THE POLITICAL PROCESS OF MONETARY MANAGEMENT[1]

The management of any public issue of significance involves first getting technicalities right, then explaining them patiently and clearly to all those concerned, and then handling skillfully the politics surrounding it. For the Hong Kong Monetary Authority (HKMA), there are three areas that require attention. First, various concepts in modern day monetary management need to be more effectively put across. Second, a high degree of transparency should be maintained. Third, the accountability of the HKMA should be considered.

I am particularly pleased to be here this evening to deliver the Thirteenth Susan Yuen Memorial Lecture. I never had the privilege of meeting the late Mrs. Susan Yuen. But in reading her brief history in the material published by the Hong Kong Management Association, I found out that she and I both came to Hong Kong from the Mainland in 1949. And we both became the first Chief Executive of the HKMA - the Hong Kong Management Association in her case and the Hong Kong Monetary Authority in my case. But I fear that I shall never achieve the distinction of having a Memorial Lecture dedicated in my name. And certainly at the age of fifty I am content not to have to ponder such matters. It is a sufficient honour to have been invited to celebrate with you Susan Yuen's distinguished record of public service.

I would like to talk about the political process of monetary management to fit in with your theme of "Managing Economic Turbulence in Asia".

Controversy

I am sure you are aware of the controversy over how we managed the financial turmoil that we have been facing. There has been many complaints about a wide range of issues. Our critics have told us that we should not have squeezed so hard on interest rates last October and that we should not have increased the cost of borrowing for business and for those who have to service their home mortgages. We should have introduced our measures to strengthen our monetary and financial systems earlier. We should not have departed from our free market policy and intervened in the stock and futures markets. That there was a lack of a "sense of crisis" in how we handled the situation. These are the more significant criticisms.

I can fully understand the sentiment behind these criticisms. The people of Hong Kong have been suffering the worst conditions we have had to face for many years. Even the most patient and understanding community will have grievances when the value of the assets they hold has been halved while they have to pay significantly higher interest costs for their liabilities. Furthermore, income has not been growing, and, for some, it has been shrinking. And, worse still, the probability that they may lose their jobs has doubled in the past year.

So, whatever the cause of this difficult situation, whether or not it arose from events outside the control of the authorities, it is considered, and rightly so, the responsibility of a caring government to do what it can to relieve these grievances. Refusal or reluctance to do so, even for very sound reasons in the larger long-term public interest, is not looked upon kindly. Even in cases where the authorities managed to be innovative, perhaps to an extent not normally expected of bureaucrats, and did the right thing, there is always the easy, popular but legitimate question of why action was not taken earlier.

The Political Process of Monetary Management

In Hong Kong, the grievances of the community are enthusiastically and effectively aired by politicians. Whether directly or indirectly

[1] This is the text of the speech by Joseph Yam, Chief Executive of the Hong Kong Monetary Authority, at the the Thirteenth Susan Yuen Memorial Lecture of the Hong Kong Management Association on 20 October 1998.

elected, the politicians have the mandate of the people and the people of Hong Kong are well served by them. But one of the peculiarities of the system of Hong Kong is that the politicians, although having the mandate of the people, do not actually have the authority to direct government policies. A consequence of this is that the Administration is always kept on its toes, much more so than in many other jurisdictions. There are lively debates on almost all issues of significance, not to mention those that are controversial. This obviously has the benefit of ensuring that the Administration performs to its best ability. But the inevitable disadvantage is simply that there can be too much of everything, to the extent of eroding rather than enhancing the efficiency and effectiveness of government. But this is the reality of Hong Kong today and we all have to live with it.

The management of any public issue of significance involves first getting the technicalities right, then explaining them patiently and clearly to all those concerned, and then handling skillfully the politics surrounding it. More often than not, handling the politics is the most difficult part. You can be one hundred percent right technically and you can spend all day explaining all the fine details, relating them to the policy objective and the public interest. But if you are not skillful enough in the handling of the politics of the issue, particularly an issue in which the confidence of the people plays a crucial part in its success, all your efforts might be wasted. A totally different perception than that intended could well result, undermining the chance of success of what you are trying to achieve.

Let me focus specifically on the management of the political process concerning monetary issues. I must say that this task is, for the HKMA, becoming increasingly difficult and time consuming. Monetary issues are unfortunately very technical and elusive, but they affect every body. Money is dear to the heart of everyone. We work hard to earn it. And we use it everyday, which can often be, thank goodness, the more pleasant aspect of it. So, quite naturally to us, the price and the value of money are things that we should be concerned about. Here, already to a lay person or to the average politician, we are being esoteric. What is the price of money? What is the value of money? And what are the differences between the two? Why should we be concerned about them? These are very legitimate questions. And they are in fact not easy questions to answer or easy concepts to put across.

