



Hong Kong Monetary Authority

**Briefing to
the Legislative Council Panel
on Financial Affairs**

3 January 2000



Y2K



Wellness checks completed



Banks operating as usual

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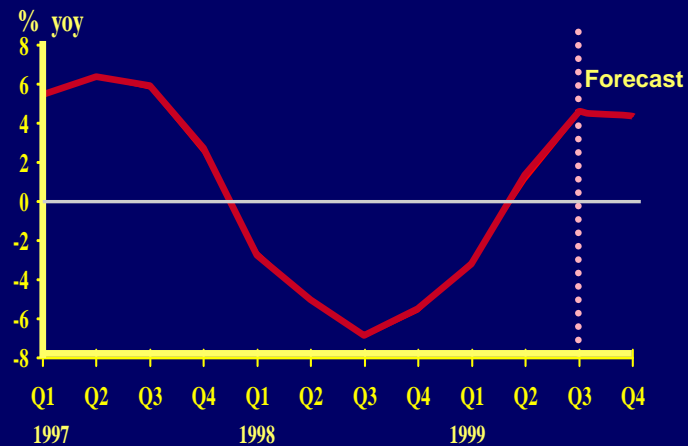
- Today is the first business day of the new millennium. Our Event Management Centre has been opened since 31 December to ensure a smooth rollover into the new millennium.
- All **wellness checks** completed. Happy to report that **[no] exception report** received so far.
- Banks opened as usual** this morning, and have been operating very smoothly.
- Will continue to monitor.



Economic Recovery

Real GDP Growth

- Strong rebound in Q2
- Q3 growth: 4.5%



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•Going into the new millennium, our economy is on the road to recovery and our financial markets have returned to stability.

•**Economic recovery** which began in the second quarter **gathered further momentum in the third quarter of 1999.**

•After a decline of 3% in the first quarter, real GDP rebounded by 1.1% year-on-year in the second quarter, followed by **4.5% growth in the third**. On a seasonally adjusted basis, real GDP recorded a strong quarterly growth of 3.2% in the second quarter and 1.7% in the third.

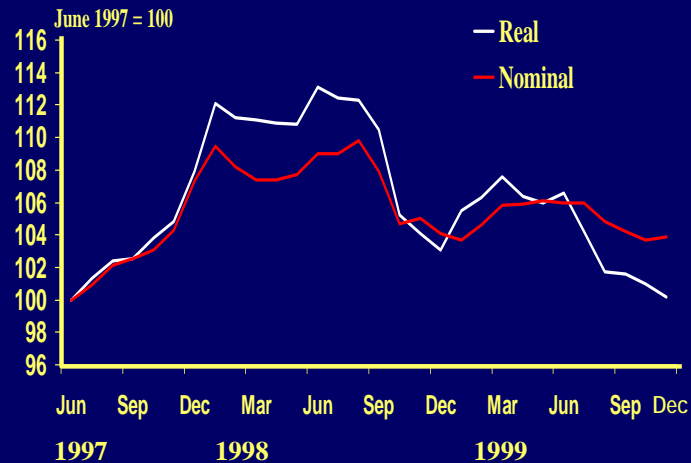
•FS has made a presentation on the economy here last month. I would only go over a few monetary factors which have a bearing on the real economy, namely the REER, interest rates, including the real rates, and bank credit.



