HONG KONG INSTITUTE FOR MONETARY RESEARCH

THE GLOBAL CRISIS: WHY LAISSER-FAIRE HONG KONG PREFERS REGULATION

Leo F. Goodstadt

HKIMR Working Paper No.01/2010

January 2010

The Global Crisis: Why Laisser-faire Hong Kong Prefers Regulation

Leo F. Goodstadt

Hong Kong Institute for Monetary Research

Trinity College, University of Dublin

The University of Hong Kong

January 2010

Abstract

This paper explains why, despite the anti-Keynesian convictions of officials and academics, Hong Kong abandoned its initial commitment to the concepts of virtuous markets and moral hazard and resisted importing the prevailing Anglo-American regulatory 'culture'. It reviews foreign attacks on the government's intervention to protect financial markets during global crises and shows that these critics have misunderstood the limits of Hong Kong's attachment to laisser faire. The analysis traces the process by which increasingly strict regulation has been introduced without hindering the expansion of Hong Kong's role as a major international financial centre.

Keywords: Laisser Faire, Autonomy, Regulation, Competition, Moral Hazard, Virtuous Markets, United States, United Kingdom

---

Hong Kong's financial system emerged virtually unscathed from the turmoil which accompanied the global crisis in the United States and much of Europe. Its success in maintaining financial stability is of considerable interest because close parallels can be identified between the causes of the current international crisis and the market behaviour and the regulatory attitudes which, in an earlier era, had led to chronic instability in Hong Kong that lasted until late in the 20th century.[1] Hong Kong has also been untouched by the often bitter polemic overseas about regulatory reforms and monetary policy. In Hong Kong, the accepted view is that, even though its financial system is integrated into global markets to a very high degree, its special circumstances require the development of its 'own mechanism for a macro-prudential approach to financial regulation and supervision' quite separate from whatever regulatory changes that Washington and London may adopt.[2]

The decision not to be led by American or British proposals highlights the long-standing divergence between Hong Kong's activist regulatory arrangements and the minimalist approach espoused elsewhere, a contrast made all the sharper by its reputation for laisser-faire government. As this paper will indicate, however, 'non-interventionism' in Hong Kong has never been a matter of economic conviction but primarily a question of political convenience.[3] The preference for a local model is also striking because Hong Kong has not resisted any other aspect of the globalisation process. The legal standards, corporate governance and business practices adopted by New York and London have been imported wholesale. Yet, when it comes to monetary affairs, Hong Kong has rejected the consensus in favour of deregulation which the United States and United Kingdom have made the guiding principle for financial markets worldwide.

Hong Kong thus presents an interesting test-case. The classical British advocates of laisser faire had believed that a government could ignore threats to the stability and integrity of the financial system only at considerable peril to the rest of the economy, and Hong Kong's experiences should shed some useful light on how far financial markets and institutions can safely be left to their own devices in the contemporary world.[4] This paper will identify laisser faire's limits in Hong Kong. It will discuss why its regulatory record has been so different from the United States and the United Kingdom even though they

1 The principal parallels are noted throughout Leo F. Goodstadt, 'Hong Kong Banking: The Losses from Laissez Faire, Bank Runs, and the Rewards of Regulation', in Greg N Gregoriou (ed.), *The Banking Crisis Handbook* (London: CRC Press, 2009).

2 Significantly, the first Hong Kong Monetary Authority (HKMA hereafter) Chief Executive quoted the latest comments of Chairman of the United States Federal Reserve Board at some length in explaining why Hong Kong would follow a different course. Joseph Yam, 'Viewpoint', *Hong Kong Monetary Authority* (*HKMA* hereafter), 19 March 2009.

3 K. Y. Yeung, Secretary for the Treasury, 'The Role of the Hong Kong Government in Industrial Development', in Edward K. Y. Chen *et al.* (eds), *Industrial and Trade Development in Hong Kong* (Hong Kong: Centre of Asian Studies, 1991), p. 49.

4 This point was made in the Hong Kong context when the colonial administration was making a last stand against regulatory reforms in the 1980s despite market collapses and a runaway money supply. A. J. Youngson, *Hong Kong's Economic Growth and Policy* (Hong Kong: Oxford University Press, 1982), p. 131.

are its largest trading partners in financial services.[5] The presentation will review how key concepts in the Anglo-American regulatory 'culture' – virtuous markets and moral hazard in particular – had become discredited in Hong Kong during six decades of recurrent financial crises from the 1920s. In parallel, the paper will provide an account of its reluctant and incremental introduction of regulatory reforms. The presentation will draw on an analysis of the dominant Anglo-American 'culture' published in two earlier HKIMR working papers,[6] as well as making use of unpublished archival material on the evolution of Hong Kong's distinctive policies.[7]

1. Current Controversies

In the wake of the current global crisis, damage to Hong Kong has been 'reputational' rather than financial, and controversy has been has been 'political' rather than policy-driven. The regulators have been bitterly attacked because their salaries and benefits have been significantly higher than their counterparts in other jurisdictions. Hong Kong's superior performance during the global financial crisis by comparison with the regulatory record of the United States, the United Kingdom, France and Germany, for example, is not questioned. The critics are simply convinced that Hong Kong pay scales are excessive. Also ignored is the considerable attention aroused in other financial centres by research findings that their regulators' failures to police market behaviour more effectively could be explained by an inability to 'attract and retain highly-skilled financial workers, because they could not compete with private sector wages'.[8]

The complaints about the regulators' earnings had their origin in the public row provoked by the mis-selling of complex derivatives on the eve of the global crisis. The costs of compensating unqualified retail investors who bought these sophisticated products were easily written off by the banks involved. But in Hong Kong, instances of banking misconduct and failures to enforce the law have serious political implications well beyond the money involved. The regulators and their performance in this affair of the 'Lehman mini-bonds' have come under continuous and hostile scrutiny because the public has an abiding intolerance of bureaucratic negligence and an intractable mistrust of government-business collusion.[9]

---

5 In Hong Kong's total trade in financial services during 2007, the United States accounted for 32 per cent of exports and 22 per cent of imports, while the United Kingdom accounted for 22 per cent of exports and 14 per cents of imports. *Report on Hong Kong Trade in Services Statistics for 2007* (Hong Kong: Census and Statistics Department, 2009), pp. 36, 43. URL: http://www.statistics.gov.hk/publication/stat_report/external_trade/B10200112007AN07B0100.pdf

6 'The Global Crisis: Why Regulators Resist Reforms', *HKIMR Working Paper No. 32/2009*, November 2009;'The Global Crisis: Fatal Decisions – Four Case Studies in Financial Regulation *HKIMR Working Paper No. 33/2009*, November 2009.

7 I am indebted once again to the Government Records Service and, in particular, to Mr Bernard Hui Sung-tak and his colleagues in the Hong Kong Public Records Office for their efficiency and invaluable assistance in locating the relevant government files.

8 The evidence in support of this conclusion is based on research from the run-up to the crises of both 1930-33 and 2007-08. Thomas Philippon and Ariell Reshef, 'Wages and Human Capital in the U.S. Financial Industry: 1909-2006', (December 2008), p. 30. URL: http://pages.stern.nyu.edu/~tphilipp/papers/pr_rev15.pdf. The impact of this paper is indicated by the attention it received from the *Economist*, for example: 'Paying the piper', 5 February 2009 and 'The coming recovery', 28 May 2009.

9 On this feature of Hong Kong's political landscape, see Leo F. Goodstadt, *Uneasy Partners: The Conflict between Public Interest and Private Profit in Hong Kong* (Hong Kong: Hong Kong University Press, 2009), 2nd ed., pp. xiv-xvi.

