

# GOVERNMENT CONTROL, TRANSACTION COST AND TRUST BETWEEN THE HONGKONG AND SHANGHAI BANKING CORPORATION (HSBC) AND THE CHINESE GOVERNMENT

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## ABSTRACT

We use the tools of transaction cost politics ('TCP') developed from transaction cost economics and economic analysis, to analyse the business relationship building between the Hongkong and Shanghai Banking Corporation (HSBC), the largest and most successful foreign bank in China and the Chinese government, between 1949 and 1978. We demonstrate the value of TCP-based approach to evaluating the specialised governance structure of trust. In particular, we identify several transaction attributes that give rise to hazards: transaction uncertainty, the role of the government in the economy and the strength of the supporting coalition. We also identify the difference between trust created through incentives by the government which was in a dominant position and trust applied to HSBC which was in a vulnerable position. Our analysis also confirms that the trust relationship between the international company and the local authorities did reduce the company's transaction costs by guarding against the local authorities' opportunism.

## 1. Introduction

Transaction cost economics has long been the focus of attention for business historians. It attributed the development of governance mechanisms for contracting, including relationship contracting, to the problems of bounded rationality and opportunism.<sup>2</sup> Williamson proposed that credible commitments could be adopted to build the relationship contracting by reducing information asymmetry and opportunism.<sup>3</sup> But transaction cost economics is mainly based on transactions between private parties. When the transaction is between the government and the private party, how should the private party reduce transaction costs? Unlike the transaction cost economics prescription of internalisation as a means to overcome contractual hazards in exchange and align the incentives of counterparties, investors facing hazards caused by government are unable to fully internalise their transactions with governments. How should the private party build a governance structure with local authorities? If the private party concerned is an international company, which factors would influence this relationship building?

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<sup>2</sup> O. Williamson, *Markets and Hierarchies* (New York: Free Press, 1975); T. Reve, "The Firm as a Nexus of Internal and External Contracts," in M. Aoki, B. Gustafsson and O. Williamson (ed.) *The Firm as a Nexus of Treaties* (London: Sage, 1990).

<sup>3</sup> O. Williamson, *The Economic Institutions of Capitalism* (New York: The Free Press, 1985), 167.

Henisz and Zelner apply the logic of comparative institutional analysis proposed by Williamson in transaction cost economics to the question of the governance of the relationship between private investors and the government. They identify political hazards as a crucial determinant of the choice of political governance and the transactional attributes that give rise to such hazards. They propose two stylised political governance structures that investors may employ to mitigate political hazards: ‘generalised’ governance and ‘specialised’ governance by comparing transactions with different levels of political hazards across institutional environments with different levels of national checks and balances and particularism.<sup>4</sup> This paper will test empirically their proposed alignments by undertaking a case study of HSBC in China, the largest and most successful foreign bank in China, between 1949 and 1978, and analysing the relationship building between HSBC and the Chinese government. Though the relationship between HSBC and the Chinese government has been mainly built on business transaction rather than political transaction, it can still fit in with the framework regarding relationship building between the government and the private party.

Our contribution to the transaction cost theories is the following. First, it is among the few case studies analysing government – international company relationship in China’s service sector. Under the government controlled economy, the business – business transaction relationship was actually replaced by government – business transaction relationship and transaction cost is mainly influenced by the government due to its supreme power.

Second, this paper tests Henisz and Zelner’s transaction cost politics framework that as political hazards increase, private parties go for a specialised political governance structure with jurisdiction over policies of particular interest to them. In our study, this specialised governance structure is trust. In order to reduce transaction costs, the international company, without other support, has to achieve the local government’s trust. “Trust” is a term with many meanings. In the seminar series organised by Gambetta, a unified observation about trust was achieved: “There is a degree of convergence in the definition of trust which can be summarized as follows: trust ... is a particular level of the subjective probability with which an agent assesses that another agent or group of agents will perform a particular action .... When we say we trust someone or that someone is trustworthy, we implicitly mean that the probability that he will perform an action that is beneficial or at least not detrimental to us is high enough for us to consider engaging in some form of cooperation with him.”<sup>5</sup> This paper follows this definition of trust.

Third, this paper shows that there is a distinction between trust created through incentives and trust applied to situations in which players retain a vulnerability to the actions and choices of others. Such a distinction is important, because economists generally have little understanding of trust and its role in economic exchanges, particularly in the absence of incentives for trustworthiness in others.<sup>6</sup> While not the

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<sup>4</sup> W. Henisz, and B. Zelner, “Explicating political hazards and safeguards: a transaction cost politics approach,” *Industrial and Corporate Change*, No. 6, 13 (2004): 901-915.

<sup>5</sup> D. Gambetta, “Can We Trust Trust?” in D. Gambetta (ed.) *Trust: Making and Breaking Cooperative Relations* (Oxford: Basil Blackwell, 1988).

<sup>6</sup> O. Williamson, “Calculativeness, trust, and economic organization,” *Journal of Law and Economics*, 36 (1993): 453-486; M. Perelman, “The neglected economics of trust: the Bentham paradox and its implications,” *American Journal of Economics and Sociology*, No. 4, 57 (1998): 381-389.

first paper to argue that there are different types of trust, this paper is among the few that shows the distinction between the above two types of trust by means of a case study.<sup>7</sup> It shows that the Chinese government was in dominant position in this trust building while the international company was in a vulnerable position.

## 2. Transaction hazard background

### 2.1 China's institutional environment and the central government's control over foreign companies 1949-1951

The basic determinants of the Chinese government's treatment of foreign investors after 1949 were the ideologies of nationalism and anti-imperialism. Chairman Mao clearly declared in his much-publicised opening address to the Chinese people's Consultative Conference on 21 September 1949, "The Chinese people have stood up! China will never again be an insulted nation".<sup>8</sup> In the Common Programme, issued a week later, the Chinese central government emphasised that "all privileges of imperialist countries in China must be abolished".<sup>9</sup>

The Chinese government did not have a good impression of the early foreign banks because before 1949 they posed a threat to China's economic development. This historical threat was manifest in the fact that foreign banks, supported by their home country's governments, had a strong influence not only over China's banking sector but also over the Chinese economy and politics.<sup>10</sup> In addition, the Chinese government was also unhappy with the manner in which foreign powers achieved their maximum advantage to the detriment of China's economy, i.e. they lacked commitment to China's market.<sup>11</sup> As a result, the Chinese government lacked trust in the foreign banks. In order to facilitate the central government's control of the banking sector, a mono-banking system was adopted. The People's Bank of China (PBC) functioned as the central bank and the Bank of China (BOC), as a department of PBC, was responsible for the execution of duties relating to control over foreign exchange and for the handling of foreign exchange.

The eradication of the remnants of imperialism in China, however, did not mean that China would not have any relationships with Western countries. The Chinese central

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<sup>7</sup> L. Zucker, "Production of trust: institutional sources of economic structure, 1840-1920," *Research in Organisational Behaviour*, 8 (1986): 53-111; O. Williamson, "Calculativeness, trust, and economic organization," *Journal of Law and Economics*, 36 (1993): 453-486; B. Lyons, and J. Mehta, "Contracts, opportunism and trust: self-interest and social orientation," *Cambridge Journal of Economics*, No. 2, 21 (1997): 239-257; E. Lorenz, "Trust, contract and economic cooperation," *Cambridge Journal of Economics*, No. 3, 23 (1999): 301-315.

<sup>8</sup> *Renmin ribao*, 22 September 1949.

<sup>9</sup> *Daily News Release*, 30 September 1949, 144; Z. Mao, *Mao Zedong Xuanji* (Chinese) Vol IV (Beijing: Renmin chubanshe, 1969), 167; A. Shai, *The Fate of British and French Firms in China, 1949-54* (London: Macmillan, 1996), 39-42.

