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Hong Kong Financial Markets: Structure, Performance, and Prospects

l. Introduction

During the past two decades, Hong Kong has been widely known for its two major economic achievements; one is its transformation from a minor entrepôt to a developed industrial economy [1], the other is the tremendous growth of its financial markets,which places it along with London, New York, Tokyo, and so on, as one of the major financial centers [2]. This paper addresses the second achievement. Its primary object is to study the characteristics of Hong Kong's financial markets and the major problems they face.
The remainder of this paper is arranged as follows. Section 2 deals with depository institutions which constitute the core of financial institutions in Hong Kong. It also examines the role of a special commercial bank that performs some of the monetary authorities' functions in the absence of a central bank in Hong Kong. Four major markets are investigated in Section 3, namely, stock market, money market, foreign exchange market, and gold market. Section 4 has a two-fold purpose. It considers some of the difficulties faced by Hong Kong's financial markets, and, more importantly, analyzes the prospects for Hong Kong as a financial center in view of the political uncertainty over its reversion to China in 1997 and the growing competition from other financial centers in the Asia Pacific region. Limited by the length of the paper, in-depth discussion of each topic will not be attempted.

2. Financial Institutions

Hong Kong's financial sector comprises a well integrated body of institutions and markets. Among institutions, commercial banks, merchant banks, deposit-taking companies, and fund-management companies are major providers of financial services to Hong Kong individuals and businesses. Since depository institutions dominate the financial scene in Hong Kong and non-bank financial intermediaries play no more than a marginal role, this section focuses only on the structure and characteristics of banking institutions. The size of major depository and non-depository institutions is given in Table 1 for comparison.

2.1 Structure Classification

Since 1981, the Hong Kong banking structure has been characterized by a three-tier system of institutions that are authorized to take deposits from the general public: (1) licensed banks, (2) restricted license banks, and (3) deposit-taking companies. As a group, they are known as authorized institutions.

Licensed Banks
With the exception of two note-issuing licensed banks - Hong Kong and Shanghai Banking Corporation (HSBC) and the Standard Chatered Bank -

Table 1: Total Assets of Selected Financial Institutions (in billions of HK Dollars).

	1980	1985	1988	1989	1990
Depository Institutions					
Licensed Banks	268	1,101	3,286	3,874	4,858
% of total assets to GDP	237.30	421.73	757.19	789.38	878.13
Deposit Taking Companies					
(including restricted licensed banks)	130	455	412	373	376
% of total assets to GDP	115.14	174.13	94.83	76.02	67.93
Non-depository Institutions					
Mutual Funds	N.A.	N.A.	76	128	142
% of total assets to GDP	N.A.	N.A.	17.50	26.14	25.75

Note:
The exchange rate between the U.S. dollar and the Hong Kong dollar is US$1 = HK$7.8.

Source:
For depository institutions, Hong Kong Monthly Digest of Statistics, various issues; for mutual funds, Hong Kong Unit Trust Yearbook, various issues.

licensed banks are virtually commercial banks. At the end of 1990, there were 168 licensed banks in Hong Kong, of which 138 were incorporated overseas. Except for the Commonwealth of Independent States (formerly the Soviet Union) and Eastern European countries, almost all major countries or regions are represented in the Hong Kong banking sector.

All licensed banks must be members of Hong Kong Association of Banks (HKAB), a statutory body that has a special role in the administration of the interest rate agreement. The agreement regulates the maximum rate of interest that may be paid by licensed banks for deposits of less than HK$500,000 with a maturity of not more than 12 months. Unlike other types of financial institutions, licensed banks may take deposits of any size and maturity from the public.

Licensed banks in Hong Kong can be classified according to their national origins into four major groups: foreign, China-related Chinese, local Chinese, and overseas Chinese banks. Among the foreign banks, the British banks occupy a dominant position in the banking system, mainly due to their close relationship with the Government. In the absence of a central bank in Hong Kong, the Hong Kong and Shanghai Banking Corporation (HSBC), one of the British banks, actually performs some of the central banking functions.

China-related Chinese banks refer to a tightly organized group of 15 banks operating under the leadership of Bank of China and controlled by the People's Republic of China. The local Chinese banks are a group of banks set up by Chinese and incorporated in Hong Kong, while the overseas Chinese banks are established by Chinese domiciled outside China and Hong Kong.

The banking licenses of licensed banks are granted at the discretion of the Governor in Council, that is, the Hong Kong Governor in consultation with the Executive Council. In order to be considered for a banking licence, a local applicant must have a paid-up capital of not less than HK$150 million and at least HK$2,500 million of assets. For a bank incorporated outside Hong Kong total assets (net of contra items) of at least US$14,000 million are required, and, besides, its country of incorporation must exercise an adequate form of prudential supervision over banks.

Restricted License Banks (RLBs)

Formerly known as licensed deposit-taking companies, RLBs are basically merchant or investment banks. Their activities include mainly loan syndication, underwriting securities, dealing in foreign exchange, and providing advisory services in mergers and acquisitions. They may take deposits of any maturity from the public, but in amounts of not less than HK$500,000. Unlike licensed banks, they are not subject to restrictions on the interest rates payable on time deposits. RLBs obtain their licenses from the Financial Secretary. Among the requirements is a minimum of issued and paid-up capital of HK$100 million. Applicants incorporated overseas must also be subject to adequate supervision. At the end of 1990, the number of RLBs stood at 46, 14 of which were incorporated outside Hong Kong, proportionately considerably less than licensed banks.

Deposit-taking Companies (DTCs)

The third category of banking institutions is deposit-taking companies or, as known before 1990, registered deposit-taking companies. In addition to taking deposits, their activities include making loans, factoring, and leasing. The minimum amount of deposits the DTCs can take from the public is HK$100,000 with a term to maturity of at least three months and subject to no interest rate restrictions. The DTCs are required to register with the Commissioner of Banking. Since April 1981, the Commissioner has granted registrations only to applicants that, if incorporated in Hong Kong, are at least 50% owned by a bank which is subject to adequate supervision. They are also required to have a paid-up capital of not less than HK$25 million. If incorporated overseas, the applicant must be a bank subject to adequate supervision. The criteria for authorization for each of the three categories of banking institutions are summarized in Table 2. All combined, there has been a trend for Hong Kong banking institutions to diversify their activities from conventional lending into a wide range of financial services including fund management and investment advice.

