Norman T L Chan: The risk of asset-price bubbles

Speech by Mr Norman TL Chan, Chief Executive of the Hong Kong Monetary Authority, at the Hong Kong Economic Summit, Hong Kong, 14 December 2009.

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Introduction

1. I am very honoured to have this opportunity to speak to you today at the Hong Kong Economic Summit.

Potential risks of an asset bubble

2. Recently, many people in Hong Kong have become concerned about the emergence of an asset-price bubble. As we all know, interest rates are now very low due to the extremely loose monetary policies around the world. Attracted by a promising outlook for economic recovery, large amounts of funds have flowed into Asia, including Hong Kong. From October last year up to now, more than HK$640 billion have flowed into the Hong Kong dollar. This will certainly exert an upward pressure on local asset markets. I am sure you are all aware that the Hong Kong asset markets have become very active again. In particular, the prices of residential properties rose for 10 consecutive months from the beginning of this year, and prices and turnover have returned to levels we saw before the financial crisis. Many people are asking whether there is already a bubble.

3. Bull markets normally occur in times of rapid economic growth, abundant liquidity and strong investment sentiment. However, as to how far a bull market can develop before it becomes a bubble, there is no easy answer. There is a view in the international community that it is very difficult to identify an asset bubble before it materialises or even after it has already formed. This is true to a certain extent. For example, property prices in Hong Kong have increased nearly 20-fold in the past 30 years. Flats in the Taikoo Shing, a large residential estate on Hong Kong Island, were sold for only $300-400 a square foot in the 70's when they were built. The prices then spiralled upwards to over $1,000 a square foot in the 80's and reached a peak of nearly $10,000 a square foot in 1997. Although there have been ups and downs in property prices in Hong Kong in the past 30 years, the trend has basically been up. During each upward leg, ordinary middle-class households usually felt that prices were too high and difficult to afford, and there were always questions about whether a bubble had developed in the property market. However, with the benefit of hindsight, the rises in the 70's and 80's were not the result of bubbles but were supported by economic fundamentals, including growth in productivity and household incomes. A real and massive bubble did occur in the 90's as a result of a bull market. However, many people at that time tried to explain the irrational surges in prices as being part of the "Hong Kong miracle". The bubble and its subsequent bursting in the third quarter of 1997 dealt a severe blow to Hong Kong. We experienced an economic contraction for five consecutive quarters and property prices plunged by more than 60%. Many families found themselves trapped in "negative equity", and the unemployment rate was above 8%. Hong Kong began to recover in 2003 after six years' hard struggle. I am sure that this experience is still fresh in our memory.

4. Japan is another good example. It enjoyed rapid economic development after World War II, quickly becoming a powerful industrial nation. During the late 80's when its stock and property markets were booming, a huge bubble was created, which we only realised afterwards. Few people spotted the emergence of a bubble at the time, and the extraordinary and irrational exuberance was interpreted as the "Japanese miracle". We all know now that what a disaster this "Japanese miracle" was for its people. Twenty years on, the Nikkei Index still hovers around the 10,000 level, only a quarter of its peak of 39,000, while the average residential land price in six major cities is equivalent to only a third of its level two decades

ago. Of course, there are other structural problems that have prevented a Japanese recovery for such a long period.

5. The current global financial crisis was caused by the bursting of the property bubble in the US, which left many financial institutions under stress. For those who take the view that asset bubbles cannot be identified with certainty, it is neither appropriate nor necessary for the government to take action to burst them. Support for this view comes from the stock market crash in 1987 and the collapse of the IT bubble in 2000. In both cases, central banks were able to stabilise the financial market rapidly by aggressively cutting interest rates and injecting large amounts of liquidity into the market, and the economy and employment quickly resumed their upward paths. But the situation may be very different this time. Because the property and financial markets were closely inter-locked, risks were dispersed by the bundling of sub-prime securities and other financial derivatives, and a large bubble formed. The bursting of this bubble caused great damage to the European and US economies and people in Europe and America have had to pay an unprecedented price. The US government used US$700 billion to bail out banks and car manufacturers, and the UK government spent GBP 76 billion on rescuing the Royal Bank of Scotland and Lloyds Bank alone. Many European governments have also bailed out their banking systems, including the injection of capital into large banks by the Dutch and Belgian governments.

