Statement by Professor Y.C. Jao to Legco Panel on Financial Affairs on November 14, 1998

1. Since the outbreak of the Asian financial crisis (AFC) in July 1997, there have been at least five major speculative attacks on the Hong Kong dollar. The last attack in August this year, which took the form of "double market play", was particularly massive and vicious. To date, all such attacks have been repulsed by the Hong Kong Monetary Authority (HKMA). Moreover, by its timely intervention in the equity market, the HKMA has succeeded in inflicting a crushing defeat on speculators-manipulators, with the result that the Government's equity portfolio had an unrealized profit of about HK$32 billion as of November 3, 1998. The stabilization of the equity market has been accompanied by that of the property market. Because shares and properties are widely used as collaterals for bank loans, the stabilization of their prices are of crucial importance to the safety of the banking sector. Furthermore, the recovery of asset prices from near-collapse can also mitigate the "negative wealth effect", which will be beneficial eventually for consumption and investment, and therefore for the real economy as well. On the whole, the HKMA deserves high marks for having so successfully defended the Hong Kong dollar and the integrity of our financial system.

2. Before the implementation of the "seven technical measures" on September 7, the HKMA relied principally on the interest rate mechanism for the defence of the Hong Kong dollar. Higher interest rates are an inevitable result of the automatic adjustment mechanism inherent in the currency board arrangement (CBA), of which our linked rate regime is a variant, when the domestic currency is under attack. However, whereas in normal times, higher interest rates can attract capital inflow quite quickly, during the current AFC, they can do so only sluggishly, or even not at all, because of the persistence of the AFC and the existence of an "Asian risk premium". Prolonged higher interest rates, especially when they become positive after adjusting for expected inflation, have serious adverse effects on the real economy. Furthermore, exclusive reliance on the interest-rate weapon can unwittingly play into the hands of the professional speculators. Typically, the speculator's favourite tactic is to sell Hong Kong dollar forward (buy US dollar forward), pushing up the Hong Kong Interbank Offered Rate (HIBOR), while selling Hang Seng Index futures at the same time. If lucky, he can reap profit from both the forex and the equity markets. Although in November last year, some scholars, including myself, had already detected such "double market play", the Securities and Futures Commission (SFC) at that time denied its existence, as did the Government's own Report on Financial Market Review of April 1998 (4.104-4.112). While the current recession in Hong Kong is basically attributable to the rapidly deteriorating external environment, high interest rates and negative wealth effect have also played their part.

3. As speculators began their massive attack in early August, the HKMA realized that a new

strategy for defending the CBA was necessary. A Sub-committee on Currency Board Operations was formed for this purpose. As a member of this sub-committee, I was involved in the intense deliberations and discussions during the critical month of August 1998. The new strategy, as embodied in the seven technical measures, were approved at the end of August by the Exchange Fund Advisory Committee and formally announced on September 5. Since its implementation on September 7, these measures have been well received, and have succeeded in further frustrating the attempts of speculators-manipulators. The most significant features of the new strategy are that, firstly, by expanding the monetary base to include Exchange Fund bills, interest rates will become less volatile and manipulable. Previously, the aggregate balance being too small, even a moderate selling of Hong Kong dollar can drive it into negative territory, causing HIBOR to over-shoot to the advantage of speculators. Secondly, by providing a "convertibility undertaking" to all licensed banks to convert Hong Kong dollars in their clearing accounts into US dollars at the fixed rate of HK$7.75 to one US dollar, the automatic convertibility is now widened from legal tender currency (through the Certificates of Indebtedness) to the whole monetary base, which will strengthen public confidence, and facilitate the working of the CBA. Thirdly, a formal Discount Window now replaces the former Liquidity Adjustment Facility and the restrictions on repeated borrowing collaterized by Exchange Fund papers have been removed. This will ease the uncertainty on the part of the banks and hence the pressure on the term structure of HIBOR. To maintain CBA discipline, however, new Exchange Fund paper will only be issued when there is net inflow of capital, i.e., net accretion to forex reserves. Two elements of the strategy are still under consideration, in consultation with scholars and experts. One is the optimal formula for determining the Base Rate at the Discount Window. The other is the gradual transition, over a period of time, of the convertibility rate from 7.75 to 7.8.