<sup>10</sup> R. Dayer, *Bankers and Diplomats in China 1917-1925* (London: Frank Cass, 1981); Z. Ji, *A History of Modern Shanghai Banking* (London: M. E. Sharpe, 2003); G. Allen, and A. Donnithorne, *Western Enterprise in Far Eastern Economic Development: China and Japan* (London: George Allen and Unwin Ltd., 1954).

<sup>11</sup> B. Sheehan, *Trust in Troubled Times* (London: Harvard University Press, 2003), 43; A. Young, *China's Wartime Finance and Inflation 1937-1945* (Cambridge: Harvard University Press, 1965); Translation of *Kuang-chou*, Chinese People's Association for Foreign Cultural Relations (Canton: Kuang-chou Literary Press, 1959); C. Schenk, *Hong Kong as an International Financial Centre: Emergence and Development 1945-1965* (USA: Routledge, 2001), 28-29; Y. Nozawa (ed.) *Monetary Reform in China and International Relations* (Tokyo: University of Tokyo Press, 1981).

government were prepared to establish both political and economic relationships with Western nations on the basis of equality. In order to restore the war-damaged economy, the Chinese central government initially guaranteed the protection of foreign nationals and their property during 1948 and 1949, despite its intention to establish a socialist society, thus eliminating Western influence.<sup>12</sup>

Foreign banks were expected to help the Chinese government to resolve the problem of foreign exchange shortages by financing China's exports. The Chinese central government, therefore, chose foreign banks with an existing business in foreign exchange operations as "Appointed Banks", to buy and sell foreign exchange on behalf of BOC.<sup>13</sup> Since HSBC had a long established reputation in the finance of China's foreign trade and as a good relationship had been established between the various overseas offices of HSBC and BOC before 1949, BOC tried to persuade the former to take part in financing China's exports.<sup>14</sup> HSBC, from 1949, was appointed as an "Appointed Bank", under the control of BOC.

The level of activity and profitability of Western investors, however, was still affected by the Chinese central government's decision to establish the economy 'under the leadership of the state-owned economy'.<sup>15</sup> Although the period 1949-51 saw co-operation between the Chinese government and the private sector, the government had begun to control the private sector and made preparations for 'the socialist transformation of capitalist industry and commerce'.<sup>16</sup> As a result, the central government exerted control over foreign trade and the economic environment of Western investors. For example, the government both increased the level of state participation in trading operations and implemented stricter foreign trade controls. From early 1950, a number of national trading corporations were established, so as to monopolise foreign trade. By the end of 1950, the state trading companies already controlled 53% of the total value of foreign trade.<sup>17</sup> The authorities also took control of both the supply of raw materials to Western enterprises and the market for their products. These policies signalled to Western investors that, in future, exploitation of China would not be tolerated. For their part, Western investors began to fear that the Chinese government would follow the Soviet Union in totally exploiting and eliminating Western interests.<sup>18</sup>

The international institutional environment, however, intensified Chinese nationalism and anti-imperialism and worsened the relationship between the Chinese government and Western countries. In November 1949, the US imposed an embargo on exports of strategic goods to China, this being followed by more general restrictions on trade, in the December of that year. The outbreak of the Korean War caused a further tightening of the Western economic embargo on China. On the 16<sup>th</sup> December 1950, the US government issued a freezing order, which froze all Chinese-owned US dollar

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<sup>12</sup> B. Hooper, *China Stands Up: Ending the Western Presence 1948-1950* (London: Allen & Unwin, 1986).

<sup>13</sup> HSBC Group Archives, GHO 154, Provisional Regulations Governing the Control over Foreign Exchange in the East China Region, 3<sup>rd</sup> June, 1949.

<sup>14</sup> HSBC Group Archives, GHO 154, letter W. Yoxall to A. Morse, 13<sup>th</sup> August 1952; HSBC Group Archives, GHO 154, Provisional Regulations Governing the Control over Foreign Exchange in the East China Region.

<sup>15</sup> *Renmin ribao*, 30 September 1949.

<sup>16</sup> T. Kuan, *The Socialist Transformation of Capitalist Industry and Commerce in China* (Peking: Foreign Languages Press, 1960); A. Shai, *op. cit.* 41-43.

<sup>17</sup> H. Lo, "Communist China's Foreign Trade," in Union Research Institute *Communist China 1949-1959*, Vol. 3 (Hong Kong: Union Research Institute, 1961), 5.

<sup>18</sup> B. Hooper, *op. cit.* 57.

assets. The Chinese government, in response, took over the American assets in China. In May 1951, the United Nations imposed an embargo on trade with China.<sup>19</sup>

The freezing order and embargo generated Chinese suspicion and ill feeling toward foreign business and encouraged barter trade. In February 1951, the Chinese central government promulgated regulations that no goods were to leave China until imports of an equal value (or foreign exchange) had arrived in China.<sup>20</sup> In March 1951, a Barter Exchange was established in Shanghai, in order to link importers and exporters and applicants for foreign exchange.<sup>21</sup>

The Western investors' situation was further worsened by the Chinese government refusing to talk to them. Some British businessmen attempted to discuss their problems with high level Chinese government officials but no one wished to entertain them.<sup>22</sup> An information asymmetry between the Chinese government and Western investors was thus formed and was compounded by the fact that both parties were operating within different paradigms. The Chinese government wanted to maximise economic growth and at the same time avoid the exploitation by Western countries. Western investors feared that the communist Chinese government, believing that the expropriators should be expropriated, would exploit and even eliminate their presence.

## 2.2 The HSBC's vulnerable position

### 2.2.1 Government control and the HSBC's transaction costs

The information asymmetry and the Chinese government's ideology of anti-imperialism and nationalism triggered the latter's opportunistic behaviour towards foreign enterprises, including Western banks, which greatly increased the latter's transaction costs. First, foreign enterprises were levied a heavy taxation. Many enterprises predicted that they might well be crippled by the levy, however, there appeared to be no alternative but to meet the demands.<sup>23</sup>

Second, foreign banks' business was highly uncertain. It was strictly controlled by BOC and the latter could raise or lower the foreign banks' profits by changing the amount of business which it offered to them.<sup>24</sup> The normal business – business transaction relationship was actually replaced by a government – business transaction relationship. As an 'Appointed Bank', HSBC was extremely restricted in its business operations.<sup>25</sup> In Shanghai it suffered from increasing losses after 1949.<sup>26</sup> Other foreign banks and Chinese banks also suffered losses after 1949 and by June 1950, the

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<sup>19</sup> D. Clayton, *Imperialism Revisited* (London: Macmillan Press Ltd. 1997); W. Shao, *China, Britain and Businessmen* (London: Macmillan Press Ltd. 1991).

<sup>20</sup> HSBC Group Archives, SHG741.8, letter W. T. Yoxall to Adamson, 27<sup>th</sup> February 1951.

<sup>21</sup> HSBC Group Archives, SHGII 958, Announcement by the Bank of China, Shanghai, 29<sup>th</sup> March 1951.

<sup>22</sup> B. Hooper, *op. cit.* 101.

<sup>23</sup> A. Shai, *op. cit.* 22-38; G. Shao, *op. cit.* 46.

<sup>24</sup> W. A. Stewart, Oral History Interview, HSBC Group Archives, 73.

<sup>25</sup> Public Record Office (hereafter PRO), FO 371/99299, "Agency Agreement," 11<sup>th</sup> February 1950.

