Mr. Yam comments on the financial turmoil in Asia Address by the Chief Executive of the Hong Kong Monetary Institute, Mr. Joseph Yam, JP, at the Euromoney Asia Pacific Issuers and Investors Forum on 2/12/97.

1. Ladies and gentlemen, I am honoured to have been invited this year to deliver the opening address for Euromoney's Asia Pacific Issuers and Investors Forum.

2. The year 1997 has been an unusual year for Asia, particularly for Hong Kong. Amidst financial turmoil of the worst kind in the history of Asia, Hong Kong went through political transition to become a Special Administrative Region of the People's Republic of China. This was achieved in the smoothest manner one could imagine. And as the currencies of Asia tumbled one after another in a process of competitive devaluation, involving sharp depletions of foreign reserves and requiring financial assistance from the International Monetary Fund and others, and sending shock waves to financial markets throughout the region and beyond, our currency, the Hong Kong dollar, remained very stable and our already very substantial foreign reserves increased. Although our asset markets have been affected by the contagion, some consolidation was in any case overdue; and in the event, for the year to date, the downward adjustment has been significantly less severe than those of many others in the region.

3. Hong Kong has thus held up extremely well under the circumstances. This has perhaps surprised many, just as they have been surprised that the financial turmoil of the region could so suddenly erupt with such severity and contagion.

4. Indeed, not long ago, stories about the Asian miracle abounded. Asia had been the fastest growing region in the world and the economic numbers had been generally sound. Asian economies had low inflation rates and exchange rates had been stable, at least until recently. Current account for the region as a whole had been broadly in balance, although understandably the situation for individual economies varied. The fiscal account excluding Japan had been in surplus. Asia also had exceptionally high savings rates of over 30% of GDP and investment rates were equally high. Official sector savings of the Asian economies, in terms of their foreign currency reserves, were very substantial, accounting for about 40% of the world's foreign exchange reserves. Now five of the top six foreign reserves holders in the world are in Asia. The work force in Asia was young, educated and flexible. The political situation was stable. Policies were outward-looking with a commitment to open markets and free trade.

5. So what went wrong in Asia? What turned the Asian miracle into what is now referred to, quite unkindly in my opinion, as the Asian myth or the Asian mirage? A few months into this fall out, there have been many explanations offered. The most talked about was the rapid growth and volatility of international capital flows.

6. According to IMF statistics, net capital inflow to emerging markets was less than US$ 50 billion a year at the beginning of the decade. By 1996, however, this had increased to US$ 235 billion. Asia has received roughly half of this capital inflow. In some Asian economies, net capital inflows have averaged 5% to 8% of GDP over a long period. Contributing to this surge of international capital flows was financial liberalization undertaken by economies which had the foresight to do so, with a view to encouraging financial intermediation, domestically as well as internationally, so that the high savings could be channelled into productive investments, thus promoting economic growth. Meanwhile, there has been continued willingness on the part of the developed economies to export capital, under the influence of sustained economic growth, low inflation and low interest rates. Increasing amount of mutual funds and pension funds of these economies looked for higher returns in the emerging markets. In the case of Japan, sustained large current account surpluses, coupled with the earlier appreciation of the yen, have forced many

Japanese firms to relocate their production to the rest of Asia. Thus capital inflows into the Asian region have been large.

7. With financial liberalization and the globalization of financial markets, a substantial part of the capital inflow into Asia has been in the form of foreign portfolio investments directed principally at financial instruments in the form of equity and bonds, and, where available, derivatives thereof. These international funds are generally highly alert to shifts in the expectation of risk, return and liquidity. They can therefore be highly volatile, with the tendency of reversing direction whenever there is the slightest hint of trouble, in respect of the macroeconomic policies, in particular financial policies pursued by governments, the robustness of the financial markets in which they operate, the soundness of the financial intermediaries with which they deal, etc.

8. Those economies which are dependent upon such capital inflows are clearly vulnerable to their reversal. Ideally therefore they ought to pay a lot of attention to pursuing sound macroeconomic policies and be transparent about them. This has perhaps proven to be politically difficult to achieve in some cases. They also need to ensure that they are in a position to deal with the volatility that characterizes the flow of international capital. And this means having:

first, an effective monetary management mechanism that is capable of delivering currency stability;

second, a regulatory and supervisory framework that safeguards the integrity of financial markets and the financial intermediaries in accordance with internationally accepted standards; and

third, a robust financial infrastructure that enables financial transactions to be conducted efficiently and with a minimum of risk of failure.

