Mr. Chan reports on the Hong Kong dollar post-July 1997 Speech by the Deputy Chief Executive of the Hong Kong Monetary Institute, Mr. Norman T.L. Chan, at the Hong Kong Business Summit '97 organised by The Hong Kong General Chamber of Commerce on 4/12/97.

I am honoured to have been invited by the Hong Kong General Chamber of Commerce to attend Business Summit 1997. This year's Summit carries special significance because this is the first Summit after the return of Hong Kong's sovereignty to China. As Hong Kong enters into a new era under the framework of "one country, two systems" and "Hong Kong people ruling Hong Kong", our attention has recently been focused on the financial turmoil in the region and its effects on Hong Kong. In view of the limited time available, I do not propose to go into the background why this financial turmoil has occurred. I would instead like to take this opportunity to clarify a few points which have been the subjects of extensive debate recently.

2. Firstly, I should reiterate that the Government's resolve in maintaining the linked exchange rate system is absolute. Given Hong Kong's small and open economy, the link has been and will continue to be the most suitable arrangement for Hong Kong. Let us not forget the fact that the link has served Hong Kong well in the last 14 years by providing an anchor for monetary stability, without which it would not have been possible for Hong Kong to weather numerous shocks during this period and to develop into a leading financial, trade and services centre in the region, with a per capita income higher than many of the developed economies, including the United Kingdom. Even in the latest regional currency turmoil, the link has once again proved its resilience and the Hong Kong dollar has remained very stable against the US dollar. However, questions or doubts have emerged on whether the price for maintaining the link is too high for Hong Kong.

3. This leads me to my next point. Is the price for maintaining the link too high for Hong Kong? The higher interest rates resulting from the defence of the HK$ under the currency board arrangement are causing some pain, especially on the asset markets and on the finance costs for doing business generally. It is true that, under the currency board mechanism, when the HK$ is under speculative selling pressure, local interbank interest rates may go up sharply, as they did on 23 October. On 24 October, the major banks raised their best lending rate by 75 b.p. to 9.5% in view of the rising funding costs. Although the short-term interbank interest rates have come down to low levels very quickly, the interest rates for the 1-month maturity and beyond had stayed above 10% for a longer while. However, since mid-November the term interest rates have also eased steadily, with one month rate falling to 7.5% early this week. While some may regard the present levels of interest rates as too high and the correction in the stock market and property market too painful, they have missed a vital point when they put all the blame on the linked exchange rate system. This is because they have assumed, quite wrongly, that under a floating rate system, Hong Kong interest rates can stay constant or low compared with what they are under the linked exchange rate system. Moreover, they assume that the asset markets would have avoided the kind of sharp falls that we have experienced. This is an unrealistic assumption because the financial turmoil in our neighboring economies is a regional or even global problem from which Hong Kong cannot be immune.

4. It may be easier to explain my point by comparing Hong Kong with our neighboring economies. You are of course aware that the regional stock markets, including Hong Kong, have seen major corrections recently. If one also takes into account the depreciation of the domestic currency against US$ as at end-November, the stock market of Thailand has fallen by 71% from its peak this year, Malaysia by 69.7%, Indonesia by 64%, Korea by 61% and

the Philippines by 61%. Even Singapore’s stock market suffered a 35.7% drop in US$ terms, which is comparable to the 37.7% fall in the Hang Seng Index. Only Taiwan recorded a lower fall of 31%, whereas the Nikkei also lost 28%. I quoted these figures in order to illustrate the magnitude of the turmoil and its contagion effects on the asset markets in the region. Singapore, which is a strong economy and given a triple-A rating by the international rating agencies, adopts a managed floating rate regime, but such regime has not insulated its asset markets from the regional turmoil. In terms of interest rates, Singapore’s one month interbank rate rose by almost 5 times to 16% on 27 October from around 3.6% on 2 July. Singapore’s one month rate is now 6.25%, which is still significantly higher than the level in early July. In the case of Hong Kong, the one month rate rose also by around 5 times from 6% in early July to a high of 30% on 23 October. At present the one month rate in Hong Kong is around 7.5%. Again I quote these figures to illustrate the point that even under a floating rate regime, as in the case of Singapore, domestic interest rates can still go up sharply in the event of external shocks. It will be wrong to assume that interest rates will remain stable if Hong Kong were under a floating rate regime when external shocks occur.

