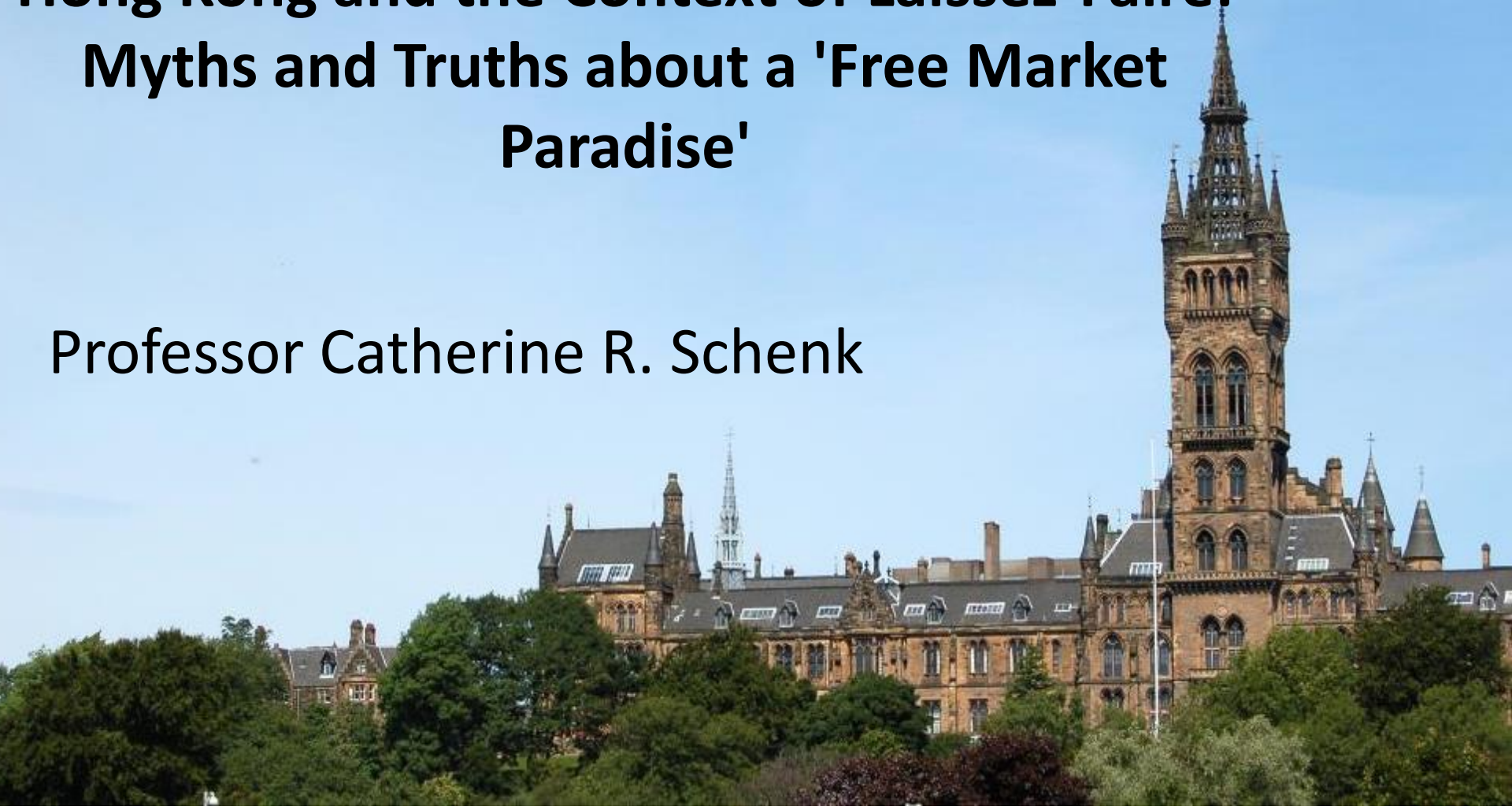


Hong Kong and the Context of Laissez-Faire: Myths and Truths about a 'Free Market Paradise'

Professor Catherine R. Schenk





Hong Kong and the History of Capitalism

- Origins: Imperialism and trade
- Commitment to Open Markets
- Small Government
- Entrepreneurial culture
 - Resilient, dominance of SMEs
- Priority of business over politics



