

HONG KONG INSTITUTE FOR MONETARY RESEARCH

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TWENTIETH CENTURY: THE STORY OF THREE REGIME
CHANGES

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HKIMR Working Paper No.17/2004

September 2004



Hong Kong Institute for Monetary Research

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Hong Kong's Exchange Rate Regimes in the Twentieth Century: The Story of Three Regime Changes

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Abstract

The three key changes to Hong Kong's monetary framework in the twentieth century are examined. In the first half of the 1930s, the rising price of silver caused mounting difficulties for China and Hong Kong, both then operating a silver standard. Consideration of a possible regime change in Hong Kong spread over a number of years, but it was always decided not to move before China. Eventually, when China left silver in 1935, Hong Kong left too and adopted what was effectively a sterling-based currency board. This is judged to have been the correct decision, although a case may be argued that the change should have taken place a couple of years earlier. In 1972, prompted by disenchantment with the weakness of sterling and the UK government's decision to let it float, the Hong Kong government abandoned both the sterling link and, in apparent ignorance of its fundamental monetary importance, the currency board principle. This propelled Hong Kong, which had no central bank at the time, into an era of monetary indeterminacy, where stability was dependent essentially on consensus and mutuality of interests between government and the principal banks. The system was destined to crack if ever market pressures exerted too great a strain, which they finally did in 1983. The currency board was then re-instituted, on this occasion based on the US dollar, and has succeeded in maintaining a stable exchange rate ever since. Various refinements in the years since 1983, including the establishment of the Monetary Authority in the role of a central bank, have made the system more robust. With a central bank, Hong Kong now has the capacity to operate an alternative monetary policy framework, should it so wish. For each of the three regime changes, this paper explores the background, both political and economic, the options which were considered and the reasons for the eventual decisions.

The author gratefully acknowledges support from the Hong Kong Institute for Monetary Research in sponsoring this project and the University of Hong Kong for facilitating the work during his appointment as Visiting Professor. He owes special thanks to Professor Y C Jao and Leo Goodstadt for many helpful insights. Thanks go, in addition, to Sarah Millard, archivist at the Bank of England, and her predecessor Henry Gillett, for identifying and facilitating access to relevant sources there; to Steven Chan Wai Wah for researching historical data; to Stefan Gerlach, Christopher Munn and seminar participants at the HKIMR and at the University of Hong Kong's Department of History in February and March 2004, respectively, for helpful discussion of an earlier draft; and to an anonymous referee.

The research underlying the paper is based predominantly on material that is publicly available, notably in the Bank of England Archive, the Hong Kong Public Records Office, and publications in the Library of the University of Hong Kong. The author has, however, also made use of personal papers and recollections from his time as Deputy Secretary for Monetary Affairs in the Hong Kong Government from 1982 to 1985, and as Deputy Chief Executive of the Hong Kong Monetary Authority from 1999 to 2003.

Except for instances where the paper merely reports what others have written, the author is solely responsible for the opinions expressed herein and for any errors. The views expressed do not necessarily reflect those of the Hong Kong Institute for Monetary Research, its Council of Advisers or Board of Directors.

Abbreviations

<i>CI</i>	<i>Certificate of Indebtedness (issued by the Exchange Fund)</i>
<i>COCC</i>	<i>Colonial Office Currency Committee (London)</i>
<i>DTC</i>	<i>Deposit-taking company</i>
<i>EF</i>	<i>(Hong Kong Government) Exchange Fund</i>
<i>HKAB</i>	<i>Hong Kong Association of Banks</i>
<i>HKMA</i>	<i>Hong Kong Monetary Authority</i>
<i>HSBC</i>	<i>The Hongkong and Shanghai Banking Corporation</i>

1. Introduction

This paper examines the history of the three major changes which took place in Hong Kong's monetary policy regime - more specifically its exchange rate regime - during the course of the twentieth century. It explores the background, both political and economic, to the decisions, the options which were considered, and the reasons for the eventual decisions, together with brief assessments of the outcomes.

The first episode is the switch from the silver standard to a sterling-based currency board in 1935. The story revolves significantly around fluctuations in the silver market, the problems which this created for China, the strong links between the Hong Kong and Chinese economies, and the international political tensions and rivalries at the time. Little research appears hitherto to have been conducted specifically into Hong Kong's decision of 1935. A number of historical sources have been consulted. Although economists and historians have tended, rightly, to regard, given the circumstances of late-1935, the switch towards sterling as the obvious and inevitable response to China's departure from silver, the present paper serves as a reminder that there had in fact been much heart-searching about Hong Kong's currency regime over a period of more than five years, which could have resulted - but in the event had not - in earlier steps, either to strengthen the silver standard or to move off silver.

The second episode is the abandonment in 1972 of the 1935 sterling link and the onset of, effectively, a monetary policy vacuum.¹ That decision, which took place against the background of the final throes of the Bretton Woods system, is considerably less well documented than the 1935 one. The regime change appears to have been implemented quite abruptly, without publicity, and without any recognition of its true monetary implications. It passed unnoticed and unchallenged at the time. This paper concurs with those economists who, having subsequently turned their attention to the matter, concluded that the resulting monetary framework was potentially unstable, and vulnerable to collapse if hit by a serious enough shock.

The third episode is the revival of the currency board, this time based on the US dollar, in 1983. The story here centres around the confidence crisis sparked by the opening of the Sino-British negotiations on the future of Hong Kong, and the urgent need for some remedial action. The paper notes how, in the heat of crisis, there were no practicable options available other than the return to a currency board, and it offers some previously unpublished insights into the discussions underlying that decision and its associated details.

Save for the final two and a half years, Hong Kong was a British colony throughout the twentieth century. This was a significant factor, helping explain why the commodity standard / currency board model prevailed, and why a fully effective central banking capability was not acquired until as late as 1993. The regime change in 1972, which may in one sense be seen as an attempt to assert monetary independence from the metropolitan currency, proved ultimately disastrous because it preceded the establishment of the necessary central banking capability.

¹ As will be described later, this refers to the situation where no macro monetary regime or machinery existed, that would have enabled the government itself (independently of the commercial banks) to control the extent to which the banking system could create deposit money, even though the banknote component of the money supply was restricted to designated banks and subject to prudential backing requirements.

The rest of the paper comprises three main sections, devoted to each episode in turn as largely self-contained narratives. These are followed by a summary assessment.

2. 1935 - from silver to sterling

2.1 Overview

As Hong Kong entered the 1930s, it was already clear that the monetary system was under some strain and that changes might need to be enacted before long. Hong Kong was, like China, operating a silver standard, long after leading economies had abandoned it. As regards China, the Kemmerer Commission² had already suggested in 1930 that the country should move to the gold standard. Prompted by that, the British authorities asked the Hong Kong government to review its situation. This led to the 1930 *Report of Currency Committee*. Subsequently in London the Secretary of State for the Colonies appointed a Commission to follow up the matter further. The Commission, reporting in May 1931, advocated various changes to the monetary regime. But action was deferred. It was not until after China had formally abandoned the silver standard in November 1935 that Hong Kong took decisive action to implement what was effectively a currency board arrangement based on sterling.

2.2 Silver

By 1930 China and Hong Kong were among very few places still operating a silver standard. Leading economies had long since moved from either a silver standard or some form of combined silver and gold standard, to the gold standard (eg Germany in 1871 and Japan in 1897), and, although many had abandoned gold because of the first world war, most had returned to it - notably Britain in 1925. The United States (among others) continued to have a role for silver in its coinage, and had a powerful lobby intent on retaining or enhancing silver's role (of which more below).³ But the price of silver had been on the decline since 1925 as a result of expanded production, sales by European nations in settlement of war debts, India's decision in 1926 to leave the silver standard, and assumed sales⁴ by French Indo-China in 1929. By 1932 the price had fallen to an average 28 cents (US) per troy ounce, as against 69 cents in 1925.⁵

Already by then there was strong pressure on the US government from its seven, electorally important, western silver-producing states for something to be done to arrest this decline. Senator Pittman of Nevada led the charge.⁶ He visited China in 1931 and endeavoured - not without some apparent success

² Edwin Kemmerer was a professor at Princeton University who was much involved in advising on currency regimes around the world and had acquired the nickname of 'the money doctor'. His report on China is understood to be available in the Princeton University archive; references to it can be found in various secondary sources - eg King (1968) and the *Report of Currency Committee* (1930).

³ And, in May 1933, amendments to the Farm Relief Act introduced an element of bi-metallism, at least in a symbolic sense, by authorising the President to accept silver at a price not exceeding 50 cents an ounce in settlement of war debts - as recounted by Lin (1935), p13.

⁴ According to King (1988), p171.

⁵ Figures from Henry E Hilliard, US Geological Survey, at <http://minerals.usgs.gov/minerals/pubs/commodity/silver/880798.pdf>.

⁶ Further background can be found *inter alia* in Hu (1995), pp172 and 194.

- to persuade the Chinese that a higher silver price would be in their interests (presumably on the grounds that it would raise the purchasing power of their reserves),⁷ even though it was clear at the time that the lower price was being instrumental in helpfully insulating China from the full impact of the Great Depression.⁸

The World Economic and Monetary Conference took place in London in June 1933 in an attempt to rebuild the monetary order following the Great Depression. Virtually its only significant achievement was the London Silver Agreement, between the main producing countries and the chief holders or users. Its aim was to stabilise the price by limiting sales and imposing quotas on producers, while the United States undertook to purchase up to 35 million ounces yearly. In fact the US administration, under pressure from its silver-producing states, hoped or intended that the agreement would not simply steady the price but move it upwards. China wanted stability, but was not at that moment thought to be averse to a modest price increase.⁹

In June 1934 the US silver lobby scored another victory in pushing the Silver Purchase Act through Congress. Pittman regarded a higher price as a cure-all for both national and regional woes. The Act provided for the nationalisation of silver holdings (in exchange for silver certificates) until the price reached a particular level, and obliged the Treasury to hold 25% of monetary reserves in silver. The underlying intention was to increase the price of silver by inflating the currency, although in the event this objective was not realised beyond the short term.

2.3 Silver and China's currency reform

During the years 1927-31, when the silver price was weak, China had enjoyed substantial inflows of silver, particularly associated with overseas Chinese investing in manufacturing industry.¹⁰ This inflow began to reverse in 1932, and, with the price spurred particularly by the London Agreement of 1933 and the US Silver Purchase Act of 1934, the outflow accelerated through both legal and illegal channels, with smuggling being abetted by the Japanese who were occupying parts of the north. It reached a scale which caused alarm among Chinese bankers and the Chinese government, as a result of which in October 1934 the Nanking government suspended the cash redemption of notes and imposed an export duty on silver at a basic 10% plus a further equalisation tax based on the forward price for silver in London. This amounted to a *de facto* devaluation.

⁷ Hu (1995), p176, states that contemporary economists, including Keynes, criticised the economic theory of the so-called 'silverites' as simplistic and erroneous. In Hong Kong, the *Report of the Commission* (1935), p104, noted that the belief that China benefitted from the high silver price had been fallacious.

⁸ For instance, as recorded in Lai and Gau (2002), Irving Fisher wrote, in 1934, that during 1930 and the first half of 1931 China was "having something like a boom with rising prices", and Friedman and Schwartz (1963), pp134 & 361-2, noted that China "avoided almost entirely the adverse consequences of the first two years of the worldwide depression which began in 1929". Cain and Hopkins (2002), p609, also refer to China not being seriously damaged by the depression starting in 1929.

⁹ Lin (1935), p13, records that at the same time China appears to have been alert to the possibility of adverse consequences, since it signed the Agreement only with the reservation that it would take such measures as its own economic interests might require.

¹⁰ Rothermund (1996), p111-112.

US Treasury Secretary Morgenthau had warned President Roosevelt about the implications for Japanese militarism of the crippling of China, to which US silver policy was contributing, with the result that for a couple of weeks in December 1934 the United States agreed not to buy at a price above 55 cents per ounce, but this undertaking was soon rescinded in response to pressure from the silver lobby.¹¹ The price soared to a peak of 80 cents in April 1935. The cumulative impact on China of the rise in silver since 1932 was devastating.¹² Any benefit that might have accrued from the increased international purchasing power of its silver holdings was swamped by the severely deflationary impact - a decline of perhaps 30% in internal commodity prices within a couple of years, declining GDP and rising business failures - and the substantial losses of silver reserves.¹³ There was an added concern lest the advancing Japanese should grab the remaining silver.

