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'Business Came First: The evolution of monetary policy in Hong Kong, 1935-80'

by

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Introduction

Hong Kong's path to prosperity has been very different from other Third World societies. It has been described as 'an unprecedented industrial colony that amazed the world'.[1] Its economic performance in the second half of the last century was a record of sustained and largely self-financed success. By 1961, this small city on the south China coast, largely populated by refugees, had eliminated unemployment; and by the middle of the decade, it had become the West's leading source of light industrial products.[2] Its growth rates were, arguably, unparalleled in economic history, and real GDP increased each year without exception from 1961 until 1998.[3] Economic expansion was never hindered by a shortage of the capital needed to finance high-speed growth.[4] Yet, the modernisation process was financed without foreign aid and with little foreign direct investment,[5] and the main source of development capital was its banking system.[6]

Equally remarkable was how little change there was in the government's economic policies in response to this period of astonishing growth. Laisser faire was

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[1] Leonard K. Cheng, 'Strategies for Rapid Economic Development: The Case of Hong Kong', *Contemporary Economic Policy*, Vol. 13. No. 1, 1995, p. 29.
[2] Cornelis J. A. Jansen and Mark Cherniavsky, *Current Economic Situation and Prospects of Hong Kong* (Asia Department IBRD, 9 May 1967, mimeo.), p. ii.
[3] Christopher Howe, 'Growth, Public Policy and Hong Kong's Economic Relationship with China', *China Quarterly*, No. 95 (September 1983), p. 512; Census and Statistics Department, *2004 Gross Domestic Product* (Hong Kong: Government of the HKSAR, 2005), pp. 20-1.
[4] Ronald Findlay and Stanislaw Wellisz, 'Hong Kong', in Ronald Findlay and Stanislaw Wellisz (eds), *The Political Economy of Poverty, Equity, and Growth. Five Small Open Economies* (New York: Oxford University Press, 1993), p. 47; Henry Smith, *John Stuart Mill's Other Island. A study of the economic development of Hong Kong* (London: Institute of Economic Affairs, 1966), pp. 18-21.
[5] M.2 Acting Financial Secretary to Governor, 10 September 1968. Hong Kong Public records Office (HKRS hereafter) 229-1-807 'Financial Aid (Including Loans) Received from the United Kingdom and Other Governments record of … '; (10)Governor to Secretary of State for the Colonies, 28 March 1962. Hong Kong Public Records Office (HKRShereafter) 163-1-1007 'Finance Estimated Capital Investment in Hong Kong'.
[6] For a review of the evidence on this issue, see Leo F. Goodstadt, 'Dangerous Business Models: Bankers, Bureaucrats & Hong Kong's Economic Transformation, 1948-86', *HKIMR Working Paper No. 8/2006,* June 2006, pp. 4-8.

discarded by the rest of the world but flourished in Hong Kong, together with free trade, a belief in the efficacy of free market forces and minimal state interference with business. Hong Kong also stuck to the monetary arrangements of the past. It declined to establish a central bank. Instead, apart from a period of confusion between 1974 and 1983, it retained the currency board system long after it had been abandoned by the rest of the British Empire. Hong Kong also remained loyal to another colonial tradition. Other British colonies had seen no need for an active monetary policy when a currency board was in place, and Hong Kong's financial secretaries tried to disclaim responsibility for monetary affairs. Quite simply, the colonial administration was convinced that business was best served by laisser faire, and 'in almost all aspects of public life, Hong Kong is about business'.[7]

The analysis that follows begins with a review of the colonial setting which shaped the process of making monetary policy. It next examines the historical setting that led the colony to stick to the currency board system in preference to a central bank and to reject the state interventionism that became fashionable throughout the British Empire. The discussion then turns to individual financial secretaries and their approach to monetary issues. The government's assumption that Hong Kong had an automatic adjustment mechanism which removed the need for active monetary polices is challenged on the grounds that the currency board did not operate as rigidly in Hong Kong as in the typical colony. In particular, the government's reserves and the banking system's ability to create liquidity were significant discretionary factors in Hong Kong's monetary affairs. Finally, the analysis assesses the colonial administration's

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[7] David Mole, 'Introduction', in David Mole (ed.), *Managing the New Hong Kong Economy* (Hong Kong: Oxford University Press, 1996), p. 4.

policy and performance in three areas: management of the fiscal reserves, the money supply and inflation.

The policy setting

The development of monetary policy in Hong Kong could not be divorced from the overall administrative culture of the colony. Monetary affairs were controlled by a bureaucracy which faced little challenge either from the community or from the legislature whose members were all appointed by the government until the first, indirect elections in 1985. Some commentators see the absence of representative government as enhancing the efficiency of the colonial administration in managing monetary and fiscal affairs.[8] But this view overlooks the way that policy-making in Hong Kong, almost always, was haphazard and piecemeal rather than a structured process that would offer a coherent guide for decision-making by the officials who ran the government.[9] Furthermore, the fundamental data required as a basis for monetary policy were not available until the late 1970s. Senior officials did not believe that reliable and comprehensive statistics were essential for sound policy, and they opposed their collection.

Hostility towards statistical information had been widespread within the colonial

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[8] *e.g.*, Jonathan R. Schiffer, 'State Policy and Economic Growth: A Note on the Hong Kong Model', in Law Kam-yee and Lee Kim-ming (eds), *The Economy of Hong Kong in Non-Economic Perspectives* (Hong Kong: Oxford University Press, 2004), pp. 212-3.

[9] This unstructured approach to policy adopted by the colonial administration has been recorded by an official who had served in other colonies. Trevor Clark, *Good Second Class* (Stanhope: The Memoir Club, 2004), p. 156.

administration before World War II and remained pervasive during the 1950s.[10] Cowperthwaite maintained an almost dogmatic disdain for statistics after he became Financial Secretary in 1961. In that post, he did his best to ensure that the government did not produce national income or balance of payments estimates.[11] He insisted that 'it is not necessary, nor even of any particular value, to have [GDP] figures available for the formulation of policy'.[12] His successor, Sir Philip Haddon-Cave, remained loyal to this colonial tradition and eventually confessed that he had tried to manage monetary affairs in a statistical void.[13] Not only did financial secretaries deny themselves the facts needed to analyse policy options in managing monetary affairs but, at the same time, they deprived the public of the information needed to assess policy proposals and their outcomes.[14] Sir John Bremridge candidly confessed that 'I [had] been a Member to this Council for seven years before I became Financial Secretary and I had no idea about the Exchange Fund whatsoever' even though this institution played a crucial role in the colony's financial affairs.[15] As a result, the colonial administration could persist in grievously mistaken policies over a long period.[16]

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[10] One governor publicly lamented the wilful opposition of his officials to statistics. Sir Geoffry Northcote, *HH*, 13 October 1938, p. 117. On the lack of improvement twenty years later, see (10) Statistician minute to Director of Commerce and Industry, 15 December 1958. HKRS22-1-96 'Population Census 1961'.

[11] He had blocked the collection of balance of payments statistics in open defiance of Colonial Office requests while still a relatively junior officer. (79) Cowperthwaite letter to W. F. Searle, Chief Statistician (Colonial Office), 8 June 1955. HKRS163-9-88 'Hong Kong Balance of Payments'.

[12] Cowperthwaite, *HH,* 25 March 1970, pp. 495-6.

[13] Sir Philip Haddon-Cave, Financial Secretary, *HH*, 27 February 1980, p. 516.

[14] For a detailed analysis of this data deficit, its causes and consequences, see Leo F. Goodstadt, 'Government without Statistics: Policy-making in Hong Kong 1925-85, with special reference to Economic and Financial Management', *HKIMR Working Paper* No. 6/2006, April 2006.

[15] *HH*, 15 January 1986, p. 479.

[16] The government was able to shrug off the sustained and unanswerable indictments of blunders in its monetary policies carried by *Asian Monetary Monitor*, for example, in the 1970s and 1980s.

No central bank

The colonial administration refused to contemplate the creation of a central bank throughout this period despite pressure from the colonial administration's own banking professionals and advice from the IMF.[17] It was not that financial secretaries were unaware of the disadvantages caused by the absence of such an institution.

- A. G. Clarke noted in 1961 the obstacles to the government borrowing funds locally (through Treasury Bills, for example) without a central bank to provide the necessary rediscount facilities.[18]
- Sir John Cowperthwaite stated that the absence of a central bank created difficulties in the management of the statutory liquidity requirements imposed on the banks by the 1964 Banking Ordinance.[19]
- Cowperthwaite also admitted that the absence of a central bank added considerably to the complexities of protecting the financial system against devaluation, both in the run-up to the 1967 sterling crisis and when seeking to maximize the guarantees against future devaluations subsequently offered by the United Kingdom.[20]
- Officials had realized by 1977 that Hong Kong could no longer manage without

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[17] Leonidas Cole, Banking Commissioner to Financial Secretary, 9 December 1969. HKRS163-3-249 'Banking Emergency 1965 – Matters arising from … staff etc'; *Far Eastern Economic Review* (*FEER* hereafter): Philip Bowring, 'Hongkong wary of controls', , 2 December 1977 and Anthony Rowley, ' "Moral suasion" versus control', 29 September 1978; Anthony Ockenden, Banking Commissioner, *Government Information Services*, 22 June 1978; Y. C. Jao, 'The Monetary System and the Future of Hong Kong', in Y. C. Jao *et al.* (eds), *Hong Kong and 1997. Strategies for the Future* (Hong Kong: Centre of Asian Studies, 1985), p. 387.
[18] A. G. Clarke, Financial Secretary, *Hong Kong Hansard* (*HH* hereafter), 1 March 1961, p. 46.
[19] J. J. C. Cowperthwaite, Financial Secretary, *HH*, 12 April 1967, p. 285.
[20] Cowperthwaite, *HH,* 29 November 1967. p. 501 and 10 July 1968, p. 326.

some form of central banking operations, yet the colonial administration declined to set up any kind of monetary authority.[21]

The colonial administration's reluctance to establish a central bank fitted in with London's colonial policies. The United Kingdom was not much in favour of colonial governments establishing central banks. In the 1930s, it had been doubtful about colonial monetary competence, and in the 1950s, London looked on independent central banks as a threat to British interests.[22] The Bank of England had its own reservations about allowing Hong Kong's financial secretaries to act as central bankers, while the colonial administration itself had no ambition to assume such a role.[23] So, the currency board survived.

