

Norman T L Chan: Who would mortgage their children?

Text of the DIGBY Memorial Lecture by Mr Norman T L Chan, Chief Executive of the Hong Kong Monetary Authority, Hong Kong, 10 April 2015.

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Dr David Li, Professor CH Leong, Professor Paul Tam, Professor Gabriel Leung, Professor CM Lo, Distinguished Guests, Ladies and Gentlemen,

It gives me great pleasure to be invited to deliver this year's Digby Memorial Lecture. When Professor Lo came to me with the invitation, I have thought long and hard on what this very distinguished audience from the medical community would want to hear from the Chief Executive of the Hong Kong Monetary Authority. I hope my remarks today would help stimulate and provoke a more informed discussion in our society on where we want our future generations to go. Instead of talking about monetary economics, which may not be of interest to most people, I have chosen a topic that is relevant to all of us, who have become accustomed to prosperity and good lives in a way that our parents and grandparents could never have dreamt of.

“1942”: Children sold by parents

2. Last year I saw a movie called “1942”. The movie was based on what happened during the great famine that occurred in the Henan Province (河南省) and the surrounding areas in China around 1942. The famine was apparently so devastating that millions of people were facing starvation and many of them fled their homes as there was nothing to eat. In the movie, several millions of refugees fled their villages and towns to go to Xi'an (西安), where they hoped they could find food and help, but most of them did not make it and perished during the long journey. In desperation, many parents sold their children for a tiny sum of money or just a bowl of rice in order to survive a few more days. The movie presented graphically a shocking story, a tragedy of the very harsh reality and unspeakable human sufferings endured by our parents' generation not that long ago.

3. Well, this very depressing and horrible scene was only a movie. We now live in a comfortable world in which food is abundant and there is no shortage of daily necessities. Most of us take good lives for granted. The ugly and unpleasant scenes of parents selling their children as depicted in the movie “1942” were something of the past and do not seem to have any relevance in modern times. Is it so?

4. For those of us who are parents, we are absolutely convinced and determined that we will do our utmost to protect our children. We will give them nothing but the best that we can afford so that they have a good life and a bright future. All of us here would find it unthinkable why any parents would want to give away or mortgage their children. So, why should I choose this subject for tonight's theme? Let me explain why the subject is a very timely and relevant topic.

War and peace: Rising government debts in developed countries since 1980s

5. During World War II, naturally most governments borrowed huge amounts of debts to finance the warfare. As a result, the public debts shot up and the ratio of public debt to GDP rose to very high levels. In the industrial nations (e.g. US, UK, France, Germany and Japan), the average government debt increased to a peak level of over 200% of GDP in 1946. Huge government borrowings had crowded out the private sector and in any case most industries not related to military supplies production did not have the opportunity to expand their business anyway. After the War, industrial nations began to pay down their public debts as they embarked on the journeys of reconstruction.

6. After two decades of hard work and economic growth, the ratios of government debt to GDP of the industrial nations came down to below 30% in the 1970s while private sector debts grew steadily to around 85% of GDP. The total debt, public and private combined, was amounting to 110% of GDP at that time.

7. A brief word about debt. When one borrows money, whether to fund investments or to finance consumption, it could bring about many beneficial effects. For example, student loans could assist many young people without the necessary means to take up education or training that would benefit their whole lives. Business loans could help entrepreneurs, large or small, to build or expand their operations that could eventually benefit not only the shareholders but also the workers and the consumers as a whole. An instalment loan could help us buy a property or consumer goods that would otherwise be inaccessible or unaffordable. While debt can bring about many attractive benefits, it has just one major drawback. That is, debt is a liability that needs to be paid back, with interests, sometime in the future. This means that someone who borrows money needs to use his or her future income to pay for interest and principal at some future time. This being the case, a prudent person or enterprise must take due care in ensuring that there is sufficient future income to meet the future payment liability arising from the debt obligation.

