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SYMPOSIUM ON HONGKONG: 1997

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Contributions from Y. C. Jao and Chu-yuan Cheng

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SYMPOSIUM

"Hong Kong: 1997"

The 1984 Sino-British Settlement on Hong Kong: Problems and Analysis

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INTRODUCTION

On September 26, 1984, after almost two years of negotiation, the United Kingdom (UK) and the People's Republic of China (PRC) initialled a Joint Declaration on the Question of Hong Kong.1 The agreement was well received by the United States, Japan, southeast Asian countries and Western European countries,2 all of whom have a stake in the continuation of the stability and prosperity of Hong Kong—the third largest financial center of the world, in the post-1997 period.

This paper intends to analyze the question of whether the Sino-British Hong Kong settlements will work in maintaining the prosperity and stability of Hong Kong after its reversion to the PRC in 1997. Before beginning an analysis of the subject, it may be helpful to provide a general background of Hong Kong.

The British-administered Hong Kong is about 70 miles (about 100 kilometers) southeast of the southern Chinese city of Guangzhou (Canton). It consists of Hong Kong and the Lan Tau Islands, the Kowloon Peninsula, and more than 200 small is-


lands. The total area is 404 square miles (1061 square kilometers) and the population is about 5 million. Hong Kong's population density, at approximately 12,500 people per square mile (4,700 per square kilometer), makes it one of the most densely populated areas in the world. Before 1949 there was no border control to restrict the entry and exit of the people between Hong Kong and the Chinese mainland. The population then was about 800,000. After 1949 a large exodus of refugees compelled the British authorities in Hong Kong to institute a tight border control to diminish the large influx of people to Hong Kong. The control has become increasingly stiff in recent years, and required all refugees who entered illegally to be repatriated to China. Despite the tight border control, it is believed that refugees from the mainland comprise the majority of the population.

British administration of Hong Kong was established in three stages:

1. After defeating China in the 1839-42 "Opium War," China agreed to cede the Island of Hong Kong to Great Britain in the 1842 Treaty of Nanking.
2. After defeating China in the 1850-1860 "Arrow War," China agreed to cede the southern part of the Kowloon Peninsula, about 3½ square miles (9 square kilometers), to Great Britain by the 1860 Treaty of Peking.
3. In 1898, China was compelled to lease to Great Britain an additional 365 square miles (949 square kilometers) for 99 years. This part later was called the New Territories. 3

There is no self-government in Hong Kong. The Governor is appointed by the Queen of the United Kingdom. The Legislative Council is also composed of appointed members. Only half of the 24 member Urban Council for Hong Kong and Kowloon (about 3.4 million people) are elected by a small number of electors. This Council has regulatory and licensing responsibilities similar to those of a City Council in such areas as health, culture, commerce, and recreation. The large rural area of the New Territories is governed by the Secretary for the New Territories and seven District Officers with political, executive, and liaison responsibilities. The judiciary is independent of the executive and

legislative organs of the government in the performance of its function. Judges are appointed.

Despite a lack of democracy, numerous freedoms, especially economic freedom, exist in Hong Kong. With the manpower and managerial skill provided by refugees, combined with the free enterprise policy of the British Hong Kong Government, the people of Hong Kong have created a standard of living matched only by a few developing countries such as Taiwan (Republic of China), Singapore and the Republic of Korea. Per capita income is about US$4000 now, which is almost 15 times that of the mainland.

THE PEOPLE'S REPUBLIC OF CHINA POLICY TOWARD HONG KONG AND THE INTERNATIONAL STATUS OF HONG KONG

Despite its nationalistic, revolutionary and anti-imperialist policy, the People's Republic of China (PRC) has an important stake in maintaining Hong Kong's prosperity since it acquires about 40 percent of its foreign exchange (now in the amount of about $80 billion U.S. dollars) through its annual trade with Hong Kong.

Moreover, Hong Kong provides an outlet for political dissidents in China to reduce the political tension at home as well as indirect contacts, such as mail and trade, with Taiwan. For these reasons, while the PRC has, since 1949, considered Hong Kong as Chinese territory to be recovered, there have been no attempts to implement that goal until last year. An editorial in the authoritative People's Daily (Renmin Ribao) of March 8, 1963, explained the PRC's policy toward Hong Kong as follows:

At the time the People's Republic of China was inaugurated, our government declared that it would examine the treaties concluded by previous Chinese governments with foreign governments, treaties that had been left over by history, and would recognize, abrogate, revise, or renegotiate them according to their respective contents. . . .

As a matter of fact, many of these treaties concluded in the past either have lost their validity, or have been abrogated or have been replaced by new ones. With regard to the outstanding issues, which are a legacy from the past, we have always held that, when conditions are ripe, they should be settled peacefully through negotiations and that, pending a settlement, the status quo should be maintained. Within this category are the questions of Hong Kong, Kowloon, and Macao and the questions of all those boundaries which have not been formally
delimited by the parties concerned in each case. . . .

The same editorial also pointed out that "there is no need for the Chinese people to prove their courage and staunchness in combating imperialism by making a show of force on the question of Hong Kong. . . ."

While the PRC was willing to maintain the status quo of Hong Kong until recently, it made clear that it would not tolerate Hong Kong becoming an independent state. In 1964, when the Soviet-sponsored World Youth Forum adopted a resolution putting Hong Kong and Macao on a par with Timor Island, Papua, Oman, Aden, and South Arabia and demanded "independence" for these places in accordance with the 1960 United Nations Declaration on the Granting of Independence to Colonial Countries and People, PRC delegates strongly protested the adoption of such a resolution.

After its entry into the United Nations, when the PRC found that the General Assembly's Special Committee on Colonialism included Hong Kong and Macao in its list of colonial territories, it sent a letter to the Chairman of the Committee on March 10, 1972, stating that:

Hong Kong and Macao are part of Chinese territory occupied by the British and Portuguese authorities. The settlement of the questions of Hong Kong and Macao is entirely within China's sovereign right and does not at all fall under the ordinary category of colonial territories.

Consequently, they should not be included in the list of colonial territories covered by the declaration on the granting of independence to colonial countries and people.

With regard to the questions of Hong Kong and Macao, the Chinese government has consistently held that they should be settled in an appropriate way when conditions are ripe. The


5. Ibid.

6. United Nations General Assembly Resolution 1514 (XV) of December 14, 1960. A convenient source to find this resolution is Ian Brownlie, Basic Documents in International Law, 3rd ed., London and New York: Oxford University Press, 1983, pp. 299-301. Paragraph 2 of the operative part of this Declaration reads: "All peoples have the right to self-determination; by virtue of that right they freely determine their political status and freely pursue their economic, social and cultural development."

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United Nations has no right to discuss these questions. In practice, the PRC tolerates Hong Kong to have a limited international status similar, to a certain extent, to that of a state. For instance, Hong Kong is a member of the United Nations Economic Commission on Asia and the Far East (ECAFE) and the Asian Development Bank. It is also an associate member of the International Maritime Organization (until 1982 Intergovernmental Maritime Consultative Organization). Hong Kong, through the United Kingdom, is in fact a party to many international conventions. It has been granted separate export quotas by its major trading partners such as the United States, the United Kingdom, Canada, and the European Economic Communities. Hong Kong also maintains its own memberships in 312 international nongovernmental organizations.

In economic terms, Hong Kong is a major center for investment, trade, finance, transportation and communication in East Asia. Each year more than 2 million people visit Hong Kong. Over 600 U.S. corporations are located in Hong Kong, doing business with China and other parts of Asia. Hong Kong's airport is served by 32 regional or international airlines, and its ports are called by over 10,000 ocean going vessels annually.

The Emergence of the Issue and the Negotiating Positions of the United Kingdom and the People's Republic of China

In the New Territories, a lease is limited to a maximum period of 15 years; thus, in 1982, it was necessary to know whether after that year a lease could still last for 15 years. This is because the British administrative rights in the New Territories will be terminated on July 1, 1997, the last date of the British Lease of New Territories from China. This fact prompted the United Kingdom to discuss the future of Hong Kong with the PRC. In September of 1982, the leaders of the PRC and the United Kingdom discussed this problem and both sides agreed that diplomatic nego-

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tiation should begin soon in order to maintain the stability and prosperity of Hong Kong.

The United Kingdom is in a poor negotiating position vis-à-vis the PRC for several reasons:

(1) The lease over these New Territories is going to expire on July 1, 1997. There is no legal ground for the UK to continue its administration there beyond that date without the PRC's consent.

(2) Legally the UK can continue to rule the southern part of Kowloon Peninsula and the Hong Kong Island beyond July 1, 1997, because these territories were ceded to the UK. However, in reality, without the New Territories, which consists of about 90% of the present Hong Kong, it would be difficult to maintain its rule there because economically and socially both the ceded and leased territories already have integrated into one. Moreover, the UK is in no position to defend this part of Hong Kong. The PRC needs not even to commit a single soldier to take over Hong Kong. All the PRC has to do is simply turn off Hong Kong's water supply. Moreover, there would be little if any support in the UK itself for such a suicidal defense, nor would any country in the world support the UK for such a senseless armed conflict with the PRC.

(3) The UK cannot simply pack up and leave as it did in terminating its mandate in Palestine in 1947, which triggered the first large scale Middle East conflict. If the UK decided to do that, Hong Kong would collapse and such a disaster would severely affect the interests of the PRC, the UK, the U.S., Japan and other powers in East and Southeast Asia. Moreover, the UK feels that it has at least a moral obligation toward the Chinese people in Hong Kong to seek the best possible solution for the future of Hong Kong.

Because of these difficulties, it is reported that the original UK position for negotiation is based on the principle of "exchanging sovereignty for administrative power" and for "continued British administration in Hong Kong upon recognition of China's sovereignty."11 In other words, the UK is willing to recognize Chinese sovereignty over the whole of Hong Kong, including those parts ceded to Great Britian in the nineteenth

century, in exchange for Chinese consent to continue British administration after 1997 for a certain period such as 30 or 50 years. Under this arrangement, while the future of Hong Kong cannot be solved once and for all, it at least can shelve the issue for a considerable period of time. At the beginning of the negotiations, many Hong Kong people believed that this solution would be acceptable to the PRC. This belief was strengthened by the fact that between 1974 and 1977, the PRC had rejected three times the Portuguese offer to return Macao to China.\textsuperscript{12}

To the surprise of many Hong Kong people, the PRC flatly denounced such a proposal. There are three major reasons for the PRC to reject this solution. First, the PRC has never recognized the legal validity of the two treaties (1842 and 1860) which ceded Hong Kong Island and the southern part of the Kowloon Peninsula.\textsuperscript{13} By accepting the UK’s proposal of “exchanging sovereignty for administrative power,” the PRC would be viewed as implicitly accepting the validity of these two treaties which is contrary to its long time position.\textsuperscript{14}

Second, assuming, \textit{arguendo}, the PRC could accept the continuation of British administration over Hong Kong under PRC sovereignty for another 30 or 50 years, how could it justify pressing its claim over unifying Taiwan with the mainland during that long period? Ironically, if there was no Taiwan problem, the PRC might tolerate the continuation of British rule in Hong Kong for an indefinite period because at any time the PRC could ask the British to leave and restore its full sovereignty there. However, the Taiwan situation is different. Taiwan has its own defensive capability and if the PRC leaves the island alone for another 30 or 50 years after 1997, the PRC might have to launch a costly military campaign, with wide adverse political and economic consequences to the PRC, in order to achieve its unification goal. In this connection, the existence of a very vocal Taiwan independence movement (albeit only a few people from Taiwan support this movement) tends only to compel the PRC to take a stiff position on both the Hong Kong and Taiwan issue.

\textsuperscript{12} “China rejects Portuguese colony”, Associate Press dispatch from Lisbon,\textit{The Sun} (Baltimore), February 2, 1977, p. A4.

\textsuperscript{13} See the lengthy legal arguments presented in Jin Fu, “China’s Recovery of Hong Kong”, \textit{supra} note 11, pp. 15-16 (English version) and \textit{Journal of International Studies}, pp. 3-5 (Chinese version).

\textsuperscript{14} \textit{Ibid.}, pp. 16-18 (English version) and \textit{Journal of International Studies}, pp. 5-6 (Chinese version).
Third, after the death of Mao Zedong in 1976, no one in the PRC seems to be in a position to make concession on the sensitive issue of sovereignty. Any leader or faction in the PRC who were to make such a concession on Hong Kong’s sovereignty may be attacked by other rival factions in the on-going power struggle in PRC domestic politics. On the other hand, the prestige of any leader or faction which can recover sovereignty over Hong Kong or Taiwan would be greatly enhanced.

The PRC is not out of touch with the reality of Hong Kong. It is fully aware of the disastrous consequence of introducing its socialist system into Hong Kong. Therefore, the PRC is trying to insulate its system into Hong Kong after the recovery of the territory, and suggests the principle of “Gangren zhigang” (self-administration by Hong Kong people), later known as “one country, two systems,” as the basic policy toward Hong Kong after 1997. From the PRC’s point of view, this policy should be able to maintain the stability and prosperity of Hong Kong after 1997 because the status quo in Hong Kong will be maintained after recovery, except for the fact that the British governor must go and the British flag must be lowered. In the following sections, this paper will analyze the problems for implementing this policy.

**The International Validity of the Sino-British Joint Declaration**

The Joint Declaration contains eight parts, three annexes, and two memoranda. Since Part 8 of the Declaration provides that “[t]his joint declaration and its annexes shall be equally binding,” there should be no doubt on the legal validity of the entire document. Moreover, this declaration, as provided in Part 8, “is subject to ratification and shall enter into force on the date of the exchange of instruments of ratification,” just like any other formal treaty concluded between states. Therefore, though this document takes the form of a “declaration,” it is a formal international agreement similar to a treaty under international law. The validity of an international agreement is not dependent on the name given to the document, be it called “treaty,” “agreement,” “declaration” or any other name. All international lawyers, including those in the United Kingdom and the PRC,

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15. E.g., see Article 4 of Harvard Research in International Law which states
support this view. In view of this, if the PRC reneges on its assurance on Hong Kong after 1997, the UK could invoke the Joint Declaration to make a diplomatic presentation to the PRC even if Hong Kong was by then Chinese territory. However, this appears to be an unlikely event. More probably the two sides might interpret the application or implementation of provisions of the Joint Declaration differently. For this situation, the Joint Declaration provides no procedure to resolve the dispute.

In accordance with international practice, if an international agreement does not provide a procedure to settle the dispute relating to the application or interpretation of the agreement, both parties can only resort to negotiation or other agreed upon modes of settlement.17 The PRC is well-known to disfavor third party adjudication in the settlement of its international disputes.18 Moreover, despite the fact that the UK has accepted the compulsory jurisdiction of the International Court of Justice (ICJ),19 the PRC, after its taking over the Chinese seat in the UN in 1971, has refused to recognize the validity of the Republic of China’s acceptance of the Court’s jurisdiction made in 1946.20 Therefore, there is no way to refer the interpretation dispute to the ICJ for an impartial adjudication.

In case of negotiating a settlement on a dispute relating to the application or interpretation of the Joint Declaration, the UK is in an unfavorable position. This is because, despite the lengthy


17. E.g., see the following statement given by the Permanent Court of International Justice in the 1923 Advisory Opinion on the Status of Eastern Carelia: “It is well established in international law that no state can, without its consent, be compelled to submit its disputes with other states either to mediate or to arbitration, or to any other kind of pacific settlement.” Cited in Bishop, *International Law, supra* note 15, p. 74.

18. Except for commercial contracts, the PRC has consistently favored direct negotiation to resolve international dispute and it has not yet accepted any third party adjudication on its dispute. See Liu Fengmin, *Xiandai guojifa gangyao* (Outline of modern international law), Peking: Mass Press, 1982, pp. 159-160.


content of the documents, the Declaration contains certain subtle grey areas, vague in nature, that would allow the PRC to maneuver its application without literally violating the Declaration. The next section will expand on this concept.

THE ESSENCE OF THE SINO-BRITISH JOINT DECLARATION ON THE POST-1997 HONG KONG REGIME

The Joint Declaration contains more than 8,000 words and is, perhaps, the second longest international agreement ever concluded by the PRC. It spelled out in detail the PRC's policy toward Hong Kong, the post-1997 Hong Kong regime and its international relations. The highlights of the Declaration are as follows:

1. After 1997, Hong Kong will become a Special Administrative Region of the PRC under Article 31 of the PRC Constitution. It will enjoy a "high degree of autonomy" except in foreign and defense affairs.

2. Hong Kong will be vested with executive, legislative and independent judicial power, including that of final adjudication.

3. Hong Kong's chief executive will be appointed by the PRC after elections or consultation in Hong Kong. The government of Hong Kong will be composed of local people.

4. Hong Kong shall maintain the capitalist economic and trade systems for 50 years after 1997.

5. The existing social and economic system will remain unchanged. Freedom of speech, movement, the press, assembly, strike, religion, and others will be protected by law. Similarly, private property rights will be protected.

6. Apart from displaying the national flag and national emblem of the PRC, Hong Kong may use a regional flag and emblem of its own.

7. Hong Kong may participate in relevant international organizations and international trade agreements. It may establish official and semi-official economic and trade missions in foreign countries. Using the name "Hong Kong, China" to maintain and develop relations and conclude and implement agreements with states, regions and relevant international organizations in appropriate fields.

8. The PRC defense force stationed in Hong Kong shall

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21. The longest PRC treaty is the 1962 boundary treaty with Mongolia.
22. Article 31 provides: "The state may establish special administrative regions when necessary. The systems to be instituted in special administrative regions shall be prescribed by law enacted by the National People's Congress in the light of the specific conditions."
not interfere in the internal affairs in Hong Kong and the expenditures for these military forces shall be borne by the PRC's Central People's Government.

Under the above arrangements, on the surface Hong Kong will enjoy a "high degree of autonomy", but a closer analysis of the Declaration and the PRC's 1982 Constitution casts serious doubt on the durability and credibility of such autonomy. First, under Article 1 of Annex 1 of the Declaration, the PRC's National People's Congress (NPC) shall enact a basic law of the Hong Kong Special Administrative Region to guarantee the continuation of Hong Kong's capitalist system and lifestyle for 50 years and other matters as provided in the Joint Declaration. While under the PRC's law, Hong Kong may elect roughly 40 delegates to the NPC,23 but the practical use and strength of 40 Hong Kong delegates among the 3,400 delegates24 in the NPC's decision-making process would be insignificant. Moreover, Article 67, paragraph 4, of the Constitution, provides that the Standing Committee of the NPC shall have the power "to interpret statutes"; thus both the legislative and interpretative powers of the basic law for Hong Kong are in the hands of the NPC. Under such circumstances, the so-called "high degree of autonomy" is at the mercy of the NPC and thus without credible guarantee.

Second, under Article 2, paragraph 1, of Annex 1 of the Declaration, "after the establishment of the Hong Kong Special Administrative Region, the laws previously in force in Hong Kong . . . shall be maintained, save for any that contravene the Basic Law. . . ." As stated above, the Standing Committee of the NPC has the right to "interpret statutes"; therefore, the Standing Committee could annul those local Hong Kong laws which it dislikes on the ground that they contravene the Basic Law.

Third, while Article 2, paragraph 2 of Annex 1 of the Declaration provides that the Hong Kong "Legislature may on its own authority enact laws in accordance with the provisions of the Basic Law and legal procedure"; Article 67, paragraph 8 of the PRC Constitution provides that the Standing Committee of the NPC has the power "to annul those local regulations or decisions of

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23. According to PRC law, city residents can elect one delegate for every 130,000 persons, while rural residents can elect one delegate for every 1,040,000 persons. See 1983 Zhongguo baike nianjian (1983 Yearbook of the Encyclopedia of China), Shanghai: Xinhua Press, 1983, p. 226. Assuming all Hong Kong residents are considered as city residents, its 5,147,900 population can elect roughly 40 delegates.

the organs of state power of . . . autonomous regions . . . that contravene the Constitution, the statutes or the administrative rules and regulations”, thus effectively placing a severe restraint on the legislative power of Hong Kong legislature.

Fourth, under Article 89, paragraph 14, of the PRC Constitution, the State Council (Cabinet) has the power “to alter or annual inappropriate decisions and orders issued by local organs of state administration at different levels”, therefore the PRC's State Council can interfere, based on a legal foundation, with the Hong Kong government’s administrative function at anytime if it chooses to do so.