<sup>26</sup> HSBC Group Archives, GHO 236, Half-Yearly Report 1956-1967; F. King, Volume IV of *the History of the Hongkong and Shanghai Banking Corporation* (Cambridge: Cambridge University Press, 1991), 154;

"Regulations of the Government Administrative Council of the Central People's Government Regarding the Repayment of Unpaid Sums Deposited with Financial Enterprises before Liberation." In *Collection of Financial Laws and Regulations* (in Chinese) (Peking: People's Bank of China, 1953), 117-19.

number of bank failures in the four principal financial centres had reached 101 in Shanghai, 50 in Tientsin, 25 in Peking and 12 in Wuhan.<sup>27</sup>

Third, as a protection against increasing inflation, the Chinese government linked wages to a basic commodity: millet in the north and rice in Shanghai. Because of the continuously increasing inflation, this policy proved to be extremely burdensome on foreign enterprises.<sup>28</sup> In addition, firms were not allowed to fire redundant staff or to close down and place their properties on a caretaker basis. Managers were harassed by staff and workers, with foreigners being subject to restricted freedom of movement within China.<sup>29</sup> Foreign businessmen were held personally responsible for the failure of their companies to pay wage or taxation demands. It seemed to foreign banks that future business would become increasingly costly.<sup>30</sup> In addition, the growth of inter-government barter trade after 1949 and the control of foreign exchange business by BOC left very little opportunity for the remaining traders and banks.<sup>31</sup>

### 2.2.2 The HSBC's commitment ignored by the Chinese government

The information asymmetry and the government control policy placed HSBC in a vulnerable position. Despite HSBC's losses after 1949, its head office did not propose to close its offices in China immediately. While the Guangzhou, Chongqing, Hankou, Qingdao, Nanjing and Mukden branches had closed before the establishment of the PRC in 1949, only one branch, the Xiamen branch, was closed in 1950.<sup>32</sup> Despite HSBC's branches in China undertaking unremunerative work, the bank still felt optimistic about its business in China's market.<sup>33</sup>

As a result of HSBC's continuous losses after 1949, its head office decided, however, to reduce the number of offices in China to the absolute minimum. It was, however, not in favour of complete closure in China and insisted on keeping its Shanghai branch.<sup>34</sup> It still expected to undertake China's foreign trade finance at the request of BOC.<sup>35</sup> The Shanghai branch was the head office of HSBC in China. It had also been HSBC's first branch in China, being established along with the Hong Kong branch, in 1865. The two names were linked to form the bank's name: the Hongkong and Shanghai Banking Corporation, which clearly reflects the importance of the Shanghai and Hong Kong branches in history of the organisation. The insistence of maintaining the Shanghai branch implied HSBC's minimum commitment to the Chinese government.

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<sup>27</sup> "The Banking Industry in China Today," *Far Eastern Economic Review*, 5<sup>th</sup> October 1950, 401.

<sup>28</sup> China Association Minutes and Circulars, Memorandum for the press regarding the situation in Shanghai, 4 August 1949.

<sup>29</sup> FO 371/83345/40, memorandum by the British Chamber of Commerce, Shanghai, March 1950, enclosed in a letter from British Chamber of Commerce to China Association, 1<sup>st</sup> April 1950.

<sup>30</sup> PRO, FO 371/99299, letter W. T. Yoxall to A. Morse, 10<sup>th</sup> January 1952.

<sup>31</sup> HSBC Group Archives, GHO 154, letter W. T. Yoxall to A. Morse, 26<sup>th</sup> December 1951.

<sup>32</sup> F. King, Volume IV, *op. cit.* 382.

<sup>33</sup> HSBC Group Archives, Chairman File 3, Talk with Sir Zsler Denning, 2<sup>nd</sup> November 1950, 3; Statement by the Chairman of the Board of Directors at the Ordinary Yearly General Meeting of Shareholders on March 10, 1950," *Supplement to Far Eastern Economic Review*, 16<sup>th</sup> March 1950, 3.

<sup>34</sup> PRO, FO 371/99305, letter A. Morse to S. A. Gray, 18<sup>th</sup> January 1952.

<sup>35</sup> HSBC Group Archives, GHO 154, letter A. Morse to W. T. Yoxall, 11<sup>th</sup> December 1951.

### 2.2.3 Lacking support from the British government

The British government valued its relationship with the Chinese government for a number of reasons. Firstly, trade with China had always been an important part of British policy towards East Asia. Sino-British trade had prospered for more than 100 years, to the benefit of the British.<sup>36</sup> In view of its economic difficulties in the post-1945 period and the dollar gap, the British government was particularly keen to develop trade relations with China.<sup>37</sup>

Secondly, Britain had already invested in building hospitals, education, medical, welfare and missionary work in China.<sup>38</sup> In the beginning, nearly half of the foreign investment in China was from Britain and by 1952, British investment in China was valued at approximately £250 million.<sup>39</sup> The United Kingdom had many more potential 'hostages' in China than the Chinese had in the United Kingdom.

Thirdly, China played an important role in the Far Eastern region, where Britain had strong political interests. Soviet control and domination of the eastern half of Europe had threatened the security of Western Europe and thus the British government hoped to deter China from permanently aligning with the Soviet Union, by maintaining reasonable and friendly relations with China.<sup>40</sup>

In addition, there was the importance of Hong Kong to Britain and the dependence of Hong Kong on China.<sup>41</sup> For Britain, Hong Kong was a valuable trading post where British firms maintained a dominant position.<sup>42</sup> At the end of the Second World War, Hong Kong's relations with China were also an important aspect of Britain's strategic and commercial policy. It was estimated that by 1949 British investment in Hong Kong had reached about £350 million.<sup>43</sup> If trade were interfered with or critically declined, Hong Kong could not possibly maintain its economy or support its population of 2,500,000 people.<sup>44</sup> In addition, Hong Kong depended on China for a considerable part of its food supply, particularly fresh food, which could not easily be obtained from elsewhere and also for its water supply. This placed Hong Kong in an extremely vulnerable position.<sup>45</sup>

As a result of the aforementioned situation, in order to protect its interests in China, Britain sought to maintain commercial links with China despite the change in regime after 1949. The British government was the first western government to announce recognition of the PRC, in January 1950.<sup>46</sup> Although some of the Chinese government policy was deemed to be unsympathetic, the British government did not give up its policy of establishing a long-term peaceful relationship with China.<sup>47</sup> Even when it

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<sup>36</sup> HSBC Group Archives, Chairman File 3, Telegram from British Chamber of Commerce Shanghai to the China Association, 18<sup>th</sup> November 1950.

<sup>37</sup> J. Jain, *op. cit.* 28.

<sup>38</sup> *Ibid.*

<sup>39</sup> *The World Today*, December 1952, 497; J. Jain, *op. cit.* 28.

<sup>40</sup> D. Watt, "Britain and the Cold War in the Far East, 1945-58." In Y. Nagai, and A. Iriye *The Origins of the Cold War in Asia* (Japan: University of Tokyo Press, 1977), 110-112.

<sup>41</sup> *Ibid.*

<sup>42</sup> E. Luard, *Britain and China* (London: Chatto & Windus, 1962), 222.

<sup>43</sup> G. Shao, *China, Britain and Businessmen* (London: Macmillan Press Ltd. 1991), 32.

<sup>44</sup> J. Jain, *China in World Politics* (New Delhi: Radiant publishers, 1976), 167.

<sup>45</sup> *Ibid.*

<sup>46</sup> D. Watt, *op. cit.* 110-112.

<sup>47</sup> "British policy in Asia," *Far Eastern Economic Review*, 3<sup>rd</sup> May 1951, 559; HSBC Group Archives, Chief

placed an obstructive embargo on China in May 1951, as a result of incessant pressure from the U.S., the British government kept negotiating with the U.S. government regarding reducing controls over China.<sup>48</sup> The above analysis of the British government's interests implies that HSBC's interests alone were insufficient to gain the British government's support at the expense of the government's wider interests.

#### 2.2.4 The HSBC's blocked closure

The restricted and limited business opportunities and high transaction costs in China's market, ignored commitment and the lack of the British government's support eventually led HSBC to conclude that its period of usefulness as a bank in China was at an end and that it was no longer wanted in the country. HSBC thus gave up its previous strategy of continuing its operation in China and adopted a policy of 'trade with China rather than trade in China'.<sup>49</sup> Thus, HSBC would prefer to finance China's trade through branches outside China, especially the Hong Kong branches, rather than through branches in China.

