HONG KONG: FROM CRISIS TO RECOVERY[1]

Hong Kong has over the last eighteen months passed a tough recession brought about by financial turmoil in Asia. Currency stability, under the linked exchange rate system, has forced the structural adjustments necessary to maintain and improve Hong Kong's competitiveness. Economic indicators give grounds for confidence in Hong Kong's ability to position itself for the recovery. With this confidence come new initiatives and a new vitality that will help propel Hong Kong into the next century.

The Adjustment

It is a great pleasure to be speaking here in London again, and to do so at this large and expert gathering. Some of you may have been present at my last speaking engagement here, in June last year at the 11th Dragon Boat Dinner, which now seems like a very, very long time ago. In that speech I described Hong Kong, against the background of the financial turmoil in Asia, variedly as a pillar of stability, the eye of the storm and the typhoon shelter of Asia. My message then was that Hong Kong, with prudent policies and robust financial structures, had been the last and the least to be affected by the storm.

Since that time, as you all know well, the tail of the storm has swept through Hong Kong and it has not been so gentle after all. The painful downward adjustment in the internal cost/price structure under a fixed exchange rate system eventually and inevitably came. This was reflected in plummeting asset prices, declining GDP and rising unemployment. Although the fundamentals of the Hong Kong economy remained sound, these events provided an attractive environment for the launch of speculative attacks. And so during the summer of last year we received a severe buffeting from attacks against our currency and financial markets, threatening a financial meltdown. We fought off these attacks in August 1998 with a dramatic and controversial operation in the stock and futures markets. We accumulated Hong Kong stocks to the value at that time of around US$ 15 bn. Since then, the value of that portfolio has increased to US$ 26 bn, a reflection of the greatly improved financial environment and, even for many of our critics, a vindication of our operation. I should stress that making huge profits was not our primary purpose in this operation. But we are not complaining. The 70% return so far represents a bonus to our reserves: too bad there are no bonuses for those responsible for acquiring the portfolio. It has been a very productive investment for the people of Hong Kong. And we now have even more resources to safeguard the stability of our currency.

But this large holding of Hong Kong stocks is arguably excessive, having regard to the traditional lack of involvement of Government in business, and to the potential conflict of interest in its dual role as regulator and shareholder. Towards the end of this presentation I shall briefly return to the question of how we intend to set about disposing of this portfolio. Before I do that, I should first like to update you on the state of our economy as the painful adjustment process draws to a close and as clear signs of economic recovery emerge.I should also like to address some of the concerns – unnecessary ones, in my view – that still seem to be clouding the view of Hong Kong from outside.

The Recovery

Those of you who heard me in June last year may well be a little sceptical about any advice from me on the outlook for the Hong Kong economy. Although I was under no illusion about the less prosperous times that lay ahead, like many at the time I was perhaps a little too sanguine in my assessment about the impact that the Asian crisis

1 This is the the text of the speech delivered by Joseph Yam, JP, Chief Executive of the Hong Kong Monetary Authority, at the HKMA Luncheon in London Roadshow on 28 September 1999.

would have on Hong Kong. However, the temptation now for many is to go to the other extreme: to be very cautious in making predictions about the future and to acknowledge signs of recovery only very reluctantly. This is understandable when we are still only just moving out of our sharpest recession on record. Yet even the pessimists would now, I think, acknowledge that the storm signals are down, the clouds are thinning out, and there are shafts of sunlight in the distance. I speak only metaphorically, of course. As those of you who have been in Hong Kong recently will know, this has been a very stormy summer from a meteorological point of view: we have just had the worst typhoon in sixteen years and the wettest typhoon since records began more than a hundred years ago.

Economically, the most recent figures suggest that our wet and windy summer has brought with it a distinct turn for the better.

