The Link: 20 Years On

This is the text of the speech delivered by Joseph Yam, Chief Executive of the Hong Kong Monetary Authority, at the Open University of Hong Kong Alumni Link Launching Ceremony cum Alumni Honorary Graduate Talk on 14 October 2003.

Delivered during the week that marked the twentieth anniversary of Hong Kong's Linked Exchange Rate system, this speech examines the factors behind the sudden strengthening of the Hong Kong dollar in the previous month. One of these factors was the large inflow of funds into Hong Kong, attributable to a return of optimism about Hong Kong's economic prospects.

It is always a pleasure to attend Open University events. It is a particular pleasure to be here to participate in the launch of Alumni Link in the presence of so many fellow graduates. Alumni Link will provide information, organise events, and help nurture a sense of community among graduates of the Open University of Hong Kong. It will also, I note, play its part in stimulating the Hong Kong economy by arranging discounts and other privileges. So Alumni Link is very obviously a good thing. This new facility underlines two fundamental principles behind the work of the Open University: first, that education is a lifelong process, which does not end with final examinations or the award of degrees; and secondly, that education is a matter of teamwork and fellowship, and not a solitary pursuit. I congratulate all those involved on having established this useful and imaginative resource.

I should also like to take this opportunity to pay tribute to the work of Professor Tam Sheung-wai, who will, I understand, be retiring as President next month. Professor Tam has made enormous contributions to the development of open and distance education within Hong Kong and beyond. I think it is fair to say that the Open University has reached its maturity as an institution under his presidency. Yet, remarkably, the momentum that has characterised the University's early years seems now to be gaining rather than slackening, with the recently announced plans for expanded services not just in Hong Kong but also on the Mainland. Professor Tam will retire with the knowledge that the Open University is in a flourishing condition and has an excellent reputation, internationally as well as locally. I join you all in wishing him health and happiness in his retirement and in wishing his successor, Professor John Leong, every success.

The Linked Exchange Rate System

I had originally planned to talk generally this evening about challenges in central banking. I shall certainly address this topic later on. But it occurred to me as I was preparing the talk that this week, in addition to launching Alumni Link, we also mark the anniversary of the launch of another Link, which I also participated in twenty years ago. Since that Link has again become quite topical over recent weeks, I thought you might be more interested if the focus of this talk was on the Link.

Twenty years ago, almost to the day, the Hong Kong Government announced and then implemented a new policy to stabilise the Hong Kong dollar. This was at a time when the dollar had been falling in value so fast that the monetary and banking systems were in a state of crisis. Many of you here will remember the run on rice and toilet paper at the supermarkets and the real sense of anxiety about our currency. Those days are as clear in my own memory as if they were last week. The policy announced on Saturday 15 October 1983 and formally introduced on Monday 17 October 1983 was to link the Hong

Kong dollar and the US dollar at the fixed rate of 7.8 Hong Kong dollars to the US dollar under a currency board system. This policy has become known as the Linked Exchange Rate system, and it is now such an established and familiar part of Hong Kong life that it is difficult to imagine quite what Hong Kong would have been like these last two decades without it. It is certainly, as far as I am aware, one of the longest lasting of the handful of currency board systems now in existence.

More recently, events have shown that monetary affairs are never predictable, even with a system as simple and transparent as the Link. For many months, market sentiment towards the Hong Kong dollar had been quite bearish. The general view was that deflation, unemployment, the budget deficit, and general economic difficulty were all prompting serious questions about the long-term viability of the Link. And, from time to time, suggestions were made that the Hong Kong dollar should be allowed to float — or at least be re-pegged — so that monetary policy could contribute more effectively to the resolution of current economic difficulties. The general wisdom was that the inevitable direction of the Hong Kong dollar under a freer exchange rate would be to depreciate. The result would be an end to deflation, a boost to economic growth, a reduction in unemployment, and the elimination of the budget deficit. In fact, all of our problems would be cured — and rapidly — by this single panacea.

