Mr. Yam focuses on how Hong Kong is coping with financial turmoil

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Introduction

It is a great pleasure to be in your beautiful city once again, and an honour to have the opportunity to speak to such a distinguished audience. Sydney and Hong Kong - both vibrant international cities with spectacular ports - have much in common. We enjoy growing cultural and economic links and, although some 4,500 miles distant, we are both part of the same region. Less happily, our economies have both taken a hammering from the financial crisis that has recently rocked the region. My focus in this talk will be on how the regional crisis has affected Hong Kong, and, equally important, on the ways in which it has not affected Hong Kong.

The Asian Financial Crisis

The complex causes that so suddenly turned the Asian miracle into an Asian mess will no doubt be debated for many years to come. The devastating effects of the massive exodus of capital from the region have been clear enough. In the worst hit economies currencies have devalued by as much as 70%. Stock markets have declined to the levels of ten years ago. Asset prices have sharply deflated, economies have contracted, and unemployment has risen. The region is going through its worst financial crisis since the Second World War. Optimists already see a stabilization of the situation and light at the end of the tunnel, and they may well be right. But deepening recession in Japan, emerging problems in Latin America, and questions about the stability of the U.S. and European markets still raise serious concerns that what began as a regional crisis may swell into a crisis of global proportions.

Hong Kong is located at the very heart of the East Asian region, and our economy is intricately, and increasingly, linked with the other economies in the region. It is therefore hardly surprising that we should have experienced some considerable stress as a result of the Asian crisis. Over the last year we have seen a roughly 50% decline in the value of property and stocks, a rise in unemployment, and a forecast contraction of 4% in our GDP for 1998. Although the stock market and property prices have seen something of a rebound during the last month, the pain of what has become an extensive economic adjustment continues, and is likely to continue for some time.

It is necessary to stress, however, that this is an adjustment, not a collapse, and that it has been one of the least dramatic, and least traumatic, of all the upheavals in the region. In US dollar terms, the Hang Seng Index has, since the crisis erupted last July, seen the smallest decline of any stock market in the region. Our banking system has remained stable and solvent. Interest rates have risen, but not as far as they have elsewhere: they are currently marginally higher than US dollar interest rates at the short end and at a premium of about 100 basis points for 3-month money. Inflation is declining, not rising. And, where other currencies have seen substantial devaluations, the Hong Kong dollar has remained stable. In fact, it remains the only freely convertible currency in Asia that has not experienced devaluation: the linked exchange rate - $7.8 Hong Kong dollars to the U.S. dollar - is as solid as ever. The tenacity and credibility of the link is, in my view, one of the main reasons why Hong Kong has weathered the crisis better than most of its neighbours. We are as committed as we have ever been to preserving the link, and we have demonstrated, throughout the turmoil of the last year, that we have the machinery - in the form of an effective currency board - to enable us to keep the link.

We are also committed to maintaining our position as the world's freest economy. Hong Kong has built its reputation on free market principles. We are proud of this reputation, and we cherish these principles because we know how much our prosperity depends on them. Whatever uses other economies might have for them, exchange controls are out of the question for Hong Kong: the Basic Law, which sets out our basic principles of government, expressly prohibits them, and, even if it did not, we know that, at least for Hong Kong, any attempt to introduce them, and to turn inwards on ourselves, would spell the end of our prosperity.

But free market principles cannot mean markets that are left defenceless against manipulation. One troubling aspect of the Asian crisis, and a sign of larger problems in the world financial system, has been the extreme volatility in markets created by the rapid flows of highly leveraged funds around the world. As markets in the region became more vulnerable, these flows increasingly took on a predatory character and became more and more subtle in their planning and sophistication. This August, as you know, the Hong Kong financial markets became the target of a well planned attack by international hedge funds. We took unconventional actions to fend off that attack and to fortify our financial system against future attacks. Not unexpectedly, these actions have been the cause of extensive controversy, and of a great deal of misunderstanding. Let me attempt to present the issue from Hong Kong's perspective by outlining what happened in August and explaining why we took action.

Oddly enough, Hong Kong became a target because of the transparency of its financial system: we were singled out for our efficiency and predictability rather than for any fundamental flaws. Under our rule-based currency board system, any change in the Hong Kong dollar monetary base must be strictly matched, at the linked exchange rate, by a corresponding change in the amount of foreign reserves held by the currency board. This is an autopilot mechanism, in which we in the HKMA have minimal discretion: the currency board simply acts passively in response to capital flows. Under the autopilot mechanism, an expansion of the monetary base causes interest rates to fall; a contraction causes them to rise. The crucial element in the monetary base influencing the rise and fall of interest rates is the aggregate balance that banks maintain in their clearing accounts held with the currency board. Notwithstanding the enormous volume of transactions that goes through our banks, the aggregate balance is minimal, because our financial infrastructure is so efficient. We have a real-time interbank payment system and no reserve requirements, so that banks in Hong Kong do not need to maintain large balances in their clearing accounts with the currency board: in August the aggregate balance was as low as HK$2 billion. This meant that the aggregate balance, and hence interbank interest rates, was highly sensitive to speculative attack.