Fifth, Article 1, paragraph 3 of Annex 1 of the Declaration provides that the “chief executive of the Hong Kong Special Administrative Region shall be selected by election or through consultation held locally and be appointed by the Central People's Government.” Since the PRC has the final say on the appointment of the chief executive, to what extent the Hong Kong people have the free will to choose their chief executive is open to serious doubt. In a genuine federal country, the election of the chief executive of a member state is the sole decision of the people of that state without any participation of the central government. For instance, in the United States a governor of a state is elected by the people of that state and there is no way for the President or federal government to block that selection.

In view of the above analysis, it is clear that the so-called “high degree of autonomy” for Hong Kong has no credible guarantee and the PRC can legally interfere with the legislative and administrative operation of Hong Kong at any time it chooses to do so. Two days after the announcement of the Joint Declaration, a lengthy article was published in the authoritative People's Daily vividly explaining the nature of the special administrative region as follows:

First of all, to safeguard China's sovereignty, unity, and territorial integrity is a basic principle we should adhere to in establishing special administrative regions. Our country should be a unified country. There is only one China in the world, and that is the People’s Republic of China. It exercises sovereignty over its special administrative regions. Ours is a socialist country with a unitary system. It is not a federal country. The NPC is the supreme power organ of the state and its permanent body is the NPC Standing Committee. Both exercise the legislative power of the state. The State Council, that is, the central peo-
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People's government, is the executive body of the supreme power organ of the state and the highest organ of state administration. The special administrative regions are local administrative regions under the unified central leadership. They are not member states. The relationship between the special administrative regions and the central authorities is one between localities and central authorities. They must exercise their powers within the limits of their authority as prescribed by the laws enacted by the NPC.  

From the above quotation, one can clearly understand that the “special administrative region” and “high degree of autonomy” are all “special favors” granted by the PRC’s central authorities and there is no credible guarantee that it will not be changed in “appropriate time”. Any attempt by the PRC's central authorites to change the status of special administrative region is, according to the PRC logic, also an internal affair of China.

Future Prospects

Will the Sino-British settlement work to maintain the prosperity and stability in Hong Kong in the post-1997 period? This depends a great deal on the political stability in the PRC because, as analyzed in the previous sections, the Sino-British settlement has ruled out any credible international guarantee for its implementation and thus subjects the fate of Hong Kong to the political fluctuation in the PRC. Until recently, Hong Kong’s capitalist system and China’s communist system have co-existed side by side with mutual benefits. But both systems are essentially incompatible and the British presence in Hong Kong served as a buffer to make the co-existence between the two possible and insulate Hong Kong from the political turmoil in China. The PRC, by insisting in removing that buffer and insultation without providing a credible substitute, attempts to mix the two essentially incompatible systems together in a great experiment. Only the future will tell whether such an experiment will succeed.

Another factor needs to be considered: the PRC’s attempt to promote the Hong Kong model of “unification” for Taiwan.  

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despite the latter's categorical rejection of this mode. Therefore, pending the final incorporation of Taiwan into the PRC, there will be an additional incentive for the PRC to honor its settlement of the Hong Kong question.

27. "Foreign Minister Rejects Hong Kong Solution," FBIS, China, October 5, 1984, p. VI.
APPENDIX
Relevant Treaty Provisions Concerning Hong Kong

1. **Treaty between China and Great Britain, signed at Nanking, 29 August 1842**

   III. It being obviously necessary and desirable that British subject should have some port whereat they may careen and refit their ships when required, and keep stores for that purpose, His Majesty the Emperor of China cedes to Her Majesty the Queen of Great Britain, & c., the Island of Hong-Kong, to be possessed in perpetuity by Her Britannic Majesty, her heirs and successors, and to be governed by such laws and regulations as Her Majesty the Queen of Great Britain, & c., shall see fit to direct.

   *(Consolidated Treaty Series, Vol. 93, p. 467.)*

2. **Convention of Friendship between China and Great Britain, signed at Pekin, 24 October 1860**

   VI. With a view to the maintenance of law and order in and about the harbour of Hong Kong, His Imperial Majesty the Emperor of China agrees to cede to Her Majesty the Queen of Great Britain and Ireland, and to her heirs and successors, to have and to hold as a dependency of Her Britannic Majesty's colony of Hong Kong, that portion of the township of [K]owloon, in the province of Kwang-tung, of which a lease was granted in perpetuity to Harry Smith Parkes, Esquire, Companion of the Bath, a member of the Allied Commission at Canton, on behalf of Her Britannic Majesty's Government, by Lan Tsung Kwang, Governor-General of the Two Kwang.

   It is further declared that the lease in question is hereby cancelled; that the claims of any Chinese to property on the said portion of [K]owloon shall be duly investigated by a Mixed Commission of British and Chinese officers; and that compensation shall be awarded by the British Government to any Chinese whose claim shall be by the said Commission estabished, should his removal be deemed necessary by the British Government.

   *(Consolidated Treaty Series, Vol. 123, pp.73-74.)*

3. **Convention between China and Great Britain respecting on Extension of Hong Kong Territory, signed at Peking, June 6, 1898**

   [Ratifications exchanged at London, August 6, 1898.]
WHEREAS it has for many years past been recognized that an extension of Hong Kong territory is necessary for the proper defence and protection of the Colony, it has now been agreed between the Governments of Great Britain and China that the limits of British territory shall be enlarged under lease to the extent indicated generally on the annexed map. The exact boundaries shall be hereafter fixed when proper surveys have been made by officials appointed by the two Governments. The term of this lease shall be ninety-nine years.

It is at the same time agreed that within the city of Kowloon the Chinese officials now stationed there shall continue to exercise jurisdiction, except so far as may be inconsistent with the military requirements for the defence of Hong Kong. Within the remainder of the newly-leased territory Great Britain shall have sole jurisdiction. Chinese officials and people shall be allowed as heretofore to use the road from Kowloon to Hsinan.

It is further agreed that the existing landing-place near Kowloon city shall be reserved for the convenience of Chinese men-of-war, mercantile and passenger vessels which may come and go and lie there at their pleasure; and for the convenience of movement of the officials and people within the city.

When hereafter China constructs a railway to the boundary of the Kowloon territory under British control, arrangements shall be discussed.

It is further understood that there shall be no expropriation or expulsion of the inhabitants of the district included within the extension, and that if land is required for public offices, fortifications, or the like official purposes, it shall be bought at a fair price.

If cases of extradition of criminals occur, they shall be dealt with in accordance with the existing Treaties between Great Britain and China and the Hong Kong Regulations.

The area leased to Great Britain, as shown on the annexed map, includes the waters of Mirs Bay and Deep Bay; but it is agreed that Chinese vessels of war, whether neutral or otherwise, shall retain the right to use those waters.

This Convention shall come into force on the 1st day of July, 1898, being the 13th day of the 5th moon of the 24th year of Kuang Hsi. It shall be ratified by the Sovereigns of the two countries, and the ratifications shall be exchanged in London as soon as possible.
In witness whereof the Undersigned, duly authorized thereto by their respective Governments, have signed the present Agreement.

Done at Peking, in quadruplicate (four copies in English and four in Chinese), the 9th day of June, in the year of our Lord 1898, being the 21st day of the 4th moon of the 24th year of Kuang Hsü.

(L.S.) CLAUDE M. MacDONALD.
(L.S.) (Seal of the Chinese Plenipotentiary.)

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The 1997 Issue and Hong Kong's Financial Crisis*

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INTRODUCTION

Although 1997, the year when Britain's lease on the New Territories expires, has cast an ominous shadow over Hong Kong's long-term future ever since the inauguration of the People's Republic of China (PRC) in 1949, it did not surface as a formal diplomatic issue until 1982. In January 1982, Mr. Humphrey Atkins, then Minister of State at the Foreign Office, brought back news from Peking that the Chinese Government was ready to discuss the future of the whole Hong Kong area, not just the lease of the New Territories, within the framework of the "five principles of peaceful co-existence". This offer was interpreted at that time as something of a breakthrough, as it was said to show that China finally recognized that 1997 was an issue that somehow must be solved. A visit by the British Prime Minister was soon arranged and announced.

Then the Falklands war erupted unexpectedly in April 1982. From about late April, reports from various sources, including top Hong Kong business leaders invited to meet Deng Xiaoping in Peking, began to reach Hong Kong, to the effect that China had decided to regain sovereignty over the whole Hong Kong...
area, while at the same time promising to preserve the territory's existing socio-economic order after 1997. The reports caused considerable unease, but because they were then unofficial, most people still clung to the hope that Mrs. Thatcher's visit would bring about a more reassuring outcome.

However, hopes that Hong Kong's constitutional and political status quo—which during the past three decades had produced one of the world's most astounding economic miracles—could continue beyond 1997 were dashed during Mrs. Thatcher's visit in September 1982. Within the next twelve months, Hong Kong went through a dramatic and traumatic financial crisis which at one point nearly brought down the whole economic system.

The purpose of this paper is to review the crisis, and analyze its cause and consequences. Specifically, it will discuss the role of the 1997 issue in this unprecedented crisis. Some tentative comments on future prospects are also offered in the light of the recently announced Sino-British agreement on the future of Hong Kong.

Development of the Crisis

The term "financial crisis" is used in this essay to comprise three conceptually distinct, but mutually inter-dependent, components: currency crisis, liquidity crisis, and fiscal crisis. Of the three, currency crisis is undoubtedly the dominant one.

(a) Currency Crisis

Before March 1977, the Hong Kong dollar was widely regarded as one of the most stable currencies in the world. Table 1 presents the trade-weighted exchanged rate index of the Hong Kong dollar, with the date of the Smithsonian Agreement as the base (December 18, 1971 = 100). As may be seen, except for 1972 and a few months in 1973, the index stayed above 100 before March 1977, signifying that the Hong Kong dollar appreciated against 15 other major currencies as a whole. Even in

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1. A recent work on financial crisis reveals that the concept can be variously interpreted: as sharp changes in interest rates, asset prices, or bankruptcy rates (Goldsmith), a threat to the stability of the system (Swaboda), or a rush to test the convertibility of assets into money, or of one money into another (Mundell). See C.P. Kindleberger and Jean-Pierre Laffargue (eds.), Financial Crisis: Theory, History and Policy (London: Cambridge University Press, 1982), p. 2. However, most of the stated characteristics were either singly or jointly observable in Hong Kong in 1982-83.
1972 and a few months in 1973, the index fell only slightly below par. In mid-March 1977, the index temporarily reached an all-time high of 115.5, but since then a persistent downtrend had set in, interrupted only occasionally by short and unconvincing rallies. The depreciation worsened significantly after July 1982, and was not arrested until after the new currency stabilization scheme went into effect in mid-October, 1983.

Broadly speaking, two stages of the currency crisis may be distinguished. The first stage was the period from mid-March 1977 to the end of June 1982. The second stage began about July 1, 1982, and reached a climax on September 24, 1983. The salient features of the first stage were that the decline in the external value of the currency was on the whole relatively slow, gradual, and manageable, and, perhaps more important from an analytical point of view, explainable by purely economic factors. In contrast, the second stage was characterized by a much steeper downtrend, and a general state of nervousness in the foreign exchange market. The date of July 1 is selected, because it was around that time that the general public in Hong Kong became aware, initially through unofficial channels, of China’s intention to regain sovereignty over Hong Kong by June 30, 1997, when Britain’s lease on the New Territories expires. This has introduced an entirely new element of uncertainty and apprehension that dominates all other relevant variables for economic and financial decisions. For example, in the 63-month period from March 31, 1977 to June 30, 1982, the exchange rate of the Hong Kong dollar fell from US$1 = HK$4.62 to US$1 = HK$5.91, representing a depreciation of about 22%, or on average about 4.1% a year; the exchange rate index dropped about 22.3% from 115.5 to 99.7, or about 4.2% a year. However, from July 1, 1982 to October 15, 1983, the Hong Kong dollar depreciated by about 28% against its US counterpart, and by about 28.3% on a trade-weighted basis. These translate into an average annual depreciation of about 21.8%. The extent of the depreciation would have been even more drastic had the quotations on September 24, 1983, the day of the panic, been selected for comparison.

While the downward drift of the Hong Kong dollar in 1977-82 can be explained by standard economic analysis, disagreement could arise as to which were the primary determinants. Few will dispute, however, the proposition that the excessive growth of money and credit must rank high among them. Specifically, a
rate of monetary growth persistently higher than the growth of the real economy will, ceteris paribus, result in sustained inflation over the long run; and if domestic monetary growth persistently outstrips foreign monetary growth, a depreciation of the domestic currency will also, ceteris paribus, be inevitable. As an illustration, Table 2 presents the relative growth rates of alternative monetary aggregates in Hong Kong and the United States during 1977-83.

It will be appreciated that monetary definitions in Hong Kong and the United States are not identical, and given the institutional differences in the respective financial structures, there can be no one-to-one correspondence in the respective monetary aggregates. Nevertheless, the major components of the three alternative definitions of money supply, M1, M2, M3, are broadly similar; a comparison of relative growth trends is therefore still meaningful provided the results are interpreted with caution. As may be seen, the growth rate of Hong Kong’s money supply, however defined, was consistently much higher than that of its US counterpart. The only exceptions were the years 1979 and 1982, when the growth rate of Hong Kong M1 was somewhat lower than that of US M1. The reason for this is easy to explain. As interest rates soared in Hong Kong in those two years, the deposit-taking companies (DTCs), which were (and still are) not subject to the banking cartel’s agreement on deposit rates, bid aggressively for time deposits of varying maturities, resulting in a significant shift by customers from non-interest-bearing demand deposits with the commercial banks to interest-bearing time deposits with the DTCs. By contrast, the US M1 includes interest-bearing “other checkable accounts”. In spite of this temporary aberration, the average growth rate of Hong Kong M1 during 1977-83 was still 76.9% higher than that of US M1; the average growth rates of Hong Kong M2 and M3 were both more than three times as high as those of their US counterparts. Even allowing for differential growth rates of the respective economies, the gap was too large to be consistent with exchange rate equilibrium.

Modern economic theory also suggests that sophisticated investors and depositors are sensitive to interest rate differentials on monetary assets, especially in international financial centers.
where movements of funds can take place freely.² During 1977-83, the interest rate differential existing between Hong Kong and the leading xeno-currency market was consistently in favor of the US dollar. In Table 3, we compute the average nominal yields on 3-month time deposits, the representative short-term monetary asset, in Hong Kong and the Euro-dollar market. As may be seen, the yield in Hong Kong was lower in all years, resulting in a negative nominal differential ranging from -1.34 to -6.03, and real differential ranging from -0.47 to -9.86 percentage points. These significant differentials were attributable mainly to the asymmetrical behavior of the banking cartel, which tended to adjust deposit rates sluggishly upward, but very quickly downward, in response to interest rate movements in the leading centers abroad.³ The problem was also exacerbated to some extent by the refusal of the Hong Kong Government to abolish the interest withholding tax on domestic currency-denominated deposits with financial institutions until very recently.⁴

Hong Kong still does not yet have a comprehensive official balance of payments accounting system comprising both the current and capital accounts. There is a time series on visible and invisible trade which begins only from 1978. It is generally believed that before 1978, the visible trade deficit tended to be more than offset by surplus on invisible trade and/or capital account. However, since 1978, the surplus on invisible trade (mainly net tourist expenditure, remittances, and receipts from banking, insurance and transportation) has no longer been sufficient to offset the deficit on visible trade account. There were several reasons for this trend. First, with final demand growing consistently at a higher rate than gross domestic product, espe-

² The sensitivity to yield differentials is particularly stressed by the "asset market theory" of exchange rate variability, which regards the financial market as much more sensitive to exogenous shocks than the goods market. For a useful survey, see S. Schadler, "Sources of Exchange Rate Variability: Theory and Evidence", IMF Staff Papers, July 1977, pp. 253-96.


⁴ Before February 25, 1982, there was an interest withholding tax of 15% on all types of time deposits in Hong Kong regardless of the currencies in which they were denominated. Bowing to the international banking lobby for further promoting Hong Kong as a financial center, the Hong Kong Government abolished the tax on foreign currency-denominated time deposits with effect from February 25, 1982, but retained the tax on domestic currency denominated time deposits, reducing it only by 5 percentage points to 10%.
cially during the "overheating" of 1978-81, a widening external deficit became inevitable. Second, rising affluence has caused significant changes in life-style and expenditure pattern, one conspicuous example being the spectacular growth of out-going tourism, which has the effect of reducing the net income from tourism. The opening up of China has reinforced this trade also. Not only have Hong Kong residents travelled more frequently to China; they also have spent more, both for themselves and on gifts (particularly imported durables such as TVs, stereo sets, radios, refrigerators, calculators, tape-recorders, etc.) for their relatives and friends in China. As shown in Table 4, the visible trade deficit grew from -HK$9,195 million in 1978 to -HK$16,212 million in 1981, or by 76.3%, while invisible trade surplus increased from HK$6,459 million to HK$7,984 million in the same period, or by 23.6% only. As a consequence, total trade deficit widened by 214.2% from -HK$2,896 million to -HK$9,099 million. Although in 1982, a year of recession, the total deficit fell by 22.1% from the previous year to -HK$7,092 million, it was still nearly 2.5 times as large as that for 1978. A growing trade deficit of this magnitude was bound to exert a depressing effect on the exchanges in the absence of equilibrating capital flows.

Whereas purely economic forces can explain most, if not all, the phenomena associated with the currency crisis in the first stage of its development, the same cannot be said of its second stage from July 1, 1982 to October 15, 1983. To be sure, the same economic determinants of currency depreciation still operated in the second stage. However, there appeared to be considerable improvement in the underlying economic structure in 1983. Thus, as of the end of September 1983, the annual growth rates of M1, M2, and M3 decelerated to 6.6%, 29.9% and 25.1%, respectively, from 9.1%, 77%, and 42.3% respectively as of the end of December 1982. Responding characteristically to the upturn in the major economies, especially the United States, Hong Kong's total exports (domestic exports plus re-exports) in the first three quarters of 1983 grew in value terms by 19.8% to HK$111,250 million; imports, however, grew at a slower rate by 17% to HK$111,250 million; imports, however, grew at a slower rate by 17% to HK$121,870 million. As a result, the visible trade gap narrowed to -HK$10,620 million, some 9.4% lower than in the corresponding period of 1982. Expenditure by incoming visitors in the first nine months of 1983 increased by 24.5% over
the same period in 1982 to HK$7,790 million. Because the banking system was compelled to adjust its interest rates upwards more frequently during 1983 in order to save the tottering Hong Kong dollar, the average nominal interest rate differential in the first nine months of 1983 narrowed to -1.65% from -3.89% in 1982. But even without these improvements, purely economic factors cannot explain adequately the fact that currency depreciation in the 15-month period had exceeded that in the previous 63-month period.

The only satisfactory solution is to invoke a new element into the equation, the element of adverse expectations about the future. It is true that uncertainty over 1997, when Britain's tenure over New Territories expires, always has been present in Hong Kong since 1949. However, until very recently it was only one among many considerations governing the long term investment plans of individuals and institutions, especially as China's own intention toward Hong Kong was not explicitly stated. However, since China's demand for sovereignty over the whole Hong Kong area was made public in the summer of 1982, the 1997 issue has become the dominant consideration, overriding all other relevant factors in the determination of investment plan and asset portfolios, as people become increasingly concerned about the viability of the socio-economic system, the protection of private property rights, and the respect for personal freedom consequent on a change in regimes. Such fundamental changes in expectations cannot fail to produce a significant, and at times dramatic, impact on the exchange rate of the domestic currency against another widely accepted and preferred foreign currency.

Politically or psychologically motivated portfolio shifts may be conveniently divided into two major types. One is the outright flight of capital, mostly, though not necessarily, associated with physical emigration. Unfortunately, for a variety of reasons, the extent of this flight cannot be quantified. All one knows is that

5. The average yield on 3-month Euro-dollar deposits in the first nine months of 1983 was 9.45%; that on Hong Kong dollar 3-month time deposits was 7.8%. Note that the yield is estimated net of tax; whereas interest income from Euro-dollar market has always been tax-free, Hong Kong currency time deposits was subject to a withholding tax before October 17, 1983.

