

Effects of the Asian Financial Crisis on Hong Kong

The Asian financial turmoil started off in Thailand immediately after Hong Kong's retrocession to China in July 1997. It quickly swept through to the rest of South East Asia. The contagion then spread to what analysts believed to be healthy countries. By the latter half of 1997, financial troubles in Japan and corporate bankruptcies in South Korea rocked North Asia. In early 1998, the fall-out in Indonesia gave a further shock to South East Asia and the rest of the region. These events have tended to compound each other, resulting in serious regional crises with profound implications for the global financial markets. Hong Kong, as a significant member of the global and regional financial community, could not have been immune. The effects of the financial crisis were similar throughout the affected countries. The most conspicuous features of the turmoil were substantial downward pressure on the stock markets, an upsurge in interest rates, rising inflation and rising unemployment, and, with the exception of Hong Kong, sharply depreciated and highly volatile exchange rates. The major outflow of cash from the region affected the business sectors causing businesses to experience widespread liquidity squeezes as the banking sectors exercised stringency on account of their diminishing deposits, falling value in collateral and worsening quality of loans.

HKMA Intervention into the Stock Market

Since the Asian crisis erupted in mid-1997, Hong Kong has experienced a number of speculative attacks aimed at toppling the HK dollar and breaking its fifteen-year old link to the US dollar. The Hong Kong government, in an attempt to defend its currency, forced interest rates beyond normal self-correcting levels and intervened heavily in the stock and futures markets to punish currency speculators. The decision to intervene was made by four people: Hong Kong Financial Secretary Donald Tsang Yam-kuen, Chief Executive of the Hong Kong Monetary Authority (HKMA) Joseph Yam Chi-kwong, Secretary of Financial services Rafael Hui Si-yan, and Chief Executive Tung Chee Hwa. The decision was not made lightly; they knew the economic and political consequences of intervention. But this group also knew that if the incentives for currency speculators weren't removed, Hong Kong would be headed down a vicious spiral of economic collapse. The peg is successfully maintained by a strict and automatic currency board system, backed by more than adequate foreign currency reserves, the third largest in the world. Only Japan and mainland China have more foreign currency reserves than Hong Kong. The Chinese reserves, through commitments of up to US\$50 billion, have had a stabilizing effect on Hong Kong. Normally, a currency board is a passive "instrument" that allows none of the manipulation that the HKMA had undertaken over the past 18 months. The tactics used have called into question Hong Kong's traditional dedication to the free market (Reyes, 50).

The October 1997 Attack

The HKMA was largely unprepared when speculators mounted their first attack in October 1997. Although the HKMA had intervened in the Hang Seng in July 1997 with a HK\$1 billion purchase to stabilize the market, most analysts believed the Hong Kong economy was somehow immune to the Asian Financial Crisis contagion. During the currency attacks, speculators took out large short positions against the HK dollar with the aim of destabilizing the linked exchange rate. Powerful international hedge funds dumped \$5 billion worth of borrowed Hong Kong dollars. These attacks activated the automatic adjusting mechanisms of the currency board and drove up interbank interest rates. The HKMA, sensing that currency speculators had been attempting to manipulate the market, raised interbank rates, at one point to an astronomical 280%. Speculators, many of whom were local banks, had to borrow locally to fund their short positions and also to maintain daily balances for normal bank operations. As a result, these speculators were forced to unwind their positions and incur heavy losses.

The first substantive attack in October 1997 failed, the currency board worked, and the link survived. But the interest rate volatility had severe effects on the community through the skyrocketed interest rate's effect on household mortgages. Most of the mortgages in Hong Kong have variable, not fixed interest rates, therefore a rise in interest rates immediately and directly affects mortgage payments.

Speculators, anticipating the effects of the currency defense, had another target in their sights. They expected the stock market to be spooked by the interest rate rise, so they had built up short positions (Reyes, 50). The Hang Seng fell 13.7% on October 28, 1997. The speculators had made far larger gains in their short positions than they had lost on the interest payments incurred on the money borrowed.