We saw a series of such attacks over the past year, when various currency speculators took large short positions against the Hong Kong dollar with the aim of destabilizing the linked exchange rate. On all these occasions the attacks drove up the interbank interest rates to very high levels. To the extent that the speculators had to borrow in the interbank market to fund their short Hong Kong dollar positions, the interbank interest rates were high enough to force the currency speculators to abandon the attacks, unwind their short positions, and incur substantial losses. The finely tuned currency board system worked well, but the interest rate volatility was extreme: during one attack, on 23 October 1997, the overnight interest rate shot up to nearly 300%. The stock market took a nosedive, and the HKMA was sharply criticized for relying on this single tool, the interest rate, to defend the Hong Kong dollar.

In August the speculators adopted a more sophisticated ploy. They introduced a form of double play aimed at playing off the currency board system against the stock and futures markets. First, to avoid being squeezed by high interest rates, they prefunded themselves in Hong Kong dollars in the debt market, swapping US dollars for Hong Kong dollars with multilateral institutions that have raised Hong Kong dollars through the issue of debt. At the same time, they accumulated large short positions in the stock index futures market. They then sought to engineer extreme conditions in the money market by dumping huge amounts of Hong Kong dollars. This sell-off was intended to cause a sharp interest rate hike, which in turn would have sent the stock market plummeting. The collapse of the stock market would have enabled them to reap a handsome profit from the futures contracts they had taken out.

A few figures will help give some idea of the scale of this attack and the vulnerability of Hong Kong's markets at the time. We estimate that the hedge funds involved had amassed in excess of HK$30 billion in currency borrowings, at an interest cost of around HK$4 million a day. They also held an estimated 80,000 short contracts, which translated into the following calculation: for every fall of 1,000 points in the Hang Seng index they stood to make a profit of HK$4 billion. If they could have engineered that fall within 1,000 days they would have broken even. If they could have achieved it within 100 days they would have netted HK$3.6 billion. All they had to do was to wait for the best moment to dump their Hong Kong dollars, to drive up interest rates and send a shock wave through the stock market. August was an opportune time: turnover in the stock market had shrunk to about a third of its normal level; there was bad news as the government announced that first-quarter GDP growth had been negative; and rumours were flying around predicting the devaluation of the Renminbi and the severing of the link between the Hong Kong dollar and the US dollar.

We acted swiftly to defeat the manipulators at their own game with a series of measures that threw them off their guard, drove them out of the market, and raised the defences against future attacks. First, drawing on the official reserves, we went into the stock and futures markets. In the second half of August we accumulated US$15 billion worth of shares: I am happy to say they are now worth US$19 billion, but our aim was not to make money; it was simply to deter manipulation by making sure that it did not pay off. That objective was achieved. The manipulators were forced to close out their short positions, in many cases with heavy losses. And we followed through with a package of technical measures to strengthen our currency board arrangement to make our money market less susceptible to manipulation. These measures are working well. Further reforms are being introduced in the securities and futures markets to reduce the possibility of market dislocation.

Our actions served their purpose of deterring market manipulation. We could not passively sit through the speculative attack and see our markets overshoot to produce profits for the manipulators, and our entire financial system brought to the brink of collapse. We do not pretend that our intervention in the markets was not a controversial act. This was not a decision that we enjoyed taking. It involved many risks, not least among them the risk of being misunderstood. Our critics, both at home and abroad, have accused us of intervening with the aim simply of propping up the stock market; of being too afraid to face the pain from the necessary interest rate volatility under a strict currency board system operating in difficult conditions; even of trying to introduce a novel form of state ownership by acquiring a substantial interest in Hong Kong's major corporations. The essence of these charges is that what we did in August marked the end of our long-standing and hugely successful philosophy of non-intervention in the markets.

