

**The Asian Financial
Crisis and
the Ordeal
of Hong Kong**

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Y. C. Jao



QUORUM BOOKS

Westport, Connecticut • London

Library of Congress Cataloging-in-Publication Data

Jao, Y. C.

The Asian financial crisis and the ordeal of Hong Kong / Y. C. Jao.

p. cm.

Includes bibliographical references and index.

ISBN 1-56720-447-3 (alk. paper)

1. Finance—China—Hong Kong. 2. Financial crises—Asia. I. Title.
HG187.H85 J348 2001

330.95125'06—dc21

00-045849

British Library Cataloguing in Publication Data is available.

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Library of Congress Catalog Card Number: 00-045849
ISBN: 1-56720-447-3

First published in 2001

Quorum Books, 88 Post Road West, Westport, CT 06881
An imprint of Greenwood Publishing Group, Inc.
www.quorumbooks.com

Printed in the United States of America



The paper used in this book complies with the Permanent Paper Standard issued by the National Information Standards Organization (Z39.48-1984).

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To My Wife Molan

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Preface

The Asian Financial Crisis (AFC), which broke out in full force on July 2, 1997, in Thailand and quickly spread to other countries in Southeast and East Asia, was one of the most traumatic and economically devastating events affecting most of Asia since the end of World War II. In the wake of collapsing currencies, banking institutions, and asset markets, many economies were crippled by negative growth and rising unemployment. At least during 1997–98, the hitherto much vaunted “Asian Miracle” gave way to a nightmare of disillusionment and despair.

As a major international financial and business center in the Asia-Pacific region, Hong Kong could not, of course, avoid being buffeted by the AFC. Although Hong Kong was the only economy with a fully convertible currency that had successfully beaten off massive attacks by speculators on its monetary and financial systems, it also paid a high price in the form of the worst recession in more than 40 years.

This book is a study of the turbulent period from the second quarter of 1997 to the first quarter of 2000. Its focus is on Hong Kong, but the analysis is conducted in the wider context of the AFC. Topics covered in this study include the outbreak, consequences, nature, and causes of the AFC; the impact of the AFC on Hong Kong’s monetary and financial systems and economy; and the role of China. Because Hong Kong’s currency peg held firm despite repeated speculative attacks, special emphasis is laid on the explanation of the working of the linked exchange rate regime, a variant of the Currency Board Arrangements (CBA). Two chapters are devoted to the explanations of two puzzles: why the AFC’s negative impact on the Hong Kong economy was so severe, and why Hong Kong appeared to be a laggard

in the Asian recovery of 1999. The book ends with a chapter on lessons and reflections.

An economic study of the trials and tribulations of Hong Kong, a major international financial and business center, with a population of almost 7 million—larger than that of many an independent state—does not need any justification. I would like, however, to ask the reader's indulgence for inserting a personal note here. On April 1, 1997, I succeeded Professor Charles Goodhart of the London School of Economics as a member of the Exchange Fund Advisory Committee (EFAC), a key statutory body that advises the Hong Kong government and the Hong Kong Monetary Authority (HKMA) on monetary and exchange rate policies. In the first three months of my membership, the EFAC was much preoccupied with the problems of possible exchange rate instability and capital outflow during the transition to Chinese sovereignty. It turned out that reunification with China took place remarkably smoothly without any disturbance on the monetary front, despite many dire conjectures and assertions. Ironically, the threat to Hong Kong did not come from the handover, but from a totally unexpected source: the AFC. During the next 18 months or so, Hong Kong had been constantly assaulted by hedge funds and other assorted speculators. As a member of the EFAC, I was closely involved in the decision-making process for the defense of Hong Kong's currency and financial systems, including some very controversial measures, such as the intervention in the capital market in August 1988, in order to thwart the speculators' "double market play."

Toward the end of 1998, it had become abundantly clear that the hedge funds and other speculators had suffered a crushing defeat. As one who has always taken a strong stand against currency speculators, I felt that I had done, *sine pecunia*, my share of community service. Meanwhile, my health had deteriorated significantly, and my doctor warned me that I must reduce my work load drastically. I had to accept his advice, and accordingly I resigned from the EFAC with effect from January 1, 1999.

Being bound by professional and ethical codes of behavior, I cannot disclose any official secret or other classified information. But I have the right, indeed the duty, to appraise and analyze government policies and measures that are already public knowledge, including the pros and cons of the linked exchange rate regime itself. The fact that I no longer hold any official position also means that I have complete freedom and independence—conditions most valued by a scholar—in studying the turbulent events of the past three years.

Professor Charles Goodhart, the creator of "Goodhart's Law," who also advised the Hong Kong government in October 1983 to return to the currency board arrangements, a move that saved Hong Kong from

financial collapse during the confidence crisis of 1982–84, and Mr. John Greenwood, the intellectual architect of the linked exchange rate regime, have both meticulously gone through an earlier draft of this book and have given me many penetrating comments and suggestions for improvement. I am most grateful to them for their advice and critique. Thanks are also due to Professor Paul de Grauwe, Professor Lawrence Lau, and Dr. David Li for helpful comments. Needless to say, I alone am responsible for the views expressed in this book and for any errors and omissions therein.

Y. C. Jao
School of Economics and Finance
The University of Hong Kong
August 15, 2000

I

The Asian Financial Crisis

The Outbreak and Consequences of the Asian Financial Crisis

SCOPE OF THE STUDY

This book is devoted to a study of Hong Kong's ordeal in the context of the Asian Financial Crisis (AFC). It will also analyze and explain the puzzling fact that while Hong Kong's currency and banking systems have survived the AFC intact, its real economy has suffered the worst recession in almost 50 years and has been recovering more slowly than those of others in the region. Although there is a burgeoning literature on the AFC, less attention has been paid to Hong Kong. Moreover, journalistic coverage of Hong Kong since the territory's reversion to China has been full of misunderstanding or misinformation. One additional purpose of this study is therefore to present an objective assessment of the Hong Kong situation without any ideological or political preconception.

Internationally, the AFC is the most serious regional financial crisis since the European monetary crisis of 1992–93 and the Mexican peso crisis of 1994–95. However, for the Asian region alone, the AFC is the most devastating economic and financial catastrophe since the Korean War of 1950–53.

To be more precise geographically, the countries or territories most affected by the AFC are located in the eastern part of Asia: Indonesia, Malaysia, Philippines, Singapore, Thailand, Vietnam, China, Hong Kong, Taiwan, South Korea, and last but not least, Japan. Other countries in East Asia, such as Cambodia, Laos, Mongolia, Myanmar, and North Korea, are either too isolated or too marginal to play any significant role in the crisis. Basic data about their economies are, in any case,

either unavailable or too sketchy, so that it would not serve any useful purpose to include them in this study.

GENESIS OF THE AFC

By general agreement, the AFC originated in Thailand. Although the AFC officially began on July 2, 1997, the day when the baht was allowed to float and depreciate, the country's troubles started much earlier.¹ In 1996, Thailand's economic growth slowed down significantly, after a decade of annual growth of about 8%. Worsening inflation and current account deficits led to persistent rumors about the impending devaluation of the baht, the Thai currency, despite massive inflow of capital. Moody's two successive downgradings of Thailand's sovereign debt (in September 1996 and April 1997) did not help matters.

Thailand's large capital account surplus until 1996 was not the boon that it appeared to be, for it disguised certain disturbing trends. In 1993 Thailand set up the Bangkok International Banking Facilities (BIBF), originally supposed to be a kind of offshore banking center, like those in Tokyo and New York, for conducting so-called "out-out" transactions. In the event, much of the capital inflow was channelled into "out-in" transactions, particularly to highly speculative asset markets. Initially, the massive inflow was attracted by Thailand's rapid economic growth, favorable interest differential, and the apparently stable de facto peg to the U.S. dollar. Beneath the surface, however, there was serious mismatch in both currency and maturity: essentially, Thailand borrowed short-term money denominated in U.S. dollars to finance longer-term domestic projects. Once the stability of the currency was called into question, the panic reaction by investors, especially foreign ones, could easily trigger a financial crisis. This was precisely what was happening in the summer of 1997.

In early 1997, falling property and stock prices gave rise to serious financial problems for both developers and financial institutions. Somprasong Land Development, a large real estate developer, defaulted on an interest payment of its US\$80 million Eurobonds in February. Then, in May, the baht came under heavy speculative pressure. On May 13, the Bank of Thailand (BOT), the central bank of the country, and three central banks of neighboring countries joined hands to support the baht. Two days later, the BOT created a two-tier baht market and prohibited foreigners from dealing in baht, pushing interest rates to over 1,000% in the offshore market. This measure temporarily inflicted heavy losses on the speculators. However, Thailand's financial fragility and other internal weaknesses doomed the over-valued baht. In June, the authorities were compelled to suspend 16 finance compa-

nies with liquidity problems. Meanwhile, the country's foreign reserves were dwindling quickly; the BOT was said to have spent US\$30 billion in just a few months. On July 2, Thailand announced the floating of the baht, which effectively depreciated by 19.5%. The Thai government also announced that it was seeking assistance from the International Monetary Fund (IMF). On August 20, a US\$20.1 billion emergency financing package was approved by IMF and a group of Asian countries (Japan, China, Hong Kong, and Singapore) for Thailand, on the basis of the country's pledge for a series of economic and financial reforms.

CONTAGION OF THE AFC

The contagion of the crisis from Thailand was remarkably swift. Within days of the floating of the baht, the Philippine peso, the Malaysian ringgit, and the Indonesian rupiah also came under heavy pressure. Initially, the authorities in these countries tried to widen the bands for exchange rate fluctuations, but this figleaf was soon abandoned in favor of straight floating. Singapore, which until the AFC generally followed a managed floating policy with a bias towards mild appreciation, also allowed its dollar to depreciate, with only token resistance.

In the autumn of 1997, the AFC spread northward to Taiwan, Hong Kong, South Korea, and Japan. Taiwan also adopted a managed floating system, but between 1989 and July 1997, it pursued a de facto peg of the New Taiwan Dollar to the U.S. dollar, with the exchange rate being held within a narrow range of NT\$26–27 to US\$1. After the AFC broke, Taiwan's central bank initially widened the band to about 28.7, with occasional interventions in the foreign exchange market to keep the rate steady. On October 17, however, the central bank suddenly left the market without intervention. By October 20, the U.S. dollar had broken through the NT\$30 barrier for the first time in ten years.²

Taiwan's depreciation exerted an immediate and devastating impact on the Hong Kong dollar. In July and August, there were some probing attacks on the Hong Kong dollar, but the Hong Kong Monetary Authority (HKMA) easily fended off such attacks without raising interest rates. The fall of the Taiwan dollar, however, gave tremendous encouragement to international speculators. They reasoned that if Taiwan, with its enormous foreign reserves (about US\$90 billion at the time), could not defend its de facto peg, neither could Hong Kong. In the week beginning October 20, hedge funds and other speculators mounted a massive onslaught on the Hong Kong dollar. The HKMA responded by selling U.S. dollars from its very strong reserves. Many foreign commercial and investment banks either financed the speculators or themselves climbed on the bandwagon. Under Hong Kong's Real Time Gross

Settlement (RTGS), installed at the end of 1996, all licensed banks must keep a credit balance on their clearing accounts, and no overdraft is allowed. On October 23, as settlement became due, many banks suddenly found themselves caught short of Hong Kong dollars and scrambled madly for cover. The HIBOR (Hong Kong Inter-Bank Offered Rate) was pushed to an unprecedented intra-day high of 280%. Although the Hong Kong dollar was saved, the Hang Seng Index of stock prices on that day fell sharply—by 1,211 points, or 10.4%. The day became known as “Black Thursday” to Hong Kong. A more detailed discussion of this affair will be made in Chapter 4.

Taiwan’s role in this débâcle has become a cause célèbre. According to Fred Bergsten, director of the Institute for International Economics, the Washington think tank, and a former U.S. Assistant Secretary of Treasury for International Affairs in the Carter Administration, Taiwan’s move was “calculated to bring pressure on Hong Kong, even force the Hong Kong dollar off its peg (to the U.S. dollar), thereby disrupting the smoothness of the transition and undermining the stability of the one country, two systems transition.” Even if Taiwan’s motivation was entirely economic, it was unjustified, in view of the island’s strong economic and financial position, he continued. “Its action was totally unnecessary and, in my view, violated every norm of international cooperative behavior.”³

In less explicit language, the Hong Kong government’s *Report on Financial Market Review*, published in April 1998, also attributed Hong Kong’s financial turmoil to Taiwan’s action: “On 20 October, the New Taiwan dollar depreciated by 5.8% as a result of the authorities’ announcement allowing the currency to float. This sparked off speculation on the resolve of Hong Kong authorities in maintaining the linked exchange rate with the US dollar.”⁴

Whatever Taiwan’s real intention might be, one fact is indisputable: Both Taiwan and Singapore have chosen the easy way out of the AFC by competitive devaluation, despite their very strong economic fundamentals and financial resources.

After Hong Kong’s “Black Thursday,” South Korea soon became the next target for speculators because the country had the same problems as those of Thailand and Indonesia. At that time, South Korea also operated a managed floating system known as “market average rate system” (MARS), under which the Bank of Korea would intervene actively if exchange rate fluctuations exceeded the permitted $\pm 2.25\%$ band. Several large conglomerates, or *chaebols*, such as Hanbo Steel, Sammi Steel, and the Kia Group, failed during January–July 1997, raising concerns about the viability of the banking system. From the third quarter of 1997 onward, the Korean currency, the won, came under increasingly heavy selling pressure, with the U.S. dollar exchange rate

rising from 870 in the first quarter to over 1,100 in the fourth quarter, while foreign reserves were depleting rapidly from US\$30 billion to less than US\$20 billion during the same period. Initially, the Korean government approached Japan for financial aid, but this request was turned down. In desperation, South Korea turned to the IMF for help. On December 4, an IMF-led support package of US\$57 billion was announced, and two days later, the won was allowed to float. Earlier, an IMF-led assistance program of US\$40 billion was approved for Indonesia, on November 5, 1997.

Japan was the last, but of course not the least, target of the contagion in 1997. On the surface, it may seem strange that the second largest economy of the world should have been affected adversely by a financial crisis originating in a small developing country. However, since at least 1991, Japan had had a simmering banking crisis after the bursting of its "bubble economy." Until the outbreak of the AFC, the Japanese authorities had managed to cover up the seriousness of the banking crisis by a series of government-sanctioned "takeovers" of smaller failed banks by larger banks under the so-called convoy system. These failed banks were mostly second-tier regional banks.

In November, however, the Hokkaido Takushoku Bank (popularly known as Takugin) collapsed. It revealed that its capital adequacy ratio (CAR) was less than zero, as against its reported figure of 9.34%. As one of Japan's 10 large nationwide city banks, Takugin's bankruptcy and deception marked a turning point in Japan's banking crisis.⁵ Many Japanese banks, especially the city banks, were heavily exposed to the countries affected by the AFC. In reaction, many of them also reduced their presence and abruptly cut back their loans to the region. In retrospect, it is clear that the superimposition of the prolonged Japanese banking crisis on an area already in distress is a key factor in making the AFC so horrifying in its duration and intensity.

As shown in Table 1.1, by the end of 1997, or nearly six months after the outbreak of the AFC, the currencies of the three most affected countries that required IMF aid had depreciated, each by more than 40%. The currencies of other countries had also depreciated by between 11% and 35%. Only the Chinese renminbi and the Hong Kong dollar held firm.

Hopes in early 1998 that there would be some amelioration of the AFC were soon dashed. Political instability and anti-Chinese ethnic disturbances in Indonesia had further shaken confidence. At one point, the Indonesian currency fell to RP17,000 to the dollar. Meanwhile, both the economic recession and the banking crisis in Japan went from bad to worse, following the failure of Yamaichi Securities in January. In June the yen-US\$ exchange rate sank to a low of 145, causing great pressure on the Chinese renminbi and the Hong Kong dollar. Only a joint inter-

TABLE 1.1
Exchange Rates of Major Asian Currencies versus the U.S. Dollar, 1997

<i>Currencies</i>	<i>July 1, 1997</i>	<i>December 31, 1997</i>	<i>Appreciation (+)/ Depreciation (-)</i>
Chinese renminbi	8.29	8.2791	*
Hong Kong dollar	7.7452	7.746	*
Indonesian rupiah	2,432.63	4,650.0	-47.6%
Japanese yen	114.96	129.95	-11.5%
Korean won	887.8	1,695.0	-47.6%
Malaysian ringgit	2.5247	3.8919	-35.2%
Philippine peso	26.36	39.975	-34.1%
Singapore dollar	1.4305	1.6755	-14.6%
New Taiwan dollar	27.8	32.638	-14.8%
Thai baht	24.7	47.247	-41.2%

* Changes less than 0.5%

Source: Underlying data from IMF, *International Financial Statistics*; Hong Kong Monetary Authority, *Monthly Statistical Bulletin*; ADB, *Key Indicators*; *The Economist*.

vention by the Japanese and U.S. monetary authorities checked the free fall in yen.

The economic situation in Hong Kong also deteriorated rapidly during 1998. In June it transpired that Hong Kong's Gross Domestic Product (GDP) registered a negative year-on-year growth rate of -2.8% in the first quarter, much worse than expected. The government had to rush through a number of emergency measures, including the temporary suspension of land auctions and a freeze of top officials' salaries, to stave off an impending crisis of confidence. China was also experiencing marked slowdown in GDP and exports, accompanied by deepening domestic deflation. Moreover, devastating floods in the summer caused further serious damage to the faltering economy.

Taking advantage of the menacing situations in Japan, Hong Kong, and China, hedge funds and other speculators deliberately spread rumors about the impending devaluation of the Chinese renminbi, and launched a vicious "double market play," that is, a simultaneous attack on the Hong Kong dollar and the equity market. By August 13, 1998, the Hang Seng Index of stock prices had fallen to 6,660, or some 60% off the peak reached on August 7, 1997. At that point, the Hong Kong authorities decided to intervene in the equity and futures market and launched a massive counterattack against the speculators by buying up about US\$15 billion worth of blue chip stocks, during the period August 14-30, 1998. This unprecedented action has become the second most controversial cause célèbre of the AFC, which will be treated in greater detail in Chapter 5.

Whatever the rights and wrongs of this intervention, the Hong Kong authorities had succeeded in their double objective of punishing the speculators and stabilizing the equity market. The weaker speculators could not hold out for long, and they were forced to liquidate their short positions, at the August or September settlements. The stronger ones attempted to “roll over” their short positions at heavy expense, but even they could not hold out beyond the October settlement. On November 6, the Hang Seng Index closed at 10,140, or up by 52.2% compared to the low of August 13. By that time, all was over for the speculators.

Other extraneous events also contributed to the Hong Kong authorities' victory. Many hedge funds lost heavily, not only because of Hong Kong's counterattack but also because of Russia's default on its external debt in August.⁶ In September, a large U.S. hedge fund, Long-term Capital Management (LTCM), nearly went bankrupt, and had to be bailed out by a consortium of banks hastily organized by the U.S. Federal Reserve (the Fed). Fearing a meltdown of the financial markets, the Fed also cut interest rates thrice, thus helping to stabilize financial markets not only in the United States but also in Asia. In Hong Kong itself, on September 5 the HKMA unveiled “seven technical measures” to strengthen the working of the Currency Board Arrangement (CBA) and to enhance public confidence in the Hong Kong dollar, which later events have proved to be highly successful. This will also be discussed more fully in Chapter 4.

As turbulence in Asian financial markets gradually subsided towards the end of 1998, incipient signs of a recovery from the AFC finally emerged in the first quarter of 1999. With the exception of Indonesia, all economies most affected by the AFC began to resume positive real growth in the year. Japan, Philippines, Singapore, South Korea, and Thailand led the way in the first quarter, followed by Hong Kong and Malaysia in the second quarter.

The most visible sign of incipient recovery is the stabilization of the major currencies. As shown in Table 1.2, with the exception of the Indonesian rupiah, all currencies that depreciated sharply in the latter half of 1997 had staged rallies of various degrees by the end of 1998 and by October 13, 1999. Table 1.3 shows the same currencies at the time of writing, compared to the eve of the AFC. Although most of them still showed depreciation, the extent of depreciation was much less than at the end of 1997, except for the Indonesian rupiah. Furthermore, though individual currencies might still slide occasionally, the kind of instant contagion that characterized the second half of 1997 was noticeably absent two years on. In the words of *The Economist*, “there could be few clearer signs that things are slowly returning to normal.”⁷ Note that Malaysia pegged its currency to the U.S. dollar in September 1998 at a

TABLE 1.2
Exchange Rates of Major Asian Currencies versus the U.S. Dollar,
1998–99

<i>Currencies</i>	<i>End-1998</i>	<i>% change on year ago</i>	<i>Oct. 13, 1999</i>	<i>% change on year ago</i>
Chinese renminbi	8.2787	*	8.28	*
Hong Kong dollar	7.746	*	7.77	*
Indonesian rupiah	8,025	-42%	8,125	+8.56%
Japanese yen	115.6	+12.4%	107	+11.21%
Korean won	1,204.0	+40.8%	1,205	+10.7%
Malaysian ringgit	3.8	+2.4%	3.8	*
Philippine peso	39.06	+2.3%	40.6	+11.86%
Singapore dollar	1.6605	+0.9%	1.68	-4.17%
New Taiwan dollar	32.22	+1.3%	31.7	+10.5%
Thai baht	36.691	+28.8%	39.6	-3.38%

* Change less than 0.5%

much depreciated level of 3.8 and coupled it with capital controls. This new peg has been holding since then. Note also that the Japanese yen had reversed its depreciation into appreciation.

CATEGORIES OF ECONOMIES AFFECTED

While the AFC has engulfed most of East Asia, different economies have been affected in different degrees. For ease of exposition, these economies are divided into four categories.

TABLE 1.3
Exchange Rates of Major Asian Currencies versus the U.S. Dollar,
End-1999

<i>Currencies</i>	<i>End-1999</i>	<i>% Change on July 1</i>
Chinese renminbi	8.2793	*
Hong Kong dollar	7.771	*
Indonesian rupiah	7,050.00	-65.4%
Japanese yen	102.05	+12.7%
Korean won	1,132.70	-21.6%
Malaysian ringgit	3.7995	-33.5%
Philippine peso	40.10	-34.3%
Singapore dollar	1.6660	-14.1%
New Taiwan dollar	31.35	-11.3%
Thai baht	37.35	-33.8%

* Changes less than 0.5%.

As shown in Table 1.4, Category A consists of three economies, Indonesia, South Korea, and Thailand, whose currencies virtually collapsed as the AFC unfolded; all three had to be bailed out by IMF and a group of other Asian countries. All three also experienced sharp GDP contraction in 1998.

Category B consists of four economies, Malaysia, Philippines, Singapore, and Taiwan, whose currencies depreciated by between 14% and 35%.

Except for Philippines, which received IMF aid before the AFC, the others did not need any external aid. Singapore even participated in IMF-led aid packages as a creditor nation. Real GDP growth of Singapore and Taiwan slowed down from 8% and 6.8% respectively in 1997 to 1.6% and 4.9% respectively in 1998, while that of Malaysia and Philippines plunged from 7.6% and 5.2% respectively to -7.4% and -0.5% respectively during the same period.

Category C consists of China and Hong Kong. Both did not devalue during 1997-99. Both participated in IMF-led aid packages for Indonesia and Thailand as creditors. China's real GDP growth slowed from 8.9% in 1997 to 7.8% in 1998, while Hong Kong's plummeted

TABLE 1.4
Economies Affected by AFC

<i>Categories</i>	<i>Effects of AFC</i>	<i>External Aid</i>
(A) Indonesia, South Korea and Thailand	Collapse of currencies, sharp contraction of economies.	All accepted IMF-led rescue packages.
(B) Malaysia, Philippines, Singapore, and Taiwan	Moderate to substantial depreciation. Relatively mild contraction or slowdown	Only Philippines accepted IMF aid prior to the AFC.
(C) China and Hong Kong	No depreciation. Slowdown for China, deep recession for Hong Kong. Both experienced deflationary trends.	No aid accepted. Both participated in IMF-led package as creditors, together with Japan and Singapore.
(D) Japan	Substantial volatility in yen/US\$ rate. Domestic banking crisis interacted with AFC. Serious recession.	No aid accepted. Served as creditor nation.

from 5.3% to -5.1% during the same period. Both experienced deflationary trends in 1998.

Category D consists of only one country, Japan, which is in a class by itself. The yen-US\$ rate showed great volatility during 1997-99. At one point it fell to a low of 145 in the summer of 1998, prompting an emergency joint intervention. But from September 1998 onward, the yen began an upward trend; and by October 18, 1999 the yen-US\$ rate reached 105. Japan's longstanding banking crisis interacted with the AFC and formed a vicious circle of banking retrenchment, credit crunch, and economic recession in the whole region. Japan's economy stagnated in the 1990s, despite a series of stimulative packages, and actually shrank by 2.9% in 1998. Japan did serve however as a major creditor in IMF-led aid packages.

NOTES

1. For a fuller account of Thailand's crisis, see Kobayashi (1999).
2. These data on Taiwan's exchange rates are taken from *Financial Statistics Monthly, Taiwan District*, Economic Research Department, the Central Bank of China.
3. See F. C. Bergsten, "The Asian Monetary Crisis: Proposed Remedies," statement before the Committee on Banking and Financial Services, U.S. House of Representatives, November 13, 1997; Charles Snyder, "Queries on Taipei's role in crisis," *Hong Kong Standard*, December 19, 1997.
4. See Financial Services Bureau (1998), p. 7.
5. For a fuller account of the Takugin affair, see Ostrom (1998).
6. See Reuters' report "Disgruntled investors bale out of global hedge funds," *South China Morning Post*, June 14, 1999. According to the report, the Quantum Fund run by George Soros and the Jaguar Fund run by Julian Robertson had seen their assets fall by a third.
7. See "Asian currencies: Knocking knees," *The Economist*, October 9, 1999.

The Nature and Causes of the Asian Financial Crisis

INTRODUCTION

The outbreak and consequences of the Asian Financial Crisis (AFC) are reviewed in the previous chapter. Much more important than the account of the course of the AFC, however, is a thorough understanding of the special nature and causes of the AFC, for both diagnostic and prognostic purposes. It is only on the basis of such an understanding that correct and effective reforms and policy measures can be adopted to prevent such a catastrophe from happening again.

THE NATURE OF THE AFC

Financial panics or crises are as old as capitalism itself and can be traced at least to the Dutch tulipmania of 1636–37, and the South Sea Bubble of 1719–20. This is not the place for a historical survey of financial crises.¹ It would be useful, however, to take the post–World War II period as our time frame, against which backdrop we can review various types of financial crisis, in order to deepen our understanding of the special characteristics of the AFC.

The first post-1945 global crisis was, of course, the breakdown of the Bretton Woods System (BWS) of fixed exchange rates, built up so painstakingly by the Allies on the eve of their victory over Nazi Germany and Imperial Japan. The architects of this system evidently hoped that it would lay a foundation for a new international financial order to replace the chaos and “beggar-thy-neighbor” policies of the interwar period. However, in the 1960s and 1970s, the intellectual tide was

turning against the fixed exchange rate regime. This new conventional wisdom was led by economists of the monetarist school, notably Milton Friedman and Harry Johnson. Friedman denigrated the fixed exchange rate regime and strongly argued that the flexible rate regime was more consistent with the functioning of a free market economy. He also asserted that uncertainties associated with floating exchange rates could be easily eliminated by using the forward market.² Harry Johnson took the argument further by proclaiming that:

The fundamental argument for flexible exchange rate is that they would allow countries autonomy with respect to their monetary, fiscal and other policy instruments. . . . The argument for flexible rates can be put more strongly still: Flexible exchange rates are essential to the preservation of the national autonomy and independence consistent with efficient organization and development of the world economy.³

With hindsight, the enthusiasm for the flexible exchange rate regime can now be seen to be rather simplistic and naive. One obvious drawback is that exchange rate volatility since 1973 has far exceeded even the most pessimistic expectations of the critics of the flexible rate regime. The monetarist assumption that real exchange rates will be relatively stable despite the volatility of nominal exchange rates has proved to be wide of the mark. Such volatility has brought about distress and disruption of the economic lives of nations, as the failure of Herstatt and countless other financial institutions has demonstrated. The argument of the advocates of flexible rates that exchange risk can be eliminated simply by the use of the forward market has also been widely discredited. But there are other flaws in the case for flexible rates. While stressing the gain in autonomy in monetary policy, advocates of the flexible rate regime ignore the fact that the regime also provides ample scope to the authorities for pursuing an irresponsible monetary policy, since the "external discipline" implied in the fixed rate regime is removed. Furthermore, even if the monetary authorities are reasonably prudent, they may not possess the necessary monetary control instruments, or the experience and expertise, to conduct any meaningful monetary policy. Equally important, the much vaunted "autonomy" may be illusory, as nations become more interdependent because of the increasing integration of the global economy. R. C. Bryant, in his exhaustive study of monetary policy from the global point of view, cogently sums up his critique of the conventional wisdom as follows:

When a nation's economy is financially open, monetary-policy actions in foreign nations affect financial and real-sector variables in the home economy whatever happens to the exchange rate. Monetary-policy actions

taken by the central bank of the home nation are not completely bottled up at home, regardless of the form and degree of exchange-rate variability. Similar conclusions apply to the international consequences of fiscal-policy actions and nonpolicy disturbances. . . . The conventional view of the insulating properties of exchange-rate variability is frequently associated with the idea that flexible exchange rates free nations' governments to forget about their balances of payments and to worry only about their domestic economies. Greater flexibility in exchange rates is also thought to cause a "dis-integration" of nations' economies. Those ideas, too, are misleading if not flatly wrong. The interdependencies among significantly open economies are much too pervasive to be neutralized by variability in exchange rates.⁴

Friedman and Johnson also implicitly theorized that once flexible rates were universally adopted, balance of payments and currency crises would become things of the past. Actually, nothing could be further from the truth. Since the breakdown of the Bretton Woods System in the early 1970s, the international financial landscape has continued to be dotted by recurrent crises of one kind or another. Until the inception of the AFC, the post-1973 crises can be classified, according to their natures and origins, into the following categories.

1. *Crises involving currencies of major industrial powers.* Essentially, these were crises involving the U.S. dollar, the pound sterling, and the Japanese yen, during different periods of time. Of these three, however, only the U.S. dollar plays the dominant role as an international trading and reserve currency.
2. *Crises of balance of payments.* These involved mainly oil-importing countries after the two oil shocks in the 1970s. Both developed and developing countries were affected. Only oil-producing or oil-exporting countries benefited financially during these crises.
3. *Third world debt crisis.* Following the default of Mexico in 1982, a large number of developing countries in Latin America, Asia, Africa, and Eastern Europe also declared their inability to repay their foreign debt. This crisis, though now overshadowed by the AFC, has still not been fully resolved.
4. *Equity market crashes.* The most spectacular mishap under this heading was, of course, the 1987 worldwide stock market crash led by Wall Street. Mercifully, the threatened global meltdown was short-lived, as the U.S. Federal Reserve immediately injected substantial liquidity into the financial system.
5. *Crises involving exchange rates in a regional currency bloc.* The principal example was the European Exchange Rate Mechanism (ERM) crisis of 1992–93, during which Britain and Italy were forced to withdraw from the bloc.

6. *Mixture of currency and debt crises.* Major examples were Mexico in 1994–95, Russia in August 1998, and Brazil in January 1999.

The AFC is different from all the listed crises in that, for three of the most affected economies, Indonesia, South Korea, and Thailand, it includes a mixture of currency, banking, and debt crises. All three economies were required to undertake financial sector restructuring, including closure of financial institutions, as a condition of IMF aid. There is also a mixture of currency and debt crises for Malaysia and Philippines, though to a much lesser extent. For Japan, there is a mixture of currency and banking crises. Moreover, nearly all the economies of East Asia have experienced equity market and property market crashes or at least severe corrections, with asset prices having fallen, at different points of time during 1997–98, by up to 70% from their peaks. Thus, one outstanding feature of the AFC is the mixture of currency, banking, and debt crises and asset markets crashes.

Another special feature of the AFC is that both its outbreak and its contagion were largely unanticipated. Indeed, before the AFC, there was widespread celebration of East Asia as a “growth pole” of the world, full of dynamism and vigor.⁵ True, a few discerning economists had warned that East Asia’s growth was attributable primarily to accumulation of factor inputs rather than total factor productivity (TFP),⁶ implying that technological progress was trivial or even nonexistent.⁶ However, none of these studies predicted any impending financial disaster. Some economists did warn of a Mexico-style currency crisis for individual countries, such as Philippines, Thailand, and South Korea, but even they did not foresee that financial difficulties in such countries would snowball quickly into a full-blown financial crisis engulfing the whole region.⁷ The IMF also detected signs of troubles in Thailand in 1996 and advised that country to take precautionary measures. But it was also caught by surprise by the virulence and scope of the AFC that began on July 2, 1997.

CAUSES OF THE AFC

Having dealt with the special nature of the AFC, it remains for us to examine the causes of this catastrophe. There is already a growing literature on this subject. Without being exhaustive, four approaches may be distinguished.

The first approach may be called the “self-fulfilling financial panic” theory, which takes its cue from traditional panics. The most well-known of such panics is the classic bank run, which may be touched off by anything, such as malicious rumors. In the case of the AFC, the blame

is put squarely on the abrupt reversal of capital flow by creditors and investors, which cascaded into a full-scale panic that resulted in an unnecessarily deep contraction. This view readily acknowledges that there were weaknesses in both macroeconomic management and financial sectors of several Asian countries, but it argues that they were not such as to explain the virulence and duration of the AFC. In effect, the approach asserts that the problem was one of liquidity, not solvency. The facts that the AFC was largely unanticipated and that the East Asian economies affected by the AFC had been highly successful for a generation are often cited as evidence in support of the approach. Typically, its advocates are also highly critical of the IMF's prescriptions for the most affected countries that requested financial assistance: harshly restrictive fiscal and monetary policies, closure of financial institutions, and the like. According to this approach, such measures have only served to aggravate the AFC by forcing the recipients into deep involuntary recessions.⁸

The second approach lays stress on the moral hazard that results from explicit or implicit government guarantee of public sector borrowings and other liabilities and other, darker sides of business behavior in Asia, such as connected lendings, lack of transparency and "arms-length" transactions, lax supervision, nepotism, or even corruption, in short, all those dubious practices conveniently summed up by the phrase "crony capitalism." Moral hazard and crony capitalism, by undermining prudence and vigilance, create the condition for financial bubbles, which are liable to burst at any moment once they reach a critical level. This in turn causes a chain reaction of speculations and panics that inevitably result in credit crunches and currency crises.⁹

The third approach, to which this writer subscribes, may be broadly labelled the "financial mismanagement and financial sector fragility" view. Financial mismanagement manifests itself in the behavior of both the private and the public sectors: "over-borrowing syndrome," mismatch of assets and liabilities in terms of both currencies and maturities, lax prudential supervision, lack of disclosure and transparency, asset bubbles, over-hasty financial liberalization, and so on. Financial sector weaknesses include weak capitalization of the banking system, over-reliance on bank credit, the rudimentary state of alternative sources of funds, especially the equity and bond markets, nonobservance of international standards of accounting and auditing, deficiencies in banking and bankruptcy laws, and so on. Financial mismanagement and financial sector fragility constitute the necessary conditions for a financial crisis. Any shock, whether internal or external and whether emanating from the real or financial sector of the economy, can touch off a full-blown crisis, of which Thailand, Indonesia, and South Korea are the most conspicuous examples. Moreover, this approach does not depend

on the state of economic fundamentals, so that even if such fundamentals were relatively sound (as most of East Asia was on the eve of the AFC), a financial catastrophe can still occur.¹⁰ Another way of putting this is that financial sector reforms and risk management practices, with a few notable exceptions, have failed to catch up with economic development in most of East Asia, so that rapid economic growth can mask only up to a point, but not indefinitely, financial sector deficiencies and maladjustments.

The fourth approach may be called the "eclectic view," which in turn has two versions. One version simply gives a list of all relevant factors, such as macroeconomic imbalances, financial sector weaknesses, short maturity of debt, poor supervision of banks, and accommodating global credit conditions, without distinguishing between principal and secondary causes. Another version adopts the impulse-propagation mechanisms traditionally associated with business cycle analysis. Impulses can come from macroeconomic or financial imbalances or from financial panic. Once the impulses are set in motion, the propagation mechanisms, which amplify and prolong the effects of the impulses, come into play. Such mechanisms are typically sudden shifts in expectations and confidence, high leverage, collapsing asset prices, credit crunch, competitive devaluations, and unhedged foreign liabilities.¹¹

How do we evaluate these four approaches? Concerning the first approach, while "self-fulfilling panic" may often be a common element in prolonged financial crises, the preoccupation with "herd behavior" begs the question of why such panics—bank runs, sudden reversal of capital inflow, and the like—occur in the first place. Normally, panics do not come out of thin air: They occur only after serious acts of imprudence or structural flaws have been exposed, like default of foreign debt, insolvency of financial institutions, or depletion of foreign reserves. If such mismanagement or structural weaknesses do not in fact exist, then rumors and suspicions can be easily dispelled, nipping in the bud any potential panic.¹² Moreover, the argument that the AFC is largely a question of liquidity rather than of insolvency grossly underestimates the seriousness of the problem. The facts that the AFC was unanticipated and that East Asia had enjoyed above average growth for a generation, do not in themselves lend any support to the approach. Even before the AFC, it was well known that small, seemingly imperceptible changes could suddenly, without any warning, degenerate into a major catastrophe. This basic insight of multiple equilibria has long been recognized and provided by catastrophe theory, and many applications of this theory to the study of bank runs and financial market turmoil had been made before the AFC.¹³ The full mathematics of the theory is beyond the scope of this book, but an intuitive application of this theory to a banking crisis can be illustrated

as follows. The same theory can, of course, be applied to a wider financial crisis.

Figure 2.1 represents what is known as a “cusp catastrophe,” which occurs in a system whose behavior depends on two control factors. The graph is a three-dimensional curved surface with a pleat. Every point on the surface represents an equilibrium state, but the points on the underside of the pleat are unstable, while those along the fold line are semistable points of inflection. For our purpose, the system’s behavior, the overall stability of the banking system, is measured on the vertical axis, while the two control factors, measured along two horizontal axes, are risk exposure (an indicator of banks’ prudence) and capital adequacy (an indicator of banks’ safety margin for absorbing losses and shocks). Starting with the point *a* on the upper surface, we note that it is a position of healthy stability, being characterized by low risk exposure and high capital adequacy. Then, owing to whatever reasons, there

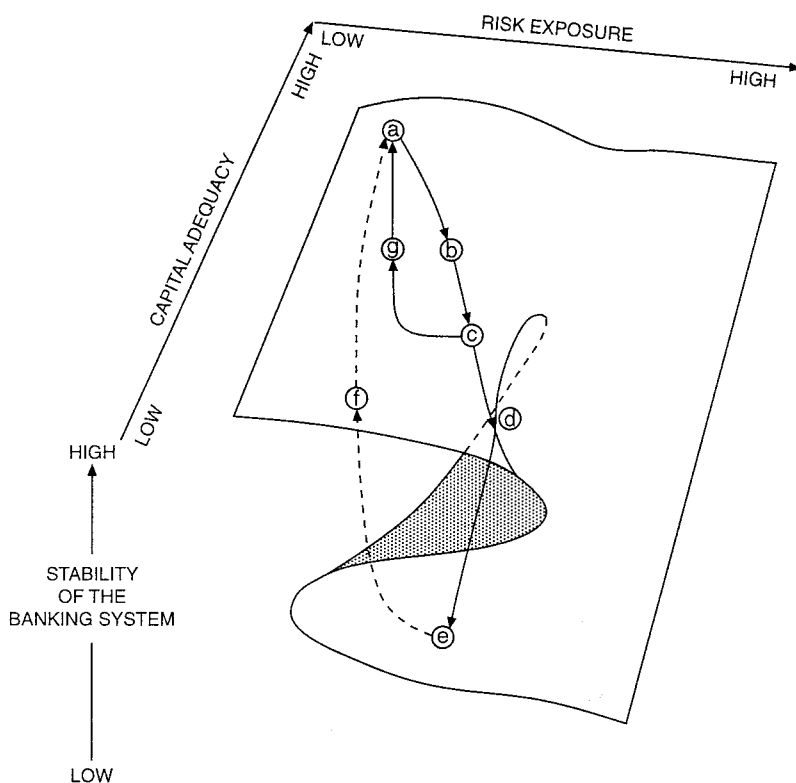


Figure 2.1 A Cusp Catastrophe Model of Banking Crisis

is a movement from point *a* to points *b*, *c*, and so on. The movement from *a* to *c* is a smooth change without giving rise to any serious disruption. However, by the time point *d* on the fold line is reached, there is likely to be a sudden drop from *d* to *e* on the lower surface, below the pleat. This is known technically as a *catastrophe*. Once *e* is reached, it would be well-nigh impossible to stage a recovery back to *a*. If the authorities act quickly to stop the rot before *d*, there is still hope that, eventually, a gradual return to point *a* via point *g* may be possible.

The second approach has the merit of being insightful on the role of moral hazard and crony capitalism, but it can also be faulted for treating these factors as the principal causes of the AFC. These problems have existed for a long time, even when East Asia was widely eulogized for its track record of dynamic growth. Ironically, just before the AFC, the conventional wisdom of "Asian values," so assiduously promoted by Asian politicians, held sway, and East Asia could seemingly do nothing wrong. Once the AFC broke, however, this old conventional wisdom was completely forgotten; it was quickly replaced by the new wisdom of moral hazard and "crony capitalism." The truth is that both "Asian values" and the combination of moral hazard and "crony capitalism" have coexisted since time immemorial, or at least since the intrusion of Western colonialism and capitalism. The two have tended, as it were, to offset each other. Put another way, moral hazard and crony capitalism can be regarded as the "flip side" of "Asian values," but they can hardly trigger a major catastrophe in the absence of other more fundamental causative factors. In our view, their role is essentially secondary, reinforcing or aggravating the catastrophe once it gets under way.

The third approach, the "financial mismanagement and financial sector fragility" view, is the most satisfying one in the sense that these factors constitute the necessary conditions for a major catastrophe such as the AFC. Moreover, to the extent that the triggering mechanisms are financial, as was the case with the three most affected countries, Thailand, Indonesia, and South Korea, financial mismanagement and financial sector fragility become both necessary and sufficient conditions for the AFC. This approach is also attractive for another reason: It can accommodate the positive elements of other approaches, such as self-fulfilling panic, moral hazard, crony capitalism, and the like, as secondary causes.

The fourth approach, the eclectic view, is flawed for merely giving a list of relevant factors, without specifying which are the primary ones. Moreover, many factors on the list are already mentioned by the third approach and can be incorporated into it quite easily. The "impulse-propagation" version, while insightful, is not wholly appropriate, for

the AFC is no ordinary cyclical movement, but a unique event of catastrophic proportions.

Having dealt with the main approaches to the causes and origins of the AFC, it remains for us to explain why the contagion has spread so quickly and so widely from the country of origin, Thailand. One obvious explanation is geographical proximity, close trade links and other economic ties, similar macroeconomic imbalances and financial fragility, and so on. This explanation would be most convincing if the crisis were confined to Southeast Asia.¹⁴ But the AFC was not confined to Southeast Asia: It engulfed the whole of East Asia and arguably affected faraway countries like Russia and Brazil. Hong Kong, for example, has much closer trade and investment links with Greater China, the United States, and Europe than with Southeast Asia. It did not share, moreover, the financial imprudence and fragility typical of the three most affected countries. Yet it did not escape the sharp impact of the AFC.

A much more potent force, in our view, is the growing trend toward globalization, integration, and liberalization of financial markets. Any shock emanating from any economy or area is likely to spread across national borders. No country, unless it is completely cut off from the rest of the world, can be immune from the effects of a major crisis. It is well known that asset markets (foreign exchange market, securities market, and property market) are much more sensitive than goods and services markets to external shocks. Interest rate and exchange rate effects tend to be magnified out of proportion, especially if there is a simultaneous shift in confidence and expectations. To be sure, the degree of contagion differs from one country to another. It is noticeable that economies whose financial sectors are less open and liberalized and where capital controls are still extensive, such as China and Taiwan, are much less affected than Hong Kong, which is unusually open and liberal in its financial sector.

Another major factor is competitive devaluation. This channel has two effects. One is that a country's devaluation will force its trade rivals to do the same, in order to maintain their competitiveness. Second, competitive devaluation will shift the attention of international speculators to those countries that have not yet devalued. Even if they do not intend to devalue, they may not have the resources or the resolve to fend off massive speculative attacks. As we shall see later in greater detail, competitive devaluation was a key factor of the heavy pressure on Hong Kong's linked exchange rate regime, and even though Hong Kong has succeeded in defeating the speculators, it has had to pay a heavy price.

Other often-cited reasons for the severity of contagion include unhedged foreign exposure and consequent scramble for cover; high financial leverage; sympathetic movements in asset markets, especially

the equity market; credit crunch due to collapsing values of collaterals, and stampede to the exits by foreign investors. Most of these, however, can be subsumed under “globalization and integration of financial markets” or “financial imprudence and financial sector imperfections.” As to the stampede to the exits by foreign investors, such “herd behavior” remains to be explained. One possibility, not yet mentioned before, is the “guilt by association” effect. Investors and creditors in the United States, Europe, and Japan tend to view “Asia” as a homogeneous group without discrimination. Thus, when the crisis first erupted, they automatically assumed that other economies, even sounder ones like Hong Kong and Singapore, were also implicated. Their precipitate panic was self-fulfilling in spreading and deepening the crisis.

Last but not least, Japan’s prolonged banking crisis and economic stagnation was another important reason for the quick contagion and severity of the AFC. As the second largest economy of the world and the largest economy of Asia, Japan could have played a stabilizing role by stopping, or at least softening, the contagion of the AFC. It is true that Japan had contributed to the IMF-led aid packages for Thailand and Indonesia, but the actual funds disbursed were trivial relative to both the scale of the crisis and Japan’s wealth. Moreover, the Japanese government’s tardiness in resolving the banking crisis and its folly of imposing a consumption tax that aborted an incipient recovery in 1997 aggravated Japan’s own difficulties. When the AFC spread to Japan, therefore, Japanese banks reacted by scaling down drastically their presence in and credits to the East Asia region. Statistics from Hong Kong, where the concentration of Japanese banks is the highest outside Japan, illustrates vividly Japan’s banking retrenchment. The total number of authorized institutions (licensed banks, restricted license banks, and deposit-taking companies) fell from 92 in 1996 to 65 in 1998, or by nearly 30%. Even more dramatic was the reduction in assets and loans and advances. Thus, total assets of Japanese banks booked in Hong Kong fell from HK\$3,516 billion to HK\$2,230 billion in 1998, or by 36.5%, while loans and advances fell from HK\$2,177 billion to HK\$1,254 billion, or by 42.4%, during the same period.¹⁵ Since Hong Kong is used as a regional center by Japanese banks, most of the assets and loans and advances represent their investments in and credits to other parts of East Asia. Furthermore, Japan’s slump and lack of openness meant that the largest economy of Asia could not serve as the export market for propelling East Asia’s recovery.

Japan’s disappointing impotence during the AFC contrasts sharply with the strong leadership role played by the United States during the Mexican crisis of 1994–95. In that episode, the United States, together with the IMF, extended massive financial assistance to Mexico. Having taken resolute steps to tackle the banking and savings and loan associ-

ations crises in the 1980s, the U.S. financial sector was in good shape at that time, paving the way for a sustained economic revival. The vast U.S. market was also made open through the North American Free Trade Agreement (NAFTA). Thus, Mexico rebounded quickly only six months after its peso crisis.

The attitude of the United States during the AFC is also in sharp contrast to its active and positive involvement during the Mexican episode. Apart from lecturing various Asian countries from time to time, the United States has done very little to help Asian countries in distress. U.S. authorities have also been reluctant to exercise tighter regulation of and surveillance over speculative hedge funds, despite strong pleas from Asian countries, especially Hong Kong. In short, the failure of the two largest economies of the world, which have substantial interests in the Asia-Pacific region, to cooperate and to ease the AFC is at least partially responsible for its unusual duration and severity.

A SCHEMA OF THE AFC

To sum up the preceding discussions of the various explanations of the AFC, the “financial mismanagement and financial sector fragility” view is the most convincing, in that it provides a clear focus on the conditions necessary for a full-blown financial crisis. To the extent that the immediate triggers are also financial in nature, such as default of foreign debt, runs on financial institutions, and speculation against the currency, financial imprudence and financial sector weaknesses also constitute both the necessary and sufficient conditions for a full-scale financial crisis. The speedy contagion and severity of the AFC can be explained not only by the geographical proximity of the originators of the crisis but also by competitive devaluation, globalization and integration of financial markets, and the superimposition of Japan’s prolonged banking crisis and economic slump. This is illustrated by Figure 2.2, a schema of the AFC.

To be sure, the schema is only a snapshot of the complex reality, but it does provide a conceptual framework for understanding the key causative factors of the crisis and its contagion. Seemingly confusing institutional and factual details may then fall into place, and be seen in their proper perspective. Thus, in Figure 2.2, the causation runs from financial imprudence and financial sector fragility to exchange rate instability and interest rate volatility, then to asset markets collapse and economic downturn and contagion, aggravated by Japan’s prolonged banking crisis and economic slump.

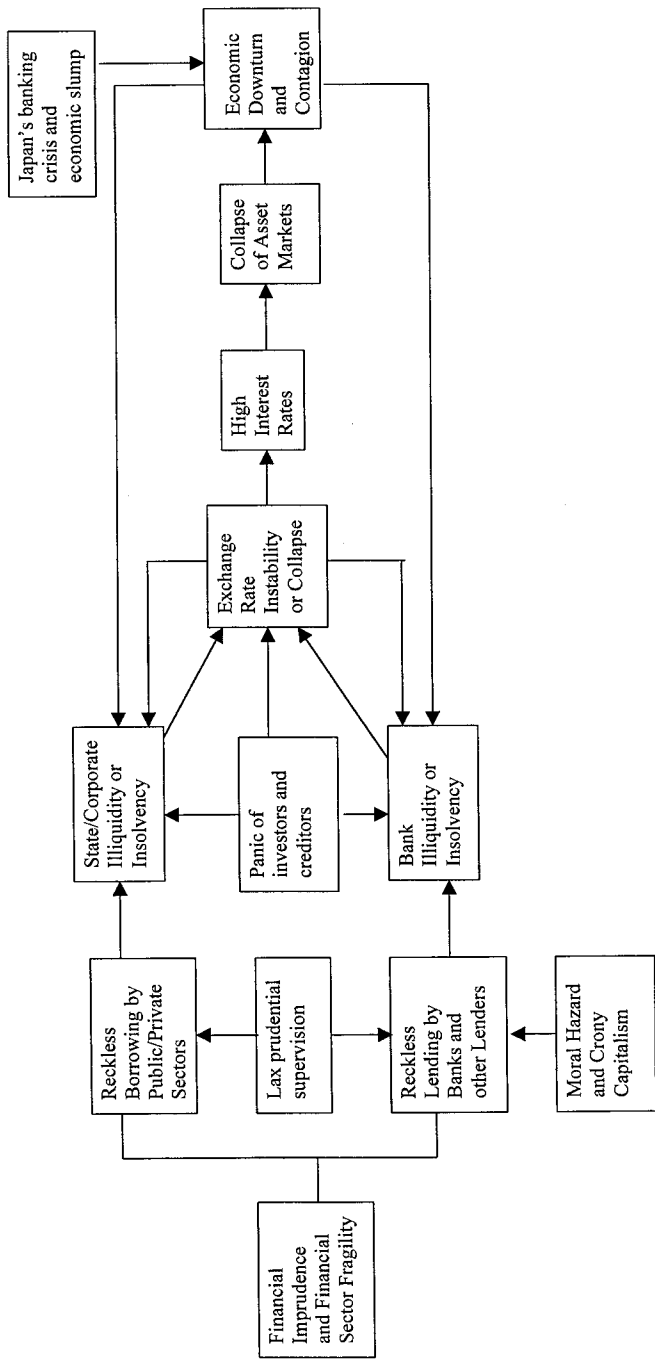


Figure 2.2 A Schema of AFC

NOTES

1. Readers who are interested in pre-1945 financial crises can refer to Kindleberger (1978), Kindleberger and Laffargue (1982), Capie and Wood (1986), and Goodhart and Delargy (1998) for details.

