Mr Yam on Europe and the euro: the view from Asia

Speech by Mr Joseph C K Yam, Chief Executive of the Hong Kong Monetary Authority, at the XII International Frankfurt Banking Evening, on 14 March 2000.

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Introduction

Mayor Roth, President Welteke, President Duisenberg, Governors, Excellencies, Ladies and Gentlemen,

There can be few things more irritating than foreigners coming to your country and lecturing you on how much better things might be for you if only they were in charge. In my particular experience as a central banker there is no shortage of gratuitous advice on how one's monetary and exchange rate policies might better be conducted. Of course, I have encountered a number of visiting bankers, businessmen and academics coming to Hong Kong who are particularly well informed, who have thought carefully through the issues, and whose advice is consequently much to be valued. But I fear that they may be in the minority. So, I certainly feel a bit awkward standing here. I don't consider myself to be an expert in matters relating to the European economy or the euro, so I beg your forgiveness right from the start. My only defence is that you did actually invite me, so what I have to say is not entirely unsolicited.

This speech is going to be largely about perceptions, or rather misperceptions, and how they may contrast with reality. Why? As I said, I am not an expert on the euro. But I can certainly tell you a lot about how it is perceived from my part of the world. And when it comes to the behaviour of financial markets we all know that perception is as important as reality.

Perception and reality - Hong Kong

Allow me to illustrate this point by starting first with Hong Kong, for I cannot resist the temptation to take advantage of this opportunity to do a bit of advertising. I would like to describe some of the negative perceptions which financial markets and analysts have had about Hong Kong over the last few years, and how these have compared with actual developments.

First was the belief that Hong Kong's fixed exchange rate with the US dollar would not survive the Asian economic crisis. The reality is that it has survived, and the Hong Kong economy has now rebounded strongly, with the year-on-year growth rate of GDP for the fourth quarter of last year recording 8.7% and the forecast for the year 2000 now put at 5%. What the doomsters refused to recognise, despite the compelling evidence of the preceding one-and-a-half decades of the same fixed exchange rate system, was that Hong Kong has a highly flexible internal cost-price structure, which can quite quickly deliver the same external relative price adjustment as a currency devaluation. Although the time profile of the adjustment process is different, as is the degree of short-term pain involved, internal adjustment arguably leaves the economy leaner and fitter than it would if everyone could simply depend on depreciation to see them right.

The *second* flawed perception was that the intervention by the authorities in the stock market in August 1998 represented a fundamental reversal of traditional non-interventionist policy. The mistake here was to fall into the trap of characterising Hong Kong as a place where the authorities never intervened. We have always made clear our preparedness to intervene for such purposes as promoting efficiency in the market economy, providing infrastructure, or providing necessary support for the most needy in society. But our emphasis has always been to keep intervention to the minimum. This may sound uncontroversial today; indeed, it is probably an attitude shared by most governments, including those here in Europe. But you should remember that when Hong Kong was first vigorously espousing this doctrine, perhaps 30 or 40 years ago, the vogue in most western countries was for the state to assume an expanding role in the economy. In keeping with Hong Kong's principles, the stock market intervention in 1998 was specifically directed towards improving the operation of the market economy rather than perverting it: it was designed to frustrate market manipulation that would otherwise have led to serious market dislocation.

A *third* example of perceptions being at variance with reality was the prediction that the Mainland Chinese currency, the renminbi, would be devalued during 1999 and that the Hong Kong dollar would inevitably be swept down with it. It is true that the economic performance of the Mainland was for a time moving in a manner such that devaluation could have been judged a not unreasonable option. But those who predicted such an event tended to give insufficient attention to the fact that the renminbi is not a convertible currency, that the prevailing external position was strong, and that the authorities had made it clear that they were not contemplating devaluation.