Table 2: Criteria for Authorization for the Three-tiers of Banking Institutions.

	Licensed Banks	Restricted License Banks	Deposit-taking Companies
Authority to be licensed by or to register with	Governor in Council	Financial Secretary	Commissioner of Banking
Capital requirement	HK$150 million (for locally incorporated bank)	HK$100 million	HK$10025 million
Assets requirement	HK$2,500 million	- -	- -
Deposits required from the public	HK$1,750 million	- -	- -
Minimum amount of deposits per account	Any size	HK$500,000	HK$100,000
Restrictions on interest rates payable	Subject to the decision of Hong Kong Association of Banks for deposits less than HK$500,000		

Source:
ANNUAL REPORT OF THE COMMISSIONER OF BANKING for 1990.

Table 3: Authorized Institutions Classified by Country of Ownership.

Country/Region	Licensed Banks					Restricted License Banks					Deposit-taking Companies				
	86	87	88	89	90	86	87	88	89	90	86	87	88	89	90
Asia & Pacific															
Hong Kong	20	19	19	15	15	5	4	4	4	3	46	34	30	25	20
Australia	4	4	4	5	5	3	2	2	2	4	6	6	4	3	2
China	15	15	15	15	15	-	1	1	1	1	17	16	16	16	16
India	4	4	4	4	4	-	-	-	-	-	4	4	4	4	4
Indonesia	2	3	3	3	3	-	-	-	-	1	20	19	16	16	16
Japan	25	26	28	30	31	6	6	6	8	11	28	28	30	29	31
Malaysia	2	2	2	3	2	1	1	1	1	2	5	3	3	4	5
New Zealand	-	1	1	1	1	-	-	-	-	-	3	2	2	1	1
Pakistan	1	1	1	1	1	-	-	-	-	-	1	1	1	1	1
Philippines	2	2	2	2	2	1	1	1	1	1	9	8	7	6	5
Singapore	5	5	4	4	5	-	-	-	-	-	8	9	9	8	8
South Korea	3	3	3	3	3	-	-	-	-	1	6	6	7	9	9
Thailand	1	1	1	1	1	-	-	-	-	1	12	10	9	8	8
Others	-	-	-	-	-	-	-	-	-	-	2	2	2	1	1
Sub-total	84	86	87	87	88	16	15	15	17	25	167	148	140	131	127
Europe															
Austria	-	-	1	2	2	-	-	-	-	-	-	-	-	-	-
Belgium/Luxembourg	3	3	3	3	3	1	1	1	-	-	6	6	6	4	3
Denmark	-	-	-	-	1	-	-	-	-	-	-	-	-	-	-
France	8	8	8	8	8	1	1	1	1	1	11	11	10	10	9
Germany	8	8	8	9	9	-	-	-	-	-	5	4	4	4	2
Italy	4	6	6	7	7	-	-	-	-	-	-	-	-	-	-
Netherlands	3	3	3	3	4	2	2	2	2	2	3	3	3	2	2
Norway	-	1	1	1	1	-	-	-	-	-	-	1	1	1	1
Republic of Ireland	-	-	1	1	1	-	-	-	-	-	-	-	-	-	-
Spain	1	1	1	3	3	-	-	-	-	-	-	-	-	-	-
Sweden	-	-	3	3	3	-	-	-	-	-	-	-	-	1	1
Switzerland	3	3	3	3	3	1	1	1	1	1	1	1	1	1	1
United Kingdom	7	7	7	7	7	9	9	8	8	7	10	7	6	5	5
Others	-	-	-	-	-	1	-	-	-	-	3	4	3	2	2
Sub-total	37	40	45	50	52	15	14	13	12	11	39	37	34	30	26
Middle East															
Bahrain	1	1	1	1	1	-	-	-	-	-	2	2	2	2	2
Iran	1	1	1	1	1	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-	4	5	4	4	3
Sub-total	2	2	2	2	2	-	-	-	-	-	6	7	6	6	5
North America															
Canada	6	6	6	6	6	2	2	2	2	2	8	4	4	3	3
United States	22	21	20	20	20	5	4	5	5	7	30	32	28	29	26
Sub-total	28	27	26	26	26	7	6	7	7	9	38	36	32	32	29
Others	-	-	-	-	-	-	-	-	-	1	4	4	4	3	4
Grand Total	151	155	160	165	168	38	35	35	36	46	254	232	216	202	191

Source: Extracted from ANNUAL REPORT OF THE COMMISSIONER OF BANKING for 1990.

2.2 Authorized Institutions Classified by Country of Ownership

It may be useful to group banking institutions by country of ownership (in terms of majority share holding) in order to analyze the market share or influence of different countries in Hong Kong's financial sector. As shown in Table 3, at the end of 1990, Japan owned more banking institutions in each of the three tiers than any other country in the Hong Kong market. From 1986 to 1990, Japan-owned banks increased at both retail and wholesale levels. The United States which used to have more banks than other countries in Hong Kong in earlier years ranked second after Japan, mainly because the number of U.S.-owned banks decreased over the same period. The two economic giants seem to hold divergent views regarding the future prospects for Hong Kong's financial markets. While Japan keeps building its interest and expanding its investment in Hong Kong for the long-range goal of using it as a gateway to the China market, the U.S. has been more skeptical about Hong Kong's future and thus reduced its interest in Hong Kong. But the region that has lost the market share most is Hong Kong itself, a result of the uncertain political outlook beyond 1997 and the difficulties to comply with the more harsh capital requirement effective in 1987 on the part of deposit-taking companies.

