

## **The Governance of the Hong Kong Monetary Authority: Comments on Some Topics**

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### General Remarks

1. The Hong Kong Monetary Authority (HKMA) was established ten years ago and notable changes have taken place in its operations. The Report by the Legislative Council Secretariat<sup>2</sup> serves as a useful point of reference for reviewing HKMA's governance. Due to the limitations of time and the complexity of the subject, I shall concentrate here on a few areas that I am more familiar with.
2. As far as central bank governance is concerned, the international trend is towards higher transparency and accountability whilst guarding the operational independence of the monetary authority. HKMA has done a good deal in enhancing its transparency and accountability, especially in the years since the 1997-1998 financial crisis. Further steps can in my view be pursued. On the other hand, increase in public control and avoidance of arbitrary discretion can be achieved through enhancing the degree and extent of legalisation (codification). However, the cost and benefit of such a move for a small open economy such as Hong Kong with freely mobile financial markets must be borne in mind. The same consideration applies, albeit to a lesser extent, to institutional changes that may affect the governance structure.
3. While it is of some use to compare the governance of HKMA with similar institutions in the SAR and other jurisdictions, it is important to take into account the specific nature of HKMA and the characteristics of the monetary, exchange

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<sup>2</sup> "The Governance of the Hong Kong Monetary Authority and Comparable Authorities in Hong Kong and Overseas Jurisdictions", Jackie Wu and Michael Yu, Research and Library Services Division, Legislative Council Secretariat, 30 April 2003.

rate and financial systems that it monitors, maintains or regulates. As a currency board system, for example, it may be instructive to also look at the frameworks of regimes like those in Estonia, Lithuania, and Bulgaria, three of the more sizable Eastern European countries that adopted currency board arrangements in 1992, 1994, and 1997 respectively.<sup>3</sup>

4. At the end of the day, the historical context and system specificity of HKMA and the evolving local economy should be the core consideration in any review process. International comparison can never be exhaustive, and it serves basically only as a reference.

#### Powers and Functions

5. HKMA is a legal person who derives its formal powers as an appointee of the Financial Secretary (FS) from two pieces of laws: the Exchange Fund Ordinance (EFO) and the Banking Ordinance (BO). This begs the question why its powers and functions are not stipulated in one legal document. Incidentally, there is a single act for the central banks of Estonia, Lithuania, and Bulgaria. Indeed, I made comparison in 1999 among the six currency board regimes including the three, HKMA, and the central banks of Argentina and Bosnia and Herzegovina.<sup>4</sup> As far as monetary policies are concerned, I found that Hong Kong had the “loosest” legal framework among the selected regimes.
6. I am not knowledgeable about the reasons why an encompassing “HKMA Ordinance” was not deemed necessary in 1992, when EFO was amended to pave the way for HKMA’s establishment in 1993. Some of the present Legislative Council Members participated in the amendment process then and they should be in a better position than I am to explain.
7. Of course, other than “unifying the laws”, another approach is to modify and extend the contents of the laws, and to make them more specific so as to reduce discretion. Two aspects are of particular importance: (1) the monetary rules that govern the policies of a central bank; and (2) rules that stipulate the appointment of key personnel and the resource allocation process of the central bank.

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<sup>3</sup> Relevant information is available on the following websites: [www.eestipank.info/frontpage/en/](http://www.eestipank.info/frontpage/en/) (Bank of Estonia), [www.lb.lt/home/default.asp?lang=e](http://www.lb.lt/home/default.asp?lang=e) (Bank of Lithuania), and [www.bnb.bg/bnb/home.nsf/fsWebIndex?OpenFrameset](http://www.bnb.bg/bnb/home.nsf/fsWebIndex?OpenFrameset) (Bulgarian National Bank).

<sup>4</sup> Tsang Shu-ki, “Legal Frameworks of Currency Board Regimes”, *Quarterly Bulletin*, HKMA, August 1999, pp.50-63.