6. Based on experience in Asia in the past two decades, I believe asset-price bubbles, rather than inflation, pose the greatest risk to financial stability. My reasons for thinking this are many and complex, and we may discuss them on another occasion. I am not saying that inflation is not a concern for Asia. But I believe it is more important to address the harm that might be caused by asset-price bubbles. Although I agree it is difficult to predict the occurrence of an asset-price bubble, I am certain that once a bubble is created, it will grow with immense power and suppressing it will be difficult. The bigger the bubble, the greater the devastation it will cause when it bursts. The best way to avoid the damage and heavy cost is to prevent the occurrence of a bubble or to contain it before it's too late. To do this, we have to make decisions at the early stage of a bubble's formation, not later. More importantly, when a bubble is taking shape, we have to take appropriate and effective steps to stop it getting too big.

Prudent risk management

7. The current extremely loose monetary policies around the world and the large inflows of funds provide an ideal environment and provided nourishment for the formation of asset-price bubbles in Asia. So the risk of asset-price bubbles is not small. But Hong Kong cannot raise interest rates as it wishes, and even if we could, this would attract more hot money with undesirable consequences. So Hong Kong, like many other small and open economies, has to resort to other means to prevent the bubble from growing too large.

8. So what methods and tools should we use? For the property market, it is obvious that if there is a bottleneck or an imbalance in the supply of land, we have to deal with it. But the factors affecting demand, supply and prices of properties are very complex. Sometimes property prices rise not because there is a shortage of residential flats to satisfy housing demand, but because people expect that the market will continue to rise making it better to buy now to reap short-term profit or hold on for bigger gains in the long run. Currently in Hong Kong, the rapid surge in luxury-property prices may not necessarily be caused by insufficient supply of high-end residential flats, since rentals have not moved up in proportion with the prices. Actually, the increases were caused by the fact that many investors, including those from Mainland China, were optimistic about the outlook for future prices.

9. Apart from regulating the supply of land, another method that has long been used in Hong Kong to reduce the risk of bubbles in the property market is for banks to act as gatekeepers in preventing sharp increases in mortgage lending. The regulatory measures implemented by HKMA on 23 October that tightened the loan-to-value ratio for luxury

properties priced at HK$20 million or more to 60% serve this purpose. Some may argue that since many buyers of luxury properties are wealthy, they may not need to apply for mortgages and therefore the HKMA's measures may not have the expected effect. I agree that this would be the case if all property buyers used their savings and did not need to borrow from banks. However, I do not believe that none of the purchasers of luxury properties borrow from banks. Some buyers do not approach banks for mortgages because they still have time before completing the transactions, or because they do not intend to hold the flats for a long time. I also do not believe that the markets for small and medium-sized residential flats could have become so active without abundant credit from banks. I therefore believe that the prudential measures that we have taken and good risk management by banks will help stop asset-price bubbles from forming.

10. While banks will help to control the risks, members of the public and corporations in Hong Kong also need to be more alert. They should consider what they can afford and not borrow too much at a time when interest rates are so low to avoid getting into financial difficulties when interest rates rise again. But I can see that this is not easy. As hot money continues to flow into Hong Kong, it pushes the market higher. If this continues, people may get into a mistaken mindset that the market can only go up and overlook the risk that capital and hot would might one day reverse course without warning.

11. Finally, I would like to share with you an article I read last week. The article pointed out the differences between an asset-price bubble and a bull market. The author was of the view that people who don't manage to enter the stock market in time or don't dare to do so when the market has gone up will regard it as a bubble and will support the government taking measures to cool things down; but investors who have entered the market will see the increases as a bull market. Price increases can be interpreted in many ways. Well, a non-mainstream view like this may have some merit and, right or wrong, it illustrates the difficulty of dealing with asset-price bubbles, particularly the courage needed to make decisions at critical moments. Whether these decisions are correct or not is difficult to say with total confidence and certainty beforehand, and mistakes may be made. But we cannot avoid mistakes by not making decisions because the damage to society of an asset-price bubble is too great to ignore. And we should not just rely on the government to stop the bubble expanding. It requires the involvement of banks, corporations and individuals – they need to be more risk-conscious and self-disciplined. My colleagues at the HKMA and I will do our best, and I invite everyone to work hard together to meet the challenges brought about by the global financial tsunami.