HSBC's closure process was however obstructed by the Chinese government. Because of the United States Treasury's freezing order, the Chinese government asked foreign banks to release the frozen US dollars held by them as a prerequisite to their closure. Since HSBC held BOC's US dollar assets which were frozen in the United States, its closure process was also obstructed by the Chinese government. The total balances of HSBC in China, which were held in the United States, amounted to \$US 2.7 million.<sup>50</sup> The Korean War and the US Treaty thus gave the Chinese government additional bargaining power.

In addition to the difficulties arising from the blocked US dollars, a further complication was the problem of "revaluation" of foreign banks' pre-war local currency deposits. In 1951, the PBC verbally demanded that HSBC deposit foreign currency with BOC, Hong Kong, to the equivalent of US \$1 for every C.N.\$20, for the total CN\$ liabilities of the Swatow Office, as at 8<sup>th</sup> December 1941.<sup>51</sup>

This demand, however, arose from the Chinese central government's opportunism. Firstly, HSBC had paid twice for the local currency deposits held before the 1946 Liberation War. The first time of their repayment was at the end of the Japanese occupation in 1945, the second being in 1947.<sup>52</sup> Secondly, the requirement made HSBC responsible for the local currency devaluation. This was contrary to the internationally accepted procedure and equity that banks should not be held responsible for the depreciation in value of a national currency.<sup>53</sup> Thirdly, a large proportion of the balances outstanding were due to foreign nationals and firms outside China, to whom remittance could not be made under the Exchange Control Regulations in China.<sup>54</sup> Accounts of foreign nationals and firms who had left the

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Managers S/O T/B. No. 8, British Trade in China, Peking Telegram No. 549, 7<sup>th</sup> July 1952.

<sup>48</sup> E. Luard, *op. cit.* 142-154.

<sup>49</sup> PRO, FO 371/99305, Minutes by J. K. Drinkall, 18<sup>th</sup> January 1952.

<sup>50</sup> PRO, FO 371/108085, Aide Memoire Ref: 1110/6/53.

<sup>51</sup> FO 371/99304, Pre-war Deposits.

<sup>52</sup> Chief Managers S/O T/B No. 8, HSBC Group Archives, Aide Memoire: The Mercantile Bank of India Ltd. to The Under Secretary of State for Foreign Affairs, 13<sup>th</sup> April 1953.

<sup>53</sup> FO 371/108085, Re-payment of Pre-war Deposits with British Banks in China.

<sup>54</sup> FO 371/99305, letter Shanghai Consulate-General to the Chancery, 5<sup>th</sup> February 1952.



country should be settled outside China, owing to the ban on remittances.<sup>55</sup> Because of these problems, HSBC refused to satisfy the verbal demand. Without paying the pre-war liabilities, however, HSBC was blocked in its closure process.

The Labour Union also asked foreign banks to pay local staff severance payments and listed this as a prerequisite for foreign banks' closure. HSBC Tientsin branch signed an agreement with the representatives of its Labour Union, after the Manager in Tientsin informed the staff that the branch had been instructed to close. The bank had already deposited approximately RMB 3,000 million with PBC to cover payments due.<sup>56</sup> The Union, however, put forward a further demand for a severance allowance of RMB 35 million per person, plus a repatriation allowance of RMB 3.5 million per person, which, in fact, violated the agreement signed between the Union and the Tientsin branch. There had been other instances of Labour Unions violating the agreements, such as in the cases of the Shell Company and the local French Consulate. As the number of alien residents and foreign concerns decreased, the rapacity of the Chinese workers towards the remainder seemed to intensify while the foreign companies' position seemed to get worse.<sup>57</sup>

Because of the Labour Union's opportunism, there was a wide difference between the opinion of labour and that of management, as to what constituted a reasonable and fair settlement.<sup>58</sup> HSBC did not receive any assistance from the Labour Bureau and to make matters worse, from autumn 1951 to late summer of 1952, the 'Three-Anti' and Five-Anti' movements arose.<sup>59</sup> Any changes in staff arrangements thus became virtually impossible.<sup>60</sup> The hard bargaining between HSBC and the Chinese government implied the HSBC's vulnerable position. It lacked the government's trust though it had shown its commitment.

### 3 The incentives for the Chinese government to build a trust relationship with HSBC

#### 3.1 The importance to the Chinese government of maintaining a relationship with the British government

The Chinese government valued the good relationship with the British government as it had a large amount of assets in British territory. For example, the Chinese government had substantial deposits in British banks, such as the Hong Kong branch of HSBC.<sup>61</sup> BOC had organisations, valuable buildings and personnel in various places in the Sterling area, where it enjoyed equal privileges with British nationals.<sup>62</sup> Sterling was also one of the main foreign currencies used by the Chinese banks.<sup>63</sup>

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<sup>55</sup> FO 371/99305, letter L. H. Lamb to R. H. Scott, 15<sup>th</sup> March 1952.

<sup>56</sup> PRO, FO 371/99304, letter E. W. Jeffery to C. T. Crowe, 31<sup>st</sup> December 1951.

<sup>57</sup> PRO, FO 371/99304, letter E. W. Jeffery to C. T. Crowe, 31<sup>st</sup> December 1951.

<sup>58</sup> HSBC Group Archives, Chief Managers S/O T/B. No. 8, Draft of Termination of Services of Employees and Workers to Tientsin Military Control Commission by Jardines, An Lee Export Company, the Chartered Bank, and HSBC, 16<sup>th</sup> September 1952.

<sup>59</sup> R. MacFarquhar, and J. Fairbank (ed.), *The Cambridge History of China*, Vol. 14 (London: Cambridge University Press, 1987), 88-89.

<sup>60</sup> HSBC Group Archives, Chief Managers S/O T/B. No. 8, letter W. T. Yoxall to A. Morse, 30<sup>th</sup> July 1952.

<sup>61</sup> PRO, FO 371/99305, Minutes for the Meeting Held at 3 p.m. on the 18<sup>th</sup> January 1952 by J. K. Drinkall.

<sup>62</sup> PRO, FO 371/99305, letter W. T. Yoxall to L. H. Lamb, 29<sup>th</sup> February 1952.

<sup>63</sup> PRO, FCO 21/97, China's Economic Links with the United Kingdom by F. Figgures, 30<sup>th</sup> August 1967.

Schenk found that 'China's earnings of HK dollars were almost entirely converted to sterling, which was the preferred currency for China's foreign exchange reserves, given the political conflict with the USA'.<sup>64</sup>

The Chinese government expected to develop a trade relationship with the British Commonwealth.<sup>65</sup> Britain was also a major importer of Chinese products.<sup>66</sup> In addition, Hong Kong was an important port for China's foreign trade. The embargoes did not sever the economic links between China and Hong Kong. Schenk maintained that Hong Kong had become a more important trading partner to China since the embargo.<sup>67</sup> The Chinese government earned a substantial surplus from exports to Hong Kong throughout the 1950's and 1960's. This surplus was China's most valuable source of foreign exchange, since these exports earned convertible Hong Kong dollars, which were then used to build up reserves and to finance imports.<sup>68</sup>

The importance of maintaining a good relationship with the British government encouraged the Chinese central government to show good will to the British banks. For example, the Chinese central government adopted a differential approach to other foreign banks' failure to repay the pre-war liabilities, in order to show its credible commitment to the British banks. Unlike its treatment of the British banks in offering them business, the Chinese central government charged the National City Bank of New York manager in Shanghai for refusing to pay pre-liberation deposits, in violation of the law.<sup>69</sup>

### 3.2 The importance of HSBC to the Chinese government

Given the embargos and frozen US dollar assets, the bulk of China's foreign trade was conducted on a government-to-government basis, either by barter or reciprocal contracts.<sup>70</sup> The knowledge capital of HSBC in government-to-government trade was thus appreciated by the Chinese central government.<sup>71</sup> Most Sino-Japanese trade was financed through HSBC and BOC in Hong Kong.<sup>72</sup> In 1952, substantial trade agreements were reached at the International Economic Conferences in Moscow and East Berlin.<sup>73</sup> The Chinese central government valued the presence of the British banks in relation to this trade relationship, especially HSBC.<sup>74</sup>

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<sup>64</sup> C. Schenk, *Hong Kong as an International Financial Centre: Emergence and Development 1945-1965* (USA: Routledge, 2001), 85.