As 1935 progressed, therefore, quite apart from its unstable political and security situation, China was suffering deflation, recession and banking problems - all to a greater or lesser extent blameable on the silver-based currency regime. Aside from the largely inconsequential establishment of the 'customs gold unit' in 1931 and even issuance of some currency notes denominated in it,¹⁴ no material progress had been made on the Kemmerer Report's recommendation of a switch to gold.

2.4 Politics, economics and the future of the Chinese currency

Behind the scenes there was considerable diplomatic activity involving the United States and Britain, both keen, among other things, to woo China into their respective currency folds. The Chinese appeared content to play one suitor against the other.

Britain wanted to protect and promote its commercial interests in China, and, seemingly for political as much as for financial reasons, was anxious to welcome China into the sterling fold if it ditched silver. In 1935 Britain sent its chief government economic adviser, Sir Frederick Leith-Ross, to China to advise the nationalist government on the currency and to secure British interests more generally.¹⁵ He arrived in September and advised the finance minister, H H Kung, that the silver standard be discarded in favour of a managed exchange-backed currency, with an independent central bank. He tried to persuade the authorities that the new regime should actually be a sterling standard, but the government would make no commitment. Anyway, the British, though hoping for a sterling link, were concerned not to offend the Americans or provoke the Japanese by appearing visibly to extend British hegemony in the region. The Chinese were also concerned not to aggravate Japan by explicitly opting for sterling, even though they had initially indicated to Leith-Ross that they favoured the idea. The possibility of a British

¹¹ Hu (1995), p200-201.

¹² See Salter (1934), for a good, concise overview of China's economic situation up to that date. Sir Arthur Salter had been an adviser to the Chinese government.

¹³ Hu (1995), p198.

¹⁴ See, for example, King (1988) p364.

¹⁵ See, for instance, both Endicott (1973) and Trotter(1975) for fuller accounts of the Leith-Ross mission. Wider issues relating to British trading interests and the regional ambitions of Japan were involved, but are beyond the scope of this paper.

loan was discussed but came to nothing, probably because there were too many strings attached to the offer.¹⁶

Meanwhile, T V Soong (the Nationalist government's finance minister until 1933 and still principal international negotiator thereafter, and subsequently prime minister) had been in the United States in January 1935, warning of an impending financial crisis in China. There followed a protracted series of negotiations, variously involving suggestions of US loans or US purchases of silver, linked at times to the idea of China fixing its currency to the US dollar. Morgenthau, at any rate, seemed to press hard for that.¹⁷

For the Chinese government it was increasingly urgent to take further action to resolve the currency crisis, since the measures of October 1934 were evidently insufficient. In particular the authorities wanted to halt the haemorrhage of the nation's silver, prospectively by nationalising all holdings and shipping the silver to a third country in order to prevent any more of it falling into Japanese hands.

Thus, on 3 November 1935, China formally abandoned silver altogether. Payments in silver were prohibited. All silver was to be surrendered. Banknotes were declared legal tender. And the government stated its intention to operate a stable, managed exchange rate. The British seemed to interpret this to mean stability against sterling, but believed that it was not formally announced as such for fear of offending political sensitivities in the United States or Japan, as explained some months later by Leith-Ross:¹⁸

“The Chinese Government ... did not link the Chinese dollar with any foreign currency but merely said that it would be maintained at its existing level. The intention ... had been to peg the Chinese dollar definitely on sterling, which in their view, as in ours, was the most appropriate currency for China to attach herself to. In the absence of any loan,¹⁹ however, it was essential for China to be able to sell large quantities of silver, and as the United States were the only buyers of silver,²⁰ they felt that they could not afford to risk antagonising the United States by definitely linking their currency to sterling. They therefore maintain an intermediate position, straddling between the United States dollar and sterling.... . The intention of the Chinese Government is, I believe, to maintain their connection with sterling rather than with the dollar, but they may from time to time follow the dollar if it should temporarily weaken more than sterling.”

¹⁶ As early as 1933, T V Soong had discussed the possibility of a British loan, but nothing transpired.

¹⁷ Hu (1995), p209-210.

¹⁸ From Leith-Ross's unpublished note on his China mission, circulated amongst officials in August 1936 - Bank of England OV104/8/18.

¹⁹ None of the various negotiations with Britain and the United States had borne fruit.

²⁰ According to Lin (1935), p81, the Annual Report of the Bank of China for 1935 noted that 50 million ounces were sold to the US government at 65 cents per ounce - seemingly at about the time that the new currency system came into effect. This appears to have been in response to China's request to the US to buy as much as 200 million ounces - see Dayer (1988), p294. According to Hu (1995), Morgenthau offered to take 100 million ounces if China would link to the US dollar. As events transpired, by July 1937 the US had bought a total of 188 million ounces for \$94.4 million.

The British authorities instructed their banks in Shanghai, which were the predominant group, to comply with the Chinese measures, but the Japanese banks, under instruction from Tokyo, refused to surrender any of their silver. Other international banks were hesitant, but, following a fall in the market value of silver in December, eventually agreed. Leith-Ross recorded that the Shanghai banks (and subsequently those in some other cities), with the exception of the Japanese, surrendered their silver in January in exchange for notes with a premium of about 5%.²¹ Without the leading co-operation of the British banks, the currency reform might not have worked at all.²²

2.5 Background - Hong Kong

Taking 1930 as the starting point, Hong Kong currency in issue comprised roughly 75% notes of the note-issuing banks (at that time the Hongkong and Shanghai Banking Corporation, the Chartered Bank and the Mercantile Bank) and 25% silver. This split was no coincidence, since at that time the Hong Kong authorities required that the note circulation should not exceed three times the value of coined dollars. However, the only legal tender in Hong Kong was silver coinage (Mexican dollar and British dollar).²³ A significant proportion of the currency was believed to circulate in southern China; as early as 1926 HSBC had estimated that 70% of its note issue was held across the border,²⁴ where these notes were preferred to the British silver dollar.

Paradoxically perhaps, in apparent contravention of Gresham's Law, although notes had for some thirty years commanded a premium over silver,²⁵ in practice very little silver circulated. The premium, which fluctuated considerably and had peaked at 20% in September 1929, was partly a reflection of the greater convenience of the paper currency, especially in terms of weight and not least for those in southern China who hoarded Hong Kong currency - and who, by implication, must also have had full confidence in the Hong Kong banks.

Another explanation of the premium was that the supply of notes was restrained. There were limits on each of the banks' issuance, although HSBC was allowed to exceed its limit so long as the excess was fully secured against silver. But with banking remittances flowing into Hong Kong without a counterpart flow of silver, the banks were constrained in how much new cash they could supply to meet deposit drawdowns. The banks were anyway under no formal obligation to meet the public's demand for notes. The costs of transporting, storing or smelting silver, and the levy of a tax on note issue at 1% pa, were forceful disincentives.²⁶ It also appears that the British authorities may have been somewhat ambivalent, for fear lest the inevitable expansion of circulation across the border, which would accompany any rise

²¹ Leith-Ross in Bank of England OV104/8/18.

²² A conclusion reached, for example, by Rothermund (1996), p114.

²³ The Hong Kong (Coinage) Order 1895 set the Mexican dollar as the standard, to which other silver coins had to conform.

²⁴ King (1988), p575; and King in Jao & King (1990).

²⁵ As recounted, for example, by a Bank of England memo of 15/9/30 - OV14/18/3

²⁶ In the light of the soaring note premium in 1929 the tax on HSBC was thenceforth confined to the first \$45mn of its issue.

in issuance, might either displease the Chinese authorities, or make the issuing banks vulnerable to events there or to unfounded loss of confidence in them.²⁷

Given the premium on notes, the banks were susceptible to arbitrage from customers depositing silver and then expecting to withdraw notes, but the banks were alert to this and either limited coin pay-ins or insisted on the customer taking back coin on withdrawals.²⁸

In 1930 the world's major economies were on the gold standard, which was still regarded as the norm - despite some imminent departures. The silver standard was based on the same principles, though may have by then been regarded as somewhat idiosyncratic, given that others had foresaken it for gold. The problem facing China was that the world silver market was behaving less stably than that for gold,²⁹ and fluctuations in the price of silver relative to gold carried implications for both trade and the domestic price level. Hong Kong was similarly affected. As noted above, the price of silver halved between 1925 and 1931 - which helped keep internal deflation at bay in China in the early part of the Great Depression - but reversed all of that in the subsequent four years, after various countries abandoned the gold standard and as deliberate steps (see above) were taken internationally to support the silver price.

In Hong Kong, by 1930 the fall in the silver price was having a distinctly inflationary impact.³⁰ Prompted by this, the Governor appointed a Currency Committee under the chairmanship of the Colonial Treasurer.³¹ Its terms of reference were to assess whether the prevailing currency regime, based on the link to silver, was the most advantageous for the Colony; to identify the satisfactory and unsatisfactory aspects of this arrangement; to consider whether the premium that existed for notes over silver coin was damaging and, if so, what should be done; and to advise on the desirability and available means of stabilising the Hong Kong dollar.³²

²⁷ Certainly this had been the tone of a British Treasury memorandum, incorporating the views of its leading economist, R G Hawtrey, back in 1910 - as recorded by King (1985), p12.

²⁸ King (1985), p13.

²⁹ Although in *Hong Kong Currency* (1931) it was suggested that over a period of 15-20 years silver may have been more stable than gold.

³⁰ Index of wholesale prices, 1922=100.

1913	1922	1924	1931	1932	1933	1934	1935	1936	1937	1938	1939	1940
64.0	100.0	106.8	136.6	122.4	103.5	91.5	77.9	103.1	131.1	130.6	128.0	173.3

Source: Hong Kong *Blue Book* for 1931 and subsequent years. Based on c.i.f. import unit values which, given the openness of the economy, would have been a good approximation to wholesale prices generally. No other intervening dates in the period 1913-31 are available. The *Blue Books* provide also a long run of annual micro data on various food prices, but these are not of a nature from which a reliable representative broader index could be calculated.

³¹ The Colonial Treasurer was C. Mcl. Messer. The Committee was quaintly described a year later, in the report *Hong Kong Currency*, as having comprised "government officers, bankers and merchants, including three Chinese gentlemen". The reference to the Chinese was probably included simply to demonstrate what today would be called political correctness; in fact, they were businessmen whose views on the currency question were similar to those of others in the business lobby.

³² 'Stabilisation' was in this context understood to mean fixing to gold - which at that time would have been equivalent in effect to fixing against sterling since sterling was on the gold standard.

The Committee held consultations locally and concluded that it would be best for Hong Kong to stick to the same monetary system as China. This was overwhelmingly the underlying tenor of the various submissions made to the Committee by the banking and business community. Just one member (R H Kotewall), echoing views expressed in a submission from the Professor of Economics at the University of Hong Kong (Robertson), expressed some scepticism towards this view and asked for the option to be explored of moving to gold even if China did not; he felt that the Committee had focused too much on the mechanism of exchange and not enough on the underlying economic realities. The report noted that China might eventually switch from silver to gold, since this had been mooted by Kemmerer. Although this was not deemed imminent, the Committee recommended that Hong Kong ought to be prepared for any such move.

The Committee also proposed, significantly, that the note issue ought not to be limited by the capital of the note-issuing banks but by the availability of acceptable collateral (at that time one third bullion and two thirds securities was deemed an adequate mix).

Hot on the heels of the Committee's work and its recommendation that expert advice should be sought in preparing a feasible scheme for stabilisation onto gold if a sudden change was necessitated, the Secretary of State for the Colonies - the British government minister responsible for Hong Kong - appointed a Currency Commission in London, comprising W H Clegg as chairman and P H Ezechiel, with G L M Clauson as secretary.³³ It was instructed "to enquire into and advise upon the question of Hong Kong currency and to make such detailed recommendations as you may consider desirable". The Commission held discussions in Hong Kong and also visited Canton and Shanghai.

