## Mr Yam discusses the sustainability of monetary and exchange rate policies

Speech by the Chief Executive of the Hong Kong Monetary Authority, Mr Joseph Yam, JP, at the International Conference on Central Banking Policies: Leading the Way Towards Sustainable Growth presented by the Monetary and Foreign Exchange Authority of Macau on 14 May 1999.

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Dr. Pessoa, Distinguished Guests, Ladies and Gentlemen,

It is a pleasure to be back in this beautiful city, and an honour to be invited to take part in such an important and timely conference. I warmly congratulate the Monetary and Foreign Exchange Authority of Macau on having put together a stimulating programme, and on having chosen this splendid new cultural centre for the venue. Apart from the inherent interest of the topics under discussion, the conference is significant in at least two respects. It takes place at a time when we are beginning to emerge from what has been, for much of this region, a period of sharp economic crisis, so that the questions we are addressing today perhaps have more relevance than ever. The conference is also taking place seven months before Macau becomes a Special Administrative region of the People's Republic of China, on 20 December 1999. Hong Kong, Macau's neighbour across the Pearl River Estuary, has a much shorter history as a city, but it does have a slightly longer experience as a Special Administrative region under the 'one country, two systems' formula. I am happy to report that this experience has been a successful one, particularly from the point of view of monetary autonomy. Indeed, the Basic Law has, since 1 July 1997, provided Hong Kong with far greater autonomy in its monetary and financial affairs, and this autonomy has been confirmed in practice by the clear confidence that the Central Government has placed in our ability to manage things on our own.

I make this point, not because Macau needs any reassurance from Hong Kong, but because it is a striking illustration of how some of the deepest forebodings about future events can often be the product of the most dismal misjudgements. Two years ago, gloomy scenarios were being painted - not about an Asian financial crisis - but about the impending demise of Hong Kong's monetary autonomy under Chinese rule: about the breaking of the link between the Hong Kong dollar and the U.S. dollar, the absorption of Hong Kong's substantial foreign reserves by the Mainland, and so on. Of course, nothing of the kind has happened, and there may well be lessons here to apply to some of the more lurid scenarios that are being drawn up for the first of January 2000. Our topic this morning, however, is not the Year 2000 problem, but the perennial question of how to devise sustainable and realistic monetary and exchange rate policies in an uncertain global financial environment. The first part of my presentation will deal with the theoretical and practical approaches to this issue, particularly in the light of the Asian financial crisis. In the second part, I shall focus on Hong Kong's experience, since 1983, of a linked exchange rate system. Finally, I shall return to the regional perspective and examine the prospects for greater exchange rate stability through monetary co-operation and other routes.

### Choice of exchange rate regime

Few of us, I think, would disagree with the proposition that there is no single exchange rate regime that is suitable to all economies all of the time. Indeed, given the experience of the last couple of years, one may be tempted to conclude that there is no regime that is satisfactory any of the time. The difficult choices and trade-offs involved in devising a workable regime call to mind a cartoon I once saw that theorised that the dinosaurs became extinct when they tried, unsuccessfully, to devise an exchange rate mechanism. But modern governments cannot escape the choice, and it is opportune to reconsider what options are available in light of the recent experience in Asia and elsewhere.

It is now well understood that exchange rate and monetary regimes are inextricably linked. The days when significant barriers to capital movements allowed governments to pursue independent monetary and exchange rate policies are long gone. So any decision on an exchange rate framework is not narrowly confined to external considerations, but must reflect broader policy choices, as well as the structure of the economy in question. The practical and theoretical considerations involved in deciding on an appropriate exchange rate system can be reduced to four broad factors: the external versus domestic orientation of the economy; the flexibility of its cost-price structure; the exposure to financial shocks; and the reputation and credibility of policy makers.

These factors, naturally, differ from one economy to another. In theory, the choice is straightforward enough: the best system is the system that best accommodates a country's "natural endowment" of these factors. Success in practice, however, is not simply — or even primarily — a question of choosing the preferred exchange rate framework from a textbook perspective. Policymakers on the ground need to address the much more demanding challenge of ensuring consistency between the overall policy framework and the exchange rate regime. Experience shows us that governments can choose exchange rate systems that do not appear optimal according to standard economic criteria yet still make them work if other policies are up to the task. At the same time, a regime that is appropriate on theoretical grounds will yield unsatisfactory results if it is not supported by other policies.