Hong Kong 1890s

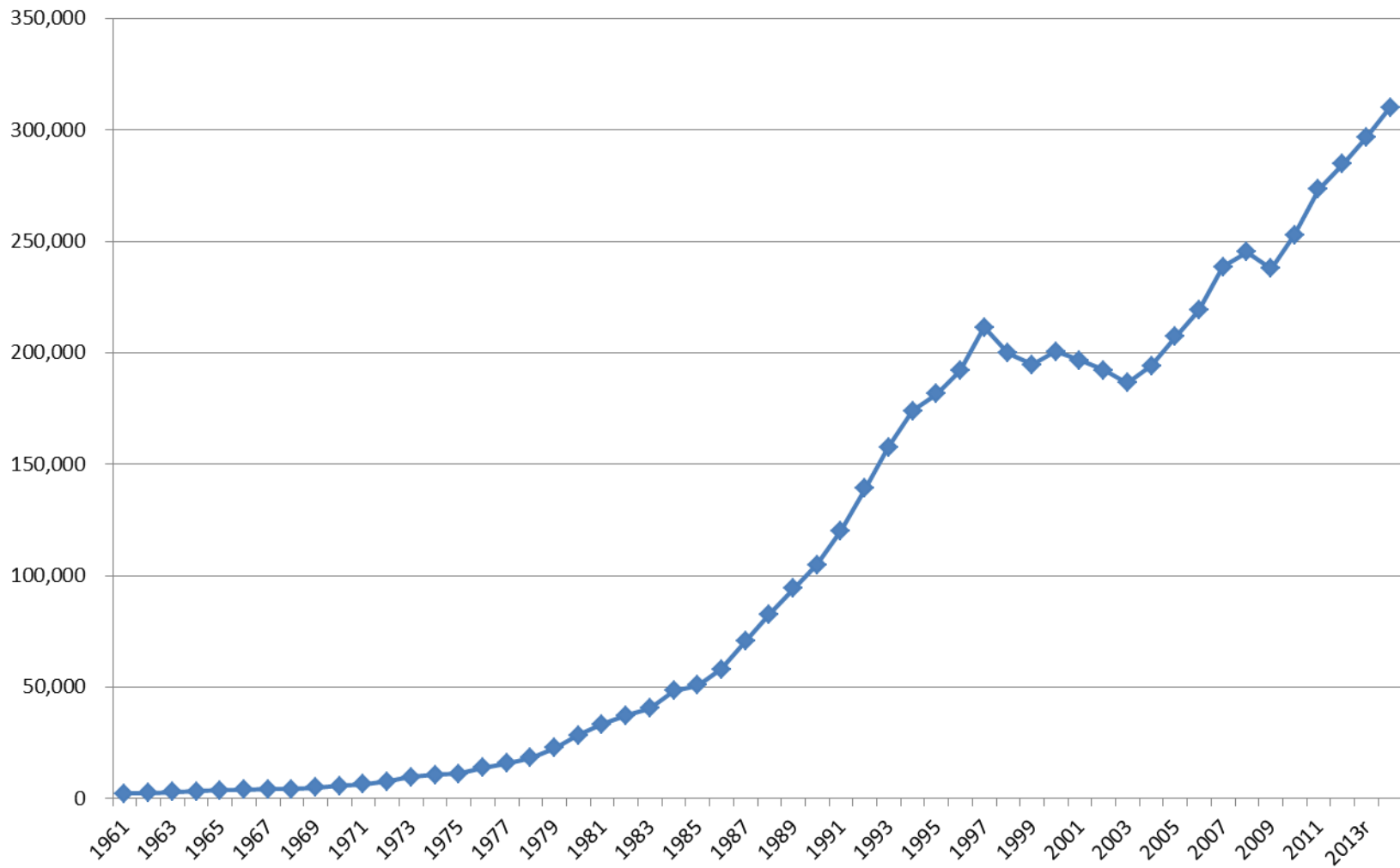
Hong Kong 2015



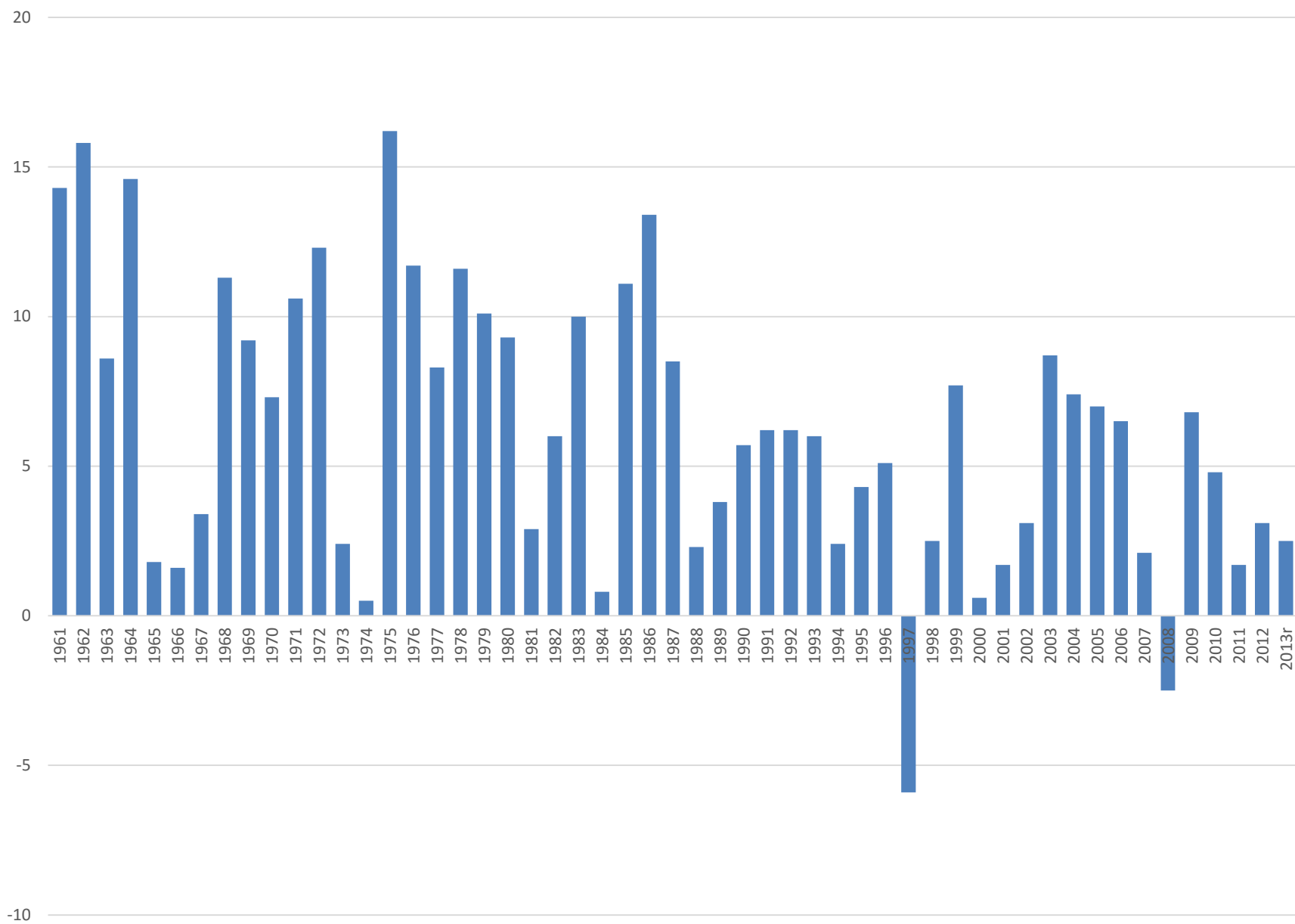
Hong Kong's Economic Success

- Evidence
 - Trade, growth per capita, transformation of economic structure in the 1980s from manufacturing to services, international financial centre