In fact, the Hong Kong banking industry has been characterized not only by its international flavor but by the presence of premier banks operating in the market. Table 4 indicates that in 1990, 125 out of a total of 168 licensed banks were among the world's largest 500 banks in the form of licensed overseas banks, and 18 of the top 20 had branches or subsidiaries in Hong Kong.

2.3 Analysis of Assets and Liabilities - the Case of Licensed Banks

In order to have an idea of the uses and sources of funds of Hong Kong's financial institutions, it is helpful to examine for illustration the balance sheet of licensed banks, by far the most important group in the three-tier system.

The simplified balance sheet presented in Table 5 highlights the growth of licensed banks and shifts in sources and allocation of funds for the years chosen for comparison. Over the past decade the balance sheet size of licensed banks has increased by 16 times. The most impressive items are those that reflect cross-country and cross-currency transac-

Table 4: Presence of World's Premier Banks in Hong Kong.

World Ranking	Licensed overseas banks					Restricted License bank					Deposit-taking Companies				
	86	87	88	89	90	86	87	88	89	90	86	87	88	89	90
1 -20	19	18	19	19	18	6	3	3	6	9	19	18	18	17	14
21 -50	27	25	25	26	26	3	5	4	2	3	22	21	18	16	17
51 - 100	27	33	31	32	32	5	4	4	4	4	24	22	21	22	20
101 - 200	14	15	21	24	29	3	1	1	1	2	13	16	14	19	24
201 - 500	13	11	12	16	20	4	5	5	4	6	24	22	21	23	24
Others	16	18	17	17	13	2	2	2	3	9	33	34	33	31	30
	116	120	125	134	138	23	20	19	20	33	135	133	125	128	129

Source: Extracted from ANNUAL REPORT OF THE COMMISSIONER OF BANKING for 1990. World ranking is based on total assets less contra items of the banks.

tions. On the assets side, the largest item for 1990 was "amount due from banks abroad", accounting for almost 50% of total assets. In 1980, it accounted for only 27% of total assets, and since then had grown by 30 times. The largest item of assets in 1980 was loans and advances. Although growing substantially in absolute terms, their share declined gradually due to an even faster rate of growth of the deposits with foreign banks. As a result, "due from foreign banks" has replaced loans and advances as the largest item of assets, reflecting the increasing activities of Hong Kong licensed banks in foreign countries as well as greater presence of foreign banks in Hong Kong.

On the liabilities side, major sources of funds comprise "due to authorized institutions", "due to overseas banks", and deposits from customers. Over the period under observation, the amount due to overseas banks increased at a rate far greater than that due to domestic banking institutions. It increased by 23 percentage points and accounted for 63% of total liabilities in 1990, thus becoming the largest source of funds for the licensed banks. In contrast, "due to authorized institutions" dropped by about ten percentage points.

The structural change manifested in rapid growth in the amount due from and to overseas banks demonstrates increasing need for funds channelled through

Table 5: Balance Sheet of Licensed Banks.

	1980		1990	
		As % of total		As % of total
	HK$'bn	assets/liab.	HK$'bn	assets/liab.
Assets				
Cash & amount due from authorized institutions	50	17	479	10
Amount due from banks abroad	78	27	2,394	49
Loans and advances	125	42	1,680	35
Negotiable certificates of deposit	4	1	19	*
Bank acceptances and bank bills of exchange	6	2	21	*
FRN and commercial paper	2	1	55	1
Securities and investments	7	2	100	2
Other assets	23	8	111	2
Total assets	295	100	4,858	100
Liabilities				
Amount due to authorized institutions	56	19	439	9
Amount due to banks abroad	118	40	3,052	63
Deposits from customers	87	29	1,155	24
Negotiable certificates of deposit	2	1	33	1
Other liabilities	32	11	179	4
Total liabilities	295	100	4,858	100

Note:
* Less than 0.5%.

Source:
HONG KONG MONTHLY DIGEST OF STATISTICS, various issues.

the banking institutions in Hong Kong, which, in the meantime, have been stepping up transactions with banks abroad. All these may be considered signs of the emergence and growth of a major financial center in Hong Kong.

Another indicator of the structural change in the balance sheet of Hong Kong banking industry is the tremendous growth of cross-currency transactions. As shown in Table 6, the proportion of total assets denominated in foreign currency jumped from 55% in 1980 to 82% in 1990, and the foreign currency component of liabilities increased by an even larger margin from 50% to 83% for the same period. The significant increase in the share of foreign currency denominated liabilities can be largely attributed to the shift in consumers' deposit portfolio, partly due to mounting anxiety over the political development of Hong Kong's future.

Table 6 also indicates that the foreign currency component of loan and advances, the second major use of funds, rose from 35% to 68% over the ten-year period, demonstrating increased preference for non-Hong Kong dollar currencies used in lending activities of licensed banks as well as a growing role of Hong Kong in international intermediation.

2.4 The Hong Kong and Shanghai Banking Corporation (HSBC) - A Unique Licensed Bank

In the absence of a single government agency that performs all the functions usually undertaken by

Table 6: Balance Sheet of Licensed Bank: Currency-Denomination Analysis (in percent).