The Commission's report, released in May 1931, considered whether Hong Kong should switch to gold. But a forceful case was made for Hong Kong to continue to have the same monetary standard as China. The Report noted "...that Hong Kong is economically part of China and must remain on the silver standard for as long as China does".³⁴ There were thought to be benefits for the entrepot trade (given that hedging instruments were not available to the extent they are today) and to Hong Kong's role as a refuge for mainland savings. It was considered important to facilitate as free a flow as possible of capital between Hong Kong and China. Nevertheless, the silver standard, as functioning in Hong Kong, had developed some serious shortcomings. Use of physical silver had become impracticable, yet there was apparently insufficient incentive for the banks to meet the full demand for notes as an alternative, although this view of shortage may have been overly influenced by the events of 1929 when the premium hit 20%.

Thus, the Commission recommended various reforms to ensure that notes would be in adequate supply

³³ Clegg was the first-ever Governor of the South African Reserve Bank, from 1920 to 1931, having previously been Chief Accountant at the Bank of England. Later (1932-37) he was a director of the Bank of England. Ezechiel held the post of Third Crown Agent for the Colonies, 1920-37. Clauson was at the time a Principal in the Colonial Office; he subsequently rose to the rank of Assistant Under-Secretary of State.

³⁴ Clauson (1944), p19 subsequently recorded that this conclusion was reached "reluctantly".

and to make them legal tender. It proposed that silver coin would only be legal tender for sums up to \$10, but that the silver standard would be preserved by providing two-way convertibility at the wholesale level between notes and silver bullion;³⁵ the government would help with the physical management of the backing; although it was presumed that this would be largely in silver, it was suggested that 20% might be in sterling securities, managed by a currency board, in anticipation of a possible switch to a sterling/gold standard at some future date. The Commission proposed that the earnings of the reserve fund which backed the currency would be retained in order to build up a reserve against possible exchange movements arising from such a regime switch.

The note-issuing banks were already empowered to continue issuing at least until 1939.³⁶ The Commission now recommended that their tax liability should be confined to the first (fiduciary) tranche of each issuer's circulation, and that the government should cover the costs of issuance. The Commission touched upon the question of the government taking over the note issue, but concluded that this could only be recommended if the banks failed to implement desirable alterations to the existing system.³⁷ In fact, the government had always been reluctant to consider burdening itself with the logistical side of note issuance, and some officials were even concerned that government-issued notes might not enjoy the same degree of public confidence as those from the long-established banks.³⁸

2.6 A period of dithering 1931-34

The desirability of reform along the lines proposed by the Commission was generally acknowledged in both London and Hong Kong, despite some hesitation on the part of HSBC.³⁹ However, no action was forthcoming. The urgency ebbed as HSBC expanded its note issue⁴⁰ and the premium eased, and as a consequence of sterling's departure from the gold standard in September 1931, which cast a mist of uncertainty over currency regimes more generally - it became unclear whether gold or sterling would be the appropriate standard to adopt if silver were to be abandoned. The Colonial Office Currency Committee,

³⁵ As noted by Tom (1964) p64, the proposal was effectively for a shift from a silver coin standard to a silver bullion standard.

³⁶ According to Section 10 of the Hongkong and Shanghai Bank Ordinance 1929, and the Mercantile Bank Note Issue Amendment Ordinance 1929.

³⁷ *Hong Kong Currency* (1931), paragraphs 111-112

³⁸ King (1988), p575, implies that the government had declined on more than one occasion to entertain the idea of taking over the issuance. The COCC noted in 1931 that the Hong Kong government might face an uncertain reception if it took over that role (see Bank of England, OV44/103).

³⁹ The Bank of England files (OV44/103) record reservations attributed to HSBC's chief manager, V M Grayburn, which were, however, rebutted by members of the Commission; the reservations appeared to include a fear of stimulating speculation and - as inferred by the commissioners - a fear that HSBC's prestige would diminish.

⁴⁰ Sources are inconclusive as to what extent HSBC may ever have been reluctant to supply sufficient notes to meet demand. An unpublished annex (see Bank of England OV44/103) to the 1931 report *Hong Kong Currency* stated that "It is a tradition, broken for a period in 1929, [for HSBC] to issue sufficient currency for the needs of the colony. But the initiative lies with the Bank". King (1988), p243, recalls that the Acting Colonial Treasurer said in evidence to the Currency Commission that he had not discovered any instance of HSBC refusing to expand issuance when the Colony's trade so required. Yet the existence of a sometimes wide premium and the possible disincentives to issuance in terms of production cost, handling cost of silver backing, absence of seigniorage on specie backing, and tax, all lend circumstantial support to the belief that supply may often have fallen short of demand. A further factor was that a high proportion of any note issuance invariably went into China, in knowledge of which HSBC may understandably have held back, provided they were satisfied that the basic needs of trade in Hong Kong were, in their judgement, being satisfied.

meeting on 14 July 1932, noted that HSBC had expressed a willingness to expand its note issue when necessary, that the premium was only small and that there was “no evidence of public dissatisfaction”; thus it concluded: “For the immediate future, there is therefore something to be said for taking no action at all”.⁴¹ This appeared still to be the majority view in Hong Kong itself almost three years later, when a commission, examining the overall economic situation during the period July 1934 to February 1935 at the Governor’s request, discerned tacit approval locally for the prevailing policy of aiming to keep the currency in step with China’s and hence based on silver, despite acknowledged vagaries of the silver market.⁴²

Nevertheless, the idea of at least tidying up and strengthening the silver-based system, in effect by establishing a formal silver-based currency board, was kept alive. The subject was raised from time to time in the COCC in London during the period 1931-34, but action even on this was continually deferred, seemingly for three main reasons. One was, as noted above, the decline in the premium to a more tolerable level. Second was concern over storage arrangements for the silver which the currency board - in effect the government - would acquire. HSBC was willing to help, but its new premises with sufficient vault capacity were not expected to be ready until late-1935. The third reason was that the Governor of Hong Kong considered that: “The weight of local opinion is on the whole still against any change ... more especially in view of the uncertain condition of many of the world’s currencies, and I generally support this opinion”,⁴³ although it is unclear why the global situation should have been thought to have a bearing on proposals to carry out some much-needed housekeeping in Hong Kong, which would not have materially affected the international relationships of the HK dollar.

2.7 Debate intensifies in Hong Kong, 1935

The steps taken by China in October 1934 in an attempt to safeguard its silver stocks sounded a clear warning that the days of China’s silver standard might be numbered. And so the idea that silver would indefinitely remain the preferred regime for Hong Kong seemed increasingly untenable. Although the COCC, meeting on 26 October 1934, decided against any immediate parallel action to China’s by Hong Kong,⁴⁴ within a couple of months an ordinance was in preparation which would allow Hong Kong to depart the silver standard.

By the spring of 1935 it was plain that China was fragmenting and the economic situation deteriorating.

⁴¹ Bank of England, OV44/103

⁴² *Report of the Commission* (1935), p103. The report noted that “silver has become a veritable gambling counter ... and lacks that measure of stability necessary for sound trading”; it also viewed “with misgiving the many factors of minor importance in America to-day tending to confuse the issue [concerning silver]”.

⁴³ Governor, Sir William Peel, to Secretary of State, 27/4/33 - see Bank of England OV44/103.

⁴⁴ Bank of England, OV44/103.

Even so, at the beginning of May the Governor of the Bank of England, Montagu Norman, still felt that the objective should be for the HK dollar to maintain approximate parity to the Chinese currency, and that it was better to follow China in any changes to the monetary regime than to precede it; and the UK Treasury was in broad concurrence.⁴⁵ Interestingly, however, a week later an internal Bank of England memo expressed the opinion that “divorce has already taken place”.⁴⁶

The COCC had meanwhile been discussing various options, including imposition of a silver export tax (to match China’s action back in October 1934); suspension of convertibility into silver; formal adjustment of the exchange rate against silver; or adoption of a sterling-based currency board.⁴⁷ Eventually it was agreed that a variable export tax on silver should be imposed immediately and that plans for longer-term stabilisation should be drawn up.⁴⁸ However, it was decided that implementation of the tax proposal should be deferred until a currency adviser was in place in Hong Kong. This was to be another official from His Majesty’s Treasury, Norman Young, who duly reported for duty in Hong Kong on 19 July.

2.8 But still no action by Hong Kong

However, Young reported back to London that there was little support among the business community for any action at all; in particular, a recent narrowing of the differential between the Hong Kong and Shanghai exchange rates, seemingly brought about by a combination of an easier world silver price (down by about 10% from its peak in terms of US dollars) because of a slackening of US purchases, and adjustment within Hong Kong via reductions in local costs, diminished the case for the silver export tax. He argued that the best opportunity to introduce the tax would have been immediately after China had imposed theirs in the previous October, or in April 1935, before the silver price began to ease, but that now it was not needed.⁴⁹

The Colonial Office appeared somewhat sceptical of these arguments, but nevertheless acquiesced to the local Hong Kong view that nothing needed to be done until Chinese policy became clearer, unless US buying started to drive up the silver price anew.⁵⁰ It is possible that by this stage a more serious breakdown in China was expected before too long, so that a modest measure aimed merely at catching up with China’s last step was considered otiose - or at least not worth a big argument between Hong Kong and London.

By October 1935 it indeed seemed to be presumed that China would very soon decide to abandon silver altogether, and the Colonial Office appears then to have decided that in that event Hong Kong should shift immediately to a sterling peg. But other departments were not necessarily in agreement as to the timing of such a move.

⁴⁵ As reported in the COCC, 2/5/35 - see Bank of England OV44/103.

⁴⁶ Memo dated 9/5/35 in OV44/103.

⁴⁷ Meeting of 2 May - see Bank of England, OV44/103.

⁴⁸ Meeting of 10 May - see Bank of England, OV44/103.

⁴⁹ Telegrams, Hong Kong to London, 19 and 23 July - see Bank of England, OV44/103.

⁵⁰ Telegram, London to Hong Kong, 30 July - see Bank of England, OV44/103.

2.9 Further deliberation

Thus, following China's abandonment of silver on 3 November, despite an immediate depreciation in the yuan relative to the HK dollar,⁵¹ Governor Norman of the Bank of England stated that he did not see clearly why Hong Kong could not stick with silver for the moment; failing that, it should move also to a 'managed' currency while China sorted itself out; he cautioned in particular against Hong Kong preceding China formally onto a sterling standard.⁵²

Underlying this view were continuing political sensitivities surrounding sterling pegs for China or Hong Kong. The British Chancellor of the Exchequer (Neville Chamberlain) wrote to the Secretary of State for the Colonies (Malcolm MacDonald) on 15 November, warning that the Japanese would regard China's abandonment of silver as part of a British design to draw China into the British bloc for political reasons. He added that the United States and France seemed averse, too, to China linking to sterling. If Hong Kong were to move first, it would merely exacerbate the situation, as well as signalling lack of confidence in China's ability to reform its currency successfully. Thus the Chancellor recommended that Hong Kong should not leap to a sterling standard but rather manage its currency to keep approximate parity with the Chinese dollar.⁵³

The Secretary of State, while noting that the economic arguments strongly favoured immediate adoption of the sterling standard, acknowledged the Chancellor's concern for "Imperial interests in relation to the United States, France and Japan" and so was willing to defer any action to link Hong Kong to sterling.⁵⁴

Thus, although by mid-November London had reached a firm technical decision that Hong Kong ought to switch to sterling, political considerations dictated that such a move should not be made for the moment.

A further reason for deferral was that the British authorities had enquired of their US counterparts whether they would be interested to buy the silver presently backing the Hong Kong currency, since this would need to be switched into currencies - ultimately mostly into sterling. The US silver lobby may be presumed to have been displeased at the abandonment of the silver standard in China and prospectively in Hong Kong. At the same time, US Treasury Secretary Morgenthau seemed displeased with Britain over alleged lack of co-operation in certain other financial matters.⁵⁵ It therefore came as no great surprise when, on

⁵¹ According to the *Report of the Commission* (1935), p103, there was an immediate rise in the (semi-official) Hong Kong-Shanghai inter-port cross rate of some 12%, although King (1968) records that at one point in the previous month the Hong Kong dollar had already reached a premium of 45% over the Chinese currency in the market.

⁵² Records of meetings at the Treasury on 4 and 7 November - see Bank of England, OV44/104/53&73

⁵³ Bank of England, OV44/104/96.

⁵⁴ Bank of England, OV44/104/98. It is a trifle ironic that the Colonial Secretary should have pressed the economic arguments while the Chancellor (finance minister) argued for the supremacy of imperial interests.