Global financial crisis: More government debts

8. Earlier I referred to the fact that the industrial nations' total debt stabilised at around 115% of GDP in the 1970s. Now, let us see what had happened in these countries since then. During the last three decades, both the private sectors and governments in the developed countries repeatedly borrow money at a rate much faster than their economic or income growth. As a result, the average ratio of total debt to GDP of the developed economies increased to about 290% before the eruption of the Global Financial Crisis in 2008. After the Global Financial Crisis, there is some reduction in the private sector debt in some countries, notably in the US. However, the levels of government debts have continued to rise. Before the Global Financial Crisis, the US federal debt was US\$9.2 trillion. In 7 years' time, the federal debt increased by almost 100% to US\$18.2 trillion. This is equivalent to an increase from 63% of GDP to 103% of GDP. In the euro-area, the level of public debt was 100% of GDP prior to the eruption of the European Sovereign Debt crisis in 2011, and it went up by another 2.7 trillion Euros and reached 120% of GDP in Q3 2014. In Japan, the situation is even worse. Public debt to GDP ratio went up steadily in the last twenty years and now reaches a stunning level of about 260%. Together with private-sector debt, the total debt of Japan adds up to about 480% of GDP, the highest in the developed world. So we don't have a pretty picture in the developed world as a whole.

9. Such rapid growth of public debt in major advanced economies reflects the lack of fiscal discipline and unrestrained spending behaviour of their governments. Except for Germany, most European governments have never been able to record fiscal surplus in any year since the early 1980s, with average annual fiscal deficits amounting to about 3–8% of GDP. In the US, the federal government still persistently registers fiscal deficits (averaging 3.2% of GDP per annum since 1980s) only except for the second term of the Clinton presidency in 1997–2001. Incurring persistent fiscal deficit means that the governments have to continuously raise additional debt to finance their spending.

Quantitative easing: Lessening of pain of excessive debts?

10. This ballooning government debt raises concerns about long-term fiscal sustainability. For now, the situation seems manageable as central banks in these economies are pursuing quantitative easing (QE) policies to artificially suppress government bond yields. The aggressive asset purchases by major central banks have now suppressed bond yields to extremely low levels, where shorter-term government bond yields in some European economies like Germany, Austria, Denmark and Switzerland have already turned negative.

Negative government bond yield means that lenders are paying borrowers for the privilege of holding their debt, which is clearly not making any sense. I doubt how long such an unusual phenomenon could last, but in any case, I'm certain that such distortions will definitely come with unintended consequences. At least, one side-effect I can already observe is that QE penalises prudent savers and pensioners very badly. In Japan, for example, QE helps reduce the financing cost of public debt at the expense of eroding the purchasing power of JGB holders, with many of which being retirees and pension funds, by paying them negative real yield.

Sovereign debt crisis: Mishaps that belong only to EMEs?

11. There is this question: why has the developed world ended up where it is now? We know how a household or company would suffer under the pressure of excessive debt. Households or companies troubled by significant debt overhang have to curtail their spending or investment, which has huge negative effects. In the end, they have to go into bankruptcy if they cannot repay their debts when due. But there is a lot of misconception when it comes to a country owing excessive debt. It is true that a country cannot technically go bankrupt in the same way as a person or company. However, it does not mean that a country cannot go into default if it borrows more than it can pay back. Even if a heavily indebted country manages to survive a debt crisis with debt restructuring, just like Mexico in the 1980s and more recently Greece, the debt overhang will still impede its economic growth and inflict huge costs and pain on its people in the form of rising unemployment and sharp drop in living standards. So how can one explain the common trend in the last 30 years of the developed world spending beyond their means and incurring debts to levels that clearly cannot be repaid by the current generation of people? One answer that I can think of is that, until quite recently, many people in the developed world had taken prosperity for granted and regarded good life as their right. So they wanted to keep on consuming and spending beyond the levels that could be supported by the growth of their economies or income. Many people in the developed world thought, rather mistakenly, sovereign debt crisis should be the kind of mishaps that can only occur in the developing economies. At the same time, the capital market seemed to be willing to support this belief as investors were happily buying government bonds of the developed countries at very low interest rates. With what happened in the US and Europe in the last five years, we have come to realise that prosperity and good life have to be earned, through hard work and productivity growth, just like what their parents, grandparents and / great grandparents in the western world great grandparents in the western world did in the past. There is now little doubt that prosperity and good life built on the basis of rising indebtedness is unsustainable and is bound to collapse some time, just like sand castles.