If only things could be so simple! But, of course, they are not. I have spoken and written at length on other occasions about the huge risks to financial and social stability that we would expose ourselves to in following such a course. Financial markets have a habit of overshooting and precipitating financial crises that are very costly to the community. And it seems, from recent events, that the very premise on which this panacea of exchange rate depreciation is based may be seriously flawed. For the market exchange rate of the Hong Kong dollar has strengthened over the past two or three weeks to the extent that it has been necessary for the HKMA to inject liquidity into the system in order to dampen excessive volatility. The market has, all of a sudden, chosen to ignore the continuing problems of deflation, unemployment and budget deficit, and the possible implications of these for the exchange rate. The clear message from the market now is that, were the Hong Kong dollar to be allowed to float, its exchange rate would rise rather than fall. Before you reach for your telephones, let me stress that we have no intention of trying this out. Monetary affairs are, as I have said, unpredictable, and the direction and magnitude in the movement of the Hong Kong dollar exchange rate, if it were allowed to float, is anyone's guess and may not have any bearing on the underlying economic fundamentals. We have no wish to find out. And, in answer to the many dramatic statements made over the past couple of weeks or so, our somewhat relaxed attitude towards small deviations in the exchange rate on the strong side of 7.80 does not mean that we are any less committed to maintaining the Link. Minor fluctuations in the market exchange rate on the strong side of the Link are a feature of our monetary system, and they are nothing to get too excited about. And there is an effective mechanism for us to ensure that these fluctuations are not so large as to undermine credibility and confidence in the Link.

It is, however, worth putting into perspective some of the reasons for the sudden strengthening of the Hong Kong dollar, because they have a significance that goes beyond short-term fluctuations in the market. The trigger, you may recall, was the political pressure from outside for a revaluation of the renminbi. The read-across to the Hong Kong dollar, combined with a realisation that the Hong Kong economy was not doing so badly after all, led to a scramble to cover short positions. This came against the background of quite volatile movements in the global currency markets, which included, most notably, a sustained weakening of the US dollar against other currencies. At the risk of stating the obvious, an orderly depreciation of the US against other currencies is in Hong Kong's interests because it means that, because Hong Kong's currency is linked to the US dollar, Hong Kong also becomes more competitive. This larger point may have been overlooked in all of the fuss about the somewhat less significant strengthening of the Hong Kong dollar against the US dollar.

With regard to the Mainland's currency, the political pressures from outside for an appreciation of the renminbi exchange rate have been prompted by the considerable attention that is being given in the US to the bilateral trade imbalance between the Mainland and the United States. The arguments for appreciation are that, from the US perspective, Chinese exports are undervalued and therefore unfairly competitive, and, from the Chinese perspective, the substantial capital inflow into the Mainland might carry long-term risks. Leaving aside the arguments about trade, let us look a little more closely at the question of capital inflow and how to manage it. First, to put things in perspective, it should be noted that the Mainland's current account surplus is really very small by international standards — perhaps something around one per cent of GDP in the first half of 2003. This is much lower than the corresponding figures for many other economies. Nevertheless, it is true that there has been substantial capital inflow into the Mainland, leading to a very rapid accumulation of foreign reserves. The Mainland authorities are well aware of the risks of this, in terms, for example, of an asset price bubble that could be quite destabilising to the financial system when it burst. They have, in fact, made quite intense efforts to deal with the inflow through a number of strategies.

Under the Mainland's present exchange rate system, the accumulation of foreign reserves is matched by an increase in the renminbi monetary base, which needs to be sterilised if the undesirable consequences of credit expansion are to be contained. The People's Bank of China has been carrying out sterilisation quite actively both through the recently introduced programme of issuing central bank bills and through reducing lending to government and financial institutions. There is scope for securitisation of these loans to produce more financial instruments for money market operations. Another tool available to the authorities is to change the reserve requirement for banks, and indeed this requirement was raised in August from six per cent to seven per cent. Further options include making changes to interest rates to discourage further capital inflow (though obviously this may have undesirable effects on the asset markets) and opening up relief valves in the capital account.

The observations to make here are that, first, the Mainland authorities have many options for managing the risks created by substantial capital inflow, and they are making very active use of some of these options; and, secondly, that there is no need to take risks by playing around with the exchange rate, which should be the absolute final resort. The Mainland authorities have made it clear that they have no intention of taking such risks, and have stressed the importance of gradualism in the reform of the exchange rate system. They have said that keeping the renminbi stable is conducive to the economic stability and development not only of China but also of the region and the world at large. I believe that this approach is right, and that, in particular, a stable renminbi is also conducive to stability in Hong Kong.

Signs of Recovery

Although the trigger may have been the political pressure on the renminbi, the strengthening of the Hong Kong dollar was also attributable to a large inflow of funds into the Hong Kong dollar, which, among other things, was reflected in the rise in the Hang Seng Index. Clearly, sentiment towards Hong Kong, and within Hong Kong, has improved in recent weeks. Recent indicators suggest a gradual recovery in the economy following the trauma inflicted on Hong Kong by the SARS crisis. There has been improvement in local consumer spending and a sharp revival in inbound tourism. Exports continue to grow, deflation has moderated, and unemployment appears to have peaked. Less easy to quantify is the change in mood, although it is, as I have said, shown to some extent in the activities in the markets, as well as in consumer spending. What is, I think, clear to every observer, however cynical, is that there has been, among all sectors of the community, a marked and quite sudden turnaround, from pessimism bordering on despair to a cheerful if cautious optimism. This comes as a huge relief after the gloom and despondency of the second quarter.