GDP – a rebound in the second quarter (in excess of 3%, quarter on quarter) after six consecutive quarterly declines (Chart 1)

External trade – exports picked up in recent months, with the overall trade balance remaining in a healthy position (Chart 2)

Retail Sales – clear rebound in the second quarter (7% increase, quarter on quarter) (Chart 3)

Tourism – uptrend re-established (up by 11% in the first seven months of 1999) (Chart 4)

Unemployment – off the peak, now at about 6% (Chart 5)

Prices – downward adjustment in CPI continuing, but the fall in core prices excluding rentals has levelled off in recent months (Chart 6)

Stock market – recovered almost all of its lost ground (Chart 7)

Property prices – off the bottom (September 1998) and stable (Chart 8)

Interest rates – stability returned, and premium over the US Dollar interest rates has fallen to pre-crisis level (Chart 9)

Non-performing loans – low (around 6%), still increasing but signs of levelling off in the second quarter (Chart 10)

Overdue mortgage payments – default ratio definitely levelling off since April (Chart 11).

Chart 1
Gross Domestic Product

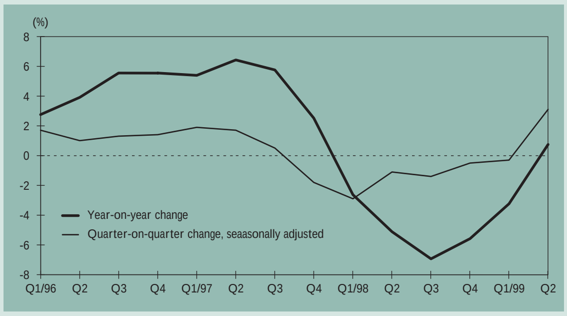


Chart 2
External Trade

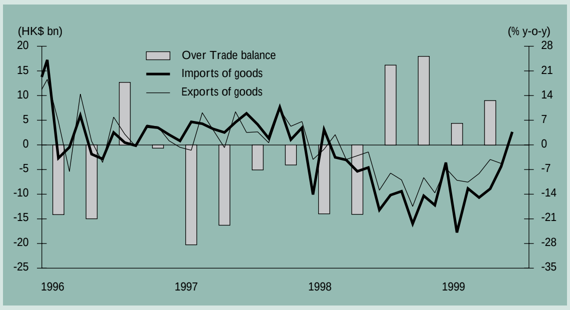


Chart 3
Retail Sales (Seasonally Adjusted)

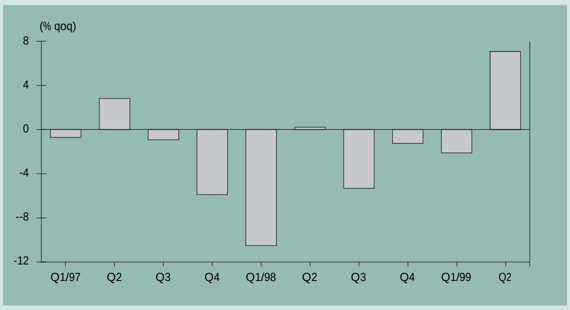


Chart 4
Tourist Arrivals

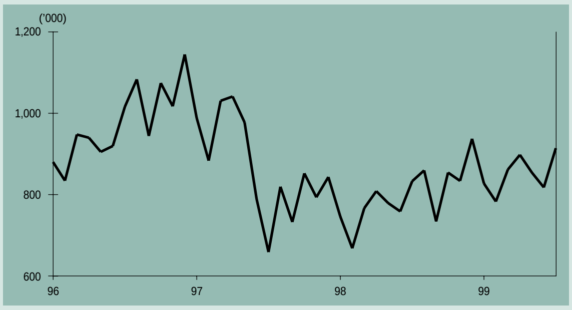


Chart 5
Labour Market

Chart 6
Composite CPI (Seasonally Adjusted, 10/94 - 9/95 = 100)

