WHY WE INTERVENED[1]

In response to the controversy over the Hong Kong Government's operations in the local stock and futures markets, Joseph Yam, Chief Executive of the Hong Kong Monetary Authority (HKMA), wrote to the Asian Wall Street Journal to explain the reasons behind the government's market intervention and pointed out that the actions were to demonstrate the Government's determination to protect the integrity of the Hong Kong dollar and the stability of Hong Kong's monetary and financial systems.

The response to the decision by the Financial Secretary to intervene in the stock and futures markets to deter currency manipulation by those who have built up large short positions in the Hang Seng Index futures has been mixed. Whilst there has been much support on this decision, expressed quietly through the many telephone calls and letters we have received from a wide spectrum of our community, criticisms have also been forthcoming, and quite vehemently. They accused the government of becoming dangerously more interventionist and portrayed the action as a major departure from the free market philosophy of Hong Kong. They also interpreted this as a demonstration of weakness in that it is a reflection of our lack of preparedness to bear the pain of economic adjustment under a currency board system. They further argued that the linked exchange rate system has, as a result, become more vulnerable. I would like to respond to these criticisms.

On whether the government has become more interventionist, it is important to appreciate what exactly is the government's economic policy stance. I fear that the true meaning of our long established policy, with the passage of time and the interpretation by some who are more than willing simplistically to wave the banner of free market without even thinking about the matter, has become a little fuzzy. Having worked closely with five financial secretaries of Hong Kong in succession, I think I am in a position to express a view on the subject, although I do not have direct responsibility over it. The best description of the policy, in my opinion, is available in a speech by Sir Philip Haddon-Cave on 2 December 1980, the then Financial Secretary of Hong Kong. I had the privilege of participating in the drafting of that speech, so I think Sir Philip would not mind my quoting one paragraph of his speech here in full:

"But in my description of our economic policy stance, I do qualify the term "non-interventionism" with the adjective "positive". Perhaps in the past I have not spelled out the implications of this adjective clearly enough. What it means is this: that the Government, when faced with an interventionist proposal, does not simply respond that such a proposal must, by definition, be incorrect. Quite the contrary. Generally speaking, or so I would like to argue, the Government weighs up carefully the arguments for and against an act of interventionism - in any sector of our economy and on the demand or supply side - in the light of present and likely future circumstances. The Government then comes to a positive decision as to where the balance of advantage lies. It is true that, more often than not, we come to the conclusion that the balance of advantage lies in not intervening; and, I must confess, I would be alarmed if we didn't. Yet, in all cases, the decision is made positively, and not by default, and it is not the non-outcome of a do-nothing approach. But, there are many examples of the Government deciding, usually on the advice of its boards and committees, to intervene, in one way or another, in the free play of market forces."

To judge whether the government has become more interventionist, one should ask whether the government's action in the stock and futures

[1] This article is written by Joseph Yam, Chief Executive of the Hong Kong Monetary Authority. A shortened version was published on the Asian Wall Street Journal on 20 August 1998.

markets is inconsistent with this policy statement. I do not believe so.

There is no doubt, in my opinion, that there has been manipulation in our currency to engineer extreme conditions in the interbank market and high interest rates in order that profits could be made in the large short positions that have been built up in stock index futures. We have no objection to the taking of short positions in stock index futures by hedge funds, and indeed by anybody. If they take the view that asset price adjustment in Hong Kong requires the stock market going down to a particular level and correspondingly position themselves, they are free to do so. If in the end the market indeed falls to that level and they benefit from the short position I would even congratulate them for having excellent foresight.

But this is not the case. They have been engaging in the double market play repeatedly and increasingly it seems, with little regard to the economic fundamentals of Hong Kong and the extent of the market adjustments that have already taken place. This presents serious risks of markets overshooting, with asset markets ratcheting down on every occasion of their engaging in this activity. This can be highly damaging to the stability of the whole financial system of Hong Kong. This also presents serious risks of undermining general confidence in our currency.

Furthermore, in my opinion, their action is now responsible for a significant part of the interest rate premium in the Hong Kong dollar over the US dollar. This premium has been unfairly attributed to the possibility of government losing its nerve in seeing through the economic adjustment imposed upon Hong Kong by financial turmoil in the region, operating under a currency board system. I do not know how many times have we expressed the view that we have to stick it out and bear the inevitable pain, and that a fixed exchange rate under our currency board system is the best option for Hong Kong. But it is unfair to ask the community to put up with excessive pain inflicted upon them by those engaging in this double play of the currency and stock futures markets.

We fully accept that, under a currency board system, capital outflow will lead to a shrinkage of the monetary base and therefore higher interest rates. But, from available statistics on some of the components, our current account balance of payments position has been stable to improving, notwithstanding that our currency has been significantly stronger than many of our trading partners. Yet the extent of the selling of Hong Kong dollars in the three days from 5 August to 7 August, and on previous occasions, was so clearly out of proportion to economy reality that it could only be attributable to currency manipulation as part of this double market play.

The question then is whether it is in the best interest of Hong Kong in this matter to continue to leave it to the free play of market forces and risk markets overshooting, with the pain of economic adjustment exacerbated and confidence in our currency undermined. Clearly it is not, and the alternative is to intervene to frustrate this double market play. We agonized over this difficult decision. We were acutely aware of the possibility of our action being misunderstood. But to us the balance of advantage, having gone through the positive process of weighing up carefully the arguments for and against this act of intervention, is to intervene. Although this is the first time government has intervened in this manner, in both the stock and futures markets, the intervention is not a departure from the traditional policy of positive non-interventionism that has served Hong Kong so well in the past.