5. While a floating rate regime will not insulate Hong Kong from possible interest rate hikes and asset market corrections when external shocks occur, to abandon the link now will have even more devastating results. According to the analysis conducted by one of the major banks in Hong Kong, a switch to a floating rate regime would lead to a sharp rise in inflation, to a double digit figure, and a sharp fall in GDP growth for 1998. Moreover, the uncertainty and disturbance caused by the change will undermine public confidence in Hong Kong’s monetary system, which may bring irreparable damage to Hong Kong’s position as the leading international financial centre in the region. In short, the price and pain for switching to a floating rate regime will be even higher.

6. Clearly I appreciate that Hong Kong’s manufacturers will be facing strong competition from our neighboring economies whose currencies have depreciated sharply in recent months. However, competitive devaluation is not and cannot be our answer to the problem. While attractive superficially, competitive devaluation is a risky and counterproductive approach. As Hong Kong has to import almost all the raw materials and equipment, devaluation of the currency does not mean that the export prices would necessarily be lowered by the same extent of the devaluation. As you know better than I do, although price is always important, competitiveness does not depend on price alone, whether or not you are talking about manufactured goods or services. Competitiveness depends on a host of factors, including better cost control, innovation, entrepreneurship, marketing and constant striving to achieve productivity gains. In this context, I cannot help tell an old, but true, story involving a conversation with an American friend 6 or 7 years ago, when the US$ was depreciating and the DM and the Yen surging to new highs. He was complaining that many countries, including the Southeast Asian economies, were manipulating their exchange rates to gain trade competitiveness. As a result, American goods were having a hard time selling overseas because they were too expensive. I told him that, while it may or may not be true that some countries were deliberately keeping their exchange rates low, the apparent difficulty experienced by US manufacturers to penetrate the Asian markets was not caused by pricing alone. For example, how could the Americans expect to sell their refrigerators to Hong Kong households if most of the refrigerators they tried to sell were almost as big as the kitchen of an average flat here in Hong Kong? How could the US car manufacturers expect to compete in the motor car market in Hong Kong if the US cars were oversized and, more importantly, had virtually no post-sale service in Hong Kong, which is so crucial in the motor car market? Of course, since then the US manufacturers have gone a long way in improving the product types and quality, and have now become much more competitive than they used to be.

7. For Hong Kong to remain competitive under the linked exchange rate system, prices, including land costs and wages, will need to adjust. This adjustment process is already taking place, as we have seen in the correction in property prices and, in due course, rentals. With the slowdown in consumer spending and easing of the demand for labour, the pressure on wage increases for next year should also reduce. I am confident that the flexibility of Hong Kong's economy will enable us to cope with external shocks effectively and to regain competitiveness. In the last 13 years, Hong Kong's manufacturers have managed to keep the unit value rise of Hong Kong's exports to 3% per annum, which is marginally much lower than the inflation rate of 3.5% in industrial countries, and well below the domestic inflation rate in terms of CPI of 8%. This is achieved through the hard work, dedication and ingenuity of our manufacturers, who have seized the opportunity to exploit the synergy between Hong Kong and the Mainland China by relocating the land- and labour-intensive processes north of Hong Kong while retaining the servicing and supporting base in Hong Kong.

8. Finally, I would like to close by echoing what Mr. C.H. Tung said in Vancouver during the APEC meeting. Hong Kong, given its sound fundamentals, robust monetary and banking systems, huge foreign reserves, flexibility and resilience in coping with external shocks, would be the first economy to rebound after this episode. We should have confidence that, while in the short run the markets may become more volatile or they may overshoot from time to time and there may be pain involved during the adjustment process, economic fundamentals should prevail in the end. We should be confident that, as we have done on so many occasions in the past, we shall be able to overcome this difficult period and emerge as a stronger and more competitive financial and servicing centre in Asia. We have done it before and we can surely do it again.