INTERNATIONAL CAPITAL FLOWS AND FREE MARKETS[1]

International capital flows are essential to effective financial intermediation and play a vital role in promoting economic development. But, as the Asian financial crisis have demonstrated, the increasing volume, velocity and volatility of capital flows have the potential to distort, disrupt or even destabilise domestic financial markets. There is a need for measures to help reduce volatility without restricting the benefits that capital flows carry with them. The effective long-term solution lies in collective action to reform the international financial architecture and to ensure that free markets continue to be able to function properly.

Introduction

I am delighted to have the opportunity to speak at this year's Asian Investment Conference organised by Credit Suisse First Boston. It is particularly gratifying to be able to speak to such a large and diverse gathering in Hong Kong itself. Many of you, I know, are old friends of Hong Kong, and to those among you who might be visiting this city for the first time I extend a warm welcome. Your presence here happily relieves me of the need to set the scene or to explain in detail how Hong Kong has been grappling with regional financial crisis and economic slowdown. You will have been able to see and hear for yourselves that, despite the difficulties of the last year or two, Hong Kong is still very much alive and well, and that it remains one of the most open, most welcoming, and freest markets in the world. International opinion continues to echo this conclusion, so these are not empty boasts: within the past couple of weeks, for example, two reputable regional surveys have found the banking system of Hong Kong to be the best and the soundest in Asia. We continue to develop our services and infrastructure in a way that will help business make the most out of changing opportunities and challenges. Recent initiatives include plans announced by the Financial Secretary earlier this month for a cyberport that will be able to offer the most advanced information technologies to a whole range of businesses and industries. Within the HKMA, we have, in the last few months, seen the completion of a major strategic consultancy study that will help to guide the broad development of our banking sector into the next century.

I single out these initiatives - and I could mention many others - for two main reasons. First, one of their aims is to help Hong Kong get the best advantage out of three closely linked and irresistible trends: the globalisation of markets, the liberalisation of trade and finance, and the rapid advance of information technology. Secondly, while we need to grasp the opportunities produced by globalisation, liberalisation and technological advance, we also have to manage the risks that they bring with them in ways that strengthen, rather than undermine, our economic fundamentals. Along with many other economies in this region, we have, over the last year or two, been grappling with this challenge in a very practical way at a time of crisis and uncertainty. The Asian financial crisis is the cumulative result of many complex causes coming together at roughly the same time. But if we were to find a single factor that has brought the crisis to a head and magnified its damaging effects, we should be looking, not to 'crony capitalism' or 'Asian values', but to a more specific and more universal phenomenon: the swift flow of large amounts of heavily leveraged capital into and out of the region through an international financial system that is globalised, liberalised, technologically advanced, but, from an international point of view, largely unmanaged and unregulated.

The freedom of capital flows is, of course, essential to effective financial intermediation in the international dimension, which has played a vital role in promoting economic development in this region. But, as the current crisis has shown, it also has the potential to distort, disrupt or even destabilise domestic financial markets: this applies

1 This is the text of a speech delivered by Joseph Yam, Chief Executive of the Hong Kong Monetary Authority, at the Credit Suisse First Boston Asian Investment Conference on 26 March 1999.

not just to ailing economies, but also to sound ones. Being small and open, with predictable policy responses, their markets are susceptible to manipulation. As you know, last summer Hong Kong was exposed to this problem in an extreme form, and we took radical and controversial measures to address it. We remain convinced not only that what we did preserved our financial system from a serious threat to its stability at a time of stress and uncertainty, but also that our actions were entirely consistent with our responsibilities as a government mandated by law to safeguard the free operation of financial business and the free flow of capital within, into and out of Hong Kong. I shall come to this episode later on. But first I should like to go a little more deeply into the characteristics of international capital flows. I shall then discuss the implications, practical and philosophical, that they have for free and open markets, which collectively make up an increasingly seamless international financial system, but which continue to rely largely on their own limited resources when they encounter the problems that this system throws up.