6. According to Hong Kong's Deputy Secretary of Monetary Affairs, "there is sufficient evidence to support the view that there has been an increased outflow of certain types of capital" in 1982-84, although he declined to quantify it. See A.R. Latter, "Changing Patterns of External Flows," paper presented to the Hong Kong Management Association, August 22, 1984. According to Mr. David Smith, the former Tourism
outflow of funds to North America and Australia has sharply increased in the past two years. The other is what may be called "precautionary diversification", in which an investor reshuffles his portfolio holdings in favor of financial assets denominated in foreign currencies, which are nevertheless held within the domestic financial system. As a fully integrated financial center where there exist no artificial segregation of "onshore" and "offshore" markets, and exchange control of any form, Hong Kong residents are free to hold deposits denominated in any currency that financial institutions are able to offer. Indeed, banks and DTCs, both local and international, have been engaged in recent years in a fierce competition for foreign currency deposits from the public. Data on this type of portfolio shift, mainly related to deposits with financial institutions, are available, though for reasons to be explained below they should be interpreted with some care.

Table 5 shows changes in the domestic currency and foreign currency components of the Hong Kong money supply during the 15-month period from June 30, 1982 to September 30, 1983. Portfolio shifts in favor of foreign currency deposits can be detected in all three measures of money supply. However, whereas the foreign currency component of M1 increased only slightly from 7.7% to 8.1%, those of M2 and M3 increased significantly from 35.5% to 49.9% and from 33.2% to 50.4%. The reason for this different pattern of shifts is of course that the narrowly defined M1 represents almost exclusively the medium of exchange function, and as long as the Hong Kong dollar is the legal tender people can only economize on M1, but cannot do without it. The more broadly defined M2 and M3 (see notes under Table 2) include interest-bearing deposits, and therefore perform the store of value or asset function in addition to the basic transaction function. The substantial increases in the foreign currency components of M2 and M3 reflected therefore people's desire to

Minister of Canada, Hong Kong businessmen invested up to US$1.5 billion in Canada during 1981-83, and the figure should go on increasing. (South China Morning Post, November 24, 1983). The U.S. and Australian government have been, however, reticent about the flight of capital to their countries, for fear of upsetting the already precarious situation in Hong Kong.

7. Although foreign currency assets can be freely sold and brought, and foreign currency deposits freely held, by both residents and non-residents in Hong Kong, the Foreign Notes (Prohibition of Circulation) Ordinance of 1913, which is still in force, expressly forbids the use of foreign currency notes as means of payment.
protect themselves against unfavourable political and economic changes in the future. But while individually the acquisition of foreign currency assets may be a rational choice, collectively the portfolio shift is bound to depress the domestic currency still further.

We call the data in Table 5 an "unadjusted" composition of money supply because they are subject to some statistical distortions. First, in all monetary statistics, the Hong Kong dollar is used as the numeraire; hence, any depreciation of the Hong Kong dollar automatically inflates the foreign currency component. This is known technically as the "valuation effect." Second, since the abolition of the interest withholding tax on foreign currency deposits in February 1982, a financial innovation known as "swap deposits" has been developed by resourceful financial institutions. Under this device, a depositor's initial Hong Kong dollar fund is converted into a foreign currency one at the spot rate, but simultaneously covered by a forward sale. The deposit-taking institution therefore undertakes to repay the depositor at a future date in Hong Kong dollars at a rate fixed in the forward contract. To the depositor, the advantages of such a deposit are that it not only can avoid the exchange risk, but also escape the withholding tax and the banking cartel's deposit rate ceilings. At present, these deposits are still classified in the official statistics as foreign currency deposits, but many analysts contend that they more properly should be regarded as Hong Kong dollar deposits. According to an estimate by the largest and dominant bank in Hong Kong, these deposits in early 1983 amounted to some HK$10 - 15 billion.8

In order to eliminate these distortions we first neutralize the "valuation effect" by assuming that the exchange rate index had remained unchanged during the period concerned, so that the nominal increase in foreign currency deposits is deflated to yield a "real" increase. Second, we then choose the upper estimate of the swap deposits—which is least favourable to the "portfolio shift" hypothesis—as the required magnitude for adjustment. It is further assumed that the total amount was distributed among the licensed banks and DTCs in the proportion of 75 : 25, which approximately reflected the relative positions of the two types of depository institutions.

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The adjusted results are presented in Table 6. For M1, the portfolio shift was reversed: the foreign currency component actually fell somewhat from 7.7% to 6.4%. Given that M1 is primarily used for transactions, the result is not surprising. What matters is that for M2 and M3, the foreign currency component still rose to 39.2% and 39.4% respectively, even though the extent of the rise was checked. Thus, even allowing fully for possible statistical distortions, portfolio shift is an empirically established fact that cannot be denied. To be sure, portfolio shift had occurred well before July 1, 1982, largely as a result of the unfavourable interest rate differential already noted. This was the case especially during the months March-June 1982, immediately after the abolition of the withholding tax on foreign currency deposits. However, the lack of detailed breakdown in the data does not permit us to determine whether the substantial rise in foreign currency component was due to residents’ shift from domestic currency deposits, or residents’ repatriation of offshore funds, or an inflow of non-residents’ funds. It is reasonable to infer, nevertheless, that after the emergence of confidence crisis over Hong Kong’s future around July 1982, repatriation of residents’ offshore deposits and inflow of non-residents’ funds must have dropped very sharply, if indeed not ceased altogether, leaving residents’ shifts from domestic currency deposits as the only significant explanatory variable. It is also pertinent to emphasize that both the Type 1 and Type 2 portfolio shifts involve a movement across the exchanges and therefore equally depress the domestic currency. Thus the mere fact that foreign currency deposits are held within the domestic financial system is no cause for complacency.

(b) Liquidity Crisis

The 1970s saw Hong Kong’s rapid rise as a financial center and with it, a spectacular increase in the number of depositons institutions, both local and international. In 1970, the monolithic grip of the financial scene by the traditional commerce banks (called licensed banks in Hong Kong) was broken by the entry of a couple of merchant banks with international background that specialized in wholesale investment banking, and multi-currency deposit-taking. This intrusion in turn spawned a host of local imitators in the form of finance companies that tended to specialize in domestic currency deposit-taking and
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stock market and property finance. At first these new intermediaries were totally unregulated, but in 1976 a Deposit-taking Companies Ordinance was passed, under which all depository institutions other than licensed banks were required to register with the authorities. Officially known as deposit-taking companies (DTCs), these institutions were permitted to take deposits of any maturity but not less than HK$50,000 for each account. Apart from a small minimum capital requirement (then HK$2.5 million), there was no minimum liquidity ratio for the DTCs similar to that imposed on licensed banks. In 1978, the 12-year moratorium on new bank licensing was relaxed for eligible foreign banks, and this led to an influx of full-service banks of international standing. From the end of 1978 to the end of 1982, the number of licensed banks increased from 74 to 128, and their offices from 759 to 1,474. The number of registered DTCs increased from 179 to 361 during the same period.

Because DTCs are not members of the banking cartel, they are free to offer higher interest rates to attract term deposits from the public. Initially they were able to grow much more rapidly and expand their market share at the expense of the licensed banks. The licensed banks then retaliated by forming wholly or partly owned DTC subsidiaries of their own. Increased competition produced certain benefits for the economy. On the micro level, more financial innovations were introduced, and a wider range of more efficient services were offered to the consumers. On the macro level, the growth of the financial sector generated high employment and income, as well as enhanced Hong Kong’s stature as a financial center. Unfortunately, however, there were costs as well to the economy. Competitive expansion of the financial sector was directly responsible for the excessive growth of money and credit. Within the financial sector itself, signs of deterioration in the quality of portfolio management also emerged. These became more noticeable during the “overheating” of 1978-81, when Hong Kong’s financial expansion coincided with a period of double-digit real growth of the economy, real estate boom, and euphoria generated by China’s post-Mao modernization drive. In that heady atmosphere, many bankers and financiers tended to throw caution to the wind. The fashionable technique of “liability management”—which in essence amounts to heavy dependence on “purchased funds,” i.e. short-term liabilities that bear competitive rates of interest, such as in-
ter-bank borrowing, Euro-dollar deposits, certificates of deposits (CDs), money market certificates etc. to finance loans—also contributed its share to the liquidity crisis.\(^9\) One manifestation of imprudence was the spectacular growth in total credit to the property sector, comprising loans to both developers and individuals. From late 1980 to late 1982, these loans by licensed banks grew more than four-fold from HK$10,228 million to HK$47,578 million, while their proportion in the total loan portfolio rose from 22% to 33.9%; in the same period, similar loans by DTCs increased by more than eight-fold from HK$2,418 million to HK$21,064 million, while their relative share rose from 24.3% to 42%. As is well-known, property loans are among the most lucrative earning assets of a financial institution, but they are also among the most non-liquid. If they are funded by essentially short-term liabilities, such as demand and savings deposits, negotiable certificates of deposits (NCDs), and inter-bank borrowing, the mismatch in assets and liabilities is bound to degenerate into a liquidity crisis of depository institutions in an adverse environment, as economic history has demonstrated time and again. Already in late 1981, the real estate boom in Hong Kong had peaked under the weight of spiralling interest rates. China’s proclamation in 1982 to take over Hong Kong proved to be the last straw, as potential investors and buyers deserted the property market. By the end of 1982, prices of land and properties, depending on their locations and uses, had fallen by 50 - 90% from their 1980-81 peaks. Stock prices also had dropped by some 57% from the all-time high reached in July 1981. The merciless erosion of asset and collateral values turned many good loans into bad, and this gave rise to a severe liquidity squeeze for the less prudent financial institutions, particularly non-bank-owned DTCs.

In early September 1982, the Tse Lee Yuen chain of jewellery shops which had issued a large amount of outstanding “gold certificates,” suddenly closed their doors. This triggered off alarmist rumors and a run on Hang Lung Bank, which had no connection with the shops but was suspected nevertheless of high

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risk exposure. Quick support actions by other leading banks temporarily suppressed an incipient banking crisis. However, barely two months later, following the disclosure of financial difficulties of two property giants, Eda Investment and Carrian, several DTCs found themselves on the brink of insolvency.\(^\text{10}\) While mismanagement was the root cause of their difficulties, the less than mature behavior of some foreign banks also contributed to their plight. Panic-stricken by the exposure to problem loans, these banks abruptly cut or even cancelled their credit lines to the DTCs, causing an immediate crisis. On November 19, 1982 the largest commercial bank and the de facto central bank in Hong Kong, the Hongkong and Shanghai Banking Corporation, issued a statement pledging its support for “soundly-based and well-managed” DTCs. Although a system-wide crisis was temporarily averted, by early 1983 seven DTCs had failed, causing heavy losses to depositors and thereby creating a prevailing sense of apprehension about the soundness of the financial system.\(^\text{11}\)

(c) Fiscal Crisis

Before 1982, Hong Kong was noted for its chronic fiscal surplus. Except for four years during the post-war period 1946-81, fiscal surpluses of varying amounts were recorded every year.\(^\text{12}\) This happy state of affairs was ended abruptly in the fiscal year 1982-83. A projected surplus of HK$2,800 million had turned into a record deficit of HK$3,200 million. In the next two years, budgetary deficits of HK$3,200 million and HK$1,100 million have been planned respectively. Thus, Hong Kong is set to undergo three consecutive years of fiscal deficit, unprecedented for a territory renowned in the past for its fiscal conservatism.

\(^\text{10}\) Both Eda and Carrian are now being liquidated, and the top executives of the latter are currently under trial for fraud and felony. The Carrian affair has also touched off a political storm in Malaysia because of the questionable involvement by the Bumiputra Malaysia Finance Ltd. Apart from this Malaysian institution, more than 50 U.S., European, and Hong Kong banks, including some controlled by the People’s Republic of China, had in the past three years lent up to US$1.2 billion to Carrian.


\(^\text{12}\) In fiscal 1946-47, 1959-60, and 1965-66, very small deficits were recorded. In 1974-75, because of the world recession, there was a sizeable deficit of HK$379.8 million. In Hong Kong, the fiscal year begins on April 1 and ends on March 31.
Space does not permit a full analysis of the causes of this fiscal crisis. While the severe recession in 1982 inevitably took its toll on government revenue, one major cause of the revenue shortfall was the collapse of the property market in 1982-83. This requires some elaboration because of the peculiarities of the land tenure system. In Hong Kong, all land is legally owned by the British Crown, and the Hong Kong Government as its agent merely sells or grants leasehold interests only, or, in other words, there is no permanent freehold. Crown leases, sold at public auctions to the highest bidders, used to be for terms of 75, 99 or 999 years, but they have now been standardized in the urban areas of Hong Kong Island and Kowloon Peninsula to a term of 75 years, renewable for a further 75 years on payment of a reassessed Crown rent (land tax). In the New Territories and New Kowloon, land leases are normally sold for the residue of a term of 99 years less 3 days from July 1, 1997. Under such a system, the government can reap windfall profits from land sales when the real estate market is booming and land prices are soaring; but by the same token, when the property market is falling, there can be an exaggerated impact on land sales, since it is a well-known and documented feature of the real estate cycle that normally rent lags behind property prices, which in turn lag behind land prices, in both the upward and downward directions. During the great property boom of 1978-81, the value of government land sales increased nearly six-fold from HK$1,830 million to HK$10,770 million. The Hong Kong Government's mistake in planning the 1982-83 budget was to assume implicitly that this high level of land revenue could continue without serious disruption. Thus, land sales were originally estimated to bring in some HK$12,450 million, accounting for nearly 100% of capital revenue and about a third of total revenue.

The collapse of the property market, partly caused by recession, but more significantly by the confidence crisis over Hong Kong's future, had thrown the whole government budget off balance, as land sales in 1982-83 turned out to be some HK$7,300 million lower than the original estimate. This was enough to turn a projected surplus into a record deficit. In the subsequent two fiscal years, stagnant land sales have remained a major cause of the revenue shortfall.

It has to be pointed out that the estimated deficits of HK$3,200 million for fiscal 1983-84, and HK$1,100 million for
fiscal 1984-85 are net figures, the original gross figures being much higher. For fiscal 1983-84, the government had to resort to additional indirect taxes, yielding some HK$3,000 million. For fiscal 1984-85, the government relied on a combination of higher direct taxes and borrowing. Fortunately, because of past surpluses, Hong Kong had accumulated considerable fiscal reserves which placed it in good stead in the recent crisis. However, by absorbing the net deficits for 1982-83 and 1983-84, the fiscal reserves were reduced from about HK$22,571 million as of April 1, 1982 to about HK$15,800 million as of April 1, 1984. From these reserves, another HK$1,100 million will have to be absorbed for the current fiscal 1984-85. Moreover, the government's rescue operation for the number of banks (see below) will probably be financed from this source as well. If other contingent liabilities are taken into account, the estimated "free fiscal reserves" as of April 1, 1985 will only be about HK$7,100 million, barely sufficient to cover about 5 months' current imports.  

From the foregoing analysis it seems clear that, while there were diverse causes for the three different types of crisis, one common thread was adverse expectations about the future. It is quite true that, even without the 1997 issue, the various acts of excesses and imprudence would still have produced currency depreciation and liquidity problems for some depository institutions. However, there was nothing to suggest that the difficulties could not have been resolved by the normal process of business cycle adjustments common to any free enterprise economy, given Hong Kong's proven record of resilience. The emergence of a confidence crisis, however, changed the whole nature of the difficulties.

In its public statements through various channels, the PRC Government has insisted on the recovery of sovereignty over the whole Hong Kong area; it also has emphasized repeatedly that sovereignty and administration are inseparable. At the same time, it has acknowledged the importance of Hong Kong's continued existence as an international free port and financial center; it has reiterated on many occasions the promise that

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Hong Kong's economic, social, and legal systems will not be changed, and that Hong Kong will be given a high degree of autonomy under the catch-all slogan of "Gangren zhigang" (literally means "Hong Kong people rule Hong Kong"). In terms of the imperatives of China's domestic politics, this special policy toward Hong Kong already represents a substantial concession on the part of Peking. The sad fact remains, however, that the record of the Communist regime in respect of economic performance and human rights is not one that inspires either domestic or international confidence. The deep anxiety and apprehension of the Hong Kong people about their future is something that even the more pragmatic and outward-looking post-Mao leadership fails to understand fully.

The confidence crisis over 1997 that surfaced after July 1982 therefore was something over which the Hong Kong authorities had little or no control. The question nevertheless may be raised whether, politics aside, the Hong Kong Government could not have undertaken structural and preventive reforms well before 1982 to strengthen the financial system. The standard official answer is that, as there is no central bank and virtually no government debt in Hong Kong, none of the usual instruments of monetary control, such as the rediscount rate, reserve ratios, and open market operations, can be applied effectively. To create a central bank from scratch would not be cost-effective, according to the official view. While there is some validity in this line of reasoning, the Hong Kong authorities cannot be absolved wholly from responsibility for the strains and stresses in the financial system up to July 1982. Most of the measures taken, whether for monetary control or prudential supervision purposes, were of an ad hoc or post hoc nature, which, at best, provided only temporary palliatives and, at worst, produced some perverse effects. Thus, it was not until the second half of 1978 that the authorities became aware of the growing threat of monetary expansion and inflationary pressures. Initial reliance on "moral suasion" for voluntary credit restraint on the part of banks and DTCs proved to be utterly futile. In early 1979, the short-term balances of the Exchange Fund with the banking system were required to be backed 100 percent by specified liquid assets, to prevent government funds from being used as a base for credit expansion.  

14. The Exchange Fund was first established in 1935, when Hong Kong followed China in abandoning the silver standard, to provide reserve backing for the Hong Kong
Then in 1980, the Hong Kong Association of Banks (HKAB) was formed as a statutory body, membership in which was made compulsory for all licensed banks, in order to strengthen the government's role in the banks' "interest rate agreement," a cartel-like arrangement governing changes in deposit rates, and, indirectly, lending rates. This was followed in 1981 by the introduction of the "3-tier system," under which depository institutions were divided under the law into three categories: licensed banks which can take deposits of any amount and any maturity; "licensed DTCs" which can take deposits of not less than HK$500,000 without restriction as to maturity; and "registered DTCs" which can take deposits of not less than HK$50,000 with a maturity of not less than three months. The official reasons for creating this new system are that it can preserve the efficacy of interest rates as a monetary control weapon, and also can protect the smaller depository institutions by preventing cut-throat competition. At the end of the same year, in an attempt to stabilize the falling external value of the Hong Kong dollar, the authorities devised a scheme of government borrowing on the inter-bank market in order to engineer a rise in the inter-bank rate in the hope of forcing those foreign banks which were habitual borrowers, to sell foreign currencies for Hong Kong dollars.\textsuperscript{15} In retrospect, it can be fairly stated (and was indeed pointed out by many economists at the time) that none of the measures has achieved its proclaimed objective. Indeed, it is ironic that the "3-tier system" has been widely perceived as having contributed, at least partly, to the DTC crisis in late 1982.\textsuperscript{16} The crux of the matter was that, from 1972 to 1983, the Hong Kong monetary system was subject to neither automatic control nor discretionary management in any effective way.\textsuperscript{17} In fiscal policy, the government during the boom

dollar and to stabilize its external value. Since 1976, through a series of administrative changes, the Fund has become the sole repository of all official financial assets, whether denominated in domestic or foreign currencies. Thus it comprises not only foreign exchange reserves, but also fiscal reserves accumulated from past budgetary surpluses.

15. In the technical literature, this device is known as an operation to influence the "term structure of interest rates". Experience in other countries, notably the United States, has shown it to be largely futile.


17. For a fuller analysis, see J.G. Greenwood, "Hong Kong's Financial Crisis: History, Analysis, Preception", Asian Monetary Monitor, November-December 1982, pp. 2-
of 1976-81 allowed government expenditure to grow too rapidly, and since civil service emoluments constitute the bulk of public expenditure, the seeds of future structural deficits were sown.

**THE PANIC OF SEPTEMBER 1983**

The downward trend of the Hong Kong dollar on the foreign exchange market took a turn for the worse in the summer of 1983 against a background of rising political tensions. As the Peking talks on the future of Hong Kong dragged on without any substantive progress, the Chinese propaganda machine mounted a strident campaign against the British for their reluctance to concede sovereignty outright, and their attempt to separate the issue of sovereignty from that of administration. Hu Yaobang's statement in mid-August that China would take over Hong Kong on or before July 1, 1997 had a most unsettling effect on sentiments. As the Hong Kong dollar fell further in reaction to such thinly veiled threats, the British and Hong Kong governments were then accused not only of failing to take appropriate steps to stabilize the situation, but also of deliberately engineering a currency crisis in order to strengthen the British case at the Peking talks (the "economic card" argument). The British responded by saying that any solution must be acceptable to China, Britain, and Hong Kong. But this "three-legged stool" concept is anathema to the Chinese Communists. A vicious circle of political tension and financial instability was thus generated.

