Mr. Yam gives a keynote address on the Hong Kong dollar link Keynote address by the Chief Executive of the Hong Kong Monetary Authority, Mr. Joseph Yam, at the Hong Kong Trade Development Council, Financial Roadshow in Tokyo on 3/3/98.

Introduction

1. I am honoured to be delivering the keynote address of this Financial Roadshow of Hong Kong. I shall, as you are aware, be talking about the Hong Kong dollar link. The Hong Kong dollar has been linked to the US dollar at a fixed exchange rate since October 1983. Notwithstanding what must be the worst financial turmoil in the history of Asia in recent months, and an abundance of events which might have undermined confidence on the Hong Kong dollar in the past fourteen and a half years of the existence of the fixed link, the exchange rate has remained very stable. Indeed, the Hong Kong dollar is one of the two major currencies in the Asian region that have not been affected by the recent tidal wave of devaluations, the other being the renminbi (RMB) of the Mainland of China. Furthermore, it is the only freely convertible currency in the region that has survived the turmoil unscathed.

2. There has been much scepticism expressed on the Hong Kong dollar's link with the US dollar over the years and in particular in the past few months when one after another the Asian currencies tumbled. Indeed, to some, the Hong Kong dollar increasingly sticks out like a sore thumb, but to others it is being seen increasingly as a pillar of stability in financial markets in the Asian region and an example of financial prudence. I hope you belong to the latter group of people rather than the former, but I fear that I may be expecting too much, for indeed it is quite natural when you do not have the chance to examine in detail an apparently controversial matter to be sceptical about it rather than to hang your faith in it. But my task today is, so to speak, to try and win you over.

Exchange Rate Policy

3. Let me start with Hong Kong's exchange rate policy. Here one is often attracted by the simplistic argument that Hong Kong, which prides itself as the freest economy in the world, should best operate with a freely floating exchange rate. I obviously do not subscribe to that view. Hong Kong, as you all know, is a highly externally oriented economy. Almost all our daily needs are imported, including for example the water from our tap at home and sand for construction. And almost all our manufactured products are exported. Furthermore, we are very much an entrepot, handling a large volume of re-exports[1], supported by the largest container port in the world. And our service industries are also very externally oriented, providing financial and other services for the region, in particular for the Mainland of China. The total value of our external trade in goods and services in a year is equivalent to well over 250% of our gross domestic product (GDP).

4. Businessmen engaged in these externally oriented economic activities would I am sure be acutely conscious of the currency risk arising from the many international transactions that they enter into. They would obviously prefer clarity and predictability in the exchange rates of the domestic currency against those currencies to which their business is exposed. They would, I am sure, prefer fixed exchange rates over floating exchange rates, unless they are in the foreign exchange business in which case it is understandable that they would prefer the greater volatility that comes with floating exchange rates. It is of course an uneasy feeling that profits might be eroded, or for that matter enhanced, by volatile exchange rates. One simply cannot plan one's business ahead properly with such volatility. Under the circumstances, prudent businessmen have no alternative but to hedge their currency exposures at considerable costs. It would clearly be beneficial for those conducting externally oriented business if currency risks could be eliminated by a fixed exchange rate system that has credibility. I believe this is why Europe has largely been operating with fixed exchange rates, the benefits of which are so clear that we shall soon see the unification of European currencies as the Euro comes into being. And I would be surprised if some of the Asian economies which floated their currencies recently are not regretting it. Indeed, there have been serious discussions to try and re-establish exchange rate stability by again fixing their exchange rates, possibly through the adoption of the currency board regime.

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[1] Re-exports totalled HK$1,245 billion in 1997, accounting for 85% of total exports of Hong Kong.

Economic Fundamentals

5. But obviously it takes a lot to establish credibility in a fixed exchange rate, or indeed any fixed exchange rate system. However, I believe that we have a highly credible fixed exchange rate system in Hong Kong. Our track record of exchange rate stability is an impressive one. This is against the background of sharp gyrations in the exchange rates of major currencies. The dollar/yen rate, for example, increased sharply in the mid-eighties to 263 in February 1985 before falling equally sharply over a short period to around 120 by the end of 1987, meanwhile triggering the worldwide stock market crash in that year. The sharp gyrations continued in more recent times, with the dollar/yen rate again falling to around 80 in April 1995 before increasing to 134 in January 1998. There was also the ERM crisis of 1992, which at the time brought sharp focus to the viability of fixed exchange rates; and there was the financial crisis in Mexico, which affected many emerging markets at the beginning of 1995. Then there is currently the worst financial turmoil in the history of Asia. On other fronts, there was also an abundance of events which could have affected confidence in the currency over the sensitive period of political transition leading to the resumption in the exercise of sovereignty over Hong Kong by China on 1 July 1997. But the Hong Kong dollar’s link with the US dollar has remained rock solid, with the exchange rate staying very close to the fixed level of HK$7.80 to US$1.

6. There are good reasons why our exchange rate has remained so stable against such eventful background. Hong Kong’s economic fundamentals are strong[2]. We pursue sound macroeconomic policies. We have an impressive track record of fiscal discipline[3]. In the last 14 years of the fixed exchange rate link, while most countries were grappling with fiscal deficits, Hong Kong has consistently run budget surpluses averaging 2% of the GDP per year. Our fiscal surplus in the financial year 1997-98 was 5.8% of GDP. As a result, we have over the years built up strong fiscal reserves. These are deposited with the Exchange Fund which holds the foreign reserves of Hong Kong, including those backing the issue of our currency. As at the end of 1997, Hong Kong’s foreign reserves stood at US$92.8 billion, which was the third largest in the world after Japan and the Mainland of China, providing not just 100% backing, but nearly 800% backing for the currency[4].