These events were a reminder that historically, as this paper will show, in Hong Kong, the most immediate and compelling incentive for government involvement in maintaining financial stability has been the unacceptable political costs of widespread losses by depositors. Bank runs and financial crises caused only limited and short-term slowing of its high growth rates.[10] Their economic consequences were only a temporary inconvenience for officials. Public indignation at bank collapses and financial scandals was a different matter, even in the absence of democratic institutions. The government found itself forced, with considerable reluctance, to introduce a level of regulation that would ensure that deposits were managed with integrity and prudence.

In Hong Kong, the community has no doubts about the merits of comprehensive regulation, perhaps because memories of past banking failures and market collapses have not yet faded. A key challenge for contemporary policy-makers, to quote a British regulator, is to 'ensure that an institutional memory is maintained so that the lessons from the [past] are not forgotten and those impediments to excessive risk-taking are not swept away once memories of the [past] crisis recede'.[11] It is for this reason that the analysis which follows will devote such attention to the historical background.

2. The Rewards of Regulation

'As one of the most open economies in the world and with its focus on financial and trade services', Hong Kong could have been especially vulnerable 'to the unfolding crisis in international financial markets and to the slowdown in the global economy', the International Monetary Fund (IMF) has observed. In explaining how Hong Kong overcame these threats, the IMF gave credit to 'steady strengthening of financial sector regulation and supervision in recent years'.[12] (Exactly a decade earlier, it will be noted later, the IMF had joined the chorus of disapproval of market intervention in Hong Kong.)

In a 2009 review of the global crisis by the Bank of England, its Deputy Governor also drew attention to the contribution made by regulatory intervention to Hong Kong's financial stability and its relevance to

10 This resilience was particularly evident in the sustained growth of the export sector and the continuing (albeit lower) growth in real GDP in the 1960s despite a banking crisis and violent anti-colonial clashes. The pattern was repeated in the following decade (with the services sector coming to the fore) despite serious defects in regulatory performance and monetary management. For the data, see Census and Statistics Department, *Hong Kong Statistics 1947-1967* (Hong Kong: Government Printer, 1969), p. 88; *2003 Gross Domestic Product* (Hong Kong: Census and Statistics Department, 2004), pp. 14-6, 20, 78-9.

11 Mervyn King, Governor Bank of England, 'Finance: A Return from Risk' (17 March 2009), p. 15. URL: http://www.bankofengland.co.uk/publications/speeches/2009/speech381.pdf

12 'IMF Executive Board Concludes 2008 Article IV Consultation Discussions with People's Republic of China – Hong Kong Special Administrative Region', Public Information Notice (PIN) No. 08/145, 8 December 2008.

policy making elsewhere.[13]

> Loan to income and loan to value ratios tend to rise in any credit boom as lending standards become lax and asset prices inflate. In theory, a ceiling on these ratios could have provided an effective brake on the excesses of the last boom [in the run-up to 2007]… the Hong Kong Monetary Authority showed how such an approach could work in practice in the 1990s: tightening the constraint on loan-to-value ratios as their property market threatened to overheat.

This endorsement was all the more impressive given the general opposition from leading officials and academics to quantitative restraints on bank lending and mortgages to prevent the emergence of property 'bubbles'.[14]

3. Regulation and Intervention

Such commendations of Hong Kong for its regulatory endeavours are a very recent development. The general expectation, especially among, proponents of economic liberalism for whom Hong Kong has had an iconic status, is that Hong Kong refrains from imposing restrictions on market behaviour.[15]

> The United States has not enjoyed fully-fledged laissez-faire capitalism since the First World War. Indeed, the only country that has enjoyed such status in living memory was the small British colony of Hong Kong before it became the Hong Kong Special Administrative Region of the People's Republic of China in 1997. For laissez- faire implies the existence only of a minimal state that serves primarily as a free market referee...

When it comes to financial markets, however, Hong Kong does not believe that it can afford to stand on the touchline.[16] Regulation is expected to be a continuous and predictable feature of its financial markets, and statutory oversight of financial markets and institutions has come to be regarded as a normal function of government in Hong Kong rather than as an assault on economic freedom. Given adequate powers, regulators minimise the need for direct intervention in the market. Under Hong Kong's monetary

13 Sir John Gieve, Deputy Governor, Bank of England, 'Seven lessons from the last three years' (19 February 2009), p. 17. URL: http://www.bankofengland.co.uk/publications/speeches/2009/speech377.pdf. But another senior British regulator indicated that such quantative restrictions are no longer suitable except for 'emerging countries (e.g. Hong Kong and Singapore)'. Lord Turner, *The Turner Review A regulatory response to the global banking crisis* (London: Financial Services Authority, March 2009), p. 70. URL: http://www.fsa.gov.uk/pubs/other/turner_review.pdf

14 House of Commons Treasury Committee, *Banking Crisis: regulation and supervision,* Fourteenth Report of Session 2008–09 (London: HMSO, HC 767, 21 July 2009), pp. 36-7. URL: http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/767/767.pdf. The IMF has endorsed Hong Kong's policy of quantative restraints as an effective 'contingency strategy to pre-empt asset price bubbles'. 'IMF Executive Board Concludes 2009 Article IV Consultation Discussions with People's Republic of China – Hong Kong Special Administrative Region', Public Information Notice (PIN) No. 09/130, 2 December 2009.

15 Charles K. Rowley and Nathanael Smith, *Economic Contractions in the United States: A Failure of Government* (Fairfax: The Locke Institute, 2009), pp. 55-6. URL: http://www.iea.org.uk/files/upld-book495pdf?pdf

16 The discussion that follows reflects in particular the analysis presented in Yam, 'Hong Kong and Asia: Strategies for Recovery', Far Eastern Economic Review Conference, *HKMA*, 16 June 1999; Yam, 'Issues in Monetary Policy' Hong Kong University Speech, *HKMA*, 19 January 2004.

arrangements, intervention means using public funds to defend the stability of the financial system (which includes the linked exchange rate with the United States currency). This is a remedy of last resort but which becomes unavoidable:

- as the price to be paid when the regulators have failed to ensure the solvency and integrity of the banks, so that a crisis of depositor confidence occurs; and
- as the cost of stabilising financial markets when threatened by external shocks which may be predictable but are outside Hong Kong's control.

Hong Kong's financial markets have grown rapidly despite an increasingly strict regulatory régime that started in 1986. Its experience thus diverges from the Anglo-American prescription of deregulation which has been widely accepted elsewhere in the world as the best strategy for financial development.

4. Scandalous Behaviour

The contrast between Hong Kong's laisser-faire reputation and its regulatory realities first provoked widespread criticism after world share markets collapsed on 'Black Monday' in October 1987. The government had to bail out the futures market and worse still for many critics, 'Hong Kong was the only major stock exchange to close its doors during the crash'. This emergency measure was made necessary because its two stock and futures exchanges were 'particularly vulnerable to abuse'.[17]

> The decision provoked enormous criticism from around the world. Hong Kong was denigrated as a "Mickey Mouse" market and was accused of reneging on its financial responsibilities. It was widely suggested that it had destroyed its credibility as an international financial center.

Hong Kong was to face almost identical criticism during the Asian financial crisis that began in 1997. During the summer of 1998, its financial system came under severe pressure, and the government believed that the economy's survival could not be left to the mercy of the markets.[18]

> Our econometric models told us that had we not done anything, the Hang Seng Index, which was then trading at about 6,000, would go down to about 4,000 in a couple of days and then keep on falling. Interest rates would rise to 50% for weeks and stay there... We asked ourselves, what's wrong with Hong Kong. What's happened to us. We balance our budget. We regulate our banks well. We have a reasonable balance of payments. We do not deserve this.

[17] Neil Gunningham, 'Moving the Goalposts: Financial Market Regulation in Hong Kong and the Crash of October 1987', *Law & Social Inquiry*, Vol. 15, No. 1 (Winter, 1990), pp. 46, 3.

[18] Donald Tsang Yam-kuen, Financial Secretary, *Government Information Services* (*GIS* hereafter), 16 June 2000.

