

# DEFENDING HONG KONG'S MONETARY STABILITY<sup>1</sup>

*The operations of the Hong Kong Government in the stock and futures market in August have been the subject of some controversy. The Government believes that the actions are well justified, and it has a responsibility to tackle manipulation and avoid serious market dislocations which can be highly damaging to the stability of the whole financial system of Hong Kong. Hong Kong remains committed to the free market as it used to be.*

As I am sure you have noticed, Hong Kong, and specifically the involvement of the Hong Kong Monetary Authority (HKMA) in the stock and futures markets in August, has been the subject of some controversy recently. This is understandable, for Hong Kong has always been in favour of leaving markets alone, as much as possible. Indeed, Hong Kong has for many years been named as one of the freest, if not the freest, markets in the world. For the authorities in Hong Kong to go into the stock and futures markets to buy shares and stock futures contracts in such a big way naturally came as a surprise to every one, apart from the few of us who had the unenviable task of taking the very difficult decisions.

Clearly the responsibility of public office includes taking difficult decisions in the overall public interest, and one must take them with courage and execute them with commitment. Furthermore, one must also try one's best to explain the rationale behind them, and be transparent in, and accountable for, the actions taken. Difficult and controversial decisions can be easily misunderstood, even by the most learned man on earth. So we need to present the arguments patiently and clearly.

This has not been easy. Domestically, although there has been tremendous support from the Hong Kong public, a lot of dirt has also been thrown around. A number of public officers, including myself, have been the targets of much of this dirt. But, thankfully, amid the inevitable, and I am sure well intentioned, political noise, there have also been constructive comments.

Internationally, the initial response has been hostile, to put it mildly. The foreign press has been critical, almost as critical as it was about the imposition of exchange controls in Malaysia. Sadly, my most respected Nobel Laureate Milton Friedman, who has been most supportive of the free market philosophy so diligently practised in Hong Kong, thought that we had simply gone crazy. Even Fed Chairman Alan Greenspan, in his testimony to the House Banking Committee, spoke up on the subject. He said in answer to a question, in his carefully chosen words, that: "I think it would be mystery to find that I think that the efforts on the part of the Hong Kong authorities to try and jack up their stock market was a wise effort."

But I am glad to see that opinions have changed more recently. Perhaps it was Russia, or Latin America, or Long Term Capital Management, or perhaps it was our untiring efforts to explain our case that did it. Let me quote a somewhat unexpected source - Barton Biggs of Morgan Stanley. On 14 September 1998, he wrote: "the more I think about it, the more sympathetic I become toward the Hong Kong Monetary Authority and its stock market intervention". David Hale of the Zurich Group also said that: "it is difficult not to sympathize with the frustrations and anxieties which compelled ... the government of Hong Kong to intervene in the stock market". And last week George Soros said in Washington, when asked what he thought of Hong Kong's actions in the stock market: "I can't really disapprove".

My correspondence with Alan Greenspan is still ongoing: while I continue to point out to him that

<sup>1</sup> This is the text of the speech by Joseph Yam, Chief Executive of the Hong Kong Monetary Authority, at the TDC Networking Luncheon in Singapore on 14 October 1998.

we were only trying to deter market manipulation, which in any case is against anti-trust laws in the US, he still has doubts. This is because of the difficulty in distinguishing between what he calls “conventional, albeit sharp-eyed, arbitrage and speculative activities” in financial markets and what I call market manipulation. I shall persevere. In my view, whilst distinguishing between the two is difficult, it is not impossible, particularly when you are close to it. Perhaps I should deploy Chairman Greenspan’s argument for the Fed’s involvement in Long Term Capital Management in justifying our case. Instead of deterring market manipulation, I could say, in Alan Greenspan’s words, that we were trying to “avoid possible serious market dislocations that could have potentially impaired the economy”. But whatever argument we use, it is my firm belief that our actions, whilst controversial, are well justified. In this connection, let me put to you a few facts and allow you to draw your own conclusions.