7. Moreover, the structure of Hong Kong’s economy is flexible and efficient, encouraged by a small government[5] with a strong commitment of public policy towards free markets. This enhances Hong Kong’s resilience in absorbing external shocks and its ability to adjust quickly. The best example is the labour market. Owing to massive relocation of manufacturing processes across the border to the southern part of the Mainland of China, employment in the manufacturing sector had declined by nearly 65 percent from 870,000 in 1986 to 310,000 in September 1997. In most economies, one would have seen a jump in structural unemployment and much politicized demands for government intervention. But not in Hong Kong. In fact, the labour market is so flexible and efficient in relocating workers to the service industries[6] that the unemployment rate in Hong Kong has remained low throughout at between 2 and 3 percent.

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[2] During the past 14 years under the linked exchange rate system, the Hong Kong economy achieved an average annual growth rate of 6.1% in real terms. Inflation rate, measured by Consumer Price Index (A), averaged 7.5% during this period. In the tradable goods sector, inflation was more subdued, with the unit price of exports rising by around 2.2% per annum. The unemployment rate stayed at a low level of 2 to 3% throughout the period.

[3] This has further been enshrined in Article 107 of the Basic Law which specifies that “the Hong Kong Special Administrative Region shall follow the principle of keeping expenditure within the limits of revenues in drawing up its budget, and strive to achieve a fiscal balance, avoid deficits and keep the budget commensurate with the growth rate of its gross domestic product.”

[4] The amount of foreign reserves as at end-1997 at US$92.8 billion was equivalent to 7.8 times the amount of currency notes and coins in circulation, 7.1 times the monetary base, 3.8 times Hong Kong dollar M1, 54% of GDP or 15 months of retained imports.

[5] Public expenditure, which comprises total government expenditure and expenditure by public sector organizations, currently accounts for only around 18% of GDP.

[6] Employment in the services sector rose from 1.1 million workers in 1986 to almost 1.8 million in September 1997, absorbing more workers than the job losses incurred by the contraction of the manufacturing sector during the period.

8. Hong Kong's robust financial system has also provided an important foundation for exchange rate stability. We have seen many examples in which the maintenance of a stable exchange rate has been undermined by a fragile financial system. Examples include the Mexican peso crisis in 1994 and the recent currency turmoil in Asia. In Hong Kong, however, we have a robust monetary management mechanism, a modern system of prudential supervision and a sophisticated financial infrastructure. Our banking system, for example, is strong, with the capital adequacy ratios of locally incorporated banks averaging around 17% and problem debt ratios of less than 2%. Although the irrational exuberance that has been a feature of asset markets in the Asian region was also present in Hong Kong, prudent risk management practices have enabled our banks to absorb the inevitable asset price deflation that has occurred as the contagion of financial turmoil spread in the Asian region[7].

9. The prudent behaviour of our banks has also encouraged prudent business practices generally. There is, in the non-bank sector of Hong Kong, much less of a maturity mismatch in borrowing short-term money to make long-term investments and a currency mismatch in borrowing foreign currency without foreign currency income. These are some of the tragic errors responsible for the dire state that some of the Asian economies have now found themselves in. Furthermore, with the benefits of financial liberalization creating an euphoria that regrettably encouraged neglect on the need to build a robust financial system in order to cope with the associated volatility in financial flows, it seems inevitable, at least with the benefit of hindsight, that there could be tremendous pressures on their currencies. Not so for Hong Kong, already with a long history of liberalized markets and the absence of any forms of exchange control. We have learnt our lessons in the early eighties and have been meticulous in building ourselves a robust financial infrastructure and continuously upgrading it. We even managed to do so, in certain issues, ahead of time rather than catching up in a crisis induced situation. Yes, there were still business failures - indeed this is an inevitable feature of free markets - but there is little moral hazard for the public sector. Yes, there were still cracks showing up in unregulated areas that require mending, for example recently in equity margin financing, but nothing of a systemic nature or of any threat to the stability of our currency.

10. These strong economic fundamentals of Hong Kong also do not require Hong Kong to get involved in the process of competitive devaluation of currencies recently seen in the Asian region. In the second half of 1997, the Thai baht depreciated by 49%, the Indonesian rupiah by 56%, the Korean won by 48%, the Malaysian ringgit and the Philippine peso both by 35%. Even the relatively strong economies of Taiwan and Singapore had allowed their currencies both to depreciate by 15%. Notwithstanding this, the Hong Kong economy is still expected to grow in 1998 by 3.5% in real terms. Although this is somewhat below the growth rate of 5.2% recorded in 1997, it is a highly respectable growth rate in the light of the circumstances that we face in the Asian region and is higher than most of the economies in the region that have devalued their currencies. Most developed economies would be delighted to achieve such a growth rate in 1998. The slowdown is also considered healthy, given a degree of irrational exuberance seen in asset markets in the past couple of years. Indeed, inflation this year will slow down further to 5% from 5.8% in 1997, with the unemployment rate staying low and the current account remaining broadly in balance. Thus the Hong Kong economy will not be too much affected by the devaluation of the exchange rates of our competitors. This is understandable for a highly service-oriented economy which Hong Kong now is[8].

One Country, Two Currencies

11. Perhaps I should digress a little here and address a related issue which has been the subject of some attention, with considerable apprehension amongst observers. This concerns whether the currency of the Mainland of China, the RMB, would be forced into devaluation by the Asian financial turmoil and if so what would be the implications for the Hong Kong dollar's link to the US dollar. The Chinese

[7] As an illustration, residential mortgage loans, which account for roughly 25% of total domestic loans extended by the banking sector, have been of very high quality, helped by the prudent lending policy of the banks, including for example a maximum loan to valuation ratio of 70%. As at the end of September 1997, the actual average of this ratio was only 52%. The delinquency ratio, measured by loans overdue for more than 90 days as a percentage of total outstanding loans, stood at only 0.1% as at end-September 1997. Even during the property downturn in the second half of 1994 and 1995, the delinquency ratio remained low, at around 0.2%.