Important initiatives, such as CEPA and the relaxation of restrictions on individual travellers from the Mainland, have undoubtedly helped to stimulate confidence. So too have the general — though by no means conclusive — signals that the world economy is also in better shape. It is also very likely that the recent surge in markets and the gradual growth in economic activity are part of a longer-term trend, going on for at least a year now, in which there have been underlying improvements in the Hong Kong economy. Deflation, under the discipline of the Link, has made Hong Kong more competitive: it is now a less expensive city in which to do business or take a holiday. The real effective exchange rate for the Hong Kong dollar — which is a true measure of the competitiveness of an economy — has declined by 24% over the past five years. Recent research carried out by the HKMA also points to a much greater degree of flexibility in wage adjustments than the official statistics might suggest.

A key component of our economy — the export of goods and services — has continued to grow strongly throughout the whole of the last five quarters. In 2002 Hong Kong enjoyed a balance of payments surplus in the current account equal to about 11% of our GDP, and this surplus has been sustained into 2003: it means, in dollar terms, that Hong Kong as an economy has been earning around US$1.5 billion in foreign exchange every month. In short, it appears that SARS, despite the large human cost, has had only a short-lived and superficial effect on our economic development. Or, to use the language of economists, the impact of SARS was a temporary demand shock rather than a permanent loss in output.

Structural Issues

The evidence suggests, then, that Hong Kong is back on the path to broad-based economic recovery. Let us hope that this is indeed the case. Since the outbreak of the Asian financial crisis more than six years ago, we have had much bad news and very little good. We are all ready for a break, and, equally important, I think we are in a position for making the best of it. But we should not assume that all our problems will be solved by economic recovery. Many of them will be, of course, and the others will be much reduced. Yet there are structural issues that have to be faced, and dealing with them may take effort, imagination and a strong will. One of these issues is the fiscal deficit. This was around HK$62 billion, or 4.9% of GDP in the last fiscal year, and, according to the Government's latest estimates, may exceed that figure for the current fiscal year. Economic recovery will undoubtedly help contain or reduce the deficit. But the larger, structural questions, such as how to produce a more stable revenue base, will still be there, and they will involve difficult choices. As we know, this much-debated question is something that the Financial Secretary is actively addressing.

The other great structural issue is unemployment, which reached its highest level in recent history during the SARS crisis, and which is expected to remain high for some time. Again, economic recovery will help to ease the problem, and sectors of the economy that have been seeing intensified growth, such as the tourism industry, will provide further opportunities in many areas of employment. But a substantial part of the unemployment problem is a structural one, resulting from our transition from industrial to post-industrial economy and from the movement of jobs, particularly unskilled jobs, out of Hong Kong. On top of this, a substantial part of the growth in one of our best-performing sectors — exports — is generated by offshore trade, which by its nature creates fewer jobs domestically than does the more traditional entrepôt trade, not to mention domestic exports. What this means is that, however quickly the recovery penetrates society as a whole, and whatever the efforts made to open up new areas of economic activity, a large pool of unemployed may still be left behind. These fellow-citizens will have a legitimate claim on the community for assistance in one form or another, and how to tackle this issue without further compromising fiscal discipline will be a great challenge. It is a challenge that many developed — and not-so-developed — economies have been grappling with for many years. But it is a fairly new and unfamiliar challenge for Hong Kong.

A related issue is the question of property values, although how far this should be classified as a structural or a cyclical issue is uncertain. Hong Kong's property market is a complex and volatile creature: it is not at all clear how the various factors on the demand and supply sides have contributed to the extraordinary collapse we have seen in the market over the past five years. How the market will behave in the future is even less clear, though it does seem that there has been some stabilisation in prices recently. What is clear is that a very large number of households in Hong Kong (over a hundred thousand mortgagors at the end of June) have, as a result of this collapse fallen into negative equity. The low interest rate environment has, thankfully, mitigated the problem somewhat. The more stable employment prospects that we hope will come with economic recovery should, for many, help dispel the terrible spectre of negative equity combined with unemployment, which has probably caused as much anxiety in our community as SARS, and over a longer period of time.

