Mr Latter comments on the euro: first impressions from Hong Kong

Address by Mr Tony Latter, a Deputy Chief Executive of the Hong Kong Monetary Authority, at the seminar entitled, "Five months of the euro: what does it mean for business in Hong Kong?" held in Hong Kong on 11 May 1999.

Introduction

It's probably true to say that the arrival of the euro passed without incident and almost without notice in Hong Kong. You might think this a somewhat ungracious statement with which to begin. But it certainly does not mean that the euro is unimportant to Hong Kong. What the statement tells us, first and foremost, is that the preparations for the euro by those sections of the community for which its arrival was of immediate importance - and here I refer principally to the financial sector and parts of the commercial sector - were totally successful in ensuring a smooth and hence unremarkable transition. I would like to congratulate all concerned on that achievement.

At the other extreme, my opening remark could also be taken as confirmation that the arrival of the euro was of no direct importance to the man in the street, who may never even have seen a European currency; even if he has, he will not have to confront the euro in physical form until the banknotes appear in 2002.

I should like to spend a few minutes discussing two aspects of the euro. One is its impact on and implications for the conduct of financial and commercial business here, essentially at the micro level. The other relates to some macroeconomic policy aspects of the euro's birth, which are also relevant to Hong Kong despite our being some 10,000 kilometres distant.

Consequences for financial markets and trade

As one would have expected, the wholesale financial markets switched quite rapidly to quoting and dealing mostly in euros instead of the constituent currencies, and many businesses also chose quickly to redenominate their relevant accounts, although a significant number have not yet done so. The choice is largely one of practicality and economy, rather than of economic significance, given that, formally, the parent currencies are now no more than sub-denominations of the euro; one might therefore expect people to opt quite quickly for the convenience of a unified denomination rather than to continue operating with up to eleven separate ones.

So far as I have been able to ascertain, the euro is trading in foreign exchange markets just as one would expect a major international currency to trade - that is, with good liquidity and fine spreads. However, total turnover is less than that for the predecessor currencies taken together; indeed one would be disturbed if that were not the case, since the rationale for cross trades and arbitrage between the former currencies has evaporated. That is why in most financial centres - and Hong Kong is no exception - dealing rooms have been slimmed down. This is the dividend in respect of resource saving which represents one of the net benefits of moving to a single currency, even though the forex traders whose skills are no longer in such demand may not see it that way.

In the bond market we have witnessed the first Hong Kong corporate issue in euro, which generated good demand - primarily from European investors but also with significant interest from local buyers. In former times an issue of this sort in any of the parent currencies would probably have been rarer, because the individual markets lacked maturity. A significant consequence of the euro's arrival is that there now exists a market with the potential for a critical mass of liquidity well beyond that which the individual parent currency markets ever managed to achieve. There is further evidence to support that view in provisional reports that global international bond issuance in euro this year has exceeded that of issuance in the parent currencies during the equivalent period last year, while the same comparison for non-euro European currencies shows a decline (although I have not yet seen the formal statistics by which to confirm this). This has been achieved despite the fact that the process of establishing the euro firmly in these markets is not yet complete. Investors are still feeling their way: for example, deciding on a benchmark yield for the euro, when there is a significant spread of perceived credit risk even between member state governments, is one area where fund managers may still be finding their feet.

Although I am not close to it myself, it is my impression that the industrial and commercial sectors have also adapted well to the euro, although the amount of adaptation that has been required differs across individual cases. Many may not be affected, but equally many may be experiencing a drift towards more quoting and invoicing in euro; in some cases there will be pressure to do so which, on competitive grounds, they can ill afford to ignore. And there will be some who find themselves at a slight competitive disadvantage if they are bidding for business in a euroland country against a competitor from another euroland country; previously both bidders had to take account of exchange risks and conversion costs, but now it is only the Hong Kong bidder who faces these.

Finally, I understand that among the general public there was an initial burst of interest in euro deposits (over and above mere redenomination of existing ones in the parent currencies), but that this interest waned somewhat with the euro's subsequent depreciation.

Challenges for policy

Turning now to macroeconomic issues, we in the Hong Kong Monetary Authority have had a particular interest in the arrival of the euro, since it was the final step in the transition of the eleven participating countries from closely aligned rates to irrevocably fixed rates, and has therefore consolidated the number of economies where, like Hong Kong, some form of fixed exchange rate arrangement is regarded as both desirable and workable.

Of course, I accept that technically the eleven currencies have not been fixed or pegged to one another, but have gone a stage further and been replaced by a single successor. But the critical point is that the euro countries individually have to a large extent, as Hong Kong did to an even larger extent over fifteen years ago, surrendered scope for exchange rate adjustment as an instrument of policy. In the euro case the surrender is not total since, although no member can any longer move relative to the ten other participants, the European Central Bank can of course still pursue an independent monetary policy relative to the rest of the world. Hong Kong is more tightly bound, since we are linked to the US dollar over whose wider value we have no influence.

