Joseph Yam: Issues in monetary policy

Luncheon talk by Mr Joseph Yam, Chief Executive of the Hong Kong Monetary Authority, at the Hong Kong University Foundation for Educational Development and Research and Hong Kong University Faculty of Business and Economics, Hong Kong, 19 January 2004.

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Introduction

I feel very honoured to have been invited to speak to my fellow HKU Alumni and friends at this lunch organised jointly by the Hong Kong University Foundation for Educational Development and Research and the HKU Faculty of Business and Economics. You were given to understand that I would be talking about "Issues and Challenges for the Hong Kong Monetary Authority". This is one of those very general titles that betray the speaker's indecisiveness on what he should talk about when accepting an invitation to speak. I have to confess that this indeed was my state of mind when Richard Wong first approached me. But Dr YC Chow came to my rescue by referring to "the latest update and outlook of Hong Kong's monetary policy" in his circular about the occasion. I shall therefore oblige, even though monetary policy is only one of the many preoccupations of the Hong Kong Monetary Authority: we can, of course, cover any of the other preoccupations, if they are of interest to you, in the Questions and Answers session to follow.

Monetary policy objective

Monetary policy is an important area of our work, as it is for all central banks in jurisdictions with their own currencies. Stability in the currency is essential to the proper functioning of the economy, and monetary policy aims to achieve that and, realistically, only that, given the limitation in the availability of monetary policy tools to either the supply or the price of money. This latter point, concerning the singularity of the monetary policy objective, is not always recognised, particularly in a situation where the economy is facing difficulties and the community is looking to government for relief. But the independence of central banks, and hence their ability to operate with relatively little political interference, supported by a strong research capability and a high degree of transparency, have helped in the greater acceptance of this reality.

It is not enough to specify the monetary policy objective simply as "currency stability". The market demands greater clarity than that, and rightly so. Increasingly, currency stability is quantitatively defined, in most cases by government, and the quantitative target is to be achieved independently by the central bank under the intense scrutiny of the market. This arrangement enhances policy credibility and therefore the effectiveness with which the monetary policy objective is achieved.

As you are, no doubt, aware, given the highly externally oriented nature of the Hong Kong economy, with external trade in goods and services equivalent to around 300% of GDP, it is considered by the Government to be most important that the external value of our currency be stable. Hence currency stability is defined by the Financial Secretary "as a stable exchange value of the currency of Hong Kong", and quantitatively, "in terms of its exchange rate in the foreign exchange market against the US dollar, at around HK$7.80 to US$1". The Financial Secretary further determined "that the structure of the monetary system shall be characterised by Currency Board arrangements". And he defines Currency Board arrangements as requiring that "the Hong Kong dollar Monetary Base to be at least 100 per cent backed by, and changes in it to be 100 per cent matched by corresponding changes in, US dollar reserves held in the Exchange Fund at the fixed exchange rate of HK$7.80 to US$1". This clear statement of monetary policy objective is contained in correspondence exchanged between the Financial Secretary and the Monetary Authority in June last year. (A copy of the statement is attached to the printed version of this speech.) It is an authoritative, modern day description of the Linked Exchange Rate system that has been with us for over twenty years.

Monetary reform

There have in fact been considerable modifications made to the system over the years, all with the objectives of strengthening it and enhancing its sustainability. Most of these, I am pleased to say, were introduced in quiet times and were, in my opinion, instrumental in pre-empting destabilising crises,

although it will not be possible to prove this. One or two of the modifications, regrettably, had to be introduced in the context of a crisis, although again it would be doubtful if they could have pre-empted, for example, the debilitating currency attacks of 1997-98.

One example of this is the expanded definition of the Monetary Base to include Exchange Fund Bills and Notes, in addition to Certificates of Indebtedness (to back the banknotes in circulation), coins and currency notes issued, and the balance of the clearing accounts of banks kept with the HKMA. This last component is usually described as the Aggregate Balance. Although traditionally it is one of the smaller components of the Monetary Base, it is also the most elastic component: its contraction or expansion is the crucial determinant in whether domestic interest rates respectively rise or fall. In 1997-8 the Aggregate Balance was proving to be so small as to encourage volatility in interbank interest rates and to invite speculation. This was the reason why we added Exchange Fund paper to the Monetary Base to provide a cushion against this volatility. Now, once again, but for very different reasons, the Aggregate Balance is in the news. I shall say more on the subject of the Aggregate Balance later on.

