**Mr. Yam discusses "Intervention true to guiding policy"** Discussion by the Chief Executive of the Hong Kong Monetary Authority, Mr. Joseph Yam, published in South China Morning Post on 24/8/98.

The current debate revolving around government intervention in the stock and futures markets to deter currency manipulation brought a feeling of nostalgia to me. It made me recall the many debates on government intervention there were within the administration when Sir Philip Haddon-Cave was financial secretary.

I was then, in the late 1970s, a young economist in the Economic Services Branch of the Government Secretariat, with little responsibility and a lot to learn. Those debates were, somehow, rather more healthy and more intellectual. There was certainly less mud being thrown around.

But the contrast is understandable. Today, this is a controversial issue. There are interested parties airing their grievances through punchy and articulate expressions of their views on this philosophical issue of interventionism. This is also an issue in which, in a more politicised environment and at a time when the community is enduring the pain of economic adjustment, the politically minded see great political mileage. A government with the whole of the legislature arguably in opposition makes a vulnerable target.

It is so easy to wave the banner of free markets and condemn any government intervention, and be seen to be righteous and knowledgeable; notwithstanding that the government concerned has been so successfully running the freest economy in the world. But we must be humble and thank those wanting to lecture us on free markets, if only for the purpose of keeping us on our toes.

Hong Kong is changing and one would expect any dynamic city to be different after the passage of 20 years. But, surprise, surprise, the policy of positive non-interventionism has not changed. Many may have chosen to ignore or forget the true meaning of this policy, but not the administration of the HKSAR. Certainly, I have not forgotten it. And, having worked continuously and closely with five financial secretaries in succession, I can vouch for all of them in their firm adherence to this policy of positive non-interventionism. It applies also to the specific case of the current intervention in the stock and futures markets. As a firm believer in such a policy, I am responsible for conducting the intervention.

The nostalgia has prompted me to take time off watching the markets to read some of the long-forgotten literature on positive non-interventionism. This gives me great pleasure, particularly when I see the rare sentences and, if I am more fortunate, paragraphs attributable to my drafting that survived the final texts. Yes, Sir Philip was a great financial secretary with a great mind. Even many of our critics hold him in high regard. I hope that in quoting him, our stance in the stock and futures market can be put into a context that our critics may be able better to appreciate.

As early as November 1973, at the Conference on Managers in a Changing Hong Kong Environment, Sir Philip spoke on, amongst other things, the role of public policy. He said that, "the Government must accept such responsibilities as are necessary to ensure that management decisions are not frustrated by imperfections in the operation of the market mechanism, leading to economic inefficiency or social distress which only the Government can remove."

In September 1979, he talked about interventionism and the adjustment mechanism, amongst other things, in a speech on the Hong Kong Economy in Transition. He said that: "A pragmatic view dictates an admission that interventionism can be relevant to the maintenance of economic stability in Hong Kong even in the general context of a philosophy of positive non-interventionism". In the same speech he cautioned against taking for granted the "efficiency with which [the] essentially automatic adjustment mechanism operates in restoring equilibrium". He then went on in the same speech to identify areas that could be collectively referred to as market imperfections which justifies market intervention.

But it was the speech he made to the Federation of Hong Kong Industries in December 1980 (and as Principal Assistant Secretary for Economic Services then it was my honour to have a hand in drafting part of the speech) in which he made abundantly clear his stance on the policy of positive non-interventionism. Here I quote two paragraphs of his speech in full.

Sir Philip said: “I have frequently described the Government’s economic policy stance as being one of “positive non-interventionism”. Not surprisingly, perhaps, some have claimed that this is really just a fancy term for laissez-faire or, less kindly, that it covers up a “do-nothing” approach. This is simply not so: positive non-interventionism involves taking the view that it is normally futile and damaging to the growth rate of an economy, particularly an open economy, for the Government to attempt to plan the allocation of resources available to the private sector and to frustrate the operation of market forces, no matter how uncomfortable may be their short term consequences.”

Sir Philip added: “But in my description of our economic policy stance, I do qualify the term ‘non-interventionism’ with the adjective ‘positive’. Perhaps in the past I have not spelled out the implications of this adjective clearly enough. What it means is this: that the Government, when faced with an interventionist proposal, does not simply respond that such a proposal must, by definition, be incorrect. Quite the contrary.

“Generally speaking, or so I would like to argue, the Government weighs up carefully the arguments for and against an act of interventionism in any sector of our economy and on the demand or supply side in the light of present and likely future circumstances. The Government then comes to a positive decision as to where the balance of advantage lies. It is true that, more often than not, we come to the conclusion that the balance of advantage lies in not intervening; and, I must confess, I would be alarmed if we didn’t. Yet, in all cases, the decision is made positively, and not by default, and it is not the non-outcome of a do-nothing approach. But, there are many examples of the Government deciding, usually on the advice of its boards and committees, to intervene, in one way or another, in the free play of market forces.”

