>
</tr>
<tr>
<td>a</td>
<td>7</td>
</tr>
<tr>
<td></td>
<td>13</td>
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<tr>
<td></td>
<td>5</td>
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<tr>
<td></td>
<td>25</td>
</tr>
<tr>
<td></td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>22</td>
</tr>
</tbody>
</table>
| Change 1957 to 1966
| Share capital | 75
| Reserves      | 137
| Total         | 212
| Capital raisings, 1957 to 1966 | 58
| **Difference** | 154

---
### Table 12.5 continued

#### (3) Hongkong and China Gas

<table>
<thead>
<tr>
<th></th>
<th>1958 $</th>
<th>1962 $</th>
<th>1966 $</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital employed</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>10</td>
<td>11</td>
<td>16</td>
</tr>
<tr>
<td>Reserves</td>
<td>9</td>
<td>19</td>
<td>21</td>
</tr>
<tr>
<td>Total</td>
<td>19</td>
<td>30</td>
<td>37</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>n.a.</td>
<td>36</td>
<td>37</td>
</tr>
<tr>
<td>Bank overdraft</td>
<td>1</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

*a = 31 December each year

Change 1958 to 1966
Share capital 6
Reserves 12
Total 18

Capital raisings,
1958 to 1966 nil

Difference 18

---

#### (4) Hong Kong Telephone Company

<table>
<thead>
<tr>
<th></th>
<th>1957 $</th>
<th>1962 $</th>
<th>1966 $</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital employed</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>30</td>
<td>65</td>
<td>100</td>
</tr>
<tr>
<td>Reserves</td>
<td>10</td>
<td>62</td>
<td>108</td>
</tr>
<tr>
<td>Total</td>
<td>40</td>
<td>127</td>
<td>208</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>48</td>
<td>108</td>
<td>310</td>
</tr>
<tr>
<td>Depreciation for year</td>
<td>7</td>
<td>12</td>
<td>25</td>
</tr>
</tbody>
</table>

*a = 31 December each year

Change 1957 to 1966
Share capital 70
Reserves 98
Total 168

Capital raisings,
1957 to 1966 124

Difference 44

---
<table>
<thead>
<tr>
<th></th>
<th>1957(^a)</th>
<th>1962</th>
<th>1966</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$ million</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital employed</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>5</td>
<td>10</td>
<td>20</td>
</tr>
<tr>
<td>Reserves</td>
<td>22</td>
<td>28</td>
<td>31</td>
</tr>
<tr>
<td>Total</td>
<td>27</td>
<td>38</td>
<td>52</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>25</td>
<td>43</td>
<td>57</td>
</tr>
<tr>
<td>Capital raisings, 1957 to 1966</td>
<td>3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Difference</td>
<td>22</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

\(a = 31\) December each year

Change 1957 to 1966

<table>
<thead>
<tr>
<th></th>
<th>1957(^a)</th>
<th>1962</th>
<th>1966</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$ million</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital employed</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>1</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Reserves</td>
<td>5</td>
<td>8</td>
<td>8</td>
</tr>
<tr>
<td>Total</td>
<td>6</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>9</td>
<td>9</td>
<td>12</td>
</tr>
<tr>
<td>Depreciation for year</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Capital raisings, 1957 to 1966</td>
<td>nil</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Difference</td>
<td>4</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

\(a = 31\) December each year

Change 1957 to 1966

<table>
<thead>
<tr>
<th></th>
<th>1957(^a)</th>
<th>1962</th>
<th>1966</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$ million</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital employed</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>15</td>
<td>15</td>
<td>37</td>
</tr>
<tr>
<td>Reserves</td>
<td>8</td>
<td>11</td>
<td>12</td>
</tr>
<tr>
<td>Total</td>
<td>22</td>
<td>26</td>
<td>48</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>16</td>
<td>13</td>
<td>24</td>
</tr>
</tbody>
</table>

\(a = 31\) December each year

Change 1957 to 1966

<table>
<thead>
<tr>
<th></th>
<th>1957(^a)</th>
<th>1962</th>
<th>1966</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$ million</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital employed</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>22</td>
<td>26</td>
<td>26</td>
</tr>
<tr>
<td>Reserves</td>
<td>4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>26</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital raisings, 1957 to 1966</td>
<td>nil</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Difference</td>
<td>26</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

\(a = 31\) December each year

Change 1957 to 1966

<table>
<thead>
<tr>
<th></th>
<th>1957(^a)</th>
<th>1962</th>
<th>1966</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$ million</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital employed</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>15</td>
<td>15</td>
<td>37</td>
</tr>
<tr>
<td>Reserves</td>
<td>8</td>
<td>11</td>
<td>12</td>
</tr>
<tr>
<td>Total</td>
<td>22</td>
<td>26</td>
<td>48</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>16</td>
<td>13</td>
<td>24</td>
</tr>
</tbody>
</table>
Table 12.5 continued

(8) Peak Tramways

<table>
<thead>
<tr>
<th></th>
<th>1958&lt;sup&gt;a&lt;/sup&gt;</th>
<th>1963</th>
<th>1967</th>
<th>$ million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital employed</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>1</td>
<td>1</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>Reserves</td>
<td>1</td>
<td>2</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>1</td>
<td>2</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>Fixed assets</td>
<td>1</td>
<td>1</td>
<td>6</td>
<td></td>
</tr>
</tbody>
</table>

<sup>a</sup> = 31 March each year

Change 1957 to 1966

<table>
<thead>
<tr>
<th></th>
<th>1957</th>
<th>1966</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share capital</td>
<td>3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reserves</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>4</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Capital raisings, 1958 to 1967 = 2

Difference = 1

(9) Kowloon Motor Bus

<table>
<thead>
<tr>
<th></th>
<th>1961&lt;sup&gt;a&lt;/sup&gt;</th>
<th>1966</th>
<th>$ million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital employed</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>31</td>
<td>31</td>
<td></td>
</tr>
<tr>
<td>Reserves</td>
<td>24</td>
<td>17</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>56</td>
<td>49</td>
<td></td>
</tr>
<tr>
<td>Fixed assets</td>
<td>41</td>
<td>72</td>
<td></td>
</tr>
<tr>
<td>Depreciation for year</td>
<td>3</td>
<td>8</td>
<td></td>
</tr>
</tbody>
</table>

<sup>a</sup> = 14 February each year

Change 1961 to 1966

<table>
<thead>
<tr>
<th></th>
<th>1961</th>
<th>1966</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share capital</td>
<td>nil</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reserves</td>
<td>-7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>-7</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Capital raisings, 1961 to 1966 = -

Difference = -7

(10) China Motor Bus

<table>
<thead>
<tr>
<th></th>
<th>1962&lt;sup&gt;a&lt;/sup&gt;</th>
<th>1966</th>
<th>$ million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital employed</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>5</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>Reserves</td>
<td>11</td>
<td>19</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>16</td>
<td>24</td>
<td></td>
</tr>
<tr>
<td>Fixed assets</td>
<td>14</td>
<td>30</td>
<td></td>
</tr>
<tr>
<td>Depreciation for year</td>
<td>3</td>
<td>2</td>
<td></td>
</tr>
</tbody>
</table>

<sup>a</sup> = 30 June each year

Change 1961 to 1966

<table>
<thead>
<tr>
<th></th>
<th>1961</th>
<th>1966</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share capital</td>
<td>nil</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reserves</td>
<td>8</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>8</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Capital raisings, 1962 to 1966 = nil

Difference = 8

Source: Hong Kong Stock Exchange, Year Book.
Table 12.5 continued

Note

This table provides information on the amount of capital employed in the several public utility companies, and on the relative importance of capital raisings and internal sources of funds. Ideally, the information required is a year by year analysis of:

- **a** = new capital raisings
- **b** = new borrowings
- **c** = funds provided from retained earnings
- **d** = depreciation allowances

But insufficient information is available on the Hong Kong public companies to make such a detailed analysis.

The Table concentrates on variations in shareholders' funds. An increase in shareholders' funds can come about through new capital raisings (including share premiums), transfers from earnings and revaluation of assets. The Table sets out the change in shareholders' funds for each company over the period 1957 to 1966, and compares this with the company's new capital raisings. The difference between these two values gives some ideas of the importance of internal sources of funds.

The fixed assets of the Company were valued at $37 million in 1966 (see Table 12.5). Expansion has been financed almost entirely from retained earnings.

**Transport**

Two companies hold exclusive franchises to provide public bus services; these are China Motor Bus, which operates on Hong Kong Island, and Kowloon Motor Bus. Both are now public companies. The rapid increase in public bus travel over the past twenty years, shown in Table 12.2, has required a large investment in new vehicles: the China Motor Bus fleet increased from 48 buses in 1947 to 502 in 1967; the fleet of Kowloon Motor Bus increased from 482 to 1,051 between 1959 and 1967. A Public Transport Survey Unit has been established in the Public Works Department to assist the bus companies in forward planning. Fares are low - a maximum of 20 cents for journeys within the urban areas - and unchanged from the late 1940s.

The two companies raised $53.5 million by share issues when they first became public companies. Both issues were heavily
oversubscribed. Except for the use of bank credit by the Kowloon company, all recent expansion has been financed from internal sources. The fall in profits of Kowloon Motor Bus from $14 million in 1963 to $6 million in 1966 brought about, it was claimed, by rising costs, and the resulting suspension of dividend payments have posed considerable problems for financing future investment: less funds are available from internal sources and it is more difficult to offer shareholders a favourable rights issue. As a local newspaper commented at the time

a public utility, privately owned and with an area monopoly, which pays no dividends cannot hope to exist for very long, let alone achieve the expansion required in the interest of the travelling public.1

The 'Star' Ferry Company operates services between Victoria and Kowloon and between Victoria and Hung Hom. Other ferry services, including vehicular ferries, are undertaken by Hongkong and Yaumati Ferry. A number of new ferry routes, many of them uneconomic, have been opened since 1946.2 The Government undertake the construction of ferry piers.

In 1965 the 'Star' Ferry sought Government approval to increase fares. Permission was obtained only to raise first class charges (from twenty cents to 25 cents).3 The widespread public disturbances which followed presumably have discouraged the other public utility companies from increasing fares and charges.

Table 12.5 showed the increase in fixed assets of the two companies between 1957 and 1966, and demonstrated the companies' heavy reliance on internal sources of funds. The recent fall in the

1 SCMP, editorial, 11 November 1966.
2 It has been claimed that, in 1964 Hongkong and Yaumati Ferry carried 28 million passengers on uneconomic routes. Legislative Council Debates, 1965, p.493.
3 This fare increase was the first change in public transport charges in twenty years. Hong Kong Annual Report, 1966, p.198.
profits of the *Star* Ferry\(^1\) creates similar difficulties in financing further expansion to those experienced by Kowloon Motor Bus.

