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*The
Monetary
System of
Hong Kong*



by

F. H. H. King



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THE MONETARY SYSTEM OF HONG KONG

WITH A CHAPTER ON:
THE MONETARY SYSTEM OF MACAO

by
Frank H. H. King

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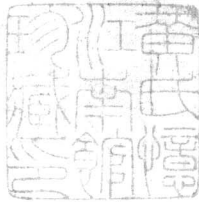
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THE MONETARY SYSTEM
OF HONGKONG



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The author accepts sole responsibility for the opinions expressed—and for any mistakes that may remain.

March 14, 1953.

Hong Kong, B.C.C.

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INTRODUCTION

Although a sound money is basic to the proper functioning of any economy, and although Hong Kong's trade and industry depend as a minimum requirement upon the existence of reasonable monetary and foreign exchange policies, there has been no recent survey of the monetary system of Hong Kong.

In some countries those interested in the monetary system might be able to read a simple official account, together with some basic commentary. Unfortunately, the regulations and ordinances pertaining to the currency and the banking system of this colony have not been collected and interpreted. This is the purpose of the present booklet.

Chapters II, III and IV summarize the legal provisions which authorize and regulate the issue of legal tender and control the activities of the Exchange Fund. This information is combined in Chapter V to form the basis of an analysis of the determinants of the money supply. The point is made that, in Hong Kong, bank money is probably more important than legal tender. The chapter therefore concludes with a brief description of the organization of the banking system in the Colony.

Continuing the analysis begun in Chapter V, Chapter VI is concerned with the ability of the banks to extend credit and, therefore, to influence the size of the money supply. This chapter, which is more technical than the rest of the booklet, has been written so that the conclusions may be understood without a detailed study of the formulae and equations upon which they are based.

The critique in Chapter VII concludes the main part of this study, but Chapter VIII contains a very brief outline of the Macao monetary system for purposes of comparison. The appendices, however, contain relevant information on the history of Hong Kong currency. And, finally, there is a bibliography.

FRANK H. H. KING.

CHAPTER I.

DEFINITIONS

The unit of account in Hong Kong is the Hong Kong dollar. Before 1935 this unit was represented by a certain weight and fineness of silver, coined into a legal tender coin, the British dollar. The British dollar and, certainly, the Mexican dollar were money. This is illustrative of the following definition: money is anything which has a fixed value in terms of the unit of account. Such a definition might include coins, banknotes, government currency notes, and current accounts or demand deposits. When a certain form or type of money is designated "legal tender", it must be accepted, if offered in the exact amount, as payment of any debt payable in money. Other forms of money need not be, but often are, accepted.

At the present time there are no coins whose intrinsic value is stable in terms of the unit of account, the Hong Kong dollar. The money of Hong Kong consists of banknotes, government currency notes, subsidiary coins whose intrinsic value

is less than their face value, and current accounts.* Of all these moneys, only banknotes and government currency notes have been designated unlimited legal tender.

BACKING—THE PROBLEM STATED

The backing of any currency consists of the goods and services it can be used to purchase.

It is true, however, that the term "backing" or "currency reserves" has a more technical meaning. A banknote or government currency note is worth the sum printed upon it only because of the authority of the bank or the government coupled with certain legal provisions. Such notes are often said to represent something which has real or intrinsic value, and it is this "something" which is the technical backing, or reserves, of the currency.

An examination of a Hong Kong banknote will give evidence of this concept of representative money. There is written, for example:

The Hongkong & Shanghai Banking Corporation promises to pay the Bearer on demand at its office here FIVE DOLLARS or the equivalent in the Currency of the Colony, Value Received.

By order of the Board of Directors.

Then it must be simple to discover the technical backing of a Hong Kong banknote. Present it and demand that the bank fulfill its promise.

* Some banks in Hong Kong pay interest on current accounts. We have nevertheless decided to include current accounts in the money supply. The reasons for this decision are given in Chapter V.

Unfortunately, the presentation of a banknote to the bank of issue does not obligate the bank to do anything but give another banknote, perhaps even the same banknote, in return. A banknote is an obligation or liability of a bank and can be met by a payment in legal tender—as can other debts. But since 1935 the banknote has been the currency of the Colony; the banknote has itself been full legal tender. Therefore, although the schroff might be persuaded to give a government currency note in exchange for a banknote, or vice versa, he is under no legal obligation to do so, and we cannot discover in this way the nature of the technical backing of the note.

We may conclude: the legal tender of Hong Kong is inconvertible paper money.

