

Mr Latter looks at the implications of e-commerce for the banking and monetary system in Hong Kong

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The internet has quite suddenly multiplied by a remarkable degree the number of potential suppliers and customers with whom we can do business, and the number of avenues through which we can perform financial transactions. This opens up all sorts of opportunities, but it also attracts all sorts of warnings - about needing to know the identity of those with whom we are dealing; about needing somehow to satisfy ourselves, remotely, as to the quality of the products or services on offer; about needing to be sure of the financial standing of counterparties, be it their ability to pay or to provide credit which concerns us; and so on.

Speaking as a central banker, I begin to have a specific interest in the development of e-commerce at the point where payment has to be made for the goods or services that are traded via the internet, or where people deposit money into internet accounts. But I also have a broader interest relating to the overall stability and integrity of the financial system. The internet undoubtedly brings us the prospect of greater choice and efficiency in financial deals, but it also sparks certain concerns. These fall under two headings: consumer protection, with worries about scams, transparency, security, accountability, legal recourse, and so on; and systemic stability, with questions as to whether the financial system might become more vulnerable to crisis as a result, for example, of a major technical failure or of a massive herd movement of money in a particular direction.

This is a vast subject, so I need to narrow down my focus today. I want to discuss some of the issues which businesses or individual members of the public may face in relation to electronic money on the internet. And I then want to discuss some points which a central bank has to address in the monetary policy context when confronted with electronic money.

In fact there are two types of electronic money: that which is held on the internet and that which is held in stored-value cards. Multi-purpose stored-value card schemes have been slow to become established, despite quite lengthy pilot projects in a number of countries. Hong Kong was nevertheless one of the first places to introduce regulations governing the issuance of such cards. Meanwhile, limited-purpose cards have proved more successful; we have a particular example in Hong Kong with the Octopus card, used to pay for public transport, which is hugely popular. Today, however, I want to devote the limited time available to talking about electronic money within the internet itself, so I shall not be discussing card-based money any further.

Many people speak of the arrival of the internet era as a revolution in business practice. From the particular viewpoint of making payments, I prefer to regard it as a step along an evolutionary path rather than as something revolutionary. Our distant forefathers were sceptical about the introduction of banknotes in place of metallic tokens and coins; and our more recent forefathers were worried as to the reliability of cheques as a substitute for cash when they first appeared. Even during the span of my own working life I can recall initial resistance by some to credit cards and debit cards on suspicions about the security of the arrangements, as well as opposition to autopay and direct debit schemes for fear of granting to a third party too general an authority to debit one's bank account.

But each of these innovations has, in the event, been assimilated and has taken its place in the range of accepted payment instruments. I would expect e-banking to follow suit, as just another step along the evolutionary path. But it is perhaps worth pausing to consider whether there is anything intrinsically different about e-banking which demands special attention from the central bank.

Let me begin by examining the question from the central bank's stance as guardian of the integrity of the payments system and as banking supervisor. I believe there are perhaps two characteristics of e-banking which may deserve some vigilance here.

The first is the technical security of access and messaging. This is a matter of accuracy, safety and secrecy. If we use the internet to move our money, or to hold our money, we expect messages to arrive at their destination without error or interception; we expect the system to be safe from fraudulent or unauthorised access; and we expect to enjoy the same degree of customer confidentiality as with conventional banking arrangements. We want to be assured not only that the execution process is reliable and secure, but also that there are adequate controls on any "read only" access facilities.

How can we obtain these assurances? Perhaps some of you mirror my own feeling of personal inadequacy in matters of electronic technology. Inevitably we are dependent on the experts. They have devised sophisticated methods of electronic signatures, encryption, certification, firewalls and the like. One way or another, by obtaining appropriate professional advice, by applying rigorous standards of compliance and computer audit, and so on, those within an organisation should be able to deliver the necessary assurances to customers, and the regulatory or supervisory authorities will need to satisfy themselves as to the dependability of such assurances. The financial authorities within countries, and on a collective basis internationally, may also have a role to play in developing recognised common standards in these arenas of technology and security.

The second characteristic deserving our special attention is the nature of the person or company which is offering us banking or payment services over the internet. If we are merely using electronic services provided by our usual bank, which we know to be sound and to be supervised by an acknowledged regulator in a known jurisdiction, then we should be in no more danger of losing our money than we would be by banking with the same bank in the conventional manner, provided of course that both the bank and the regulator have kept pace with the requirements of internet banking, such as in respect of the security aspects discussed already.

But it is quite a different story if we are tempted to part with money to some organisation masquerading as a bank, or which actually is a bank but is registered in a jurisdiction with lower supervisory standards than those to which we are accustomed. In Hong Kong, in order to protect the public we already have legislation governing usage of the word "bank", and governing the advertising for deposits within our boundaries by anyone not authorised to take deposits in Hong Kong. But we cannot protect people from the possible consequences of clicking onto a website in a far-off place which is luring them to part with their money. The message is clear: make sure that you know and trust your banker.

In Hong Kong there has been some talk of new banks being established for the sole purpose of conducting internet banking. In deciding whether to authorise such a bank, the Monetary Authority would expect to apply very much the same criteria as for a conventional bank, but would need to pay particular attention to the business plan in order to ensure that it reflected realistic assumptions and prudent banking principles. We intend in the near future to issue guidelines for any such applications.

Already, as the supervisory body for existing banks, the Monetary Authority needs to take account of any particular risks that pertain to internet banking and to be sure that banks who conduct such business do themselves properly appreciate and allow for such risks. I would mention in particular the strategic risk, in that venturing into a new business arena may not always be assured of success; the operational risk, of dependence on IT networks, and the associated security considerations to which I have already referred; and any additional banking risks which may arise if internet transactions are deemed to be potentially more volatile or unpredictable, or customers less reliable, than in normal banking business.

