Joseph Yam: Building stability in unstable times

Speech by Mr Joseph Yam, Chief Executive of the Hong Kong Monetary Authority, at the Hong Kong Institute of Bankers Lunch Talk, Hong Kong, 24 October 2001.

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Thank you for inviting me to speak today. It is a pleasure to see such an excellent attendance - a sure sign of the vitality of the Institute and the relevance of its work to the banking community. It is less of a pleasure to be speaking at a time when the international situation is a grave and unstable one, when our own economy is under immense strain, and when conditions are likely to get worse before they get better.

What is the role of our financial community in times like this? And, more specifically, what should the regulator be doing to ensure that monetary and financial systems are conducive to stability and are an aid to recovery? The answers, I believe, are to safeguard the strength of our banking system, to ensure that our financial infrastructure remains sound, even under stress, and to maintain steady policies that are conducive to stable, robust and efficient markets. I shall, in this talk, give some examples of how, thanks to the hard work that has been put in over the years, Hong Kong is well equipped to deliver on these aims. The examples may provide reassurance. But I have to confess that they will not be exciting to those who advocate quick fixes - and in particular to the small minority who believe that something more spectacular, such as depegging or repegging the Hong Kong dollar, is the panacea for all our problems. In the last part of this talk I shall devote some time to this question, which has received some attention in the past few weeks, with the aim of explaining why, in my view, tinkering with the Link is not a solution.

Unstable times

Let me first, however, offer some comments on the environment that we now find ourselves in. Internationally, prior to the tragic events of September 11th, there were already signs that a global slowdown was either imminent or already in progress, although it was not clear quite how long or how severe the slowdown would be. September 11th, and its aftermath, has not made the answers to these questions any clearer, but it has left no doubt that the deterioration will be sharper, or that the subsequent recovery will take longer.

A number of factors in connection with September 11th are at play. Some have immediate effects that are to a certain extent quantifiable: the physical damage caused by the atrocity; the cost - in additional security and insurance, lost revenue, lost jobs - to the airline and tourist industries; the blow to markets worldwide. Others present considerable uncertainty: for example, the extent and duration of the collapse in business and consumer confidence, and the question of how far monetary and fiscal stimulus will contain the collapse; and the scope and economic effects of the war against terrorism, which, we have been told, will be long and unlike any other war.

The effects on our regional economy are likely to be severe. We are heavily dependent on exports to the USA, at a time when these are declining and likely to continue to decline for some time to come. Capital inflows into the region are falling because of increased risk aversion. Within the region, many countries face persistent internal problems, in some cases - such as Indonesia - both economic and political. The big engine of the region - Japan - continues to falter, with declining exports, rising unemployment, a weak banking sector, and an economy officially teetering on the brink of yet another recession. The latest news from Singapore - in many senses our sister-city in the region - is not good at all.

The bright spot in the region continues to be China, which has sustained real GDP growth of 7.6% and export growth of 7% for the first three quarters. It seems inevitable that exports, and in turn GDP, will be affected by the decline in consumer spending in the US, which accounts for around 20% of China's export market: the latest figures already suggest this. The impetus to growth will therefore increasingly need to shift to domestic demand, which is already enormous, and which has been growing quickly in recent years. For the medium and longer terms, dynamic and far-reaching economic transformations will be set in motion by China's accession later this year to the World Trade Organisation. As a result of accession, China's trade flows are projected to double between now and 2005. There will be profound changes in the financial landscape, including an increased presence of financial institutions.

All this is, as I have pointed out before, good news for Hong Kong. It will, we estimate, increase our annual GDP by around half to one per cent, just through the resulting increase in re-export trade. It should additionally provide a great boost to our professional, mediatory and service industries. Those who despair about Hong Kong's future viability should perhaps reflect on the opportunities that our position as China's international city will bring post-WTO accession.

Yet it is understandable that the focus of attention should currently be on immediate problems rather than on future benefits. The rapid deterioration of the external environment now threatens to prolong the cyclical downturn in Hong Kong, engulfing the vigorous, but all too brief, resurgence last year. Growth this year is likely to be in negative territory again, and price deflation is expected to persist. Such a prolonged downturn is unprecedented in Hong Kong's recent economic history.