9. This is a tall order, even for a relatively closed financial system that operates under more benign circumstances, not to mention for a newly liberalized financial system under stressful conditions. It is therefore understandable that when the reversal of capital inflows came, it caused the damaging financial turmoil that we have seen in a number of Asian economies.

10. Financial liberalization encourages greater financial intermediation, domestically and internationally, and this obviously is beneficial to economic growth and development. But clearly the risks arising from this worthy process must be identified and managed properly before the long term beneficial effects could be realized. The risks are, nevertheless, not well appreciated, simple as they may be, particularly with the benefit of hindsight.

11. There is, as always, credit risk. Yet it is such a common feature that undue exuberance on the part of investors would push price to earning ratios well beyond fundamentals. Bankers also fail to assess the impact of interest rate hikes on the value of collateral or on cash flows. The result is therefore the usual over exposure of investors and lenders to asset losses. Then there is maturity risk. To say that it is risky to finance illiquid non-tradables, such as property, with short term capital inflows is, I suppose, teaching grandmothers to suck eggs, particularly in this company, but this again has been a common feature underlying financial shocks, not just in Asia but also in other parts of the world. The same with currency risk. Many borrowers, in both the private and public sectors, were keen to borrow foreign currency funds to finance investments that do not generate sufficient foreign exchange to repay the debt. Such debts were also unhedged. And so when exchange rates move sharply, which they do, the currency mismatch results in large losses.

12. But I suppose we all learn from mistakes. We in Hong Kong did so the hard way in the early 1980s when the situation was compounded by uncertainties about the political future of

Hong Kong. We had our currency crisis in 1983, after nine years of operating with a floating exchange rate, against volatile capital flows, without any effective mechanism for monetary management or currency anchor. Our banks had been overly exposed to credit, maturity and currency risks, and a total of seven banks had to be rescued directly or indirectly through the use of public funds. In short, we had been complacent.

13. But, thankfully, never have we been in any doubt about the need to maintain free and open markets, and a liberal financial system. The correct response to financial turmoil is not to resort to controls or to apportion blame, but to put one's own house in order, and ensure that one is in a position to cope. This we did through a series of reform measures to strengthen our monetary and financial systems implemented in the past ten years. This was, in part, also spurred by the desire to minimize the risk of possible financial disturbance ahead of and through political transition, and to provide the environment for Hong Kong's continuing development as an international financial centre, as required under the Basic Law. Our experience tells us that financial reform takes time and determination, and the ability to bite the bullet and bear the short-term pain. It is also very much a continuous process, with financial innovation creating new circumstances and presenting new challenges all the time.

14. I believe that we have successfully achieved this, which is the important reason why we have stood out as an oasis of calm, at least relatively speaking, in the storm of financial turmoil that is currently sweeping through the region and beyond. Some say that we are sticking out like a sore thumb, referring particularly to our fixed exchange rate link with the US dollar. I can of course respond to that by pointing to how well our linked exchange rate system, a currency board system that functions on auto-pilot, has worked. I can point to the supervisory efforts which have put our banking system on a very sound footing, and to our advanced financial infrastructure which has helped tremendously to contain and manage risks of a systemic nature. But many of you are, I am sure, already sick of my talking all the time, and may even dismiss what I say as trumpeting. I do not blame you. I am well aware of the possibility that over ten years of direct involvement in monetary reform in Hong Kong may have introduced a degree of bias in my views on the subject, which I have tried consciously to avoid.

15. But I would urge you instead to look at the reports of our annual medical check-ups conducted by the IMF since 1990 in the form of what are known as the Article IV Consultations. The IMF team was in fact in Hong Kong for this year's Consultation in the second half of October, when the short-lived but somewhat intense attack on our currency occurred. It was the best time for any diagnosis of financial problems. But after observing us closely over the period the team again gave us a clean bill of health. Let me give you a few relevant quotes from the Concluding Statement of the Consultation, which has already been published. It said that:

"The authorities' commitment to a rules-based and non-interventionist approach should enhance the economy's ability to withstand the recent regional and financial market turmoil."

"As in the past, the mission strongly endorses the authorities' continued commitment to the linked exchange rate system."

"Appropriately, the authorities have taken forceful action during the past two weeks to tighten significantly monetary conditions, and have successfully demonstrated their ability and commitment to defend the link."

"It is important to recognize that allowing interest rates to rise in response to exchange market pressures is an essential element of the currency board mechanism that lies at the heart of Hong Kong's monetary arrangements."

“Recent events demonstrate that the system is working exactly as intended ...”

“Our discussions with market participants have indicated a widely-held consensus that the prudential and regulatory oversight of the financial sector is strong, which has helped underpin confidence in the system.”