The need to be confident about the intermediaries with which you are dealing is also very relevant when we examine schemes for so-called digital cash or a cyberpurse. There have been some false starts and business failures in this field, but some potentially more durable systems are now emerging in a number of countries, albeit still mostly in only embryonic form. The concept is of a storage location - or account - somewhere in cyberspace, into which you transfer funds from your bank account or credit card, just as you would draw cash from the bank and store it in your wallet. The

schemes are designed essentially for the retail shopper, who can then make payments from the purse for items purchased over the internet: the purse operator responds to your instructions by transferring funds from your purse to an account of the seller.

You may wonder what the advantage of such schemes is supposed to be. Why not simply pay for each transaction by an electronic instruction to your bank or, more typically in the case of most retail internet purchases, by credit card? The answer is that digital cash purports to offer three advantages. First, it may be cheaper than other means for a series of relatively low value retail transactions. Second, it can be used by those who cannot or do not have a credit card - for instance teenagers. Third, it offers a degree of anonymity and perhaps a stronger feeling of security, in comparison to using a bank account or credit card, since account-related personal data need not be passed on to the individual sellers of the goods or services.

However, people should exercise some caution before utilising such cyberpurse facilities. Regardless of how the system may be presented, the purse operator is in effect acting very much as a bank, in particular by holding your money in a sort of deposit. Even if you initially acquired the digital cash or credit for free (through a loyalty or bonus point scheme, for example), the accumulated "savings" represent value which you would doubtless wish to protect. Customers will want to be assured that the money or credit points are in safe hands. Regulators, too, may desire to verify that no banking activity is taking place that is unlawful, although they will first need to ascertain the location of this virtual operation (a task which is itself almost a contradiction in terms) so as to identify what is the applicable jurisdiction. Although in most of these schemes the maximum sum which anyone may hold in a purse may, for the moment, be quite modest, and so the scale of potential losses limited, we need to establish the foundations of prudent behaviour and regulation in preparation for the time when the sums may be much larger.

Thus far I have been looking at the phenomenon of e-banking and e-payments largely from the regulatory point of view. I would like to turn now to examine whether there are any noteworthy implications for the key central bank responsibility of monetary policy.

I want first to consider possible implications for the physical currency. Central banks or their government shareholders enjoy a steady stream of profit from the issue of currency in the form of notes and coin - the so-called seignorage. It is noteworthy that the public's demand for currency has been much less affected over the years than one might have expected by the emergence of successive new forms of non-cash payment such as cheques and cards. And personally I would doubt whether the development of cyberpurses, cybercash and cyberpayments would have much impact on cash in circulation, at any rate in the near term. But suppose I am wrong. Suppose there is a complete revolution such that cybercash, including electronic stored-value cards, substantially displaces physical currency within a few years. How should central banks react?

In such circumstances, central banks would lose an important source of income and would have to find ways of replacing it. Perhaps some central banks would lose their financial independence and become dependent - or more so than hitherto - on subvention from the government budget. But in a broader sense they should welcome the development because it would be evidence that the economy as a whole was enjoying a more efficient and less expensive means of money holding and transmission.

With regard to operational aspects of monetary policy in pursuit of the general macroeconomic objective of stability in the value of the currency, the advent of this new means of payment would, if it caught on to a significant extent, have some impact on the public's allocation of money holdings as between physical currency, various forms of deposit and, now, electronic forms. This in turn might affect the monetary statistics and their interpretation. However, any changes would only occur gradually. Besides, nowadays there are scarcely any central banks which rely single-mindedly and exclusively upon measures of money supply to guide their monetary policy decisions. Therefore I do not believe that there is anything much to worry about on this front.

Next, it has been suggested that internet banking in its various manifestations could introduce additional and unpredictable volatility into world financial markets by enabling millions of people to switch funds between investments or between currencies at the click of a mouse. In general I am sceptical about such worries. Global financial markets have already been exploiting the IT age with its

immediacy of information and electronic dealing for some years. Capital is already hugely mobile in both scale and speed. I doubt whether the inclusion of new players at the retail level would have much of an additional impact.

In particular cases where monetary policy is supported by capital controls, however, internet banking may make enforcement of such controls more difficult, since it would be operationally easier for those wishing to evade regulations to maintain offshore bank accounts. Of course, every bank in reputable jurisdictions has in place rigorous procedures to combat money-laundering, but these procedures do not normally result in customers being turned away if they are merely trying to escape capital controls or the tax regime in their home countries.

Similar considerations lead some observers to enquire whether the internet might encourage substitution out of the national currency, resulting in dollarisation and also perhaps weakening the central bank's influence over domestic monetary conditions. If internet facilities enable or encourage people either to economise on the usage of money (for example by netting payments due among two or more parties or by practising barter) or to reduce the frequency of movements of money (for example by leaving export receipts in an internet account in order to pay for imports, rather than repatriating them first), then there may be a prospect of a general reduction in transactions traffic in all currencies. The usage of some may fall more than others. I do not, however, see anything particularly sinister in such developments, except to the extent that the internet might facilitate avoidance of rules on remittances. The survival of the national currency and its acceptability to the public will continue to depend on the central bank carrying out a responsible monetary policy which protects the value of the currency. Discharge of this duty should not be materially affected or impeded by technological developments in payment methods. The central bank's ability to influence interest rates or the exchange rate through its market operations will not be diminished.

I conclude that, all in all, there are few concerns for the central bank in its monetary policy role that arise from the development of e-commerce; where there is an impact it is likely to be gradual and central banks should be able to adapt to it as readily as they have to other structural changes in the financial sector over the years. For the reasons discussed earlier, however, the challenge to the banking regulatory side of the central bank is likely to be rather greater.