Fact number **one**: Hong Kong maintains a fixed exchange rate through a currency board system. Such a system requires any change in the monetary base to be matched by a corresponding change in the amount of foreign reserves held by the currency board, with the currency board acting passively in response to capital flows. With a very efficient financial infrastructure, characterized by a real time interbank payment system, and in the absence of reserve requirements, banks in Hong Kong do not need to maintain large balances in their clearing accounts held with the HKMA. This means that the crucial part of the monetary base, in the form of the aggregate balance in the clearing accounts that all the licensed banks maintain with the Hong Kong Monetary Authority, is very small. This in turn makes interbank interest rates in Hong Kong very sensitive to capital flows into and out of the currency board. The sale of a small amount of Hong Kong dollars by a bank to the HKMA, which has to take it and provide US dollars at the fixed exchange rate in accordance with the discipline of currency board arrangements, could send interbank interest rates sharply higher.

Fact number **two**: the hedge funds had been borrowing and sitting on large amounts of Hong Kong dollars. From the beginning of this year to the middle of August, over HK\$30 billion of one

and two-year money were raised through the issue of debt paper in Hong Kong. The issuers were the multilateral institutions such as the World Bank, the Asian Development Bank, the Nordic Investment Bank, the European Investment Bank, the European Bank for Reconstruction and Development, the Council of Europe, etc. We welcomed these multilateral issuers making use of, and therefore helping to develop, the debt market in Hong Kong. But the real borrowers behind these Hong Kong dollar debt issues were predominantly the hedge funds, providing, through swaps arranged by intermediaries, attractive US dollar funding at below LIBOR to the multilateral institutions. To use less jargon, as I said the hedge funds have been borrowing and sitting on large amounts of Hong Kong dollars. They of course do so for a purpose. But since I am talking about facts I do not wish to venture a guess here. All I would like to point out is that the cost of running a HK\$30 billion position, with an interest rate premium over the US dollar that had been driven up to about 5 percentage points, is over HK\$4 million a day. And I would only add that the hedge funds are not exactly in the habit of throwing money away for nothing and that they do not seem to have been using the money to buy up Hong Kong stocks.

Fact number **three**: on the securities side, the potential for serious market dislocation had been building up. While the turnover in our stock market fell quite substantially as financial turmoil in the region intensified, activity in our stock index futures market grew sharply and disproportionately. A thin cash market, coupled with an ultra-active futures market, is a recipe for market dislocation, if not disaster, beyond the realms explainable by economic fundamentals. Furthermore, at least before the recent changes to the rules on shorting stocks, in terms of the financing cost there has always been a structural bias in favour of shorting stocks. The cost of borrowing stocks was low and there were rather lax settlement requirements that specified T+2 but said at the same time that you could have a few days’ grace if you did not have the stocks on settlement day, even though going “naked” short in stocks was against the law. Indeed, along with increasingly heavy bets being placed in the futures market there had been continuous shorting in the cash market.

Fact number **four**: there had been an abundance of bad news, bad numbers and rumours. In July and the first half of August, an unusually large number of investment houses published research papers on the Hong Kong dollar's link with the US dollar, predicting that the link would soon be broken. There were also many articles predicting the Renminbi's devaluation. Rumours abounded and the shorting of the Hong Kong dollar ahead of the weekend had become a weekly affair. In the first half of August, Hong Kong's GDP growth for the first quarter was revised down to -2.8%. Wall Street was down sharply. The yen fell to over 147 against the US dollar. On the approach of the long weekend in the middle of August, rumours of a devaluation of the RMB and/or the abandoning of the Hong Kong dollar's link with the US dollar intensified, risking the creation of panic and a breakdown of confidence in the currency.

Fact number **five**: there had been much selling pressure on the Hong Kong dollar in the first half of August. In accordance with the discipline of the currency board arrangements, the HKMA would have had to sell foreign reserves and buy Hong Kong dollars passively. This would have created a serious shortage in the Hong Kong dollar monetary base, thus sending interbank interest rates sharply higher and the stock market sharply lower. Given, however, the need to fund the budget deficit for this financial year, the opportunity was taken to switch some of our accumulated fiscal reserves held in foreign currencies back into Hong Kong dollars, leaving the monetary base and therefore interbank interest rates largely unchanged. The amount of Hong Kong dollars absorbed in this manner was large, exceeding the HK\$30 billion accumulated by the hedge funds.