The August 1998 Attack

The situation had become much more complicated in the attack of August 1998. Speculators launched a coordinated and well-planned attack on the financial market. Over HK\$30 billion were sold on August 5, 1998, chiefly through U.S. investment banks. Speculators took advantage of the built in mechanisms of the currency board to drive up interest rates, which subsequently applied downward pressure on stock prices. Intensively selling HK dollars over a short period had the right effect. This, combined with rumors and pressure on the government to delink the HK dollar to the US dollar and also rumors that the PRC would devalue the renmenbi,

had catastrophic effects on the stock market. By pressuring the currency and selling stocks short, speculators anticipated profits from stock index futures contracts, even if they could not break the exchange rate link.

This time, the HKMA was ready. Instead of absorbing the HK dollars, it got the Treasury to buy them. The government claimed that it needed the extra HK dollars because it planned to run a fiscal deficit of over HK\$20 billion to fund its stimulus packages (Reyes,

50). Unlike in October of the preceding year, there was no change in the HK dollar balance in the banking system, so interbank rates climbed only three percentage points to 7.5%. Although limiting the interest rate effects on the Hang Seng, a far greater fear swept through the markets. This intervention had led analysts to believe that HK had dropped the peg. This rumor coupled with rumors from the Chinese central bank that the PRC was considering a devaluation, although both Beijing and Hong Kong issued denials, sent the Hang Seng to a five-year low on August 13 of 6,544 points.

The HKMA was successful in routing the short-sellers, but the hedge funds were believed to have had over 20,000 Hang Seng Index futures contracts ready to expire in two weeks. The strike price was estimated to be between 8,000 and 9,000 points (Reyes, 51). The HKMA used official reserves to purchase stocks to ensure speculators did not profit. The HKMA has since admitted the cost of its intervention in the stock market in August 1998 was HK\$118 billion (US\$ 15.2 billion). That figure amounts to nearly HK\$20,000 for every man, woman and child in the territory (Yam).

Hong Kong's fundamental strengths have in a way made them vulnerable to market manipulation and forced them to take such drastic measures during the crisis. The HK economy and markets are small in relation to the rapidly growing volume of international capital. They are liquid and open enough to be attractive for speculators to seek and exploit arbitrage situations and actually manipulate the market (as witnessed in August 1998). The currency board correction mechanisms are predictable, and the effects of this correction (higher interest rates) on the stock market are also predictable. Hong Kong's economic fundamentals of being small, open, and predictable allowed the Asian financial flu into their markets. In the short amount of time since contracting the AFC contagion, the HKMA, not able to affect the size of neither its market nor wanting to tarnish their commitment to openness, had only the "predictability" variable to resort to.

The Aftermath

The government, in an attempt to distance itself from its equity holdings has created a body called the Exchange Fund Investment (EFI), under the HKMA, to oversee its shareholdings. The hope is that the EFI will reinforce the government's desire to be seen as an impartial, long-term shareholder in "Hong Kong Inc." It might be tempting to get out while the going is good; its equity holdings have profited handsomely as the Hang Seng has nearly doubled from the depths of last August. A number of institutional investors have quietly offered to buy the government's stakes, but any substantial sale would put the market at risk.

The government is committed eventually to selling its shareholdings, which represent about 7.3% of the 33 companies that make up the Hang Seng index. In the long run, the threat of this eventual sale will depress share prices. In the meantime, locking up so many shares has sharply cut the number that might be traded on any given day: the so-called "free float" which corresponds to greater market volatility is just the opposite of what the government hoped to achieve. The last 18 months have witnessed Hong Kong dilute its free-market image as it fought the Asian contagion and warded off speculative attempts

on its currency. This intervention has not only built up stakes in the private sector but has also led to questions about the government's credibility and confidence.

The Political Dilemma

Democratic groups in the legislature assert that the authorities face intolerable conflicts of interest. For instance, the government is now the owner of nearly 12% of New World Development and of more than 10% of Cheung Kong, two giant property conglomerates. Yet in Hong Kong the government is the sole supplier of fresh land for development. The government also owns 8.8% of HSBC, the biggest banking group in the territory, whose main regulator is the monetary authority itself ("Hong Kong. Fair Shares" 79).

HKMA Intervention Conclusion

The Hong Kong Monetary Authority's intervention over the past 20 months has been aimed to strip the economic gains and incentives of currency speculators. Hedge funds and investment banks were playing an easy game of selling short in the HK stock market by dumping HK dollars and shocking the market. At first, the intervention was targeted to equalize interest rates to break the speculative cycle. This intervention then led the world to believe Hong Kong would abandon the peg and subsequently sent the Hang Seng into a tailspin, thus forcing the HKMA to support the stock market through equity purchases in an attempt to circumvent short-sellers' speculative gains. The HKMA has positioned itself as the buyer of "first" resort willing to defend the 6500 point level on the Hang Seng. The ramifications of HKMA's defense of the Hang Seng are yet to be seen, but calls into question the issues of financial moral hazard and governmental conflicting interests.

