Mr. Chen discusses monetary relations between China and Hong Kong
Speech by the Deputy Governor of the People's Bank of China, Mr. Chen Yuan, at the Bank of England Seminar held in London on 10/9/96.

INTRODUCTION

In less than three hundred days, China will resume the exercise of sovereignty over Hong Kong. Given Hong Kong's role as an international financial centre, it is natural for the international investment community to be interested in the future of Hong Kong. I am grateful to Governor George for giving me this opportunity to share with this distinguished audience the Chinese Government's policy on the monetary relationship between the mainland of China and Hong Kong after 1997.

By way of introduction, let me first explain the origin of the basic principle of "one country, two systems", which forms the backbone of China's policy towards the Hong Kong Special Administrative Region as from 1 July 1997. This will help people to understand why China is so committed to implementing this very important principle in Hong Kong.

THE "ONE COUNTRY, TWO SYSTEMS" PRINCIPLE

What does "one country, two systems" mean? It means that after 1997, the socialist system and policies shall not be practised in the Hong Kong Special Administrative Region, and the previous capitalist system and way of life shall remain unchanged for 50 years.

This principle was not a compromise solution reached in the Sino-British negotiations for political expedience. It was not even an idea floated by the British side. It was in fact a paramount guiding principle adopted by the Chinese Government for advancing the unification of China. The principle was also the outcome of intense research by the Chinese Government on what factors contributed to the economic success and stability of Hong Kong and how they could be preserved beyond 1997. We are convinced that this principle would serve not only China's long-term national interest but also that of Hong Kong.

It was against this background that the Chinese Government put forward in the negotiations the concept of "One Country, Two Systems" and the guiding principles. These were subsequently incorporated in the Sino-British Joint Declaration in 1984 and then in the Basic Law promulgated by our National People's Congress in 1990. I should add that the principle of "one country, two systems" as a fundamental policy for the unification and development of China has been written into our country's constitution and become a long-term irreversible national policy. The Sino-British Joint Declaration is a treaty registered with the United Nations. The Chinese Government is committed to implementing fully and faithfully the provisions of the Joint Declaration and the Basic Law.

My second point is that notwithstanding our commitment, there is no lack of sceptics who doubt that the Chinese Government would abide by the Basic Law and fulfil its commitments after 1997. This brings to mind those sceptics who doubted China's commitment to the open door policy and the economic reform which China initiated in late 1979. Such critics thought that the problems faced by China in the reform process were so huge that we were doomed to fail. They also doubted how our economic reform could square with China's socialist economy. Today, you and I can both see that these critics have been proven wrong.

Between 1979 and 1995, China's GDP has increased by an average of 9.9% every year and the standard of living has improved significantly. The economic and monetary conditions and the legal and institutional reform of our financial sector have made progress beyond the expectations of many. China's foreign reserves reached a record high of US$ 90.7 billion in early August 1996.

The critics are right in pointing out that China is a vast country, with a large population of over 1.2 billion people. It is natural that in the implementation of our reform we could run into difficulties of one sort or another. At times we need to adjust our pace a bit to resolve those problems but there is no question that China is firmly resolved to continuing with economic reform. Equally, China remains firmly and totally committed to maintaining the prosperity and stability of Hong Kong, in accordance with the provisions of the Joint Declaration and the Basic Law. I am sure that the facts and events will demonstrate that the sceptics will once again be proven to be wrong.

Ladies and gentlemen, let me now proceed to outline first the legal and policy framework and then the seven basic principles governing the monetary relationship between the mainland of China and Hong Kong. Finally, I will describe China's policy on Hong Kong's participation in international and regional financial institutions and forums.

THE LEGAL AND POLICY FRAMEWORK

According to the Joint Declaration and the Basic Law, Hong Kong will enjoy autonomy in all areas other than foreign affairs and defence matters. The key provisions on the monetary and financial sides provide that:

The Government of the Hong Kong Special Administrative Region shall provide an appropriate economic and legal environment for the maintenance of its status as an international financial centre. Hong Kong shall, on its own, formulate monetary and financial policies, safeguard the free operation of financial business and financial markets, and regulate and supervise financial activities in accordance with the law.

The Hong Kong dollar, as the only legal tender in Hong Kong, shall continue to circulate, and the existing currency issue mechanism shall continue. The Hong Kong dollar shall remain freely convertible, with free flow of capital and no exchange controls. The Exchange Fund, which holds Hong Kong's foreign reserves, shall be managed and controlled by the Government of the Hong Kong Special Administrative Region, primarily for regulating the exchange value of the Hong Kong dollar.

The above provisions form the foundation for defining and establishing the monetary relationship between the mainland and Hong Kong under the principle of "one country, two systems". Under these provisions, this relationship can be best summarised as one country, two currencies, two monetary systems and two monetary authorities, under two different social and economic systems within a sovereign state.