The read-across to the Hong Kong dollar required an even greater leap of the imagination. Our exchange rate had never been dislodged from its peg by previous depreciations of the Mainland's currency, which have amounted cumulatively to some 75% over the period since the establishment of our peg in 1983. Moreover, any reasons for expecting a devaluation of the renminbi to have a knock-on effect on the Hong Kong dollar because of competitiveness considerations are weaker now than before, because Hong Kong has evolved much more as a complementary economy to the Mainland of China than as a competitor.

As a *final* example I might mention the various misperceptions which people have had more generally about the relationship between Hong Kong and the Mainland of China, which have perhaps caused some volatility in financial market sentiment towards Hong Kong. I say "have" advisedly, rather than "do", because, now that we are in our third year of "One Country, Two Systems", I am pleased to find that the number of foreigners that I encounter who still seriously misunderstand our system has dwindled away. I would not anyway criticise those who did, or still do, have mistaken understandings of Hong Kong's constitutional position. After all, Hong Kong is a small territory, a third of the way round the globe from here, and it would be conceited to assume that everybody should know the intimate details of our situation.

Anyway, for the avoidance of doubt, let me tell you that Hong Kong enjoys complete constitutional autonomy in its monetary and financial policies. And I can assure you that this autonomy has been fully respected by the Mainland authorities. They are, indeed, as anxious as I am to preserve a stable and prosperous financial environment in Hong Kong.

I hope you will forgive me for spending all this time talking about Hong Kong and its currency rather than about the euro. I have done so with a purpose, namely to illustrate the extent to which observers may often be mistaken about the direction of policy or the status of a currency. This is the source of much frustration to those of us trying to preserve financial and monetary stability. But we do have the consolation of knowing that there is a good chance that those who have perpetrated or adopted those misperceptions may have lost a lot of money as a result - if they were brave enough to put their money where their mouth was.

Perceptions of the euro

I shall turn now to the euro.

I would be deceiving you if I said that the euro, as seen from Hong Kong, enjoyed a particularly positive image at present. Arguably one could expect no better for a currency which has lost around 18% of its external value in little over a year, regardless of whether this was judged to be the result of the strength of the US dollar rather than any intrinsic weakness of the euro itself. It is worth noting, however, that the euro was launched at a time when the Euroland currencies were particularly firm against the dollar - having climbed, in the case of the Deutsche mark, by almost 50% since its low point in 1985. Against this background, and the widening of interest differentials in favour of the dollar in recent months, the direction of the euro's movement is, with hindsight, hardly surprising.

The depreciation of the euro is of course a fact, and it is perhaps the only concrete basis for the scepticism that one hears being expressed about the euro. But, from what I gather as an observer from afar, there are a number of other factors, less tangible, which also contribute to that scepticism. I shall go through some of them with you, noting once again that perception from many miles away may indeed be quite different from reality.

The first factor concerns *structural rigidities*, which appear to observers from my side of the world to be more serious in Euroland than in many other economies, big and small. The severity of these structural rigidities is seen to be undermining the ability and the efficiency with which Euroland can respond to change. Of course, we recognise that some loss of adaptability may be the price that has to be paid for a relatively stable society and a comfortable social safety net, and that the trade-off has effectively been arrived at through a democratic process. But it is hard to believe, as an outsider, that the trade-off is an optimal one. I cannot imagine, for example, what goal of social stability could justify labour market and social security arrangements that deliver an unemployment rate of double digits; or contribute to delaying, if not preventing, the arrival of the "new economy" in Euroland. I understand that some still do not believe that there can be a new economy, in which the technological revolution enables productivity gains that are capable of sustaining a much higher rate of non-inflationary growth. Of course, we should always question and critically examine any unusual phenomena, rather than embrace them blindly. But, meanwhile, investors are putting their money where this unusual phenomenon is allowed, by structural flexibility, to be manifested in full force, notably in the United States. This is seen to be a factor contributing to the strengthening of the dollar and the weakening of the euro, and reinforcing the scepticism about the euro.