Exchange Rates

Effective Exchange Rate Indices

- REER back to pre-crisis level
- Not a strong impediment to competitiveness



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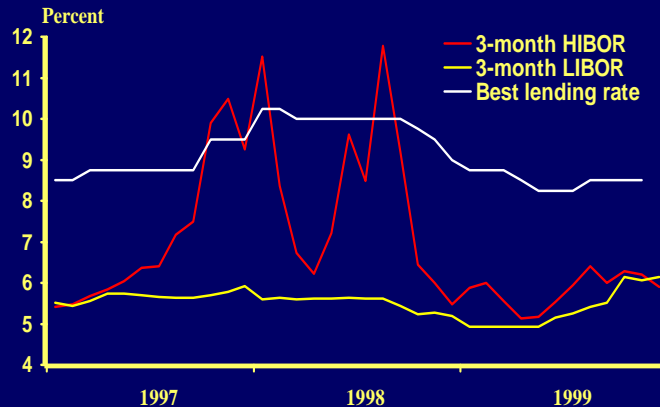
- Under the linked exchange rate system, we cannot use nominal exchange rate adjustment as a tool to enhance price competitiveness. This is a price to pay. But, in HK, the other channel that restores price competitiveness - reductions in domestic costs and prices - has been functioning smoothly. This is illustrated by movements in the REER.
- With the strengthening of the yen and other Asian currencies, the nominal effective exchange rate (NEER) **declined by 5.4%** from August 1998 to November 1999.
- Together with the continued downward adjustment in domestic prices, the **real effective exchange rate** of the Hong Kong dollar has **declined by around 12%** from its peak level in August 1998, returning roughly to its pre-crisis level in July 1999. This has helped to restore the competitiveness of Hong Kong.



Interest Rates

Nominal Interest Rates

- Stable since September 1998
- Premium over USD interest rates has narrowed



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• **Interest rates have remained relatively low and stable**, as speculative pressure on the Hong Kong dollar subsided since August 1998 and the technical measures to strengthen the currency board system in Hong Kong were successfully implemented in early September last year. The Hong Kong prime rate was cut seven times by a total of 175 basis points to 8.25% from October 1998 to May 1999, before being raised by 25 basis points at end-August 1999.

• As for the interbank interest rates, the three-month HIBOR has been moving largely around 5-6% so far this year, compared with an average of 8% in 1998. The **spread of three-month HIBOR** over the corresponding US dollar rate narrowed significantly from over 1000 basis points in August 1998 to an average of around **15 basis point** in November 1999, reflecting improved market confidence in the Hong Kong dollar.

• As a result of the continuous pressure of demand for HK dollars in the foreign exchange market, three-month HIBOR eased further and has **converged close to its US counterpart since the beginning of December**.



Interest Rates

Real Interest Rates

- Long-term rate still high but has come down
- Well below headline rate
- Not as serious an obstacle to recovery as sometimes is thought



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•The high level of real interest rates is often viewed as an impediment to recovery in Hong Kong. Despite declines in nominal interest rates from the peaks reached last year, deflation has pushed up commonly cited measures of real interest rates to unprecedented levels.

•But should real interest rates be measured by looking at past inflation and short term interest rates, or should it be measured in a forward looking way using long term rates and expected inflation. After all, if you borrow for investment, you're looking at **future** opportunity cost and **future** inflation.

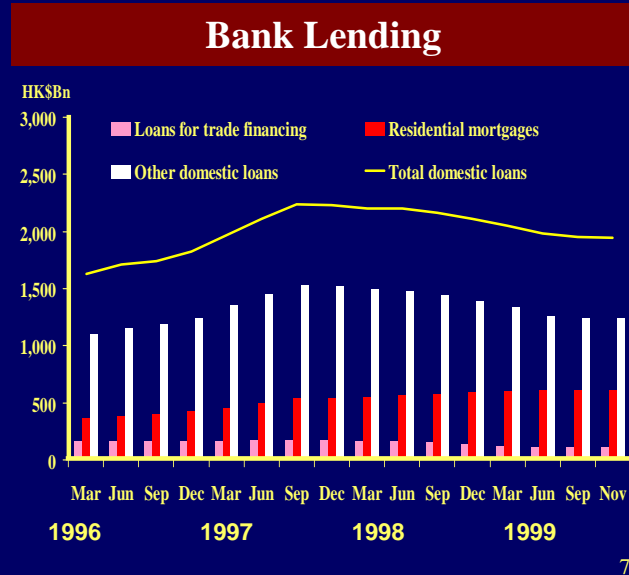
•Using our estimates of the long-term expected real interest rate derived from the 5-year Exchange Fund Bills yield and the long-term expected inflation rate shows a significantly different picture from the backward-looking short-term rate. **This measure of long term real interest rate did rise to very high levels in 1998, but it has fallen significantly since**, as nominal bond yields have declined sharply, while underlying long-term inflation expectations have been relatively stable.