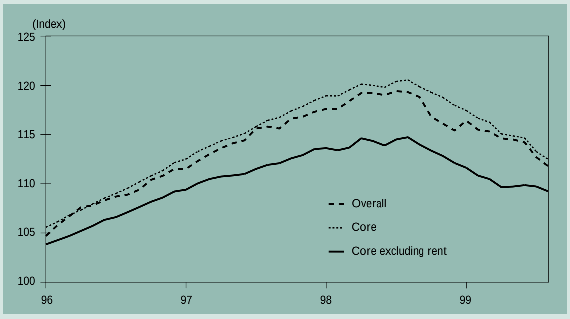


Chart 7
Hang Seng Index

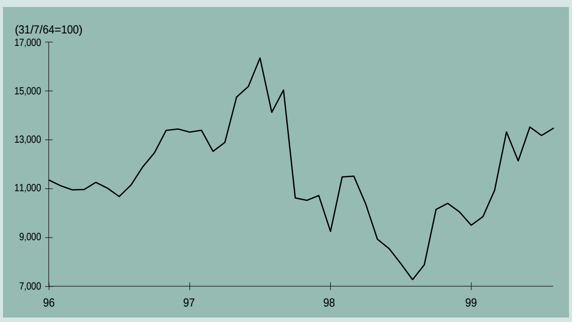


Chart 8
Residential Property Price Index

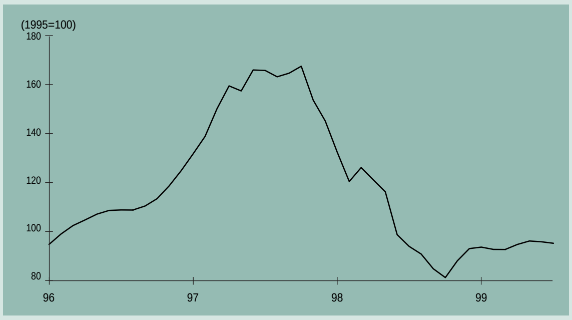


Chart 9
Interest Rates

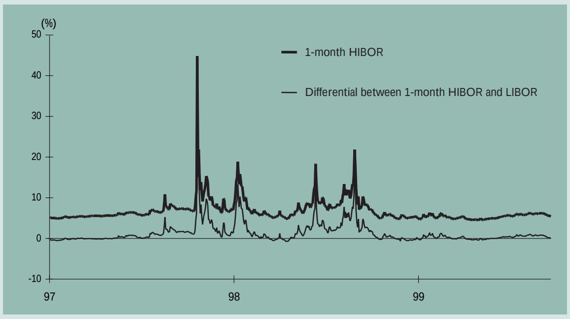


Chart 10
Loans Delinquency Ratio of Local Banks

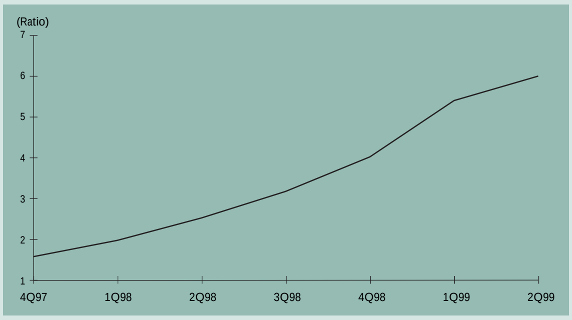


Chart 11
Mortgage Loans Delinquency Ratio

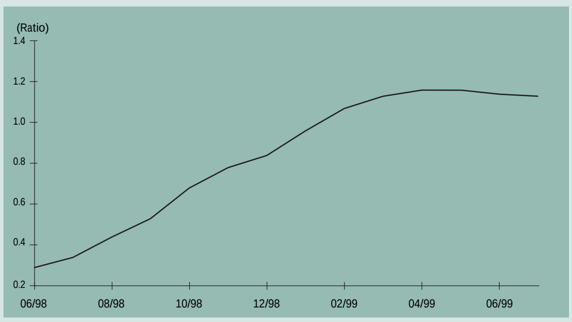
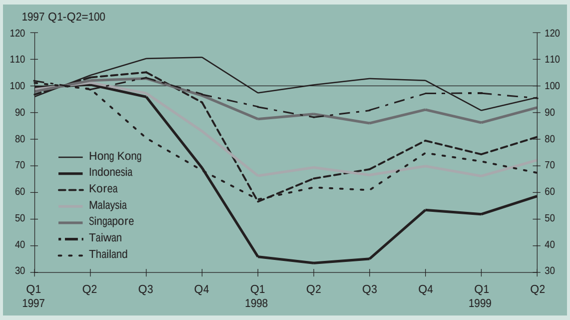