BACKING—THE HISTORICAL APPROACH

The historical approach is the simplest method of explaining the problem of backing. While it is true that the paper money of Hong Kong is inconvertible, this does not necessarily mean that it is without specific technical backing or reserves, i.e. that it is a fiduciary issue.

The economy of Hong Kong has close historical connections with China, and its money had to be directly related to the monetary system on the mainland. This, at least, was the accepted policy. Until 1935 silver was the currency of China and, therefore, of Hong Kong. As silver has intrinsic value, there was no problem in discovering its backing!

Silver coin is not convenient for large transactions due to its relatively high weight to value ratio, and its supply is subject to fluctuations which may cause a shortage of coin. This would be a hindrance to trade. For these reasons certain Hong Kong banks were authorized under conditions and regulations to be discussed fully below, to issue banknotes. These notes were not legal tender, and the bank promised to pay the bearer of the notes on demand in the currency of the Colony, i.e., silver coin. That is the origin of the promise which still appears upon the notes of the banks of this colony.

Silver was drained from China and Hong Kong in 1934 and 1935, causing both a shortage of silver and fluctuations in its price, thus making it impossible for business to operate in a silver coin currency. Speculations in silver hindered the vital business of foreign trade. In November 1935, China went off the silver standard. Following China the Government of Hong Kong passed in November, 1935, the Dollar Currency Notes Ordinance, No. 42 of 1935, and then, less than a month later, the Currency Ordinance, No. 54 of 1935.

The Dollar Currency Notes Ordinance gave authority to the Government to print legal tender one-dollar currency notes to be backed initially by silver surrendered for them and by a current account in the Hongkong and Shanghai Bank. These notes are still issued; they make no promises! They were, from the beginning, inconvertible.

The Currency Ordinance nationalized silver, i.e., it ordered the surrender of silver owned both by banks and by the public. In return banknotes were made legal tender.

BACKING—THE SOLUTION

The current monetary situation in Hong Kong dates from these two 1935 ordinances.

Before 1935 the backing of banknotes had been either silver or sterling securities, readily convertible into silver. Legal tender had been silver coin of specified weight and fineness.

In 1935 the banks surrendered the silver backing of their notes to the Government. The Government established an Exchange Fund with this silver and issued the banks certificates of indebtedness equal to the amount of silver surrendered.* The public surrendered their silver to the Government through the banks and were either paid in banknotes or in one-dollar government currency notes.

After 1935 the silver which would formerly have been considered security or backing for the banknotes was in the hands of the Government or had been invested by the newly established Exchange Fund in securities, or had been used to purchase foreign exchange. In practice, the Exchange Fund purchased sterling securities or sterling. The Currency Amendment Ordinance, No. 9 of 1937, demonetized silver, that is to say, the Government denied its obligation to buy silver dollars at face value after August 1st, 1937. Thus the coins might fluctuate in terms of the unit of account in response to changes in the price of silver. Coins which fluctuate in terms of the unit of account are no longer, by our definition, money.

We are now in a position to identify the backing of the legal tender of Hong Kong. Banknotes

* An example of a certificate of indebtedness is given in Appendix 2.

are backed by sterling securities or by certificates of indebtedness. These certificates are backed by an equivalent value of sterling and sterling investments. Government currency notes are backed by deposits in the Hongkong and Shanghai Bank and by sterling investments. The bank itself has sterling assets.

Therefore, simply and basically, the technical backing of the legal tender of Hong Kong is sterling. Hong Kong has a managed sterling-exchange currency; Hong Kong is on the sterling-exchange standard.



CHAPTER II.

LEGAL TENDER: BANKNOTES

Control of the currency has long been recognized as a prerogative of the state. There has been a tendency, especially obvious since the breakdown of metallic standards, for governments to undertake responsibility for the issue of paper money or notes. This has been done either through the control of government or privately owned central banks, as in the United States, through nationalization of the issuing bank as in England and Wales, or by direct government issue as in many of the Colonies.

In Hong Kong the most important part of the note issue is still in the form of private bank liabilities, i.e. banknotes. Although it was provided in the Bank Note Issue Ordinance, No. 2 of 1895, that "it shall not be lawful for any bank to make, issue, or circulate within the Colony banknotes payable to bearer on demand, except with the sanction of the Secretary of State" the Ordinance made specific exceptions. There are today three note issuing banks in the Colony, the Mercantile Bank of India, Ltd., the Chartered Bank of Australia,