After a relatively stable July, the exchange rate against the US dollar was quoted at HK$7.325 on August 1. By August 31, the rate had fallen to HK$7.595, a depreciation of 3.6% in barely a month. The trade-weighted exchange rate index fell by 2.8% during the same period from 73.3 to 71.3. In the next four weeks, the currency depreciation accelerated dramatically and began to take on the proportions of a classic panic. By September 16, the exchange rate against the US dollar had dropped to

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69. See also Y.C. Jao, "Financial Structure and Monetary Policy in Hong Kong", and "Financial Structure", supra note 3.

18. The Chinese took the argument that the British were playing the "economic card" quite seriously. Thus, a high-powered delegation of visiting Chinese economists repeated the argument in September in a joint symposium with Hong Kong economists. For a verbatim report, see "On the Future of the Hong Kong Economy: Minutes of a Symposium," (in Chinese), Economic Reporter, October 17, 1983, pp. 5-12. See also Xu Dixin, "On the Current Crisis of the Hong Kong Dollar", (in Chinese), Economic Reporter, October 1, 1983, pp. 52-55.
HK$7.89, and the exchange rate index to 68.3. On that evening, the Financial Secretary, Sir John Bremridge, delivered a speech reviewing the state of the economy. It was widely expected by the market that he would announce a package of currency stabilization measures, including the abolition of the interest withholding tax on Hong Kong dollar deposits. However, apart from painting a relatively rosy picture of export-led recovery, Sir John did not announce any action on the currency front. Instead, he repeated the well-known government position as follows: 19

It is not possible for the Government to fix the exchange rate of the Hong Kong dollar at any particular level. This must depend upon the forces of the market place. Adjustment must therefore be expected in accordance with market factors, which will in time reflect underlying values.

Rightly or wrongly, this passage was widely interpreted to indicate that the government was either powerless or unwilling to stabilize the exchange rate. Moreover, after the speech, Sir John, in an interview with the press, blamed the Bank of China for buying heavily US dollars, and declared that the slide of the Hong Kong dollar could not be arrested until “Peking gives a positive sign about the progress of the talks”. 20 Naturally, these remarks provoked an angry rebuttal from the Bank of China, and denunciations from the Communist press. The next day, the US dollar rate broke through the HK$8 mark for the first time in Hong Kong history.

During the next week, the decline of the Hong Kong dollar continued relentlessly, reaching a climax at the week-end of September 23-24. In the afternoon of September 23, news was received in Hong Kong that the Peking talks had ended in a stalemate, and even the usual cosmetic adjectives “useful and constructive” were missing from the communique. This touched off an immediate panic. The exchange rate against the US dollar dropped sharply to HK$8.73 from the last closing rate of HK$8.86. On September 24, the panic not only deepened on the financial markets, but also spread to other sectors of the economy. The exchange rate against the US dollar dropped to HK$9.55, and the exchange rate index fell to 57.2, both record lows. In barely 48 hours, the Hong Kong currency depreciated

19. Speech by the Financial Secretary to the Foreign Correspondents’ Club, September 16, 1983, reported in South China Morning Post, September 17, 1983.
20. Hong Kong Standard, September 17, 1983.
by 12.9% against its US counterpart, and by 11.6% on a trade-weighted basis against 15 major currencies as a whole. People not only tried desperately to switch from Hong Kong dollar to US dollar deposits; many even converted their US dollar deposits in Hong Kong into US dollar notes, forcing some banks to suspend payment temporarily. Because it was a Saturday, the banks were able to close earlier at noon, but this did not prevent rumors from spreading about the soundness of some banks and financial institutions. Some shops dealing in imported items began to quote prices in US dollars and refused to accept even legal tender notes. More ominously, panic buying broke out at supermarkets, with consumers stockpiling food and other staples.

Alarmed by these developments, and fearing that self-fulfilling runs on the currency and the banking system might cause a complete collapse of the financial structure, the Hong Kong Government abruptly reversed its financial policy stance from laissez-faire to active intervention. On September 25, it announced that various proposals for currency stabilization were being actively considered, the basic prerequisite of which was "full convertibility of the currency". The statement also added that the Exchange Fund would play a more active role in exchange rate determination by intervention in the foreign exchange and money markets. In a coordinating move, the Hong Kong Association of Banks raised the prime rate by 3 percentage points to 16%, and most deposits rates by the same amount, effective from September 27, in order to shore up the currency. When the market opened on Monday, September 26, the US dollar at first fell sharply from the previous close of HK$9.55 to just below HK$8 in the morning, but rose again in the afternoon to close at HK$8.9. In the next two weeks, the exchange market was characterized by extreme nervousness and volatility. Thus, the exchange rate against the US dollar appreciated by 7.9% from September 26 to September 30, only to depreciate again by 6.9% between September 30 and October 3. However, from October 5 onwards, the market seemed to sense that the government was capable of introducing and implementing a successful stabilization scheme. By October 13 - 15, just before the announcement of the scheme, the US dollar was trading at around HK$8.15 - 8.35, representing an appreciation of the Hong Kong dollar of about 16.3% from its all-time low on September 24. By then the exchange rate index had appreciated also by about 12.4%.
Hong Kong's Financial Crisis

China blamed the September currency crisis on rampant speculation, which in turn was seen as part of a British plot to play the "economic card". It is hard to believe that the British and Hong Kong authorities deliberately engineered the panic in order to force China to make concessions at the diplomatic talks. As our analysis makes clear, the root cause of the panic was the confidence crisis, which reflects profound apprehension about the uncertain future of the territory. As to speculation, it is a truism that speculative activity always exists in a free market, which is often difficult to distinguish from other forms of market activity like hedging, arbitrage, investment and commercial transactions. However, to attribute the panic wholly to speculation is to confuse symptoms with causes. Quite apart from the fact that speculation may be stabilizing or destabilizing, only a deep anxiety and apprehension about the future can induce a persistent flight from the domestic currency.

Another view of the panic which comes perilously close to a "conspiracy theory" has been suggested by some economists of the "rational expectations" school. The basic idea seems to be that the Hong Kong Government favored continuous depreciation of the Hong Kong dollar as a way out of the financial crisis resulting from the collapse of the property and stock markets. The argument is implausible since it ignores completely the portfolio shift generated by the anxiety and fears over 1997. It is also flawed for being based on a misunderstanding of the note-issuing mechanism under the floating regime from November 1974 to October 1983. In any case, the argument has been rendered irrelevant by the Hong Kong authorities' strong actions to defend the currency in October 1983.

Apart from the currency panic, a banking panic was also brewing over the weekend of September 24-25, as rumors circulated rapidly about the liquidity problems of a number of banks. On September 27, the Hong Kong Government rushed through

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21. A more subtle evidence that speculation plays a role in exchange rate determination is given by the fact that the "covered interest arbitrage theorem" did not hold in Hong Kong, implying that speculators dominated arbitrageurs in the market. See Y.C. Jao, "Financial Structure and Monetary Policy in Hong Kong", supra note 3, pp. 44-45. For a rigorous empirical test that confirms the above conjecture, see Y.K. Ho and N.K. Mak, "A Test for the Covered Interest Rate Parity Hypothesis", July 1983, (mimeo).

emergency legislation to enable it to take over Hang Lung Bank, which was unable to meet its obligations. This bank, as mentioned earlier, suffered a run in September 1982 because of its exposure to property loans and close connections with a deposit-taking company, Dollar Credit, which subsequently failed. Barely five days later, the government participated in a rescue package for Sun Hung Kai Bank, which also suffered heavy withdrawals of deposits. Two of the bank's international shareholders, Compagnie Financière de Paris et des Pays-Bas (Paribas) of France, and Merrill Lynch of New York, agreed to increase their shareholdings to 51 per cent; the Hongkong and Shanghai Banking Corporation promised to provide substantial but undisclosed "credit facilities" to it; while the Hong Kong Government also agreed to add the bank to its list of qualified depositories for the official Exchange Fund, which would place deposits with the bank on normal commercial terms.

Although these swift actions have fortunately saved Hong Kong from a banking crisis which could dwarf that of 1965, the fact that it became necessary for the government to take some extraordinary steps clearly shows the havoc which a combination of confidence crisis, bad financial management, and lax regulatory framework can make of the financial system.

THE STABILIZATION SCHEME OF OCTOBER 15, 1983

At noon on Saturday, October 15, when the exchange market was closed, the Hong Kong Government announced two measures to stabilize the currency. The first measure, which was of overriding importance, concerned the note-issuing mechanism. Effective from October 17, the two note-issuing banks, the Hongkong and Shanghai Banking Corporation and the Chartered Bank, were to be required, before they could issue Hong Kong dollar notes, to pay to the government's Exchange Fund an equivalent amount of foreign exchange, at the fixed rate of US$1 = HK$7.8, for Certificates of Indebtedness (CIs) as legal backing for the note issue. Similarly, CIs were to be re-


deemed for foreign exchange at the same fixed rate from the same date. The other measure, long awaited, was the abolition of the interest withholding tax on Hong Kong dollar deposits, so that henceforth there would be no tax advantage in holding foreign currency deposits, or in holding Hong Kong dollar deposits offshore.

The change in the note-issuing mechanism requires some explanation. Before June 1972, Hong Kong was on the sterling exchange standard, and CIs were issued and redeemed against sterling, also at a fixed rate, though subject to variation on any official devaluation of sterling. After the floating of sterling in June 1972, Hong Kong was forced to leave the Sterling Area, and the Hong Kong dollar was pegged to the US dollar at US$1 = HK$5.65 from July 6, 1972 to February 13, 1973, and at US$1 = HK$5.085 from February 14, 1973 to November 25, 1974. On November 26, 1974, the Hong Kong dollar itself was allowed to float. After the break with sterling in July 1972, the note-issuing mechanism was significantly modified. Instead of surrendering sterling or other foreign currencies, a note-issuing bank that wished to issue more notes could acquire CIs from the Exchange Fund merely by crediting the Fund’s account with the bank with the same amount in Hong Kong dollars. The Fund then used its discretion to purchase a variety of foreign currencies on the open market with the Hong Kong dollar proceeds to serve as ex post backing for the note-issue. When the Hong Kong dollar was strong (as it was during 1972-1977), this new procedure did not pose any difficulty, as the Fund always could acquire the desired foreign currencies without unduly disturbing the foreign exchange market. Problems arose when the Hong Kong dollar became a weak currency. In the words of a former Deputy Secretary for Monetary Affairs, “when the Hong Kong dollar is relatively weak, the proceeds from increases in the note-issue will tend not to be converted into foreign exchange and there may even be occasions when the Exchange Fund needs to be a seller of foreign currencies.”

sure on the Hong Kong dollar. A vicious circle thus was formed after 1977, which became much more violent in 1982-83.

The new note-issuing mechanism often has been described as a return to the pre-1972 full foreign exchange backing and fixed exchange rate regime. In terms of its *modus operandi*, this view is incorrect. Before July 1972, not only were CIs priced in terms of sterling; the Exchange Fund was obliged to maintain the sterling parity, i.e., to buy and sell sterling indefinitely against the Hong Kong dollar at a fixed rate, subject to an officially prescribed spread between buying and selling rates.26 From July 1972 to November 1974, when the Hong Kong dollar was pegged to the US dollar, the Exchange Fund was similarly obliged to buy and sell the US dollar indefinitely within 2.25% on either side of the central rate. Under the new system, however, the Exchange Fund deals only with the two note-issuing banks through the issue and redemption of CIs in terms of a fixed price of the US dollar, but otherwise does not deal direct with other non-issuing banks and the non-bank public. In principle, therefore, the Fund has no obligation at all to maintain a fixed exchange rate regime, though whether in practice it entirely refrains from intervention is another matter. It is more correct to say that the Hong Kong dollar is linked, rather than pegged, to the US dollar.

What is relied upon to bring about a highly stable exchange rate vis-à-vis the US dollar is the process of “arbitrage and competition”, in which the Exchange Fund, the banks and other depository institutions, and the public are active participants. Thus, for illustration, suppose that the market rate for US dollar is HK$7.9, and the discrepancy of HK$0.1 with the linked rate exceeds the transaction costs involved in arbitrage. Then it will be profitable for a note-issuing bank to retire Hong Kong dollar notes and redeem them with the Fund for US dollars at the official rate of HK$7.8, re-selling the US dollars so obtained to the market. A non-issuing bank or DTC can do the same by tendering Hong Kong dollar notes to a note-issuing bank in exchange for US dollars.27 Conversely, if the market rate is HK$7.7, the


27. A non-issuing bank, however, is not allowed to use checks to obtain US dollar
arbitrage is reversed: US dollars will be bought on the market and re-sold, either by a note-issuing bank to the Fund, or by a non-issuing bank or DTC to a note-issuing bank. Apart from these operations by the financial institutions, the public will also refuse to buy US dollars at a rate unreasonably higher than the official rate, and sell them at a rate unjustifiably lower than the official rate, as long as there is genuine competition among the financial institutions. In short, arbitrage and competition automatically marshall forces that will bring about a convergence of the market rate toward the official rate, if not indeed the exact equivalence of the two. Needless to say, the speed of the convergence depends on the knowledge and skill of the market participants, and serves as an indicator of market efficiency.

The ideas underlying the two stabilization measures are not new: they have been advocated by economists for some years. However, until the outbreak of the panic in late September, the Hong Kong Government had refused adamantly even to consider them seriously. As noted already, as late as September 16 the Financial Secretary still publicly declared that “it is not possible for the Government to fix the exchange rate of the Hong Kong dollar at any particular level.” As to the interest withholding tax on Hong Kong dollar deposits, which by discriminating against holders of domestic currency assets was clearly detrimental to monetary stability, the authorities’ main argument was that its abolition would cause a serious loss of fiscal revenue. This, even if

from a note-issuing bank. The reason for this is to preserve a symmetrical relationship such that note-issuing banks provide notes to, and accept them from, other banks on the same basis as they themselves deal with the Exchange Fund, i.e., against payment in US dollar at the rate of US$1 = HK$7.80. These procedures are spelled out in two documents: Monetary Affairs Branch, Hong Kong Government, “Government Measures to Stabilize the Exchange Rate” dated October 15, 1983 and circularized to all licensed banks and DTCs; and circular dated October 15, 1983 by H.W. Paterson, Assistant Manager, Foreign Exchange and Treasury, The Hongkong and Shanghai Banking Corporation, to other banks.

true, reflected a lamentable confusion of priorities and failure to discern which represented the greater threat: a systematic monetary shift that undermined the whole economy, or a temporary loss of revenue which could be made good by other means. With the appearance of "swap deposits", which successfully escaped the withholding tax, even the "revenue" argument lost its validity.

Effects of the Stabilization Scheme

At the time of writing (late November, 1984), the currency stabilization program has been in force for only 13 months, so it is still too early to pronounce the final verdict on its success or failure. Nevertheless, apart from a few days of initial confusion, the scheme so far has been generally successful, despite widespread skepticism.

On the first day of the implementation of the scheme, October 17, there was considerable confusion on the foreign exchange market, as market participants still did not quite understand the new note-issuing mechanism, and the "arbitrage and competition" process. After considerable gyrations, the US dollar closed at HK$8.00, which was still 2.6% above the official "linked" rate. On the second and third days, the US dollar fell gradually to HK$7.93 and HK$7.83 respectively, as overnight HIBOR soared at one stage to 41% on October 19, when the note-issuing banks, perhaps at the prodding of the authorities, applied a severe squeeze on those financial institutions, mostly foreign, which were short of Hong Kong dollars.29 On the fourth and fifth days, the US dollar dropped below par at HK$7.793 and HK$7.778 respectively. It was not until the sixth day, October 22, that the market rate, at HK$7.795, came very close to the official rate. From that point onward, however, as information about and knowledge of the new system improved steadily, the "arbitrage and competition" process generally has worked well to prevent the market rate from diverging too far from the official rate. The exception to this relative tranquility was the period July 6-14, 1984, when rumors that the Sino-British talks had run into difficulties triggered off a speculative attack against the Hong Kong dollar. On July 6, after the Hong Kong market

29. HIBOR is the acronym for "Hong Kong inter-bank offered rate", which is widely regarded as a barometer of the cost of funds, especially by those financial institutions that do not possess a local currency deposit base.
closed, a bout of selling of the Hong Kong dollar in Europe pushed the US dollar rate to HK$7.94. The Hong Kong Association of Banks reacted quickly, and raised the prime rate by an unprecedented 3.25 percentage points to 17%. By July 16, the exchange rate had been pulled back nearer the peg at about HK$7.83.

With the exception of this mini-crisis, the linked system has performed well, certainly much better than expected when it first went into effect in October 1983. Actual fluctuations have not exceeded 1.8% either side of the official peg.

One price that has had to be paid by the linked rate system is the increased volatility of interest rates. After the prime rate was raised by 3 percentage points to 16% on September 27, 1983 at the height of the currency crisis, it was lowered on seven occasions between October 25, 1983 and March 12, 1984 to 8 1/2%; then raised again on six occasions between March 26, 1984 and July 7, 1984 to 17%; subsequently, it was lowered once more on four occasions between August 3 and October 27, 1984 to 12%. However, the interest rate weapon has proved to be much more potent than the pre-peg days for stabilizing the currency. The reason lies in the working of two different note-issuing mechanisms. Between July 1972 and October 1983, the CIs were issued and redeemed in Hong Kong dollars. There was thus no ex ante foreign exchange constraint on the monetary base. Because the interest rate instrument was an alternative to, or substitute for, control of the money stock, its effect on the monetary aggregate was at best indirect, primarily via credit expansion or contraction. Sole reliance on it as a device for exchange rate stabilization, therefore, became increasingly ineffective during times of stress and uncertainty. After October 17, 1983, as the foreign exchange constraint was reimposed on the note-issue, interest rate variations have become necessarily associated with variations in the monetary base and hence money supply. Thus when an unexpected excess demand for US dollars arises, CIs have to be redeemed, causing the contraction of currency and money stock, and forcing up interest rates automatically. The overall stability of the Hong Kong dollar can be shown by the fact that the trade-weighted exchange rate index stood at 74.4 at the end of October 1984, representing an appreciation of nearly 30% over the panic of September 24, 1983.

There is some controversy about the chosen fixed rate at
HK$7.80 to one US dollar. Since the latter closed at HK$8.15 just before the announcement of the stabilization scheme, some economists regarded this closing rate, or an average of the closing rates of the last few trading days, as being more realistic and easier to maintain.30 However, while a rate of HK$8.15 or higher already represented some appreciation over the panic rate of HK$9.6, it still embodied a substantial depreciation over a period of barely two months. Given that Hong Kong is a price-taker for essential goods imported from abroad, such as foodstuffs, fuel, and raw materials, the inflationary potential implicit in the market rate was unacceptably high.31 The authorities also thought that some punishment should be meted out to speculators against the Hong Kong dollar. In that event, the linked rate was set at a level that amounted to an appreciation of 4.9% on the market rate.

In view of the panic and near-collapse of the financial system in September and early October, 1983, the speedy stabilization of the currency and the broader financial structure after October 17, 1983, has surprised and confounded many critics. Even as a short-run phenomenon, the apparent success requires some explanation.

There can be little doubt that the improved political atmosphere since October 1983 is a key element in the viability of the stabilization scheme. One effect of the panic was that both China and Britain realized that any prolonged confrontation, even at the diplomatic or verbal level, would be disastrous for Hong Kong. In response to Britain’s concessions on sovereignty and administration, China toned down its propaganda campaign considerably, and offered more concrete reassurances about local autonomy and preservation of the existing socio-economic system after 1997. The reappearance of the phrase “useful and constructive” after each round of Sino-British talks also had produced some “placebo effect”. Although renewed concern about the progress of the talks, especially about the Chinese proposal of a “joint liaison group”, triggered off a brief mini-crisis in

31. It is estimated that a 10 per cent depreciation in the import-weighted effective exchange rate will result in a 10 per cent increase in import prices, and a 5 per cent rise in Hong Kong’s consumer price index. See A.A. Mclean, “Some Recent Developments in the Hong Kong Monetary System and Their Implications”, Discussion Paper No. 22, Department of Economics, University of Hong Kong, October 1983.
July, the situation calmed down again after the second visit to Peking by Sir Jeffrey Howe, the British Foreign Minister, in late July, during which it was apparently agreed that the "joint liaison group" would only be a consultative group, with no administrative or supervisory powers over Hong Kong both before and after 1997. Subsequently, other remaining problems—land leases, civil aviation, and nationality—were also solved through mutual accommodation. In anticipation of a settlement, both the Hong Kong dollar and the Hang Seng Index of stock prices steadily improved from August onward. People reasoned that, as long as there was a formal Sino-British agreement, the next 13 years at least would be safe. This was in marked contrast to the state of mind last September, when the collapse of the financial system, the imposition of exchange control, and the takeover by China all seemed imminent.