International capital flows

Like wind currents and weather patterns, international capital flows carry with them a mixture of benefits and risks. Let me try briefly to pin down what makes them so powerful and so protean in their effects on the international financial landscape. I find it helpful, as a mnemonic, to think of their main characteristics in terms of what I shall refer to as the six 'V's: Virtue, Volume, Variety, Velocity, Volatility, and Viciousness.

By Virtue, I mean simply that international capital flows, by promoting an efficient and balanced use of financial resources, bring enormous benefits throughout the world. Over the past few decades they have been of crucial importance in developing new economies and revitalising old ones. When they work smoothly, international capital flows help to relieve shortages of capital in previously segmented markets. They provide a competitive environment that encourages innovation. And, by affording better returns to investors, they help to put spare capital to the best possible use. We have seen the value of this in our own region in the 1980s and early '90s, and, when discussing the problems created by capital flows, we should never forget that they have specific and beneficial functions.

The second characteristic is the sheer Volume of capital movements around the world. In April 1995, the global value of foreign exchange transactions taking place on an average day was US$1.2 trillion. In April 1998 this figure increased to US$1.5 trillion, or, to put it in more meaningful terms, to around 48 times the daily value of world trade. It is also worth stressing that these are largely private capital flows. In 1997, for example, the amount of private capital flowing into developing economies was estimated by the World Bank to be five times the size of official flows.

Within these private flows there is considerable Variety and fluctuation in the nature and organisation of capital. With financial liberalisation and the globalisation of financial markets, portfolio capital flows are of increasing importance compared with the more traditional foreign direct investment and commercial bank lending as a source of international capital flows. An aspect of this Variety is the growing number of complex investment tools, and different orders of derivatives therefrom, involving different degrees of leverage, available for moving money around the world, or, indeed enabling investments to be made in markets without having actually to move money around.

The variety and volume of capital flows are made even more potent by the Velocity with which capital moves around the world. The advance of telecommunications and information technology now means that distance and national boundaries are no longer important restraints. Two consequences follow from this. First, huge amounts of money can be moved into an economy in a very short space of time, and can be moved out just as quickly. In 1996, for example, capital was flowing into the emerging economies of Asia at the rate of about US$100 bn. By the second half of 1997, it was flowing out of the region at about half that speed. Secondly, with the negation of distance and boundaries, events in one particular market can have immediate, dramatic, but often quite unpredicted effects on other markets on the other side of the world. Last year, for example, the debt default in Russia affected mortgage-backed securities as far away as the USA and Brazil. Earlier this year, the devaluation of the Brazilian Real raised expectations - unfounded, as it turned out - that the ripples from that crisis would destabilise the Renminbi.

During periods of instability or uncertainty, the volume, variety and velocity of international capital flows can, in an increasingly liberalised and globalised financial environment, often add up to the fifth 'V': Volatility. Indeed, the behaviour patterns of capital flows can magnify minor local uncertainties into extensive, prolonged and highly destabilising crises. While other factors were also at play, it is clear that something of this kind took place in the spate of local troubles that snowballed into what we now call the Asian crisis. Private capital inflows, attracted by high short-term returns, fuelled Asia's economic boom. The Thai baht crisis of July 1997, which many initially dismissed as a local blip, snowballed into a regional crisis, when a sudden reversal of these flows took place following a rapid and wholesale reassessment of emerging market risk. In one way or another, the crisis has affected nearly every emerging market and has slowed growth throughout the world. Stampedes of this kind take little account of the economic fundamentals behind the markets: there were ongoing problems in many Asian economies, but there was no macroeconomic reason why there should have been such a sudden and wholesale withdrawal of funds at this particular time. To quote the U.S. Deputy Treasury Secretary, Lawrence Summers: 'Financial crises have elements of a self-fulfilling prophecy, like bank runs. Everyone expects failure or everyone expects everyone else to expect failure, leading to a rush to be the first one out and thus causing failure.' The Asian Financial Crisis, in which untold and unnecessary damage has been caused by such behaviour, is a classic illustration of this.