In defiance of the Anglo-American 'culture' which dominated regulatory policies elsewhere, the government embarked on an intervention exercise that was 'almost unique' not only in 'size, scope and intensity', according to a prominent British academic, but also as 'a rare example of waging a successful battle against speculators'.[19] Bitter attacks on Hong Kong followed, with the most damaging comments coming from Alan Greenspan, then Chairman of the Federal Reserve Board.

> I think that the effort on the part of the Hong Kong authorities to try to jack up their stock market was an unwise effort. One, I don't think it can succeed. And, two, I think that the consequences of doing that erode some of the extraordinary credibility that the Hong Kong monetary authorities have achieved over the years.[20]

This gloomy prediction proved no more accurate than the ominous forebodings that had followed the 1987 market intervention. The linked exchange rate did not buckle in 1998, and share prices quickly stabilised. The government was showing a profit of over HKD90 billion a year later on the HKD118 billion initially allocated to this rescue operation.[21]

Greenspan had been speaking on behalf of a very wide consensus well beyond the United States. The IMF expressed misgivings, but in more measured terms. It had no hesitation in declaring in 1998 that 'the financial position of Hong Kong's banks, and the quality of the regulatory and supervisory system, are very strong by international standards'. But it warned that 'the [intervention] strategy has also had costs'.[22]

> ... in particular, it has raised concern about the role of the government in the securities market, potential conflicts of interest, a reduction in the free float for many shares; greater difficulties in hedging, which has affected trading in certain derivatives markets; and a loss of competitiveness of certain financial products compared with offshore markets.

The financial press was much less restrained, both editorially and in reporting the views of business executives and economists.

---

19 Charles Goodhart and Lu Dai, *Intervention to Save Hong Kong: Counter-Speculation in Financial Markets* (Oxford: Oxford University Press, 2003), pp. 2, 4.

20 Alan Greenspan, Chairman of the Federal Reserve Board, testimony before the U.S. House of Representatives, Committee on Banking and Financial Services, 16 September 1998, p. 310.
URL: http://commdocs.house.gov/committees/bank/hba51202.000/hba51202_2.HTM. Greenspan eventually complimented the HKMA on this coup. Scott Lanman, 'Greenspan Says Hong Kong's Yam Was Right to Buy Stocks in 1998', *Bloomberg*, 19 May 2009.

21 Tsang, *GIS*, 23 September 1999.

22 International Monetary Fund, *Concluding Statement for the Article IV Consultation with the People's Republic of China in respect of the Hong Kong Special Administrative Region* (30 October 1998)
URL: http://www.imf.org/external/np/ms/1998/103098.htm

> ...the government casually tossed aside the carefully cultivated free-market ethics that have distinguished Hong Kong from other Asian markets... The ultimate ignominy now seems to lurk on the horizon – a forced end of the 14-year-old link to the U.S. dollar. (*Far Eastern Economic Review*)[23]

> Donald Tsang, Hong Kong's financial secretary... is left with an estimated US$13bn to US$14bn hole in the US$96bn reserves, strained investor confidence and plenty of speculators betting on a falling market into September. (*Financial Times*)[24]

> A poisonous air of mistrust pervades Hong Kong following the government's stock market intervention of 1998... [Some bankers] say the rhetoric employed by Hong Kong civil servants during the intervention period was the sort of thing they're used to hearing from Beijing's propaganda machine. (*FinanceAsia*)[25]

5. The Anglo-American 'Culture'

This controversy was less about practical issues than 'ideological' principles.[26]

> Hong Kong was seen by academics as an exemplar of the relationship between economic growth and liberal, non-interventionist, but properly regulated, institutional environments. Milton Friedman even went so far as to suggest that to understand "how the free market really works, Hong Kong is the place to go". However, by 1999, Friedman was bemoaning a Hong Kong government that was "disposed to more frequent regulation"... a series of government actions [in the following years] seemed conspicuously to have eroded the free-market, non-interventionist, impartial image with which the city had, correctly or otherwise, become synonymous.

In criticising Hong Kong, Friedman and Greenspan were acting in defence of what a leading British regulator has described as the 'absolutely dominant intellectual conventional wisdom' embraced by bankers, officials and economists almost everywhere prior to the global crisis.[27]

> ... there was a philosophy of regulation which emerged, not just in this country but in other countries, which was based upon too extreme a form of confidence in markets and confidence in the ideas that markets were self-correcting, which therefore believed that the fundamental role of the supervision of financial institutions, in particular banks, was to make sure that processes and procedures and systems were in place, while

---

23 Alkman Granitsas *et al.*, 'Politics and the Peg: Hong Kong fends off speculators at the price of credibility' *Far Eastern Economic Review* (*FEER* hereafter), 27 August 1998.

24 Louise Lucas, 'Hong Kong: State defence of currency under attack', *Financial Times*, 29 August 1998.

25 Jame DiBiasio, 'Hong Kong's Cultural Revolution', *FinanceAsia*, September 2000, p. 28.

26 Edmund R. Thompson, 'Dangers of Differential Comprehensions of Hong Kong's Competitive Advantages: Evidence from Firms and Public Servants', *China Quarterly*, Vol. 167, (September 2001), p. 707.

27 Lord Turner, FSA Chairman, House of Commons Treasury Committee, *Banking Crisis*, Vol. I Oral evidence (HMSO: HC 144–I, March 2009), pp. EV277, 280, 281.
URL: http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/144/144i.pdf

> leaving it to the judgment of individual management to make fundamentally sensible decisions. As Alan Greenspan said, that is the intellectual framework which has received an extraordinary challenge.

As Chairman of the Federal Reserve of the United States from 1987 to 2006, Greenspan had been the leading proponent of this international regulatory 'culture'. His opposition to official involvement in the markets was expressed in the most uncompromising terms.[28]

> Markets have become too huge, complex, and fast-moving to be subject to twentieth-century supervision and regulation. No wonder this globalized behemoth stretches beyond the full comprehension of even the most sophisticated market participants. … Regulators can still pretend to provide oversight, but their capabilities are much diminished and declining…. Regulation by its nature, inhibits freedom of market action, and that freedom to act expeditiously is what rebalances markets.

This 'culture' was a joint venture of the United States and the United Kingdom.[29] New York had invented the money centre-banking model in 1967, which was adopted by almost all international banks within ten years. Thus, the modern system of banking began with an overwhelming American content, but it had a crucial offshore dimension, which added an important British component.[30] The United States and the United Kingdom led the international trend towards deregulation, and their financial sectors boomed. In other countries, the credibility of central planning and state controls was fading fast during the Greenspan era, and private enterprise was being embraced even by nations where, previously, Marxism had reigned. As a result, an increasing number of countries liberalised their financial markets. In the process, they became integrated into a global system dominated by New York and London, which gave their shared regulatory 'culture' considerable influence worldwide. They were the world's largest exporters of financial services as well as of the legal and corporate practices on which financial transactions depend.[31] In terms of both market size and expertise, they had no serious competitors. In the current decade, the identity of outlook in New York and London has been reported to be almost total.[32]

---

28 Alan Greenspan, *The Age of Turbulence: Adventures in a New World* (New York: Penguin Press, 2007), p. 489.

29 Financial services are the one market in which the United Kingdom can claim to be a genuine competitor with the United States. See Sir John Gieve, Bank of England Deputy Governor, 'The City's Growth: The Crest of a Wave or Swimming with the Stream?', London Society of Chartered Accountants (26 March 2007), p. 2.
URL: http://www.bankofengland.co.uk/publications/speeches/2007/speech306.htm. But note the more sceptical assessment in House of Commons Treasury Committee, *Banking Crisis: regulation and supervision,* Fourteenth Report of Session 2008–09 (London: HMSO, HC 767, 21 July 2009), pp. 48, 49.
URL: http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/767/767.pdf

30 The offshore operations in London were important not only as a response to United States tax and exchange control policies but also to accommodate the political requirements of the Soviet Bloc and China during the Cold War. See Donald W. Fryer, 'The Political Geography of International Lending by Private Banks', *Transactions of the Institute of British Geographers*, Vol. 12, No. 4 (1987), p. 416.