<sup>65</sup> HSBC Group Archives, Chief Managers S/O T. B. No. 13, letter W. T. Yoxall to G. H. Stacey, 19<sup>th</sup> April 1955.

<sup>66</sup> E. Luard, *op. cit.* 176-198.

<sup>67</sup> C. Schenk, *Hong Kong as an International Financial Centre: Emergence and Development 1945-1965*, *op. cit.* 41.

<sup>68</sup> C. Schenk, "Banks and the Emergence of Hong Kong as an International Financial Center," *Journal of International Financial Markets, Institutions and Money*, 12 (2002): 329.

<sup>69</sup> PRO, FO 371/108086, Telegram from Peking to Foreign Office No. 523, 5<sup>th</sup> September 1953.

<sup>70</sup> HSBC Group Archives, Chief Managers, S/O, T.B. No. 10, memorandum attached to letter W. Yoxall to M. Turner, 18<sup>th</sup> May 1954.

<sup>71</sup> HSBC Group Archives, Chief Managers, S/O, T.B. No. 10, memorandum attached to letter W. Yoxall to M. Turner, 18<sup>th</sup> May 1954; HSBC Group Archives, Chief Managers, S/O, T.B. No. 10, memorandum attached to letter M. Turner to W. Yoxall, 9<sup>th</sup> February 1954.

<sup>72</sup> HSBC Group Archives, Chief Managers, S/O, T.B. No. 10, memorandum attached to letter W. Yoxall to M. Turner, 18<sup>th</sup> May 1954; HSBC Group Archives, F. Black, Oral History Interview, 103.

<sup>73</sup> HSBC Group Archives, Chief Managers, S/O, T.B. No. 8, Peking Telegram No. 549, 7<sup>th</sup> July 1952; HSBC Group Archives, Chief Managers, S/O, T.B. No. 8, letter S. Gray to A. Morse, 11<sup>th</sup> July 1952.

<sup>74</sup> HSBC Group Archives, Chief Managers, S/O, T.B. No. 8, letter S. Gray to A. Morse, 11<sup>th</sup> July 1952; HSBC Group Archives, Chief Managers, S/O, T.B. No. 10, letter M. Turner to S. Gray, 18<sup>th</sup> May 1954; HSBC Group

The dominant position of HSBC in Hong Kong's financial market and the importance of the financial relationships between Hong Kong and China helped to strengthen the importance of HSBC to the Chinese central government. The main financial link between Hong Kong and China after 1951 was by means of remittances. A large number of remittances from overseas Chinese to their relatives in China were made through banks in Hong Kong.<sup>75</sup> Schenk's study argues that these financial relationships are also important in understanding the subsequent position of British banks, especially HSBC, in the Chinese government's policy. In Hong Kong, HSBC was the major note-issuing bank, issuing 90% of the Hong Kong currency, the remainder being issued by the Mercantile Bank and the Chartered Bank.<sup>76</sup> BOC in Hong Kong greatly relied on HSBC's co-operation to carry out its business. HSBC had, throughout, co-operated with BOC in financing China's trade in Hong Kong.<sup>77</sup> In addition, there was a good relationship between BOC's and the HSBC's various overseas offices.<sup>78</sup> The exchange sterling of HSBC was largely sold to BOC.

Though HSBC was a member of the Exchange Banks' Association and had been established and run by the British, the name of HSBC reflecting two Chinese cities, namely Hong Kong and Shanghai, illustrated its close relationship with China.<sup>79</sup> In particular, it was registered in Hong Kong, the management of the bank was firmly located in Hong Kong and its policy decisions were made in Hong Kong based on local conditions and information, which was different from other British banks, thus it appealed to the Chinese central government who were prepared to deposit large sums with the bank.<sup>80</sup> As a result, HSBC not only held far more of the Chinese government's deposits than other foreign bank but it also had significantly more assets in China than other foreign banks. This reflected the importance of HSBC to the Chinese government.<sup>81</sup>

### 3.3 The Chinese central government's hints to HSBC: the Chinese government need the bank

Given the importance of maintaining a good relationship with the British government and the importance of HSBC to the Chinese economy, it is not surprising that after the bank applied for closure, the Chinese central government began to take measures indicating that it was likely to be more sympathetic to the bank in future. First of all, there was improved communication and contact between HSBC and the Chinese

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Archives, Chief Managers S/O T. B. No. 13, letter W. T. Yoxall to G. H. Stacey, 19<sup>th</sup> April 1955.

<sup>75</sup> C. Schenk, *Hong Kong as an International Financial Centre: Emergence and Development 1945-1965*, *op. cit.* 19, 127.

<sup>76</sup> C. Schenk, *Hong Kong as an International Financial Centre: Emergence and Development 1945-1965*, *op. cit.* 9.

<sup>77</sup> F. King, Volume IV of *The History of the Hongkong and Shanghai Banking Corporation* (Cambridge: Cambridge University Press, 1991), 391; PRO, FO 371/99304, Minutes by J. Drinkall, 18<sup>th</sup> January 1952; BE, EC5/435, Telegram fro R. Black, 12<sup>th</sup> March 1958.

<sup>78</sup> HSBC Group Archives, GH0 154, letter W. Yoxall to A. Morse, 13<sup>th</sup> August 1952.

<sup>79</sup> G. Jones, "International Financial Centres in Asia, the Middle East and Australia; A Historical Perspective", in Y. Cassis (ed.) *Finance and Financiers in European History, 1880-1960* (Cambridge: Cambridge University Press, 1992), 417.

<sup>80</sup> F. King, Volume IV of *The History of The Hongkong and Shanghai Banking Corporation* (Cambridge: Cambridge University Press, 1991), 247-250; HSBC Group Archives, O. P. Edwards, Oral History Interview, 137.

<sup>81</sup> PRO, FO 371/99304, Minutes of British Banks in China by J. Drinkall, 6<sup>th</sup> February 1952; PRO, FO 371/108085, Aide Memoire, Ref: 1110/6/53.

central government, especially BOC, which represented the authority's will.<sup>82</sup>

Secondly, while HSBC's closure application did not receive permission from the Chinese government, the BOC made repeated approaches to offer business to the HSBC's Shanghai branch.<sup>83</sup> The offer indicated a desire on the part of the Chinese central government to avoid taking drastic action against the British banks because they had decided that the banks could still be of use to them. The preference of the Chinese central government for HSBC was reflected by the fact that by May 1954, the Chinese central government looked primarily to HSBC for co-operation over future trade but ignored other British banks in this respect.<sup>84</sup>

Thirdly, the Chinese central government helped HSBC to solve its troubles. For example, on 20<sup>th</sup> February 1953, the Chinese central government promulgated regulations for the repayment of bank deposits lodged before the 1949 "liberation" and still outstanding, replacing the oral requirements of 1950.<sup>85</sup> According to the promulgated regulation, HSBC's liabilities were reduced to £100,000, the Chartered Bank's £45,000, and the Mercantile Bank's £15,000.<sup>86</sup> HSBC also received the government's permission to sell its Peking premises to the Indian Embassy, in order to help it to pay for pre-war liabilities.<sup>87</sup>

#### 4 The HSBC's vulnerable position in building a trust relationship with the Chinese government

##### 4.1 Lack of support from the British government

HSBC's original strategy was to withdraw from China. In order to realise this strategy, it had to solve the problems caused by the frozen US dollar assets, pre-war liability repayment and labour union trouble. HSBC had expected that the British government might make representation to the Chinese government and take other actions in order to assist HSBC in solving these problems and help facilitate the closure process, such as the British government exploiting the prosperous presence of BOC in the British territory.<sup>88</sup> To solve the pre-war liabilities repayment problem, HSBC proposed a protest strategy and the British government was expected not only to protest against the application of the unreasonable pre-liberation liabilities regulations to the British banks in China, but also to give notice that they would deny to the British banks the right to transfer currency to China to comply with the regulations.<sup>89</sup> In this sense, HSBC hoped to avoid the responsibility and transfer the blame for their repayment

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<sup>82</sup> HSBC Group Archives, Chief Managers, S/O, T.B. No. 8, letter W. Yoxall to A. Morse, 14<sup>th</sup> June 1952.