Hongkong Tramways operates 162 trams (126 in 1954) on a 6.2 mile route (unchanged since the War). Fares have been constant at ten cents and twenty cents for any distance. A funicular tram service to the Peak is provided by Peak Tramways Company.

Balance sheet information for the two concerns is given in Table 12.5. All the funds for expansion in Hongkong Tramways has been provided from internal sources. Capital raisings have been a significant source of funds for Peak Tramways.

The Government-owned Kowloon-Canton Railway operates a 22 mile route between Kowloon and the Chinese border. The volume of both passenger and freight traffic fell suddenly with the establishment of Communist control in south China and the U.N. embargo, but has since increased steadily. Table 12.6 shows the recent trends in revenue and expenditure. The purchase of rolling stock is included in expenditure in the Table, but capital expenditure on track and terminals is omitted.

Table 12.6

<table>
<thead>
<tr>
<th>Revenue</th>
<th>Expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ million</td>
<td></td>
</tr>
<tr>
<td>1947-48</td>
<td>4</td>
</tr>
<tr>
<td>1957-58</td>
<td>8</td>
</tr>
<tr>
<td>1967-68</td>
<td>12</td>
</tr>
</tbody>
</table>


\(^1\) Profit fell from $2.2 million in 1964 to $0.6 million in 1966. The Company's Chairman attributed the fall in profits to 'continuing losses on the Hung Hom service, heavy expenditure on necessary repairs to Government piers, rising maintenance costs and the swing from first to second class travel [after the increase in first class fares]'. SCMP, 23 March 1967.
The Government commissioned a mass transport feasibility study in August 1965 to advise on the Colony’s urban transport requirements until 1986. In its report, made public in February 1968, the unit found that an underground railway system covering a 40 mile, four lane circuit, would be feasible. The study estimated that the transport system would cost $3,400 million – $200 million in each of seventeen years of development. Estimates of passenger demand suggested that the authority would pay its own way if the necessary funds could be found at 4.2 per cent. The Report suggested that public funds will be required for the development, not only to cover the deficiency of private finance, but also ‘to offer a more attractive proposition to investors’ by way of return. The Government has still to announce its decision on the proposal.

Communications

Telephone services within the Colony are a monopoly of Hong Kong Telephone Company. Despite the opening of additional exchanges, there has been much public criticism of delays in telephone installation, and the Government established an Advisory Committee on Telephone Services in 1964 to review periodically the Company’s rate of expansion. Telephone rentals, which have increased by only a small amount in the last twenty years, are at present $225 per annum for a residential line and $300 per annum for a business line. There are no call charges.

The telephone company has relied more on new capital raisings than the other utility companies (Table 12.5). To assist the expansion of the telephone service, the Government in 1952 took the unusual step of underwriting one of the Company’s share issues. It was required to take up only a few shares. In 1966 and 1967 the

1 SCMP, 15 February 1968, p.10. In his 1967 Budget Speech the Financial Secretary referred to ‘a possible new public transport system, the estimates of the cost for which are so terrifying that I will not spoil today’s, I hope, not unhappy occasion by mentioning them.’
telephone company received $120 million in financial accommodation from the United Kingdom Exporters Refinance Corporation.

The Post Office is operated as a Government Department and separate financial accounts are not maintained. The Government's expenditure and receipts from postal services are shown in Table 12.7. Expenditure on new buildings is excluded from the Table; this is treated in the Government's accounts as public works non-recurrent and is financed from Government revenue.

| Table 12.7 |
| POST OFFICE, REVENUE AND EXPENDITURE, SELECTED YEARS 1947-48 TO 1967-68 |

<table>
<thead>
<tr>
<th>Year</th>
<th>Revenue $ million</th>
<th>Expenditure $ million</th>
</tr>
</thead>
<tbody>
<tr>
<td>1947-48</td>
<td>7</td>
<td>2</td>
</tr>
<tr>
<td>1957-58</td>
<td>30</td>
<td>19</td>
</tr>
<tr>
<td>1967-68</td>
<td>99</td>
<td>56</td>
</tr>
</tbody>
</table>


Public Works

The level and distribution of Government expenditure on public works were shown in Tables 9.5 and 9.11. Total spending on public works (Public Works Department, public works recurrent and public works non-recurrent, including housing, waterworks and education) increased from $10 million in 1947-48 (eight per cent of total Government expenditure) to $692 million in 1965-66 (39 per cent). Expenditure on civil engineering projects rose from $9 million in 1950-51 to $140 million in 1965-66, the main items in which were roads, reclamations and site development. These are 609 miles of road in Hong Kong. It has been claimed that 'except at a few intersections, traffic congestion has not yet reached the level experienced in most Western cities.' But by 1986 the number of

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1 Hong Kong 1966, p.190.
registered vehicles in Hong Kong will have quadrupled from the 93,000 registered in late 1966. Three main industrial areas have been developed by the Government: Kwun Tong (640 acres), Tsuen Wan (500 acres) and Kowloon Bay (550 acres). Industrial leases in these areas have been sold at open auction. Site formation has commenced for the establishment of satellite towns of 750,000 to one million people at Castle Peak and Shatin. The present airport was constructed in the late 1950s at a cost of $130 million.

Apart from a loan of $48 million from the British Government towards the cost of the airport and the Rehabilitation Loan of $50 million raised locally in 1948, all civil engineering projects have been financed from Government revenue.

The construction of a road link under the Hong Kong harbour is, however, to be undertaken by private enterprise. A town planning report in 1948 stressed the need for a cross-harbour road link. The Government commissioned a feasibility study on a cross-harbour tunnel in 1954, and subsequently set up as an inter-departmental committee to advise on whether the Government should accept responsibility for the project. The Committee found that a cross-harbour tunnel would be of insufficient economic or social importance either to take precedence over other public works or to justify a Government subsidy. This conclusion was accepted by the Government but at the same time it announced that privately sponsored schemes, either for a tunnel or a bridge would be considered. In 1961 the Victoria City Development Company submitted an analysis of the feasibility of a cross-harbour road link, and it was given a franchise from the Government to build and operate the tunnel. These rights were later transferred to The Cross-Harbour Tunnel Company, the General Managers

of which are the long-established merchant firm, Wheelock Marden.\textsuperscript{1}
The estimated cost of the tunnel scheme is $280 million, which is to be financed from equity capital, contractors' finance and loans.

The conditions laid down by the Government include that the Company offer stated proportions of its shares to the ferry companies, the public and the Government; that after 30 years all assets will be transferred to the Government; that construction be completed by August 1970; and that the Company pay $12 million to the Government to cover the cost of engineering works which would not otherwise have been required.

Start on the construction of the tunnel was delayed in 1967 because of difficulties in arranging contractor finance and renewed uncertainty about the Colony's future.\textsuperscript{2}

Port Facilities

Port facilities - an important part of the infrastructure of an entrepot - are probably more the responsibility of private enterprise in Hong Kong than in any other international port.\textsuperscript{3} The Government provides only navigation aids, moorings, typhoon shelters, sea walls, and routine dredging.

There are four main wharf and godown companies - Hong Kong and Kowloon Wharf and Godown, China Provident and its subsidiary North Point Wharves, and Holt's Wharf - and about 100 smaller companies. The large companies between them have storage space of well over a million tons. The recent expansion of wharf and godown facilities has been financed mainly from internal sources and the sale of

\textsuperscript{1} Wheelock Marden and the John D Hutchison group are committed each to provide $28 million of the equity capital.

\textsuperscript{2} See HS, 28 September 1967.

\textsuperscript{3} As a senior official of one of the major trading firms has commented: the Hong Kong Government's 'general policy of supporting free enterprise... has been carried through almost to the ultimate insofar as shipping is concerned: D.K. Newbigging, 'The Shipping Industry of Hong Kong', University of Hong Kong, Extra - Mural Lecture, November 1966.
properties; the public companies did not raise new capital from shareholders in the period 1957 to 1966.

A new overseas terminal was completed by Hong Kong and Kowloon Wharf and Godown in 1966 at a cost of $70 million. Unusually, about one-half of the cost was provided from the Government, by way of a grant of $10 million (including $4 million to cover the cost of the terminal's public car park) and a loan of $30 million at six per cent interest repayable over twenty years. This financial assistance, provided because the terminal was considered too large a scheme for a privately-owned company, represented a first departure in the Government's traditional policy of leaving port development to private enterprise.

In 1966 the Government established a Committee to inquire into 'the implications for Hong Kong trade and industry' of the 'development of containers and transport services' and to advise on the need for container handling facilities in Hong Kong. The Committee concluded that 'unless a container terminal is available in Hong Kong to serve [the containerships which will be operating in the Pacific area by 1970] the trading position of the Colony will be affected detrimentally' and that local industry would 'derive considerable advantages as a result of containerisation'. The Committee was not in a position to consider the commercial viability of a container terminal and depot. But in view of the high capital cost, a period of several years before optimum utilization can be reached, and the difficulty of forecasting tonnage moving and the number of containerships calling, it is of the opinion that it may take some time before private enterprise will come forward with firm proposals.

The Government appears willing to accept responsibility for a large part of the cost of the container terminal: in his 1967 Budget Speech, the Financial Secretary estimated that almost $200 million,

1 See Chairman's Statement, Hong Kong and Kowloon Wharf and Godown, 1965.
over an unstated period would be allocated from public funds for this purpose. However, Hong Kong and Kowloon Wharf and Godown in mid-1967 expressed its interest in a privately-developed container terminal, costing around $70 million, a part of which would need to be provided from Government sources.¹

The discussion in this Chapter has pointed to the high level of investment made in the infrastructure over the post-war period. Much of the investment has been of a long term nature. Of course, a much larger investment has been required in some utilities - such as water and electricity supply - than in others. The utility companies have raised an appreciable sum from new capital raisings ($271 million in the period 1958 to 1966, out of total public capital raisings of $630 million). They have been well placed to obtain this equity capital from the narrow Hong Kong share market: the companies are well known and their monopoly positions give them, over the longer period at least, virtually assured profits.² But not all privately owned utility companies have made recourse to the new issue market. The telephone company, largely because its rate of expansion has been a particularly rapid one, has relied most on new capital raisings. Other than a small purchase of shares in the telephone company, the Government has not provided direct financial assistance to privately-owned utility companies. Capital obtained from abroad has been of importance only in the case of electricity supply and telephones. Commercial bank loans have not been a significant source of funds. Retained earnings have been the main source of funds; criticism of the extent to which retained earnings have been used in at least two of the utility companies was noted earlier.