31 Beth A. Simmons, 'The International Politics of Harmonization: The Case of Capital Market Regulation', *International Organization*, Vol. 55, No. 3 (Summer, 2001), pp. 592-5.

32 'They have really become one and the same'. Joe Nocera, 'New York and London: Twins in Finance and Folly', .*New York Times*, 9 May 2009.

6. A Likely Partner

Hong Kong looked like a natural Asian outpost for this Anglo-American regulatory 'culture' which paralleled a similar phenomenon in an earlier age. In the 19th century, there had developed a 'global civil society', it has been argued, modelled on British values, most notably in 'business transactions across continents and cultures' from which emerged 'a "likemindedness", as it would be termed today,... created, managed and financed by Britain'.[33] Hong Kong was a British dependent territory until 1997, and its legal and political arrangements were a colonial importation. How could it avoid acting as an extension of the United Kingdom economy and a branch of the London markets?[34] Furthermore, the Chinese government had entrenched the non-interventionist traditions of the British era in the Basic Law, the constitutional blueprint for the post-colonial administration, including the free port, free movement of capital and currency, balanced budgets and minimal taxation.

Hong Kong also seemed very close to the United States and the United Kingdom in its economic 'ideology'. The colonial administration was rarely doctrinaire. But when it came to economic theory, officials were implacably opposed to Keynesianism. This hostility had been a feature of British colonial territories in general, which preferred balanced budgets to deficit financing and foreign loans.[35] Hong Kong officials argued that Keynesianism was particularly unsuited to their small open economy; would lead to financial irresponsibility; and 'create an immediate balance of payments crisis'.[36] By the 1970s, the Financial Secretary was so fearful of raising expectations of a Keynesian approach to public finance that he avoided using the words 'monetary policy' in public.[37] This outlook survived the end of British rule. After 1997, the first Chief Executive declared himself unable to adopt reflationary policies despite the first recessions in some four decades.[38]

---

33 It should be noted that the author does not believe that this phenomenon could occur in the contemporary world and specifically not in financial services. A. G. Hopkins, 'Back to the Future: From National History to Imperial History' *Past & Present*, No. 164 (August 1999), pp. 235, 238.

34 This was the traditional view of British colonial economies. Ida Greaves**, 'T**he Character of British Colonial Trade', *Journal of Political Economy,* Vol. 62, No. 1 (February 1954), pp. 3, 4-6.

35 See H. W. Singer, 'The Distribution of Gains between Investing and Borrowing Countries', *American Economic Review*, Vol. 40, No. 2 (May 1950), p. 473; Hla Myint, 'Economic Theory and the Underdeveloped Countries', *Journal of Political Economy*, Vol. 73, No. 5 (October 1965), pp. 477-8.

36 Sir Robert Black Governor 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'); Sir John Cowperthwaite, Financial Secretary, *Hong Kong Hansard* (*HH* hereafter), 26 February 1964, p. 47; 24 February 1966, p. 57.

37 In Hong Kong, he insisted, public finance could not seek to 'pursue social justice or to manipulate – or rather try to manipulate – the rate and pattern of economic growth'. Sir Philip Haddon-Cave, *HH*, 7 April 1976, p. 802. He seemed not to know that the 1964 Banking Ordinance included among its aims: 'to regulate such [banking] business for monetary policy purposes'.

38 Tung Chee Hwa, *GIS*, 10 August 2000.

> It would have been easier for all of us, in the short run, to ease back into another bubble economy built on asset price inflation, and supplementing them with heavy doses of Keynesian fiscal and monetary stimulus. But let me tell you, we are definitely not taking that route.

With anti-Keynesianism went a conviction that the Hong Kong economy was self-regulating.[39] The economy was believed to adjust automatically so that markets were best left to find their own solutions to monetary shocks and to the ups and downs of the business cycle.[40] After the exchange rate collapsed in 1983, the need for more activist monetary policies seemed overwhelming. But the 'ideological' bias against market involvement was so strong that officials could not bring themselves to reveal how much intervention was required to make a success of the newly-established linked exchange rate with the United States dollar.[41]

Economists, almost without exception, belonged to the Chicago School[42] and believed that 'Hong Kong's economic miracle' was best explained by its 'minimal government intervention in the market' and 'an unusual degree of economic and civic freedoms'.[43] They vigorously opposed government intervention in economic and social affairs, even during the Asian financial crisis.[44]

Overseas, custodians of the Anglo-American regulatory 'culture' claimed that the most faithful advocates of their principles were to be found in Hong Kong. For Milton Friedman, the paragon of economic rectitude was Sir John Cowperthwaite. As Hong Kong's Financial Secretary in the 1960s, the Nobel Laureate declared, he pursued 'a laissez-faire capitalist policy', and his legacy was 'a striking demonstration of the productivity of freedom, of what people can do when they are left free to pursue their own interests'.[45] Friedman also mentioned approvingly Cowperthwaite's successor, Sir Philip Haddon-Cave.

The historical record demonstrates that neither official regarded non-intervention as an article of faith.

---

39 (79) Cowperthwaite letter to W. F. Searle, Chief Statistician (Colonial Office), 8 June 1955. HKRS163-9-88 'Trade. Balance of Payment Statistics. Policy regarding preparation of…'.

40 *e.g.*, *HH*: Cowperthwaite, 27th February 1963, p. 41; 10 March 1966, p. 57; 8 October 1969, p. 85; Haddon-Cave, 28 March 1973, p. 645 and 26 February 1975, p. 484, f.n. 53; 3 April 1975, p. 691, f.n. 4 and *GIS*, 1 February 1982.

41 Tony Latter, 'Rules versus Discretion in Managing the Hong Kong dollar, 1983-2006', *HKIMR Working Paper No. 2/2007*, January 2007, p. 9.

42 Tang Shu-hung, 'The Economy', in Joseph Y. S. Cheng and Sonny S. H. Lo (eds), *From Colony to SAR: Hong Kong's Challenges Ahead* (Hong Kong: Chinese University Press, 1995), p. 130.

43 Y. C. Richard Wong, 'Public Policies in the Hong Kong Economy: Emphasis on Manufacturing', in F. Gerard Adams and William E. James (eds), *Public Policies in East Asian Development: Facing New Challenges* (Westport: Praeger Publishers, 1999), p. 146.

44 On the economists' hostility to government intervention to protect the exchange rate and the financial markets in 1998, see Y. C. Jao, *The Asian Financial Crisis and the Ordeal of Hong Kong* (Westport: Quorum Books, 2001), p. 87. They had succeeded in blocking government plans for an old age pension scheme in 1994. Francis T. Lui, *Retirement Protection: A Plan for Hong Kong* (Hong Kong: City University of Hong Kong Press, 1998), pp. 6-7.

45 Milton Friedman, 'Hong Kong Wrong: What would Cowperthwaite say?', *Wall Street Journal*, 6 October 2006.

- Cowperthwaite had frequently advocated departures from laisser faire: cheap land and subsidised finance to promote manufacturing in the 1940s[46] and anti-monopoly measures against public utilities in the 1950s.[47] He introduced rent controls in 1962[48] and contemplated assistance for 'infant industries' and the introduction of building licences to control the over-heated property sector.[49]
- Haddon-Cave proved more interventionist. He reversed his predecessor's rejection of government initiatives to promote Hong Kong as a financial centre[50] and the provision of subsidised industrial loans in 1972.[51] He endorsed proposals in 1979 for government measures to take advantage of the expected oil boom in the South China Sea (which did not materialise),[52] and he actively sought to facilitate the shift from manufacturing to services.[53]

7. A Legacy of Mistrust

The political disincentives against adopting the Anglo-American 'culture' were very powerful. Hong Kong officials had struggled to maximise their autonomy during a long history of political and economic disputes first with London and later also with Washington. Hong Kong had developed its own political 'culture' in which an absence of 'patriotism' and a preference for 'political neutrality' were defining features of its external policies.[54]

As early as 1935, an official Hong Kong report had stated bluntly that the colony's interests were generally ignored or even sacrificed by London when it came to foreign trade and recommended that Hong Kong should be free to ignore Colonial Office economic directives and manage its own external

46 M. 4. Acting Director of Supplies, Commerce and Industry to Labour Officer, 31 July 1947. HKRS163-1-305 'Retail Price & Wages Index. Preparation of …'.