- Explanations
 - Rule of law, political stability, English language, geographical location, open markets, low tax burden, low regulatory burden, links to mainland China

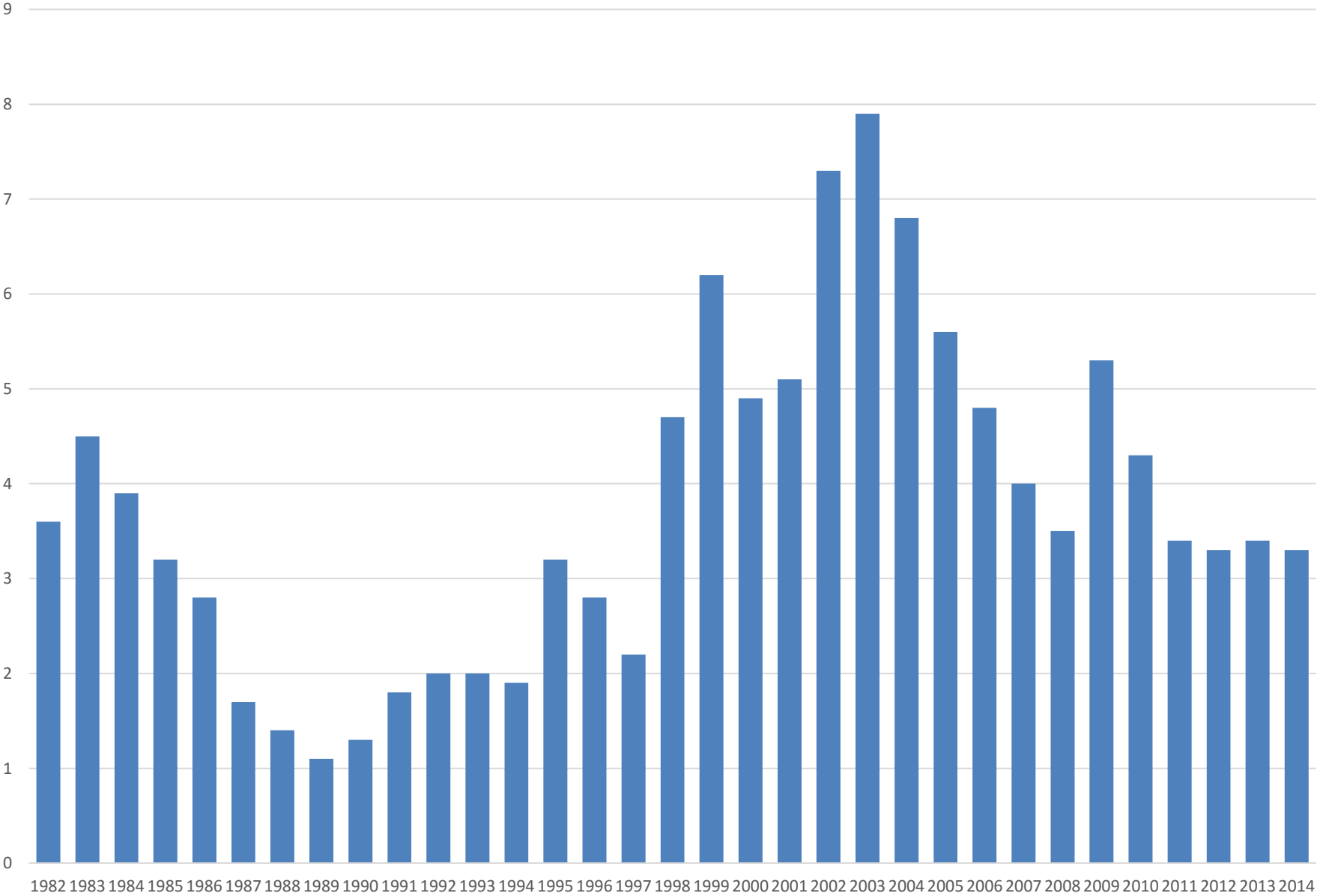
Hong Kong's Per capita GDP



Year-on-year % change in GDP (2013 dollars)

