Joseph Yam: Current issues for monetary and financial stability in Hong Kong

Speech by Mr Joseph Yam, Chief Executive of the Hong Kong Monetary Authority, at the Hong Kong Management Association Annual Fellowship Dinner, Hong Kong, 27 November 2007.

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Introduction

I feel especially honoured to have been asked to speak at this HKMA Fellowship Dinner, one particular reason being that the Hong Kong Management Association and the Hong Kong Monetary Authority share the same initials. I have, ever since the establishment of the Hong Kong Monetary Authority in April 1993, felt some what indebted to the Hong Kong Management Association in its acquiescence to our use of that symbol of excellence, the HKMA, no doubt in the hope that we too would in time mature to deserve the respect that those initials command. About fifteen years on, I hope we have not disappointed you.

This evening I would like to talk about the monetary and financial issues currently confronting Hong Kong. I have chosen to do so because what is going on around us on the monetary and financial fronts appears, to me at least, to be unusually complex, presenting risks to monetary and financial stability that are perhaps less well understood and possibly less benign than those that we have been experiencing since the economic recovery from the second quarter of 2003. And I believe that the best way of managing risks is for those concerned, not just the authorities responsible for the maintenance of systemic monetary and financial stability but more importantly also those actually assuming risks, whether as investors or as financial intermediaries, to be alert to them, and to understand that they may have peculiar characteristics. Then there are importantly those innocent parties in society, who are often hard-pressed to make ends meet or struggling to acquire a dwelling place, who could be further disadvantaged if there were monetary and financial instability, should the risks materialise to the extent of causing a shock of systemic dimension.

Sub-prime crisis

The **FIRST** such issue is the sub-prime crisis in the United States. The use of the word "crisis" is not an exaggeration on my part, notwithstanding the absence so far of anything approaching a crisis in Hong Kong. It is the word that is increasingly being used in the developed markets and in international finance when talking about the current difficulties in the United States and Europe that originated from sub-prime mortgages. At the risk of over-simplifying something that is really quite complex, let me make a few observations that might help understand what is going on.

First, sub-prime mortgages are really mortgages extended to those who are, to put it bluntly and simply, not credit worthy. And as mortgages are assets on the books of the lenders, sub-prime mortgages are really sub-standard financial assets.

Second, when property prices were rising and there was a clear expectation that they would continue to rise, those who were responsible for lending took comfort from the possibility of second mortgages providing borrowers with funding for servicing the first, sub-prime mortgages, in the event that the borrowers encounter difficulties in their mortgage payments. Indeed, when property prices were on a rising trend, the delinquency rate of sub-prime mortgages was quite low and sub-standard financial assets were considered as good quality assets.

Third, through securitisation the lender was able to off-load the sub-standard financial assets to third parties quickly. This eroded the incentive of the lender to carefully assess the ability of the borrower to service the sub-prime mortgage. Instead, the lender was more interested in accelerating the production line in this “originate and distribute” model, earning a fee and providing other customer services. Ironically, therefore, financial innovation in the form of securitisation and credit risk transfer to those in a better position to assume risks, while it should theoretically enhance financial efficiency and promote financial stability, has led to distortions in the incentives of financial intermediaries, eroded credit standards and undermined financial stability.

Fourth, the powers of financial innovation continued to work after the sub-standard financial assets got into the hands of the third parties. Slicing, mixing and re-packaging came in and the sub-prime mortgages were buried in very complex financial arrangements to become what are nicely described as Collateralised Debt Obligations (CDO), or generally as structured products.

Fifth, the complexity of many of these structured products and the risks involved were simply beyond the comprehension of the ordinary investors and perhaps even the professional investors who did not have the time to look into the fine details of the financial arrangements. And so the rating agencies were relied upon, for a fee, to provide an objective view, or rather a rating that was as objective as it could be under the circumstances. But we all noticed the instability of these ratings, some falling from AAA to junk within a short time span, which threw doubt not so much on the integrity of the rating agencies – they are respectable organisations essential to the functioning of the financial system and they do a good job generally – but, in my view, on the appropriateness of the models that they used. Relative ratings comparing the risks of different financial structures do not throw light on the absolute level of risk when different structures are taken together. This I think requires a wider market or general equilibrium view, taking account of the behaviour of the entire economy and the financial markets in particular.