The Hong Kong Property Market

When the Hong Kong government successfully defended its currency against speculation, it came at great costs. The high interest rates needed to defend the peg to the U.S. dollar pushed down stock prices and tight credit hit the overly inflated property market where property prices had risen 65% since 1996. The combination of higher mortgage costs and lower capital gain prospects sent buyers running the other direction (Sprague and Law, "The Hong Kong" 78). Consequently, the Hong Kong government's decision to intervene and buoy real estate values was hinged on concerns that a collapse in the property market would result in a complete loss of confidence in the territory and weaken the banking system, ultimately sending the entire economy to a crashing halt.

Situation before the Crisis

Property prices were at its highest levels in the third quarter of 1997 leading to concerns about Hong Kong's decreasing competitiveness in Asia as a result of rising costs. As the new chief executive of the newly established Special Administrative Region (SAR), Tung Chee Hwa was determined to lead the former British colony through its transition to Chinese rule by re-establishing Hong Kong's competitiveness in Asia through a more

activist development strategy of high-tech and value-added industries (Sprague 67). Hong Kong was to be weaned of its dependence on stock and property as the main vehicles through which to make money. In his first policy address Tung Chee Hwa vowed to diversify the economy away from its longtime dependence on the property sector and to turn towards more value-added real enterprises to boost competitiveness (Reyes 45-50). Promising to discourage speculation and to bring property values down to a "soft landing", he pledged 85,000 new flats a year to Hong Kong residents until the year 2007 (Ko 17). According to Tung Chee Hwa, maintaining Hong Kong's competitiveness as a regional business center in Asia was contingent upon lower property prices, which in recent years have deterred foreign investment in Hong Kong.

Affects of Crisis on Property Market

When the Asian Financial Crisis hit Hong Kong, the chief executive was forced to place his ambitious plans on hold. Overnight interest rates were raised to heights of 16% to defend speculation on the Hong Kong dollar. The subsequent stock market crash led to a dramatic free-fall in property prices. The government's defense of the Hong Kong dollar sent property on a downhill spiral, ultimately forcing the government to intervene by propping up the sector. On June 22, 1998 the government intervened by instituting a temporary nine-month moratorium on all new land sales (Gilley 64-65). Authorities feared that unless the downward spiral in property prices was stopped, a total loss of confidence in Hong Kong was imminent ("A High Rise Bust" 40). The government insists that the move was intended to restore confidence and stimulate the economy. Critics, however, have accused the Tung administration of unfairly favoring the property sector by choosing to reduce supply through the temporary land sale freeze, pointing out that the move is only a short term solution that fails to address a root flaw in the property dependent SAR (Lucas, "Shaken Foundations" 3).

Property is a sensitive issue in Hong Kong, with real-estate accounting for an estimated 40 percent of Hong Kong's GDP and total credit ("Hong Kong Property Bubble Gets Bigger" 8). Ten of the twelve biggest companies receive a large portion of their profits from real estate, while property groups account for more than 40 percent of stock market capitalization ("Hong Kong's Property Bubble Get Ever Bigger" 8). Years of spiraling prices helped fuel consumer spending and supplied a steady stream of business for the banking sector. The property sector also provides employment for 17 percent of the labor force. These 513,000 jobs are especially important as Hong Kong is experiencing unemployment for the first time since WWII (Zheng 66-67). Furthermore, the Hong Kong government depends on land related sales such as land-use premiums, profit taxes from property developers and banks, and direct land auctions for more than 30% of its total revenues ("A High Rise Bust 40). In 1997, the government collected HK\$70 billion in land sales alone (Sprague and Law, "Upturn in Hong Kong" 59-60). With an economy dependent on real estate in one form or another, the government argues that it had little alternative than to safeguard the economy by intervening.