The colonial administration was able to avoid public controversy over the currency board system which was at the heart of Hong Kong's monetary arrangements. The term was never used by officials in explaining their management of the economy to the legislature throughout the last century, and until the late 1970s, there was no public discussion of the currency board system in Hong Kong and its policy implications.[24] This silence was strange because, elsewhere, this institution, now often hailed 'as a panacea for all monetary disorders', was denounced 'as a form of colonial subjugation'

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[21] Central banking responsibilities were divided between the Monetary Affairs Branch and the Exchange Fund. Sir Murray MacLehose, Governor, *HH*, 5 October 1977, p. 13.

[22] R. S. Sayers, *The Bank of England, 1891-1944* (Cambridge: Cambridge University Press, 1976), Vol. 2, p. 521; Gerold Krozewski, 'Sterling, the "minor" territories, and the end of formal empire, 1939-1958', *Economic History Review*, Vol. XLVI, No. 2 (1993), p. 257.

[23] Catherine R. Schenk, Hong Kong as an International Financial Centre. Emergence and development 1945-65 (London: Routledge, 2001), p. 65.

[24] One financial secretary made a passing, historical reference to the term 'currency board'. (Cowperthwaite, *HH*, 18 December 1963, p. 303) An elected legislator commented very briefly on the currency board system in the context of monetary policy in the dying days of British rule. (Christine Loh, *HH*, 27 March 1996, p. 153)

for several decades after World War II.[25]

The main complaints against the colonial currency boards were 'the opportunity cost of holding more than 100% backing in low return British assets, the lack of a lender-of-last-resort function, the difficulty in dealing with seasonal swings in the trade balance and the costs of increasing the money supply in rapidly growing economies'.[26] The only one of these criticisms that found an echo in Hong Kong was the practice of holding the official reserves in London instead of repatriating these funds to finance local industrial development. The business community fought a protracted but largely fruitless campaign on this issue throughout the second half of the last century.[27] Significantly, the currency board system itself never came under attack in the colony.

Following China

The years between 1935 and 1950 saw Hong Kong undergo radical changes in its economic and social structures, and it was far from inevitable that Hong Kong would preserve the traditional economic policies of British colonialism so faithfully. The colony had to survive revolutionary turmoil on the Mainland, Japanese aggression and the start of the Cold War. These turbulent years saw the start of Hong Kong's manufacturing take-off in the 1930s and the demise of its entrepôt role during the

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[25] Y. C. Jao, 'The Working of the Currency Board: The Experience of Hong Kong 1935-1997', *Pacific Economic Review*, Vol. 3, No. 3 (1998), pp. 219, 220.
[26] Atish R. Ghosh *et al.*, 'Currency Boards: More than a Quick Fix?', *Economic Policy,* Vol. 15, No. 31 (October 2000), p. 271.
[27] The case against the colonial administration's policy on industrial financing is presented in Alex H. Choi, 'State-business relations and industrial restructuring', in Tak-Wing Ngo (ed.), *Hong Kong's History. State and society under colonial rule* (London: Routledge, 1999), pp. 147-50.

Korean War. During this period, the colony laid the foundations of its post-war monetary arrangements which were based on a combination of the currency board system and a commitment to laisser faire.

In the years between the two world wars, Hong Kong faced much the same monetary issues as were to arise in the second half of the century: exchange rate uncertainties, unstable money supply, imprudent banking behaviour and excessive market speculation. Of these, the most pressing problem was the currency. Until 1935, the colony had not been tied to sterling, in contrast to the rest of the British Empire. Hong Kong was economically and financially part of China, and both were on a silver standard. The Hong Kong currency was issued not by a currency board but by HSBC and two other commercial banks. When they expanded or contracted the note issue, they made a commercial judgment about the benefits of tying up assets in silver to back the banknotes. In the 1920s, HSBC declined to increase the currency in circulation unless it made a profit from the new bank notes, a policy which aroused considerable public criticism.[28] Furthermore, demand for Hong Kong's currency was generated not only within the colony but quite widely in southern China. The Chinese government abandoned the silver standard in 1935, and the colony followed suit. The challenge for the colonial administration now was how to reconcile the need for the closest possible currency links to Hong Kong's mainland markets with the stability offered by a relationship with sterling. While the Chinese authorities hesitated about whether or not to establish a link with sterling, Hong Kong made the switch but on the understanding that the colony would follow whatever final decision China might make on its

[28] C. F. Joseph Tom, *Monetary Problems of an Entrepot: The Hong Kong Experience* (New York: Peter Lang, 1989), pp. 66-70.

currency.[29]

Thus, although Hong Kong had bow adopted the same currency board system as other colonies, the new connection with sterling was seen as a temporary break with the historical currency link with the Mainland. The full implications of this stopgap move were not grasped immediately. There was no sense of the part played by the reserves in regulating the money supply, for example, and the Governor regarded the backing for the note issue now held in sterling instead of silver as a Hong Kong asset which ought to generate an income for use in the colony, a point of view he persuaded London to accept.[30]

At the time, monetary economics was a novelty, which was just coming to prominence in the United Kingdom, and the colony's perceptions of how the financial system worked were based on practical experience. The official assumption was that the banks provided the liquidity needed by the economy, and, in the years between the two world wars, the banks had amply met the demands of business, for industrial expansion in particular. [31] At the same time, banks were criticised as responsible for the excessive creation of credit which financed alarming volumes of speculative activity. During the 1920s, falling silver prices had helped to boost an influx of Overseas Chinese funds speculating in foreign exchange, and these swelled deposits in the banks

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[29] These pre-war developments are explained in Tony Latter, 'Hong Kong's Exchange Rate Regimes in the Twentieth Century: The Story of Three Regime Changes', *HKIMR Working Paper No. 17/2004*, September 2004, pp. 7-11, 13, 15-6.

[30] The principle was conceded although the looming world war prevented its implementation in practice. (4) Governor secret letter to Secretary of State for the Colonies, 2 February 1939; (5) Secretary of State letter to Governor, 3 April 1939. HKRS163-1-507 'Excess Population Committee Pre-war correspondence re … '.

[31] Report of the Commission … to enquire into the Causes and Effects of the Present Trade Recession…(Hong Kong: Noronha & Co., 1935), p. 103; Report on the Social & Economic Progress… for the year 1939, p. 45.

to a level that they found difficult to cope with.[32] When silver prices started to surge in the 1930s, a banking boom started, with a sharp rise in the number of local Chinese-owned banks.[33] The complaint was that these firms, tempted by high interest rates, made funds too easily available for dubious projects, particularly in the property sector.[34] The accepted wisdom was that the remedy for this situation lay in prudent management by the banks rather than direct action by the government.[35]

State controls

Currency could well have remained the primary monetary challenge after World War II because the colony was tied to sterling which appeared to face a grim future. However, when officials in London were planning for post-war economic reconstruction, Hong Kong was seen as a special case because of its dependence on China rather than on markets in the United Kingdom and the British Empire. It was taken for granted that its free-port status, free financial markets and commitment to laisser faire would continue unchanged.[36] After the restoration of British rule, Hong Kong was able to maintain the colony's special exemption from the full rigours of

[32] The problem was aggravated by the dysfunctional arrangements for the note issue which hindered the smooth expansion of the money supply to match economic growth. *Report of Currency Committee, 1930*, pp. 105-6.
[33] (13) J. J. Paterson (Jardine Matheson) letter to Financial Secretary, 17 February 1939. HKRS170-1-305 'Banking Legislation Miscellaneous Correspondence of the Committee appointed in January 1939 to consider the proposed new … '
[34] Report of the Commission … to enquire into the Causes and Effects of the Present Trade Recession, p. 104.
[35] For example, proposals for legislation to improve the quality of banking standards were regarded as unlikely to be effective. *ibid*, p. 104.
[36] (15) 'Hong Kong Civil Affairs Policy Directives. Financial Policy', revised draft, 7 July 1944. HKRS211-2-20.

Sterling Area exchange controls.[37]

Thus, inflation became the principal monetary issue after the Japanese surrender. Rising prices and rents provoked social unrest and industrial disputes which undermined the political legitimacy of British rule. Public utilities aroused serious public discontent by charging what the traffic would bear despite government pleas for restraint.[38] Shortages of machinery and raw materials were a threat to Hong Kong's manufacturing take-off and its growing domestic exports.[39] The government could not leave market forces to restore economic equilibrium because world trade was not operating normally, and food and essential supplies were being allocated through international agreement. In addition, foreign exchange and trade transactions were subject to strict controls throughout the British Empire and by most foreign governments.[40] The colonial administration's solution was sweeping state controls although these were introduced as reluctantly and temporarily as possible, and they did not completely disappear until 1954.[41] Officials also took direct responsibility for

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[37] War Office secret telegram to Commander in Chief Hong Kong, no. 522263 F5, 22 March 1946. HKRS 169-2-26 'Currency and Banking'. Commander in Chief telegram to War Office, 19 January 1946; War Office/Colonial Office telegram to Commander in Chief Hong Kong, 16 January 1946. HKRS169-2-53 'Rehabilitation of Business'; Officer Administering the Government telegram to Secretary of State for the Colonies, no. 958, 6 June 1947; S Caine (Colonial Office) telegram to D. M. MacDougall (Hong Kong), no. 982, 21 June 1947. HKRS163-1-442 'Import and Exchange Control in Hong Kong Proposed visit of a H.K. Govt. officer to the U.K. in connection with…'.

[38] For details of the unsuccessful efforts to influence the power companies, see HKRS163-1-602 'China Light & Power Co. Ltd. and Hong Kong Electric Co'. Where government approval was required for changes in utilities charges, officials refused consent, as in the case of bus fares. For example. C. G. S. Follows, Financial Secretary, *HH*, 29 March 1950, p. 109.

[39] The severity of these problems is recorded in detail in HKRS41-1-3378 'Cotton textiles. 1. Agreement with Chinese Govt. re Supply of … to Hong Kong 2. Alternative Supply of … from Japan, U. S. A. and India'.

[40] Appendix C Hong Kong Departmental Report (1946-1947) Department of Supplies, Trade and Industry (Hong Kong: n.p., n.d.), p. 11.

