Managing the external balance sheet: a Hong Kong perspective

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Hong Kong is perhaps a somewhat atypical and unhelpful case study to include in this collection. Atypical, because the government has no external debt; in fact, the government has no direct debt at all, internal or external (although the Exchange Fund issues bills and notes for market development purposes and to facilitate operation of the discount window, and certain public sector bodies – eg railways and airport – raise funds in their own names in debt markets). Unhelpful, because there are no statistics on the external balance sheet of the non-bank corporate sector or the personal sector. Indeed, the statistical distinction between residents and non-residents has never been considered of particular importance in Hong Kong, and has only been introduced comparatively recently, primarily at the behest of balance of payments compilers.

Hong Kong's foreign exchange reserves stand at over US$ 90 billion. This puts Hong Kong at fourth or fifth position in the world rankings, but we would be among the first to admit that this type of league table is of little value without some accompanying assessment of the relative need for reserves, their optimal level, and indeed the possible negative implications of excessive reserve accumulation.

In Hong Kong we cannot claim that our reserve position is the result of any particularly scientific calculation of optimality. Reserves were accumulated over time largely as a consequence of persistent fiscal surpluses which were invested in foreign currencies. These developments were, in turn, symptomatic of Hong Kong's deliberately conservative management of public finances, for strategic reasons (for instance, up until the handover of sovereignty in 1997, successive British governments were keen that the colony should be financially self-sufficient) and as a means of building financial confidence. Moreover, particularly in a small economy such as Hong Kong's, there would have been limited opportunities to invest fiscal surpluses domestically, without unacceptable credit risk or the build-up of significant conflicts of interest in an environment where the government has always aimed to limit its involvement in the economy.

The conventional IMF calculation of the import cover of reserves produces a figure of approximately six months, but we do not regard this as a key yardstick. More important, in the context of Hong Kong's currency board arrangements, is the fact that reserves provide more than threefold cover for the monetary base, which is defined as physical currency on issue, banks' balances with the Exchange Fund and debt instruments issued by the Exchange Fund. The excess is more than sufficient to cover the accumulated fiscal surplus, leaving a substantial unassigned surplus.

Under the currency board arrangement, changes in the monetary base are fully and simultaneously matched by changes in reserves (in effect, unsterilised intervention). However, the Monetary Authority can also buy or sell reserves outside the currency board account (sterilised intervention). It does so mainly in association with changes in the fiscal position, but some flexibility can be exercised, notably in the timing and tactics of such operations in the light of prevailing conditions in the foreign exchange and money markets.

That portion of reserves which is earmarked as backing for the monetary base under the currency board is, partly for operational reasons but equally importantly for presentational reasons, held in the most liquid US dollar instruments. The remainder is invested, either by the Monetary Authority directly or by appointed fund managers operating to strict guidelines, in highly rated instruments in major currencies. Although some of these investments may be in long-term bonds or even in equities, there is an emphasis on investing only in very liquid markets.

During the 16-year period of operation of the HK$/US$ exchange rate peg, there has mostly been a premium on HK dollar interest rates over those on US dollars for comparable instruments and maturities. This raises the question of the apparent implicit negative interest carry on the authorities' net foreign currency asset position. However, as noted above, given the policy of running fiscal surpluses, it would have been difficult not to invest surpluses overseas. And, in practice, active management of the foreign asset portfolio has produced returns which, though fluctuating from one year to the next, have typically exceeded the interest rate on domestic liabilities.

When, as in the recent recession, the fiscal position has moved into temporary deficit, there has been no hesitation to finance it by

reducing overseas assets. If, however, deficits were to persist, the point might be reached where the reduction in external assets adversely affected confidence in the exchange rate regime specifically, or in the government's economic management more generally. The premium on HK dollar interest rates would then increase. Clearly, it would be wise to have shifted towards some domestic borrowing, while preserving external assets intact, before that point was reached. There has not, however, been any conclusive research to identify that point; in any case it may never be reached, since to run persistent deficits would conflict with Hong Kong's *Basic Law*. As noted above, certain public corporations, which operate outside the government budget, already have borrowing programmes in local currency.

There are no reliable data on the balance sheet of the non-bank private sector, but it is generally presumed that the gross foreign currency components are substantial. This is a long-standing feature of Hong Kong's open economy and not something which of itself causes concern. It is probable that some borrowing from abroad and some placement of funds abroad have, at the margin, been prompted by the lack of a mature local debt market. The HKMA is keen to facilitate the development of that market and has taken a number of initiatives in that direction. However, the motivation here, in Hong Kong's case, has been to develop channels of financial intermediation with a view to achieving a better allocation of resources, rather than to attempt explicitly to reduce the scale of flows through external channels because of any concerns about the vulnerability of the external balance sheet.

The financial crisis which struck Hong Kong in August 1998 was not caused by problems with the balance of payments, or with the scale or liquidity of the external balance sheet. Rather, it arose because large international players could muster sufficient resources to give them a dominant influence in relatively small markets. In particular, with Hong Kong's very transparent currency board system it was possible for individual large players to be price-setters rather than mere price-takers in the short-term money market. Measures have since been adopted to broaden the base of the local money market so that inflows or outflows can occur across a considerably wider range than hitherto before triggering sizeable shifts in interest rates. The measures have curtailed but not entirely eliminated the scope for manipulative behaviour.