One thing that we have learned from the Asian financial turmoil is that global financial markets, made highly efficient by financial liberalisation and the advance of information technology, have become rather intolerant about policy mistakes. Strengths as well as weaknesses are magnified in financial market behaviour to a disproportionate degree as a result of the explosion of *international finance*. What until recently were considered to be small aberrations in policy can now be brutally punished by the market. Even those who have been particularly prudent can be tossed around rudely, as market sentiment sways and, occasionally, succumbs to manipulative forces. So far, the emerging markets have been the ones affected, overwhelmed by international finance, perhaps to an unjustifiable degree relative to their economic fundamentals. Although they found the situation difficult to cope with at the time, most of them pulled through and are now recovering strongly. The one common quality that they possess, which is responsible for this rapid turn-around, is structural flexibility. The explosion of international finance is poised to continue, after the current lull, and will be made even more potent by further advances in information technology. Euroland is, of course, much bigger and more sophisticated than the emerging markets in Asia, and so the risk of Euroland being similarly overwhelmed by international finance is distinctly lower. But, seen from Asia, even for the large and sophisticated markets, the risk is not so low that it can be safely ignored. And if problems materialise, structural rigidities that inhibit adjustment may exacerbate and prolong the pain and disruption.

I sense also that there are still doubts about whether Euroland will cope well with the *discipline* of adjustment imposed upon it by currency union and therefore be able to realise fully the potential of such a union. Let me draw your attention to an interesting and highly significant parallel between your system of a unified currency across eleven countries and Hong Kong's currency board system fixed to the US dollar. We both depend to a very much greater degree than would otherwise be the case on internal market flexibility as a mechanism of economic adjustment. As you are aware, Hong Kong has always enjoyed a reputation as a flexible economy. It is precisely that flexibility in the labour, property and other markets that has ensured the sustainability of Hong Kong's high rate of economic growth and currency stability over the nearly seventeen-year history of our currency board system. It is that flexibility, involving sizable and quite swift price adjustments, accompanied by a considerable degree of labour mobility within and between sectors, that has enabled Hong Kong to cope with economic shocks. But, rightly or wrongly, the impression from afar is that Euroland is some way from possessing these necessary elements of structural flexibility. Consequently, there is concern whether intra-Euroland adjustment between disparate regions, when the exchange rate is no longer an instrument and fiscal policy is supposedly constrained by Treaty criteria, will prove to be too painful for some.

There are *other structural features* of Euroland, which also cause some concern to observers from my side of the world. These include high taxation, stringent regulation and cosy corporate governance characterised by the equity of major businesses being closely held by friendly groups of long-term investors, including one's bankers and associate companies - or Euroland's version of the crony capitalism for which parts of Asia have been so severely rebuked. From bitter experience, I know as well as you do that the media tend to exaggerate the negative and overlook the positive. The vision of Euroland which may consequently predominate in the sub-conscious of Asian readers might include such things as French truckdrivers blockading autoroutes; German resistance to foreign takeovers; relatively high taxes and a heavy burden of social security contributions; and statutory ceilings on the number of hours employees may work.

But let me refrain from venturing too far and turn to the *financial system* of Euroland. The perception is that it is dominated by the banking sector, which is in turn dominated by a handful of huge traditional commercial banks. I understand that, as at December 1999, commercial bank assets in Euroland represented over half of total assets in the bank, debt and equity markets. The corresponding figure in the United States is only 15.8%. It is true that the relatively greater dependence on banks in financial intermediation in the main Euroland countries has served those countries remarkably well for many years. It provided continuity of funding and support for long-term strategies, and therefore insulated them from the scourge of "short-termism". But the pendulum appears to have swung in the opposite direction over the past 10-15 years. Competitive equity and debt markets have been more efficient at delivering the corporate restructuring and the funding for "new economy" activities in a speedy manner in a world of particularly rapid technological change and a world where international finance is highly mobile. Such efficiency, with globalised markets, coupled with a buoyant economy, is seen to be attracting substantial capital to the US markets, and I understand that one major source from where such capital comes is Euroland. Seen from Asia, this has been another important factor contributing to the weakness of the euro.