⁵⁵ Telegram, Washington to London - see Bank of England, OV44/104/72.

19 November, the British received a brief and somewhat frosty negative response, noting that the proposal that the United States might buy the silver was “one-sided”; that they were “not interested”; and that anyway the London and New York markets were open.⁵⁶

However, Hong Kong could not defer radical action indefinitely. Already on 9 November it had been necessary to impose a ban on the export of silver (other than remittance of silver coin to China), because of speculation against the Hong Kong dollar following China’s break from silver a week earlier.

2.10 Hong Kong eventually moves

At last, therefore, Hong Kong legislation was enacted, on 5 December, which terminated the silver standard and established a managed currency.⁵⁷ All silver coin and the silver backing for the note issue held by the three note-issuing banks were to be surrendered to the newly created government Exchange Fund within one month. The banks would receive certificates of indebtedness in exchange for their silver. The EF would hold its assets in gold, silver, or securities approved by the Secretary of State. The formal arrangement was not precisely that of a currency board based on sterling. Indeed, it was presented as an exercise in stabilisation rather than ‘sterlingisation’, partly at least for the political reasons alluded to above.⁵⁸ In practice, however, the exchange rate was held steady against sterling and the assets of the Exchange Fund were soon to be held almost exclusively in sterling.⁵⁹

In presenting the Bill to the Legislative Council on 5 December, the Attorney General stated that the note-issuing banks were in full concurrence with the proposals.⁶⁰

Uncertainty over the future of the Chinese currency persisted. For instance, in March 1936 Leith-Ross reported that the Shanghai authorities would formally peg the yuan to sterling - having already been operating a *de facto* peg⁶¹ - but a Bank of England official confirmed that no such formal move had yet been made.⁶² The Governor of Hong Kong had mentioned in February the possibility of China returning to silver,⁶³ but in April Leith-Ross reported a Chinese official as considering this unlikely.⁶⁴ This opinion was confirmed in a Bank of England memo in September, which referred also to the possibility still of China fixing to the US dollar.⁶⁵

⁵⁶ Reported in telegram, Washington to London - see Bank of England, OV44/104/107. In fact, all the silver was sold on the market in the course of the following year without noticeable impact on the price.

⁵⁷ Laws of Hong Kong, chapter 66.

⁵⁸ Consistent with this view, King (1988), p198, refers to both China and Hong Kong as having moved to a ‘managed currency standard’.

⁵⁹ A Bank of England memo of 17/11/1936 stated that the assets were by then “almost entirely in sterling”. OV44/106/57.

⁶⁰ *Hong Kong Hansard* 1935, p250.

⁶¹ Bank of England OV44/105/72.

⁶² Fisher, in Bank of England OV44/105/74.

⁶³ Letter to Secretary of State, in Bank of England OV44/105/74b.

⁶⁴ Bank of England OV44/105/112.

⁶⁵ Bank of England OV44/106/32. A choice between the US dollar and sterling was more political than economic, since the sterling-dollar exchange rate was fairly stable at the time.

2.11 Operation of the new Hong Kong regime

In the earlier years of the British colonial currency board model it appears to have been well understood that the note issue should not be secured against a colony's own securities, although it is not clear whether this was ever specified in any colony's legislation or was simply an unwritten rule. Hong Kong's Exchange Fund Ordinance of 1935 was not entirely clear on this point. Although the ordinance stipulated that the silver which backed the existing stock of notes must be transferred to the government in exchange for certificates of indebtedness, for the future it only stated that CIs, which were denominated in HK dollars, should be paid for by "transfer of face value".

At the time, however, it was clear that new certificates were to be backed by foreign currency. Thus, in presenting the Ordinance to the Legislative Council, the Attorney General elaborated that "Further certificates may be issued to the note-issuing banks in payment for any foreign exchange acquired from them by the Fund, and certificates in their possession will be accepted by the Treasurer in payment for any foreign exchange sold to them by the Fund".⁶⁶ One historian later asserted more specifically that "it is the policy of this Colony that certificates of indebtedness shall be sold only against a concurrent sale of *sterling* to the Exchange Fund" (italics added).⁶⁷ And right from the start the EF accounts, for 1936, itemised CIs as being "issued against sterling purchases" and showed the amounts outstanding as being "valued at the rate at which the Exchange Fund is prepared to redeem them - the Fund's selling rate in London".⁶⁸ The reference to London is a reflection of the fact that the Crown Agents for the Colonies, based in London, managed the sterling investments of the EF at that time, and the appropriate sterling transfers were effected between the Crown Agents and the note-issuing banks. Thus, in practice, the note-issuing banks effectively paid for the CIs in sterling, by making an immediate sale of sterling to the EF at the officially agreed rate.

It is hardly surprising, in view of political sensitivities described earlier, that there was in fact no reference to sterling either in the Ordinance or in its presentation to the Legislative Council. It is also noteworthy that the Ordinance allowed for the EF to buy and sell currencies at rates to be fixed by the Colonial Treasurer. There could be no presumption that the rate would necessarily remain fixed indefinitely against a particular currency. Despite the problems facing China, Hong Kong opinion was still strongly in favour of keeping the currency in step with Shanghai, and it was obviously deemed desirable to retain administrative discretion to that end. The fact that Shanghai was shadowing sterling meant that Hong Kong could keep all parties happy by doing so too. Thus, a Bank of England memo of 21 January 1936 recounted: "Hong Kong is managing the currency by reference to Shanghai and therefore at the moment by reference to sterling".⁶⁹

⁶⁶ *Hong Kong Hansard* 1935.

⁶⁷ King (1953) p43.

⁶⁸ Copies of the accounts for the early years are in the Bank of England archive. It is unclear whether they were formally published in Hong Kong. Nugee (1995) summarises balance sheet data for the period 1936-1994.

⁶⁹ Bank of England OV44/105.

In late-February 1936, the Governor of Hong Kong wrote to the Secretary of State, itemising the options and seemingly keeping them all open.⁷⁰ The current policy - buying or selling sterling against Hong Kong dollars at present fixed rates - could continue for as long as China kept its currency at about its present level against sterling. If China depreciated against sterling, Hong Kong might, if the cause was a fall in the price of silver, follow the yuan down, but otherwise would consider stabilising formally on sterling. Hong Kong might anyway consider announcing a link to sterling in view of the fact that China was increasingly making suggestions that it was linked to sterling - although China had not actually yet taken that step formally.⁷¹ On the other hand, Hong Kong might still need to consider a return to silver if China did so.⁷²

In March, Hong Kong merchants were still reported as considering parity with Shanghai as paramount, a view which seemed still to be supported by the Bank of England.⁷³ As late as November 1936 the Colonial Office and Bank of England appeared still to be debating how important it might be for Hong Kong to keep its currency in step with China,⁷⁴ but by then China's internal political troubles were beginning to mount and its currency regime tending to fragment. Certainly, when full-scale Sino-Japanese hostilities took hold in 1937, there was no longer sense in thinking of keeping the two currencies in close alignment. From then on the Hong Kong dollar assumed unambiguously its sterling link.

2.12 The rate

By early November 1935, the exchange rate for the Hong Kong dollar against sterling had already declined significantly from its peak of around 30d per Hong Kong dollar in April.⁷⁵ Imposition of the ban on the export of silver then effectively broke the link to silver. According to official sources, from then until the Ordinance was passed on 5 December the market rate moved between 16d and 18d; after the Ordinance became law the rate came down to 15³/₈d - a move that "was unattended by any very marked disturbance in local banking" - and thereafter settled in the range 15³/₈d to 15⁷/₈d.⁷⁶ These numbers were a slight premium to the rates set for the transactions relating to CIs between the EF and the note-issuing banks: the EF bought the sterling from the banks at 15d and sold sterling (in the event of a contraction in the note issue) at 14¹³/₁₆d - a buy/sell spread of 1¹/₄% - although these rates were not

⁷⁰ Bank of England OV44/105/74b.

⁷¹ Bank of England OV44/105/72,74.

⁷² This seemed an unlikely move for China, as was confirmed, for example, by a Chinese official to Leith-Ross in April - Bank of England OV44/105/112.

⁷³ Bank of England OV44/105/71,74.

⁷⁴ Internal memo, Bank of England OV44/106/57.

⁷⁵ The units are (old) pence. In various documents the rate is quoted in shillings (s) and pence (d), there having been 12 pence to a shilling, but, for convenience, in this paper the amounts are expressed in pence only.

⁷⁶ Hong Kong *Administration Report* 1935

made public.⁷⁷ The major banks undertook informally to set buy/sell rates at a close spread around the EF's rates,⁷⁸ and the evidence of the ensuing years suggests that there was no serious difficulty in maintaining an equilibrium for the exchange rate at that level.

Some commentators have suggested that with the introduction of the new regime Hong Kong engineered a very deliberate devaluation.⁷⁹ In fact, however, much of the depreciation against sterling since the spring was the consequence of the easier silver price. On top of this, there had been speculative outflows in October/November as a result of developments in China. After Hong Kong's ban on silver exports on 9 November there could be no pretence of maintaining a silver parity; the preferred objective was plainly to try to maintain parity with Shanghai.⁸⁰ It was this consideration which largely determined the rate selected once the Ordinance came into effect. Market forces had already driven the rate close to that point.

2.13 Evaluation

In the mid-1930s the world's leading economies were searching for renewed monetary stability after the Great Depression and after associated departures from gold, which were at the time generally regarded as temporary. Although major currencies were perforce floating in one way or another, there was no presumption, as was to emerge in the 1970s, that floating was in some sense a preferred system and that the days of the fixed exchange rate were over.

Against this background it is not surprising that neither London nor Hong Kong ever appears to have considered taking any actions in respect of the Hong Kong currency other than those which would either make the silver standard work more efficiently or would 'stabilise' the HK dollar against what would for Hong Kong be a less volatile standard - prospectively another currency, which would most obviously be sterling, or gold.

⁷⁷ The Attorney General had announced to the Legislative Council that these rates would not be published - *Hong Kong Hansard* 1935, p250. It was not until September 1939 that a formal announcement was made to the effect that the Exchange Fund would exchange sterling with the note-issuing banks at those rates - see *Administration Report* for 1939. Later the redemption rate was raised to 14⁷/₈d. Subsequently, in 1965 the government agreed that the buy/sell spread should not apply to the ebb and flow of note circulation precipitated by bank runs, and in 1967 that it should similarly not apply to the seasonal surge around Chinese New Year. The spread was dropped by administrative arrangement in 1969, and would anyway have ceased to have any relevance once the Hong Kong dollar became the vehicle of payment for certificates of indebtedness in 1972. See Nugee (1995) for elaboration of these points. The spread was not resurrected when US dollar payments were introduced in 1983 - certificates of indebtedness have, since then, been both purchased and redeemed at the same 7.80 rate.

⁷⁸ The variance between the rates thus implied and those reported from the *Administration Report* might be explained by the latter source quoting the rates for buying sterling from merchants.

⁷⁹ Miners (1987), p24, refers to the establishment of the Exchange Fund being used "to bring about a substantial devaluation"; Welsh (1993), p403, refers to Hong Kong devaluing to a competitive level under the freedom acquired to manage its own currency; and Clauson (1944), p20, hints as much by talking of the rate "being allowed to decline" to the 15d. level.

⁸⁰ As mentioned in a telegram from the Secretary of State - Bank of England OV44/104/138.

Stabilisation may have meant different things to different people. The merchant community in Hong Kong primarily wanted stability vis-à-vis China, but China was itself ambivalent as to whether it should, once the decision was taken to abandon silver, target sterling or the US dollar. There were political reasons for prevarication by China, which therefore adopted the conveniently imprecise term 'managed currency'. In practical terms this happened to produce stabilisation for the time being as much on the US dollar as on sterling. However, in the event, China's new regime did not have much of a clear run, since in July 1937 full-scale hostilities with Japan broke out, and the currency began to depreciate and fragment. But Hong Kong did not have that benefit of hindsight when needing to address the future of its currency, still very much in the context of its relations with China, in the closing months of 1935.