There is also evidence that China, concerned about the dire consequences of a financial collapse in Hong Kong, has been extending credit quietly to various financial institutions in the territory during the past two years. Two-way trade and investment flows between Hong Kong and China have expanded enormously since the onset of the post-Mao era. However, a relatively neglected aspect of the economic nexus is transactions between Hong Kong's financial institutions and their counterparts in China. Recently available statistics show that since 1982, China has reversed its status from a net debtor to a net creditor vis-à-vis Hong Kong. A summary of this trend is provided in Table 7.

As the table shows, whereas before 1982 China had consistently borrowed on a net basis from Hong Kong's financial institutions, since 1982 it has been lending on a net basis to them. By September 30, 1984, China's net claims had reached HK$13,784 million (equivalent to US$1,758 million), a sum which cannot be dismissed as trivial. In an article elsewhere, I offered two possible interpretations of this remarkable reversal.32 One interpretation, purely from the perspective of contemporary banking practice, is that the Bank of China's many branches and subsidiaries in Hong Kong have learned the trick of "liability management", one manifestation of which is to take deposits from the head office and on-lends them to finance local loans.33 The other

33. It is to be noted that the Bank of China's branches and subsidiaries in Hong
interpretation takes into account the changing political environment since 1982, and sees the growing net lending as a conscious attempt on China's part to stabilize the financial sector in Hong Kong. The lack of detailed breakdown in the statistics prevents any further analysis of how the funds are actually used. But whichever view is more correct, it cannot be gainsaid that China has a strong vested interest in the viability of Hong Kong's financial system.

Insofar as the panic was caused by self-fulfilling expectations, a reversal of mass sentiments could happen quickly in a calmer atmosphere, bringing with it self-corrective results. Thus, the re-imposition of a 100 percent foreign exchange constraint significantly boosted public confidence that the note-issuing privilege would not be abused. The public was apparently also impressed by the government's declaration that the Hong Kong dollar would be revalued only in the upward, but not the downward direction. Furthermore, heavy losses incurred by those who speculated against the Hong Kong dollar after the panic subsided had a sobering effect on the market. By the same token, the familiar "leads and lags", a form of trader speculation whereby exporters deliberately delay their foreign exchange receipts and importers, accelerate their foreign exchange payments, underwent an overdue correction. Portfolio shift toward foreign currency assets also slowed down as wealth-holders modified their expectations about exchange rate movements, especially as the tax advantage from holding foreign currency assets has disappeared.

The stabilization scheme was helped also by economic fundamentals. In 1983, Hong Kong responded quickly to the U.S. recovery, and the real growth rate of the economy rose to 5.2% against only 2.2% a year before. The export-propelled growth is continuing this year, with the real growth rate rising to 8%, the unemployment rate falling to 4%, and the inflation rate also falling to about 9%.34 For an economy subjected to an excruciating political uncertainty for two years, this is a most impressive performance.

Nevertheless, the short-run success of the stabilization scheme does not imply that a long run stability of the currency is

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Kong are treated as Hong Kong entities in the financial statistics released by the Hong Kong Government, in accordance with international practice. Ibid., p. 29.

34. Speech by the Financial Secretary, Sir John Bremridge, to the Hong Kong Economic Association, Sept. 14, 1984.
assured. The critical factor is still public confidence in Hong Kong’s future. An unanticipated and highly adverse political shock, for example, could again drastically undermine public confidence and trigger off another currency crisis. The Exchange Fund is a jealously guarded secret, whose assets have never been published by the Hong Kong Government. There are various “guesstimates” of the Fund’s resources whose reliability can only be a matter of judgment. Taking the conservative but not unreasonable estimate that the Fund’s liquid assets are approximately twice the outstanding currency issue, then they covered about 115% of M1, 22% of M2, and 18% of M3, denominated in Hong Kong dollars as of August 30, 1984. Thus, although the Fund has more than enough assets for the full convertibility of the outstanding currency in circulation, it cannot withstand a sudden and massive shift from deposits to domestic currency and thence to foreign currency. While the probability of this eventuality appears to be small at present, it cannot be ruled out entirely.

The longer term macroeconomic implications of the new currency standard can only be sketched here because of space limitations. By linking its currency to the US dollar, the Hong Kong economy is constrained to follow closely the path of its US counterpart. In other words, Hong Kong will become more susceptible to the transmission of cyclical disturbances emanating from the United States. More generally, the new currency system, being essentially a variant of the classical “specie-flow mechanism”, shifts the burden of adjustment from the exchange rate to money supply, interest rates and employment. Two brief comments may be offered regarding the implications of the classical system for present-day Hong Kong. First, under this system, money supply is largely determined by the ebbs and flows of the balance of payments. But whereas the relationship between the two was necessarily very close in the heyday of the gold standard, it has become much more attenuated under a highly developed banking system such as Hong Kong’s, owing to the growing importance of domestic credit creation. The relationship is further complicated by the fact that rapid financial and technological innovations have resulted in changing definitions of money supply. Second, as is well known, the successful operation of the

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35. For a quantitative analysis of this relationship, see Y. C. Jao, “Proximate Determinants of Money Supply in Hong Kong”, *Hong Kong Economic Papers*, March 1974, pp. 1-17.
classical system depends, not only on political stability, but also on full price flexibility. Although Hong Kong is probably still more flexible than most other countries, institutional rigidities in the economy have nevertheless also increased over the years. Thus Hong Kong was lucky that the new currency scheme was introduced at the time when the economy was on an export-led upswing, temporarily masking the problem of unemployment as an adjustment cost. But the real test is yet to come, and Hong Kong may have to face an agonizing choice between exchange rate stability and loss of output and employment.\textsuperscript{36}

**Concluding Remarks**

Hong Kong's financial ordeal in 1982-83 had its endogenous and exogenous origins, the interactions of which need careful analysis. None but the most extreme ideologue can, however, deny the crucial role of the confidence crisis that has arisen from the apprehension and uncertainty over Hong Kong's future political status.

The Sino-British agreement on the future of Hong Kong was initiated and released on September 26, 1984, as this paper was being completed. Because it is such a recent event, only a brief preliminary assessment of its implications, with special reference to Hong Kong's financial sector, can be attempted here.

Under the agreement, sovereignty over Hong Kong will revert to the People's Republic of China on July 1, 1997. Hong Kong will then become a Special Administrative Region (SAR) of China, which will enjoy a high degree of autonomy except in foreign and defense affairs. The existing economic and social systems will remain unchanged for fifty years after China resumes sovereignty. A Basic Law will be promulgated for Hong Kong, subject to which existing laws in Hong Kong (the common law, rules of equity, ordinances, subordinate legislation and customary law) will be maintained. The government of the future SAR will be composed of local inhabitants, whose chief executive will be appointed by the Central People's Government on the basis of local elections or consultations. Existing human rights and indi-

\textsuperscript{36} The possible incompatibility between external and internal equilibrium has long been recognized. For a classic treatment, see J.M. Keynes, *A Tract for Monetary Reform*, 1923, Chapter 4, reprinted in Royal Economic Society, *The Collected Writings of John Maynard Keynes*, (London: Macmillan, 1971), Vol. IV.
individual liberties will all be protected by law.\textsuperscript{37}

With regard to the economic and financial systems, Hong Kong is to retain its status as a free port, a separate customs territory, and an international financial center. Its existing markets for foreign exchange, gold, securities and futures will continue. There will be a free flow of capital without exchange control. The Hong Kong dollar will continue to circulate and remain freely convertible. The future SAR will have an independent fiscal system and will not pay taxes to the Central People’s Government. The SAR may also maintain and develop economic and cultural relations and conclude relevant agreements with other states and international organizations under the name of “Hong Kong, China”.

On paper, the agreement seems to allow Hong Kong to carry on “business as usual”, after transfer of sovereignty. Most demands by Hong Kong’s civic and professional organizations concerning their rights and freedoms during the past two years appear to have been accepted and incorporated in the agreement.

The agreement also formally recognizes British rule over Hong Kong until June 30, 1997. This removes the ambiguity and uncertainty over the legitimacy of British presence, since China has never recognized the three “unequal treaties” on which British rule is based. The immediate and practical significance of the agreement is therefore that, in the next 13 years at least, Hong Kong’s present status will remain intact.

The Chinese people of Hong Kong, who constitute 98% of the total population, have reacted to the agreement with mixed feelings. On the one hand, there is widespread satisfaction that a complex issue left over from history has been solved, and China’s national honor has been restored peacefully through diplomatic negotiations; on the other hand, there is equally widespread uneasiness over the prospect that Hong Kong will become part of a totalitarian state. This feeling of unease, however, has been mol-

\textsuperscript{37} The formal title of the agreement is “Joint Declaration of the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People’s Republic of China on the Question of Hong Kong”. Apart from the text of the declaration, there are three annexes. Annex I, which is longer than the declaration, is entitled “Elaboration by the Government of the People’s Republic of China of its Basic Policies Regarding Hong Kong”. The two other annexes deal with the Sino-British joint liaison group and land leases respectively. There is also an exchange of memoranda between the two governments on the question of nationality.
lifted to some extent by the high degree of autonomy granted to Hong Kong, and the guarantees of individual rights and liberties in the agreement, which are more comprehensive and detailed than expected.

On the whole, the Sino-British agreement has been greeted in Hong Kong with relief, but not jubilation. Because the settlement, as already mentioned, had been discounted by the financial markets, the immediate impact of the announcement was minimal. Internationally, most trading partners of Hong Kong—U.S.A., the European Economic Community, Japan, South Korea, Australia and the ASEAN countries—have welcomed the agreement.

It is fair to conclude that, over the short to medium term (say one to eight years), the agreement generally will have a stabilizing effect on the economy of Hong Kong, especially its financial sector. Over the longer run, beyond 1997, uncertainty will remain, despite the settlement. Like any other international treaty, the Sino-British accord is only as good as its faithful observance and implementation. The critical factor is whether China will be willing, or able, to adhere to both the letter and spirit of the agreement. On this there is considerable controversy, into which politics and ideology unfortunately too often intrude themselves. Cynics and critics naturally emphasize the fact that no Communist state ever can be trusted to observe any international agreement. Communist China’s abominable domestic record, according to them, renders its promises about human rights and liberties meaningless.

There is much force, of course, in this line of argument. On the other hand, it can be argued also that historical facts may or may not be relevant for future projections; what is more important is the current and evolving trend. Those who take a more positive view of the Sino-British agreement appeal to the following observations:

1. Although the PRC’s domestic record, especially during the Maoist period, was indeed deplorable, its international record with respect to treaties and agreements has been relatively decent. Specifically, with regard to Hong Kong, the PRC has since 1949, in its dealings with the British Government and Hong Kong Government, by and large observed correctly the three “unequal treaties” which it has never formally recognized;

2. The PRC itself has changed very substantially from its
Maoist days in both its domestic and foreign policies. There is a real difference between the Maoist regime, which was dedicated to class struggle and world revolution, and the post-Mao Dengist regime, which emphasizes modernization and economic reforms, even though both profess to be Marxist-Leninist;

3. There are strong motives and incentives for the PRC to maintain Hong Kong’s stability and prosperity. Economically, Hong Kong regularly provides about a third of China’s hard currency earnings. It also serves as a highly convenient and efficient source of capital funds, market information, managerial expertise, and technological innovations. Politically, a widely perceived successful “Hong Kong model” will be conducive to Peking’s ultimate goal of reunification. Put another way, the existence of a strong and stable Taiwan will exert a restraining influence on Peking’s behavior toward Hong Kong.

Clearly, this view, based on China’s evolving Realpolitik, is also quite persuasive. Only time will tell which view is more correct. At this juncture, all one can hypothesize is that if China really means what it says and allows Hong Kong a high degree of autonomy without undue interference, and more important, if China can ensure internal political stability, and continue its pragmatic, outward-looking program of modernization and reform on a sustained long-term basis, then Hong Kong will have a good chance of surviving, or even prospering, beyond 1997 as a great financial, trading, and manufacturing center. Moreover, the growing China-Hong Kong nexus can become a powerful mutually-reinforcing engine of growth, if China’s modernization drive proceeds on course. That Hong Kong provides a substantial proportion of China’s scarce foreign exchange reserves is already well-known; however, it is not often appreciated that China’s policy of supplying Hong Kong regularly with foodstuff, raw materials, fuel, and consumer goods at competitive prices irrespective of its own political turmoils has stabilized Hong Kong’s domestic costs, and in effect has subsidized Hong Kong’s post-war export-led industrialization. In 1982-83, China suffered an exchange loss of some US$1.1 billion, as a result of the sharp depreciation of the Hong Kong dollar. And yet it has re-

frained from passing on this loss to Hong Kong in the form of higher prices.\(^{39}\)

To conclude, then, Hong Kong’s recent history provides a cautionary tale for all. To Peking, the message is clearly that confidence can be extremely fragile, even in a normally dynamic community, like Hong Kong. Should China plunge into another period of political turmoil after Deng’s death, or should there be a reversal of its present pragmatic policies, the effect on Hong Kong could be even more catastrophic than the crisis of 1982-83. To Hong Kong, the lesson is that various excesses in the financial sector, and laxities in the regulatory framework, must be rectified if its credibility as a leading financial center in the Asian-Pacific region is to be preserved. Finally, Hong Kong’s recent sharp economic recovery shows beyond any doubt that its proverbial resilience will not be easily repressed, as long as its free enterprise system remains intact. Thus it would be premature for the pessimists to write off Hong Kong.\(^{40}\) To paraphrase Mark Twain, the report about Hong Kong’s imminent demise is greatly exaggerated.

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39. The applicable period is from July 1, 1982 to October 17, 1983. It can be plausibly assumed that China converts its Hong Kong dollar earnings as they become due at a steady rate. For our calculation therefore the monthly average exchange rate between the Hong Kong dollar and the US dollar is used. During the period, China’s net trade surplus against Hong Kong was about HK$31,932 million, from which alone an exchange loss of about US$750 million can be inferred. For non-trade earnings, such as remittances, tourism, investment profits etc., I used an extrapolation of my previous estimates. See Y.C. Jao, “Hong Kong’s Role in Financing China’s Modernization”, in A.J. Youngston, supra note 38. This yields another exchange loss of about US$350 million.

40. However much I admire and agree with Professor Chalmers Johnson’s brilliant analysis of the 1997 issue and the course of the Sino-British negotiations, I must beg to differ with him on his recent description of Hong Kong as a “crick”—a “collapsing recently industrialized country” See his “The Mouse-trapping of Hong Kong: A Game in Which Nobody Wins”, Issues and Studies, Vol. XX, No. 8, August 1984, pp. 26-50.
<table>
<thead>
<tr>
<th></th>
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<td>85.8</td>
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<td>104.9</td>
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<td>88.7</td>
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<td>90.1</td>
<td>89.5</td>
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<td>104.0</td>
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<td>109.6</td>
<td>112.2</td>
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<td>72.0</td>
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<td>109.7</td>
<td>112.8</td>
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<td>111.8</td>
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<td>107.4</td>
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<td>108.6</td>
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<td>105.9</td>
<td>107.4</td>
<td>114.4</td>
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<td>88.2</td>
<td>85.9</td>
<td>80.1</td>
<td>68.3</td>
<td></td>
</tr>
</tbody>
</table>

Source: *Hong Kong Monthly Digest of Statistics*
## Table 2

**Growth Rates of Money Stock**

(Percent per annum)

<table>
<thead>
<tr>
<th>Year</th>
<th>Hong Kong</th>
<th>U.S.A.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>M1</td>
<td>M2</td>
</tr>
<tr>
<td>1977</td>
<td>28.6</td>
<td>20.7</td>
</tr>
<tr>
<td>1978</td>
<td>23.2</td>
<td>25.6</td>
</tr>
<tr>
<td>1979</td>
<td>3.7</td>
<td>13.2</td>
</tr>
<tr>
<td>1980</td>
<td>15.7</td>
<td>28.7</td>
</tr>
<tr>
<td>1981</td>
<td>4.1</td>
<td>21.3</td>
</tr>
<tr>
<td>1982</td>
<td>9.1</td>
<td>77.0</td>
</tr>
<tr>
<td>1983</td>
<td>12.4</td>
<td>24.7</td>
</tr>
<tr>
<td>Average</td>
<td>13.8</td>
<td>30.2</td>
</tr>
</tbody>
</table>

**Source:** For Hong Kong, *Hong Kong Monthly Digest of Statistics*. For U.S.A., *Federal Reserve Bulletin*.

**Definitions:**

**Hong Kong Money Supply**

- **M1** = Total legal tender notes and coins with the public, plus customers' demand deposits with licensed banks.
- **M2** = Total M1 plus customers' savings and time deposits with licensed banks, plus negotiable certificates of deposit issued by licensed banks and held outside the monetary sector.
- **M3** = Total M2 plus customers' deposits with licensed and registered deposit-taking companies, plus negotiable certificates of deposit issued by deposit-taking companies held outside the monetary sector.

**U.S. Money Supply**

- **M1** = The sum of (1) currency with the public; (2) travelers checks of nonbank issuers; (3) demand deposits at all commercial banks other than those due to domestic banks, the U.S. Government, and foreign banks and official institutions less cash items in the process of collection and Federal Reserve float; and (4) other checkable accounts at banks and thrift institutions.
- **M2** = M1 plus money market deposit accounts, savings and small-denomination time deposits at all depository institutions, overnight repurchase agreements at commercial banks, overnight Eurodollars held by U.S. residents other than banks at Caribbean branches of member banks and balances of money market mutual funds.
- **M3** = M2 plus large-denomination time deposits at all depository institutions, term RPs at commercial banks and savings and loan associations, and balances of institution-only money market mutual funds.
## Hong Kong's Financial Crisis

### Table 3

**Average Yield on 3-month Deposits**

(Percent per annum)

<table>
<thead>
<tr>
<th>Year</th>
<th>Hong Kong</th>
<th>Euro-dollar Market</th>
<th>Nominal Differential</th>
<th>Real Differential</th>
</tr>
</thead>
<tbody>
<tr>
<td>1977</td>
<td>2.35</td>
<td>6.32</td>
<td>-3.97</td>
<td>-4.97</td>
</tr>
<tr>
<td>1978</td>
<td>2.98</td>
<td>8.85</td>
<td>-5.87</td>
<td>-4.07</td>
</tr>
<tr>
<td>1979</td>
<td>7.30</td>
<td>12.09</td>
<td>-4.79</td>
<td>-5.49</td>
</tr>
<tr>
<td>1980</td>
<td>8.16</td>
<td>14.19</td>
<td>-6.03</td>
<td>-7.83</td>
</tr>
<tr>
<td>1981</td>
<td>11.42</td>
<td>16.78</td>
<td>-5.36</td>
<td>-9.86</td>
</tr>
<tr>
<td>1982</td>
<td>9.27</td>
<td>13.16</td>
<td>-3.89</td>
<td>-8.79</td>
</tr>
<tr>
<td>1983</td>
<td>8.37</td>
<td>9.61</td>
<td>-1.34</td>
<td>-8.04</td>
</tr>
</tbody>
</table>

Source: For Hong Kong, *Hong Kong Monthly Digest of Statistics* and Hong Kong Association of Bank; for Euro-dollar market, *International Financial Statistics* and *Euromoney*.

Note: The Hong Kong rates were those quoted by Category II banks in the Interest Rate Agreement of the Hong Kong Association of Banks, which were higher than those quoted by Category I banks by half percentage point.

Real differential is nominal differential adjusted for consumer price inflation.

