Norman T L Chan: When markets fail

Speech by Mr Norman T L Chan, Chief Executive of the Hong Kong Monetary Authority, at the 6th Caixin Summit 2015, Hong Kong, 6 November 2015.

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1. The topic of my speech today ("When markets fail") is a little controversial as there are some who do not accept the premise that markets can fail. They believe that markets are capable of self-correcting and will eventually achieve the most efficient price discovery and resource allocation. However, I have some reservations about this notion because our experience tells a slightly different story. Markets do sometimes fail to perform their price discovery and resource allocation functions. In some more serious cases, market failures have even led to destabilising financial shocks and crises.

2. Indeed, the 2007–08 global financial crisis, which ravaged the US and Europe, clearly repudiates the general belief that market failures and financial crises will only occur in third world countries or underdeveloped economies. On the face of it, the bursting of the US property bubble triggered the collapse of the subprime mortgage market, which in turn led to the financial crisis in the US. However, if we look more deeply, we find that prior to the crisis, the banking and financial systems had been churning out a great number of subprime mortgage-backed securities. In addition, various derivative instruments using subprime mortgage-backed securities as underlying assets, like CDO^2 and CDO^3, added layers of risks like snowpack. The subprime mortgage crisis precipitated an avalanche that nearly buried many financial institutions with tremendous losses. Obviously, human greed was at play. But this was not a sufficient explanation. Human greed has always existed. Why then had the US financial market sleepwalked toward the brink of collapse? Whenever an asset or credit bubble forms, many bewildered market participants are often of the view that it will be different to previous bubbles, and that the market boom is well supported by fundamentals. "This time is different," so they say. In my view, the main cause of the market failure and near meltdown of the market was the collective failure of the various "safety valves" that maintain the orderly operation of the market. They include the internal risk control functions of financial institutions, the external discipline imposed by regulators and the ratings assigned by international credit rating agencies (CRAs), etc. In fact, it's worth noting that many of the subprime mortgage-backed securities and related credit derivatives rampant in the market at that time were assigned the highest AAA rating by the major CRAs. And, according to the general estimates of these agencies, the probability of default within a year for debt instruments with such a rating was near zero (0.000%); while the probability of default within five years was a mere 0.09%. Now, we all know that these CRAs were dead wrong. Many people, including professional and institutional investors, had a misplaced trust in these agencies and underestimated the risks involved. They learnt a painful lesson in 2008/09.

3. Of course, CRAs cannot be blamed for every market failure. Let's turn to the European sovereign debt crisis, the epicenter of which has been Greece. When Greece joined the eurozone in 2001, its sovereign debt rating was a mere A-. The market yield of its sovereign debts denominated in the Greek drachma in 1995 was about 17%. In 2003 after its accession to the eurozone, Greece had its credit rating upgraded slightly to A+, still not a very high rating. Yet, in the ensuing nine years or so, market players were particularly exuberant on the country's prospect and piled into Greek sovereign bonds without really taking into account its economic fundamentals, fiscal positions and sovereign rating. At one stage in 2005, the Greek sovereign bonds were traded at a spread of as low as eight basis points above the triple-A rated German Bunds. Looking back, this was essentially blind chasing of high risk investments by tens of thousands of market players and investors impervious to objective economic analysis and credit ratings. In the end, they suffered great losses. Furthermore, the capital market failed to price in a reasonable risk premium for the Greek sovereign debts, suppressing Greece's borrowing costs for a prolonged period of time.

This effectively encouraged a borrowing binge by Greece that ended up in the plight today. If the market had asked for a higher risk premium, the increase in borrowing costs might have sent a sobering message to the Greek government and its people to avoid overstretching themselves and therefore might have avoided a near breakdown of their economic and financial systems.