Piece together these facts and you will have quite a clear picture of what happened and whether there had been manipulation or a danger of serious market dislocation. Your views are as good as mine; but for what it is worth, let me give you my assessment. In contrast to October last year, when they had to pay very penal interest rates to fund their short Hong Kong dollar positions, during the currency attack in August this year the hedge funds had pre-funded themselves. This they did by swapping US dollars for Hong

Kong dollars, through intermediaries, with multilateral institutions which had issued Hong Kong debt paper, incurring an interest cost of HK\$4 million a day for the HK\$30 billion position. But this was not a lot of money to them. We had reason to believe that they had been building up and maintaining quite large short positions in stock index futures. With an estimated 80,000 short contracts held amongst these hedge funds, for every thousand-point fall in the stock market index, they stood to profit HK\$4 billion. The cost and benefit calculation is clear. And this is the case regardless of economic or market fundamentals. So they waited for a good opportunity to sell the Hong Kong dollars they had borrowed, in the hope of creating a severe shortage in the money market and sharply higher interbank interest rates, thereby sending the stock market into a nosedive. And as if this was not blatant enough, all this occurred in a climate of malicious rumours about the RMB and the Hong Kong dollar, glorified by publications from the so-called in-house currency strategies and analysts, and by the usual "reliable information from authoritative sources".

Well, it did not quite work out the way they intended. They miscalculated on two counts. **First**, they did not factor in the need for the HKSAR Government funding this year's budget deficit, unexpected at the time when the budget was drawn up, through a draw down of foreign reserves. And so the currency board adjustment mechanism involving sharply higher interest rates was not triggered. **Second**, they did not realize that the HKSAR Government was far from the sitting duck they thought we were. Committed to the free market as we may be, we took the view that free markets do not mean that markets can be freely manipulated. They need to be fair markets as well. We have a responsibility to tackle market manipulation and avoid serious market dislocations developing.

So after much agonizing we acted on two fronts. **First** we intervened in the stock and futures markets to deter market manipulation, by making sure that the manipulation did not pay off. **Second** we followed this action through with various measures to strengthen our monetary and financial systems. On the monetary side, we introduced technical measures to modify our currency board arrangements of our linked

exchange rate system to make it less susceptible to manipulation. On the securities side, we are in the process of introducing a series of reform measures to lessen the potential for market dislocation.

I am happy to say that our actions have been successful. There has been no indication of further market manipulation since the end of August. We have seen substantial unwinding of the short positions in our currency by the hedge funds, with considerable losses. And with the stock market having recovered substantially from the level at which we entered the market in the middle of August, more considerable losses were incurred also in their short positions in the stock index futures. Much of the interest rate premium of the Hong Kong dollar over the US dollar has disappeared, clearly reflecting with hindsight the extent of the excessive pain that had been so mercilessly inflicted on the community by the manipulative plays. I hope you are now more sympathetic towards the controversial actions that we have taken. But in case you still have doubts, let me specifically address four accusations that have been hurled at us.

The **first** accusation is that we were trying to jack up the market against trends dictated by fundamentals. Alan Greenspan used those words. But this is simply not true. We do not mind where the level of the market is, if that is what the adjustment process demands. No official view on the "right" market level has been taken and there never will be such a view. So if somebody shorted the market thinking that the adjustment should be deeper, and if the market did fall and he benefited from the short position, we would even congratulate him for having excellent foresight. But we are against market manipulation, specifically the manipulation of our currency market, taking advantage of our passiveness under the discipline of the rule-based currency board arrangements, to produce very high interest rates with a view to sending the stock market into a nosedive and benefiting from a short position in stock index futures. Such manipulation was conducted with no regard to economic fundamentals. This presents serious risks of market dislocation or overshooting, with asset markets ratcheting down every time this double play is staged. This can be highly damaging to the

stability of the whole financial system of Hong Kong. It also presents the serious risk of undermining general confidence in our currency. Our aim has been to deter market manipulation, not to jack up the market.