### Table 4

**Visible and Invisible Trade Account**

(HK$ mn.)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic Exports</td>
<td>40,711</td>
<td>55,912</td>
<td>68,171</td>
<td>80,423</td>
<td>83,032</td>
<td>104,405</td>
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<tr>
<td>Re-exports</td>
<td>13,197</td>
<td>20,022</td>
<td>50,072</td>
<td>41,739</td>
<td>44,353</td>
<td>56,294</td>
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<tr>
<td>Imports of Goods</td>
<td>65,103</td>
<td>85,908</td>
<td>111,651</td>
<td>158,375</td>
<td>142,893</td>
<td>175,442</td>
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<tr>
<td>Visible Trade Balance</td>
<td>-9,195</td>
<td>-9,974</td>
<td>-13,408</td>
<td>-16,212</td>
<td>-15,508</td>
<td>-14,743</td>
</tr>
<tr>
<td>Visible Trade Gap (%)</td>
<td>14.6</td>
<td>11.6</td>
<td>12.0</td>
<td>11.7</td>
<td>10.9</td>
<td>8.4</td>
</tr>
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</table>

<table>
<thead>
<tr>
<th>Invisible Trade</th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Exports of Services</td>
<td>14,737</td>
<td>19,258</td>
<td>22,203</td>
<td>27,218</td>
<td>30,088</td>
<td>35,106</td>
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<tr>
<td>Imports of Services</td>
<td>8,278</td>
<td>11,968</td>
<td>14,912</td>
<td>19,234</td>
<td>20,796</td>
<td>24,655</td>
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<tr>
<td>Invisible Trade Balance</td>
<td>6,459</td>
<td>7,290</td>
<td>7,291</td>
<td>7,984</td>
<td>9,292</td>
<td>10,451</td>
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Source: Hong Kong Government, *1984 Economic Prospects*
## Table 5

**Unadjusted Composition of Hong Kong Money Supply**

(Per cent)

<table>
<thead>
<tr>
<th>Time</th>
<th>M1</th>
<th>M2</th>
<th>M3</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>HK$</td>
<td>Foreign Currency</td>
<td>HK$</td>
</tr>
<tr>
<td>June 30, 1982</td>
<td>92.3</td>
<td>7.7</td>
<td>64.5</td>
</tr>
<tr>
<td>Sept. 30, 1983</td>
<td>91.9</td>
<td>8.1</td>
<td>50.1</td>
</tr>
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</table>

Source: Underlying data from *Hong Kong Monthly Digest of Statistics*

## Table 6

**Adjusted Composition of Hong Kong Money Supply**

(Per cent)

<table>
<thead>
<tr>
<th>Time</th>
<th>M1</th>
<th>M2</th>
<th>M3</th>
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<tr>
<td></td>
<td>HK$</td>
<td>Foreign Currency</td>
<td>HK$</td>
</tr>
<tr>
<td>June 30, 1982</td>
<td>92.3</td>
<td>7.7</td>
<td>64.5</td>
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<tr>
<td>Sept. 30, 1983</td>
<td>93.6</td>
<td>6.4</td>
<td>60.8</td>
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Source: Underlying data from *Hong Kong Monthly Digest of Statistics*
Table 7

NET FINANCIAL TRANSACTIONS BETWEEN
HONG KONG & CHINA*
(million Hong Kong dollars)

<table>
<thead>
<tr>
<th>Date</th>
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<th>Desposit-taking Companies</th>
<th>Total</th>
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</thead>
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<td>March 31, 1979</td>
<td>+4,725</td>
<td>+96</td>
<td>+4,821</td>
</tr>
<tr>
<td>June 30, 1979</td>
<td>+5,231</td>
<td>+102</td>
<td>+5,333</td>
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<tr>
<td>Sept. 30, 1979</td>
<td>+5,266</td>
<td>+116</td>
<td>+5,382</td>
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<tr>
<td>Dec. 31, 1979</td>
<td>+5,701</td>
<td>+32</td>
<td>+5,733</td>
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<tr>
<td>March 31, 1980</td>
<td>+5,386</td>
<td>+190</td>
<td>+5,576</td>
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<tr>
<td>June 30, 1980</td>
<td>+4,676</td>
<td>+445</td>
<td>+5,121</td>
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<tr>
<td>Sept. 30, 1980</td>
<td>+4,617</td>
<td>+390</td>
<td>+5,007</td>
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<td>Dec. 31, 1980</td>
<td>+5,352</td>
<td>+445</td>
<td>+5,797</td>
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*A negative sign denotes net liabilities to China, while a positive sign denotes net claims on China

Source: Underlying data from Hong Kong Monthly Digest of Statistics
Hong Kong’s Prosperity: Foundation and Prospects

Chu-yuan Cheng
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The recent signing of the Sino-British Joint Declaration on the Questions of Hong Kong concluded a lengthy period of negotiation. Now that the problem of sovereignty has been resolved, the main concern of the 5.5 million Hong Kong residents is whether the region’s prosperity can be maintained during the 13-year transitional period, and what the prospects are for Hong Kong’s economy after 1997.

FOUNDATION OF HONG KONG’S PROSPERITY

When China ceded Hong Kong to the British in 1842, it was a barren fishing village with a population of less than 20,000. In the course of 142 years the territory has developed into the world’s third largest financial center with a per capita income of $5,100 ranking third highest in Asia.¹ This economic miracle is the result of several historical and institutional factors.

1) Legal and economic environment

Hong Kong has been the epitome of the classic economic model of laissez-faire. The British authorities adopted a free-port policy, and an English legal system has provided law and order, protected private property, and administrated justice. The government had provided the social infrastructure for the economy, but it also has allowed the market mechanism to determine allocation of productive resources. Governmental non-intervention, coupled with a traditional work-ethic on the part of the local population, has created a very attractive environment for foreign investors.²

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(2) *Ample supply of skilled labour*

As an enclave to China, immune to China’s internal disturbances, Hong Kong has served as a shelter for Chinese entrepreneurs and capital. During historic periods of turmoil such as the Taiping Rebellion, the 1911 Revolution, and the early stages of the Sino-Japanese War, Hong Kong absorbed a huge influx of Chinese capital. The 1949 revolution drove large numbers of adventurous entrepreneurs and skilled laborers to Hong Kong. Chinese immigrants have created a reservoir of manpower which have kept wages flexible and responsive to external conditions. This has contributed significantly to Hong Kong’s competitive edge in the world market.

(3) *High rate of capital formation*

A long period of tranquility attracted Southeast Asian capital. The continuous influx of foreign capital facilitated high rates of capital formation. In the mid-60s investment was estimated to be 20% of total expenditure. This figure rose to 27% between 1977 and 1981. The annual growth-rate of capital formation in 1971-1980 was 12.4% compared to 9.8% for private consumption and 8.9% for general consumption.

(4) *Rapid expansion of foreign trade*

Hong Kong, like Japan and Taiwan, followed a strategy of export-expansion. Foreign trade was the driving force behind its growth and accounted for 60% of its GNP in 1983. During the 1966-1981 period, when Hong Kong’s GDP (at constant prices) grew at 9.45% per annum, exports grew at 11.4%. Between 1975 and 1982 exports grew at 20% per annum. The high rate in the growth of exports was spurred by the emergence of new products. Exports of watches and clocks, for example, grew from HK$175 million in 1971 to HK$1,694 million in 1977, and accelerated to a staggering HK$7,168 million in 1982, accounting for...

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one-third of the total world supply. Other new products, such as toys and transistors, have advanced to the front ranks of the world market. Hong Kong’s total trade in 1984 (including re-exports) may have exceeded $55 billion, ranking 16th in the world.

(5) Rise of the tertiary sector

The rapid growth of industry and foreign trade substantially increased per capita income and created a strong demand for housing and real estate. A real estate boom, beginning in the early 1970s, reached its peak in 1981. Corresponding to the real estate boom, Hong Kong’s banking business also entered a period of great expansion. By December 1982 total banking assets reached HK$600 billion. In the last six years employment in trade, services, the financial sector, and government has grown at the rate of 8% per annum as compared to 3% for general employment, reflecting rapid growth in the tertiary sector.

(6) Constant improvements of infrastructure

Expansion in employment and high land prices provided increased financial resources to permit the Hong Kong government to improve the social infrastructure. The most notable contributions were the construction of the Hong Kong-Kowloon tunnel and subway systems, improvement of the school system, and large-scale construction of public housing. By 1977 public housing projects accommodated two million people, accounting for 45% of the colony’s total population.

These six factors form an upward spiral, since each stimulates the others. Should there be no external disturbance, Hong Kong could become one of the advanced industrialized economies in the world by the end of this century.

The Impact of 1997

The upward spiral was disrupted suddenly in September 1982 when British Prime Minister Margaret Thatcher visited Peking to initiate talks regarding Hong Kong’s future status. Peking’s re-

8. Christopher Howe, supra note 4.
sponse was the announcement of its intention to reclaim sovereignty over Hong Kong in 1997. This decision immediately touched off a chain reaction.

First, since China is a socialist state based on public ownership of means of production and central planning, there arose a genuine fear that once the transfer of sovereignty takes place the legal basis of private property and personal freedom will not be maintained. Worry concerning the region’s political future sent local stock and property values into a deep slump. During the past two years local stock prices fell by 20%, while property values dropped more than 50%,\(^{10}\) causing the bankruptcy of many real estate companies, including Carrian Investments, once the fastest rising star in Hong Kong’s real estate market.

Second, lack of confidence in the future prompted a precipitous decline of the value of the Hong Kong dollar. In the short span of three years, the exchange rate between the Hong Kong and the U.S. dollars dropped by 50% from HK$4.8 to US$1, in July 1980, to HK$9.6 to US$1, on September 24, 1983. After Hong Kong government intervention in October 1983 the rate has stabilized.\(^{11}\) The current rate of HK$7.8 to US$1 is still 40% below that of July 1980.

Third, concerned about the eventual evacuation of British authorities, several major British conglomerates opted for early withdrawal. Jardine Matheson & Co., the “Noble House” of the Colony since 1841, decided on March 28, 1984, to move its headquarters to Bermuda. Another major British firm, Hutchison Whampoa, distributed HK$2 billion out of its HK$2.5 billion cash reserve as special dividends to its stockholders in March 1984, instead of re-investing it.\(^{12}\) The Hong Kong and Shanghai Bank, a British bank which functions as Hong Kong’s central bank, has transferred 70% of its assets outside the colony. Four years ago it acquired 51.08% of Marine Midland Bank, the 15th largest bank in the USA.\(^{13}\) This illustrates the rapid exodus of British capital from Hong Kong.

Fourth, deeply concerned by the uncertainty of the future, many Chinese capitalists have transferred capital abroad. Ac-

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\(^{10}\) The Hang Seng Stock Index which reached 1,472 in January 1982 fell to 676 in the winter of 1982. It stood at around 1,000 by November, 1984.


\(^{13}\) *China Daily News*, New York, August 9, 1984.
According to an Australian government report, $730 million were transferred to Australia in 1983. An August 1984 Newsweek report estimated that several billion US dollars had fled to Canada and the USA. The sharp rise in real estate values in the Chinatowns of New York, San Francisco, Los Angeles, and Toronto, reflects this flight of capital from Hong Kong. Moreover, there has been an increasing exodus of professional manpower.

In less than three years the social psychology of the colony has changed from a state of euphoria to dismay. Factors which previously had fostered Hong Kong’s economic growth have rapidly disappeared. The possibility of loss of personal freedom and change in legal structure threatens Hong Kong’s role as shelter for capital from China and Southeast Asia. In contrast, local Hong Kong capital is now looking for shelter in Singapore, Australia, and North America. The sharp decline in real estate values has reduced government revenues and forced suspension or postponement of many construction projects essential to Hong Kong’s economy. The exodus of social elite threatens the improvement of Hong Kong’s industrial structure. Instead of enjoying an upward spiral, the Hong Kong economy is confronting a vicious circle.

China’s Efforts to Maintain Prosperity

Because of Hong Kong’s vital importance to China’s modernization, Peking authorities have put forward a series of programs to dispel people’s fears. In October 1984 Peking announced a six-point statement of principles with the intention of restoring people’s confidence in Hong Kong’s future:

1. Hong Kong will become a “special zone” of the People’s Republic of China with a high degree of autonomy and with administration of the territory in the hands of Hong Kong people.
2. The territory’s socio-economic system will remain unchanged for fifty years after 1997.
3. Hong Kong’s present legal system will continue.
4. The Hong Kong dollar will remain an international currency.
5. In economic affairs Hong Kong will be allowed to deal

15. South China Morning Post, Hong Kong, October 24, 1983 p.15.
freely with the rest of the world, although foreign policy will be determined by the People's Republic of China.

(6) Hong Kong's lifestyle will not be altered.

The recent Sino-British Joint Declaration has followed those principles in more detail. The following provisions are intended to maintain the status quo of Hong Kong:16

(1) The territory's legal system will be preserved, and the power to make laws will continue to reside with Hong Kong legislative authority. Judicial power, including right of final appeal, will reside in Hong Kong courts.

(2) Hong Kong will be able to determine its economic and trade policies, and maintain its status as a free port. Rights of property ownership and free movement of goods will be preserved.

(3) Hong Kong will maintain its status as a separate customs territory, free to participate in international trade organizations and to enjoy its own export quotas.

(4) Hong Kong will manage its own financial affairs and raise its own revenues for its purposes. The Hong Kong dollar will be convertible freely into other currencies.

(5) Hong Kong residents will retain their rights to travel abroad, and their freedom of choice of education. Public servants can keep their jobs and pension rights.

To enhance further the people's confidence in the special zone status, Peking leadership has advanced the concept of "one nation, two systems," emphasizing its desire for a long-term co-existence of socialist and capitalist systems. As one Chinese official put it, "The goal of China is to keep the capitalist economy of Hong Kong as a gateway to the international market, technology transfer, and management know-how."17

The People's Republic of China has stepped up direct investment in Hong Kong to replace the depleted British capital. There are now more than fifty Chinese state enterprises in Hong Kong under the supervision of the China Resource Corporation, an agency of the Ministry of Foreign Economic Relations and Trade, and the Guangda Industrial Co., a newly established quasi-state enterprise. Total direct investment has been disclosed officially as US$4 billion, far exceeding Hong Kong's investment in China.18 This investment extends to various fields including the stock exchange, real estate, and supermarkets.

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financial network centering around the Bank of China and its thirteen associated banks has absorbed a sizeable amount of deposits and issues huge quantities of loans to local industries.

Furthermore, to make Hong Kong more dependent upon the mainland market, The People’s Republic has increased trade with Hong Kong. In 1978 China imported only HK$81 million from Hong Kong, making it the 37th partner in Hong Kong’s export market. By 1982 China became Hong Kong’s fourth largest export market with imports of HK$3.8 billion. In the first nine months of 1984 China had advanced to become the second largest export market for Hong Kong.19

Another measure to restore local confidence has been the intensive campaign to persuade American and Japanese businessmen to increase investment in Hong Kong. Ji Pengfei, Director of Hong Kong and Macao Affairs of the PRC State Council visited Japan in June 1984 to engage in personal solicitation of Japanese investors.

These strenuous endeavours, however, have failed to prevent the outflow of local capital and professional manpower. Overt differences among Chinese leaders concerning the Hong Kong issue, and many mistakes in investment operations have deepened the credibility crisis for local residents. The most dramatic event occurred on May 26, 1984, when Deng Xiaoping openly denounced Huang Hua and Geng Biao, two vice-chairmen of the National People’s Congress on the issue of stationing the PLA in Hong Kong.20 Deng’s public castigation of high officials alarmed the local people. Their confidence was shaken further in June by the sudden cancellation of an earlier commitment to purchase a large real estate property worth HK$970 million by the Guangda Industrial Co. This helped to reinforce the downward spiral of Hong Kong economy.

**Hong Kong Prosperity at Stake.**

The twelve years between 1985 and 1997 will be a period of trial for Hong Kong prosperity.

First, Hong Kong’s prosperity stems from its long-time stability. After the British Parliament approves the Joint Declaration

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the present administration in Hong Kong becomes a lame-duck government. There will be a power vacuum before the new autonomous authority is established. In a society such as Hong Kong which permits a maximum degree of personal freedom and a minimum degree of social control, the existence of organized crime and underground activities is inevitable. In recent years the rising index of violent crime has become a great concern of local residents.  

Second, from 1950 to 1977 the Hong Kong government was able to maintain a budget surplus. As a result of falling real estate values and a lower growth rate of GNP, Hong Kong is facing a large budget deficit. It was HK$3.5 billion in 1982, HK$3.1 billion in 1983, and an estimated HK$2.1 billion in 1984. It is expected that the deficits will remain until 1986. This has drained Hong Kong’s money reserves and will force the government to raise taxes next year.

Third, with few natural resources Hong Kong depends on expanding foreign trade for survival. Hong Kong may lose some of its favorable conditions for trade expansion. It has signed more than 300 treaties and agreements with foreign governments to conduct business. Some may be terminated after 1997. Approximately half of Hong Kong’s manufactured exports are under quota restrictions. Recent USA regulations regarding original place of manufacturing affected one-seventh of Hong Kong’s textile exports to the USA which, in turn, affected 50,000 textile workers and 200,000 people. Apart from rising protectionism in Western countries, Hong Kong faces fierce competition from other newly industrialized countries, notably Singapore, Taiwan, and South Korea. This is especially keen with regard to electronics and computers. These three countries have poured enormous capital and technical manpower into these new industries. Without large-scale new investment to match, Hong Kong will lose its competitive edge.

Fourth, although China recently has channeled more capital into Hong Kong than the total of Hong Kong’s investment in the mainland, this is only a temporary situation. To attain the pro-

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23. Hong Kong Annual Report, various years.
claimed goal of quadrupling the gross output value of agriculture and industry by 2000, China has to borrow US$200 billion in foreign capital, a substantial portion of which is to come from Hong Kong. When fourteen coastal cities were opened to foreign investment delegations were dispatched to Hong Kong to solicit local capital. This continued drain on Hong Kong capital will hamper its efforts at improving its own industrial structure.

Fifth, Hong Kong's most significant asset is its human capital. Two-thirds of Hong Kong's 5.5 million population are refugees from China or their descendents. Facing transfer of sovereignty in twelve years those who can afford it have made contingency plans to leave Hong Kong. Some have sent families abroad to establish residency which will facilitate their own emigration later. 26 Many businessmen now prefer to rent rather than buy factory space. Others have postponed expansion plans. Loss of entrepreneurship may undermine the basic foundation of Hong Kong's prosperity.

In short, the prosperity of Hong Kong cannot be guaranteed by the recent Joint Declaration. Unless the People's Republic faithfully carries out its part of the agreement, local confidence cannot be restored. Without confidence in the future Hong Kong's prosperity will fade away.

26. In 1983, a total of 14,133 Hong Kong residents migrated to other countries. This figure has doubled that in 1978. China Times, New York, October 20, 1984.
The 1984 Sino-British Agreement on Hong Kong and Its Implications on China's Unification*

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On September 26, 1984, the United Kingdom (UK) and the People's Republic of China (PRC) initialed, after almost two years of negotiation, a Joint Declaration on the Question of Hong Kong.¹ The agreement was well received by the United States, Japan, Southeast Asian countries and West European countries,² all of whom have a stake in the continuation of the stability and prosperity of Hong Kong – the third largest financial center of the world, in the post-1997 period. While this agreement is related solely to the Hong Kong question, when the PRC negotiated the agreement with the UK, it was fully aware of the agreement's implications on the unification of Taiwan with the mainland. From the PRC's point of view, this agreement is an example of successful implementation of the "one country, two systems" policy advocated by Teng Hsiao-p'ing, which should serve as the basis for incorporating Taiwan into the PRC.³

Prepared for presentation at the 26th Annual Meeting of the American Association for Chinese Studies, November 2-4, 1984, Radisson Hotel, Wilmington, Delaware.

On October 4, 1984, the Foreign Minister of the Republic of China, Chu Fu-sung, told the Foreign Affairs Committee of the Legislative Yuan (Congress) that the so-called theory of "one country, two systems" is nothing but a guise used to confuse foreign nations as the Chinese Communists pursue their political plots. He thus categorically rejected the Hong Kong model as the basis for unification.

This paper intends to analyze the question of whether the Hong Kong model is an appropriate and practical one to achieve the goal of a peaceful unification of China. It will begin with an analysis of the international validity of the PRC-UK Joint Declaration.