2. See Friedman (1953).

3. See Johnson (1972).

4. See Bryant (1981). For a recent critique of the monetarist approach, see Flood and Rose (1999).

5. A typical example of such celebration is World Bank (1993).

6. See Kim and Lau (1994), Krugman (1994), and Young (1995).

7. See Lau and Park (1996) and Park (1996).

8. The most prominent advocates of this view are Radelet and Sachs (1998a and 1998b). Other earlier or current models of self-fulfilling panics are Diamond and Dybvig (1983), Krugman (1979), Obstfeld (1986, 1996), and Flood and Marion (1998).

9. The most influential economist espousing this view is Krugman (1998). For a journalistic account of "crony capitalism" and denial of "Asian values," see Backman (1999). For a more balanced view, see Sheridan (1999).

10. See, inter alia, Goldstein (1998), McKinnon and Pill (1998), Chan-Lau and Chen (1998), Kasa (1998), Moreno, Pasadilla, and Remolona (1998), Miller (1998), and Jao (1999), for different shades of this broad approach.

11. The first version of this approach is represented by Eichengreen (1999), while the second version is illustrated by Glick (1998).

12. In November 1997, a run occurred on the International Bank of Asia, a medium-sized local bank in Hong Kong, as a result of baseless rumors. Since the bank was in fact sound, a strong statement of support from the Hong Kong Monetary Authority soon stopped the run.

13. For applications of the catastrophe theory to the banking crisis in nineteenth-century Britain and to that in Hong Kong in the 1980s, respectively, see Batchelor (1986) and Jao (1988). For a good bibliography on catastrophe theory, see also Batchelor (1986).

14. See Glick and Rose (1998).

15. See *Hong Kong Monetary Authority Annual Report for 1998* for the relevant data.

II

The Impact on Hong Kong

Hong Kong on the Eve of the Asian Financial Crisis

INTRODUCTION

The focus of this book is Hong Kong's ordeal during the AFC. To understand this ordeal fully, it is necessary to describe Hong Kong's economic and financial conditions on the eve of the AFC. Specifically, it is not often realized that, prior to the AFC, Hong Kong had undergone another ordeal, from 1982 to 1997: the uncertainties, anguish, and crises associated with the territory's transition from a British Crown Colony to a Special Administrative Region (SAR) of the People's Republic of China.

For Hong Kong, the month of July 1997 was a month of double historic significance. On July 1, Hong Kong was formally reunited with China, after 156 years of British rule. Barely one day later, the AFC erupted in full force. Although the two events were unrelated, they nevertheless must be treated together for any meaningful analysis of Hong Kong's contemporary economic and financial scenes.

Since the AFC is a mixture of currency, banking, and debt crises, we will begin with a survey of Hong Kong's monetary system and exchange rate regime, followed by separate discussions of banking and financial sectors and macroeconomic performance, from the early 1980s up to the end of June 1997. Owing to space constraint, this retrospect will be made in broad outline, so that more detailed discussions can be reserved for the ordeal of the AFC itself.

MONETARY SYSTEM AND EXCHANGE RATE REGIME

In the years prior to the AFC, one major preoccupation was whether the linked exchange rate system, hastily installed in October 1983, could

withstand a massive outflow of capital as the epochal date of July 1, 1997, drew near. This had nothing to do with any clairvoyance of the impending AFC, but rather with the certainty of the agreed transfer of sovereignty between Britain and China. To understand this anxiety, one must briefly refer to the currency crisis of 1982–83 that shook Hong Kong to its very foundation.

In September 1982, following former Prime Minister Margaret Thatcher's visit to Beijing, China and Britain jointly announced that they would begin diplomatic negotiations concerning Hong Kong's constitutional future after the expiry of the lease of New Territories on June 30, 1997.¹ This immediately triggered a pervasive confidence crisis, which in the monetary sphere manifested itself in a massive portfolio shift from local to foreign currency deposits, capital outflow, continuous depreciation of the Hong Kong dollar (which was under a floating rate regime between November 1974 and October 1983), a sharp fall in asset markets, and brain drain. The political shock was, however, preceded by a period of rising inflation, when both money and credit went out of control under the floating exchange rate regime.²

This crisis reached its climax in September 1983, when the Sino-British negotiations bogged down in a stalemate. On "Black Saturday," September 24, 1983, panic selling of the Hong Kong dollar drove the exchange rate to an all-time low of US\$1 = HK\$9.6. At that point, shops began to quote prices in U.S. dollars and refused to accept Hong Kong legal tender notes, and panic buying of staples and imported items also broke out. Equally ominously, rumors spread quickly about the solvency of banks and finance companies. Moreover, owing to the collapse of the property and equity markets (prices having dropped by up to two-thirds between 1981 and 1984), Hong Kong experienced two consecutive years of fiscal deficit, hitherto unknown in the territory's history. Hong Kong on "Black Saturday" was therefore in the depths of three crises: a currency crisis, a banking crisis, and a fiscal crisis.

Faced with the imminent breakdown of the financial system, the Hong Kong government announced the next day that it was considering a currency stabilization plan based on full convertibility. On October 15, 1983, the government unveiled a two-point program. The first measure, of overriding importance, was the reimposition of the foreign exchange constraint by requiring note-issuing banks to pay U.S. dollars to the Exchange Fund to obtain the Certificates of Indebtedness (CIs) as cover for banknotes issued, at a fixed rate of US\$1 = HK\$7.8. The other measure was the abolition of the 10% withholding tax on interest income from Hong Kong dollar-denominated deposits with financial institutions, thereby removing the tax advantage from holding foreign currency-denominated deposits.

This new monetary regime has been called by the government the “linked exchange rate” (LER) system. In my own writings, I have preferred the term Dollar Exchange Standard (DES), which in my view more correctly describes the essence of the monetary system. First, being analogous to the previous Sterling Exchange Standard (SES) during 1935–72, the DES immediately conveys the fundamental notion that it is a variant of the currency board. Second, LER seems to suggest that it is just another form of the conventional fixed or pegged rate and has proved to be a source of unnecessary misunderstanding and confusion. However, since LER is already entrenched in popular usage, in this book the terms LER and DES will be used interchangeably.

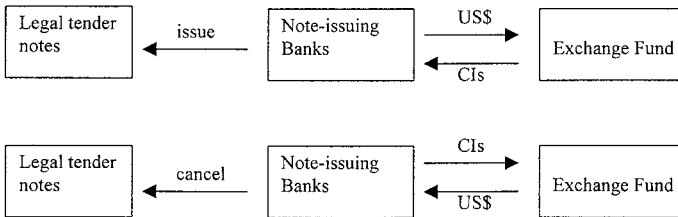
The DES, installed in the nick of time, has been widely recognized as a readoption of the currency board.³ While this view is broadly correct, there are certain technical differences distinguishing the DES from the SES, quite apart from the obvious fact that the U.S. dollar replaces sterling as the anchor currency.

Before the collapse of the Bretton Woods system in 1973, most countries were under the fixed exchange rate regime, whereby the monetary authorities, including that of Hong Kong, were obligated to intervene on the foreign exchange market to keep fluctuations within a band of 2.25% (later reduced to 1%) of the par value. The DES was, at that time, somewhat unique in a world of general floating or, at least, “managed floating.” Moreover, the Exchange Fund under DES does not charge a spread between the buying and selling rates for the U.S. dollar, whereas under SES a spread, varying from time to time, was imposed, causing considerable resentment to the note-issuing banks. Certificates of Indebtedness (CIs) were not issued and redeemed at the same sterling rate until 1969. Why is the DES usually referred to as a variant of the currency board? First, the legal tender currency is issued not by a formal currency board, but by three commercial banks.⁴ Second, there was no statutory provision for a 100% foreign exchange cover for the currency or for a fixed exchange rate, either under the SES or under the DES. The Exchange Fund Ordinance, last amended in 1995, merely stipulates that the Financial Secretary is authorized to issue a CI to a note-issuing bank as cover for banknotes lawfully issued (Sec. 4.1). Third, whereas a typical currency board is not supposed to perform any banking function, whether central or commercial, certain institutional developments in recent years have tended to enhance the central-banking powers of the Hong Kong Monetary Authority (HKMA), which manages the Exchange Fund.

Nevertheless, the DES retains the fundamental characteristics of the currency board, namely, the 100% foreign exchange cover and the mutual unlimited convertibility between the domestic currency and the chosen anchor currency (U.S. dollar) at a fixed exchange rate. As coroll-

laries, two adjustment mechanisms are also inherent in the system. One is the classic automatic specific flow mechanism, also known as the Cantillon-Hume mechanism.⁵ To be sure, at the time when the price-specie-flow mechanism was formulated, currency was virtually coterminous with money stock. With the tremendous growth in deposit banking, currency now only accounts for a small proportion of money stock, however defined. But as long as this proportion remains more or less stable over a finite period, the classic mechanism still works, albeit indirectly, as the U.S. dollar replaces gold. The other mechanism, known as “arbitrage and competition,” was previously unavailable under the SES because of the spread on the sterling rate. However, under the DES, as CIs are issued and redeemed at the same rate of US\$1 = HK\$7.8, the mechanism becomes feasible, as shown in Figure 3.1.

It works in a way not unlike that of the “gold points” under the classic gold standard. “Arbitrage” means that, if the market rate rises over 7.8 by more than the transaction costs, banks will have an incentive to buy U.S. dollars with Hong Kong banknotes from the Exchange Fund at the fixed rate of 7.8, for resale in the open market; conversely, if the market rate falls under 7.8 by more than the transaction costs, banks will have an incentive to buy U.S. dollars in the open market for resale to the Exchange Fund at the fixed rate of 7.8. Such arbitrage puts pressure on the market rate to move toward the official rate. “Competition” means that a financial institution cannot quote any U.S. dollar rate that deviates too much from the official rate without losing business to its competitors. Thus, “arbitrage” in tandem with “competition” generates market forces that make for convergence toward the official rate. It is sometimes queried whether cash arbitrage does in fact occur, because of the inconvenience of moving large quantities of banknotes. This misses the point that physical arbitrage is not necessary. Provided that the majority of market participants perceive or believe that arbitrage will work, the market rate will in fact converge toward the official rate.



CIs = Certificates of Indebtedness, the legal backing for banknotes

Legal tender bank-notes are both issued and redeemed at US\$1 = HK\$7.8

Figure 3.1 Linked Exchange Rate, or Dollar Exchange Standard, since October 15, 1983

TABLE 3.1
New Trade-Weighted Effective Exchange Rate Index (Nov. 1983 = 100, period average)

Month/Year	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Jan.	126.9	123.4	115.3	101.7	115.6	111.6	108.6	100.7	100.3	108.4	108.1	109.2	113.5	129.6	123.3	123.5	126.0
Feb.	127.3	124.0	115.2	101.5	117.3	109.8	107.7	101.2	100.4	108.2	107.4	110.0	113.7	128.4	123.0	123.5	127.6
Mar.	128.1	126.3	115.4	100.2	117.7	108.8	106.9	100.4	101.1	109.6	109.5	111.3	113.1	127.8	120.8	123.7	128.0
Apr.	128.3	127.9	113.2	100.7	115.7	108.6	105.2	99.6	101.5	110.1	110.8	111.7	111.7	127.4	118.7	123.9	128.6
May	129.2	127.7	110.0	102.9	116.2	107.3	104.3	99.6	102.7	109.5	111.5	110.9	111.4	127.0	118.6	123.9	127.7
June	129.5	128.8	106.7	103.7	115.9	107.3	104.9	100.5	103.8	109.7	113.3	109.9	111.6	126.5	118.4	124.3	127.1
July	127.2	129.4	108.6	105.8	114.5	109.7	105.7	101.9	102.7	108.7	112.9	108.7	112.2	125.1	118.9	124.3	128.2
Aug.	123.5	127.0	105.6	106.8	113.5	109.4	105.3	102.2	102.8	107.6	112.2	108.4	111.9	124.9	120.9	123.8	129.8
Sep.	119.8	126.7	98.0	109.7	114.3	109.3	104.3	102.3	103.3	106.6	111.4	108.7	111.8	124.0	122.5	124.3	130.3
Oct.	118.8	118.8	95.2	111.8	112.5	109.5	104.1	101.1	102.5	104.9	111.1	109.8	112.2	123.4	122.6	124.8	131.0
Nov.	124.2	117.3	100.0	111.0	112.6	110.5	102.2	99.3	102.5	105.6	110.2	111.8	113.0	123.4	122.3	124.5	132.6
Dec.	125.1	116.6	100.4	113.8	112.2	110.1	100.9	99.3	104.8	107.9	109.2	113.0	113.4	124.0	122.5	125.0	136.4

Source: Hong Kong Monthly Digest of Statistics

One complication was that, at the time the link was announced, the note-issuing banks, not wishing to bear the possible exchange risk alone, insisted that they dealt in banknotes with other, nonissuing banks, only on the same basis as they themselves dealt with the Exchange Fund, that is, to receive or pay out Hong Kong dollar banknotes only against U.S. dollars at the fixed rate of 7.8. This was known as the pass-on arrangement.⁶ When the U.S. dollar was above par, there was no problem. But when the U.S. dollar was below par, as it has been since 1991, those non-issuers that had net receipts of cash found themselves exposed to exchange risk, as the excess notes that they returned to the issuers were credited to their accounts in U.S. dollar value at the rate of 7.8, not in Hong Kong dollar value. During 1991–93, the non-issuers therefore resorted to the practice of imposing handling charges on those customers who paid in large sums of notes, a move that unsurprisingly caused much resentment. Eventually, the HKMA and the Hong Kong Association of Banks (HKAB) reached agreement in early 1994 to end the pass-on. Non-issuers that returned their surplus notes to the issuers would be credited in Hong Kong dollar value, thus eliminating any exchange risk. But like the nonbank public, the non-issuers could no longer have any access to U.S. dollars at the fixed rate of 7.8 and, by the same token, could no longer participate in the arbitrage process.

The primary objective of the new monetary regime was the stabilization of the exchange rate. Given the extreme openness of the Hong Kong economy and the state of currency panic ruling at that time, this objective obviously made sense.⁷ On this criterion the DES can be judged, without any exaggeration, an unqualified success. With respect to the link with the U.S. dollar, apart from the first week, when the market rate slowly drifted downward from 8.2 toward 7.8, and the weekend of July 6, 1984, when speculative selling of the Hong Kong dollar pushed up the rate to 8.05, the fluctuations of the market rate have been held within 1% either way of the parity of 7.8 since October 24, 1983, despite such external shocks as the worldwide stock market crash of 1987, the Tiananmen tragedy of 1989, the European currency turmoils of 1992–93, the Mexican peso crisis of 1995, the death of Deng Xiaoping in February 1997, and the Asian currency crisis in the summer of 1997.

With respect to a more broadly based indicator, Table 3.1 presents a new trade-weighted index published by the Hong Kong government in 1995 (Nov. 1983 = 100).⁸ The index has been compiled in such a way that any number above 100 signifies an appreciation, while any number below 100 signifies a depreciation, of the Hong Kong dollar collectively against 17 other currencies of the territory's trading partners. As may be easily seen, apart from the periods September–October 1983 and April–May 1988, the index had always stayed above 100. The range of fluctuations from January 1981 to June 1997 was between 95.2 and 128.6.

Space does not permit the reproduction of the full series, but it can be established from the same source that before the establishment of the DES, the index fell relentlessly from its peak of 170.2 in March 1977 to 84.3 on "Black Saturday," September 24, 1983, a total depreciation of 51%.

With the Hong Kong dollar stabilized, the panic that gripped Hong Kong during 1982–83 gradually subsided. The authorities gained valuable breathing space to tackle, and finally to overcome, the concurrent banking crisis during the critical period 1983–86. Then, with the whole financial sector returning to normalcy, the real economy also recovered quickly, so that by fiscal year 1984–85 the norm of regular fiscal surplus had also been regained. As Hong Kong had been hit simultaneously by a currency crisis, a banking crisis, and a fiscal crisis in 1982–84, the consequences would have been unimaginable had the dollar exchange standard not been established in the nick of time. Thus it is not an exaggeration to say that the DES saved Hong Kong from financial ruin and economic collapse.

Despite the success of the new exchange rate regime in maintaining currency stability, there was still doubt whether it could survive the transfer of sovereignty on July 1, 1997. Moreover, despite the explicit assurances in the Joint Declaration and the Basic Law concerning the monetary independence of Hong Kong, there was still endless speculation about China's intention toward the Hong Kong dollar and the territory's foreign exchange reserves after reunification. China itself was aware of such uncertainties and became sufficiently worried that it took the important step of explicitly clarifying these issues.

On September 1, 1996, Chen Yuan, then Deputy Governor of the People's Bank of China, the central bank of China, enunciated seven principles governing monetary relations between China and Hong Kong after July 1, 1997, at a Bank of England seminar held in London.⁹ These principles are so important that they are worth reproducing here for the public record.

First, the currencies and monetary systems of mainland China and Hong Kong will be mutually independent of each other. To quote Mr. Chen,

The Hong Kong dollar and the renminbi will circulate as legal tender in Hong Kong and mainland respectively. The Hong Kong dollar will be treated as a foreign currency in the mainland. Likewise, the renminbi will be treated as a foreign currency in Hong Kong. . . . The two monetary systems are of equal importance to China in its reform and liberalization. One does not precede or be subsidiary to the other. They will operate in a mutually independent manner.

Second, the two monetary authorities in China and Hong Kong, the People's Bank of China (PBC) and the Hong Kong Monetary Authority (HKMA), will be mutually independent but will cooperate closely with each other. The PBC will not set up any office in Hong Kong.

Third, financial institutions of China and Hong Kong setting up branches or offices in each other's territory will be regulated by the host authorities and treated respectively as foreign entities.

Fourth, the PBC will support currency stability in Hong Kong. Pursuant to its goal, the PBC and HKMA have signed a repurchase agreement in respect of U.S. Treasury obligations. But Chen declared that "under no circumstances will China draw on or resort to Hong Kong's Exchange Fund or other assets in any way and for any reason." Fifth, financial transactions between China and Hong Kong will be conducted in accordance with the rules and practices of international financial activities.

Six, mainland financial institutions in Hong Kong must abide by the laws of Hong Kong and will be supervised by the HKMA.

Seven, Shanghai and Hong Kong will have complementary and mutually reinforcing relationships as financial centers.

These principles can be consolidated into one guiding principle, namely, "one country, two currencies," which is the counterpart to the political principle of "one country, two systems." It totally rejects the notion that the Hong Kong dollar might be merged with the renminbi.

Chen's "Seven Principles" could not have come at a more appropriate time. They serve to strengthen the Joint Declaration and the Basic Law by clarifying certain "gray areas" hitherto undefined in both documents. They have also enhanced immeasurably confidence in the Hong Kong dollar during the transition to and beyond China's resumption of sovereignty.

During the two years prior to the handover, a stream of Chinese government officials and scholars came to see me and sought my view of the monetary situation. I told them that if the Joint Declaration, the Basic Law, and Chen's "Seven Principles" were fully respected and observed, if the DES continued to be maintained, then there would not be any currency crisis, as marked by capital outflow and the collapse of the currency peg. My views were summarized in a paper presented to a seminar organized by the Hong Kong and Macau Office of the Bank of China on February 17, 1997. In my book on Hong Kong as an international financial center, published in May 1997, I made the same points.¹⁰ I also pointed out the phenomenon of "currency substitution," or portfolio shift from local currency deposits to foreign currency deposits, had greatly eased after 1990, as shown in Table 3.2.

As may be seen from the table, foreign currency deposits had increased rapidly since 1980 without interruption. But their relative pro-

TABLE 3.2
Foreign Currency Deposits and Their Share of Total Deposits

<i>End of</i>	<i>Foreign Currency Deposits (HK\$m.)</i>	<i>% of Total Deposits</i>
1980	16,745	13.00
1981	27,656	16.90
1982	92,025	39.54
1983	127,236	44.17
1984	141,655	39.91
1985	194,318	45.11
1986	277,283	50.36
1987	372,915	53.00
1988	455,088	53.82
1989	556,805	55.27
1990	711,156	57.76
1991	770,401	56.05
1992	819,052	54.49
1993	867,734	50.28
1994	929,369	47.77
1995	1,054,612	47.37
1996	1,058,180	43.05
1997 (June)	1,097,756	41.20

Source: HKMA *Monthly Statistical Bulletin* and *Hong Kong Monthly Digest of Statistics*.
Note: Foreign currency deposits are adjusted to exclude “swap deposits” using official published figures since 1984. For 1980–83, they are adjusted using my own estimates in Y. C. Jao, *Currency Substitution: A Case Study of Hong Kong*. Research Paper, School of Economics, University of Hong Kong, 1992.

portion of total deposits has shown a more varied pattern. It started in 1980 with a modest 13%, then made a “quantum jump” to 39.54% in 1982, the year when the confidence crisis over 1997 started. It continued its upward trend until 1990, when it reached a high of 57.76%. After that, it showed a downward trend; by the end of June 1997, on the eve of the handover, it had dropped to 41.2%.

The preceding account is only my personal view. There were, of course, many other views on Hong Kong’s monetary system in the postcolonial era. We need not be detained by sensationalist and lurid predictions of doom for Hong Kong that abounded in Western mass media during 1995–97. We will confine ourselves here to the views of respected scholars on the monetary situation.

One view was highlighted by remarks attributed to Milton Friedman, a Nobel Laureate and an influential pioneer of modern Monetarism. In an interview with the *Far Eastern Economic Review* in early 1995, he asserted that China would not allow the Hong Kong dollar to circulate

after July 1, 1997, and would abolish it within two years after the handover. He also alleged that "China covets the US\$43 billions reserves accumulated by the Hong Kong Monetary Authority."¹¹

Another view, represented by Obstfeld and Rogoff, was highly skeptical of the ability of the DES to survive the handover. In a wide-ranging critique of the fixed exchange rates, they had this to say about the LER:

One prominent target for attack by currency markets is the link between the Hong Kong and U.S. dollars. . . . After China takes over in 1997, it will also assume ultimate ownership of Hong Kong's foreign currency reserves. Despite its promise not to tamper with Hong Kong's economy, China would not likely want to see the dowry squandered in battling speculators. Thus, even Hong Kong's currency ultimately could fall. Markets are aware of this possibility, and the country [sic] has already experienced speculative capital outflows on occasions, most recently in January 1995 after the start of the Mexican crisis.¹²

Clearly, these two views are very different from mine. We will wait until Chapters 4 and 10 to see which view is more accurate as judged by actual facts, not conjectures.

BANKING AND FINANCIAL SECTOR DEVELOPMENTS

Prior to 1970, Hong Kong's banking structure was monolithic in the sense that no specialist banks or near-banks other than the traditional commercial banks (called licensed banks) were in existence. In 1970, the appearance of a number of merchant banks with international backgrounds spawned a host of smaller finance companies, which exploited a legal loophole in taking only time deposits. At first, there was no regulation at all of these new intermediaries, whose number soon escalated to over 2,000. In 1976, a Deposit-taking Companies Ordinance was passed, under which all depository institutions other than licensed banks were required to register with the Government, and to observe a minimum paid-up capital requirement (then HK\$2.5 million). Officially known as deposit-taking companies (DTCs), these intermediaries were allowed to take time deposits of any maturity of an amount not less than HK\$50,000 for each account, but were barred from taking demand and savings deposits. Not being members of the interest rate cartel of the licensed banks, the DTCs grew very rapidly in the 1970s, causing some erosion of the deposit base of the licensed banks. In retaliation, the licensed banks formed DTC subsidiaries of their own and simultaneously put pressure on the government to tighten its regulation of their rivals. The result was the three-tier system inaugurated in 1981,

which can be divided into two phases: the first phase from 1981 to 1989, and the second phase from 1990. Institutional details of this banking structure are summarized in Table 3.3.

All depository institutions under the three-tier system are officially known as "Authorized Institutions" (AIs). The rationale of this system is that the scope of banking business should vary directly with the degree of prudential supervision. Thus licensed banks, which are the most strictly regulated, can take all types of deposits. For the two other tiers, for which regulation is less demanding, deposit-taking is confined to time deposits. Note that the second tier "restricted license banks" since 1990 comprise mostly merchant banks/investment banks, which can call themselves "bank" provided this is qualified by a description such as "restricted license," "merchant," "investment" or "wholesale." The change in terminology is motivated by the desire to promote Hong Kong as an international financial center. Since 1981 it has also been the policy of the authorities to weed out undercapitalized DTCs. No new DTCs will be permitted to commence business unless they are majority-owned by licensed banks.

Before 1964, Hong Kong's banking sector was conspicuous by the absence of any prudential supervision. This state of affairs has been variously described as "free banking" or "wildcat banking," depending on the point of view of the observer. The first Banking Ordinance of 1948 was derisively rudimentary by present-day standards. It only provided for the licensing of banks, examination of bank books, publication of bank statements, and the appointment of an advisory committee. No mention was made of a supervisory body, nor of prudential measures such as minimum capital, liquidity ratio, and the like. Following a bank run in 1961, the government invited a senior official from the Bank of England to advise on a new ordinance. The result was the revised Banking Ordinance of 1964, which provided for the appointment of a Banking Commissioner, laid down minimum paid-up capital (then HK\$5 million) and a liquidity ratio of 25%, and limitations on loans and investments.¹³ Ironically, this ordinance was followed almost immediately by a severe banking crisis. Between 1964 and 1982, there had been relatively minor amendments to the ordinance. Then another banking crisis engulfed Hong Kong in 1982–86. The confidence crisis at that time over Hong Kong's future after 1997, resulting in a collapse of the asset markets, was undoubtedly a contributory factor, but imprudence and mismanagement (especially overexposure to the property market), or even fraud, remained the principal causes. The government had to use the Exchange Fund to bail out several banks in distress.¹⁴ An overhaul of the whole regulatory regime therefore became urgent. Again, a team from the Bank of England was commissioned in 1984 to study the issue; its report laid the groundwork for the new Banking

TABLE 3.3
The Three-Tier System of Depository Institutions in Hong Kong

	<i>Old 3-Tier System (1981-89)</i>	<i>New 3-Tier System (from 1990)</i>
(1) First Tier		
Name	Licensed Banks	Licensed Banks
Minimum paid-up capital	HK\$100 million	HK\$150 million
Scope of deposit-taking	All types of deposits	All types of deposits
Minimum denomination and term to maturity of deposits	No restriction	No restriction
Minimum liquidity ratio	25%	25%
Minimum capital adequacy ratio	5% after Sept. 1, 1988, but Banking Commissioner may order a bank to raise it to 8%	8%, but Banking Commissioner/HKMA may order a bank to raise it to 12%
(2) Second Tier		
Name	Licensed Deposit-Taking Company (LDTC)	Restricted License Bank (RLB)
Minimum paid-up capital	HK\$75 million	HK\$100 million
Scope of deposit-taking	Time deposits only	Time deposits only
Minimum denomination and term to maturity of deposits	HK\$500,000, no restriction on maturity	HK\$500,000, no restriction on maturity
Minimum liquidity ratio	25% after Sept. 1, 1986	25%
Minimum capital adequacy ratio	5% after Sept. 1, 1988, but Banking Commissioner may order an LDTC to raise it to 10%	8%, but Banking Commissioner/HKMA may order an RLB to raise it to 16%
(3) Third Tier		
Name	Registered Deposit-Taking Company (RDTC)	Deposit-Taking Company (DTC)
Minimum paid-up capital	HK\$10 million	HK\$25 million
Scope of deposit-taking	Time deposits only	Time deposits only
Minimum denomination and term to maturity of deposits	HK\$100,000, not less than 3 months	HK\$100,000, not less than 3 months
Minimum liquidity ratio	25% after Sept. 1, 1986	25%
Minimum capital adequacy ratio	5% after Sept. 1, 1988, but Banking Commissioner may order a RDTC to raise it to 10%	8%, but Banking Commissioner/HKMA may order a DTC to raise it to 16%

Notes: Liquidity ratio defined as the ratio of liquefiable assets to total one-month liabilities.

Capital adequacy ratio defined as the ratio of the sum of paid-up capital, reserves, and undistributed profits to total risk assets.

Ordinance that came into force on September 1, 1986. The main points of this new ordinance can be summarized as follows:

1. Additional discretionary powers given to the Banking Commissioner, such as revoking and suspending licenses; vetting the backgrounds of owners, directors, and managers; issuing guidelines; and so on.
2. Tightening of the auditing process by a tripartite—management, commissioner, auditor—review, appointment of a second auditor, disciplinary action against negligence or misconduct of the auditor(s).
3. A “fit and proper” test for and tougher vetting of owners, directors, and managers of a bank before their appointment.
4. Stricter limitations on loans to a group of companies, directors, and advances to a company against its securities.
5. A minimum capital adequacy ratio of 5%, which the commissioner might at his discretion raise to 8% for banks and 10% for DTCs.
6. Redefinition of the “liquidity ratio” as the ratio of “liquefiable assets” to “qualifying liabilities,” that is, liabilities maturing or callable within one month.

The 1986 ordinance marks a significant shift in the focus and orientation of prudential supervision. The regulatory authorities are no longer satisfied merely with the pro forma observance of ratios or quantitative indicators, but will look more closely into the quality of management of the supervised institution, by on-site and off-site examinations, as well as by more rigorous auditing. For the first time, a minimum capital adequacy ratio (CAR) was imposed, two years ahead of the Basle Accord.

Since 1986, the ordinance has been regularly reviewed and updated in the light of developments in the banking industry, but so far most amendments have been of a technical nature. For instance, after 1993, the term “Monetary Authority” (MA), the abbreviation for HKMA, replaces “Commissioner.” The ordinance was amended in 1995 to establish the MA as the licensing authority responsible for the authorization, suspension, and revocation of all three types of AIs. It was further amended in 1997 for the purpose of regulating the issue of multipurpose stored value cards, and money brokers operating in the interbank forex market.

When the 8% CAR was announced under the Basle Accord, Hong Kong was well positioned to meet it. Indeed, Hong Kong met the criterion in 1990, two years ahead of the target date of 1992. At the end of 1996, six months before the Asian crisis, the average CAR of the banking system stood at 17.8%, one of the highest ratios in the world.

There is no formal central bank in Hong Kong, but this does not mean that central bank functions are unknown to the territory. Before the establishment of the Hong Kong Monetary Authority (HKMA) in 1993, such functions were shared by a number of public and private agencies. Thus, the issue of legal tender was handled by two British banks (the Hongkong and Shanghai Banking Corporation, now called HSBC, and Standard Chartered Bank), the supervisory function and the conduct of monetary policy were undertaken by the Monetary Affairs Branch of the Hong Kong government, the maintenance of exchange rate stability was the responsibility of the Exchange Fund, the lender of last resort was performed jointly by the Exchange Fund and the two note-issuing banks, and so on. The Monetary Affairs Branch itself was created in 1976, which marked the first attempt of the government to streamline certain central banking functions. The Exchange Fund, set up in 1935 when Hong Kong left the silver standard and opted for the sterling exchange standard, was steadily enlarged to include not only foreign exchange reserves as backing for the note issue, but also the government's fiscal surplus.

In 1993, the HKMA was established by combining the Exchange Fund Office with the Commissioner of Banking Office. This new statutory body was justified on the grounds that central banking functions needed to be further streamlined and strengthened in order to ensure exchange rate and banking stability in preparation for the transition to Chinese sovereignty in 1997. The remaining part of the former Monetary Affairs Branch was reorganized into a new Financial Services Bureau, which is mainly responsible for the supervision of nonbank financial institutions and securities markets.

The HKMA is widely regarded as the *de facto* central bank of Hong Kong. Certainly it performs an impressive array of traditional central bank functions, such as the conduct of monetary policy, maintenance of exchange rate stability, prudential supervision of banks, custody and management of foreign exchange reserves, provision of clearing, discount window, and lender of last resort facilities.¹⁵ However, it is important to note that in several important respects, the HKMA differs from the fully fledged central bank. First, it does not issue legal tender notes. Under Hong Kong's present currency system, which is a variant of the Currency Board Arrangement (CBA), the Exchange Fund issues on demand Certificates of Indebtedness (CIs) to the note-issuing banks on payment of U.S. dollars at the fixed exchange rate of US\$1 = HK\$7.8, which has remained unchanged since October 17, 1983. The CIs form the legal backing for the notes and can be redeemed in U.S. dollars at the same exchange rate. In 1994, the Bank of China joined the two British banks as the third note-issuing bank. Second, the HKMA does not require commercial banks and other depository institutions to keep

with its non-interest-bearing reserves, other than a positive balance in their clearing accounts. Third, under the present linked exchange rate system, the HKMA cannot conduct monetary policy independently of the Federal Reserve System of the United States.

Since its inception, the HKMA has steadily expanded its central banking functions, while carrying out simultaneously important reforms. To meet international standards and minimize settlement risks, Real Time Gross Settlement (RTGS) was introduced on December 9, 1996, for large-value interbank payments. All licensed banks were required to keep a clearing account direct with the HKMA, rather than with the HSBC as before. No daylight overdraft was allowed, though liquidity assistance could be obtained through the HKMA's Liquidity Adjustment Facility (LAF). Thus, the HKMA effectively took over the central clearing function from the HSBC, the largest bank in Hong Kong. Earlier, in 1992, the HKMA also set up a Central Moneymarkets Unit (CMU), which serves as a central custodian and clearing agent for Hong Kong dollar debt instruments issued by the private sector.

Still another useful role is the promotion of the local debt market. The absence of a risk-free benchmark rate was often blamed in the past for the rudimentary state of Hong Kong's bond market. This was remedied by the issue of Exchange Fund bills and notes beginning from 1990. The bills had maturities of 91, 182, and 364 days, while the notes had maturities ranging from two to ten years. These bills and notes were not issued for covering the fiscal deficit, but solely for monetary policy purposes. As of the end of June 1997, the total outstanding amount of such obligations stood at HK\$98 billion (US\$12.7 billion).

Like banking, Hong Kong's securities markets were at first totally unregulated. During the stock market boom in the early 1970s before the first oil crisis, there were no fewer than four stock exchanges. It was not until 1986 that the four exchanges were combined, under intense government pressure, into one single entity, the Stock Exchange of Hong Kong (SEHK). During the world-wide stock market crash commencing on October 19, 1987, led by Wall Street, the Hong Kong Futures Exchange (HKFE) was unable to fulfill its obligations. Both the SEHK and HKFE suspended trading for four days. When trading resumed on October 26, stock prices and futures prices fell by 33% and 44% respectively in one single day, forcing the government to organize hastily an HK\$4 billion package to bail out the HKFE.

Stung by this scandal, the government appointed a special committee to review the operations of the two exchanges and their regulatory bodies. The report of this committee strongly criticized not only the two exchanges for poor management, but also the two regulatory bodies, the Securities Commission and the Commodities Trading Commission, for ineffective supervision.¹⁶ The committee therefore recommended a

reconstitution of the two exchanges and the establishment of a new independent supervisory body outside the civil service to regulate the securities market. The government accepted these recommendations, and thus the Securities and Futures Commission (SFC) came into being in 1989, replacing the former two commissions mentioned earlier. It supervises the securities, financial investment, and futures industries and administers a host of ordinances relating to protection of investors, securities, commodities trading, insider dealing, leveraged forex trading, and the like. The SFC also registers or licenses securities, forex, and commodities dealers.

A comprehensive Insurance Companies Ordinance came into effect in 1983, replacing the scattered pieces of legislation, enacted between 1907 and 1981, dealing with life, fire, marine, or motor insurance business. It provides the first unitary set of regulatory provisions for the authorization and prudential supervision of all insurers, both general and long term.

Thus, on the eve of the handover and the AFC, prudential supervision of the financial sector, while not perfect, had improved immeasurably compared to the situation before 1964, when there was no prudential supervision of any kind in the whole financial sector.

EMERGENCE AS AN INTERNATIONAL FINANCIAL CENTER

Since 1978, Hong Kong has emerged as a major international financial center (IFC). I have written a whole book on Hong Kong's rise as an IFC, published just before the territory's reversion to China.¹⁷ Space does not permit any full treatment of this topic here, but it would be useful to dispose of some popular misconceptions. One, which prevails in some quarters in Hong Kong and China, is that Hong Kong is the third largest financial center of the world. Even some foreign observers subscribe to this view.¹⁸ The criteria upon which this assertion is based have never been clearly spelled out, but it has been vaguely suggested that the number of foreign-owned banks in Hong Kong is the third highest of all cities in the world, or that the participation of foreign entities in Hong Kong's financial sector is weaker only than that in London and New York. It may well be true that the number of foreign banks in Hong Kong is the third highest of all cities the world. But this is only one of the possible criteria for evaluating the ranking of a financial center, and not necessarily the most important one. Other criteria, such as the size of the banking sector, the turnover and market capitalization of financial markets, and the variety of financial services and innovations, are more significant. On such criteria, Hong Kong is

far from being the third largest financial center of the world, as is shown in Table 3.4.

The other misconception, which is surprisingly common outside Hong Kong, is that Hong Kong is an offshore financial center or offshore banking center. Even respected scholars commit this solecism.¹⁹

By general agreement, an "offshore financial center" or, more narrowly, an "offshore banking center" is a center where the host country accords preferential treatment to banks and other financial institutions in terms of taxation, regulatory restrictions, prudential supervision, and so on, provided that such banks and financial institutions deal only with nonresidents and in foreign currencies and are thus effectively insulated from the host country's domestic financial sector.

On this definition, it is clear that Hong Kong is not an offshore financial center. The Hong Kong government has never set up an offshore center or free zone with special regulatory or tax concessions that is completely insulated from the domestic economy. In fact, the authorities do not even distinguish between residents and nonresidents, or between domestic and foreign currency financial activities. In other words, onshore and offshore activities are completely fused together in Hong Kong, and no artificial barriers exist between them.

Hence, it is more accurate to say that Hong Kong is an integrated center in the sense that the onshore financial sector is not deliberately insulated from the offshore sector. Once a bank or financial institution is licensed or authorized to operate in Hong Kong, it can engage in both onshore and offshore business, whether denominated in local or foreign currencies. The only restriction (which is now under review) was that foreign banks licensed after March 1978 could open only one office, that is, they could effectively transact only wholesale banking business. This, however, did not pose any problem to international banks. First, foreign banks licensed before 1978 are not affected; they can engage in both retail and wholesale business. Second, international banks themselves at that time were not keen to conduct retail banking, because of the high costs involved. Even if they were interested, they could do so in a more cost-effective way by acquiring interests in locally incorporated banks. In short, foreign banks and nonbank financial institutions are accorded full national treatment, but by the same token, they do not enjoy any special privileges or exemptions.

Although Hong Kong is noted for its low rate of taxation and simple tax system, it is definitely not a tax haven. Hence, it is also definitely not a paper center or a booking center. It is a genuine functional center in which the financial sector generates substantial income and employment.

From the geographical standpoint, although Hong Kong conducts financial business with all the principal continents and areas in the

TABLE 3.4
Ranking of Hong Kong as an IFC

<i>Categories</i>	<i>Asia-Pacific Ranking</i>	<i>World Ranking</i>
<i>Banking (1996):</i>		
No. of foreign banks	1	2
Banks' foreign assets	2	5
Banks' foreign liabilities	2	5
Cross-border interbank claims	3	8
Cross-border interbank liabilities	2	4
Cross-border credit to non-banks	2	3
Syndicated credits by volume	2	8
Signed project finance deals	1	2
<i>Forex Market (1995)</i>		
Net daily turnover	3	5
<i>Derivatives Market (1995)</i>		
Net daily forex contract turnover	3	5
Net interest rate contract turnover	4	8
Overall	3	7
<i>Stock Market (1996):</i>		
Market capitalization	2	7
Value traded	6	14
No. of listed domestic companies	7	17
Value of new equity issues	1	N.A.
<i>Bond Market (1995)</i>		
	8	N.A.
<i>Gold Market (1996)</i>		
	1	4
<i>Insurance (1995)</i>		
No. of authorized insurance companies	1	N.A.
Premium income	5	27
Qualified actuaries	1	N.A.
<i>Fund management (1996)</i>		
	2	N.A.
<i>Source of Foreign Direct Investment (1996)</i>		
	2	5

N.A. = not available

Source: Y.C. Jao (1997); *International Financial Statistics*; *Emerging Stock Markets Factbook 1997*; *International Financing Review*; *World Investment Report*; World Bank; *Project and Trade Finance*.

world, its core remains the Asia-Pacific region or the Pacific Basin. Hong Kong is not in the same league with London, New York and Tokyo, which are the world's only three global financial centers. At the same time, Hong Kong's financial activities are clearly not confined within its territorial limits. It is therefore best described as a regional financial center.

Within the Asia-Pacific region itself, Hong Kong is already the *de facto* financial entrepôt for Greater China, or the Chinese Economic Area (CEA), comprising mainland China, Taiwan, Hong Kong, Macau, and the overseas Chinese community. For example, Hong Kong accords full national treatment to banks and other financial institutions from both China and Taiwan. Hong Kong is the preferred capital-raising center for China-owned state enterprises or China-related companies. About a third of China's foreign exchange earnings comes from Hong Kong. The Hong Kong dollar has served as both a medium of exchange and a store of value for South China and Macau for over a century. In short, Hong Kong is the only Chinese city in which financial institutions from both sides of the Taiwan Strait can peacefully coexist and in which they can compete on a level playing field without political interference or protectionist restrictions.

To sum up our characterization, Hong Kong is an integrated functional financial center. It is an international financial center (IFC) in its own right, not just an appendage of London, New York, or Tokyo. While it may not be the third largest financial center of the world, it is definitely one of the three leading financial centers of the Asia-Pacific region and one of the world's top six or seven financial centers.

ASSET MARKETS

Since the collapse of asset markets was an important element of the AFC, a sketch of price movements in the stock and property markets in Hong Kong prior to the crisis will also be useful as background information.

Table 3.5 shows stock market crises during the period 1964–96, as measured by the Hang Seng Stock Price Index.²⁰

As may readily be seen, during that period there were six major bear markets. The worst was the period 1973–74, when stock prices crashed by a whopping 91.6%. Although the first oil crisis provided the backdrop for the collapse, the main reason was that stock prices were exorbitantly overpriced: at its height, the Hang Seng Index (HSI) was selling at an average price-earnings ratio of 101, which was clearly unsustainable. The HSI therefore began its steep decline in March 1973, well before the oil crisis broke out near the end of the year.

Table 3.5 also shows that the reasons for the crashes can be divided into two broad categories: political shocks (Sino-British negotiations on Hong Kong, June 4 incident, etc.) and economic shocks (oil crisis, worldwide stock market crash, high and rising interest rates, etc.).

After the correction of stock prices in 1994–95, the uptrend of HSI continued. As shown in Table 3.6, by the end of June 1997, buoyed by

TABLE 3.5
Hong Kong Stock Market Crises as Measured by Hang Seng Stock Price Index (July 31, 1964 = 100)

<i>Period</i>	<i>High</i>	<i>Low</i>	<i>Price change (top to bottom)</i>	<i>Reasons for Price Collapse</i>
1964–67	103.5	60.2	–41.8%	Banking crisis followed by political disturbance
1973–74	1,774.96	150.11	–91.6%	Overpricing
1981–83	1,810.2	676.3	–62.7%	Confidence crisis during Sino-British negotiations on Hong Kong
1987	3,949.7	1,894.9	–52.1%	Worldwide stock market crash
1989	3,309.6	2,093.6	–36.8%	June events in China
1994–95	12,201.09	6,967.93	–42.9%	Higher interest rates in United States and Hong Kong

the euphoria over a smooth handover, both the HSI and daily turnover had risen to new highs. At 15,197, the HSI was selling at an average price-earnings (P/E) ratio of 17.6, which, while not cheap, was not excessively high by Asian or international standards.

The other asset market that is of great importance for Hong Kong's economy is the property market. Historically, the two serious banking crises of 1965–66 and 1983–86 were closely associated with slumps in the property market.

TABLE 3.6
Stock Price Index and Daily Turnover

<i>End of Year/Quarter</i>	<i>Hang Seng Index</i>	<i>Average Daily Turnover (HK\$ billion)</i>
1995 Q1	8,587	3.2
Q2	9,206	3.3
Q3	9,646	3.4
Q4	10,073	3.4
1996 Q1	10,957	6.1
Q2	11,021	3.8
Q3	11,902	4.6
Q4	13,451	8.1
1997 Q1	12,534	10.1
Q2	15,197	15.0

Source: Hong Kong Monthly Digest of Statistics

In the 1990s, except for a short period of adjustments in 1994-95 due to rising interest rates, housing prices and rentals generally followed a rising trend. As shown in Tables 3.7, 3.8, and 3.9, the domestic rental index nearly doubled, while the domestic price index more than quadrupled, from the end of 1989 to the end of June 1997, just before the AFC broke out. The uptrend was more modest for private commercial/business premises, with their rental index first rising to 140 in the first quarter of 1995 but then dropping to 117 at the end of June 1997. Their price index showed more fluctuations, but stood at 217 at the end of June 1997, more than double the level at the end of 1989.

Table 3.10 compares the indexes of nominal GDP, HSI, private domestic premises, and private office premises, with 1989 as the base. It can be seen that while nominal GDP rose by more than 2.5 times, HSI more than quintupled, and private domestic premises more than quadrupled. Only the private office premises rose somewhat less than the nominal GDP. Thus, it could be argued that a bubble was developing in the equity and property markets, even though it was much more modest than that in Japan. It is true that the HSI, selling at a P/E ratio of 17.6

TABLE 3.7
Private Domestic-Rental Indexes by Class (1989 = 100)

<i>End of Year/Quarter</i>	<i>A</i>	<i>B</i>	<i>C</i>	<i>D</i>	<i>E</i>	<i>All Classes</i>	
1989	100	100	100	100	100	100	
1990	116	113	112	103	98	110	
1991	125	123	122	110	99	119	
1992	134	133	138	127	114	130	
1993	140	140	148	142	133	140	
1994	161	167	183	184	181	170	
1995	Q1	165	171	192	199	196	177
	Q2	167	172	187	191	191	176
	Q3	166	171	184	184	187	174
	Q4	162	167	181	174	179	169
1996	Q1	163	165	179	175	173	168
	Q2	164	167	178	172	176	169
	Q3	166	171	182	178	182	172
	Q4	167	176	185	183	183	175
1997	Q1	177	184	197	193	191	185
	Q2	183	193	204	199	203	193

Note: Class A—saleable area not exceeding 39.9 m²
 Class B—saleable area of 40 m² to 69.9 m²
 Class C—saleable area of 70 m² to 99.9 m²
 Class D—saleable area of 100 m² to 159.9 m²

TABLE 3.8
Private Domestic-Price Indexes by Class (1989 = 100)

<i>End of Year/Quarter</i>	<i>A</i>	<i>B</i>	<i>C</i>	<i>All Classes</i>
1989	100	100	100	100
1990	112	111	113	111
1991	153	155	156	153
1992	210	219	229	215
1993	223	244	261	237
1994	263	306	341	293
1995 Q1	261	297	320	284
Q2	258	289	318	280
Q3	247	271	296	264
Q4	242	269	289	261
1996 Q1	252	289	304	277
Q2	261	300	326	289
Q3	270	310	332	298
Q4	294	341	372	329
1997 Q1	350	410	457	395
Q2	382	447	497	429

Note: Class A—saleable area not exceeding 39.9m²

Class B—saleable area of 40m² to 69.9m²

Class C—saleable area of 70m² to 99.9m²

Class D—saleable area of 100m² to 159.9m²

Class E—saleable area of at least 160m²

Source: Rating and Valuation Department, *Hong Kong Property Review 1999*

on the eve of the AFC, was not excessively high by international standards. However, the HSI comprises only seasoned “blue chips.” Other, more widely based indexes, comprising many speculative stocks, were then selling at much higher P/E ratios. For example, at their peaks, the average P/E ratios for Red Chips and H-Shares were 52 and 30 respectively. (Red Chips are stocks of companies incorporated in Hong Kong but largely owned or controlled by Chinese interests, while H-Shares are shares of Chinese state-owned enterprises listed on the Stock Exchange of Hong Kong).

MACROECONOMIC PERFORMANCE

Official estimates of Gross Domestic Product (GDP) became available only in 1961. Table 3.11 gives a synopsis of Hong Kong’s macroeconomic indicators, starting from the 1960s. As may readily be seen, real GDP growth was initially very high, averaging some 8.9% per annum in the 1960s, but over the next three decades it had shown a declining

TABLE 3.9
Private Office-Rental and Price Indexes by Grade (1989 = 100)

<i>End of Year / Quarter</i>	<i>Grade A</i>	<i>Rents</i>			<i>Prices</i>			
		<i>Grade B</i>	<i>Grade C</i>	<i>Overall</i>	<i>Grade A</i>	<i>Grade B</i>	<i>Grade C</i>	<i>Overall</i>
1989	100	100	100	100	100	100	100	100
1990	102	98	104	101	95	96	96	96
1991	93	94	101	95	91	104	105	97
1992	97	100	108	101	126	144	144	133
1993	108	109	117	110	155	171	166	159
1994	136	130	135	134	224	241	204	222
1995 Q1	144	134	140	140	206	217	196	205
Q2	136	129	137	134	193	216	187	195
Q3	133	124	133	130	176	186	172	177
Q4	124	117	126	122	171	184	171	174
1996 Q1	114	112	121	115	184	190	171	182
Q2	111	106	117	111	182	193	175	183
Q3	111	106	117	111	174	181	167	174
Q4	111	108	118	111	202	189	174	196
1997 Q1	113	109	118	113	220	211	187	214
Q2	115	112	121	115	223	212	194	217

Note: Private Office: premises for commercial/business purposes.

Grade A: modern with high-quality finishes

Grade B: ordinary design with good-quality finishes

Grade C: plain with basic finishes

Source: Rating and Valuation Department, *Hong Kong Property Review 1999*

TABLE 3.10
Indexes of Nominal Gross Domestic Product, Stock Prices, and Property Prices (1989 = 100)

<i>End of Year/Quarter</i>	<i>Nominal GDP</i>	<i>HSI</i>	<i>Private Domestic Premises</i>	<i>Private Office Premises</i>
1990	111	107	111	96
1991	128	151	153	97
1992	149	194	215	133
1993	171	419	237	159
1994	193	289	293	222
1995	206	355	261	174
1996	228	474	329	196
1997 (Q2)	255	536	429	217

Source: Underlying data from Census and Statistics Department, *Estimates of Gross Domestic Product*; Rating and Valuation Department, *Property Review*; and *Hong Kong Monthly Digest of Statistics*.