[8]8 The contribution of the services sector to GDP is now about 85%.

leaders have clearly and repeatedly said that the RMB will not be devalued[9]. The cynics would of course immediately remind us that in the monetary history of the world, devaluations of currencies were frequently preceded by strong denials and that these matters are determined by market forces and not the words of government officials. But I hope the cynics would also spend a little time to look at the facts.

12. First, there are still capital controls in the Mainland of China. That makes the control of the exchange rate much easier. Indeed, the foreign exchange market in the Mainland of China is dominated by one large player sitting on about US$140 billion of foreign reserves and that is the State Administration of Foreign Exchange (SAFE) of the People's Bank of China (PBoC). One simply cannot take a short position against the RMB and so technically the RMB is not exposed to speculative attacks.

13. Second, there are political and policy considerations for the Mainland of China to refrain from involving itself in competitive devaluation. A devaluation of the RMB would risk creating trade friction, particularly with the United States given that the trade surplus of the Mainland of China with the United States has risen to almost US$50 billion in 1997, very close to Japan's trade surplus with the United States at US$55.7 billion. On the multilateral front, a devaluation may also undermine China's re-entry to the World Trade Organization because it could be seen as a move to gain undue competitive advantage and increase its trade share. It would also be highly destabilizing for the currencies and financial markets of the Asian region, including those of Hong Kong which the Mainland is very keen to avoid. It could even be destabilizing for financial markets beyond the region, and all this would inevitably in the end impact on the Mainland of China itself. A devaluation would also adversely affect the flow of foreign direct investments into the Mainland and renew inflationary pressures, which would be a pity after winning the tough battle against inflation in the past three years[10].

14. Third, there are other less risky and more effective means of maintaining competitiveness. Continuing reform of the state-owned sector, confirmed by the decision of the Party Congress in September 1997, unleashing the powerful forces of the market, will achieve more efficient allocation of resources and enhance productivity of the economy. There is also continued trade reform[11], liberalizing import barriers and cutting import tariff rates on more than 4,800 product categories by over 26% effective from 1 October 1997. The reform of export tax rebates will also benefit exporters. Continuing efforts to strengthen financial markets and the financial infrastructure[12] will enable more effective financial intermediation and promote economic growth and development.

15. Fourth, in any case, the competitiveness of the Mainland of China is based on broader structural factors including underlying factor costs, market leadership and the trade policies of major importers. Even after the marked depreciation of Asian currencies, labour costs in the Mainland of China is still lower than most of Asian economies, perhaps with the exception of Indonesia[13]. And there is in China a continued access to a huge labour pool made up of redundant state sector workers and surplus labour in rural areas. The effect of devaluation on the manufacturing costs in the Asian economies, on the other hand, are

[9] Chinese Vice-Premier Mr Zhu Rongji said on 14 January 1998 that 'the renminbi will be maintained at a stable rate.... it will not be devalued'. Governor of the People's Bank of China, Mr Dai Xianglong, reiterated this on 16 February 1998.

[10] Based on the Mainland's consumer price index, inflation declined from 24.1% in 1994 to 2.8% in 1997 and, based on the retail price index, from 21.7% to 0.8%.

[11] According to European Union (EU) Trade Commissioner Sir Leon Brittan who led an EU team to visit Beijing in February 1998, China had promised to submit to the WTO in March 1998 detailed tariff cuts as part of its bid to re-join the trade body.

[12] The General Bank Clearance Centre was established by the PBoC in December 1997 to help prevent financial risks and maintain a stable payment order. The PBoC has also abolished credit quotas for working capital loans for all state-owned commercial banks since January 1998. Besides, in a banking conference held at that time, PBoC Governor Dai Xianglong highlighted four major banking reform directions, namely reorganizing the PBoC's branch network, streamlining commercial bank operations, converting co-op banks into commercial banks and cleaning up non-performing loans.

[13] Based on Goldman Sachs and World Bank's studies, the estimated total worker compensation (i.e. wages plus social security benefits) per week in the manufacturing sector in 1998 is US$30 for China, US$21 for Indonesia, US$71 for Malaysia, US$47 for the Philippines, US$56 for Thailand, US$244 for Korea and US$329 for Taiwan.

likely to be offset by higher inflation, higher costs of imports and higher interest rates. China has also established market leadership in a variety of products in world markets. It is difficult to see this dominant position being significantly eroded, particularly with the existence of international trade barriers which limit the extent of the possible shift of export orders from China to other Asian economies.

16. Fifth, the economic fundamentals of the Mainland of China are strong. Economic growth in 1998, forecasted to be 8% in real terms, is only a shade below the growth rate of 8.8% achieved in 1997. Furthermore, inflation is expected to be below 3%. Last year, the Mainland of China ran a trade surplus of US$40 billion, equivalent to 4.5% of GDP. Foreign direct investment amounted to US$45 billion. Its foreign reserves are the second highest in the world. Its foreign debt amounted to only about 14% of GDP and consisting of mostly long-term loans from official sources such as the World Bank and the Asian Development Bank, and the debt service ratio at well below 10% of exports. The fiscal deficit in 1997 was small at below 1% of GDP and the monetization of such deficits is now prohibited. My contacts in Beijing have told me that even on the basis of very extreme assumptions with the amount of foreign direct investments and the growth rate of exports being halved in 1998, there will still be a balance of payments surplus. In the circumstances there really is no pressure to devalue the RMB.