[41] Alan Birch, 'Control of Prices and Commodities in Hong Kong', *Hong Kong Law Journal*, Vol. 4, Part 2, 1974, pp. 133-50; G. B. Endacott, *Hong Kong Eclipse* (Hong Kong: Oxford University Press, 1978), pp. 262-78, 280; Harold Ingrams, *Hong Kong* (London: HMSO, 1952), p. 243. Most controls were abolished during 1953. (87) Director of Commerce and Industry memo to Financial Secretary, 30 March 1953; (89) UK [Colonial Office] Circular 305/53, 'Price Controls', 2 April 1953. HKRS170-1-418(2) 'Price Control. Machinery and Direction of …'.

overcoming the obstacles faced by commercial and manufacturing firms.[42]

This period saw an important test of the government's understanding of the potential value of monetary policy. In May 1949, the exchange rate on the free market fell briefly to USD1=HKD8 when the Chinese Communist Party's now irresistible military advance across the Mainland created alarm.[43] The following year saw Hong Kong's external trade start to collapse as the United States and the United Nations imposed an economic blockade against the Mainland which was the colony's largest trading partner. Hong Kong's banks became increasingly nervous about local borrowers and started to reduce credit facilities.[44] Business confidence ebbed, and the Financial Secretary believed that 'many people would be glad to unload [their assets] at any reasonable price'.[45]

As recession loomed, the government and the business community took very different views of the appropriate solution. Officials saw the danger as a general collapse of the economy, while leading businessmen were concerned about a monetary crisis caused by the credit squeeze. Despite the colonial administration's distaste for government economic intervention, its response was to manage the situation just as the government had accepted responsibility for directing post-war reconstruction. Officials devised a series of largely impractical initiatives: make-work programmes and a

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[42] Financial Secretary memo to DS&D, 13 December 1949. HKRS170-1-418(2); (12) DST&ID memo to Colonial Secretary, 'Cotton Yarn', 19 January 1948. HKRS41-1-3378; Gene Gleason, *Hong Kong* (London: Robert Hale Ltd, 1964), p. 96.
[43] Follows, *HH*, 8 March 1950, p. 46.
[44] 'Cotton Spinning in Hongkong', *FEER*, 21 September 1950; 'Commercial Reports', *FEER*, 9 November 1950; 'The Hongkong Cotton Mills Pool', *FEER*, 6 September 1951.
[45] Financial Secretary minutes to Governor, 17 August 1949 and 27 December 1950. HKRS163-1-634 'Public Utilities Companies Proposed control of the charges and dividends levied by … '

campaign to persuade large employers not to close down or lay off staff.[46] Business leaders pleaded in vain with the government for measures to end the credit squeeze and maintain bank liquidity.[47] The colonial administration could not see that the crisis was capable of a simple financial solution, and the costs of this avoidable deflation were to be recalled by Cowperthwaite twenty years later.[48]

Hong Kong as a Special Case

From the start of post-war reconstruction, the colonial administration was adamant about retreating from control of the economy at the earliest possible date.[49] When it came to monetary affairs, Hong Kong's adherence to the currency board system provided the government with the justification for non-interventionism on the grounds that the system was self-regulating.

The currency board itself was part of the laisser-faire legacy of Victorian Britain which, until World War II, had obliged colonial governments to stick to free trade and

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[46] The background to these events is recorded in HKRS1017-2-6 'Committee to Review the Unemployment Situation in the Colony' and HKRS163-1-1376 'Industry and Production. Industrial Situation in Hong Kong'..

[47] (35) Lawrence Kadoorie note, 'Labour Conditions in Hong Kong as Affected by the U.S. Ban on Raw Materials', 30 December 1950. HKRS163-1-1376 'Industry and Production. Industrial Situation in Hong Kong'. (1) Spinners Club letter to Commissioner of Labour, 6 January 1951; note 'Unemployment Relief'; (6) notes on a meeting, Labour Department, 2 April 1952; (11) Labour Officer memo to Commissioner of Labour, 2 May 1952; J. Keswick letter to Commissioner of Labour, 12 May 1952. HKRS1017-3-4 'Unemployment Relief'.

[48] (26) Cowperthwaite letter to Sir Frank Figgures (United Kingdom Treasury), 19 October 1970 and 'A Preliminary Note on the International Monetary Fund with reference to dependent territories (and with particular reference to Hong Kong)', p. 11. HKRS163-9-217 '(A) Meeting of Senior Commonwealth Finance Officials 1970. Sterling Area Balance Of Payments - Developments and Prospects To Mid-1971 (B) Overseas Sterling Area Countries Statistics'.

[49] G. E. Strickland, Attorney General, *HH*, 20 October 1948, pp. 298-301.

avoid intervening in economic affairs.[50] Ironically, in the 1930s, Hong Kong had sought to break away from these constraints and to enlarge the government's responsibility for economic progress.[51] After World War II, the Colonial Office retreated from its traditional style of economic management and directed the governments of its colonial territories to take charge of economic and social development. It was especially keen to speed up industrialisation in the colonies, and it put forward a wide range of initiatives to support development plans, including direct government involvement in economic management, investment incentives and protection for infant industries.[52] Once development programmes had been adopted, monetary measures were seen as important to their success.[53] But the currency board system offered few facilities of this kind. Not surprisingly, colonies moving towards statehood preferred central banks, which were seen as enabling governments 'in the economically backward areas to pursue a monetary policy designed to promote more rapid economic development and to mitigate undue swings in national money incomes'.[54]

The Colonial Office's development initiatives were very much in line with Hong Kong's pre-war outlook and the post-war demands of the business community. Nevertheless, after a brief burst of enthusiasm for development planning in 1946, the

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[50] In this period, London was anxious to prevent colonial authorities from encouraging industries which would compete with United Kingdom exports. David Meredith, 'The British Government and Colonial Economic Policy, 1919-39', *Economic History Review*, Vol. 28, No. 3 (August 1975), pp. 485, 498-9.

[51] Report of the Commission … to Enquire into the Causes and Effects of the Present Trade Recession, pp. 82-3, 86.

[52] Despatch from the Secretary of State for the Colonies to Colonial Governments, *Colonial Development and Welfare …*(Cmd 6713/1945), pp. 3-5; HKRS41-1-6032, 'Colonial Industrial Development – Legislation to encourage … '.

[53] Atish R. Ghosh *et al.*, 'Currency Boards: More than a Quick Fix?', *Economic Policy,* Vol. 15, No. 31 (October 2000), p. 271.

[54] Arthur I. Bloomfield, 'Some Problems of Central Banking in Underdeveloped Countries', *Journal of Finance,* Vol. 12, No. 2 (May 1957), p. 190.

colonial administration ignored London's blueprint for prosperity.[55] There was to be no long-term development programme and no constitutional reform to encourage the government to take charge of economic and monetary affairs. The colonial administration left the private sector to run the economy and remained faithful to the currency board system. In the absence of overt campaigns for an end to British rule, it did not seem to matter that the currency board system as blatant colonial exploitation was under attack almost everywhere except Hong Kong.

Theoretical limitations

The currency board and its arrangements seemed simple enough. The traditional board issued notes and coins only in exchange for sterling assets of equal value so that the money supply was linked to the balance of payments. A colony was obliged to hold the assets backing the currency in sterling, which meant that the colony deposited surplus export earnings in London each time it increased the supply of currency. In consequence, a currency board seemed to leave officials with little scope for discretionary policies or the market intervention typical of central banking – features lauded by many contemporary commentators but roundly criticised in the past.[56]

Although the government's role seemed minimal under these arrangements,

[55] The Colonial Office's focus was on the typical colonial economy dependent on agriculture. Some projects in the rural New Territories went forward. The history of the committee and its activities can be found in HKRS41-1-796 'Colonial Development and Welfare Committee 1. Appointment of … '.

[56] Economists dealing with currency boards, both in the contemporary world and in the context of Hong Kong's experience, draw attention to the 'passive' nature of monetary policy under a currency board. *e.g.*, Steve H. Hanke, 'Currency Boards', *Annals,* Vol. 579, (January 2002), pp. 90, 91, 101; Tony Latter, 'Rules versus Discretion in Managing the Hong Kong dollar, 1983-2006', *HKIMR Working Paper No. 2/2007*, January 2007, pp. 3-6.

management of Hong Kong's monetary affairs could still be handicapped by misconceptions among officials about the economy and its financial institutions. There had been a dearth of economic expertise in the colony before World War II.[57] After the war, the Colonial Office chided Hong Kong for its economic philistinism,[58] perhaps unfairly because development economics was still far from being a rigorous discipline.[59] The application of monetary economics to Third World countries was still descriptive rather than analytical and often tentative rather than prescriptive because of an awareness of the problems of applying the Keynesian approach to non-industrial market economies.[60]

Not surprisingly, then, financial secretaries experienced considerable difficulties with economic theory. Even Sir Sydney Caine, the distinguished economist and a pre-war holder of this post, paid little attention to the macroeconomic aspects of economic growth in presenting London's strategy for colonial development.[61] In the mid-1950s, Clarke, was not clear about the concepts of the multiplier and value added. As a result, he did not grasp how radically the economy had altered when Hong Kong switched from entrepôt to manufacturing for export. 'In a sense it is more of an entrepot

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[57] With the exception of Sir Sydney Caine, who served as Financial Secretary from 1938 to 1940 and went on to a distinguished career as an economist both in the United Kingdom Civil Service and as Director of the London School of Economics. The general quality of the economic analysis available to the pre-war colonial administration may be gauged from *Report of Currency Committee, 1930* (Legislative Council Sessional Paper 7/1930) and *Report of the Commission…to Enquire into the Causes and Effects of the Present Trade Recession*.

[58] W. F. Searle (Chief Statistician, Colonial Office) letter to W. Ramsay-Main (Economic Secretary), 22 March 1955. HKRS163-9-88.

[59] 'The [development] problem is usually very generally defined, rigor is frequently completely absent, and the variables considered inevitably spill over into areas which economists have long treated as beyond the scope of the discipline'. Henry J. Bruton, 'Growth Models and Underdeveloped Economies', *Journal of Political Economy,* Vol. 63, No. 4 (August 1955), p. 322.

[60] An interesting example is Michael Zuntz, 'Some Observations on Monetary Policy in Underdeveloped Countries', *Economic Development and Cultural Change*, Vol. 1, No. 4 (December 1952).