These sort of images may explain why people talk of a reluctance of foreigners to invest in Euroland, despite the very clear signs that the overall prospects for non-inflationary economic growth are now quite encouraging. You may argue that these images are mistaken and flawed. You may well be right; I am not in a position either to refute or to verify them. Euroland officials should perhaps consider how much a problem there is of substance and how much of perception, and address each as appropriate.

Another factor that may contribute to scepticism over the euro concerns *monetary policy*. But there is not a lot that I would wish to say on the subject. You will appreciate that central bankers are not anyway the sort of people to make public assessments of one another! On the whole, I sense a feeling of some sympathy for the European Central Bank. In the technical sense it appears to have done most things right, in terms of keeping inflation under wraps and so preserving the internal purchasing power of the euro, but it has nevertheless had to preside over a substantial decline in the euro's external value. Given that Euroland as a whole is a relatively closed economy, the decline of the euro may have caused more concern to outsiders than to insiders. It has certainly influenced international investor perceptions.

My own observation, perhaps slightly cynical, of businessmen and investors is that they are less concerned about the technical content of monetary policy - provided that it is seen to be reasonably disciplined - than they are about the conviction with which it is delivered. Thus, the so-called "strong dollar" stance of the United States is clearly stated. It is not contradicted from anywhere within the administration. It inspires confidence, even though it may lack precision - in fact what I think it means is that the authorities will not stand in the way of a strengthening of the dollar, rather than that they would necessarily resist a weakening. By contrast, different Japanese officials have over the past years made rather different pronouncements about where the yen should be and what they might or might not do to secure that. International sentiment towards the yen and investment in Japan appear to have been damaged by such apparent vacillation.

If these arguments are transposed to Euroland, they imply that the ECB must continue to develop its own identity and assert its own policies. Emerging uncertainties over whether an exchange rate policy is lurking somewhere in the background should be firmly resolved. Furthermore, national central bank governors and finance ministers should exercise extreme self-discipline in commenting publicly on monetary policy if their views in any way diverge from the official ECB line, notwithstanding the withdrawal symptoms from which they may suffer. The problem was nicely summed up by the caption beneath a photograph of G7 finance ministers in a recent edition of your German magazine, "Capital". It noted that there was just one minister each to speak for the dollar, yen and pound, but three who debated with one another about the euro. This may be a scandalous misrepresentation of the true state of affairs, but there are many readers who would, I am sure, have sensed a grain of truth there.

Another cause of possible scepticism over the euro relates to what I would like to call *popular acceptability*. Let me explain what it is. No one has yet seen the euro in the form of cash. From Hong Kong we cannot witness as closely as you can here in Euroland the extent to which the euro has already become part of economic life. The separate national currencies are still quoted in Hong Kong and any traveller knows that he can only take those and not the euro in banknote form on his journey. There is a feeling that, whatever the law says, the euro will not really have arrived until it is there in your pocket. The sceptics will go on to suggest that poor performance of the euro to date, coupled with nationalistic resentment of the imminent loss of one's own banknotes - to many an emotive symbol of national identity and sovereignty - might yet cause a wave of popular opposition to the euro at the eleventh hour.

I should stress that this may not be a widely held viewpoint, and most international businessmen and bankers have long since discarded the national currencies from their minds and books in favour of the euro. But it is possible for just a few vocal doubters to have a disproportionate effect on the overall mood. Plainly, the sooner the euro is in physical circulation the better, and I personally feel that the plan of a three-year wait was a trifle generous.

I should add an associated observation concerning pride in one's currency. A currency is unlikely to win the widespread confidence of international financiers if nationals of the currency zone themselves lack pride or confidence in it. It is fully understandable, though nevertheless unhelpful, that people whom I meet here in Germany, for example, seem to have moved from pride in the Deutsche mark to nostalgia for the Deutsche mark, rather than from pride in the Deutsche mark to pride in the euro.