17. The stability or otherwise of the RMB, understandably, would appear to some observers to have implications for the Hong Kong dollar's link with the US dollar, particularly given the economic closeness between Hong Kong and the Mainland of China. But this does not necessarily mean that the Hong Kong dollar will need to move in sync with the RMB, in the highly unlikely event that the RMB is devalued. The Hong Kong dollar is linked to the US dollar and not to the RMB. The economic relationship has always been very close between Hong Kong and the Mainland of China. There has always been separate currencies for Hong Kong and the Mainland, and "one country, two currencies" is further enshrined in the Basic Law governing Hong Kong for 50 years after the resumption of sovereignty[14]. The many differences between Hong Kong and the Mainland of China argue for monetary segregation and not monetary union. In 1994 when measures were taken in the Mainland to unify the official and market exchange rates for the RMB, involving a de facto devaluation of the RMB of 33% on an unweighted basis and 7% on a weighted basis.[15] But this did not affect the Hong Kong dollar at all. So why should a devaluation in the exchange rate of the RMB, which in any case has been ruled out by the Chinese leaders, affect the stability of the Hong Kong dollar's link to the US dollar now or in the foreseeable future?

The Currency Board System

18. Technically, the Hong Kong dollar's link to the US dollar is a very strong form of fixed exchange rate system which is called, in academic terms, a currency board system. It is quite different from the pegged exchange rate system that is more widely known and which requires active intervention in the foreign exchange market by the central bank to keep the exchange rate within pre-determined levels. By contrast, a currency board system does not require this type of foreign exchange market intervention. Instead, it requires the monetary base, defined in the case of Hong Kong as the amount of Hong Kong dollar bank notes issued and the Hong Kong dollar clearing balance of the banking system held with the Hong Kong Monetary Authority (HKMA), to be fully backed by US dollars at a fixed exchange rate[16]. In other words,

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[14] Article 111 of the Basic Law provides, among other things, that "the Hong Kong dollar, as the legal tender in the Hong Kong Special Administrative Region, shall continue to circulate".

[15] As a matter of fact, in the fourteen and a half years since the Hong Kong dollar's link was established in October 1983, the RMB has depreciated by a total 76% against the US dollar.

[16]16 Insofar as the banknotes are concerned, since the inception of the linked exchange rate system in October 1983, the issue and redemption of bank notes, through the note issuing banks, are required to be made against US dollars at the fixed exchange rate of HK$7.80 to US$1. However, at the time when the linked exchange rate system was introduced, there was no institutional arrangement whereby banks in Hong Kong maintained clearing accounts with the currency board. This situation was rectified in 1988 through the so-called Accounting Arrangements which required the Hongkong and Shanghai Banking Corporation Limited, as the Management Bank of the Clearing House of Hong Kong Association of Banks, to maintain a clearing account with the then Monetary Affairs Branch of Government for the account of the Exchange Fund. Thus the monetary base was only clearly defined then. The Accounting Arrangements were subsequently replaced by another arrangement, on the occasion of the introduction of Real Time Gross Settlement for interbank transactions in Hong Kong

any change in the monetary base has to be matched by a corresponding change in the amount of US dollar reserves held by the HKMA, and the change brought about by the HKMA rather passively converting Hong Kong dollars in the monetary base into US dollar reserves and vice versa at much the initiative of the banks.

19. The advantage of such a requirement is that whenever there is capital outflow, which would take the form of the sale by the banks of Hong Kong dollars to the HKMA for US dollars at the fixed exchange rate, there will, on settlement of the deals, be a shrinkage of the clearing balance of the banking system. This will lead to Hong Kong dollar interest rates in the interbank market increasing. The greater the outflow, the larger will be the fall in the clearing balance of the banking system and the higher will be the interest rates in the interbank market. And this process is very much an automatic one which does not require the exercise of discretion on the part of the HKMA. There is no active foreign exchange market intervention as such, and certainly no money market operations for recycling Hong Kong dollars sold to the HKMA when there is capital outflow; or sterilization of Hong Kong dollars passively provided to the market by the HKMA when there is capital inflow. Even until now, after we have been operating such a system successfully for over fourteen years, this technical strength of our exchange rate system and the important technical distinction from other fixed exchange rate systems are still not very widely appreciated. But I cannot really blame the uninformed. Perhaps we have not done enough to keep them informed on these admittedly rather esoteric monetary issues.

20. And the situation is not helped by ourselves also armed with the usual central banking armoury of being in a position to exercise discretion to influence monetary conditions in the interbank market by virtue of the fact that we run the interbank clearing system and therefore also serve as the lender of last resort in facilitating day to day interbank clearing. There has been some concern that the HKMA might then be subject to political influence to exercise discretion and use the central banking armoury to create money in order to relieve the interest rate pain and in the process undermine the credibility of the currency board arrangement itself. Whilst this is a legitimate concern, given the experience in other monetary systems, the situation in Hong Kong is actually quite different. For as long as the monetary policy objective is exchange rate stability within the framework of a currency board system, the additional armoury available to the HKMA, the authority of which was derived from the same legislative foundation for the currency board system, cannot be used in a manner inconsistent with the objective of the currency board itself. In other words, it is arguably ultra vires for the HKMA to conduct money market operations or other market activities contrary to the objective of the maintenance of exchange rate stability. This is a legal nicety which is again not well appreciated.

21. The events leading to the sharp interest rate increase seen on one day last October illustrate quite clearly how our system works. There was substantial capital outflow earlier that week, caused by people taking a short position in the Hong Kong dollar and sparked off by Taiwan allowing its currency to depreciate in order to maintain its export competitiveness[17]. The outflow caused the clearing balance of the banking system to shrink sharply, in accordance with the discipline of the currency board system, as the banks sold Hong Kong dollars to the HKMA for US dollars. There was in fact not enough Hong Kong dollar in the clearing accounts of the banks to effect settlement with the HKMA. So many banks were bidding for money that, collectively speaking, did not exist in the interbank market. As a result, the interest rate for overnight money shot up to almost 300%[18]. Contrary to press reports and comments from analysts, the high interbank interest rates were the making of the banks themselves and not the result of the HKMA squeezing

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towards the end of 1996, requiring all licensed banks to maintain a clearing account with the HKMA for the account of the Exchange Fund. In operating the Accounting Arrangements (1988 - November 1996) and the settlement accounts (since December 1996), the Monetary Affairs Branch and subsequently the HKMA have ensured that the whole of the monetary base is subject to the discipline of the currency board arrangement.