Widespread volatility resulting from financial panic and herd behaviour is one of the more worrying aspects of international capital flows because small fires can spark off major conflagrations. This volatility becomes Vicious when market participants with extensive control or influence over capital flows line themselves up, manipulate the prevailing negative and disturbed public mood, and exploit the discrepancies and vulnerabilities that inevitably arise in a global financial system that is held together by localised jurisdictions. The most vulnerable of these jurisdictions are often those which are held up as models of free-market economics: the small or medium open markets with few or no controls on capital movements and with transparent financial systems that operate according to simple and precise principles.

In Hong Kong last summer we found ourselves in exactly this situation. We were a choice target because our options were limited. We are prohibited by law from imposing exchange controls, and, even if we were not, it would be an act of lunacy for Hong Kong, with its highly externally oriented economy, even to consider them. The cornerstone of our financial system is the linked exchange rate between the Hong Kong dollar and the U.S. dollar. This link is maintained by a classic currency board system so transparent and predictable in its responses to market conditions that it was, at least at that turbulent time, vulnerable in one of its central features. Under the currency board's autopilot mechanism, any expansion in the monetary base causes interest rates to fall, while a contraction causes them to rise. The crucial part of the monetary base influencing this rise and fall is the aggregate balance that banks maintain in their clearing accounts held with the currency board: it is extremely small, and, at the time, made the monetary system susceptible to speculative attack.

In their attempts to destabilise the Hong Kong dollar in late 1997 and early 1998, speculators found that, although breaking the link was impossible, driving up interest rates by putting pressure on the Hong Kong dollar was not so difficult a matter. Late in the summer of 1998 they developed their strategy into a pre-concerted, heavily leveraged cross-market assault, which sought to play off the currency board system against the stock and futures markets: according to this strategy, extreme conditions created by a large-scale dumping of Hong Kong dollars would cause the stock market to plummet to a level that would allow them to make large profits from the futures contracts they had taken out.

We prevented them from reaping these profits – and in fact caused many of them to incur a loss – by investing a small part of Hong Kong's official reserves in Hang Seng Index constituent stocks and futures contracts in sufficient quantities to ensure that the strategy failed. We followed this up with technical changes to the currency board system to make it less susceptible to manipulation. The results of our market operation in August and our technical measures in September have been stable interest rates and financial markets that have been free of the manipulation that posed such a threat to stability and confidence over the summer. For an economy that is still working its way through its worst recession in more than a generation this is good news. Many critics, however, were shocked by what they saw as a gross violation of free-market principles in a city that had been held up as one of the world's great models of free-market economics. We did not, and do not, see it in this way. And, six months or so after the event, now is perhaps an appropriate time to place the events of last summer in some perspective.

Free markets

What, then, is a free market? It might be helpful to go back to basic economics to set out a few simple principles. In bald terms, a free market is a market in which buyers and sellers are free to trade on whatever terms they wish without government interference. The great writers on free markets, from Adam Smith to Milton Friedman, argue that free markets and free enterprise, rather than governments or monopolies, are the most efficient means of producing and distributing wealth and, as a consequence, the soundest basis for a just and prosperous society. In Adam Smith's conception, it is the 'invisible hand' of the free market that organises the seemingly chaotic and self-interested activities of human beings into a beneficent and productive social order. For Milton Friedman, 'the organisation of the bulk of economic activity through private enterprise operating in a free market' is 'a necessary condition for political freedom.'

In its daily operation, a free market serves three main purposes. It manages resource allocation by supplying answers for buyers and sellers to the basic economic questions of what, how, and for whom goods and services are to be produced. It provides price discovery by channelling competition and adjusting prices to reflect changes in supply and demand for different commodities. And specifically in terms of money, it arranges financial intermediation by matching the needs of ultimate lenders - or those in possession of surplus loanable funds - with those of ultimate borrowers - or those in need of liquid funds: interest rates, which are determined by the supply and demand of liquidity in the loanable fund market, play a crucial role in this process.