Consider, for instance, an economy with relatively inflexible wages and prices that adopts a fixed exchange rate regime. Such an economy would need to ensure maximum scope for fiscal policy to buffer shocks that would otherwise lead to unacceptable swings in unemployment. This would require a rather conservative underlying fiscal policy in normal times to avoid a loss of confidence at times when fiscal stimulus is needed. Similarly, a very open economy that chooses a flexible exchange rate regime must ensure that its policies are set in a long-term framework that establishes a clear anchor for inflation. Otherwise, external shocks that cause large movements in the exchange rate can lead to policy uncertainties and broader instability.

These lessons have been learnt well, and the view that overall macroeconomic policies must complement the functioning of the exchange rate regime is now generally accepted. Unfortunately, the challenges do not end there. Ensuring that macroeconomic policies are mutually consistent is merely a necessary — not sufficient — condition for ensuring stability in a world experiencing an explosion in capital flows. The volume, velocity and volatility of global capital movements introduce a whole new dimension to policy making — a dimension that is relatively recent, and one that we are only gradually learning to deal with.

How do capital flows affect the sustainability of exchange rate and monetary policies? There is a school of thought that maintains that mobile international capital can play a useful global role as a sort of 'policeman' of sound policies. The theory is that, in a liberalised global financial system, international capital flows reward countries with sound economic policies and punish those which pursue unbalanced and inconsistent policies. International capital flows also prevent distortions from getting as far out of line as they would if the economy in question was closed to outside investors. Thus, according to this view, capital flows act as an early warning system that forces quick corrections of policy errors.

Undoubtedly, there have been circumstances in the past that have lent substance to this view. In the Latin debt crisis of the late 1970s and early 1980s, for example, many borrowers were clearly pursuing unsustainable and destabilising macroeconomic policies. The resulting outflow of funds and the short-term economic crisis that ensued served to bring policies to task and to trigger lasting economic reforms in some countries, notably Chile.

More recent experience, however, raises serious questions about this view of the role of international capital as a robust, reliable and objective referee of the soundness of economic policies. Events during the Asian crisis naturally come to mind. The flight of international capital bore practically no relation to a forward-looking assessment of changes in the policies and macroeconomic fundamentals of the region. It is true that some countries were pursuing quasi-fixed exchange rate regimes that may have allowed pressures to build up for too long. But these same exchange rate regimes were in place when the funds were flowing in, which suggests that they were not viewed as a serious structural flaw by investors at that time.

Similarly, the underlying weaknesses in many Asian economies that so many observers (with the benefit of hindsight) now point to — 'crony capitalism', inadequate risk management, speculative lending to the property sector — were all present at the time when the funds were pouring into the region. Not only did these weaknesses fail to deter investors on the way in: the abundance of inward investment prior to the crisis tended to exacerbate the problems, rather than act as a corrective force on policies. More recently, we have witnessed what appears to be the start of a new wave of capital flowing back into the region, even though it is far from clear that these structural problems have been fully addressed.

I think it is not going too far to say that these 'hot' capital flows not only failed to act in a way that policed policies effectively, but actually became a powerful destabilising force in their own right. The huge swings in interest rates and exchange rates that resulted from capital flight in this region did far-reaching damage to corporate, financial, and government sectors, which, in turn, reinforced the initial withdrawal of capital. In such an environment, it requires a very courageous investor to be willing to step in against such a speculative tidal wave, regardless of how far out of line with reality markets may have gone.

Pursuing sustainable exchange rate and monetary policies requires countries to devise defensive strategies against such forces. This is no easy task. Capital controls have been suggested by some. In Hong Kong's case, such controls would be anathema to our free market philosophy: they are anyway prohibited by Hong Kong's Basic Law (as they are, with effect from 20 December, in the Basic Law of Macau). But, even for jurisdictions that wish to consider the option, the practical problems are considerable. Traditional types of controls have impeded growth, and have proven difficult to administer. Attempts to impose capital controls may also foster evasion that undermines the transparency and integrity of markets. More recently, innovative schemes have been suggested aiming at taxing short-term capital inflows, or otherwise obliging lenders and borrowers to pay a price that reflects the risk to the overall economy of this activity. Some of these proposals are quite interesting and may be appropriate for consideration by some developing countries, especially those in the process of financial liberalisation.