TABLE 3.11
Basic Macroeconomic Indicators (Period Average)

	1962–69	1970–79	1980–89	1990–97	
Real GDP (% change)	8.9	8.0	7.3	5.1	
GDP deflator (% change)	3.8	9.5	9.0	7.0	
Consumer price inflation (% change)	2.5	8.9	8.4	8.5	
Unemployment rate (%)	N.A.	5.0	3.0	2.2	
	1980–85	1986–90	1991–95	End 1996	End Q2 1997
Per capita nominal GDP (U.S. dollars)	5,630	7,250	14,950	24,520	25,531

trend; by the 1990s, it had fallen to 5.1%, just before the handover and the AFC. In part, this decline is a result of the natural maturing of the economy and the enlargement of the economic base, but more important reasons might be the decline of the manufacturing industries and the structural shift into a service-based economy.

The inflation rate, as measured by both the GDP deflator and the consumer price index, showed a big upsurge in the 1970s and 1980s, primarily as a result of the two oil crises. But even after the oil crises were over, inflation remained high in the 1990s before the AFC, because of the structural changes in the economy. Meanwhile, the unemployment rate had shown a sharp downtrend, falling from an average of 5% to only 2.2% in the 1990s. This remarkable fall in unemployment can be explained by a mixture of demographic, social, and political factors. The natural rate of increase of the population had fallen steadily from 2.9% to 0.4% in 1997. In 1974, the Hong Kong government ended its traditional policy of allowing entry to all immigrants from Mainland China, but illegal immigrants who managed to reach the urban areas were still allowed to stay. In 1980, however, facing the threat of a massive inflow of illegal immigrants, the authorities abandoned this “reached-base” policy and began to enforce a compulsory repatriation of all illegal immigrants. This effectively closed off a major source of cheap labor, which hitherto had propelled Hong Kong’s post-World War II industrialization. Meanwhile, from about 1982 onward, the uncertainty over the 1997 transition had caused rising emigration and “brain drain” to affluent industrialized English-speaking countries, especially the United States, Canada, and Australia, with the total number of emigrants rising from about 22,000 in 1982 to a peak of 66,000 in 1992, before tapering off in the ensuing years. Thus, during the 1990s before the handover and the AFC, Hong Kong experienced a “labor shortage” situation.

By 1980, Hong Kong's model of export-propelled growth based on labor-intensive light industries had run into trouble. With rising wages and land prices, Hong Kong could no longer maintain its competitive advantage against other low-cost emerging economies. China's launching of its economic reform in the previous year, however, had opened a new vista of economic growth and development. Thus began Hong Kong's "Second Reorientation," marked by a massive relocation of manufacturing industries to Mainland China, particularly in the Pearl River Delta, and a significant structural transformation into a service-based economy, especially entrepôt trade, transport and communication, and financial services. Hong Kong's rise as an IFC, as sketched in the previous section, also roughly paralleled this reorientation.

This structural metamorphosis is best shown in the percentage contributions to GDP by various types of economic activity. As shown in Table 3.12, the primary sector, agriculture, had all but disappeared by 1996. Within the broad industrial sector, mining and quarrying had also gone out of existence. The total contribution of industry fell steadily from 31.7% in 1980 to 15.5% in 1996, while that of manufacturing fell even more dramatically, from 23.7% to 7.3%. Only utilities managed to increase their share. The tertiary sector, or service industries, increased its total contribution from 67.5% to 84.4% during the same period. All subsectors of services increased their shares of GDP during the same period.

TABLE 3.12
Production-based GDP by Economic Activity (%), 1980–96

	1980	1985	1990	1995	1996
Agriculture and Fishing	0.8	0.5	0.3	0.1	0.1
Industry (Total)	31.7	29.9	25.3	16.1	15.5
Mining and quarrying	0.2	0.1	*	*	*
Manufacturing	23.7	22.1	17.6	8.3	7.3
Electricity, gas, and water	1.3	2.6	2.3	2.3	2.4
Construction	6.6	5.0	5.4	5.4	5.8
Services (Total)	67.5	69.6	74.5	83.8	84.4
Wholesale, retail, and export/import trades, restaurants and hotels	21.4	22.8	25.2	26.6	26.7
Transport, storage and communications	7.4	8.1	9.5	10.1	9.8
Financing, insurance, real estate, and business services	23.0	16.0	20.2	24.4	25.1
Community, social, and personal services	12.1	16.7	14.5	17.3	17.6
Ownership of premises	8.9	10.5	10.6	13.3	13.1
Adjustment for financial intermediation	-5.4	-4.6	-5.5	-7.9	-7.9
Grand Total	100.0	100.0	100.0	100.0	100.0

Source: Census and Statistics Department, Hong Kong Government, *Estimates of Gross Domestic Product 1961 to 1998*, March 1999

*Less than 0.05%

Some scholars have argued that the decline of manufacturing industries has been exaggerated: While physical production facilities of most manufacturing establishments have been moved across the border, other key functions, such as management, marketing, finance, and design, have remained with the head offices in Hong Kong, and they have been erroneously classified as "services."²¹ The point is well taken. But even allowing for the required statistical corrections, the general pattern of structural changes in unlikely to be significantly affected.

Table 3.13 shows that the employment pattern also reflects the structural change. Thus, the number of persons employed in manufacturing dropped from 907,463 in 1980 to 482,100 in 1996, while their share of the labor force fell even more, from 39.1% to 15.6%. However, the job losses in manufacturing had been more than offset by job gains in all other major industries, especially in the tertiary sector, so that the unemployment rate actually fell from 3.8% at the end of 1980 to 2.8% at the end of 1996. The revival of entrepôt trade, China's increasing use of Hong Kong's infrastructure and financial and business services, played a major role in job creation. Significant progress in education and vocational training and the famed flexibility and mobility of the Hong Kong labor market have also helped the territory's smooth structural transformation.

TABLE 3.13
Employment by Major Industry Group (persons engaged at year-end)

	1980	1985	1990	1996
Manufacturing	907,463 (39.1)	847,615 (32.2)	751,000 (27.3)	482,100 (15.6)
Construction	90,498 (3.9)	66,313 (2.5)	226,000 (8.2)	269,600 (8.7)
Wholesale, retail and import-export trades, restaurants, and hotels	455,100 (19.6)	600,405 (22.9)	703,200 (25.6)	887,400 (28.7)
Transport, storage, and communications	77,272 (3.3)	95,352 (3.6)	268,400 (9.8)	331,800 (10.7)
Financing, insurance, real estate, and business services	131,600 (5.7)	180,851 (6.9)	208,600 (7.6)	353,600 (11.4)
Community, social, and personal services	167,966 (7.2)	205,403 (7.8)	511,800 (18.6)	649,500 (21.0)
Others	10,121 (0.4)	11,613 (0.4)	42,700 (1.6)	33,800 (1.1)

Source: Underlying data from *Hong Kong Annual Digest of Statistics*

Note: Parentheses indicate percentages of total labor force.

During 1994–95, there was a mild downturn as well as a correction in the asset markets, primarily because of rising interest rates in both the United States and Hong Kong, and to a lesser extent because of economic adjustments in China, then suffering from high inflation. The downturn was a kind of “growth recession,” with real GDP growth falling from 5.4% in 1994 to 3.9% in 1995 and with unemployment rising from 2.2% in 1994 to a peak of 3.75% in the third quarter of 1995. As shown in Tables 3.5 and 3.8, stock prices fell by about 43% from peak to trough, while property prices fell by 11–21%. Real wages fell on average by 3%, enabling the economy to recover relatively quickly. But the growth rate of real GDP, even in the recession of 1994–95, was still positive and, by international standards of mature economies, was still respectable.

At about that time, there was also widespread concern about Hong Kong’s competitiveness vis-à-vis not only the other three “dragons,” Singapore, South Korea, and Taiwan, but also other emerging economies like Malaysia, Thailand, and Mexico. However, according to a study by an IMF team, during the period 1980–96 Hong Kong’s annual labor productivity growth still averaged a respectable 4.1%. In general, labor productivity in manufacturing was much higher than those in the service industries, as expected. But even among the latter, the labor productivity growth was still positive, with the exception of the subsector financing, insurance, real estate, and business services.²²

Table 3.14 compares the annual growth rates of nominal GDP, monetary aggregates, and bank loans for use in Hong Kong. In general, we find that the growth rates of the two versions of the three monetary

TABLE 3.14
Annual Growth Rates of Nominal GDP, Monetary Aggregates, and Bank Credit (%)

End of	Nominal GDP	M1		M2		M3		Bank loans for Use in Hong Kong (all currencies)
		HK\$	Total	HK\$	Total	HK\$	Total	
1990	11.2	7.8	13.3	14.8	21.5	15.4	22.2	17.3
1991	14.8	21.7	19.5	17.8	13.3	15.6	11.6	18.3
1992	16.6	24.8	21.1	14.3	10.8	13.7	9.5	11.1
1993	15.2	20.8	20.6	26.9	16.0	25.2	15.6	17.9
1994	12.6	-0.4	-1.2	18.7	12.9	18.3	13.6	15.9
1995	6.6	2.2	2.7	15.1	14.6	14.9	14.2	12.0
1996	10.7	15.5	14.2	19.3	10.9	18.9	10.5	16.0
1997 (June)	16.0	15.5	14.9	24.0	16.3	28.8	16.0	23.9

Source: Underlying data from *Estimates of Gross Domestic Product* and *HKMA Monthly Statistical Bulletin*

aggregates—those denominated in Hong Kong dollars only and those denominated in all currencies—moved in line with that of nominal GDP, or at least did not move excessively out of line with it. But in the first half of 1997, on the eve of the handover and the AFC, the growth rates of the broader monetary aggregates, M2 and M3 denominated in Hong Kong dollars, and bank loans for use in Hong Kong did show a big upsurge, partly reflecting the strong growth of the economy, partly reflecting influx of capital and general expectations of a smooth handover. Note that in 1994, the growth rates of M1 in both versions were negative owing to a mixture of factors: rising interest rates and deregulation of deposit rates on time deposits caused widespread switching from demand deposits to savings and time deposits.

Since its inception in 1993, the HKMA has conducted surveys of the residential mortgage lending of 33 authorized institutions, which accounted for about 90% of total mortgage loans. Unfortunately, the time series started with the end of 1992, and annual growth figures are only available from 1993. Table 3.15 shows that the growth rate accelerated from 1995 onward, after the brief adjustment during 1994–95. By the end of June 1997, the growth rate had surged to 27.6%.

Taking these two tables together with other tables on the asset markets, it seems clear that in the year before the handover and the AFC, a bubble economy was forming in Hong Kong, characterized by rising asset prices, monetary aggregates, and bank credit, even though the bubble was not so excessive as that of Japan or some other Asian countries.

In concluding this review, it should be stressed that from 1982 to June 1997, Hong Kong had gone through an ordeal of nerve-wrecking crisis of confidence. Yet despite all the uncertainty and anguish, Hong Kong's per capita income still managed to quintuple to US\$25,531 during the period. Beginning from the late 1980s, the World Bank has classified Hong Kong among the high-income economies. Moreover, according to the World Bank's estimate, Hong Kong's per capita GNP in PPP inter-

TABLE 3.15
Annual Growth Rates of Residential Mortgage Lending by 33 Authorized Institutions

<i>End of</i>	<i>Growth Rates (%)</i>
1993	15.2
1994	12.5
1995	14.9
1996	18.8
1997 (June)	27.6

Source: HKMA Monthly Statistical Bulletin

national dollars stood at \$24,350 in 1997, the fifth highest in the world, below those of Singapore, United States, Switzerland, and Japan only.²³ Even in terms of unadjusted U.S. dollars, Hong Kong's per capita GNP was also higher than those of United Kingdom, Italy, Canada, Australia, and many other industrialized countries. For a small and poor entrepôt just after World War II, this track record of growth and metamorphosis is by any standard a remarkable one. It is against this background that we will examine and assess the impact of the AFC on Hong Kong in the ensuing chapters.

NOTES

1. From the British point of view, the "Hong Kong Question" was essentially the lease of the New Territories. The British regarded the three treaties on Hong Kong, namely, the Treaty of Nanjing of 1842, the Convention of Beijing of 1860, and the Convention of Beijing of 1898, as valid treaties for the perpetual cession of the Hong Kong island and the Kowloon peninsula and the lease of the New Territories. The Chinese government, whether Nationalist or Communist, had never recognized these treaties, ever since Dr. Sun Yat-sen, the father of the Republic of China, denounced them as "unequal treaties."

2. For more detailed analysis of the 1982–83 financial crisis, see Greenwood (1982) and Jao (1985).

3. Hong Kong under British rule had adopted twice the currency board arrangement. The first was the Sterling Exchange Standard of 1935–72 (interrupted by the Japanese occupation of 1941–45), under which sterling was the anchor currency. The second was the DES or LER that began on October 15, 1983. See, inter alia, Greenwood (1984) and Jao (1990, 1998). The DES or LER has been maintained since Hong Kong's reversion to China.

4. When the DES was installed in October 1983, there were only two note-issuing banks: the Hongkong and Shanghai Banking Corporation and the Standard Chartered Bank. Since May 1994, the Hong Kong branch of the Bank of China has also been authorized to issue legal tender notes, subject to the same rules and conditions as those of the two other British-owned banks.

5. For a more detailed discussion of this mechanism, see the appendix to the next chapter.

6. See Latter (1993).

7. In 1983, the ratio of total external merchandise trade to GDP was 162%. By 1996, this ratio had increased to 245%.

8. For details, see "Revision of the Effective Exchange Rate Indices for the Hong Kong Dollar," *Hong Kong Monthly Digest of Statistics*, April 1995, pp. F1–F18.

9. See Chen (1996). Chen is now the president of China Development Bank.

10. See Jao (1997a, 1997b).

11. See N. Holloway, "Paradise Lost," *Far Eastern Economic Review*, February 23, 1995, p. 55.

12. See Obstfeld and Rogoff (1995), pp. 90–91.

13. See Jao (1974), Chapter 9.

14. See Jao (1987).
15. See Yam (1994).
16. See Securities Review Committee (1988).
17. See Jao (1997a).
18. For example, a French expert on China writes: "Hong Kong est la troisième place financière du monde. Elle est de plus en plus considérée comme une alternative à Tokyo par les investisseurs étrangers désirant s'installer en Asie orientale. Les banques internationales y sont plus nombreuses qu'à Paris ou à Tokyo (560 banques, dont 360 succursales de banques étrangères)" (Cini 1993, p. 117).
19. See Dufey and Giddy (1978); Johns (1992).
20. The HSI, composed of 33 constituent "blue chips," is not the only stock price index. Other indices include Hang Seng 100 Index (2 January 1998 = 100), Hang Seng China Enterprises Index (8 July 1994 = 1,000), Hang Seng China-Affiliated Corporations Index (4 January 1993 = 1,000), New Hang Seng MidCap 50 Index (2 January 1998 = 1,000), and All Ordinaries Index (2 April 1986 = 1,000). However, HSI remains the most influential and the most widely followed and used, because it has the longest time series.
21. See Enright, Scott, and Dodwell (1997), Chapter 1.
22. See Dodsworth and Mihaljek (1997), Chapters 2 and 3.
23. PPP international dollar is defined by the World Bank as "the number of units of a country's currency required to buy the same amounts of goods and services in the domestic market as \$1 would buy in the United States." See World Bank, *World Bank Atlas 1999*, sections on Economy and Technical Notes.

Speculation Against the Hong Kong Dollar

INTRODUCTION

The outbreak of the Asian Financial Crisis (AFC) in Thailand, and its speedy contagion to other Asian countries are described and analyzed in Chapter 1. In this chapter, we examine in detail speculative attacks on the Hong Kong dollar, more specifically, the linked exchange rate regime and the HKMA's defense strategy against such attacks.

During the first three months of the AFC (July 2–mid-October 1997), Hong Kong was relatively sheltered from external pressures. Some probing attacks on the Hong Kong dollar were easily repulsed by the HKMA without the need to raise interest rates. In January 1995, when the Mexican crisis briefly spread to Asia, the HKMA waited until the exchange rate rose from US\$1 = HK\$7.738 on January 3 to HK\$7.769 on January 12, before it intervened to keep the rate at or below HK\$7.75. This time, it adopted the strategy of intervening in the foreign exchange market at or around the exchange rate of US\$1 = HK\$7.75. In other words, whenever the exchange rate rose to or over 7.75, the HKMA would step in and sell U.S. dollars, and it would buy them back when the rate fell to around 7.73. This strategy worked very well initially, with the level of interest rates remaining basically unchanged and foreign reserves even continuing to rise. But the premium on 12-month forward rate did jump from 255 decimal points at the end of June to 1,400 decimal points at the end of August 1997, implying that speculators were lurking in the background.

From mid-October 1997 onward, however, the situation deteriorated rapidly. The Hong Kong dollar and the Chinese renminbi became the

only two major currencies in East Asia that had not depreciated against the U.S. dollar, as tables in Chapter 1 clearly show. However, China retained a full array of exchange controls on the capital account, so that massive speculation against the renminbi inside China was impossible. The Hong Kong dollar has always been a freely convertible currency, without any form of exchange control. In October 1997, therefore, the Hong Kong dollar became the favorite target of international speculators, who reckoned that it could not hold out for long in the midst of the AFC. One must admit that this view had many adherents in the mass media and the financial community, and even among academic economists. Thus began the Hong Kong currency's two-year ordeal.

THE "BLACK THURSDAY" AND ITS AFTERMATH

As mentioned in Chapter 1, between 1989 and July 1997, Taiwan pursued a de facto peg of the New Taiwan dollar to the U.S. dollar, with the exchange rate being held within a narrow range of NT\$26–NT\$27 to US\$1. After the AFC broke, Taiwan's central bank initially widened the band to about 28.7, with occasional interventions to keep the rate steady. On October 17, however, the central bank suddenly left the market without interventions. By October 20, the U.S. dollar had broken through the NT\$30 barrier, for the first time in ten years.

Taiwan's decision to abandon the de facto peg gave tremendous encouragement to international speculators. They reasoned that if Taiwan, with its enormous foreign reserves (about US\$90 billion at the time) and strong economic fundamentals, could not or would not defend its peg, neither could or would Hong Kong. As also mentioned in the same chapter, Taiwan's decision to devalue has become the first cause célèbre of the AFC. Even disregarding the rights and wrongs of this decision, one fact is indisputable: This action has triggered a two-year ordeal for the Hong Kong dollar, which by October 17, 1997, had become the only freely convertible currency in East Asia that had not depreciated against the U.S. dollar.

In the week beginning October 20, many hedge funds (mostly United States-based) and other assorted speculators mounted a massive onslaught on the Hong Kong dollar by selling it short or forward (typically for three or six months).¹ Legitimate hedging activities by overseas investors undoubtedly also increased, but the ferocity of the selling clearly indicated that speculation dominated the transactions. Moreover, many commercial and merchant banks either funded the speculators or themselves jumped on the bandwagon. To counter this selling, the HKMA sold a substantial amount of U.S. dollars from its reserves.

Under the Real Time Gross Settlement (RTGS) inaugurated in December 1996, the HKMA automatically debited the clearing account of the banking system with the sale of U.S. dollars. Since no overdraft was allowed, any bank short of Hong Kong dollars would have to either borrow it from the interbank market or approach the Liquidity Adjustment Facility of the HKMA for assistance.

On October 23 and 24, as settlements for sales of Hong Kong dollars came due, the banks collectively found themselves caught short in Hong Kong dollars for delivery to the HKMA, as their total credit balance was grossly insufficient for this purpose. A scramble for Hong Kong dollars therefore began, as the spot rate remained intact, and both the Hong Kong government and the HKMA were resolute in their commitment to the linked exchange rate regime. Three other developments further exacerbated the scramble for liquidity. One was that, on the morning of October 23, the HKMA issued a circular to all licensed banks, warning them that the HKMA might impose penal interest rates for repeated borrowers to discourage the use of LAF to fund a short Hong Kong dollar position.² The second was that certain major interbank lenders held on to their surplus liquidity under the very tense and uncertain market conditions. The third was that there was a rumor that the HKMA would, like the Bank of Thailand about five months earlier, charge an exorbitant rate of 1,000% on LAF borrowing. The combined result of these developments was that the overnight Hong Kong Inter-bank Offered Rate (HIBOR) shot up to 280% around noon, though it eased to 100–150% in the afternoon. Under the pressure of such a high rate, many speculators were forced to unwind their positions. The exchange rate closed on that day at 7.735, falling further to 7.725 on the following two days, indicating clearly that the HKMA had won a tactical victory, at least temporarily, over the speculators. On October 24, both lending and deposit rates were raised by 0.75% across the board by the Hong Kong Association of Banks. The daily closing U.S. dollar exchange rates and trade-weighted exchange rate index for the month of October are given in Table 4.1. Although the Hong Kong dollar was saved, the abrupt rise in interest rates and the squeeze on liquidity caused a heavy fall on the Hang Seng Index of stock prices by 1,211 points (10.4%) on October 23, with a record turnover of HK\$34 billion. The day therefore came to be known as “Black Thursday.” The turmoil on the asset markets will be treated in more detail in the next chapter.

Some critics have claimed that the HKMA “shut down” its LAF on “Black Thursday,” thus causing an unprecedented débâcle. It is true that the HKMA did not inject liquidity into the interbank market except when it bought back U.S. dollars, in accordance with the well-known ground rule and discipline of the currency board arrangement (CBA).

TABLE 4.1
Daily Exchange Rates of U.S. Dollar and Trade-Weighted Exchange Rate Index, October 1997

		<i>HK\$ per US\$</i>	<i>Trade-Weighted Exchange Rate Index (Nov. 1983 = 100)</i>
October	3	7.736	130.8
	4	7.737	130.5
	6	7.736	130.6
	7	7.736	130.6
	8	7.736	130.6
	9	7.736	130.3
	11	7.733	130.2
	13	7.735	130.3
	14	7.736	130.3
	15	7.737	130.4
	16	7.737	130.3
	17	7.740	130.6
	18	7.738	130.8
	20	7.748	131.0
	22	7.750	131.2
	23	7.735	131.5
	24	7.725	131.6
	25	7.725	131.8
	27	7.730	131.8
	28	7.730	131.9
	29	7.725	131.7
	30	7.730	131.6
	31	7.732	131.5

Source: HKMA Monthly Statistical Bulletin.

But the chief culprits were those banks that funded the speculators, or participated in the speculation. Why should the HKMA come to the aid of such banks, which had only themselves to blame for aiding the speculators and for not managing its Hong Kong dollar liquidity properly?

This said, however, the HKMA did make a technical error when, in its circular of October 23, it did not define what was meant precisely by "repeated borrowers." Thus while overnight HIBOR soon eased, term HIBOR remained higher than the best lending rates, as shell-shocked banks stubbornly held on to their liquidity. It was not until the HKMA issued another circular on November 12, clarifying the definition of "repeated borrowers," that term HIBOR began to drift downwards across the board.³

Table 4.1 shows that, even during the critical month of October 1997, the U.S. dollar rate fluctuated within the narrow range of 7.725–7.75, while the trade-weighted exchange rate index, comprising 17 currencies of Hong Kong's most important trading partners, also remained remarkably stable within the range of 130.2–131.9. These figures clearly demonstrated the effectiveness of HKMA's defense of the linked rate at around 7.75, even against the formidable onslaught of international speculators.

Nevertheless, despite the apparent stability of the exchange rate, conditions in the forex market and money market remained tense. Interest rate differential between Hong Kong and the United States widened substantially, reflecting not only the "Asian premium" but also doubts about the sustainability of Hong Kong's own currency peg among international investors. In January 1998, confidence was shaken further by the failure of two securities investment firms, the Peregrine Group and C. A. Pacific; the political and economic turmoil in Indonesia, with the rupiah falling to a low of over 10,000 to US\$1 on January 8; and the deterioration of the Japanese economy. On January 12, the best lending rate was raised again by 0.75% to 10.25%, the highest since 1991. It was lowered only marginally by 0.25% on March 30.

Under the double pressures of higher interest rates and deteriorating economic fundamentals, both the equity market and the property market continued their downward adjustments. A more detailed analysis of the asset markets will be given in the next chapter.

Although the defense of the currency in October was successful, the high price paid in terms of interest rate volatility, incipient collapse of the asset markets, and worsening performance of the economy had given rise to considerable criticisms. The Financial Secretary of the Hong Kong SAR government therefore called for a review of the currency defense, and views and suggestions were solicited from the financial, professional, and academic communities. The conclusions and recommendations of the review are contained in the "Report on Financial Market Review" published by the Financial Services Bureau of the SAR government in April 1998.

The report reaffirmed and endorsed the defense strategy of the HKMA and argued that the "interest rate pain" was an inevitable feature of the linked exchange rate regime, a variant of the Currency Board Arrangement (CBA). Apart from supporting the idea of the "fixed mortgage rate" plan, it had virtually no new ideas for the monetary sector. It rejected the suggestions of US\$LAF, Exchange Fund Notes redeemable or guaranteed in U.S. dollars, and "dollarization" advanced by some local and overseas scholars. On the banking system, it merely supported the idea of a strategic review conducted by a consultancy firm. Concerning the securities and futures markets, it recommended

some reform measures, all of a technical nature, but firmly rejected the suggestion of market manipulation. In sum, the report had a tone of self-satisfaction and failed to tackle the crucial problem of confidence in the currency. As we shall see, the report was quickly overtaken by subsequent events.

THE "DOUBLE MARKET PLAY"

During the spring and summer of 1998, both the domestic economic situation and the external environment continued to deteriorate rapidly. At the end of May, the government announced that real GDP growth in the first quarter had turned negative. For Hong Kong, which was used to continuous positive growth even during the severe downturn of 1974–75, this worse-than-expected news came as a great shock. Externally, Indonesia was engulfed in political strife and economic turmoil, while Japan's recession worsened sharply, with the yen caught in a downward spiral. In mid-June, the yen fell to as low as 145 to the U.S. dollar, and only a one-off joint intervention temporarily stopped its free fall.

Meanwhile, the HKMA, in an effort to increase the transparency of the currency board operations, began to publish daily figures of the clearing balance of the banking system and its forecasts. The purpose of this measure is to alert the banking system of any possible liquidity squeeze, so as to avoid another crunch like that of the "Black Thursday." While this was undoubtedly of some psychological and technical value, in itself it could not stamp out speculation against the Hong Kong dollar.

In fact, beginning from about early 1998, hedge funds had been borrowing and building up Hong Kong dollar funds up to about HK\$30 billion through swaps with multilateral institutions such as the World Bank, Asian Development Bank, European Investment Bank, Nordic Investment Bank, European Bank for Reconstruction and Investment, and the Council of Europe.⁴ At the same time, they had also built up short positions in the securities and futures markets, so that by August, they held some 80,000 short contracts. Thus began the infamous "double market play" by international speculators in July and August of 1998. The modus operandi can be roughly described as follows. Speculators aggressively sold short the Hong Kong dollar on both the spot and forward markets, coupled by simultaneous shorting of Hong Kong stocks on both the cash and futures markets. Since the selling of the Hong Kong dollar would normally push up HIBOR, the stock market and futures market would fall heavily. If the speculators were not checked, they could reap enormous profits from both the forex and the securities markets. The collapse of the asset markets could cause serious

difficulties for the banks or even trigger a banking crisis, which in turn would make the currency peg impossible to defend, as had happened in other countries like Thailand.

Moreover, in July and August, the speculators and their friends orchestrated a campaign of lies and rumors concerning the renminbi and the Hong Kong dollar, exploiting unscrupulously a series of bad news events, such as the floods in China and the deepening slumps in Hong Kong and Japan. In effect, the objective of the vicious “double market play” was to bring down the whole financial system.

Confronted with this threat, the Hong Kong government and the HKMA decided on August 14 to launch a counterattack against the speculators and manipulators by directly buying in the securities markets. Since this operation concerned the asset markets, we will defer it to the next chapter for a more detailed treatment. In this chapter, we will confine ourselves to the speculation against the currency.

It so happens that the summer months of July and August are normally “dry” months for the Treasury. The government therefore asked the HKMA to convert part of its fiscal reserve, previously denominated in U.S. dollars, back into Hong Kong dollars. Thus, when the HKMA countered the speculators’ buying of U.S. dollars by selling the same, the banking system’s clearing balance was not debited with the Hong Kong dollar equivalent, as the government needed it for spending. Hence, while the HIBOR also rose, it did not rise as much as the speculators had hoped for. Certainly the extreme conditions of the “Black Thursday” were not repeated.

Table 4.2 presents daily closing exchange rates of the U.S. dollar and the trade-weighted exchange rate index during the critical month of August 1998. Actually, in January and June, there were also attacks on the currency, but as they were of smaller scale, their daily figures are not reproduced, due to space constraint.

As may be seen from the table, from August 1 to 22, the U.S. dollar rate was perilously close to 7.75, where the HKMA drew the line for its defense. Indeed, on August 14–18, the rate closed at 7.75; on August 22, the line was briefly breached to close at 7.751. After that, however, the rate eased again to below 7.75, signifying that the speculators were once again repulsed. The trade-weighted index varied within a narrow range of 138.1 to 140.1. In fact, this index, reflecting the weakness of the Japanese yen, was too high for the comfort of Hong Kong’s export industries and economy.

THE “SEVEN TECHNICAL MEASURES”

Although the HKMA had successfully beaten back four major waves of speculative attacks against the Hong Kong dollar, the territory’s

TABLE 4.2
Daily Exchange Rates of U.S. Dollar and Trade-Weighted Exchange Rate Index, August 1998

		<i>HK\$ per US\$</i>	<i>Trade-Weighted Exchange Rate Index (Nov. 1983 = 100)</i>
August	1	7.748	138.1
	3	7.748	139.1
	4	7.749	139.1
	5	7.749	138.9
	6	7.749	139.2
	7	7.748	139.5
	8	7.748	139.8
	10	7.747	139.9
	11	7.749	140.1
	12	7.748	139.6
	13	7.748	139.8
	14	7.750	139.3
	15	7.750	139.6
	18	7.750	139.8
	19	7.747	139.7
	20	7.748	139.2
	21	7.747	139.2
	22	7.751	139.4
	24	7.749	139.8
	25	7.741	139.8
	26	7.743	139.8
	27	7.743	139.8
	28	7.745	139.8
	29	7.746	139.1
	31	7.743	139.3

Source: HKMA Monthly Statistical Bulletin.

economic and financial situation in the summer of 1998 was extremely grave. By the end of July, the authorities had realized that, in order to prevent further speculations, it was necessary to strengthen public confidence in the currency. But public confidence could not be strengthened without some tangible commitment from the Government itself. Second, the authorities also realized that they could not rely on interest rate alone as the sole weapon of defense, given that interest rate was a double-edged weapon. Specifically, the monetary base, defined until that time as the sum of legal tender currency plus the banking system's clearing balance, was too narrow.⁴ Even a moderate amount of U.S.

dollar selling by the HKMA in response to speculators' attacks would be enough to drive the aggregate balance into negative territory, forcing up HIBOR to an unnecessarily high level. In short, the authorities had to come to grips with the crux of the matter, which the April "Report on Financial Market Review" failed to address.

I was a member of the Exchange Fund Advisory Committee of the government from April 1, 1997, to December 31, 1998; in that capacity, I took part in all the major decisions for the defense of Hong Kong's monetary and financial system during that time. Moreover, on August 1, I was appointed a member of the Subcommittee of Currency Board Operations chaired by Joseph Yam, Chief Executive of the HKMA. During the extremely critical month of August 1998, the subcommittee met frequently and discussed intensively a new strategy for defending the Hong Kong dollar and strengthening the working of the currency board arrangement. This new strategy was unveiled on September 5 in the form of "Seven Technical Measures."⁵ They are so important that they need to be elaborated as follows:

1. The HKMA provides a clear undertaking to all licensed banks to convert Hong Kong dollars in their clearing accounts into U.S. dollars at the fixed exchange rate of HK\$7.75 to US\$1. This is known officially as the Convertibility Undertaking.
2. The bid rate of the Liquidity Adjustment Facility (LAF) is abolished.
3. A Discount Window replaces the LAF with the Base Rate (formerly known as the LAF Offer Rate), to be determined from time to time by the HKMA.
4. The HKMA removes the restriction on repeated borrowing in respect of the provision of overnight Hong Kong dollar liquidity through repo transactions using Exchange Fund bills and notes.
5. New Exchange Fund paper will be issued only when there is an inflow of funds.
6. A schedule of discount rates is applicable for different percentage thresholds of holdings of Exchange Fund paper by the licensed banks for the purpose of accessing the Discount Window.
7. The restriction on repeated borrowing in respect of repo transactions involving debt securities other than Exchange Fund paper is retained.

The first measure clearly demonstrates the government's commitment to the linked exchange rate regime. It is true that the undertaking is limited to the licensed banks, and furthermore only to the extent that they have credit balances on their clearing accounts. In other words, there is no guarantee for all bank deposits. Nevertheless, some guaran-

tee is better than no guarantee at all. Moreover, this limited undertaking is credible, because it is enforceable under Hong Kong's legal system.

The second measure takes into account the new reality of AFC and the evolving interbank market. It has the additional function of preventing some banks from deliberately placing funds with the HKMA rather than with the interbank market, thus causing unnecessary interest rate volatility.

The third and fourth measures replace the relatively informal LAF with a formal Discount Window and allow freer access to day-end liquidity through the pledging of Exchange Fund paper, which is fully backed by foreign exchange reserves. They will make the money market less susceptible to manipulation and will dampen excessive interest rate volatility, without departing from CBA discipline. They will also in effect broaden the definition of "monetary base" by including Exchange Fund paper.

The fifth measure ensures that all new Exchange Fund paper will be fully backed by foreign exchange reserves, in accordance with the broadened definition of "monetary base" and CBA discipline.

The sixth measure is designed to prevent excessive use of Exchange Fund paper by charging a penal rate when such use exceeds a certain threshold of a bank's holdings. Thus, for the first 50% of Exchange Fund held by a licensed bank, the applicable discount rate is the base rate; over that threshold, the applicable rate is the Base Rate plus 5% or overnight HIBOR for the day, whichever is higher.

The seventh measure deals with eligible paper other than Exchange Fund paper. Overnight repos using such paper will still be allowed. For triple-A rated paper and Specified Instruments, the schedule of discount rates for Exchange Fund paper will apply.⁶ For other eligible paper, the schedule of discount rates will be at a premium of 0.25% over those applicable to Exchange Fund paper. Repeated borrowings, in accordance with the existing definition, using eligible paper other than Exchange Fund paper, will continue to be discouraged through penal rates.

Two other points need clarification. The first is that the exchange rate at which the "Convertibility Undertaking" took effect was initially fixed at 7.75, not the official rate of 7.8. This was done because, as mentioned earlier, the HKMA had chosen 7.75 as the "intervention rate" when the AFC broke. In time, the market came to regard 7.75 as the de facto official rate. The HKMA's strategy had been severely criticized by some purists as a violation of the automatic adjustment mechanism inherent in the CBA. The HKMA's response was that allowing the exchange rate to rise above 7.75 might well precipitate a *sauve qui peut* due to the public's "herd instinct." It is difficult to either support or reject this claim, because of the impossibility of conducting controlled

experiments. But there are two undesirable side effects that the HKMA implicitly acknowledges: overvaluation of the domestic currency and excessive interest rate volatility. Accordingly, shortly after the seven "technical measures" were implemented, the HKMA also accepted a recommendation of the Sub-Committee on Currency Board Operations that, effective from April 1, 1999, the exchange rate would be raised by HK\$0.0001 every day, so that by the end of 500 calendar days, the Convertibility Undertaking rate would coincide with the official rate. This scheme has worked very well, without any adverse effect on the forex market, because the adjustments have been preannounced and infinitesimal. Indeed, the actual market rate since April 1, 1999, has tended to be below the daily announced "Convertibility Undertaking" rate, especially during the last two months of 1999, when there was substantial inflow of capital.

The other technical problem was the determination of the Base Rate, the rate at which the Discount Window discounts eligible paper. After consultations with the Hong Kong Association of Banks (HKAB) and academic economists, the subcommittee recommended a formula, as follows: Base Rate = U.S. Fed Fund Target Rate + risk factor or simple average of 5-day moving averages of overnight and 1-month HIBOR, whichever is higher. This formula was approved by the Exchange Fund Advisory Committee to take effect from November 26, 1998. The risk factor was fixed at 150 basis points, but this factor as well as the whole formula would be reviewed from time to time as appropriate.

Finally, to achieve greater transparency, starting from November 25, 1998, the HKMA would publish the size of the monetary base and its components on a daily basis.

When the subcommittee on Currency Board Operations recommended these measures in late August 1998, its members, including myself, regarded them as "technical" only and did not entertain any high hopes concerning their ability to improve the economic and financial conditions substantially. However, these measures have proved to be much more effective than expected.

First, the most sensitive and reliable indicator of confidence, the premium on U.S. dollar forward rate, fell steadily from August 1998 onward across the board. Indeed, by the end of 1999, the premium on shorter maturities had fallen to the pre-AFC levels, as shown in Table 4.3.⁷

Second, the average HIBOR also fell steadily across the whole term structure from August 1998, as shown in Table 4.4, though the downward trend was less dramatic than that of the forward premium.

Third, the yield differentials between Hong Kong Exchange Fund Notes and U.S. Treasury Bonds, another measure of the "Hong Kong premium," also narrowed substantially, as shown in Table 4.5.

TABLE 4.3
Premium on U.S. Dollar Forward Exchange Rates (HK\$ per US\$)
(decimal points, period averages)

<i>During</i>	<i>1-week</i>	<i>1-month</i>	<i>3-month</i>	<i>6-month</i>	<i>9-month</i>	<i>12-month</i>
1996	-1	-2	5	37	92	161
1997	19	96	302	608	880	1,153
1998	32	149	543	1,356	2,266	3,264
Aug	116	438	1,203	2,488	3,703	5,010
Sep	35	187	765	1,826	3,015	4,235
Oct	8	41	267	826	1,568	2,394
Nov	5	28	179	648	1,232	1,896
Dec	4	8	93	448	951	1,512
1999	6	44	223	624	1,099	1,650
Feb	9	47	215	662	1,160	1,776
Mar	4	26	139	489	947	1,547
Apr	0	7	62	233	519	931
May	0	5	58	266	568	915
Jun	8	29	94	286	593	959
Jul	11	50	154	378	662	996
Aug	14	66	205	508	833	1,171
Sep	5	31	123	351	615	909
Oct	4	17	73	222	426	691
Nov	2	9	58	175	343	573
Dec	-8	-12	11	99	220	396

Source: HKMA Monthly Digest of Statistics

TABLE 4.4
Hong Kong Interbank Offered Rate (% per annum, period average)

<i>During</i>	<i>Overnight</i>	<i>1-week</i>	<i>1-month</i>	<i>3-month</i>	<i>6-month</i>	<i>9-month</i>	<i>12-month</i>
1996	5.10	5.20	5.30	5.46	5.61	5.67	5.88
1997	6.03	6.91	6.85	7.12	7.29	7.34	7.47
1998	5.59	6.53	7.42	8.06	8.73	8.97	9.31
Aug	9.84	12.13	12.03	11.78	12.02	11.63	11.71
Sep	5.83	7.01	8.29	9.19	9.93	10.02	10.33
Oct	4.52	5.00	5.67	6.44	7.03	7.32	7.74
Nov	4.61	5.05	5.43	5.99	6.54	6.79	7.31
Dec	4.23	4.55	5.25	5.48	5.97	6.36	6.73
1999	3.96	4.80	5.39	5.87	6.33	6.53	6.92
Feb	4.96	5.23	5.59	5.99	6.62	6.98	7.27
Mar	4.50	4.76	5.16	5.55	6.17	6.69	7.17
Apr	4.44	4.56	4.86	5.14	5.48	5.95	6.30
May	4.47	4.63	4.86	5.17	5.63	6.14	6.43
Jun	5.21	5.36	5.36	5.53	5.93	6.47	6.80
Jul	5.51	5.67	5.86	5.95	6.39	6.63	6.90
Aug	5.55	5.93	6.17	6.40	7.01	7.17	7.35
Sep	5.12	5.43	5.76	6.00	6.69	6.88	7.03
Oct	5.37	5.44	5.56	6.29	6.43	6.70	6.92
Nov	5.01	5.24	5.49	6.20	6.30	6.53	7.92
Dec	3.58	4.59	6.01	5.97	6.13	6.44	6.68

Source: HKMA Monthly Digest of Statistics

TABLE 4.5
Yield Differentials between Exchange Fund Notes and U.S. Treasury
Bonds (basis points) (period averages)

		<i>2 year</i>	<i>5 year</i>	<i>10 year</i>
1997	June	8.3	39.2	71.1
	July	38.6	65.0	65.7
	Aug	81.8	74.8	79.2
	Sep	78.5	67.8	74.0
	Oct	126.3	104.3	110.6
	Nov	360.1	284.1	236.7
	Dec	390.9	326.6	305.2
1998	Jan	543.4	461.2	438.4
	Feb	375.0	371.6	370.2
	Mar	235.6	242.7	254.4
	Apr	204.3	236.0	246.3
	May	288.9	314.2	328.4
	June	436.3	434.4	441.8
	July	421.5	453.7	467.2
	Aug	463.5	455.0	449.1
	Sep	444.8	446.9	431.0
	Oct	333.6	336.1	306.8
	Nov	232.1	254.6	236.6
	Dec	175.0	183.4	199.4
1999	Jan	202.2	213.9	206.9
	Feb	201.6	211.0	219.0
	Mar	170.7	188.6	199.5
	Apr	118.6	154.9	172.7
	May	102.8	144.5	175.8
	June	88.9	136.2	176.7
	July	80.9	130.0	170.4
	Aug	70.0	110.4	153.0
	Sep	74.1	117.8	153.3
	Oct	52.3	95.6	139.9
	Nov	33.6	89.2	141.8
	Dec	14.4	80.2	141.5

Source: Underlying data from "Currencies and Capital Markets," *South China Morning Post*

Confidence in the currency further strengthened in November 1999 by a series of good news. First, the government successfully disposed of HK\$33.33 billion worth of its portfolio (about 16% of its current market value) acquired during its intervention in the securities markets in August 1998, thus adding to an already strong fiscal reserve deposited with the Exchange Fund. Second, it was announced that

real GDP recorded a year-on-year growth of 4.5% in the third quarter, much better than expected. Third, the government also announced that it had concluded an agreement with Walt Disney to build a theme park in Hong Kong, enhancing enormously the territory's position as a tourist center, which would also provide much impetus to certain depressed sectors such as construction, retailing, and hotels. As a result of these developments, there was a significant inflow of capital in the last two months of 1999. Not only was the spot rate of the U.S. dollar consistently below the government's "Convertibility Undertaking" rate, but also the premium on U.S. dollar forward rate for short maturities up to one month had turned negative, the first time since the AFC broke out in July 1997.⁸

Thus, while it would be premature to claim that the risk of currency attack has ceased to exist, it could nevertheless be safely said that as the AFC was drawing to a close, speculators against the Hong Kong dollar during 1997-99 had been completely routed.

WHY HAS THE PEG SURVIVED THE AFC?

During the financial turmoil of 1997-99, a host of pundits, financial analysts, and other self-proclaimed experts have regularly opined and declaimed, ad nauseam, that the Hong Kong dollar's link with the U.S. dollar at 7.8 could not survive the AFC, that neither the authorities nor the people of Hong Kong could stomach the pains of adjustments, that China would not allow Hong Kong to squander its foreign reserves in battling the speculators, and that therefore the fall of the Hong Kong dollar was a matter of time. Many had gone so far as to predict the magnitude of the necessary devaluation. It would be highly amusing to compile and review the pronouncements of such "experts" and to see how they had to eat their own words. We must be content, however, with the more mundane but serious task of explaining why Hong Kong's exchange rate regime and monetary system have survived the AFC unscathed.

One obvious reason is Hong Kong's strong foreign exchange reserve which, moreover, is a free reserve as the territory has no sovereign debt. Table 4.6 presents the end-of-month figures of Hong Kong's official reserves, which by convention, do not include gold holdings. As may be seen, the ratio of foreign reserves to currency was over 5 times before the handover, but after the handover in July 1997, the ratio has increased to over 7 times, as China punctually transferred the Land Fund under its custody to the Hong Kong SAR government. Moreover, during 1997-99, the ratio of foreign reserves to retained imports averaged more than 17 months. At its height, Hong Kong's foreign reserve ranked third

TABLE 4.6
Hong Kong's Foreign Exchange Reserves (US\$ billion)

<i>Year</i>	<i>End of Month</i>	<i>Amount</i>	<i>Ratio of Reserves to Currency</i>
1997	Jan	65.9	5.1
	Feb	63.8	5.3
	Mar	63.4	5.2
	Apr	63.6	5.6
	May	66.6	5.8
	June	67.6	5.4
	July	81.6	7.1
	Aug	85.4	7.3
	Sep	88.2	7.4
	Oct	91.4	7.8
	Nov	96.5	8.3
	Dec	92.9	7.8
1998	Jan	98.1	6.7
	Feb	96.8	7.9
	Mar	96.8	8.2
	Apr	96.1	8.2
	May	96.4	8.1
	June	96.5	8.3
	July	96.5	8.4
	Aug	92.1	8.1
	Sep	88.4	7.4
	Oct	88.7	7.7
	Nov	88.6	7.7
	Dec	89.6	7.5
1999	Jan	90.1	7.2
	Feb	89.8	6.8
	Mar	89.5	7.0
	Apr	89.5	7.2
	May	88.9	7.3
	June	88.5	7.2
	July	89.1	7.3
	Aug	89.2	7.1
	Sep	90.5	7.1
	Oct	90.3	7.2
	Nov	92.6	7.3
	Dec	96.3	6.0

Source: HKMA Monthly Statistical Bulletin

TABLE 4.7
Foreign Currency Deposits 1997–99

<i>Year</i>	<i>End of Month</i>	<i>Foreign Currency Deposits (HK\$m)</i>	<i>% of Total Deposits</i>
1997	July	1,117,967	41.8
	Aug	1,118,876	42.1
	Sep	1,147,286	42.3
	Oct	1,197,821	44.5
	Nov	1,179,538	44.4
	Dec	1,170,454	43.9
1998	Jan	1,205,487	45.1
	Feb	1,213,430	44.8
	Mar	1,197,037	44.1
	Apr	1,184,541	43.8
	May	1,166,548	43.7
	June	1,187,203	43.8
	July	1,223,388	43.5
	Aug	1,251,789	43.9
	Sep	1,268,155	44.1
	Oct	1,306,772	44.3
	Nov	1,279,861	43.9
	Dec	1,298,328	43.9
1999	Jan	1,318,118	44.6
	Feb	1,306,884	44.5
	Mar	1,299,401	44.0
	Apr	1,315,750	43.8
	May	1,311,100	43.9
	June	1,314,979	43.9
	July	1,373,856	45.0
	Aug	1,394,649	45.6
	Sep	1,413,141	45.6
	Oct	1,414,468	45.5
	Nov	1,438,972	45.6
	Dec	1,445,082	45.5

Source: HKMA Monthly Statistical Bulletin

in the world, but this fell to the fifth in the second half of 1998, as the HKMA had to use some of the reserves to combat the speculators. But in terms of per capita holding of foreign reserves, Hong Kong's world ranking has remained second, next only to Singapore.

The mere existence of strong reserves, however, is not enough to deter speculators. There must also be the willingness to use such reserves if and when necessary. Thus, Singapore and Taiwan also have enormous

reserves. In fact, on a per capita basis, Singapore has ranked first in the world for many years. Yet, very early during the AFC, both Singapore and Taiwan chose “competitive devaluation” as a way out of their difficulties. There is therefore a crucial difference between the ability and the will to defend the currency.

By contrast, Hong Kong has always had both the ability and the will to defend its currency. Quite early on in the AFC, Hong Kong had decided to tough it out and to accept the costs of domestic adjustments. During that time, Hong Kong had used a substantial part of its foreign reserves to battle the speculators not only in the forex market, but in the securities markets as well, as we shall see in the following chapter, to thwart their “double market play.”

However, prophets of doom for the Hong Kong dollar insist that no fixed exchange rate regime can last long against continuous speculation even if the authorities have both the ability and the will to defend the currency. This seemingly plausible argument ignores the fundamental difference between a fixed exchange rate under a currency board arrangement (CBA) and a non-CBA fixed exchange regime. Hong Kong’s linked exchange rate is, of course, a variant of the CBA. It is well known that under the CBA, there is an automatic adjustment mechanism, which used to be called the price-specie-flow mechanism in the days of the gold standard. Now that the gold standard is only a historical relic, and the banking system is much more developed and sophisticated, a more appropriate name should be, in my opinion, the Cantillon-Hume mechanism, after the two eminent economists who discovered it. A contemporary interpretation of this mechanism is given in the chapter appendix.

Briefly, to put it in words, under the CBA, the monetary base is fully backed by foreign reserves, primarily in terms of the anchor currency. Whenever there is a loss of reserves, for whatever reason, such as outflow of capital, speculative attack, or balance of payments deficit, the monetary base will contract because of the foreign exchange constraint. This contraction of the monetary base will drive up interest rates and initiate a series of downward adjustments in prices, costs, and wages as required for the fixed exchange rate. Eventually, both the higher interest rates and the improved competitiveness will attract capital inflow and restore the original equilibrium. This was basically what happened in Hong Kong during 1997–99.

Meanwhile, the “seven technical measures,” explained in some detail earlier, have greatly improved the working and efficacy of the CBA. For instance, the HKMA’s Convertibility Undertaking shows that it is putting its money where its mouth is, which enormously enhances its credibility and public confidence that the peg will hold.

By contrast, under the non-CBA fixed exchange rate regime, there is no prior foreign exchange constraint. Even after a substantial loss of

foreign reserve, the monetary base will not necessarily contract, and there is no automatic adjustment mechanism to restore the original equilibrium. Thus, the Central Bank can still print or create more money in the face of a serious payments deficit. Under such a regime, it is indeed true that the fixed exchange rate cannot withstand prolonged speculative attacks.

Soon after the AFC began, I wrote an article entitled "Of Boards and Pegs," which was first published in the *Asian Wall Street Journal* and then reprinted in the *HKMA Quarterly Bulletin*.⁹ I concluded the article by saying that "failure to understand in depth Hong Kong's monetary system explains why, during the past 14 years, countless predictions of the imminent fall of the link have proved to be grotesquely wrong. It also explains why speculators against the Hong Kong dollar have repeatedly been routed." This conclusion appears to be as valid today as when it was written in August 1997.

Despite painful domestic adjustments, which resulted in the worst recession in more than 40 years, the people of Hong Kong have borne the ordeal stoically. There were grumbles from time to time, of course, but there was no mass unrest or calls for the abandonment of the peg. Opinion polls have consistently shown that the majority of the population still support the linked exchange rate.¹⁰ A more substantive evidence is that even during the most critical period, such as the summer of 1998, there was no general panic and shift into foreign currencies.

In the previous chapter, we have shown that during the confidence crisis of 1982–83, there was massive portfolio shifting into foreign currency deposits, which calmed down only after 1990. During the AFC, the proportion of foreign currency in total bank deposits did rise moderately after the "Black Thursday," but it generally stabilized at around the 43%–46% level. It never reached over-50% levels during 1986–1993.

This remarkable absence of panic on the part of the public was partly due to the memory of how the linked exchange rate had saved Hong Kong from total collapse in 1983, and partly to the Government's resolve and ability to hold the line against the speculators.