[17] On 17 October 1997, Taiwan's central bank vice governor Liang Cheng-chin said there was "no need for the central bank to intervene" and it was "the right time" to let market forces determine the Taiwan dollar rate." As a result, the Taiwan dollar closed 3.3% lower at T$29.5 per US dollar on that day.

[18] This was only for about an hour on 23 October 1997. When speculative shorting of the Hong Kong dollar was quickly reversed, the overnight interbank interest rate came down quickly and closed at 100%-150% on 23 October and further to 7% on 24 October.

the money market. We were just sitting there passively, on settlement day, waiting for the banks to give us the Hong Kong dollars that they had sold to us - Hong Kong dollars that they did not have.

22. In the circumstances, the banks had only two alternatives. First is for them to borrow Hong Kong dollars from the HKMA at the end of the settlement day, through the Liquidity Adjustment Facility (LAF), Hong Kong's version of a discount window. This would obviously not be cheap, particularly for repeated borrowers, as the HKMA is not in the business of providing cheap Hong Kong dollar funding to those shorting the Hong Kong dollar. And this would only be for overnight money. Second is for the banks to obtain Hong Kong dollars more permanently from the HKMA by selling US dollars back to the HKMA, which the HKMA again takes passively in accordance with the discipline of the currency board system. This is exactly what happened on 23 October 1997 and the speculative capital outflow then was as quickly reversed as it had started, in a matter of only two days, with the system operating very much on auto-pilot.

Interest Rates

23. But it had taken a little time for interbank interest rates for term money to come back down, notwithstanding the fact that the crucial part of the monetary base, as represented by the clearing balance of the banking system, has in fact returned to a level which is a lot higher than before the speculative attack and that the HKMA had been accumulating more foreign reserves in the process[19]. I would attribute this to market sentiment being affected by the continuing financial turmoil in the region. There is now clearly an Asian premium in the interest rates for Asian currencies and Hong Kong, notwithstanding our currency having remained very stable throughout, is not immune. This Asian premium will remain, for as long as financial turmoil in the region lingers on and with uncertainties in the financial system of Japan looming large in the background.

24. The higher interbank interest rates for the Hong Kong dollar could also be attributed to a realization on the part of the banks of the need to be a lot more careful in their funding strategies. On the one hand, they might have mistakenly provided cheap funding to finance speculative shorting of the Hong Kong dollar by their customers. In doing so they put themselves in a difficult position when the interbank market tightened to beyond their expectations implicit in the pricing of their lending to the speculators. On the other hand, the contagious nature of financial turmoil with globalized financial markets is such that the possibility of further attacks on our currency, unsuccessful as they inevitably would turn out to be, could not be dismissed. The banks have therefore been somewhat reluctant to lend longer term money in the interbank market since the October shock, even though they are flushed with liquidity, as reflected by the clearing balance of the banking system being at a high level. This perhaps reflects a lack of depth in the debt market which we have been separately trying to address. As a result, while the short term interest rates of the Hong Kong dollar, for example for overnight money, have fallen to quite low levels, significantly below corresponding US dollar interest rates, the yield curve has become sharply upward sloping, with one-month and longer term money commanding a significant premium over corresponding US dollar interest rates.

25. But I believe the Hong Kong dollar yield curve will in time flatten further, as it has done so after the sharp hike on 23 October 1997. There will, nevertheless, be occasional jumps, as sentiment continued to be affected by events in other economies in the region and possibly beyond. Interestingly, the higher interest rates have been attracting some inflow of funds into the Hong Kong dollar, as investors took advantage of the higher return and as borrowers chose to finance their activities by raising US dollars and switching them into Hong Kong dollars, being comfortable about a little currency mismatch given our strong commitment to the link with the US dollar. As a result, Hong Kong's foreign reserves have continued to

[19] Foreign currency assets as at end of: US$ billion

June 1997	82.9
July 1997	81.7
August 1997	85.3
September 1997	88.1
October 1997	91.4
November 1997	96.5
December 1997	92.8
January 1998	98.1

grow, contributing further to the easing of Hong Kong dollar interest rates at the longer end of the yield curve.

Pain of Adjustment

26. There is no doubt, however, that the discipline of the currency board system requiring rather harsh adjustments through interest rate changes means that there are innocent parties who may rather unfortunately be affected. I am conscious of the plight of, for example, the businessmen who happened to have interbank rate related loans due for interest rate fixing on 23 October 1997, or the home mortgage payers who have now to live with a mortgage rate, after two increases, which is 150 basis points higher than before, or those who have been investing their life long savings in the stock market, the property market and other asset markets, seeing these markets fall under the influence of higher interest rates. Although some consolidation has been overdue in these asset markets which had overshot as a result of irrational exuberance, when they do fall sharply our exchange rate link with the US dollar inevitably would be blamed as the culprit, at least when everybody was in the heat of it all.

27. Thankfully, it is perhaps in the nature of human beings that even the innocent parties who were unfairly hurt are capable of appreciating the big picture and rationally assessing what the alternative might be. Interest rate volatility is the price to pay for a stable exchange rate. Clearly it would not be in their interest for Hong Kong to get involved in the process of competitive devaluation of others in the region and suffer even higher interest rates. And why should we, given that our competitive position, as very much a service oriented economy, is not really very sensitive to exchange rate changes? The currencies of the Asian economies, other than the Mainland of China, have recently been on a free fall. I am sure even the International Monetary Fund (IMF) is surprised by the extent of the devaluation seen in the Asian currencies after they were floated.