Repeated US interest rate cuts have allowed a timely easing of monetary conditions in Hong Kong. But, up to a point, further cuts in interest rates are akin to pushing with a string. Given the gloomy mood that now prevails, it may therefore take some time for monetary easing to have an impact on economic activity. Of particular concern now is the unemployment rate. Having declined from a peak of 6.3% at the darkest time of the Asian financial crisis to 4.4% in late 2000, it has been slowly rising, and is likely to edge up further. Part of this is the result of the global slowdown. But unemployment is also complicated, and aggravated, by the structural transformation of our economy, as our manufacturing sector continues to contract and as skill mismatches make it difficult for the growth industries - such as financial services and, until recently, IT - to take up the slack.

Behind all the figures are stories of individual pain and hardship - of lost jobs, negative equity, bankruptcies - and a general sense of insecurity and pessimism in the community. These are the conditions for very unfavourable, and potentially destabilising, interactions between the real economy and the financial sector. The Hang Seng Index has dropped by more than 30% since the beginning of the year. Sluggish lending is hurting banks' profits. The delinquency ratio for credit card receivables is on the rise. That for home mortgages has nevertheless been falling, thanks to substantially lower mortgage interest rates, but higher unemployment may reverse the trend.

At times such as this, it is necessary to look very carefully to see how our financial system is coping with the stresses and strains of prolonged economic difficulty, particularly since that difficulty is likely to continue for some time. In the light of September 11th, it is also important to reflect on how resilient our system is in the face of a sudden emergency. How strong is the financial and banking infrastructure we have built in Hong Kong over the years, and what further building is necessary to make it still stronger?

Building stability

The attacks in Lower Manhattan on September 11th were, among many things, an attempt to bring the world's largest financial centre to its knees. Given the scale and the location of the attacks, it is remarkable how quickly operations resumed in New York and, consequently, how little disruption occurred to financial markets across the world. In particular, the all-important payment systems were able to remain in operation without failure or gridlock. This is a tribute to the crisis-readiness of the organisations involved - whether private or public - and an example of that quality of determination in the New York spirit, which has impressed, and moved, all of us.

Because the US financial infrastructure was robust enough to cope, there was no contagion in Hong Kong or elsewhere. But the possibility of a systemic problem of global dimensions involving the world's most important currency was a serious concern at the time. And the events in New York quite naturally prompted us to look at our own contingency plans, especially for crucial operations, such as our payment and settlement systems. These plans had already been greatly expanded and rigorously tested in advance of the Y2K transition. They cannot specifically address every possible disaster - whether at home or elsewhere - but we are pretty confident that they are robust and flexible enough to enable us to maintain our core operations in all but the most unmanageable situations.

More broadly, the events on 11 September have also prompted us to reflect on the nature and structure of global clearing systems. Last year, as you know, Hong Kong launched its own US dollar clearing system, to provide real-time settlement for the full range of US dollar transactions in the Asian time zone. The aim is to cut down Herstatt risk - that is the foreign exchange settlement risk relating to the delivery of different currencies in different time zones - and to provide a fast, efficient and cheap service for our own region. September 11th brought home to us the risk of serious disruptions to the global settlement system and underlined the importance of our US dollar clearing system as a risk management service. Clearly, greater use of the local system for real-time settlement of Hong Kong dollar versus US dollar transactions would bring real benefits in terms of reduction and diversification of risk. Banks in Hong Kong will no doubt be looking seriously at their existing settlement arrangements for such transactions, and at the greater use they can make of local services to achieve finality of settlement for the currencies simultaneously in our time zone.

For our own part, the HKMA will continue to develop and reinforce our local financial infrastructure and to link it more efficiently with global systems. We have, for example, started on the development of a two-way linkage with Euroclear, one of the world's largest central securities depositories. The two-way linkage, which will be highly automated for heavy usage, will enable investors in the Asian region to gain trading access to securities lodged with Euroclear.

The infrastructure providing for payment and settlement form the essential roads and bridges that connect banks and other institutions with each other. What of the banks themselves? In Hong Kong, they have seen declining profits at a time of increasing competition. Yet the banking sector remains remarkably strong, with an average capital adequacy ratio of 18%. With good reason, the general public, and the international financial community, have a very high degree of confidence in Hong Kong's banks. They have maintained, and in many cases increased, their strength during a prolonged period of financial crisis, at a time of far-reaching change to the banking industry worldwide and important regulatory reforms at home.