[61] Any of his less distinguished Hong Kong successors would have used much the same presentation. See Sydney Caine, 'British Experience in Overseas Development', *Annals,* Vol. 270 (July 1950), pp. 118-25.

than ever for our factories import all their raw materials, add to their value by some form of processing, and export them again', he declared.[62] As financial secretaries in the 1960s and 1970s, Cowperthwaite and his successor, Haddon-Cave – both trained economists – derided the notion that economic analysis was of much help in foreseeing adverse market trends, and they dismissed suggestions that the government should be capable of taking precautionary measures to bring excessive liquidity and speculative markets under control.[63]

The lack of economics expertise was particularly damaging in the 1970s. The government had not realised when the link with sterling was cut in 1972 that by waiving the requirement for full backing of the note issue in foreign assets, 'not only did the Hong Kong authorities allow the price of the currency to be freely determined in the foreign exchange markets, but they also made no provisions to control the quantity of money in Hong Kong'.[64] The colonial administration privately admitted that it was handicapped by a lack of technical expertise. As a Hong Kong central bankers later lamented: 'If just one monetary economist had been consulted, the change … might never have been enacted, even as a temporary measure'. But officials were slow to realise the connection between the new monetary arrangements and excessive bank lending. The government's monetary policies were chaotic in consequence, and it lost control of the money supply.[65] Only after the currency collapsed in 1983 was stability restored to monetary affairs by reviving the currency board system. A coherent monetary policy was now possible with the fixed exchange rate which identified the

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[62] Clarke, *HH*, 2 March 1955, p. 60.
[63] Cowperthwaite, *HH*, 28 March 1968, p. 212; Haddon-Cave, *HH*, 16 April 1980, p. 733.
[64] John Greenwood, 'The Monetary Framework Underlying the Hong Kong Dollar Stabilization Scheme', *China Quarterly,* No. 99 (September 1984), p. 633.
[65] The Financial Secretary misunderstood what was driving the money supply until the end of the decade. Haddon-Cave, *HH*, 16 November 1978, pp. 208-9; 28 February 1979, p. 548.

appropriate level for liquidity and interest rates and indicated the effective criteria for management of the reserves.

Hands-off monetary management

Scepticism about economics and its relevance to government policies, combined with a dearth of accurate data, encouraged financial secretaries to define the scope of monetary economics in narrow terms. Although they did not invoke the currency board by name, this system encouraged them to put their faith not in policy measures but in leaving the economy to make its own adjustments. The mood of the 1950s was captured in confidential correspondence with the Colonial Office arguing that it was pointless to collect economic data because ‘our economy is almost wholly external … and our balance of payments is self-regulating either through the free exchange market or through our currency mechanism’.[66]

Clarke publicly expressed resolute opposition to ‘a policy of Government control of the money market and of the volume of money’.[67] He defined ‘a thoroughly sound monetary policy’ as no more than ensuring that ‘the Hong Kong dollar is the most trusted currency in the East’.[68] This goal was more rhetorical than real. The leading academic expert on this topic in the 1950s declared that ‘the colonies are in practice overseas parts of the United Kingdom monetary system, and have no responsibility for

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[66] (79) Cowperthwaite letter to W. F. Searle, Chief Statistician (Colonial Office), 8 June 1955. HKRS163-9-88.
[67] Clarke, *HH*, 24 March, 1954 p. 136.
[68] Clarke, *HH*, 1 March 1061, p. 46.

maintaining foreign exchange reserves or taking any other measures that would affect the value of their own currencies'.[69]

In the 1960s, Cowperthwaite resisted pressures to take a broader view of his responsibilities for managing the economy. He insisted that what he called 'the modern school' of economics did not apply to a small, open economy like Hong Kong.[70] Size seemed hardly relevant in this context. A respectable academic argument in that period was that it was not feasible 'to have a fully-fledged independent monetary system in some of the small isolated territories of the world – Malta, Mauritius and so on?' But Hong Kong did not fall into this minor league. In addition, the small size of the domestic market had dissuaded the colonial administration from adopting infant industry and similar policies. Otherwise, being small and open hardly seemed to make Hong Kong virtually impotent in managing its monetary affairs. Cowperthwaite, nevertheless, warned that Keynesianism would lead to financial irresponsibility and 'create an immediate balance of payments crisis'.[71] So adamantly was he opposed to anything connected with 'modern' economics that he insisted on drafting the annual budget with only minimal regard for its monetary consequences.[72]

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[69] Ida Greaves, 'Dollar Pooling in the Sterling Area: Comment', *American Economic Review,* Vol. 45, No. 4 (September 1955), p. 656.

[70] A. R. Prest, *Public Finance in Underdeveloped Countries*(New York: Praeger, 1963), p. 108; *Report of the Commission…to Enquire into the Causes and Effects of the Present Trade Recession…*(Hong Kong: Noronha & Co., 1935), pp. 89-90; Sir Robert Black letter to Sir Hilton Poynton (Colonial Office), 19 July 1958 Hong Kong Public Records Office (HKRS hereafter) 270-5-44 'Commercial and Industrial Development – Major Policy'.

[71] Cowperthwaite, *HH*, 26 February 1964, p. 47; 24 February 1966, p. 57.

[72] 'There are, it seems to me, good policy grounds for underspending in the good years with a view to overspending in the not so good. Our normal course tends to the reverse order, with the danger that public sector activities exaggerate both depression and boom. I have always maintained that we had little scope for Keynesian economics but … we can at least set aside surpluses in good years for spending to some little of the same effect in bad'. Cowperthwaite, *HH*, 25 February 1970, p. 363. '… underspending in good years and over-spending in the not so good is a sound practice, this does not mean that I believe we should deliberately go out to seek a surplus with this in mind (far less with any Keynesian ideas)'.Cowperthwaite, *HH*, 25 March 1970, p. 490.

In the 1970s, Haddon-Cave confessed that he avoided the term 'monetary policy' in public for fear of raising expectations of a Keynesian approach to public finance. He accepted that his fiscal measures might involve monetary policy but insisted that 'the purpose of the fiscal system is to appropriate a suitable proportion of this community's resources for public expenditure and not, in addition, pursue social justice or to manipulate – or rather try to manipulate – the rate and pattern of economic growth'.[73] Like his predecessor twenty years earlier, he thought that monetary policy should be confined to currency matters. The colonial administration had 'an active monetary policy', he stated, in so far as 'our exchange rate policy and the management of the Exchange Fund's assets have monetary consequences'.[74]

Haddon-Cave offered the best summary of why, like his two predecessors, he believed that, given the nature of the Hong Kong economy, the government was tied to non-interventionism.[75]

> The Government does not attempt to regulate the economy either through its expenditure decisions or in other conventional ways, using monetary or fiscal devices. This is because the money supply is largely determined by the balance of trade as influenced from time to time by capital movements; whilst any major attempt to regulate demand through variations in tax rates or internal borrowing would tend to bring about changes in expenditure on imports rather than influence the volume of domestic output in the required direction.

This analysis was pure currency board theory proclaimed, ironically, just as Hong Kong was inadvertently abandoning the system, as will be discussed in a later section.

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[73] Haddon-Cave, *HH*, 7 April 1976, p. 802.
[74] Haddon-Cave, *HH*, 2 March 1977, p. 579.
[75] Haddon-Cave, *HH*, 3 April 1975, p. 691, f.n. 4.

By the end of the decade, he was talking in very different terms. The exchange rate had slumped and inflation had spiralled, he admitted, as a result of the government's misunderstanding of monetary affairs. Management of the government reserves now became a key element in an active monetary policy.[76]

Currency board mechanics

The mechanics of the colony's monetary arrangements were summed up by one of Hong Kong's best-known monetary economists. [77]

> …the quantity of money [in Hong Kong] consisted of banknotes plus deposits, and depended on the volume of banknotes (the monetary base) together with the quantity of bank loans or bank credit and hence deposits created by the banks. The quantity of deposits would typically have been a fairly stable multiple of the quantity of banknotes or base money in the system. In this way the aggregate money supply was systematically related to the overall balance of payments…From a different perspective the system provided an automatic adjustment mechanism whereby the money supply was automatically adjusted in such a way as to maintain equilibrium in the overall balance of payments. Over a period of years the fulfilment of this condition necessarily implied that the aggregate price level in Hong Kong would remain approximately in line with prices in Britain.

On this analysis, the colonial administration could largely ignore monetary issues because problems would be temporary and self-solving.

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[76] He defined this monetary objective as 'to manage the public finances generally as to minimize the extent to which the monetary environment is disturbed, that is to say, to minimize the extent to which the growth rate of the money supply is altered by an expansion or contraction of currency in circulation or by a budget surplus or deficit'. Haddon-Cave, *HH*, 28 February 1979, p. 548.

[77] Greenwood, 'The Monetary Framework Underlying the Hong Kong Dollar Stabilization Scheme', pp. 631, 632.

- Overall liquidity would rise or fall in line with export performance.
- Credit creation by the banking system was not a significant or separate source of liquidity.
- Changes in the money supply would trigger the changes within the economy required to ensure the healthy state of the balance of payments.
- Any inflation was imported.

This analysis was derived from the standard account of how currency boards operated throughout the British Empire. The discussion which follows will argue that officials did not realise that what might be true of the typical colony was not applicable to Hong Kong. This high-growth manufacturing city did not suffer from ‘the paucity of assets, the weak degree of institutional diversification, the existence of extensive government interventions, and the emergence of an informal financial sector [which] make the nature of financial markets and their macroeconomic role potentially very different in developing nations’.[78] Although Hong Kong had much the same institutional arrangements as any other colony, the currency board system did not eliminate discretionary influences on its money supply. The reserves of both the government and the banking system, the levels at which they were set and how they were managed, made the adjustment mechanism less automatic than was supposed to be case under a traditional currency board. Also of crucial importance was the scope permitted the banking system to create liquidity. As a result, the colonial administration was mistaken in its conviction that there was little, if any, room for monetary policy

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[78] Pierre-Richard Agénour and Peter J. Mintiel, *Development Macroeconomics* (Princeton: Princeton University Press, 1999), second edition, pp 189-90.

under a currency board.

The automatic adjustment mechanism ascribed to the colonial boards was more a result of the level of economic development than of the system itself. Most colonies were pre-industrial, often semi-subsistence and, almost always, dependent for growth on exports of a narrow range of agricultural commodities and mineral products. Cash dominated local business life. Banking services were limited, and banks maintained high levels of liquidity, which restricted their creation of credit.[79] These were the financial symptoms of a lack of economic development that would have prevailed even in the absence of the currency board system.[80] Under such conditions, monetary policy appeared to be redundant because the currency board seemed to guarantee a high degree of self-regulation of the money supply. As a senior colonial official explained before World War II.[81]

> [A currency board] is responsible for supplying and withdrawing local currency, but merely by a sort of mechanical process; it has no power to fix the quantity to be put into circulation. If any individual, firm or bank wants additional local currency, he pays sterling to the Board and gets local currency in lieu. Conversely, if anyone has an excess of local currency he pays it in to the Board and gets sterling in lieu…the currency has no independent existence of its own, but is simply parasitical upon sterling.