•Our real interest rates are still high, but have already come down and stabilized, and may not be impeding the recovery by as much as some people think. Witness recovery in asset markets and overall economy.



Domestic Credit

- Domestic loans showed first rise in 17 months
- Should increase further with continuing economic recovery & resolution of GDE issue



• Domestic loans rose by 0.3% in November, ending 17 consecutive monthly decline between May 1998 and October 1999.

• Along with the recovery in economic activity, signs of moderation is the decline in domestic loans started to emerge in the second half of 1999. The rate of decrease slowed from a monthly rate of 1.1% in the first half of 1999 to 0.5% from July to October. Compared with the peak in September 1997, domestic loans have fallen by 12.9%. Excluding mortgages, the decline was sharper, of 21% at end-September 1999.

• A combination of factors have contributed to the decline in domestic loans. These included weak investment demand, high interest rates (though not as serious as people thought as explained in previous chart), scaling down of foreign bank operations, reduction of exposure to Mainland enterprises following the closure of GITIC in October last year, and banks' cautious lending stance amid an increase in credit risk and concerns on deterioration of asset quality.

• With the recent agreement in principle between creditor banks and the Guangdong Government on the debt problem of GDE, banks will have greater confidence in lending to Mainland-related companies. Also, the recovery in the domestic economy will also give a boost to bank lending. Banks are still very cautious in lending to SMEs. To help provide banks with more credit information to assess the risks, the HKMA will study the feasibility of setting up a commercial credit register in Hong Kong which may hopefully establish a sound base for lending to SMEs and other companies. The HKMA also intends to discuss with the Data Privacy Commissioner whether it would be possible for banks to disclose to credit reference agencies a wider range of information about the indebtedness of their personal customers.



Challenges and Opportunities

Technology

Globalisation

Volatile
Capital Flows



Changing Financial Landscape



Banks

Small Open Economies

- Consolidation for scale

- Bigger markets
- Strengthen own financial systems

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• Before presenting work plan, go over some challenges that impact on HK. First is the challenges brought by a **changing financial landscape**, caused by:

• **Advancement in technology** - this is permitting the development of new financial products and new ways of delivery these products, such as over the internet.

• **Globalisation** - this is happening rapidly with financial liberalisation, and advancement in technology and telecom.

• **Volatile capital flows** - we have all seen the power of this during the Asian crisis.

• This new financial landscape has profound impact at both the micro level (on banks) and the macro level (on economies):

• **banks** - the need to invest in technology and compete against both domestic and global competition has reinforced the need to achieve scale, and has become a catalyst for **consolidation** which is happening around the world.

• **economies** - with the massive capital flows, small open economies need to either build bigger markets or **strengthen their own financial systems** so that they will not be trampled underfoot by “elephants”.



Challenges and Opportunities

International Reforms

- Risk Management
- Code of Good Practices
- Transparency

Regional Initiatives

- AMU?
- Technical Cooperation
- Bond Market

Domestic Responses

- Self-strengthening
 - ▶ resources
 - ▶ market development
 - ▶ regulatory coordination
 - ▶ tighter rules

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•This brings me to the second challenge - the need for small open economies to build stronger financial system in light of the inadequacy of the international financial architecture to cope with the explosion of international finance.

•At the **international** level, it is recognised that improved **counterparty risk management** and **transparency** of HLIs will check the degree of leverage they can attain and reduce their potential risk to the financial system. There is a high degree of consensus between the public and private sectors in recommendations towards this direction. While these initiatives help the supervisors and counterparties of HLIs, it does not directly help the small open markets where the size, concentration of positions, and aggressive trading behaviour of HLIs could pose the so-called “**elephant in the pond**” problem.

•There is as yet no initiative to enable smaller markets to know that “elephants are coming to or already in the pond”. In light of this, HK has put forward and the international financial community has shown interest in the development of a **Code of Good Practices** to encourage proper risk management and responsible market behaviour.