Sixth, then, the structured products containing sub-prime mortgages were given the necessary qualifications to get into the hands of different investors, high net-worth individuals who probably can assume the risk and take the hit, leveraged hedge funds that may be a lot more vulnerable, financial institutions with surplus liquidity, and so on. These investors had two characteristics: they knew very little about having bought sub-standard financial assets and, through globalisation, they were all over the world, as importers of sub-standard financial assets manufactured in the United States.

Seventh, as the property market in the United States slowed and property prices adjusted downward, the delinquency rates of sub-prime mortgages shot up. The ratings and the prices of structured products containing, or suspected to contain, sub-prime mortgages fell sharply, and the whole market froze, with no transactions and therefore no price discovery mechanism, making it impossible for those holding such financial assets to mark them to market and incur reasonable write-offs. Even the market for interbank funds showed signs of significant lack of liquidity as participating banks were unable to evaluate the credit risk of counterparties.

Eighth, understandably many players involved in this chain of events got hit – many of the originators have had to be closed down, different investors have had to take large losses, etc. But of systemic concern was the situation of the financial institutions providing the back-up lines to the conduits and Structured Investment Vehicles (SIV) involved in the manufacture and distribution of the structured products containing sub-prime mortgages. Put simply, they found themselves having to take back substantial assets for which there were no market prices. But their ability to do so was limited because they were operating with relatively low capital adequacy ratios, which was why they had pursued disintermediation through securitisation in the first place. This process of re-intermediation put considerable pressure on the profitability, asset quality and capital adequacy, to the extent of creating great tension in the inter-bank market, as financial institutions hoarded liquid funds.

Ninth, as you all know, major central banks had to step in to provide liquidity in order to ease tightness in the money market. They have been doing so for about three months now, which is not a good sign, because of the implication of a continuing lack of trust among financial institutions in lending to each other. In one particular jurisdiction, a problem at the wholesale money market level triggered a breakdown of depositors' confidence at the retail level, resulting in a bank run. In the United States, the Fed further responded with a shift in monetary policy, notwithstanding continuing concerns over rising inflation, and cut interest rates twice, presumably to pre-empt credit tightness from adversely affecting economic prospects generally and the property market in particular.

Tenth, meanwhile, financial institutions in the United States are writing off large amounts quarter after quarter and this is affecting the general availability of credit and prospects of the economy, notwithstanding lower interest rates, and increasing the probability of a recession, although many still put this at less than 50-50. This seems to be the general sentiment currently reflected in financial market performance in the United States. There has also been much greater short-term volatility, as new information is absorbed by the market, indicating considerable nervousness. There is risk that the situation may drag on, given that much of the structured products, with varying degrees of uncertainty of repayment, have yet to mature and the associated losses to be realised. This would not be good for the economy and for financial market performance, and so we see ongoing efforts to end this. There is, notably, the super fund or SIV initiated by major banks to buy structured products on the market at a discount, thus helping to re-introduce a pricing mechanism for them, but the details of the scheme are still not publicly known.

How the sub-prime crisis will play out is still unclear. The fact that Hong Kong and many emerging markets have so far been spared is not a reason for letting our guard down. The global significance of a slow down, or a recession, in the US economy, after a long period of sustained growth, should not be underestimated. The talk about a de-coupling of the Asian economies from the US economy has not been borne out by empirical evidence. And we all know how debilitating it can be for an economy when property prices adjust substantially downwards, forcing families to sit on negative equity mortgages. With a savings rate at near to zero the ability to sit it out is limited, thus possibly adding more downward pressure. Financial markets are very good at telescoping the future and reflecting it in today's prices; hence the current volatility and the possibility of sharp adjustments should the telescope focus on a disappointing picture. Financial globalisation will readily transmit this to our markets.

Monetary and financial developments on the mainland

Let me turn to the **SECOND** issue with implications for monetary and financial stability in Hong Kong. This must of course be the monetary and financial developments on the Mainland. Here I also have ten observations to share with you.

First is the increasing size of the current account surplus of the balance of payments. Not only has this become a pressing issue in international politics, it is presenting the Mainland with a most difficult task in effectively managing its monetary and financial affairs.