A large part of this programme of reform has aimed at enabling our banking system to build further on its strengths and to channel them more efficiently. An important theme in the reform programme is the removal of barriers to competition with the aim of driving efficiency and energy in the banking sector. One of the outcomes has been the considerable progress made recently towards the consolidation of banks into institutions of a size and scope that can make them more capable of deploying their strengths in an increasingly globalised environment.

The complementary theme in the reform programme is improving and expanding safety measures, not with the aim of sustaining weak institutions, but in order to prevent systemic contagion should a bank run into difficulties and to provide a greater measure of protection to the small depositor. In 1999 we clarified our role as lender of last resort, a measure of some importance in times of economic or financial uncertainty. We have made progress in implementing our risk-based supervisory approach, which is intended to produce a more focused and accurate assessment of the areas of greatest risk to individual institutions - and to take pre-emptive actions. Our plans for a deposit insurance scheme - which will provide a safety net for small depositors in the event of a bank failure - are progressing well. Consultations on the technical details are continuing, and we expect to be able to introduce the necessary legislation in late 2002.

The aim of all these measures - and the first duty of any banking regulator - is to maintain and improve the stability and strength of the system as a whole. During these times of difficulty, there is a further impetus to seek, where possible, to alleviate some of the burdens carried by the community, if only for the purpose of safeguarding the asset quality of the banks. A balance needs to be drawn between efficiency, profitability and prudent risk management - which are the essential ingredients of banking stability - and concessions to the individual customer, however desirable these may seem. But banks in Hong Kong have shown that, by balancing the two in an imaginative and sensitive manner, these aims are not incompatible. Banks have, for example, generally been careful so far to ensure, in their setting of fees and charges, that vulnerable groups are not excluded from basic banking services. They have - far more perhaps than has been acknowledged - been both forbearing and constructive in their treatment of mortgage-holders facing difficulties; in particular, they have responded positively to our recent measures to enable them to be more flexible in offering relief to homeowners in negative equity. I have no doubt that they will act equally positively on the proposed $1.9 billion loan guarantee scheme for small and medium enterprises recently announced by the Government.

Such schemes, like the various other relief measures announced in the annual policy address a couple of weeks ago, will provide some palliative, and perhaps some stimulus, during hard times. Ultimately, however, sustained recovery will come only when the external situation improves. In the meantime, we should take what measures we can to control the damage, maintain stability and strength in our financial and banking systems, and position ourselves as best we can to get the best advantage out of recovery.

The link

One question, raised by a few commentators, is whether Hong Kong would be benefited if we were to change, or even abolish, the Linked Exchange Rate system. Some have simply recommended a thorough, but not urgent, review of the system. Some have suggested a repegging - at a lower value - or an abandonment of the peg when times are less unstable or when the economy is booming again. Others have called for action now. Still others, though not very convincingly, and not very constructively either, have criticised the Government for not introducing changes in the 1990s. The reasoning behind most of these commentaries claims that the Link hinders Hong Kong's competitiveness, and therefore our recovery; that the Link removes from us control over our monetary policy; and that the Link is fuelling deflation.

Before I respond to these claims, let me make three points very clear. The first is that I have no objection to an open and informed public debate on the merits and disadvantages of the Link - and on possible alternative exchange rate systems. It is absolutely right that a policy that forms the keystone of our financial system should be open to scrutiny. The strong public and market confidence in our currency can only be sustained if the reasons for adopting the monetary policy we choose are properly understood, and if the limitations, and the merits and demerits of possible alternatives, are examined through informed and reasoned debate. We encourage this process in the various publications we put out, in our educational programmes, and through the presentations and discussions that my colleagues and I take part in with people from all walks of life.

Secondly, the benefits and disadvantages of the Link - its effects on the economy, the experience of similar systems elsewhere, the possible alternatives - are, and always have been, subject to continuous and critical review. This process has been considerably strengthened in recent years with the creation of a dedicated research department within the HKMA, the establishment of the Currency Board Sub-Committee, and the opening of the Hong Kong Institute of Monetary Research. A very large part of the output of these institutions is made public, so that the range and depth of the research they carry out is available to anyone who is interested.