There are limits to the amount that regulation of short-term capital inflows can achieve. It would not, for instance, prevent massive speculative positions from being quietly built up in currency and stock markets. It would not stop manipulation of individual markets by large investors. And it would not stop speculators from exploiting the reality that sharp capital movements can themselves affect an economy's fundamentals and panic other investors. For the avoidance of any misunderstanding I should state once again, for the record, that I am not advocating capital controls of any kind for Hong Kong.

The concerns that arise from 'hot' capital flows are particularly acute in Asia, whose markets are relatively small by the standards of the large industrial countries, yet relatively liquid by the standards of developing markets as a whole. The world will not become a safer place for such countries — or a better place for intermediating capital flows that ultimately foster growth and development — until we take concrete steps to reform the global financial architecture.

Transparency is a critical issue. On the one hand, there is widespread support for the notion that governments should be more open in their operations — and I am happy to say that Hong Kong is at the leading edge in this area. On the other hand, there is only lukewarm support for the notion that the operation of markets could be enhanced by increased transparency on the part of private participants. I fail to see the basis for this asymmetry on conceptual grounds. On practical grounds, there are no doubt important issues to be resolved and obstacles to be overcome. But progress will not be made until all parties concerned start to address the issue in a more energetic and concerted manner. By 'all parties' I mean both the industrialised countries and the emerging market economies. Countries that perceive that they have little at stake in improving the system from their own perspective may be underestimating the implications on their own growth of sound growth in emerging market economies. And emerging markets that have been through the crises of the past two years have valuable experience to contribute and special needs to address.

**The path taken by Hong Kong**

Let me now turn to Hong Kong's experience in the light of the general points I have made above. As you may know, Hong Kong had only a relatively brief experience with floating exchange rates, from 1974-83. This episode was not very satisfactory: inflation rose to rather high and volatile levels, and the period ended in an exchange rate crisis triggered by uncertainties about the objectives of monetary policy and about Hong Kong's political future.

Against this unfavourable background, the linked exchange rate system was reintroduced to restore confidence and stabilise expectations. In addition to these psychological factors, there was - and still is - a strong case for believing that a fixed exchange rate regime was appropriate from the point of view of Hong Kong's fundamentals. Hong Kong is a very externally oriented economy, with a completely open capital account and a large financial sector. These factors leave us heavily exposed to financial shocks stemming from volatilities either in domestic confidence or in external markets. As the recent experience has shown, financial shocks can feed on themselves when they induce large swings in interest and exchange rates that undermine the fundamentals and further reduce confidence.

At the same time, Hong Kong possesses a highly flexible economic structure that has proven capable of adapting quickly to new circumstances. This flexibility owes much to the inherent entrepreneurial instincts of the people and to a tradition of economic management that has emphasised the role of market forces, self-reliance and individual initiative. Our exchange rate system has, I believe, supported this flexibility by establishing a clear anchor on which to base decision-making. It is evident to Hong Kong residents that the ultimate responsibility for adjusting to new challenges lies with themselves. Armed with this knowledge, people have continued to behave in a pragmatic and realistic manner in response to changing circumstances, even as rising incomes have brought unprecedented prosperity. Affluence has not bred complacency.

The response to the Asian crisis bears this out. Coming at the same time as the bursting of short-lived bubble in property markets, the crisis led to a plunge in property prices of some 40-50%, from the peaks in mid-1997 to the troughs twelve months later. Yet this striking decline has been accommodated without major incident. Mortgage delinquencies have edged up, but they remain below the typical levels in industrial countries, and the banks remain highly capitalised and profitable. Equally important, property prices have dropped quickly to levels consistent with underlying supply and demand. As a result, markets have remained liquid, and activity has recently picked up. There is a renewed sense of optimism that, whatever adjustments remain to be worked out, the worst is now over.