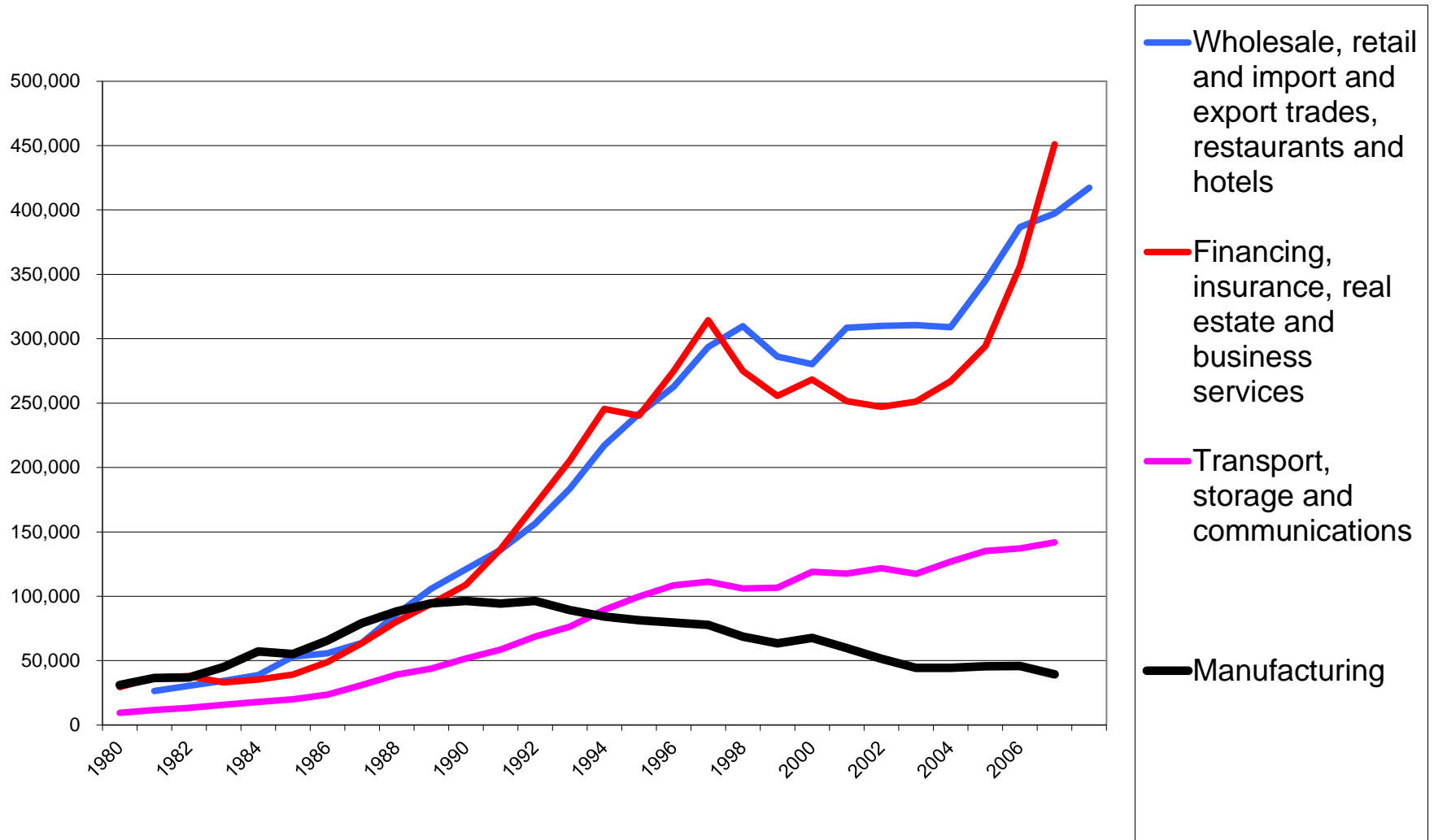


Hong Kong Unemployment Rate (%)