Thirdly, we are under no illusions about the limitations imposed by the Link. We agree that it rules out the possibility of using the exchange rate to help us adjust more quickly to sudden shocks. We agree that it ties Hong Kong to US monetary policy at times when the economic cycles of the Hong Kong and the US may not necessarily be moving in sync. We agree that it is a cause of asset price inflation in the nineties and deflation more recently. We agree, in short, that it is not a perfect system. But then, no exchange rate system is perfect. And the question to be asked, I would suggest, is not "Where is the exchange rate system that will remove these limitations?" It is "Are these limitations so severe, so constricting, so damaging as to outweigh the advantages that the Link brings to Hong Kong, or to outweigh the risks and uncertainties that would inevitably arise if we were to change or abandon the Link?" I think that the answer has to be no.

Let us take the question of competitiveness first. The claim is made that, without exchange rate flexibility, our products, and Hong Kong generally, have become uncompetitive when compared with economies in the region that have devalued their currencies. Even ignoring the fallacy of competitive devaluation, this claim assumes that the nominal exchange rate on its own is a reliable measure of an economy's competitiveness. Of course, it is not so for any economy, and is still less so for Hong Kong, which is going through structural transformation. The nominal exchange rate is relevant, but more relevant is the real effective exchange rate (REER), which also takes into account the inflation rate and the trade patterns. The REER for the Hong Kong dollar has depreciated by around 13% since the crisis period in 1998. During the same period, the REERs for other Asian currencies have appreciated by various degrees, reflecting both a rebound in nominal exchange rates as well as higher domestic inflation.

Hong Kong's competitiveness can also be measured by our economic achievement in terms of real GDP growth over the past few years. Here again the figures show that Hong Kong, with an annual average of around 3% growth in GDP between 1997 and 2000, has not performed badly compared with other economies in the region. And remember, these other economies have had their currencies devalued substantially. The sharp deceleration in growth this year is due mainly to the slowdown in the major industrial economies outside the region, not because of our competitive position, and certainly not because of the strength of our currency. All of us within the region are affected to one degree or another, and some, such as Singapore, Taiwan and Korea, have been badly affected because of their strong dependence on exports of electronics and computer parts. Hong Kong has done rather less badly so far, though we are still slowing down.

The second claim is that, with the Link we place the control of our monetary policy in the Federal Reserve and thus lose monetary policy as an instrument for stimulating (or restraining) the economy. In particular, we have, during the life of the Link so far, had the experience of low interest rates imported from the US when a tighter policy might have been more suited to our macroeconomic needs; and, more recently, in the aftermath of the Asian financial crisis, the opposite problem. But these misalignments are one of the trade-offs that we have to accept from time to time in return for exchange rate stability.

At present, and more often than not, the US and Hong Kong economies are more or less in sync, and the interest rates we import are perhaps more appropriate for our needs than they have been at any time over the past decade. That in itself does not alter the point about loss of control of monetary policy, though it makes it less relevant and less forceful at a time like this. But the complaints about shackling our interest rates to those of the US beg the larger question of whether, if we free ourselves of that burden, we would really be able to run a truly independent monetary policy. How far, for example, would we be inhibited from reducing interest rates at times when that would be appropriate because of inflationary concerns generated by exchange rate depreciation? And how far, in any case, would we be able to avoid importing US monetary policy even in the absence of the Link? The experience elsewhere in the region does not give ground for much optimism.

The third question is how far the Link is fuelling deflation, and how far this is detrimental to our economy. Internal price deflation is indeed a part - and a necessary part - of the process of adjustment imposed on the economy under the Link when there is a fall off in external demand. It is also, incidentally, a feature of our longer-term economic integration with the Mainland of China. It is the counterpart of currency depreciation under a floating regime, except that the adjustments that it forces to take place tend to involve less overshooting, less instability, and more lasting restructuring. Price deflation brings pain to those who see the value of their assets shrink dramatically, and, as we know, there are many in Hong Kong who are, sadly, in this position. But there are many more who have seen their purchasing power increase, as prices for the whole range of goods and services steadily decline. And the effect, equivalent to that of devaluation, on adding to the attraction of Hong Kong as a regional centre, and as a destination for tourists, can only be positive. The concern comes when price deflation, as part of the adjustment process under the Link, turns into the kind of spiralling deflation that inhibits investment and fuels recession. At present, and despite nearly three years of steady price deflation, this does not appear to be happening. Indeed, the experience last year of robust growth and moderate price decline underlines the point that price deflation and economic expansion are quite compatible under a linked exchange rate system.