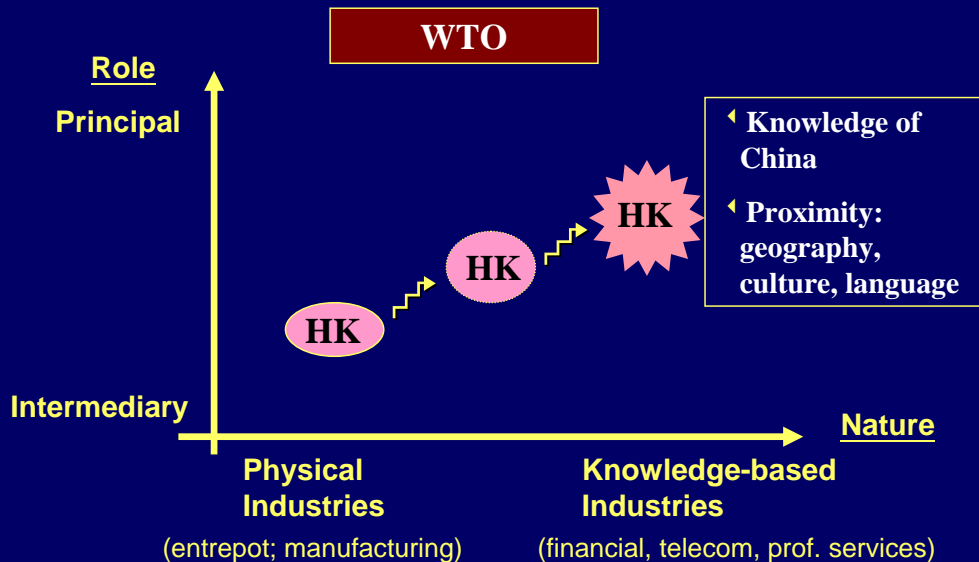
•At the **regional** level, perhaps bigger markets can be built to tackle the vulnerabilities of being small. I have floated the idea of an **AMU**, which is still a remote ideal. Given the political, geographical and economic diversity of the region, it will take a long long time for this to happen. Falling short of that, we shall continue to urge the building a more financial infrastructure for the region. A number of **regional initiatives**: linking up debt clearing system to form what we like to call Asiaclear; standing invitation to others to link up RTGS; and developing a regional bond market - HK has been leading an APEC initiative on this. Furthermore, HK is making use of various regional groupings like EMEAP and Manila Framework to promote improvement and harmonisation of regulatory standards.

•At the **domestic** level, self-strengthening will become a more prominent feature of small open economies. Need to strengthen domestic monetary and financial system to reduce vulnerabilities. But this involves cost and efforts:

- substantial resources** - e.g. we used US\$10 bn reserves to build cushion
- pro-active **market development** - e.g. banking reforms, merger of exchanges
- regulatory **cooperation** - e.g. Cross-Market Surveillance Committee
- tighter rules** for the markets - e.g. position limits. Some may stray into stronger forms of restrictions, e.g. credit/exchange controls of Singapore, Thailand and Indonesia.