SEVEN PRINCIPLES GOVERNING THE MONETARY RELATIONSHIP BETWEEN THE MAINLAND AND HONG KONG

I will now set out the seven principles governing the monetary relationship between the mainland of China and Hong Kong.

The first principle concerns the relationship between the two currencies and between the two monetary systems.

According to the Basic Law, Hong Kong will continue to maintain its own system of currency issuance and management after 1997. The Hong Kong dollar and the renminbi will circulate as legal tender in Hong Kong and the mainland respectively. The Hong Kong dollar will be treated as a foreign currency in the mainland. Likewise, the renminbi will be treated as a foreign currency in Hong Kong.

The three note-issuing banks in Hong Kong will continue to issue Hong Kong dollar bank notes, with 100% backing by US dollars under the linked exchange rate system. The currency in circulation in Hong Kong is in fact backed over five times by foreign reserves. Here I would like to stress that China supports Hong Kong's commitment to the maintenance of the linked exchange rate system, which has served Hong Kong well by providing monetary stability since its introduction in 1983.

Corresponding to the two currencies will be two monetary systems. They possess their own characteristics, reflecting the differences between the two economies. The two monetary systems are of equal importance to China in its reform and liberalisation. One does not precede or be subsidiary to the other. They will operate in a mutually independent manner.

The second principle relates to the relationship between the two monetary authorities. It follows from the two mutually independent monetary systems of the mainland and Hong Kong that the two monetary authorities will also be mutually independent. The Hong Kong Monetary Authority will be accountable solely to the Hong Kong government. The People's Bank of China will not take the place of the Hong Kong Monetary Authority and will not set up any office there.

As Hong Kong and the mainland develop increasingly close economic ties in both trade and investment, close co-operation between the two monetary authorities becomes even more important. The two monetary authorities must, therefore, strengthen further the present sound co-operation of central banking functions, including monetary management, banking supervision and the development of the financial infrastructure.

The third principle concerns co-operation in prudential supervision. According to the Basic Law, the Hong Kong government will continue to supervise financial institutions in Hong Kong, including financial institutions from the mainland. Supervision will continue to be undertaken in accordance with international rules and practices.

Notwithstanding different business practices in the mainland and Hong Kong, we have reached consensus on licensing procedures and supervision of each other's financial institutions. It has been agreed that :

Financial institutions based in the mainland and Hong Kong setting up offices in each other's territory shall be approved on the same basis as foreign financial institutions. The mainland offices of Hong Kong-based financial institutions shall continue to enjoy the same preferential treatment in the mainland as other foreign financial institutions. mainland financial institutions in Hong Kong shall not enjoy any privileges. They shall abide by the law of Hong Kong and be regulated by the relevant supervisory authorities in Hong Kong.

This arm's length treatment will certainly help to underscore the implementation of the "one country, two systems" principle.

The fourth principle is that the People's Bank of China will support the currency stability of Hong Kong. On behalf of the PBOC, I have early this year signed a bilateral agreement with the HKMA on the repurchase of US treasury paper. We are prepared to offer liquidity support to the HKMA for the purpose of stabilising the exchange rate of the Hong Kong dollar. We also stand ready to use our foreign reserves to support the Hong Kong dollar, if necessary.

However, I must point out that under no circumstances will China draw on or resort to Hong Kong's Exchange Fund or other assets in any way and for any reason. I mentioned earlier that the Basic Law states that the Exchange Fund shall be managed and controlled by the Hong Kong government. It is also stated that the financial revenues of the Hong Kong Special Administrative Region shall be used exclusively for its own purposes. In addition, the Basic Law stipulates that the Chinese Government shall not levy taxes in Hong Kong. These triple safeguards are evidence that China does not have its eyes on siphoning off the resources of Hong Kong.

The fifth principle relates to the treatment of financial business between China and Hong Kong. After 1997, all financial business between the two places will be conducted in accordance with the rules and practices of international financial activities. Claims and liabilities between banks and companies from the mainland and those in Hong Kong will continue to be regarded as external claims and liabilities. When raising funds in Hong Kong, Chinese entities will have equal treatment as other international and local market participants, without any special privileges. Disputes relating to contracts between banks and companies of the mainland and those of Hong Kong shall be handled in accordance with international practice. Where China's Arbitration Law and other relevant laws and regulations are applied, the provisions relating to arbitration involving foreign parties will apply.

The sixth principle is about the standing of mainland financial institutions in Hong Kong. As discussed earlier, mainland financial institutions in Hong Kong must abide by the law of Hong Kong and be regulated by relevant regulatory authorities there. I would like to stress that the Bank of China group, though being one of the three note-issuing banks and a leading commercial bank in Hong Kong, shall not be treated more favourably than other banks. It shall not carry out any activities beyond the role of a commercial bank.