When we pegged the Hong Kong dollar to the US dollar in 1983 we did so at a time of crisis and partly because there was, for institutional reasons, effectively no viable alternative available to us at the time. European countries, by contrast, had a full range of workable options and chose the euro only after a long and thorough process of analysis, deliberation and preparation.

If adopting a fixed rate was going to succeed anywhere, Hong Kong was certainly a prime candidate, because of the proven flexibility of the economy - not least the labour market, in terms of both inter-sectoral mobility and wage-cost flexibility. What has been surprising to many outside observers about the road to the euro is that, while it has all along been acknowledged that greater internal flexibility within the member economies would be required as a substitute for adjustment of relative price levels via the exchange rate, progress in that direction has been extremely slow. Indeed, in the period since the euro proposal first acquired real momentum it is probably true to say that some of the internal adjustment mechanisms in participant countries have become more rigid rather than less so.

It is perhaps not surprising, therefore, to hear of worries about possible tensions in policy-making which the persisting disparities of economic performance across Euroland may cause. I have even read - but from sources which are probably more gossip than anything else - of the possibility of Maastricht budget deficit criteria in parts of Euroland being breached in order to sustain or stimulate growth. Of course, you may argue that this - budgetary relaxation - is precisely what we are doing in Hong Kong. Yes, but we are employing fiscal policy as an additional instrument to the flexible structure of our market economy, whereas in Europe the danger would be of it being regarded more as a substitute, although I acknowledge that a significant part of budgetary spending there is nowadays directed towards achieving the necessary structural reforms. And in Hong Kong we are working from a position in which monetary policy is clearly quite tight and has to remain so for the moment (given our link to the US dollar), whereas euro monetary policy is not so rigidly constrained.

In the broader sweep of history, a regime of fixed exchange rates is by no means an outlier. Remember that most of the world’s currencies were fixed on some sort of metallic standard until the first world war, and that the world enjoyed 25 years of virtually fixed rates after the second. Interestingly, I have seen it argued that one of the reasons (though certainly neither the only one nor the primary one) for it being impossible to sustain fixed rates in the inter-war period may have been the growing rigidity of labour markets as the century progressed. And one of the main reasons for the breakdown of the Bretton Woods arrangements at the beginning of the 1970s was the collapse of budgetary discipline of one member in particular - the United States. There are no doubt lessons from history, even though the read-across to the present day may be subject to many qualifications.

Personally, I would expect the fiscal discipline of Maastricht to be retained and observed. And I am yet more confident that the European Central Bank will remain steadfast in its counter-inflationary role. That combination will, as is widely acknowledged, transfer a considerable burden of adjustment onto structural and microeconomic policies. It is good that the focus should rest there and it will be even better when more progress is visible on that front - better not simply for Europe but for the world, which needs a strong European economy. And within Europe itself I feel that there is something of a political imperative for the impact of the euro to have been demonstrated as unequivocally beneficial by the time that the potentially rather emotional withdrawal of national banknotes takes place in 2002.

The concerns over the apparent tensions in economic policy in consequence of the euro’s arrival have plainly had some adverse effect on sentiment towards the euro in foreign exchange markets, although we know that other factors, notably the conflict in the Balkans, have been important too. When you look at the ups and downs of the relationships between the world's leading currencies over the years you will recognise that the depreciation in the euro since its inception is not all that exceptional, however much we may regret that movements of this sort may nowadays be regarded as within the definition of normal. But the attitude of international businesses and investors outside Euroland to the euro will be coloured, to a degree, by perceptions of its likely volatility, and in that sense the start has not been as auspicious as one might have wished.

Prospects and opportunities

But I suspect that those of us living a long way from Euroland tend to underestimate the impact which the euro is having in terms of cost savings and risk reduction in cross-border trade, although we may see and feel something of the side effects in terms of heightened competition and usage of the euro in world business. At the same time, as I tried to elaborate earlier, the euro has the potential to become a force in global financial markets. As that happens, we in Hong Kong hope to play our part. Indeed, we believe we are excellently placed to be involved in the expansion of usage of the euro in international financial markets.

As a central banker I must repeat that I hope and expect that the ECB will be a staunch guardian of monetary discipline. This certainly does not mean that we can make accurate predictions about the exchange rate or interest rates, but it is likely to mean that the euro should in due course consolidate itself as a leading world currency in trade and finance, not least in this part of the world. Meanwhile, the unified currency provides Euroland with the opportunity to strengthen its collective economy, albeit an opportunity which has to be worked upon. And a strong and stable European economy is probably of greater importance to the world at large than is any particular level for the euro's exchange rate.

So, the euro has arrived. It has already made an impact on financial markets and trade, and that impact is likely to expand over time. We disregard it at our cost. And we should focus on the longer-term implications of the euro rather than dwell too much on its short-term vicissitudes.

Finally, in Hong Kong we should perhaps be watching with special interest the evolution of the euro and the way in which the associated macroeconomic challenges within Euroland are tackled, to see what lessons might be put in store for a future generation of central bankers in this region, who might at some stage decide that the time had come to launch a similar initiative.