So, imagine trying to explain, and obtain support for, the following proposal: "to dampen interest rate volatility and lessen the interest rate pain by redefining the monetary base to include debt paper discountable at the HKMA through overnight repurchase agreements and fully backed by foreign reserves without departing from the monetary rule of currency board arrangements which requires the monetary base to change only with a corresponding change in foreign reserves". This really is a mouthful. And to some, I must have been speaking Greek. But I can assure you that the wording of the proposal is precise and technically 100 percent correct. In fact, this was exactly what we did when we introduced the seven technical measures in early September to strengthen our monetary system. And the proposal has worked well so far. But had the proposal been presented in those terms, I think even the most learned academics would take some time to figure out what we were up to.

The likely result is that nobody would be willing to comment on the proposal for fear of exposing ignorance on the subject. This might be considered a good result, in terms of ourselves being able to achieve what in our professional opinion should be done. And if the community has faith in the HKMA, confident that we know what we are doing, we may even get public support. But it is also a risky result. First of all, we can of course be wrong. It would be naive to think that we can be right all the time. Nobody can be. We can only be less wrong. But more importantly, public support should not be built merely upon faith in an esoteric and aloof HKMA being professional and acting in the best interest of Hong Kong. Whatever reputation the HKMA has been able to achieve, domestically and internationally, such support could never be sustained for long. We do run a system that, at times, inflicts considerable pain on the community. Many of the decisions taken by the HKMA are unpopular. The pain and the unpopular decisions may become too severe to bear just on the foundation of faith, particularly in the peculiar political setup of Hong Kong.

An essential part in the management of the political process concerning monetary issues, therefore, is to promote a better general understanding on those issues. This is not easy. Not only are those issues technical, but they are also changing all the time with the rapid changes in the global financial scene. Financial liberalization and the globalization of financial markets, encouraged by the advance of telecommunications and information technology, have drastically changed the behaviour of money. On top of all this, we have the complication that Hong Kong's monetary system has really only started to take shape in the past ten years or so, as monetary reform measures were introduced to modernize it so it could cope with the demands and expectations of modern day finance. But these difficulties are not excuses for not trying. And we have tried; although I must confess, on the basis of the reaction from some of the politicians to the actions we have taken recently, that the returns on our efforts to promote a better general understanding of monetary issues in Hong Kong have not been impressive.

So we must try harder, and we will. There are then the questions on how and the areas in which we need to concentrate our efforts. On the former I shall seek advice from my colleagues. On the latter, the recent episode surrounding our operations in the stock and futures markets, culminating in the defeated Motion Debate in the Legislative Council on 30 September 1998 to review the HKMA, provides excellent guidance. If one filters away the noise from political posturing, including the rather unpleasant and unnecessary personal attacks, there are three areas that require attention.

Basic Monetary Concepts

The first area that requires attention concerns various concepts in modern day monetary management that need to be more effectively put across. This is essential if discussions on the technical issues are to be more meaningful. I am aware that this is not intended to be a lecture on monetary economics, so let me just bring out one or two of them here for illustration.

Under our linked exchange rate system, stability in the exchange rate is ensured through the control on what is called the monetary base. If you were to ask any representative grouping of the community, say, the Legislative Council, what the monetary base is, I would be surprised if more than ten percent of the group could come up with the correct answer. Many would be tempted to relate this to the various definitions of the money supply, because that is the term mostly heard in commentaries on money and finance. But they are quite different things. The crucial part of the monetary base and the money supply, however defined, are in fact on the different sides of the balance sheet of the banking system. Put this question to a group of academics and you would probably, on the contrary, get as many definitions as there are people in that group.

This confusion is understandable and, at least partly, in the context of Hong Kong, a reflection of the rather peculiar institutional framework for monetary management of the past that is now, one hopes, history, with the ten years of reforms to our monetary system. You may be surprised to hear this. It was not until the end of 1996 that the monetary base for Hong Kong was properly defined. This was when, on the occasion of the introduction of Real Time Gross Settlement for interbank transactions, all licensed banks were required to operate a clearing account with the HKMA instead of with a commercial bank. Yet we have been, somehow, controlling, or we claimed to have been controlling, the monetary base ever since the linked exchange rate system was established in October 1983.