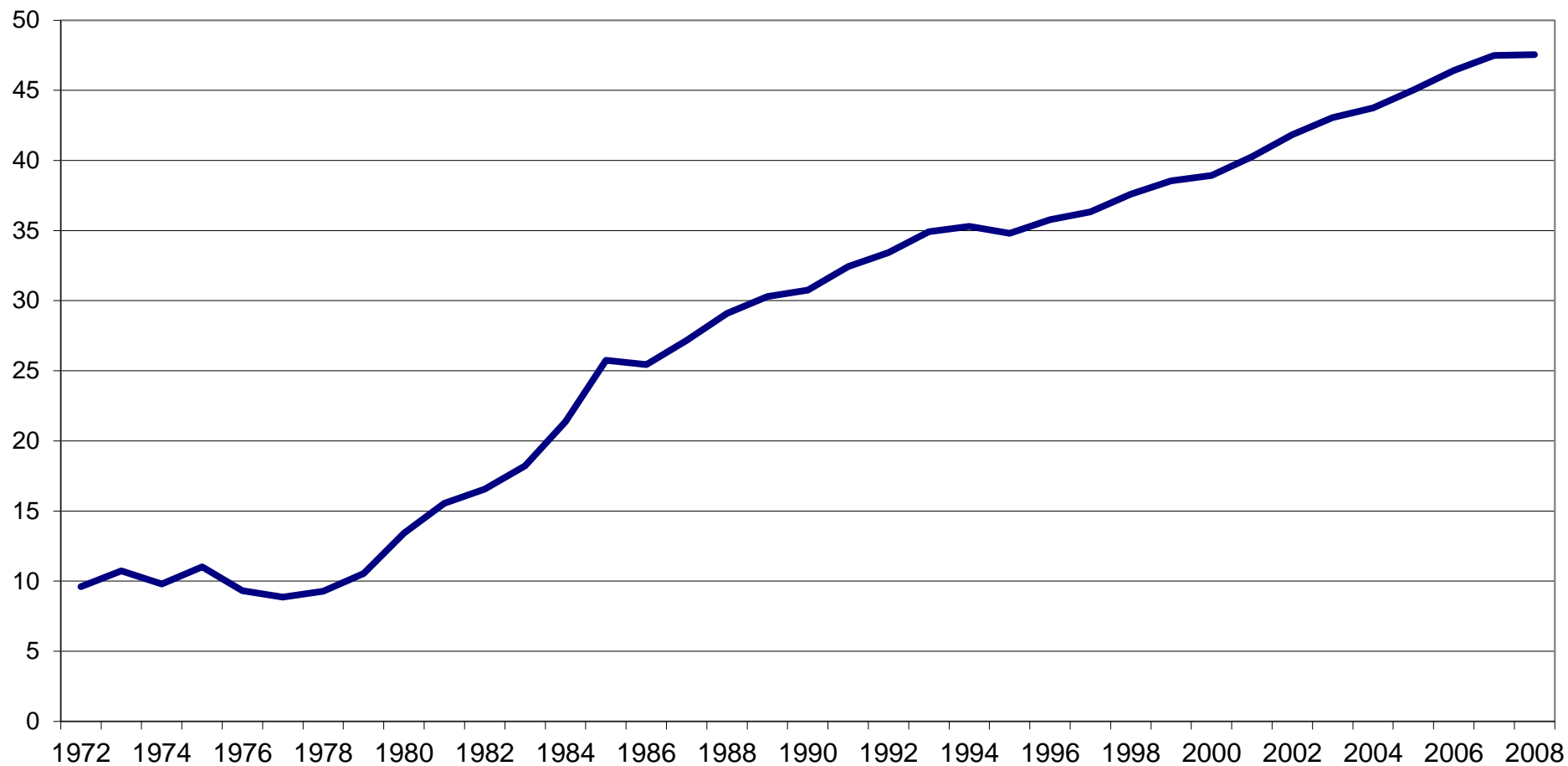


Hong Kong GDP HK\$ million

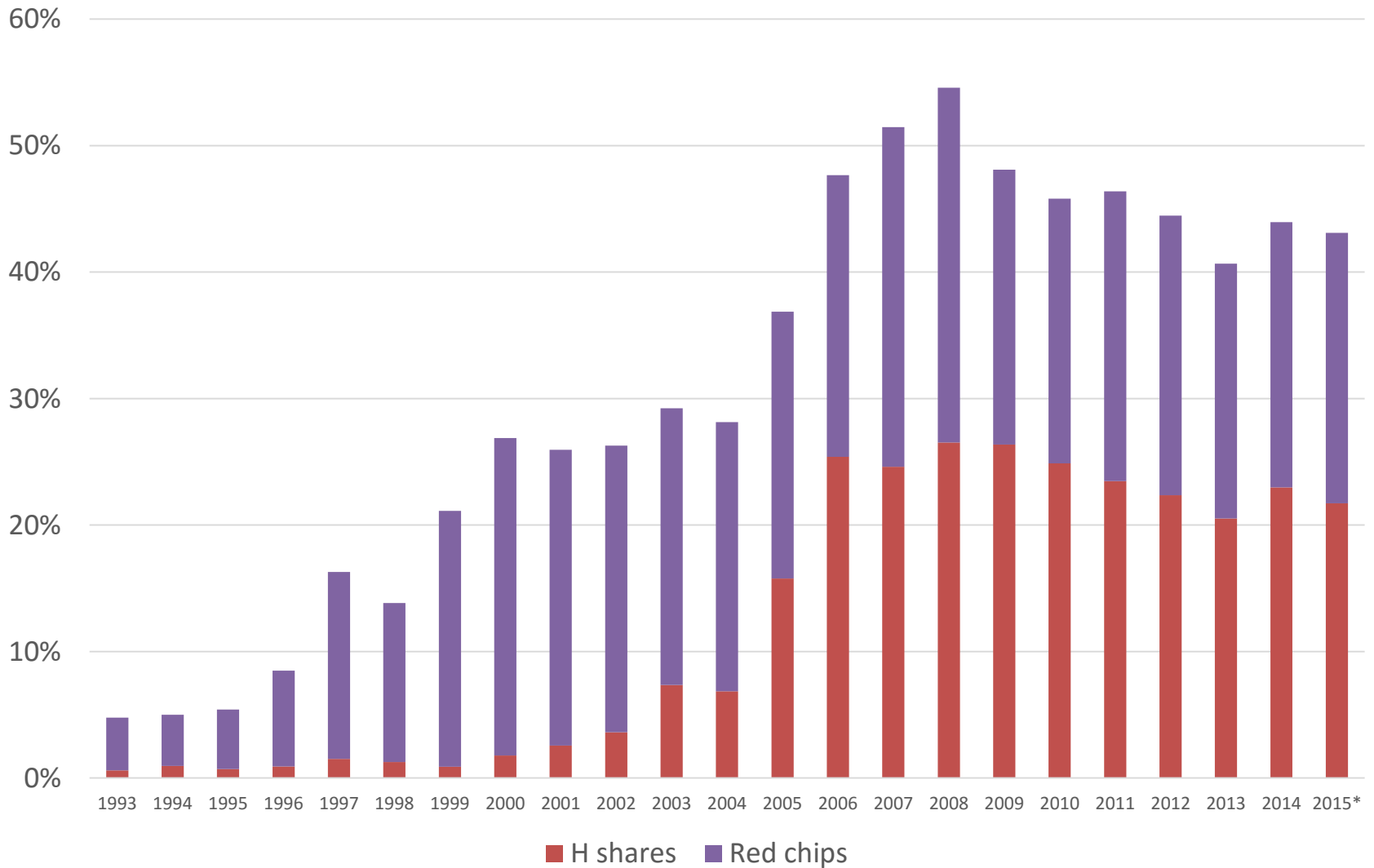
1980-2007



Share of Mainland China in Hong Kong's Total Trade



Hong Kong Stock Market Capitalization (% Total)



Hong Kong's Economic Success

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Myths of Hong Kong

- Free market paradise:
 - ranked most economically free market in the world by Fraser institute (1970-2015)
 - Heritage Foundation (1995-2015)
- Milton Friedman's analysis comparing Hong Kong and UK in 1980 (and 1998)
- Hong Kong Isolated from Mainland until 1978
- Laissez-Faire and Positive Non-Interventionism

Positive Non-Interventionism

- Devised by Haddon-Cave
 - Role for regulation in case of market failure
- Declared over in 1992 by Financial Secretary Hamish Macleod, then by Chief Executive Donald Tsang in September 2006 and again in August 2015 by Leung Chun-ying
 - Persists across the return to Chinese sovereignty
- 2006 replaced by: ‘Big market, Small government’



財政司辦公廳



FINANCIAL SECRETARY'S OFFICE,
THE SECRETARIAT,
HONG KONG.

Dear K.S.,

11th March 1981

Thank you very much (on Betty's and Francis' behalf as well as my own) for a delightful dinner last night in your most elegant house. I'm so glad that you, at least, seem to be in good spirits: the way in which so many in the market place, in these scratchy times, damn us if we even suggest something and simultaneously damn us if we do nothing, is beginning to get me down! I am determined, for as long as I am here, to keep the economy, and all the markets within it, free and that means free from unnecessary and clumsy Government intervention, free from fiscal discrimination, free from the stifling effects of excessive taxation and an over-large public sector and free from all other influences which inhibit competitive forces. How to do this is the tricky bit: but it can be done, if the temperature is kept down and there is a calm and rational exchange of views within the consultative system, the underlying theme of which is broad consensus.

Yours ever,

(Philip Haddon-Cave)

Mr Li Ka-shing,
Cheung Kong (Holdings) Limited,
China Building,
Hong Kong.

Haddon-Cave to Li Ka-shing (1981)

