

Legco Panel on Financial Affairs

Proposed scope of discussion with academics and market practitioners on the mechanism for defending the Linked Exchange Rate system

(1) Conventional mechanism for defending the Linked Exchange Rate (LER) system

- In normal circumstances the interest rate adjustment mechanism is both a market (ie supply/demand) driven and self correcting mechanism. In the absence of unusual external forces the LER is effective, and should be able to take care of itself so long as domestic confidence stays.
- The seven-point package should make the peg more effective.
- However, alternative strategies to cope with unusual conditions, coordinated attacks or other emergencies are also needed.

(2) Tactics used by market manipulators, and how they affect the economy

Tactics

There were a variety of different tactics, but the “double play” involved selling the HKD forward thereby driving up interest rates along the curve, whilst at the same time shorting the equity market and the HSI futures.

A rise in interest rates would be expected to lead to falling shares prices, especially in interest-rate sensitive stocks such as property and banking counters.

These interest rate and share price movements were exacerbated by negative research reports from some big brokerage companies.

Stock Borrowing was the key as many investment houses sourced stock to short for the speculators;

Finally, investment bank trading houses were trading the difference between the cash market and the futures, which aggravated the situation.

Affect on the HK economy

Clearly a rise in interest rates led to a drop in asset prices, both property and stocks. Given that the net worth of the households is made up of holdings in these two asset classes, there was a considerable drop in wealth.

Rising interest rates also hits corporate cash flow leading to an increase in the NPL ratios for banks.

In a very asset based economy like HK rising nominal rates also dampen inflation expectations, driving up the real interest rate. This is negative for the economy.

The cumulative effect is that consumer demand drops, the financial services sector retrenches and unemployment rises.

(3) Seven point plan

- It is very effective in increasing liquidity, and should help keep HIBOR low
- Less effective in reducing risk premium
- Effective in currency/future “double plays”, but may not to other kind of double plays
- The seven point package lowers HIBOR drastically - could provide cheap HKD for future attack

(4) Effectiveness of 30 points

- Some of them have made double play more difficult
- Can not prevent speculation - in fact not all speculation is bad
- Without touching offshore speculation, it is hard to eliminate the problem
- Broad and undefined power for the administration is a negative

Adverse effects on status

- This is a price HK may have to pay to stabilise the peg.
- Losing some future business to Singapore is a risk, but HK can counter this.
- Future status depends on Future Exchange's ability to develop new products.

(5) How does HK compare with other free market economies?

Transparency

This is essential in any free market economy. Transparency in HK should be good given that there is a currency board, and therefore the setting of interest rate policy is not influenced by political concerns. However transparency has reduced somewhat in HK with the HKMA now a major player. The stock overhang issue is now a factor for investors

LER

Recent changes have made it more difficult to change the aggregate balance in the LAF which helps the HKMA. However, there has been some deviation away from the pure currency board operation, especially in relation to managing interest rates. Clearly speculative excesses drove rates too high, but the money market have been kept awash with funds. Other issues relate to the banking system in that technically HK has no lender of last resort. With a large stake in the largest note-issuing bank in HK, critics will contend that there is a conflict of interest for the HKMA. However this will ease as time goes

on, and investors see that HK does remain true to its traditional non-intervention stance.

Credibility

The HKMA has enjoyed significant goodwill from the international community over the past ten years, and its commitment to the peg is seen as credible. Despite short-term concerns, this should not damage HK's well deserved reputation.

A H Smith

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