Another important reason that the Hong Kong dollar has remained solidly stable is the territory's traditional fiscal discipline and probity. Fiscal deficit is the exception rather than the rule. In the half century before the AFC, there was a surplus of varying size in all but five fiscal years. Hong Kong has little or no sovereign debt, denominated in foreign currencies. The HKMA, it is true, has issued sizeable Exchange Fund bills and notes, but as explained earlier, they are designed for monetary policy and debt market development purposes, not for covering fiscal deficit. Such debt, moreover, is adequately covered by the Exchange Fund's assets and operating profits. Other public bodies such as the Mass Transit Railway and the Airport Authority have issued

bonds, mostly in Hong Kong dollars. In short, the default of foreign currency debt, which triggered the AFC, was not a problem for Hong Kong.

As a result, the government has accumulated a sizeable fiscal surplus, which stood at HK\$458 billion (US\$59 billion) as of April 1, 1998. Because of the serious recession in the wake of the AFC, the government has had to use expansionary fiscal policy for stabilization purposes, resulting in substantial deficits for two consecutive fiscal years, 1998–99 and 1999–2000. The Financial Secretary predicted in his budget speech that the fiscal reserves would fall from HK\$458 billion to a low of HK\$383 billion (US\$49 billion) at March 31, 2001, before picking up again.¹¹ Even this reduced figure is still formidable, and it is surely a *rara avis* in today's world, where government deficit is the norm rather than the exception.

Last but not least, China's support is also a key factor for the robustness of the linked exchange rate. This support has taken three forms. First, on the very day of the reunification, July 1, 1997, China transferred the huge Land Fund, worth some HK\$197 billion (of which US\$15.8 billion were in foreign currencies), to the Hong Kong SAR government punctually in accordance with its pledge.¹² Hong Kong's foreign exchange reserves and fiscal reserves thus grew overnight by 23% and 20% respectively. This not only boosted Hong Kong's financial resources but also enhanced public confidence in the currency tremendously. Second, ever since the outbreak of the AFC, China's leaders, from President Jiang Zemin downward, have repeatedly declared China's support for Hong Kong's currency peg and its promise to come to Hong Kong's aid if requested. Although Hong Kong has never requested such aid, China's pledge has nevertheless been an important morale booster. Moreover, China's premier, Zhu Rongji, has also repeatedly pledged that the renminbi will not be devalued in the course of the AFC, a pledge that has remained valid. Third, under the Basic Law, China is responsible for Hong Kong's defense. By the same token, China itself absorbs the cost of its garrison in Hong Kong. By contrast, under British rule, Hong Kong had to pay 65% of the foreign exchange costs of the British garrison, under the bilateral "Defense Cost Agreement." In the last three years of British rule, such costs averaged about HK\$1 billion annually. Although the sum is not large, it is still a saving for Hong Kong, adding to the territory's fiscal reserves, and can be used to support the economy. I estimate that, during the severe recession of 1998, this saving was able to support the livelihood of 22,000 persons under the "Comprehensive Social Security Assistance (CSSA) scheme."

Hong Kong's successful defense of its currency during the AFC is a remarkable achievement, one that is likely to be remembered by future historians as an epic event in the annals of international finance.

CHAPTER APPENDIX: A NOTE ON THE CANTILLON-HUME MECHANISM

The price-specie-flow mechanism, or the automatic adjustment mechanism under the gold standard, has been widely attributed to David Hume (1711–76), the renowned Scottish philosopher and economist. Careful research now establishes that Hume was anticipated by many other writers, notably Richard Cantillon (1680–1734), an Irish economist and banker. His masterpiece, *Essai sur la nature du commerce en général*, was written and published in French. This perhaps explains why he was better known and more influential in France than in English-speaking countries.

Cantillon was “rediscovered” by the eminent English economist, W. S. Jevons (1881), who thought his treatment of currency, foreign exchange, and bank credit, judged against the work of the time, “almost beyond praise” (p. 342). Schumpeter (1954) considered Cantillon’s analysis of banks, bank credit, and coinage a “brilliant performance, which in most respects stood unsurpassed for about a century” (p. 223). He further said that although many economists had described and discussed the automatic adjustment mechanism, the most eminent were “Cantillon and Hume” (p. 366).

Hong Kong’s linked exchange rate regime is a variant of the Currency Board Arrangement, which in turn works more or less like the Gold Standard, except that the anchor currency (U.S. dollar in Hong Kong’s case) now replaces gold. Since there is no specie flow involved, it seems more appropriate to call the automatic adjustment mechanism the Cantillon-Hume mechanism.

Cantillon and Hume wrote at a time when money consisted almost entirely of currency. Their automatic mechanism was one where gold inflow and outflow matched changes in currency one for one. The modern version of the Cantillon-Hume mechanism takes into account a much more sophisticated banking system and a key concept called monetary base. It says that changes in foreign reserves lead to proportional changes in monetary base, and hence in money supply, in the same direction.

The easiest way to present this modern version is to use the well-known model of money supply determination developed by Friedman and Schwartz (1963) and modify it for our purposes.

The Friedman-Schwartz framework can be described as follows:

Let

M = money supply (The various definitions of money can be ignored because they will not affect the substance of the model.)

C = legal tender currency

D = total bank deposits (Again, the various forms of deposits can be ignored.)

H = high-powered money, or monetary base

R = banks' reserves with the Central Bank or monetary authorities

Then, by definition,

$$M = C + D \quad (1)$$

$$H = C + R \quad (2)$$

Dividing equation (1) by equation (2), and further dividing through by C and multiplying through by D/R ,

$$\frac{M}{H} = \frac{C + D}{C + R} = \frac{D/R(1 + D/C)}{C/R + D/C} \quad (3)$$

Let $b = D/R$, $p = D/C$, and by substituting and rearranging,

$$M = H \cdot b(1 + p)/(b + p) \quad (4)$$

It will be noted that b is the reciprocal of the reserve ratio, the banks' behavioral parameter, while p is the reciprocal of the currency ratio, the nonbank public's behavioral parameter. Taking logs of equation (4),

$$\log M = \log H + \log b + \log(1 + p) - \log(b + p) \quad (5)$$

Differentiating equation (5) with respect to time, t , and collecting terms,

$$\frac{\dot{M}}{M} = \frac{\dot{H}}{H} + \frac{P}{b(b+p)} \frac{db}{dt} = \frac{(b-1)}{(1+p)(b+p)} \frac{db}{dt} \quad (6)$$

where a dot over a variable means its time derivative, i.e., $\dot{M} = \frac{dM}{dt}$ etc.

Friedman and Schwartz assume that

$$\frac{p}{b(b+p)} \approx \frac{1}{b'(1+p)(b+P)} \approx \frac{1}{p}$$

Substituting into equation (6),

$$\frac{\dot{M}}{M} \approx \frac{\dot{H}}{H} + \frac{\dot{b}}{b} + \frac{\dot{p}}{p} \quad (7)$$

They further assume that b , p , the two behavioral parameters, are stable and can be taken as constants in the short run. Hence,

$$\frac{\dot{M}}{M} \approx \frac{\dot{H}}{H} \quad (8)$$

This framework can be modified for the Currency Board Arrangement (CBA) case. Let F = foreign reserves. Then CBA requires that

$$H = \alpha e F \quad (9)$$

where e is the exchange rate, α is the ratio of H to F . Note that in Hong Kong, there is no Central Bank, and the Hong Kong Monetary Authority does not require the banks to keep reserves with it against their deposit

liabilities. However, it does require them to keep positive clearing balances with it since the implementation of the Real Time Gross Settlement in December 1996. Hence R in (2) should denote aggregate clearing balance of the banking system.

Second, e in Hong Kong means of course the peg at US\$1=HK\$7.8. Third, the prototype CBA requires that $\alpha = 1$. But in Hong Kong, even the enlarged monetary base is 3.6 times backed by foreign reserves, hence $\alpha < 1$.

Substituting equation (9) back into equation (4), and working through the same algebraic manipulation, while assuming that α is constant,

$$\frac{\dot{M}}{M} \approx \frac{\dot{F}}{F} \quad (10)$$

From equation (8), we finally get

$$\frac{\dot{M}}{M} \approx \frac{\dot{F}}{F} \approx \frac{\dot{H}}{H} \quad (11)$$

In words, the proportional rate of change in foreign reserves is matched by approximately the same rates of change in monetary base and money supply in the same direction. This is the essence of the modern Cantillon-Hume mechanism.

By contrast, under the non-CBA conventional fixed exchange rate regime, the monetary base has no full foreign reserve cover. The loss of foreign reserves will not lead to a contraction in monetary base or money supply. Hence the inability of this regime to withstand speculative attacks.

One caveat is that the assumption that b, p are constants, while probably valid in normal times, may not hold in extreme circumstances, such as a severe banking crisis. The monetary authorities, in performing their lender-of-last-resort (LOLR) duties, may depart temporarily from the monetary rule in equation (11), even under a CBA.

This "LOLR" discretion has aroused the ire of some critics. As indicated in Chapter 3, Hong Kong's currency crisis in 1982–83 was also accompanied by a protracted banking crisis, which did not end until 1986. During that critical period, the Exchange Fund assumed a high profile in bailing out "problem banks," either by direct takeovers or by guaranteeing their doubtful assets to facilitate their acquisition by other banks (Jao, 1987).

These rescue operations were roundly condemned at the time. Purists argued that a currency board should not perform any banking function, whether central or commercial. It was true that before the 1980s, Hong Kong, following the classic currency board tradition, delegated the "LOLR" function to two British overseas banks that were also note-issuing banks: the Hongkong and Shanghai Banking Corporation (HSBC)

and the Standard Chartered Bank. But even then, it was tacitly understood that the Exchange Fund stood behind these two banks.

By the early 1980s, however, the political situation had changed so radically and the banking crisis had become so serious that the two British banks were no longer willing to perform the function of the "LOLR." Hence the Exchange Fund, Hong Kong's sole repository of foreign reserves and fiscal reserves, had no choice but to take over the function itself. Moreover, the government reasoned that the banking crisis, if not decisively brought under control, could fatally jeopardize the newly established linked exchange rate. In any case, the problem banks directly taken over (Overseas Trust Bank, Hong Kong Industrial and Commercial Bank, and Hang Lung Bank) were eventually sold at a profit to other financially sound banks. Thus, both the banking system and the linked exchange rate regime had been rescued at no cost to the taxpayer.

Another controversy concerned an institutional change called "accounting arrangements" introduced by the authorities in July 1988. Previously, all banks were required to keep clearing balances with the HSBC, the management bank of the clearing system, but the latter did not have to keep any clearing balances with anybody. Under the new arrangements, the HSBC itself was required to keep a clearing account with the Exchange Fund, where the balance should not be less than that of the rest of the banking system. The control of interbank liquidity thus passed from the HSBC to the Exchange Fund.

Greenwood (1988) attacked this change as the first step toward a central banking regime. Following him, Schwartz (1993) also declared that this change represented "a slippery slope that portends further erosion of rule-based behavior." As I pointed out at the time (Jao, 1988), Greenwood's claim was exaggerated, as the authorities did not have the power to issue fiat currency and did not require banks and other depository institutions to keep non-interest-bearing reserves with them. It was true that the move did give the authorities some limited capability to engage in "non-sterilized operations" (Chan, 1997; Freris, 1991; Jao, 1990). But this was designed to protect the link with the U.S. dollar, not to expand the authorities' central banking powers as such.

One point totally missed by the critics was the need to remove the special privilege of the HSBC, a privilege long resented by other banks. In December 1996, on the implementation of the Real Time Gross Settlement System (RTGS), the Hong Kong Monetary Authority took over from the HSBC the management bank's role as the settlement institution. All banks, including the HSBC, would henceforth keep settlement accounts direct with the HKMA (Hong Kong Marketing Authority, 1997). This was the logical outcome of a widely shared view in the banking industry that no profit-making bank that competes with

other banks should enjoy any quasi-central banking power. Similarly, the Liquidity Adjustment Facility, Hong Kong's version of the discount window, was established in 1992 in response to the demand by smaller banks that resented having to borrow continuously from the HSBC without any alternative. In any case, events since 1988 have amply shown that the key characteristics of the currency board remain intact, and the critics' assertion that Hong Kong is sliding into a full-scale central banking regime has not been borne out.

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NOTES

1. For a fuller account of the tactics of the speculators, see Financial Services Bureau (1998), pp. 17–18.
2. For the full text of the circular, see *ibid.*, Annex 3.2.

3. For the full text of the circular dated November 12, 1997, see *ibid.*, Annex 3.3. "Repeated borrowers" are defined as those licensed banks that have borrowed through LAF on eight occasions in any period of 25 days, or on four consecutive days on which LAF is open.

4. See Yam (1998b).

5. See HKMA Research Department (1998) for the official announcement and explanation of the "seven technical measures."

6. "Specified Instruments" denotes notes issued by public sector corporations like Hong Kong Mortgage Corporation, Airport Authority, and Mass Transit Railway Corporation under their respective notes-issuance programs arranged by HKMA.

7. The following numerical example will facilitate the understanding of Table 4.3. The closing spot rate of the U.S. dollar at the end of August 1998 was 7.743, and the corresponding premium on 12-month forward rate was 5,010. This meant that the market expected that the spot rate 12 months later would be $7.743 + 0.501 = 8.244$.

8. As reported in *South China Sunday Morning Post*, December 19, 1999.

9. See Jao (1997c). For other assessments of the linked rate regime, see Tsang, Cheng, and Sin (1998), and Kwan, Lui, and Cheng (1999).

10. See Financial Services Bureau (1998), pp. 19–20.

11. See "The 1999–2000 Budget: Speech by the Financial Secretary, 3 March 1999" (Hong Kong Government Printing Department), paras. 115–119.

12. The Land Fund was established in 1986 in accordance with the 1984 Sino-British Joint Declaration, under which one half of land sales prior to July 1, 1997, would be paid into the Land Fund and reserved for the future Hong Kong SAR government. Until July 1, 1997, the Land Fund was under the custody and management of the central government of the People's Republic of China.

Impact on the Asset Markets

INTRODUCTION

In the first few months after the outbreak of the Asian Financial Crisis (AFC), its negative impact on the asset markets was temporarily overshadowed by the euphoria over the smooth transition to Chinese sovereignty. During 1996–97, there was also a massive inflow of capital from Mainland China, which found its way into the securities and property markets in anticipation of a successful handover. The Hang Seng Index (HSI) of stock prices rose to a historic high of 16,673 on August 7, 1997. Indexes of rentals and prices of private sector residential and commercial office premises also reached their peaks in the third quarter of 1997, though rental and price indexes of private flatted factories peaked earlier in the first quarter of the same year. From October 1997 onward, however, in tandem with the worsening of the AFC, both securities and property markets experienced a rapid downturn, which at times bordered on a meltdown reminiscent of the crisis of 1982-83.

In the following sections, we review developments in the securities and property markets and the measures taken by the authorities to prevent a total collapse.

THE SECURITIES MARKETS: FROM CRISIS TO INTERVENTION

After reaching its peak on August 7, the HSI drifted downward in sympathy with other regional markets. At first, the correction was

relatively mild and orderly: by mid-October, the HSI had fallen to around 13,384, a decline of about 20%. But as described in the last chapter, the frantic speculative assault on the Hong Kong dollar, culminating in the “Black Thursday,” saw the HSI tumbling by 1,211 points, or by 10.4%, on October 23 alone, with a record turnover of HK\$34 billion. Next day, the market made a technical rebound of 718 points. However, Hong Kong’s “Black Thursday” soon reverberated worldwide; on October 27, the Dow Jones Industrial Average (DJIA) plunged by 554 points, which in turn triggered a record fall of HSI by 1,438 points (13.7%) on October 28. Following Wall Street’s rebound on October 28, the HSI closed with its largest single-day gain, by 1,705 points (18.8%), on October 29.¹

This extraordinary period of extreme volatility eased somewhat after the first week of November, but the HSI continued to drift downward, and by January 12, 1988, the HSI had fallen to a low of 8,121 on January 12, or off 51% from its peak, following the failure of two investment firms, the Peregrine Group and C. I. Pacific.

In the next three months, there was a mild technical rally, aided by a small cut in interest rates of 1/4% at the end of March 1998, bringing the HSI to the 10,000–11,810 range. However, from mid-May onward, as news of the negative growth in the first quarter became known and as the external environment continued to deteriorate rapidly, the HSI also began a steep downtrend. Meanwhile, as mentioned in the last chapter, hedge funds and other speculators were busily preparing their infamous “double market play” throughout the spring and summer of 1998. By August 13, the HSI was down to a low of 6,660, or down 60% from its peak at 16,673 on August 7, 1997. Other indexes also hit their lows. For example, the Hang Seng China Enterprises Index (H-share index) fell to 232 on August 28, down by 86.5% from its peak of 1,727 on August 25, 1997, while the Hang Seng China-Affiliated Corporation Index (Red Chips index) reached a low of 576, down by 86% from its peak of 4,110 on August 27, 1997. But it was the meltdown of HSI, the “Blue Chips” index, that caused the greatest concern.

In the morning of August 14, 1998, an emergency meeting of the Exchange Fund Advisory Committee (EFAC), of which I was a member, was held. The Financial Secretary, Mr. Donald Tsang, and the Chief Executive of the HKMA, Mr. Joseph Yam, briefed members on the imminent collapse of the stock market and futures market and its serious consequences for the banking system and the currency. In the words of Mr. Yam,

We had reason to believe that they (the hedge funds) had been building and maintaining quite large short positions in stock index futures. With an estimated 80,000 short contracts held among these hedge funds, for

every thousand-point fall in the stock market index, they stood to profit HK\$4 billion. The cost and benefit calculation is clear. And this is the case regardless of economic or market fundamentals. So they waited for a good opportunity to sell the Hong Kong dollars they had borrowed, in the hope of creating a severe shortage in the money market and sharply higher interbank interest rates, thereby sending the stock market into a nosedive. And as if this was not blatant enough, all this occurred in a climate of malicious rumors about the RMB and the Hong Kong dollar, glorified by publications and the so-called in-house currency strategies and analysts, and by the usual "reliable information from authoritative sources."²

Both Mr. Tsang and Mr. Yam therefore stressed the necessity of using the Exchange Fund reserves to take direct actions in the stock and futures markets, in order to frustrate the speculators' "double market play." This suggestion was unanimously approved by members of the EFAC. In the afternoon, the HKMA entered the market by buying up shares, pushing the HSI to 7,224. In the next two weeks, the HKMA continued its operations to squeeze the short-sellers in both the cash and futures markets, while at the same time selling US dollars to counter currency speculators in the forex market.

Here I should explain that, although major decisions concerning money and finance require prior approval by the EFAC, once such an approval is given, the HKMA has a free hand in its execution of the approved policy or directive. I therefore knew nothing about the operational details of the market intervention. I myself knew about the magnitude of the buying campaign only through the mass media.

Table 5.1 shows the portfolio of shares, all of which are the 33 constituents of the HSI, and their average purchase prices. As may be seen, the total cost of the operation amounted to HK\$118.12 billion (US\$15.24 billion), a colossal sum by any standard.

Although the government's unprecedented intervention in the securities markets was well received by the general public, who intuitively understood that this difficult decision was taken in the overall interests of Hong Kong, it was strongly criticized locally by some politicians, economists, and certain sections of the press and almost universally and violently condemned abroad. Milton Friedman thought that the Hong Kong authorities had "simply gone crazy," and Alan Greenspan, chairman of the U.S. Federal Reserve Board, in his testimony to the House Banking Committee, doubted whether the "efforts on the part of the Hong Kong authorities to try and jack up their stock market was a wise effort."³

I was one of the few Hong Kong economists who openly supported the government's action. I argued that it was the duty of every government to safeguard the integrity of the country's monetary and financial

TABLE 5.1
Shares Acquired by the Government during August 1998

<i>Company</i>	<i>Average Purchase Price (HK\$)</i>	<i>Initial Value (HK\$m)</i>
Amoy Properties	3.83	273
Bank of East Asia	8.46	703
Cable & Wireless HKT	15.24	14,814
Cathay Pacific	6.25	746
Cheung Kong Holdings	33.53	7,969
Cheung Kong Infrastructure	14.33	1,381
China Resources	5.68	775
China Telecom	10.88	5,210
Citic Pacific	10.41	1,527
China Light & Power	35.02	4,763
First Pacific	2.59	373
Great Eagle	6.56	162
* Guangdong Investment	1.40	221
Hang Lung Development	6.62	220
Hang Seng Bank	43.75	4,777
Henderson Investment	4.23	386
Henderson Land	23.77	2,029
* HK & Shanghai Hotel	4.18	240
HK China Gas	9.0	2,603
HK Electric	24.95	3,103
* Hopewell Holdings	4.13	173
HSBC	57.34	40,772
Hutchinson Whampoa	38.06	11,591
Hysan Development	5.22	316
New World Development	8.93	2,112
Shanghai Industrial Holdings	10.99	785
Shangri-la	5.03	310
Sino Land	2.58	277
Sun Hung Kai Property	25.77	4,939
Swire Pacific	24.0	2,770
TVB	17.6	629
Wharf	7.59	923
Wheelock	4.16	260
Total Costs of Acquisition		118,132

Source: Exchange Fund Investment Ltd.

*Replaced by Dao Hang Bank, SmarTone, and Johnson Electric in December 1999.

system. The government's purpose was to stop the speculators' vicious attacks on both the currency and the equity market, not to interfere with the normal working of the financial markets. To condemn Hong Kong for the so-called intervention is like condemning a victim of robbery (or maybe even a worse crime) for trying to defend herself. At any rate, the operation was a one-off thing: once the speculator-manipulators were defeated, the government would withdraw from the markets in an orderly manner. In short, its action was necessary and did not in any way contradict its free market philosophy and policies. I also denounced, over Radio Hong Kong, the speculators and their friends in the media, and for this I was taken to task by some newspapers.⁴

On September 7, the government unveiled a 30-point package designed to tighten regulation of the futures and stock markets, including criminalizing unreported short selling and increasing penalties for illegal short selling from a maximum fine of HK\$10,000 and six months' jail to a HK\$100,000 fine and two years' jail. Another part of the package was designed to ensure more coordination between the exchanges and regulatory agencies and more transparency of the exchanges.

Predictably, this package was also attacked by speculators and their friends as well as by those who had vested interests, such as brokerage houses, for violating "free market principles." Such arguments are exactly the kind of "interested sophistry" which Adam Smith so strongly attacks in his *Wealth of Nations* (1776). Short selling by itself is not illegal, provided it observes the rule that stocks must be borrowed in advance. However, during the recent episode, many "naked short-sellers" did not even bother to abide by this rule. Another loophole was that the T+2 rule (delivery two days after transaction) was not observed. The Hong Kong Clearing was found to have given big speculators the escape route of T+5, frustrating the government's plan to squeeze them. Fortunately, the government and Hong Kong Clearing have now reached an agreement to strictly enforce T+2.

The 30-point package was also designed to deal with the asymmetry problem—the classic "asymmetric information"—a fundamental issue that even serious economists have missed. The government is expected to be more and more transparent in its operations, and over the past decade it has been just that. However, hedge funds and other major players in the futures and stock markets are not under such constraints.

As to the criticism that it would be futile for the authorities to prop up share prices, I argued in a newspaper interview that the purpose of the government was to stop market manipulation and to restore market order, not to maintain stock prices at any predetermined level.⁵ At any rate, the government was in a strong position, as it bought up quality "blue chips" in cold cash and could afford a "war of attrition" with the speculators. If the market conditions were favorable, the government

could dispose of its holdings bit by bit in an orderly fashion. If, on the other hand, conditions were unfavorable, the government could simply hold on to its portfolio as long-term investments. By contrast, the hedge funds and other “high-leveraged institutions” (HLIs) could not afford to engage in a protracted war with a strong adversary, because of their heavy reliance on borrowings. Both interest rate burden and adverse price movement could prove fatal to them if they did not close out quickly.

At the time of this interview, the economic and financial situation in Hong Kong was extremely precarious. Fortunately, subsequent events have vindicated my views.

The titanic struggle between the HKMA and the speculators climaxed on August 31, when the HSI closed at 7,275, 9% higher than the intra-month low of 6,660, but 8.2% lower than the intra-month high of 7,923 on August 27. In the following months, the HKMA eventually gained the upper hand. The HSI rose to 7,883 at the September settlement. At that point, the weaker speculators could not hold on and were forced to liquidate their positions, while the stronger ones desperately tried to “roll over” their short positions to the next month, but at punishing costs. By the October settlement, however, the HSI had risen to 10,154. Since then, the HSI had generally shown a steady uptrend, except for a mild correction during January–February 1999, when it dipped slightly below 10,000. With the marked turnaround in the economy in the third quarter, stock prices also rose sharply, and the HSI reached a new high of 17,370 on January 3, 2000. But it crashed to 15,847 on January 5, a fall of 1,226 points, or by 7.2%, following Wall Street’s sharp correction due to fears of rising interest rates. Given the interest rate uncertainty, more volatility in share prices can be expected. But this does not affect the fact that practitioners of “double market play” had been thoroughly defeated.

In November 1998, the government announced the formation of an independent company called Exchange Fund Investment Ltd., which took over the management, custody, and eventual disposal of the government’s portfolio of shares acquired during the August excursion. All the details of this operation—the names of the companies, the purchase prices of their stocks, and so on—were disclosed. Although the government owned a substantial proportion of the shareholdings of some of the companies, it did not demand a board seat. The EFI in turn declared the appointment of several well-known investment banks, all foreign in origin, to advise on the eventual orderly disposal of its portfolio to the public. These actions demonstrated clearly that the government’s August excursion was meant as an exceptional operation against speculators and manipulators, not as a permanent departure from its traditional policy of “positive nonintervention.”

In June 1999, the EFI announced that it had decided in principle to dispose gradually of its portfolio through the creation of a unit trust. This unit trust was formally named the Tracker Fund, so called because it would closely track the performance of the HSI; and an initial public offering (IPO) with a total value of HK\$10 billion was announced in October 1999. The public's response to this offer was so enthusiastic that it was four times oversubscribed when applications were closed on November 4, 1999. On November 8, 1999, the EFI announced that 2,587,992,500 units of Tracker Fund, which would be listed on the Stock Exchange of Hong Kong, with a total value of HK\$33.33 billion, would be allocated to subscribers at the issue price of HK\$12.88, representing a 5.25% discount on its market price. This initial offer represented about 16% of the existing value of the original portfolio. Subsequently, Tracker Fund shares were sold to institutional investors through the "tap" method. According to Joseph Yam, chief executive of the HKMA, by the end of July 2000, a total of HK\$72.5 billion had been disposed of, representing about 61% of the original cost of acquisition. Even after deducting such sales, the remaining portfolio still had a market value of HK\$175 billion.⁶ The cumulative rate of return during the two years, in other words, was 109.7%, a spectacular performance by any standard.

With this record, the government can claim that it has more than fulfilled its original objective in entering the market: punishing the speculator-manipulators, stabilizing the equity market, and making a huge profit into the bargain.

One puzzle that needs explanation is the fact that, in its Report on Financial Market Review, published only four months before the market intervention, the Government still insisted that there was no evidence of market manipulation.⁷ So why this about face? My interpretation is that, first, between February (when the report was written) and August, the market situation had deteriorated rapidly. Table 5.2 shows that short-selling did reach its climax in August 1998, in terms of both the number of shares and the value of transactions.

Second, when the market crash started in October 1997, the HSI was still selling at around 11,000. Intervention at that level would have been extremely risky and might even have played into the hands of the speculators. By the time the HSI was driven down to 6,660, the average price-earning ratio was only 7 times, and the market was clearly oversold. The government presumably calculated that intervention at this level would entail minimum risk and might even yield a rewarding return. As it turned out, the government's assessment of the situation was correct.

As a result of this highly successful operation, total assets of the Exchange Fund—now the sole repository of government assets de-

TABLE 5.2
Monthly Short-Selling Transactions, 1998

<i>Month</i>	<i>No. of Designated Securities</i>	<i>No. of Shares</i>	<i>Value of Transactions (HK\$m)</i>
Jan	310	283,625,835	5,711
Feb	310	194,805,000	2,709
Mar	325	173,732,600	3,010
Apr	325	321,878,382	7,465
May	325	332,427,200	8,547
June	325	352,519,700	7,373
Jul	325	280,075,700	6,125
Aug	325	761,225,782	17,105
Sep	325	171,081,400	5,158
Oct	325	197,707,000	5,078
Nov	195	154,256,300	3,641
Dec	195	80,687,300	2,269

Source: The Stock Exchange of Hong Kong, *Stock Exchange Fact Book 1998*

nominated in both Hong Kong dollars and foreign currencies, including the portfolio of shares—exceeded one trillion Hong Kong dollars at the end of 1999. Table 5.3 presents the balance sheet of the Exchange Fund during the 1990s. It may be seen that the Fund's assets increased steadily throughout the period, even during the AFC of 1997–99. The average annual compound rate of growth was about 8%.

After the orderly and successful disposal of shares through the Tracker Fund, the international community has also realized that Hong Kong has not departed from its traditional noninterventionist philosophy and policy. On November 29, 1999, the Heritage Foundation, a prominent U.S. think tank, announced in its "2000 Index of Economic Freedom" that Hong Kong, for the sixth consecutive year, ranked number one in terms of economic freedom.⁸ Then on January 11, 2000, a joint report by Canada's Fraser Institute and other think tanks announced that Hong Kong shared with Singapore the title of the world's freest economy in their "Economic Freedom of the World 2000" annual report.⁹ Both reports use a large number of variables to assess the degree of economic freedom, the gist of which is that economic freedom varies inversely with government intervention in the economy. These authoritative reports should lay to rest the canard that Hong Kong has abandoned its free market tradition after reunification and the outbreak of the AFC.

Figures 5.1 and 5.2 show respectively the monthly movements of HSI during 1964–1998, and daily movements of HSI during 1999.

TABLE 5.3
Exchange Fund Balance Sheet 1990–99 (million HK\$, end of year)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Assets										
Foreign currency assets	192,323	225,333	274,948	335,499	381,233	428,547	493,802	588,475	701,239	755,100
HK dollar assets	3,874	10,788	12,546	12,987	24,617	32,187	40,715	48,215	220,163	247,640
Total	196,197	236,121	287,494	348,486	405,850	460,734	534,517	636,690	921,402	1,002,740
Liabilities										
Certificate of indebtedness	40,791	46,410	58,130	68,801	74,301	77,600	82,480	87,015	86,465	118,195
Placements by government funds	63,226	69,802	96,145	115,683	131,240	125,916	145,898	237,629	424,562	392,206
Coins in circulation	2,003	2,299	2,559	2,604	3,372	3,597	4,164	5,399	5,778	5,777
Exchange Fund bills and notes	6,671	13,624	19,324	25,157	46,140	53,125	83,509	89,338	98,334	101,828
Balance of banking system	480	500	1,480	1,385	2,208	1,762	474	296	2,527	7,960
Other liabilities	391	4,834	3,220	7,314	22,815	38,600	45,130	26,802	61,303	85,982
Total	113,562	137,469	180,858	220,944	280,076	300,600	361,655	446,479	678,969	711,948
Accumulated earnings	82,635	98,652	106,636	127,542	125,774	160,134	172,862	190,211	242,433	290,792

Source: Hong Kong Monetary Authority Monthly Statistical Bulletin

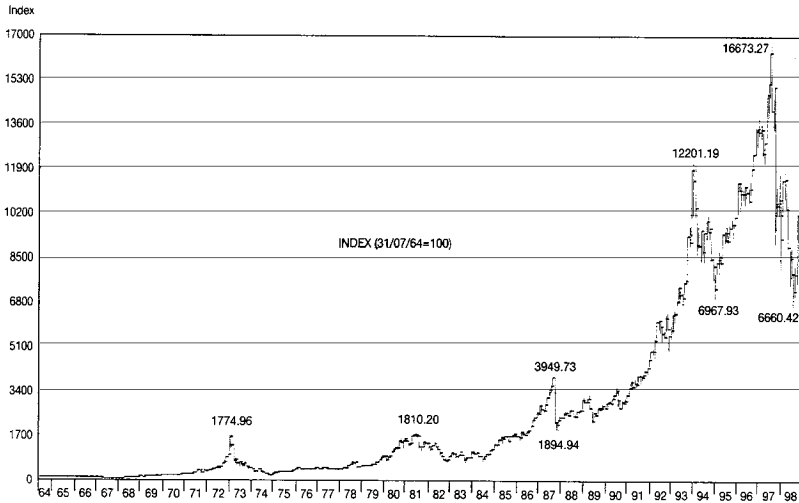


Figure 5.1 Hang Seng Stock Price Index, Monthly Movement 1964–98. Source: Stock Exchange of Hong Kong, Stock Exchange Fact Book 1998

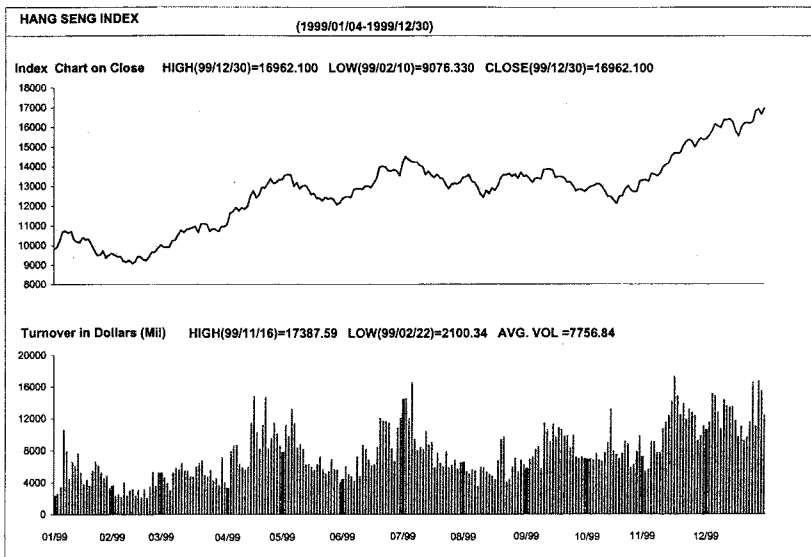


Figure 5.2 Hang Seng Stock Price Index, Daily Movement 1999. Source: The Stock Exchange of Hong Kong

THE PROPERTY MARKET: FROM CRISIS TO STABILIZATION

Chapter 3 shows how before the handover and the AFC, a bubble in the property market was developing. Because of the smooth handover, the bubble in the property market continued even after the AFC erupted, well into the third quarter of 1997. However, after “Black Thursday” on October 23, 1997, as interest rates soared and liquidity tightened, the property market, in tandem with the securities markets, also fell sharply.

Tables 5.4 and 5.5 show that both domestic rental and price indexes for all classes reached their peaks in Q3 at 200 and 433 respectively. Then from Q4 onward, they tumbled rapidly; by the end of Q4, 1998, they had fallen to 145 and 253 respectively, representing falls of 27.5% and 41.5% respectively. Actually, these are average figures. For individual properties, falls in rentals and prices respectively by more than 30% and 50% were not unusual.

TABLE 5.4
Private Domestic-Rental Indexes by Class (1989 = 100)

<i>Year/Quarter</i>	<i>A, B & C</i>	<i>D & E</i>	<i>All Classes</i>
1995 Q1	172	198	177
Q2	172	191	176
Q3	171	185	174
Q4	167	176	169
1996 Q1	166	174	168
Q2	167	174	169
Q3	170	180	172
Q4	174	183	175
1997 Q1	183	192	185
Q2	190	201	193
Q3	197	211	200
Q4	195	210	198
1998 Q1	175	191	178
Q2	167	178	169
Q3 *	153	161	154
Q4 *	144	151	145

*Provisional

Note: Class A—saleable area not exceeding 39.9m²

Class B—saleable area of 40m² to 69.9m²

Class C—saleable area of 70m² to 99.9m²

Class D—saleable area of 100m² to 159.9m²

Class E—saleable area of at least 160m²

Source: Rating and Valuation Department, *Hong Kong Property Review 1999*

TABLE 5.5
Private Domestic-Price Indexes by Class (1989 = 100)

<i>Year / Quarter</i>	<i>A, B & C</i>	<i>D & E</i>	<i>All Classes</i>
1995 Q1	282	325	284
Q2	277	329	280
Q3	263	305	264
Q4	259	295	261
1996 Q1	275	319	277
Q2	286	340	289
Q3	295	350	298
Q4	324	400	329
1997 Q1	389	486	395
Q2	423	525	429
Q3	427	528	433
Q4	417	518	422
1998 Q1	350	416	354
Q2	318	373	321
Q3*	261	302	263
Q4*	250	297	253

*Provisional

Note: Class A—saleable area not exceeding 39.9m²

Class B—saleable area of 40m² to 69.9m²

Class C—saleable area of 70m² to 99.9m²

Class D—saleable area of 100m² to 159.9m²

Class E—saleable area of at least 160m²

Source: Rating and Valuation Department, *Hong Kong Property Review 1999*

Table 5.6 shows that, while rental indexes for all classes of private commercial office buildings peaked in Q4, price indexes for them peaked much earlier, in Q2 of 1997. By Q4 1998, both had fallen, by 24.8% and 51.6% respectively, from their peaks.

The situation of private flatted factories, as shown in Table 5.7, presents a rather different picture. Owing to long-term structural reasons—mainly the relocation of manufacturing industries to Mainland China—there was no bubble comparable to those in other sectors of the property market. Moreover, both rental and price indexes peaked much earlier, in Q1 of 1995. By Q4 of 1998, rental and price indexes had fallen by 27% and 47.5% respectively from their peaks. Furthermore, the indexes in Q4 of 1998 were actually lower than the base (1989 = 100).

While the downward adjustments in rental and prices in the property market is a necessary part of the domestic adjustment to restore Hong Kong's competitiveness under the linked rate regime, too precipitate a fall may be counterproductive, for this may threaten the banking sys-

TABLE 5.6
Private Office-Rental and -Price Indexes by Grade (1989 = 100)

Year / Quarter	Rents				Prices			
	Grade A	Grade B	Grade C	Overall	Grade A	Grade B	Grade C	Overall
1995 1	144	134	140	140	206	217	196	205
2	136	129	137	134	193	216	187	195
3	133	124	133	130	176	186	172	177
4	124	117	126	122	171	184	171	174
1996 1	114	112	121	115	184	190	171	182
2	111	106	117	111	182	193	175	183
3	111	106	117	111	174	181	167	174
4	111	108	118	111	202	189	174	196
1997 1	113	109	118	113	220	211	187	214
2	115	112	121	115	223	212	194	217
3	117	111	121	116	204	200	193	202
4	118	111	120	117	191	192	190	191
1998 1	115	108	113	113	161	156	158	159
2	108	100	106	106	145*	138*	149*	144*
3	97*	90*	97*	95*	104*	115*	120*	110*
4	90*	82*	91*	88*	103*	108*	109*	105*

*Provisional

Note: Grade A: modern with high-quality finishes.

Grade B: ordinary design with good-quality finishes.

Grade C: plain with basic finishes.

Source: Rating and Valuation Department, *Hong Kong Property Review 1999*

tem, which traditionally is heavily exposed to the property sector. A banking crisis, in turn, can quickly degenerate into a currency crisis, as the AFC has clearly demonstrated. International speculators were aware of this, and in 1997–98 they and their friends (mostly “analysts” in brokerage houses, investment funds, and the media) mounted a concerted campaign, predicting ominously the dire consequences of the imminent collapse of the whole property market. By the spring of 1998, some government officials became sufficiently alarmed that they started talking about “flexible” implementation of the controversial “85,000 residential units” target of the official housing policy, and encouraging “fixed-rate mortgages.” But the situation continued to deteriorate, following the announcement in May that the growth of GDP in the first quarter had turned negative.

On June 22, the government, in an attempt to stabilize the property market, announced that public auctions of land would be suspended for a period of nine months. On October 7, 1998, the chief executive of

TABLE 5.7
Private Flatted Factories—Rental and Price Indexes (1989 = 100)

<i>Year/Quarter</i>	<i>Rents</i>	<i>Prices</i>
1995 Q1	133	183
Q2	133	173
Q3	131	157
Q4	126	151
1996 Q1	122	149
Q2	118	143
Q3	115	138
Q4	116	140
1997 Q1	119	147
Q2	118	145
Q3	118	141
Q4	117	135
1998 Q1	114	123
Q2	109	119
Q3	102*	106*
Q4	97*	96*

*Provisional

Source: Rating and Valuation Department, *Hong Kong Property Review 1999*

the Hong Kong SAR government, Mr. Tung Chee-hwa, further announced that the main scheme of the Sandwich Class Housing Scheme would be suspended in view of the sharp drop in housing prices.¹⁰ These two measures, together with the three interest rate cuts in the autumn following the U.S. lead, seemed to have stabilized the property market at around the depressed current level.

On the positive side, the Hong Kong Mortgage Corporation (HKMC), which began operations in October 1997, could not have appeared at a more appropriate time. Modelled after the U.S. Federal National Mortgage Association (“Fannie Mae”), the HKMC purchases mortgage loans from the banks and repackages and resells them as marketable securities to investors. As such, it can enhance the liquidity and correct “maturity mismatch” in the banking sector, encourage securitization, and promote the development of capital markets.

Since early 1998, the authorities have been pushing for “fixed rate mortgages” to insulate homebuyers from the volatility of interest rates. The main idea is to encourage banks to grant “fixed-rate mortgage loans” to homebuyers. These mortgages will then be sold to the HKMC, which in turn securitizes them for sale to the bond market and the cash-rich Hong Kong Housing Society.

By the end of 1998, the HKMC had purchased a total of HK\$11.4 billion of mortgages. It had established a regular program for fixed-rate mortgages with 8 participating banks and listed its HK\$20 billion Note Issuance Program on the stock exchange effective from October 29, 1998. It was profitable in its first year of operations.¹¹

Although the initial results are encouraging, it will be some time before the HKMC can exert an appreciable influence on the whole residential property market. Moreover, since the mortgage loan delinquency rate is among the lowest of all types of loans, and the banks themselves began a "mortgage war" in the 4th quarter of 1999, they may have diminished their interest, at least for the time being, in disposing of their mortgage loans to the HKMC.

At the time of writing, the latest data available were those for 1999 and Q1 of 2000. Table 5.8 presents indexes of property prices and rentals during 1999 and Q1 2000.

For residential apartments, both price and rental indexes in 1999–2000 showed a softening trend. Compared with the peaks in Q3 of 1997, they were 44% and 30% lower respectively.

For office space, both price and rental indexes also drifted lower, though the rates of decline were not as steep as in 1998. Compared with their peaks in 1997, price and rental indexes were down by 58% and 40% respectively.

For shopping space, again both indexes drifted lower, though at a more moderate rate. Compared to their peaks in 1997, price and rental indexes were down by 52% and 21% respectively.

Reflecting the weak performance of domestic exports and relocation of manufacturing processes, prices and rentals in the industrial property market continued to decline in the first three quarters. Compared to their peaks in 1997, they were down by 59% and 36% respectively on average.

TABLE 5.8
Indexes of Property Prices and Rentals (1989 = 100)

		<i>Residential flats</i>		<i>Office space</i>		<i>Shopping space</i>		<i>Flatted factory space</i>	
		<i>Price index</i>	<i>Rental index</i>	<i>Price index</i>	<i>Rental index</i>	<i>Price Index</i>	<i>Rental Index</i>	<i>Price Index</i>	<i>Rental Index</i>
1999	Q1	264	146	97	79	215	167	89	93
	Q2	264	144	97	73	218	164	83	89
	Q3	256	144	92	71	215	164	81	87
	Q4	243	141	93	71	202	168	79	87
2000	Q1	246	139	92	74	193	169	77	88

Source: Rating and Valuation Department, as quoted in Hong Kong SAR Government, *Half Year Economic Report, 2000*. All figures were provisional.

The accelerating pace of economic recovery in the latter half of 1999 will probably stabilize the property market as a whole, especially as the government formally abandoned its "85,000 units" policy in June 2000. Long-term demographic, economic, and social forces all seem to work for the stability of the property sector, especially the residential subsector, after painful adjustments: increased immigration quotas for people from Mainland China, the decline of the extended family and the rise of the nuclear family, the desire to upgrade the quality of housing combined with the strong aspiration for home ownership, and the passing of the AFC and eventual recovery, among other factors. At any rate, land sales by public auctions, suspended temporarily in June 1998, were successfully resumed in April 1999.

SOME CONCLUDING REMARKS

The impact of the Asian AFC on the asset markets was extremely sharp and nearly fatal, at least initially. Sharp increases in interest rates, outflow of capital, credit crunch, adverse expectations about the economy, and speculators' manipulation had all played their parts.

With regard to the securities markets, at its worst the Hang Seng Index, representing prices of quality "blue chips," was down by 60% from its peak in 1997, but some other, more broadbased indices fell even more. Detecting that there was a vicious "double market play" by the speculators, the Hong Kong authorities launched a highly controversial counterattack against the manipulators in August 1998. Whatever the rights and wrongs of this move, the authorities succeeded brilliantly in their double objective of punishing the speculators and stabilizing the equity market. Moreover, by disposing of some HK\$72.5 billion through the Tracker Fund, the authorities reaped a handsome profit into the bargain, thus strengthening Hong Kong's already strong fiscal reserves. More orderly sales of the Tracker Fund will undoubtedly be made in the foreseeable future. Thus, with the defeat of the speculators in the currency market described in the last chapter, Hong Kong has now earned the enviable reputation of being the only economy that has soundly beaten the hedge funds and other sophisticated speculators at their own games during the AFC. Nor can any precedent be found in any other previous international financial crisis.

The authorities also intervened, albeit only indirectly, on the supply side of the property market, in order to prevent a meltdown that could endanger the banking system and the currency peg itself. As a result, by and large the property market seemed to have stabilized toward the end of 1999. Even so, depending on the types of premises, prices had

fallen by 40–58% and rentals had fallen by 20–40% respectively from their peaks in 1997 or earlier.

NOTES

1. For detailed underlying data concerning stock price movements, see the Stock Exchange of Hong Kong, *Stock Exchange Fact Book*, 1997 and 1998, and *Hong Kong Monthly Digest of Statistics*.

2. See Yam (1998b), p. 77, and also Yam (1998a).

3. As quoted in Yam (1998b), p. 75. A notable exception among foreign commentators is the renowned economist Paul Krugman of MIT. He said that if hedge funds were deliberately manipulating the markets, the HKMA had no alternative but to intervene. The practices of hedge funds would “constitute criminal activity in the United States if spotted by the Securities and Exchange Commission.” *South China Morning Post Business Post*, August 27, 1998.

4. Notably the English-language *South China Morning Post*, September 2, 1998.

5. See “Scholar’s view on the Hong Kong economy,” *Ta Kung Pao*, Hong Kong, September 14, 1998.

6. As reported in *Hong Kong Economic Journal*, August 4, 2000.

7. See Financial Services Bureau (1998), pp. 77–80.

8. See G. P. O’Driscoll and K. R. Holmes, “Freedom marches on,” *Asian Wall Street Journal*, November 30, 1999. The authors are co-editors of the “2000 Index of Economic Freedom.”

9. David Saunders, “HK shares title as world’s freest economy,” *South China Morning Post*, January 12, 2000.

10. The Sandwich Class Housing Scheme was introduced in 1993 to help middle-income families, who were too rich to qualify for public housing, to buy their own homes. The lower and upper monthly income limits for the scheme were revised in 1998 to HK\$33,001 and HK\$60,000 respectively.

11. See the annual report of the Hong Kong Mortgage Corporation for 1998.

Impact on the Financial Sector

INTRODUCTION

One distinctive feature of the AFC, as mentioned earlier, is the mixture of currency, banking, and debt crises. Banking crisis, in the form of massive nonperforming loans (NPLs), insolvency of banks or near-banks, low capital adequacy ratios (CARs), or even outright runs on individual banks or other nonbank financial intermediaries, was particularly serious for Thailand, Indonesia, and South Korea. In Japan, a prolonged banking crisis has been going on since the bursting of the bubble economy in 1990 and is still not yet fully resolved. How Hong Kong's banking system has fared during the AFC is therefore a topic that deserves careful investigation. Moreover, Hong Kong is, by general consent, a leading international financial center (IFC) in both the Asia-Pacific region and the world. The impact of the AFC on Hong Kong's status as an IFC is another interesting and important question.

IMPACT ON THE BANKING SECTOR

As pointed out in the previous chapter, the Hong Kong dollar initially bore the brunt of the AFC. Between July 1 and October 30, the banking system was little affected. Indeed, the postcolonial epoch in its first few months was marked by a euphoria that reached its crescendo during September 23–25, when the World Bank Group and IMF joint annual meetings were held in Hong Kong, attended by some 300 finance ministers and central bank governors from 180 member countries. Altogether 19,500 persons took part in the various meetings/seminars

organized by the two international financial institutions. The events were widely acclaimed as a great success, symbolizing Hong Kong's continued status as a leading IFC under Chinese sovereignty.

As in the currency market, however, the atmosphere in the banking sector abruptly changed after "Black Thursday," October 23, 1997. In the wake of the sharp fall of the asset markets and the rapid deterioration of the macroeconomic situation, the banking system could not escape being adversely affected as well.

The negative impact on the banking sector manifested itself in several aspects. The most important one was the steady deterioration of asset quality from Q4 1997 onward, which did not stabilize until Q4 1999. This is shown in Table 6.1. As may easily be seen, problem assets as percentages of total loans nearly quadrupled from 1.07% at end-1997 to 4.1% at end-1998 for all authorized institutions (AIs) and more than doubled from 1.81% to 5.1% for locally incorporated banks.¹

Table 6.2 presents percentage classification of total loans. The Hong Kong Monetary Authority (HKMA) adopts a five-category classificatory system (details of which are given in the chapter appendix). Briefly, "pass" means loans whose repayment is on schedule; "special mention" are those loans whose borrowers are experiencing difficulties; "sub-standard" loans are those whose borrowers are displaying a weakness that may jeopardize repayment; "doubtful" loans are those

TABLE 6.1
Problem Assets of the Banking System

	<i>As % of total loans</i>	
	<i>Dec. 97</i>	<i>Dec. 98</i>
(a) All authorized institutions		
Problem assets:		
overdue over 3 months and rescheduled	1.07%	4.10%
3–6 months	0.20%	1.09%
over 6 months	0.70%	2.26%
rescheduled	0.17%	0.75%
(b) All local banks		
Problem assets:		
overdue over 3 months and rescheduled	1.81%	5.10%
3–6 months	0.32%	1.45%
over 6 months	1.26%	2.58%
rescheduled	0.23%	1.07%

Source: HKMA Annual Report 1998

TABLE 6.2
Asset Classification of the Banking System

As % of total loans	<i>Special</i>		<i>Substandard</i>	<i>Doubtful</i>	<i>Loss</i>
	<i>Pass</i>	<i>Mention</i>			
	(%)	(%)	(%)	(%)	(%)
(a) All authorized institutions					
- 1998	85.81	9.10	2.44	2.26	0.39
- 1997	92.63	6.14	0.57	0.56	0.10
(b) All local banks					
- 1998	84.68	7.99	3.18	3.93	0.22
- 1997	94.87	3.05	0.72	1.29	0.07

Source: HKMA Annual Report 1998

where collection in full is improbable; and "loss" means of course loans that are considered uncollectable. Clearly, during 1997–98, the "pass" category had declined considerably, while other categories had increased correspondingly.

