THE REAL LESSONS OF "BLACK THURSDAY" [1]

In wake of the "Black Thursday" on 23 October 1997, there have been much criticism and debate on Hong Kong Monetary Authority (HKMA) strategy in defending the Linked Exchange Rate System. The debate reflected heightened interest in public policy issues, but some of the assertions made were not borne out by facts. This article discusses the real lessons learned from the "Black Thursday", an abridged version of which appeared in the South China Morning Post on 11 May 1998.

In the wake of the "Black Thursday", October 23, 1997, when a sudden spike in interest rates caused a sharp fall in asset markets, a vigorous debate has ensued on the strategy which the Hong Kong Monetary Authority (HKMA) has adopted in defending the linked exchange rate. This debate is to be welcomed because it reflects heightened interest in public policy issues.

However, for such a debate to serve any useful purpose, there must be a calm, reasoned discourse based on objective facts. Emotional name-calling can never settle any argument, or solve any problem. Obviously, in a short article one cannot cover all issues, but in this commentary I wish to discuss some assertions or allegatons, which in my view are not borne out by facts.

The first assertion is that the HKMA deliberately jacked up the overnight Hong Kong inter-bank offered rate (HIBOR) to 280% on "Black Thursday", and hence somehow destroyed public confidence. Let us see what actually happened. Having tasted blood after Taiwan gave up the defence of its dollar, speculators mounted a massive onslaught on the Hong Kong dollar, in the week commencing October 20, 1997. Many banks either financed this speculation, or themselves jumped on the bandwagon of short-sellers. In response to the attack, the HKMA sold a very substantial amount of US dollars. Under the Currency Board Arrangement (CBA), the HKMA could debit the banks' clearing account for the Hong Kong dollars sold. Moreover, under the Real Time Gross Settlement system (RTGS) installed in December 1996, no bank is allowed to have a debit balance. On October 23, 1997, the settlement day, there was therefore a wild scramble for Hong Kong dollars. The inevitable result must be a rocketing of HIBOR. The HKMA, it is true, did not inject liquidity into the system. But why should it, as the defender of the Hong Kong dollar, inject liquidity at a time when the linked rate was under such a ferocious attack?

It is also true that, on the same day, the HKMA issued a warning that repeated borrowers from the Liquidity Adjustment Facility (LAF), Hong Kong's equivalent of the discount window, would be subject to a penal rate. Such a penal rate is among the standard weapons of central banks/monetary authorities all over the world. Prudent banks which did not finance speculators had nothing to fear.

In retrospect, if there is any valid criticism that can be levelled at the HKMA, it is that the circular of October 23 failed to define clearly what was meant by "repeated borrowers", hence causing unnecessary confusion and uncertainty. When the HKMA did clarify "repeated borrowers" in a subsequent circular dated November 12, HIBOR at the shorter end quickly fell to more normal levels, though those of longer maturities eased much more sluggishly. In any case, the 280% level lasted for only a few hours. The whole affair has been blown out of proportions.

The second assertion is that the HKMA's "central banking trappings" are either unnecessary or downright harmful. If only the HKMA can get rid of them, then all will be well. This argument betrays a profound misunderstanding of the origin and evolution of CBA.

The currency board was originally established in British colonies or protectorates around the

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middle of the last century. As Britain was then on the gold standard, the currency board was rightly regarded as a variant of the gold standard. Its basic automatic adjustment mechanism, known as the specie flow mechanism, was worked out earlier by writers such as the Irish economist Richard Cantillon and the Scottish philosopher and economist David Hume. They wrote at a time when deposit banking was still rudimentary, and cheques were hardly used. Money stock in their days therefore was almost equivalent to currency. Even at the height of the controversy between the Currency School and the Banking School, cheques were not widely used outside London. This was one of the reasons why the former won the argument, at least temporarily, with the passing of the Bank Charter Act in 1844, which implicitly acknowledged that only Bank of England notes mattered. At any rate, when the monetary and banking system was that simple, the currency board could indeed operate without any central banking arsenal. A few British overseas banks acted occasionally as lender of last resort, but that was all.

Contemporary Hong Kong is, however, a far cry from pre-1844 England or 19th century colonies. We now boast one of the most developed banking systems in the world. Legal tender currency currently accounts for only 5.6% of HK$M3. The fact is that "cash arbitrage", by which critics of HKMA set so much store, has never been actually carried out since October 17, 1983. No one can produce any evidence that any bank has actually moved a large quantity of cash to and from the Exchange Fund whenever the market rate diverged significantly from the peg of 7.8. It is rather chancy, therefore, to rely on this untested mechanism as the sole means of defence against speculation.