There will always be debate about the architecture and mechanics of our Currency Board system. It is healthy that there should be. For the present, I think we have the structure of the system more or less right. We have the Monetary Base unambiguously defined and operated transparently in accordance with the Currency Board rule. We have reduced the excessive volatility of our interest rates in response to the inflow and outflow of funds into and from our currency, and have therefore lowered the probability of interest rate shocks, but of course at the cost of committing more of our foreign reserves as backing for the Monetary Base. I do not want to bore you with all the technical details that are perhaps only of market or academic interest. But I would like to make one general point here. The fact that the exchange rate remained stable, in both the spot and forward markets, when the unemployment rate was 8.7%, the deflation rate was over 3% and the budget deficit was equivalent to 6% of GDP, is attributable, at least in part, to the robustness of our monetary system.

We nevertheless have to be always on the alert to changing circumstances and the possible need for further modifications. Globalisation and the revolution of information technology have made international capital rather more potent than before, and have consequently made the task of maintaining monetary stability for a small, open economy a much more onerous one. An amount of international capital that might only create ripples in, say, the very large US market, could create tidal waves in the smaller markets: we all witnessed these events during the Asian financial crisis of 1997-98. And when the movement of such international capital could be made freely with a few keystrokes on the computer, and easily triggered by rumours, there simply is no scope for complacency in monetary management in these small, open markets.

Market sentiment

We have recently seen just how fickle international capital can be. At a time when there has been considerable concern expressed on the sustainability of our Linked Exchange Rate system, in view of the potent combination of problems that we face, namely unemployment, deflation and budget deficit, the Hong Kong dollar all of a sudden strengthened. This turn in sentiment is of course to be welcomed. The threat of an interest rate shock, arising from possible capital outflow if the concerns were heightened to the extent of affecting confidence in the currency, regardless of the robustness of the monetary system, has quickly subsided. One possible explanation of the sudden turn in sentiment is that financial markets are forward-looking and have reacted quickly to the early signs of improvement in the economy. But the structural components of the economic problems remain and difficult decisions will need to be taken to resolve them if the long-term stability in the currency is not to be undermined.

Nevertheless, the market or rather market analysts always have interesting answers to market behaviour. There is first the recent weakness of **the US dollar**, which has pulled the Hong Kong dollar down against other currencies not fixed to the US dollar. Some felt that this is unjustifiable, forgetting the need, as indicated by the high unemployment rate, for Hong Kong further to enhance its competitiveness vis-a-vis markets with currencies not fixed to the US dollar. The weakness of the US dollar has had the benign effect of moderating the pain of structural adjustment arising from the increasing economic integration between the Mainland and Hong Kong. It lessens the extent of deflation necessary as part of that structural adjustment.

There is then the political pressure on **the RMB** to appreciate or for its exchange rate to have greater flexibility. Some felt that if there is greater flexibility in the RMB exchange rate, it would appreciate, and the Hong Kong dollar would be pulled along with it. Again the argument is flawed. First of all, I do not see the need for an appreciation of the RMB exchange rate. The Mainland is running a current account surplus that is less than one per cent of GDP, and this is shrinking under the influence of WTO, indicating that there is nothing fundamentally wrong with the level of the exchange rate. There is nevertheless considerable capital inflow partly to take advantage of direct investment opportunities there, as the economy continues to boom, and partly to speculate on an exchange rate appreciation. This capital inflow is in fact presenting monetary management problems for the authorities. Sterilisation of monetary injections resulting from the rapid build up of foreign reserves is proving to be quite challenging. This is notwithstanding the creation of a central bank bills programme that had built up to over RMB400 billion outstanding in less than a year and the raising of the bank reserve requirement from 6% to 7%. Partly because of this, credit creation has been accelerating and, if the November inflation rate of 3% is not a blip, there are inflationary consequences that have to be dealt with. But there is the policy response of further, cautious capital account liberalisation through, for example, the approval of QDII schemes, which would have the effect of reducing or stemming net capital inflow. There is no need to mess around with the exchange rate.

But even in the event that greater flexibility is introduced to the determination of the RMB exchange rate and there is some appreciation, there is no reason why the Hong Kong dollar exchange rate should appreciate along with it. The Government is firmly committed to the maintenance of a fixed exchange rate and the policy has served Hong Kong very well in the past twenty years.