In the first quarter of 1999, the asset quality of all local banks continued to deteriorate, as shown in Table 6.3. But the HKMA took the view that "classified loans," or "problem loans," stabilized in the third quarter. For although the proportion of such loans rose slightly to 10.33% from 10.14% in the previous quarter, this was due more to a decline in

TABLE 6.3
Asset Quality of All Local Banks

		<i>Sep/98</i>	<i>Dec/98</i>	<i>Mar/99</i>	<i>Jun/99</i>	<i>Sep/99</i>
		<i>as % of total loans</i>				
Pass loans		88.22	84.61	82.18	81.77	81.43
Special mention loans		6.79	8.06	8.99	8.09	8.25
Classified loans ¹		4.99	7.33	8.82	10.14	10.33
o/w	Substandard	2.23	3.18	3.94	4.80	4.33
	Doubtful	2.65	3.93	4.61	5.02	5.56
	Loss	0.11	0.22	0.27	0.31	0.43
Overdue > 3 months						
o/w	Overdue > 3 months	3.18	4.04	5.41	5.92	6.36
	Rescheduled loans	0.63	1.08	0.98	1.09	1.17
Non-accrual loans ²		-	-	-	6.70	7.22

¹Classified loans are those loans graded as "substandard," "doubtful," or "loss."

²Loans on which interest has been placed in suspense or on which interest accrual has ceased. Not available prior to June 1999.

Source: HKMA Quarterly Bulletin, Nov. 1999.

total loans rather than a rise in classified loans. Indeed, both "classified loans" and "special mention loans" fell slightly in absolute term.²

The second aspect of the negative impact, which is of course related to the first, is the sharp drop in profitability of locally incorporated banks. According to the HKMA, in 1998, average pretax operating profits of local banks fell by 33.6%, while their posttax profits fell by 34.4%, a stark contrast to average profit growth of 11.7% and 9.7% respectively in 1997.³

The main reason for this poor performance was the large increase in bad debt charge. According to the HKMA, the bad debt charge in local banks' domestic books rose by 344% and rose as a percentage of average total assets to 0.64% in 1998 from 0.15% a year earlier. The bad debt charge of the banking sector as a whole (which comprises nonlocally incorporated banks) also rose, but to a lesser degree than for local banks, from 0.13% in 1997 to 0.43% in 1998. Other reasons for the drop in profitability were the decrease in net interest margin (from 2.44% to 2.26%), and the decline in lending and income from fees and commissions, in the wake of the AFC-induced recession in most of East Asia. Table 6.4 shows return on assets (ROA) for locally incorporated banks in 1997–98.

Despite this setback, there was no banking crisis comparable to that in 1983–86, when seven licensed banks had had to be bailed out in various forms. While all local banks and some international banks

TABLE 6.4
Return on Assets for Locally Incorporated Banks

Components of ROA	<i>Contribution to ROA as % of average total assets</i>	
	1997	1998
1. Net interest income	2.26	2.07
2. Other operating income	1.03	0.95
3. Total operating income (1 + 2)	3.29	3.02
4. Operating expenses	1.25	1.20
5. Bad debt charges	0.15	0.64
6. Other provisions	0.01	0.01
7. Operating profit before tax (3 – 4 – 5 – 6)	1.88	1.17
8. Profit on sale of fixed assets & other investments exceptional items	0.04	0.00
9. Profit before tax (7 + 8)	1.92	1.17
10. Taxation	0.27	0.16
11. Extraordinary items	0.00	0.00
12. Post tax profits (ROA) (9 – 10 + 11)	1.65	1.01

Source: HKMA Annual Report for 1998

that have strong roots in Hong Kong (such as HSBC, Standard Chartered, and Bank of China) had suffered reduced profitability, they were still profitable. Only one local bank (the Hong Kong Chinese Bank) actually suffered a loss in 1998. No bank had failed during the AFC. There was a small-scale run on International Bank of Asia in November 1997 following some malicious and unfounded rumors, but it soon petered out after the HKMA issued a statement strongly supporting the bank.

An important evidence of the general soundness of the banking system was the high average capital adequacy ratio (CAR). This rose from 17.5% at end-1997 to 18.6% at end-1998, and further to 20.1% at end-September 1999. Admittedly, this increase partly reflected the banks' contraction of their loan portfolios and shift to a more conservative stance. Still, Hong Kong's CAR is among the highest in the world, far in excess of the 8% minimum recommended by the Basle Committee as an international benchmark.

At the time of writing, financial statements of local banks for 1999 were not yet available. But first half results showed that most local banks had resumed positive profit growth, reflecting the gradual improvement of the economy. Because the delinquency ratio of residential mortgage loans, at 1.12% at end-September 1999, was the lowest among all types of loans, banks started a campaign in the last quarter of 1999 to solicit more borrowings from prospective home-buyers by offering various incentives, including a preferential interest rate of up to 100 basis points below the Best Lending Rate (BLR) and cash refund.⁴ How long this "mortgage war" will last remains to be seen.

In the wake of the improving economic outlook and the winding down of the AFC, leading international credit-rating agencies such as Moody's and Standard and Poors have, since December 1999, upgraded the outlook for Hong Kong's domestic banks from "negative" to "stable."⁵

For comparative purposes, Goldman Sachs, a prominent investment bank, has made estimates of Camel ratios of domestic banks in Hong Kong, Indonesia, South Korea, Malaysia, Philippines, Singapore, and Thailand.⁶ It has, however, erroneously included HSBC among Hong Kong's domestic banks. Actually, HSBC moved its legal domicile to the United Kingdom in 1990 and is no longer a Hong Kong domestic bank. After removing it, we can readily see that Hong Kong and Singapore banks have the best Camel ratios, as expected. For other countries, some data are either unavailable or not meaningful. Therefore in Table 6.5, only the Camel ratios of domestic banks in Hong Kong and Singapore in the first half of 1999 are compared. The banks included are Bank of East Asia, Dah Sing Financial Holdings, Dao Heng Bank, Hang Seng Bank, International Bank of Asia, Liu Chong Hing Bank, Wing Hang

TABLE 6.5
Average Camel Ratios of Domestic Banks (%), First Half of 1999

	<i>Equity/Assets</i>	<i>NPL Ratio</i>	<i>LLR/NPL</i>	<i>Cost/Income</i>	<i>ROA</i>	<i>ROE</i>
Hong Kong	9.96	4.69	53.03	35.45	1.23	11.69
Singapore	9.38	10.58	56.18	31.88	1.10	10.04

Notes: NPL = nonperforming loan LLR = loan loss reserves
 ROA = return on assets ROE = return on equity

Source: Goldman Sachs, *Asia Banks Fact Sheet*, Vol. 2, No. 2, Jan. 12, 2000.

Bank, and Wing Lung Bank of Hong Kong and DBS Group Holding, Keppel Tat Lee Bank, Overseas Chinese Bank Corporation, Overseas Union Bank, and United Overseas Bank of Singapore.

From Table 6.5, it can be readily seen that Hong Kong's domestic banks are ahead of their counterparts in Singapore in respect of equity/assets ratio, ROA, and ROE, which are the higher the better. Hong Kong also out-performs Singapore for the NPL ratio, the lower the better. Hong Kong is only behind Singapore in respect of the LLR/NPL ratio, the higher the better, and cost/income ratio, the lower the better. On balance, Hong Kong's domestic banks can be regarded as sounder than their Singapore counterparts, which are generally regarded as the strongest in Southeast Asia, if not in the whole of Asia.

The general soundness of the banking system owed much to the progress and reform in the prudential framework already reviewed in Chapter 3. Unfortunately, this record was marred by the failure of two securities investment firms, the Peregrine Group and C. C. Pacific, in January 1998. Although these firms were not banks, their default nevertheless upset public confidence in an already nervous environment and was one of the reasons for a currency attack at that time, necessitating another big increase in interest rates of 0.75%.

Even without the AFC and its impact on the banking sector, a long-term review and planning for the banking sector had become necessary for some time in view of the globalization of financial markets, proliferation of new financial products, rapid progress in information technology, and growing competition from other financial centers. The AFC had, however, made this review even more urgent.

The HKMA therefore commissioned in March 1998 a consultant firm, KPMG Barents, to conduct an in-depth review of Hong Kong's banking sector for the next five years. The report of the consultants was completed and released at the end of 1998, the main recommendations of which are summarized in Table 6.6.

At the time of writing, the government has accepted most of the recommendations. The significance of the proposed banking reform will be discussed in the next section.

TABLE 6.6
Proposed Banking Reform

<i>Phases</i>	<i>Regulatory recommendations</i>	<i>Supervisory recommendations</i>
<i>Phase 1 – enhanced risk-based supervision</i>	<p><i>To enhance safety and stability:</i></p> <ul style="list-style-type: none"> ▣ Introduce financial disclosure by foreign branch banks (limited disclosure introduction in progress). ▣ Clarify the HKMA's role as lender of last resort. <p><i>To enhance competitiveness:</i></p> <ul style="list-style-type: none"> ▣ Relax the one-building condition to allow three branches for foreign banks. ▣ Begin monitoring process prior to start of deregulation of IRRs. 	<ul style="list-style-type: none"> ➤ Develop a formal strategic planning process. ▣ Develop a formalized risk assessment framework and quality assurance program. ▣ Integrate risk management principles into off-site surveillance activities. ▣ Revise on-site surveillance activities to more explicitly evaluate institutions' risk management capabilities. ▣ Develop guidelines as to types and degrees of supervisory responses. ▣ Define core capabilities, revise job descriptions and the performance management process, develop a formalized career development program, perform a training needs assessment and expand the current training curriculum. ▣ Create additional specialist teams. ▣ Enhance the supervisory database and management information systems. ▣ Assess risks associated with longer-term economic integration with Mainland China.
<i>Phase 2 – market restructuring</i>	<p><i>To enhance safety and stability:</i></p> <ul style="list-style-type: none"> ▣ Raise minimum capital requirements for local authorized institutions. ▣ Study of alternatives to enhance explicit depositor protection. <p><i>To enhance competitiveness:</i></p> <ul style="list-style-type: none"> ▣ Simplify the three-tier system. ▣ Reassess access criteria for RTGs. ▣ Stage 1 of deregulation of the IRRs (time deposits up to 6-days) ▣ Stage 2 of deregulation of the IRRs (current accounts). 	<ul style="list-style-type: none"> ▣ Assess supervisory gaps and/or overlaps and options to address.
<i>Phase 3 – market liberalization</i>	<p><i>To enhance safety and stability:</i></p> <ul style="list-style-type: none"> ▣ Implementation of enhanced explicit depositor protection scheme. <p><i>To enhance competitiveness:</i></p> <ul style="list-style-type: none"> ▣ Stage 3 of deregulation of the IRRs (remove all remaining interest rate caps). ▣ Reduce the time period and relax the association with Hong Kong entry criteria. 	

Source: KPMG/Barents, *Hong Kong Banking into the New Millennium*, 1998

Note: IRR = Interest Rate Rules

RTGS = Real Time Gross Settlement

IMPACT ON IFC STATUS

Chapter 3 reviewed Hong Kong's rise as an international financial center (IFC), not only in the Asia-Pacific region but also in the world. Before the handover, there was much negative comment and speculation about the territory's status after its reversion to Chinese sovereignty. It turned out that contrary to such assertions, the adverse effect has come not from China, but from a totally unexpected source: the AFC.

That the AFC has had some negative effect in absolute terms can hardly be denied. But since in the Asia Pacific region, the two other leading IFCs, Tokyo and Singapore, have also been affected by the AFC, the relative impact on Hong Kong has not been too great. However, considering that the two super-IFCs, London and New York, and secondary European centers like Frankfurt, Paris, and Zürich, have not been affected at all by the AFC, Hong Kong's relative world ranking has inevitably suffered, though it would be difficult to be precise about the extent of the damage, as relevant data are lacking.

Detailed data about world turnover of foreign exchange and the over-the-counter (OTC) derivatives market are available, thanks to the triennial survey by central banks and monetary authorities under the auspices of the Bank for International Settlements (BIS). Table 6.7 presents a summary of the survey.

As may be seen, in the forex market Hong Kong's turnover dropped by 13% between April 1995 and April 1998, while its world ranking slipped from number five to number seven. The HKMA's explanation is that

adjusting for the depreciation of the yen and the Deutschemark against the US dollar (dollar-yen and dollar-Deutschemark transactions accounted for about half of total foreign exchange turnover in the 1998 survey), the net daily turnover of Hong Kong actually increased by 5%. Apart from the valuation effect, a number of other factors also acted to keep the growth down: the scaling down of treasury operations and surrender of their licenses by some foreign institutions and the effects of the Asian crisis on the risk appetite of financial institutions and on the volume of corporate and customer driven foreign exchange business.⁷

In the over-the-counter (OTC) derivatives market (which comprises forex derivatives and interest rate derivatives), Hong Kong's turnover dropped by 12% (note that fractional figures in the table have been rounded), while its world ranking slipped from number nine to number eleven. The HKMA's explanation is that "the decline is attributable to a reduction in the size of treasury activities of some foreign institutions, caused partly by restructuring and partly by diminishing appetite for

TABLE 6.7
Survey of Foreign Exchange and Derivatives Market Activity
Preliminary Global Data (US\$ billion)

Country	Foreign Exchange ⁽¹⁾			Derivatives ⁽²⁾			Total ⁽³⁾		
	Apr-95	Apr-98	% change	Apr-95	Apr-98	% change	Apr-95	Apr-98	% change
United Kingdom	464(1)	637(1)	37%	74(1)	171(1)	131%	538(1)	808(1)	50%
United States	244(2)	351(2)	44%	53(2)	91(2)	71%	298(2)	442(2)	48%
Japan	161(3)	149(3)	-8%	33(3)	42(4)	28%	194(3)	191(3)	-2%
Singapore	105(4)	139(4)	32%	18(5)	11(7)	-38%	124(4)	150(4)	22%
Germany	76(7)	94(5)	24%	14(6)	34(5)	149%	90(7)	129(5)	43%
France	58(8)	72(8)	24%	22(4)	46(3)	105%	80(8)	118(6)	47%
Switzerland	87(6)	82(6)	-6%	4(9)	16(6)	259%	91(6)	98(7)	7%
Hong Kong	90(5)	79(7)	-13%	4(9)	4(11)	-12%	95(5)	82(8)	-13%
Australia	40(9)	47(9)	18%	4(9)	5(10)	21%	43(9)	51(9)	18%
Netherlands	26	41(10)	61%	5(8)	5(10)	2%	31	46(10)	51%
Canada	30	37	23%	5(8)	8(8)	42%	35(10)	44	26%
Italy	23	28	22%	2(10)	4(11)	83%	26	33	27%
Belgium	28	27	-6%	6(7)	6(9)	-8%	34	32	-6%
Denmark	31(10)	27	-10%	4(9)	5(10)	26%	34	32	-6%
Luxembourg	19	22	16%	2(10)	31	8%	21	25	16%
Spain	18	19	5%	4(9)	4(11)	-3%	22	23	4%
Sweden	20	15	-23%	2(10)	4(11)	87%	22	20	-11%
Austria	13	11	-21%	2(10)	5(10)	100%	16	15	-3%
Others	39	95	145%	10	12	21%	48	107	120%
Total "net-gross" Turnover⁽³⁾	1,572	1,971	25%	270	474	76%	1,841	2,445	33%
Estimated Global Turnover⁽⁴⁾	1,190	1,490	26%	196	362	85%	1,386	1,852	34%

⁽¹⁾Data include spot transactions, outright forwards, and foreign exchange swaps.

⁽²⁾Data include foreign exchange derivatives (currency swaps, OTC options, and other OTC products) and single currency interest rate derivatives (forward rate agreements, interest rate swaps, OTC options, and other OTC products).

⁽³⁾Data adjusted for local double-counting ("net-gross" basis).

⁽⁴⁾Data adjusted for cross-border double-counting ("net-net" basis). Estimated global turnover for foreign exchange transactions also includes estimates for less than full coverage within individual reporting countries and for underreporting of activity involving nonreporting countries. Figures in brackets denote world rankings.

Source: HKMA Quarterly Bulletin, Nov. 1998, p. 55

risk."⁸ When the two markets are combined, Hong Kong's total turnover dropped by 13%, while its world ranking slipped from number 5 to number 8. In terms of stock market capitalization, Hong Kong's world ranking slipped from number 9 in 1997 to number 11 in 1998, but recovered to number 10 in 1999, as shown in Table 6.8.

In my book on Hong Kong as an international financial center, I give a detailed analysis of the world ranking of Hong Kong's banking sector on the basis of cross-border transactions. Unfortunately, the IMF's *International Financial Statistics* has ceased publishing its "international banking" survey since July 1997, depriving me of an important data source. Only a section on "international liquidity" remains. Moreover, since January 1, 1999, following the inauguration of the euro, the foreign assets and liabilities of European national domestic banks are combined under "Euro Area." With these changes in statistical sources taken into

TABLE 6.8
Stock Market Capitalization of Domestic Listed Companies
(US\$ millions)

<i>Exchange</i>	<i>November 1999</i>		<i>November 1998</i>		<i>November 1997</i>	
	<i>Rank</i>	<i>Market value</i>	<i>Rank</i>	<i>Market value</i>	<i>Rank</i>	<i>Market value</i>
New York	1	10,787,221.0	1	9,933,501.7	1	8,879,630.6
Tokyo	2	4,244,181.6	2	2,416,903.3	2	2,085,370.3
London	3	2,774,530.6	3	2,182,956.0	3	2,068,245.8
Paris	4	1,304,093.3	5	953,274.6	5	674,404.8
Germany	5	1,229,512.4	4	1,164,307.0	4	825,232.9
Toronto	6	692,511.4	9	531,257.3	7	567,635.1
Switzerland	7	661,636.5	6	686,751.2	6	575,339.3
Amsterdam	8	617,619.9	7	576,576.3	8	468,630.7
Italy	9	610,106.1	8	545,103.4	10	344,664.2
Hong Kong	10	536,630.5	11	355,045.5	9	413,322.6

Market value excludes investment funds.

Source: FIBV (*International Federation of Stock Exchanges*) *Monthly Statistics* (most representative exchange for each country)

account, Table 6.9 presents comparative figures of the major economies in terms of the foreign assets and liabilities of their banking sectors.

Several points about the table should be noted. First, the euro area includes, of course, important countries such as Germany, France, Italy, and Netherlands. Even so, their combined total foreign assets and liabilities were still less than those of the United Kingdom, confirming that London is still the largest banking center of not only Europe but also the world, in terms of international transactions. Second, Japan's data are not available after the first quarter of 1997. No reason is given,

TABLE 6.9
Foreign Assets and Liabilities of Domestic Deposit Banks (US\$ billion)

	<i>Time Period</i>	<i>Assets</i>	<i>Liabilities</i>
1. United Kingdom	March 1999	1,827.7	1,895.0
2. Euro area	July 1999	1,739.0	1,755.0
3. United States	February 1999	784.1	1,255.5
4. Japan	March 1997	1,098.9	711.3
5. Hong Kong	June 1999	452.5	372.8
6. Singapore	July 1999	49.0	49.8
— with Asian Currency Unit (ACU)		373.0	381.9
7. Switzerland	May 1999	292.0	243.0

Source: IMF *International Financial Statistics*, Oct. 1999

though one suspects that this has to do with Japan's worsening banking crisis and the AFC. Third, Singapore's domestic banking sector is very small, but if the Asian Currency Units (the Asian Dollar Market) are included, then Singapore's total foreign liabilities are somewhat larger than Hong Kong's, though their total assets are still smaller than Hong Kong's. On balance, Hong Kong is probably still the fifth largest banking center in terms of international banking business.

The total number of authorized institutions under the three-tier system fell, however, from 368 in 1996 to 333 in 1998, while the presence of the world's largest 1,000 banks also fell from 334 to 309 during the same period, reflecting mainly the withdrawal of Japanese banks and deposit-taking companies.⁹ The total number of insurance companies decreased slightly from 223 to 211 during the same period. On the other hand, the total number of unit trusts and mutual funds (including sub-funds and umbrella funds) rose from 1,311 at end-1996 to 1,535 at end-September 1998.¹⁰

In my book on IFCs, I compared Hong Kong and Singapore as of 1995–96 and concluded that "Hong Kong can still be considered a larger or more important IFC than Singapore. But it must be admitted that the edge is so small that Singapore can easily overtake Hong Kong, especially if the 1997 transition is not managed well."¹¹ Looking back, the transition to Chinese sovereignty has been completed much more smoothly than expected, but Hong Kong's status has instead been threatened by the AFC. Table 6.6 shows clearly that the territory now lags behind Singapore in the forex market and derivatives market, and the relative position has worsened somewhat since 1994, even though Singapore has also been affected by the AFC.

Of course, neither Hong Kong nor Singapore can challenge Tokyo, even though Tokyo has been even more badly hit by the AFC, as well as by its own banking crisis. However, Tokyo is still far ahead because of the sheer size of Japan's economy and financial sector. As to other potential competitors such as Shanghai and Sydney, they are still essentially domestic or national financial centers rather than IFCs. For Hong Kong, therefore, what really matters is still the challenge from Singapore.

Hong Kong, however, leads Singapore in banking, stock market, insurance, and fund management, as data in Tables 6.7 and 6.8 and elsewhere indicate. One problem with Singapore is that its small size belies its global ambition. No matter how hard it tries to replace Hong Kong as an IFC, as it has done over the past 30 years, especially after the 1997 problem surfaced in the early 1980s, it has failed to succeed in this objective. One amusing episode was that soon after the Hong Kong government intervened in the equity market in August 1998 and imposed tighter regulations on both the stock market and the futures

market to deter speculators from exploiting their “double market play,” Singapore thought that an opportunity had come for enticing business away from Hong Kong. The Singapore International Monetary Exchange (SIMEX) therefore relaunched the Hong Kong Stock Index Futures, now renamed Hong Kong Morgan Stanley Capital International (HIMSCI) stock index futures, on November 23, 1998. But one year later, the new contract had captured less than 0.1% of the market. Indeed, for some months, for example March, April, and December 1999, SIMEX failed to register a single trade. Market participants therefore unanimously agreed that SIMEX’s effort was an embarrassing flop.¹²

Nevertheless, it would be a mistake for Hong Kong to be smug and to dismiss Singapore’s challenge out of hand. The Hong Kong authorities, to their credit, are aware of this, and many measures have been taken to promote and consolidate Hong Kong’s position as an IFC.

As noted in the previous section, the government has accepted most of the recommendations of the consultancy firm concerning the relaxation of entry barriers to foreign banks, deregulation of interest rates by removing the remaining IRRs (Interest Rates Rules), a kind of quasi-cartel arrangement, liberalization of the access to Real Time Gross Settlement (RTGS), raising minimum capital requirement for local authorized institutions, simplification of the three-tier system, and upgrading the supervisory framework detailed in Table 6.6. These measures, if and when implemented, will enhance the competitiveness and safety of Hong Kong’s banking sector, thereby contributing to its status as an IFC. But they also will have domestic repercussions. In particular, small and medium-sized banks will face much greater competitive pressures. Although most of them have, since the banking crises of the 1960s and 1980s, allowed outsiders (mainly foreign and mainland banks) to acquire interests in their shareholdings, more consolidations can be expected. Small and medium-sized banks can survive only if they merge among themselves, sell majority holdings to larger and stronger banks, or form strategic alliances with others.

Under government prodding, the stock exchange and the futures exchange have agreed to demutualize and to merge into a new entity called Hong Kong Exchanges and Clearing Ltd., which hopefully will greatly increase efficiency and transparency and avoid the confusion and noncooperation exposed during the crisis of August 1998. Other innovations include the successful IPO of Tracker Fund on November 12, 1998, with more offerings to come from time to time; the creation of a second board called Growth Enterprise Market (GEM), which caters to the funding needs of technology and innovation-based companies in Hong Kong, Mainland China, and Taiwan, with first listings taking place on November 25, 1999; the signing of a Dual Listing Pilot Program

with Nasdaq of the United States in December 1999; the development of the bond market by the listing agreement for bonds issued by China, the listing of Exchange Funds notes and issues of the Hong Kong Mortgage Corporation, and improvement of services, regulation, and disclosure. These measures are designed to ensure that Hong Kong will remain one of the "top ten" equity markets of the world and an integral part of the 24-hour global securities market.¹³

These efforts are, of course, to be commended. What is needed now is a joint government-industry study of the decline in the turnover in the forex and derivatives markets, and effective measures to counter it.

An IFC cannot live in a vacuum. It needs the support from other sectors of the economy, such as infrastructure and telecommunications. Hong Kong has never spared any effort in constantly expanding and modernizing its infrastructure. Its new airport at Chek Lap Kok, completed in 1998 despite initial confusion and mishap, is now widely recognized as one of the most modern and efficient airports of the world. In the coming years, it will no doubt contribute to Hong Kong's position as an international air transportation hub, especially as charges have been lowered since January 1, 2000. Hong Kong and Singapore have alternatively shared the honors of being the busiest terminal ports of the world. Construction work on Container Terminal No. 9 and the Western Railway project have also begun.

Given that economic and financial information needs to be acquired, processed, and diffused quickly, even instantaneously, and at reasonable costs, the importance of telecommunications can hardly be overestimated. Recognizing this, the government has been pursuing a policy of gradual liberalization, beginning with the termination of Cable and Wireless Hong Kong Telecom's monopoly of telephone international services and circuits in 1998. The latest developments include the granting of 17 new licenses for fixed network services on January 17, 2000. By more price competition, these measures will cut telecommunications costs still further and will therefore strengthen Hong Kong's positions as both an IFC and an information technology hub. The significance of this is not lost on Singapore. Only days after Hong Kong's decision, Singapore also announced that it would scrap all limits on foreign ownership in the telecommunications industry with immediate effect and bring forward the deadline for full competition by two years, to April 1, 2000.¹⁴

Closely related to Hong Kong's status as an IFC is its role as an international business center. While space does not permit a detailed discussion of this subject, an important indicator is the choice of Hong Kong as regional headquarters for Asia-Pacific, or a part of the region, such as Greater China. Table 6.10 shows the number of multinational corporations and their source countries/territories in the 1990s.

TABLE 6.10
Hong Kong as Regional Headquarters by Source Country of Ultimate Parent Companies

<i>Source Country/Territory</i>	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
United States	252	258	206	182	178	198	188	219	194	205
Japan	20	44	74	88	91	116	122	121	109	114
United Kingdom	77	75	73	81	91	94	90	86	95	82
Mainland China	-	-	-	67	62	71	85	117	70	69
Germany	13	30	28	26	35	33	40	53	59	55
France	29	25	25	21	26	28	26	35	38	36
Netherlands	31	31	24	26	22	28	30	27	27	32
Switzerland	34	31	33	25	34	23	27	30	28	32
Taiwan	-	-	-	-	14	22	25	28	26	28
Others	125	112	133	113	164	163	180	219	183	195
	581	606	596	629	717	793	829	935	829	848

Source: Industry Department, Report on the Survey of Regional Representation by Overseas Companies in Hong Kong, various years

As may be seen, the total number increased steadily from 581 in 1990 to a peak of 935 in 1997, just before the handover. Then it dropped sharply to 829 in 1998, or by 11%, reflecting no doubt the AFC and the slump in Hong Kong itself. However, it picked up again to 848 in 1999, following signs of an easing of the AFC and recovery of Hong Kong.

The most stable source countries/territories are the United States, Japan, the United Kingdom, Mainland China, Germany, France, Netherlands, Switzerland, and Taiwan. Others are often transitory and highly changeable. Note that the number of companies from Mainland China surged sharply from nil in the early 1990s to 117 in 1997, but then fell sharply to only 70 in 1998, a drop of 40%, and did not recover in 1999, suggesting that they had been hard hit by the AFC.

CONCLUDING REMARKS

The impact of the AFC on the banking sector manifested itself primarily in reduced profitability of banks in 1998. There was however, no banking crisis, nor any default of any individual bank. As the general economic environment improved in 1999, most if not all banks resumed their positive profit growth. Timely reforms of both the banking system and the supervisory framework have borne their fruits, making Hong Kong's banking system one of the soundest in the whole Asia-Pacific region. The government's efforts in stabilizing the asset markets, discussed in the previous chapter, have also helped.

The AFC has had also a negative, though mild, impact on Hong Kong's status as an international financial center (IFC). Hong Kong remains the second largest IFC in the Asia-Pacific region. However, as European centers have so far not been affected at all by the AFC, Hong Kong's world ranking has thereby fallen. At the time of writing, full quantitative indicators were not yet available. But an educated guess is that its world ranking has probably gone down one notch, from between the sixth and seventh largest to between the seventh and eighth largest among the IFCs of the world.

NOTES

1. "Authorized institutions" (AIs) mean licensed banks, restricted-license banks, and deposit-taking companies under the three-tier banking structure in force since 1981.

2. *HKMA Quarterly Bulletin*, November 1999, p. 121.

3. See HKMA Annual Report for 1998, pp. 30–32.

4. The delinquency ratio of residential mortgages in Hong Kong is also very low by international comparison. In the downturn of 1990–91 in the United States, the

corresponding ratio was 3.71. See E. Guyot and Yu Wong, "Home Loans Insulate Banks in Hong Kong from Crisis," *Asian Wall Street Journal*, March 12, 1998.

5. See Peter Chan, "SAR banks win vote of confidence," *South China Morning Post*, December 9, 1999.

6. CAMEL is the acronym of the five criteria for evaluating the soundness of banks: capital adequacy, asset quality, management quality, earnings performance, and liquidity. Banks are scored on a scale of 1 (the best) to 5 (the worst) on the basis of CAMEL ratings. Pioneered by the Federal Reserve System in the United States, the measure has now been widely adopted elsewhere, including Hong Kong.

7. See "Turnover of Foreign Exchange and Derivatives Markets in Hong Kong," *HKMA Quarterly Bulletin*, November 1998, pp. 54–55.

8. *Ibid.*, p. 56.

9. For details, see HKMA Annual Report for 1998, pp. 140–143.

10. Details are given in the annual reports of the Securities and Futures Commission and the Commissioner of Insurance.

11. Jao (1997a), p. 108.

12. Barry Forter, "Singapore play with HK futures ends feeble year," *South China Morning Post*, November 23, 1999. When the new product was introduced a year earlier, both the Hong Kong government and the Hong Kong futures exchange reacted strongly and denounced it as a "predatory" action. Singapore first introduced a Hong Kong futures contract in March 1993, but terminated it in August 1997 because of a lack of interest.

13. See the "1999 Year End Review" by Alec Tsui, chief executive of the Hong Kong Stock Exchange.

14. See Barry Porter, "Singapore unleashes telecoms free-for-all," *South China Morning Post*, January 22, 2000.

CHAPTER APPENDIX: HKMA LOAN CLASSIFICATION SYSTEM

Category	Definition	Typical Overdue Period *	Provisioning
Pass	Loans where borrowers are current in meeting commitments & full repayment of interest & principal is not in doubt.		A general provision of at least 1% across-the-board should be established. Alternatively, the provision may be calculated according to a formula based on past loan loss experience in respect of different categories of loans (e.g. 1/2% on residential mortgages, 2% on taxi loans, etc.)
Special mention	Loans where borrowers are experiencing difficulties which may threaten the institution's position. Ultimate loss is not expected at this stage but could occur if adverse conditions persist.	Unsecured or partially-secured: Up to 3 months [N.B. downgrading to substandard may be justified, even if the loan has not been overdue for more than 3 months, where other significant deficiencies are present which threaten the borrower's business, cash flow & payment capability.] Fully secured: Up to 12 months [N.B. fully secured loans need not be downgraded to substandard until they are over 12 months overdue]	No specific provision is necessary against loans classified as special mention, but it may be appropriate to increase the general provision against such loans to, say, 2% (whether secured or unsecured). For taxi loans a specific provision of 2% on top of a general provision of 2% is recommended.
Substandard	Loans where borrowers are displaying a definable weakness that is likely to jeopardise repayment. Includes loans where some loss of principal or interest is <i>possible</i>	Unsecured or partially-secured: Generally more than 3 months up to 6 months [N.B. downgrading to doubtful may be justified, even if the loan has not been overdue for more	Specific provisions should normally be made as soon as a loan is classified as substandard, unless there are good reasons to the contrary (however, provisions against

Category	Definition	Typical Overdue Period *	Provisioning
Substandard (cont.)	<p>after taking account of the "net realisable value" of security, & rescheduled loans where concessions have been made to the customer on interest or principal (i.e. which have been made on non-commercial terms). N.B. Such loans may be upgraded to pass once they have been serviced according to the revised terms for 6 months (monthly repayments) / 12 months (other than monthly repayments).</p>	<p>than 6 months, where other significant deficiencies are present which threaten the borrower's business, cash flow & payment capability.]</p> <p>Fully secured: Over 12 months</p>	<p>substandard loans may not be necessary where the policy of the AI is to classify loans promptly as doubtful & to provision accordingly).</p> <p>Provisions should be determined on a loan-by-loan basis, with full provision being made for the likely loss (i.e. the irrecoverable amount). However, in practice it may be difficult to reliably estimate the likely loss (particularly at the comparatively early stage of a loan being downgraded to substandard). Generally speaking, therefore, the level of provisions in respect of individual loans tends to be related to the loan classification.</p> <p>In the case of substandard loans, an AI may typically provide 20-25% against the unsecured portion of those loans that it is unable to assess on a loan-by-loan basis.</p> <p>In the case of portfolios of loans with similar characteristics (e.g. credit cards) the provision may be based on past loan loss experience.</p>
Doubtful	<p>Loans where collection in full is improbable & the institution expects to sustain a loss of principal &/or</p>	<p>Unsecured or partially-secured: Generally more than 6 months</p>	<p>Given that, generally speaking, the level of provisions in respect of individual loans tends to be related to</p>

Category	Definition	Typical Overdue Period *	Provisioning
Doubtful (cont.)	Interest after taking account of the net realisable value of security.		<p>the loan classification, higher provisions will generally be required when loans are downgraded into a lower category (e.g. from substandard to doubtful).</p> <p>Typically, loans will be reclassified from substandard to doubtful when the overdue period increases to more than 6 months. With this passage of time the position of the borrower & therefore the position as regards the degree of recoverability of the loan may become clearer, & it may be possible to more accurately assess the likely loss on a loan-by-loan basis. Consequently a range of provisioning levels is possible.</p> <p>Typically, however, provisions are likely to be in the range of 50-75% against the unsecured portion. Provisions at the higher end of this range (& perhaps as high as 100%) may be appropriate where there has been no sign of progress/improvement over time (e.g. further provision should be considered against loans which show no improvement from one review period to the next).</p> <p>If it is still not possible to reliably estimate the likely loss on some loans, it</p>

Category	Definition	Typical Overdue Period *	Provisioning
Doubtful (cont.)			is prudent for an AI to provide at least 50% against those doubtful loans that it is unable to assess on a loan-by-loan basis.
Loss	Loans which are considered uncollectible after exhausting all collection efforts such as realisation of collateral, institution of legal proceedings, etc.		All outstanding principal & interest which are not covered by the value of collateral should be fully provided for or written off (e.g. 100% provision)

*In the case of loans under restructuring, the overdue period should be measured from the time the loan first went overdue.

Source: HKMA *Quarterly Bulletin*, November 1999

Impact on the Real Economy

INTRODUCTION

In the previous four chapters, we have reviewed and analyzed the impact of the AFC on the currency, the asset markets, and the financial sector. The general conclusions are that the monetary system and exchange rate regime have remained intact and stable despite several massive attacks, that the banking system suffered initially a sharp drop in profitability but otherwise experienced no crisis, and that the asset markets also suffered initially sharp losses, but the equity market stabilized thanks to government intervention and later rebounded, while the property market managed to stabilize around the current depressed level.

In this chapter, the impact on the real economy is examined. It must be stressed that, for expository convenience, the analysis adopts a sectoral approach. In reality, the macro-economy is organically connected to each and every sector, though the overall effect can be regarded as the weighted average of the impact on each separate sector.

MACROECONOMIC PERFORMANCE

In the first six months after the outbreak of the AFC, Hong Kong still managed to register a relatively respectable positive growth of real gross domestic product (GDP) (see Table 7.1). In fact, in Q3 of 1997, the real growth rate was still as high as 5.7%. After "Black Thursday," however, the economy visibly slowed down, but the growth rate was still positive at 2.4%. The whole-year growth rate was 5.2%, marginally higher than the 5% recorded in 1996. From Q1 1998 onward, however,

TABLE 7.1
Year-on-Year Growth Rates of Real GDP (%)

	1997	1998	1999
Q1	6.0	-2.6	-3.0
Q2	6.8	-5.1	1.1
Q3	5.7	-7.0	4.4
Q4	2.4	-5.6	8.7
Whole Year	5.2	-5.1	2.9

Source: Economic Division, Financial Services Bureau

the economy deteriorated rapidly, with five consecutive quarters of negative year-on-year growth rates, before positive growth resumed in Q2 of 1999. The contraction of per capita real GDP in 1998 was even higher at -7.8% .

From a quarter-to-quarter perspective, there were six consecutive negative growth periods of real GDP from Q4 1997 to Q1 1999, as shown in Table 7.2.

The decline in real income or output in 1998 was broadly based, with all components of GDP being hard hit with the exception of government consumption, as clearly shown in Table 7.3.

This macroeconomic performance was the worst since an official GDP estimate was first compiled and released in 1961. Table 7.4 presents real GDP growth rates in previous downturns during the period 1961–95. As Table 7.4 shows, what happened in previous downturns was a reduction, in varying degrees, in real GDP growth rates, which remained, however, positive. In other words, only “growth recession” was experienced. But in 1998, the economy contracted significantly in absolute terms.

In terms of *per capita* real GDP, negative growth rates were also recorded for the years 1967, 1974, 1975, and 1985, but they were all easily dwarfed by the -7.8% recorded for 1998.

It was quite possible that in 1951, when Hong Kong lost its entrepôt trade, the mainstay of its economy, overnight because of the United

TABLE 7.2
Quarter-to-Quarter Growth Rates of Real GDP (%)

	1997	1998	1999
Q1	1.9	-2.9	-0.3
Q2	1.7	-1.1	3.1
Q3	0.5	-1.4	4.4
Q4	-1.8	-0.5	8.7

Source: Economic Division, Financial Services Bureau

TABLE 7.3
Expenditure-based Gross Domestic Product (GDP) Estimates

<i>Expenditure component</i>	<i>(HK\$ million)</i>			
	<i>At current market prices</i>		<i>At constant (1990) market prices</i>	
	<i>1997[#]</i>	<i>1998[#]</i>	<i>1997[#]</i>	<i>1998[#]</i>
Private consumption expenditure	798,883 (10.6)	767,560 (-3.9)	501,017 (6.2)	467,585 (-6.7)
Government consumption expenditure	113,807 (9.0)	118,134 (3.8)	61,606 (2.4)	62,069 (0.8)
Gross domestic fixed capital formation	445,775 (19.7)	388,904 (-12.8)	304,580 (12.7)	285,226 (-6.4)
<i>of which: Construction</i>	134,493 (14.3)	139,454 (3.7)	90,088 (4.7)	85,939 (-4.6)
Machinery and equipment	183,832 (11.8)	162,232 (-11.7)	162,156 (13.1)	151,394 (-6.6)
Change in inventories	12,313	-12,685	10,927	-14,899
Total exports of goods	1,455,949 (4.2)	1,347,649 (-7.4)	1,404,124 (6.1)	1,343,716 (-4.3)
<i>of which: Domestic exports</i>	211,410 (-0.4)	188,454 (-10.9)	202,369 (2.1)	186,393 (-7.9)
Re-exports	1,244,539 (5.0)	1,159,195 (-6.9)	1,201,755 (6.8)	1,157,322 (-3.7)
less Imports of goods	1,619,468 (5.2)	1,432,423 (-11.5)	1,533,705 (7.2)	1,424,031 (-7.2)
Exports of services	298,176 (0.7)	267,394 (-10.3)	217,818 (-0.1)	203,366 (-6.6)
less Imports of services	180,270 (5.5)	176,499 (-2.1)	137,360 (4.0)	136,588 (-0.6)
Total expenditure on GDP	1,325,165 (11.2)	1,268,034 (-4.3)	829,007 (5.0)	786,444 (-5.1)
Per capita GDP ^(a) (\$)	203,806 (7.9)	189,621 (-7.0)	127,498 (1.9)	117,604 (-7.8)
Implicit Price Deflator (1990=100)		% change		% change
GDP	1997	over 1996	1998	over 1997
GDP	159.8	5.9	161.2	0.9
Domestic demand ^(b)	156.1	4.8	157.7	1.0

Notes: Figures in brackets represent percentage changes over the preceding year.

^(a) Per capita GDP is equal to the total expenditure on GDP divided by the total mid-year population.

^(b) Domestic demand is defined as the sum of private consumption expenditure, government consumption expenditure, gross domestic fixed capital formation, and change in inventories. The implicit price deflator of domestic demand thus provides a general measure of domestic inflation.

^(#) Revised (September 1999) estimates.

Source: Economic Analysis Division, Financial Services Bureau, *Third Quarter Economic Report 1999*

TABLE 7.4
Real GDP Growth Rates During Downturns 1961–95

<i>Period</i>	<i>Nature of Downturn</i>	<i>Real GDP Growth (%)</i>	<i>Per Capita Real GDP Growth (%)</i>
1966–67	Aftermath of 1965 banking crisis, followed by leftist disturbances	1.7% in 1966 1.7% in 1967	0.8% in 1966 -0.8% in 1967
1974–75	First oil shock, worldwide recession	2.3% in 1974 0.3% in 1975	-0.2% in 1974 -1.4% in 1975
1982	Worldwide recession and confidence crisis in Hong Kong	2.7	1.2
1985	Appreciation of U.S. dollar and slowdown after previous year's strong growth	0.4	-0.6
1989	Effect of Tienanmen tragedy	2.6	1.5
1995	Mild downturn after interest rate rises in U.S. and Hong Kong	3.9	1.9

Source: Underlying data from Census and Statistics Department, *Estimates of Gross Domestic Product 1961 to 1998*

Nations and United States embargoes against China during the Korean War, the territory experienced an even more severe contraction. But prior to 1961, there was no official and reliable system of national income accounting. Even in private studies of national income, the time series start at 1952. In short, the downturn of 1998 came close to being a “depression” rather than just a “recession.”

EXTERNAL TRADE

Hong Kong is an extremely open and trade-dependent economy. The ratio of total external trade (domestic exports, re-exports, and imports) to GDP has been consistently over 200%. Even in 1998, a year of severe slump, the ratio was still as high as 219%. A review of external trade in 1997–99 is therefore necessary for understanding the impact of the AFC on the real economy.

Like other sectors, the external trade sector began to feel the negative effect of the contagion only after “Black Thursday.” For 1997 as a whole, the whole sector was still able to register positive growth. In 1998, however, the full impact was so overwhelming that domestic exports,

TABLE 7.5
Total Exports, Re-exports and Domestic Exports
(year-on-year growth rate (%))

		Total exports			Re-exports			Domestic exports		
		In value terms	In real terms	Change in prices	In value terms	In real terms	Change in prices	In value terms	In real terms	Change in prices
1997	Annual	4	6	-2	5	7	-1	*	2	-2
	Q1	2	4	-1	4	5	-1	-6	-4	-2
	Q2	4	6	-2	5	7	-2	-1	*	-2
	Q3	3	4	-2	3	4	-2	3	6	-3
	Q4	7	10	-2	8	10	-1	2	5	-3
1998	Annual	-7	-4	-4	-7	-4	-4	-11	-8	-3
	Q1	-1	1	-3	*	2	-3	-7	-5	-2
	Q2	-3	-1	-3	-3	-1	-3	-4	-1	-3
	Q3	-10	-7	-4	-10	-7	-5	-12	-9	-3
	Q4	-14	-10	-5	-13	-9	-5	-19	-15	-3
1999	Annual	*	4	-3	2	5	-3	-9	-7	-2
	Q1	-9	-5	-4	-8	-4	-5	-12	-9	-3
	Q2	-6	-2	-4	-4	*	-4	-15	-13	-3
	Q3	4	8	-2	7	11	-2	-10	-8	-3
	Q4	10	12	-1	12	14	-1	-1	1	-2

*Change of less than 0.5%.

Source: Economic Analysis Division, Financial Services Bureau, 1999 *Economic Background*

re-exports, and imports all fell sharply in both value and volume terms, as shown in Tables 7.5 and 7.6 respectively. (Total exports are the sum of domestic exports and re-exports.)

Note that within total exports, the negative growth of domestic exports was much greater than that of re-exports. In Q3 of 1999, total exports and re-exports resumed positive growth, but domestic exports still showed negative growth. Correspondingly, the decline in retained imports (the difference between total imports and re-exports) was much steeper than that of total imports. Indeed, from Q3 1998 to Q2 1999, retained imports registered double-digit negative growth, reflecting very weak domestic economic activity.

Mainland China and the United States are Hong Kong's largest trading partners. Between them they take over half of Hong Kong's domestic exports and re-exports. Other important markets are the United Kingdom, Japan, Germany, Singapore, and Taiwan. All together, these markets take about 75% of total exports. It would be illuminating to see how these markets fared during the slump of 1998.

Table 7.7 shows real growth rates of domestic exports by major markets. As may be readily seen, in 1998, only domestic exports to Germany maintained a positive growth of 3%. All other markets regis-

TABLE 7.6
Imports and Retained Imports (year-on-year growth rate (%))

		<i>Imports</i>			<i>Retained imports</i>		
		<i>In value terms</i>	<i>In real terms</i>	<i>Change in prices</i>	<i>In value terms</i>	<i>In real terms</i>	<i>Change in prices</i>
1997	Annual	5	7	-2	6	8	-3
	Q1	4	6	-2	5	8	-4
	Q2	5	7	-2	4	6	-3
	Q3	6	7	-2	12	14	-2
	Q4	6	8	-2	1	3	-4
1998	Annual	-12	-7	-5	-18	-14	-5
	Q1	-5	-2	-4	-12	-9	-5
	Q2	-6	-2	-5	-9	-4	-5
	Q3	-15	-10	-6	-24	-19	-6
	Q4	-18	-13	-5	-27	-24	-4
1999	Annual	-3	*	-2	-11	-12	*
	Q1	-14	-10	-4	-23	-23	-2
	Q2	-11	-8	-3	-23	-23	-3
	Q3	4	7	-2	-1	-2	-1
	Q4	11	12	*	9	6	3

*Change of less than 0.5%.

Source: Economic Analysis Division, Financial Services Bureau, 1999 *Economic Background*

TABLE 7.7
Domestic Exports by Major Market^(a) (year-on-year rate of change in real terms (%))

		<i>Mainland of China</i>	<i>United States</i>	<i>United Kingdom</i>	<i>Germany</i>	<i>Japan</i>	<i>Singapore</i>
1998	Annual	-7	-1	-4	3	-39	-36
	Q1	1	8	-5	-3	-32	-28
	Q2	3	10	1	2	-36	-37
	Q3	-10	-1	-4	9	-43	-45
	Q4	-20	-14	-6	2	-45	-33
1999	Annual	-6	-6	6	-10	-15	-23
	Q1	-14	-5	-1	-1	-21	-43
	Q2	-12	-13	-4	-7	-21	-33
	Q3	-3	-9	12	-21	-6	-10
	Q4	5	5	16	-9	-10	-4

Note: ^(a)Volume indices for domestic exports to Taiwan are not available.

Source: Economic Analysis Division, Financial Services Bureau, 1999 *Economic Background*

tered negative growth, even including relatively prosperous markets like the United States and the United Kingdom. In particular, the drop of nearly 40% in domestic exports to Japan and Singapore was nothing less than catastrophic. The decline continued in 1999, and only in Q3 did the growth rate turn positive for the United Kingdom. Note also that the negative growth rate of domestic exports to Mainland China accelerated from Q3 1998 onward and did not moderate until Q3 of 1999, a trend no doubt reflecting China's slowdown and weak domestic consumption.

The performance of re-exports, as shown in Table 7.8, was somewhat better, though for the year 1998, all markets registered negative growth except the United States and the United Kingdom. Things improved considerably in 1999, with the United Kingdom and Singapore resuming positive growth in Q1. By Q3, all markets had resumed positive growth.

Another important aspect of Hong Kong's external trade is outward processing, which is defined by the Hong Kong government as an arrangement between Hong Kong companies and manufacturing entities in China (which may be local firms, joint ventures, or other forms of enterprise involving foreign investment), under which the Hong Kong companies concerned subcontract the whole or part of their production processes to the mainland entities.¹ Most, if not all, of the finished products are then sent back to Hong Kong for re-exporting to third countries. This form of trade has grown rapidly since China adopted reform and open-door policies in 1979 and has become a

TABLE 7.8
Re-exports by Major Market (year-on-year rate of change in real terms (%))

		<i>Mainland of China</i>	<i>United States</i>	<i>Japan</i>	<i>United Kingdom</i>	<i>Germany</i>	<i>Singapore</i>	<i>Taiwan</i>
1998	Annual	-4	2	-12	6	-6	-14	-4
	Q1	7	8	-11	10	1	-13	9
	Q2	1	4	-11	11	-3	-12	-7
	Q3	-7	-2	-14	4	-7	-23	-8
	Q4	-13	-2	-11	1	-11	-9	-10
1999	Annual	3	6	11	12	7	15	7
	Q1	-8	-2	*	2	-9	12	-10
	Q2	-5	2	6	6	*	12	4
	Q3	11	10	15	17	11	17	12
	Q4	12	12	21	18	23	18	21

Note: *Change of less than 0.5%

Source: Economic Analysis Division, Financial Services Bureau, *1999 Economic Background*

TABLE 7.9
Domestic Exports, Re-exports, and Total Exports to Mainland China for
Outward Processing (year-on-year rate of change in value terms (%))

		<i>Domestic exports to the Mainland for outward processing</i>	<i>Re-exports to the Mainland for outward processing</i>	<i>Total exports to the Mainland for outward processing</i>
1998	Annual	-10	-9	-10
	Q1	-1	-8	-6
	Q2	7	-4	-2
	Q3	-19	-10	-12
	Q4	-23	-16	-17
1999	Q1	-14	1	-2
	Q2	-19	3	-2
	Q3	-6	15	11

Source: Economic Analysis Division, Financial Services Bureau, *1999 Economic Background*

barometer of the economic health of both Mainland China and Hong Kong, and of their economic integration. It is a measure of the severity of the slump in Hong Kong and slowdown in China during the AFC that both exports to Mainland China for outward processing and imports from Mainland China after outward processing declined substantially in value terms in 1998, as shown in Tables 7.9 and 7.10.

INBOUND TOURISM

Inbound tourism is also an important pillar of the Hong Kong economy and can be regarded as a part of the external trade in services. It accounted for about 24% of export of services during 1987–96. This sector was badly hit by recessionary forces even before the onset of the AFC. As shown in Table 7.11, the disastrous drop in the number of visitors from Japan began as early as Q2 of 1997, followed by the same pattern for visitors from South and Southeast Asia. It was not until Q3 1998 onward that the numbers resumed positive growth.

Visitor spending also decreased sharply in two consecutive years, 1997 and 1998, and only in 1999 did the decrease moderate significantly, as shown in Table 7.12.

EMPLOYMENT AND UNEMPLOYMENT

In the wake of the deepening of the AFC and the consequent sharp economic downturn, the numbers of persons both unemployed and

TABLE 7.10

Imports from Mainland China and Re-exports of Mainland Origin to Overseas Markets after Outward Processing (year-on-year rate of change in value terms (%))

		<i>Imports from the Mainland after outward processing</i>	<i>Re-exports of Mainland origin after outward processing</i>
1998	Annual	-3	-6
	Q1	5	4
	Q2	2	-5
	Q3	-4	-8
	Q4	-11	-13
1999	Q1	-2	-4
	Q2	-2	1
	Q3	1	1

Source: Economic Analysis Division, Financial Services Bureau, 1999 *Economic Background*

underemployed, as well as the unemployment and underemployment rates, have also surged. At the same time, both labor force and persons employed have also increased, though much more moderately.² The details are given in Table 7.13.