Second is the appreciating exchange rate of the renminbi, under political as well as market pressure. The renminbi has appreciated against the US dollar by over 10% since the introduction of flexibility in the exchange rate in July 2005, but this has not produced any significant impact on the current account surplus.

Third is the rapid accumulation of foreign reserves as the current account surplus and continuing net inflow in the capital account are absorbed by the authorities. With an appreciating domestic currency, this presents considerable challenges to the investment management of foreign reserves. More importantly, it also presents difficult challenges to the management of the monetary system.

Fourth, consequently, the reserve ratio for commercial banks has to be raised successively, now standing at a historical high of 13.5% of deposits. There is of course a cost involved for commercial banks in holding reserves with the central bank earning fairly low interest, with implications for the profitability of the banks and the efficiency of the banking system in financial intermediation.

Fifth, concurrently, the central bank also has to issue vast amounts of central bank paper to sterilise that part of the renminbi monetary base injected into the banking system as a result of the continuing purchase of foreign reserves. This also represents a cost to the central bank, if the foreign reserves, after adjusting for exchange rate appreciation of the domestic currency, earn an investment return less than the interest rate paid on the central bank paper issued.

Sixth, notwithstanding the efforts to sterilise monetary injections, inflation has been on the rise, reflecting economic buoyancy and imbalances in individual commodity markets, presenting considerable challenges to macro adjustment and control.

Seventh, although interest rates have been raised, the concern about attracting further capital inflows constrains the scope for their use. Instead there has been continued dependence on the use of administrative measures that risks distortions and lowers the efficiency of the allocation of financial resources.

Eighth, there has been greater recognition of the need for an orderly outflow of capital, both to relieve upward pressure on the exchange rate and to achieve a more stable, risk-adjusted rate of return for the very large savings of the community, so that consumption may be encouraged and the growth of fixed investment in the economy contained, thus achieving more balanced and sustainable economic growth. But this recognition has yet to be translated into concrete action, although there are concrete proposals being explored, notably the through train for investment in Hong Kong stocks.

Ninth, however, there is considerable pent-up demand on the Mainland for capital market instruments generally and outward investment in particular. This will need to be satisfied and it is the right time for introducing relaxations on outward investment. It will be unfortunate if the much needed outward capital mobility is forced through black channels and investors subject to the malpractices of unregulated intermediaries.

Tenth is the sensitivity of the capital markets to changes in policy, not just those in the area of macro adjustment and control, but also those relating to capital market development. Given the nascent state of these markets on the Mainland, the possibility and the advantages of making greater use of the corresponding, more sophisticated markets in Hong Kong, and the desire in the fullness of time to achieve a complementary, co-operative and inter-active relationship between the two financial systems, there has been (and will continue to be) frequent policy changes affecting capital market performance.

Implicit in these observations are strong forces pulling in different directions in the monetary and financial system on the Mainland, all with implications for monetary and financial stability, not just on the Mainland, but also for Hong Kong, being so close to and so integrated with the Mainland. There is great emphasis on controllability, gradualism and the ability to take initiatives in the reform and liberalisation of the Mainland, all in the context of the building of a socialist, market economy. I have no doubt that the Mainland authorities will be able to steer the right course through this potent scenario on the monetary and financial fronts, and avoid mishaps. One can therefore be optimistic about Hong Kong, as the international financial centre of the country, continuing to benefit from monetary and financial developments on the Mainland, although we should not forget that in the capitalist, free market environment that we are in, there is a possibility of market volatility or adjustment being magnified. The task is for all concerned to ensure that they are in a position to cope with magnified volatility, in other words, manage market risks that may be greater than what they have seen in the past.

The linked exchange rate system

Let me turn to the **THIRD** and last issue that I wish to cover this evening. This concerns our own exchange rate system. I should of course start by re-iterating the firm HKSARG policy of keeping our exchange rate to the US dollar within the range of 7.75 to 7.85 through the linked exchange rate system, characterised by currency board arrangements that require our monetary base, and any changes in it, to be 100% backed by US dollars.

With the weakening US dollar and the strengthening renminbi; with the local inflation rate, excluding the temporary effects of tax relief, edging higher; with an "asset bubble" on the lips of many commentators; with the exchange rate hitting the strong side Convertibility Undertaking late last month, requiring our passive and un-sterilised foreign exchange intervention, injecting quite a lot of Hong Kong dollar liquidity into the inter-bank market; and with current US monetary policy possibly becoming inappropriate for Hong Kong; questions have understandably been raised on the appropriateness of the system. Let me provide answers to these questions.

