

# THE IMPORTANCE OF THE EURO FOR HONG KONG<sup>1</sup>

*The Euro, soon to be introduced, will help to stimulate economic growth and business opportunities in the global economy. The existing trade and financial links between Hong Kong and the European Union countries reinforce the importance of the Euro to Hong Kong. In preparation for the launch of the new single currency, HKMA has been taking appropriate regulatory steps and has advised banks to gear up for the launch.*

I am very pleased to be here this morning to speak at this seminar on the Euro organized by the Vocational Training Council in conjunction with the British Consulate-General and the Hong Kong Institute of Bankers. With the introduction of the Euro less than two months away, this is obviously a good time to hold such a seminar. It is also fitting to hold it in Hong Kong where our fixed exchange rate system gives us a natural sympathy for its logical extension, the single currency. We are fortunate to have a number of experts on the Euro here today to give us the benefit of their views, including my former colleague from Bank of England, John Townsend.

My role in the seminar is to say a few words on the importance of the Euro for Hong Kong. I will also take the opportunity to brief you on some of the regulatory steps which we have been taking to prepare for the Euro.

The introduction of the Euro is a truly momentous change in the global economic and financial landscape. It is not simply a change of currency for the participating countries - though that in itself is a major event. Rather, it is a crucial step in the economic and monetary integration of the European Union (EU) countries and the creation of the single market. This change will involve 300 million consumers, 16% of world GPD and 29% of world trade. This demonstrates why the Euro is an important event for Hong Kong. As the UK Chancellor of Exchequer recently made clear, we are now living in a global economy, in which each economy can directly affect the prospects of every other. Where the economy concerned is the size of the EU, its potential to

affect other economies - for good or bad - is without question.

This is reinforced by the existing trade and financial links between Hong Kong and the EU countries:

- the EU ranks 3rd among Hong Kong's trading partners in the world;
- in the first eight months of this year, the EU accounted for HK\$245 billion or 13.2% of Hong Kong's total trade - much of this represents entrepot trade between the EU and Mainland China;
- the EU is the largest external investor in Hong Kong, accounting for over HK\$200 billion or 34% of the total;
- more than 700 EU companies use Hong Kong as regional headquarters or regional offices;
- the EU is the 2nd largest source of visitors and 4th largest source of tourist earnings for Hong Kong;
- there are over 50 licensed banks and other authorized institutions in Hong Kong from the EU countries, the largest concentration in Asia.

Clearly, what happens in the EU matters to Hong Kong. What therefore will be the impact of the Euro on the participating countries? There should certainly be a number of economic benefits, including in particular:

<sup>1</sup> This is the text of the speech by David Carse, Deputy Chief Executive of the Hong Kong Monetary Authority, at the Seminar on Euro on 9 November 1998.

- a huge increase in transparency from the single currency which will make it easy to compare prices across national frontiers. This will boost competition, bring down costs and prices and improve efficiency;
- a reduction in transaction costs, in particular from the elimination of foreign exchange commissions. This will encourage trade and cross-border investment flows;
- lower interest rates in individual countries from the elimination from the foreign exchange risk premium. This will reduce financing costs and stimulate investment and output;
- the development of larger and more liquid debt and stock markets across the Euro zone. This will create a vast new pool of capital for companies, thus giving a further stimulus to investment;
- tighter fiscal discipline on the member countries under the Stability and Growth Pact and monetary discipline exercised by the new European Central Bank. Both these should ease inflationary expectations and produce a more stable financial environment for the Euro zone.

In summary, the single currency should be able to deliver higher economic growth and therefore increased demand for imports by the Euro countries. As one of the EU's major trading partners, this should benefit Hong Kong. Hong Kong may also be able to take advantage of the increased flow of funds for global investment which may be forthcoming from a greatly enlarged European capital market. Furthermore, to the extent that an offshore Euro market develops, Hong Kong would be an obvious location for this in Asia. This reflects the existing large presence of European banks in Hong Kong and our role as a bridge between Europe and Mainland China. Finally, Hong Kong is one of the world's largest holder of foreign exchange reserves and the Euro will provide interesting opportunities for diversification of our portfolio.

Of course, the advent of the single currency also brings with it certain risks. The discipline imposed by the single currency will not always be comfortable, particularly when the business cycles diverge in different member countries. This could set up tensions which could at worst lead to a break-up of the Monetary Union or at least undermine confidence in the Euro. The current dispute between politicians and the European Central Bank over interest rate policy might be a foretaste of what is to come. A break-up of the Monetary Union seems highly unlikely, but the potential for internal wrangling is clearly there and that could be disruptive to world financial markets.

There must also be at least a possibility that closer integration of the EU could make it more self-contained and inward-looking. Intra-EU trade could increase, while that with the rest of the world and Hong Kong could diminish. Moreover, will the enlarged EU capital market suck in capital from Asia to Europe? In the first four months of this year, for example, Japanese net purchases of European securities totalled US\$9.9 billion, while net sales of bonds and stocks in Asia totalled US\$2.1 billion. Extended diversion of capital to Europe would undermine Asia's growth prospects as well as Hong Kong's position as an international financial centre. This could also happen if the European banks are tempted to consolidate their business in Asia to focus their efforts on their enlarged home market.

This is not the occasion to be pessimistic. Overall, I believe that the Euro will be a good thing for Europe and for the world economy. But as with any major change in the world financial architecture, Hong Kong will need to monitor developments closely and respond quickly to emerging threats as well as opportunities.

Let me now turn to the HKMA's regulatory response to the Euro in Hong Kong. First, banks in Hong Kong need to be prepared to handle and account for the Euro, particularly during the awkward transitional period before the legacy currencies disappear entirely. If they are not ready, many of the potential benefits of the Euro for Hong Kong will simply not materialize. We have

therefore issued advice to the banks on the steps that they need to take, such as: review of business strategies and business processes that might be affected by the Euro; review of nostro accounts in the legacy currencies; adaptation of information systems; and review of contracts that might be affected by introduction of the Euro.

Secondly, we have thought it sensible to introduce legislation that will provide for continuity of contracts in relation to the introduction of the Euro. In doing so, we are following the example of the EU itself as well as some other jurisdictions. In theory, such legislation may be unnecessary since the well-established “lex monetae” or “law of the currency” principle means that the currency of a payment obligation should be determined by the law of the country of that currency. This means for example that a payment obligation payable in French francs would become payable in Euro after the introduction of the Euro because that is the situation that applies under the law of France.

However, despite this general principle, concerns have been expressed that parties to contracts might argue that the introduction of the Euro represented a fundamental change of circumstances, bringing the contract to an end or requiring its terms to be adjusted. In addition, another feature of the introduction of the Euro is that it will replace the ECU at a rate of one for one on 1 January 1999. The ECU is a currency basket but not a currency in its own right. The “lex monetae” principle does not apply in this case and therefore the Euro will not automatically substitute for the ECU in contracts.

It is to remove uncertainty on these points that we have decided to legislate. We believe that this is appropriate for an international financial centre such as Hong Kong. The financial and legal community in Hong Kong strongly supports this view.

This is just one specific example of how Hong Kong is affected by the introduction of the Euro. There will undoubtedly be more far-reaching effects on our economy and our financial system as the single currency takes root. This is why this seminar is timely and important. I hope that you will find it enjoyable and useful. ☺