Challenges and Opportunities

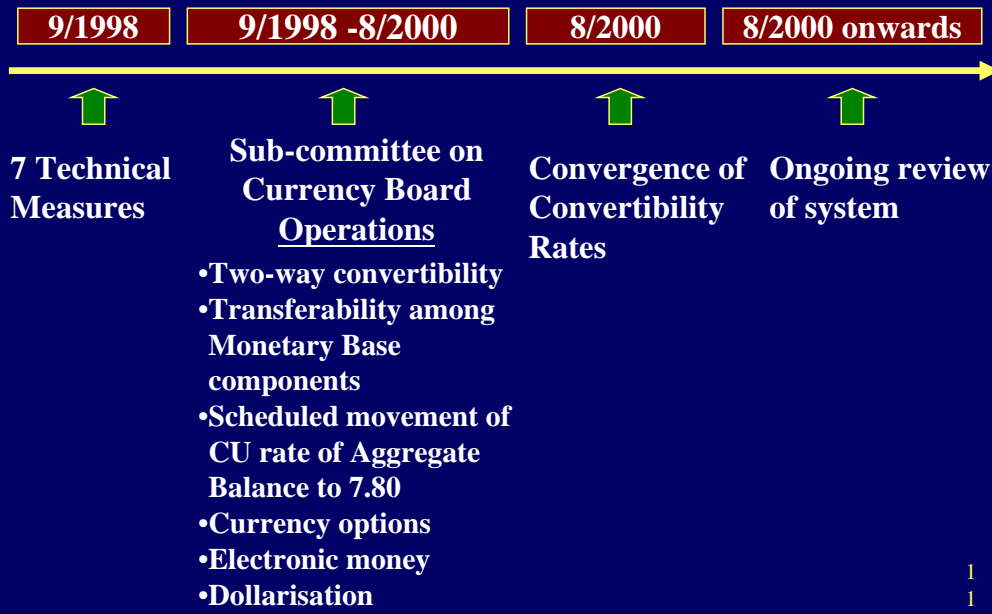


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- The third challenge is China's accession to WTO. For Hong Kong's financial sector, the opening up of the RMB market for foreign banks will present exciting opportunities for HK's banks. But to compete with other global banks going into China at the same time, the **need for scale** is again very important, and this should provide another impetus for banks to think about the need for alliances and consolidation.
- On the impact for HK as a whole, I understand the Government Economist is undertaking a full scale research. What I just wish to mention here is a transformation that I can see HK going through.
- Looking at the chart here, the vertical axis indicates **the role** HK will be playing. With the possibility of direct access into China, no doubt HK's **middlemen role** will be partly eroded, but at the same time, the opening up also provides lots of opportunities for HK businessmen to **invest as principals** and compete with other newcomers to the market.
- On the horizontal axis, the nature of industries HK is involved in may also change in terms of mix. The proportion of business may gradually **shift from physical industries** like manufacturing or entrepot trade, **into more knowledge based industries** such the "to-be-opened" financial services, insurance, telecom and other professional services.
- Thus we can see HK moving from the bottom left hand quadrant to the middle or even the upper right hand quadrant. HK no doubt has the ability to undertake this transformation, with its **knowledge** of and experience in dealing in China and its **proximity** in terms of geography, culture and language.
- HK has gone through many changes, like from entrepot to manufacturing to services. Sure that HK can adapt and take advantage of the opportunities presented by WTO.



Work Plan 2000 - Monetary



•Themes of work plan next year: maintain monetary stability, liberalise the banking sector within a safe and sound environment, and build financial infrastructure to keep HK on the cutting edge.

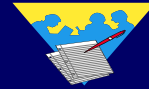
•On the **monetary** front, since the implementation of the 7 technical measures in Sept 1998, the HK dollar exchange rate has remained rock solid. Short term interest rates have also been remarkably stable, helped by the technical reforms and the effective functioning of the Discount Window.

•Established in the summer of 1998, the **EFAC Sub-Committee on Currency Board Operations** was entrusted with the responsibility to oversee the currency board operations and to recommend, as and when appropriate, measures to strengthen the currency board system. Discussion during the monthly meetings in the past year covered a wide range of subjects, including the convertibility and transferability with respect to specific components of the Monetary Base, scheduled movement of the Convertibility Rate in respect of the Aggregate Balance to 7.80, dollarisation, the use of currency options and the monetary implications of electronic money. The records of the meetings of the Sub-Committee are published.

•In August this year, the Convertibility Undertaking for the Aggregate Balance will **converge** with the Convertibility Undertaking for Certificates of Indebtedness (at 7.80). This is a milestone in our recent reforms. The Sub-Committee will continue its **ongoing review of the currency board system** and be ready to recommend further modifications if deemed necessary to meet the challenges of a rapidly changing financial environment.