	1980		1990	
	HK$	Foreign Currency	HK$	Foreign Currency
Assets				
Hong Kong notes and coins	100.00	0.00	100.00	0.00
Amount due from authorized institutions in Hong Kong	48.50	51.50	44.41	55.59
Amount due from banks abroad	8.00	92.00	1.56	98.44
Negotiable Certificate of Deposit held	4.00	96.00	52.38	47.62
Loans and advances to customers	65.50	34.50	32.32	67.68
Bank acceptance and bank bills of exchange held	13.00	87.00	6.93	93.07
Floating rate notes and commercial papers held	26.60	73.40	15.63	84.37
Treasury bills, securities, share-holdings and interests in land and buildings	88.40	11.60	43.24	56.76
Other assets	52.50	47.50	24.31	75.69
Total assets	45.20	54.80	18.24	81.76
Liabilities				
Amount due to authorized institutions in Hong Kong	74.60	25.40	44.23	55.77
Amount due to banks abroad	3.30	96.70	3.27	96.73
Deposits from customers	87.80	12.20	36.49	63.51
Negotiable Certificate of Deposits outstanding	61.30	38.70	80.32	19.68
Other liabilities	75.70	24.30	50.36	49.64
Total liabilities	49.90	50.10	17.13	82.87

Source:
HONG KONG MONTHLY DIGEST OF STATISTICS, various issues.

central banks in other economies, Hong Kong is one of the few places in the world where currency notes are issued by commercial banks. In Hong Kong, several institutions share the role of a central bank, one of them is the HSBC [3]. It is a very unusual phenomenon because the HSBC is basically a profit-making commercial bank that acts as a quasi-central bank. In this section, a closer look will be taken at this unique institution.

The Organization

The HSBC was founded in 1864. After years of successful operation it has built a special relationship with the Government and become the most dominant bank in Hong Kong. The HSBC controls the majority interest in Hang Seng Bank, the largest ethnic Chinese bank in the territory. Among its subsidiaries, four are wholly owned, including Marine Midland Bank, a commercial bank in the U.S., the British Bank of the Middle East, an important regional bank in the Middle East, and the Hong Kong Bank of Canada(formerly the Bank of British Columbia), the largest foreign bank in Canada. In fact, the HSBC is a hodgepodge of financial institutions consisting of commercial banks, merchant banks, finance companies, investment companies, insurance companies, and financial services companies.

Central Bank Functions

In the absence of an official central bank, the HSBC performs several important central banking functions. Firstly, it is the principal note-issuing bank in Hong Kong. There are two categories of currency issue - commercial and government. Notes are issued by two commercial banks: the HSBC and the Standard Chartered Bank, while the Government only issues subsidiary coins. As presented in Table 7, the HSBC has issued more than 80% of the notes and more than 70% of the total currency in circulation during 1980-90.

The note-issuing mechanism depends on the monetary standard adopted by the Hong Kong Government at different times. In 1935, Hong Kong abandoned the silver standard and joined the sterling area. In the same year the Exchange Fund, the

Table 7: Legal Tender Notes and Coins in Circulation (in millions of HK$).

	1980	1985	1986	1987	1988	1989	1990
Commercial Bank Issue							
HSBC	7,734	14,234	17,054	22,504	26,734	31,264	34,764
	(70.47)	(73.15)	(76.09)	(78.23)	(78.43)	(78.81)	(80.36)
Standard Chartered Bank	2,000	3,732	3,572	4,422	5,092	6,022	6,122
	(19.11)	(19.18)	(15.94)	(15.37)	(14.94)	(15.18)	(14.15)
Government Issue	1,090	1,493	1,786	1,841	2,262	2,384	2,373
	(10.42)	(7.67)	(7.97)	(6.40)	(6.64)	(6.01)	(5.49)
Total	10,464	19,459	22,412	28,767	34,088	39,670	43,259
	(100.00)	(100.00)	(100.00)	(100.00)	(100.00)	(100.00)	(100.00)

Note:
Figures in parentheses are percent of total.

Source:
HONG KONG, various years.

repository of foreign exchange reserves, was set up to administer the reserve backing for the currency. Before the sterling exchange standard came to an end in 1972, the note-issuing banks had to deliver sterling assets to the Exchange Fund in exchange for Certificates of Indebtedness (CIs) in order to print new currency.

After the sterling began to float in 1972, Hong Kong withdrew itself from the sterling area. Since then each time the note-issuing banks issued notes, they just credited the Exchange Fund's account with a specified amount of Hong Kong dollars for the CIs, and the Fund acquired the same amount of foreign currencies or foreign currency assets with the proceeds. This note-issuing mechanism went on until 1983 when the Government put into operation the current linked exchange rate system.

Under the linked rate system, the CIs are issued to the note-issuing banks for U.S. dollars at a fixed exchange rate of US$1 for HK$7.8. The CIs are held as cover for the issue of Hong Kong currency notes. Thus, any issue of notes has to be backed by U.S. dollars rendered to the Exchange Fund by the note-issuing banks.

The second important role of central bank assumed by the HSBC is that it serves as the manager of the clearing house of the Hong Kong Association of Banks (HKAB). Since all the licensed banks are required to be members of the HKAB, they have to keep clearing accounts with the HSBC. However, the HSBC does not pay any interest on the credit balances in the clearing accounts, but a charge equivalent to the prime rate is normally made on the debit balances in the clearing accounts of other banks, an arrangement considered to be inequity by other members of the HKAB.

Despite its entity as a commercial bank, the HSBC concurrently serves as a government agency in implementing monetary policy such as intervention in the money and foreign exchange market. However, this status has been weakened by the recently-implemented accounting arrangements between the Exchange Fund and the HSBC.

As noted before, the Exchange Fund, a Government unit managed by the Monetary Affairs Branch of the Financial Secretary, was established primarily for regulating the exchange value of the Hong Kong currency. Effective from July 1988 the HSBC is required to maintain with the Fund a Hong Kong dollar account (the Account) carrying not less than the net clearing balance (NCB) of the rest of the banking system. If the balance in the Account falls short of the NCB, the HSBC pays interest on the difference to the Fund. If the NCB is in debit, the HSBC also pays interest on the debit amount to the Fund. The Fund may use the Account to settle its transactions with the HSBC and other licensed banks. When the Fund credits or debits the Account in the settlement of its transactions with other licensed banks, the HSBC will correspondingly do the same at the clearing accounts of banks dealing with the Fund. Thus, through the HSBC's clearing account with the Fund, the Government controls the inter-bank liquidity, a function previously monopolized by the HSBC.

Furthermore, through the control over the inter-bank market, the Government can more effectively maintain the Hong Kong dollar exchange rate at US$1 = HK$7.8, a target level in the current linked exchange rate system.