Chart 12
Nominal GDP Indices in US$ Terms



Sustainability

My apologies for this heavy dose of numbers and charts, particularly when, at the sharp turning point of an economic cycle, we should all treat economic figures with extra care. I would certainly not wish at this moment to use them as a basis for any precise forecasts for the future. But it does seem clear from all these that, after about 18 months of painful adjustment, the Hong Kong economy is now on its road to recovery. For some time the financial markets have been anticipating this. And further confirmation is available in the many upward revisions of private sector forecasts of economic growth for the year as a whole. The government's own estimate of 0.5% growth earlier in the year no longer appears to be as unrealistic as some commentators once thought. The recovery is also taking place against a background of renewed buoyancy generally in the region, and continuing strong growth specifically in the Mainland of China. So there is some ground for optimism that our recovery will continue with some vigour.

But I would like to sound a note of caution here. There are important issues on the reform of the international financial architecture to be resolved quickly. The G7 Financial Stability Forum, supported by its various working groups, and with inputs from other committees, notably those of the BIS, is making good progress in its deliberations. Attention is rightly given to limiting the destabilising effects of deleveraging when highly leveraged institutions are overwhelmed by market forces. But I am pleased to notice that the plight of small open markets being overwhelmed by the activities of highly leveraged institutions is also being addressed. Reform of the international financial architecture is crucial if the broad recovery of the Asian region is to be sustainable in the longer term. The volatility of international finance was an important cause of the recent financial turmoil in the region. Without appropriate reforms to the international financial architecture, the small open markets of the region will remain vulnerable and the achievement of long term sustainable growth may be undermined.

Performance

This regional background brings me to the comparisons of performance that are now made between Hong Kong and its neighbours. There is a claim that Hong Kong is lagging behind in its recovery. One reason for this, it is argued, is that our fixed exchange rate prevents us from using the exchange rate as an expeditious adjustment vehicle. It also prevents us from using interest rates to stimulate growth, as it binds our monetary system to that of the US – an economy half way across the world now going through a different phase of the economic cycle.

These observations are valid. Fixed exchange rates do involve certain costs. But I think they are of a short term nature and certainly, in the circumstances of Hong Kong, do not constitute an argument for any change to a system that has demonstrated over time to be in the long term interest of Hong Kong.

In any case, what is the alternative? We saw it, or the lack of it, in many of the markets in Asia – huge and uncontrollable volatility in the exchange rate, overshooting in both directions, unless monetary restrictions, such as exchange controls, were quickly introduced. The currency collapses in Asia clearly caused serious social and economic damage, and Hong Kong is able to avoid that without infringing the freedom of anybody to operate in our markets. This does not include, I hasten to add, the freedom to manipulate markets. The recoveries in the crisis economies in Asia may have come sooner than in Hong Kong, but they reflect to a large extent a background of deeper and earlier recessions than Hong Kong's.

Furthermore, while they adjust through the exchange rate, arguably the easy way out, Hong Kong adjusts through internal restructuring, which brings prices down and pushes productivity up. This process takes time, and it brings with it a certain amount of pain, but the longer-term improvements in efficiency that result are likely to be more substantial than the immediate across-the-board gains in competitiveness that might have been achieved through currency devaluation. The discipline of our fixed exchange rate forces the necessary efficiency and structural reform, rather than postponing it. This process is already clearly visible in many sectors of our economy, from the larger corporations to the smallest retail outlets, although the noise of the pain has been diverting attention from it.