I think it is now increasingly recognized throughout the world that what we did was both necessary and effective. But let me emphasize this: our actions in August were not the end of non-interventionism, not an abandonment of our free market principles, but a measure taken to ensure that those principles prevailed. Free markets cannot mean markets that can be freely manipulated, particularly by large players operating in small markets. We did the minimum that was necessary to preserve the integrity of our linked exchange rate system and allow our financial markets properly to perform the role of financial intermediation. Our responsibility was to keep the markets free and fair for all investors. Not to have acted would, in my view, have been the very height of irresponsibility, and would have seriously damaged Hong Kong's credibility as an international, and freely accessible, financial centre.

We now have a substantial shares portfolio. We have put that portfolio under the management of a separate company at arms length from the HKMA to ensure that there is no conflict of interest between our shareholdings and our daily operations as a regulator. Our intention is to sell off these shares very gradually in a way that will have no impact on the markets. This may well mean holding on to them for some time. Meanwhile, the markets have stabilized, and the Hang Seng Index has, like other markets, been enjoying something of a resurgence over the last few weeks.

Hong Kong's Economic Strengths

I believe that in the future we shall be able to look back on our actions in August and September as a resounding reaffirmation of our resolve to maintain our fifteen-year record of currency stability through the linked exchange rate. The link was introduced in October 1983 at a time of uncertainty over Hong Kong's future and declining confidence in the Hong Kong dollar. The link has survived successive political and economic shocks, both global and regional. It is not only weathering the current crisis, the greatest test so far: it will, I believe, come out of the crisis more resilient than ever, fortified by the technical refinements to our currency board system and, more important, be strengthened by the clear message that we have given about our determination to maintain it.

The link is the lynchpin of our monetary system and a vital factor in our prosperity. It is worth explaining why the stability of the Hong Kong dollar is so important to our economy, and why it is that we have been able to maintain this stability at a time when the fixed exchange rates of so many other freely convertible currencies in the region have collapsed.

We are a predominantly externally-oriented economy, and an economy that comes the closest of any in the world to running itself on pure free market principles. The annual value of our external trade is at least two and a half times that of our gross domestic product: most of it takes the form of re-exports. We import nearly all of our daily needs, including food and water. We export most of our manufactured products, together with a large range of financial and other services. We are an international financial centre with huge capital inflows and outflows, and no exchange controls.

In such an economic environment, volatile exchange rates would introduce instability and unpredictability without bringing any corresponding advantages, except possibly to those in the foreign exchange industry. Businessmen would face greater currency risks in their international transactions and would be forced to hedge their considerable currency exposures at great cost. Sharp gyrations in the exchange rate, and the kind of overshooting that we have seen in the recent currency devaluations elsewhere would seriously undermine the stability of our financial system, and confidence in it. Nor is devaluation necessary to help make us more competitive, even given the fact that many of our neighbours have seen currency devaluations of between 20 and 80 per cent. Currency devaluation is not the only means to achieve economic adjustment, and the argument that Hong Kong is losing out by maintaining the link makes little sense for such an externally oriented economy. Hong Kong is achieving its adjustment through other variables. Asset prices and the cost of production, particularly in the form of land and rentals, have come down very sharply. Wages are easing. Manufacturers and service providers are increasingly able to lower their costs while at the same time seeking improvements in productivity.

It is therefore quite misleading to claim, as many sceptics do, that without currency devaluation Hong Kong cannot be competitive. We have chosen an alternative route towards adjustment, and we consider ourselves fortunate that we have the capacity to make that choice. This capacity comes from the fundamental strengths that make it possible for us to run an effective currency board. These fundamentals can be reduced to four basic, and some what obvious, points. They are so obvious, in fact, that they are too often overlooked in the narrow discussions about the prospects for the link, and it is worth setting them out.

First, our ample foreign currency reserves. These are the fruits of strict fiscal discipline, which has produced surpluses year after year, and of prudent investment. Our reserves currently amount to US$88.4 billion, the third largest in the world, after Japan and the Mainland of China. They are equivalent to more than seven times the currency in circulation, one of the highest levels in the world.

Secondly, we pursue a prudent fiscal policy, with small government and no external debt. We have a simple tax structure, a low tax rate, and a public sector expenditure that accounts for only 18% of GDP.

Thirdly, our financial system is sound. The banking system is strong and solvent, and well able to cope with the interest rate movements necessary under the currency board system. Capital adequacy ratios among locally incorporated banks average around 18%, and their problem debt ratio is about 3.7%. Our standards of prudential supervision are among the highest in the world.

Fourthly, Hong Kong’s economy is flexible and responsive. Because they are governed by free market principles, the markets respond quickly to interest rate changes and other variables, making the economy resilient in absorbing external shocks and capable of adjusting efficiently to validate the linked exchange rate.