47 Acting Financial Secretary minute to Colonial Secretary, 25 April 1957. HKRS163-1-634 'Public Utilities Companies Proposed Control of the Charges and Dividends levied by …'.

48 Measurable family hardship caused by rising rents was not acute. But the public mood, he intimated, demanded immediate statutory controls. *HH*, 26 September 1962, pp. 280-2.

49 'Completely new industries' were his actual words. *HH*, 30 March 1962, pp. 131–4 and 26 February 1964, p. 45.

50 Compare Cowperthwaite, *HH*, 30 March 1967, p 251 and Haddon-Cave, *HH*, 5 January 1972, p. 318.

51 There was no economic case for these loans. Industry Development Branch, 'The Case for Improved Access to Loans for Re-equipment Purposes by Small Scale Industry' (Department of Commerce and Industry, IND 2/903, 27 October 1969, mimeo) and 'Memorandum to the Loans for Small Industry Committee' (Commerce and Industry Department, IND 2/903, 4 November 1969, mimeo). The scheme failed and was wound up in 1976. H. C. Y. Ho, *The Fiscal System of Hong Kong* (London: Croom Helm, 1979), p. 62.

52 *Report of the Advisory Committee on Diversification 1979* (Hong Kong: Government Printer, 1979), p. 167.

53 *HH*, 13 April 1978, p. 812.

54 It should be noted that most Hong Kong academics assume the opposite. Financial policy is presented as a major instance of United Kingdom exploitation of the colonial relationship 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. 149-50.

commercial relations.[55] By 1961, London had realised that 'crudely stated', Hong Kong's view was that if the United Kingdom's textile industry 'was going to be ruined, it might as well be at the hands of Hong Kong as those of third countries'.[56]

The most telling example of Hong Kong's determination to protect its financial interests regardless of London's instructions was the refusal to help defend the British pound in the years when this was the overwhelming concern of the British government. Hong Kong resisted enforcing the Sterling Area's exchange controls. This policy of insubordination was initiated discreetly by the Governor himself,[57] and it was reinforced by starving London of information it needed to monitor foreign exchange flows and banking activities in the colony.[58] As sterling's crisis worsened in the 1960s, Hong Kong's efforts to manage its monetary affairs independently of London intensified.[59] By the 1970s, London had been compelled to accept Hong Kong's financial autonomy – despite its colonial status – but warned that British support in a financial crisis must not be taken for granted.[60] The colony was left in no doubt that it could not depend on the United Kingdom's goodwill.

Relations with Washington were always going to be strained because of its protectionist policies. The United States, like other developed countries, tended 'to discriminate against finished products from simple, labour-intensive industries and in favour of trade in raw materials and semi-processed natural resources', with Hong Kong as a major target.[61] Washington's demands for the right to police export controls on the ground in Hong Kong also created friction, as did disputes over intellectual property rights.[62] After Hong Kong became a major international financial centre. United States officials accused

55 *Report of the Commission…to Enquire into the Causes and Effects of the Present Trade Recession…*(Hong Kong: Noronha & Co., 1935), pp. 82-3, 86.

56 Sir Lesley Robinson (Board of Trade) (12) Minutes of the Sixth Meeting, 22 August 1961. HKRS270-5-56 'Cotton Advisory Board. Minutes of Meeting'.

57 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), pp. 345-6.

58 Economic Secretary minute to Financial Secretary, 17 May 1952; (79) Cowperthwaite to Searle, 8 June 1955; (294) Cowperthwaite letter to Searle, 11 August 1959. HKRS163-9-88.

59 The best account of Hong Kong's struggle for financial autonomy is Catherine R. Schenk, 'The empire strikes back: Hong Kong and the decline of sterling', *Economic History Review*, Vol. LVII, No. 3 (August 2004), pp. 570-3.

60 A confidential British Treasury statement said that it was 'inappropriate for [the United Kingdom government] to enter into specific commitments to provide assistance to Hong Kong' in a financial crisis. Alastair Mackay (British Treasury) letter to Financial Secretary, 22 July 1971. 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'.

61 Gordon A. Hughes *et* al., 'Protection and Developing Countries' Exports of Manufactures', *Economic Policy*, Vol. 1, No. 2 (April 1986), pp. 412, 422.

62 See the comments of Suzanne Berger and Richard K. Lester (eds), *Made By Hong Kong* (Hong Kong: Oxford University Press, 1997), pp. 152, 163; GIS, 6 August 1997, 9 August 1999; Chau Tak Hay, Secretary for Trade and Industry, *GIS*, 2 May 1998.

Hong Kong of tolerating dubious business practices in the financial sector, a row which did not end until the late 1990s.[63]

But the biggest cause of resentment in Hong Kong was Washington's campaign during the 'Cold War' to block all China's commercial and financial transactions with the outside world. Hong Kong's survival depended on its economic relations with the Mainland, and it was identified as the largest potential loophole in the blockade and a prime target for American surveillance and sanctions.[64] When North Vietnam also became subject to a United States embargo, Washington used investment pressures in an unsuccessful bid to force Hong Kong to close the port to ships bound for Hanoi.[65]

Even without these 'diplomatic' tensions, Hong Kong had persuasive grounds for reservations about the gains to be obtained from falling in with the Anglo-American regulatory 'culture'.

- Hong Kong's monetary officials did not need Anglo-American guidance on professional oversight of financial markets. Its 1964 Banking Ordinance had established a modern regulatory system with statutory authority '15 years before Britain took much milder supervisory powers'.[66]
- In the 1970s, Hong Kong saw how business practices imported from New York or London created new and serious regulatory problems. The arrival of the new, American money-centre banking model was accompanied by an increase in self-destructive behaviour among international financial institutions in Hong Kong which, as will be explained below, created an irresistible case for more regulation.[67]
- In the 1980s, Hong Kong's financial independence became all the more important as the transition to the resumption of Chinese sovereignty began and the process of defining the 'high degree of autonomy' to be incorporated into the Basic Law got under way.[68] Hong Kong could not hope to win

[63] Mark S. Gaylord, 'The Chinese Laundry: International Drug Trafficking and Hong Kong's Banking Industry', in Harold H. Traver and Mark S. Gaylord (eds), *Drugs, Law and the State* (Hong Kong: Hong Kong University Press, 1992), p. 90. *GIS*, 4 July 1999; David Carse, Deputy Chief Executive, HKMA, *GIS*, 15 September 1999.

[64] Examples of the scope of this campaign were reported in *FEER*: 'Hongkong Company Meetings', *FEER*, 20 May 1954 and Derek Davies, 'HONGKONG AFFAIRS: The Hong Kong Hilton', 4 July 1963. See also Richard I. Devane , 'The United States and China: Claims and Assets', *Asian Survey,* Vol. 18, No. 12 (December 1978); Chi-kwan Mark, 'American "China Hands" in the 1950s', in Cindy Yik-yi Chu (ed.), *Foreign Communities in Hong Kong, 1940s-1950s* (New York: Palgrave Macmillan, 2005), pp. 176-8, 181-4.

[65] Secretary of State for the Colonies savingram to Officer Administering the Government, 'United States Investment Guarantee', 19 October 1965; (20) Financial Secretary note, 18 June 1966. HKRS163-3-269 'Investment Guarantees by the United States Government'.