28. All concerned might have underestimated the effect of a general realization of the need for hedging when a currency moves from a fixed exchange rate system into a floating exchange rate system. It has now become quite clear that there has been overshooting in the depreciation of some of the Asian currencies. It must be doubtful if these very large depreciations are necessary for correcting the imbalances in these economies. There are economic and financial problems that needed to be put right, but the plunge in their currencies and asset markets seems excessive. I believe the people of Hong Kong realize this. They realize that the implications for Hong Kong of a break in the linked exchange rate system are clearly a lot worse than the rather short term pain that they have had to bear and which is now hopefully easing. By contrast, the pain of economic adjustment that some of the Asian economies have to go through is much greater, is now only beginning to be felt and likely to last for some time.

29. I believe, however, that the ability of the Hong Kong economy to tolerate the pain of adjustment could be enhanced, thereby further strengthening the robustness of the currency board arrangement. First, the risk of interest rate volatility, particularly for the innocent parties, could be alleviated by the promotion of fixed rate borrowing as a matter of consumers' choice. Clearly those on fixed rate mortgages would not be affected by hikes in short term interest rates. There is hitherto a lack of long term fixed rate funding for banks and so mortgages are predominantly arranged at floating rates. Here the newly formed Hong Kong Mortgage Corporation does have an important role to play. The Corporation should not have any difficulty in raising long term fixed rate funds from the market, particularly with the forthcoming institutionalization of savings through the establishment of a Mandatory Provident Fund scheme. Second, the HKMA will continue to reinforce successful efforts in the past to ensure that the banks in Hong Kong are in a position to manage prudently their risks, having regard to the special circumstances of Hong Kong's currency board system, and pay special attention to the quality of their assets so as not to be overly exposed to those which are vulnerable to interest rate volatility. A consultant study on the future development of the banking system of Hong Kong covering this aspect, amongst others, is to be conducted in the near future.

Support for the Link

30. There is wide support amongst the community of Hong Kong on the exchange rate link. In early December last year an opinion poll carried out by one of our leading newspapers reported that only seven percent of the people of Hong Kong think that our link with the US dollar should be broken. Seventy-

one percent think that it should be kept and twenty-two percent express no opinion[20]. This degree of public support - support from those having Hong Kong dollar assets - is crucial to our success in maintaining the exchange rate link, whereas the sceptical views of those without Hong Kong dollar assets are rather irrelevant.

31. The authorities in the Mainland of China, whilst repeatedly emphasizing that the responsibility for monetary policy in Hong Kong is for Hong Kong, in accordance with the principle of "one country, two systems", have also expressed unequivocal support for the Hong Kong dollar's link to the US dollar. There is a standing offer for extending help, if help is required, in the use of the Mainland's foreign reserves. There is also a clear commitment of not devaluing the RMB, with full and convincing economic justifications in their own right, but also out of concern on the possible adverse psychological impact on the Hong Kong dollar's fixed link with the US dollar.

32. But we obviously should not be complacent. Typically in financial markets there are inevitably those who feel that a doomsdayish forecast will bring them headline attention, without bothering too much about the facts. And as always responses from officials supported by hard facts are given only very little attention. But we shall continue to stick firmly to our policy, as we did in the past fourteen years, without wavering. We did so through an abundance of events, including the stock market crash in 1987, the events in the Mainland of China in June 1989, the collapse of BCCI in 1991, the ERM crisis in 1992, Mexico in 1994, Barings in 1995 and now financial turmoil in Asia, and every time the Hong Kong dollar remained rock solid.

33. We are also acutely aware that the credibility of our exchange rate policy is quite crucially dependent upon our ability to pursue sound economic policies. This we do with vigour and determination, to the satisfaction of many with a keen interest in our affairs, including the IMF who year after year gives us a clean bill of health in its annual Article IV Consultations on Hong Kong. They were in Hong Kong for the 1997 Consultation towards the end of October 1997 and witnessed the after effects of the currency attack. And the report was full of praise on how we handled the situation, which is to me quite comforting, in contrast to the criticisms then from all sides which had been heaved at the HKMA for inflicting too much pain in our defence of the currency. Little do these critics know, as I explained to you earlier, that our system operates on auto-pilot without the need for the HKMA to exercise discretion in intervention in either the foreign exchange or the interbank markets. This the IMF concurred and in its report said specifically that "it is important to recognize that allowing interest rates to rise in response to exchange market pressures is an essential element of the currency board mechanism that lies at the heart of Hong Kong's monetary arrangements. Recent events demonstrate that the system is working exactly as intended ...."[21]

Review of Currency Defence

34. We have also been prudent over the years in strengthening our monetary system through a series of monetary reform measures. These were not crisis induced, but were put together in quiet times after careful consideration and consultation. I would not wish to bore you with further technical details, other than to say that these reform measures implemented in the past ten years, inconspicuous they might be at the time of introduction, have each proven to be most useful and effective in ensuring the stability of our currency under rather stressful conditions.

35. Notwithstanding this, we have taken advantage of the occasion arising from the currency attack last October to conduct yet another review of our currency defence to see if there is still room for improvement. We have met with many of those who have a keen interest in this area, including the academics, the analysts and the bankers. And I have personally been in correspondence with the IMF and a couple of Nobel Laureates. The review was completed in January this year. I am pleased to say, first of all,

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[20] The poll was conducted by Asian Commercial Research Limited and its results were published in Sunday Morning Post on 7 December 1997.

[21] Concluding Statement of the IMF Article IV Consultation Discussions with the People's Republic of China in respect of the Hong Kong Special Administrative Region dated 4 November 1997.

that there was unanimous support on the Hong Kong dollar's link with the US dollar. No one thought that it should be abandoned. And we have received a few suggestions on how we should improve upon the operation of our system. We welcome these discussions which have sharpened our own thinking in the process of debate and analysis. Whilst one or two of these idea may have some psychological but possibly only short term value, they also carry considerable downside risks of undermining confidence in a well tried system. I am also pleased to say, therefore, that we have indeed been quite thorough in our monetary reform in the past ten years.