The philosophers are agreed that, in general, the less a government has to do with these various functions the more efficiently the market can do its job: centralised, directive authorities, or 'big government', are anathema to true economic freedom; governments should, at most, play a minimal, instrumental role in fostering the conditions in which each individual has the freedom to make his or her own economic choices. But this does not mean no government. In a free market, a government has a number of specific and limited functions to address well-known areas where the unregulated functioning of markets can result in outcomes that are undesirable from the perspective of society as a whole. In general, these areas involve some form of what economists call 'externalities' - spillover effects of one person's behaviour on others that are not incorporated in the market prices that people pay and receive. Public goods are an example, where the benefits to society as a whole of, say, police protection, are not easily captured by unconstrained market forces. Protection against monopoly practices is another - situations in which individual market participants can take prices away from levels consistent with free competition. All countries are involved in correcting instances of market failure in one form or another: indeed, from a philosophical perspective, it would not be too strong to say that that is what governments are all about. Many countries, of course, have become involved in the economy in ways that go well beyond such cases of market failure. In general, the experience has been unsatisfactory, and there is a worldwide trend towards limiting government involvement in the economy.

Here it may be helpful to turn from theory to practice, and to our experience in Hong Kong as an economy long acknowledged to have one of the freest markets in the world. In Hong Kong, government is probably as small as it can get in the modern world. Government expenditure as a percentage of GDP, although now at a historical high, is only about 20%. Yet the Government is involved in supporting the free market in a number of limited but key areas. First, it provides infrastructure and facilitation to enable markets to thrive and progress: these range from highly visible projects, such as the new airport and its associated facilities, to the HKMA's own quiet successes over the last few years in developing an advanced and robust interbank payment and settlement system or in stimulating the development of a local debt market. The Hong Kong method is for such projects to be done, where possible, as partnerships between government and private sector, with a heavy emphasis on private sector involvement. Nevertheless, the role of government is essential in getting them off the ground and in mobilising resources that cannot always be easily provided by the private sector.

Secondly, the Government provides regulation and protection. This ranges from the highly visible, and currently much debated, rule of law, which is the ultimate guarantee of contracts between individuals, to the day-to-day regulation of the markets themselves. Much of the activity in this area is also left to the private sector: only a small proportion of contracts are ever disputed in the public courts, and a large part of the regulation of the markets and the professions is self-regulation. Once again, however, government involvement is of key importance. It is there in the background as the last resort when conflicts arise, and, in consultation with market practitioners, it takes the initiative to reform regulatory systems when new conditions require it: the far-reaching reforms proposed for Hong Kong's securities and futures markets in the recent budget are a good example of this.

Finally, the Government is prepared to intervene in isolated, clearly identified cases where markets appear to be malfunctioning. In this respect, the Hong Kong Monetary Authority has a special role to play within the financial sphere. One of its primary tasks is to promote the stability and integrity of Hong Kong's financial system, and one of its tools - in addition to the linked exchange rate, banking regulation, and the financial infrastructure- is the Exchange Fund, our official reserves. The Exchange Fund, among other things, is available to be drawn on to maintain the stability and the integrity of the monetary and financial systems of Hong Kong. This is done rarely and sparingly, but it is necessary to have this provision for reasons that should be readily apparent. In addition to being a free market, Hong Kong is also an open market. This gives it one of its main strengths as an economy, for our links with overseas markets are a vital part of our success as a financial and commercial centre. But it also renders Hong Kong exposed, and therefore vulnerable, to economic and other forces that are entirely beyond its control. We would not have it any other way, because the advantages of openness far outweigh the disadvantages. But the risks involved in this exposure were brought home to us by the Asian financial crisis.