[66] This point was made by a former banking commissioner. Robert Fell, *Crisis and Change. The Maturing of Hong Kong's Financial Markets* (Hong Kong: Longman, 1992), p. 150.

[67] On the impact of the new model on Hong Kong and on regulatory challenges generally, see Y. C. Jao, 'The Rise of Hong Kong as a Financial Centre', *Asian Survey*, Vol. 19, No. 7 (July 1979), p. 688; Robert Z. Aliber, 'Financial Innovation and the Boundaries of Banking', *Managerial and Decision Economics*, Vol. 8, No. 1 (March 1987), pp. 67-9.

[68] Hong Kong's formal dialogue with the Chinese government on the continuity of the financial system began in May 1987 and continued throughout the next decade. Yam, 'Viewpoint', *HKMA*, 3 May 2007.

Beijing's endorsement of its role as a financial centre if it were perceived as a satellite of New York or London.

8. Concepts in Common

Hong Kong, nevertheless, had begun the development of its regulatory arrangements with very much the same preconceptions that the Anglo-American 'culture' was to incorporate in a later period. The colonial administration's earlier discussions of monetary affairs frequently foreshadowed the Chicago School, and the presentations of contemporary American and British regulators are very similar in outlook to their Hong Kong counterparts in earlier decades, especially in addressing the concepts of virtuous markets and moral hazard.

8.1 Virtuous Markets

The Anglo-American consensus asserts that the regulatory process does more harm than good. American officials argued in 2002 that interference in the market did little to protect the public while hampering the market's freedom to innovate and expand, citing specifically the development of credit derivatives.[69] In 2009, the Chairman of the Federal Reserve Board expressed alarm that 'innovation, once held up as the solution, is now more often than not perceived as the problem'. The opportunities for 'responsible innovation' must not be blocked, he urged, despite the damage done by 'subprime mortgage loans, credit default swaps, structured investment vehicles, which have become emblematic of our present financial crisis'.[70] An important factor in the British government's currently cautious approach to reforms has been the perceived loss of business opportunities for financial services that would follow increased regulation.[71]

Four decades earlier, the concept of the virtuous market was widespread in Hong Kong. The government was convinced that the economy had an in-built and automatic self-adjustment mechanism, which made state involvement unnecessary.[72] 'In the long run, the aggregate of the decisions of individual businessmen, exercising individual judgment in a free economy, even if often mistaken, is likely to do less

69 Roger W. Ferguson, Jr., FRB Vice Chairman, 'Financial Engineering and Financial Stability', Annual Conference on the Securities Industry, American Institute of Certified Public Accountants (20 November 2002) URL: http://www.federalreserve.gov/boarddocs/speeches/2002/20021120/default.htm

70 Ben S. Bernanke, FRB Chairman, 'Financial Innovation and Consumer Protection', Sixth Biennial Community Affairs Research Conference (17 April 2009). URL: http://www.federalreserve.gov/newsevents/speech/bernanke20090417a.htm

71 *Reforming financial markets* (Cm 7667/2009), p. 140. URL: http://www.hm-treasury.gov.uk/d/reforming_financial_markets080709.pdf

72 Cowperthwaite, *HH*, 8 October 1969, p. 85; Haddon-Cave, *HH*, 13 December 1972, pp. 218-229, 14 November 1974, p. 218.

harm', Cowperthwaite had proclaimed, 'than the centralized decisions of a Government; and certainly the harm is likely to be counteracted faster'.[73]

This self-confident, laisser-faire rhetoric concealed the extent to which the government had lost faith in the theory that free and fair competition automatically led to optimal outcomes for financial markets.[74] In the 1950s, the Financial Secretary had insisted that freedom to enter the banking market was a beneficial and important principle. Cowperthwaite took a totally different view when he assumed this post in the following decade. He declared that Hong Kong was dangerously over-banked, despite a lack of supporting evidence.[75] He insisted that the banking industry's interest rate cartel, together with a moratorium on new bank licences, were essential safeguards of the integrity as well as the stability of the financial system.[76] This assessment was proved wrong by the inability of the constraints on competition to prevent future crises. Indeed, the scandals worsened over the next two decades. Cowperthwaite's mistrust of competition continued to influence policy for the rest of the century, nevertheless.

In the 1970s, a secondary banking sector expanded rapidly, unlicensed and unregulated. The government was very aware of the mismanagement and misconduct that plagued these deposit-taking companies (DTCs) and their contribution to property and share 'bubbles' during the decade. Officials decided to take no action. They feared that large numbers of DTCs would be unable to pass regulatory scrutiny and their closure would hinder Hong Kong's expansion as a financial centre.[77]. The two companion papers show that American and British regulators justified similar decisions in the run-up to 2007 by invoking the concept of virtuous markets. In Hong Kong, this policy was no longer sustainable by the end of the 1970s, and minimalist oversight of DTCS was introduced reluctantly.[78]

In the 1980s, it seemed that the virtuous market concept would return to favour. A new Financial Secretary had been recruited from the business sector who was convinced that market forces were benign. Before his appointment, he had publicly praised 'those little men who have made fortunes by

73 In an earlier passage, he had declared: 'The trouble is that economic analysis of future events is a matter, not of demonstrable fact, but of judgment and opinion… Government should not in general interfere with the course of the economy merely on the strength of its own commercial judgment. If we cannot rely on the judgment of individual businessmen, taking their own risks, we have no future anyway'. Cowperthwaite, *HH*, 24 March 1966, pp. 215, 216.

74 Policy-makers had similar misgivings about the merits of unfettered competition in other markets, including export manufacturing. (3) Director of Commerce and Industry (H. A. Angus) letter to Wilkinson and Grist, 25 July 1962. HKRS163-1-2861 'Cotton Textiles Allocation of quota to restricted markets' and *Hong Kong Report for the Year 1969* (Hong Kong: Government Press, 1970), p. 50.

75 See Catherine R. Schenk, 'The origins of Anti-competitive Regulation: Was Hong Kong 'Over-banked' in the 1960s?', *HKIMR Working Paper No.9/2006*, July 2006, pp. 8-9, 11, 15.

76 The change in attitude between the two financial secretaries is evident from a comparison of Circular No. 68 'Deutsch-Asiatische Bank,' 10 December 1957 with Circular No. 95 'Banking Ordinance – chapter 155 Bank Negara Indonesia', 16 June 1961. HKRS 163-1-679 'BANKING ADVISORY COMMITTEE'.

77 Haddon-Cave, *HH*, 8 January 1975, pp. 340, 341-2; 15 March 1978, pp. 623-4.

78 Fuller details of the regulatory problems of the decade can be found in Leo F. Goodstadt, 'Dangerous Business Models: Bankers, Bureaucrats & Hong Kong's Economic Transformation, 1948-86', *HKIMR Working Paper No. 8/2006.* June 2006, pp. 15-21.

intelligent speculation', and he was unconvinced that regulation would enhance financial stability.[79] But unprecedented corporate scandals in 1982 and 1983 compelled him to change his mind.

- Dollar Credit, a small deposit-taking company (DTC), engaged in cheque-kiting to a total value of USD21.7 million (USD50 billion in current terms). The fraud had gone unnoticed by the staff at Citibank, HSBC and Chemical Bank and by auditors and regulators.[80]
- The collapse of the Carrian group in the following year led to criminal convictions of senior banking and legal executives and was followed by the murder of a Malaysian banker; the suicide of a prominent British lawyer; and the flight from justice of chief executives from HSBC's merchant bank, a British clearing bank and a German landesbank, as well as several Hong Kong solicitors.[81]

Almost a hundred DTCs had closed by the end of the crisis, and the failure of seven licensed banks between 1982 and 1986 could be linked directly to the turmoil in the DTC sector.[82] The government spent almost HKD4 billion on rescuing and restructuring them.[83] The contribution to GDP from 'financing, insurance, real estate and business services' fell from 23 percent in 1980 to 17 per cent in 1986.[84] The Financial Secretary announced his conversion to radical reforms to ensure that financial institutions 'are operated in a responsible, honest and business-like manner [and adopt] proper standards of conduct and sound business practice'.[85]

The case against the concept virtuous markets has not been seriously challenged since. Indeed, by the end of the century, the HKMA argued that policy-makers who put their trust in free market forces were endangering the economy.[86]

> The fact of the matter is that free markets can sometimes fail. Free markets can sometimes behave in a manner very much against the long term interests of society. When this occurs, if those of us in the Administration hide conveniently behind the banner of free markets and do nothing, we are failing in our

79 His arguments against regulation also included the difficulties of enforcement in an open economy like Hong Kong. Bremridge, *HH*, 30 July 1975, pp. 948-51.