### Modes of Organisational Control, Autonomy and Accountability

8. Regarding the first aspect, I think that we have to be very careful about what to put into laws. As I argued in my 1999 analysis,<sup>5</sup> “a law is rather rigid and may take a long political process to formulate, enact, revise or exit from. .... Even for the obviously critical core of the (monetary) rules, i.e. the convertibility undertaking by the monetary authority on the exchange rate, Argentina and Lithuania have chosen to be legally asymmetrical. .... Also controversy remains on what else should be brought within the ambit of law, especially concerning the operations of a modern currency board regime with regard to liquidity management and lender of last resort facilities” (p.50) While committing to a set of rules may enhance credibility, it is by no means guaranteed if the rules are perceived to be excessively restrictive and hence not viable in the long run in face of changing circumstances.<sup>6</sup> Discretion or flexibility would then be a wiser alternative.
9. As to the second aspect, i.e. rules that stipulate the appointment of key personnel and the resource allocation process of the central bank, there are many different practices in the world. They range from control by the government to that by the legislature, with varying degrees of stipulations in laws. In most cases, though, the operational autonomy of the central bank is provided for and undue influences from the political process are regarded as not desirable. The US Fed is an example of political control (appointment of Board Members by the President with the advice and consent of the Senate) that preserves autonomy (Board Members not removable other than for fraud and other personal misconduct). The Fed is also relatively free in determining its own budgets as there is little political influence over its funding.
10. The approach in Estonia and Lithuania further tilts towards legislative control. For Eesti Pank (Bank of Estonia), the Chairman of the Supervisory Board (Members of the Supervisory Board) is (are) appointed by the Parliament on the proposal of the President of the Republic (appointed by the Parliament upon the

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<sup>5</sup> Tsang Shu-ki, “Legal Frameworks.....”

<sup>6</sup> Hence there is a variable linkage between “commitment” and “viability” of a currency board system. And commitment is also related to “exit cost”, the cost associated with giving up a certain rule. See Tsang Shu-ki, “Commitment to and Exit Strategies from a CBA”, paper presented at the Seminar on Currency Boards: Experience and Prospects, organized by the Bank of Estonia, Tallinn, 5-6 May 2000. ([www.eestipank.info/pub/en/majandus/rahasysteem/raamistik/seminar\\_2000\\_05\\_05-06/pan3-hk.html](http://www.eestipank.info/pub/en/majandus/rahasysteem/raamistik/seminar_2000_05_05-06/pan3-hk.html))

proposal of the Chairman of the Supervisory Board). A separate Governor of Eesti Pank is appointed to office for a term of five years by the President of the Republic on the proposal of the Supervisory Board. In Lithuania, while the Chairman of the Board of the central bank is similarly elected by the Parliament, Deputy Chairpersons and Members of the Board are appointed by the President on the recommendation of the Chairman of the Board.

11. However, two measures are adopted in the central bank law<sup>7</sup> to protect the independence of the bank: (1) The “autonomy” (of the Bank of Estonia) and the “independence” (of the Bank of Lithuania) are spelt out (in Article 3 of the Act and the Law); (2) Its funding is instituted in such a way that its annual budget is free from political influence. This involves the setting up of statutory/authorised capital, reserve capital, and other reserves (or “foundation capital”), which form buffers to the fluctuations in annual income and expenditure.
12. At the other end of the spectrum, the appointment of key personnel and the resource allocation process of a central bank can be controlled by the executive arm of the government, with or without detailed legal stipulations. The Bank of England is an example. The Bank of England Act gives the HM Treasury the power to appoint its Governor, two Deputy Governors and 16 Non-executive Directors who collectively make up the Court of Directors, which is the management board of the Bank. The 16 Non-executive Directors also form a sub-committee of the Court (the so called NedCo), which has the statutory functions of reviewing the Bank’s performance and its internal financial controls, as well as determining the financial packages for the Governor and Deputy Governors and the terms and conditions of services of members of the Monetary Policy Committee (MPC) who are appointed by HM Treasury. The Bank can, with the consent of HM Treasury, remove members of the Court.
13. Despite the above-mentioned facets of governmental control, the operational independence of the Bank of England is provided for in the Act (although HM Treasury could itself make or override decisions on interest rates in the light of public interest or extreme conditions). Moreover, the Court is the approval mechanism for the budgetary autonomy of the Bank, which has abundant financial resources. Hence it can maintain its resource independence from the Government. Accountability is ensured through requirements in the Act on the