The poorer a colonial economy was, the larger the share of physical cash in the

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[79] Contemporary observers remarked on the preference of colonial banks and Third World banking generally for low ratios of loans to deposits. *e.g.,* G. L. M. Clauson, 'The British Colonial Currency System', *Economic Journal*, Vol. 54, No. 213 (April 1944), p. 22; Arthur I. Bloomfield, 'Some Problems of Central Banking in Underdeveloped Countries', p. 192.
[80] See the analysis in Bloomfield, *ibid*, pp. 192-3 in particular.
[81] Gerard L. M. Clauson, 'Some Uses of Statistics in Colonial Administration', *Journal of the Royal African Society*, Vol. 36, No. 145 (October 1937), p. 14.

money supply, the smaller the value added by the domestic sector and the stronger the connection between the money supply and the balance of payments. But in the rare colony which had a broader-based foreign trade sector and a well-developed banking system, the money supply was not limited by the volume of currency in circulation. The banking system could create liquidity on a significant scale, and the money supply was not entirely at the mercy of changes in export earnings.[82] Furthermore, as the value added from domestic production of goods and services increased with economic modernisation, the importance of the balance of payments in determining the monetary situation declined.

Hong Kong was just such an exceptional colony, .and its monetary affairs were not subject to a self-regulating mechanism that worked as rigidly as in other colonial territories. Unlike almost every other colony, its economy had never been an extension of the United Kingdom but, instead, had been dependent on China, and as a China Trade Port, Hong Kong had been integrated into world markets from the very start. Furthermore, the switch from entrepôt activities to manufacturing for export that occurred in the 1940s and 1950s increased the value added in the domestic sector

Credit creation

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[82] The role of the commercial banks in determining the money supply under a colonial currency board has been widely ignored. One exception which recognises their powerful influence is Prest, *Public Finance in Underdeveloped Countries*, pp. 101-2. There has also been a failure to draw the obvious comparisons with the role of the banks under an exchange standard. Compare the passing reference to commercial banks under a colonial currency board and the important discussion of the same mechanism in the Dominions in Bell, *The Sterling Area in the Postwar World; Internal Mechanism and Cohesion 1946-1952*, pp. 5-6, 67-9.

Even more important for Hong Kong in undermining the currency board's normal adjustment mechanism was the involvement of the banks in credit creation, a fact which had been observed even of its pre-World War II economy.[83] In the typical colony, 'local banks were merely branches of London banks, maintaining their basic liquidity in London'.[84] Hong Kong's banking system was always independent of London, and Hong Kong had been a regional financial centre and home to major foreign banks since early in the twentieth century.[85] Its banking system's ability to create credit was not dependent on the volume of currency in circulation nor dictated by the balance of payments, as was the case for the rest of the colonial empire. Hong Kong's dependence on entrepôt trade with Chinese Mainland markets up to 1949 meant that a large proportion of business transactions were offshore, involving payments and receipts in foreign currency which had to involve the banking system at some point.[86] As Hong Kong moved from its traditional re-exports and transhipments to reliance on exports of domestic manufactured products to Western markets, external transactions could not be handled without banking services, while the scope for on-shore creation of bank credit expanded still further.[87] Bank liquidity became a major factor in the money supply.

How the banks managed their liquidity had important monetary implications and

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[83] The first to perceive the difference between Hong Kong and other colonies appears to have been Clauson, 'The British Colonial Currency System', pp. 2, 22.
[84] Anthony Latter, 'The Currency Board Approach to Monetary Policy – from Africa to Argentina and Estonia, via Hong Kong', in *Proceedings of the Seminar on Monetary Management organized by the Hong Kong Monetary Authority on 18-19 October 1993* (Hong Kong: Hong Kong Monetary Authority, n.d.), p. 27. The resentments these arrangements created can be gauged from James H. Mittelman, 'Underdevelopment and Nationalisation: Banking in Tanzania', *Journal of Modern African Studies*, Vol.. 16, No. 4 (December 1978), pp. 389-9 in particular.
[85] Howard Curtis Reed, 'The Ascent of Tokyo as an International Financial Center', *Journal of International Business Studies*, Vol. 11, No. 3 (Winter 1980), 'Table 3 Rankings of Asian International Bank Centers', p. 28; E. Stuart Kirby, 'Hong Kong and the British Position in China', *Annals*, Vol. 277 (September 1951), pp. 199-200
[86] On the vital importance of the local Chinese-owned banks to Mainland trade and investment, 'Conditions of Banking in Hongkong', *FEER*, 19 November 1947.
[87] See f.n. 6 above.

so, in consequence, did government policy about statutory liquidity requirements. The level at which these were set and how they were enforced had a direct effect on the volume of credit which the banks could create. In the 1950s, the government did not believe that a bank's lending could exceed its local deposits, although foreign-owned banks persistently allowed their loans to do so. [88] When restrictions on loan/deposit ratios were introduced by the 1964 Banking Ordinance, banks with headquarters outside the colony were able to avoid these constraints.[89] In the 1970s, the government continued to exempt foreign-owned banks from any obligation to set aside local funds to comply with their legal liquidity obligations.[90] As a result, a significant proportion of the banking system could create liquidity unrestrained by any consideration other than commercial prudence. The colonial administration's decisions on how to handle this feature of Hong Kong's monetary arrangements had important consequences for the stability of financial markets particularly in the 1970s, as will be explained in later sections.

The role of the reserves

There was a tendency to ignore a government's ability to influence monetary

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[88] (302) P. Mardulyn, Manager Banque Belge, letter to DFS, 30 November 1960; (303) DFS's reply to Mardulyn, 3 December 1960; (312) Statistician memo to DES, 'Banking Statistics', 22 April 1961; M. 35 AS(E) to DES, 19 May 1961. HKRS163-1-625 'Banking Statistics – 1. Supply of … to S of S 2. Policy Correspondence concerning'.

[89] For details of how this legal loophole worked, see Leo F. Goodstadt, 'Painful Transitions: The Impact of Economic Growth and Government Policies on Hong Kong's 'Chinese' Banks, 1945-70', *HKIMR Working Paper* No. 16/2006, November 2006, pp. 10-11.

[90] These arrangements are described in Y. C. Jao, 'Monetary system and banking structure', in H. C. Y. Ho and L. C. Chau (eds), *The Economic System of Hong Kong* (Hong Kong: Asian Research Service, 1988), p. 45. The Government tried consistently but unconvincingly, to argue that these arrangements were conventional deposits rather than 'window dressing'. *e.g.*, Haddon-Cave, *HH*, 11 April 1979, pp. 706-7.

conditions under a colonial currency board through the management of its reserves. The biggest item in a colonial portfolio was usually the assets to back the currency, which had to be held in sterling. In practice, these would not be drawn down because a colony was unlikely to abandon its own currency. There were also the sterling accounts needed to finance procurement and pension payments abroad.[91] There was little leeway for a government to alter these balances at its own discretion. Matters changed during World War II when colonies assisted the British military effort with goods and services for which the United Kingdom was unable to pay during hostilities because all its available resources were diverted from civilian production (including exports) to defence purposes. After the war, prices for agricultural products and the other commodities exported by the colonial empire rose significantly. As a result colonial governments' reserves increased considerably, and they ran substantial budget surpluses.[92] The importance of these new reserves was not always recognised. Budget surpluses were regarded as a passing phenomenon, the outcome of fiscal policies which would become politically impossible once a territory started to finance an ambitious economic development programme.[93]

In Hong Kong's case, these budget surpluses became a permanent feature of the financial landscape. Unlike other colonies, Hong Kong's did not depend on the cyclical exports earnings from plantation crops or mining which 'straitjacketed the economy

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[91] I. C. Greaves, 'The Sterling Balances of Colonial Territories', *Economic Journal*, Vol. 61, No. 242 (June 1951), pp. 434, 437.

[92]. Michael Havinden and David Meredith, *Colonialism and Development: Britain and Its Tropical Colonies, 1850-1960* (London: Routledge, 1993), pp. 269-70.For contemporary data and analysis, see H. A. Shannon, 'The Sterling Balances of the Sterling Area, 1939-49', *Economic Journal,* Vol. 60, No. 239 (September 1950), pp. 548-9.

[93] 'The achievement of a budgetary surplus for any length of time is simply out of the question for the ministers of finance of a developing country'. Albert 0. Hirschman, 'Economic Policy in Underdeveloped Countries', *Economic Development and Cultural Change,* Vol. 5, No. 4 (July 1957), p. 366.

in a low-level equilibrium trap'.[94] Its unreformed political institutions allowed the government to hold down public spending on economic development and social services, and the annual budget showed a surplus in most years. Under a currency board system, the surplus itself had no monetary implications. What mattered was where the surplus was held. If the government retained the funds in Hong Kong, they remained within the banking system and a part of the money supply, and their impact on the money supply was neutral. If they were transferred overseas, the funds were removed from the banking system, and the budget surplus was deflationary. The colonial administration was free to decide whether or not to keep the funds in Hong Kong. This discretionary power to decide the size and location of the fiscal reserves gave the government direct monetary leverage in a way not envisaged by most commentators on colonial finances.

Where the reserves were kept involved both investment and monetary considerations. Although critics saw the reserves as obvious United Kingdom exploitation of its colonial economies, British officials viewed them as an overseas portfolio that produced substantial returns for the territories they ruled.[95] A currency board was able to give a high priority to generating income because its only obligation was to redeem notes and coins in sterling on demand, and it was inconceivable that a colonial population should demand the redemption in sterling of any significant proportion of the currency. (By contrast, a central bank has to use its resources to achieve monetary objectives even if it incurs a loss in the process.)

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94 See Michael Howard, *Public Finance in Small Open Economies: The Caribbean Experience* (Wesport: Praeger Publishers,1992), p. 151.

95 'The business is a very profitable one, most of the currency boards have their liabilities for outstanding coins and notes covered to the extent of 110 per cent, and pay over large sums to the Colonial Governments from the interest on their securities'. Clauson, 'Some Uses of Statistics in Colonial Administration', p. 14.