Work Plan 2000 - Monetary



The Hong Kong Institute for Monetary Research



Research

Seminars



Possible Topics:

- Competitiveness issues
- Repercussions of Asian crisis on regional financial markets
- Mainland's financial developments and interface with Hong Kong
- Monetary linkages among Asian economies

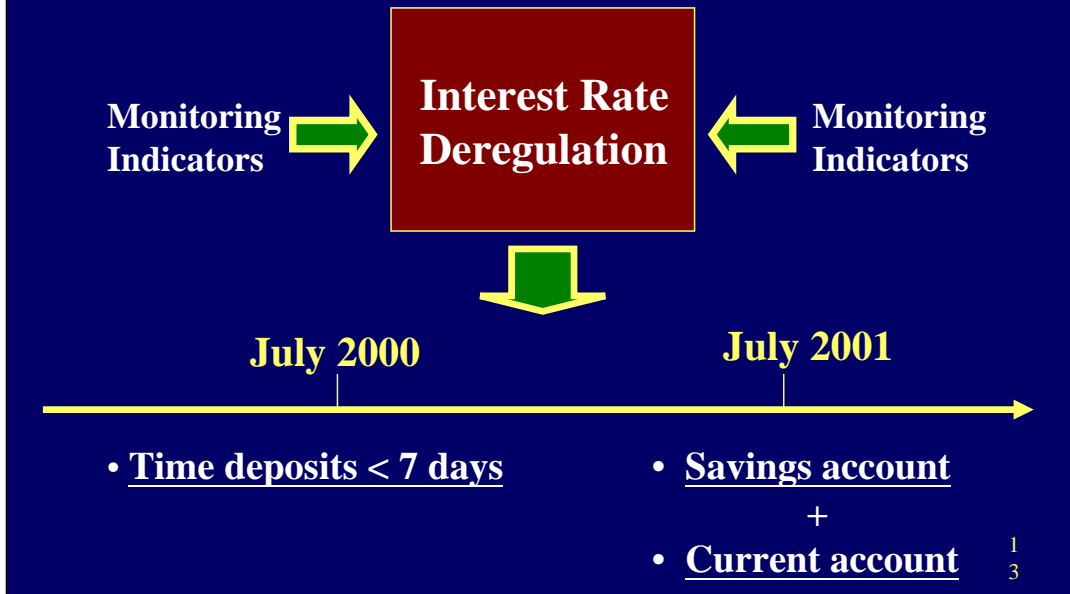
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•The Hong Kong Institute for Monetary Research was formally established in August 1999. It is an affiliate of the HKMA, with the objective to enhance “the research capability of Hong Kong to conduct longer-term and wider monetary and banking policy analyses so as to position Hong Kong to play a leading role in research and policy analysis in the region”.

•The HKIMR has hosted an **inaugural seminar** in December 1999 on currency arrangements in Asia. In the coming year, the Institute will invite its first batch of **visiting scholars** to come to HK to conduct research in different areas, and the outcome will be published as occasional papers. Areas of research may include competitiveness issues, repercussions of Asian financial turmoil on the regional financial markets and the fund flow patterns, mainland’s financial developments and interface with Hong Kong, and monetary linkages among regional economies.



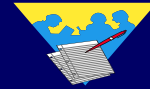
Work Plan 2000 - Banking



- On the **banking** front, the main area of work relates to the implementation of the recommendations of the banking consultancy study.
- On **interest rate deregulation**, we have announced our intention to deregulate the remaining interest rates in two phases.
- Provided that the prevailing economic and financial conditions are not unfavourable, the IRRs covering time deposits with a maturity of less than 7 days will be deregulated in the middle of this year while IRRs on savings and current accounts will be removed in July 2001.
- This measure should help to promote greater efficiency and encourage innovation of new deposit products. We hope that it will also give banks an incentive to think harder about the possibilities of merger or other forms of strategic alliance.



Work Plan 2000 - Banking



Depositor Protection

Factors	Plan
<ul style="list-style-type: none">• Increased Competition• Stability of the banking system• International Practice• Cost and moral hazard issues	<ul style="list-style-type: none">▶ Consultancy Study in H1 2000▶ Public Consultation