The aim of the intervention is not to prop up the stock and futures markets, although we are aware of the possibility of our action being misinterpreted. Our action is targeted at currency manipulation that took advantage of the automatic adjustment mechanism of our currency board system to produce extreme conditions in the interbank market and high interest rates to profit from a short position in stock index futures. We wish to send the very clear message to those manipulating our currency for this purpose that they may stand to lose money instead. But if there were no currency manipulation, there would be no such intervention.

Turning to the currency board system, our resolve in adhering to it has never been stronger. The experience of many of our neighbouring economies in the past year or so speaks a lot. There simply is no better alternative for Hong Kong. Financial liberalization and the globalization of financial markets have left little scope for a small open economy to pursue flexible exchange rates. It has become increasing clear, at least in central banking circles, that either the currency is firmly fixed to a major currency through the adoption of a currency board system or it has to be freely floating. I would even go further to say that floating is not really a viable long term alternative. No matter how sturdy a little boat is built, it can hardly stand the rough seas of international finance, now characterized by highly volatile and voluminous capital flows, moving around with high velocity and facilitated by a large variety of financial instruments. It will be tossed around so badly that it will crack and eventually sink. It is a lot better for the boat to be welded onto a big liner, in particular the one named recently, and precisely in this context, by Paul Volcker as the U.S.S. United States of America. Although the boat may occasionally be under water, or above, particularly when the sea is rough, but it will not sink.

We are prepared, and have the ability, to bear the pain of economic adjustment under a currency board system. But currency manipulation, coinciding with malicious rumours of all sorts, and timed to produce maximum volatility, is in our opinion clearly and disproportionately exacerbating the pain. We owe it to the people of Hong Kong that the pain is not made unnecessarily harsh. In fact, we are not talking about the pain of economic adjustment under a currency board system. We are talking about the pain being unfairly inflicted on our community by the currency manipulators. It is in practice difficult to distinguish between the two, but the numbers involved, the way the moves are structured and timed leave us with no doubt and no alternative. Our action is not a demonstration of weakness. It is a demonstration of determination to protect the integrity of our currency and the stability of our monetary and financial systems.

There has also been much misunderstanding on how a currency board system is supposed to operate in modern day circumstances, having regard to the technologically sophisticated arrangements of modern day finance where money is transmitted electronically and transactions are settled largely without the use of cash. There has been little literature written on the subject and there is a tendency for commentators to apply old theory dogmatically. Although currency board systems are not a modern day invention, Hong Kong is probably the first place on this globe where such a system is successfully run under modern day financial arrangements.

But this is obviously not the occasion for a thesis on the mechanics of a modern day currency board system. What I would like to point out here clearly is that the Hong Kong Monetary Authority strictly observes the monetary rule of a currency board system. This requires any change in the monetary base to be brought about only by a corresponding change in foreign reserves in the specified currency, i.e. the US dollar, at the fixed exchange rate. Whatever is said that we have done subtly or blatantly, in contravention of the monetary rule, these accusations will need to be substantiated by proofs that we have allowed the monetary base to be altered without a corresponding change to our foreign reserves. We have been entirely transparent in the operation of our currency board arrangements. We even publish the aggregate balance in the clearing accounts of our banks, that crucial component of the monetary base non-existent in currency boards of the old days, almost on real time, and subject ourselves to the scrutiny by all concerned.

But adherence to the monetary rule does not preclude the government funding a budget deficit by drawing down its fiscal reserves that are held in foreign assets in the Exchange Fund. The fact that this was done at a time when our currency is being manipulated by speculators may have caused some annoyance and surprise to them. But they only have themselves to blame for not doing their homework and for manipulating our currency in the first place. Adherence to the monetary rule also does not preclude a portfolio shift outside the balance sheet of the currency board from other assets into Hong Kong stocks for whatever purpose considered to be in the best interest of Hong Kong.

Our currency board system is as robust as ever and our determination to maintain it is as firm as ever. There has been no weakening of resolve and our action in the stock and futures markets is not a "desperate defence" of our linked exchange rate system.

Let me close by indulging further in what will appear to some as blasphemy. If the market cannot be wrong and governments are generally wrong, why are we witnessing the emerging markets shaking themselves to bits? If emerging markets continue to devalue their currencies, which some commentators still suggest that this is inevitable, the costs will be borne either through massive deflation in the developing world or bubbles in the developed markets, or both. Success or bubble, call it what you will, built upon the collapse of emerging markets, cannot be fundamentally sound. The burden borne initially by the loss of jobs and recession in the emerging markets will ultimately be borne by the G-7 economies. Even speaking as an official of the freest economy in the world, I think there is now a need to get a message to G-7 that abstaining from intervention to maintain global financial stability, particularly currency stability, may no longer be a viable option. They will ultimately bear the costs of adjustments when they either have to re-capitalize the international financial institutions and engage in Brady Bond type adjustment mechanisms, or have to be sucked into a global deflationary process through a collapse of demand for their exports.

Many have argued along with the Washington consensus the unspoken premise, as spelt out by World Bank Chief Economist Joe Stiglitz that governments are worse than markets. But whether we like it or not, governments have a role in protecting the level of income and employment of their people. The Hong Kong economy has the lowest level of government intervention in the world, and the strongest economic fundamentals with no debt. And yet, manipulative speculative activities threaten to undermine the fabric of this model economy. And if Hong Kong's strongest fundamentals can be threatened by such speculation, what hope is there for the rest of the non-industrial and emerging markets? We need to provide a more balanced picture of the dangers of panicking markets leading to widespread contagion, rather than promoting the unrealistic view that devaluation (and by implication volatile markets) is the solution to the global crisis. As you are aware, competitive devaluation is adding to the deflationary pressure in the world. We are already witnessing how panicking markets have sent some of the strongest economies in Asia to crisis and distress. We have an obligation to present a balanced picture of the situation.