The International Validity of the Sino-British Joint Declaration

The Joint Declaration contains eight parts, three annexes, and two memoranda, since Part 8 of the Declaration provides that "[t]his joint declaration and its annexes shall be equally binding," there should be no doubt on the legal validity of the entire document. Moreover, this declaration, as provided in Part 8, "is subject to ratification and shall enter into force on the date of the exchange of instruments of ratification," just like any other formal treaty concluded between states; therefore, though this document takes the form of a "declaration," it is a formal international agreement similar to a treaty under international law. The validity of an international agreement is not dependent on the name given to the document, be it called "treaty," "agreement," "declaration" or any other name. All international lawyers, including those in the United Kingdom and the PRC, support this view. In view of this, if the PRC reneges

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4 "Foreign Minister Rejects Hong Kong Solution," FBIS, China, October 5, 1984, p. V1.
5 E.g., see Article 4 of Harvard Research in International Law which states: "The international juridical effect of a treaty is not dependent upon the name given to the instrument." Cited in William W. Bishop, Jr., International Law, Cases and Materials, 3rd ed. (Boston and Toronto: Little, Brown and Co., 1971), p. 93.
on its assurance on Hong Kong after 1997, the UK could invoke the 
Joint Declaration to make a diplomatic presentation to the PRC even 
if Hong Kong was by then Chinese territory. However, this appears 
to be an unlikely event. More probably the two sides might take 
different interpretation in the application or implementation of 
provisions of the Joint Declaration. For this situation, the Joint 
Declaration provides no procedure to resolve the dispute.

In accordance with international practice, if an international 
agreement does not provide a procedure to settle the dispute relating 
to the application or interpretation of the agreement, both parties 
can only resort to negotiation or other agreed modes of settlement.⁷ 
The PRC is well known to disfavor third party adjudication in the 
settlement of its international disputes.⁸ Moreover, despite the fact 
that the UK has accepted the compulsory jurisdiction of the Interna-
tional Court of Justice (ICJ),⁹ the PRC has, after its taking over 
the Chinese seat in the UN in 1971, refused to recognize the validity 
of the Republic of China's acceptance of the Court's jurisdiction 
in 1946.¹⁰ Therefore, there is no way to refer the interpretation 
dispute to the ICJ for an impartial adjudication.

In case of negotiating a settlement on a dispute relating to the 
application or interpretation of the Joint Declaration, the UK is in 
an unfavorable position. This is because, despite the lengthy content 
of the documents, the Declaration contains certain subtle grey areas, 
vague in nature, that would allow the PRC to maneuver its application 
without literally violating the Declaration. The next section will 
expand on this point.

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⁷E.g., see the following statement given by the Permanent Court of International 
Justice in the 1923 Advisory Opinion on the Status of Eastern Carelia: “It is 
well established in international law that no state can, without its consent, be 
compelled to submit its disputes with other states either to mediation or to 
arbitration, or to any other kind of pacific settlement.” Cited in Bishop, Interna-
tional Law, supra note 5, p. 74.

⁸Except for commercial contracts, the PRC has consistently favored direct 
negotiation to resolve international dispute and it has not yet accepted any 
third party adjudication on its dispute. See Liu Feng-ming, Hsien-tai kuo-chi-
fa kang-yao (現代國際法綱要 Outline of Modern International Law) (Peking: 

⁹For the text of UK's acceptance of the compulsory jurisdiction of the Interna-
tional Court of Justice, see International Court of Justice Yearbook 1982-

¹⁰See Wang and Wei, International Law, supra note 6, p. 480.
The Essence of the Sino-British Joint Declaration on the Post-1997 Hong Kong Regime

The Joint Declaration contains more than 8,000 words and is, perhaps, the second longest international agreement ever concluded by the PRC.\textsuperscript{11} It spelled out in detail the PRC's policy toward Hong Kong, the post-1997 Hong Kong regime and its international relations. The highlights of the Declaration are as follows:

(1) After 1997, Hong Kong will become a Special Administrative Region of the PRC under Article 31 of the PRC Constitution.\textsuperscript{12} It will enjoy a "high degree of autonomy" except in foreign and defense affairs.

(2) Hong Kong will be vested with executive, legislative and independent judicial power, including that of final adjudication.

(3) Hong Kong's chief executive will be appointed by the PRC after elections or consultation in Hong Kong. The government of Hong Kong will be composed of local people.

(4) Hong Kong shall maintain the capitalist economic and trade systems for 50 years after 1997.

(5) The existing social and economic system will remain unchanged. Freedom of speech, movement, the press, assembly, strike, religion, and others will be protected by law. Similarly, private property rights will be protected.

(6) Apart from displaying the national flag and national emblem of the PRC, Hong Kong may use a regional flag and emblem of its own.

(7) Hong Kong may participate in relevant international organizations and international trade agreements. It may establish official and semi-official economic and trade missions in foreign countries. Using the name "Hong Kong, China" to maintain and develop relations and conclude and implement agreements with states, regions and relevant international organizations in appropriate fields.

(8) The PRC defense force stationed in Hong Kong shall

\textsuperscript{11} The longest PRC treaty is the 1962 boundary treaty with Mongolia.
\textsuperscript{12} Article 31 provides: "The state may establish special administrative regions when necessary. The systems to be instituted in special administrative regions shall be prescribed by law enacted by the National People's Congress in the light of the specific conditions."
not interfere in the internal affairs in Hong Kong and the expenditures for these military forces shall be borne by the PRC's Central People's Government.

Under the above arrangements, on the surface Hong Kong will enjoy a "high degree of autonomy," but a closer analysis of the Declaration and the PRC's 1982 Constitution casts serious doubt on the durability and credibility of such autonomy. First, under Article 1 of Annex 1 of the Declaration, the PRC's National People's Congress (NPC) shall enact a basic law of the Hong Kong Special Administrative Region to guarantee the continuation of Hong Kong's capitalist system and lifestyle for 50 years and other matters as provided in the Joint Declaration. While under the PRC's law, Hong Kong may elect roughly 40 delegates to the NPC, the practical use and strength of 40 Hong Kong delegates among the 3,400 delegates in the NPC's decision-making process would be insignificant. Moreover, Article 67, paragraph 4, of the Constitution, provides that the Standing Committee of the NPC shall have the power "to interpret statutes," thus both the legislative and interpretative powers of the basic law for Hong Kong are in the hands of the NPC. Under such circumstances, the so-called "high degree of autonomy" is at the mercy of the NPC and thus without credible guarantee.

Second, under Article 2, paragraph 1, of Annex 1 of the Declaration, "after the establishment of the Hong Kong Special Administrative Region, the laws previously in force in Hong Kong...shall be maintained, save for any that contravene the Basic Law...." As stated above, the Standing Committee of the NPC has the right to "interpret statutes"; therefore, the Standing Committee could annul those local Hong Kong laws which it dislikes on the ground that they contravene the Basic Law.

Third, while Article 2, paragraph 2 of Annex 1 of the Declaration provides that the Hong Kong "Legislature may on its own authority enact laws in accordance with the provisions of the Basic Law and

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13 According to PRC law, city residents can elect one delegate for every 130,000 persons, while rural residents can elect one delegate for every 1,040,000 persons. See 1983 Chung-kuo pai-k'e nien-chien (1983 年中國百科年鑑 1983 Yearbook of the Encyclopedia of China) (Shanghai: Hsinhua Press, 1983), p. 226. Assuming all Hong Kong residents are considered city residents, its 5,147,900 population can elect roughly 40 delegates.

legal procedure”; Article 67, paragraph 8 of the PRC Constitution provides that the Standing Committee of the NPC has the power “to annul those local regulations or decisions of the organs of state power of... autonomous regions... that contravene the Constitution, the statutes or the administrative rules and regulations,” thus effectively place a severe restraint on the legislative power of Hong Kong legislature.

Fourth, under Article 89, paragraph 14, of the PRC Constitution, the State Council (Cabinet) has the power “to alter or annul inappropriate decisions and orders issued by local organs of state administration at different levels,” therefore the PRC’s State Council can interfere, based on a legal foundation, with the Hong Kong government’s administrative function at anytime if it chooses to do so.

Fifth, Article 1, paragraph 3 of Annex 1 of the Declaration provides that the “chief executive of the Hong Kong Special Administrative Region shall be selected by election or through consultation held locally and be appointed by the Central People’s Government.” Since the PRC has the final say on the appointment of the chief executive, to what extent the Hong Kong people have the free will to choose their chief executive is open to serious doubt. In a genuine federal country, the election of the chief executive of a member state is the sole decision of the people of that state without any participation of the central government. For instance, in the United States, a governor of a state is elected by the people of that state and there is no way for the President or federal government to block that selection.

In view of the above analysis, it is clear that the so-called “high degree of autonomy” for Hong Kong has no credible guarantee and the PRC can legally interfere with the legislative and administrative operation of Hong Kong at any time it chooses to do so. Two days after the announcement of the Joint Declaration, a lengthy article was published in the authoritative People’s Daily vividly explaining the nature of the special administrative region as follows:

First of all, to safeguard China’s sovereignty, unity, and territorial integrity is a basic principle we should adhere to in establishing special administrative regions. Our country should be a unified country. There is only one China in the world, and that is the People’s Republic of China. It exercises sovereignty over its special administrative regions. Ours is a socialist country with a unitary system. It is not a federal country. The NPC is the supreme power organ of the state and its permanent body is the NPC Standing Committee. Both exercise the legislative power of the state. The State
Council, that is, the central people's government, is the executive body of the supreme power organ of the state and the highest organ of state administration. The special administrative regions are local administrative regions under the unified central leadership. They are not member states. The relationship between the special administrative regions and the central authorities is one between localities and central authorities. They must exercise their powers within the limits of their authority as prescribed by the laws enacted by the NPC.\textsuperscript{15}

From the above quotation, one can clearly understand that the "special administrative region" and "high degree of autonomy" are all "special favors" granted by the PRC's central authorities and there is no credible guarantee that it will not be changed in "appropriate time." Any attempt by the PRC's central authorities to change the status of special administrative region is, according to the PRC logic, also an internal affair of China.

Can the Hong Kong Model Serve as the Basis for Peaceful Unification with Taiwan

On September 27, 1984, a day after the announcement of the Joint Declaration, an editorial of the authoritative People's Daily stated that the Hong Kong Declaration will "promote Taiwan's return to the motherland" and notes how the same formula could be applicable to Taiwan.\textsuperscript{16} The ROC government and public opinion in Taiwan immediately rejected this expectation.\textsuperscript{17} Why? The reason is simple. By agreeing to become a "special administrative region" of the PRC, the ROC would immediately lose its international personality and sovereignty. Without international personality and sovereignty, there would be no legal restraints to prevent the PRC from taking away what it promised Taiwan at the time of unification.\textsuperscript{18} In this connection, one needs only to recall the recent "autonomy" experience of Tibet under the PRC between 1950 and 1959.

\textsuperscript{16}People's Daily, September 27, 1984, pp. 1, 4.
\textsuperscript{17}See note 4 supra and accompanying text.
On May 23, 1951, an agreement on the "peaceful liberation" of Tibet was concluded. According to the agreement, the PRC agreed, among other matters, not to "alter the existing political system in Tibet," "the established status, functions, and powers of the Dalai Lama," and that all "officials of various ranks shall hold office as usual." It also provided that the "Tibetan people have the right of exercising national regional autonomy." It was under those conditions that the Tibetan people returned "to the big family of the motherland — the People's Republic of China." As the PRC Party, military, and government cadres entered Tibet in increasing numbers, their impact upon politics, economy, religious life, and educational system of that region became correspondingly more pronounced. When they were followed by masses of Chinese immigrants, violence began to break out in sections of Tibet. Then, in 1959, widespread rebellion against the PRC broke out in Tibet. The revolt was ruthlessly put down by the PRC's "People's Liberation Army" and the Tibetan government was dissolved.\(^{19}\)

In the case of Taiwan, the PRC leaders have stated that no military or administrative personnel will be sent to Taiwan after unifications. But, as the case of stationing troops in Hong Kong indicates, the PRC leaders may change their minds at any time.\(^{20}\) There is no credible guarantee to prevent the PRC from doing so.

Moreover, in the case of Hong Kong, the PRC's promise to maintain the status quo there is at least incorporated in an international agreement. However, this will not be the case for Taiwan. The PRC has insisted on negotiation between the Chinese Communist Party and the Chinese Nationalist Party; thus, even if the two parties reached an agreement it would not be an international agreement and would have no validity under international law. Thus, after unification, Taiwan would be in a much worse situation than Hong Kong if the PRC reneged on the unification agreement, as no country has a legal right to urge the PRC to honor the agreement.

The history of PRC-UK negotiation, and the tactics of the PRC to press concessions from the UK have also strengthened the ROC's

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conviction that to initiate negotiations with the PRC could only bring disaster to Taiwan. For almost two years when the UK and the PRC were engaging in negotiations, the financial market in Hong Kong was in disarray, real estate transactions were depressed and at a virtual standstill, and the population transferred a large amount of capital to other countries. Therefore, once the ROC would begin negotiations with the PRC on the Hong Kong model approach to the unification, a similar situation most likely would occur in Taiwan, and might even cause severe political chaos.

The history of UK-PRC negotiation on Hong Kong will not encourage the ROC to negotiate with the PRC. A familiar tactic of the PRC in negotiations is to put pressure on the other side to agree on the principle first. Once the other side agrees to the principle, then the PRC presents a posture of flexibility and generosity in negotiating concrete arrangements in implementing the principle. This is because in the future the PRC can renege on any part of the concrete arrangement by invoking the agreed principle. Moreover, even in the concrete arrangements, which are usually spelled out in great detail to show the "sincerity" of the PRC, a provision is always included to reserve the PRC's right to cancel all or part of the arrangements. The history of Hong Kong negotiation vividly illustrates this tactic.

When the negotiations on Hong Kong began, the PRC insisted on the principle of establishing sovereignty in 1997 over both the leased territory and those parts (Hong Kong Island and the Kowloon Peninsula) ceded to the UK under two Sino-British treaties.\(^{21}\) The negotiation was deadlocked over this issue for sometime until the UK finally agreed to this principle. Then, both sides began seriously to negotiate on details of the post-1997 Hong Kong regime and system. Even then, the PRC continued to put undue pressure on the UK. For instance, the PRC announced that unless an agreement was reached by September 1984, it would unilaterally announce its own program for governing post-1997 Hong Kong. Under such Chinese pressure, the agreement on Hong Kong was reached.

Commenting on the history of Hong Kong negotiation, ROC Foreign Minister Chu Fu-sung said: "During the process of negotiations, the British Government was in a posture of concession, retreat

and abandonment. It accepted all demands set down by the Chinese Communists, and disregarded the wishes of the Hong Kong residents.\(^{22}\) Therefore, it is clear that the ROC is not impressed by the process of Hong Kong negotiations and thus the whole episode further discourages it from engaging in negotiations with the PRC.

Finally, the domestic situation in Taiwan also supports the ROC government's policy of no negotiation with the PRC on the Hong Kong model of unification. Practically the whole population in Taiwan, who enjoy ten times more per capita income than those on the mainland, oppose placing their fate in the hands of the PRC by becoming a "Special Administrative Region."

**Future Prospects**

Despite the rejection of the Hong Kong model for unification by the ROC for convincing reasons, the PRC appears determined to promote this model. Moreover, in order to effectively promote the Hong Kong model for Taiwan, it is believed that pending the final incorporation of Taiwan into the PRC, the latter will generally observe the PRC-UK Joint Declaration on Hong Kong. This will put the ROC in an unbearable defensive position, because some, especially those in the West, without sufficient understanding of the Chinese Communist tactics would ask: If the PRC's model for unification works for Hong Kong, why not for Taiwan, especially since the PRC has promised even more generous terms for Taiwan? Therefore, the ROC must work out a more sophisticated response to the PRC's peaceful unification offensive in the future.

\(^{22}\) See note 4, *supra*. 
PROSPECTS FOR THE UNIFICATION OF CHINA

An Analysis of the Views of the Republic of China on Taiwan

Hungdah Chiu

Before normalizing its relations with the United States on January 1, 1979, the People’s Republic of China (PRC) continually advocated the “liberation of Taiwan” as a means for uniting China. Between 1971 and 1977, apart from official communications, Zhou Enlai and his associates, including Deng Xiaoping, elaborated their views on how Taiwan would be administered after “liberation” in at least 20 statements to various visitors, especially the Taiwan Chinese. Included among these statements were suggestions by PRC leaders offering high autonomous status, a long process of social transformation, the gradual transition of the capitalist economic system to a Communist one, and the maintenance of a high living standard on Taiwan after “liberation.”1 Aside from serving the cause of Chinese nationalism, what benefits the Chinese people in Taiwan would gain after “liberation” were not explained. Furthermore, how Taiwan could maintain its high standard of living after phasing out its capitalist system, including foreign investment and enterprise, was also not explained. Under such circumstances, it was not surprising that almost no one in Taiwan took these offers for “liberation” seriously. The 1978 PRC Constitution continued this hardline approach to the Taiwan question by stating that “we are determined to liberate Taiwan and accomplish the great cause of unifying our motherland.”2 This policy was not changed until the establishment of diplomatic relations between the PRC and the United States.

On January 1, 1979, when these diplomatic relations were established, the Standing Committee of the rubber stamp parliament of the PRC—the National People’s Congress (NPC)—sent a “Message to Compatriots in Tai-
wan" calling for "unification" of Taiwan with the mainland. It said that the PRC leaders would take present realities in Taiwan into account in accomplishing the "great cause of reunifying the motherland," would respect the status quo on Taiwan and the opinions of people in all walks of life there, and would adopt reasonable policies and measures in settling the question of reunification so as to avoid causing any losses to the people of Taiwan. The same day, the PRC also stopped the bombardment of Quemoy and other offshore islands controlled by the Republic of China (ROC) on Taiwan.\(^5\) It also launched a campaign for establishing "three links"—mail, trade, and air and shipping services—and "four exchanges"—relatives and tourists, academic groups, cultural groups, and sports representatives—with Taiwan as a first step toward the ultimate goal of reunification.

On September 30, 1981, the PRC made a specific nine-point proposal to Taiwan with more concrete terms for unification. The essential parts of it are as follows:

(3) After the country is reunified, Taiwan can enjoy a high degree of autonomy as a special administrative region and it can retain its armed forces. The Central Government will not interfere with local affairs on Taiwan.

(4) Taiwan's current socio-economic system will remain unchanged, so will its way of life and its economic and cultural relations with foreign countries. There will be no encroachment on the proprietary rights and lawful right of inheritance over private property, houses, land and enterprises, or on foreign investments.

(5) People in authority and representative personages of various circles in Taiwan may take up posts of leadership in national political bodies and participate in running the state.

(6) When Taiwan's local finance is in difficulty, the Central government may subsidize it as is fit for the circumstances.\(^4\)

On the surface, the PRC's terms for unification are quite reasonable and also seem responsive to the reality in Taiwan, but they still receive a negative response from the Republic of China on Taiwan. Why? Is it because Taiwan, especially the Chinese Nationalist Party, is too "stubborn," as claimed by the PRC and its supporters? Or is it because the Chinese Nationalists learned from their more than 50 years of dealing with the Chinese Communists and know too well the Communists' tactics in presenting sugar-coated poison for them to swallow? The intent of this article is to analyze and study this question. I will begin with a concise analysis of several of the most important factors that may influence the ROC's view of the PRC's proposal.
Several Principal Factors Affecting the ROC's Attitude Toward the PRC's Proposal for Peaceful Unification

There are six principal factors that might affect the ROC's attitude toward the PRC's peaceful unification proposal: past experience in dealing with the Chinese Communists; the Tibetan experience; the PRC's behavior toward the ROC after making peace overtures; political reality in Taiwan; the existence of a creditable guarantee for Taiwan after unification; and political stability in the PRC. The history of the Nationalists' dealing with the Communists needs voluminous study and definitely cannot be covered within the scope of this article. For the purpose of this article, it is only necessary to mention two important historical events. On September 22, 1937, the Chinese Communist Party appealed to the Nationalist government in a manifesto entitled "Together We Confront the National Crisis" in which it pledged, among other things, to "abolish the name and insignia of the Red Army, which is to be reorganized as the National Revolutionary Army and is to be subject to control by the [ROC] government's Military Commission; it is ready to march forward and fight the Japanese at the front." The Nationalist government accepted the offer and the 30,000-man Red Army was reorganized as the 8th Route Army—later renamed the 18th Route Army. The Nationalist government also provided logistic support for the maintenance of the force. However, from the very beginning, the Communists regarded this as a tactic designed to free the Communists from Nationalist attacks and used the opportunity provided by the Sino-Japanese War, which tied down almost the entire Nationalist military force, to build up its own strength during the war. In this connection, Mao Zedong said: "Our fixed policy should be 70 percent expansion, 20 percent dealing with the Guomindang, and 10 percent resisting Japan." As a matter of fact, according to war archives released in Japan after the war, the Communists did not fight a single major battle with the Japanese forces in China. On the other hand, according to Mao, the Communist forces did expand from a meager 30,000 men in 1937 to 910,000 men by April 1945.