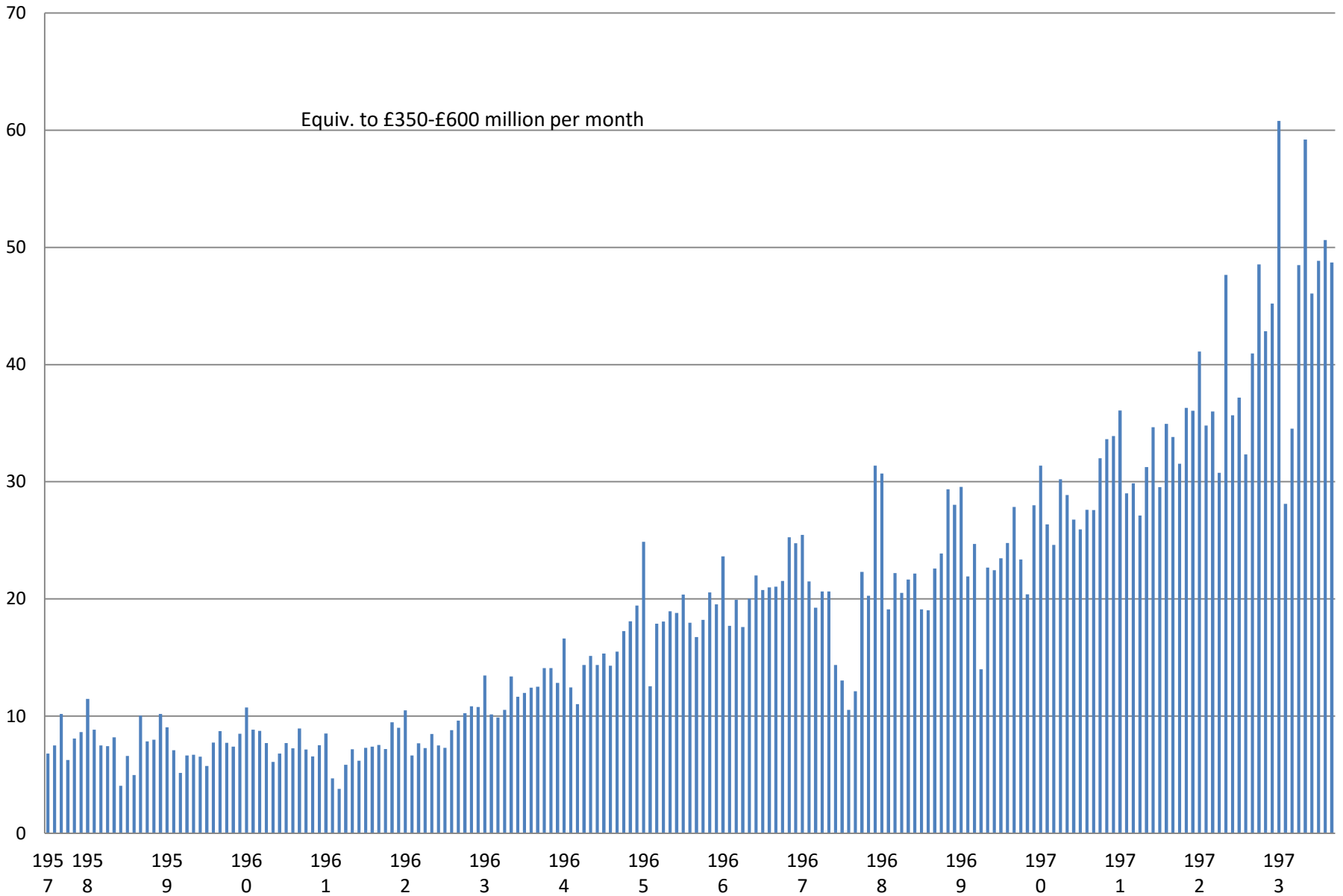
the way in which so many in the market place, in these scratchy times, damn us if we even *suggest* something and simultaneously damn us if we *do* nothing is beginning to get me down! I am determined, for as long as I am here, to keep the economy, and all the markets within it, free and that means free from unnecessary and clumsy Government intervention, free from fiscal discrimination, free from the stifling effects of excessive taxation and an over-large public sector *and* free from all other influences which inhibit competitive forces

Challenging the Myth

- Recent rising income inequality and social/political unrest
- State controls land (scarcest resource)
- State subsidises housing (subsidises labour intensive industry) 30% people in public housing, rents 14% private
- Integration with China before 1978 (cheapens food, costs of labour)
- Banking System tightly controlled
- Weak regulation promotes instability

Sterling Sold to China Against HK\$ (£ million)

Equiv. to £350-£600 million per month



Banking System I

- Slow and reluctant regulation and supervision
- Repeated banking crises: 1961, 1965, 1983
 - Depositors bailed out (moral hazard)
 - Banks taken over by government
- Foreign banks resisted: ‘parasitic’
- Open FX and gold markets, but tax on foreign currency deposits means Asian offshore market goes to Singapore 1968-1986

Banking System II

- Draconian Barriers to Entry to protect incumbent banks from 'excessive competition'
 - Moratorium on new bank licences 1965-1981
 - Limits on branches until 2001
- Interest rates set by a cartel until 2001
- No central bank (until 1993), no deposit insurance (until 2010)

Outline Chronology of Bank Regulation

Interest Rate Agreement (Cartel)	1964
Moratorium on new bank licences	1965
Lobbying for Limits on new bank branches	1966-69
Barclays Bank seeks licence	1971-1972
Moratorium on new bank licences lifted	July 1978
Moratorium on new bank licences re-imposed	August 1978
Moratorium on new bank licences lifted: one office only allowed	1981
New foreign banks restricted to 3 offices	1999
Restriction on number of offices lifted	2001

Positive Non-Interventionism in the Banking Sector

- Role of incumbent banks (especially HSBC and Chartered Bank)
 - Exchange Banks Association: frame, debate and implement policy
- Banking Supervisor under-resourced
 - Inspections are late and incomplete
- Government doesn't understand monetary system (de-links HK\$ in 1974, inflation to 1983)
- Repeated banking crises until 1986

The Hon Sir Philip Haddon-Cave KBE CMG JP
Financial Secretary
Government Secretariat
HONG KONG

2 February 1981

Dear Philip

The recent movement in deposits between the Banks and the Deposit Taking Companies seems to me to be a matter of great concern. I am not talking about the Hongkong Bank but the banking industry as a whole. It is significant that the shorter term deposits including even savings accounts are increasingly moving to the DTC's whose lending portfolios incline towards the long term.

There maybe room for argument in the saying that slow horses and fast women lead to personal ruin (presently I have three of the former and two teenage daughters) but there is no disputing the adage that borrowing short and lending long is a sure way to corporate disaster.

As I understand it, there are two main arguments put forward against the redefinition of banks. First that financial institutions of all sorts should be able to offer every facet of financial services because their customers want to be able to use only one institution. Secondly that to change the ground rules is unfair. In my opinion both are specious as I will try briefly to show.