(a) Role of interest rates

36. One school of thought promoted by a group of academics in Hong Kong with specific proposals for various schemes, which I must confess I have found difficult to appreciate, seems to be based on the notion that one could maintain stability in both the exchange rate and the interest rates at the same time. No matter how these schemes are dressed up, involving insurance products, guarantees, options or other fancy derivatives of one type or another, I fear that they have very little likelihood of success. Keeping interest rates artificially down when there is capital outflow amounts to providing cheap funding to those who are shorting the currency. It requires massive intervention in the forward market or a contingent commitment of foreign reserves that even those with very large foreign reserves would find the situation difficult to hold. It also sends a clear message that one is not prepared to bear the interest rate pain. It is a demonstration of weakness and the lack of resolve in the defence of the currency. This was the case in 1992 when sterling departed from the ERM. This was also the case I believe in the troubled Asian economies when they intervened both in the forward market as well as the spot market.

37. The academics have, in this connection, further argued that the contingent liability arising from these derivatives can be contained by limiting the amount involved and possibly also by suitable pricing mechanisms for such derivatives. But the fact of the matter is that the limited supply of such derivatives would benefit only those with access to the product and that there will be irresistible political demands for supplying it to all - speculators, those with a genuine need to hedge and the man on the street. Where would this end? More likely in misery than greater confidence in the currency link. The pricing of the derivative product is also a tricky issue. If one allows the free market to price the product, by auction or by tender, chances are that the price would reflect the market interest rate differential between the Hong Kong dollar and the US dollar, which would defeat the original purpose of the product of trying to dampen the interest rate pain. If alternatively the pricing of the product is administratively determined, thus involving a subsidy, then the difficulty is again to target equitably a group of beneficiaries entitled to the comfort afforded by that product.

38. We have, as part of our review, invited the IMF also to look at these schemes suggested by the academics. The response from the IMF confirmed our reservations. The best guarantee that the link will not be changed is for us to stick to our guns and not to invent fanciful derivatives which may have the political and psychological attraction of ourselves "putting money where the mouth is", while really what it means is that the credibility of a simple, rule-based and well tried system could well be undermined to the detriment of Hong Kong.

(b) Liquidity Adjustment Facility

39. Another area of controversy arising also from discussions with the academics concerns whether the HKMA should lend to banks at the end of the day through the LAF. They identified this practice as the HKMA playing the role as lender of last resort whereas it is merely a lender of convenience so that banks can settle interbank payments outstanding at the end of the day. The HKMA runs a real time interbank payment system in which each of the 180 licensed banks in Hong Kong maintains a clearing account with the HKMA to effect the settlement of interbank transactions. It is one of the most robust interbank clearing systems in the world, and is a very important piece of financial infrastructure contributing greatly to financial stability in Hong Kong. But in running the system, the HKMA cannot avoid lending to the banks at the end of the day to effect what are really residual interbank payments. But in providing such liquidity money is created in the form of a larger overnight balance of the banking system that appears not to be directly matched by an increase in the holding of foreign reserves by the HKMA.

40. However, the manner in which this “last resort” liquidity is provided does not involve any real conflict with the discipline of the currency board system. Lending through the LAF is organized largely through a repo arrangement of paper issued by the HKMA[22]. Such paper, in the form of Exchange Fund Bills and Notes, are liabilities of the HKMA which are fully backed by foreign currency assets. The HKMA runs an Exchange Fund debt programme involving the issue of debt instruments of maturity from three months to ten years. The proceeds of such issues have largely been switched into foreign currency assets. In any case, with a real time payment system, overnight lending in the term of repos through the LAF, though essential, is infrequent and the money is to be repaid the first thing in the following morning. Further, the HKMA discourages the repeated use of the overnight facility by charging repeated borrowers, which is clearly defined, very penal interest rates[23].

41. Were the HKMA to suspend the operation of the LAF, interbank interest rates would be even more volatile as banks, in the case of capital outflow, scrambled for liquidity which may not be there. In the end, transactions could not be settled, creating chaos in the interbank market which would in turn damage confidence on the banking system as a whole. This is the reality of modern day finance that we all have to accept and monetary authorities have a responsibility to guard against.

(c) The auto-pilot trigger

42. Yet another area of controversy concerns the exchange rate level at which the HKMA passively buys or sells US dollars against the Hong Kong dollar balances in the clearing accounts of the banks in accordance with the discipline of the currency board system, thus triggering the auto-pilot adjustment mechanism. There seems to be three alternatives. First is for the HKMA to do so passively always at the fixed exchange rate of HK$7.80 to US$1. This is the most transparent alternative. But the effect of this is that all Hong Kong dollar against US dollar transactions will then be conducted with the HKMA, thus on the one hand killing off the foreign exchange market in Hong Kong and on the other hand generating much greater volatility in interest rates as the liquidity in the banking system changes along with each and every one of such transactions done with the HKMA.

43. Second is a variation of the first alternative by introducing a spread around the fixed rate of 7.80 amounting to, say, half a percent or one percent or whatever, by which the HKMA would passively buy or sell US dollars against the clearing balance of the banking system. This alternative is also transparent and allows an exchange rate range within which the foreign exchange market would function freely. But it creates identifiable targets for currency attacks which is undesirable. Every time the exchange rate trades near the upper or lower limits, perhaps even only for seasonal reasons, there may be speculative position taking against those limits.

44. The third alternative, which is the current practice, is to leave the foreign exchange market alone under normal circumstances but for the HKMA to establish its passive presence only when exchange rate instability is detected, for example, when there is a currency attack as in the case of October last year. The HKMA would do so at a level of defence, which would of course be close to 7.80, considered suitable by the HKMA in the light of prevailing market conditions. There is therefore an element of “constructive ambiguity”. This approach is arguably less transparent but I am not in favour of showing all my cards to speculators. Furthermore, it is very much in accordance with Hong Kong’s free market philosophy that the foreign exchange market be left very much alone. I therefore see no reason why our approach should be changed.