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<sup>7</sup> For the Eesti Pank Act see <http://www.legaltext.ee/text/en/X70022.htm>; and for the Law on the Bank of Lithuania, see [http://www.lb.lt/eng/acts/law\\_lb.htm](http://www.lb.lt/eng/acts/law_lb.htm).

Bank's reporting and information revelation processes to HM Treasury and the Parliament.

#### HKMA as a Special Case

14. In the case of HKMA, its Chief Executive as the “Monetary Authority” (MA) is appointed by FS, as stipulated by EFO. The Exchange Fund Advisory Committee (EFAC), on the other hand, is the “de facto management board” and chaired by FS. Its members are appointed by the Chief Executive of the HKSAR. As the Report puts it, “there are no statutory requirements prescribing the membership of EFAC”. The budget of HKMA is approved by FS, with expenditure charged to the EF.
15. So on the whole, HKMA is under the legal control of the Government through FS. It is more akin to the UK model, albeit with less statutory autonomy regarding policy making and implementation, appointment (removal), and resource allocation. Of course, there is strong evidence to suggest that the operational autonomy of MA has been highly respected by FS since its inception. From that perspective, HKMA could alternatively be regarded as “too powerful” or “powerless”. The fact remains, however, that the autonomy which HKMA has apparently been enjoying is not buttressed by legal stipulations or formal institutional arrangements. It remains largely a policy of the government, albeit a time-honoured policy. This is not meant to be a criticism in itself: the linked exchange rate of HK\$7.80/US\$, a cornerstone for Hong Kong's monetary and financial system since October 1983, is also only a policy not backed by any statutory provisions.<sup>8</sup>

#### Some Thoughts concerning Possible Reforms

16. In reviewing the governance of a central banking institution, the evolving context of that institution as well as the environment that it has been facing should be taken into account. While different aspects of the governance structure of similar institutions may be compared, one needs to be careful so as not to commit the error of “misplaced concreteness”, i.e. taking bits of “best practices” in various facets of governance from different institutions and arguing that they should be adopted. The danger is that these bits may not add together, because they are not

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<sup>8</sup> See Tsang Shu-ki, “Legal Frameworks .....”; and Tsang Shu-ki, “Commitment to and Exit Strategies .....”.

structurally coherent or consistent.

17. Changes and improvements have been initiated by FS and HKMA in the past few years, including the measures that aim at increases in transparency, accountability and professionalism in the operations of HKMA. The establishment of the EFAC Sub-Committee on Currency Board Operations in 1998, the publication of its records of meetings, and the enhanced disclosure of information on the Exchange Fund and Currency Board Accounts are examples. The Remuneration and Finance Sub-Committee of EFAC, consisting of all non-executive and non-bank members and set up in 2002, is another.
18. That is in my view a move in the right direction. Possible further near-term improvements may be concluded from a more detailed review of the UK model, from which the Hong Kong system has apparently taken clues. Of course, one possible criticism is that not enough has been done, and timely done. The transformation of EFAC into a Board similar to the Court of the Bank of England with a beefed up non-executive Directors' sub-committee similar to NedCo is conceivable after careful consideration of its pros and cons. In any case, special local factors need to be borne in mind.
19. An alternative approach is to move from one model to another model of governance: e.g. from the UK to the US or the Baltic framework, shifting the control centre from the Administration to the legislative/political arena. This would involve costs while the benefits might not be clear. A case has to be made first that short of a major overhaul, accumulated or hidden problems might deteriorate and generate potential instability; or that the shift would produce significant advantages. That would go beyond the exercise of local and international comparisons. Otherwise, incremental reforms may be more justified.