Let me add another point. If one is doing an international comparison of how various economies have performed through the financial crisis in Asia, one should also try expressing the relevant numbers in a common unit of measurement. Let me show you yet another chart (Chart 12). We fared distinctly better in comparison with others when everybody's economic performance is measured in US dollar terms.

Exchange Rate

The qualms that some people have expressed about our fixed exchange rate illustrate some of the difficulties of analysing an economy like Hong Kong, which is very much in a category of its own. It is natural that there should be concerns, and right that there should be healthy debate, about how we conduct our monetary affairs. But my own conviction of the importance of the Hong Kong dollar's link to the US dollar, and my confidence in our ability to maintain the link, through currency board arrangements suitable to modern day finance, have only been strengthened by the experience of the last two years. Since its introduction during a time of political anxiety in 1983, the link has served Hong Kong as an anchor of stability during the spectacular transformations of the '80s and '90s and in the trials we have faced more recently. I see no reason for abandoning or modifying it. No better alternative has been put forward by those who believe that it will, or should, be dismantled. Its usefulness to Hong Kong's externally oriented economy is understood by the community in Hong Kong and by those who know Hong Kong well.

It is worth adding here a comment on the relationship – or rather the lack of relationship – between the Hong Kong dollar and the renminbi (RMB), the currency of the Mainland of China. For some time now, despite firm statements made by the leaders in Beijing, there have been spasmodic rumours that the RMB is about to be devalued. There have also been predictions that any devaluation of the renminbi will have serious implications for the Hong Kong dollar. You will not be surprised if I tell you that I hold a different view. The likelihood of a devaluation in the RMB in the foreseeable future seems to me to be very small. Given the Mainland's continuing balance of payments surplus, the continuing inflow of foreign direct investments, and the strictly enforced capital controls, the expectation ought, on the contrary, to be that the RMB should strengthen, as indeed it has in recent months. But even if there were a reversal of these trends in the Mainland's international payments, and if consequently the forces of supply and demand produced a devaluation of the RMB, why should the implications for Hong Kong or the Hong Kong dollar be negative? This may be the current market sentiment and unfortunately nowadays market sentiment is often disproportionately influenced by those whose job it is to play the market. They often choose to ignore, or should I say they are very selective in looking at, or drawing attention to, the fundamentals. But I am glad to see that the fundamentals are now being brought out by an increasing number of analysts. They find little justification for an adverse impact on the Hong Kong dollar if there were to be a devaluation of the RMB. There is clear empirical evidence on this in the past sixteen years. Put simply, the Hong Kong dollar is linked to the US dollar and not to the RMB.

A 'hazy future'?

Negative feelings about the exchange rate link often form part of a larger picture of a Hong Kong losing its vigour and going down the drain. Throughout its history as a financial and commercial centre Hong Kong has somehow been a magnet to sceptics and cynics of all descriptions. Every few years or so, some reason, either political or economic, persuades someone to predict the imminent death of Hong Kong. A couple of years ago it was the handover, and the question of whether Hong Kong really would enjoy the autonomy and freedoms that it needed to preserve its vitality as a city. In the early eighties it was the uncertainties surrounding Hong Kong's future; in the seventies the oil crisis; in the sixties the widespread social disturbances; and in the fifties the UN embargoes on trade with China. These episodes are all within my lifetime. No doubt we could search back further in history for similar examples. More recently, now that Hong Kong at last appears to be pulling out of the recession, the predictions – articulated most recently in one of London's most distinguished magazines, *The Economist* – are for a slow and almost imperceptible decline: a 'hazy future', in which Hong Kong slides into second-, third-, or even fourth-rate status while other cities in the region leap ahead. Although this is not as histrionic as the death sentence once passed on Hong Kong by another magazine, isn't this all still a little too melodramatic? I am glad that the Financial Secretary gave a robust response, which *The Economist* printed on 27 August. I just want to add here that I have no doubt that Hong Kong will survive the diagnosis of *The Economist*, just as it has survived all the other doomsdayish scenarios so sensationally meted out in the past.

