

Chief Executive's Statement



The past year will be remembered as one of the most difficult and testing in Hong Kong's recent history. Much of the region continued to endure a prolonged recession, and the effects on Hong Kong were severe. A sharp contraction in economic output, combined with the economic adjustments necessary to revitalise our competitiveness, brought pain and anxiety. As an open international financial centre, with a fixed exchange rate, Hong Kong was also exposed to a succession of speculative attacks brought on by the continuing regional turmoil and linked to crises in other parts of the world. Our financial system passed through its toughest ordeal in many years. Yet the system not only survived the ordeal undamaged: it was also strengthened by a number of measures implemented during the year. Some of these, notably the decision in August to enter the stock and futures markets, provoked controversy. They nevertheless

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helped enable the HKMA to continue to achieve its objectives of maintaining currency and banking stability and ensuring the integrity of Hong Kong's financial system. Fulfilling these objectives is crucial to Hong Kong's continuing role as an international financial centre and vitally important to the stability of the region as a whole.

At the end of 1998 Hong Kong's linked exchange rate system was as solid as ever. Substantial improvements to the currency board system during the year made it much less susceptible to the manipulation that had caused so much volatility during the early months of the Asian financial crisis. Our banking system remained one of the most resilient in the

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world. Continuing economic difficulties and unsettled global conditions require further patience and vigilance. Recovery will take time and effort. But, while we must remain alert to present dangers, we also need to look beyond current problems and strive to obtain the greatest advantage from the technological, infrastructural and other changes that lie ahead. In 1998 we saw how many years of careful preparation equipped us to defend Hong Kong against problems that have overwhelmed many other monetary and banking systems. We also saw progress in a number of projects designed to prepare Hong Kong's monetary and banking systems for the challenges and opportunities of the next century.

Hong Kong in recession

Under the influence of the continuing Asian financial crisis, Hong Kong's economy moved into recession in 1998, recording negative growth in all four quarters and a decline in GDP of 5.1% over 1997. The unemployment rate more than doubled, from 2.5% in late 1997 to 5.7% in late 1998. Asset prices continued to fall. By the end of 1998, property prices had declined by over 40% from their peak in October 1997. In the summer, share prices fell by around 50% from their highest value in 1997, although they regained some of their lost value by the end of the year. The recession is likely to continue for much of 1999. It has been all the more intense because it persists for longer than many had initially expected and because it has come so suddenly after several years of vigorous growth. Distressing though they continue to be, the economic adjustments associated with the recession are necessary if Hong Kong is to maintain and increase its competitiveness as a regional and international centre.

Further attacks on the Hong Kong dollar

The pains of economic adjustment were exacerbated by continuing speculative attacks on the Hong Kong dollar, notably in January and June. Like the acute but short-lived attack in October 1997, these attacks failed to topple the linked exchange rate, but they drove up

interest rates and, in combination with rumours and continuing bad news, undermined both local and international confidence. In the late summer these attacks developed into a preconcerted, heavily leveraged cross-market assault, which sought to play Hong Kong's transparent and predictable currency board system against the stock and futures markets. The engineers of this double play strategy intended that extreme conditions created by their large-scale dumping of Hong Kong dollars would cause the stock market to plummet to a level that would allow them to reap large profits from the futures contracts they had taken out.

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This attempt to exploit weaknesses in the international financial system and vulnerabilities within Hong Kong posed the most serious threat to the stability and integrity of our financial system in many years. Rapid and radical action was needed to prevent a collapse in confidence. In the second half of August, the Hong Kong Special Administrative Region Government, drawing on the Exchange Fund, entered Hong Kong's stock and futures markets with two simple objectives: to ensure that the double players failed to make a profit, and to encourage them to think twice about returning to the markets with similar schemes. This limited market operation achieved its aims, and the double players were forced to close out their short positions, in many cases with heavy losses. A consequence of the operation is that the Government now holds a substantial shares portfolio. This portfolio has, since October 1998, been placed under the management of Exchange Fund Investment Ltd (EFIL), a separate company at arm's length from the HKMA. Apart from a small part that will be held as a long-term investment, the shares will be disposed of at an appropriate time and in a way that will have a minimal impact on the markets.