Hong Kong, however, was not the typical colony, and there was considerable potential for conflict between a profit-seeking investment strategy and monetary goals. In practice, financial secretaries throughout the post-war period generally gave priority to interest income and capital gains in managing the reserves rather than to influencing local monetary conditions.[96] This investment priority was tenable while Hong Kong adhered to the currency board system. But it caused severe strains between 1972 and 1983 when fear of suffering significant capital losses on the government's overseas holdings bedevilled management of the currency after the link with sterling was broken and Hong Kong later switched to a floating rate.[97]

Excessive surpluses

There was considerable controversy, overseas as well as in Hong Kong, over whether a colony's reserves should be retained locally. The benign view was that the lack of a modern financial infrastructure in most colonies meant that the funds had to be held in London. But critics argued that the colonial territories' sterling reserves were a forced loan to the United Kingdom which should be brought to the colonies to finance their economic development.[98]

During the 1950s, the Financial Secretary rejected these criticisms and adopted a

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[96] Clarke, *HH*, 27 March 1957, p. 117; Cowperthwaite, *HH*, 1 March 1967, p. 83. Haddon-Cave, *HH*, 13 December 1972, p. 222.
[97] Haddon-Cave, *HH*, 25 February 1976, p. 517.
[98] Greaves took a benign view, which was challenged by Arthur Hazelwood, 'Colonial External Finance Since the War', *Review of Economic Studies*, Vol. 21, No. 1 (1953-1954), pp. 48-9.

policy of accumulating surpluses until the fiscal reserves equalled a full year's recurrent expenditure. The business community could not believe that budgetary prudence on this scale was justified. In other colonies, the government also accumulated substantial reserves after World War II but these were regarded as 'a vital element in funding their ten-year development plans'.[99] But Hong Kong had no state planning, and in 1957, business representatives in the legislature called for the government's overseas reserves to be brought back to the colony and invested in the local economy.[100] This demand clashed with Clarke's desire to maximise the earnings from the reserves. Interest rates were higher in London than in Hong Kong, and he thought it wrong not to take advantage of this profit opportunity. London's attractions had led him to continue this practice in 1955 when HSBC was tightening the supply of loan funds for local borrowers. As a result, there was a severe credit squeeze which, it seems, he had neither anticipated nor intended. The transfer of these funds to London ceased only in 1959.

Of all the financial secretaries in this period, Cowperthwaite had the best grasp of how the currency board system functioned and of the monetary consequences of the management of the reserves. He understood the separate roles of the backing for the currency, the government's fiscal reserves and the liquid assets of the banking system which were held mainly overseas because Hong Kong had neither a central bank nor the financial instruments to absorb these funds. He thought Clarke's target for the fiscal reserves was excessive but he still maintained them at a level comfortably adequate to

[99] Havinden and Meredith, Colonialism and Development: Britain and Its Tropical Colonies, 1850-1960, p. 269.

[100] The controversy and its protagonists are recorded in *HH*: Clarke, 2 March 1955, p. 52; 29 February 1956, pp. 91-2; ; 27 February 1957, p. 31; 6 March 1958, p. 47; Lo Man Wai, 21 March 1956, p. 118; Ngan Shing-kwan, 21 March 1956, pp, 118, 121; C. E. M. Terry, 20 March 1957, p. 61.

cover a half year's recurrent expenditure.[101] Cowperthwaite abandoned Clarke's policy of earmarking government reserves for use in a recession to maintain government spending programmes and 'get on with the task of providing our people with their needs'.[102] Instead, the reserves would be dedicated to offsetting unexpected deflationary pressures on the banking industry.[103]

Because of Cowpwerthwaite's hostility to the use of statistical information in policy making, he made decisions on the deployment of the reserves which were in conflict with prevailing economic conditions. In 1965, Hong Kong's sterling holdings rose substantially which added to the credit squeeze that followed the bank runs that year. Cowperthwaite realised that an increase in the overseas reserves would contract the money supply.[104] He argued, nevertheless, that the increased reserves were evidence of the economy's robustness. The full impact of the 1965 crisis was not felt until the following year when the rate of economic growth fell sharply. This slowdown was aggravated by the government's decision once again to expand its London holdings in 1966, thus adding a further constraint on liquidity.[105]

In the 1970s, Haddon-Cave was thoroughly muddled about the relationship between the overseas reserves and the money supply.[106] When the Hong Kong dollar switched to a floating rate in 1974, this misunderstanding blinded him to the consequences of abandoning the currency board system and its requirement of full

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[101] Cowperthwaite, *HH*, 26 March 1969. p. 206.
[102] Clarke, *HH*, 23 March 1960, pp. 128-9.
[103] Cowperthwaite, *HH*, 24 February 1966, p. 57 and 1 March 1967, p. 82.
[104] In 1970, Cowperthwaite specifically referred to the deflationary impact of an increase in the government's overseas holdings. *HH*, 25 February 1970, p. 363.
[105] *HH*, 22 February 1966, p.57; 1 March 1967, p. 82.
[106] The confusion is very clear, for example, in Haddon-Cave, *HH*, 16 November 1978, p. 208.

backing with foreign assets for the currency in circulation. He failed to recognise that without either a currency board or a central bank, the government had no means of removing from the financial system its own reserves. As they accumulated with local banks, they swelled the deposit base on which bank lending could expand. He seemed convinced that because the currency was still issued by commercial banks, nothing had changed. Yet, with every increase in the note issue, a corresponding increase took place in the government's deposits within the local banking system, allowing a cycle of further expansions in bank lending and new increases in the note issue.

Managing the money supply

The government's preference was to leave bank liquidity to market forces. Difficulties arose, however, when excessive credit creation by the banks led to serious inflation of share and real estate prices. Before World War II, the government was very aware of this problem, but the general consensus among both officials and leading business representatives was that little could be done to reduce this risk even though banks themselves were vulnerable to the inevitable market crashes. After World War II, credit rationing was widely used in Western economies to combat inflationary pressures, and Hong Kong also experimented with this approach. In 1955, HSBC became nervous about soaring share and property prices. This burst of inflation was probably fuelled by the bank's decision to redeem a significant quantity of banknotes in 1954,[107] although the colonial administration was also involved because the bank acted in close

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[107] This 'surplus' had had been created by the suppression of the circulation of Hong Kong currency on the Mainland after Mao Zedong's victory in 1949. A large quantity of HSBC banknotes had been .brought back to the colony in consequence. HKRS 163-1-1943 'Hong Kong Exchange Fund Operations by the Hong Kong & Shanghai Banking Corporation', letter to Colonial Office, 25 June 1959.

consultation with officials in managing the note issue.[108] (Under the currency board system, the redemption of currency in circulation was inflationary.) With the Financial Secretary's approval, HSBC introduced a credit squeeze to stabilise the markets.[109] The reaction from the business community was hostile as bank lending was cut back, and liquidity started to shrink. The local Chinese-owned banks suffered a sharp decline in both deposits and profits as the stock market collapsed and turnover slumped on the gold and foreign exchange markets. Liquidity tightened still further after six local Chinese banks failed in late 1955.[110] Speculation had been squeezed out of the economy, but investment was also drying up. HSBC blamed the government for the mounting crisis on the grounds that the colonial administration had intensified the initial credit squeeze by transferring government balances from local banks into sterling, thus reducing the money supply.[111]

This situation was in conflict with Clarke's desire to leave business to its own devices.[112] HSBC now urged the government to reflate the economy, and the Financial Secretary injected additional liquidity into the banking system by bringing funds back from London.[113] Clarke explained publicly that the colonial administration felt a duty to ensure an adequate supply of credit. But he warned that this responsibility might

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[108] Memo (secret), 'Note Issuing Banks in Hong Kong', 14 May 1954, pp. 4-5.HKRS163-1-1943.
[109] Clarke, *HH*, 29 February 1956, p. 77.
[110] Ricardo, 'Development of Banking in Hongkong during 1955', *FEER*, 2 February 1956.
[111] On the relationship between transfers of official reserves to and from sterling and the local money supply in the 1950s, see Frank H. H. King, *Money in British East Asia* (London: HMSO, 1957), p. 120.
[112] Even before he became Financial Secretary, for example, Clarke had opposed interfering with public utilities' profits though they were so exorbitant that the Governor, Sir Alexander Grantham, considered nationalising these companies. Clarke argued that high profits could be explained by 'efficient organization and efficient operation'. Acting Financial Secretary minute to Chief Secretary, 10 August 1948; Governor note, 11 August 1948; Deputy Financial Secretary minute to Financial Secretary, 23 January 1950. HKRS163-1-634 'PUBLIC Utilities Companies Proposed control of the charges and dividends levied by… '
[113] Frank H. H. King, The Hong Kong Bank in the Period of Development and Nationalism, 1941-1984. From Regional Bank to Multinational Group (Cambridge: Cambridge University Press, 1991), p. 338.

require 'a much greater say in credit policy' for the government in future.[114] Henceforward, however, there were to be no more attempts of this kind to manage the money supply, and Clarke's successor disclaimed any government obligation to do so.[115]

Cowperthwaite was adamant that, regardless of monetary theories, the government had to let a recession run its course, as was noted earlier. But he also believed that this constraint did not apply if deflation began in the financial sector. 'One of the few elements of modem monetary policy we can safely indulge in', he argued, was to reverse a contraction in the banking system's liquidity by direct injection of government funds. For this reason, he adopted a policy of maintaining 'abnormally high' levels of reserves by comparison with other governments, which should 'be held to a great extent abroad'.[116] This view had significant implications not just for fiscal policy but also for the management of the government's reserves which were a major determinant of the monetary environment. This policy meant that budgets had to be consistently deflationary to generate the surpluses for transfer overseas. This was monetary policy by default and without public debate.