Trap of excessive indebtedness: Easy to get into and hard to get out

12. There is another pertinent question on why so many countries do not seem to be able or willing to get out of the trap of high indebtedness or excessive leverage. For one, it is far too tempting to spend, consume now and worry about payment later. That explains why, in addition to public debts, household debts have risen to very high levels all over the world. But there is a limit, largely determined by market forces, on how much debt an individual or a firm can incur. Lenders, whether banks, finance companies or bond investors, would look at the creditworthiness of the borrowers and demand high interest rates to cover the credit risks or simply refuse to lend any more if the repayment ability of the borrower is in doubt. Moreover, a person with a reasonable mind would need to consider the risk of facing the unpleasant consequence of bankruptcy if he fails to repay his debts on time. The same applies to the owners or managers of companies. However, it is quite different when it comes to government debts.

13. In times of war, the government has no choice but to borrow from every possible source to finance the warfare as it is a question of survival of the nation. We all understand this and

so did the peoples of the countries at war. However, the developed countries have not been at war with each other for a long time since 1945 and why did their governments keep on piling up public debts to unsustainable levels? There are many complicated reasons as well as some rather simple reasons. Let me go straight to the simple reasons today. If a government borrows money to finance productive investments in physical infrastructure, such as ports, airports, roads, bridges and power plants, or to finance the development of human capital, such as education, research and training, then these investments should bear fruit in the future by raising the productivity and competitiveness of the economy concerned. In that case, the repayment of the money borrowed should not be problematic in the future. However, if the government borrows to finance consumption, wasteful investments and excessive welfare, then over time the economy will find it hard to repay the debts.

14. It is difficult for anyone to be overly optimistic on the prospects of an early resolution of the leverage trap in the developed world. Leveraging brings about enjoyment and pleasure, as it supports domestic consumption and demand, for as long as the capital market is willing to finance the borrowings at reasonably low interest rates. Deleveraging brings the opposite outcome, which is very, very painful. Deleveraging could result in economic recession, fall in asset prices, rise in unemployment, drop in personal, corporate and government income etc. in the short run. None of these is pleasant and it is not surprising at all to see the very strong pushback by the people in the crisis-hit countries in Europe on measures that attempt to redress the fiscal sustainability problem.

Excessive government debt and “collective irresponsibility” syndrome

15. There is also another simple but important reason why people as well as the politicians elected by them would want to continue to spend beyond their means even though they realise that they could not afford to repay the debts in their lifetime. This is what I would like to call the “collective irresponsibility” syndrome. A father or mother will do almost anything to protect their children. Some would be prepared to sacrifice their happiness and even lives for their children. It is only in great desperation, such as the great famine in China depicted in the movie “1942”, that we would witness children being sold by their starving parents. But that was a very extraordinary and tragic situation. We can hardly say that the developed world is now in that desperate situation. There is an interesting point here: when a parent mortgages his child, he is accountable for this brutal and inhumane act.

However, when a voter elects politicians who promise continued and unsustainable spending he is just one of many, many voters. The vote is cast in anonymity and the voters have no direct accountability for how they vote and for the consequences of such voting decisions. The voters may also think or hope that, even if the national debts can only be paid back by the next generation, it would be someone else’s children, not their own, who will have to shoulder the burden. Under the influence of anonymity that cultivates “collective irresponsibility”, the temptation of “spend now and not having to repay” mind-set can easily overwhelm common sense in favour of populist policies with unsustainable fiscal consequences in the medium to longer run.

How to get out of a government debt crisis: Painful deleveraging and resolute structural reforms

16. It seems clear enough even to people without training in economics that the solution to a crisis caused by excessive level of government debts is not through borrowing more money and piling up more debts. The solution must be through deleveraging over time in the overly indebted sectors. At the national level, three things must be done at the same time. First, the government must implement a credible fiscal consolidation programme to reduce public spending and increase revenues. Second, the government should, within the reduced budget, strive to allocate resources to infrastructural and other productive investments that could facilitate the return of healthy economic growth in the medium to long term. Third, the

government must pursue structural reforms that would enhance the flexibility and capacity of the labour, product and services markets that would raise the productivity and competitiveness of the economy and its workers.