<sup>83</sup> HSBC Group Archives, Chief Managers, S/O, T.B. No. 8, letter W. Yoxall to A. Morse, 8<sup>th</sup> July 1952; HSBC Group Archives, Chief Managers, S/O, T.B. No. 8, letter A. Morse to S. Gray, 17<sup>th</sup> July 1952; HSBC Group Archives, Chief Managers, S/O, T.B. No. 8, letter A. Morse to S. Gray, 31<sup>st</sup> October 1952; HSBC Group Archives, Chief Managers S/O T. B. No. 10, letter M. W. Turner to S. A. Gray, 4<sup>th</sup> July 1953.

<sup>84</sup> HSBC Group Archives, Chief Managers S/O T. B. No. 10, letter M. W. Turner to S. A. Gray, 18<sup>th</sup> May 1954.

<sup>85</sup> PRO, FO 371/108085, Re-payment of Pre-war Deposits with British Banks in China.

<sup>86</sup> PRO, FO 371/108085, Re-payment of Pre-war Deposits with British Banks in China.

<sup>87</sup> Chief Managers S/O T. B. No. 8, letter M. W. Turner to Zhou Enlai, 12<sup>th</sup> June 1953; FO 371/108086, Telegram from Peking to Foreign Office, No. 422, 9<sup>th</sup> July 1953; PRO, FO 371/108087, from Peking to Foreign Office, No. 637, 22<sup>nd</sup> October 1953.

<sup>88</sup> FO 371/99305, letter W. T. Yoxall to L. H. Lamb, 29<sup>th</sup> February 1952; FO 371/99305, letter L. H. Lamb to R. H. Scott, 15<sup>th</sup> March 1952.

<sup>89</sup> Chief Managers S/O T/B. No. 8, HSBC Group Archives, Joint letter of protest by the three British Banks to Foreign Office, 15<sup>th</sup> April 1953.

refusal to the British government and transfer the problem between the British banks and the Chinese government, to become a problem between the British government and the Chinese government.

Since maintaining economic and political contact with the PRC was deemed essential for protecting British interests in China and in the Far East, the British government declined to risk a political falling out over the difficulties of private interests in China. HSBC's closure strategy, retaliation suggestions and protest plan thus did not receive the British government's support.<sup>90</sup> The bank thus remained exposed and unsupported.<sup>91</sup>

Without the British government's support, HSBC's opportunism was limited and it had to deal with the Chinese government directly, to try to solve the troubles through making some credible commitment to demonstrate its good faith. Facing the Chinese government's good will, HSBC had to demonstrate its appreciation. Consequently, it decided to send representation to New York to ask the US Treasury to release the blocked US dollar assets of its branches in China. It did this rather than pay the equivalent value to the Chinese, because it was afraid of the Chinese government's opportunism and that the payment might easily be taken as evidence of weakness, leading to increased pressure on the staff.<sup>92</sup> The representations continued until September 1953, when the United States Government yet again turned down a request for the unfreezing of British banks' frozen dollar assets.<sup>93</sup>

In 1954, HSBC took advantage of the British Trade Delegation visit to Peking and sent its representative to talk to the Chinese authorities about its commitment to them. The representative told the Chinese central government that HSBC had done all that it could in Washington to achieve unfreezing the US dollar assets but it failed. The government had thought that the failure of repayment was attributed to HSBC's non-cooperation and thus the representative's explanation helped to relieve the government's suspicion toward HSBC.<sup>94</sup> Because of the foreign exchange shortage of the Chinese government, this explanation of HSBC's efforts in trying to help China to resolve the frozen US dollar problem also helped HSBC earn the goodwill of the Chinese authorities.<sup>95</sup>

At the request of the Chinese central government, in 1954 HSBC proposed a credit line which would facilitate Sino-Anglo trade.<sup>96</sup> In addition, HSBC was heavily involved in financing China's trade through BOC's Hong Kong office. A good relationship had been built up between HSBC and BOC and especially with the China

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<sup>90</sup> FO 371/99305, letter L. H. Lamb to R. H. Scott, 15<sup>th</sup> March 1952; FO 371/108085, Re-payment of Pre-war Deposits with British Banks in China; Chief Managers S/O T/B. No. 8, HSBC Group Archives, letter Foreign Office to W. R. Cockburn, 18<sup>th</sup> May 1953.

<sup>91</sup> D. Clayton, *op. cit.* 165; HSBC Group Archives, Chief Managers S/O T. B. No. 8, letter A. Morse to S. A. Gray, 17<sup>th</sup> July 1952; HSBC Group Archives, Chief Managers S/O T. B. No. 8, letter S. A. Gray to A. Morse, 26<sup>th</sup> July 1952; HSBC Group Archives, Chief Managers S/O T/B. No. 8, letter W. T. Yoxall to M. W. Turner, 26<sup>th</sup> April 1953.

<sup>92</sup> PRO, FO 371/99305, letter A. Morse to S. A. Gray, 18<sup>th</sup> January 1952; PRO, FO 371/99305, letter A. Morse to S. A. Gray, 24<sup>th</sup> January 1952.

<sup>93</sup> PRO, FO 371/108086, Foreign Office telegram No. 495 to Peking, 24<sup>th</sup> September 1953.

<sup>94</sup> HSBC Group Archives, Chairman File 2, Report on Visit to Peking by F. Black, 10<sup>th</sup> December 1954.

<sup>95</sup> HSBC Group Archives, Chief Managers S/O T. B. No. 21, Report on Visit to Peking by F. C. B. Black enclosed by letter G. H. Stacey to S. A. Gray, 10<sup>th</sup> December 1954.

<sup>96</sup> HSBC Group Archives, Chief Managers S/O T. B. No. 21, Report on Visit to Peking by F. C. B. Black, 10<sup>th</sup> December 1954.

Resources Company in Hong Kong.<sup>97</sup>

The problem of frozen US dollars and pre-war liabilities repayment had not, however, been resolved. Unemployment loomed large as a problem and the Chinese authorities launched a campaign against it. They were reluctant to allow closure, not only of HSBC but of all firms, especially the larger ones, regardless of nationality.<sup>98</sup>

By now, the HSBC's officers realised that any overt attempt to close down their business might upset the Chinese government, to the detriment of HSBC's position in China. They also began to realise that the Chinese government had no intention of letting HSBC permanently withdraw. It seems, also, that the commitments offered to the Chinese government were being acknowledged, as BOC officers increasingly visited HSBC's Shanghai branch offering it business. Trust, it would appear, was already being established between the two parties.<sup>99</sup>

Without the British government's support, as a result of the demands and requirements of the Chinese government and HSBC's fear of damaging its relationship with the government, the Shanghai branch closure was not carried out. The fact that HSBC retained its Shanghai Office was the result of not only accepting the Chinese government's goodwill but also of showing its great forbearance to the adverse situation caused by the ideology of nationalism and anti-imperialism. It had to endure unfair competition with BOC and the restrictions imposed on its managers' social life. It tried its best, however, to tolerate its non-privileged conditions, in order not to upset the Chinese authorities.<sup>100</sup> HSBC's forbearance and the sacrifice of its short-term interests, demonstrated its vulnerable position in building a trust relationship with the Chinese government.