In labour markets, wage freezes are the norm, combined in many cases with cuts in bonuses in sectors that have been most affected by the crisis. Nominal wages are likely to show little, if any, growth this year, compared with increases of 7-8% in the period leading up to the crisis. Price inflation has also dropped markedly, and has turned negative in recent months. Price reductions inevitably cause short-run dislocations. But they are a key channel of adjustment for Hong Kong, and the improvements in our competitiveness that result will set the stage for a sound recovery. The important consideration is that this process should be completed quickly, and there is every indication that it will be.

A few critics maintain that we should have ‘let the link go’ during the crisis to allow nominal exchange rate depreciation to restore our competitiveness. I believe that such a step would have been fraught with risks. Any direct impact on growth would almost certainly have been offset by reduced confidence in our longer-term policy direction and heightened anxieties about the short-term impact on the financial and corporate sectors. I do not need to remind you that Hong Kong did not suffer from the structural problems in these sectors that have been ascribed to some other economies. But there is no guarantee that major and lasting damage would not have been done by the types of dramatic exchange rate overshooting that have been witnessed elsewhere in the region. And it is unrealistic to expect that exchange rates would not have overshot, given Hong Kong’s openness and exposure to international capital flows. If Hong Kong’s peg had been abandoned last year, it is likely that the attacks on other regional currencies would have been even more dramatic and widespread, with negative feedback on the region and on our own performance. That Asia — including Hong Kong — now appears to be entering a recovery phase was by no means assured twelve months ago. We might well wonder what conditions we could now be facing had the crisis proceeded to yet another level, with widespread currency collapses along the lines witnessed in Indonesia.

Other observers have argued that, from a longer-term perspective, fixed exchange rate regimes are inflexible and stifle growth. Again, I believe that Hong Kong’s experience belies this view. I would agree that, in the absence of the ability to adjust interest rates in response to cyclical conditions, output fluctuations can be larger than would otherwise be the case — at least in response to certain types of shocks. At the same time, though, the certainty generated by such a solid and clear-cut anchor reduces the impact of shocks to confidence and other factors that might undermine policy credibility.

At the end of the day, the question is an empirical one. Here, there is no evidence that Hong Kong's long term growth has been impeded by our exchange rate regime. Indeed, there is some evidence that Hong Kong has grown more rapidly than would otherwise be expected on the basis of our factor endowments. Perhaps this should not be surprising. It would seem natural that the very flexibility required to respond to short-term shocks under a fixed exchange rate regime would foster a climate of innovation capable of turning challenges into opportunities. Hong Kong's involvement in the rapid opening and development of the Mainland economy is an excellent example of this.

It seems to me, then, that the sustainability of our exchange rate system has been demonstrated through its performance. While the economic logic is important, of course, it is irrelevant unless it is complemented by a high degree of public support — the ultimate test of sustainability is that the public at large recognise and endorse the benefits of the linked exchange rate. The high degree of public support that the linked exchange rate continues to enjoy — in spite of the painful aspects of the current adjustment process — testifies to the strength of the consensus that our system is appropriate.

**The choices for Asian economies**

The linked exchange rate system, with its strict currency board arrangements, has served Hong Kong well since 1983. I might add here that the currency of Macau, the pataca, has been linked to the Hong Kong dollar since as long ago as 1977. But not all economies are in a position to meet the preconditions necessary for linked exchange rates to endure. In the aftermath of financial crisis in Asia and elsewhere, many economies are searching for new approaches to exchange rate management. The recent trend is clearly towards more flexible exchange rate mechanisms. We cannot ignore a smaller camp, though, that is opting for greater fixity of exchange rates, supported by more robust institutional structures than have sometimes been in place in the past. The integration of European monetary systems in the form of EMU is an obvious example. Similarly, a handful of economies have successfully adopted currency board systems similar to our own.

We must recognise, however, that many economies do not currently have the preconditions to make such a regime work successfully. It seems inevitable that they will have to live for the time being with some sort of managed float. The disadvantages of this system are that the lack of a transparent anchor and of a clear commitment to some well-defined policy objective make credibility difficult to establish. These conditions invite over-shooting in financial markets, as speculators attempt to test the limits to which the authorities are willing to let the exchange rate move.