4. Since the intervention in the equity market and the implementation of the seven measures, the state of public confidence has improved considerably. The yield differential between 2-year Exchange Fund bills and US Treasury bills, a reliable and sensitive indicator of confidence in Hong Kong, had narrowed from 566.5 basis points on August 31 to 262.4 basis points on November 3, 1998. The partial recovery of asset prices is another indicator. These successes, however, do not warrant any complacency. Luckily for Hong Kong, certain extraneous events, such as the financial troubles of hedge funds, the Federal Reserve's two interest rate cuts, and the sudden weakening of the US dollar, have unwittingly contributed to the success of the HKMA's new strategy. Economic fundamentals in Hong Kong itself remains weak. The Government's task is how to stimulate economic recovery and growth without jeopardizing currency stability.

5. Because of the peg to the US dollar, Hong Kong cannot, independently of the US, pursue expansionary monetary policy and lower interest rates. Other policy options for stimulating

the economy include appropriately expansionary fiscal policy (cutting tax rates, refunding tax payments, increasing spending on infrastructure etc.), labour. policy (vocational training and re-training, increasing labour productivity etc.), incomes policy (tripartite social compact on wage-price restraint on the part of labour, management and government), housing policy (adjusting supply to stabilize property prices) etc.

6. On September 7, the Government unveiled a 30-point package designed to tighten regulations of the futures and stock markets, including criminalizing unreported short selling, and increasingly penalties for illegal short selling to a HK$100,000 find and two years' jail. Another part of the package concern more coordination between the exchanges and regulatory agencies, and more transparency of the exchanges. The August events have exposed many loopholes in the existing regulations, which were inadequate to deal with destabilizing speculation. The lack of cooperation between the exchanges and regulatory authorities, and their public squabbles were even more damaging to Hong Kong's financial stability and status as an international financial centre. The package is both justified and necessary to stop vicious speculators and manipulators who are out to destroy Hong Kong.

7. Predictably, this package has been attacked by speculators and their friends, as well as by vested interests, such as brokerage houses, for violating "free market principles". Such self-interested arguments cannot be taken seriously. Short-selling by itself is not illegal, provided stocks are borrowed in advance. Similarly, strict observance of the T + 2 rule is necessary to prevent irregularities, and to protect the interests of genuine investors. One admittedly controversial measure is that the Government will study whether to grant the Chief Executive of the SAR the power to give direction to the exchanges and clearing houses to ensure that the Government can react quickly whenever public interests are under threat. My personal opinion is that, if such power is granted to the Chief Executive, it would be widely interpreted at best as an over-reaction, and at worst, as an act of political interventionism. If emergency power is indeed needed to deal decisively with a grave crisis, it is sufficient to grant it to the Financial Secretary, not the Chief Executive.

8. One valid concern is whether recent measures might weaken Hong Kong's competitiveness as an international financial centre. A recent example is the plan of the Singapore International Monetary Exchange (Simex) to re-launch Hang Seng Index futures. This move is widely seen as Singapore's attempt to exploit Hong Kong's current difficulties. My personal view is that it is neither possible nor justifiable to ban competition from other centres. After all, Hong Kong itself has introduced trading in Taiwan stock index futures. The correct response is to increase our own competitiveness, not to retreat to protectionism. Another serious setback is that, according to a recent Bank of International Settlements survey, Hong Kong's world ranking as a forex trading has dropped from the fifth to the seventh, while that of derivatives trading has dropped from the eleventh to the sixteenth. The challenges from Singapore and other centres

should therefore be taken very seriously. I propose that the HKMA, the Securities and Futures Commission, various professional and trade bodies, and scholars and experts, should get together to form a special task force on how to strengthen Hong Kong's position and reputation as an international financial centre. At the same time, the AFC has also taught us that we should not lower the standards and quality of our prudential supervision in order to attract financial business. In other words, "competition by laxity" is a bad strategy in the long run.

9. It is not possible to compare Hong Kong's monetary and financial systems with those of other free market economies in a short statement. I wish to highlight only Hong Kong's unique features:

- Monetary base is now 3.6 times backed by foreign reserves, even if the former is enlarged to include all outstanding Exchange Fund bills and notes;

- Hong Kong always pursues a prudent fiscal policy, and still has a considerable accumulated fiscal reserve, even allowing for a large deficit in the current fiscal year;

- The Hong Kong Government has no external debt;

- The average capital adequacy ratio of the banking system is now about 17%, one of the highest in the world, and more than twice the 8% recommended by the Basle Committee;

- Despite the August intervention in the equity market (which was an emergency operation, not a regular practice), Hong Kong remains one of the most open, free, and transparent economies of the world.

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