For example, suppose the Hong Kong dollar rises against the U.S. dollar and moves away from the linked rate of HK$7.8 per U.S. dollar. Also assume the Government instructs the Fund to buy U.S. dollars in order to strengthen the U.S. currency against the local currency and at the same time ease the Hong Kong inter-bank market. In the absence of the Account as it was before July 1988, the purchase of U.S. dollars might not pump in Hong Kong dollar reserves for the banking system because licensed banks could always swap their Hong Kong dollars for U.S. dollars with the HSBC when they found their balances with the HSBC were too high. But after July 1988, the HSBC has to keep an account with the Fund. The purchase of U.S. dollars would thus result in a credit to the Account with the Fund, which would increase the supply of funds to the market. The increased availability of funds tends to lower the inter-bank rate and helps to move the market exchange rate towards the linked rate.

This example serves to explain that the introduction of the Account enables the Fund to exercise the ultimate control of the liquidity in the inter-bank market. Although losing some of its power on monetary control, the HSBC still performs its remaining central banking functions.
At this connection it may be opportune to point out the major difficulty the linked exchange rate system faces. Hong Kong has been troubled by two-digit inflation since 1990. Normally interest rates would be raised to fight inflation. But in Hong Kong they have been adjusted downward [4]. The reason is that interest rates in Hong Kong must move in line with those in the United States to keep the linked exchange rate system viable. As the United States lowers its interest rates to revive the economy, Hong Kong has also to reduce its interest rates to stay close to those in the United States, but only to fuel the inflation. Thus, strong opinions have been expressed to remedy this problem. One of the favored recipes for action is the raising of interest rates combined with the relaxing of the linked rate. It is believed in this suggestion that Hong Kong's inflation could be brought down if the exchange rate is to be de-linked and interest rates to be adjusted to a level concomitant with inflation.

3. Financial Markets

In this section, four major markets will be covered. They are the stock market, the money market, the foreign exchange market, and the gold market.

3.1 The Stock Market

Among the money and capital markets in Hong Kong, the stock market is considered more developed and quite active. Hong Kong's first stock exchange, the Hong Kong Stock Exchange, was founded in 1891. After one hundred years of stock-trading activities and a number of reorganizations, the Hong Kong stock market now ranks third in Asia in terms of capital market capitalization.
During the early years following the Communists came to power in China in 1949, the volume of transactions was fairly small because the stock market was not an important source of funds. The attitude of China toward Hong Kong was one of the major factors that discouraged equity investment and impeded the growth of the market. Besides, Chinese family-owned firms were dominant in the economy, many of them were reluctant to release their control over business to "outsiders". Thus the number of listed companies was quite small, ranging from 50 to 70. And only shares of around 25 firms were actively traded.
The stock market took a turn and began to have a boom in 1969. China's announcement of shelving indefinitely the Hong Kong-reversion issue was the primary reason for the upsurge. Steady growth of the Hong Kong economy also contributed to the boom. Three more stock exchanges, namely, Far East, Kam Ngan, and Kowloon, were set up from 1969 to 1972, stimulating the public's interest in share trading. As can be seen in Table 8, the value of stock exchange turnover skyrocketed in 1970

Table 8: Value of Stock Exchange Turnover - Year End Figures (in millions of Hong Kong dollars).

Year	Turnover	Year	Turnover	Year	Turnover	Year	Turnover
1960	876	1973	48,317	1985	75,821	1988	199,481
1965	389	1975	10,335	1986	123,128	1989	199,147
1970	5,989	1980	95,684	1987	371,406	1990	288,715

Source:
HONG KONG MONTHLY DIGEST OF STATISTICS, various issues.

and kept climbing until 1973. The stocks quoted on the new stock exchanges were virtually the same as those on the Hong Kong Stock Exchange, but the number of listed stocks increased considerably as 251 additional companies were listed between 1969 and 1973.

In 1986, a major development took place. The four stock exchanges were unified into the Stock Exchange of Hong Kong (SEHK), a private company with limited liability. The unification brought with it the inception of computer-assisted trading at the stock exchange. It also attracted more international investors as well as corporate brokers to the market. As a result, the value of stock exchange turnover soared by three times in one year.

Due to the small size of Hong Kong's economy and its lack of natural resources, only four main sectors are represented on the SEHK, viz., property, finance, utilities, and consolidated enterprises and industriales. Conspicuously absent are the heavy industriales, chemicals and insurance which are prominent in other major markets. The distribution of market capitalization by sectors is given in Table 9. Since the unification of stock exchanges in 1986, about 10% of the companies listed on the SEHK account for 70% of the total market capitalization. The indicator that reflects the general trend of share price movements is the Hang Seng Index, which consists of 33 constituent stocks and is weighted by market capitalization. These stocks represent on average 70% of the market's capitalization and turnover value. The historical dividend yield for Hang Seng Index stocks is around 3%. As the Hang Seng Index is weighted by market capitalization, its movement is dominated by the few largest constituent stocks [5].

Following the Crash in 1987, it was the general sentiment in the market that the conventional principle of self discipline and self regulation should give way to more explicit rules of supervision. Further, a strengthened regulatory framework is essential if Hong Kong aspires to make its stock market a primary capital market in the region. Against this background, some measures have been taken recently for regulation and are worth noting. Two regulatory ordinances came into effect in September 1991. One of them requires disclosure of information about holdings of ownership. Shareholders who own ten percent or more of a company are required to inform the company and the SEHK. Changes of their ownership by a percentage point must also be reported. Disclosure of information

Table 9: Stock Market Capitalization and Its Distribution by Sector (in billions of HK$).