For Hong Kong, the consequences of that crisis have been first, a sharp recession, and secondly the series of attacks on our currency which I have already described. At the height of these attacks, during the summer of 1998, there was clear evidence that the free market in Hong Kong was in danger of failing to fulfil its functions. Specifically, the currency, securities and futures markets were being distorted to the point where efficient resource allocation had given way to manipulative speculation; where prices in the markets were no longer being determined by changes in underlying supply and demand; and where interest rates, instead of reflecting the supply and demand of liquidity, were being hijacked for the purpose of engineering dramatic changes in the markets. Strong evidence suggests that at the time a very small group of players were responsible for a preponderant proportion of the short futures contracts open at that time. We also estimate that currency borrowings to the tune of HK$30 billion, arranged in advance to avoid the expected interest rate volatility they were hoping to generate in Hong Kong, had been made by a similarly small group of players to be quickly dumped at a time when the markets were most vulnerable. In short, we were far from the model of 'atomistic competition' among small individual actors envisaged by thinkers such as Adam Smith. The invisible hand of the market had been replaced by a very visible club being wielded by a concentrated group of speculators.

In many other jurisdictions, this cornering of the markets would have been subject to investigation under anti-trust legislation: the Salomon Brothers scandal in the U.S. in the early 1990s, which many of you will recall, is a parallel that springs to mind. In Hong Kong we have no such laws: it is probably time that we thought out the cases for and against having them. We should also look at safeguards against market concentration. As things stood in August last year, we were watching (in a loosely worked metaphor that might appeal to those of you who will be attending the Rugby Sevens this weekend) a playing field that had become so badly slanted that ordinary players could barely stand up, and a game that was about to be cornered by a highly oversized and unsportsmanlike team with steroid-enhanced muscles, playing by its own rules. As a referee with limited powers, but with responsibility for preserving the basic integrity of the game, we intervened using the quickest, most efficient, and fairest methods that we had at our disposal. Stability on the playing field was restored, and Hong Kong remains an open market, and, we believe, like the Rugby Sevens, attractive to participants from all over the world who are keen to play a fair game.

We have been taking another look at the rules of the market to ensure that its free workings receive the best safeguards possible. The reforms include the currency board measures, now in place, and the proposed reorganisation of the securities and futures markets that I have already mentioned. It has to be stressed, however, that there is a limit to what can be done locally in an international financial system that still lacks international forms of regulation. There is consensus that some international action is now needed to build a global financial architecture that can cope with volatile fund flows more effectively than can individual jurisdictions on their own. Various international agencies and forums have been grappling over the last six months with this issue, and Hong Kong, with its direct experience of speculative attacks, has been pushing as hard as it can for an internationally backed and non-intrusive system of disclosure and indirect regulation of cross-border fund flows. While some progress has been made in working out what the problems that need to be addressed consist of, we are still a long way from seeing results, and with the absence of major speculative attacks in the last few months, we are in danger of being lulled into a false sense of security.

Conclusion

To summarise: the problem to be tackled is essentially this: capital flows are moving through a financial system that is now to a large extent global and borderless. Market liberalisation and advances in information technology mean that the system will continue to develop in this direction. Yet the machinery that regulates this system is still largely operated by individual governments. There is much that governments can do, and are doing, on their own to help ensure that markets can channel the benefits that capital flows bring while minimising the risks. But managing these risks - which lie mainly in volatilities exacerbated by high volume and high velocity, and occasionally by deliberate viciousness – may ultimately be beyond the capacities of individual jurisdictions. Crisis management and rescue packages are expensive and disruptive methods of clearing away the damage and picking up the pieces. The only effective long-term solution lies in prevention through collective action to reform the international financial architecture and ensure that free markets continue to be able to function as they should. Given what we have been through in Hong Kong and in this region in the last twenty months, we are eager that the momentum on this issue should not be lost, and that it should not require the disruptions and dislocations of another major financial crisis for the importance of preventive action to be driven home.