These are Hong Kong’s economic strengths. Not all economies have them, or would necessarily wish to have them, but they have enabled us to maintain a monetary system appropriate to Hong Kong’s unique needs and capable of withstanding the storms that any open and externally oriented economy must necessarily expose itself to.

One of our greatest underlying economic strengths is our relationship with the Mainland of China, a relationship which helped fuel rapid growth in both economies over the last two decades. Our two economies maintain extensive and highly productive economic links yet at the same time operate entirely separate economic systems under the one country, two systems formula. Not much more than a year ago, just before the Asian financial crisis erupted and on the eve of the transfer of sovereignty over Hong Kong, pessimists were depicting this relationship as a weakness rather than a strength: they were predicting extensive meddling by the Central Government, and consequently a loss of autonomy and dynamism in Hong Kong. They have been very wrong on this. The track record so far has been impressive, and all the more so given the succession of crises over the last year.

As far as Hong Kong’s monetary system is concerned, the transfer of sovereignty has meant more, not less, autonomy for Hong Kong. Whereas before the handover monetary policy often required close consultations with the Secretary of State in London, the Central Government in

Beijing has left such matters entirely in the hands of the HKSAR Government. Furthermore, it has strongly and clearly reiterated its support for what we are doing, its confidence in our ability to manage things on our own and its preparedness to help in the unlikely event that help is needed. Our fundamental policies are enshrined in the Basic Law: among these are fiscal independence; maintenance of Hong Kong as an international financial centre; and a financial system governed and protected by locally enacted laws. Most important, the Basic Law prescribes a separate currency for Hong Kong - the Hong Kong dollar - which is to continue to be freely exchangeable and fully backed by reserves. These points are worth stressing, because there has been much misunderstanding about Hong Kong’s position.

The challenges ahead

I believe we should also look to the future, and not just dwell on current anxieties or deal with the political fall-out from our recent measures against market manipulation. As I see it, there are two main challenges ahead. One is the challenge before every economy in the region, including Hong Kong, to pull ourselves out of the economic difficulties that now face us. The other is a challenge to the global financial community as a whole.

For Hong Kong, the challenge is to see through the economic adjustment that is now in train, to continue to promote our competitiveness, and to plan for economic recovery. There is no denial that this is a painful process. Nor can there be any pretence that the current downturn will be over quickly, whatever the positive signs in the markets over the past few weeks. In the financial markets we need to be vigilant against future attacks and to introduce further safeguards in our financial system. These safeguards will include improvements to cross-market surveillance in Hong Kong, and an in-depth exploration of possibilities for further strengthening the resilience of the currency board system - an exercise which is now making good progress. More widely, we need to continue to develop Hong Kong’s position as a premier international financial centre. Practical measures recently announced by the Chief Executive of the HKSAR will help in this: they include schemes ranging from the upgrading of the security and efficiency of our entire financial infrastructure to the expansion of research facilities in the form of a monetary institute affiliated to the HKMA.

The emphasis in all of this is not on intervention, but on facilitation. As a government, we do not direct the form that economic growth should take: we simply strive to provide the best environment that we can to enable growth to take place. In the financial sphere that means a stable currency, a credible and secure banking system, and markets that sustain, rather than undermine, economic development. There is much that we can do - and have done - locally to achieve these aims. But increasingly, the solutions have to be global solutions, because, as the events of the last year have amply demonstrated, some of the most intractable problems facing our financial systems straddle borders and thrive in the cracks and holes between jurisdictions. Globalization - the breaking down of economic barriers - has brought many benefits, particularly to our own region. But it has also brought risks and instabilities that can only be tackled through co-operation between governments.

Over the last two months an international consensus has emerged about the dangers of unmonitored, highly leveraged cross-border capital flows. In August we talked about the dangers to small or medium markets, such as Hong Kong. Since the LTCM debacle in September, the focus has been on the damage that huge international hedge funds, which are subject to virtually no regulation, are capable of inflicting even on the larger markets. We now have a situation in which the global financial market is outgrowing its infrastructure, or, to quote Charles Goodhart of the London School of Economics, ‘Finance is rapidly becoming global; but laws and regulations are national.' The world financial community has now awoken to the dangers, and seems to be unanimous on the point that action is needed. The G7 communique in late October calling for strong global action to promote greater transparency in highly leveraged fund flows is a step in the right direction. This has been reiterated at the APEC Summit last week in Kuala Lumpur. The challenge will be in translating these calls into an effective system to ensure that the kind of turmoil that has ravaged economies throughout our region does not repeat itself. And the larger aim of this co-operation should be not just to draw up defensive measures, but to create positive opportunities for building a new global financial order appropriate to the needs of the twenty-first century.