	Finance	Utilities	Properties	Consolidated Enterprises & Industrials	Others	Total Capitalization
1980	49.73	17.44	76.05	51.79	12.62	207.62
1985	52.46	51.33	70.20	152.47	19.14	345.60
1986	71.02	79.52	103.97	152.47	12.30	419.28
1987	68.39	73.30	109.58	151.03	17.32	419.61
1988	79.85	100.16	165.05	209.45	25.87	580.38
1989	89.53	109.36	158.60	217.29	30.35	605.15
1990	83.28	132.17	169.50	242.67	22.79	650.41

Source:
For 1980 and 1985, HONG KONG ECONOMIC JOURNAL MONTHLY, various issues; for 1986 to 1990, FACT BOOK 1990.

should help to make the market more competitive and efficient.

Another ordinance that took effect in September 1991 deals with insider trading. Under the new legislation stiff penalties can be imposed on those found to have used their privileged access to price sensitive information to profit on the stock market; they can be fined an amount up to three times the gains made from insider trading and prohibited from being involved in the management of a company for up to five years. The improvements in the regulatory environment are expected to enhance the credibility and reputation of Hong Kong's stock market and help it to catch up with the major stock markets of the world.

In the meantime, the SEHK has set its sights on becoming a major capital-raising market for China. China's financial sector is still in the primitive phase of development and falls well behind its rapidly growing economy. Thus, there exists an enormous need to tap global capital markets for the much needed funds. In view of this trend, it is Hong Kong's long-term mission to develop a more responsive regulatory environment and efficient market wherein Chinese issuers of securities and global investors can meet.

3.2 The Money Market and Debt Instruments

Compared with the equity market, Hong Kong's money and capital markets have developed slowly, and this has something to do with the Government's fiscal policy. Traditionally, the Hong Kong Government has maintained a conservative budget and accumulated a substantial surplus. As a result, it seldom needs to borrow. Government bonds issued so far amount to only HK$1.25 billion. Short-term government securities, Exchange Fund Bills, were launched in March 1990, not so much for raising funds for spending as for the purpose of helping to develop a broader financial market in Hong Kong. In the absence of the government's participation, the local money and capital markets are basically inactive. The only segment in the money market which can be considered mature and active is the inter-bank money market.

It was not until the seventies that the inter-bank market began to take off, mainly boosted by the emergence of deposit-taking companies and the entry of foreign banks. In this wholesale market deposits denominated in local and foreign currencies are traded among local and overseas institutions, with maturities ranging from overnight to six

Table 10: Inter-bank Liabilities of Authorized Institutions (in billions of Hong Kong dollars).

	HK$	Foreign Currency	Total	As % of Total Liabilities of Authorized Institutions
1980	51	36	87	20
1985	129	179	308	20
1986	149	277	427	20
1987	173	312	485	15
1988	190	271	461	12
1989	235	288	522	12
1990	244	307	551	11

Source:
HONG KONG MONTHLY DIGEST OF STATISTICS, various issues; and ANNUAL REPORT OF THE COMMISSIONER OF BANKING for 1990.

months for Hong Kong dollars and to twelve months for U.S. dollars. The market in foreign currency is part of the global Eurocurrency market. The lenders of Hong Kong dollars are usually the local banks, and the borrowers are largely foreign banks without a strong Hong Kong dollar deposit base. Transactions in the market are made at prices in line with HIBOR (Hong Kong Inter-bank Offered Rate), which is an indicator of the Economy's liquidity.

It can be seen in Table 10 that although the total inter-bank liabilities increased by 6.3 times from 1980 to 1990, they declined steadily over the same span of time in terms of percentage of total liabilities of authorized institutions. This is because, as analyzed in 2.3., the amount of liabilities to banks abroad soared much too fast so that other items all decreased as percentage of total liabilities.

Other than the interbank money market, money and capital markets are far from being mature. Conspicuously lacking is a significant bond market. Not only is the amount of government bonds negligibly small, but corporate bonds still remain to be an unpopular means of financing. The debt instruments frequently used in Hong Kong compromise commercial papers (CP) and notes, both issued by private sector companies, and certificates of deposit issued by financial institutions.

As shown in Table 11, the volume of commercial papers and notes began to grow in 1985, but the rate of growth slowed down after 1987. The minimum denomination of a CP issue normally varies between HK$500,000 and HK$1 million. Generally, institutional investors dominate the market and hold the CP until maturity. The secondary market virtually does not exist.

Notes have been used less frequently than CP in Hong Kong. Their maturity is longer than that of CP, ranging from one to five years. One variety of notes is the floating rate notes (FRNs), the interest rates of which are adjusted periodically in line with the HIBOR (Hong Kong inter-bank offered rate). Since the interest rate risk of FRNs is lower than that of fixed-income securities, FRNs are more popular than fixed rate notes in Hong Kong.

Certificates of deposit (CDs) are a form of time deposit which only authorized institutions are permitted to issue. All the CDs issued in Hong Kong after 1977 are negotiable and called negotiable certificates of deposit (NCDs). The first NCD denominated in Hong Kong dollars was issued in 1973. In 1980, the first U.S. dollar-denominated NCDs were offered in the Hong Kong market. Most of the recently issued NCDs carry a maturity of three years. For the past three years, issues of NCDs

Table 11: Debt Instruments - Commercial Paper, FRNs, and NCDs (in billion of HK$).

	Commercial Paper and FRNs			NCDs		
	HK Dollar	Foreign Currency	Total	HK Dollar	Foreign Currency	Total
1984	1.8	34.6	36.5	5.9	8.8	14.8
1985	5.5	69.3	74.8	10.9	9.3	20.2
1986	10.9	84.9	95.8	20.4	9.3	29.8
1987	11.3	83.9	95.1	23.8	10.6	34.4
1988	11.3	78.6	89.9	25.9	9.0	34.1
1989	12.2	80.9	93.1	25.6	8.3	33.9
1990	11.6	82.5	94.2	28.4	7.9	36.2

Source:
HONG KONG MONTHLY DIGEST OF STATISTICS, various issues.

denominated in Hong Kong dollars were in large part arranged on fixed rate terms. In general, issues on floating rate terms assume a longer maturity, ranging from 5 to 10 years. The volume and growth of NCDs are also presented in Table 11.