Even assuming that the definition of the monetary base is well understood, there is then the important question of how it should be controlled. Herein lies one of the most interesting subjects in monetary management and that is the choice between discretionary control with people making decisions, and automatic rule-based control with no discretionary decisions involved. Associated with this are considerations concerning, and possibly another choice between, flexibility in management and the credibility of the monetary system. Even the most professionally competent central banker can be wrong. A system that involves discretionary decisions is therefore subject to human errors of judgement that may undermine the credibility of the system, and some would go as far as to argue that this would eventually lead to failure of the system. On the other hand, an entirely rule-based system without any discretion is inflexible and may not serve the best interest of the community, even though short-term interests may sometimes be involved - witness the many calls for lowering interest rates even when the exchange rate is under pressure.

Another related conceptual issue that needs to be put across clearly is that the classical currency board system, as structured in the old colonial era, whilst still theoretically sound, has long become impracticable in coping with the complexities of modern day finance. In the old days, transactions were conducted predominantly with the use of physical cash. And so the focus of attention in currency board theory was merely that the issue of cash should be backed 100 percent by foreign reserves and rather simplistically that cash arbitrage would keep the exchange rate stable. There was nothing much about the monetary base and the adjustment process in response to capital flows involving movements in domestic interest rates. The theory also did not take into account the many and much larger volumes of transactions nowadays conducted with the use of electronic money and settled electronically without the use of physical cash. As a result, the crucial part of the monetary base is no longer the amount of cash in circulation but a much smaller yet highly leveraged element in the form of the aggregate balance that banks have in their clearing accounts maintained with the currency board, that is the HKMA.

The old theory also did not take into account the need for the currency board to be controlling the interbank payments system and therefore performing the role as provider of liquidity to the banking system. As a result when our currency board arrangements were modernized through monetary reform in the past ten years, many of our actions were misunderstood even by leading monetary economists. But to be fair, even we ourselves were not entirely sure about a few things, as we moved into the uncharted waters of modern day currency board theory and practice.

Yet another conceptual issue to be put across clearly is the fact that an inevitable cost of fixing the exchange rate through currency board arrangements is interest rate volatility. An external shock involving any substantial flows of funds into or out of the currency will lead to interest rate changes. The larger the flow the sharper the changes, in a manner very much dictated by the market. And as there is little or no discretion on the part of the HKMA on interest rates, the HKMA was in fact not responsible, for example, for overnight interbank interest rates hitting 280% last October. We did not squeeze interest rates. It was those shorting the Hong Kong dollar who squeezed the interest rates and, on that occasion, squeezed themselves as well, along with the innocent borrowers. Interest rate volatility can be dampened by discretionary action, but that would undermine the credibility of the system. Alternatively this could be done by further modifying our currency board arrangements and incurring the cost in the form of greater fluctuation in our foreign reserves while eschewing the exercise of discretion. This was the objective of the seven technical measures we took in early September to make our system less susceptible to manipulation.

I do not wish to continue to bore you with these conceptual issues. Although they are technical, they are essential if there is to be sensible and meaningful discussion about monetary management in Hong Kong. I shall be stepping up the efforts of the HKMA to promote a better understanding of them.

Transparency

The second area that requires attention in the political process of monetary management concerns the transparency of the HKMA. To at least the minority of those members of Legislative Council who supported the defeated Motion to review the HKMA, the transparency of the HKMA was found to be lacking. Although the Motion was defeated, the fact that transparency was an issue, even to the minority of the Legislature, is quite surprising to me. It is perhaps not something that I can afford to ignore. However, compared with other central banks, the HKMA must be among the most transparent in the world. In monetary management specifically, I am quite sure that we are the most transparent in the world. I know of no other central bank that discloses information about the monetary base, and operations affecting it, on a real time basis. There is also an abundance of information published in the HKMA's regular series of monthly, quarterly and annual reports, and in the ad hoc publications on specific monetary and banking issues. Figures on foreign reserves are published monthly and soon we shall be publishing the balance sheet of the Exchange Fund also on a monthly basis.

Perhaps this minority view was based on the practice, now becoming quite common in other central banks, that the proceedings of monetary policy committees are published, so that the public is made aware of how monetary policy decisions are taken by those entrusted with the authority to make them. There are the examples of the Federal Open Market Committee (FOMC) of the Federal Reserve Bank in the United States and the Monetary Policy Committee of the Bank of England. The minutes of their meetings are published with an appropriate time lag. In Hong Kong we do not have an equivalent of the FOMC or the Monetary Policy Committee. This is simply because we do not have an independent monetary policy and an independent body making that policy. We do not have a system whereby the HKMA has to take discretionary decisions to determine interest rates or to specify monetary targets. There has therefore not been a need for a mechanism for public scrutiny of discretionary decisions because there is nothing to scrutinize.