In any case, any hypothetical appreciation of the RMB would be unlikely to cause economic difficulties to Hong Kong to the extent of bringing into question the appropriateness of our fixed exchange rate. On the contrary, with continuing economic integration between Hong Kong and the Mainland - and these are two economies still with considerable differences in factor and non-tradable goods prices - a realignment of the exchange rate between the two currencies could arguably be beneficial. It would, arguably, hasten the completion of the process of structural adjustment. As we are all aware, that process has been going on for five or six years and it has involved considerable dislocation to the economy and society, and pain for some. Its early completion is of course desirable. But the important question is whether a realignment of the exchange rate, brought about by whatever means - an appreciation of the RMB or a depreciation of the Hong Kong dollar - would necessarily be a benign one. In all probability it would not be. The risks of the exchange rate overshooting to the extent of sparking off a financial meltdown are quite real, although I would admit that the risks for Hong Kong are lower if the realignment is brought about by an orderly appreciation of the RMB than by an uncontrollable depreciation of the Hong Kong dollar. At least the Mainland, with exchange controls, is in a position to steer the move, avoid overshooting and its destabilising consequences. But there is considerable doubt in the first place as to whether the Mainland economy would benefit from an appreciation of the RMB, even if an orderly one could be arranged.

There are **other reasons** explaining the turn in sentiment on the Hong Kong dollar. The economy is indeed recovering nicely, Hong Kong is running a very significant current account balance of payments surplus and performance of asset markets, particularly the stock market, has been impressive. And so there has been some capital inflow, arising both from greater foreign portfolio investment and possibly some portfolio shift by residents back in favour of Hong Kong dollar assets. The rumour of an appreciation in the Hong Kong dollar exchange rate, along with that of the RMB, against the US dollar may have been a factor intensifying that inflow. It may also have reduced the extent of capital outflow that traditionally mirrors the current account surplus.

Dynamics of the monetary system

Whatever the reason for the recent strong tone of the Hong Kong dollar, I consider it a much more pleasant problem to deal with than a currency exhibiting a tendency to weaken. As you know, on the **weak side**, currency board arrangements translate any weakness in the exchange rate arising from capital outflow into a contraction of the Monetary Base and the foreign reserves backing the currency, and higher domestic interest rates. And interest rates can go very high, in fact, as high as it takes to stem and reverse capital outflow. In a deflationary environment, and with high unemployment, the ability of the economy to absorb the painful effects of sharply higher interest rates is limited. The possibility of those in negative equity mortgages being forced by high interest rates, loss of job or further falls in residential property prices into bankruptcy, affecting stability of the banking system, had

been one of our foremost concerns until recently. I am sure that I am not the only one who is very happy that this possibility is rapidly diminishing.

On the **strong side**, currency board arrangements translate currency strength arising from capital inflow into an expansion of the Monetary Base, more foreign reserves and lower domestic interest rates. Specifically, the classical currency board rule requires the conduct of non-discretionary, non-sterilised foreign exchange intervention. As US dollars are sold to the Exchange Fund, the Aggregate Balance in the Hong Kong dollar clearing accounts of the banks - the crucial element of the Monetary Base - correspondingly increases and interest rates in the interbank market fall. As some of you may be aware, the Aggregate Balance has already increased to HK$52 billion from its traditional level of less than HK$1 billion necessary as engine oil in the very efficient real time inter-bank clearing system. Corresponding to that, the Currency Board Account of the Exchange Fund has taken in US$6.7 billion. These are, of course, large numbers, but the important point to realise is that there is no limit as to how large they can become. There is no limit to the amount of domestic money that can be created if the demand is there. As long as banks want to sell US dollars to us, for the Currency Board account of the Exchange Fund, at the exchange rate determined by us, we have to create those Hong Kong dollars. There is no limit to the size of the Aggregate Balance. Nor is there any concern on our part about its size. We take no view on what its size should be.

Outlook for monetary conditions

You may wonder how this episode of Hong Kong dollar strength will play out. It depends mainly on the attitude of the banks and also of those holding large idle Hong Kong dollar balances. There are two scenarios. The **first** is for the Aggregate Balance, which is earning no interest, to increase to a size in which the total opportunity cost for holding on to it, relative to the perceived risk of the alternative, becomes too significant for the banking system as a whole. The alternative is, of course, to switch out of Hong Kong dollars into foreign assets earning some return: for example, one might switch into US dollars and earn a deposit interest of around one per cent. The risk of the alternative is a sudden appreciation of the Hong Kong dollar, which, for reasons that I was trying to dispel, is presumably still perceived by the market to be significant.