3.3 The Foreign Exchange Market

Hong Kong has a mature foreign exchange market, which is well integrated with the corresponding global market. The Hong Kong foreign exchange market was relatively inactive before 1973. The abolition of exchange control and the free convertibility of the currency in 1974 provided the basic conditions for the development of the foreign exchange market.

The rapid expansion of the market is the result of a large volume of trade, the presence of a great number of international banks with huge amount of foreign exchange transactions, and a highly advanced telecommunications system. It is also a reflection of Hong Kong's increasing role as a financial center. With an average daily turnover of US$49.1 billion, Hong Kong's foreign exchange market ranks the fifth in the world after London, New York, Tokyo, and Singapore [6].

The major participants in the Hong Kong foreign exchange market are banks, deposit-taking companies, and large corporations. Examples of important institutional participants are Citibank N. A., HSBC, Morgan Guaranty Trust, Barclays Bank, Union Bank of Switzerland, Fuji Bank, just to name a few. Foreign exchange deals can be made either directly between the participants, mainly financial institutions, or through brokers. Most of the brokerage firms are from overseas. In Hong Kong, more than 60% of foreign exchange deals are done directly between financial institutions.

Most major currencies are traded on the Hong Kong foreign exchange market. All currencies have to be traded against the U.S. dollar, and all rates are quoted against the U.S. dollar. Therefore, the U.S. dollar is the most actively traded currency. After the U.S. dollar, other actively traded currencies include Deutschmark, Yen, Sterling, Swiss franc, Australian dollar, and Canadian dollar.

Along with Tokyo and Singapore, Hong Kong is among the leading exchange markets in Asia. While Tokyo has the largest market in this region, it serves a different market and is not a major competitor of Hong Kong. Hong Kong's main competition comes from Singapore where a major Asian dollar market has developed. Besides, Singapore has drawn away from Hong Kong well-trained foreign exchange dealers and professionals, worsening the ever-growing problem of brain drain in Hong Kong. In addition to the difficulty in retaining experienced professionals, another problem faced by Hong Kong is the limited availability of products offered in the market. The major foreign exchange transactions are primarily confined to spot and forward dealings. To maintain its role of an important link of the global network, it is essential for the Hong Kong market to fully develop more instruments such as currency options and futures.

3.4 The Gold Market

Hong Kong ranks with London, New York, and Zurich as one of the four largest gold markets in the world. There are two sectors in the market, separately operated by the Chinese Gold and Silver Exchange Society (the Society) and the loco-London market.

The Society was founded in 1910. It has a limited membership of 193, all of them are ethnic Chinese corporate members. Unless the existing members drop to less than 150, interested parties can gain membership only through a transfer from an existing member. Gold traded at the Society is of 99 percent fineness weighed in taels and quoted in Hong Kong dollars.(One tael is equivalent to 1.20 troy ounces.) Each contract lot contains 100 taels of 99 percent fine gold.

The way gold is traded on the Society is old-fashioned and unique. It is also dubbed the "open outcry system". Shouts and cries are mingled with hand signals among the traders for the bidding on the floor, and whoever touches the seller's body first wins the deal. Turnover on the Society totalled 47 million taels in 1990, declining for the third consecutive year from 51 million taels in 1989 and 59 million taels in 1988.

In addition to gold trading on the Society, the London bullion dealers have established offices in Hong Kong, which are basically an extension of the London gold market and commonly known as the loco-London gold market. In this market, gold of 99.95 percent fineness is traded. Delivery takes place in London and payment is made in U.S. dollars. The major participants are banks, international bullion houses, and gold trading companies. Due to differences in fineness of gold, the units of weight contracted, and the currency used in settlements, arbitrage between the two sectors of the Hong Kong gold market has been active. However, statistics on the volume of trading at the loco-London market are not available.

4. Prospects

The emergence and growth of a major financial center requires the existence of many conditions. In Hong Kong, the strategic geographical location, political stability, the absence of restrictions on capital flows, convertible currency, favourable tax environment, competent labor force, sound legal system, and so on, all have contributed to make its financial markets efficient and attractive. But whether Hong Kong's success as a financial center can continue in the future is a question inseparable from the reversion of Hong Kong to China in 1997. The answer to the question depends largely on the market participants' attitudes toward the 1997 issue because loss of confidence or distrust in the government beyond 1997 may well damage those conditions that have been so helpful for and conducive to Hong Kong's rise as a financial center in the past two decades.

According to a survey conducted by SRI International Project Team, wide differences in attitudes and expectations exist among individuals and institutions [7]. At the level of individuals, expatriates and those local Chinese who are able and planning to emigrate seem to hold a pessimistic view about the prospects for Hong Kong's financial markets. They tend to be skeptical about China's commitment to the terms laid out in the Sino-British Joint Declaration. On the other hand, those who are unable or unwilling to emigrate appear to be among the most optimistic about the future of the markets and have a greater sense of responsibility about the markets even after Hong Kong is turned over to China's rule.

At the institutional level, financial institutions from different regions hold different views regarding Hong Kong's future. Among the foreign groups, Japanese financial institutions are the least concerned about the uncertainty caused by the 1997 transition. They view Hong Kong as a gateway to China and an important and well established center for trading and financing activities in Asia. Hence, they continue to increase their presence in Hong Kong in the form of more investment and financial establishments. However, other foreign institutional participants are less optimistic. Being skeptical about the future prospects, they normally hold back from committing themselves to long term developments in Hong Kong. Their goal is rather simple - how to make money in the short run. Their business and service are mostly short term in nature. Some have reduced their involvement in Hong Kong's financial markets; some have moved their legal domiciles out of Hong Kong. Striking examples are the shift of the legal domiciles of HSBC, the largest commercial bank, and Jardine Holdings, the leading British conglomerate,to London and Bermuda, respectively.