Every multinational company employs a multiplicity of financial companies. They are not only used to this, they prefer to do so. I can't think of any large (not necessarily multinational) company who doesn't have accounts and dealings with more than one financial institution - again from preference.

To talk of changing the ground rules is equally misleading. I am afraid I just do not believe Jack Cater was correct when he said at Exco that he drafted the legislation covering the definition of banking and it was purposely worded in that way.

It is quite clear that the present situation arose out of poor drafting or, to put it another way, the lawyers of the

(cont'd)

(cont'd)

deposit taking companies were smarter than Government's draftsmen! To my mind to redefine banking is to achieve what was all along intended. I don't call that changing the ground rules.

If redefinition had been made when the loophole was first discovered, I agree it would have been more palatable to all but procrastination has not changed the fundamental.

The compromise solution I understand is to dramatically increase the minimum deposits which DTC's may accept. This will not only bring cries of "too high" on the one hand and "too low" on the other, it will lead to continual, wearisome and divisive demands for review in the light of inflation and experience. However, its greater drawback in my opinion will be the almost certain break-up of the interest rate agreement for amounts over the minimum limit.

I know there has been criticism of the interest rate agreement from time to time but it was cobbled together after great effort by all concerned including Government and, in my belief, has served Hong Kong well. I cannot think that a free for all would be of benefit to Hong Kong in general and will certainly bring difficulties to the smaller Chinese Banks in particular. At the moment they have a good measure of protection by virtue of the category system and this in itself brings the competition and choice that customers expect.

I know compromise is tempting as the easy way always is. However, the easy way is seldom the right way and it would be uncharacteristic (thank goodness) of Government to follow a route through lack of courage.

Here I am not writing "through our pocket" as we and the other large banks have in-house DTC subsidiaries. But it would lead to a serious undermining of Hong Kong's financial structure which we have all laboured so hard (and so successfully) to build up since the crisis of 1965, if we weakly allow the financial structure to be stood on its head with the DTC's rather than the Banks being the future keepers of the public money. You are probably better placed than I am to judge how near we were to real disaster in 1965, but the imprudent lending at that time was perhaps secondary to the fact that the medium/long term facilities were fueled by short term deposits. That is to say, it was more of a liquidity crisis (as indeed in many cases the secondary banking crisis in London has turned out to be) where those with a sound and long term deposit base have, with patience, been able to recover their advances.

Rereading what I have written I apologise for a somewhat schoolmasterish approach. This was not intended but you I have always felt strongly about the subject. The only

(cont)

財政司辦公廳



FINANCIAL SECRETARY'S OFFICE
THE SECRETARIAT
HONG KONG

9th March 1981

Dear Sir,

As I was instrumental in landing
five Haddon-Caves on you at the races
on Budget Night I clearly ought to have
written to thank you very much for being
so tolerant and hospitable despite a
simply dreadful hangover the next morning;
and long 'ere this, but I haven't been too
organised recently.

Yours truly,

(Philip Haddon-Cave)

The Honourable M.G.R. Sandberg, O.B.E., J.P.,
The Hongkong and Shanghai Banking Corporation,
Admiralty Centre,
Tower I,
22nd Floor,
Hong Kong.

Banking Commissioner (Leo Cole) to Financial Secretary (JJ Cowperthwaite) December 1969

- ‘if there are further questions or criticisms regarding the policy of my office, I will request the right to answer them in person, insofar as there is nobody else qualified to do so. It is abundantly clear that there is a **complete lack of comprehension or knowledge of the duties that my office performs**; this is a point upon which I have spoken to you many times in the past and more recently concerning the status and authority of this office. I am asking for an interview with HE [His Excellency the Governor] upon this last point. **The time has come, in my opinion, to establish whether the Colony’s banking authority is to have the independence and status which it deserves or not**’

HSBC/MBLD

STRICTLY PRIVATE & CONFIDENTIAL		MEMO
To	Chairman	Date 12 June 1981
From	General Manager Hong Kong	Sender's References
Reference	Your memorandum of 20 May 1981	Receiver's Filing Ref and Initial
Subject	FINANCIAL SECRETARY / HONG KONG ASSOCIATION OF BANKS	

A number of reports are produced by the Bank; it is not in my view desirable, even if it were practicable, for me to undertake the task of editing them all to ensure that they reflect confidential understandings between, for example, the Committee of HKAB and the Financial Secretary.

I cannot concieve that Philip would wish such confidential matters broadcast to the world at large, and so he must accept some divergence in the views expressed in our reports.

He would probably not be so touchy if it were not that he is overworked and in indifferent health, for I cannot believe that in normal circumstances he would have written about such a petty matter.

I agree with you that, as long as the Bank does not publicly clash with Government on fundamentals, there is much to be said for letting it be seen that we are not wholly their creatures and that we sometimes have views of our own.


T. WELLS

cf

Banking Crises 1982-1986

- 7 Banks fail + 100 other deposit-taking companies close
- 3 Banks taken over by Government and Government offers financial support for take-over of the other 4
- Combination of Fraud, inter-linked markets, poor supervision, over-exposure to asset markets

Conclusions

- Beware the trade-off between light regulatory touch and special interests
- Banking system not freely competitive: controls introduce damaging distortions
- Need to avoid helicopter views of policy environments: day-to-day interactions are revealing
- Clarify our understanding through close historical treatment of capitalism(s)