¹ See SCMP, 22 June 1967.
² The Chairman of China Light stated to the Electricity Commission that shares in his Company were the nearest investment in Hong Kong to trustee stock.
Thus, the shortage of long term investible funds in the Hong Kong capital market has not prevented a considerable, and in most cases apparently adequate, expansion of utility services. The limited capital market, though, has apparently required a relatively greater reliance on internal sources of funds (and, in the case of water supply, on general Government revenue) than is the case with utility services in other countries. Given this need to rely heavily on internal funds, the recent decline in the profits of two companies greatly complicates future capital formation.

The post-war stability in the charges of most utility services has both resulted from, and contributed to, the relative absence of inflation in other sectors of the economy. Utility charges appear to be low by international standards.

There has been, too, a high level of expenditure on public works projects. A suggestion that the Government has been more willing to undertake spending on public works than current expenditure on social services was cited earlier.\(^1\)

\(^1\) See p. 247.
Chapter 13
THE ADEQUACY OF THE FINANCIAL SYSTEM - II: INDUSTRY AND TRADE

Industry

The lack of detailed and precise information on the level of investment in manufacturing industry and on the sources and adequacy of this flow of funds has been commented on by both a Government Committee which investigated the need for an industrial bank, and the Economist Intelligence Unit:

We have found it very difficult to secure any precise information on this subject ... the [Chinese Manufacturers'] Association did not feel able to provide information and assured us that an appeal to members for information to be communicated confidentially direct to the Committee would meet with no response.¹

Of all the subjects which we examined in Hong Kong, the supply and use of capital in industry was the most difficult on which to find concrete information.²

Among the reasons for this lack of reliable information on company finance are the small number of public companies, the highly competitive conditions in most lines of industry so that few businesses will disclose information they believe may be of use to their competitors, and a reluctance by businessmen, which is certainly not unique to Hong Kong, to admit to many financial difficulties they may be experiencing.

It is necessary, then, to rely on fairly rough estimates.

Table 13.1 shows several indicators of the level of fixed capital formation in industry over recent years. This Table, which is based on one presented in the Economist Intelligence Unit Survey, must be interpreted carefully: it understates both the actual

¹ Industrial Bank Committee, Report, mimeographed, 1960. This Report was published in full in FEER, 4 August 1960, pp.226-31, and references to the Report in this study are to the latter printing.

² Economist Intelligence Unit, op. cit., p.15.
Table 13.1
INDICATORS OF FIXED CAPITAL INVESTMENT IN INDUSTRY, 1956-67

<table>
<thead>
<tr>
<th></th>
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<td>$ million</td>
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<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Land</td>
<td>8</td>
<td>10</td>
<td>6</td>
<td>5</td>
<td>34</td>
<td>31</td>
<td>76</td>
<td>75</td>
<td>94</td>
<td>15</td>
<td>4</td>
<td>2a</td>
</tr>
<tr>
<td>Buildings</td>
<td>11</td>
<td>12</td>
<td>32</td>
<td>22</td>
<td>40</td>
<td>41</td>
<td>47</td>
<td>62</td>
<td>96</td>
<td>186</td>
<td>134</td>
<td>n.a.</td>
</tr>
<tr>
<td>Machinery imports less re-exports</td>
<td>11</td>
<td>33</td>
<td>20</td>
<td>42</td>
<td>86</td>
<td>62</td>
<td>41</td>
<td>52</td>
<td>116</td>
<td>94</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Textile</td>
<td>24</td>
<td>49</td>
<td>41</td>
<td>86</td>
<td>97</td>
<td>102</td>
<td>136</td>
<td>173</td>
<td>191</td>
<td>227</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Other</td>
<td>35</td>
<td>82</td>
<td>61</td>
<td>128</td>
<td>183</td>
<td>164</td>
<td>177</td>
<td>225</td>
<td>307</td>
<td>321</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Total imports</td>
<td>54</td>
<td>104</td>
<td>99</td>
<td>155</td>
<td>257</td>
<td>236</td>
<td>300</td>
<td>362</td>
<td>497</td>
<td>522</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Total fixed investment</td>
<td>15</td>
<td>4</td>
<td>2a</td>
<td>18</td>
<td>32</td>
<td>8</td>
<td>183</td>
<td>164</td>
<td>225</td>
<td>307</td>
<td>321</td>
<td>n.a.</td>
</tr>
</tbody>
</table>

a = 11 months.

Definitions:
- Land: Sales of new industrial land by Government.
- Buildings: Value of new industrial buildings completed, urban area.
- Machinery: Industrial machinery imports less re-exports.

Sources:
- Economist Intelligence Unit, Industry in Hong Kong, 1962, p.16.
- Commissioner of Rating and Valuation, Annual Report, various numbers.
- Department of Commerce and Industry, End-Use Analysis of Imports, 1959-65, mimeographed.
- Superintendent of Crown Lands and Survey, personal communication.
level of fixed capital formation in industry and (though to a much smaller extent) the rate of increase of this fixed investment. Excluded from the Table are land purchases other than new industrial land, the value added locally to imported machinery and the cost of industrial machinery produced in Hong Kong (this latter item, which includes air conditioning equipment and plastic moulding machinery, is unlikely yet to be very large). The value of the several items omitted from the Table almost certainly increased over the period covered by the Table.

There is no way of estimating the precise value of investment in industrial working capital. It has been suggested, though, that 'the increase in working capital was of the same order as, or greater than, the increase in fixed capital investment'.

Whatever the limitations of Table 13.1, it cannot be denied that there has been a remarkable increase in industrial investment even over the relatively short period covered. The question which must now be asked is how this capital formation has been financed.

(a) Sources of funds for industrial investment.

(i) Foreign capital

As we have seen, it was with imported capital - mostly from Shanghai industrialists - that cotton spinning, the Colony's first large-scale industry, was established. This industry was set up with modern machinery and a supply of raw materials, mostly purchased from the United States, at a time when there were world shortages both of capital equipment and raw materials, and of the goods which the cotton mills could produce. Some local funds, mostly credits from the British banks, were made available to these cotton spinning mills, but in most cases expansion was financed from new capital inflow, and, more frequently, from retained profits.

There was little further direct overseas investment in industry until the late 1950s when a number of manufacturing enterprises

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1 Economist Intelligence Unit, op. cit., p.16.
with mainly United States and Japanese capital were set up. This foreign investment was given no special encouragement or concessions, nor was it motivated by the prospect of producing for a tariff-protected home market.

Indirectly, the inflow of foreign capital into other sectors has assisted capital formation in industry. The expansion of bank deposits to which foreign capital contributed, made possible a rapid increase in bank lending for industrial purposes. Overseas investment in the property and share markets freed funds for investment in manufacturing.

(ii) Share issues

Public share issues have not been a significant source of funds for industrial investment. $66 million was raised by manufacturing firms by public capital raisings in the period 1958 to 1966 (total public share subscriptions during the period were $630 million). The narrow share market and the investing public's preference for the more assured returns of utility companies and building companies have discouraged public share issues by manufacturing concerns. The role of the stock market as a mobiliser of funds for manufacturing industry has thus changed little since the Economist Intelligence Unit observed.

The Stock Exchange, which might be expected to make some contribution to industrial financing, however small, makes none; even the few existing public companies in Hong Kong industry have not sought to raise additional capital there.

There is no way of estimating how much share capital has been raised by private companies. Certainly, the advantages of incorporation have been widely appreciated. Many previously unincorporated businesses have been incorporated, and 'most new businesses of any magnitude are probably incorporated as limited companies'.

1 Economist Intelligence Unit, op. cit., pp.17-8.
Table 13.2 shows the authorised capital of newly registered companies (public and private) by industry groups in 1962/63 and 1965/66. The statistics do not relate to paid up capital, and do not include increases in the authorised capital of existing firms.

Table 13.2

NOMINAL CAPITAL OF NEWLY REGISTERED COMPANIES
BY INDUSTRIAL GROUPS, 1962-3 AND 1965-6

<table>
<thead>
<tr>
<th></th>
<th>1962-3 $ million</th>
<th>1965-6 $ million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Garments</td>
<td>6</td>
<td>25</td>
</tr>
<tr>
<td>Textiles</td>
<td>7</td>
<td>32</td>
</tr>
<tr>
<td>Engineering, etc.</td>
<td>10</td>
<td>22</td>
</tr>
<tr>
<td>Other</td>
<td>21</td>
<td>72</td>
</tr>
<tr>
<td>Total Manufacturing</td>
<td>44</td>
<td>151</td>
</tr>
<tr>
<td>Non-manufacturing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Financiers</td>
<td>50</td>
<td>60</td>
</tr>
<tr>
<td>Import and export</td>
<td>153</td>
<td>170</td>
</tr>
<tr>
<td>Land and Building</td>
<td>471</td>
<td>94</td>
</tr>
<tr>
<td>Other</td>
<td>164</td>
<td>243</td>
</tr>
<tr>
<td>Total non-manufacturing</td>
<td>838</td>
<td>567</td>
</tr>
<tr>
<td>All companies</td>
<td>882</td>
<td>718</td>
</tr>
</tbody>
</table>

Source: Registrar-General, Annual Report, various numbers.

(iii) Commercial Banks

The commercial banks have lent to industrial firms over almost the whole post-war period. Bank credit was provided during the immediate post-war reconstruction to assist the re-establishment of the ship building and ship repair industry. From an early stage, the banks financed the cotton spinning industry; one estimate suggests that twenty per cent of the fixed capital of the early mills was financed from bank loans,¹ a significant contribution to an industry which had yet to establish itself. Bank loans for industrial purposes slowly increased to around $200 million in 1958, and then doubled in the two years to 1960 (see Table 13.3). There is no way of estimating the volume of bank credit employed in manufacturing industry between 1960 and 1964, but it appears from

¹ FEER, 6 July 1950, p.3.
Table 13.3

COMMERCIAL BANK LOANS FOR MANUFACTURING INDUSTRY,
SELECTED DATES, 1957 TO 1967

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans for manufacturing industry</td>
<td>170</td>
<td>205</td>
<td>420</td>
<td>1,015</td>
<td>1,151</td>
<td>1,072</td>
</tr>
<tr>
<td>Total bank advances</td>
<td>940</td>
<td>980</td>
<td>1,860</td>
<td>5,183</td>
<td>5,475</td>
<td>5,401</td>
</tr>
<tr>
<td>Per cent</td>
<td>18</td>
<td>21</td>
<td>23</td>
<td>20</td>
<td>21</td>
<td>20</td>
</tr>
</tbody>
</table>

a = 31 December each year


The Table that industrial loans increased at a similar rate to total bank advances (i.e., between twenty and thirty-five per cent per annum). In December 1966 commercial bank loans to industry stood at $1,151 million. Table 5.7 gave the distribution of these loans by industry group.