I do not know what it will take, or for how long it will take, for this perception to change. The banking system of Hong Kong traditionally runs a short Hong Kong dollar position, partly because of the lack of quality Hong Kong dollar assets and partly because of the desire, for whatever reasons, of some to hedge against the so-called Hong Kong risks. And when there is sudden realisation that the Hong Kong dollar might strengthen, the short Hong Kong dollar position naturally becomes a concern. The banking system might attempt to reduce that short position. There would obviously be reluctance to increase that short position, notwithstanding the favourable interest rate differential.

May be it is necessary for the risk-adjusted opportunity cost to be made bigger. This is the **second** scenario of how this episode will play out. We have the powers to introduce charges on large balances maintained by banks in their clearing accounts held with us, so that the interest rate differential between holding Hong Kong dollars and holding US dollars becomes a lot higher than the current one per cent. Outflow from the Hong Kong dollar would then be generated, the exchange rate would weaken, US dollars would be sold at 7.80 and the Aggregate Balance would be returned to a more normal level. Hong Kong dollar interest rates would also be more in line with those of the US dollar. But some have expressed reservations in this, which amounts to the imposition of negative interest rates, in view of their unfair impact on the smaller depositors if the banks were to pass them on. Whether banks would do this or not is, of course, a commercial decision for each bank to take. But there seems to me no reason why they should. The customer deposit base of a bank is far greater than the clearing balance. There is scope for banks to arrange matters in a way that would not affect ordinary depositors, for example by passing the charges on only to very large depositors.

This is, of course, all hypothetical, for we are not currently contemplating taking action that would lead to this second scenario developing. Low interest rates are helpful to the economic recovery. They are also helpful to those still repairing their balance sheets, including those servicing negative equity mortgages. And there does not seem to be any sign of excessive credit creation. Indeed, the demand for credit remains rather subdued. Even in the event that the present low interest rate environment proved to be somewhat inflationary, this would just mean the elimination of deflation in Hong Kong, which we all would welcome. So, again for the time being, if there is further inflow, you will see us buying US dollars and increasing the Aggregate Balance passively. This is of course a profitable operation. We are earning at least one per cent on the US dollars bought but paying no interest on our

Hong Kong dollars created. We are buying US dollars at an exchange rate slightly cheaper than 7.80 but we will not sell those US dollars until the exchange rate moves back to 7.80. And, most importantly, we are determined to keep the exchange rate fixed. In short, the profit is assured.

However, it may be that the size of the Aggregate Balance, for whatever reason, and the associated loose monetary conditions become a matter of concern. If so, there is a **variation of the first scenario** that may develop, which is something that was envisaged in the introduction of the seven technical measures to strengthen the Currency Board system in September 1998[1]. We could take the exceptional step of mopping up the large pool of Hong Kong dollars in the Aggregate Balance, or part of it, through the issue of more Exchange Fund paper. Since the paper that would replace the Aggregate Balance in this manner would be fully backed by US dollar reserves and would still be part of the Monetary Base, the Currency Board rules would continue to be observed. This would in effect be a mechanism for preventing or mitigating the emergence of extreme monetary conditions on the strong side, and one that would be symmetrical to the cushion afforded on the weak side by the same pool of Exchange Fund paper eligible for accessing the Discount Window. We keep an open mind on this possibility.

Strong side convertibility undertaking

There is obviously a need to monitor developments closely. There may be circumstances in which some mopping up of inter-bank liquidity through the exceptional issue of Exchange Fund paper would be desirable. There may also be circumstances in which negative interest rates could become justifiable, if only for the purpose of underlining the Government's determination to maintain the Linked Exchange Rate system. It may also be that a more formal convertibility undertaking on the strong side of the Link, mirroring the one that already exists on the weak side, becomes necessary. There are pros and cons for retaining some discretion in the determination of the intervention level on the strong side. On the one hand, the constructive ambiguity inherent in discretion inhibits speculative shorting of the Hong Kong dollar by making it difficult to calculate the downside risk involved. On the other hand, the total absence of discretion may enhance further the credibility of the system, to the extent that this is considered necessary, although it would also limit the downside risks of and thus encourage currency speculation.