How can the authorities anchor policies and expectations in such an environment? The only policy rule in common use in developed countries with floating exchange rates is inflation targeting: so far this appears to have been quite successful, although the experience is still limited. The technical requirements are demanding, however, and especially so for developing economies. Policy makers must be able to accurately forecast not only inflation but also the response of inflation to changes in the policy levers. This is a challenging enough task for the highly trained staff in central banks of developed economies, who generally benefit from dealing with a relatively stable economic structure and from considerable experience in monetary management under floating exchange rates. Needless to say, the success of developing economies in operating such a system is far from assured.

An alternative approach would be to proceed along the same path that Europe is pursuing, in the form of a monetary union. There are clear advantages to this approach. One of these is the creation of markets in a single currency that are sufficiently large to make it difficult for individual speculators or groups of speculators to manipulate markets. Another advantage is that trade within the monetary union is fostered by the certainty and ease of transaction in a single currency. Of course, as the EMU experience shows, there are important political issues that must be resolved before monetary union can become a reality. Decision-making power for monetary policy must be vested in an agency that is both independent but accountable; other macroeconomic policies must be harmonised; and structural policies must support the flexible adjustment needed to accommodate shocks.

Looking at this region, I believe that the economic advantages of some form of 'Asian Currency Unit' are clear. But I have no illusions about the practical and political difficulties involved in creating such a structure. Moves in this direction will undoubtedly be part of a long, drawn-out process. In Europe, the process took many decades. In our own politically and economically diverse region, we have even more hurdles to overcome, so it is unrealistic to expect rapid progress. But discussion of these issues, even if only at the theoretical level, will help focus our thinking and perhaps lead to small, practical steps that can improve our individual exchange rate systems along the way.

A unilateral — but asymmetric — approach to monetary union can, of course, be achieved by simply adopting the currency of another country. This has been a topical issue of late, with the dollarisation option that is being widely discussed for Argentina. Some have suggested that this might also be an option for Hong Kong. Compared with our currency board system, it would represent an even more irrevocable link to an anchor currency — one that might well be expected to eliminate currency risk premia and speculative attacks. But there are also costs: a loss of seignorage; constraints on liquidity management, including the provision of lender-of-last-resort support; and substantial costs associated with the transition process. In the case of Hong Kong, we would also face important legal issues regarding the provisions of the Basic Law, as well as how to provide an efficient US dollar clearing and settlement system in Hong Kong. We will continue to study these issues because, at the very least, research into all possible options helps us to clarify and refine our existing policies. I am, however, confident that the measures taken last autumn to strengthen the currency board arrangements, and the additional credibility gained from weathering the storm of 1997-98, have put the existing system on an even more solid — and sustainable — footing.

## Conclusion

To recap the main arguments in this presentation, let me reiterate that exchange rate policies must meet the needs of the economy they serve if they are to be more than mere empty promises. They must also be compatible with broader policy choices and capable of sustaining the external shocks that arise in an increasingly globalised financial environment. In particular, as the Asian financial crisis has demonstrated, the exchange rate regimes devised for small and open economies must be able to deal with 'hot' capital flows, which are not only the conductors of external shocks, but increasingly the main agents of volatility and instability. This is no easy matter, as the collapse of one exchange rate policy after another has shown. Much can be done by individual governments to craft exchange rate policies that truly complement economic fundamentals. But actions by individual jurisdictions can only go so far towards tackling problems that also arise from defects in the international financial architecture and not just out of local imbalances. Reforms to the international financial architecture are needed to help ensure that capital flows reinforce, rather than undermine, monetary stability. In the long run, we should also be looking towards a more sophisticated and solidly based regional financial system: this would include taking further the debt market and infrastructural development that is already in progress, as well as greater monetary co-operation - perhaps, on the distant horizon, even monetary union.

For Hong Kong's part, the experience of the last two years has left us more firmly convinced of the appropriateness of our linked exchange rate system to the special needs and characteristics of Hong Kong's economy, and more confident in our ability to defend the link under the currency board arrangements. I am not so complacent as to suppose that there is no room for improvement, and we continue to explore ways of refining the system. Nor do I suggest that such a system is suitable for every economy in the region. But I believe that it has provided Hong Kong with the anchor of monetary stability that such an externally oriented economy needs, particularly during these years of global instability. I also believe that it will continue to serve Hong Kong well in the years to come.