As may be seen, the number of unemployed more than tripled, from fewer than 70,000 in Q3 1997, when the impact of AFC began to be felt, to 219,600 in Q4 1999. Correspondingly, the number of underemployed also more than tripled from 33,100 to 100,200 during the same period. Meanwhile, the total labor force increased by 10.6% and persons employed increased by 6% during the same period. The fact that total employment still managed to increase in the midst of a deep slump is perhaps the only bright spot in an otherwise grim picture.

Official statistics on unemployment began to be compiled only in the early 1970s, and the existing time series starts from 1975. Table 7.14 shows that the unemployment rate surged from 2.2% to 6.1% from Q3 1997 to Q4 1999, while the underemployment rate also rose sharply from 1% to 2.8% during the same period. However, after reaching a peak of 6.2% in Q1 1999, the unemployment rate appears to have stabilized at 6.1% in the subsequent quarters. The median duration of unemployment, after rising from 73 days in Q3 1997 to 99 days in Q1 1999, also declined somewhat, to 97 days in Q4 1999.

Unemployment rates by major economic sector in 1998–99 are given in Table 7.15. As may be seen, unemployment rates were very high in construction and manufacturing, due to both cyclical and structural factors, but very low in financing, insurance, real estate and business

TABLE 7.11
Number of Incoming Visitors by Residence (year-on-year rate of change %)

	1997					1998					1999				
	Annual	Q1	Q2	Q3	Q4	Annual	Q1	Q2	Q3	Q4	Annual	Q1	Q2	Q3	Q4
	All Sources	-11	9	2	-27	-23	-8	-25	-16	10	5	12	13	10	11
Mainland China	-1	17	2	-21	1	13	-5	-1	52	15	19	30	21	10	16
Taiwan	-2	25	19	-18	-18	2	-1	*	3	4	10	6	9	13	13
South and Southeast Asia	-7	4	14	-26	-20	-20	-32	-33	-14	6	19	17	19	26	15
Japan	-43	*	-33	-59	-65	-31	-60	-36	7	-6	8	15	-1	1	18
US	7	15	23	-8	-3	-3	-20	-8	7	10	4	5	*	9	3
UK	-14	13	-2	-41	-28	-4	-21	-18	28	15	-5	-13	-10	2	1
Others	-4	1	6	-15	-10	-17	-32	-22	-8	-2	6	4	2	9	9

*Change of less than 0.5%.

Source: Hong Kong Tourist Association

TABLE 7.12
Visitor Spending in Hong Kong

<i>Year</i>	<i>Amount (HK\$ billion)</i>	<i>Year-on-Year Change (%)</i>
1997	72.1	-14.7
1998	53.1	-26.3
1999	51.0	-4

Source: Hong Kong Tourist Association

services, and community, social, and personal services. This phenomenon is consistent with the general trend during the past 20 years of sectoral shift in both GDP and employment toward the tertiary sectors.³

DEFLATION

One unprecedented phenomenon that took Hong Kong by surprise, plagued as it was by structural inflation in 1987–97, was deflation. As measured by the composite consumer price index, deflation (or negative inflation) began in November 1998. Table 7.16 shows the year-on-year change in the four consumer price (CPI) indices for 1998–99.⁴

As shown in Table 7.16, deflation deteriorated from November 1998 onward, reaching its peak in the Q3 of 1999. The causes of this deflationary trend will be explained in greater detail in the next chapter. At this juncture, it is sufficient to note that no price decline

TABLE 7.13
Labor Force, Employment, Unemployment, and Underemployment

		<i>Labor Force</i>	<i>Persons Employed</i>	<i>Persons Unemployed</i>	<i>Persons Under-employed</i>
1997	Q1	3,160,900	3,090,200	70,700	34,500
	Q2	3,180,800	3,112,800	68,000	39,900
	Q3	3,192,200	3,122,400	69,700	33,100
	Q4	3,330,200	3,253,400	76,800	44,000
1998	Q1	3,272,800	3,166,600	106,200	63,600
	Q2	3,348,000	3,204,300	143,700	86,000
	Q3	3,379,900	3,200,500	179,400	90,200
	Q4	3,433,700	3,232,500	201,200	102,100
1999	Q1	3,439,600	3,226,300	213,300	104,400
	Q2	3,474,500	3,263,100	211,400	99,800
	Q3	3,463,000	3,239,100	223,900	108,900
	Q4	3,529,000	3,309,500	219,600	100,200

Source: Census and Statistics Department, *General Household Survey*

TABLE 7.14
Unemployment and Underemployment Rates

		<i>Seasonally Adjusted Unemployment Rate</i>	<i>Underemployment Rate</i>
1997	Q1	2.5	1.1
	Q2	2.4	1.3
	Q3	2.2	1.0
	Q4	2.5	1.3
1998	Q1	3.5	1.9
	Q2	4.4	2.6
	Q3	5.0	2.7
	Q4	5.7	3.0
1999	Q1	6.2	3.0
	Q2	6.1	2.9
	Q3	6.1	3.1
	Q4	6.0	2.8

Source: Hong Kong Tourist Association

of such duration and magnitude had occurred for 50 years. In 1947 and 1948, there were mild declines, but for only a few months, according to the Retail Price Index (March 1947 = 100).⁵ Since the General and Modified CPI were compiled in the early 1960s and were then replaced by the present CPIs in the 1970s, no deflationary

TABLE 7.15
Unemployment Rates by Major Economic Sector (%)^(a)

	1998				1999			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Wholesale, retail, and import/export trades, restaurants and hotels	3.3	4.9	5.4	6.0	6.5	6.5	6.2	6.5
Transport, storage, and communications	2.7	3.4	3.9	4.7	5.5	5.6	5.3	4.7
Financing, insurance, real estate, and business services	1.8	2.6	3.3	3.6	3.4	3.3	3.1	3.5
Community, social, and personal services	1.4	1.6	1.7	2.1	2.1	2.1	2.4	2.3
Manufacturing	4.6	5.0	5.7	6.8	7.5	7.2	6.9	7.1
Construction ^(b)	5.6	7.6	9.0	11.5	13.0	12.7	12.8	11.6

Notes: ^(a)Not seasonally adjusted, and not including first-time job-seekers and re-entrants into the labor force

^(b)Including both site and nonsite workers

Source: General Household Survey, Census and Statistics Department

TABLE 7.16
Consumer Price Indexes (year-on-year rate of change %)

		<i>Composite CPI</i>	<i>CPI (A)</i>	<i>CPI (B)</i>	<i>CPI (C)</i>
1998	Nov.	-0.7	-0.9	-0.9	-0.2
	Dec.	-1.6	-1.4	-1.7	-1.8
1999	Jan.	-1.1	-0.9	-1.6	-0.5
	Feb.	-1.7	-1.5	-2.3	-1.1
	Mar.	-2.6	-2.3	-3.3	-1.9
	Apr.	-3.8	-3.3	-4.5	-3.3
	May	-4.0	-3.5	-4.6	-3.6
	June	-4.1	-3.7	-4.8	-3.6
	July	-5.5	-5.0	-6.3	-5.1
	Aug.	-6.1	-5.2	-6.9	-6.1
	Sep.	-6.0	-4.9	-6.9	-6.1
	Oct.	-4.2	-3.1	-5.1	-4.1
	Nov.	-4.2	-2.9	-4.9	-4.5
	Dec.	-4.0	-2.9	-4.9	-4.1

movement had been recorded until 1998. This is surely unmistakable evidence of the negative impact of the AFC.

Price decline is, of course, not wholly harmful. It will obviously benefit consumers in general, especially lower-income and fixed-income groups such as pensioners and retirees. But this benefit is dependent on relatively stable levels of employment and income. When deflation is accompanied by higher unemployment and more failures of firms and employers, as it was in 1998–99, prolonged deflation can cause great hardship. Furthermore, deflation also raises the real interest rate (in the *ex post* sense), thus discouraging both consumption and investment and triggering a vicious downward spiral. Hong Kong was in the throes of such a spiral for at least one year, until signs of an economic recovery appeared toward the end of 1999.

CONCLUDING REMARKS

The impact of the AFC on the real economy of Hong Kong was truly devastating. Real GDP fell in five consecutive quarters year-on-year and contracted by a staggering 5.1% in 1998, the worst performance in 40 years. Unemployment shot up from 2.2% just before the AFC to 6.3% at one stage, the worst since September 1975, when unemployment statistics first became available. Meanwhile, an unprecedented deflationary trend also began in November 1998 and was still continuing at the time of writing. All these facts suggest that what Hong Kong

experienced during the greater part of the AFC was not just a recession, but something close to a depression.

NOTES

1. Mention should be made of another phenomenon, transshipment, which is shipment consigned on a through bill of lading or a through air waybill from a place outside Hong Kong to another place outside Hong Kong. Since this does not impinge on the economy directly, except for the transient use of port facilities, it is not discussed in the text.

2. Unemployed persons are officially defined as those aged 15 or above who are available for work but do not have a paying job, or are seeking work. They also include discouraged workers, first-time job seekers, and re-entrants. Underemployed persons are those aged 15 or above who are involuntarily working less than 35 hours per week. Employed persons are those who have a paying job. The labor force, or economically active population, is the sum of employed and unemployed persons.

3. For a comprehensive discussion of labor market developments in Hong Kong before 1997, see Suen and Chan (1997).

4. There are four consumer price indexes in Hong Kong. Consumer price indexes (A), (B), and (C) (formerly known as the Hang Seng Consumer Price Index) are compiled on the basis of the Household Expenditure Survey for different groups of households as follows:

	Approximate proportion of households covered	Monthly expenditure range (at 1994/95 prices)
CPI (A)	50	4,000 to 15,999
CPI (B)	30	16,000 to 29,999
CPI (C)	10	30,000 to 59,999

The Composite Consumer Price Index is compiled by aggregating the above three indexes.

5. See Census and Statistics Department, *Hong Kong Statistics 1947-1967*, and *Hong Kong Annual Digest of Statistics*, for subsequent years.

III

Two Puzzles

Why Was Hong Kong's Economic Downturn So Severe?

INTRODUCTION

The previous chapters reviewed the impact of the AFC on Hong Kong, first on different sectors and then on the real economy as a whole. Our findings are that, while the impact differed from sector to sector, the total effect on the real economy was devastating in 1998–99, resulting in the worst contraction of real income in 40 years, the highest unemployment rate in 24 years, and an unprecedented deflationary trend beginning in November 1998. It was only in the second quarter of 1999 that the economy began to resume positive growth, though initially at a faltering pace. The deflationary trend has, however, continued, though at a more moderate rate from the final quarter of 1999. As mentioned in the last chapter, the catastrophic performance of the economy in 1998 justifies the term “depression” rather than “recession.”

This disaster was all the more shocking because it was totally unanticipated. All economic forecasts, by both public and private sectors, agreed that there would be a significant slowdown, but no one predicted a contraction of real GDP. For example, the government's official forecast was that real GDP growth would slow down from 5.2% in 1997 to 3.5% in 1998. The corresponding forecasts by the territory's two largest banks, the HSBC and the Bank of China Group, were 3% and 4% respectively. Those by private sector economists, including myself, ranged from 2.5% to 3.5%. The most pessimistic forecast I have seen was that by the OECD, but at 1% it was still positive. The actual outcome of -5.1% deviated so much from predictions that the situation must rank

as one of the most bizarre and egregious failures in the history of economic forecasting.

Official explanations of the débâcle, which tend to put all the blame on the AFC, are not wholly convincing. This chapter examines in depth and impartially the causes of the worst catastrophe in 40 years.

THE EXTERNAL STOCK AND ITS CHAIN REACTION

In Chapter 2, a schema of the AFC depicts the causes and consequences of the AFC in diagrammatic form. As the readers can see, the causal chain runs from financial imprudence and financial sector fragility to financial crisis, the collapse of exchange rates, and thence to sharp economic downturn.

This schema does not, however, apply to Hong Kong. While undoubtedly individual cases of financial imprudence did exist, there was no pervasive financial mismanagement, no reckless borrowing internally or externally. Hong Kong's banking system was one of the best supervised in the world, as reviewed in Chapter 3. Hong Kong had no sovereign debt. While the private sector undoubtedly had some external debt, collectively it was well covered by its external assets. During the whole AFC, there was no single case of corporate failure due to excessive external debt comparable to South Korea's Daewoo, for example.¹ Hong Kong also did not have any serious or chronic balance of payments (BOP) problem on the eve of the AFC. The territory was rather slow in establishing a balance of payments accounting system, and BOP statistics were compiled and released for the first time only very recently. The statistics indicate that in 1997, Hong Kong had a BOP surplus of HK\$95 billion. This was followed by a deficit of HK\$53.7 billion in the following year. However, in the first quarter of 1999, the BOP switched back into surplus. A summary is given in Table 8.1.

Furthermore, unlike many other countries in the region, Hong Kong not only did not have a chronic fiscal deficit necessitating internal or external borrowing, but actually had a huge accumulated fiscal reserve, as also explained in Chapter 3, on the eve of the AFC. A new schema is therefore needed to explain the severity of the impact on Hong Kong. This is given in Figure 8.1.

The diagram shows that the causal chain runs from globalization and integration of financial markets, and the rapid contagion of the AFC, to economic downturn. As Hong Kong is an extremely open and trade-dependent economy, and a major international financial and business center into the bargain, it is particularly vulnerable to regional turmoil as shattering as the AFC. Any adverse economic or financial event in

TABLE 8.1
Hong Kong's Balance of Payments Account (HK\$ million)

	1997	1998	1999 (Q1)
<i>Standard Components</i>	<i>(Balance)</i>		
Current Account	-47,681	17,736	10,344
Goods	-133,923	-60,667	-8,761
Services	88,236	66,743	12,836
Income Flows	10,475	23,520	9,283
Current Transfers	-12,467	-11,860	-3,014
Capital and Financial Account	47,681	-17,736	-10,344
Capital and financial non-reserve assets (net change)	142,768	-71,490	-2,999
Reserve assets (net change)	-95,087	53,754	-7,346
Overall Balance of Payments	95,087	-53,754	7,346

Source: Census and Statistics Department

the region, no matter how modest or localized it may be initially, will have repercussions for Hong Kong, which can be visualized as a kind of nerve center. To appreciate this, one has only to see that both China and Taiwan have been much less affected by the AFC, because they both retain exchange controls on the capital account, and their currencies are more or less shielded from direct speculative attack. Even for Singapore, which is also an IFC, there is an implicit capital control in the form of prohibitions against the use of the Singapore dollar as an international currency.

Not so for the Hong Kong dollar. Not only is there no exchange control whatsoever on either current or capital accounts, but also no restriction on the use of Hong Kong dollar. Indeed, the hedge funds' swaps with multilateral institutions for Hong Kong dollars was a prelude to the "double market play" in 1998, as explained in Chapter 4. By the time that Taiwan decided to abandon the defense of the de facto peg of its currency to the US dollar in mid-October 1997, the Hong Kong dollar became the only convertible currency in Asia that had not been devalued. As also mentioned in that chapter, Taiwan's move triggered a ferocious attack on the Hong Kong dollar. Whatever Taiwan's motivation may be, there is no doubt that its decision to devalue gave tremendous incentive and encouragement to speculation against the Hong Kong dollar, which looked like a sitting duck to most speculators.

Because Hong Kong was firmly committed to the linked rate regime, and the authorities had repeatedly declared that they would not shrink from using high interest rates to defend the currency, two big increases in the best lending rates (BLR) followed in quick succession in October 1997 and January 1998. These hefty hikes dealt body blows to the asset

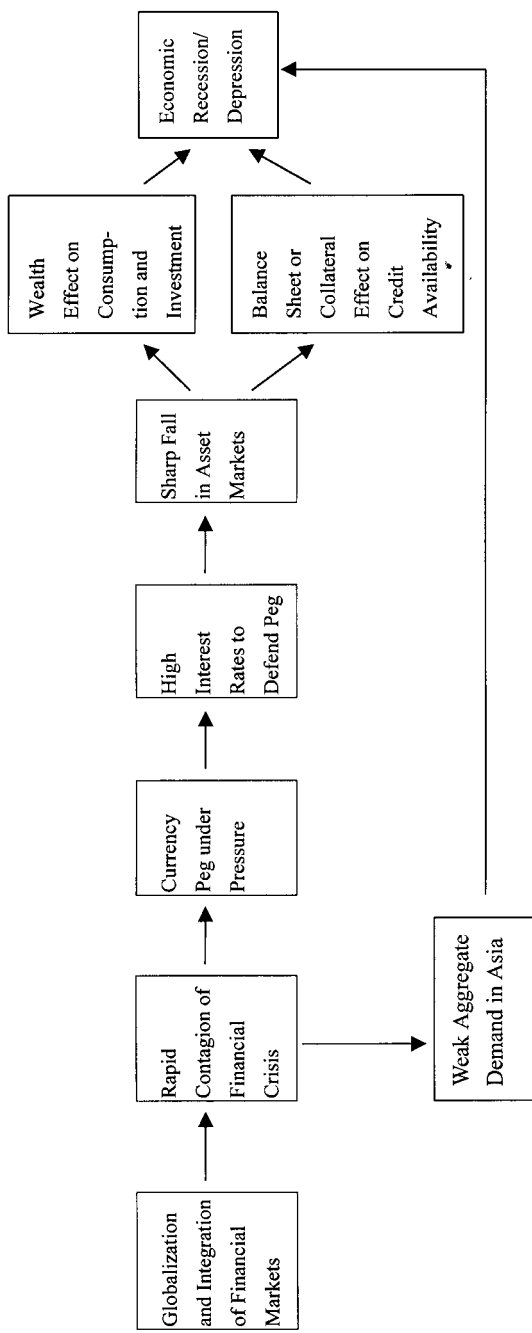


Figure 8.1 Effect of Asian Financial Crisis on Hong Kong

markets. As mentioned in Chapter 5, at one stage the HSI had fallen by 60%, while property prices had also fallen by half. Just imagine what would have happened to the American economy or the world economy if the Dow Jones Industrial Average or the U.S. property market had dropped by the same magnitude.

Economic theory has suggested that changes in asset prices, if substantial, can have two effects on the real economy. One is the well-known effect on consumption. But wealth can also affect investment through Tobin's "q ratio," which says that if stock market valuation of real assets (capital equipment, plant, machinery, etc.) is greater than their replacement costs, then entrepreneurs will have an incentive to invest in capital formation, and vice versa.² The other, less well-known effect is called balance sheet, or collateral effect, on credit availability. Briefly, this theory holds that, in a modern economy, credit is granted by banks and other financial institutions on the basis of collateral provided by the borrower. The most popular and widely used collaterals are real properties, land, and marketable securities. When there is a substantial fall in their values, new borrowers will find it much more difficult to obtain credit. Even those who have already obtained credit will face growing pressure from the lenders either to provide more collateral or to repay at least part of their outstanding debt. In the extreme case, the lender may force the sale of the existing collateral to liquidate the debt. Economists have constructed models showing that substantial changes in the prices of collaterals can generate cyclical fluctuations.³ Thus, a sharp decline in the value of collaterals depresses aggregate investment and output, which in turn further depresses aggregate activity, causing a self-fulfilling vicious circle.

This propagation mechanism through collateralized lending was certainly at work in Hong Kong during 1997–99 and was one of the principal causes of the worst macroeconomic performance in 40 years. Meanwhile, the attack on the currency, the subsequent rise in interest rates, and the initial loss of reserves set in motion the Cantillon-Hume mechanism, explained in Chapter 4, which entailed corresponding adjustments in money supply, prices, and costs. Sensing the catastrophic consequences of the collapse of the equity market, the Hong Kong government intervened in August 1998, as reviewed in detail in Chapter 5. Since then, the Hang Seng Index has more than doubled, but the damage had been done during the precipitate fall from October 23, 1997 to August 13, 1998. Property prices have only stabilized at depressed levels, but have not rebounded to any significant extent. In short, the combination of monetary contraction and credit crunch goes a long way in explaining the horrors of the 1998 depression.

Table 8.2 presents six versions of monetary aggregates, whose definitions are given in the notes under the table, during the period 1996–99.

TABLE 8.2
Monetary Aggregates (Monthly Averages), (HK\$ million, adjusted for swap deposits)

	<i>HK\$ M1</i>	<i>Total M1</i>	<i>HK\$ M2</i>	<i>Total M2</i>	<i>HK\$ M3</i>	<i>Total M3</i>
1996	181,688 (6.0)	207,247 (17.4)	1,373,622 (15.5)	2,400,833 (11.4)	1,389,785 (15.1)	2,480,500 (11.1)
1997	202,440 (11.4)	222,806 (10.7)	1,636,678 (19.2)	2,705,979 (12.7)	1,653,833 (19.0)	2,791,395 (12.5)
1998	177,023 (-12.6)	196,073 (-12.0)	1,724,751 (5.4)	2,900,964 (7.2)	1,738,644 (5.1)	2,964,935 (6.2)
1999	184,023 (4.0)	203,476 (3.8)	1,847,543 (7.1)	3,165,725 (9.1)	1,859,256 (6.9)	3,214,937 (8.4)

Figures in brackets denote year-on-year percentage changes.

Notes: HK\$ M1 = sum of legal tender currency and demand deposits denominated in HK\$ only

Total M1 = sum of legal tender currency and demand deposits denominated in all currencies

HK\$ M2 = sum of HK\$ M1 plus savings and time deposits with licensed banks plus negotiable certificates of deposits (NCDs) issued by licensed banks held outside the banking sector denominated in HK\$ only

Total M2 = sum of Total M1 and savings, time, and NCDs with or issued by licensed banks denominated in all currencies

HK\$ M3 = sum of HK\$ M2 plus time deposits with restricted licence banks (RLBs) and deposit-taking companies (DTCs) plus NCDs issued by them held outside the banking sector denominated in HK\$ only

Total M3 = sum of total M2 and time deposits and NCDs with or issued by RLBs and DTCs denominated in all currencies

Source: HKMA *Monthly Statistical Bulletin*

We use monthly averages in order to eliminate seasonal influences and other aberrations. As may be seen, both versions of M1 registered a decline of over 12%, a very abrupt and unusual occurrence. Moreover, given that the previous year there was still double-digit growth, the implied swing of 23% was enough to send the economy into a tailspin. It is true that the growth rates of the broader aggregates, M2 and M3, were still positive in 1998, but they were sharply lower than the double-digit growth in the previous years. Moreover, it is well known that M2 and M3, containing as they do savings and time deposits and certificates of deposits, are held generally as assets, because of the strong "saving" element in both. M1, by contrast, is held for transactions purposes, and it is M1 that has the most direct and immediate impact on aggregate activity.

Table 8.3 shows loans and advances granted by authorized institutions in Hong Kong. Loans for use in Hong Kong contracted by 5.6% in 1998, as against double-digit growth in previous year. The swing was as much as 29.4%, a sure sign of credit crunch. For loans outside Hong Kong, the contraction actually began in 1996, suggesting that banks,

TABLE 8.3
Loans and Advances by Authorized Institutions (HK\$ million)

<i>As at end of</i>	<i>Loans for use in Hong Kong</i>	<i>Loans for use outside Hong Kong</i>
1996	1,822,496 (15.9)	2,092,394 (-3.4)
1997	2,233,433 (22.8)	1,883,237 (-10.0)
1998	2,106,699 (-5.6)	1,197,728 (-36.4)
1999	1,936,143 (-8.1)	878,050 (-26.7)

Figures in brackets denote year-on-year percentage changes.

Source: HKMA *Monthly Statistical Bulletin*

especially multinational banks based in Hong Kong, began to take a much more cautious attitude towards the region even before the AFC. In 1998, the year-on-year contraction was as much as 36.4%. Japanese banks, in particular, reduced drastically their exposure to Hong Kong and the region, partly because of the AFC, partly because of their own liquidity and bad-loan problems. For example, in 1998, Japanese banks' HK\$ assets fell by 26.5%, while foreign currency assets fell by 33%, compared to a year earlier.⁴

Credit crunch can either be demand induced or supply constrained. The former type arises because firms and individuals reduce their demand for credit in view of poor economic prospects. The latter, on the other hand, is caused at the lending institutions' own initiative to reduce risk exposure and to control loan default. Though conceptually distinct, the two are not wholly independent of each other and are in practice difficult to disentangle. All we can say is that both elements were at work in Hong Kong during the period 1997–99.

On the surface, the highest level of the best lending rate (BLR), or prime rate, reached during the AFC, or 10.25%, was not the highest on record. The highest on record was 20% reached in October 1981. But during the early 1980s, when inflation was raging, the real interest rate was actually relatively low (in the ex post sense). During the currency crisis of 1983–84, the highest BLR was 17%, reached on July 9, 1984, which was required to defend the linked rate in its infancy. However, such a high nominal rate did not last long, and because inflation was still a problem, the level of real interest rate was also low.⁵ Moreover, the newly installed linked rate of 7.8 represented a nominal devaluation of 34% compared to the market rate at the end of 1980. The effect of the high nominal interest rate on the economy was therefore not as serious as the nominal figure might suggest. The situation was very different during the AFC. The duration of high nominal interest rate was much longer, as Table 8.4 shows. The two rises in BLR in October 1997 and

TABLE 8.4
Movements of Best Lending Rate (% per annum)

<i>As at effective dates in 1983-85</i>		<i>As at effective dates in 1997-2000</i>	
Apr. 20, 1983	11.50	Mar. 27, 1997	8.75
May 24, 1983	13.50		
July 6, 1983	12.50	Oct. 24, 1997	9.50
July 25, 1983	11.50		
Sept. 9, 1983	13.00	Jan. 12, 1998	10.25
Sept. 27, 1983	16.00		
Oct. 27, 1983	15.00	Mar. 30, 1998	10.00
Nov. 2, 1983	13.50		
Jan. 23, 1984	12.50	Oct. 19, 1998	9.75
Jan. 30, 1984	11.50		
Feb. 15, 1984	10.00	Nov. 23, 1998	9.50
Mar. 12, 1984	8.50		
Mar. 26, 1984	10.00	Dec. 7, 1998	9.25
Apr. 9, 1984	11.00		
May 10, 1984	12.00	Dec. 31, 1998	9.00
May 28, 1984	12.75		
June 27, 1984	13.75	Jan. 11, 1999	8.75
July 7, 1984	17.00		
Aug. 3, 1984	15.00	Apr. 12, 1999	8.50
Aug. 23, 1984	14.00		
Oct. 1, 1984	13.00	May 3, 1999	8.25
Oct. 29, 1984	12.00		
Nov. 26, 1984	11.50	Aug. 30, 1999	8.50
Dec. 24, 1984	11.00		
Jan. 14, 1985	10.50	Feb. 14, 2000	8.75
Jan. 28, 1985	10.00		
Apr. 1, 1985	9.50		
Apr. 22, 1985	9.00		

Source: Hong Kong Monthly Digest of Statistics and HKMA Monthly Statistical Bulletin

January 1998 were very abrupt and hefty, dealing sharp and immediate blows to both the asset markets and the real economy. From October 1998 onward, following cuts in US interest rates, the BLR in Hong Kong was lowered by seven steps of 0.25% each, to 8.25% on May 3, 1999.

However, from June 1999 onward, as the Fed started to tighten monetary policy and raise interest rates, Hong Kong had to follow suit, not instantaneously, it is true, but still inescapably. The onset of deflation from November 1998 has also complicated matters, as this has also raised inexorably the ex post real interest rates. High and sustained real

interest rates could not fail, of course, to depress aggregate economic activity.

Adding to Hong Kong's woes is that, while Hong Kong's linked exchange rate has remained stable since the outbreak of the AFC, other regional currencies, with the exception of China's renminbi, have tumbled one after another, resulting in a relative appreciation of the Hong Kong dollar. As Hong Kong is highly trade dependent, its currency appreciation unavoidably has had a very depressive effect on its total exports and inbound tourism. It is true that competitiveness ultimately depends on real exchange rate, that is, nominal exchange rate adjusted for relative inflation rates. It is therefore necessary to examine Hong Kong's time series of real exchange rates. Table 8.5 presents two series: one deflated by traded goods prices, and the other deflated by consumer price index. The series have been compiled in such a way that any figure above 100 denotes real appreciation relative to the base period, while any number below 100 denotes real depreciation, also relative to the base period.

As shown in the table, both series rose steadily after the eruption of the AFC in July 1997, reaching their peaks in June–July of 1998. Since then, both gradually fell, particularly after the deflationary trend began in Hong Kong in November 1998. By the end of 1999, both series had fallen to the pre-AFC levels. In short, real exchange rates worked against Hong Kong's total exports and inbound tourism in the first year of the AFC, and it was only in the latter half of 1999 that they became more favorable. Note also that, as services now account for 85% of GDP, while manufacturing accounts for only about 9% of GDP, it is the CPI-deflated series that is more relevant for assessing Hong Kong's competitiveness.

The serious recession that engulfed most of East Asia was, of course, another major factor of the poor performance of Hong Kong's external trade and inbound tourism, quite apart from the relative appreciation of the Hong Kong dollar.

As shown in Table 7.7 in the last chapter, domestic exports to Japan and Singapore registered declines in real terms of 39% and 36% respectively in 1998. This trend continued in the first two quarters in 1999. Domestic exports to Mainland China, Hong Kong's largest export market, also began to decline from Q3 1998 onward, in tandem with the marked slowdown of the Chinese economy. A disturbing phenomenon was that domestic exports to countries not affected by the AFC, such as the United States, the United Kingdom, and Germany, all of which are important export markets, also fell during most of 1998–99. While domestic exports to Germany managed to maintain a positive growth in 1998, they soon deteriorated in 1999. This performance suggests that Hong Kong lost its competitiveness from Q4 1997 to Q3 1999.

TABLE 8.5
Real Exchange Rate Index (Jan. 1994 = 100)

<i>Year</i>	<i>Month</i>	<i>Traded Goods Prices Deflated</i>	<i>CIP Deflated</i>
1997	July	88.7	108.8
	August	89.3	110.0
	September	89.2	110.2
	October	89.3	111.6
	November	88.9	112.6
	December	91.2	116.0
1998	January	93.9	120.4
	February	92.1	119.5
	March	91.6	119.4
	April	91.0	119.2
	May	91.0	119.2
	June	90.8	121.7
	July	92.7	120.7
	August	92.7	120.7
	September	90.7	119.3
	October	88.1	113.5
	November	87.3	112.2
	December	86.8	110.9
1999	January	87.8	113.3
	February	88.9	114.1
	March	88.8	115.5
	April	88.6	114.2
	May	88.2	113.8
	June	88.8	114.5
	July	87.9	111.9
	August	87.2	109.2
	September	86.1	109.1
	October	85.6	108.5
	November	85.1	107.7
	December	84.8	107.2

Source: HKMA

The performance of re-exports, shown in Table 7.8, in the last chapter, was somewhat better. Nevertheless, re-exports to Japan and Singapore still registered double-digit declines in 1998. Only the United States and the United Kingdom maintained positive growth in that year. However, re-exports seemed to have improved substantially from Q3 1999 onward in all major markets.

As shown in Table 7.11 in the last chapter, the slump in inbound tourism began well before the AFC. In particular, there was a disastrous drop in visitors from Japan from Q2 1997 onward. There were complex

reasons for this. Before the handover, there was misapprehension or misunderstanding about the change in sovereignty in Japan, which tended to deter Japanese tourists. At about the same time, there were allegations about cheating of Japanese tourists by tour operators. Then from 1998 onward, Japanese tourists were further deterred by the precipitous fall of the yen. The same trend was also noticeable for visitors from South and Southeast Asia, for obvious reasons. It was not until Q3 1998 that the declining trends were reversed. Meanwhile, tourist revenues continued to decline for three consecutive years, due to lower hotel tariffs, retail prices, and tour charges.

The deflationary trend since November 1998 is another unprecedented event that needs explanation. First of all, let us examine the weights of the 1994/95 based CPIs, as given in Table 8.6.

Food and housing in all four indexes account for nearly 60% of the total weights. While deflation has affected all expenditure components, it has affected the housing component that covers rents, rates, water and sewage, and other housing charges, the most. The fall in rents alone therefore accounts for much of the deflation. In 1999, there was another special factor, namely, the 50% cut in the "rates" payable for the July–September quarter, one of the relief measures of the government. According to the government, as a result of this rates concession, the Composite CPI was dampened by 0.7 of a percentage point in the third quarter of 1999. Likewise, the CPI(A), CPI(B), and CPI(C) were lower by 0.8, 0.6, and 0.7 of a percentage point respectively.⁶ While this tax relief was a one-off affair, the fall in housing is likely to persist for some time, since at any one time, only a part of residential leases are up for renegotiation.

TABLE 8.6
Weights in Consumer Price Indexes

<i>Expenditure component</i>	<i>Composite CPI</i>	<i>CPI(A)</i>	<i>CPI(B)</i>	<i>CPI(C)</i>
	(%)	(%)	(%)	(%)
Food	29.50	37.30	29.37	20.38
Housing	28.83	25.34	28.18	34.00
Fuel and light	2.36	3.37	2.16	1.50
Alcoholic drinks and tobacco	1.35	2.06	1.18	0.77
Clothing and footwear	6.66	5.12	6.95	8.04
Durable goods	5.49	4.34	5.85	6.31
Miscellaneous goods	6.14	6.03	6.44	5.79
Transport	7.77	7.17	7.57	8.79
Miscellaneous services	11.90	9.27	12.30	14.42
All items	100.00	100.00	100.00	100.00

The other item that has experienced a sharp fall is "clothing and footwear." Like others, this item has been hit, perhaps more sharply, by weak consumer demand, but one cannot preclude the possibility that retailers, which hitherto had enjoyed very high margins, could afford to make substantial discounts and still survive. For example, import prices of consumer goods fell by 6% and 5% respectively in 1997 and 1998, yet the average consumer price inflation rate were 5.8% and 2.8% respectively in those two years.

A long deflationary trend has mixed effects on the economy. To the extent that it is part of the adjustment process under the linked exchange rate regime, it will help the economy to regain its competitiveness. But a deflationary spiral out of control may also entail extensive business failures and rocketing unemployment. Deflation also raises ex post real interest rates, which could choke off recovery. This point will be discussed again in the next chapter.

THE HANDLING OF THE CRISIS

It is generally agreed that Hong Kong was a victim, not an originator, of the AFC in the sense that Hong Kong did not trigger currency, banking, and debt crises through financial imprudence and mismanagement, as well as deliberate "competitive devaluation." Indeed, by maintaining its linked rate regime, it has prevented further rounds of devaluations, and has thus contributed to the eventual easing of the AFC.

This generally valid thesis, however, has been overexploited by the government, which in its explanations of the disastrous downturn of 1998 has tended to put all the blame on the external shock and its contagion. Due allowance can and should be made for the fact that AFC was a totally unexpected and severe external shock. But the government can not absolve itself of all responsibility for the worst depression in 40 years. It is important that all errors in judgment, policies, and measures be openly, frankly, but impartially assessed, so that they will not be committed again.

First of all, there can be little doubt in retrospect that those in power in Hong Kong had, during the first ten months of the AFC, grossly underestimated the severity of the crisis. Thus, the Financial Secretary was reported to have told the press in the autumn of 1997 that the AFC would be over by Christmas. Even after negative growth was recorded for the first quarter of 1998, some high government officials still insisted that there was no recession. Such a cavalier attitude meant that the crisis was not being tackled seriously at its early stage until it was rather late.

As a concrete example, inbound tourism had already showed signs of serious trouble as early as Q2 1997, as mentioned in the last chapter. But despite warnings from the industry, the government did nothing. It was not until the end of May 1998, when alarmed by the rapidly deteriorating situation, that the government agreed to simplify immigration procedures for visitors from Mainland China and Taiwan. This measure did eventually attract more visitors from the two sources, but it came too late to avert the disastrous downturn in inbound tourism for the whole year.

The HKMA's resolute defense of the Hong Kong dollar and its defeat of the speculators was a great achievement for which it deserved full credit. But in no society can monetary policy be conducted in complete disregard of the real economy, whose interests it ultimately serves. Viewed in this light, its strategy of relying on the interest rate as the sole weapon, at least during the first phase of the AFC, can now be seen to be flawed. For the interest rate is a double-edged weapon: It can indeed save the currency from collapse, but it can also have a devastating effect on the real economy if applied too bluntly. To be fair to the HKMA, it was confronted with an acute dilemma during the crisis of October 1997. For if it had recoiled from high interest rates, its hesitancy would have been interpreted by the speculators as lack of resolve and would have led to even more frenzied attacks on the currency. A more reasoned critique would be that the mere use of high interest rates without tackling the crux of the matter, namely, the confidence of the public, would not be fully effective.⁷ To the credit of the HKMA, it soon realized this important insight. The "seven technical measures," implemented in September 1998, have proved to be effective in both strengthening confidence and dampening undue volatility in interest rates, as fully discussed in Chapter 4. One could rightly ask what the situation would have been if these measures had been carried out six months earlier.⁸

In Chapter 4, we have referred to HKMA's technical error of issuing a stern warning to the banks dated October 23, 1997, on the possible use of a harsh "penal rate" on "repeated borrowers," without clearly defining what these terms meant. The HKMA's anger at the behavior of some banks, which during the crisis of October 1997 not only actively financed the speculators but also participated in the speculation themselves, was understandable. But while it was justified in dealing firmly with a few aberrant banks, it was wrong to bludgeon all banks indiscriminately into submission and to engage in a perpetual confrontation with the banking system. As recounted in Chapter 4, frightened by the HKMA's threat, the banks stubbornly refused to lend to the interbank market, causing the HIBOR to stay at abnormally high levels. It was not until a letter of clarification was sent by HKMA, dated November 12,

1997, that the term structure of HIBOR began to soften, but the stage was set for another rise in the BLR.

It was extremely unfortunate that the insolvencies of the Peregrine Group and C. A. Pacific should have occurred in early January 1998. As the HKMA had done a good job of cleaning up the banking system after the banking crisis of the 1980s and overhauling the whole framework of prudential supervision, there was no systemic crisis, although banks suffered sharply reduced profitability in 1998. The two failed firms were not banks or "authorized institutions" under the three-tier system, but merely brokerages or securities investment companies. They were under the supervision of the Securities and Futures Commission. The government's *Report on Financial Market Review* therefore devoted considerable space to the tightening of regulations over such firms, without however coming to grips with the crux of the matter, namely, public confidence. But in the extremely nervous environment of early 1998, even the collapse of nonbank financial intermediaries tended to undermine confidence further and gave the wrong signal to speculators. Another rise in the BLR therefore became inevitable after the failure of the two firms.

In retrospect, while the first rise in BLR, in October 1997, was unavoidable and indeed, indispensable, the second rise in BLR in January 1998 was arguably avoidable. Yet this second rise nearly broke, as it were, the camel's back.

The opening of the new Hong Kong International Airport (HKIA) at Chek Lap Kok on July 6, 1998, was supposed to usher in a new era of high-tech air travel, with all its associated economic benefits for Hong Kong. Instead, the first few weeks in July and August became a nightmare of chaos and confusion, brought about by the breakdown of the computer system. Passenger service was disrupted for a whole week, while air cargo service was suspended for more than a month. These disruptions to foreign trade and tourism due to bureaucratic bungling could not have come at a worse moment, as the economy was already in deep recession.⁹ It has been estimated that this disaster had cost the economy about 1% of real GDP, a loss that could have been avoided by more careful preparation and coordination among various agencies responsible for the opening of the new airport.

Last but not least, the government's housing policy had inadvertently caused the near-fatal collapse of the property market in 1998. On October 8, 1997, the chief executive of the Hong Kong SAR government, Mr. Tung Chee-hwa, unveiled a 10-year housing program, the main aims of which were (a) to build on average not less than 85,000 residential units a year (with 50,000 supplied by the public sector and 35,000 by the private sector); (b) to achieve 70% home ownership; and (c) to shorten the waiting time for public rental housing from seven to three years.

The rationale of this ambitious program was actually conceived in the previous British administration in the form of a policy document called *Long Term Housing Strategy Review*.¹⁰ This policy, with minor modifications, was accepted and put on the agenda for implementation by the new SAR government.

To be fair to the new government, the housing strategy was adopted in perfect good faith and with the best intentions. Clearly, the rampant speculation in the housing market, which put prices beyond the reach of most families with modest means, was unacceptable. There is no doubt also that in Hong Kong there has always been a deep and unsatisfied aspiration for home ownership. But the timing of the new policy was extremely unfortunate. The new policy has been embroiled from the start in a continuing controversy.

First, the announcement of a production "target," with all its overtones of a planned economy, for a free-market economy like Hong Kong, has raised many eyebrows. Some extreme libertarians even suggested darkly that the program was the thin end of the wedge of wholesale "socialization" under Chinese sovereignty, forgetting conveniently that the basic idea was conceived under the previous administration. A more reasoned critique would be that the inclusion of private sector-built units is self-contradictory: If the number is voluntary, it cannot be part of a target; but if it is part of the target, then it is "planned" and therefore compulsory.

Second, the timing of the program was most unfortunate. Only two weeks after the announcement, "Black Thursday" and its aftermath caused asset markets to plunge, undermining the basic rationale of the program. Worse still, in December 1997, the Housing Authority launched a new Tenant Purchase Scheme (TPS), selling flats to sitting tenants at below-market prices. This had the effect of accelerating the downward spiral in the property market, with its enormous negative wealth effect.¹¹ By the early summer of 1998, this knock-on effect began to threaten not only the economy but also the banking system and the currency itself. Alarmed by such developments, the government hastily suspended land auctions and the Sandwich Class Housing Scheme, as mentioned in Chapter 5, in effect abandoning the "85,000 target."

CONCLUDING REMARKS

This chapter examines the reasons that the economic downturn in 1998, the worst in 40 years, was so severe. We agree that the primary cause was the external shock of the AFC, whose scope, duration, and intensity were totally unanticipated. The depressed condition in the front-line Asian economies was further aggravated by the prolonged

banking crisis and economic recession in Japan and the marked slowdown in China, affecting two of the largest trading partners of Hong Kong.

Domestically, the need to defend the linked exchange rate entailed abrupt rises in interest rates, which had knock-on effects on the asset markets and the real economy through wealth effect, collateral effect, and credit availability effect. Monetary contraction, which is inherent in the CBA, and the relative appreciation of the currency, were additional depressants for the economy.

But the authorities were at least partly responsible for the severity of the downturn. Errors in judgment, policy measures, and crisis management strategy made the downturn worse than it would have been. Errors included underestimation of the AFC, initial neglect of inbound tourism, over-reliance on the interest rate weapon for defending the currency, defects in prudential supervision of nonbank intermediaries and financial markets, over-hasty opening of the new airport without adequate preparation and coordination, and poor timing in the implementation of the public housing program.

NOTES

1. The collapse of the Peregrine Group in early 1998 was not due to inability to repay foreign debt, but rather to imprudent investment in Indonesia.

2. For a more detailed discussion of "Q ratio," see Chirinko (1992).

3. See Kiyotaki and Moore (1997), Kasa (1998), and Edison, Luangaram, and Miller (2000).

4. HKMA Annual Report for 1998, p. 152.

5. Strictly speaking, real interest rate in the *ex ante* sense is more relevant than real interest rate in the *ex post* sense. This will be discussed in greater detail in the next chapter.

6. Economic Analysis Division, Financial Services Bureau, *Third Quarter Economic Report 1999*, p. 184. "Rates" in Hong Kong is a kind of tax on housing occupancy.

7. The most dramatic example was the failure of the Riksbank to defend the Swedish krona, even though the Riksbank raised its overnight rate to 500% during the European currency crisis of September 1992. Earlier, the United Kingdom decided on September 16 to withdraw from the ERM after failing to stabilize sterling, even though the Bank Rate was raised from 10% to 15%.

8. On this point, see Tsang (1999).

9. Several official investigations of the mishap at the opening of the new airport had been launched. For full details, see Office of the Ombudsman (1999) and Legislative Council (1999).

10. For a review and critique of Hong Kong's public housing policy, see Wong (1998).

11. See Ho (1998) for the consequences of the near collapse of the property market.

Why Was Hong Kong a Laggard in Economic Recovery?

INTRODUCTION

Since the AFC erupted in July 1997, it has been widely assumed by government officials and economists in Hong Kong that, once the AFC began to ease, Hong Kong, which alone among the countries of the region had successfully beaten off speculators against its currency and financial systems, would be among the first, if not the first, to recover from the crisis, given the proven soundness of its currency and banking systems.

Yet more than two years after the outbreak of the AFC, it has become clear that Hong Kong was a laggard, rather than the leader, in the recovery, at least initially. This is another puzzling and embarrassing surprise, for both the government and private sector economists. To unravel and explain this puzzle is the task of this chapter.

SOME COMPARISONS

Before we attempt to provide a comprehensive answer to this question, it is necessary to compare briefly the macroeconomic performance of the more important countries/territories in the region. The year 1998, it is agreed by all, was a most traumatic one, during which the AFC wreaked havoc on the economies in the region, most of which went into serious recession. Table 9.1 presents growth rates of all the major economies in that year.

As may be seen, only China, Taiwan, and Singapore managed to maintain positive growth rates, but they all experienced slowdowns

Table 9.1
Growth Rates of Real GDP (%) in 1998 Measured in Domestic
Currencies (year-on-year)

China	7.8
Japan	-2.8
Hong Kong	-5.1
Taiwan	4.8
Indonesia	-13.7
Korea	-5.8
Malaysia	-7.7
Philippines	-0.5
Singapore	1.5
Thailand	-8.0

Source: Asian Development Bank, Key Indicators of Developing Asian and Pacific Countries

compared to the previous year: China from 8.5% to 7.8%, Taiwan from 6.8% to 4.8%, and Singapore from 8% to 1.5%. Singapore, moreover, had two quarters of negative growth in Q3 and Q4 in the same year. Among those that had negative growth, Hong Kong was better only than Indonesia, Korea, Malaysia, and Thailand, but worse than Japan and Philippines.

With the easing of the AFC toward the end of 1998, all the economies shown in Table 9.1 resumed positive growth in Q1 of 1999. (China and Taiwan had positive year-on-year growth in all quarters during the AFC). Hong Kong, Malaysia, and Indonesia, however, continued to contract in Q1 of 1999. Hong Kong resumed positive growth only in Q2, with a paltry 1.1%.

FACTORS RESPONSIBLE FOR SLOW RECOVERY

This section examines the various factors that can, in their own way, explain at least part of the puzzle.

Valuation Effect

One obvious explanation for Hong Kong's apparent poor showing is the "valuation effect," or the effect of exchange rate changes. As Hong Kong's currency link to the U.S. dollar remained very stable, while most other currencies had tumbled, measuring real GDP in terms of local currencies would exaggerate Hong Kong's poor performance. A more appropriate comparison, according to this argument, is to measure real

GDP in terms of the most important international currency, namely, the U.S. dollar, eliminate the “valuation effect.”

Table 9.2 reveals a very different picture from that of Table 9.1. Hong Kong’s relative performance suddenly becomes much better (in fact, the second best), when the US\$ is used as the unit of measurement, due to the stability of its exchange rate. China’s growth rate remained the same for the same reason. All other economies, which had devalued substantially, showed much worse performance. Interestingly, the growth rates of Singapore and Taiwan turned negative quite significantly. Indonesia, in particular, had a horrendous contraction of over 75%.

This apparent improvement may assuage the collective self-respect of economists and officials, but it is of cold comfort to the ordinary people of Hong Kong. In all countries, except during hyperinflation, what matters for the overwhelming majority of the population is income and output measured in domestic currencies, which form the basis of evaluating welfare. Real GDP measured in an international currency is relevant only for the elite, who travel and reside frequently abroad.

Moreover, in 1999, some regional currencies, such as the Korean won, the Singapore dollar, and the New Taiwan dollar, had stabilized or even appreciated somewhat. The “valuation effect” virtually disappeared for them. In other words, their growth rates measured in U.S. dollars are just as strong as those measured in domestic currencies. At the time of writing, the relevant data for 1999 are not yet fully available; hence, we cannot construct a table similar to Table 9.2. Preliminary data indicate that the growth rates of Korea, Singapore, and Taiwan in 1999 were 10.7%, 5.4%, and 5.7% respectively. Hong Kong’s 3% for the same year was unimpressive in comparison.¹

Table 9.2
Growth Rates of Real GDP (%) in 1998 Measured in US\$ (year-on-year)

China	7.8
Japan	-10.2
Hong Kong	-5.1
Taiwan	-10.0
Indonesia	-75.2
Korea	-36.0
Malaysia	-33.1
Philippines	-28.3
Singapore	-10.0
Thailand	-30.5

Source: Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries*

Real Exchange Rate Effect

Because Hong Kong's currency peg to the U.S. dollar remained stable throughout the AFC during 1997–99, while other regional currencies tumbled in varying degrees, the Hong Kong dollar in effect appreciated against all of them. This must hurt Hong Kong's total exports and inbound tourism. It is true that what matters for competitiveness is real exchange rate, not nominal exchange rate. However, as shown in Table 8.5 in the previous chapter, both series of real exchange rate index (traded goods price deflated and CPI deflated) moved strongly against Hong Kong immediately after the outbreak of the AFC, and it was not until Q3 of 1999 that both of them dropped to pre-AFC levels. Unsurprisingly, it was not until then that Hong Kong's export performance began to improve significantly.

In the same way, because the Chinese renminbi remained virtually unchanged during 1997–99, it effectively appreciated against all other regional currencies. China's export performance also worsened steadily from 1998 onward. Because a very large part of Hong Kong total exports consists of re-exports to and from China, China's slowdown in 1998–99 inevitably also retarded Hong Kong's recovery.

Structural Effect

This effect has to do with the changing structure and nature of the Hong Kong economy. As discussed in Chapter 3, during the past four decades, Hong Kong's economic structure has undergone significant changes. From 1980 to 1996, the primary sector had virtually disappeared, the share of GDP of secondary sector (industry) had decreased by more than half from 31.7% to 15.5%, while that of the tertiary sector (services) had increased from 67.5% to 84.5%. In particular, the share of manufacturing had declined sharply from 23.7% to only 7.3%. Most of Hong Kong's domestic manufacturing processes have relocated to Mainland China. Thus, the export-propelled growth mechanism (growth led by the surge of domestic merchandise exports) is no longer available to Hong Kong.² Re-exports now account for about 86% of Hong Kong's total exports. This means, essentially, that Hong Kong has to wait for China's recovery before it can resume its own. The fact that both China and Hong Kong kept their currencies pegged to the U.S. dollar during 1997–99, while other regional currencies all depreciated, also retarded Hong Kong's recovery.³

Being an extremely open and free economy, Hong Kong over the years has also evolved into a leading financial, business, transportation, and tourism center in the whole Asia-Pacific region. Any economic or financial mishap or setback will affect Hong Kong quite quickly. To give

just one example, Hong Kong had, before the AFC, the highest concentration of Japanese banks outside Tokyo. The decisions of many Japanese banks to reduce their presence and to cut back drastically their lending and investment in or from Hong Kong, in the wake of the AFC and Japan's own banking crisis, was one of the principal causes of the credit crunch and deep recession in 1998. This is not to say that Japanese banks' retrenchment had no effect on other countries, but it did hit Hong Kong especially hard.

On the surface, Hong Kong's position as a regional hub and its stable currency and banking system would suggest that Hong Kong would be among the first to recover. This was, indeed, the tacit assumption of many officials and economists during the initial phase of the AFC. Unfortunately, this has not been the case. Hong Kong is too small to be a locomotive for the whole region. The straitjacket of the linked exchange rate has also made this role all but impossible. In other words, Hong Kong cannot be a leader, but only a follower, in any general upturn. It has to wait for others' recovery before it can resume its own.

