Letterhead of THE HONG KONG FINANCIAL MARKETS ASSOCIATION
香港財資市場公會
(Incorporated with limited liability)

The seven new technical measures were introduced just before the emergence of financial problems of certain hedge funds. Banks tightened their credits to hedged funds which thus could not increase their exposure in various financial markets to challenge government intervention. These technical measures thus produced desirable result in stabilising market sentiment, however, the effectiveness of these measures have not been subject to the test of large scale fund flows. The main feature of the new measures is that pressure on interest rates during heavy cash outflows will be partially reduced at the expense of falling foreign currency reserve. Bear traders also need to engage more funds to push interest rates. If economy is deteriorating, capital outflow is accelerating and budget deficit is mounting, One can still attempt to test CBS and pressured asset prices.

Since October 1997, Management of regulatory bodies and the Exchanges have demonstrated improving coordination, the proposed 30 new measures are expected to make manipulation in financial markets more difficult. However, substantial increase in supervision inevitably imposes a negative impact on liquidity of interest rate, foreign exchange and stock markets. For example, interest rate instruments such as interbank money, forward and debt markets have experienced apparent fall in turnover. Fast dropping interest rate in past weeks also has reflected the seriousness of credit contraction policy of wholesale foreign banks as reducing borrowing interest by foreign banks in interbank market from deposit rich retail banks tells the fact that foreign banks have cut their lending to corporate Hong Kong.

Decrease in liquidity local financial markets in general has an adverse effect on profitability of financial institutions. Sinking demand for financial services in the region also pressures income, and thus there is a growing trend that multi-national commercial and investment banking institutions are cutting staff and scale of operation. Recently publicised survey in international foreign exchange turnover by Bank of International Settlements has already posed a warning signal, i.e the ranking Hong Kong drops to the seventh in 1998 from fifth of 1995.

As Hong Kong is the only international financial centre adopting a strict linked exchange rate system, it is very difficult to compare our system to the other two major offshore financial services centers - London and Singapore. In sum, Hong Kong is still one of the most liberal places in terms of monetary policies and financial systems and offering a relatively competitive cost of operation and business opportunity to international financial institutions.

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Comments on the mechanism for defending the Linked Exchange Rate System

In October 1997, Hong Kong Dollar market experienced tremendous volatility and there were different opinions on the relation of capital flows and interest rate movements.

Indeed, October 1997 was not the first external attempt on Hong Kong Dollar since "Emerging Markets" concept leads to large short term international capital flow into and out of relatively small economies. In February 1995 Hong Kong Dollar was under pressure amidst the Mexican Peso crisis, HKMA briefly withdrew liquidity from the banking system via the Net Clearing Account Balance arrangement practiced before the introduction of Real Time Gross System. Short term interest rate increased to about 11-14%, Hong Kong Dollar was strengthened very quickly as higher rates attracted buying interest from banks and citizens. Impact on the economy and asset prices had not been serious. This case demonstrated that chance of success for attempts on the Currency Board System (CBS) should be little if there is no deterioration in domestic economy.

In October 1997, HKMA's initial reaction was similar but Hong Kong's economy was showing signs of exhaustion and it was obvious that impact was much deeper this time, short term interest rate soared to 300% and high interest rate persisted and asset prices fell substantially, economic growth slipped and provided further excuses for later attempts. It is inevitable HKMA has to intervene and execute certain discretions as market conditions and economic fundamentals vary each time.

After October 1998 HKMA has introduced various measures to strengthen the CBS, however, as economic situation remained unstable in the region, cross border trading oriented funds pressured Hong Kong financial markets again and again in January, July and August this year. Bear traders applied certain basic implementations, they took advantage of adverse development in the region or other emerging markets and pushed up Hong Kong Dollar interest rate by borrowing via instruments such as money market and forward contracts and then short-selling Hong Kong Dollar in the spot currency market to HKMA's intervention rate of 7.75 00 and triggered a contraction of aggregate balance of banking liquidity. A negative aggregate balance meant that banks would not have enough liquidity to settle all transactions, interest rate would then soar to a level that HKMA could buy back United States Dollar and the aggregate balance returned to a positive figure. The extent of rate volatility depended on market sentiment, confidence among citizens, and HKMA's target level of buying US Dollar.

Such raids had imposed pressure on asset prices and stock and interest rate markets. As interest rate remained unstable, asset prices continued to drop. These factors indirectly led to contraction of lending appetite among some foreign banks which do not have Hong Kong Dollar deposit base. Credit crunch increased the difficulty for fund raising among corporations, cost of money also increased, resulting in further slowing down of the economy.