When the Communists attained the upper hand, they never demonstrated magnanimity toward the Nationalists in negotiation. In April 1949, when the Nationalist government was still in Nanking, it requested a negotiated settlement of the end of the Civil War. The Communists put forward a peace agreement containing eight articles with 24 provisions that not only demanded the complete unconditional surrender of the Nationalist government but also insisted on punishing Nationalist leaders as "war criminals."
These two historical events would be sufficient to explain why the Nationalists are deeply suspicious of the Communists in any dealings with the latter. The second factor that may affect the ROC’s attitudes is the experience of Tibet. Under the threat of an armed invasion of Tibet, an agreement was concluded between the PRC and Tibet on May 23, 1951. According to Article 3 of the agreement, the “Tibetan people have the right of exercising national regional autonomy.” The PRC agreed in Article 4 not to “alter the existing political system in Tibet” or “the established status, functions, and powers of the Dalai Lama,” and also pledged in Article 5 that all “officials of various ranks shall hold office as usual.” In 1959, the PRC ruthlessly took Tibet by force, killing thousands of Tibetans and driving large numbers of refugees into India. The Tibetan government under the Dalai Lama was dissolved.

On December 14, 1982, an article entitled “Trilogy of the Fall of Tibet” by a Taiwan author, Huang Peng-hsiao, was published in Chung-yang jih-pao (Central Daily News). The article recalled that in 1950 the PRC made an offer of “peaceful liberation” to Tibet similar to the one now offered to the ROC. The article noted:

As soon as Peking completed its military occupation of Tibet, it forgot completely the promises it had made to the Tibetans and started tightening its iron-fisted rule.

Finally in 1954, the Chinese Communist authorities disbanded the Tibetan armed forces and appointed puppets to high positions while the Dalai Lama and the Panchen Lama were in Peking attending the First National People's Congress.

By the time the Tibetan leaders returned to their homeland they had become virtual prisoners in their own fief.

On December 17, 1982, at the Chinese Nationalist Party Central Standing Committee meeting, President Chiang Ching-ko, who is concurrently Chairman of the Party, called on the people of the ROC to regard the tragedy of Tibet, vividly analyzed by Huang Peng-hsiao, as an object lesson in dealing with the Chinese Communists’ peace overture.

In view of the ROC's concern over the Tibetan case, the PRC put out three lengthy articles to explain the situation in Tibet. The conclusion of the second article noted:

Following more than 30 years of liberation, Xizang [Tibet] accomplished its democratic and socialist reforms and abolished the serf system. Under the direct leadership of the central people’s government, Xizang practices national autonomy, the people will never allow the wheels of history to be turned back. That is
why earlier this year, when the Dalai Lama said the Xizang autonomous region must also be allowed to enjoy autonomous rights like those of Taiwan, which will become a special administrative region after its return to the motherland, the CPC flatly refused. This is understandable and it meets with the people's approval. This explanation could hardly convince anyone in the ROC since it is an open secret that the Tibetan people do not like Chinese Communist rule as evidenced by numerous reports of Tibetan refugees and foreign visitors to Tibet. If the PRC is so confident of the Tibetans' "happiness" under its rule, why not conduct a credible plebiscite in Tibet to determine whether they prefer the present form of rule or one similar to the PRC's nine-point proposal to Taiwan.

The third principal factor is the PRC's behavior toward the ROC since 1979. Despite the peace overtures made since then, the PRC has never relaxed its pressure to isolate the ROC in all international fora, to prevent other countries from establishing commercial offices in Taiwan and vice-versa, and to frustrate the ROC's purchase of defensive arms. It also openly supports some dissidents in Taiwan, despite those dissidents' well-known views favoring Taiwan independence. PRC behavior such as this do not seem to enhance ROC confidence in the former's peace overtures.

The fourth factor is the political reality in Taiwan. The Taiwan Chinese are now gradually entering the decision-making process in the ROC. At present, the Taiwan Chinese constitute about one-third of the membership of the powerful Central Standing Committee of the Chinese Nationalist Party. Moreover, they are now moving into certain sensitive security and military positions, such as the Taiwan Garrison Commands, the Bureau of Investigation, army division level commanders, and others. The Party leaders seem to feel that until they staff a sufficient number of Taiwan Chinese in these key positions, it would be unwise to consider any PRC peace proposal, assuming it is a credible one; otherwise, it could create suspicion among the Taiwan Chinese and those Chinese who came to Taiwan after 1949. This cautious approach appears to be supported even by some responsible opposition leaders.

The fifth factor concerns any credible guarantees the PRC would offer after unification. So far, there have been none.

The last factor affecting the ROC's attitude is the political stability of the mainland. Unless the PRC can maintain political stability for a considerable period of time and institutionalize its transfers of power, it does not make much sense for the ROC to negotiate any peaceful unification with a PRC faction that is not even sure of its own future.
Analysis of the PRC’s Peace Overtures to Taiwan Since 1979

On the surface, the terms of the PRC’s nine-point proposal on peaceful unification were quite generous, but they are preconditioned by the requirement that the ROC give up its sovereignty and downgrade itself to be a “special administrative region” under PRC sovereignty and jurisdiction. However, once the ROC gives up its sovereignty, it could not trade, purchase arms, or engage in any external activities without the approval of Beijing, nor could it prevent Beijing from sending military forces to Taiwan. There would be no legal restraints to prevent the PRC from taking away what it promised Taiwan at the time of reunification.

The Constitution of the PRC adopted on December 4, 1982, further confirms the fear by the government and people in Taiwan of unification under the PRC formula. Article 31 of the PRC Constitution provides: “The state may establish special administrative regions when necessary. The systems to be instituted in special administrative regions shall be prescribed by law enacted by the National People’s Congress in the light of the specific conditions.” PRC leaders made it clear that this article was enacted for the purpose of unifying Taiwan, Hong Kong, and Macao. However, once Taiwan is unified with the PRC, the latter can unilaterally change the terms of unification through its rubber stamp NPC in total disregard of the original terms agreed upon. Under Article 64, paragraph 2, of the PRC Constitution, “statutes and resolutions are adopted by a majority vote of more than one half of all the deputies to the National People’s Congress.” In a recent PRC broadcast to Taiwan, it was stated that under liberal application of the PRC “election laws,” Taiwan can be expected to send 100 delegates to the NPC after unification. However, the practical use and strength of 100 Taiwan delegates among the 3,000 delegates in the NPC’s decision-making process would be almost nil. In this connection, a recent ROC article commented:

[Article 31 of Communist China’s Constitution] is the base melody in the Communists’ orchestrated effort to solve the “Taiwan problem,” i.e., destroy the Republic of China and establish Communist China’s “sovereignty” over Taiwan. What deserves special notice is this: the “special administrative districts” are to be established “when necessary” and when the necessity is no longer operative, they may be abolished. The entire system to be practiced there will be “stipulated by law” by the Chinese Communists. In due course it may be revised or eliminated “by law.” The strategy employed here is one of absolutely gradual, step-by-step encroachment. The ambition and the cunning that lie behind it need no comment.
Soon after the PRC’s nine-point proposal was issued, a three-member delegation of Tibetan exiles in India sent by the Dalai Lama requested that the PRC accord Tibet the same treatment as the nine-point proposal provided Taiwan. The request was rejected on the grounds that “Tibet has been liberated for more than three decades. . . . The nine-point principle, therefore, is not applicable to Tibet.”14 This attitude toward Tibet seems to suggest that the nine-point proposal toward Taiwan is just a transitional policy to entice Taiwan to unify with the PRC. Thus, after unification, the terms could easily be nullified and Taiwan turned into another Tibet—i.e., under tight control of the PRC with autonomy in name only.

The PRC’s strong opposition to U.S. arms sales to Taiwan also demonstrates its lack of sincerity in proposing to let Taiwan maintain its armed forces after unification. Without an adequate supply of arms, Taiwan’s military forces would be obsolete in a few years, thus placing Taiwan at the mercy of the PRC.

Finally, the PRC, as stated earlier, has never renounced its right to use force against Taiwan. In essence, therefore, from the ROC’s point of view, what the PRC simply wants is for Taiwan to surrender under the euphemism of “peaceful reunification.”

The ROC’s Response to the PRC’s Peace Overtures

As stated earlier, the seemingly reasonable peace overtures of the PRC, whether they be the “three links,” “four exchanges,” or nine-point proposal, are preconditioned on the ROC’s relinquishment of its sovereignty and the extension of the PRC’s sovereignty over Taiwan. Under such circumstances, it is only natural for the ROC to reject such an offer categorically because any slight indication of a willingness even to consider the extension of the PRC’s sovereignty to Taiwan would immediately create panic among the Chinese people in Taiwan and start capital flight from there. The recent panic in Hong Kong caused by the PRC’s announcement of its intention to extend its sovereignty to Hong Kong in 1997 clearly illustrates this point.15

From the ROC’s point of view, the purpose of the PRC’s peace overtures is to mislead the Chinese people in Taiwan and the international community and put the ROC in a dilemma: If the ROC does not reject the overtures, chaos would immediately occur in Taiwan as just explained; if it rejects them, as expected by the PRC, it would appear to be stubborn, irrational, and unrealistic in the international community vis-à-vis the PRC’s seemingly reasonable peace overtures. In response to the PRC’s peace offensive, the
ruling Chinese Nationalist Party in the ROC put forward a campaign of “unification through [Dr. Sun Yat-sen’s] Three Principles of the People [Nationalism, Democracy and People’s Livelihood]” as a counter offer for unification. This offer, while not explicit on this point, is preconditioned on the PRC’s renunciation of communism. While this campaign does not receive much attention in the international community, except in overseas Chinese communities, it embarrasses the PRC considerably because Mao Zedong had advocated practicing “Three Principles of the People” in China. At the Expanded Sixth Central Committee Meeting of the Chinese Communist Party held on October 12–14, 1938, Mao said:

There is no doubt that all Communist Party members should . . . together with the Chinese Nationalist Party, all other parties in the country and all the people of the country, faithfully and wholeheartedly practice “Three Principles of the People.” Anyone who is not faithful in believing and practicing “Three Principles of the People” . . . is not a faithful Marxist.16

Mao also said: "What type of country should we establish? There is one simple answer: To establish a Republic of ‘Three Principles of the People.’” 17

Another embarrassment to the PRC is that after more than 30 years of Communism on the mainland, its per capita income is still less than one-tenth that of Taiwan under the allegedly "reactionary" Nationalist Party rule and supposedly "outdated," as claimed by the Chinese Communists, Three Principles of the People. In spite of this, the PRC has so far put out at least 50 articles criticizing or denouncing the ROC's campaign of "unification through Three Principles of the People."

While formally rejecting the PRC's offer for "three links" or "four exchanges," the ROC has nevertheless indirectly responded positively to these peace overtures in order to avoid any implication of acceding to the PRC's sovereign claim to Taiwan. According to a knowledgeable American expert on the Taiwan question:

Despite the firm opposition of the Taiwan authorities to opening direct links with the PRC, they have tolerated a growing indirect trade between Taiwan and the mainland, which probably exceeded $300 million in 1980. They also permit scientists and others from Taiwan to sit down with their counterparts at international meetings and even encourage fraternization between students from Taiwan studying abroad and PRC students. The Chinese crew of a German-registered freighter that docked at Keelung was given a conducted tour of Taipei and a table tennis team from the mainland whose plane had been diverted because of weather conditions to Taoyuan airport for a few hours was courteously received.
UNIFICATION OF CHINA

Thus, contact and communication between individuals in Taiwan and the PRC is slowly increasing.18

Another American professor observed after a recent visit to Taiwan:

I discovered that a substantial percentage of the island’s mainland population has already reestablished contact with loved ones on the continent. Over the past few years, they have exchanged letters and photographs through third parties in Hong Kong, the U.S. and elsewhere. In addition, they have sent "care packages" to the mainland through the same channels.19

Moreover, in the early summer of 1982, when the Fifth World Women's Softball Championships were held in Taipei, the ROC team issued an invitation to the PRC team to participate, but the offer was declined, and the PRC even urged other countries, such as Japan, to boycott the championships.20 The ROC also allows its sport teams to compete in international Olympic Games under the name of China-Taipei, thus opening the door for the ROC team to compete with the PRC team in international sporting events.

Ironically, the ROC's conciliatory policy, in some cases, was met by a negative response from the PRC. For instance, because the PRC had a large unfavorable balance of trade with the ROC, it imposed restrictions on imports from Taiwan to reduce the trade deficit.21 Another case worth mentioning is that of a PRC student in Canada, Chen Zhenjian, who wanted to meet his relatives from Taiwan in Tokyo on his way back to China but was forced to cancel the trip. The reason for the cancellation, as alleged by Chen after his return to the PRC, was that a "Taiwan agent" tried to "entice" him to go to Taiwan to take up a high-paying teaching position.22 This incident seems to contradict the PRC's offer of "academic exchange"—one of the "four exchanges."

On an official level, after prolonged discussion among liberal and knowledgeable elements of the ROC government and the Chinese Nationalist Party, Premier Sun Yun-suan of the ROC delivered an important speech on June 10, 1982, on the issue of unification. He pointed out that the ROC would not negotiate its own demise as demanded in the PRC's peace offer, nor even attempt to negotiate under the military threat posed by the PRC. He said:

In September 1981, "Marshal" Yeh Chien-ying made his nine-point "peace talk" proposal on behalf of the Chinese Communist regime, calling on the Kuomintang of China to talk with the Chinese Communist party as equals. Yeh said the Chinese Communists would allow Taiwan (under the rule of the Republic of China) to maintain its military, economic and social autonomy. But almost in the
same breath, the Chinese Communists threatened to "downgrade diplomatic relations" with the United States if it continued selling arms to the Republic of China on Taiwan. The Chinese Communists also demanded that countries with which they maintain diplomatic ties not have representative agencies in Taiwan. Recently the Chinese Communists disrupted international athletic activities by refusing to send a team to the fifth world women's softball championships in Taipei and by trying to dissuade other countries from participating. All of these developments provide evidence that the Chinese Communists' "peace talk" proposal and their clamor for "three links" (mails, trade, and air and shipping services) and "four exchanges" (exchanges between relatives and tourists, academic groups, cultural groups, and sports representatives) are means of deception in the attempt to communize free China . . .

On January 20, 1961, in his inaugural speech, President John F. Kennedy said the United States would never fear to negotiate but would never negotiate out of fear. President Reagan said in his State of the Union address in 1982 that America will negotiate only from a position of strength.

The eminent views of these two American presidents clearly express the position and attitude that should be adopted by a responsible government.23

Instead of the type of anti-communist polemics that usually found their way into speeches by ROC leaders, Premier Sun appealed to the PRC leaders to "take steps to change their way of life" and kept the door for reunification open indefinitely by saying: "If the political, economic, social and cultural gaps between the Chinese mainland and free China continue to narrow, the conditions for peaceful reunification can gradually mature. The obstacles to reunification will be reduced naturally with the passage of time."24 This speech was overwhelmingly endorsed by people of all walks of life in the ROC, especially the younger generation, which constitutes more than two-thirds of the population. Unfortunately, this conciliatory gesture received no direct positive response from the PRC, although it did respond indirectly through its newspaper Hsin Wan Pao (New Evening News) in Hong Kong. In a news commentary appearing in that paper on June 15, 1982, the PRC still called for contact and negotiation without responding to the crucial issue of arms sales and other problems raised in Sun's speech.25

Apparently since the PRC at that time was counting on its pressure on the U.S. to stop arms sales to the ROC in order to force the ROC to accept the PRC's peace proposal—which would amount to the ROC's signing its own death warrant in a disguised form—the PRC made no positive response to the ROC's overture. Under such circumstances, the ROC, in order to main-
tain its dignity and self-respect, announced by way of a talk by President Chiang Ching-kuo to a group of Chinese scholars on July 22, 1982, that it would never negotiate with the Chinese Communists.26

Later, the U.S. agreed to limit the quantity and quality of its arms sales to Taiwan and ultimately to phase them out totally pursuant to the August 17, 1982, joint communiqué with the PRC.27 Encouraged by its diplomatic victory on this issue with the U.S., the PRC not only renewed its military threat to Taiwan, but also hardened its terms for unification.

After the issuance of the August 17, 1982 communiqué, PRC high officials on several occasions made it clear that force might be used to solve the Taiwan question. For instance, on the date the communiqué was issued, PRC Ambassador to the U.S. Chai Zemin said in a television interview with CBS that "We [will not] make any commitment to any country on the peaceful settlement of the Taiwan problem. We consider the Taiwan problem to be China’s internal affairs. It is up to us to decide how to solve this problem." The PRC also published this statement in its official English newspaper, The China Daily, on August 27, 1982. Then, in October 1982, the PRC tested its submarine-based rockets in the sea area north of Taiwan to show off its military might to Taiwan. Although the PRC denied that the test was intended to threaten Taiwan, most people in Taiwan would hardly agree.28

The PRC terms for unification were also hardened by its adoption of Article 31 of the Constitution of December 4, 1982, as explained in the earlier part of this article. In response to the hardening of the PRC position, the ROC also responded in kind. On January 25, 1983, Foreign Minister Chu Fu-sung, at a briefing for a group of over 60 National Assemblymen, reaffirmed the government’s position of no negotiation, no compromise, and no contacts with the Chinese Communists.29

Moreover, the PRC now seems to wish to recant or at least put a more restrictive interpretation on its nine-point proposal. For instance, one of the PRC’s nine points is to allow Taiwan to maintain its "economic and cultural relations with foreign countries." However, the PRC has now demanded that Taiwan be expelled from the Asian Development Bank even though the ROC has never claimed to represent the whole of China at the Bank.30

Furthermore, some PRC acts were clearly inimical to the interests of the entire Chinese people in Taiwan. For instance, after the United States Congress amended the Taiwan Relations Act of 1979 to give Taiwan an immigration quota of 20,000 annually (formerly, the quota for mainland China
and Taiwan together was 20,000), the PRC filed a protest with the United States despite the well-known fact that Taiwan’s population density is five times larger than that of the mainland and that it has been under severe population pressure.31

**Future Prospects**

If the PRC insists on its current terms for unification, the future of peaceful unification will be bleak. Why should the Chinese people in Taiwan, who enjoy ten times more per capita income than those on the mainland, place their fate in the hands of the Chinese Communists? If the PRC would be willing to offer more credible terms for peaceful unification, however, the situation might be different. Based on this author’s personal observation, credible terms should contain at least the right to self-defense, including the right to purchase adequate defensive weapons, before and after unification; no possibility of unilateral alteration of the settlement terms after unification; complete, not just “a high degree” of autonomy, and appropriate international status in foreign relations and international organizations. If these terms could be offered, if the mainland could attain a certain degree of political stability and economic development, and if the people there could enjoy considerable political and economic freedom, then the Chinese people in Taiwan would definitely be willing to consider peaceful unification.

At present, it seems unlikely that the PRC would be willing to approach the question of peaceful unification along these lines. The PRC’s current policy still includes resorting to the threat of the use of force, international isolation, and other possible pressures in an attempt to force the ROC and its 18 million Chinese people to accept the PRC’s terms of unification. Under such circumstances, the possibility of peaceful unification between Taiwan and the mainland remains remote.

**Notes**


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8. For details of PRC suppression of the Tibetan people, see The Question of Tibet and the Rule of Law (Geneva, 1959), and Tibet and the Chinese People's Republic (Geneva, 1960), both published by the International Commission of Jurists.
17. See ibid., p. 76.
24. Ibid.
26. Text of the talks distributed by the Commission for Youth Assistance and Guidance of the Executive Yuan, Republic of China.
27. For the text of this Communiqué, see New York Times, August 18, 1982, p. H12.

30. In a statement issued by the spokesman of the ROC Central Bank on February 21, 1983, it is stated, among other things, that: "The ROC's subscription to the [Asian Development Bank's] initial capital stock was determined on the basis of the territory and population under the effective control of the ROC and its GNP, tax revenues, and exports. This is totally different from the case of the ROC's membership in the IMF or IBRD." Press Release, Information & Communication Division in New York, Coordination Council for North American Affairs, No. 83-016 (February 22, 1983), p. 3.

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