Mixed Effects of Deflation

Deflation has mixed effects, both positive and negative. As explained in the last chapter, a significant part of the decline in the CPI was due to falling costs of housing. Since high rental and other housing expenses are a perennial complaint of business firms, especially multinational corporations, their fall is, in principle, beneficial to the restoration of Hong Kong's competitiveness. Indeed, price deflation is part of the automatic adjustment mechanism inherent in the CBA, which enables an economy to become "lean and mean" again after an initial shock. Deflation is also beneficial to consumers in general and to low-income or fixed-income groups, provided they still retain their jobs and income.

Economic reality is, however, always more complex than what theory suggests. Prolonged deflation reflects weak domestic demand and, if it persists for a long period, carries with it the risk of widespread business failures and rising unemployment. In Hong Kong, unemployment did not peak, and the economy did not stop contracting, until Q2 of 1999.

Deflation also complicates the downward price-wage adjustment process. During the downturn of 1994–95, a decline of 3% in real wages was sufficient to trigger a quick recovery.⁴ At that time, the inflation rate was still positive and fairly high at about 9%. It was relatively easy and painless, therefore, to engineer a fall in real wages. To put it crudely, even if nominal wages increased at about 6%, a fall in real wages of 3% could be brought about if inflation stayed at about 9%. But during the downturn of 1998–99, it was impossible to repeat this trick because of the continuing deflation. Table 9.3 shows that, in Q2 of 1999, although

TABLE 9.3
Nominal and Real Wage Indexes of Major Economic Sectors

	1998 Q3	1998 Q4	1999 Q1	1999 Q2	1999 Q3	Q3 1999 Q3 1998
Indexes of payroll per person engaged of selected sectors (Q1 1994 = 100)						(% change)
Nominal index						
Manufacturing	117.9	123.8	137.3	117.3	117.7	-0.2
Wholesale, retail and import/export trades, estaurants and hotels	112.4	119.2	136.2	110.6	109.8	-2.3
Financing, insurance, real estate and business service	118.5	133.3	139.1	118.9	117.0	-1.3
Real index						
Manufacturing	89.3	96.0	107.0	92.3	94.7	+6.0
Wholesale, retail and import/export trades, restaurants and hotels	85.1	92.4	106.1	87.0	88.3	+3.7
Financing, insurance, real estate and business services	89.8	103.3	108.3	93.5	94.1	+4.8

Note: Real indexes are derived by deflating the nominal indices by the 1994/95 based Composite CPI.

Source: Census and Statistics Department, *General Household Survey and Quarterly Survey of Employment and Vacancies*.

nominal warnings fell on a year-on-year basis, real wages still rose in most economic sectors.

Deflation also raises real interest rate, which will exert a depressing effect on both consumption and investment and thus retard recovery. Here, however, a theoretical digression is necessary. Strictly speaking, real interest should be calculated in the *ex ante* sense, that is, the formula should be, according to received theory:

$$r = i - \pi^*$$

where r is real interest rate, i is nominal interest rate, and π^* is expected inflation rate. In Hong Kong, however, most analysts have tended to calculate real interest rate on an *ex post* basis, i.e., their formula is:

$$r = i - \pi$$

where π is current or actual inflation rate.

The question is, since "expected inflation" is not directly observable, how should it be quantified? By general agreement, this can be done by one of the following methods: (a) direct survey of representative agents' expectations, (b) observation of the yields on inflation-adjusted bonds,

and (c) econometric estimation. In Hong Kong, inflation-adjusted bonds are not available, while (a) has so far not been done.

It can be argued therefore, that the *ex post* calculation of real interest rate is rather crude and misleading.⁵ Over the longer term, agents will generally expect positive inflation, or in other words, they will normally regard deflation as a temporary aberration.

Undoubtedly, there is considerable force in this line of argument. Nevertheless, *ex post* real interest rates are not totally meaningless, as past and current price changes do influence the formation of expected inflation, especially if the relevant time horizon is short. Over a longer term, expected inflation can be regarded as the weighted average of past and current inflation, with declining weights for the more distant past. Hence, persistently high levels of real interest rates (*ex post*) do have a depressing effect on aggregate demand.

Another interesting question is whether deflation can generate the "Pigou effect," named after the renowned British economist A. C. Pigou (1877–1959). Pigou argued that, given a constant money stock, a falling level of prices will increase the real value of that quantity of money. At the limit, there is always a price level low enough and a real value of money large enough to bring an economy back from depression into full employment equilibrium. This theory was originally conceived in the wake of the Great Depression of the 1930s, to counter the argument of J. M. Keynes that capitalism, if left to its own devices, cannot restore full-employment equilibrium after an exogenous negative shock.

The "Pigou effect," also known as the "real balance effect," has always been highly controversial.⁶ Keynesians and post-Keynesians have tended to regard it as unworkable, since deflation is usually associated with rising bankruptcies and unemployment. Indeed, according to them, money is "endogenous," so that it may fall together with the decline in economic activity. Some economists argue that, even if the effect is valid, it is confined only to "outside money," that is, money backed by claims against the external sector, and not "inside money," that is, bank deposits that have their counterparts in domestic debt. Any rise in the real value of money, in other words, will be offset by the rising value of debt.

This is obviously not the place to review this controversy, except to note that most economists would now agree that the "Pigou effect" should in principle be allowed for, but its practical applicability is limited. Certainly, no government would use it consciously as a policy tool.

How relevant is the "Pigou effect" or "real balance effect" to Hong Kong? As shown in Table 8.2 in the previous chapter, both HK\$M1 and total M1 declined in 1998, but the broader monetary aggregates all exhibited positive, albeit much slower, growth. In 1999, however, all six versions of monetary aggregates reverted to positive and higher rates

of growth, providing a more favorable environment for the “Pigou effect.” Moreover, the unemployment rate peaked at Q2 of 1999, and the economy resumed positive growth in the same sector. Even if one accepts that only “outside money” is subject to the “real balance effect,” one should note that Hong Kong’s monetary base is not just fully backed, but more than three times backed, by foreign currency assets. Thus, there are reasonable grounds to believe that the “real balance effect” did work in Hong Kong and contributed, at least partially, to the recovery beginning from Q2 of 1999, even though it was not robust.

Exchange Rate Constraint on Policy Mix

It is a well-known proposition in international economics that in open economies, the efficacy of monetary and fiscal policies is determined by the exchange rate regime and the degree of capital mobility. In particular, under a fixed exchange rate regime with perfect capital mobility, monetary policy will be totally ineffective as an instrument of countercyclical stabilization.

Hong Kong is a good illustration of this proposition. Under its present linked exchange rate regime, the monetary base is fully backed by U.S. dollars, and the Hong Kong dollar is pegged to the U.S. dollar at a fixed rate. This means in effect that Hong Kong cannot pursue any meaningful monetary policy independent of the Federal Reserve. Hong Kong’s interest rates cannot diverge from their U.S. counterparts for any but a transitory moment without triggering destabilizing capital movements. By contrast, fiscal policy does not suffer from this disability.

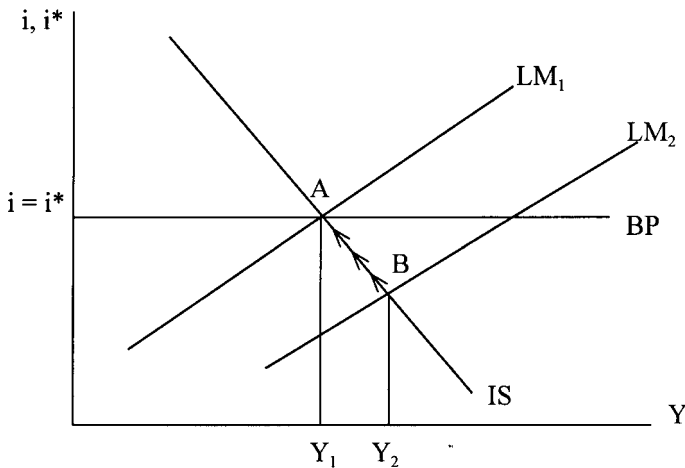


Figure 9.1 Mundell-Fleming Model: Monetary Policy, Normal Case

The preceding proposition can best be shown by the famous Mundell-Fleming model in diagrammatic form. In Figure 9.1, i and i^* denote domestic and foreign interest rates respectively, Y is national income, IS is the combinations of Y and i that ensure equilibrium in the goods market, LM shows the same combinations that ensure equilibrium in the money market, while BP shows the same combinations that ensure balance of payments equilibrium. BP is horizontal because perfect capital mobility is assumed. Suppose the initial general equilibrium, the intersection of the three curves at A , is not considered satisfactory because of high unemployment. An expansionary monetary policy is engineered to move LM_1 to LM_2 . This new level intersects IS at B . But at B , the domestic interest rate is lower than the given foreign interest rate, i^* . This will cause capital outflow, and LM will shift left from LM_2 to the original LM_1 , leaving the level of income Y unchanged. Similarly, the reader can visualize that contractionary monetary policy to combat inflation will not work. A shift to the left of LM , resulting in an interest rate higher than the foreign interest rate, will induce capital inflow which frustrates the policy. Hong Kong actually experienced this problem in 1991.

Fiscal policy can avoid this trap. In Figure 9.2, an expansionary fiscal policy causes IS to shift right to IS_2 . At B , the domestic interest rate is higher than the given foreign interest rate i^* , causing capital inflow, which will in turn induce a secondary movement of LM from LM_1 to LM_2 . As a result, Y expands successively from Y_1 to Y_2 and then to Y_3 .

These two diagrams depict the optimal policy mix under normal conditions. But the AFC is anything but normal. We have to modify the

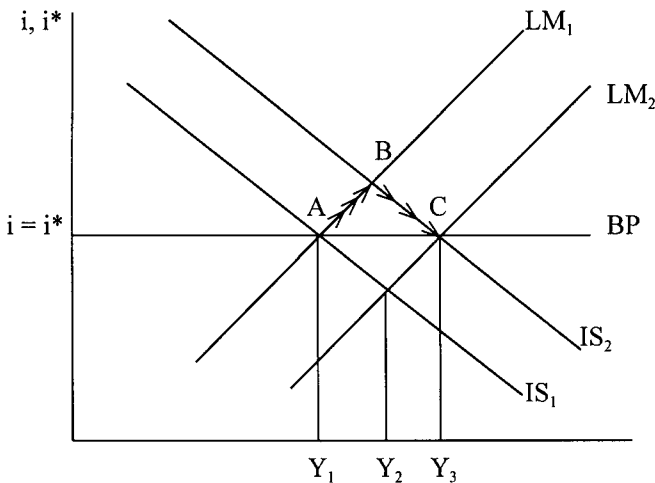


Figure 9.2 Mundell-Fleming Model: Fiscal Policy, Normal Case

diagrams to depict the abnormal conditions in which Hong Kong found itself when its currency was under attack and there was an "Asian premium."

Figure 9.3 illustrates this constraint on policy. Suppose the initial equilibrium was at *A*. After a currency attack on Hong Kong, LM_1 would shift to LM_2 as a result of the HKMA's action and the adjustment mechanism already elaborated in earlier chapters. Under normal conditions, the higher domestic interest rate at *B* would induce capital inflow, and shift it back to LM_1 . This indeed happened when the Mexican crisis (the "tequila effect") briefly affected Hong Kong.

However, the AFC was much more serious. LM_2 shifted only sluggishly and partially to LM_3 , because of the "Asian premium" that foreign investors demanded as a hedge against currency risk. The higher domestic interest at *C* depressed domestic demand and induced a secondary shift of *IS* leftward to IS_2 , intersecting LM_3 at *D*. At that point, the interest rate was slightly lower than at *C*, but the economy was very depressed, with Y_1 falling to Y_3 .

An expansionary fiscal policy could shift *IS* from IS_2 back to IS_1 , but would not move the LM_3 . The vertical distance *CE* can be regarded as the "Asian premium." The economy got stuck at Y_2 . This was the situation in which the Hong Kong economy was trapped, during much of 1998–99. It was true that the cuts in the U.S. interest rate in the autumn of 1998 provided some relief, as Hong Kong was able to follow suit, but U.S. monetary policy tightened in the summer of 1999, with successive increases in interest rates. Hong Kong had to follow suit,

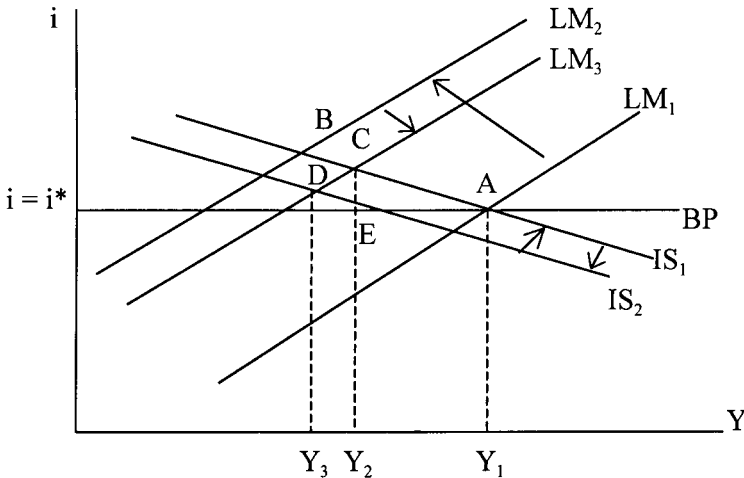


Figure 9.3 Mundell-Fleming Model: Abnormal Case

despite the fact that its recovery was still in its initial stage of recovery and rather fragile. By contrast, other countries that had floated their currencies were not subject to such an exchange rate constraint.

The Limits of Fiscal Policy

Even fiscal policy has its limits. First, Hong Kong being an extremely open but small territory, which is moreover highly dependent on imports of consumer as well as producer goods, an expansionary fiscal policy is subject to large leakages from the income stream generated domestically. Even in the best of times, expansionary fiscal policy will be dampened by the higher propensity to import.⁷ In terms of the Mundell-Fleming model shown in Figure 9.2, the *IS* will shift less to the right in Hong Kong for any given public expenditure than in a less open or less import-dependent economy.

Second, an expansionary policy more often than not results in a fiscal deficit. While a temporary fiscal deficit may not matter much, once a deficit is incurred, it may acquire a life of its own and might easily become chronic or structural. During times of crises and uncertainty, such as the AFC, chronic fiscal deficit will adversely affect public confidence, particularly the confidence of foreign investors, and may even increase the risk of currency attack.

Third, there is also a constitutional constraint on fiscal policy. Article 107 of the Basic Law clearly specifies that “the Hong Kong Special Administrative Region shall follow the principle of keeping expenditure within the limits of revenues in drawing up its budget, and strive to achieve a fiscal balance, avoid deficits and keep the budget commensurate with the growth rate of its gross domestic product.” In effect, this is a constitutional “balanced budget rule.” While this article can be flexibly interpreted as “fiscal balance over an economic cycle” rather than over every year and while the central government of China has certainly made no objection to Hong Kong’s two consecutive years of deficit, clearly there is a limit to continuing a deficit.

As the Hong Kong government could not use monetary policy independently of the United States for stabilization purposes, fiscal policy became the main instrument for stabilization. Thus, in the 1998–99 budget, the government cut the effective rate on salary income, increased personal allowances, granted tax deductions for interest charges on home mortgages, reduced the corporation tax by 0.5 percentage point, cut the estate duty, government “rates,” the hotel accommodation tax, and the passenger departure tax. It also froze many government fees and charges. These tax relief measures, together with increased expenditures, especially those on infrastructure, housing, and social welfare, resulted in a big deficit of HK\$32.3 billion. This

expansionary policy could not save Hong Kong from the worst setback in 40 years, partly because of the inevitable time-lag and partly because of the high leakage. But it did pave the way for the eventual recovery.

In the 1999–2000 budget, no further tax cuts were announced, but the budget did provide for a 10% rebate of the previous year's salary tax and a one-off rebate of government "rates" for the third quarter of 1999. It also contained new project proposals such as the Cyberport and further measures to encourage tourism. The planned deficit of HK\$36.5 billion eventually turned into an actual surplus of HK\$9.9 billion, due to the much improved economic environment.

CONCLUDING REMARKS

Contrary to expectations of government officials and economists at the start of the AFC, Hong Kong has been a laggard, not a leader, in the subsequent recovery. Many factors were responsible for this phenomenon: the valuation effect, the structural effect, the real exchange rate effect, mixed effects of deflation, the exchange rate constraint on policy mix, limits of fiscal policy, and so on.

However, Hong Kong's sluggish recovery in 1999, while disappointing, does not necessarily imply Hong Kong's long-term decline. This was a short-term trend, which may be reversed, if recovery picks up speed in 2000; and Hong Kong's traditional resilience may yet be vindicated again. Indeed, there are some grounds for the belief that, as Hong Kong's banking and financial systems are generally much sounder than those of other countries in the region, Hong Kong's recovery, though slower initially, may be more sustainable in the long term. In 1999, for example, positive growth accelerated from 1.1% in Q2 to 4.4% in Q3 and further to 9.2% in Q4. In Q1 of 2000, the growth rate surged to as high as 14.3%. This spectacular performance was probably a statistical fluke, unlikely to be sustainable. Nevertheless, on May 27, 2000, the government revised its real GDP growth for 2000 from 5% to 6%, and subsequently further to 10.5% in the fall of 2000.

One fact that needs emphasis is that, by defending its currency peg resolutely, Hong Kong has rejected the soft option of "competitive devaluation" during the AFC. It has accepted painful domestic adjustments rather than shifting this burden to others. Thus, Hong Kong has contributed to stability in the region and to the eventual easing of the AFC. But this point is not generally appreciated by economists elsewhere, let alone by the mass media.

NOTES

1. An HKMA working paper (Meredith, Kwan, and Kwok, 1999) argues that, adjusted for differences in trend growth rates, Hong Kong's performance is very

similar to Singapore's. This is surely a rather complacent view, reflecting the official line of playing down Hong Kong's tardy recovery; for Hong Kong's trend growth rate, much lower than those of the other "little dragons," is itself a disturbing phenomenon that needs some explanation.

2. In 1984, one year after the adoption of the linked exchange rate regime, Hong Kong recorded an astonishing growth of real GDP of 10%. At that time, manufacturing still accounted for about 23% of GDP, and relocation of manufacturing to Mainland China was still in its initial phase. While the linked rate of 7.8 amounted to a revaluation of 23% against the panic rate of 9.6 on "Black Saturday," September 24, 1983, it still represented a depreciation of 23% against the market rate of 6.0 just before the "1997 issue" surfaced in the summer of 1982. Thus, both the real exchange rate effect and the structural effect still worked in Hong Kong's favor in 1984.

3. The peg of China's renminbi to the U.S. dollar was only *de facto* during 1997–99.

4. See Dodsworth and Mihaljek (1997).

5. See HKMA Research Department (1999).

6. See Patinkin (1992) for a fuller discussion.

7. For a discussion of the impact of recent fiscal policy, see HKMA Research Department (2000).

IV

The Role of China

Hong Kong's Money and Finance Under Chinese Sovereignty

INTRODUCTION

In Chapter 3, we noted that, during the two years before the handover, there were many speculations and divergent views about what would happen to Hong Kong's currency and foreign exchange reserves: whether there would be massive outflow of capital after the handover, whether China would allow Hong Kong to maintain its separate monetary and financial systems, and whether it would honor its many pledges and promises in the sphere of money, banking, and finance. This chapter will examine these conjectures or assertions on the basis of facts, not ideological or political pre-conceptions.

REALITY CHECK FOR SOME PRE-HANDOVER ASSERTIONS

We will begin by considering some very pessimistic and extreme assertions about Hong Kong's money and finance under Chinese sovereignty, not only because they were rather sensational but also because they were made by eminent economists who were influential both inside and outside their profession.

To recapitulate, Milton Friedman, a Nobel Laureate and a pioneer of modern monetarism, stated categorically that China would not tolerate a separate currency under its sovereignty and therefore would abolish the Hong Kong dollar within two years of the handover, and merge it with the renminbi. China also coveted Hong Kong's large foreign exchange reserves and would therefore directly take them over to form part of China's own foreign exchange reserves.¹

More than three years after the handover, the Hong Kong dollar is still circulating freely as a separate and convertible currency. It is still pegged to the U.S. dollar at a stable fixed rate, and is almost as good as the U.S. dollar. Meanwhile, the Hong Kong Monetary Authority still maintains full control of the Exchange Fund, the sole repository of Hong Kong's foreign exchange and fiscal reserves denominated in both Hong Kong dollars and foreign currencies. Hong Kong's forex reserves had grown from the US\$46 billion mentioned by Mr. Friedman to US\$96 billion at the end of 1999. China's own forex reserves had grown from US\$73.6 billion in 1995, the time when Mr. Friedman made his allegation, to US\$154.7 billion at the end of 1999.

Even disregarding China's pledges and promises to Hong Kong, from a rational self-interest point of view it is hard to see why China should abolish the Hong Kong dollar. China benefits enormously from the fact that the Hong Kong dollar is independent and freely convertible. China has had a trade surplus in its trade with Hong Kong for over half a century. Other important channels of foreign exchange earnings are inward remittances and inbound tourism. Since 1979, Hong Kong has always been China's top source of foreign direct investment. With such earnings denominated in Hong Kong dollars, China can convert them at will into other hard currencies on Hong Kong's open market. Scholarly studies all agree that Hong Kong is an important source of China's forex reserves: they differ only in the exact quantity and proportion of China's forex reserve attributable to Hong Kong.² The abolition of the Hong Kong dollar would therefore mean the loss of huge foreign exchange income overnight.

Moreover, even if China "covets" Hong Kong's huge forex reserve, what better way to do this than for it to retain the Land Fund, which was under China's direct custody and management prior to the handover? Yet China transferred this huge fund, worth HK\$197 billion (of which US\$15 billion were denominated in foreign currencies) to the Hong Kong SAR government punctually as promised, on July 1, 1997. As already mentioned, this transfer boosted overnight Hong Kong's fiscal and forex reserves and was a key factor in Hong Kong's success in defending its currency and financial markets during the darkest days of the AFC.

The assertion by Maurice Obstfeld and Kenneth Rogoff, two well-known experts on exchange rate economics, is less extreme than Friedman's. But they share with Friedman a deep distrust of the Chinese government. Their main points are the following.³

1. China will assume ultimate ownership of Hong Kong's foreign exchange reserves.

2. China will not allow Hong Kong to squander its reserves in battling speculators.
3. Markets are aware of this possibility, and Hong Kong experienced capital outflow during the Mexican crisis in January 1995.

The first point is factually incorrect. The ultimate ownership of foreign exchange reserves still rests with Hong Kong. Specifically, they form part of the assets of the Exchange Fund, which is in turn managed by the Hong Kong Monetary Authority and nobody else. China has never laid claim to such reserves. As a further evidence of this, we can cite again the punctual transfer of the Land Fund, which now forms part of the Exchange Fund.

The second point is also factually incorrect. From January to September 1998, Hong Kong spent nearly US\$10 billion in battling speculators both in the forex market and the equity market. Yet China has never objected to such actions. The Hong Kong government and the HKMA decided to intervene in the equity market against the speculators in August 1998 at their own initiative, without consulting the central government of China, as this action fell within Hong Kong's autonomy under the Basic Law. After being informed of this intervention, the central government openly supported it. There was no question of China not wanting "to see the dowry squandered in battling speculators." In fact, as described in Chapter 5, the Hong Kong government's intervention was highly successful, resulting in a further strengthening of the already strong forex and fiscal reserves.

As regards the third point, Obstfeld and Rogoff insinuated that the Hong Kong dollar was unstable and vulnerable during the Mexican crisis of 1994–95. What they did not mention was that speculators at that time were easily routed by the HKMA. The fact was as follows. Soon after the peso crisis (the "tequila effect") spread to Asia, speculators began to test the Hong Kong dollar, pushing up the exchange rate with the U.S. dollar from 7.738 on January 3 to 7.769 on January 12, 1995. At that point, the HKMA intervened, and by the next day the exchange rate fell to 7.751 and fell even more in the next few days. All was over for the speculators in just one or two days. Neither the best lending rate (BLR) nor the HKMA's Liquidity Adjustment Facility (LAF) offer rate changed. Overnight and one-week HIBOR rose from 5.38% and 5.88% respectively on January 12 to 7.5% and 9% respectively on January 13. But otherwise, there was no undue volatility in interest rates. Table 10.1 presents the daily closing exchange rates of the U.S. dollar.

The AFC was, of course, a much more serious affair than the "tequila effect." But as recounted in Chapters 4 and 5, the HKMA had repeatedly defeated the hedge funds and other assorted speculators at their own game during 1997–98. Since the implementation of the "Seven Technical

TABLE 10.1
Daily Closing Exchange Rates (HK\$ per US\$), January 1995

Jan.	3	7.738
	4	7.739
	5	7.743
	6	7.757
	9	7.756
	10	7.767
	11	7.762
	12	7.769
	13	7.751
	14	7.754
	16	7.745
	17	7.744
	18	7.741
	19	7.740
	20	7.743
	21	7.734
	23	7.740
	24	7.736
	25	7.733
	26	7.731
	27	7.734
	28	7.733
	30	7.735

Source: HKMA *Monthly Statistical Bulletin*, February 1995

Measures" in September 1998, speculation against the Hong Kong dollar has virtually disappeared. It was in the absence of speculation that the HKMA was able to introduce a preannounced scheme, effective from April 1, 1999, of raising the U.S. dollar exchange rate by 0.0001 every calendar day, so that by the end of the 500 calendar days, the "convertibility undertaking rate" will converge to the official rate of 7.8. This scheme, as noted, has also been working very successfully.

To summarize, with all due respect to Messrs. Friedman, Obstfeld, and Rogoff, I regret to say that their assertions about the Hong Kong dollar and Hong Kong's foreign exchange reserves can now be seen to be totally untrue.

By contrast, before the handover, I took the view that Hong Kong's monetary system would be able to continue in its existing form and that there would be no massive outflow of capital, provided that China kept its word and Hong Kong maintained its linked exchange rate regime.

Looking back, I can say that I was right about the handover. Like other economists, however, I did not foresee the AFC. But this is another matter. The ironic thing is that, contrary to what some people had alleged, the threat to Hong Kong's money and finance did not come from China, but from hedge funds and other speculators, who in the summer of 1998 nearly caused the collapse of Hong Kong's monetary and financial systems. All of them were from countries other than China.

REALITY CHECK FOR CHINA'S PLEDGES AND PROMISES

Before the handover, China also had made a number of pledges and promises concerning Hong Kong's monetary and financial systems. They are contained in formal documents such as the Sino-British Joint Declaration, the Basic Law, and Chen's Seven Principles.⁴ It would be interesting to check such pledges and promises against current reality. We propose to do this under the following headings: currency, foreign exchange reserves, exchange rate regime and exchange control, central banking and supervisory authorities, financial markets and institutions, financial transactions, financial center, and public finances.

Currency

Article 3(7) of the Joint Declaration states that "the Hong Kong dollar will continue to circulate and remain freely convertible." That pledge is further confirmed in Article 111 of the Basic Law, which stipulates that "the Hong Kong dollar, as the legal tender in the Hong Kong Special Administrative Region, shall continue to circulate." Article 112 adds that "the Hong Kong dollar shall be freely convertible." The first principle of Chen's Seven Principles governing monetary relations between China and Hong Kong after July 1, 1997, is much more specific. It states that

the Hong Kong dollar and the renminbi will circulate as legal tender in Hong Kong and mainland respectively. The Hong Kong dollar will be treated as a foreign currency in the mainland. Likewise, the renminbi will be treated as a foreign currency in Hong Kong. . . . One does not precede or be subsidiary to the other. They will operate in a mutually independent manner.

Current reality: The Hong Kong dollar continues to be the legal tender of Hong Kong, freely convertible and independent of the renminbi.

Both the Hong Kong dollar and the renminbi are treated as a foreign currency in each other's territory respectively.

Foreign Exchange Reserves

Section VII in Annex 1 of the Joint Declaration stipulates that "The Exchange Fund shall be managed and controlled by the Hong Kong Special Administrative Region Government, primarily for regulating the exchange value of the Hong Kong dollar." Article 113 of the Basic Law states that "the Exchange Fund of the Hong Kong Special Administrative Region shall be managed and controlled by the government of the region, primarily for regulating the exchange value of the Hong Kong dollar." The fourth principle in Chen's Seven Principles states that "The People's Bank of China will support currency stability in Hong Kong. Under no circumstances will China draw on or resort to Hong Kong's Exchange Fund or other assets in any way or for any reason."

Current reality: The Exchange Fund, the sole repository of Hong Kong's fiscal reserve and foreign exchange reserve, is fully controlled and managed by the HKMA. China has never drawn on or attempted to draw on the foreign currency assets of the Exchange Fund. As mentioned earlier, China transferred the Land Fund under its custody and management to Hong Kong punctually on July 1, 1997, which now forms part of the Exchange Fund.

Note Issue, Exchange Rate Regime, and Exchange Control

The Joint Declaration deals only with the issue of currency, rather than with any specific form of exchange rate regime. Section VIII of Annex 1 says that

the authority to issue Hong Kong currency shall be vested in the Hong Kong Special Administrative Region Government. The Hong Kong Special Administrative Region Government may authorise designated banks to issue or continue to issue Hong Kong currency under statutory authority, after satisfying itself that any issue of currency will be soundly based and that the arrangements for such issue are consistent with the object of maintaining the stability of the currency.

Article 111 of the Basic Law repeats the Joint Declaration's wording but adds two sentences: "The issue of Hong Kong currency must be backed by a 100 per cent reserve fund. The system regarding the issue of Hong Kong currency and the reserve fund system shall be prescribed by law."

Section VII of Annex 1 of the Joint Declaration states that “No exchange control policy shall be applied in the Hong Kong Special Administrative Region.” Article 112 of the Basic Law is more specific: “No foreign exchange control policies shall be applied to Hong Kong. The Hong Kong dollar shall be freely convertible.”

Current reality: All three note-issuing banks, the HSBC, the Standard Chartered Bank, and the Bank of China, must pay U.S. dollars first to the Exchange Fund to obtain Certificates of Indebtedness, which are the legal backing for the note issue. They can then issue legal tender notes up to 100% of the U.S. dollars paid in and converted at the fixed exchange rate of US\$1 = HK\$7.8. This exchange rate regime and note issuing system have been in force since October 17, 1983. There is no exchange control whatsoever on either the currency or the capital account.

Central Banking and Prudential Supervision

Neither the Joint Declaration nor the Basic Law contains any reference to central banking and supervision. Chen's Second Principle states that “the two monetary authorities in China and Hong Kong, namely the People's Bank of China (PBC) and the Hong Kong Monetary Authority (HKMA), will be mutually independent, but will cooperate closely with each other. The PBC will not set up any office in Hong Kong.” His Third Principle states that “financial institutions of China and Hong Kong setting up branches or offices in each other's territory will be regulated by the host authorities, and treated respectively as foreign entities.” His Sixth Principle states that “mainland financial institutions in Hong Kong must abide by the laws of Hong Kong, and will be supervised by the HKMA.”

Current reality: All these principles are being observed. The PBC and HKMA are independent of each other, but cooperate with each other on matters of mutual concern. The PBC does not have an office in Hong Kong. All banks and nonbank financial institutions from China have to abide by the laws of Hong Kong and are supervised by the Hong Kong Monetary Authority as foreign entities.

Financial Transactions between China and Hong Kong

Neither the Joint Declaration nor the Basic Law says anything on this subject. Chen's Fifth Principle states that “financial transactions between China and Hong Kong will be conducted in accordance with the rules and practices of international financial activities.”

Current reality: Financial transactions between China and Hong Kong are indeed conducted according to international rules and practices, both mutually treated as independent entities. Thus the PBC and the HKMA have a repurchase agreement concerning U.S. Treasury obligations, similar to the ones that HKMA has with other countries.

Financial Markets and Institutions

Section VII and Annex 1 of the Joint Declaration state that “the monetary and financial systems previously practiced in Hong Kong, including the systems of regulation and supervision of deposit-taking institutions and financial markets, shall continue. . . . Markets for foreign exchange, gold, securities, and futures shall continue.” The contents of this section are repeated in Articles 110 and 112 of the Basic Law.

Current reality: Not only financial markets and institutions established prior to 1997 continue to exist, but new institutions and markets such as derivatives, e-banking, and Internet trading have continued to appear. Some markets, such as the commodity markets for cotton and soya-bean, had closed before 1997, for commercial reasons, not because of the handover.

Financial Center

Article 3(7) of the Joint Declaration states that “the Hong Kong Special Administrative Region will retain the status of an international financial center.” Article 109 of the Basic Law stipulates that “The Government of the Hong Kong Special Administrative Region shall provide an appropriate and economic and legal environment for the maintenance of Hong Kong as an international financial center.” Chen’s Seventh Principle states that “Shanghai and Hong Kong will have complementary and mutually reinforcing relationships as financial centers.”

Current reality: Hong Kong is still the second largest and most important financial center in the Asia-Pacific region, three years after the handover and the AFC. Shanghai is now primarily a domestic financial center, not an international financial center, because of the inconvertibility of the renminbi, the existence of capital controls, and the inability to grant “national treatment.” There is still a long way to go before Shanghai can become a true IFC. Hong Kong is already a major IFC in its own right, whether evaluated on a regional or a worldwide basis. Even if Shanghai does become an IFC someday, the two cities can still

be complementary to each other. Thus, Hong Kong and Singapore are often depicted as archrivals, but this simplistic view ignores the fact that the two are complementary in many ways.

Public Finances

Article (8) of the Joint Declaration states that “the Hong Kong Special Administrative Region will have independent finances. The Central People’s Government will not levy taxes on the Hong Kong Special Administrative Region.” Article 106 of the Basic Law repeats these two sentences and adds a supplementary one, as follows: “The Hong Kong Special Administrative Region shall use its financial revenues exclusively for its own purposes, and they shall not be handed over to the Central People’s Government.”

Current reality: Hong Kong enjoys full fiscal independence. It draws up its own budget for approval by its Legislative Council, collects its taxes, and raises other revenues exclusively for its own use. The central government not only does not levy taxes on Hong Kong, but it also helps Hong Kong save money by absorbing defense costs itself. By contrast, under the previous administration, Hong Kong had to contribute to the costs of the British garrison. As mentioned in Chapter 4, during the last three years of British rule, such costs averaged HK\$1 billion annually. Hong Kong does not have to contribute anything toward China’s finances. This is in sharp contrast to cities in China like Shanghai, which have to hand over a significant share of their municipal revenue to the central government.

Our review of current reality is based on plain and unadorned facts. Since facts speak for themselves, the reader can readily infer from such facts whether China has kept its word.

CONCLUDING REMARKS

Whatever criticisms one may make of its domestic human rights record, China has behaved correctly toward Hong Kong after the hand-over. Indeed, in the field of money, banking, and finance, the evidence is indisputable that China has scrupulously observed all its pledges and promises. Thus, the more extreme conjectures or assertions made before the handover regarding China’s intentions have proved to be unfounded.

NOTES

1. See Chapter 3 for the source of Friedman’s remarks.
2. See Sung (1991).
3. See also Chapter 3 for the original quotation from Obstfeld and Rogoff (1995).

4. The English text of the Joint Declaration is published in full in Bill Knight (ed.), *Hong Kong* 1985, Hong Kong Government publications. The English text of the Basic Law is published by the Consultative Committee for the Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China, and printed by C&C Offset Printing Co. Ltd., Hong Kong, April 1990. For Chen's principles, see Chapter 3.

China and the Asian Financial Crisis

INTRODUCTION

To understand fully Hong Kong's ordeal during 1997–99, a review of what China has gone through and its efforts to cope with the AFC is not only necessary but indispensable, for two reasons. The first one, quite obviously, is the growing integration between the two economies, especially after Hong Kong's reversion to China. Any major economic or financial shock in one will inevitably have its repercussions on the other. The second is that China is the second-largest economy in the Asia-Pacific region. Even without the AFC, any major economic or financial event in China will have repercussions throughout the region. Hong Kong will be the first to be affected, given its geographical proximity and its historical and cultural ties to China. As the focus of this book is on Hong Kong, however, this chapter will not give an exhaustive treatment of the impact of the AFC on China and China's response to it. The emphasis will be on China's experience insofar as it impinges on Hong Kong.

THE IMPACT OF THE AFC

On the surface, China seemed to have survived the AFC remarkably well. It has so far avoided the kind of concurrent currency, banking, and debt crises that befell many Asian countries, particularly Thailand, Indonesia, and South Korea. The exchange rate of the renminbi against the U.S. dollar remained virtually unchanged during 1997–99. Although China had its own serious banking and corporate problems, no

single major bank failed, and neither the state nor the corporate sector as a whole had defaulted on foreign debt that required IMF-led rescue operations and rescheduling.

Table 11.1 presents the exchange rate of renminbi against the U.S. dollar for the period 1979–99. As may be seen, since 1979, the year China began its reform and open-door policies, the renminbi had steadily depreciated, itself a reform of the artificial overvaluation in the pre-reform era. However, during the AFC of 1997–1999, the exchange rate remained virtually unchanged, both in terms of end-of-period and period average values.

Why was China able to escape the worst consequences of the AFC and the crises of other economies like Brazil and Russia? Economists

TABLE 11.1
Exchange Rate of Renminbi (Yuan per US\$)

<i>Year</i>	<i>End of Period</i>	<i>Period Average</i>
1979	1.4962	1.5550
1980	1.5303	1.4984
1981	1.7455	1.7045
1982	1.9227	1.8925
1983	1.9809	1.9757
1984	2.7957	2.3200
1985	3.2015	2.9367
1986	3.7221	3.4528
1987	3.7221	3.7221
1988	3.7221	3.7221
1989	4.7221	3.7651
1990	5.2221	4.7812
1991	5.4342	5.3234
1992	5.7518	5.5146
1993	5.8000	5.7620
1994	8.4462	8.6187
1995	8.3174	8.3514
1996	8.2982	8.3142
1997	8.2798	8.2898
1998	8.2787	8.2790
1999	8.2789	8.2775

Note: Beginning from January 1, 1994, the People's Bank of China (PBC) quotes the mid-point rate versus the U.S. dollar based on the previous day's prevailing rate in interbank forex market. Authorized banks quote their transaction rates within the floating margin set by PBC. Prior to this date, the official exchange rate of renminbi was adjusted according to movements in the value of a basket of internationally traded currencies.

Source: IMF *International Financial Statistics*

generally agree on the following major reasons.¹ First, while China liberalized exchange controls on current accounts in 1994, it has still retained the full array of exchange controls on capital accounts. Neither residents nor nonresidents can buy foreign currencies freely for capital transactions or borrow renminbi freely for shorting or for selling forward. There is no direct means, in other words, of attacking the renminbi. It is true that there are “nondeliverable forward” (NDF) contracts in renminbi in Hong Kong and Singapore. But since there is no actual delivery of renminbi, the contract is in essence a bilateral hedging (betting?) device, and the transaction cost is prohibitive.²

Second, China’s external position was relatively sound. During the course of the AFC, its foreign exchange reserves continued to rise, while its trade account continued to register a surplus. Table 11.2 shows China’s gold and forex reserves since 1979, the year when it launched its reform and open-door policies. As may be seen, gold reserve has

TABLE 11.2
China’s Foreign Exchange and Gold Reserves

<i>End of Year</i>	<i>Gold Reserve</i> (1,000 ounces)	<i>Foreign Exchange Reserve</i> (US\$ million)
1979	12,800	840
1980	12,800	-1,296
1981	12,670	2,708
1982	12,670	6,986
1983	12,670	8,901
1984	12,670	8,220
1985	12,670	2,644
1986	12,670	2,072
1987	12,670	2,923
1988	12,670	3,372
1989	12,670	5,550
1990	12,670	11,093
1991	12,670	21,712
1992	12,670	19,443
1993	12,670	21,199
1994	12,670	51,620
1995	12,670	73,597
1996	12,670	105,029
1997	12,670	139,890
1998	12,670	144,960
1999	12,670	154,700

Source: China Statistical Yearbook, 1999 and current press reports

remained unchanged since 1981, while foreign exchange reserve has skyrocketed from a trifling US\$840 million in 1979 to US\$154.7 billion in 1999. In absolute terms, China's foreign exchange reserve ranked second in the world. Of course, on a per capita basis, China's foreign reserve of about US\$120 was easily dwarfed by Hong Kong's US\$13,733. Still, China's foreign exchange reserves could cover more than its total foreign debt, and about a year's imports.

Third, most of China's capital inflow takes the form of foreign direct investment (FDI), that is, real investment in plant, capital equipment, and other productive facilities. As is well known, such "sunken" capital is the least vulnerable to sudden shifts in market sentiments, as opposed to portfolio investment. In 1998, for example, China received about US\$58.55 billion in foreign capital, of which FDI took US\$45.46 billion. China's two stock exchanges are not fully open to nonresidents, who can only buy B-shares denominated in foreign currencies. The possibility of foreign investors or speculators dumping their shares and withdrawing their capital precipitately, as happened in 1997–98 in most Asian countries, including Hong Kong, is rather limited in China. Table 11.3 shows utilization of foreign capital in China from 1979 to 1998.

Fourth, China's external debt, both before and after the AFC, was predominantly long term. This is shown in Table 11.4, where it can be readily seen that in 1998, long-term foreign debt accounted for 88.1% of total debt, while short-term debt accounted for only 11.9%. For the period 1993–98, the average percentages of long- and short-term debt were 87.3% and 12.7% respectively. The three main risk indicators of foreign debt, namely, debt service ratio, liability ratio, and foreign debt, shown in Table 11.5, were all reasonably sound, implying that China did not face any immediate threat of default.

Thus, China had avoided the trap of overhasty exchange liberalization that caused massive capital inflow, which in turn fuelled domestic credit expansion and asset bubbles in many Asian countries just before the AFC. The sudden reversal of such hot money inexorably led to currency, banking, and debt crises. China had also wisely exercised quality control of capital inflow by giving preference to FDI.

Finally, again in contrast to several Asian countries most affected by the AFC, China before the AFC had enjoyed a trade surplus on the current account for several years. This surplus reached its peak in 1998, but decreased substantially in the subsequent two years. The surplus continued in the first half of 2000, as shown in Table 11.6.

Notwithstanding these good external fundamentals, China has not been immune to the AFC, even though it is a relatively "closed" economy in the sense that its total foreign trade accounted for only 34.4% of its GDP in 1998. The growth rate of its GDP reached a peak of 14.2% in 1992, followed by three more years of double-digit growth. However,

TABLE 11.3
Utilization of Foreign Capital in China (US\$ billion)

Year	Total		Foreign Loans		Direct Foreign Investments		Other Foreign Investments
	Number of Projects	Value	Number of Projects	Value	Number of Projects	Value	
Total Foreign Capital in Signed Agreements and Contracts							
1979-1983	1471	23.78	79	15.06	1392	7.42	1.74
1984	1894	4.91	38	1.92	1856	2.65	0.22
1985	3145	9.87	72	3.53	3073	5.93	0.40
1986	1551	11.74	53	8.41	1498	2.83	0.50
1987	2289	12.14	56	7.82	2233	3.71	0.61
1988	6063	16.00	118	9.81	5945	5.30	0.89
1989	5909	11.48	130	5.19	5779	5.60	0.69
1990	7371	12.09	98	5.10	7273	6.60	0.39
1991	13086	19.58	108	7.16	12978	11.98	0.45
1992	48858	69.44	94	10.70	48764	58.12	0.61
1993	83595	123.27	158	11.31	83437	111.44	0.53
1994	47646	93.76	97	10.67	47549	82.68	0.41
1995	37184	103.21	173	11.29	37011	91.28	0.64
1996	24673	81.61	117	7.96	24556	73.28	0.37
1997	21138	61.06	137	5.87	21001	51.00	4.18
1998	19850	63.20	51	8.39	19799	52.10	2.71
Total Amount of Foreign Capital Actually Used							
1979-1983		14.44		11.76		1.80	0.88
1984		2.71		1.29		1.26	0.16
1985		4.65		2.69		1.66	0.30
1986		7.26		5.01		1.87	0.37
1987		8.45		5.81		2.31	0.33
1988		10.23		6.49		3.19	0.55
1989		10.06		6.29		3.39	0.38
1990		10.29		6.53		3.49	0.27
1991		11.55		6.89		4.37	0.30
1992		19.20		7.91		11.01	0.28
1993		38.96		11.19		27.52	0.26
1994		43.21		9.27		33.77	0.18
1995		48.33		10.33		37.52	0.29
1996		54.80		12.67		41.73	0.41
1997		64.41		12.02		45.26	7.13
1998		58.56		11.00		45.46	2.09

Source: China Statistical Yearbook 1999

TABLE 11.4
Outstanding Balance of Foreign Debt

<i>Type of Debts</i>	1993	1994	1995	1996	1997	1998
Total (US\$ billion)	83.57	92.81	106.59	116.28	130.96	146.04
By Type of Debt						
Loans from Foreign Governments	14.32	19.59	22.06	22.16	20.78	22.41
Loans from International Financial Institutions	10.46	12.93	14.80	16.74	19.21	22.95
International Commercial Loans	41.08	47.34	52.63	56.94	64.77	68.22
Others	17.71	12.94	17.11	20.43	26.20	32.46
By Repayment Terms						
Long-term Debt	70.03	82.39	94.67	102.17	112.82	128.70
Short-term Debt	13.55	10.42	11.92	14.11	18.14	17.34
By Type of Debt (%)						
Loans from Foreign Governments	17.1	21.1	20.7	19.1	15.9	15.4
Loans from International Financial Institutions	12.5	14.0	13.9	14.4	14.7	15.7
International Commercial Loans	49.2	51.0	49.4	49.0	49.4	46.7
Others	21.2	13.9	16.0	17.5	20.0	22.2
By Repayment Terms (%)						
Long-term Debt	83.8	88.8	88.8	87.9	86.1	88.1
Short-term Debt	16.2	11.2	11.2	12.1	13.9	11.9

Source: China Statistical Yearbook, 1999

TABLE 11.5
Risk Indicators of Foreign Debt (%)

<i>Year</i>	<i>Debt Service Ratio</i>	<i>Liability Ratio</i>	<i>Foreign Debt Ratio</i>
1985	2.7	5.2	56.0
1986	15.4	7.3	72.1
1987	9.0	9.4	77.1
1988	6.5	10.0	87.1
1989	8.3	9.2	86.4
1990	8.7	13.5	91.6
1991	8.5	14.9	91.9
1992	7.1	14.4	87.9
1993	10.2	13.9	96.5
1994	9.1	17.1	78.0
1995	7.6	15.2	72.4
1996	6.0	14.2	67.7
1997	7.3	14.5	63.2
1998	10.9	15.2	70.4

Notes: Debt service ratio refers to the ratio of the payment of principal and interest of foreign debt to the foreign exchange receipts from foreign trade and nontrade services of the current year.

Liability ratio refers to the ratio of the balance of foreign debt to the GDP of the current year.

Foreign debt ratio refers to the ratio of the balance of foreign debt to the foreign receipts from foreign trade and nontrade services of the current year.

Source: China Statistical Yearbook 1999

TABLE 11.6
China's Foreign Trade (US\$ billion)

<i>Year</i>	<i>Imports</i>	<i>Exports</i>	<i>Trade Balance</i>
1994	115.61	121.01	0.54
1995	132.08	148.78	16.70
1996	138.83	151.05	12.22
1997	142.37	182.79	40.42
1998	140.17	183.76	43.59
1999	165.80	194.90	29.10
2000 (first half)	102.10	114.50	12.40

Source: China Statistical Yearbook, 1999 and current press reports

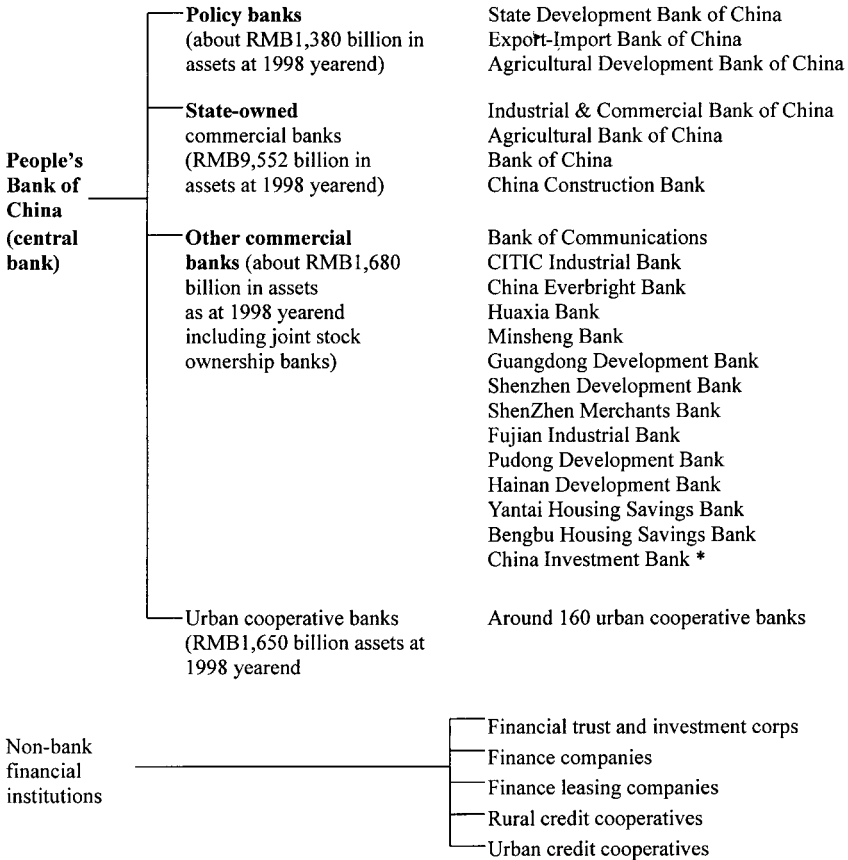
that period was also one of overheating, with consumer price inflation reaching 24% in 1994. By restrictive monetary policy, inflation was gradually brought down to 0.8% in 1997. The growth rate of real GDP slowed steadily from 8.8% in 1997 to 7.8% in 1998, and further to 7.1% in 1999. The official forecast is for another 7% growth in 2000, though the actual GDP growth in the first half was 8.2%. Then, beginning in October 1997, a deflationary trend set in, evidenced by a fall of retail prices and followed some months later by that of consumer prices, which was to continue uninterrupted until early 2000. This deflationary trend was mainly caused by weak domestic demand due to layoffs and uncertain job outlook, but slow exports attributable to the AFC may have also played a part. Meanwhile, FDI dropped from US\$45 billion in 1998 to US\$40.4 billion in 1999.

HIDDEN RISKS AND UNRESOLVED ISSUES

The fact that China has so far avoided the worst consequences of the AFC does not mean that it will be immune from risks or even crises in the future. The fragility of its banking system has been a well-known problem for many years. Debilitated by nonperforming loans (NPLs), poorly managed and undercapitalized by international standards, unable to offer a wide range of services and products appropriate to a modern economy, burdened by high government taxes, and subject to political interference, especially in regard to "policy lending," China's banking sector as a whole is not commercially viable, and certainly is unable to play a vigorous but prudent role in financial intermediation. Figure 11.1 gives a snapshot of China's banking structure at the end of 1998.

Because of the lack of transparency and full disclosure of the banking system, the total amount of NPLs remains a mystery. Chinese banks

Structure of China's Banking System



*China Investment Bank was taken over by China Development Bank in December 1998 and subsequently merged into China Everbright Bank in March 1999.