Our monetary system is rule-based. To the extent that there is a need to have a mechanism for public scrutiny, it should be aimed at ensuring that the HKMA adheres to the rules and does not indulge secretly in discretionary monetary management. We have already volunteered this mechanism in providing real time information on the monetary base. Changes and forecasts of changes to the monetary base are announced almost immediately after the relevant transactions have been conducted. There is no parallel with this practice in any other jurisdiction.

But the process of modernization of our currency board arrangements is likely to be a continuous one, in the light of possible rapid and significant changes in the international financial architecture. The Financial Secretary as controller of the Exchange Fund, and myself as Monetary Authority under his delegated authority, are responsible for making decisions in this area, in consultation with the statutory Exchange Fund Advisory Committee (EFAC). Recently, with the agreement of the Financial Secretary, a sub-committee of the EFAC on currency board operations chaired by me has also been set up to advise, among other things, on currency board arrangements.

Whilst it can be argued that transparency in this area of work would help to enhance the credibility of the system and the HKMA, it must, however, be noted that proposals in this area are likely to be market sensitive. It will not be easy to strike a balance. But we should obviously try. I shall shortly be making a proposal to the Financial Secretary initially for the minutes of meetings of the sub-committee, other than those concerning market sensitive issues, to be published, with an appropriate time lag. Consideration will also be given to the sub-committee conducting public hearings to receive opinions and suggestions on monetary management from members of the public. In the light of experience of this practice, consideration can later be given to do the same for the minutes of meetings of the EFAC.

Accountability

The third area that requires attention in the political process of monetary management concerns the accountability of the HKMA. Here again, there are certain characteristics peculiar to Hong Kong. Unlike arrangements in other jurisdictions, the HKMA, as the institution responsible for issues generically called central banking, is not a body established by law. The legal entity is the Monetary Authority, as a person, appointed by the Financial Secretary to assist him in the performance of his duties under the Exchange Fund Ordinance. I have the honour of being the person who has been so appointed. That means I am accountable to the Financial Secretary for my actions when exercising the authority delegated to me by the Financial Secretary under the Exchange Fund Ordinance. The Financial Secretary is advised by the EFAC appointed by the Chief Executive of the HKSAR, whose authority has been delegated to the Financial Secretary.

It is through the Financial Secretary that the Monetary Authority is accountable to third parties, and the form this takes is determined by the Financial Secretary. If the Financial Secretary wants me to appear before the Legislative Council and formally present a report to the Council every six months, as suggested by some, I am quite happy to do so. But the Financial Secretary must of course make an assessment of whether the implications of such a practice is acceptable. He must take a view on whether this would introduce an avenue for political interference in the work of the HKMA, in particular in monetary management. He must also take a view on whether this would undermine the effectiveness of the relationship between the Administration, in particular himself, and the HKMA.

Insofar as getting things done at the technical level is concerned, for example in achieving the broad policy objectives of monetary and banking stability, and the development of the financial infrastructure, the existing relationship between the Administration and the HKMA has worked well. The Hong Kong dollar exchange rate has remained very stable and the banking system robust, and Hong Kong now has one of the most sophisticated financial infrastructures in the world.

It is of course up to the Administration to consider whether, for political reasons, the unusual arrangements for the appointment of the Monetary Authority and the framework defining his accountability should be looked at. But it should be remembered that those unusual arrangements had the agreement of the Legislative Council as recently as late 1992 when it approved the required amendments to the Exchange Fund Ordinance. Admittedly, the details of the amendments then reflected expediency dictated by political considerations at the time. But the arrangements have worked well for Hong Kong.

The Administration may feel that there is a need for the existing arrangements to be replaced by a separate Ordinance establishing an institution called the HKMA, having its own board and clearly defined functions. This appears sensible and is at least consistent with arrangements in other jurisdictions. But it is my strong view that, should this be considered desirable for whatever reasons, the opportunity should be taken to achieve greater and not less autonomy for the HKMA. There should be more, and not fewer, safeguards against political interference in the work of the HKMA. The Administration has indicated that it will take the matter forward in due course and no doubt the Legislature will be consulted when the Administration has formulated more concrete proposals. My advice, for what it is worth, is to proceed cautiously and in quieter times when market conditions are less unsettled.