I have already addressed the general criticism that the linked exchange rate impedes recovery, and I have argued that there are considerable exaggerations in this view, that the link enables us to avoid the misery of currency collapse, and that the discipline exerted by the link has long-term benefits for Hong Kong that would not be conferred by a floating exchange rate. Let me now comment on a few other concerns.

Real Interest Rate

The first of these is that Hong Kong now has a prohibitively high real interest rate that drives away investment and stifles growth. There is no doubt that the current real interest rate is high – much higher than we are used to. Indeed, declines in nominal interest rates since the summer of last year, reflecting a substantial narrowing of the interest rate premium over the US dollar to pre-crisis levels, have been more than offset by falling prices. The recent up-tick in US interest rates added to the concern. But it is misleading, particularly at the sharp turn of economic cycles, to use backward-looking, short-term measures of inflation in calculating real interest rates. They offer a distorted view of what might be expected in the future. It is also misleading to infer from this approach the likely behaviour of business investments and asset prices. An alternative approach is to be forward looking and to take a longer term view, involving forecasts of inflation and nominal interest rates. This suggests that the real interest rate in Hong Kong facing an investor is both lower and more stable than conventional measures would have us believe. This also helps to explain why asset prices are now stable or increasing, and why capital is flowing into Hong Kong. For the extensive research behind this alternative approach, I refer you to the long article on the subject in the HKMA's August Quarterly Bulletin, which can be found on our website. The implications of this research are that, while Hong Kong would be better off if real interest rates were lower, the situation is by no means as unhealthy as we might have been led to fear.

Deflation?

A related concern is that there is worsening deflation in Hong Kong. This is, I think, a needless anxiety. To start with, it is doubtful whether an economy as externally oriented as Hong Kong, with external trade in goods 2.5 times its GDP, can experience deflation, when that term is understood to mean a spiralling process of falling prices and production. Hong Kong prices are determined, probably more so than in any other economy, by world prices of tradable goods. However, the prices of non-tradables can fall, and fall quite sharply, as a necessary part of the internal adjustment process that goes with a fixed exchange rate in response to a severe external shock. This compensates for the fact that the currency itself does not devalue, and is an important factor in strengthening our overall competitiveness. But there is much less of a spiralling process involved. It is more of a one-time change in Hong Kong's price levels. It should not inhibit consumption or investment to any permanent or prolonged extent. Further, for the average Hong Kong household it is a welcome respite after many years of relatively high increases in the prices of non-tradable goods.

Competitiveness

There is a related but somewhat opposite concern, and this is whether the internal price adjustments that have taken place in Hong Kong have gone far enough for reducing the cost of doing business in Hong Kong. The high cost of living and doing business is a complaint that we hear in all of the world's large financial centres. I have heard it in Tokyo, in New York, in Paris a couple of weeks ago, and, only today, again in London. We would all like to see a reduction in costs in Hong Kong, and with the price adjustments now in progress we are actually seeing this happening: not as rapidly as many would wish, and not as quickly or as extensively in some sectors as in others. But it is happening. It will continue if the demand is not there. It will stop or reverse itself when sufficient demand, relative to supply, is generated. Office rentals are now about half of the levels before the crisis. Staff costs are significantly lower with the sharp reduction of bonuses and higher productivity. With the internal price adjustments, the real effective exchange rate of the Hong Kong dollar has declined substantially by about 10% in the last 12 months, helped recently by the weaker US dollar.

Competitiveness of Hong Kong, in particular as an international financial centre, is more than just a question of costs. Nor does the success of other cities in the Asian region, from Sydney to Singapore to Shanghai and Seoul, at different times in the financial history of Asia, preclude the continuing success of Hong Kong. On the contrary, these cities in the region play differing and complementary roles. There is a great deal of co-operation and exchange, and the healthy competition is a stimulus to all of us to do better in a still expanding regional economy, not the destructive zero-sum game that it is sometimes depicted as being.