In fact, of course, any government attempt to reflate the economy during a recession would involve expanding liquidity within the financial system. Significantly, Cowperthwaite implied in his confidential correspondence with London that he would have pumped money into the banking system during the Korean War crisis if he had been financial secretary, which would, in practice, have been a 'Keynesian' solution

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[114] Clarke, *HH*, 27 March 1957, pp. 116-7.
[115] Cowperthwaite, *HH,* 1 March 1967, p. 83; 25 February 1970, p. 363.
[116] See f.n. 46 above.

to the threat of mass unemployment.[117]

In the 1960s, the government acquired a new weapon with which to regulate the creation of credit by the banking industry. The 1964 Banking Ordinance introduced a minimum liquidity ratio of 25 per cent. Hong Kong had no central bank or money market to provide a vehicle in which these liquid assets could be held locally. As a result, the bulk of them had to be held overseas which, under the currency board system, sterilised them very effectively, reducing the capacity of the banking system to create loans.[118] The colonial administration made it clear that that the aim of this new statutory requirement was partly monetary. 'The minimum liquidity ratio set for banks is designed not only to ensure the ready availability of funds to repay deposits', the Financial Secretary declared, 'but also to prevent the inflationary effects of credit creation through excessive bank lending'.[119] By 1966, the Financial Secretary had come to believe that a ratio of 25 per cent was not an adequate barrier to excessive credit creation but decided not to change the legal requirement because the banking industry as a whole was maintaining a much higher ratio on a voluntary basis.[120]

Thereafter, the colonial administration declined to make use of its statutory power to vary the minimum liquidity ratios to restrain banks from expanding the money supply recklessly. Cowperthwaite did not feel able to resist business opposition to any intervention that would restrict their profit opportunities. Thus, he admitted that as early as 1963, there had been a strong case for direct measures to stabilise the property

[117] See f.n. 46 above.
[118] Cowperthwaite, *HH*, 16 September 1964, p. 331; 24 February 1966, pp. 75-6.
[119] Cowperthwaite, *HH*, 26 March 1969, p. 205.
[120] Cowperthwaite, *HH*, 24 February 1966, p. 75-6.

market whose excesses were to trigger the 1965 bank runs.[121] He decided to do nothing, he said, because 'businessmen would have fiercely resisted' any government intervention, and he would have been overwhelmed by a 'torrent of angry protest'.[122] Later in the decade, 'a sudden, and inevitably ill-considered, expansion of [bank] advances' took place, said the Financial Secretary. But he preferred to let the banking system find its own solution because of his anxiety about 'the private sector which we must be sure not to starve of funds if we are to maintain our rate of growth'.[123]

Cowperthwaite was, first and foremost, an expansionist who would do nothing to impede the fastest possible growth in the overall economy even when liquidity was growing at an alarming rate.[124] He knew that 'excessive bank lending' led to inflationary pressures.[125] But he also pleaded that the government was incapable of resolving the practical problem of identifying 'what rate of expansion of the economy would be "right" … [and how] to regulate it at that rate'. He saw no way of judging when an industry or market was suffering from 'over-expansion'. Thus, he was prepared stand aside even when, as he put it, the growth rate was threatening 'uncomfortable, even injurious, effects on some individuals or some sectors'.[126]

A similar situation emerged under a new financial secretary in the 1970s. By 1973, speculation had driven share prices to unrealistic levels thanks to the same generous creation of liquidity by the banks that had led to the 1965 bank crisis. The Hang Seng

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[121] For evidence that the government had ignored the growing signs of excessive bank liquidity, see the data cited by Cowperthwaite, *HH*, 24 February 1966, p. 54.
[122] Cowperthwaite explained frankly how he could have used administrative measures to control the property excesses even before the introduction of statutory liquidity requirements. *HH*, 26 February 1964, p. 45.
[123] Cowperthwaite, *HH*, 26 March 1969, p. 206.
[124] His thinking on this issue was expressed most clearly in *HH*, 8 October 1965, p. 85.
[125] His understanding of the banks' role is clear from Cowperthwaite, *HH*, 26 March 1969, p. 205.
[126] *HH*, 8 October 1969, p. 85.

Index rose as high as 1775 early in 1973 before crumbling to 400 at year-end and to 150 in December 1974. Turnover was HKD48 billion in 1973 but slumped to HKD11 billion in the following year.[127] The government was attacked for allowing the surge in bank liquidity that financed the stock market speculation and to which the foreign-owned banks were regarded – correctly – as making a major contribution. Haddon-Cave countered by arguing that the banking industry was still behaving responsibly even though lending had become less conservative than in the previous decade, an assertion which was not easy to assess in the absence of published data on this issue. He claimed – quite wrongly – that foreign banks were importing capital to fund their local operations when, in fact, they were exploiting on a grand scale a loophole in the legal definition of minimum liquidity ratios.[128]

At the end of the 1970s, speculative activity had begun again in the share and property markets. The Financial Secretary refused to tighten up the definition of liquidity requirements for foreign-owned banks despite complaints that they were guilty of imprudent lending.[129] Far more alarming was his reluctance to extend any form of statutory liquidity requirements to deposit-taking companies until the end of the decade, even though these were being used by licensed banks to evade all legal controls and official oversight of their lending and investment activities.[130] What made this situation particularly alarming was the abrogation of the currency board system in 1974

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[127] Frederick Ma, Secretary for Financial Services and the Treasury, *Government Information Services*, 18 November 2002.
[128] Haddon-Cave, *HH*, 29 November 1973, p. 229. On the inaccuracy of his defence of the foreign-owned banks, see M. 11 Exchange Controller to DES, 23 August 1972. HKRS163-3-12 'Banking Statistics /1. Supply of to S. of S. Policy concerning … '. On the substantial role played by foreign-owned banks in this bubble market, see Leo F. Goodstadt, 'Dangerous Business Models: Bankers, Bureaucrats & Hong Kong's Economic Transformation, 1948-86', *HKIMR Working Paper No. 8/2006,* June 2006, pp. 15, 16-7.
[129] Haddon-Cave, *HH*, 11 April 1979, p. 709; 15 November 1979, p. 217.
[130] Haddon-Cave, *HH*, 15 March 1978, p. 624.

when Hong Kong moved to a floating rate régime. Haddon-Cave acknowledged publicly that, as a result, 'the banks are no longer completely constrained by their liquidity ratios'.[131] What he failed to recognise was that there was no longer any restriction other than self-restraint on their ability to create liquidity.

Although Haddon-Cave realised that statutory liquidity ratios could be used to influence credit creation within the banking system, he refused to make use of them for two reasons. In the first place, he misunderstood the way in which foreign-owned banks could create liquidity regardless of the apparent statutory restrictions. He argued that as long as their head offices had designated adequate funds to meet demands for cash from their Hong Kong depositors, the mechanics of their liquidity ratios did not matter.[132] In terms of monetary policy, the freedom of these banks to lend money in excess of their local deposits was, of course, highly significant. The second and more important consideration was his desire in the early 1970s not to deter financial institutions from using Hong Kong as their Asian base through the imposition of controls on their business activities in the colony. He could have provided them with fiscal incentives to operate from Hong Kong but decided not to. Thus, the only significant inducement he could offer was to minimise official regulation of foreign financial institutions, including the liquidity requirements imposed on them.[133] This anxiety to promote Hong Kong's role as an international financial centre explains the government's reluctance to impose controls on the freedom of the banks and DTCs to create liquidity.

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[131] Haddon-cave, *HH*, 2 March 1975, p. 807.
[132] 'The amount of such liquidity, and in particular the amount of any deposits at the head office overseas of a foreign bank in Hong Kong, is reported each month to the Commissioner of Banking: he satisfies himself that those deposits are genuinely at the disposal of the branch in Hong Kong in case of need —which is, after all, what liquid assets are designed for'. Haddon-Cave, *HH*, 11 April 1979, p. 707
[133] This message seems very clear from Haddon-Cave, *HH*, 28 February 1973, pp. 494-5.

The government passed legislation in 1975 allowing the statutory liquidity ratio to be varied. But Haddon-Cave gave bankers the reassurance 'that it is not envisaged that the ratio would ever be varied for monetary control purposes'.[134] Under the floating rate régime, the money supply situation had deteriorated, as he himself confessed. Domestic consumption began to increase at what the government termed an unsustainable rate in 1977. Yet, officials still placed their trust in 'the inevitable mechanism of the market operating in this instance through the exchange rate, interest rates and the money supply'.[135] By 1979, the banks were pumping liquidity into the share and property markets on an alarming scale, and Haddon-Cave was talking openly of the need to find 'suitable constraints for Hong Kong's particular circumstances'. The weapon immediately to hand, he noted, was banks' liquidity ratios. But he still found it repugnant 'to impose any form of direct control on the supply of credit … I would much prefer to leave matters to the banking system itself'. Nevertheless, he warned that he might be compelled to restrain credit creation through higher liquidity ratios which would also apply to DTCs.[136] But he hesitated because he now grasped that they would not apply to banks with headquarters outside the colony. Changes in the liquidity ratio would be unfair to HSBC and local banks, he explained, 'inasmuch as it would be easier (and possibly less costly) for foreign banks in Hong Kong to replace any liquidity taken up by an increase in the ratios than it would be for locally-incorporated banks'.

Eventually, with considerable reluctance, he took legal powers to vary statutory

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[134] Haddon-Cave, *HH*, 5 November 1975, p. 190.
[135] MacLehose, *HH*, 5 October 1977, p. 11.
[136] Haddon-Cave, *HH*, 28 February 1979 p. 554.

liquidity ratios to support the government's monetary policies.[137] He never used them, and business autonomy remained a cornerstone of Hong Kong's financial status. In the end, he blamed the colony's monetary woes on the floating exchange rate introduced in 1974 rather than on his own policy errors and argued that it had made inflation an insoluble problem.[138]

> To the extent that our present floating exchange rate regime leads, from time to time, to an expansion of the money supply disproportionate to the economy's ability to absorb additional credit without inflation, awkward questions of monetary management will continue to arise, but we are not the only government that find such questions awkward.

Haddon-Cave convinced himself that his one practical weapon to influence the money supply was management of interest rates through a cartel operated by the Hong Kong Association of Banks. 'The only really satisfactory and practicable method of exercising control over the growth rate of the money supply in Hong Kong is the use of interest rates', he insisted, a view to which he stuck throughout his career as Financial Secretary.[139] While the cartel was a powerful force, the colonial administration had considerable influence on the money market: movements in interest rates were closely linked to changes in the level of government deposits within the local banking system.[140]. Haddon-Cave seemed oblivious to this phenomenon.

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137 Haddon-Cave, *HH*, 11 April 1979, pp. 709-10.
138 Haddon-Cave, *HH*, 25 February 1981, p. 523.
139 Haddon-Cave, *HH*, 28 February 1979 p. 554; 25 February 1981, p. 528; 29 April 1981, p. 810.
140 Leo Goodstadt, "The government joins the monopoly," *Euromoney*, July 1979, p. 139.

Inflation is good for you

Although inflation was an issue which aroused regular public indignation, the colonial administration made a vigorous effort to deny the need for any special policy measures to stabilise prices and markets. Officials invoked the automatic adjustment mechanism that was supposed to be an in-built feature of the Hong Kong economy. They also argued that inflation was a beneficial side-effect of burgeoning prosperity. Rising prices and speculative remained a serious source of public disquiet, nevertheless.