4. Hong Kong also experienced market failure in 1998, a year after the Asian financial crisis had severely hit a number of regional economies. Although Hong Kong managed to stand on its feet after the crisis, market confidence and sentiment were weak. International predators, with meticulous preparation and organisation, launched an attack on the Hong Kong dollar and our financial markets. They first discreetly borrowed Hong Kong dollars and waited for the right moment to profit by short selling the currency and attacking our Linked Exchange Rate System. At the same time, they built up substantial short positions in the stock and futures markets. These global predators also spread doomsaying through the Hong Kong media to stoke panic among Hong Kong people, creating an environment ripe for their short selling activities. The Hang Seng Index (HSI) dived 50% to 8,000 in August 1998 from 16,000 a year earlier and the predators boasted they would push down the HSI by another 50% to 4,000, which was an extremely low level. Aggregating the earnings of all listed companies, when the HSI was at 8,000, the price-earnings ratio was eight, and if the Index fell another 50%, the ratio would drop to just four. The Hong Kong SAR Government was facing a "double-play" by the predators – manipulation and profiteering in the money market and stock market through massive short-selling. It was a critical situation – not only were we confronted with a sharp fall in the stock market and great losses to shareholders, there were also systemic risks to our monetary system and financial markets. Classical economics does not differentiate between big and small markets and assumes that market prices will not be manipulated by just a few players. Reality, however, is different from theory. At that time, the market capitalisation of the Hong Kong stock market was only US$340 billion, a mere 3% of the New York stock exchange's US$10.3 trillion. The predators were unable and hence did not choose to make their move on the big US markets, but were able to plunder Hong Kong's mid-sized and open market with impunity.

5. However, on 14 August 1998, with the authorisation of the Hong Kong SAR Government and backed by the war chest of the Exchange Fund, the HKMA intervened in the stock and futures markets through market operation to counteract the double-play by international predators. When the market operation was completed by the end of August, the HKMA had used about HK$120 billion to acquire a vast amount of Hong Kong stocks, propelling the HSI from the pre-operation level of 6,700 points to 7,800 points.

6. The operation attracted harsh criticism from various quarters, with arguments that the Government's intervention to prop up the markets was contrary to the basic principles of a free market economy. Nevertheless, the operation has proven to be a success. During an extraordinary time of market failure, our resolute and extraordinary measures stabilised the Hong Kong dollar and the local stock and futures markets, restored confidence of Hong Kong people and investors, and helped preserve the stability of Hong Kong's financial system. But this is only half of the story; equally important is success in engineering a smooth exit. Our biggest challenge was to release the huge amount of Hong Kong stocks amassed during the operation to the market with minimal impact on market stability. This was no easy task. In a clear message issued promptly to the market when the operation ended, the HKMA made two pledges. First, the operation was only an extraordinary measure taken at an extraordinary time. The HKMA would arrange to dispose of the stocks as soon as possible. Secondly, the Hong Kong SAR Government would not intervene in the daily operations of the listed companies concerned through its shareholdings. We fully respect and uphold the clear division of labour between the public and private sectors under the market economy. Indeed, I can still remember that following the operation, my colleagues and I worked very hard on explaining at international forums and on other occasions the rationale behind the operation and our intention to start disposing of the stocks quickly. After much careful study and

planning for a year, the HKMA launched the Tracker Fund, an open-ended exchange-traded fund, in November 1999 and resold HK$33.3 billion worth of stocks to 180,000 investors. We continued to recoup over HK$100 billion in the next three years through the same mechanism. Ultimately, our market operation turned in a profit of nearly HK$100 billion at prevailing stock prices at that time.

7. The experience of Hong Kong clearly shows that market failures do occur. In the example I have just outlined, market intervention by the HKMA proved to be bold and effective in securing the safety and soundness of Hong Kong's monetary and financial system. It was, indeed, undertaken in a life-and-death but smokeless war on the financial front. Hong Kong prides itself on being one of the world's freest and most open markets. Nevertheless, as a much smaller market compared with our American and European counterparts, Hong Kong could fall prey to global predators, resulting in market failures. If the markets were allowed to plunge in free fall, the entire financial system might face a total meltdown. It was at such a critical moment that the Hong Kong SAR Government was left with no other option than to take unprecedented action. Today, with 17 years behind us, Hong Kong remains a free and open market and an international financial centre as before, and any lingering doubt has vanished. After all, "actions speak louder than words". The operation was an extraordinary strategy to deal with extraordinary circumstances. And, we delivered on our pledge to exit promptly and effectively. Over the years, we have drawn on this experience to further refine the Linked Exchange Rate System, enhance risk management and strengthen the resilience of our financial system.

8. Recently, our country has also been faced with the need of taking some extraordinary steps to stabilise the stock markets and guard against systemic risk. Any further measures by the Central Government and their effectiveness will be closely watched. In my view, if the Central Government can devise a robust exit mechanism as soon as market stability returns and continue to push through financial reforms, including liberalising the capital account and internationalising the renminbi – in other words demonstrating its staunch commitment to reform and liberalisation – it will be able to regain and reinforce confidence within the country and around the world in the market development and investment environment in China.

9. Thank you.