The Industrial Bank Committee's Report stressed the contribution bank credit had made to industrial financing and gave several reasons why these loans have been granted.

The same phenomenon is observable in Hong Kong as in the United Kingdom, that is, the extension of bank lending policy from short-term commercial loans to medium-term or even long-term industrial loans.

There are a variety of reasons for this new development. First, in Hong Kong industry has now become of first importance in the economy... Secondly, a new type of bank has been developing in Hong Kong; its interests have from the beginning been in finance of local activity rather than foreign commerce, although its main interest has so far been in real estate rather than in industry. Thirdly, the funds available to banks from deposits have grown very much faster than the volume of foreign trade...

The two large British banks were the first institutions to lend for manufacturing purposes and these two banks are still responsible for a very large proportion of all bank lending to industry. Recently, several local banks have actively sought borrowers from manufacturing industry. To some extent, this

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Industrial Bank Committee, Report, p.228.
development reflects the continued growth of the manufacturing sector, but the more mature outlook of a number of local banks and the reduced returns available on real estate development have also contributed.

The commercial banks usually prefer a charge over land, buildings or machinery as security on industrial advances, but have frequently relaxed this requirement. A range of interest rates has applied on industrial loans. Minimum rates are low on international standards:

Only in North America and Switzerland has industrial borrowing from the commercial banks been regularly and substantially cheaper than borrowing from the main British banks in Hong Kong. Rates charged by Chinese and foreign banks are higher but the risk accepted is greater.

It has been claimed, too, that the minimum lending rate is available to a 'larger proportion of industry than is perhaps realised.'

There is no way of estimating the proportion of industrial investment financed from bank credit. A leading banker claimed in 1965 that 'many' medium and large scale manufacturing firms have borrowed 'more' from the banks than they have provided from their own sources. A little information is available from the balance sheets of the few manufacturing concerns which are public companies, but not all of these firms state separately their indebtedness to commercial banks (several companies include bank loans with provisions for taxation, dividends and other creditors), and there is the common difficulty that stated values of shareholders' funds may be little related to the size of actual capital. What information can be obtained from the balance sheets of manufacturing firms listed on the Stock Exchange is presented in Table 13.4. The Table

1 See above, p.130.
2 Economist Intelligence Unit, op. cit., p.17.
3 P.A. Graham, SCMP Banking Supplement, 1965, p.11.
4 Ibid.
Table 13.4
MANUFACTURING FIRMS LISTED ON THE HONG KONG STOCK EXCHANGE, SELECTED FINANCIAL INFORMATION, 1957, 1960 AND 1966

<table>
<thead>
<tr>
<th>1957</th>
<th>1960</th>
<th>1966</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ million</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(1) Amoy Canning Corporation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Issued capital</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Reserves</td>
<td>9</td>
<td>10</td>
</tr>
<tr>
<td>Bank overdraft</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>(2) Green Island Cement</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Issued capital</td>
<td>9</td>
<td>9</td>
</tr>
<tr>
<td>Reserves</td>
<td>5</td>
<td>8</td>
</tr>
<tr>
<td>Bank overdraft</td>
<td>n.s.</td>
<td>n.s.</td>
</tr>
<tr>
<td>(3) H.K. Aircraft Engineering Co.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Issued capital</td>
<td>n.l.</td>
<td>n.l.</td>
</tr>
<tr>
<td>Reserves</td>
<td>n.l.</td>
<td>n.l.</td>
</tr>
<tr>
<td>Bank overdraft</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(4) H.K. Breweries</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Issued capital</td>
<td>n.l.</td>
<td>n.l.</td>
</tr>
<tr>
<td>Reserves</td>
<td>n.l.</td>
<td>n.l.</td>
</tr>
<tr>
<td>Bank overdraft</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(5) Metal Industries</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Issued capital</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Reserves</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Bank interest paid</td>
<td>n.s.</td>
<td>n.s.</td>
</tr>
<tr>
<td>(6) Nanyang Cotton Mills</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Issued capital</td>
<td>15</td>
<td>20</td>
</tr>
<tr>
<td>Reserves</td>
<td>3</td>
<td>7</td>
</tr>
<tr>
<td>Bank overdraft</td>
<td>6</td>
<td>7</td>
</tr>
<tr>
<td>(7) South Sea Textiles</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Issued capital</td>
<td>n.l.</td>
<td>n.l.</td>
</tr>
<tr>
<td>Reserves</td>
<td>n.l.</td>
<td>n.l.</td>
</tr>
<tr>
<td>Bank overdraft</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(8) Textiles Alliance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Issued capital</td>
<td>n.l.</td>
<td>n.l.</td>
</tr>
<tr>
<td>Reserves</td>
<td>n.l.</td>
<td>n.l.</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>n.l.</td>
<td>n.l.</td>
</tr>
<tr>
<td>(including overdraft)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(9) Textiles Corporation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Issued capital</td>
<td>8</td>
<td>8</td>
</tr>
<tr>
<td>Reserves</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>Bank interest paid</td>
<td>0.3</td>
<td>0.2</td>
</tr>
</tbody>
</table>

n.l. = not listed
n.s. = not stated

Source: Hong Kong Stock Exchange, Year Book.
shows that for the textile firms, at least, bank credit has been a significant source of funds.

As is commonly the case, the larger manufacturing firms have been better placed to obtain bank credit. The Chairman of the Smaller Business Management Committee of the Federation of Hong Kong Industry has expressed his 'strong suspicion' that ninety percent of bank loans for industry are taken by the larger industrial enterprises (those with a paid up capital in excess of $500,000).¹

The small firms' difficulties in obtaining bank credit have been lessened somewhat by two developments mentioned already: the establishment of branch networks by the British banks, which has given them closer contact with smaller manufacturing enterprises,² and the recent soliciting of industrial loans by a number of local banks.

Because of the rapid increase in bank deposits over the period (except in 1967) the banks have not, at any stage, had to reduce their lending for industrial purposes.³ Nor, with one important exception, has bank lending to manufacturing businesses been restricted because the banks were too heavily committed in other directions. The exception was the tendency, until late 1964, of the smaller banks virtually to avoid lending for industrial purposes to profit as fully as possible from real estate advances.

(iv) Retained earnings

Retained earnings have financed a significant portion of industrial capital expenditure: outside long term funds are in

¹ K.S. Lo, 'Local Small Scale Industries', University of Hong Kong, Extra-Mural Lecture, November 1966.
² In 1960 the Hongkong Bank directly approached the Chinese Manufacturers' Association to facilitate borrowing by small manufacturers. Suty Hsin and Derek Davies, 'Finance for Industry', FEER, 23 May 1963, comment that 'many such loans were arranged but gradually the demand fell off'.
³ In 1965 a group of larger banks assured representatives of two industrial associations that they would assist smaller industrialists affected by the slight credit squeeze of that year.
limited supply, many industrialists seek to maintain a tight control over their enterprises, and a number of small firms cannot offer sufficient security to obtain bank credit. The retention for further investment of a high proportion of business earnings is assisted by the low rate of profits tax and encouraged by the relatively quick turnover of funds in labour-intensive Hong Kong industry. There must be many cases where industrialists, particularly those in the smaller firms, have stinted personally to permit the re-investment of past earnings. These sacrifices have increased the overall rate of capital formation.

Because of the importance of smaller firms in the industrial sector and, until 1965, the inability of most manufacturing businesses to offer a comparable return to that available on real estate investment, manufacturing industry may have had to rely on self-financing to a greater degree than other sectors of the economy.

(v) Government

The Government has not provided funds for investment in the manufacturing sector as it has financed capital formation in water supply and in the housing and primary producing sectors. But there have been several examples of indirect Government financial assistance. Purchasers of new industrial land can make a ten per cent initial payment and pay the balance over twenty years with ten per cent interest. This form of Government 'credit' to industry was worth $28.5 million in 1960.\(^1\) A more recent estimate is not available, but 'the vast majority of purchasers elect to pay by instalments over the maximum period possible.'\(^2\) There is no price subsidy involved in these land sales: all industrial blocks are sold at auction, with reserve prices sufficiently high to cover the 'cost of production' involved in reclamation or levelling.

\(^1\) Economist Intelligence Unit, op. cit., p.17.
\(^2\) Personal communication from Superintendent of Crown Lands and Survey.
The Government has constructed factory blocks to house manufacturing businesses previously operating in squatter areas. Almost two million square feet of factory space had been provided in this way by the end of 1967, at a cost of $31 million.¹

(vi) Other sources of funds

Non-bank financial institutions have made negligible sums available to manufacturing industry: there is no industrial finance corporation; insurance companies have invested most of their funds outside Hong Kong; and hire purchase credit had usually financed consumer durable goods. The merchant houses have been the main non-bank institutional source of funds for industry. Their assistance had benefited mainly the smaller manufacturers.

Because of the labour-intensive character of much Hong Kong industry, the network of export houses to undertake marketing arrangements and the availability of rented premises, a manufacturing enterprise can be formed with a small amount of capital. The personal savings of managers, profits from real estate, share transactions and trade, and loans from relatives and the unorganised market have all been used to finance industrial capital formation. Frequently, new manufacturing businesses have been formed by skilled workers and technicians from existing enterprises, using their own savings and funds borrowed from the unorganised market.² A senior Government official has described this mobility of funds in this way.

In the early years of industrialisation ... a large number of Hong Kong's industrialists ... were not really industrialists at all; some were merchants who had been deprived of their business by the close of the China trade and saw lucrative opportunities offered by a world sellers' market for consumer products; others were investors who assessed risks against possibilities for profit and came

¹ Personal communication from Superintendent of Crown Lands and Survey.
² K.S. Lo, op. cit.
out in favour of industrial enterprise. Once industry proved to be profitable all sorts of people with a little money and a head for business joined in.¹

This tendency has continued through most of the post-war period. For example, in late 1967 real estate developers complained of the way that idle funds from within the real estate sector were being invested in industry to benefit from the higher returns available there.²

The main features of industrial financing appear, then, to be these: the early manufacturing investment was financed mainly from capital inflow; retained earnings appear to have been the main source of long term funds; especially since around 1958 the commercial banks have provided a considerable amount of finance for industrial investment and, often, these funds have been lent on a medium term basis; and, most important, profits earned in speculation and other transactions have been invested - often through the unorganised market - in lines of industry which promise a relatively quick return. There has not developed a broad market in company securities, nor has there been long term lending for industrial purposes from non-bank financial institutions or official sources (other than, in the latter case, credit on Government land sales). There has been a continuing reliance on retained earnings and, for the smaller firms, on the unorganised market. The main development in the system of industrial finance in the post-war period has been the increasing role of the commercial banks as providers of credit for manufacturing investment. Despite the very restricted supply of long term funds, a high, and in most years rapidly increasing, level of industrial capital formation has been financed. Finance has been found, too, for the rapid establishment of new lines of manufacturing activity.