There is a further consideration and this is the impact of a two-way convertibility undertaking on the jobs of all those employed in the dealing rooms of banks trading the Hong Kong dollar against the US dollar. Depending on whether there is a spread between the strong side and the weak side in the convertibility undertaking, market activity will be diverted to us and we would play the role as the market maker. In the extreme case when there is no spread and we buy and sell both at the level of 7.80, all buying and selling of Hong Kong dollar against US dollar will be diverted to us. We would be the counter-party to every deal and there would be much less a need for dealers that live on market volatility. Obviously, this is not something that any of us would wish to see, particularly at a time when unemployment is still high, and it is, in fact, a general practice among central banks throughout the world not to introduce policies or practices that would inhibit or erode the development of legitimate financial markets. But such a possibility could not be entirely ruled out: if, for example, we faced a situation in which a two-way convertibility undertaking with no spread was what was necessary for us to discharge our responsibility in the maintenance of a stable exchange rate - if the public interest required it - then it is clear where our duty would lie.

These are subjects that have been reviewed periodically by the Currency Board Sub-Committee of the Exchange Fund Advisory Committee. No doubt the Sub-Committee will continue to revisit these subjects in the future. Those interested in monitoring how our thinking on these matters has developed should examine the records of the Sub-Committee.

International finance

As events unfold in the coming months both in the international and domestic financial markets, there will continue to be questions and comments on the appropriateness of the Linked Exchange Rate

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[1] The fifth of these measures was the clear commitment from the HKMA that new Exchange Fund paper would only be issued when there was an inflow of funds enabling the additional paper to be fully backed by Foreign Reserves.

system and on the mechanisms we employ to operate it. And the year ahead looks like one that promises considerable volatility in world financial markets. There could be, and arguably we are already seeing, less-than-benign exchange rate adjustments brought on by heightened concerns about external imbalances, particularly in the United States. There could be greater-than-expected inflationary pressures developing to the extent of requiring upward adjustments in interest rates that are larger and sooner than expected. There could be unexpected escalation of geopolitical tension leading to sharp market adjustments. Discussions about our monetary policy may, consequently, become lively.

In listening to these discussions and possibly contemplating the making of market transactions, for example, to adjust your portfolio allocation, I hope you will bear in mind what the Government's firm monetary policy objective is and the ability of the HKMA in delivering that objective. There is something else that I would like you also to bear in mind. Financial markets often exhibit the tendency of having a life of their own, relegating the original purposes of their existence to secondary importance, if that. Globalisation and the revolution of information technology have increased this tendency, as international capital roams around the globe with the touch of a few buttons to look for opportunities to make quick profits. Much of it has developed a predatory character, its operators skilfully justifying their destabilising and possibly destructive activities by pointing to policy, market or governance weaknesses and handing down what they called "punishments by the free market". Many jurisdictions have fallen prey to these predators, as we saw in the Asian financial turmoil of 1997-98. To be sure, policy and other weaknesses did feature prominently, but I think not to the extent of justifying the severity of the punishment handed down.

The long-term public interest of having financial markets to facilitate financial intermediation that promotes economic growth and development often does not align with the private short-term interests of financial intermediaries. This regrettably is a fact and the financial history of Hong Kong is punctuated by events brought on by heightened misalignments of those interests. In 1987, for example, the intermediaries forced a closure of the stock market and a painful disruption in the functioning of an important channel of financial intermediation. I have no intention of belittling the important role of financial intermediaries, or casting doubt on their integrity, or degrading their expert views on financial markets. But it is important for all to be reminded every now and then about one thing. The long-term public interest must prevail.

It may be that there is a need to revisit the role of the domestic currency of small economies, from the academic, economic development, market and monetary policy perspectives. As I implied earlier, the maintenance of monetary and financial stability in a small, open economy is proving to be an increasingly onerous task under the influence of globalisation and the revolution of information technology. This is particularly so for an economy that is highly externally oriented, in the sense that the external sector is large and financial markets are dominated by international financial transactions. The task is even more onerous if the economy aspires to be an international financial centre, in which financial intermediation of an international dimension, possibly not involving either savings or investments of the domestic economy, takes place in abundance.

Smallness and openness are sources of vulnerability, and the associated risks have to be properly managed by the authorities. Regrettably, since the Asian financial turmoil, quite a number of Asian economies have reduced their openness as a defence, through for example the introduction of controls or restrictions that limit the availability of the domestic currency to non-residents. This is understandable, although such controls or restrictions may have the undesirable effect of undermining the efficiency in the allocation of international capital. Perhaps attention should instead be given to addressing the smallness of their markets by enlarging them to such an extent as to enable them to absorb the volatility that may arise from the free flow of international capital, and not be constantly threatened by monetary and financial instability. Given that these economies share a common interest, and there is increasing interdependence among them, as evidenced by the rapid expansion of intra-regional trade, one way of enlarging their markets is monetary union. But perhaps this is a subject for another occasion on another day.

Thank you for listening to me so patiently.