#### 4.2 Competition from the Chartered Bank

The HSBC's commitment to the Chinese government was also a result of competition with other foreign banks and HSBC's wish to maintain its dominant position among foreign banks. Despite HSBC's group action strategy, it never overlooked the competition between itself and other foreign banks, especially the Chartered Bank. During the period when HSBC was considering post-closure position in China, the Chartered Bank had applied to withdraw its closure application.<sup>101</sup> The HSBC head office thought that the Chartered Bank's action would harm its improved relationship with the Chinese authorities and would be harmful to its interests in China, thus encouraging it to withdraw its closure application.<sup>102</sup>

Without British government support, HSBC's problem solving depended on the Chinese government's support and it thus emphasised building a good relationship with the latter. The Chartered Bank's withdrawal of its closure application and the

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<sup>97</sup> F. King, Volume IV, *op. cit.* 396.

<sup>98</sup> HSBC Group Archives, Chief Managers S/O T. B. No. 8, Memorandum by W. T. Yoxall, 29<sup>th</sup> June 1953.

<sup>99</sup> HSBC Group Archives, Chief Managers S/O T. B. No. 10, letter M. W. Turner to S. A. Gray, 4<sup>th</sup> July 1953; HSBC Group Archives, GH0 157, Shanghai Office 1960-1963, Memorandum Presented to the Board at a Meeting on 20<sup>th</sup> March 1962.

<sup>100</sup> HSBC Group Archives, W. A. Stewart, Oral History Interview, 77, 87.

<sup>101</sup> HSBC Group Archives, Chief Manager S/O T/B No. 21, letter W. T. Yoxall to G. H. Stacey, 10<sup>th</sup> May 1955.

<sup>102</sup> HSBC Group Archives, Chief Manager S/O T/B No. 21, letter W. T. Yoxall to G. H. Stacey, 5<sup>th</sup> May 1955.

Chinese government's expectation of HSBC's withdrawal of its original application to close, forced HSBC to change its previous closure policy and to continue its presence in China.<sup>103</sup> The head office of HSBC accepted the Shanghai manager's advice and withdrew the application to close the Shanghai branch by June 1955. It decided to remain in China as long as was permitted by the Chinese authorities.<sup>104</sup>

Since business development was an important requirement of the Chinese government of foreign banks, good results from these banks would be regarded as indicative of a strong commitment to the government on the part of the former. Whenever HSBC found its business poorer than the Chartered Bank's, it would take measures to improve its business.<sup>105</sup>

## 5 Government trust and the HSBC's improved position

### 5.1 Government trust and the HSBC's problem solving

HSBC's co-operation and commitment helped it to build trust with the Chinese government and guard against the government's opportunism. This trust not only relieved its pressure to repay the frozen US dollar assets but also facilitated its negotiations with the Chinese government regarding its pre-war liabilities.<sup>106</sup> These negotiations were based on the idea of "all-for-all". Its main idea was that HSBC would hand over all its buildings and properties in China as collateral for all pre-war liabilities.<sup>107</sup> Finally, the agreement based on the concept of "all-for-all", was signed on 26<sup>th</sup> April 1955.<sup>108</sup> Unlike HSBC, which enjoyed the Chinese government's trust and support and signed the Agreement with its closure application, the Chartered Bank, without this trust and support, had to apply to withdraw its closure application before signing the Agreement.<sup>109</sup>

The government's restricted opportunism also had some positive effects on HSBC's closure programme. The reduction of staff and office closures continued and after 1955, only 2 foreign staff remained in China.<sup>110</sup> Compared with other foreign firms in China, HSBC had achieved much: the closure of agencies and the transfer of liability to the Shanghai branch, large reductions in staff and the agreement regarding liquidation. Most foreign firms had to be burdened with these problems until they eventually met their liabilities and withdrew.<sup>111</sup>

In order to show the government's restricted opportunism and provide positive signal to HSBC, the Chinese government also differentiated between HSBC and the Chartered Bank, in terms of the frozen US dollar repayment. In March 1962, the

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<sup>103</sup> HSBC Group Archives, Chief Managers S/O T. B. No. 13, letter W. T. Yoxall to G. H. Stacey, 19<sup>th</sup> April 1955.

<sup>104</sup> HSBC Group Archives, Chairman File 2, letter M. Turner to S. Gray, 6<sup>th</sup> July 1954.

<sup>105</sup> HSBC Group Archives, GH0 154, letter A. M. Mack to R. G. L. Oliphant, 10<sup>th</sup> September 1956; HSBC Group Archives, GH0 155, letter W. A. Stewart to F. C. B. Black, 4<sup>th</sup> May 1959.

<sup>106</sup> HSBC Group Archives, Chief Managers S/O T. B. No. 21, Report on Visit to Peking by F. C. B. Black enclosed by letter G. H. Stacey to S. A. Gray, 10<sup>th</sup> December 1954.

<sup>107</sup> PRO, FO 676/470, Telegram from Foreign Office to London Office of HSBC, No. 48, 29<sup>th</sup> January 1954.

<sup>108</sup> F. King, Volume IV, *op. cit.* 395.

<sup>109</sup> HSBC Group Archives, Chief Manager S/O T/B No. 21, letter W. T. Yoxall to G. H. Stacey, 5<sup>th</sup> May 1955.

<sup>110</sup> F. King, Volume IV, *op. cit.* 377, 378.

<sup>111</sup> HSBC Group Archives, Chief Manager S/O T/B No. 13, letter W. T. Yoxall to G. H. Stacey, 1<sup>st</sup> April 1955.

Chartered Bank, although enjoying a privileged position in China due to its long history of trade in this country, received instructions from BOC that it must pay for the blocked US dollar assets.<sup>112</sup> As there was little hope of any progress being made with the U.S., these repayments caused difficulties.<sup>113</sup> As the Chartered Bank did not wish to be forced out of China, it agreed to pay BOC the equivalent of the frozen dollars in some other currency. It hoped that this would be accepted as a gesture to the Chinese authorities, which might enable it to remain.<sup>114</sup> Payment was made to BOC in August 1962.<sup>115</sup> HSBC, on the other hand, did not receive such a request from BOC.

Although profit remittance of foreign enterprises was prohibited, the HSBC Shanghai branch did receive permission to remit HK\$29,000 to head office in 1962. The Shanghai branch of the Chartered Bank also received the government's permission to remit some profits to its head office but the amount was less.<sup>116</sup> Since that time, the remittance has never ceased (See Table 7.1). The remittance permission once again reflected the Chinese government's credible commitment to HSBC and the improved relationship between HSBC and the Chinese government. HSBC thus received new privileges in China.

Table 1 The remittance of profits by HSBC's Shanghai branch 1963-1971

	Profit Remitted (HK\$)
1963	16000
1964	25000
1965	45000
1966	50000
1967	48000
1968	42000
1969	40000
1970	56650
1971	123460.3

Source: HSBC Group Archives, GHO 236, Shanghai Office Half-Yearly Reports 1956-1967; HSBC Group Archives, GHO 345, Report on Shanghai Office 1968-1971.

In appreciation of the Chinese government's evident commitment to HSBC, it finally made the decision to repay the frozen US dollars in 1965 though the U.S. Treasury Authorities indicated that the U.S. dollars would remain blocked in the U.S.<sup>117</sup> After a period of fifteen years, this problem was finally resolved and HSBC decided to maintain its Shanghai branch. The trust between HSBC and the Chinese government as regards the financing of China's trade had been established.