¹ T.D. Sorby, op. cit., See also Richard Hughes, op. cit., p.25.
² HS, 8 October 1967.
More evident that any development in the sources of industrial finance over time have been differences in the financing of the large and small industrial enterprises. The larger businesses have usually been better placed to obtain funds from both external and internal sources:

The dichotomy between the financing of large, well-established firms and the rest of industry is apparent the whole way through. It is almost as if two entirely separate systems of industrial financing existed side by side. By and large it is the big or medium-sized well-run firms which go to the banking system; smaller enterprises and ill-managed concerns of whatever size must resort to private lenders. It is, most probably, the bigger, solidly-based firms which have been able to finance substantial additions to fixed assets from retained profits; profit margins in the rest of industry may well have been too small and too uncertain to cover significant additions to capital.1

This statement, made in 1961, has now to be qualified to the extent that more of the better run smaller firms are able to obtain funds from commercial banks.

(b) The Industrial Bank Report. The formation of an industrial bank or development corporation has been favoured by the Chinese Manufacturers' Association (which was responsible for the establishment of the Government Committee to inquire into this problem), and a number of individual industrialists and commentators.2 In most cases, the establishment of an official industrial bank has been suggested - of course, with no restriction on its right to borrow from non-official organisations. Nothing has come of one or two reports that an industrial bank was to be established by private interests.3 The riots of 1967, which

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1 Economist Intelligence Unit, op. cit., p.18.
3 See FEER, 19 March 1959, p.416 and 16 April 1959, p.549.
discouraged private investment - especially long and medium-term investment - stimulated further interest in the establishment of an industrial bank.

The Industrial Bank Committee was established in 1959 'to advise whether there was a need for an industrial bank for the financing of industry in Hong Kong and, if so, whether Government should take steps to set up such an institution'. The Committee, was composed of representatives of banks and commerce. The Assistant Financial Secretary was Chairman. The Committee found that 'the need for an industrial bank is not proven'.

The Report briefly mentioned the working of industrial banks in other countries, where governments 'felt that official action was necessary to stimulate the growth of industry'. No attempt was made to review in detail the working of these institutions, but the Committee made two observations:

One comment we might be permitted is that such bodies are more often found where progress has been slow and scanty than where it has been rapid and extensive; they are a remedy for failure rather than a cause of success.

It seems doubtful if any of the special roles assigned to industrial banks in under-developed territories can be held to be appropriate or necessary here. Certainly, enterprise is not lacking and requires no stimulation. There is no need in this Report to stress Hongkong's debt to the enterprise of its industrialists in the post-war period.

The Report outlined the main sources of industrial finance in Hong Kong and noted the difficulty faced by industry in obtaining long term funds. It was on the difficulty 'of securing finance for investment in industry requiring a relatively long term to reach maturity or to redeem their original capital', the Committee argued, that the case for an industrial bank 'must largely stand or fall'.

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1 FEER, 4 August 1960, p.226.
2 Ibid., p.231.
3 Ibid., p.226.
4 Ibid.
5 Ibid., p.229.
Four reasons supported the Committee's view that an industrial bank was not necessary. The most important was that:

In general it would seem that such a bank could not increase the supply and would at most divert it to industry from other competing uses - although even that is not necessarily so; it might merely provide a different channel leading to the same uses.\(^1\)

Given this limited supply of investible funds,

there would appear to be no advantage in Hong Kong's present circumstances in diverting capital to industries which require a relatively heavier capital investment and a correspondingly longer redemption period.\(^2\)

The Committee claimed that no concrete example was given to them of an industrial development 'frustrated by lack of financial facilities', and that because the 'majority of risks which go to make up the interest rate [at present charged by commercial banks] are normal commercial ones which any lender must look at when deciding against or in favour of a loan ... the interest rates charged would not differ materially from those charged by commercial banks'.\(^3\)

The Committee's general conclusion was qualified, however, by the statement that 'We do not exclude the possibility that an industrial bank may become necessary or at least desirable, at some future stage of development'. It was specifically noted that an industrial bank would be an appropriate body to distribute any funds which international agencies might make available for investment in Hong Kong industry.

The Report can be criticised for overlooking the advantage even to the existing labour-intensive industry of genuine long term loans. Most commercial bank advances to manufacturing firms are nominally repayable on demand\(^4\) and, even where loans remain

\(^1\) FEER, 4 August 1960, p.229.
\(^2\) Ibid.
\(^3\) Ibid., pp.228-9.
\(^4\) This was stressed by P.A. Graham, 'The Banking Industry of Hong Kong', op. cit.
outstanding for four or five years, they are less appropriate to expenditure on fixed capital assets than would be the advances of a specialised industrial bank. This is simply to say that commercial banks, with their necessary insistence on liquidity, cannot as willingly undertake long term lending as an industrial bank whose liabilities are not repayable on demand.

The Committee, moreover, did not discuss the non-financial problems of industry: problems of management, productivity, quality control, etc. Thus, no mention was made of the contribution an industrial bank might make in these fields.

Thirdly, the Committee overlooked the financial problems of the Colony's main heavy industry, shipbuilding. The provision of long term credit to buyers has been a main aspect of international competition in this industry, and the local shipbuilders are said to have lost orders because they could not match the deferred payment terms offered by foreign competitors.¹

Perhaps, too, not enough emphasis was placed on the bank's possible role in attracting funds from overseas sources. It may be preferable to have such an institution established before approaches are made for overseas credits.

These arguments strengthen the case for the establishment of an industrial bank. On the other hand, the Report failed to mention that the intensely competitive conditions in industry would considerably complicate the operations of the industrial bank. The industrial bank might reduce one barrier - the financial one - to further increases in industrial output, and so contribute to the overproduction which has disrupted several lines of industry. This would suggest that the industrial bank should seek to finance the introduction of better techniques and scale - i.e., that it emphasise its non-economic role.

Surprisingly, the Committee made no mention of the financial problems of smaller businesses. The establishment of an institution

to assist the smaller manufacturing firms has been strongly recommended by the Smaller Business Management Committee of the Federation of Hong Kong Industry. It has been suggested that the official support be given by way of a credit guarantee or, more directly, by chanelling public funds through a body such as a 'Small Manufacturers' Aid Organisation'.

Such an authority would probably face several of the difficulties discussed already in connection with an industrial bank. The high risk surrounding many of the authority's loans would make losses virtually inevitable, and a fringe of unsatisfied borrowers would remain. Again, however, the non-financial services of the authority - its contribution to improved management and production techniques - could prove to be of considerable significance.

Trade

Finance for trade purposes is required for the Colony's entrepot trade, domestic exports and imports, and local wholesale and retail transactions. The growth of the foreign trade was shown in Table 1.3. There is no way of determining the rate of expansion or the present level of the Colony's wholesale and retail trade, but, in line with the rising population and income levels, a rapid increase must have taken place.

(a) External Trade. There has been no evidence of a shortage of funds to finance the Colony's external trade. The main sources of this finance have been the commercial banks and the export houses.

(i) Commercial Bank finance

The finance of foreign trade is the most sought after business of the commercial banks. The Hong Kong commercial banks are well placed to finance international trade: this business has been central to the operations of many banks since their establishment; they are

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1 K.S. Lo, 'Is there a place for an Industrial Bank in Hong Kong', op. cit.
well represented in the countries with which Hong Kong trades; and, most important, many have access to world financial centres should additional funds be required to meet a sudden increase in the trade volume.\(^1\) The banks have not had to limit their lending for trade purposes because they were 'loaned up', and there was no contraction in the supply of finance for foreign trade purposes after the 1965 banking crisis.

The letter of credit is used more widely in Hong Kong than in most countries.\(^2\) Several years ago some 80 per cent of imports and 60 per cent of exports were financed in this way.\(^3\) In 1966 the proportions were around two-thirds and one-half. In 1963, 60 per cent of import bills by value were expressed in sterling, ten per cent in U.S. dollars and 30 per cent in other currencies, including Hong Kong dollars.\(^4\) Export bills were written 50 per cent in sterling, 25 per cent in U.S. dollars and 25 per cent in other currencies.

Most banks provide pre-shipment finance or packing credits. Packing credits - usually for one month - are similar to a clean overdraft. The bank has no guarantee that the advances is used for the purposes intended, or even that the goods are exported.\(^5\) The banks negotiate bills drawn under an overseas bank's letter of credit or provide facilities for the purchase of export bills on DA or DP

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1. One leading banker has commented 'Naturally, of course, the banks are limited in the amount of import and export finance which they can give according to the size of their resources, but smaller organisations are frequently able to obtain discount facilities from their international correspondents in the principal centres abroad such as London and New York - so once again we find that the good credit standing of the banking industry enables Hong Kong to obtain a measure of outside finance.' P.A. Graham, op. cit., p.14.

2. The following paragraphs draw heavily on ibid., and David Williams, 'Hong Kong' in W. Crick (ed.), op. cit.


4. Much of the Colony's imports from China is denominated in Hong Kong dollars.

5. David Williams, op. cit., p.423.
terms. DA terms are the more usual for known customers. The proportion of exports financed on DP terms appears to be higher than in most trading countries. Bill usance is tied to the shipment period and to the buyers' requirements. Usance is commonly for 60 days (for textiles) to 90 days, but 120 or 180 days is still arranged when the parties are well known. More frequently now, bills are being drawn at sight.

On the import trade, letters of credit are opened, usually for 120 days, but for a longer period on some commodities, including raw cotton. The banks are also frequently involved in providing short term credit to the importer, to permit the settlement of bills at maturity. These advances usually take the form of a trust receipt: the customer promises to hold the goods in trust for the bank and to surrender the proceeds when the goods are sold. For less known borrowers, collateral security is required. Loans arranged under trust receipts have become 'a very close adjunct to bill financing', and well over half the customers engaging the banks in bill financing are accommodated in this way. The currency of these loans is usually 30 or 60 days. Interest is charged at the same rate as on bill finance.