The **second** accusation is that we panicked because the pain of adjustment with a fixed exchange rate, including the interest rate pain arising from capital outflow under the currency board arrangements, had become unbearable. We did not panic. We were trying to prevent the market panic and overshooting that those manipulating our markets were trying to engineer. And Hong Kong is prepared and well equipped to bear the inevitable pain of economic adjustment necessitated by the financial turmoil that originated in this region and is now spreading to the developed markets. As head of the Hong Kong Monetary Authority I have repeatedly been asking our community to stick it out. We have seen downward adjustments in asset markets of about 50% in less than twelve months. While not taking a view as to whether such adjustments are adequate in the circumstances, we can do without the excessive and destabilising interest rate volatility brought about by market manipulation. We can do without what is now clearly proven to be the excessive interest rate premium brought about by the continuous presence of the market predators. We can do without the market overshooting that many of our neighbouring economies have been made to suffer. We can do without confidence being undermined by the greed of those that intent only on making profits at the expense of our people. We have the wherewithal to tackle the situation and we did so decisively.

The **third** accusation is that we have dangerously departed from the currency board discipline and ventured into discretionary monetary management. We have not. And without bothering you with too much technical detail, the measures introduced recently have the effect of strengthening the currency board arrangements of Hong Kong rather than eroding them. There has been much confusion about this matter, stemming from the somewhat academic debate as to whether a currency board should also be responsible for the provision of liquidity to the banking system that involves an increase in the

monetary base. The purists would say no to this, but they should really come down to earth and recognise that in modern day finance the majority of transactions are conducted electronically without the use of cash. For the effective operation of currency board arrangements, the organisation responsible for running the system has to manage the electronic interbank clearing system as well. This requires that the banks operate clearing accounts with the currency board and that the aggregate of the balances in their clearing accounts forms the crucial part of the monetary base which is subject to the monetary rule of the currency board. This puts the responsibility for the provision of liquidity to the banking system squarely on the currency board. But this arrangement need not involve any significant departure from the discipline of currency board arrangements. The important issue is how liquidity for the purpose of facilitating the clearing of interbank transactions is provided. In Hong Kong this is provided through the repurchase of debt issued by the currency board and fully backed by foreign reserves. There is therefore no departure from the discipline of currency board arrangements.

The **fourth** accusation is that we were too late in introducing our technical measures to strengthen our currency board arrangements and that had we done so earlier we could have avoided having to intervene in the stock market. Frankly, I do not think that we could have turned around the market sentiment with just part of the package of actions. The measures to strengthen our currency board arrangements have been effective. But basically what we have done, amongst other things, was to dampen interest rate volatility by accepting some fluctuation in our foreign reserves. In isolation this would probably not have been effective in deterring market manipulation. The timing for doing anything is of course an easy question to pose, but the reality is much more complex than that. One should realise that the system, before the introduction of the technical modifications, has served Hong Kong very well for almost fifteen years. Furthermore, there is no free lunch. Costs are involved. The larger fluctuations in foreign reserves may affect confidence. It may be seen as a sign of weakness, although with foreign reserves in multiples of the monetary base

this should not be a cause for concern. Tightening the provision of liquidity to the banking system by denying access to the discount window paper other than those issued by the currency board may affect the development of the debt market. And making explicit the passive convertibility of the monetary base into foreign reserves may dampen activity in the foreign exchange market. The pros and cons must be considered carefully before making these significant changes.

I think I have spoken long enough. I hope I have made my case convincingly. Thank you Victor for giving me this opportunity. In closing, may I quote Barton Biggs again. He said: "I have come around to agreeing with the HKMA that it could not simply stand by idly and watch the speculators and hedge funds create a vicious circle involving the stock market, the currency and interest rates. ... When the hedge funds become a pack and attack a country the way they attacked Hong Kong, they are engaged in destabilising and essentially immoral activity. They are intent only on making profits for themselves at the expense of The People. ... The speculators cannot be allowed to rule the world, and the State must use the weapons it has against them when they attack".

May I also leave you with this question: if the authorities of the freest market in the world are pushed into controversial market intervention action, could it be that there is something seriously wrong with the international financial architecture? Paul Krugman in one of his articles in a recent issue of the Fortune magazine provides some insight into this question. He said that "speculative conspiracies against companies are effectively regulated; those against countries are not. ... Capital markets are global, but the institutions that support and regulate them - that allow them to work - remain national. It's hard to imagine how truly global institutions could come into existence - how we could, for example, prosecute American traders working in London for manipulating some market in China. But until we figure it out, it's going to be a very rough ride."

The task at hand for everybody is to figure this out, urgently, even though you might not yet have a fire in your backyard. ☸