I have tried to place these complaints about the Link in a larger perspective. That is not to deny that the complaints have some validity. The Link does have shortcomings. It does impose restrictions. We should all have the courage to speak of and accept them, while not overlooking the advantages of the system. And there are two clear and simple advantages of overriding importance for Hong Kong. A stable exchange rate provides a predictable and conducive business environment for an economy that imports practically everything that it consumes, processes or re-exports. And, for a financial centre with strong international capital flows but no capital controls, linking our currency to a strong international currency provides stability and strength. Although not perfect, the Link has served Hong Kong well, and there is no better and less risky alternative. There is no intention or plan to change or abandon it.

Given the renewed interest in the subject, and for the sceptics who remain, let me go the extra mile here for their benefit. Let me tackle the question of what would happen if Hong Kong were to depeg. Within the HKMA we think of this a great deal. This is not because we expect or intend it to happen. It is because any responsible central banking institution must have an idea of what conditions might be like under an alternative system - if only to clarify its understanding of, and justify its adherence to, the present system. And any organisation must have contingency plans to deal with the unexpected and the unintended. We do not, of course, make public our contingency plans, though we do, as I have mentioned earlier, make public a great deal of research carried out within the HKMA or under our auspices on issues surrounding the Link.

What, then, might happen if Hong Kong were to depeg? The answers would, of course, depend on what monetary policy was adopted in its place. It would also depend on domestic, and particularly external, conditions at the time. The outcome could, I think, even with the most benign conditions and the best-judged strategy, be summarised in two words, "uncertainty" and "instability". Uncertainty, because the Hong Kong dollar would become a magnet to speculators eager to test the limits and the weaknesses of the new regime, with all the instability that would bring. Uncertainty in the effects on business and on daily life, if, as a result of that instability or of a general fall in confidence, the value of the Hong Kong dollar depreciated dramatically and, in consequence, the price of our imports increased sharply. Uncertainty and instability, because if imported inflation was high, and if monetary policy were to be targeted towards stable domestic prices (which is the general alternative to an exchange-rate-based regime), it may not be possible to keep interest rates low.

If, heaven forbid, depegging were to be carried out in the conditions that we have now, then we might add a third word to "uncertainty" and "instability": "catastrophe", since nearly everyone seems to recognise that the worst possible time to change a fundamental monetary policy of this kind is when the economy is weak and when the outlook is full of risk.

Those of you who are old enough will recall the circumstances that led to the creation of the Link in October 1983. At that time, we were facing a crisis in confidence in the future of Hong Kong, concerns about the soundness of a number of banks, and speculative attacks on the Hong Kong dollar. The crisis followed almost a decade of a floating exchange rate system, during which inflation rose to well over 10%, and sometimes hit 20%, and the value of the Hong Kong dollar declined from around five to the US dollar to a low of 9.6 on 23 September 1983. In the uncertainty that prevailed during that crisis, people rushed to the supermarket to stock up on rice, instant noodles, cooking oil, soya sauce, detergent and toilet paper, not knowing how much these basic commodities might cost in a week or a month's time. Some shops were reluctant to accept Hong Kong dollars. No one, I think, who lived through those times would wish to live through similar events again.

Conclusion

The creation of the Link eighteen years ago helped restore stability at an unstable time. History does not repeat itself. Times change. But let us at least remember the experience of those years when we talk about the usefulness or otherwise of the Link to Hong Kong during what are, arguably, even more unstable times. At this time of great global uncertainty and local distress, our efforts should be directed towards building stability, not destroying or undermining it. I have given some account in this talk of how, in its banking system and financial infrastructure, and in its currency, Hong Kong enjoys a position of great strength. It is from this position of strength, and not through any sudden and destabilising gimmickry, that we will best be able to weather the difficulties that now face us, and to embrace the opportunities to come.