A stronger currency board system

The attacks on the Hong Kong dollar struck at the very heart of Hong Kong's monetary system: our fifteen-year-old linked exchange rate between the Hong Kong dollar and the US dollar, which is the basis of our monetary policy. Under this system, Hong Kong's currency is fully backed by ample and well managed foreign reserves. A flexible, free-market economy, a strong banking sector, and a long-standing policy of fiscal prudence ensure that the linked exchange rate serves Hong Kong as an anchor of stability and not as a millstone around its neck. The link is ideally suited to Hong Kong's unique needs. We are

an outward-looking, entrepot economy, with an annual external trade equal in value to over twice our gross domestic product. We import virtually all of our material needs. We act as one of the main channels of trade and finance between the Mainland of China and the rest of the world. Our status as an international financial centre depends on a credible currency and on the continuing absence of exchange controls, which, since 1997, have anyway been prohibited by law. With the link, a freely convertible currency is maintained at a stable level, businesses have a measure of certainty in an uncertain world, and depositors and investors are assured of the external value of their savings and investments. Equally important at this time of global crisis, the economy as a whole can be allowed to adjust through internal variables to a changing external environment without the collateral damage and general loss of confidence associated with the sharp currency devaluations that have destabilised so many other economies since the crisis broke.

The vulnerability in the linked exchange rate that attracted the speculative attacks in 1998 lay not in any shortcoming in the reserves that underpinned it – or indeed in any other fundamental flaw – but in the predictability and transparency of the rule-based currency board system. The rule requires that any change in the Hong Kong dollar monetary base must be strictly matched, at the exchange rate of HK\$7.8 to the US dollar, by a corresponding change in the amount of foreign reserves held by the currency board. Under the currency board's autopilot mechanism, any expansion in the monetary base causes interest rates to fall, while a contraction causes them to rise. The crucial part of the monetary base influencing the rise and fall of interest rates – the aggregate balance that banks maintain in their clearing accounts held with the currency board – is extremely small, at least until September 1998, making the monetary system susceptible to speculative attack.

A set of seven technical measures introduced in September refined the mechanisms of the currency board system to help insulate it from manipulation: two key provisions, the explicit Convertibility Undertaking, and the replacement of the Liquidity Adjustment Facility with a Discount Window, allow for greater interbank liquidity and reduce excessive interest rate volatility arising out of the small size of the aggregate balance. In combination with the market operation, these measures have been effective in safeguarding the system from further speculative attack. Since September the Hong Kong dollar interest rate has stabilised, and the machinery for maintaining the link has been markedly strengthened.

Currency board reform is a continuing process, and refinements to the system continue to be introduced with the advice of the Currency Board Operations Sub-Committee, formed in the summer of 1998 under the Exchange Fund Advisory Committee. The aim is to ensure that Hong Kong continues to be provided with a practical, robust currency board system that can hold its own in an unsettled and highly volatile global environment.

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The collapse of exchange rate systems elsewhere, and the interest rate volatility associated with Hong Kong's currency board system prior to the September measures, have raised larger questions among some commentators about the future and validity of the linked exchange rate. The alternatives they have put forward range from dollarisation to a return to the floating exchange rate. It is right that we should re-examine fundamental principles, but such proposals offer few advantages and would, if implemented, have the serious disadvantage of promoting uncertainty and eroding confidence. Our actions in August and September left no doubt about our determination to defend the link. It is also clear that, whatever misgivings might remain about our actions in August, the community in Hong Kong recognises the special importance of the linked exchange rate to the stability of our economy, and shares our determination to maintain and strengthen it.

A resilient banking sector

Throughout this year of recession, and in contrast to banking crises elsewhere in the region, Hong Kong's banking system handled the asset price deflation and interest rate volatility of 1998 with remarkable success. The asset quality and liquidity of Hong Kong's banks continued to be satisfactory, and the capital adequacy ratio of all locally incorporated authorised institutions stood at a healthy 18.6% at the end of the year. A natural consequence of a slowing economy was an increase in bad debt during the year and a decline in profitability for many banks. In the last quarter of the year the collapse of GITIC heightened concerns about the extent of the exposure of banks in Hong Kong to problematic Mainland debt. The restructuring of Mainland investment enterprises is part of a process of regulatory reform that will benefit Hong Kong's financial system in the long run. The consequences in the short term, however, have increased the burdens of some banks, and the situation will require careful monitoring and management.