80 Fell, *Crisis and Change*, p. 158; Leo Goodstadt, 'Mum's the Word', *Asian Banking*, January 1983, p. 32. The criminal features of the financial scandals of this period are summarised in R. T. Naylor, *Hot Money and the Politics of Debt* (Montreal: McGill-Queen's University Press, 2004), 3rd edition, pp. 208-22.

81 Contemporary reporting of these events is recorded in Philip Bowring and Robert Cottrell, *The Carrian File* (Hong Kong: Far Eastern Economic Review Ltd, 1984).

82 Customer deposits with 241 DTCs were equivalent to 17 per cent of the total with licensed banks in 1978; 22 per cent in 1982; but only 10 per cent in 1987. *Hong Kong Annual Digest of Statistics, 1988 Edition* (Hong Kong: Census and Statistics Department, 1988), pp. 125-8.

83 T. K. Ghose, *The Banking System of Hong Kong* (Singapore: Butterworths, 1987), p. 96. The actual exposure of the Exchange Fund in supporting these banks was probably significantly greater at the height of the crisis.

84 Census and Statistics Department, *2003 Gross Domestic Product* (Hong Kong: Hong Kong SARG, 2004), p. 81.

85 Bremridge, *HH*, 19 March 1986, p. 771.

86 Yam, 'Towards a Stronger Financial System', Hong Kong Society of Accountants, *HKMA*, 29 October 1999.

duties. And to those who accuse us of betraying the philosophy of positive non-interventionism, let me ask this question: Why do you think Sir Philip Haddon-Cave used the word “positive” when he coined the phrase?

8.2 Moral Hazard

A second pillar of the Anglo-American ‘culture’ is the concept of moral hazard. Greenspan’s successor as Chairman of the Federal Reserve Board declared his opposition to any form of ‘prescriptive regulatory regime’ on the grounds that, ‘by creating moral hazard in the marketplace, it leaves the system less rather than more stable’.[87] This concept became an almost ‘iron law’ invoked by American and British regulators in the years before 2007 when declining to take action against questionable market practices, with costly consequences in the global financial crisis.[88]

As with the concept of virtuous markets, Hong Kong had started out with an almost unconditional belief in moral hazard. ‘We never intended to set ourselves up as nursemaids and governesses to silly people who put their money into shaky institutions’, one official declared in 1950.[89] This attitude was based on two erroneous expatriate preconceptions.

- The first was a conviction that Chinese depositors did not object to the loss of their deposits because they were not looking for safety and stability from their banks but for the maximum possible return.[90]
- The second was the perception that regulation was unnecessary because in the absence of public protests when deposits were lost, there was no political risk in allowing banks to fail.[91]

Such an unconditional commitment to moral hazard could not survive the onset of mass banking in the early 1960s. The refusal in 1965 to save a bank with over 100,000 depositors led to street demonstrations

87 Ben S. Bernanke, FRB Chairman, ‘Hedge Funds and Systemic Risk’, Federal Reserve Bank of Atlanta Financial Markets Conference (16 May 2006) URL: http://www.federalreserve.gov/newsevents/speech/bernanke20060516a.htm

88 The Bank of England was castigated by a parliamentary inquiry for its over-emphasis on moral hazard during the first stage of the global financial crisis. This official report, nevertheless, remained true to this principle in its recommendations. House of Commons Treasury Committee, *The run on the Rock Fifth Report of Session 2007-08*, Vol. I (London: HMSO, HC56-I, January 2008), pp. 43, 77. URL: http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/56/56i.pdf

89 This statement was made in the context of discussion among officials about whether the 1948 Banking Ordinance ought to be enforced with any diligence. See HKRS41-1-3044 ‘The Nam Sang Bank - 1. Application from ... for a Banking Licence. 2. Balance Sheet of ... 3. Cancellation of the Licence of ...’.

90 This view was regarded as racist nonsense by a leading expatriate businessmen at the time. Colonial Treasurer memorandum, 25 August 1936; Patterson minute to Colonial Secretary, 31 August 1938. HKRS170-1-307 ‘Banking legislation – 1. General supervision of Banking Concerns in Hong Kong... ’.

91 The pre-war allegation of Chinese indifference to bank failures was repeated two decades later: ‘The Government itself does not seem to have received complaints, direct or indirect, from depositors who have lost their money’. (86) Financial Secretary, 23 October 1959. HKRS 163-1-679.

which so alarmed the colonial administration that, henceforward, no bank would be allowed to fail at the depositors' expense.[92]

Officials were reluctant to abandon moral hazard altogether. In the 1970s, the Financial Secretary remained loyal to the concept of moral hazard as unlicensed DTCs mushroomed. He refused even to collect data from non-bank DTCs until 1978 on the grounds that such a statistical exercise might imply a duty to ensure their prudent management, which officials were determined to avoid.[93] The government hoped to escape any obligation to bail out unlicensed and unregulated DTCs which lost their depositors' confidence. Inevitably, this repudiation of responsibility for DTCs meant that their 'imprudence, mismanagement, and malpractice' went unchecked', according to Hong Kong's leading banking economist.[94]

In the 1980s, the Financial Secretary had a deep personal conviction of the value of moral hazard as a guide to policy. He had argued during his previous business career that it was impossible to 'legislate for the complete protection of fools'. For this reason, he had opposed calls to extend regulation to DTCs.[95] Now, however, moral hazard became too much of a political liability for the colonial administration. As explained in the previous section, public indignation mounted in the early 1980s at the spate of financial scandals. Revelations of official indifference towards illegal and incompetent management of DTCs coincided with the first, indirect elections to the legislature in 1985. These made it politically imperative to draft sweeping regulatory reforms, and their introduction the following year brought to an end six decades of bank crises and market collapses.[96]

9. Surviving Values

Hong Kong officials have never totally discarded their attachment to the theoretical preconceptions with which the government first approached the oversight of the financial system and to which their contemporary American and British counterparts remain committed.[97] In the current decade, officials have invoked the concept of virtuous markets and the belief that market forces should determine the fate of

92 The one exception was the Hong Kong branch of the BCCI in 1991. Its local operations were solvent , but it could not survive its overseas parent's collapse. Its failure provoked runs on four other banks, including Standard Chartered, a note-issuer. See Michael Taylor, 'Hongkong: Exchange of Views', *FEER*, 17 October 1991.

93 Haddon-Cave, *HH*, 8 January 1975, pp. 342–3; F. W. Li, appointed member, *ibid.*, 15 November 1978, p. 172.

94 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. 59.