Quite apart from its effects on individuals and families, negative equity has broader economic implications. It has an enervating effect on spending. And it adds to the pressures on the banking system, although it should be added that the delinquency ratio on mortgages continues to be very low. This is, I think, attributable partly to the fortitude with which homeowners in negative equity have borne the problem, and partly to the willingness of most banks to restructure loans in cases of difficulty. The community and the banking sector have coped with this problem extremely well. It is to be hoped that stabilisation in property prices will help to contain and gradually reduce negative equity. Nevertheless, the problem is likely to be with us for some time to come.

The Role of the HKMA

The question arises of what is the role of a central bank — or, more specifically, of a central banking institution like the HKMA — in an environment such as this. In my view, the role is quite straightforward: it is to sustain a monetary and banking environment that is conducive to resolving the economic and fiscal problems that face our community — not just in the public sector, but also in businesses and households. This is not the passive, static role that it may seem, as the maintenance of a rule-based monetary system in the form of the Link misleadingly suggests. Indeed, there is the scope — and often the need — for an active and imaginative use of financial, supervisory, communication and other skills. The degree of openness and the relatively small size of Hong Kong's financial system, against the background of globalisation, mean that the maintenance of monetary and banking stability is a particularly difficult task. There is also the requirement, implicit in the Basic Law, to look ahead, and in particular, to develop the financial infrastructure that will secure Hong Kong's position as an international financial centre and provide it with the means to build on that position. And there are other important tasks, such as seeking to help the Government in its efforts to contain the fiscal deficit by achieving a favourable return on the fiscal reserves deposited with the Exchange Fund — subject always to meeting the other investment objectives of the Fund.

All of these tasks present challenges to keep me and my colleagues busy enough. But there have also been suggestions that the HKMA should take further steps to help stimulate growth. I have already mentioned the doubtful argument about changing the Link to jump-start the economy, and there have been other ideas put forward — all of them well intentioned — for example, that the Government should dig further into the foreign reserves to stimulate growth. One very specific suggestion which comes up periodically, and which gained currency once again over the summer, is the proposal that the HKMA should relax the guideline that says that banks should not lend more than 70% of the value of a residential property for which a mortgage loan is taken out: this is known as the 70% loan-to-value guideline. The idea behind the suggestion was that relaxation of the guideline would make it possible for prospective homeowners to borrow more and that this would help stimulate property purchases and thus stabilise the property market. I think the idea has now passed, partly because the property market appears to have stabilised, but mainly because it seems that public opinion accepted the reasoning that we and others put forward for maintaining the guideline.

Setting aside the question of whether relaxing the guideline would have had any effect at all on demand for property, let us go through this reasoning. It is, in fact, quite simple. The guideline exists to prevent banks from excessively exposing themselves to the risks posed by an extremely volatile property market. The guideline was introduced in order to provide a level playing field at a time when many banks were already themselves applying this restriction. It continues to have the broad support of the banking industry. It has helped maintain banking stability during a period of considerable stress, and, no less important, it has helped limit the problem of negative equity. The guideline does not prevent borrowers from obtaining further finance from other sources, and indeed there are many products on the market to enable homeowners to borrow up to 90% of the value of their home, and many homeowners who have taken advantage of these products. In other words, the 70% guideline is intended to restrict the risk exposure of banks, not to limit the amount of finance that borrowers can obtain.

The guideline is therefore a not a tactical tool for affecting property prices in the short term but a strategic measure for maintaining banking stability over the longer term. Anyone who wishes to see what happens when there is no such guideline in a falling market can find plenty of examples overseas. Or you can look again at the situation in Hong Kong in 1983, when banks became dangerously exposed, directly and indirectly, to a volatile property market in which the bubble had burst and from which confidence was draining fast: there was, of course, no 70% guideline in those days.

Functions and Responsibilities in Monetary and Financial Affairs

You may have noticed here parallels with monetary policy. Like the 70% guideline, the Link is maintained over the longer term for the greater economic well-being of our community, even though it might seem tempting from time to time to try to use monetary policy for short-term tactical gains. In fact, although the spotlight tends, quite understandably, to be on newsworthy issues — bank rescues, intervention in the stock market, the latest Exchange Fund results, the “alarming” strengthening of the Hong Kong dollar — much of the work of any central bank has to be focused on the longer term, on the implementation of sustainable, consistent, dependable policies on a horizon that lies well beyond the daily concerns of most of us. For this reason the general consensus is that a central banking institution must be somewhat set apart from the daily workings of government and politics. The HKMA, as Hong Kong’s central banking institution, has, throughout the 10 years of its existence so far, always had a special position as an organisation that is a part of the Government and yet operates at some distance from the Government proper. This relationship between the HKMA and the Government has recently been set out in a series of documents produced in response to suggestions from within Hong Kong and recommendations by the IMF that the roles of various senior officials involved in monetary and financial affairs should be set out more clearly.