(ii) The export houses

A large part of the Colony's trade is conducted on open account between the commercial houses and their branches and counterparts abroad. The large merchant houses work on similar principles to the exchange banks. They operate a system of set off accounts, crediting the account of the Hong Kong branch with the proceeds of goods exported from the Colony, and debiting these accounts by the value of goods imported into Hong Kong. To the extent that transactions balance, the merchant houses avoid exchange commission and transfer costs. Of course, a part of this trade is financed indirectly with

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1 David Williams, op. cit., p.423.
2 The first half of this paragraph draws on P.J. Drake, op. cit., pp.363-4.
bank credit. But the numerous export-import businesses have
themselves considerable funds from mainly internal sources. The
largest trading firms have a capital built up over a long period of
time, while the many smaller businesses have funds provided by their
owners and from past profits, and access to additional finance from
relatives and other sources in the unorganised market to meet any
short period increase in trade turnover. Several larger houses, most
notably Jardine Matheson, can borrow in foreign monetary centres.

(iii) Other sources of funds

No information is available on other sources of funds for
external trade. Local manufacturers and suppliers in other countries
have occasionally offered extended credit terms, but, more usually,
this finance is provided by merchant houses.

The Government has not provided funds to finance trade. It did,
though, set up the Export Credit Insurance Corporation, and it has
underwritten the Corporation's policies to the value of $500 million.
The Government has not sought to make the Corporation's policies a
means of securing long term advances for manufacturing industry.

(b) Domestic Wholesale and Retail Trade. The commercial banks
and the export-import firms also finance most of the wholesale and
retail trade. A considerable part of the wholesale trade, especially
in consumer durables and luxury items, is arranged and presumably
financed by the trading houses themselves. Bank funds are provided
by the British banks and several well-established local banks. Credit
from the export-import firms is less important in the retail trade,
and the bank credit employed comes mainly from the smaller banks. A
number of small retail businesses borrow from the unorganised market.

1 Jardine Matheson in December 1966 had current liabilities to bank
advances and creditors in excess of $200 million.

2 Bank loans outstanding for retail sales stood at $97 million (or
less than two per cent of total bank lending) in 1966.
As bank loans for domestic trade purposes are usually less liquid and less profitable than foreign trade credits, bank lending for internal trade has fallen when the banks have experienced liquidity difficulties or there has been reduced confidence in the Colony's economic or political future. For example, there was a reduction in bank lending for local retail and wholesale trade in 1965.\footnote{See Chairman's Statement to Shareholders, Dairy Farm, Ice and Cold Storage Limited, FEER, 2 June 1966, p.458.}
Chapter 14

THE ADEQUACY OF THE FINANCIAL SYSTEM - III: CONSTRUCTION AND OTHER SECTORS

Table 14.1 sets out the little information available on the value of building activity over recent years. The Table suggests that a boom in private construction started soon after the Korean War, and reached its peak in 1960-61. After a fall in new construction in 1961 (caused by a temporary oversupply of many types of residential flats and reduced bank lending), the value of new building work more than doubled in two years. The rate of increase was slower after 1963 and from 1965 there was frequent reference to a 'recession' in the real estate industry.\(^1\) Certainly, an excess supply of luxury accommodation developed. Building construction was depressed further by the 1967 disturbances. Public spending on building construction has risen steadily since the Government accepted responsibility in this field in 1954.

Table 14.2 sets out the volume and types of new housing provided between 1960 and 1967. Over this period there was a considerably increased interest in the construction of middle standard and low cost housing.

There is no way of estimating the return earned on capital employed in private building construction, but there are many indications that profits have been high, often spectacularly so. It has frequently been claimed that until 1963 capital invested in private construction schemes was returned in three years: one analysis shows that in 1962-63 capital was liquidated in 1.75 years on property for sale and in three to five years on property

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1 One real estate developer in 1966 described 1965 as the 'gloomiest period of real estate market after the war.' K.C. Pang, 'An Analysis of Hong Kong's Real Estate Development', University of Hong Kong, Department of Extra-Mural Studies, Public Lecture, October, 1966.
Table 14.1
COST OF NEW BUILDING WORK COMPLETED, URBAN AREA, 1950-51 TO 1966-67

<table>
<thead>
<tr>
<th></th>
<th>Factories and godowns</th>
<th>Offices and shops</th>
<th>Houses and flats</th>
<th>Others</th>
<th>Total private</th>
<th>Government capital expenditure</th>
<th>Development Loan Fund increase in housing loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ million</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>a</td>
<td></td>
</tr>
<tr>
<td>1950-51</td>
<td>15</td>
<td>23</td>
<td>59</td>
<td>25</td>
<td>121</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>1951-52</td>
<td>10</td>
<td>4</td>
<td>41</td>
<td>14</td>
<td>69</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>1952-53</td>
<td>8</td>
<td>35</td>
<td>75</td>
<td>28</td>
<td>146</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>1953-54</td>
<td>7</td>
<td>7</td>
<td>46</td>
<td>11</td>
<td>71</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>1954-55</td>
<td>9</td>
<td>6</td>
<td>49</td>
<td>27</td>
<td>90</td>
<td>22</td>
<td>3</td>
</tr>
<tr>
<td>1955-56</td>
<td>13</td>
<td>4</td>
<td>129</td>
<td>28</td>
<td>174</td>
<td>16</td>
<td>13</td>
</tr>
<tr>
<td>1956-57</td>
<td>11</td>
<td>20</td>
<td>103</td>
<td>22</td>
<td>156</td>
<td>15</td>
<td>28</td>
</tr>
<tr>
<td>1957-58</td>
<td>12</td>
<td>13</td>
<td>134</td>
<td>23</td>
<td>182</td>
<td>20</td>
<td>22</td>
</tr>
<tr>
<td>1958-59</td>
<td>32</td>
<td>30</td>
<td>140</td>
<td>56</td>
<td>258</td>
<td>20</td>
<td>39</td>
</tr>
<tr>
<td>1959-60</td>
<td>22</td>
<td>27</td>
<td>214</td>
<td>25</td>
<td>288</td>
<td>28</td>
<td>34</td>
</tr>
<tr>
<td>1960-61</td>
<td>40</td>
<td>59</td>
<td>250</td>
<td>47</td>
<td>296</td>
<td>42</td>
<td>40</td>
</tr>
<tr>
<td>1961-62</td>
<td>41</td>
<td>7</td>
<td>177</td>
<td>49</td>
<td>275</td>
<td>44</td>
<td>58</td>
</tr>
<tr>
<td>1962-63</td>
<td>49</td>
<td>56</td>
<td>210</td>
<td>50</td>
<td>363</td>
<td>65</td>
<td>53</td>
</tr>
<tr>
<td>1963-64</td>
<td>62</td>
<td>27</td>
<td>338</td>
<td>159</td>
<td>586</td>
<td>65</td>
<td>61</td>
</tr>
<tr>
<td>1964-65</td>
<td>96</td>
<td>51</td>
<td>587</td>
<td>59</td>
<td>793</td>
<td>120</td>
<td>51</td>
</tr>
<tr>
<td>1965-66</td>
<td>186</td>
<td>105</td>
<td>622</td>
<td>104</td>
<td>1,017</td>
<td>125</td>
<td>18</td>
</tr>
<tr>
<td>1966-67</td>
<td>134</td>
<td>143</td>
<td>598</td>
<td>116</td>
<td>990</td>
<td>122</td>
<td>16</td>
</tr>
</tbody>
</table>

* = Resettlement and Low-Cost Housing Only.

Sources: Commissioner of Rating and Valuation, Annual Report, various numbers. Accountant-General, Annual Report, various numbers.
Table 14.2
NEW HOUSING PROVIDED, BY TYPE, 1960 TO 1967

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Private developers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>tenement floors</td>
<td>2,200</td>
<td>8,400</td>
<td>4,400</td>
<td>7,700</td>
<td>8,600</td>
<td>14,100</td>
<td>20,800</td>
<td>11,500</td>
</tr>
<tr>
<td>flats, houses</td>
<td>1,700</td>
<td>8,700</td>
<td>5,200</td>
<td>12,400</td>
<td>1,400</td>
<td>5,800</td>
<td>10,300</td>
<td>4,500</td>
</tr>
<tr>
<td>Government quarters</td>
<td>2,200</td>
<td>200</td>
<td>300</td>
<td>900</td>
<td>1,100</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Resettlement and Low Cost Housing, flats</td>
<td>8,000</td>
<td>14,300</td>
<td>14,100</td>
<td>20,400</td>
<td>28,900</td>
<td>19,400</td>
<td>19,700</td>
<td>28,700</td>
</tr>
<tr>
<td>Co-operative Societies, flats</td>
<td>400</td>
<td>600</td>
<td>400</td>
<td>500</td>
<td>300</td>
<td>300</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Housing Society, flats</td>
<td>1,000</td>
<td>1,000</td>
<td>1,800</td>
<td>700</td>
<td>1,100</td>
<td>4,900</td>
<td>1,300</td>
<td>1,700</td>
</tr>
<tr>
<td>Housing Authority, flats</td>
<td>2,200</td>
<td>1,800</td>
<td>3,800</td>
<td>5,600</td>
<td>5,700</td>
<td>900</td>
<td>200</td>
<td>400</td>
</tr>
</tbody>
</table>

a = 31 December each year.

Source: Hong Kong Annual Report, various numbers.
constructed for renting purposes. Since 1964, however, rents on luxury accommodation have fallen, lengthening the period over which capital is returned. The quick turnover of funds has attracted capital to building construction from several sources (the unorganised market, capital inflow and the commercial banks) and has compensated for the political uncertainty. At the other extreme, rents in Government-provided housing have provided for the amortisation of capital over forty years.

The shortage of land, which has necessitated multi-storey development of most sites, requires development companies to have a relatively large capital. It has been said, for example, that a larger volume of funds is required to establish a land development company than to enter most branches of industry. ²

Sources of finance for construction

(i) Commercial banks

Commercial bank finance of real estate activity has already been outlined. Loans and investment in real estate were for long a 'mainstay' of the smaller banks, making the real estate market a 'bank made' one. ³ Before the 1964 Banking Ordinance many banks took a direct interest in real estate development. New bank lending for construction purposes was reduced in 1960-61 and again after 1964, in the latter case because of the Banking Ordinance, bank liquidity difficulties and reduced profits in construction. In December 1966 this form of bank credit stood at $957 million, or 17.5 per cent of all bank loans.