In contrast, locally-controlled Chinese financial institutions display far more confidence in Hong Kong's transition and the years beyond 1997. It is this group that makes stronger and broader commitment to the future of Hong Kong's markets. They believe that economic reforms in China will continue and Hong Kong, as a major trade and financial center, will play a significant role in bringing the reform to success. Furthermore, because their business has been mainly tied to the local market, they have more at stake than other groups. Thus, hoping for the best, they are also the most optimistic of all. In a nutshell, the future development of Hong Kong financial markets hinges to a large extent on the participants' expectations and the market sentiment regarding the conditions that have helped to develop Hong Kong into its present position. But whether the conditions can be preserved is still a matter of concern and aspiration. In reality, many are concerned that the Basic Law which lays the ground for China's prospect of "one country, two systems" and the promise that "Hong Kong remains unchanged for fifty years beyond 1997" may not guarantee a truly autonomous territory in Hong Kong. The concern is not unwarranted since the Party-dominated National People's Congress has the sole power to interpret and amend the Basic Law.

Another dimension in considering the prospects for Hong Kong's financial markets relates to the rise and impact of other financial centers in the Asia-Pacific region. Notwithstanding its unique attributes and advantages, Hong Kong faces mounting competition from Tokyo and Singapore. Even before Tokyo's financial liberalization and deregulation, it was generally believed that Tokyo would emerge as "the" leading financial center. Compared to Tokyo, Hong Kong does not have the "hinterland" of a financial center, a condition emphasized by KINDLEBERGER (1974) for the formation of financial centers [8]. It can not match Tokyo in terms of economic power and scale of banking and financial transactions. Hong Kong probably is not in the same league as Tokyo which should join London and New York in the first-tier international financial centers.

While Tokyo is in a different tier, Singapore is more similar to Hong Kong in background, and competition has been keen between them. In terms of foreign exchange turnover, Singapore has outstripped Hong Kong and is ranked only behind the first-tier financial centers. Hong Kong also falls behind in the size of bond and futures markets. Besides, for some of the financial institutions beset in the environment of uncertainty surrounding the 1997 transition, Singapore seems to be able to offer a less convenient but readily accessible alternative for the regional financial headquarters [9].

However, Hong Kong is still ahead of Singapore in gold and equity markets and fund management. With a larger economy than that of Singapore, Hong Kong has a larger domestic banking market. Hong Kong's proximity and affinity to China contribute to make it a key financial intermediary and entrepôt for China as well as overseas Chinese business communities, provided that China continues to pursue economic reform and maintain its open-door policy.

Another source of competition, however remote, comes from Taipei. With huge exchange reserves, steady and rapid economic growth, and commitment to the ambitious recently-implemented 6-year plan for infrastructure modernization, Taipei has the potential to develop into another regional financial center. Eager to capitalize on the rampant uncertainty over Hong Kong's future, Taiwan has the additional impetus to move faster in order to turn the potential into reality. Since 1987, Taiwan has taken a series of measures of financial liberalization including relaxation of exchange control and interest rate deregulation, all pointing to the goal of setting up a financial center in Taipei [10].

Increasing rivalry or competition, however, does not necessarily lead to a reduction in financial activities in Hong Kong. As more competitors participate in the market, it is likely that activities created may be more than activities diverted [11]. Therefore, financial liberalization and internationalization in Tokyo and Taipei may bring more business for the entire region. Since Taiwan's relaxation of restrictions on its banks to set up branches overseas, for example, several Taiwanese banks are reportedly planning to establish branches in Hong Kong. Another example is the potential complementarity between Hong Kong and Singapore, which has drawn an analogy to the relationship between the London and Zurich financial centers [12]. Indeed, the complementarity has already existed between Hong Kong and Singapore. One example is that while Singapore's neighboring countries are not able to siphon out all the funds in its Asian dollar market, the excess is channelled through Hong Kong's financial intermediaries to other countries including Taiwan, China, South Korea, and Hong Kong itself.

5. Conclusion

Over the past two decades, Hong Kong has developed into not only a financial entropôt between economies in the Asia Pacific region, but one of the centers for the intermediation of flows of savings and investment between the region and the economies in Europe and North America. It is only behind New York and London in having the largest number of foreign commercial banks; 84 of the top 100 banks in the world have operations in its financial sector. Hong Kong's gold and foreign exchange markets form an integral part of the global network. Hong Kong has an active stock market, although it lacks a significant bond market and product variety in the capital market.

The long-term future of Hong Kong financial markets depends very much on whether the conditions and attributes which are conducive to Hong Kong's success thus far can be preserved beyond the transfer of sovereignty to China in 1997. Further, the market participants' confidence and attitudes toward the prospects for Hong Kong's financial markets can have a significant impact on the development of the markets during the transition period. In the meantime, Hong Kong must deal with the overhanging uncertainty on the one hand and the growing competition of other financial centers on the other.

Footnotes

[1] Of all the Asian newly industrializing economies Hong Kong had the highest per capita GDP in 1990.

[2] For an interesting discussion of how Hong Kong is ranked as an international financial center, reference is made to HUI (1991).

[3] Other institutions that share the central bank's role include the Monetary Affairs Branch and the Exchange Fund.

[4] Currently, the real interest rate is an astonishing negative 8%.

[5] The statistical data related to market capitalization and Hang Seng Index are taken from FACT BOOK and THE SECURITIES JOURNAL, various issues. Both are publications of Stock Exchange of Hong Kong.

[6] US$49.1 billion is the amount estimated for 1989. See HONG KONG 1991, p. 70.

[7] The opinions surveyed by SRI were compiled in SRI INTERNATIONAL (1989).

[8] See KINDLEBERGER (1974).

[9] The main reason for being less convenient is that Singapore pursues a policy of rigid control and regulation of its financial markets.

[10] For a summary of financial liberalization in Taiwan, see CUNNINGHAM (1991).

[11] An analogy can be handily drawn to the concept of "tradecreation" vs. "trade diversion" in international trade.

[12] For the analogy see SRI INTERNATIONAL (1989), p. 124.

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