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INTELLIGENCE BRIEF

RISE IN COMMUNIST CHINA'S EARNINGS
OF CONVERTIBLE FOREIGN EXCHANGE FROM HONG KONG

DIRECTORATE OF INTELLIGENCE
Office of Research and Reports

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RISE IN COMMUNIST CHINA'S EARNINGS
OF CONVERTIBLE FOREIGN EXCHANGE FROM HONG KONG*

Since January 1964, Communist China's efforts to expand earnings of convertible foreign exchange have been aided considerably by the growth of its economic relations with Hong Kong. During the full two years 1964-65 it is expected that foreign exchange earnings from Hong Kong will have risen nearly 50 percent and, for the full year 1965, will reach US \$525 million to US \$550 million. On the basis of present projections, this would represent about one-half of China's total earnings of Free World currencies in 1965.

Favorable trade and financial transactions through Hong Kong have contributed substantially to the buildup of China's holdings of both gold and Western currencies, which are estimated to have risen from US \$300 million at the end of 1964 to between US \$400 million and US \$450 million by mid-1965. To a significant extent, China's efforts to expand its commercial relations with Hong Kong have been prompted by the large deficits it has incurred with Western nations. Since 1961 there has been a particularly compelling need to offset the deficits arising from the large purchases of Canadian and Australian grain.

Two-thirds of the earnings from Hong Kong come from the export of food, textiles, and other goods. The remainder come from non-trade sources, such as profits from commercial enterprises in Hong Kong and remittances of overseas Chinese made through Hong Kong banks. A sizable proportion of Chinese commodity exports to Hong Kong are re-exported to Free World countries whose importers make payments to middlemen in Hong Kong. The expected 10 to 15 percent gain in earnings in 1965 is attributable primarily to an increased demand for Chinese foodstuffs and raw materials by Hong Kong's growing population; earnings from non-trade sources may be slightly less than last year.

It is believed that China will experience further gains in foreign exchange earnings from Hong Kong in the future, but the rate of increase is not expected to approach that of the period 1964-65.

* This publication is concerned exclusively with Chinese trade and financial relations with Hong Kong and the remainder of the Free World. China's trade with Communist countries is conducted on what amounts to a barter basis, being financed through clearing accounts without exchange of convertible currencies.

1. Role in Total Earnings, 1958-64

During 1958-64, Hong Kong was the source of \$2.2 billion, or 47 percent, of China's estimated total convertible currency earnings of \$4.7 billion, as follows:

Communist China's Earnings of Convertible Foreign Exchange, 1958-64

	<u>Billion US \$</u>	
	<u>Hong Kong</u>	<u>Total Free World</u>
Exports	1.6	4.0 <u>a/</u>
Overseas Chinese remittances	0.4	0.4
Other non-trade earnings	0.2	0.3
 Total earnings	 <u>2.2</u>	 <u>4.7</u>

a. Excluding an estimated \$700 million of exports on clearing account with Free World countries which did not involve the receipt of foreign exchange.

Because Communist China's payments to Hong Kong are negligible, practically all China's income from Hong Kong has been available for financing imports from those Free World areas with which China ran a trade deficit. Large trade deficits have been incurred with Western Europe and, since 1961, with Australia and Canada. More recently, Hong Kong earnings have contributed to the buildup in China's holdings of gold and Western currencies, which are estimated to have risen from US \$300 million at the end of 1964 to between US \$400 million and US \$450 million by mid-1965.

a. Earnings from Commodity Exports

Commodity exports to Hong Kong amounted to 40 percent of all receipts from such exports by Communist China to the Free World during 1958-64. An important component of the \$1.6 billion in trade earnings from Hong Kong during this period was the reexport trade. At least US \$500 million, nearly one-third of the total trade earnings with Hong Kong, was realized from Chinese goods that were reexported to Free World countries, particularly Malaya, Japan, and other countries of non-Communist Asia. Importers in these countries, as well as Chinese Communist export corporations, have long found it both convenient and profitable to deal through Hong Kong middlemen. Such

middlemen are particularly useful because of their readiness to accept bulk delivery of Chinese goods, which they then break up for distribution in job lots among a large number of small Asian import firms. Moreover, Hong Kong as a major entrepot offers extensive commercial and financial services.

b. Earnings from Non-Trade Sources

The estimated US \$600 million in non-trade earnings from Hong Kong in 1958-64 accounts for an overwhelming share of the total of such receipts from Free World countries, estimated at US \$700 million. The remittances of US \$400 million from overseas Chinese made up two-thirds of the non-trade receipts from Hong Kong. The remaining US \$200 million of non-trade foreign exchange receipts from Hong Kong represented profits from China's banking and commercial interests there and other miscellaneous income.

c. Hong Kong as Middleman

Hong Kong's importance as a middleman is evident not only in trade but also in other financial transactions with the West. In fact, of the total US \$2.2 billion in foreign exchange which Hong Kong transferred to China during 1958-64, as much as US \$700 million to US \$800 million actually originated outside the crown colony. Besides the US \$500 million realized from reexports, a large part of overseas remittances came from Chinese in other countries and was first transferred to Chinese banks in Hong Kong. In addition, other earnings on non-trade account, probably amounting to at least US \$100 million, also originated outside Hong Kong.

2. Current Trends

Current evidence suggests that Communist China's foreign exchange earnings from Hong Kong may rise by 10 to 15 percent in 1965, to a total of US \$525 million to US \$550 million, or about one-half China's total anticipated earnings of Free World currencies. In 1964, China received about US \$475 million from Hong Kong -- nearly 30 percent above the preceding year. Trade returns for the first half of 1965 indicate that commodity exports to Hong Kong for the full year will grow by 20 to 25 percent, compared with an increase of 33 percent last year. The gains are especially pronounced in food and textiles, presumably because of an increased demand by Hong Kong's growing population and industries for Chinese foodstuffs and raw materials.

Remittances of overseas Chinese through Hong Kong in 1965 appear to be holding their own. Data on China's non-trade earnings in Hong Kong, excluding remittances, show a small absolute decline during the first six months of 1965. One possible explanation is that the rapid growth of these earnings in 1963-64 resulted from intensified efforts by Peking to maximize its foreign exchange acquisitions, including foreign currency held by Chinese-controlled enterprises in Hong Kong; having depleted this source for the time being, the Chinese Communists might be expected to suffer a decline in these earnings in 1965.

3. Prospects

For several years to come, Hong Kong clearly seems destined to remain the single most important source of Communist China's earnings of convertible foreign exchange. Its major role as a middleman in Chinese trade and other financial transactions with the Free World appears assured so long as its political status is undisturbed. Hong Kong will remain an important market for Chinese exports because of its dependence on the mainland for food and specialty products for its overwhelmingly Chinese population as well as because of its need for raw materials for fast-growing industries. Furthermore, the relative affluence of the Hong Kong population enables its Chinese citizens to continue making large remittances to relatives on the mainland. As China's trade with the Free World continues to grow, Hong Kong will remain the most important single source of earnings, but its relative importance will gradually decline.

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