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There is no doubt that 1999 will be a difficult year for many of Hong Kong's banks. But, equally, the banking sector as a whole has never been better prepared to manage the current difficulties or to respond to the opportunities that arise out of changing local and global trends. The thoroughgoing reforms in the 1980s and 1990s to the supervision and transparency of Hong Kong's banking system are now showing their worth. The system is stable and strong enough to weather the current crisis. It also has the confidence and trust of the community.

During 1998 the HKMA adopted a number of measures to further improve the transparency and supervision of the banking sector and took important steps to assist banks in responding to technological and global changes. In May, requirements were introduced to increase disclosure by authorised institutions of their financial positions. In February and August, two surveys were carried out to assess compliance with the Code of Banking Practice, which sets out the standards for consumer banking: the surveys revealed a high level of compliance, and also enabled the HKMA to better focus its supervisory activities in areas of deficiency. During the course of 1998 more than three quarters of all authorised institutions adopted the Submission Through Electronic Transmission (STET) system that we had introduced in December 1997, a facility that both increases the efficiency of banking returns and helps improve the HKMA's monitoring of authorised institutions.

Much of the HKMA's work on the banking side in 1998 involved long-term preparation both to accommodate changing conditions and to address a very specific future event. The specific event – the arrival of the Year 2000 and the challenge this poses to information technology systems - has seen an intensification of the HKMA's supervisory efforts to monitor the progress that authorised institutions are making to achieve Year 2000 compliance. On-site examinations, reporting requirements, and contingency planning were stepped up, and further efforts were made to promote public awareness of the issue, both through regular bulletins and on the HKMA's website. By the end of 1998, 85% of all authorised institutions reported that they had achieved Year 2000 compliance for their critical systems. In December the HKMA itself received certification from the Information Technology Association of America for its rigorous treatment of the Year 2000 problem.

The future of Hong Kong's banking system in a changing financial landscape was the focus of a major consultancy study commissioned by the HKMA and completed in 1998. Released in December, the study's report recommends developments in banking supervision and regulation to strengthen the ability of Hong Kong's banking system to manage changing customer needs and make the most out of a rapidly evolving and increasingly complex global financial environment. The central message is that competitive barriers should be progressively removed without compromising safety and soundness standards. The report is now under consideration by the Government and the HKMA, following a three-month period of extensive public consultation in early 1999.

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Hong Kong in a global financial community

A strategic location and the absence of controls on capital and information flows have helped make Hong Kong a major international financial centre, with one of the largest and most varied representations of the world's banks and financial institutions. Globalisation, together with the liberalisation of other financial markets, has helped Hong Kong develop its prime position as a regional syndication centre for loans and debt securities and as one of the world's largest foreign exchange trading centres. As the speculative attacks in 1998 starkly illustrated, globalisation and advances in information technology have also brought increasing risks from the facility and rapidity with which unregulated and highly leveraged fund flows have been able to disrupt open financial systems such as our own.

The dislocation between market behaviour and economic fundamentals has been an essential feature of the Asian financial crisis and a source of instability in other parts of the world. There is now a consensus throughout the world that concerted international action is needed to rebuild the global financial architecture so that it can cope with these fund flows more effectively and provide monitoring and regulatory functions that cannot be arranged by individual jurisdictions on their own. The many international agencies and forums grappling with this issue have made some progress, but we are still a long way from seeing results. Action is needed urgently on this issue, for we cannot assume that the absence of major speculative attacks in the past few months means that the problem

has gone away. This long overdue opportunity for fundamentally reforming the international financial system – by reducing its reliance on the ad hoc rescue packages or defence measures that have been increasingly necessary in recent years – must not be lost. Hong Kong, along with other economies in the region with direct experience of the problem, has much to contribute in the formulation of these reforms and will continue to play an important role in discussions.

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The prevention – or at least the mitigation – of future regional crises also requires the creation of a more sophisticated regional financial system, one that is less dependent on short-term financing from overseas lenders or on the recycling of regional wealth through overseas markets, with all the loss of contact between borrowers and lenders that that entails. The region needs to work hard to build its own deep and diversified debt markets and to bring its financial systems in line with the considerable advances made in other sectors of the economy. In 1998 Hong Kong continued to play a practical role, both in the development of its own debt market and in leading the APEC initiative on bond markets.