The surging prices that followed the end of World War II had to be tackled by vigorous state intervention (which was described earlier). In the 1950s, world and domestic markets returned to normal; the inflationary spiral subsided; and rising prices ceased to be a major political threat. Taking the 1950s as a whole, prices were stable, and so was the volume of currency in circulation.[141]

In the 1960s, inflation became a political issue as property prices rose sharply and domestic rents followed suit. At first, the colonial administration tried to deny that the increasing cost of property was a matter for concern. Cowperthwaite argued that Hong Kong's economic system did not permit serious inflation.[142] 'Rent increases are rather the result of pressures arising from our present prosperous economic condition', he told legislators, 'They are one symptom of that prosperity rather than a cause of

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[141] Shou-eng Koo, 'The Role of Export Expansion in Hong Kong's Economic Growth', *Asian Survey*, Vol. 8, No. 6 (June 1968), p. 507.
[142] 'There have been several references in the debate to inflation. This is a rather imprecise term. We do not have it in its worst economic sense because our monetary system does not allow that to happen'. Cowperthwaite, *HH*, 30 March 1962, p. 128.

inflation'.[143] This explanation failed to persuade the public. Political discontent continued until legislation to restrict rent increases was enacted eight month later, and rent controls were to remain on the statute book in some form or another for the rest of the century.[144]

As the economy boomed in the first half of the decade, the business community continued to complain about rising land and labour costs, both of which were viewed very widely as undermining Hong Kong's export competitiveness. Cowperthwaite refused to take such direct measures to check inflationary pressures as expanding the fiscal reserves held overseas to remove excess liquidity from the financial system. 'Our inflation is not the bad kind', he declared, 'but a reflexion of high economic activity'.[145] The Governor joined the debate, attributing 'cost inflation' to 'high export demand' and interpreting it as 'a consequence of increasing prosperity rather than as a premonition of ruin'. He argued that, in the past, excessive competition among local manufacturers had kept export prices excessively low. 'It is a good thing, surely not a bad thing, that our [export] prices should be forced up to correct world competitive levels by the high tension of our economy'. He also expressed the colonial administration's view that 'socially and politically it is most valuable that labour should enjoy so large a share of the increment'.[146] The Financial Secretary was left free to ignore arguments for a monetary policy to counter inflation.

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[143] Cowperthwaite, *HH*, 17 January 1962, p. 6. Legislation to control rent increases was introduce eight months later. (C. Burgess, Colonial Secretary, *HH*, 26 September 1962, pp. 278-88)
[144] For details of its final demise, see Housing Department, *Consultation Paper: Landlord and Tenant (Consolidation) Ordinance (LTO) (Cap.7) Security of Tenure* (Housing, Planning and Lands Bureau January 20030, p. 1.
[145] Cowperthwaite, *HH*, 27 February 1963, p. 41.
[146] Sir Robert Black, Governor, *HH*, 26 February 1964, p. 37.

The government's critics were not convinced, and, at the end of his career, Cowperthwaite was still trying to persuade the community that inflation was good for Hong Kong. He listed the weapons available to the colonial administration for squeezing liquidity out of the system: expanding the government's reserves, for example, or raising the banking industry's statutory liquidity requirements. But an active monetary policy would not be cost-free, he warned. In the last resort, he explained, the colony faced 'the familiar dilemma between rapid growth and stabilization'. The government would face widespread opposition within the community if it tried 'to reverse all our previous policies and choose stabilization rather than growth'. He also tried to outflank his critics in the business community by adopting a more egalitarian pose than was customary among colonial officials.[147]

> We hear much today about the danger of rising wages as if wages were the price of a commodity or a raw material, the increase in which should somehow be controlled, …although less is said in this vein of profits which are a phenomenon of a not dissimilar nature; if we are to have an 'incomes policy' it would have to be imposed on all incomes … I myself welcome increasing wages … because they help to ensure both maximum export prices and the most productive use of our scarce resources; and at the same time redistribute more fairly our growing national income, even if this inevitably means, in our circumstances, generally rising internal price levels.

Inflation remained a serious issue in the 1970s. But as usual, the colonial administration did not see monetary measures as the solution. 'The main contribution the Government can make towards containing inflationary trends is through its social policies', the Governor proclaimed, listing cheap public housing and rent controls, free

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[147] His lengthy defence of the government's refusal to tackle inflation is presented in Cowperthwaite, *HH*, 9 October 1970, pp. 112-5.

primary education and 'almost free' medical care.[148] The new Financial Secretary, Haddon-Cave, stuck to the Cowperthwaite line: the colony did not need active monetary policies because an automatic adjustment mechanism controlled the economy. Haddon-Cave was soon confronted with runaway property and share prices, which business representatives interpreted as clear evidence of a mounting inflationary threat. Although the system no longer seemed to be either automatic or very effective in stabilising prices and markets, Haddon-Cave still struggled hard in 1973 to counter demands for government intervention. He insisted that 'in the Hong Kong economy market forces do exercise a corrective influence' though not in the short-term. [149] He claimed that Hong Kong could not suffer from serious domestic inflation so long as public expenditure did not increase faster than GDP over a significant period. With the colony's open economy, there was no danger of wages and other production costs spiralling out of control, he declared. [150]

By the following year, Haddon-Cave came close to admitting that the era of automatic adjustment was over. Gone was the insistence that a free and open economy guaranteed that there would be a spontaneous adjustment to changing economic conditions in the rest of the world. That had only been possible while the colony had been 'curiously isolated from outside influences', he explained, when Hong Kong depended almost entirely on domestic exports of manufactured goods. Import restrictions in Western markets, he continued, had protected Hong Kong from lower-cost producers seeking to enter these markets because they lacked the quota and

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[148] MacLehose, *HH*, 17 October 1973, p. 26. The government also pointed to its strict control of the rice trade to ensure adequate supplies. D. H. Jordan, Director of Commerce and Industry, *HH*, 27 March 1974, pp. 710-21.
[149] Haddon-Cave, *HH*, 28 March 1973, p. 640.
[150] Haddon-Cave, *HH*, 29 November 1973, p. 239.

other access rights established by the colony's manufacturers since the 1950s. In the 1970s, he argued, Hong Kong was an emerging financial centre and, as such, was doomed to suffer unstable monetary conditions.[151]

> Our interest rates are no longer determined internally in isolation, but have to adapt to the trend of interest rates world-wide. Our stock market is no longer as parochial as once upon a time for prices are clearly now influenced by the state of equity markets and general economic conditions elsewhere. And the Hong Kong dollar is no longer simply an extension of sterling, but is linked to the US dollar and has to find its own level, therefore, in relation to other currencies.

There was, indeed, no escape from unstable monetary conditions in this decade but not because the colony was somehow more vulnerable to external economic conditions than in the past. The instability was the direct outcome pf the government's monetary misconceptions and mismanagement.

Conclusions

There is a remarkable consistency about Hong Kong's monetary policy throughout the period 1935-80. Even before World War II, officials saw themselves as powerless to exert much control over monetary affairs apart from fixing the exchange rate. This narrow view of monetary policy was acceptable in that age, but not because of the commitment to laisser faire and the adoption of a currency board. Hong Kong in the 1930s had already disowned any ideological attachment to non-interventionism as a

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[151] Haddon-Cave, *HH*, 14 November 1974, pp. 217-8.

fundamental principle. More important was the fact that macroeconomics was still in its infancy. The basic analysis needed for more ambitious monetary management was simply not available.

The post-war era saw a radical break with laisser faire throughout the British Empire, together with disenchantment with the traditional colonial monetary arrangements. Rehabilitation of Hong Kong's war-torn economy after Japan's defeat ushered in a period of state controls in Hong Kong as well as prolonged business demands for active government support for industrialisation. The colonial administration chose to be unfashionable and stuck to non-interventionism and the currency board system. Financial secretaries felt able to claim that in Hong Kong's circumstances, monetary policy would be of no benefit. This decision reflected a dearth of economic expertise that had much in common with the weak state of monetary economics before World War II. The financial secretaries reviewed here displayed a striking similarity over three decades in their repeated rejection of 'modern' or 'Keynesian' economics and their dogged conviction that Hong Kong had an in-built adjustment mechanism. At the same time, it is revealing that, in each decade from 1950 to 1980, each of them discussed their monetary policy options, including direct intervention. In so doing, they were acknowledging that a case could be made for active monetary management and that the government had the tools to implement a monetary policy. At the same time, these officials did not comprehend that the rejection of responsibility for monetary policy was not a neutral decision. It had significant monetary consequences.

- In the 1930s, ample bank liquidity had financed the start of the colony's manufacturing take-off. Its contribution to speculation on financial and property markets was probably less important in generating instability than the turmoil caused by revolution and war in that era.

- In the 1950s, the ample liquidity created by foreign-owned banks was a positive factor in funding the emergence of Hong Kong as a leading exporter of light industrial products.
- In the 1960s, the Financial Secretary thought that growth should be the overwhelming priority regardless of the economic and social costs involved. It is open to question whether Cowpwerthwaite's refusal to check the banks' unrestrained creation of credit for the property market which, by his own admission, was followed by the 1965 bank crisis was a reasonable price for a strategy of growth at any price.
- In the 1970s, the Financial Secretary's fear of alienating foreign banks led to a similar decision to let financial and property markets find their own level. The costs in this decade were compounded by Haddon-Cave's misunderstanding of Hong Kong's monetary system which led to the currency collapse in 1983.

Some modern economists argue that it is wrong for the monetary authorities to try to counter excessive liquidity that generates immoderate speculation on share and property markets. They contend that because inadequate banking supervision and defective management are the real causes of 'bubble' conditions –which was certainly true of Hong Kong in the 1960s and 1970s –monetary policy is not the appropriate remedy.[152] But in Hong Kong, it can be shown, the colonial administration's policies

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[152] See the case presented, for example, in Adam S. Posen, 'Why Central Banks Should Not Burst Bubble', *International Finance*, Vol. 9, No. 1 (2006).

had created the market environment for severe monetary problems, and the government could have averted disaster by accepting responsibility for monetary affairs. The property boom of the 1960s and its collapse can be attributed principally to the abnormal market conditions caused by changes in both building legislation and official policies.[153] Similarly, the chaotic market conditions of the 1970s can be blamed on the colonial administration's mismanagement, as has been explained earlier.

The record of the financial secretaries reviewed above demonstrates that monetary policy could have contributed to the proper management of the colony's economic development. The problem was that laisser faire had ideological implications. A belief in the superior efficacy in market forces inevitably meant that officials would believe that business knew best and that state intervention must be perilous. The conviction among senior officials that Hong Kong was self-regulating provided the ideal excuse for standing aside as instability gathered momentum. Financial secretaries were able to survive their monetary mistakes because of the absence of representative and accountable government. Hong Kong was able to survive because the community generated continuous expansion of the economy from one year to the next regardless of the external threats to its survival, the overseas barriers to its exports and the avoidable crises within its financial system.

[153] The best account of the market consequences of the changing government policies and regulations is Stephen N. S. Cheung, 'Rent Control and Housing Reconstruction: The Postwar Experience of Prewar Premises in Hong Kong' *The Journal of Law and Economics*, Vol. XXII, April 1979, pp. 46-8.