Accordingly, a series of institutional reforms, beginning with the "accounting arrangements" of July 1988 and culminating in the Real Time Gross Settlement (RTGS), was put in place. Before July 1988, all banks had to keep clearing balances with the Hongkong and Shanghai Banking Corporation (HSBC) as the management bank of the Clearing House. The Exchange Fund also kept its Hong Kong dollar balances on deposit with the HSBC. The HSBC, however, did not have to keep any clearing account with anybody. This institutional set-up impeded the proper working of the CBA. To illustrate, suppose the Hong Kong dollar came under pressure, and the authorities were obliged to sell US dollars. The monetary base would not shrink, and the money market would not tighten, as required by the CBA, because the decrease in the US$ buyers' HK$ balances were exactly offset by the increase in the Exchange Fund's HK$ balances. After the 1988 reform, however, the HSBC itself had to keep a clearing account with the Exchange Fund, whose balance must not be less than that of the rest of the banking system. In this way, when the Exchange Fund sold US dollars, it could directly debit HSBC's account; in turn, the HSBC debited the other banks' clearing accounts, thus immediately causing the monetary base to shrink, thereby facilitating the working of the CBA. By the time RTGS was installed, the role of the Hongkong Bank as management bank had also been phased out. All licensed banks were required to keep clearing accounts direct with the HKMA. Note that the clearing balances are not the same thing as reserves under other central banking regimes. Such balances are not subject to any fixed ratio, and are used for clearing and settlement only.

In any case, the reforms outlined above have facilitated the working of the CBA, and have proved their worth both during the Mexican crisis of 1994-95, and the current Asian crisis. The RTGS has the following additional advantages: it embodies the state-of-the art technology; it reduces systemic risk arising from inter-bank default; and last but not least, it provides a level playing field for all banks. In this connection, I may as well add that, almost exactly 10 years ago, the report of the Working Party of the Chinese Banks Association, of which I was the convenor, already advocated that the clearing function should be undertaken by a monetary authority rather than by a commercial bank.

It is also strange that the problem of "moral hazard" has not received the attention that it deserves. Some people seem to think that high interest rates can be suppressed if the HKMA provides cheap credit on demand through LAF. But this was precisely the mistake made by such countries as Thailand, Indonesia, and Korea. The two eminent authorities on currency and banking of the

19th century, Henry Thornton and Walter Bagehot, understood the "moral hazard" problem perfectly, even though they did not actually use this modern jargon. Thornton was the first economist to declare that the authorities' responsibility was to the whole banking system, not to any individual bank, while Bagehot was the author of the famous dictum to the Bank of England during a crisis: "Lend freely, but at high rates". Bagehot recognized that high rates were not only necessary to discourage imprudent behaviour, but also to attract specie inflow, the key mechanism of the gold standard.

From the above observations, the allegation that the HKMA has committed grave policy errors and undermined confidence evidently does not pass muster. For if it were true, we would be witnessing now a crumbling peg, incessant speculation, massive shift into foreign currencies etc. However, the facts are that the link has remained rock-solid; HIBOR has fallen across the board since February, enabling a modest lowering of the best lending rate to 10% at the end of March the proportion of foreign currency deposits has remained stable at about 43%. All these are not exactly signs of a confidence crisis.

To conclude then, the real lessons of "Black Thursday" are as follows. First, in the last analysis, what really counts are fundamental factors such as the adequacy of forex reserves; the size of fiscal deficit and sovereign debt (of which Hong Kong has none); the determination of the authorities to maintain currency stability; the soundness of government policies and prudential supervision etc. Neither investors nor speculators will be impressed by the fact that the authorities have a few tricks up their sleeves in the form of some exotic derivatives. Second, the well-known proposition that no central bank/monetary authority can simultaneously target more than one of the three policy variables, namely, exchange rate, interest rate, and money stock, has once again been vindicated by events of the past year. As Hong Kong opted for exchange rate stability, quite correctly and fortunately, in the dark days of October 1983, as its overriding policy objective, then money supply and interest rates must be allowed to adjust freely to whatever levels that are consistent with the peg. Third, since traditional monetary policy cannot be used to stimulate the real economy, fiscal policy has a useful role to play. This is exactly what the government has done in its latest budget: huge spending on infrastructure and programmes, extensive tax cut and reliefs, accelerated depreciation allowances, tax deductibility for mortgage interest etc. And securitization and fixed rate mortgages are also useful measures. Fourth, moral hazard is a serious problem. The last thing the HKMA should do is to relax its prudential supervision, and to provide cheap credit on demand. It should, of course, exercise its discretion over penal rate with great caution and restraint, but it should never give up this powerful weapon. Last but not least, historical experience has clearly shown that, as long as the monetary and banking system remains sound and robust, then after a painful period of adjustment, the real economy will bounce back. In 1982-83, for instance, we went through a much graver crisis. Indeed, on "Black Saturday", September 24, 1983, the whole financial system nearly went under. But once the linked rate system gained its initial, though still fragile, credibility, the real economy recovered eventually. The same conclusion will hold true for Hong Kong in the current Asian crisis.