The energetic part Hong Kong takes in international and regional initiatives draws strength from our continuing status as an international financial centre and from the example we can help to set by continuing to keep our own house in order. It is also greatly facilitated by the high degree of autonomy given to Hong Kong under the one country, two systems formula. In the monetary sphere this means that Hong Kong not only enjoys such fundamental facilities as a separate currency, fiscal independence and a financial system separate from that of the Mainland: its government is also mandated by the Basic Law to maintain Hong Kong's status as an international financial centre. There is perhaps no greater test of a new system than a period of intense strain and crisis: the experience of 1998 has clearly demonstrated that the one country, two systems formula is a workable one, and that the Central Government in Beijing is content to leave the management of Hong Kong's monetary policy entirely in the hands of the Hong Kong SAR Government. What is more, the Central Government has, throughout the year, reiterated its support for what we are doing, its confidence in our ability to manage things on our own, and its preparedness to help in the unlikely event that help is needed.

The HKMA and Hong Kong

Hong Kong's continuing success as an international financial centre depends on international confidence in our free, open and well regulated financial system. It depends equally on the confidence of the people of Hong Kong, whose resourcefulness, enterprise

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and hard work are the foundation of our economic success. The pains of economic adjustment and the volatilities caused by financial crisis have naturally prompted debates about the monetary policies followed in Hong Kong and, not least, about the unconventional measures adopted to maintain the integrity of our financial system. Monetary management, and particularly the workings of the currency board system, must always be set somewhat apart from shifting daily political concerns if it is to be sound and effective. But the community, directly or through its representatives, has a legitimate part to play in shaping Hong Kong's broad monetary policies, and the HKMA has a duty not only to explain its work, but also to facilitate debate. Public support for our work and our policies can no longer be built merely on unquestioning faith in a remote and mystical monetary authority acting professionally in the best interests of Hong Kong: it must be fostered through explanation, education, and informed discussion.

Recognising that confidence in our banking and monetary systems is nourished by accurate and reliable information, we continued to develop the transparency of our daily operations, with the decisions taken in November to publish daily the size of the monetary base and the minutes of meetings of the new EFAC Sub-Committee on Currency Board Operations. These initiatives, added to the earlier decision in 1996 to disclose information about the Aggregate Balance on virtually a real-time basis, make the HKMA one of the most transparent organisations of its kind in the world.

In 1998 we intensified our efforts to explain our work to the community and to involve the community in our work. Our contacts with Legislators increased. We expanded our programme of workshops for teachers, journalists and other groups, and stepped up our consultations with academics and market practitioners. In addition to the Banking Sector Consultancy Study, which was put out for full public consultation in December, we issued a comprehensive study of the currency board system with the aim of facilitating discussion about how the system should be developed. We strove to improve the readability of our

publications, and received recognition for this in the gold award from the Hong Kong Management Association for our 1997 Annual Report. We also expanded our website – already one of the most visited of all government websites – and made preparations for a public Resource Centre, which opened in our offices in Central in January 1999.

The HKMA faced more challenges in 1998 than in any year since its establishment in 1993. Our success in meeting these challenges and in delivering fully on our policy objectives owes much to the skilled guidance of the Exchange Fund Advisory Committee, under the energetic leadership of the Financial Secretary. Above all, the dedication, capability and resourcefulness of the staff of the HKMA have ensured that we have been able to fulfil our responsibilities with the highest degree of professionalism and efficiency. I take this opportunity to pay a warm tribute to their hard work and cool-headedness in the face of enormous pressure.

The magnitude and persistence of the Asian crisis have reminded us all that our financial stability and economic prosperity cannot be taken for granted. At this time of economic difficulty, we all have a part to play in reinvigorating Hong Kong's competitiveness and in reinforcing our existing strengths as a centre of international trade and finance. There are too many external factors at play, many of them unresolved, to say with certainty when recovery will take place. For the time being, we must not only remain alert to further difficulties, but must also retain the initiative in the measures we take to develop Hong Kong as a global financial centre. When recovery does take place, I am confident that Hong Kong's monetary and banking systems, strengthened by the ordeal through which they have passed, will be ready to embrace the challenges and opportunities that the new century holds in store.

A handwritten signature in black ink, appearing to be 'Joseph Yam', with a long horizontal flourish extending to the right.

Joseph Yam
Chief Executive