Indeed there are many examples of intervention. We built the airport because, without government intervention, it would simply not have been economically viable. We built roads and bridges. We provided public housing, medical services, the list is long. But we tend to do less than other jurisdictions and so the size of our public sector in relation to gross domestic product is one of the smallest in the world.

Specifically in the monetary and financial systems, there is significant intervention in the form of the regulation of financial markets and the supervision of financial institutions. This is precisely because we feel that, in the words of Sir Philip, ‘the balance of advantage’ lies in so intervening and because ‘imperfections in the operation of the market mechanism [may lead] to economic inefficiency’.

In very much the same spirit, we intervened in 1996 and built a real time payment system because the private sector was not able to come up with this highly desirable piece of financial infrastructure. We have been intervening since the beginning of 1990 to develop the Hong Kong dollar debt market, again because the market was considered essential for effective financial intermediation, and, regrettably, the private sector was not able to develop one that is properly structured.

The linked exchange rate system is also a product of the policy of positive non-interventionism. The Government intervened to fix the exchange rate because we found out in 1983, and since, that there is a need for a monetary anchor. In the absence of such an anchor, the value of our currency will be, in mathematical terms, an indeterminate. In other words, it is not something that the free market can determine in the best interest of the community without intervention.

We have had four speculative attacks on our currency since the outbreak of financial turmoil in the region in the middle of last year.

It is very well known to almost everyone in the market that a handful of hedge funds have on each occasion conducted a double play in the stock futures market and the currency market. We have come to realise how this double play works, although it has only become apparent, at least to us, in the third and fourth attacks in June and August this year respectively.

On each occasion, interbank interest rates were pushed higher, to varying degrees, with a view to engineering a sharp fall in the stock index futures.

While the August episode is still being played out, it is clear that these currency attacks, or manipulations, have introduced a large interest rate premium for the Hong Kong dollar over the US dollar. This currency manipulation premium amounts to around three to four percentage points. With the community already in considerable pain, having to go through the inevitable, and already very sharp, economic adjustment necessitated by financial turmoil in Asia, we can do without the pain being disproportionately exacerbated by those manipulating our currency in order to benefit from their short stock futures positions. There is further the serious risk of this double play creating a situation of over-shooting in the stock and other asset markets, undermining the stability of our otherwise robust financial system.

I must emphasise, however, that I am in no position to judge whether or not there has been overshooting and, if so, the extent of the overshooting. But we can all see that markets can overshoot badly and uncontrollably if we just look around us in the region. Whatever accusations one can throw at the Indonesians - "crony capitalism, nepotism, corruption, racism, poor macroeconomic management, neglect of financial development" - even if all these were true, they still do not justify the extent of the meltdown of their currency and their financial system, and the distress they are in. But the brutal reality is that they are now in that position.

Markets panic and overshoot, and if we are not careful, we can easily be pushed into that situation. And the culprits would be the handful of hedge funds having little or no interest in Hong Kong, not to mention in our well being, other than it being a free market which they can manipulate and from which they can take money, somewhat like an ATM machine, as others have put it.

The HKSAR administration is run by people who have put Hong Kong on the map as the freest economy in the world. It is clear to us that there are, again quoting my great teacher Sir Philip, "imperfections in the operation of the market mechanism", possibly leading to "economic inefficiency" and "social distress". So the administration decided to intervene to deter currency manipulation, to get rid of the unnecessary and unfair pain that has been inflicted on the community as reflected in the currency manipulation interest rate premium, and to avoid market adjustments overshooting in panic into an uncontrollable tailspin.

Consistent with Sir Philip's view that interventionism should be "relevant to the maintenance of economic stability in Hong Kong", and with Exchange Fund Advisory Committee backing, Financial Secretary Donald Tsang Yam-kuen made the order to intervene in the free play of market forces.

There has been no departure from the long established policy of positive non-interventionism that has served Hong Kong so well in the past. Those who think that we have so departed should try and refresh themselves of what this policy really means.

And no one needs to take my word for it. Those are the words of Sir Philip, the architect of that policy and someone who commanded and still commands a lot of respect.

Indeed as Monetary Authority chief, I have no responsibility over that policy. It rests on the broad shoulders of Sir Donald Tsang who is carrying it bravely. Let us all make a little effort to give him the support that he needs, spiritual or otherwise, by trying to gain a better appreciation of what the policy of positive non-interventionism really means.

Whilst on the subject of intervention, may I reiterate that our intervention in the stock and futures market to deter currency manipulation does not imply any weakening of our resolve to adhere to the linked exchange rate system. This resolve has never been stronger. Indeed, as I have mentioned elsewhere, there simply is no better alternative for Hong Kong. The experience of many of our neighbouring economies in the past year or so underlines why.

As the financial storm in this region spreads to almost everywhere now, and with increased intensity, the discipline of currency board arrangements of our linked exchange rate system is our best safeguard for our long-term prosperity and stability.