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³ See above p.107.
(ii) Capital inflow

Real estate has attracted much - in one estimate 'more than half' - of the post-war capital inflow into Hong Kong. In part this reflects the attractive return available on real estate investment, but there is also a strong preference for property investment on the part of many overseas Chinese, who have provided the large part of foreign investment in Hong Kong and who have frequently been debarred from purchasing land in the country in which they reside. The overseas Chinese funds have been invested in family companies, lent to developers by way of mortgage loan and used to purchase flats in multi-title estates. There has been some capital inflow from the advanced countries, such as the Mobil Oil group's investment.

(iii) Unorganised market

Considerable funds have been lent to developers from the unorganised market. A significant part of the profits earned by traders during the early part of the Korean War was apparently invested in real estate development. A 1963 survey found that 38 per cent of construction companies obtained their finance from private individuals only while another 37 per cent of companies were financed partly from private individuals. Because of the security offered and the relatively quick turnover of funds, real estate developers appear to have been better placed in most years to obtain funds from the unorganised market than other sectors of the economy.

Advance payments have also provided funds for construction:

Liberal regulations governing the multiple ownership of buildings have...helped to finance the building industry. Along with the vertical development of buildings in Hong

1 FEER, 28 January, 1965, p.188.
3 L.F. Goodstadt, op. cit.
Kong, developers started selling self-contained units within the building. Builders depended heavily on customer credit financing for their development schemes and many buildings were sold 'on paper' before construction actually began. There were instances where 70% of a building was sold, people having paid deposits two years previously, before construction had even started. This method of financing helped initial financing, and the small initial investment with quick returns quickly resulted in even more activity in this field.1

As much as $200,000 has been paid for the title to a single flat, some time before completion.2

(iv) Public share issues

Several land development companies are listed on the local Stock Exchange, and these companies raised $93 million by new capital issues in the period 1958 to 1966. Balance sheet information on the two main development companies is given in Table 14.3. These companies have been mainly concerned with the development of commercial properties - one owns a large section of the commercial district of Hong Kong Island - but both have built and manage factory blocks and a number of low cost and middle standard housing estates.

(v) Government

The Government's involvement in the provision of low cost and middle standard housing has been mentioned.3 There has been no attempt to provide housing at subsidised rents: the Government has argued that a direct subsidy4 would be both inequitable (in that housing cannot be provided for the whole population) and undesirable

3 See above, pp.232-5.
4 An indirect subsidy is provided in that land is made available at less than the market value and loans are granted for long periods at relatively low interest rates.
Table 14.3

HONG KONG LAND, INVESTMENT AND AGENCY AND HONG KONG REALTY AND TRUST, SELECTED FINANCIAL INFORMATION, 1957 TO 1966

(1) Hong Kong Land Investment and Agency

<table>
<thead>
<tr>
<th>Year</th>
<th>Share capital $ million</th>
<th>Reserves $ million</th>
<th>Total $ million</th>
</tr>
</thead>
<tbody>
<tr>
<td>1957 a</td>
<td>60</td>
<td>51</td>
<td>111</td>
</tr>
<tr>
<td>1962</td>
<td>105</td>
<td>46</td>
<td>151</td>
</tr>
<tr>
<td>1966</td>
<td>200</td>
<td>53</td>
<td>253</td>
</tr>
</tbody>
</table>

Fixed assets:

<table>
<thead>
<tr>
<th>Year</th>
<th>$ million</th>
</tr>
</thead>
<tbody>
<tr>
<td>1957 a</td>
<td>113</td>
</tr>
<tr>
<td>1962</td>
<td>151</td>
</tr>
<tr>
<td>1966</td>
<td>244</td>
</tr>
</tbody>
</table>

Change 1957 to 1966:

- Share capital: 140
- Reserves: 2
- Total: 142

Capital raisings, 1957 to 1966: 55

Difference: 87

Change 1957 to 1966:

- Capital raisings: 12
- Difference: 21

Source: Hong Kong Stock Exchange, Year Book.

(by reducing commercial rents, the subsidy might discourage the activities of private builders).

Virtually all the finance for Government-provided housing has come from public revenue. A scheme whereby applicants for low cost housing can secure their applications by making rent-in-advance payments.

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payments had contributed some $7 million to the Government's low cost housing program by late 1966.

It is not possible to discuss in other than a most general way the use of funds in other sectors of the economy.

Purchases of consumer durables are financed mainly by the commercial banks and the unorganised market, and less frequently, the several hire purchase companies. The finance of consumer spending is an unimportant part of the financial system and has not interfered with the flow of funds to investment uses.

Much of the investment in the small primary sectors of the economy has been provided from the Government and from welfare funds. There has been a considerable increase in the output of foodstuffs over the post-war period, but the rapid increases in population have prevented the Colony from gaining anything like self-sufficiency. In almost all cases, incomes in primary industry are still very low.

There was a boom in hotel construction in the early 1960s. Some $300 million was invested in new hotels in six years to 1964. Bank credit financed a part of this development. A large part of the cost of the Hong Kong Hilton Hotel was provided by the Hongkong Bank on security of bonds. It was reported that investors in the Hilton sought a return of capital in ten years. City Hotels raised $18 million by a public share issue in 1963. Other funds for investment in hotels came mainly from private sources. The $90 million invested in the President Hotel was provided by a syndicate of Chinese brothers.

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1 See above, pp.207-11.
2 See Appendices IV and XII of the Director of Agriculture and Fishing, Annual Report.
3 See, for example, L.F. Goodstadt, 'Are the Farmers Worth It?' FEER, 15 September 1966.
4 FEER, 28 November 1963, pp 484-5.
5 Ibid.
6 Ibid.
In other sectors of the economy - for example, restaurants, other entertainment and newspapers - there appears to have been a heavy reliance on private savings and the unorganised market.
Chapter 15

CONCLUSION

The development and operation of the Hong Kong financial system and the way in which recent economic growth has been financed have now been set out. In this Chapter we look a little more closely at the interrelation between the financial system and economic development - an interrelation referred to a number of times - and briefly discuss the relevance of the Hong Kong financial experience to other underdeveloped countries.

The financial system of the pre-war economy was a relatively simple one, oriented to the needs of the entrepot trade. The dominant institutions of this financial system were the exchange banks and the agency houses. Through these businesses Hong Kong had efficient and close links with the important financial and commercial centres of Europe, South Asia and the Far East. The banks' main business throughout the period was trade bill finance and exchange transfers. The agency houses as well as arranging the movement of goods provided insurance, warehouse and shipping services. Taxes were low. Public expenditure was confined mainly to administration, law, order and defence. Following the currency system of the main trading partner, the currency was silver-based.

But the observation that the financial system was directed towards the needs of the entrepot trade does not mean that it was an unchanging one. At first the agency houses were the main institutions, and performed a full range of commercial and financial activities, but this early dominance and the houses' banking functions were lost to the exchange banks. The methods through which the banks conducted exchange transfers and trade finance developed in line with the increasing complexity of Eastern trade, the connection of the telegraph and variations in silver
prices. The operations of the agency houses again changed in the
1870s and 1880s, when many businesses ceased trading on their own
account. Chinese-owned businesses and native banks developed from
the 1880s, complementing rather than competing against, the
established Western businesses. There were in effect two banking
systems: the British and other expatriate banks which financed the
foreign merchants, and the local banks and the compradores of the
larger institutions, which acted as bankers to the Chinese
community.

The most apparent weakness of the financial structure was the
currency system. Because it maintained a silver-based currency in
a world using, increasingly, gold or managed currencies, Hong Kong
had a variable exchange with the majority of its trading partners.
These fluctuations greatly complicated exchange remittances and the
finance of trade. Further, because the supply of banknotes was at
times inflexible there was a variable exchange rate even between
Hong Kong and China. But these weaknesses in the currency system,
which were not corrected until 1935, did not prevent Hong Kong
developing as one of the world's great entrepots.

In general there can be little question that the financial
system contributed to the success and growth of Hong Kong as an
entrepot, simply because the availability of a range of
financial and commercial services attracted additional trade
to the Colony. But we must ask a further question: might
the financial system have discouraged economic development in fields
other than the entrepot trade? For example, can it be argued that
the financial system was partly responsible for the restricted
industrial growth of Hong Kong compared, say, with Shanghai? We
saw in Chapter 2 that Hong Kong financial institutions were
willing, from an early stage, to lend and invest funds in fields not
directly connected with the entrepot trade: the Hongkong Bank made
advances to local industry from the 1860s; Jardine Matheson
invested a large sum in an unsuccessful attempt to set up a cotton
spinning industry; and finance was found for the establishment and
development of the shipbuilding industry. Perhaps more relevant were Shanghai's several non-financial advantages, including a larger and more prosperous hinterland, more active entrepreneurs (the post-war development of Hong Kong was initiated by Shanghai and not Cantonese entrepreneurs), and, in the present century, Chinese tariff protection. Also, the Hong Kong merchants had little incentive to establish manufacturing businesses while there was scope further to expand the entrepot trade in Chinese goods.

At first sight, the present financial system is little changed from that of the entrepot economy. The currency is issued under arrangements adopted before the Pacific War in response to the collapse of the silver standard and the wartime threat by Britain and the United States to freeze the currency balances of occupied China. The system of issuing currency is modified only to the extent that a free market in foreign currencies for a wide range of financial transactions was 'tolerated' in 1946 and formalised in 1967. The sterling exchange standard in a most pure form is still employed. And, despite the growth of the banking sector, the main determinant of the money supply is still the balance of payments. Commercial banks remain the dominant institutions of the financial system. There has not been the sudden proliferation of non-bank financial institutions, including a relatively wide market in fixed interest securities and equities, that elsewhere has commonly been associated with economic development. There is no central bank. Public finance is conducted on most conservative lines and the Government outlook is still a laissez-faire one. There has been no attempt to use the budget as a means of stabilising the economy, and negligible use has been made of borrowed funds. Most businesses continue to rely on retained earnings and on private sources of funds.

However, on closer analysis a number of quite important financial developments becomes evident. While the commercial banks have maintained their dominant position, the banking system has
developed considerably in activities, structure and stability. Almost all banks are now important as collectors of deposits. There is a considerable volume of local advances. Of course, even before the Pacific War the Hong Kong banks sought local deposits, they functioned as depositories for the savings of residents elsewhere in the East, and the institutions made some local advances from an early date. But the local business of the main institutions is now so important that the title exchange bank is inappropriate, despite the considerable volume of trade finance business still written. The banking system is more unified. Many Chinese residents and businesses deal with the British banks. The local Chinese banks are much larger and have a stronger capital, they have set up trade finance sections and have adopted more conventional standards of liquidity and security. These local banks now compete with the British and expatriate banks over a fairly wide field. Even the small local banks have moved towards operations of a more conventional commercial banking nature, away from the money changing and money lending which dominated their activities in the entrepot economy. The banking system, too, is stronger and more stable. There are fewer banks, individual institutions have a stronger capital and are more security- and liquidity-conscious, and the whole banking system is better regulated and controlled.