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[22] The HKMA also accepts certain high quality private sector debt securities as eligible securities for Repo under LAF. However, the interest rate charged by the HKMA on LAF Repo involving those private sector paper is set at 25 basis points above that for the Repo of Exchange Fund Bills and Notes. Private sector debt securities normally accounts for less than 10% of LAF Repo activities.

[23] To improve market order and remove uncertainty towards the banks’ access to the LAF, the HKMA issued a circular to banks on 12 November 1997 clarifying the definition of “repeated borrowers” upon which a penal rate may be charged on LAF borrowing. “repeated borrowers” are defined as those licensed banks which have borrowed through LAF on eight occasions in any period of 25 days or on four consecutive days in which LAF is open.

(d) The exercise of discretion

45. It is obvious that, even after so many years of operating the exchange rate link under the currency board arrangement, the rationale behind the HKMA's occasional presence in the foreign exchange and money markets, whether or not involving the exercise of discretion in the use of its monetary armoury, does not seem to be clearly understood. Certain of its actions in the markets have been subject to all sorts of interpretations. Yet there is a practical need for the HKMA to be in the markets performing its other functions which do not have any implications on the management of the exchange rate. One example is the investment management of the fiscal reserves. When fiscal surpluses are transferred from the Government's accounts with the banking system to the HKMA, a shortage of interbank liquidity would be created if the money is not somehow recycled into the banking system. This is sometimes misinterpreted as the HKMA conducting open market operations of a discretionary nature, akin to a central bank engaging in discretionary monetary management, whilst the intention of the HKMA's presence in the market in the performance of these other functions is, as a rule, to ensure that the monetary base is not affected. There is a need, therefore, to have the circumstances in which the clearing balance of the bank system, the crucial part of the monetary base, will be affected clearly set out for all concerned to see. These are outlined as an annex to this speech.

Conclusion

46. We shall continue to listen to constructive ideas for strengthening our monetary system and examine them vigorously as we have diligently done so in the past ten years or so. Prudent macroeconomic policies, our rule-based monetary system, sound regulatory framework and robust financial infrastructure are the best guarantee for the stability of the currency, more precisely the durability of the Hong Kong dollar's fixed link to the US dollar. We shall continue to be, in the words of Michel Camdessus of the IMF, a pillar of stability for the Asian region.

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ANNEX

The Clearing Balance of the Banking System

1. This note sets out the circumstances in which the clearing balance of the banking system, the crucial part of the Hong Kong dollar monetary base, will be affected. The clearing balance of the banking system is the sum of the Hong Kong dollar balances in the clearing accounts that all licensed banks maintain with the Hong Kong Monetary Authority (HKMA) for the purpose of effecting the Hong Kong dollar settlement of transactions between the banks themselves and transactions between the banks and the HKMA.

Inflow and Outflow of Funds

2. In line with the discipline of the currency board system, the clearing balance of the banking system will be affected by the flow of funds into or out of the Hong Kong dollar.

3. Specifically, when there is an inflow of funds involving the HKMA passively buying US dollars sold to it by the banks and providing the Hong Kong dollars, the clearing balance of the banking system will rise. This is the result of the HKMA, in the settlement of the deals, crediting the clearing accounts of the banks selling the US dollars to it with the Hong Kong dollars required for settlement.

4. Conversely, when there is an outflow of funds involving the HKMA passively selling US dollars and buying Hong Kong dollars from the banks, the clearing balance of the banking system will fall. This is the result of the HKMA, in the settlement of the deals, debiting the clearing accounts of the banks the Hong Kong dollars required for settlement.

5. The HKMA adheres strictly to this discipline which in effect involves the clearing balance of the banking system varying with the amount of US dollars sold to or bought from the HKMA at the initiative of the banks.

Exceptional Circumstances

6. There are, nevertheless, exceptional circumstances in which the HKMA may vary the clearing balance of the banking system directly without the corresponding change in its US dollar holdings. These operations, as set out below, are carried out for the benefit of promoting general market stability, having regard to the level of sophistication of present day financial arrangements:

(a) when Initial Public Offerings of shares and other large scale Hong Kong dollar transactions risk creating extreme conditions in the interbank market and affecting the stability of the exchange rate, the HKMA may lend to or borrow Hong Kong dollars from the interbank market temporarily to dampen such extreme conditions; and

(b) the HKMA may enter into intraday repurchase arrangements (Repos) of Exchange Fund Bills and Notes and other eligible paper and overnight Repos through the Liquidity Adjustment Facility (LAF) to facilitate the smooth settlement of interbank transactions. It does not, however, encourage "repeated borrowings" from LAF, a term which has been clearly defined in the HKMA circular dated 12 November 1997.

Other HKMA activities

7. In all other activities conducted by the HKMA which may have the effect of varying the clearing balance of the banking system, the HKMA ensures that such effect is neutralized as the case may be, by recycling or sterilizing Hong Kong dollar liquidity. For example:

(a) a transfer of fiscal surpluses from the Government held temporarily in commercial bank accounts to the HKMA for the account of the Exchange Fund will be recycled to ensure that there is no effect on the clearing balance of the banking system. This will be done either through the purchase of foreign assets when market conditions permit or through lending Hong Kong dollars in the interbank market;

(b) similarly a drawdown of fiscal reserves by the Government will be sterilized to ensure that there is no effect on the clearing balance of the banking system. This will be done either through the sale of foreign assets when market conditions permit or through borrowing Hong Kong dollars in the interbank market; and

(c) proceeds from the issue of Exchange Fund Bills and Notes not for redemption of earlier issues will be recycled either through the purchase of foreign assets when market conditions permit or through lending Hong Kong dollars in the interbank market.