The Currency Commission in 1931 had recommended retention of silver for the time being, in preference to moving to gold. But its recommendations were delivered while sterling was still on gold. Soon after, sterling left gold, and in 1935 it had not returned to gold. Although the US dollar was still defined in terms of gold, no serious consideration seems then to have been given to hitching Hong Kong to gold. Because Hong Kong was a British colony and sterling still a major world currency, there was seemingly an automatic presumption that the Hong Kong dollar should switch its allegiance from silver to sterling. Indeed, there is no trace of any other option having been seriously considered initially.

When, however, China began to talk in terms of a 'managed currency', there was pressure on Hong Kong to be ready to follow suit in order to maintain a stable rate against the yuan. For political reasons this was preferred to moving directly to an explicit sterling peg. But Hong Kong had no central bank, and the possibility of creating one does not appear ever to have been raised. Thus, in operational terms a commodity standard or a currency board were really the only viable options - a reality which came to be aptly demonstrated in the period after 1972. If Hong Kong, with the mechanisms of its new Exchange Fund, which invested its assets in hard currencies, had been obliged to shadow the yuan through discretionary intervention while the yuan was falling against sterling, the result might have been quite messy. As it transpired, however, for the period that the focus on stability against the yuan lasted, the yuan was steady against sterling; and thereafter Hong Kong was happy to track sterling. Thus, from the moment that the Exchange Fund was established, maintenance of a fixed rate against sterling was the continuous functional objective.

And, given that the 1931 Commission had recommended procedural reforms which would bring more classical rigour to the operation of the silver standard, it was only natural that the principles of those proposals should be applied to the pegging of the currency when it was apparent that sterling would take the place of silver. And so in December 1935 Hong Kong's sterling-based currency board became a reality. But it was almost another four years before the exchange rates at which CIs were issued or redeemed by the EF were made public. More significantly, there was never any statutory requirement that those rates should remain fixed, nor indeed that sterling had to be the reference currency.⁸¹

⁸¹ The absence of a statutory basis was frequently acknowledged in official documents over the years; see for example Hong Kong *Annual Report* 1973.

Following its break from silver, and largely as a consequence, the Chinese economy enjoyed a brief period of relative prosperity as deflation reversed and activity recovered. Hong Kong was to a considerable extent pulled along in the wake.

The extent of available economic statistics for the period is limited, but total Hong Kong trade, which had slumped from HK\$1,280 mn in 1931 to \$636mn in 1935, recovered to \$1,084mn by 1937.⁸² Currency circulation, which had declined by 14% in the two years preceding the currency reform, expanded by 54% in the ensuing two years. Wholesale prices, which averaged 36% lower in 1935 than 1932, rose 68% over the next two years.⁸³

With hindsight it may seem fairly obvious that a peg to one of the world's major reserve currencies was preferable to a peg to a commodity the price of which was strongly hostage to sectional interests in the United States. One might then argue that it would have been better for Hong Kong to have moved off silver some years earlier so as to avoid the deflationary impact of the rising silver price from 1931. But during that period the merchant lobby believed in, and successfully persuaded the authorities of, the virtue of sticking close to China. It appears that they continued to attach paramount importance to stability of the Hong Kong-China exchange rate right through to the eventual demise of China's silver link, and beyond for a while, despite the rocky ride which both the silver price and China's economy experienced in much of that period.

It is interesting to note that not long after stability was established in the rate against sterling - and approximately against other western currencies - Hong Kong officials were extolling the advantages for trade of that particular brand of stability. Thus, for 1937, "The result has amply justified the abandonment of silver. The steadiness of exchange has promoted confidence in foreign exchange dealings and enabled merchants to take a longer view...".⁸⁴ And for 1938, "... these advantages [steadiness of exchange and a managed currency] continued to be enjoyed. It appeared to be the general desire of the business community that no attempt should be made to make the Hong Kong dollar follow the Chinese dollar".⁸⁵ Thus, despite not following the Chinese dollar, trade with China flourished, although this may have been partly explicable by the fact that, with China suffering from the Japanese invasion and civil hostilities, the southern region had gained share in trade at the expense of Shanghai.

⁸² Hong Kong external trade (exports plus imports) HK\$ million (% of total in italics)

<i>vis-à-vis</i>	1931		1935		1937		1938	
United Kingdom	87.7	6.9	33.0	5.2	71.2	6.6	80.6	7.1
China	524.1	41.0	269.4	42.4	419.0	38.6	483.0	42.7
Rest of Asia	484.4	37.8	223.4	35.1	368.9	34.0	308.9	27.3
USA	77.4	6.0	47.7	7.5	92.9	8.6	106.7	9.4
Rest of world	106.3	8.3	62.5	9.8	132.4	12.2	150.9	13.6
Total	1,279.8	100.0	636.0	100.0	1,084.4	100.0	1,130.1	100.0

Source: *Hong Kong Statistics 1947-67*

⁸³ See footnote 30.

⁸⁴ Hong Kong *Administration Report 1937*.

⁸⁵ Hong Kong *Administration Report 1938*. Chinese dollar is synonymous with yuan.

All of this suggests that the merchant lobby was inherently conservative. It endorsed whichever exchange regime was in place. It probably wielded more influence than should have been allowed. In the event, the breaking of the link to the Chinese currency was not obviously damaging to the entrepot trade. Businessmen may not make very good economic policy makers, and it may be significant that the only economist consulted in the preparation of the 1930 Committee Report recommended that the case for breaking away from China and silver should be more thoroughly considered. Although there might have been little advantage in switching to sterling at that moment - shortly before sterling left gold - it might, with hindsight, have been beneficial for Hong Kong to have made the switch in 1933, before the silver price rise gathered full momentum. However, this remains a matter of conjecture.⁸⁶

In sum, the currency reform adopted by Hong Kong in 1935 may be judged to have been the correct one, but there are grounds, albeit far from conclusive, for arguing that it might to advantage have been implemented a couple of years sooner.

The new system was operated in accordance with the precepts of a currency board, even though the relationship with sterling was not a statutory one. It was the looseness of the Ordinance's wording in this respect, however, that was to provide an opening for the accidental abandonment of the monetary anchor in a later phase of Hong Kong's history.

⁸⁶ Tom (1963 ch VI and 1964 ch VII) expresses the contrary opinion, that Hong Kong's entrepot trade would have suffered if the exchange rate with China had not stayed fixed.

3. 1972 - discipline inadvertently abandoned

3.1 Chronology

The sterling based currency board survived the interruption of the second world war. The HK dollar retained its peg against sterling unaltered when the Bretton Woods parities were set after the war and also when sterling devalued in 1949. When sterling was next devalued in November 1967, Hong Kong initially kept its rate against sterling unchanged, implying a 14.3% devaluation against other currencies, but within a week the decision was taken to revalue by 10%, leaving a residual devaluation of 5.7%.

The start of the 1970s was a period of considerable uncertainty and turmoil in the world's currency markets. The Bretton Woods system of the gold exchange standard was still theoretically in operation, although central banks had, since the two-tier gold market was established in 1968, effectively terminated the last vestiges of gold convertibility. In August 1971 the United States ceased gold convertibility altogether, even for other central banks. The Smithsonian agreement of December 1971 was a desperate attempt to shore up the fixed-rate system. It involved a devaluation of the US dollar by some 8% - technically via an increase in the dollar price of gold from \$35 to \$38 an ounce. Hong Kong decided to maintain its rate against sterling, implying a revaluation of 8.6% against the US dollar. The respite was shortlived. In June 1972 the UK authorities decided to allow sterling to float. Two weeks later, on 6 July, the Hong Kong government announced that it would sever its fixed link to sterling and instead move to a US dollar link, aiming to keep the currency within a margin of 2% on either side of a rate of HK\$5.65 to the US dollar - representing an immediate appreciation of 5.2% against sterling. Hong Kong left the sterling area and all exchange controls were lifted.

It was at this point that a significant alteration was made to the backing arrangements for banknotes. Henceforth the note-issuing banks would pay the government for CIs not in sterling but by merely posting a HK dollar credit to a government account on their own books, and debiting that account in the event of a CI redemption.

In February 1973 the United States formally devalued by a further 10% against gold - to \$42. Hong Kong decided to leave its declared gold parity unchanged, so revaluing against the US dollar.

But by then the fixed rate system was in its final throes and the world was moving to generalised floating. Eventually the Hong Kong authorities, too, opted to cut loose from other currencies altogether. From 24 November 1974 the HK dollar was allowed to float without any official undertaking to hold it at a particular rate or within a particular range.

3.2 Hong Kong's most crucial decision

From Hong Kong's monetary perspective the key event in this episode was the decision in July 1972 to alter the method of payment for CIs, since this propelled Hong Kong into a era where there was no effective framework to deliver monetary stability or through which to exercise monetary control.⁸⁷ In the absence of a central bank, there was no anchor for the currency and no means whereby the authorities could, on their sole initiative, operate in the money market to regulate the volume of liquidity of the banking system or to control the level of short-term interest rates. The amount of money created was in practice determined by the banks, free of any obligation to maintain a particular exchange rate or of any technical mechanism inclining them towards one. Monetary policy was largely rudderless and impotent.

Why was this decision taken? Whether and to what depth this specific question may have been analysed or its consequences evaluated is something of a mystery. There is no trace of any such discussion in available archive material.⁸⁸ One is therefore obliged to piece together the story with a measure of surmise.

The most obvious reason which may be adduced for changing the backing arrangement was that sterling was perceived as a weak currency at the time, and the HK dollar as relatively strong. By taking local currency in payment for CIs the authorities gave themselves scope to diversify their reserves into third currencies without going through sterling first. They saw the decision as affirmation of the strength of the economy and the currency. At that time the monetary concern uppermost in official minds was the future of the agreements with the UK authorities, originally negotiated in 1968, for the partial guarantee of reserves held in sterling against sterling depreciation. Thus, it is noteworthy that a lengthy statement by the Financial Secretary to the Legislative Council in December 1972 on the monetary situation was almost entirely devoted to the guarantee question, without a single mention of the revised CI mechanism.⁸⁹

Another probable reason why so little attention was given to this change is that officials originally expected it to be only temporary. The pegging of the exchange rate to the US dollar was seen as an interim measure, and the Financial Secretary stated the intention to set a new fixed rate against sterling (and presumably, by implication, though it was not said, to revert to the previous arrangement for CIs) in due course.^{90,91}

⁸⁷ Some observers have maintained that the regime change occurred only in November 1974 when the Hong Kong dollar was allowed to float. However, while it is true that the currency was held within a narrow band around a fixed rate until November 1974, through official intervention when necessary, the crucial change in the operational monetary framework had already been effected in July 1972.

⁸⁸ It may be significant that some of the Hong Kong Executive Council papers and minutes for the period have been withheld from release (by means of an exemption from the 30-year rule which would otherwise make them publicly available). The minutes for 27 June report baldly the decision to initially stick with sterling following sterling's float. Those for 4 July record that "The Financial Secretary informed members that a close watch was being kept on developments in the international monetary situation as a result of the floating of the pound sterling, and that a memorandum would be submitted to the Council for consideration within the next few days", but no such memorandum is available for public access. The released minutes for 11 July contain no reference to that memorandum, but there is indication of a censored item, which may - or may not - have been relevant.

⁸⁹ *Hong Kong Hansard*, 1972-73, pp218-229.

⁹⁰ *Ibid* p224.

⁹¹ For a further discussion of the possible motivations for altering the payment arrangements for CIs, see Jao, p60, in Jao & King (1990).

The Financial Secretary based this view on the belief, which was either encouraged or at least not discouraged by London, that sterling would itself, before long, be re-pegged to the US dollar, particularly if - as was suggested in some quarters - action to restore at least some degree of stability to sterling would be a pre-requisite to the United Kingdom formally joining the European Economic Communities on 1 January 1973.