There have been important developments in the operations of the merchant houses since economic and political changes on the Mainland denied them their traditional role as middlemen of the China trade. These institutions now trade mainly in imported raw materials and capital and consumer goods for sale in Hong Kong, and in the export of local manufactures. They have marketed a large part of the Colony's output of manufactured goods since the start of industrialisation. On the basis of this trade the long established houses have grown appreciably over the post-war period. Several have set up manufacturing subsidiaries.
There have been some changes also within the public finance system. Direct taxes, introduced as a wartime measure in 1940, are now a permanent charge and their level has been slightly increased. Mainly because of these direct taxes, Government revenue has been more than responsive to the recent growth in incomes. On the expenditure side, the main feature has been an increase in spending on public works. The Government's entry into the field of low cost housing is perhaps the single most important development in the public finance system. There has also been heavy public expenditure on water storage and there is growing Government involvement in the provision of infrastructure. Government expenditure on education is considerably increased. These developments in the public finance system were forced on the Government by the fundamental demographic changes of the past two decades.

The capital market has developed in some aspects. The housing finance institutions formed since the War have financed the construction of housing for a quarter of a million people. Co-operative societies have been set up to assist capital formation in agriculture and fishing. Turnover on the stock exchange is considerably increased, and for the public utilities and land development companies, at least, public share issues have been important sources of funds.

Overall, though, changes in the structure and operation of existing institutions have been more important than the development of new financial intermediaries and the emergence of a complex financial market. It is largely because the existing financial institutions - especially the commercial banks - have undertaken new functions and accepted a wider role that the financial system has changed so little during the post-war economic development.

Another aspect of the financial system is also relevant. One of the most important characteristics of the Hong Kong financial system to emerge from this study is the mobility of investment funds
to the unorganised market and in private hands. Profits earned in speculation in commodities and precious metals in the late 1940s were invested in real estate and industrial developments, and real estate profits in the 1950s were later invested in manufacturing industry. Because of this mobility, funds have usually been quickly directed to the most profitable - i.e., the most rapidly expanding - sectors of the economy. (It also follows that, more than in most countries, productive investment has constantly to compete for funds with speculative investment). The general short term outlook, the abundant supply of entrepreneurs and the prevalence of the Chinese family firm have led to this mobility of private funds.

Chapter 1 traced the remarkable economic growth experienced in Hong Kong over the post-war period. In less than two decades and with a laissez-faire economic system, Hong Kong has developed from an entrepot trading port to a significant manufacturing centre. It is worth now summarising the main ways in which the financial system has actively contributed to this economic growth - i.e., the ways in which the financial sector has been a 'leading factor' in the process of economic development.

First, the stability and convertibility of the local currency have been important in attracting to Hong Kong the overseas funds which did much to initiate and sustain the Colony's development. Of course, a part of this capital inflow would have taken place regardless of the strength of the Hong Kong dollar. Investment in Hong Kong is the 'nearest thing to investment in China', there is no discrimination in the Colony against investment by those of Chinese race, and the laissez-faire economic system is attractive to foreign investors. But the stable and convertible currency has greatly enhanced the Colony's appeal to foreign investors. At the very least, the ease with which funds can be repatriated has compensated investors for the political risk surrounding investment in Hong Kong.
Secondly, the availability of commercial bank loans and advances virtually from the start of industrialisation - often to relatively untried businesses and against little security - has contributed to the rapid success of industrial development. The Hong Kong commercial banks have to some degree accepted risks which elsewhere are the responsibility of equity investors. Their liberal lending policy is the more surprising when one considers that a large part of deposits is owed to foreigners and the banks are not supported by official rediscount facilities. As well as directly assisting development, the liberal availability of industrial loans must have had a favourable effect on entrepreneurial outlooks. And, through the spread of the banking habit the commercial banks have made available for investment funds earlier held in hoards of currency and precious metals.

Because of the mobility of investible funds resources in Hong Kong have been efficiently transferred to sectors with the most promising return. On both the organised and unorganised markets investible funds appear more mobile than in many developing countries.

Fourthly, the availability of developed marketing networks though the agency houses facilitated the rapid establishment of manufacturing businesses.

Finally, the public finance system has assisted economic development in several ways. The light tax burden has permitted the re-investment of a high proportion of business earnings and the quick turnover of capital. Taxes have not discouraged initiative. The public sector has not caused inflation or balance of payments difficulties. Considerable sums have been made available for the provision of low cost housing.

The main weakness of the financial system is doubtless the restricted supply of outside long term and equity finance. It is long term funds rather than risk capital which has been in short supply in Hong Kong. This weakness in the financial system has limited industrial development in several fields, including the
expansion of capital intensive industries such as shipbuilding, it has restricted the activities of the housing finance institutions, and has, required consumers of utility services to finance a high proportion of capital expenditures. Also, there has been criticism that Government spending on education, health, welfare services and slum clearance has not increased fully in line with the community's rising demand for expenditure in these fields. And, as a result of the underdeveloped money and capital markets, local banks and insurance companies hold a high proportion of their assets outside the Colony. Because of the freedom with which funds can be transferred overseas, Hong Kong businesses have continually to compete for investible funds with foreign institutions and securities.

These several weaknesses in the financial system will perhaps be more keenly felt in the future. The present financial system - which is directed mainly to the finance of small business units and light industry - may prove increasingly inadequate as manufacturing industry develops and greater emphasis is placed on scale and on capital intensive methods of production. Should the supply of investible funds be less adequate in the future it will become more desirable that the banks and other financial institutions hold more of their assets locally. The rising expectations of the larger and more prosperous community will doubtless involve the Government in increased expenditure on infrastructure and social services, which it might not be easy to finance under the present system.

It is also possible that an institutional system in which the money supply depends mainly on the balance of payments could prove disruptive in the future. At the same time, the growth in the domestic sector might give rise to locally generated increases in demand and prices which call for some form of stabilisation policy and, perhaps, the establishment of a central bank.

There are some ways in which the Hong Kong financial experience is instructive to those concerned with the financial aspects of
economic development in other countries. The main features of the financial system shown in this study are the dominant role of the commercial banks and the flexibility of their operations, the importance of retained earnings as a source of investible funds, and the mobility of funds on the unorganised market. If the commercial banks had been more restricted in their activities - as would have been the case had comprehensive banking legislation modelled on that of developed countries been imposed early in the post-war period - or had heavier taxes restricted the re-investment of business earnings, the financial system would almost certainly have functioned less efficiently, to the detriment of economic growth. This study stresses the benefits, to an economy in which the main business decisions are taken by private enterprise, of a flexible and enterprising banking sector. We have seen, too, that economic development need not be associated with the emergence of a complex and sophisticated capital and money market, largely because, given the right environment, retained earnings can provide a major source of development funds and resources can be efficiently transferred to the more progressive sectors on the unorganised market. Finally, the study demonstrates that a colonial sterling exchange currency standard need not be a disadvantageous monetary system to a developing country.

But there are several important differences between the financial problems of Hong Kong and many other developing countries. For one thing, the supply of funds has been more adequate in Hong Kong than in most countries: a considerable volume of overseas funds has flowed into Hong Kong and, domestically, businesses have made heavy use of retained earnings, the population has been parsimonious and the Government has pursued prudent financial policies. To some extent, as we have already seen, the financial system has contributed the apparently adequate supply of funds. The strong currency has attracted foreign capital. The local banks have collected for productive investment the funds of domestic
savers. The system of public finance has permitted businesses to retain a high proportion of earnings for further investment. But several non-financial factors have also been relevant, including the attraction of this predominantly Chinese city to overseas Chinese and the traditional thrifty nature of the Chinese. Whatever the reason, there is not the necessity to seek ways in which the financial system might be restructured to encourage a higher rate of saving that is found in many developing countries.

Largely because of its financial system, Hong Kong has not suffered from the balance of payments difficulties experienced by many underdeveloped countries. Probably, the 100 per cent foreign exchange backed currency issue is a less disadvantageous system in Hong Kong than in most countries: the balance of payments has regularly been in surplus (thus the monetary system has not imposed a deflationary bias), the Colony is not dependent on one or two exports with variable prices, and the supply of investible funds has been so large that the 'locking up' of resources as currency backing has not seriously restricted development expenditures.

A third difference is the mobility of funds on the Colony's unorganised market which has permitted an efficient distribution of capital funds despite the relatively narrow capital market. Because of this characteristic of the financial system it appears less necessary to develop a network of financial institutions in Hong Kong than in most countries. The usual case for official assistance in establishing and nurturing non-bank financial institutions in a private enterprise economy is that individual savers are not the most efficient investors or these individual savers are not in the most profitable sectors. Through the re-investment of private savings and the unorganised market, private investible funds in Hong Kong seem already highly mobile between sectors, while the relatively quick turnover of capital has compensated investors for the illiquidity of direct investment and of loans on the unorganised market.
Hong Kong is an outstanding example of an underdeveloped country which has experienced rapid economic growth without planning or controls. The few exceptions in the laissez-faire system are the Government restrictions on the production of many textile goods, introduced to meet the Colony's marketing commitments, the Government's provision of low cost housing and industrial land, and the relatively minor investment incentives. The rapid development and industrialisation were initiated by the group of entrepreneurs which moved to Hong Kong from China in the late 1940s. Economic growth was facilitated by the institutional structure - including the banks and commercial institutions - which had developed during the entrepot economy, by an adequate and adaptable labour force, and by the continuing inflow of funds, largely from overseas Chinese. Apparently then, Hong Kong has been better placed than most developing countries in entrepreneurship, labour and capital, to achieve rapid economic growth under a laissez-faire economic system. These favourable circumstances have overcome the Colony's disadvantages of an uncertain political future and a lack of raw materials. It can readily be argued that a laissez-faire economic system is more acceptable in Hong Kong, with its adequate supply of entrepreneurs, a colonial Government and an uncertain political future, than in most countries. Nonetheless, awareness of the recent experience of economic growth in Hong Kong is instructive to students of many other - and even semi-planned - developing countries, at the very least because of the success of the industrialisation and of the speed with which the economic development has taken place.
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