16. But what the internationally renowned doctor, in the form of the IMF, says may not always be universally acceptable, particularly for those who may have been innocent parties having to suffer the pain of market adjustment, inevitable as it may be. It is quite understandable therefore that there will always be grievances and consequently calls for prescriptions for pain killers and other preventive medicine. I welcome constructive suggestions very much and we are in the process of meeting with those who are so kind as to offer their views and go through the vigorous technical discussions that good ideas deserve.

17. So far I am glad that there is full support for our linked exchange rate system. No one liked the prospect of Hong Kong being swept along in the process of competitive devaluation in the region and sharper downward adjustment in asset prices. At the technical level, two schools of thought could be identified at this stage. One expressed concern on the scope in which the Hong Kong Monetary Authority exercised discretion in our rule-based monetary system. Associated with this are also suggestions for improvement on how the system could be allowed to work more effectively and automatically. The other felt that the HKMA should have been more forthcoming in relieving the tightness in the money market and therefore the pain of those affected.

18. Interestingly, the two schools of thought are quite polarized. And, as always, the correct course should be somewhere in between, involving a good mix of pragmatism in the light of present day circumstances in financial markets, having regard also to the need for the HKMA to function as the lender of last resort to the banking system, but without any departure from the strict discipline of the currency board system requiring full US dollar backing for the Hong Kong dollar monetary base. This, incidentally, has very much been the attitude of the HKMA. Discussions continue, as part of the review initiated by the Financial Secretary, and I look forward to more of the technical scrutiny of ideas which can be quite enjoyable and revealing.

19. Meanwhile, elsewhere in the region, the full doses of the medicine prescribed by the IMF for a number of the Asian economies are being dutifully and courageously taken. If they persevere, they stand a good chance of coming out of this financial turmoil quickly and the damaging contagion that has spread across the world would be effectively contained. And for the longer term, I am hopeful that the new framework for enhanced Asian regional cooperation to promote financial stability, agreed upon at the Manila meeting of Asian finance and central bank deputies, and subsequently endorsed by APEC economic leaders at the Vancouver meeting, would play an effective role.

20. The framework, which recognizes the central role of the IMF in the international monetary system, includes important initiatives:

first, there will be established a mechanism for regional surveillance to complement global surveillance by the IMF;

second, there will be enhanced economic and technical cooperation particularly in strengthening domestic financial systems and regulatory capacities;

third, there will be measures to strengthen the IMF’s capacity to respond to financial crisis; and fourth, there will be a cooperative financial arrangement that would supplement IMF resources on a case by case, contingent basis.

21. But it is perhaps in the nature of financial flows that they do more often than not lead to overshooting in financial markets. The strong growth track record of Asia and indeed of other emerging markets has, with the benefit of hindsight, brought about excess optimism in these markets, producing a compression of yield spreads which underpriced the underlying credit, market and other risks that are typical of emerging markets going through financial liberalization. Indeed, Alan Greenspan said recently that “in retrospect, it is clear that more investment monies flowed into these economies than could be profitably employed at modest risk”. With the sharp correction seen in financial markets in Asia, against the background that the economic fundamentals have largely remained sound, whether in isolation or relative to other emerging markets beyond the region, it is possible that there might now have been overshooting in the other direction.

22. I am sure, however, that the markets will eventually find their right levels, reflecting new circumstances, for better or for worse. I am not convinced, in any case, that the devaluation brought about by floating the exchange rate is necessarily the panacea for the ills of our Asian neighbours. First year economics tells us that the four elasticities of demand and supply of imports and exports may not interact to produce a clearly positive contribution to the balance of payments position from devaluation. Furthermore, when stable exchange rates are replaced by flexible, volatile and, in all likelihood, depreciating ones, the demand for hedging in the more volatile environment and under liberalized arrangements may drive exchange rates to such debilitating levels that many would regret the lack of resolve in pursuing sensible policies and in the defence of stable exchange rates in the first place. There is no doubt that confidence in the stability of a few Asian currencies has now been badly undermined and rebuilding it may take more than just time. Nevertheless, as the very productive Asian economies find their feet again, they will soon be on their way with renewed vigour.

23. For Hong Kong, as very much a service-oriented economy, any erosion of competitiveness, as a result of our currency holding stable against the US dollar while others have fallen, is likely to be mild. Our economy is not particularly sensitive to exchange rate changes. The IMF forecast for Hong Kong’s growth rate next year is 4.25%, only a shade below our trend growth rate of 5%, representing a healthy consolidation in the circumstances.