Each of the regional centres in Asia has special strengths and characteristics and its own quite distinct hinterland. In Hong Kong's case, the main hinterland that it serves is the Mainland of China, for which it acts as the international financial centre, a major trading entrepot, and a provider of increasingly sophisticated services. Given the advanced state to which these functions have been brought in Hong Kong, it is difficult to see how they can easily be replaced. And with the developments and reinventions currently in progress within Hong Kong, it is more than likely that they will be enlarged and extended. We could point to such projects as the cyberport or silicon harbour, which will help Hong Kong and the region it serves to tap more directly into the latest information technology. We could draw attention to the plans to make even more out of Hong Kong's role as a centre of tourism and entertainment, particularly at a time when China as a whole is fast becoming one of the world's top tourist destinations and a considerable source of tourists in its own right. Nearer to my own area of responsibility, a comprehensive set of reforms will help to ensure that Hong Kong's banking sector continues to thrive into the next century as one of the strongest yet most open in the world. And substantial progress has been made over the last year or two in linking Hong Kong's advanced clearing and settlement systems with other systems in the region – a process that will help promote both the development of the financial infrastructure in the region and the position of Hong Kong as a leading centre in the regional debt market.

The Portfolio of Hong Kong Stocks

The government plays a quiet but crucial role in taking forward projects such as these. Like public housing, schools, hospitals, and the magnificent new airport that now serves our city, they are among the many examples in Hong Kong of the government taking the lead where the free market is not expected, or in fact fails, to provide a solution in the best interests of Hong Kong. And this brings me back to our operation in the stock and futures markets last summer, and to the frequently voiced opinion – familiar I am sure to all of you – that the Hong Kong government has over the past couple of years abandoned its free market principles and its policy of positive non-interventionism. I do not see it in quite these terms. At the time, we were clearly faced with the prospect of market failure, as a result of excessive concentration of positions and market manipulation. I do not think it is necessary or appropriate to go into this again other than to say that nothing has come to light since then to weaken my conviction that what we did was right.

But we do now have a large portfolio of Hong Kong stocks to handle. I am not embarrassed by it. I think it is quite legitimate that we should invest part of Hong Kong's reserves in the future of Hong Kong. But the portfolio is perhaps too large in the context of a conservative asset allocation strategy for official reserves and in relation to the market itself. So the intention is to reduce our holdings substantially but to do so in a gradual and orderly manner. In accordance with the benchmark of our asset allocation strategy, our aim over the long run is to hold an amount equal to about 5% of the total assets of our Exchange Fund.

This is of course not a simple task, particularly when one important consideration is to minimize market impact. I am happy, though, that this, and the management of the stock portfolio, are not my responsibilities, but those of the company called Exchange Fund Investment Limited (EFIL) established last year with its own independent board of directors. In June this year, EFIL announced that it planned to begin the disposal of a portion of the shares by the development and launch of a unit trust product designed to track the Hang Seng Index. The unit trust product can cater for the needs of investors. It is market-neutral, having the least impact on stock movements, which satisfies our aim of disposal in an orderly and gradual manner. I believe that, with the economy now showing clear signs of recovery, and with a stable and improving stock market, the work that is now in progress on the development of the unit trust is timely. I am afraid I cannot say more on this subject. My lawyers seem to get very excited about some selling restrictions in the Financial Services Act. In any case, I have already occupied too much of you time.

Conclusion

To sum up the messages in this speech: Hong Kong has over the last 18 months passed through a rough recession brought about by financial turmoil in Asia. We have toughed it out, accepting the painful adjustments through the discipline of our linked exchange rate, recognising that there are no easy alternatives and that this disciplined approach to adjustment is in the long term interests of Hong Kong. Thankfully, there were no catastrophes, and Hong Kong's strong economic fundamentals remain sound. With the passing of the tail of the storm, something of the old confidence is returning to Hong Kong, as our economic indicators show clearly that we are turning the corner. With that confidence comes new ideas, new plans, and a new vitality that will propel Hong Kong into the next century. I hope you will all find the opportunity to come over to Hong Kong soon and see these processes at work.