17. Of course, I appreciate that these three things are very hard to implement. However, I don't think there is any short cut or easy way out. The adjustments after any financial crisis triggered by excessive debt are by nature very painful. Speaking about pain, let me remind you of the pain that Hong Kong endured the last time we made the mistake of getting into a big property bubble and excessive leverage in the 1990s. After the bursting of the property bubble in 1997, Hong Kong's GDP shrank by around 9% in just over a year. Housing prices dropped by 66% from October 1997 to July 2003. Unemployment rate shot up from 2.1% in 1997 to 8.5% in June 2003, which is the highest level since Hong Kong started to compile unemployment statistics. Prices in Hong Kong, as measured by the Consumer Price Index, went down by a staggering 16%, which was a very sharp fall within a fairly short time span of 5 years. This was a really difficult and painful period for Hong Kong and most of us here would probably not want Hong Kong to repeat this experience ever again. Looking back, Hong Kong proved to be highly resilient and tenacious during this very difficult period. Hong Kong people endured the pain and did not give up. Hong Kong also undertook many reforms and adjustments that have helped put our economy and financial system in a much stronger position to withstand future shocks and turbulence, which actually came following the eruption of the Global Financial Crisis in 2008 and of the European Sovereign Debt Crisis in 2011.

18. I think, and hope, that the developed world may before long come to appreciate that the time for reckoning is just round the corner. They will probably realise that debts borrowed by developed countries are still debts and must be repaid one way or the other in the future. Moreover, excessive debt or leverage would drag down the economy sooner or later, just in the same way it did to the developing economies. It is natural that most people would prefer to get out of the indebtedness trap without the pain that would be inflicted on them when the economy undertakes the necessary fiscal consolidation and structural reforms. So it is not surprising that people would like to think that if they can find someone who is very clever to lead the government or to be in charge of the central bank, then somehow good life can return and business is back to normal once again without the painful adjustments. No one can rule out the possibility of finding a very clever person who can save the world without pain, but I suspect that it would probably not be a bad idea, and hopefully not too late, to start studying and learning from the Hong Kong recovery story after the eruption of the Asian Financial Crisis.

Conclusion: Don't mortgage our children

19. Ladies and Gentlemen, while I have talked a lot about the predicament of the developed world, it is not my intention to suggest that the developing world is all home and dry. Many Emerging Market Economies (EMEs) have had a wealth of experience in the mismanagement in their macroeconomic, fiscal and monetary policies, and all of them had paid a heavy price for their past mistakes. The fact that the latest series of crises erupted in the developed world does not mean EMEs are immune from the spillover effects. More fundamentally, the Emerging Market Economies, including Hong Kong where household debt to GDP ratio saw a record high, must learn from the latest mistakes of the developed world and take extra care in not getting into the mind-set or habit of spending beyond our means, whether at the household, corporate or government level. Hong Kong should in particular guard against the temptation of "collective irresponsibility" by pushing for or condoning public policies that entail spending that cannot be sustained in the medium to longer run, or else we would be mortgaging the future of our children and grandchildren. This again is easier said than done, and requires considerable wisdom of Hong Kong people and the courage and skills of our leaders to resist increasing pressure and temptations for unrestrained public spending. Hong Kong's population is aging, and aging fast. At present, the elderly

dependency ratio of Hong Kong is 5:1. This means that Hong Kong now has 5 persons within the age group of 15–64 supporting each person over the age of 65. However, in over two decades' time, the ratio will deteriorate significantly to 2:1, which means that there will only be 2 persons in the age group of 15–64 supporting one elderly person. The Government has already made it clear that, while we are having budget surpluses, structural budget deficits will occur within a decade mainly due to changing demographic structure.

20. Ladies and Gentlemen, I have just made a long speech and now I would like to leave you with several key takeaways. First, it is very easy for governments to fall into the trap of going down the path of fiscal unsustainability as a result of the collective irresponsibility syndrome as well as population aging. Second, it is very, very hard and immensely painful to try to get out of a government debt crisis. Third, more likely than not, it is the next generation and the next and the next that will have to shoulder the costs and to suffer the pains for excessive spending and stock piling of debts by the current generation. If we don't want to mortgage the future of our children and grandchildren, try not to leave with them a pile of debts as in the case of many developed countries. How can we do this : we must take great care in not demanding or condoning policies that would undermine the long-established fiscal prudence and discipline of our Government.

To push my point further, not only we should not spend now and ask our children to pay later, I would argue that our generation, like our parents and grandparents before us, must seek to protect our children and grandchildren by standing ready to make sacrifices from time to time for the benefit of a better Hong Kong in the future.

21. Thank you for having me this evening and thank you for your patience.