The seventh principle is on the complementarity between Shanghai and Hong Kong. As you know, Shanghai used to be China's financial centre. With China's deepening reforms and open-door policy, Shanghai is becoming a vibrant city with tremendous potential for further development. To a certain extent, Shanghai has met the conditions for reviving herself as a financial centre. While there are concerns as to whether Shanghai will replace Hong Kong, I would like to emphasise that these are groundless speculations because the Basic Law has already stipulated that Hong Kong shall maintain its status as an international financial centre.

We are of the view that Hong Kong and Shanghai will have a complementary and mutually reinforcing relationship. In the short run, and at least before the renminbi becomes fully convertible, it will not be possible for Shanghai to become an international financial centre. Given the size of China's economy, there is plenty of room for more than one financial centre.

Hong Kong and Shanghai will likely become two complementary and mutually reinforcing financial centres that will each develop with its own characteristics.

HONG KONG IN INTERNATIONAL MONETARY RELATIONS

Apart from these seven principles, it is also important for Hong Kong as an international financial centre to continue to develop its international monetary relations and participate in the activities of international and regional financial institutions, central bank forums etc.

There are therefore provisions in the Joint Declaration and the Basic Law that Hong Kong may, on its own, maintain and develop financial relations and conclude and implement agreements with other countries, regions and relevant international organisations, using the name of “Hong Kong, China”.

Some international financial organisations restrict their membership to sovereign states. In those cases, where negotiations are held on matters involving Hong Kong, the Chinese Government would normally consult Hong Kong and include its representatives in the Chinese delegation. When entering into international financial agreements which may involve Hong Kong, the Chinese government will first seek the views of Hong Kong before deciding whether such agreements will apply to it.

Taken together, these provisions will enable Hong Kong to continue and also develop its current international monetary relationship.

PROSPECTS FOR HONG KONG AFTER 1997

I believe Hong Kong will remain prosperous and stable after 1997. Why? This is because:

First, the strong economic fundamentals of Hong Kong and the entrepreneurial and management skills of the people of Hong Kong are the basis for its continued prosperity and stability.

Secondly, the Basic Law has provided a legal safeguard for the maintenance of the prosperity and stability of Hong Kong.

Thirdly, the economic development of the mainland has created excellent conditions for Hong Kong’s continued prosperity and stability. As pointed out by China’s Vice-Premier Zhu Rongji at his meeting on 29 May this year with senior officials of four main financial regulators and institutions from Hong Kong including the Hong Kong Monetary Authority - China is confident in Hong Kong’s maintaining prosperity and stability and its status as an international financial centre after 1997 because we have full confidence in the economic development of China.

As Hong Kong will continue its role as an international financial centre, it will become the most important funding centre for China and very likely for the Asian region as a whole. With the ongoing reform and open-door policy, the mainland of China has achieved sustained and strong economic growth. Our target for economic growth in 1996 is 8% but it could exceed 9%. Inflation should be within the range of 7 to 8% for 1996.

The mainland of China's growth will obviously benefit Hong Kong's economy tremendously as we are its largest trading partner. The mainland of China is also one of the leading investors in Hong Kong, with total investment reaching US$ 25 billion last year. At the same time, Hong Kong has also contributed greatly to the mainland of China's reform and modernisation, both in terms of investment and know-how. Hong Kong is the largest investor in the mainland. Total cumulative direct investment from Hong Kong has now reached US$ 78.6 billion, accounting for 58% of total foreign direct investment. In 1995 alone, about half of the foreign direct investment in the mainland came from Hong Kong, which amounted to some US$ 20 billion. Also, for the 23 Chinese companies listed on overseas stock markets, the trading of such overseas stocks is most active in Hong Kong. Out of the 23 companies, 21 had their primary listing in Hong Kong.

As China continues with its financial and economic reforms, Hong Kong's role as a financial centre for China will become even more important. It is therefore vital that Hong Kong remain the vibrant financial centre with its own economic system that we know now. We certainly would not do anything which would jeopardise Hong Kong's prospects.

To conclude, I have no doubt that Hong Kong will continue to do well after 1997 as it has done in the past three decades during which Hong Kong survived numerous shocks and market turbulence. History has shown that Hong Kong has been extremely resilient to external shocks and was able to regain its vitality and competitiveness through swift internal adjustments. Investors who had the foresight and wisdom of capitalising on the opportunities in Hong Kong have done well and will be able to continue to share in the prosperity of Hong Kong.

Ladies and gentlemen, 1997 is not a time when Hong Kong will need a miracle in order to survive the transition. I hope you will also come to the conclusion that China, particularly Hong Kong, offers tremendous business potential for investors, both local and overseas.