

Joseph Yam: Financial stability issues, dollarisation and price dynamics

Opening remarks by Mr Joseph Yam, Chief Executive of the Hong Kong Monetary Authority, at HKIMR Summer Workshop 2003, Hong Kong, 27 August 2003.

* * *

Ladies and Gentlemen,

I am delighted to welcome you to this first "HKIMR Summer Workshop in Money and Finance". This is an event that we hope from now on will take place annually. The organisers have put together an interesting programme with three papers dealing with issues that are of current or potential importance for Hong Kong.

The first paper, to be presented by Professor Charles Goodhart, focuses on financial stability issues. These issues are of particular interest to an international financial centre, as the success or otherwise in the maintenance of financial stability, and therefore the efficiency of financial intermediation, not only has an impact upon the domestic economy but also on the economy of the region that centre serves.

The second paper, to be presented by Professor Genberg, deals with the subject of dollarisation. Dollarisation, in the traditional sense of the US dollar replacing or displacing the Hong Kong dollar as a medium of transaction in respect of domestic economic activity, is in my opinion unlikely to occur here in Hong Kong. This is notwithstanding the operation of a currency board system with the US dollar as the anchor currency. But, from another perspective, we are seeing continuing economic integration between Hong Kong and Mainland China. We are also noticing the inevitable trends, on the one hand, of greater use of the Hong Kong dollar on the Mainland and, on the other hand, of continuing financial liberalisation on the Mainland: this will, in the fullness of time, culminate in the RMB becoming freely convertible. The subject of dollarisation, whether the predominant currency is the Hong Kong dollar or the RMB, is a fascinating one.

On a different dimension, in our attempt to enhance our status as an international financial centre, we have adopted the strategy of providing a financial infrastructure to facilitate the conduct of international financial intermediation activities in Hong Kong. This financial infrastructure is characterised by a platform on which financial activities can be transacted and settled real time in this time zone in the major currencies without, for example, Herstatt risk. We now have Real Time Gross Settlement systems for the US dollar and the euro, and of course the Hong Kong dollar. And the lead-time for the inclusion of another currency, such as the RMB, in our settlement platform, if that is considered appropriate, could be as little as six months. If this strategy is successful, it is not difficult to envisage an increasing proportion of the balance sheet of the banking system denominated in foreign currencies, and the greater use of, say, the US dollar in both the equity and debt markets. I am not sure if this is a dimension covered in Professor Genberg's paper on Endogenous Dollarisation, but it is of particular relevance to Hong Kong.

The third paper, to be presented by Professor Kumhof, deals with issues regarding price dynamics. Professor Kumhof's paper focuses on pricing policies and inflation inertia, at a time when we are experiencing deflation in Hong Kong: I am sure, however, that there are insights that we can derive from the paper and the discussion. Research on price formation is high on the agenda of the HKIMR and the HKMA, and possibly in academic and other organisations active in economic research in Hong Kong. We have had deflation for some five years now and we are still debating the relative importance of cyclical and structural factors behind that deflation. There is also debate on whether measures could and should be taken to limit the damaging effects of deflation, notwithstanding the fact that Hong Kong is a highly externally oriented economy. Views on price dynamics will contribute to these debates.

As you know, the HKIMR was established by the HKMA. This reflects the importance we attach to thorough analysis of monetary and financial issues that Hong Kong is facing. Developments in the local, regional and global economies provide many opportunities for Hong Kong, but also serve as potential sources of risks. It is therefore critical that we actively seek to understand these developments. To promote economic research of the highest quality, it is essential that the research activities of the HKIMR are, and are seen to be, carried out freely, without interference from interested parties, including the HKMA. It is therefore not desirable for the HKMA to exercise control of the

HKIMR's day-to-day activities. But, of course, the professional quality and academic integrity of its activities need to be monitored and ensured. For this reason, a Council of Advisors, whose members are all distinguished economists working in and outside of Hong Kong, has been established. Many of them are in fact here today. The role of the Council is to ensure the quality of the HKIMR's activities and to alert the Board of Directors if shortcomings become apparent. While the relationship between the HKIMR and the HKMA remains close, the HKIMR does enjoy independence in research matters. One consequence of this is that the views expressed in its different publications do not necessarily reflect those of the HKMA.

One of the distinguished members of the HKIMR's Council of Advisors is our first speaker today, Charles Goodhart, and it is my great pleasure to introduce him. It was very much his visit to Hong Kong that gave the HKIMR the idea of organising this workshop.

As you all know, Charles is one of the world's foremost monetary economists and an expert on central banking issues. But what some of you may know is that he has had a very long involvement in, and influence on, monetary issues here in Hong Kong. This began almost exactly twenty years ago when Hong Kong, suffering from a crisis of confidence in its political future, and without any effective form of monetary control, was on the brink of a financial meltdown. The exchange rate was depreciating sharply and Charles was brought in from the Bank of England to advise us on how Hong Kong could be rescued. He gave valuable advice on a proposal to return to a fixed exchange rate system through the currency board arrangement of linking the Hong Kong dollar to the US dollar. As you all know, that exchange rate link was subsequently established, in October 1983, and it is still in operation now. It commands a high degree of confidence and credibility. It has served Hong Kong extremely well in the past twenty years. In his advice, Charles also covered other strategic issues of central banking for Hong Kong. As the only remaining person in the public sector continuously involved in this area of work from then until now, I can say with some authority that the views of Charles have exerted much influence on the development of the monetary system of Hong Kong.

I do not know whether you remember, Charles, your piece of advice to the then Financial Secretary, the late Sir John Bremridge, written on 6 October 1983. I have kept a copy of it, and I often refer to it for inspiration in the past twenty years. Fortunately for me, but not perhaps for others, the advice is so highly classified that it will probably never see the light of day. But it should be all right for me to quote from your covering letter to Sir John, where you said: "I have put in all the points of substance that I wanted to make, and I hope and believe that they will stand the test of time." They certainly did. And so did your suggestion that it might be desirable for the Exchange Fund in time to adopt "more of a feature of a Central Bank": hence the HKMA, which was formed ten years after the advice you gave. Of course, we also had the privilege of your involvement over the period from 1990 to 1997 as a member of our board, the Exchange Fund Advisory Committee, and in your occasional trips to Hong Kong.

So, ladies and gentlemen, it is with great pleasure that I now invite Charles to speak in our first session of this HKIMR first Summer Workshop.