The key document as far as the HKMA is concerned is the Exchange of Letters between the Financial Secretary and the Monetary Authority on 25 June 2003. Given what was happening in Hong Kong at this time, it is perhaps not surprising that these letters did not attract too much publicity when they were published a few days later, although they were favourably noticed in the editorials and commentaries. Generally speaking, and with one important addition that I shall describe in a minute, the Exchange of Letters introduced no change to existing arrangements. Most of the contents set out the existing division of responsibility between the Financial Secretary and the Monetary Authority under the main laws governing the work of the HKMA. There is nothing particularly novel in any of this, although it is useful to have the division of work spelt out in one place. Anyone interested in knowing exactly what the HKMA does and how it connects with the rest of the Government need look no further than this for an authoritative statement.

There are two aspects of the letter that are significant in what they say about the relationship between the HKMA and the rest of the Government. The first is the clear distinction between the setting of the monetary policy objective on the one hand and the achievement of that objective on the other. The former falls within the province of the Financial Secretary. The latter is the responsibility of the Monetary Authority, who (to quote from the Exchange of Letters) shall "on his own be responsible for achieving the monetary policy objective, including determining the strategy, instrument and operational means for doing so." An accompanying letter from the Financial Secretary to the Monetary Authority specifies in black and white, for the first time, the monetary policy objective and the structure of the monetary system for Hong Kong. In fact, this accompanying letter does nothing more than describe the existing arrangements, which have been transparently clear to all of us for the past 20 years. Nevertheless, the clarity with which this objective is now expressed, and the responsibility now formally given by the Financial Secretary to me, as Monetary Authority, to achieve independently this monetary policy objective have important things to say about the operational independence — and accountability — of the HKMA.

The second aspect of this Exchange of Letters is, in my view, even more important. This involves the disclosure, for the first time, of the details of the delegation of statutory powers from the Financial Secretary to the Monetary Authority to enable the Monetary Authority to discharge independently his functions and responsibilities. In making this disclosure, the Financial Secretary commits himself to explaining publicly, within three months, subject to considerations of market sensitivity, any decision by him to override or bypass the Monetary Authority in the exercise of these delegated powers. There is also an undertaking that any changes to the content of the letter, and any changes to the delegations, shall be made public. These commitments provide important safeguards of the independence of the HKMA in its day-to-day operations.

I should add here that there has never in the past been any instance of the Financial Secretary's overriding or bypassing the Monetary Authority in the exercise of these delegated powers. So we would not expect to see disclosures of this kind very often. Nor would we expect to see frequent changes to the content of the letter or the form of the delegations, for an important part of operational independence is that it should be stable and predictable, and not something that is tinkered with at whim. The Exchange of Letters will, I believe, provide a clear basis for the HKMA to continue to carry out its work with a high level of autonomy in the years to come.

Conclusion

These will, naturally, be years of challenge for Hong Kong: there have been very few times in Hong Kong when this was not the case. The HKMA, as Hong Kong's central banking institution, has its part to play in helping Hong Kong meet the challenges. It also has its own special challenges.

The main challenges in central banking are to maintain a monetary and banking environment that is optimal for stable and sustainable economic growth, and, particularly in the case of present-day Hong Kong, an environment that is conducive to resolving our current problems. In doing this, we should not lose sight of two other, related challenges. One is to keep an eye on the longer term, both in applying solutions to current problems and in building the infrastructure for future needs. The other is to maintain confidence in our monetary and financial systems. This requires, above all, doing our job effectively through achieving the objectives set for us by the Government. It also requires transparency and education. And here, there is, I think, some final observation to be made on recent events.

We have, as you know, placed great stress on transparency, to the extent that our accounts and operations, at least on the monetary side, are for the most part an open book. We have also paid a lot of attention to public education, on our website, in our publications, and through numerous special events: our efforts here will be boosted later in the year with the opening of a permanent HKMA Information Centre, which I cordially invite you all to visit. But, despite all this work, it seems, from the events in the market in the last few weeks, that there is nothing as good as real-life experience to encourage people to learn more about how our system works. This has been brought home to us in the HKMA by the quite remarkable surge in visits to the information on our website about the Link and the Currency Board system over the past couple of weeks.

All of this serves, I think, to demonstrate the wisdom of the Open University's approach, which is to provide formal education at the time in life when people are getting the most out of their practical, real-life experience. Alumni Link — and, I believe, occasions such as this — will help to further this approach. I thank the Open University for having invited me to give this talk, and I look forward very much to your questions and comments.