Figure 11.1 Structure of China's Banking System. *Source:* People's Bank of China

began in 1995 to follow a uniform system of classifying problem loans, but the methods are very lenient or incomplete by Basle or international accounting and auditing standards. In early 1998, Dai Xianglong, governor of the People's Bank of China (PBC), disclosed that NPLs accounted for 25% of total loans.³ However, even before the AFC, independent scholarly studies had concluded that NPLs had all but wiped out capital in China's biggest banks. For example, Nicholas Lardy, a renowned authority, argued that as the NPLs were understated,

while capital was overstated, “on a realistic accounting, these (major) banks’ capital adequacy is negative, and they are insolvent,” and “these numbers (NPLs) suggest that China’s four major banks as a group have a negative net worth and thus are insolvent.”⁴

It is not unusual for a bank to be technically insolvent but still able to function, provided that the public believes that it is “too big to fail.” This happened in the United States, for example, in the early 1990s, when several big banks were believed to be technically insolvent due to their heavy exposure to third world debt. In China’s case, the big banks are all owned by the state, and the public genuinely believes that their deposits are de facto guaranteed by the government. Moreover, China’s savings deposits grew at an annual rate of 32.8% from 1978 to 1996, though this rate slowed down significantly to about 20% in 1997–98.⁵ As a result, bank runs similar to those in market economies have so far not occurred in China. But this does not mean that they will never happen, especially if economic and financial situations deteriorate significantly. One reason for the high growth rate of bank savings deposits is, of course, the lack of alternative investment vehicles.

The Chinese monetary authorities are well aware of the hidden risks, especially after the eruption of the AFC. In November 1997, a National Financial Work Conference was held in Beijing to discuss the AFC and its implications for China. Following this important conference, the authorities have carried out the following measures to address the fragility of the banking system, and to strengthen risk management:

- An injection of RMB270 billion to recapitalize the four largest state-owned banks, through bond issues.
- Allocation of RMB30 billion to enable the banks to write off their bad debts, with more increases to follow in coming years.
- Reorganization of the PBC’s local branches along regional lines to reduce political interference in lending decisions by provincial and municipal authorities.
- Establishment of a risk management system for the banks and the phasing out of mandatory lending quotas.
- Tightening of foreign-exchange trading, especially in regional currency swap centers, to prevent capital flight.
- Closure of a number of international trust and investment corporations (see next section).
- Setting up four asset management companies (AMCs), modelled basically after the U.S. Resolution Trust Corporation, to clean up the NPLs of the big four state-owned banks.
- Tightening supervision not only over banks, but also other other financial institutions such as insurance companies and brokerages.

- Granting seven more RMB-dealing licences to foreign banks to encourage competition.
- Establishment of a credit information system by requiring all financial institutions to submit credit information on their borrowers into a centralized electronic network.

Whether these measures will succeed in resolving all the problems of China's banking system remains to be seen.⁶ At the end of 1999, Goldman Sachs, a leading investment bank, gave the following overall ratings for banking systems in Asia:

China and India: Some fragility

Philippines and Malaysia: Fragile

Korea, Thailand, and Indonesia: Very fragile

Hong Kong and Singapore: Solid

Table 11.7 presents Camel fundamentals estimated by Goldman Sachs for the big four state-owned banks. They compare unfavorably with those of the leading domestic banks of Hong Kong and Singapore given in Table 6.5 in Chapter 6.

China's banking woes are related to two other major structural problems. One is loss-making state-owned enterprises (SOEs). Such firms, having borrowed from the banks huge amounts that are unpaid or uncollectible, are the chief cause of the banks' NPLs. The main reasons for the poor performance of SOEs have been identified by scholars as inefficiency (evidenced by low factor productivity), overstaffing, "soft"

TABLE 11.7
Camel Fundamentals for China's Big Four State-Owned Banks

	<i>Equity/Assets</i>	<i>LLR/Loans</i>	<i>ROA</i>	<i>ROE</i>	<i>NIM</i>	<i>L/D</i>
	(%)	(%)	(%)	(%)	(%)	(%)
Bank of China	5.10	2.46	0.21	4.80	1.19	80.84
Industrial Commercial Bank of China	5.68	0.35	0.11	2.46	2.10	86.32
China Construction Bank	5.21	0.22	0.07	1.80	3.49	83.44
Agricultural Bank of China	2.53	0.39	0.03	1.29	2.61	89.69

Notes: LLR = loan loss reserve NIM = net interest margin
 ROA = return on assets L/D = loan deposit ratio
 ROE = return on equity

Source: Goldman Sachs Investment Research, "China Banks," December 14, 1999.

budget constraint (meaning the lack of financial control and discipline, and excessive reliance on fiscal subsidies), rising competition from the nonstate sector, and generally poor management.⁷

On becoming prime minister in 1998, Zhu Rongji pledged to turn the SOEs round within three years. His strategy consists of more autonomy for and less political interference with the SOEs (“separation of politics from enterprises”); proactive fiscal and monetary policies to stimulate internal demand and reduce excess inventories; and massive layoffs and debt-equity swaps. This strategy, while generally necessary and justifiable, is not without its problems. To prevent social unrest, the laid-off workers are still paid minimum wages. Thus the financial burden is simply shifted from the SOEs to the national treasury. Similarly, the debt-equity swap will not benefit the creditor banks in terms of cash flow, unless they can quickly earn dividends from the profits of the SOEs. The strategy can also be faulted for not giving any room for privatization.

According to Sheng Huairan, director of the State Economic and Trade Commission, in 1998, SOEs made a total profit of RMB49 billion and had a total loss of RMB102.3 billion, yielding a net loss of RMB53.3 billion. In 1999, total profit increased to 96.7 billion, while total loss decreased to RMB86.14 billion, resulting in a net profit of RMB10.56 billion. He was therefore confident that Premier Zhu’s pledge could be fulfilled.⁸ This, of course, remains to be seen.

The third structural problem, which is again related to the first two, is chronic fiscal deficit. Since economic reform began in 1979, China has incurred fiscal deficits every year, of varying sizes, with the exception of 1981 and 1985. It is also well known that, contrary to international practice, China counts receipts from domestic and foreign debt issues as revenues, thus greatly underestimating the true magnitude of fiscal deficit.⁹ A better concept is “hard deficit” (*ying chizi*), which is equal to the difference between government expenditure and revenue, exclusive of receipts from domestic and foreign debt issues. However, to the extent that interest payments on such debts are excluded from government expenditure, the “hard deficit” still underestimates the true deficit. In the latest budget for the year 2000, an improvement in budgetary practice has been made by including interest payments under government expenditure. This has resulted in a planned deficit of RMB229.9 billion, the largest since 1979.

The parlous state of China’s public finance is a complex problem that merits a whole book rather than a few paragraphs. For our purpose, it suffices to note that its basic reasons are the steady erosion of the tax base of the central government due to the lack of a nationwide, uniform tax system, and an unsatisfactory ad hoc revenue-sharing system with provincial and municipal governments; weak and unprofitable banking

sector and state-owned corporate sector; excessive subsidies; wasteful spending; and poor tax administration, with widespread evasion, corruption, smuggling, and theft of state-owned assets. After the AFC broke, the need to adopt pump-priming policies (including export tax rebate) has further aggravated the chronic deficit problem. Exclusive reliance on bond issues to finance the fiscal deficit has resulted in the ballooning of national debt, and the rising interest payment has acted as a perennial drain on the national treasury.

These three structural problems—fragile banking systems, loss-making SOEs, and chronic fiscal deficit—have now formed a vicious circle in which the whole economy is bogged down. To break this circle, nothing less than an all-out and integrated approach to tackle the ills of the banking system, the SOEs, and the fiscal system is urgently required. Moreover, simultaneous reforms in the legal, accounting, auditing, pensions, and social security systems are also necessary for the modernization of the economy, so that Chinese banks and enterprises can really compete internationally if and when China does finally join the WTO. It goes without saying that this gigantic task cannot be achieved within a few years. In my judgment, at least a whole generation of determined effort is needed to once and for all get rid of the rigidities, inefficiencies, and irrationalities of a “command economy.”

THE PROBLEM OF “ITICS”

While the fragility of the banking system has been in the limelight for many years, one consequence of the AFC is that it has also exposed relentlessly the sorry mess of other nonbank financial institutions. The most prominent among them are the “international trust and investment corporations” (itics).

In the two years before the AFC and the handover of Hong Kong, there was a simultaneous boom in the asset markets of Guangdong Province, which was the first province to open up and which boasted the highest growth rate in the whole country, and Hong Kong. The itics owned or controlled by the Guangdong Provincial Government initially made a lot of money by borrowing heavily and speculating in both the asset markets of Guangdong and Hong Kong.

The advent of the AFC and the collapse of asset markets, especially property markets, in both Hong Kong and Mainland China immediately caused financial difficulties for these highly leveraged institutions. Things came to a head when the central government in October 1998 closed the Guangdong International Trust and Investment Corporation (GITIC) and ordered a review of more than 240 other itics.¹⁰

Earlier, Beijing had closed down Hainan Development Bank and scores of urban credit cooperatives. But the closure of the GITIC, the largest of them, had international repercussions, because of its heavy indebtedness to foreign banks, including those from Hong Kong. Initially, Beijing's position was that the GITIC's debt was the responsibility of Guangdong Province, and not sovereign debt. This caused an uproar among the international banking community, as it claimed that foreign banks lent to Guangdong entities believing in good faith that the Chinese government would be ultimately responsible for the repayment of loans. This was, of course, a classic example of "moral hazard" that plagued other Asian countries affected by the AFC, especially Thailand, Indonesia, and South Korea.

The closure of the GITIC gave rise to a predictable "domino effect": Banks in Hong Kong curtailed their credits to China-related borrowers, which in turn triggered the collapse of a number of investment companies owned by the Guangdong government, of which the largest was Guangdong Enterprises (GDE) and its associated companies and subsidiaries. The GDE group owed a debt of about US\$5.59 billion to banks in Hong Kong, including not only foreign banks and local Chinese banks but also China's own banks, such as the Bank of China Group.

After more than a year's protracted and often acrimonious negotiations between the Guangdong government and creditor banks, a preliminary agreement was finally reached on December 16, 1999. Under this restructuring plan, GDE would repay its debt with a mixture of new bonds, a 19% equity stake in Dongshen Water Supply, a company owned by the Guangdong government, and cash. On its part, the central government would lend RMB38 billion (US\$4.6 billion) to the Guangdong government to repay its foreign liabilities. The central government clearly realized that China's international reputation and credit standing would be at stake if it insisted on its earlier "hands-off" attitude.¹¹

At the time of writing, the approval of the restructuring plan by all creditor banks, numbering some 120, is still pending. One thing, though, has become crystal clear: The GITIC and GDE affairs have greatly shaken the confidence of Hong Kong-based banks in China-related entities, with the exception of those whose management and profitability are beyond dispute (such as China Telecom, CITIC, and China Resources). According to the latest survey by the HKMA, total lendings by authorized institutions to China-related entities at the end of 1999 decreased by 21% compared to the same date a year earlier.¹²

Table 11.8 shows that eight China-incorporated banks of the Bank of China Group had very high NPL ratios, mainly due to their heavy exposure to China-related entities.

TABLE 11.8
Balance Sheet Highlights of Bank of China Group in Hong Kong
(HK\$ million, end of 1999)

<i>Name of Bank</i>	<i>Total Assets</i>	<i>Deposits from Customers</i>	<i>Loans to Customers</i>	<i>Provisions</i>	<i>NPL/Total Loans %</i>
Bank of China	249,515	99,525	74,526	2,294	7.63
China State Bank	41,405	36,308	22,056	1,042	13.81
Kwangtung Provincial Bank	61,846	56,011	25,997	901	11.30
Sin Hua Bank	79,902	70,610	40,681	2,322	17.74
Yien Yieh Commercial Bank	39,652	35,041	19,968	453	7.41
National Commercial Bank	43,562	40,050	20,734	1,066	19.25
China and South Sea Bank	38,283	34,878	19,035	824	14.64
Kincheng Banking Corporation	54,366	46,058	25,097	1,380	17.97

Source: Bank of China Group, Hong Kong

Moreover, both the Chinese central government and Hong Kong's Independent Commission Against Corruption (ICAC) have launched investigations into possible corruption, embezzlement, fraud, and other criminal offenses by senior officials of GITIC and GDE and their associated companies and subsidiaries. Thus, China has paid a heavy price for the poor management and lax supervision of its "itics."

THE RENMINBI QUESTION

Since the eruption of the AFC, China's top officials in charge of monetary affairs, such as Prime Minister Zhu Rongji (who during his tenure as vice-premier was concurrently governor of the People's Bank of China, PBC), and Dai Xionglong, current governor of the PBC, have repeatedly pledged that China's currency, renminbi, would not be devalued in the course of the AFC. This pledge had been honored, now that the AFC has more or less dissipated. Why did China make such a pledge in the face of the no doubt considerable pressure of devaluation?

First, China had weighed carefully the pros and cons of devaluation and had apparently come to the conclusion that the costs of devaluation greatly exceeded its benefits. In 1997, China had a large foreign debt totalling some US\$131 billion. A substantial devaluation would immediately increase China's debt burden and debt service, which would be self-defeating. Also, at that time, China had just managed to bring its double-digit inflation during 1993–96 under control. A devaluation, China feared, would reignite inflationary pressures that had obsessed

Chinese leaders for some time. Since China's wages were among the lowest in Asia, even allowing for the substantial depreciation of many Asian currencies, the Chinese government reckoned that the country's export industries could still maintain their competitiveness for some time.

Second, China also considered that there was no need to devalue, as its external fundamentals were reasonably good. As shown in Table 11.6, China still enjoyed substantial surplus in its current account despite the AFC. Its foreign exchange reserves also continued to rise during the same period. Moreover, as already mentioned, there could be no overt attack on the renminbi, because of the extensive exchange controls on the capital account. China's short-term foreign debt obligations were such that there was no risk of immediate default.

Third, the Hong Kong situation was another important factor. China had pledged to come to Hong Kong's aid if requested. A devaluation of renminbi would have increased the pressure on the Hong Kong dollar to such an extent that a mobilization of China's forex reserves would have been necessary—an eventuality that China would be anxious to avoid.

This pledge therefore had been honored during the course of the AFC during 1997–99. Despite this, there had been frequent rumors and speculations during that period that devaluation of the renminbi was imminent. No doubt, they were exploited by speculators who were keen on bringing down the Hong Kong dollar, which, unlike the renminbi, was and still is fully convertible and therefore could be directly and openly attacked. The rumors or outright fabrications reached their feverish crescendo in the summer of 1998, when hedge funds and others launched their frantic “double market play,” as fully described in Chapter 4. They reasoned that if the Hong Kong dollar fell, the renminbi would follow. But their concerted attack ended in a *débâcle*. Both the Hong Kong dollar and the renminbi stood firm throughout the AFC.

This is not to suggest that the renminbi had no problems. Growth of exports first slowed down sharply in 1998, then became negative in 1999. Trade surplus declined sharply from US\$43.6 billion in 1998 to US\$29.1 billion in 1999, or a fall of one third. FDI also fell from US\$45 billion in 1998 to US\$40.4 billion, a fall of just over 10%. Moreover, forex reserves in 1998 increased by US\$5 billion only, far short of what a trade surplus of US\$43.6 billion and a FDI of US\$45 billion would imply.

There are many reasons for this shortfall. A legitimate reason is that, because of the virulence of the AFC, many Chinese export firms had to make concessionary payment terms in order to retain their market shares. A less legitimate one is the “leads and lags” phenomenon well known to students of international trade and finance. When there is fear of a devaluation of the domestic currency, importers and borrowers

with foreign currency obligations will hasten their payments; on the other hand, exporters and other creditors will try to delay their receipts.¹³ This pattern of “leads and lags” will quicken the depletion of reserves in the case of a country suffering from trade deficit, while it will slow down the increase in reserves for a country still enjoying a trade surplus. This behavior was probably quite prevalent among Chinese foreign trade corporations during 1997–99.

An even less legitimate reason was that many export firms tried to keep forex earnings over and above what they were permitted to retain. From this, it was only a short step to outright capital flight, which has always been illegal. Even before the AFC, it was widely believed that the large amount of “net error and omission” in China’s balance of payments contained a substantial capital flight. In 1998, this item came to US\$12.8 billion.¹⁴

The Chinese government since the third quarter of 1998 has tightened forex control, by ordering export firms to repatriate their forex earnings over and above their permitted retention quota, banning premature repayment of foreign obligations, curtailing renminbi lending to import firms, and the like. As a result, the increase in forex reserves in 1999 improved to US\$9.7 billion. But even this falls short of the total sum of trade surplus and FDI.

However, from the second half of 1999 onward, China’s exports visibly improved, partly due to the easing of the AFC and the recovery of most Asian countries, partly due to the fact that most Asian currencies began to appreciate from their lows in the previous year, so that China’s external competitiveness correspondingly improved. The momentum apparently continued in the first half of 2000. Rumors and fears about the renminbi’s devaluation also dissipated towards the end of 1999 as a result.¹⁵

One issue that will be of great concern to Hong Kong is: If and when the renminbi does devalue, how would that affect the Hong Kong dollar? To answer this question, one must first dispose of one fallacy especially prevalent outside Hong Kong. This is that the renminbi and the Hong Kong dollar are so inextricably tied to one another that the fall of one must also mean the fall of the other. Actually, these two currencies are separate and independent of each other, as explained fully in Chapters 3 and 10. One is as yet inconvertible, while the other is fully convertible. One is a managed currency, while the other is based on the CBA. There is no peg between the two, and there is no reason that the two cannot diverge in their exchange rate fluctuations.

Since Hong Kong adopted its present linked exchange rate system in October 1983, the renminbi has been devalued five times. Each time, the Hong Kong dollar’s linked exchange rate had remained solidly stable, without being affected in any way. Indeed, in those years of relatively

high inflation in Hong Kong, China's devaluation actually benefited Hong Kong, which was highly dependent on food, fuel, and cheap consumer goods from the Mainland. China's devaluations therefore had helped Hong Kong to maintain its competitiveness. Since 1983, Hong Kong's entrepôt role has also revived, and China's rapid growth of exports through Hong Kong has given the territory a new lease on life.

One can acknowledge that, had China devalued during the AFC, the impact on the Hong Kong dollar would have been severe. At the very least, speculators would have been greatly encouraged, as they were by Taiwan's decision to devalue in mid-October 1997, which directly led to "Black Thursday." But the fact is that China honored its pledge and did not devalue during the AFC. Now that the AFC has passed, the potential damage of devaluation has thereby also lessened significantly. Moreover, as long as China's external fundamentals remain in reasonably good shape—forex reserves still increase, trade surplus is still positive, and FDI keeps coming in—there is no immediate pressure for devaluation. As noted already, China's competitiveness has improved following the recovery of most Asian economies and the appreciation of most major Asian currencies.

From time to time, economists and think tanks in China have advocated greater flexibility in the renminbi's exchange rates.¹⁶ It must be emphasized that, officially, China's exchange rate system remains one of "managed floating." The de facto peg of the renminbi to the U.S. dollar during the past three years or so at 8.28 has created a widespread misunderstanding that any widening of the band for fluctuations implies devaluation. This misunderstanding has, of course, been repeatedly exploited by speculators or others with ulterior motives. In my judgment, a modest widening of the band to, say, 2.5% either way would only have a minimal, and essentially psychological, impact on the Hong Kong dollar. Meanwhile, Hong Kong's linked rate regime and public confidence in the peg have both been greatly strengthened since the implementation of the "Seven Technical Measures," as fully recounted in Chapter 4. If Hong Kong could beat back the hedge funds and other sophisticated speculators in August 1998, when the economy was on the slide rapidly, it can surely do so even more effectively now that the economy has regained its vigor. Furthermore, once the public correctly understands that China's devaluation, to the extent that it stimulates its exports, will actually benefit Hong Kong, then China's devaluation, even if it comes, will cease to be the bogeyman that it used to be.

Whatever may happen to the renminbi, one fact is indisputable: China honored its pledge not to devalue its currency during the AFC of 1997–99. Like Hong Kong, China, by refusing to play the game of "competitive devaluation," had accepted domestic sacrifices for the

common good. Thus both have contributed to the stability of Asia at the most critical juncture in its economic history and to the eventual passing of the AFC. Both therefore deserve credit for their responsible behavior.

CONCLUDING REMARKS

China has apparently survived the AFC remarkably well without the combination of currency, banking, and debt crises that crippled and humiliated Thailand, Indonesia, and South Korea. Nevertheless, hidden risks and unresolved issues still remain, which may erupt into crises in the future if not handled well. These risks revolve around three structural issues: fragile banking system, unprofitable SOEs, and chronic fiscal deficit.

In March 2000, Fitch IBCA, a leading credit rating agency, reaffirmed China's long- and short-term currency ratings after Beijing survived the test of the AFC better than most other Asian-Pacific economies. The long- and short-term ratings were reaffirmed at A minus and F1 respectively. Its report concludes with the judgment that "China's sovereign rating encompasses an extraordinary mixture of external strengths and domestic weaknesses." This is surely a fair assessment, which is fully consistent with the analysis in this chapter.

NOTES

1. See Lardy (1998), pp. 197–199; Fernald and Babson (1999).
2. See "Spectre of devaluation haunts RMB assets," *Asiamoney*, September 1999, pp. 180–82.
3. As quoted in *Ta Kung Pao* (Hong Kong), January 20, 1998.
4. See Lardy (1998), Chapter 3, pp. 95 and 119. See also "The worst banking system in Asia," *The Economist*, May 2, 1998, pp. 69–71.
5. See Lawrence and Saywell (1998), and "Problems left over from history," *The Economist*, December 11, 1999, pp. 73–74.
6. See Lardy (1998), Lawrence and Saywell (1998), Jao (1998b), and Chow (2000) for a review of these measures. The accounts of more recent measures are based on current press reports.
7. See Lardy (1998), Chapter 2; Lin and Tan (1999); and Watanabe (1999).
8. As reported in *Wen Wei Pao* (Hong Kong), March 8, 2000.
9. See Ding (2000) and "An anatomy of China's fiscal woes," *North Asia Intelligence, HSBC Economics and Investment Strategy*, August 1999.
10. A clear distinction should be made between China International Trust and Investment Corporation (CITIC) and other itics owned and controlled by local governments. CITIC is owned and chartered by the central government. It is well managed and profitable. In fact, it is one of the most popular SOEs quoted on the stock exchange of Hong Kong.

11. See "State, Creditors Begin Revamp of Ailing GDE," *Asian Wall Street Journal*, December 17, 1999; "Beijing finally starts throwing lifeline to drowning trusts," *South China Morning Post* (Hong Kong), December 21, 1999; "Mixed response to GDE debt plan," *South China Morning Post*, January 13, 2000.
12. As reported in *Wen Wei Po*, March 22, 2000.
13. For a classic study of this phenomenon, see Einzig (1968).
14. See *China Statistical Yearbook*, 1998, p. 100.
15. See "Risk of Yuan Devaluation Fades on Export Growth," *Asian Wall Street Review*, September 17, 1999.
16. As reported in *South China Morning Post*, March 2, 2000.

Epilogue

Lessons and Reflections

INTRODUCTION

As this book is drawing to a close, it would be useful to stand back and take a retrospective look at the trials and tribulations of the past three years, so that Hong Kong can learn from past mistakes and map out a better strategy for crisis management in the future. This epilogue will therefore consist of two sections: One section deals with the immediate lessons that should be learned from the AFC, while the other contains more fundamental reflections on the post-AFC era.

LESSONS FROM THE AFC

Beginning from Q2 of 1999, the Hong Kong economy has gradually emerged from the worst recession in 40 years. As stated earlier, real GDP resumed its positive growth in Q2, which accelerated to 9.2% in Q4 of 1999, and further to 14.3% in Q1 of 2000. Yet there was no widespread sense of elation or euphoria. It is true that Hong Kong has survived the AFC with its currency peg stable and its banking system still basically sound, thus avoiding the horrendous crises and humiliation that befell Thailand, Indonesia, and South Korea. But Hong Kong had also paid the heavy price of a negative growth of 5.1% in 1998 and an initial meltdown of asset values. Although the stock market seemed to be quite buoyant in the first half of 2000, it was partly propelled essentially by a high-tech craze imported from Wall Street. The property market remained in doldrums, and unemployment, by Hong Kong standards, remained high at 5%. The trauma of 1997–99 has left its marks on the

collective mentality of Hong Kong as it entered the new millenium. In the summer of 2000, a series of noisy, though peaceful, protests and demonstrations suddenly erupted, reflecting no doubt widespread discontent and frustrations.

It is of paramount importance that we in Hong Kong should examine critically with an open mind our recent past and should understand, on the basis of cold facts and not preconceived dogmas, what went wrong. In short, what immediate lessons should we learn from the AFC?

The first lesson is that, as a small but extremely open economy, always vulnerable to external shocks, Hong Kong should at all times maintain a strong foreign exchange reserve and a strong fiscal reserve. Without its foreign reserve of US\$91 billion, and its fiscal reserve of over HK\$400 billion (US\$51 billion) at the time when the full force of the AFC hit Hong Kong in October 1997, it could never have successfully defended its currency and financial markets against the massive speculative attacks.

For an economy that adopts the CBA, like Hong Kong, the ability to maintain a strong foreign reserve depends on a sustained growth of total exports, which in turn is determined by competitiveness. This can only be done by enhancing productivity and keeping costs of doing business under control. We will elaborate on this point shortly.

The ability to maintain a strong fiscal reserve depends on fiscal discipline and a sound revenue system. Fortunately, Hong Kong is blessed with a tradition of fiscal prudence and probity, enabling it to accumulate a huge reserve, which was used not only for thwarting the speculators' "double market play," but also to launch a expansionary fiscal policy that eventually paved the way for recovery. In retrospect, one can see how shortsighted and superficial was the fashionable critique, before the AFC, of Hong Kong's fiscal policy are "too conservative," according to a host of self-styled experts.

However, the three consecutive years of fiscal deficit caused by the AFC has raised the specter of "structural deficit." Before he presented his budget for the fiscal year 2000–01 on March 8, 2000, the financial secretary, Mr. Donald Tsang, had repeatedly warned of the need to broaden the tax base, particularly the need for introducing a broadly based tax such as a sales tax. To sound out public opinion, he convened a meeting with leading academic economists on December 15, 1999. At that meeting, I expressed my reservations about introducing a sales tax at this juncture, citing three reasons. First, Hong Kong's recovery was still at its initial phase, and consumption expenditure was still weak, as evidenced by the continuing deflation. Second, even without a sales tax, many housewives have acquired the habit of organizing one-day shopping trips to Shenzhen to buy cheaper consumer goods there. The imposition of a sales tax would encourage more such trips, to the

detriment of Hong Kong's own retail market. Third, I cited the lesson from Japan. In the spring of 1997, Japan, also worried by its "structural deficit" which was, however, much more serious than that of Hong Kong, imposed a 5% "consumption tax." This effectively killed Japan's incipient recovery at the time and plunged the country again into a deep recession. However, I also agreed that, from a long-term point of view, a broadening of the tax base would be both necessary and desirable; I therefore recommended that a special commission should be formed to review the whole tax structure.

It is most gratifying to note that in the 2000–01 budget, presented on March 8, 2000, the financial secretary accepted my suggestions. No new tax was announced, but two committees would be formed to review the tax system and the sea-land departure tax respectively. Actually, the fiscal situation was not so serious as the government had claimed it to be. In his budget speech, the financial secretary admitted that the HK\$36.5 billion deficit planned for the 1999–2000 fiscal year was likely to shrink to only HK\$1.6 billion by the end of March 2000. For the new fiscal year 2000–01, a small deficit of HK\$6.2 billion was planned, which was entirely manageable.¹ At the end of April 2000, the government announced that the HK\$36.5 billion deficit projected for the 1999–2000 fiscal year had turned into a surplus of HK\$9.9 billion, due to the improving economy.

The government itself was also at least partly responsible for the "narrow tax base" of which it complained. It had been, for example, too generous in increasing personal allowances. From fiscal year 1996–97 to fiscal year 1998–99, total personal allowances had been increased by 37%, even though the cumulative inflation rate during those three years was only 16%. The government had also abolished certain taxes, unnecessarily in my view, such as the entertainment tax and the excise tax on cosmetics. Nevertheless, it is most reassuring that the financial secretary has reiterated the principle and tradition of "fiscal prudence" in his latest budget.²

The second lesson to be learned is that, while the government's handling of the AFC was on the whole quite successful in protecting the integrity of the currency and the banking sector, a heavy price was paid, in terms of the worst recession in 40 years. This suggests that the techniques of crisis management can be improved. Specifically, we noted in Chapters 4 and 5 that the HKMA's initial exclusive reliance on high interest rates had caused the immediate collapse of the asset markets and the rapid deterioration of the economy. It was not until the implementation of the "seven technical measures" in September 1998 that the key questions of confidence and interest rate volatility were addressed. Similarly, the Housing Authority's single-minded pursuit of the "85,000 units" target had undermined public confidence to such an

extent that the imminent collapse of the property market directly threatened the banking sector, necessitating the hasty suspension of land auctions in June 1998 and the modification of the housing target later. The moral of all this is that no government agency should blindly pursue its sectoral objective in total disregard of the overall interests of the economy. In any future crisis, therefore, there must be a better coordination and cooperation between different government agencies and departments, with the overriding aim of achieving a soft landing of the economy. But what happened in 1998 was a hard landing, with great suffering for ordinary people.

The third lesson is that any asset bubble can easily snowball into a general financial crisis, especially if such bubbles are financed by banks or other nonbank financial institutions. This has happened too frequently in Hong Kong and elsewhere to need any further elaboration. We noted in Chapter 3 how bubbles in both the property and equity market had formed before the AFC in 1996–97. To the credit of HKMA, it had indeed issued warnings repeatedly to banks against overexposure to the property market and had given administrative guidelines on the ceilings of property loans (70% of the assessed value of the property and 40% of the total loan portfolio). Unfortunately, apart from such measures, which economists tend to group under the rubric of “moral suasion,” the HKMA cannot use more substantive weapons, such as raising interest rates, independently of the U.S. Federal Reserve, because of the constraint of the linked exchange rate, in order to nip in the bud an incipient bubble. Nevertheless, the HKMA should continue its vigilant surveillance of the banking sector and insist that banks and other deposit-taking institutions should observe the code of behavior issued by the HKMA and constantly upgrade their internal risk management. Furthermore, the participation of many China-related entities in the speculative euphoria in 1996–97, and in its subsequent collapse, suggest that better coordination and interface between the regulatory authorities of China and Hong Kong are urgently needed.

The fourth lesson is that prudential supervision of nonbank financial institutions (NBFIs) needs to be strengthened. The HKMA rightly deserves credit for overhauling the prudential supervision of the banking sector so effectively before the AFC that, apart from reduced profitability, no single bank failed during the AFC. However, the failure of Peregrine and C.P. Pacific in early 1998 necessitated another abrupt and steep rise in interest rates, which aggravated the economic downturn. The two brokerage firms were the responsibility not of HKMA but of the Securities and Futures Commission (SFC). However, the moral is clear: In an environment of crisis and uncertainty, even the failure of NBFIs can have serious knock-on effects, and therefore different regu-

latory bodies should strive to improve their coordination and cooperation in crisis management.

The fifth lesson is that, while downward adjustment in prices and costs is an inevitable part of the adjustment process inherent in Hong Kong's linked exchange rate regime, prolonged deflation also has its negative effects, as explained in detail in Chapter 9. One less painful way to increase international competitiveness is to introduce more competition into all industries and sectors of the economy. One good example is that, by deregulating the telecommunications industry even before the AFC, the costs of telecommunications, especially long-distance overseas calls, a key element in the costs of business, has gone down considerably. However, while Hong Kong's manufacturing sector, long exposed to global competition, has effectively cut its wages and costs, the same is not true of many service industries or occupations. The government has now begun an Enhanced Productivity Program for its own employees, in conjunction with other reforms of the civil service. The public sector, in other words, will no longer be a haven for soft jobs, with security and automatic salary increases. But this performance-related compensation system should be extended to other private sector professions, notably law, medicine, and accounting, that are still full of restrictive practices. This is not just a matter of "value for money," but of economic survival. Hong Kong must keep its costs down and productivity up in order to survive and develop in a brutal world of globalization.

The sixth lesson is that, while Hong Kong's civil service is generally regarded as reasonably efficient and clean, bureaucratic arrogance, bungling, and incompetence and lack of interagency coordination and cooperation can still from time to time cause catastrophes. I am referring, of course, to the débâcle in the opening of the new airport in July 1998, when a breakdown of the computer system disrupted passenger service for a whole week and air cargo service for a whole month, which dealt further blows to inbound tourism and exports at a time when the economy was already in deep recession. This disaster, which was avoidable, nearly tipped the economy over the abyss. The Government must take its full responsibility for this colossal calamity, reorganize the whole Airport Authority, and make sure that such incidents will never happen again.

The seventh lesson is that the whole financial sector, including the banking system and the financial markets, must be continuously reformed and upgraded, not only in order to cope with contingencies such as the AFC but also to meet the challenges of the globalization of banking and finance. One problem exposed during the speculators' "double market play" in August was the lamentable lack of coordination and cooperation between the Stock Exchange of Hong Kong and

the Hong Kong Clearing. It is encouraging to note that a series of reform measures have been taken since September 1998, when regulations of the stock and futures markets and clearing arrangements were tightened to prevent manipulation. These measures include the merger of the Stock Exchange of Hong Kong and Hong Kong Clearing into a new unified body called Hong Kong Exchanges and Clearing Ltd., reform of the banking sector (modification of the three-tier system, phasing out of the interest rate rules, better depositor protection, further liberalization of entry regulations for foreign banks, study of a central credit register, strengthening bank supervision through the new risk-based approach, and so on), the establishment of an open and secure electronic network that will allow all securities and derivatives transactions to be processed straight through, the development of a multicurrency clearing system, building a leading debt market by attracting companies outside Hong Kong to issue debt papers in Hong Kong, establishing linkages with central clearing and depository systems overseas, and the enactment of a composite Securities and Futures Ordinance. Hopefully, these measures, on their full implementation, will reduce the vulnerability of Hong Kong's financial sector to external shocks, while consolidating and promoting Hong Kong's status as a major international financial center.

REFLECTIONS ON SOME POST-AFC ISSUES

Now that the AFC, or at least its most virulent phase, has passed, it is time to reflect on some fundamental and long-term issues that affect the future of the international financial system and that of China and Hong Kong and their evolving relationships. These topics deal with events yet to come and may require another treatise. Here I wish only to jot down some personal thoughts as closing remarks for this book.

The first issue that will obviously occupy the minds of Hong Kong and many other countries in the Asia-Pacific Region is whether the AFC will recur and, if so, will there be a coordinated and effective response to such a contingency?

Since the 53rd joint annual meetings of the IMF and World Bank held on October 6–8, 1998 in Washington, much has been written about the "New International Financial Architecture," which has quickly become a fashionable buzzword. However, apart from some familiar and banal statements about the desirability of transparency, strengthening banking and financial systems, involvement of the private sector in coping with financial crises, liberalization, and modernizing financial markets, no real international agreement has been achieved on how to curb excessive volatility in exchange rates and interest rates, on containing

the contagion of financial crises, and on the establishment or adoption of better mechanisms or techniques of crisis management without huge losses in employment and income.

As a victim of the AFC, Hong Kong during the past three years has spoken frequently on the need of close surveillance and regulations of aggressive trading behavior of highly leveraged institutions (HLIs), such as the hedge funds, which often pose systemic risks to small open economies. It has also advocated greater international cooperation to raise the disclosure and regulatory standards of offshore financial centers. Unfortunately, Hong Kong's pleas have so far fallen on deaf ears.

The heart of the matter, as I pointed out in a conference paper in 1999, is that Hong Kong is too small to count.³ The agenda for international finance is, in fact, determined by the G-7. This body is not representative of the world economy either economically or geographically. Of the seven members, the United States, the United Kingdom, Japan, Germany, France, Italy, and Canada, no less than four are from Europe, two are from North America, and one is from Asia, but all of them are highly industrialized and developed countries. Not one single emerging economy is represented. It was true that Hong Kong was invited as a member of G-22 to a meeting of finance ministers and central bank governors held in April 1998 in Washington in the wake of the AFC, but G-22 was an ad hoc body convened by the U.S. Government and lacked the permanent standing and prestige of the G-7. The interests of these major powers, to say the least, do not coincide with those of emerging economies, particularly small open economies like Hong Kong.

Very recently, Robert Mundell, the 1999 Nobel Laureate of economic science, has persuasively argued that the ideal ultimate solution of international currency crises and problems is the adoption of a single world currency, issued and managed by a single world central bank. Failing this, the second-best solution would be for the three major currencies, the U.S. dollar, the Euro, and the yen, to have fixed exchange rates among them or, at least, to have their fluctuations minimized.⁴ To quote Mundell:

My own view is that the biggest danger to world prosperity arises from wide swings not based in any economic fundamentals, in the exchange rates of these three currencies; that central banks can and should conduct their affairs to dampen this volatility, evolving policies that provide for intervention in the foreign exchange markets; and that these would be salutary steps toward the ultimate development of one currency managed by a world central bank.

Mundell's view echoes those of many other eminent economists in the past, including the idea of a "target zone," which would hold

exchange rate fluctuations within reasonable limits through joint cooperative interventions by key currency countries. Unfortunately, preliminary suggestions of setting "target zones" for the three key currencies were brusquely ruled out of court in the spring of 1999 by the United States. The U.S. official position was that sound economic policies, not efforts to stabilize exchange rates, are the key to calming the foreign exchange markets. This position is surely disingenuous, for in the past, the United States did not hesitate to organize joint interventions, such as the Plaza Agreement of 1985 and the Louvre Accord of 1987, if they suited its own purposes.⁵ To quote Mundell again:

A pattern recurrent in the history of money is that the dominant country rejects meaningful monetary reform, probably because it involves power sharing and a weakening of its monopolistic currency position. But it is not a healthy sign that the only option for smaller countries is to fix their currencies to one of the G3, a situation reminiscent of the monetary colonialism of the 19th century.

The moral of all this is that, while Hong Kong should continue to make its voice heard at any suitable international forum, it should not harbor any illusions about any new financial architecture that would look after its interests, as long as the present dominance of the G-7, especially the dominance of the United States, is not changed. It should rely on its own resources and efforts, as it did during the AFC, for defending its own currency and financial system.

The second reflection is a logical extension of the first, as well as a natural consequence of Mundell's insight. Since the ideal state of a single world currency is unattainable, at least in the foreseeable future, the essence of the existing exchange rate regimes can be reduced to two basic types. One type tries to fix the economy and let the exchange rate adjust to whatever is regarded as the optimal state of the macroeconomy. This is the essence of the flexible or floating exchange rate regime, whether "clean" or "dirty." The other type tries to fix the exchange rate and let the economy adjust to that rate. This is the essence of the fixed exchange rate regime, the most extreme form of which is the CBA, of which Hong Kong's present linked rate is a variant. An inordinate amount of ink has been spilled on the relative merits of the two regimes, but it is a fact that the jury is still out on the verdict.

In Hong Kong's case, the linked rate regime has indeed survived the AFC, but the economy has been put through a wringer of gruelling "internal adjustments" that have resulted in the worst recession in 40 years, as discussed fully in Chapters 7 and 8. It is all very well for highly paid officials with job security to talk blithely about the necessity of "adjustments," but it is the ordinary people of Hong Kong who have

actually borne the brunt of such “adjustments,” in the form of reduced earnings or even the loss of income and employment. They are the real heroes of Hong Kong’s turbulent economic history, as well as its economic miracle, during the past half century.

The most serious disadvantage of Hong Kong’s present peg system is that the territory cannot pursue any meaningful monetary policy independently of the Fed. When the business cycle of the United States and Hong Kong perfectly synchronize, there need be no serious problems. Problems arise when cyclical movements diverge significantly in the two economies, resulting in such absurdities in Hong Kong’s monetary policy as lowering interest rates when the economy is overheating and raising them when the economy is still in recession. In an article reviewing currency board operations in Hong Kong published in 1998, I said:

Under Chinese sovereignty, Hong Kong’s economic ties with China will almost certainly strengthen over the long run, while those with the United States will most likely decline in relative importance. The cyclical movements in the Hong Kong economy will therefore be more tuned to those in China rather than in the United States. Thus the possibility that one day, the costs of the second currency board will outweigh its benefits cannot be ruled out. While the subject is beyond the scope of this paper, both economists and policy-makers should begin to think hard about the long-term implications of the present monetary regime and its possible modifications.⁶

It is true that in 1999 the economy had rebounded, with the growth rate of real GDP accelerating to 9.2% in Q4. But because there was still negative growth in Q1, the average growth for the whole year was a modest 3%, far below that of South Korea, Singapore, and Taiwan. For the year 2000, the official revised forecast was for a further growth of 10.5%. If this target is realized, the linked rate regime may be vindicated once again. But should the economy falter again because of rising U.S. interest rates, questions and doubt would persist and even grow about the linked rate regime. After all, an exchange rate regime is only a means, not an end in itself. There is nothing sacrosanct about any exchange rate regime. The ultimate arbiter for any economic policy and institution must be economic welfare in terms of income, employment, growth, and price stability. People will rightly ask what is the point of a permanently fixed currency peg if the economy is dead?

I agree that during the AFC, it would be inappropriate to talk about the review of the exchange rate regime. Even the mention of the word “review” might well encourage speculators and undermine public confidence. But now that the AFC is basically over and the speculators

have been thoroughly trounced, the time has come for economists and policy-makers to think hard about the long-term future of the exchange rate regime and, if necessary, to "think the unthinkable." If an open review is still judged too sensitive, then the HKMA should at least have an in-house review of all options, to cope with all possible contingencies.

The better macroeconomic performance of Singapore also provides food for thought.⁷ Singapore, like Hong Kong, used to be on the sterling exchange standard, the classic form of CBA. In the early 1970s, it exited from this regime and gradually adopted a managed floating system that pegged the value of the Singapore dollar to a trade-weighted basket of currencies within an undisclosed band. To be fair to Hong Kong, however, there were special circumstances for Hong Kong's reversion to the CBA in 1983. First, Hong Kong also exited from the sterling exchange standard in 1972, but the floating rate system during 1974–83 did not work well and was partly responsible for the crisis in 1982–83. When the 1997 issue surfaced in its full dimension, the currency crisis almost got out of control and was only stopped by the adoption of what I called the "second currency board" in October 1983. Singapore, however, did not have any 1997 problem. Second, Hong Kong's present regime is fully transparent, unlike Singapore's, which is nontransparent and is entirely subject to the discretion of the Monetary Authority of Singapore (MAS). Nevertheless, the better macroeconomic performance of Singapore still deserves careful consideration by Hong Kong.

The third reflection concerns the structural transformation of the Hong Kong economy itself. Hong Kong is now in the midst of another major structural metamorphosis, variously called the Third Restructuring or the Third Wave. Briefly, Hong Kong has gone through three major restructurings during the past half century. The first one, begun soon after the U.N. and U.S. embargoes against China during the Korean War that destroyed Hong Kong's entrepôt trade with the mainland, was an export-led industrialization based on labor-intensive light industries exporting, under a strict system of certification of Hong Kong origin, to markets in developed industrialized countries, particularly the United States. This phase lasted from about 1952 to about 1978. The second one occurred just after China launched its reform and open-door policies in 1979. This phase was characterized by relocation of manufacturing facilities to the mainland, revival of the entrepôt trade, and a rapid expansion of the services sector, particularly of financial services and business services, to the extent that services accounted for 85% of GDP at the end of 1996. The latest phase, which most scholars and analysts agree began soon after the handover and the AFC, aims at upgrading and diversifying the present service-oriented economy into a knowl-

edge-based, information technology (IT)–driven world-class metropolitan economy. In terms of government policies and initiatives, this phase is being characterized by emphasis on computer skills, incentives to IT industries by the creation of a Cyberport, possible development of knowledge-related industries such as a Chinese medicine center, further liberalization and reform of the financial sector to promote and consolidate Hong Kong's status as an IFC, encouragement of applied scientific and technical research through government seed money in the form of an Innovation and Technology Fund, modernization of the infrastructure (rail network and container port), introduction of more competition through deregulation of telecommunications and other service industries, radical overhaul of the whole educational system, and liberalization of immigration procedures to attract skilled professionals, particularly from the Mainland.

However, the policy package of Cyberport and IT has also aroused the ire of a small but vocal group of critics, who denounce it as a form of "industrial policy" and an abandonment of the *laissez faire* tradition that they claim was the foundation of Hong Kong's past success. In my view, this critique is singularly misleading and misplaced. The present government does not try to decree what industries should be developed, it does not try to pick the winner, and it does not have any equity stakes in any IT firms or industries. It only tries to provide a favorable environment for developing high-tech, especially IT, industries. It also provides some seed money to encourage R & D, but does not itself finance or subsidize any high-tech or IT firm. The policy has also the advantage of correcting the past overreliance on the property sector, which was partly responsible for the property bubble and the consequences of its bursting and the relative neglect of high technology and IT by the previous administration. One is led by the virulence of the language of the critics to suspect that what they really want is that Hong Kong should remain forever a quaint little place whose sole *raison d'être* is to amuse foreign tourists and visitors. Fortunately, neither the government nor the population will care for such "advice." As Dr. Victor Fung, chairman of the Hong Kong Trade Development Council and himself a successful entrepreneur, has aptly remarked, "Hong Kong is changing the 'enclave mentality' which, for obvious reasons, constrained pre-1997 approaches to economic development."⁸

It is encouraging to note that the Government's initiatives concerning Cyberport and IT have received a warm response from the private sector, as evidenced by the proliferation of local internet and IT firms and their links with their overseas counterparts. Even real estate developers have diversified into e-commerce, as they realized, to their credit, that the days of excess profits from property dealings are over and that

they must adopt IT both for diversifying risks and for enhancing the efficiency of their core property business.

The most spectacular development to date is, of course, the defeat of the formidable Singapore Telecom (SingTel) by a hitherto unknown Hong Kong internet firm, Pacific Century Cyberworks (PCCW), in the takeover battle for Cable and Wireless–Hong Kong Telecom worth some US\$38 billion, the largest corporate takeover in Asia, at the end of February 2000.⁹ The significance of this event is manifold. First, it demonstrates that Hong Kong has the talent, capital, and infrastructure to develop as an internet hub for the Asia-Pacific region. Second, it confirms that despite the double ordeal of the 1997 transition and the AFC, Hong Kong's entrepreneurs have lost none of their élan. This augurs well for Hong Kong's long-term economic development. Even before this sensational takeover, PCCW, headed by Richard Li, the younger son of Li Ka-shing, Hong Kong's legendary entrepreneur, had a stock market value of US\$21 billion in January 2000 through investments in 30 technology companies in the United States and Hong Kong. Third, it also confirms our analysis in Chapter 5 that Hong Kong is still the second largest IFC in the Asia-Pacific region. PCCW was able to raise a sum of US\$11 billion from four major banks, namely, HSBC, the Bank of China, Banque Nationale de Paris, and Barclays, over a weekend, a feat that can be achieved only in a world-class financial center.

To be sure, the mania for high-tech shares in both Hong Kong and the United States have raised the specter of a gigantic bubble waiting to be burst. The sharp fall of high-tech shares in April in both Hong Kong and the United States are only warning signals. But in my view, Hong Kong's high-tech bubble, if it exists, is much less serious than the property bubble just before the AFC; in any case, the high-tech mania, unlike the property mania, does not directly threaten the livelihood of ordinary people.

My fourth reflection has to do with China's evolving long-term relationship with Hong Kong. In Chapter 10, we have argued that China has behaved correctly toward Hong Kong since the handover and that, in the realm of money, banking, and finance, China has scrupulously observed its pledges and promises to Hong Kong. This good behavior is partly motivated, no doubt, by Hong Kong's enormous contributions to China's economic reform and modernization. Hong Kong is not only a principal source of foreign exchange earnings and FDI for China, it is also the most important capital-raising center for China's SOEs. In addition, Hong Kong also helps China by providing the "software" necessary for modernization and development: a knowledge of modern management, financing, marketing, legal and accounting practices, international market intelligence and trade links, and the like.

But the potential of Hong Kong cannot be fully realized if it is allowed only a limited time horizon. Both the Joint Declaration and the Basic Law provide that Hong Kong's present capitalist system and life-style will remain unchanged for 50 years after July 1, 1997. This means, in effect, that in two decades' time, Hong Kong will be confronted with uncertainty about its future all over again, as it was in the early 1980s.

As early as 1988, I argued in an article that, if China was really serious about the "one country, two systems" principle, it should allow Hong Kong to retain its capitalist system indefinitely, in order to get rid of the confidence problem once and for all.¹⁰ China has hinted that it would be prepared to extend the time horizon when necessary, but a formal declaration of indefinite extension would be far more effective. It would strengthen enormously international and domestic confidence in Hong Kong and magnify Hong Kong's value to China beyond even the most optimistic expectations.

Last but not least, China should also, by the same token, take a long view of the Taiwan problem. Beijing was understandably angered by the provocative remarks by Lee Teng-hui, the former president of Taiwan, about "state-to-state relations." However, China's threats to use force will not solve the problem. Any actual resort to force would, on the contrary, be calamitous not only for both sides of the Taiwan Strait but also for Hong Kong and Macau, the two other members of Greater China. As I argued in my book on Hong Kong as an international financial center published in 1997, but written during the 1996 missile crisis, one of the six premises for Hong Kong's continued existence as an IFC is that cross-strait relations will not deteriorate into a military confrontation.¹¹ If China devotes its energy to economic development, accompanied preferably by political reform, then Beijing's centripetal attraction will grow and ultimately become irresistible. Peaceful reunification is not only the best, but also ultimately the most effective option, if Beijing will keep its cool and remain patient.

Taiwan, for its part, should be content with its present status quo of de facto independence and avoid any unnecessary provocation of, and confrontation with, China. Any move toward de jure independence will have incalculable consequences. Taiwan should also allow, and not obstruct, direct cross-strait trade, investment, communication, and transportation links.

In short, both sides of the Taiwan Strait should exercise the utmost restraint to avoid any military showdown, whose consequences would be too horrible even to contemplate. Hong Kong is powerless to exert any real influence over cross-strait relations. It can only pray that reason will prevail and that both sides will agree, at least tacitly, to resolve their differences by peaceful means.

NOTES

1. See the 2000–01 budget speech, “Scaling New Heights,” by the financial secretary, moving the second reading of the appropriation bill, 2000, 8 March 2000, esp. paras. 161–208.

2. Ibid, paras. 72–73.

3. Jao (1999).

4. Mundell (2000).

5. Under the Plaza Agreement, the G5 (United States, United Kingdom, France, Germany and Japan) pledged to work for a gradual depreciation of the U.S. dollar, then considered overvalued. Under the Louvre Accord, the G7 (G5 plus Italy and Canada) agreed to keep exchange rates stable at current levels. While the official communiqué was rather vague, many economists have interpreted this accord to be a form of “target zone.”

6. Jao (1998a).

7. See Lu and Yu (1999).

8. Victor K. Fung, “Hong Kong’s Third Wave,” *Asian Wall Street Journal*, October 17, 1999.

9. See “Upstart PCCW’s Takeover of HKT Marks Coup for Li, May Transform Asia Market,” *Asian Wall Street Journal*, March 1, 2000; “HKT Victory for Richard Li” and “Record US\$11b loan to fund bid,” *South China Morning Post*, March 1, 2000.

10. See Jao (1988c).

11. See Jao (1997a), pp. 86–89.

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