So much for possible sources of negative perceptions. At the same time there are *positive aspects* about the emergence of the euro, although not all of them are necessarily clearly visible from Asia.

A notable achievement has been the establishment of the euro as a major force in the international foreign exchange and bond markets. High degrees of liquidity are being enjoyed, and in the bond market issuance in euro quickly overtook the combined issuance levels of the former component currencies. In this sense the euro has already proved that it is greater than the sum of its parts, and has succeeded in reaping those economies of scale which were advertised as one of the several benefits of the single currency.

A related achievement has been the spread of usage of the euro for invoicing and financing trade, not only within Euroland but also by firms in other countries trading or competing with Euroland or involved in supply chains leading there. This is a phenomenon that is perhaps less evident in Asia than in countries nearer to you here.

Even less evident to us in Asia is the impact which the euro may be having on competition and internal pricing within Euroland, now that the single currency has stripped away exchange costs and other impediments to price comparison. I must emphasise that I have not had the opportunity to test this thesis for myself, so I can only rely on what others tell me. Some claim that this will prove to be one of the most emphatic benefits of the move to a single currency. I could well believe that, but I am unsure what progress may yet have been recorded.

Thus, you will appreciate how in Asia we may not be aware of the various benefits that the euro is delivering, whereas we are relatively well served by the sceptics. There may be a marketing job to be done here. And it is one which, to carry conviction, must be performed as much by businessmen or bankers who actually use the euro and experience the benefits, as by central bank, government or European Commission officials, or by politicians and their aides.

The HKMA view

But let me say here that, insofar as the perception of the euro within the Hong Kong Monetary Authority (HKMA) is concerned, it is clearly a supportive one.

As I implied earlier, we have a keen interest in the euro and a quiet wish for its success. This should demonstrate to the world that a fixed exchange rate (in your case more than a fixed rate - a unified currency) vis-a-vis some or all of one's trading partners is a viable option. There have been few other "fixers" since the Bretton Woods system broke down in the early 1970s. But Hong Kong since 1983 and other more recent currency board countries, such as Argentina, Bulgaria and Estonia, have shown that fixing is a viable strategy. It may indeed even be superior, given the discipline it imposes and the salutary attention it focuses at the national level on structural efficiency and flexibility. Of course it may not suit all, and the IMF, for instance, continues mostly to espouse free floating in its prescriptions for individual countries. But the IMF does acknowledge that options at the other extreme of the spectrum from free floating may be appropriate in some circumstances, and in its pronouncements the IMF has given unflinching support to Hong Kong's peg - as indeed it has to the euro.

The success of the euro has further implications for the Asian region. One lesson learned from the experience of the Asian financial turmoil is that if we wish to reduce the vulnerability of the small and open emerging markets in Asia to international finance we need, among other things, to build bigger markets. One way of achieving this, if not the only way, is to follow the example of Euroland and go for some form of currency union. Although the Euroland type of pre-conditions for currency union are far from being satisfied in Asia at present, with so much diversity and fragmentation in the geography, culture, stages of development and policies, this is an option that Asia can ill afford to ignore in the long run. The experience of Euroland operating with the euro is therefore something that should be watched in Asia, and is being watched in the HKMA, with keen, supportive interest.

Meanwhile, one way of reducing the short-term vulnerability of small and open markets in Asia to the destabilising influence of international finance, while continuing to benefit from it, is perhaps to promote the greater and prudent use of foreign currencies in financial market activities. This is not an advertisement for "dollarisation" - quite the opposite in fact. It is a suggestion for consolidating the position of national currencies by sparing them from certain extraneous influences. This is particularly relevant to Hong Kong as an international financial centre where non-domestic financial business and movements in portfolio capital unrelated to economic developments intrinsic to Hong Kong are abundant. In line with this thinking, we have come to the conclusion that we need to develop our financial infrastructure to facilitate the use of foreign currencies in international financial transactions in the Asian time zone. We have just started work on building a US dollar payment system and would have a keen interest in doing the same, in due course, for the euro, if demand for such facilities in the Asian time zone was evident. Hong Kong looks forward to and is ready to facilitate the greater use of the euro in Asia.