95 Albeit while he was still a businessman. Bremridge, *HH*, 30 July 1975, p. 949.

96 See Bremridge, *HH*, 9 April 1986, pp. 981–7.

97 A former Commissioner of Banking and for Securities writing in 1990, close to the ignominious collapse in 1987, was still anxiously lobbying for minimal regulation. Robert Owen, 'Hong Kong Maintains Tradition of Light-Handed Regulation', in Securities and Futures Commission, *Securities Regulation in Hong Kong* (Hong Kong: Securities and Futures Commission, 2002), pp. 71-2 and 76.

financial enterprises.[98] But in Hong Kong, this principle has to be tempered with political pragmatism, and the HKMA has accorded a much higher priority to avoidance of the business disruption that bank failures would cause than it has enjoyed in recent British official thinking, for example.[99]

Hong Kong officials continue to be attached to the theoretical merits of moral hazard and are anxious to retain the threat of liquidation as a penalty for mismanaged banks. [100] Thus, the HKMA has cautioned depositors that an efficient banking system cannot be entirely free from risk. But to meet the public's expectation of regulatory responsibility, this warning has had to be accompanied by the reassurance that depositor protection would come first, regardless of the doctrine of moral hazard.[101]

Official attitudes were affected by the continuing nervousness among officials about the impact of uncontrolled market forces on the financial system. [102] The anti-competition measures introduced in response to the 1965 banking crisis were increasingly difficult to justify after the 1986 regulatory reforms. They were not to disappear until the end of the century, however. The restrictions on competition were finally discarded only after it was shown that they were damaging Hong Kong's status as an international financial centre. The Asian financial crisis led the HKMA to commission consultants to review the regulatory changes that Hong Kong would need in increasingly competitive global and markets.[103] This document demonstrated that although 'compared to other Asian centres, Hong Kong appears to be more attractive', it fell behind both the United States and the United Kingdom on most of six tests of fair and well-regulated markets. To catch up, the consultants argued, Hong Kong needed to get rid of the barriers to competition inherited from the past.

At the same time, it was noted, the Asian financial crisis had uncovered increasing risks to international as well as local stability. The solution proposed was that banks should be given greater market

98 Yam, 'Viewpoint', *HKMA* 18 October 2007.

99 The British view was that moral hazard should be preserved: 'Banks should be allowed to "fail" so as to preserve market discipline on financial institutions… The Government must take steps to ensure that its framework for maintaining financial stability does not provide free insurance to banks'. House of Commons, *The run on the Rock*, pp. 74, 77.

100 'There is a further argument for maintaining a degree of constructive ambiguity in order to avoid encouraging moral hazard by setting out too clearly the terms on which support might be forthcoming. This is a valid point. But it is also worth noting that the problem of moral hazard, while it can never be entirely eradicated, has been considerably reduced in Hong Kong in recent years'. Yam, 'The Lender of Last Resort', Hong Kong Association of Banks, *HKMA*, 29 June 1999

101 Yam, 'Viewpoint', *HKMA* 18 October 2007.

102 Tsang, *GIS*, 12 June 1997. The research evidence showed that this nervousness was unjustified. See Guorong Jiang *et al*., "Banking Sector Competition in Hong Kong – Measurement and Evolution Over Time," *Hong Kong Monetary Authority Research Memoranda(* 20 April 2004). Note the continuing concern about competition expressed by Yam, 'View Point', *HKMA*, 31 August 2006.

103 A persuasive account of why HKMA did not believe that financial markets could be left to find their own remedies for instability after the Asian financial crisis was presented by the current HKMA Chief Executive in 1998. Norman Chan, HKMA Deputy Chief Executive, 'The Asian Financial Crisis: What have we Learnt?', Oxford University Asia-Pacific Affairs Society (7 June 1999).

opportunities, while the HKMA's oversight of the financial system should be strengthened. [104] Implementation began swiftly. The last remnants of the interest-rate cartel disappeared in 2001. Restrictions on foreign bank branches were finally eliminated in the same year, and the gap between entry conditions for local and foreign banks was drastically reduced in 2002. The result was to bring Hong Kong up to much the same level as New York and London on the consultants' criteria. In defiance of the conventional Anglo-American wisdom, however, increased competition in Hong Kong had come with greater regulation rather than less.

10. Conclusions

The decision to discard non-interventionism has been justified, it has been shown, by the stability that has prevailed since the 1986 reforms. But it is also validated by international experience during the global financial crisis. IMF data suggest that the level of damage sustained during the current global financial crisis was less severe in those economies where the Anglo-American 'culture; had the least influence.[105] At the same time, Hong Kong's strict regulatory régime has done nothing to hinder its success as a financial centre. Its role as a major location for financial institutions active in Asia is reflected by its 2008 international rankings.[106]

- International banking: 69 of the world's 100 largest banks have offices in Hong Kong;
- Foreign exchange trading: the world's sixth largest centre;
- FDI: the world's largest seventh largest recipient and Asia's second largest;
- Stock market capitalisation: seventh highest in the world and third in Asia;
- IPOs: fourth largest in the world and second in Asia.

These impressive volumes of transactions are generated overwhelmingly by Mainland demand. Nevertheless, Hong Kong's financial markets continue to be influenced more by developments in United

104 KPMG and Barents, 'Hong Kong Banking into the New Millennium', Consultancy Study (December 1998), Table 1.6.1 'Sector-level key success performance comparison', pp. 9, 17; Table 1.10.1 'Proposed implementation approach for key recommendations', p. 42; Table 1.10.2 'High-level implementation plan – key regulatory and supervisory recommendations', p. 43. URL: http://www.info.gov.hk/hkma/eng/guide/doc/pdf/c18_12_98a.pdf; HKMA, 'Policy Response to the Banking Sector Consultancy Study' (June 1999) URL: http://www.info.gov.hk/hkma/eng/public/hkbnm3/toc_index.htm

105 IMF analysis indicates that it was the American and British banking system which suffered the heaviest damage during the global crisis. Estimates of their cumulative losses on loans and securities for 2007-10 are similar: United States, 8.2 per cent, United Kingdom, 7.2 per cent. The losses estimated for the Eurozone's banks were 3.6 per cent and for Asia's banks, only 2.1 per cent.International Monetary Fund, *Global Financial Stability Report: Navigating the Financial Challenges Ahead October 2009* (Washington: International Monetary Fund, 2009), Table 1.2. 'Estimates of Global Bank Writedowns by Domicile (2007-10)', p. 10 and Table 1.15 'Cumulative Loss Rates, 2007-10', p. 60.
URL http://www.imf.org/external/pubs/ft/gfsr/2009/02/pdf/text.pdf

106 The data are from John C. Tsang, Financial Secretary, *GIS*, 18 September 2009; *Hong Kong 2008* (Hong Kong: Information Services Department, 2009), p. 65.

States markets than by Mainland market trends.[107] New York and London are still its closest trading and corporate partners in the financial services sector, which accounts for 20 per cent of Hong Kong's GDP. A continuing Anglo-American connection is the natural outcome of Hong Kong's status as a leading Asian international financial centre since early in the 20th century.[108]

Despite the claims that Hong Kong has betrayed its laisser faire traditions, a post-1998 survey of governments in the East Asian region showed that Hong Kong was conspicuously free from almost every form of state interference with business.[109] Hong Kong may be more interventionist in financial affairs than the purists would like, but it has also been rated as the world's 'freest economy' by such institutions as the American Heritage Foundation and the Canadian Fraser Institute every year since the mid-1990s. It continues to be as laisser faire as is compatible with financial stability and the community's expectations of accountable government.

[107] Dong He *et al*., 'Hong Kong's Financial Market Interactions with the US and Mainland China in Crisis and Tranquil Times', *Hong Kong Monetary Authority Working Paper 10/2009*, 16 June 2009. See also the overall conclusions from the research papers presented in Hans Genberg and Dong He (eds), *Macroeconomic Linkages between Hong Kong and Mainland China* (Hong Kong: City University of Hong Kong Press, 2008).

[108] Y. C. Jao, 'Hong Kong as a Financial Centre of China and the World', in Lok Sang Ho and Robert Ash (eds), *China, Hong Kong and the World Economy. Studies in Globalization* (New York: Palgrave Macmillan, 2006), pp. 123-4, 130, 132; 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.

[109] Stephen Knowles and Arlene Garces-Ozanne 'Government Intervention and Economic Performance in East Asia', *Economic Development and Cultural Change*, Vol. 51, No. 2 (January, 2003), pp. 451-477.