Yet, if just one monetary economist had been consulted, the change to the CI arrangements might never have been enacted, even as a temporary measure. It appears, however, that this was regarded as a fund management and operational issue, not an economic one. Given that point of view, it is perhaps not surprising to find no evidence of London even having been consulted on the specific point. As to currency policy more generally, there is one rather plaintive message in an official telegram from Hong Kong to London on 3 July, saying “We feel handicapped by an absence of expert technical advice”.⁹²

The change relating to CIs was considered so inconsequential locally that it does not appear to have been formally announced, let alone reported in the press. The main concerns reported in the press in early July⁹³ were a certain resentment about the HK dollar being dragged down with sterling against other currencies in the two weeks between sterling’s float and Hong Kong’s decision to break away from sterling, and a query as to whether Hong Kong had moved quickly enough before sterling’s drop to diversify its reserves out of sterling to the full 10% which was then permitted under agreements with the UK authorities.⁹⁴

3.3 Substitute policies

The Hong Kong dollar remained firm for some time. Its trade-weighted index rose by some 10% while the nominal rate was being held against the US dollar between July 1972 and November 1974, and was a further 7% higher by the first quarter of 1977.⁹⁵ Thereafter, however, the exchange rate weakened and the growth of money and credit accelerated. Even if the Exchange Fund was buying foreign currencies promptly with the HK dollars received against issuance of CIs, there was no obligation that these transactions should be at a fixed rate, and there was no mechanism for anchoring the rate of exchange.

As its inability to exert effective monetary control became apparent, the government was driven to practise a number of second-best measures in an attempt to exert some influence on monetary developments. Formal mechanisms covered four main areas: interest rate control; liquidity ratios; foreign exchange market intervention; and money market operations.

⁹² Bank of England OV44/266.

⁹³ Reports in South China Morning Post.

⁹⁴ Afterwards the assets of the Exchange Fund were diversified quite rapidly, with the sterling proportion falling to 53.9% by end-1974 and to 16.5% by end-1976 - see Nugee (1995).

⁹⁵ Hong Kong *Monthly Digest of Statistics*.

3.4 Interest rates

Cartel-like determination of interest rates on bank deposits - via the setting of ceilings for particular classes of deposit - had been operational *de facto* since 1964 as a means of avoiding an interest rate war which might have proved damaging to the stability of the banking sector, although it was not until 1981 that the cartel received statutory backing under the Hong Kong Association of Banks Ordinance. The interest rate rules set the maximum payable on deposits taken by banks for sums smaller than \$500,000, but did not apply to the emerging deposit-taking companies, which could bid competitively for deposits of a minimum \$50,000, nor to swap deposits.⁹⁶ Banks themselves established DTC subsidiaries. The controlled interest rates were scarcely relevant to the wholesale markets where the exchange rate was determined. For the sake of the smaller banks in particular, the controlled rates could not be allowed to become too misaligned relative to wholesale rates.

As the years passed, the rules began to assume an increasingly important profile as a presumed monetary policy instrument. Yet, although they may have remained an effective means of preventing cut-throat competition among the banks, the extent to which they were actually able to play a meaningful role in the macro-monetary context is open to debate. HKAB was under a continuing obligation to consult the administration - in the person of the Secretary for Monetary Affairs or equivalent forerunners - each week on the appropriate level of interest rates. Given the prevailing level of interest rates in the wholesale markets, the extent of the government's influence could be little more than to delay or accelerate by a week or so a change in the controlled rates, and consequently, in practice, in the banks' benchmark lending rate (the so-called best lending rate). However, the consultation process could itself influence the wholesale markets. If a consensus could be reached between government and banks as to the desired level of rates, the banks - more particularly HSBC as the dominant player - could usually be relied upon to conduct their own operations so as to validate those rates. This process probably constituted the chief mechanism of monetary control. The weakness of a system dependent on this arrangement, however, was that, while HSBC might be willing and able to fashion the market in reasonably quiet conditions, it could not outweigh the will of the market (nor ride roughshod over the interests of its shareholders) in more disturbed circumstances - in which case, whatever the government's preference, the HKAB decisions had to bow to market pressures rather than steer the market.

3.5 Liquidity requirements

Liquid asset requirements, which were anyway primarily in place for prudential reasons, were an even less effective mechanism from the monetary policy standpoint. The banks generally possessed liquidity far in excess of the minimum requirements, and many of them could anyway manufacture as much additional liquid assets as they might need by borrowing from overseas offices. Moreover, much of the system's liquidity was held in foreign currencies, as a result of which a call for additional liquidity might have the effect of weakening the exchange rate. Measures introduced in 1978 to extend comparable liquidity requirements to DTCs and to require 100% liquidity against short-term deposits from the EF underlined the government's commendable concern at its shortage of monetary armoury, but did little in practice to strengthen it.

⁹⁶ The practice developed of banks offering US dollar denominated term deposits linked to foreign exchange swap contracts (spot purchase and forward sale of US dollars by depositing customers); the interest rate on foreign currency deposits was not covered by the HKAB rules.

3.6 Foreign exchange market

In the absence of a central bank, HSBC performed the central banking function of determining the ultimate HK dollar liquidity of the system. Official foreign exchange market intervention (eg to support the HK dollar) would not drain liquidity from the system since the HK dollars purchased by the government against US dollars would unavoidably be recycled into the banking system - unless accompanied by conscious monetary tightening by HSBC.

Even though the domestic monetary impact of foreign exchange intervention may, therefore, have usually been sterilised, it was nevertheless believed to have some effect.⁹⁷ And abstention from intervention often played as important a role as intervention itself. Thus, as the period progressed, the authorities confessed that they were not always able to switch their Hong Kong dollar balances into foreign currency as they would have wished, for fear of causing the exchange rate to weaken.⁹⁸ But the corollary to this tended to be faster, uncontrolled growth of the money supply.⁹⁹ Such episodes illustrated the growing realisation of, and concerns about, the general impotence of monetary policy.

An additional role of official foreign exchange intervention was to signal to the banks, and in particular to HSBC, the government's belief in and commitment to a particular exchange rate, pursuant to which the bank might be willing to conduct supportive operations for its own account in the market, possibly on a much greater scale than the Exchange Fund. In this way official intervention could gain extra leverage.

3.7 Money market scheme

In November 1981 a money market intervention scheme was hatched in collaboration with HSBC, whereby HSBC would withdraw funds from the money market on behalf of the government and at the government's expense (in terms of interest), and then refrain from re-lending them into the market. This was supposed to have the effect of tightening interest rates, as a result of the withdrawal of liquidity.

Although this mechanism could prop up interbank rates on a particular day, the impact faded thereafter, since banks and others could draw on facilities with HSBC to replenish liquidity, and the government's presence as a ready bidder would merely encourage round-tripping. The effect could only be sustained by borrowing ever-cumulating amounts, at rising cost. There was nothing in the agreement to limit the

⁹⁷ eg. via the portfolio channel: purchasers of foreign exchange would gradually have their demand satisfied.

⁹⁸ The first admission of this problem, and of the fact that it was linked to the change in the CI arrangements, appears to have been in the Financial Secretary's (Haddon-Cave) statement to the Legislative Council in 1978: "... since the middle of 1972, Certificates of Indebtedness have been issued against the creation of Hong Kong dollar deposits and, particularly since the floating of the Hong Kong dollar in November 1974, it has not always been possible to use these Hong Kong dollars to acquire foreign currency assets because of the virtual certainty of the foreign exchange market being disturbed." (*Hong Kong Hansard*, 1978, p208).

⁹⁹ As also confessed by Haddon-Cave: "... at 31 December [1978], the Government's Hong Kong dollar balances at \$5,800 million represented nearly 9% of total bank deposits and, indeed, would have been much higher, but for certain arrangements we were able to make during 1978 with the note-issuing banks to acquire foreign currency assets outside the market. ... The relative importance of our Hong Kong dollar balances and the rate at which they have increased suggest that the Government has involuntarily contributed to the undesirable growth rates of the money supply and bank advances...." (*Hong Kong Hansard*, 1979, p550)

overall size of HSBC's position vis-à-vis the remainder of the banking sector, and although HSBC played to the spirit of the agreement by refraining from any deliberate recycling of liquidity, there was little that they could do, or would have wanted to do, to deny others access to facilities with it.

Despite its shortcomings, the scheme could be effective in the short term and continued to be employed even after the 1983 regime change, notably in the early days thereof in order to assist the convergence of the market exchange rate.¹⁰⁰

3.8 Survival

What is perhaps surprising about the 1972-83 regime is not that it ended in crisis but that it lasted so long before a lethal crisis struck.

Monetary survival from 1972 to 1983 owes much to co-operation between government and HSBC, which was the overwhelmingly dominant bank in Hong Kong. It was often said that what was good for HSBC was good for Hong Kong and vice versa. Certainly, to the extent that HSBC's profitability was linked to the overall economic performance of the Hong Kong economy there was a clear coincidence of interest, and, although the bank may have been positioned to make short-term exchange gains from any depreciation of the Hong Kong dollar, or at least be well enough covered to avoid losses, the longer-term goal of a stable economy and avoidance of excessive inflation is likely to have prevailed as a more important consideration. HSBC was also a major provider of banking services to government and, as the 1970s progressed, began to need the support of the government, as banking regulator, in its global ambitions.

The relationship was not without its tensions. Over the years there had been differences between HSBC and government in such matters as the monetary impact of the transfer of reserves to London, the sterling balance guarantees, the nature of banking supervision and the development of capital markets. But most of these disagreements had expired or been resolved by the mid-1970s.¹⁰¹ On the government side there remained, nevertheless, occasional suspicions that HSBC might be taking improper advantage of the close relationship and its dominant position as supplier of banking services to government. On the other side, among banks more generally there may at times have been impatience with officials and frustration at the poverty of policies to address some of the fundamental banking and monetary challenges facing Hong Kong. But the two sides managed, by and large, to co-exist satisfactorily.

If such co-operation was the key feature of this period, what did it achieve in substance? Anecdotal evidence¹⁰² indicates that the chairman of HKAB and the Secretary for Monetary Affairs reviewed the latest state of the markets and economic indicators at their weekly meeting before reaching a judgement

¹⁰⁰ The scheme became formally redundant only when the Accounting Arrangements were introduced in 1988.

¹⁰¹ See chapter IX, "The Hongkong Bank - The Ultimate Survivor", in Goodstadt (2004).

¹⁰² Coupled with the author's personal experience in the final phase of this period. Public records are not accessible until 30 years have elapsed.

as to whether prevailing cartel interest rates were appropriate or needed to be adjusted. No adjustment could be made which would be much in defiance of market rates. Where the parties identified the direction in which rates should desirably move in the near future, this message was communicated back to the banks with the implication that the major players should seek to steer markets in that direction. For reasons explained above, there were often good reasons for the banks to be willing to cooperate, but equally there were acknowledged limits to that cooperation.

As regards intervention in the foreign exchange market, government and HSBC (effectively the two crucial players) would usually each want to know that the other was sharing, for its own account, in any intervention, as evidence of a joint commitment and a shared vision about where the exchange rate should be.

The banks - most importantly HSBC - could not, however, disregard the interests of shareholders on those occasions when a clear gulf appeared between government and shareholder interest. In a confidence crisis such as 1983's, when the currency was depreciating and there was little prospect of an early resolution of the political uncertainties that were unsettling markets, HSBC had little choice but to draw a line in the sand to limit its support for the exchange rate. Although HSBC may have been large enough to impose its will on a closed Hong Kong market in most situations, it was small in relation to the open world to which Hong Kong, through its free market philosophy, was in practice exposed.

The Hong Kong economy performed well enough in the 1972-83 era, with *per capita* GDP growth averaging 5¹/₂% pa. Although inflation was a problem, notably in the period 1978-1982 when it averaged 13%, this was a comparable rate to many other emerging economies and not greatly worse than industrial countries (averaging 10%).¹⁰³

Surprisingly little empirical research has been carried out on that period. One study¹⁰⁴ found that both inflation and output were more volatile than in the subsequent (post-1983) currency board period; a counterfactual simulation suggested that, if the currency board had operated during this period, both inflation and growth might have been lower, but more stable. Another study¹⁰⁵ found that money (M1) tended to adjust passively to inflation and that there was no evidence of banks creating any instability by expanding deposits or credit - lending support to the thesis of benign co-operation between banks and government. Neither study, therefore, suggests that, until the 1983 crisis broke, this was in any sense a disastrous period.

But the 1972 regime was probably doomed to collapse as soon as a big enough shock hit it, and this is what eventually happened in 1983.

¹⁰³ Schuler (1989) inclines to the view the lack of monetary control was responsible for Hong Kong's high inflation, but the figures which he quotes - cumulative inflation over the period 1974-83 of 128% in Hong Kong as against 102% in the US, 209% in the UK and 95% in Japan - do not prove that Hong Kong was seriously out of line with others.

¹⁰⁴ See Kwan & Liu (1996).