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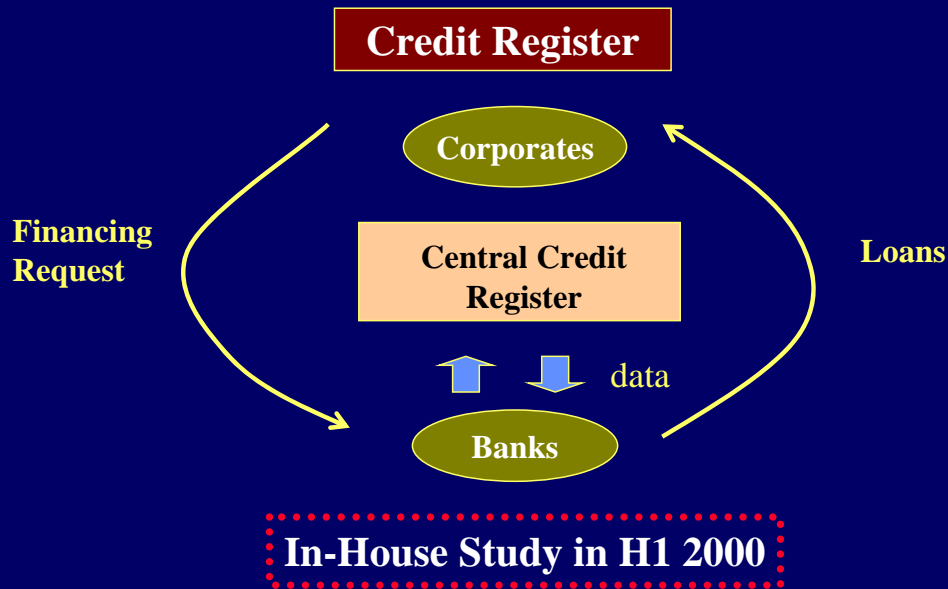
▪ Since **increased competition** in the banking sector may lead to increased risk, there is a need to revisit the issue of depositor protection since it was last considered in 1992. Good protection should help to promote consumer confidence and thus maintain the stability of the banking system.

▪ **Internationally**, there has been a trend towards adoption of more explicit forms of deposit protection, as indicated by the recommendations of the G22 Working Party on Strengthening Financial Systems. The time is therefore opportune to look at the issue again in Hong Kong.

• The HKMA will therefore conduct a **detailed study in the first half of this year** to identify ways to enhance depositor protection in Hong Kong. The study will evaluate the suitability of various forms of depositor protection schemes including, but not limited to, **deposit insurance**. It will clearly need to look not only at the benefits but also at some of the drawbacks, including **moral hazard and costs**. The HKMA will subsequently undertake an extensive public consultation on the proposals arising from the study.



Work Plan 2000 - Banking



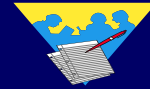
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•Timely information relating to the extent of indebtedness of borrowers is essential to banks for credit decision purposes. The HKMA will therefore look into the feasibility of establishing a **central credit register** in Hong Kong, through an **in house study in the first half of this year**.

•There would be a number of important practical difficulties involved in setting up such a system, but it would provide a means for banks to better assess the creditworthiness and overall indebtedness of their customers. This would better assist the banks to fulfil their important intermediation role, including helping to channel funds to small and medium size enterprises.



Work Plan 2000 - Banking



Consolidation

- **Market-based approach**
- **HKMA, as supervisor, will facilitate**
- **No mandated consolidation for healthy banks**
- **Approaches to consolidation :**
 - ▶ **Alliance**
 - ▶ **Mergers and Acquisitions**

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•As mentioned earlier, technological advancement, further liberalisation and hence increased competition of the local banking sector, and new opportunities such as the opening up of China after the WTO agreement, will all provide incentives to lead banks to think hard about the need for consolidation, or some form of strategic alliances.

•Strictly speaking, this should not really fall under the ambit of our “work plan”, because the HKMA has no intention of seeking to direct changes of this kind. We believe that a **market-based approach** must be a right one. Mandated consolidation or forced marriages will not work.

•Nor will we just sit back. There is always a risk that if banks do not respond quickly enough to challenges, and when change is forced upon them by market pressure, **the impact will be rather brutal**. The interest of creditors, and more importantly depositors may be adversely affected. There is also a danger of having systemic consequences.