First, the appropriateness of the linked exchange rate system should be judged by its ability to deliver monetary and financial stability in Hong Kong through economic cycles, and should not be judged by the short-term cyclical conditions of the economy relative to that of the US economy. The linked exchange rate system has served Hong Kong extremely well since its establishment. Given the small and externally-oriented nature of the Hong Kong economy and its role as an international financial centre, maintaining exchange rate stability against the US dollar, which is the most commonly used currency for conducting international trade and finance, is conducive to the long-term economic development of Hong Kong.

Second, on linking the Hong Kong dollar to the renminbi instead of the US dollar: this is inappropriate and technically not feasible. The US dollar is still the most appropriate anchor currency for the Hong Kong dollar, taking into account factors such as international usage, business cycle synchronisation between Hong Kong and the US being higher than that between Hong Kong and the Mainland, the different stages of economic development between Hong Kong and the Mainland, and the fact that the renminbi is not freely convertible.

Third, on inflation and the linked exchange rate system: it is true that the weakness of the US dollar and the strength of the renminbi may increase inflationary pressures in Hong Kong, but rapid growth in productivity in Hong Kong and diversification of sources of imports can in part mitigate the inflationary pressure. HKMA research showed that a 10% appreciation in the renminbi would increase Hong Kong's inflation rate, as measured by the CCPI, by roughly 0.4 percentage points. Furthermore, only about 9-17% of imports retained in Hong Kong come from the Mainland.

Fourth, on asset bubbles and the linked exchange rate system: the monetary policy objective of Hong Kong is exchange rate stability, rather than to target asset prices or inflation. Asset bubbles are not unique to economies with fixed exchange rates. Economies with floating exchange rates experience similar problems. In any case, it is difficult to tell ex ante whether there is an asset bubble. On the other hand, most research studies find that monetary policy is too imprecise and blunt to be used as a tool for targeting asset prices.

Fifth, on the Hong Kong dollar being undervalued: there is no evidence. Recent empirical research by the HKMA and the IMF show that there is no evidence of currency misalignment for the Hong Kong dollar at present. Given the flexible and adaptive nature of the Hong Kong economy, wages, prices and other economic variables would adjust so that any misalignment in the real effective exchange rate would be corrected. Even a flexible exchange rate is not immune to sustained currency misalignment. Exchange rate movements are affected not only by economic fundamentals but also by market dynamics. A flexible exchange rate is arguably more prone to currency misalignment, particularly for small and open economies which are more vulnerable to changes in capital flows.

Sixth, on widening the exchange rate band: the simple answer is no. It would only serve to undermine the credibility of the linked exchange rate system and invite speculation on the likelihood of further band-widening. It would probably not relieve pressures for currency appreciation, rising inflation and buoyant asset prices.

Seventh, on the so-called reverse double play: the scope is limited. The reverse double play aims at profiting from a long position in Hong Kong stocks by engineering a capital inflow large enough to trigger passive exchange market intervention on our part, which would push interest rates to very low levels and asset prices higher. But interest rate adjustments when the exchange rate hits the strong side of the band are bounded by the floor of 0%, while they might be a lot more dramatic at the weak side, and the sensitivity of stock prices to these different adjustments differs. Herd reaction, which is what most speculative plays aim at, is a lot easier to instigate through the fear factor, when interest rates rocket up, risking a stampede to exit from the market, but a lot more difficult through the greed factor, when interest rates fall, and the rush to buy does not necessarily materialise.

Conclusion

I hope these answers are clear and the high degree of confidence in and credibility of the linked exchange rate system built up over the past quarter of a century is sustained. This would obviate the need for the type of interest rate adjustments seen earlier in the month and dampen volatility in Hong Kong dollar interest rates around those of the US dollar. Indeed, monetary and financial stability is dependent to a large extent on confidence in and credibility of monetary and financial policies. As we move further into a period in which the external environment, characterised by unusual monetary and financial developments in the United States and the Mainland of China, presents increasing risks to monetary and financial stability in Hong Kong, such confidence and credibility will be crucial for us to stay the course and not be derailed.