For Hong Kong the emergence of the euro as a major currency alongside the US dollar is also welcomed from a reserve management standpoint, since the options for investment are broadened. There is now a clearer alternative to the US dollar than before monetary union. And it is a time when conservative, long-term investors are looking for such an alternative. As you are aware, there is in the US increasing concern about inflation being rekindled, notwithstanding rapid, IT induced productivity growth. Of course, prospects of tighter monetary policy tend to lend support to the dollar. But there is the possibility that at some point the extent of interest rate hike needed to preempt inflation and the associated fears for its consequences for the real economy are such as to scare investors away from US financial markets. Another reason would be the possibility that productivity gains arising from IT investments may experience diminishing returns.

In the HKMA, we certainly are putting our money where our mouth is. I have personally attracted some attention in the foreign exchange markets for remarks I have made about the management of Hong Kong's Exchange Fund, which holds, among other assets, our foreign exchange reserves. Our target exposure to European currencies (which may not necessarily mean the euro alone) is set at 15% of the Fund and we have, over the past few months, moved from an underweight position to the neutral position of 15%. This target exposure may strike you as low. But we do hold some Hong Kong dollar assets in the form of the Hong Kong dollar equities that we have acquired in 1998 and we are obliged to hold US dollars one-for-one as backing for the monetary base under our currency board. If we exclude these, then among the remaining foreign currency assets our targeted exposure to European currencies at present is effectively a little over 20%. Superficially, this may still seem on the low side. But with our peg to the dollar we feel more comfortable having a substantial dollar reserve which covers much more than just the monetary base, even though we do not formally commit ourselves to convertibility at the fixed rate for anything more than the monetary base.

In managing our foreign reserves we also tend to be averse to volatility. Thus, given our dollar focus, we have naturally been worried by the volatility of the euro's exchange rate. Very recently we informally polled ten leading financial institutions in London. Their forecasts for the dollar/euro exchange rate by the end of this year ranged from $1.22 down to 90c. This is a considerably wider spread than the trading range already experienced and suggests a huge measure of uncertainty, to a horizon of only ten months.

Of course, one might argue that this represents uncertainty over the dollar as much as the euro. Yes indeed, and I apologise for analysing things very much from a dollar base. Over time, all currencies have experienced considerable volatility - the dollar, the yen, the euro and its ancestors, sterling and so on. Yet in all of these, investors have been able to enjoy significant positive real rates of return over the long term. That may not be good enough for everyone: some seek short-term gains; others may be worried by mark-to-market volatility in the short term even if they are there for the long haul. But long-term investors will give considerable weight to the overall economic and monetary management of the economy. As I mentioned earlier, there are a number of aspects of the management of the Euroland economy about which perceptions from Asia may be somewhat sceptical. As for monetary policy, I would suggest that it is perhaps natural for outsiders to be rather hesitant in their assessments, in view of the new infrastructure for monetary policy, but as the ECB beds down one would expect confidence to grow.

Conclusion

My theme today has been that perceptions may be at variance with reality, but it is often perceptions that drive financial markets. Economic fundamentals can probably explain some of the euro's weakness over the past 14 months, but not all of it. I have tried to be frank in my assessment of the way in which the euro is viewed from Asia. I hope I have not been so frank as to be discourteous. Sentiment does appear currently to be somewhat frail and the outlook uncertain. I derive no satisfaction at all from that - we are all in more or less the same boat when it comes to the vagaries of the markets. And as the manager of Hong Kong's substantial foreign reserves, I am also held accountable for the investment decisions taken. But I am confident that sentiment will improve and our investment in the euro will come good.