<sup>112</sup> J. Jain, *China in World Politics, A Study of Sino-British Relations 1949-1975* (London: Martin Robertson, 1976); HSBC Group Archives, Chief Managers, S/O T/B No. 23, letter G. O. W. Stewart to J. A. H. Saunders, 14<sup>th</sup> March 1962.

<sup>113</sup> Ibid.

<sup>114</sup> HSBC Group Archives, Chief Managers, S/O T/B No. 23, letter G. O. W. Stewart to J. A. H. Saunders, 26<sup>th</sup> March 1962.

<sup>115</sup> HSBC Group Archives, Chief Managers, S/O T/B No. 23, letter G. O. W. Stewart to J. M. Stevens, 7<sup>th</sup> August 1962.

<sup>116</sup> HSBC Group Archives, GHO 157, letter W. A. Stewart to F. J. Knightly, 7<sup>th</sup> August 1963.

<sup>117</sup> HSBC Group Archives, GHO 157, Shanghai Office - Closure, March 1962; PRO, FCO 21/96, Confidential.

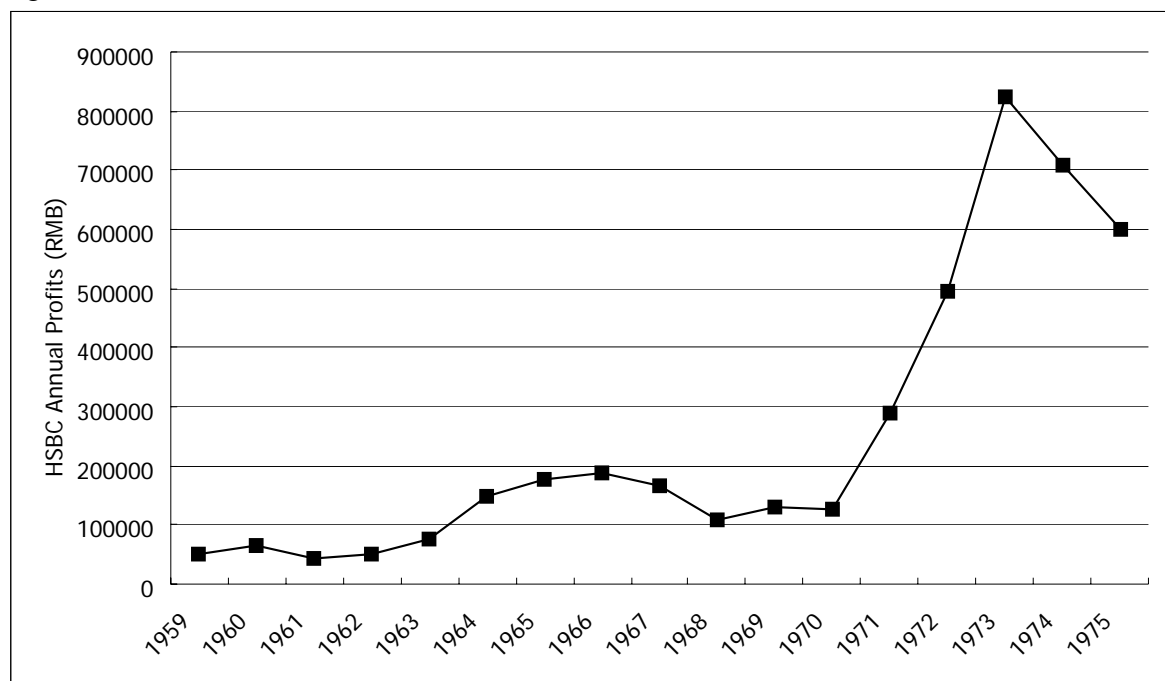


## 5.2 Government trust and the HSBC's business development

The Chinese government's trust towards HSBC also reduced its transaction costs by reducing business uncertainty. From 1956, Britain gradually began to remove the commodities on the embargo list and Sino-Anglo trade began to increase. In return, BOC offered increased business to the HSBC Shanghai branch.<sup>118</sup> BOC also kept its word by arranging sufficient business to the Shanghai branch to enable it to pay its way.<sup>119</sup>

In return for the Chinese government's preferential treatment concerning frozen US dollar repayment and the profit remittance permission, HSBC actively encouraged its Shanghai branch to expand its business operations and retaliatory proposals were dropped.<sup>120</sup> The Shanghai branch of HSBC responded positively by financing China's trade using its own foreign exchange. Between 1959 and 1961, as a result of the extension of its business contacts with Correspondent Banks throughout the world and with the assistance from the various state trading corporations and BOC, the Shanghai branch of HSBC earned a profit of some RMB 62,000. With the government's trust, the business of HSBC's Shanghai branch has since expanded continuously, even at the climax of the Cultural Revolution, 1966-1970.<sup>121</sup> Its profits gradually increased up to 1970 and then sharply increased up to 1973 (See Figure 7.1).

Figure 1 HSBC Annual Profits (RMB)



Source: HSBC Group Archives, GHO 236, Shanghai Office: Half-Yearly Reports 1956-1967; HSBC Group Archives, GHO 345, Report on Shanghai Office 1968-1971; HSBC Group Archives, GHO 350.4, Half Yearly Results 1965-1975.

<sup>118</sup> HSBC Group Archives, W. Stewart, Oral History Interview, 73.

<sup>119</sup> HSBC Group Archives, GHO 157, Shanghai Office – Closure, March 1962.

<sup>120</sup> HSBC Group Archives, Chief Managers, S/O T/B No. 23, letter J. A. H. Saunders to G. O. W. Stewart, 28<sup>th</sup> March 1962.

<sup>121</sup> HSBC Group Archives, GHO 156, letter F. C. B. Black to W. A. Stewart, 2<sup>nd</sup> September 1959.

## 6. Conclusion

We have analysed a long-term business relationship building between an international company, HSBC and the Chinese central government in light of the insight provided by the work of Oliver Williamson on 'transaction cost economics' and Witold Henisz and Bennet Zelner on 'transaction cost politics (TCP)'. We have tried to illustrate our points by reference to the voluminous public record of documents and HSBC's archives. In doing so, we believe that we have demonstrated the value of the TCP-based approach in evaluating the specialised governance structure of trust. In particular, we have identified several transaction attributes that give rise to hazards: transaction uncertainty, the role of the government in the economy and the strength of the supporting coalition. As opposed to Henisz and Zelner's analysis in which the choice of the governance structure is made by private parties, this paper shows that private parties, facing government control, were in a vulnerable position in building a trust relationship with the government.

We have also identified the difference between trust created through incentives by the government which was in a dominant position and trust applied to HSBC which was in a vulnerable position. The motivation for the Chinese government to trust the international company was positively related to the importance of maintaining a good relationship with the international company's home country government and the importance of the international company to the Chinese government. Our analysis also confirms that the trust relationship between HSBC and the Chinese government did reduce the HSBC's transaction costs by guarding against the Chinese government's opportunism.

Our case study, however, analyses the situation in China's service sector before China's open and reform. The current Chinese economy is a government oriented market economy, rather than a central government controlled economy. The central government still plays a very important role in the economy but regional government has gained certain significant power in controlling the regional economy. What is the state of the current relationship building between the international company and the Chinese government? The resumption of Chinese sovereignty in 1997 has been followed by major changes in Hong Kong's financial relations with the Mainland's economy, encouraged by the modernisation and liberalisation of the Mainland's own financial institutions. This period has also witnessed considerable changes in Hong Kong's relations with the financial systems of the Asian region and with international financial markets. It would be interesting to explore how these changes have affected the relationship between HSBC and the Chinese government. All of these questions require further research by developing and testing empirically the transaction cost politics approach proposed by Henisz and Zelner.