¹⁰⁵ See Luk (1991).

4. 1983 - back to basics

4.1 The case for restoring the pre-1972 system

Up until 1983 there does not appear to have been any clear acceptance within government circles of any need for monetary reform. As noted above, the economy was generally doing well enough. Outside government there had been a few papers exposing the fundamental weakness of the monetary system and suggesting restoration of the formal currency board mechanism as one of the available options, but these engendered pique more than serious interest among officials.¹⁰⁶

As the confidence crisis relating to the Sino-British negotiations on the future of Hong Kong unfolded in the spring and summer of 1983, officials began to explore options. An internal memorandum analysed the existing system's weaknesses and set out the steps which would need to be followed if Hong Kong were to move to a more conventional managed floating rate regime.¹⁰⁷ Essentially, this would have required central banking mechanisms for market intervention to be put in place, either through a fairly tight agency agreement with HSBC, which was the settlement bank and provider of ultimate liquidity to the banking system and was therefore in complete control of the system's liquidity position, or by institutional reform - in essence, by establishing a central bank. The necessary financial instruments and markets for open market operations would also have had to be created. The challenge first to reach consensus on such reforms and then to execute all the necessary institutional groundwork seemed too daunting. The idea was not pursued.

Meanwhile the exchange rate was slipping, from 7.20-30 to the US dollar for much of July (already some 20% weaker than a year earlier) to a low of 9.60 on 24 September (closing quotation - there were reports of trades at beyond 10.0). During this period it became apparent that doing nothing was no longer an option. But without a central bank and without any of the conventional instruments of monetary control, the only available course of action was to restore the currency board mechanism by requiring the note-issuing banks to submit foreign currency as backing for any expansion of their note issue. When this was eventually announced to the public on 15 October, for implementation on 17 October, many observers and much of the media greeted it as if it was some revolutionary new invention. In fact it was merely a reversion to the mechanism which had been in place until eleven years previously.

4.2 Possible flaws

Although monetary officials reached agreement that this was the best solution in the prevailing circumstances, it would be an exaggeration to say that they were fully confident that stability could thereby be restored. There were two areas of concern regarding the mechanism itself.

¹⁰⁶ The most persistent and cogently argued critiques and proposals came in the pages of *Asian Monetary Monitor* (July-Aug 1981, Nov-Dec 1981, Nov-Dec 1982 and Sept-Oct 1983), essentially from John Greenwood. At one point it seemed that officials were more intent on exposing minor factual errors in Greenwood's texts than in absorbing the monetary diagnosis or heeding the warnings therein.

¹⁰⁷ Author's personal records.

First, because the adjustment mechanism to pressure of inflows or outflows would have to operate ultimately via interest rates, the possibility was acknowledged that interest rates could in extreme circumstances be driven to exceptionally high levels which, if sustained for anything beyond a short period of time, could be so damaging to the economy and to the banks as to force abandonment of the peg.

Second, although success could be assisted by maximising the psychological impact - through persuasive presentation and supporting assurances from the banking community - in the final analysis it would depend on how successful a transmission mechanism existed from the fixed rate for banknotes to other parts of the market.¹⁰⁸ There was no evidence to suggest that the demand for currency was particularly interest-elastic, so the presumed mechanism of banks raising interest rates when the exchange rate was significantly weaker than 7.80 in order to reduce the demand for banknotes seemed somewhat tenuous. Moreover, banks were under no legal obligation to supply banknotes to customers, and it was possible to envisage a scenario where the note-issuing banks rationed note supplies rather than either raising interest rates or suffering the loss from, say, buying US dollars in the market at 7.90 in order to purchase CIs at 7.80.

Some comfort could be derived from the fact that currency boards had functioned very smoothly in the past, including in Hong Kong, on the proposed basis. But it did not follow that the traditional mechanism would work effectively in the now more sophisticated 1980s' world of large and open international capital markets.

Apart from that uncertainty over the fundamental viability of the scheme, a number of other hurdles had to be cleared. The banks had to be brought on side; the legal basis had to be clarified; the reference currency and exchange rate had to be decided; operational details had to be settled; and the entire plan had to be cleared at the highest level in government.

4.3 The banks' concerns

The note-issuing banks (two at that time, HSBC and Standard Chartered) were generally supportive of the proposal, being as anxious as anyone to see stability restored to the financial markets. Though not convinced that the move would necessarily deliver all that was hoped of it, they realised that almost anything would be better than just leaving things to drift. But they raised concerns in two areas.

One concern was that, if there was a surge in note requirements from other banks, the note-issuers alone would be left with the task of submitting the equivalent foreign currency to the EF. Given the climate of crisis at the time of these discussions and absence of absolute faith in the proposed system, the negotiators could be excused for presuming that the market rate might typically be weaker than the chosen peg. In that case the note-issuing banks would indeed face a loss when the note issue expanded, if they had to purchase US dollars in the market at, say, 7.90 in order to purchase CIs valued at 7.80.

¹⁰⁸ It was only much later in 1998, after the Monetary Authority had been established, that an equivalent formal convertibility promise was extended to banks' balances.

A deal was therefore struck that, when other banks drew notes from (or returned them to) the note-issuers, they would pay/receive US dollars to/from the note-issuers calculated at 7.80. This arrangement would apply only to banks - not to their customers in turn. Officials did not initially believe that this arrangement was particularly desirable, since it tacitly acknowledged the possibility - still worse the expectation - that the market rate might not converge to 7.80, but they were willing to endorse it in order to secure the note-issuers' support.

In fact, this move had more profound consequences than were anticipated at the time of its negotiation. It opened the way for arbitrage between notes and bank deposits. Thus, hypothetically at least, if the market rate was at 7.90, a bank which was not a note-issuer might collude with one of its customers so that the customer transferred deposit money to an account with a note-issuer, withdrew the sum in notes, deposited the notes with the non-note-issuer, which would then redeem them via the note-issuer and receive US dollars at 7.80, which it could then sell in the market for HK dollars at 7.90 - making a profit on the round trip. An opposite process could be followed, equally profitably, if the rate was stronger than 7.80.

This type of institutional round-tripping would not of itself have helped the exchange rate to converge on 7.80, since it gave rise to a balanced purchase (by the note-issuer) and sale (by the non-note-issuer) of US dollars. However, the potential for such a process, at the expense of the note-issuers, whenever the rate was sufficiently distant from 7.80, came to be regarded by officials as a potentially useful source of pressure on the note-issuers (more especially on HSBC as the bank which effectively controlled the money market) to act upon interest rates and liquidity in a manner which would serve to move the market exchange rate towards 7.80. And some attention was given to this potential transmission route in official briefings about the currency board mechanism.

In the ensuing months and years, however, the note-issuing banks made it perfectly clear that they regarded any such round-tripping, or the threat of it, by other banks, not as part of the adjustment mechanism within the currency board system but as unfair exploitation of their note-issuing role. They would therefore impose handling charges on any customers who appeared as large drawers or depositors of notes ostensibly for that purpose. Of course, it was the note-issuers who had originally pressed for this particular arrangement. Many years later the arrangement was abandoned and non-note-issuers subsequently conducted all their note transactions with the note-issuers against HK dollar transfers.

The banks' other concern was over the status of CIs and the US dollar backing in the event of any subsequent change in the rate at which the HK dollar was pegged. In particular - with visions only of HK dollar weakness - they enquired whether CIs acquired prior to such a change would be redeemable at their original purchase rate. This enquiry was possibly something of a throwback to the late-1960s when, following sterling's devaluation, the Bank of England, as part of an exercise to discourage central banks from diversifying official reserves out of sterling, gave partial guarantees against further devaluation to official holders of sterling, and the Hong Kong government, exceptionally, extended similar, limited guarantees to the banks (the so-called "Sterling Exchange Guarantee Scheme"). But that had been an altogether different circumstance, and, even at that time, CIs were regarded firmly as HK dollar instruments and were sold to the banks and redeemed from them only at the prevailing official rate. The answer to the enquiry in the present case was clearly negative. CIs, though paid for in US dollars, were denominated

in HK dollars and they served as backing for notes which were denominated also in HK dollars. Note-issuing status did not expose the balance sheet to any special exchange risk. Assuming that any hypothesised change in the pegged rate would be reflected equally in the market rate, application of the new rate to all subsequent purchases or sales of CIs would ensure that banks made neither windfall gains nor losses. The banks, on reflection, accepted that this represented the appropriate neutral treatment.

4.4 Administrative basis

In much the same way as the note-issuing banks had transferred sterling in exchange for their CIs up until 1972 without any explicit statutory obligation to do so (as noted above, the Exchange Fund Ordinance referred only to “transfer of face value”), the change to US dollars in 1983 was initially just a consensual agreement between the government and the note-issuing banks. In due course - in May 1984 - the Exchange Fund Ordinance was amended to empower the Financial Secretary to determine statutorily the currency of payment and the rate of exchange. The arrangement for the non-note-issuing banks to settle for notes in US dollars with the note-issuers was effectively just a contractual arrangement between the banks, albeit one which was known to have official blessing at that time.

4.5 Reference currency and rate

There was unanimity among officials and others consulted that the reference currency should be the US dollar. Already in 1972 Hong Kong had dropped its link to sterling and for two years thereafter kept a steady rate to the US dollar. Sterling was no longer a major international currency. Only 5% of Hong Kong’s trade was still with the United Kingdom, whereas 21% was directly with the United States¹⁰⁹ and still more of it was denominated in US dollars. The idea of a basket of more than one currency was raised but quickly dismissed. Despite the advantages which this might have brought in terms of minimising fluctuations against trading partners on average, officials decided that Hong Kong needed a simple and transparent system, which could be operated very directly, and could be monitored and understood as readily by the man in the street as by a banker or economist.

Anyway, considerations about trade and payments are only of secondary importance in selecting a reference currency for a currency board. The crucial factor is that there should be confidence that the anchor currency will be managed responsibly by its central bank. Monetary stability in the anchor economy should, other things being equal, promote monetary stability in the pegging economy. Of course, other things cannot be counted upon to be equal, and difficulties have subsequently arisen when the US and Hong Kong economies have been at different phases of the economic cycle and because of the implications of structural differences for their comparative rates of inflation. Divergences of that sort were to be expected, though their precise nature may not have been predicted. They did not alter the conclusion that the dollar was the most suitable anchor.

¹⁰⁹ Census and Statistics Department website, via www.info.gov.hk..

With regard to the choice of rate, the rate against the US dollar had been around 6.60 at the beginning of 1983, before the political jitters began. It had hit an end-of-day low of 9.60 on 24 September and settled back in the range 8.30-8.80 in early October, when it was known that the government was contemplating a structural alteration to the monetary regime. An internal assessment suggested that the equilibrium rate before the crisis was in the range 6.50-7.00. Already, however, the additional inflation resulting from several months of weakness would have caused that figure to drift a bit higher. Early in September a rate of 7.25-7.50 was mooted as reasonable in macroeconomic terms. But it was acknowledged that too ambitious a rate might test credibility in the markets and result in a prolonged period of high interest rates which could even enforce abandonment. At the other extreme, too weak a rate would threaten inflation and could attract international accusations of deliberate action to secure a competitive advantage. It was also felt that, psychologically, the figure should be below 8.00 in order to demonstrate that the situation was being positively stabilised rather than caving in to the whim of the market. The chosen rate could afford to be stronger than the prevailing market rate, to the extent that convergence was judged to be achievable within a short space of time.

The range was thus narrowed to 7.60-7.95. Finally 7.80 was selected. The figure sequence 7-8 sounds auspicious when spoken in cantonese;¹¹⁰ this was not a significant factor in selecting the rate, although it may have played a small part in confirming the selection. In macroeconomic terms, the rate might have seemed a bit weak, but there was a danger in not winning market confidence, especially in view of the continuing political uncertainties, if an attempt was made to recoup more ground. In the event, the US dollar strengthened for the ensuing two years, pulling the HK dollar up against other currencies, although this could not, of course, have been built into the calculations at the time.

4.6 Operational considerations

The operational arrangements were straightforward. It was merely necessary for the two note-issuing banks and the government to specify the US dollar accounts to and from which the payments associated with CI transactions were to be made. The note-issuers would make similar arrangements with the other banks.