•The question is how HKMA can help in ensuring a smooth evolution. **The HKMA, as supervisor, will facilitate**, by advocating publicly the idea of consolidation, and follow up with private discussions with individual banks. We will however bear in mind that we cannot and should **not force mergers on healthy banks**, and that property rights of owners of such banks must be regarded as sacrosanct.

•What is more specifically within our remit is to **keep the regulatory structure under continuous review** to ensure that it is appropriate to current and prospective market conditions, and does not contain feature that might inhibit banks from upgrading their capabilities or delaying their response to changes in the local and global financial landscape. This was the thinking behind the consultancy study done last year and implemented in the coming year.

There are basically two approaches to consolidation. One is by **alliances** among individual banks. A recent example is the setting up of the Bank Consortium Trust, which is an encouraging response to the competitive environment strongly supported by us. The other is through **mergers and acquisitions**, which I hope will start to emerge not before long.



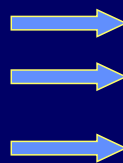
Work Plan 2000 -Infrastructure



USD Clearing

HKMA

Settlement Institution



USD Cheques
Securities Trading
in USD
Bulk Clearing

In phases in H2 2000

- ✓ Enhance competitiveness as IFC
- ✓ Enhance settlement efficiency
- ✓ Enhance monetary stability

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•On the **infrastructure** side, we will be moving full steam ahead next year with the setting up of the USD clearing system, which is of strategic importance for the future development of Hong Kong as a leading international financial centre in the regional.

•The benefits include:

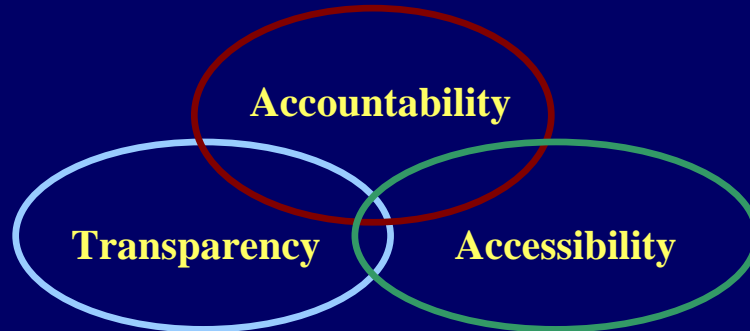
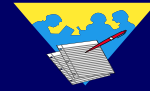
- Enhance **competitiveness of HK** as an IFC, being the first full scale USD clearing centre in the Asian time zone.
- Enhance **settlement efficiency** and reduce settlement risk.
- Enhance **monetary stability** as the development of a USD denominated capital market, e.g. the denomination of H-shares in USD, would reduce the pressure on the HKD as a vehicle currency to conduct non-domestic financial business.

•Once established, you can present USD cheques in HK and obtain value the next day without having to wait for over 2 weeks. You can buy/sell USD denominated shares in HK and obtain HKD value as if you're buying/selling HKD denominated shares. For large transactions e.g. to sell USD, you can obtain your HKD value real time, without having to wait until NY opens and bear the overnight risk.

•We are now selecting the Settlement Institution, and expect the system to be implemented in **phases starting from the second half of the year.**



Work Plan 2000 - HKMA in Community



• Website,
Bulletins,
Publications

• Public
Education
Programme

• Regular
Briefings
to LegCo

• Exhibitions
at
Districts

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• We will continue to pay a lot of attention to cultivating a high degree of understanding, and hopefully sympathy, in the community of our policies, our roles and the manner we conduct our affairs. **Accountability, transparency and accessibility** continue to be high on our agenda.

• We have been a lot more proactive last year on this front, and will continue these efforts in the coming year:

- website, bulletins and publications - **review website** to make it more accessible, continue with our quarterly and monthly bulletins, and publish other papers/books, including new ones which aim to explain policies in **plainer language**

- **public education** programme - continue to talks to schools, teaches, journalists, etc

- **regular briefing to Legco** - I've offered to brief members two times a year on our work, plus of course other briefings to the panel on ad hoc basis.

- **Exhibitions** at districts - this is being planned for the **summer this year**, and is intended to reach out to the general public and enhance their understanding of the work of the HKMA.