4.7 Consultation

All the discussions on the plan in its early stages were taken in hand by the Monetary Affairs Branch of the Government Secretariat, with the Financial Secretary being kept closely informed of progress. At that time the only non-official members of the Exchange Fund Advisory Committee were the representatives from the two note-issuing banks,¹¹¹ and they were fairly continuously involved in discussions once the peg option came under serious consideration towards the end of September. The Government Economist¹¹² also participated.

¹¹⁰ Approximately 'assured of good luck'.

¹¹¹ Bill Brown, General Manager of Standard Chartered; and Michael Sandberg, Chairman of HSBC, although the latter delegated the detailed negotiations to John Gray, Assistant General Manager Finance; Peter Hammond, Deputy Chairman of HSBC, also played a part.

¹¹² Alan Maclean.

The UK government was kept closely in the picture. Professor Alan Walters, the personal economic adviser to Prime Minister Margaret Thatcher, was an advocate of a return to the formal currency board and exerted influence behind the scenes to that effect. As the proposal took shape in Hong Kong, the Financial Secretary formally requested an expert opinion from London. London speedily despatched two experts - David Peretz, a senior Treasury official, and Charles Goodhart, chief monetary adviser at the Bank of England, to Hong Kong. They held discussions with relevant government officials and the note-issuers, as well as with academics.¹¹³

The experts produced a report which broadly endorsed the proposal, believing that it stood a fair chance of success, noting that there were few other practicable options which could be quickly effected, and observing that the return to the formal currency board would certainly be an improvement on the prevailing situation, even if it did not turn out to be ideal.¹¹⁴

Armed with that recommendation, officials finally needed to win the support of the Executive Council. In formal terms, the Governor was seeking the advice of the Council before approving the measure. Discussion straddled two meetings. It was not easy for members, coming fresh to the topic, to absorb all the technical arguments. It was recognised that something must be done about the currency crisis, but in some ways this plan looked all too simple. Eventually, however, it was endorsed without dissent.¹¹⁵

It was then decided to implement the proposal as soon as possible. In practical terms the announcement could not be made while markets were open, and time was needed for the banks to be notified of, and to prepare for, the new note-issue arrangements. The announcement was therefore scheduled for immediately after the close of the local market on Saturday 15 October, with the new arrangements going live at the start of business on Monday 17 October.

4.8 Performance and evolution

The announcement had an immediately powerful psychological impact, but there was still a mixture of some incomprehension and some scepticism both in the market and among commentators. It was acknowledged in official circles that the mere technical mechanism of the currency board as then constituted - with banknotes as the sole fulcrum - might well be insufficient to produce full convergence. Yet it was clear that the favourable initial reception and the overall credibility of the arrangement might dissipate if convergence was not achieved quite soon. The government and HSBC were therefore active in the market for some time in support of the exchange rate, and the money market scheme continued to be operated in an attempt to ensure the associated tightness of the money market.

¹¹³ They met with Y C Jao and Steven N S Cheung of the University of Hong Kong, and John Greenwood of G T Management, who had also, by invitation, made a presentation on the merits of the currency board system to a meeting of officials and representatives of the note-issuing banks on 25 September.

¹¹⁴ The report was not made publicly available.

¹¹⁵ Proceedings remain confidential, but the author would pay tribute to the skilful role of the Governor, Sir Edward Youde, in steering the discussion towards a final decision.

In the event, the market exchange rate moved close to 7.80 within a few days and the credibility of the new system became established. Apart from a day in July 1984 when the currency was reported to have traded above 8.0 outside Hong Kong business hours (the weakest closing rate in Hong Kong at that time was 7.90), the rate generally stayed within 1% of 7.80. But the fact remained that the theoretical mechanism alone could not be relied upon in practice to keep the rate anchored around 7.80. Yet the longer the rate was observed to hold close to that point, the more public confidence in the mechanism matured, even if unspoken doubts lingered in some minds.

In July 1988 an important step was taken to strengthen the mechanisms ancillary to the currency board. The money market scheme was discarded in favour of the so-called Accounting Arrangements whereby HSBC, which was the settlement bank for the banking system, maintained a balance at the EF (the "aggregate balance") which could only be altered by transactions at the discretion of the government, and was charged a penal rate of interest by the government if the balances of the banking system with HSBC exceeded the aggregate balance, or if the banks were collectively in deficit on their balances with HSBC.¹¹⁶ This in effect gave the government, for the first time, direct influence over the liquidity of the banking system, by providing HSBC with a clear incentive (via penal charges) to conduct its operations so as to keep the banks' overall balance close to the particular level of the aggregate balance set by the government.

This meant, in turn, that, if it so wished, the government could, for example, choose to allow the HK dollar leg of a sale by it of US dollars to the market to be settled against the aggregate balance and so induce HSBC to contract interbank liquidity. In other words, the government could choose to let the impact of foreign exchange intervention be felt in the money market - as with unsterilised intervention (where the monetary base is contracted/expanded one-for-one against a sale of foreign currency by/to the monetary authorities) - whereas previously the default path was to leave the volume of HK dollars in the money market unchanged. Non-sterilisation of such operations was consistent, in terms of monetary discipline, with the note-issue arrangements, and provided a new formal dimension to Hong Kong's currency board system.

Therefore, the pressures of the currency board mechanism now operated not only through the note issue but also through the banks' ultimate liquidity in the form of their clearing balances - to the extent that the government chose to settle any of its HK dollar transactions with the banking sector against the aggregate balance and to the extent that HSBC responded to the related inducements.

¹¹⁶ Jao p96ff and appendix E, in Jao & King (1990), provides a more detailed description and analysis.

Subsequently, in December 1996, all banks were required to open accounts directly with the Exchange Fund, and so the intermediary role of HSBC was terminated. But the government (by then in the shape of the Hong Kong Monetary Authority, which had been established in 1993) still executed foreign exchange deals with the banks only on a purely discretionary basis, albeit of course with a view to maintaining confidence in the 7.80 currency peg.¹¹⁷ This lasted until the HKMA, as part of a number of measures to strengthen the system in September 1998,¹¹⁸ gave a firm and unconditional undertaking to sell US dollars to banks, against their balances at the EF, at the fixed rate of 7.80,¹¹⁹ while, however, continuing to exercise discretion over the rate at which it would intervene to buy US dollars when the market exchange rate was stronger than 7.80.

These moves established clearly the principle that all central bank money - not just the banknote equivalent - was subject to the currency board mechanism.¹²⁰ Thus the system has evolved considerably since its restoration in 1983. At the time of the introduction of the Accounting Arrangements in 1988, there was some debate as to whether, by establishing a mechanism which could be used for discretionary monetary management, the textbook currency board principles of automaticity and non-discretion were being compromised.¹²¹ However, if there had been no move in that direction - and subsequently to the position where banks hold their ultimate reserve money on an account with the EF, which qualifies for the convertibility undertaking - the currency board mechanism would never have applied beyond the note issue. It seems, on balance, preferable that the coverage should have been broadened, even if, by so doing, the authorities gained for themselves a degree of incidental discretionary power.

The peg at 7.80 is generally regarded as having been a success in terms of establishing and maintaining monetary stability. There is scope for debate as to whether Hong Kong, now that it possesses the instruments and infrastructure that would be required to operate a more discretionary monetary policy, should in fact move in that direction. But that debate lies beyond the scope of the present paper.

¹¹⁷ However, for a considerable period the market rate became focussed on 7.75, which the government tolerated.

¹¹⁸ HKMA (1998).

¹¹⁹ In fact the initial rate was 7.75 and it was moved up to 7.80 at the pace of one pip per calendar day over the ensuing 250 days from 26 November.

¹²⁰ HKMA also includes EF bills and notes in its definition of the monetary base since, although they cannot be directly settled against foreign currency, they are immediately convertible by banks, at an appropriate discount rate, into balances at the EF.

¹²¹ The debate can be found in Jao (1988) and Greenwood (1988a, 1988b).

5. Assessment

Hong Kong has always been something of an odd-man-out in the context of currency regimes. It kept to the silver standard up until 1935, for the understandable reason of matching China but nevertheless increasingly distinct from everywhere else. It then adopted a currency board; this was not uncommon at the time for colonial situations, but, with the exception of the aberrant years 1972-83, Hong Kong clung to that system during the second half of the century when it was being abandoned almost everywhere else, albeit with a modest resurgence in the 1990s.¹²²

In effect, therefore, Hong Kong practised some form of fixed rate arrangement for all but nine years (1974-83)¹²³ of the century. By contrast, the major currencies of the world moved from gold standard early in the century to enforced abandonment of gold, first through war and later the Great Depression; then, after some years of floating and another war, back to the quasi-gold standard of Bretton Woods; then generalised floating; and finally to what may be characterised as a bi-modal distribution of regimes, with a cluster opting for some degree of fixity (the merging of twelve currencies into the euro being the extreme example) while the remainder continue to float, albeit with varying degrees of intervention.

Hong Kong's choice of regime was always limited by the fact that it had, until 1993, no central bank. Given that limitation, there were effectively only three choices - a commodity standard, a currency board or indeterminacy - and in fact Hong Kong tried all three.

The earlier existence of a central bank would have widened the policy choice to include, for example, a managed float (in contrast to the rudderless float of 1974-83) and would have allowed for monetary independence. This was the route taken by most other British colonies with currency boards when they transitioned to independence - albeit often with disastrous consequences. However, Hong Kong remained a colony. Even so, it was financially a highly mature one, and colonial status did not of itself prohibit the creation of a central bank, as events were eventually to prove. As the second half of the century progressed, the question was probably raised from time to time. Although no discussions are documented, one may surmise that there were three main reasons for prevarication.

First, Hong Kong prided itself in keeping government small. A highly convincing case would have to have been made for creating any new public institution, and the idea of a central bank would probably have failed that test. Second, the creation of a central bank would have risked upsetting the delicate balance of mutual interests between the government and the banks, notably HSBC. Third - and a likely consideration particularly later in the period - in the context of relations with China it may not have been tactful to indulge in explicit institution-building of this sort; the HKMA was eventually established only after the framework for the handover of sovereignty had been agreed.

¹²² eg Argentina, Estonia, Bulgaria.

¹²³ It maintained a fixed rate within a narrow margin from July 1972 to November 1974, despite having already altered the basic framework.

The 1935 regime change was very deliberate. It had been in preparation, or at least under discussion, for more than five years. It was precipitated mainly by external events - the high silver price and China's decision to leave silver. The decision was formally dictated from London, but only after taking account of local opinion and advice. The move is generally judged to have been the right one although, arguably, it might to advantage have come sooner, and the economy was seen to benefit.

The 1972 change presents a stark contrast. From the available evidence - which admittedly may not be complete because some official papers may be still being withheld - it was a hasty decision, prompted by disarray in the international currency markets rather than any home-grown crisis. The decision was taken locally and seemingly without advice from London; since the move did not involve any statutory measures, formal consultation with London was not anyway required. The decision also appears to have been taken without any recognition of the economic implications of abandoning the monetary anchor implicit in a currency board. In the event, the consequences were not obviously adverse for the ensuing ten years, since the Hong Kong economy prospered. But monetary stability was heavily dependent on consensus and mutuality of interest between government and leading banks. By its very design the system was almost certain to collapse if hit by a big enough shock, and that is what happened in 1983.

The 1983 change was also quite a hasty decision, with the period from the first focused official deliberations to implementation being a matter of weeks. But this was long enough for the monetary policy dimension to have been thoroughly and expertly explored. Action was necessitated by a Hong Kong-specific confidence crisis, the impact of which was magnified by the shortcomings of the prevailing regime. The decision was taken locally but after full consultation with, and blessing from, London. It has been generally acclaimed as a success: certainly it stabilised the situation quickly, and delivered monetary stability and a very respectable economic performance through the sensitive period of negotiations over Hong Kong's future.

Whether the currency board still remains appropriate today is beyond the essentially historical scope of this paper. However, Hong Kong now possesses a central bank (in the shape of the HKMA) and the freedom to operate alternative regimes. Although the HKMA may lack the degree of independence from government (in the guise of the Financial Secretary) that might nowadays be regarded internationally as best practice for conducting active monetary policy, Hong Kong is, in principle, no longer so limited in its choice of monetary regime as it was in 1935, 1972 or 1983. Only time will tell whether Hong Kong exploits this broader capability.

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