Government Intervention

Although Tung Chee Hwa initially announced plans to reign in property prices to boost Hong Kong's competitiveness as a regional business center, he was weary of property values plunging too quickly, and instead, was determined to bring property values down to a "soft landing". The property market's subsequent downhill spiral was what Tung Chee Hwa feared most: a quick meltdown leading to a complete loss of confidence in the territory. (Lucas, "Shaken Foundations" 3). The authorities were concerned that local interest rates would rise to intolerable levels and the banks would come under unbearable strain ("A High Rise Bust" 40). The government saw little alternative to intervention; in the wake of the Asian Financial Crisis, confidence had to be maintained at all costs (Lucas, "Shaken Foundations" 3).

Opponents, however, dismiss government fears of a collapse in the banking system as grossly exaggerated, arguing that the overly inflated property bubble was over-due for a correction. They point out that only those who bought property in the past two years have seen values decline and that the 30% deposit automatically discourages default. As of March 1998, property related loans including borrowings by developers stood at \$120 billion, 42% of total lending. Although default rate has risen from less than 1% to 1.16% in April 1999, it remains one of the lowest in the world (Quak and Tharmaratnam 6). As a result, critics insist that the government's interference only continued to mask deeper problems prolonging Hong Kong's recovery (Lucas, "Shaken Foundations" 3).

The Rise of the Property Bubble

There were signs of the property market overheating long before the Asian Financial Crisis hit. Policies that encouraged speculation and high capital inflows fuelled a buying frenzy resulting in gross asset inflation. Speculators were only required to pay a 10% deposit of the asking price of a property in exchange for the right to buy that property at a future date. Much like an options contract, such trades were extremely profitable in a rising market. After securing the right to buy at 10% of the full price, the property could be resold within the completion period at a higher price and transferability could be made before full payment (Loh, "Property Market Failure").

Too much money in the system and the virtually unrestrained lending by Hong Kong banks also fuelled an asset appreciation. Money supply was expanding at 23% in the year leading up to the handover with high international inflows. Much of the money was coming from dubious sources in Mainland China. As much as US\$10 billion net left China in 1997, and the Hong Kong Monetary Authority admits that it does not know exactly how much inflow comes from across the border (Sender 66-67).

At the height of property prices in late-1997, credit lending as a percentage of GNP growth was at 140 percent, the same as Thailand before the collapse of the Thai economy. The percentage going to the property sector was 40 percent, compared to 30 percent in Thailand (Sender 66-67). There were solid reasons for the government to be concerned. In hindsight, there existed more profound differences in the banking and

political systems that set Thailand apart from Hong Kong. The comparisons at the time, however, were alarming.

Hong Kong's property bubble was further inflated by an alliance between Hong Kong's colonial rulers, the Chinese communists, and a cartel of billionaire developers ("Hong Kong's Economy: Gloomy" 70). As the owner of all land in Hong Kong, the government leases land rights for set time periods (usually 99 years) with set uses and plot ratios, and limits the annual supply of land released to the auction block. In 1984, the Chinese government was suspicious of the colonial British government running off with massive proceeds from land auctions before the 1997 hand-over, thus insisting that the British government place further restrictions of 50 hectares a year (124 acres) on land sales (Asia Society). The limited land supply resulted in high auction revenues which the Hong Kong government used to fund their fiscal surpluses. Consequently, the huge cost of developing land created an oligopoly of developers that, in turn, further restrict supply (Loh, "Can People Afford It?"). The artificial shortage kept all major players happy. The British government could take credit for rising property prices, the Chinese government could claim that high prices were a barometer of confidence in their impending rule, and the biggest developers could keep smaller rivals from acquiring land ("Hong Kong's Economy: Gloomy" 70).

Property Cartel

Four major land developers, Cheung Kong Holdings, Henderson Land, Sun Hung Kai Land and New World Development dominate the Hong Kong property market. Since developers are confident that demand will exceed supply, they keep a substantial amount of idle property sitting in land banks further restricting supply and thus pushing up land values. Approximately 70% of the private sector land supply comes from these four major land banks whose owners can control the timing and manner for release affecting the supply of land at any one time. It is estimated that the combined undeveloped land bank of 60 million sq. feet can house well over 1 million Hong Kong people (Loh, "Property Market Failure"). In the past decade, the four developers have successfully bid smaller players out of the property market (Sprague and Law, "The Shifting Ground" 66-67). A study conducted by the Hong Kong Consumer Council in July 1996 concluded, "since 1981 no new firms have become major players (capable of producing 5% or more of the annual supply of new private housing.)" (Loh, "Can People Afford It?").

The June 22 moratorium on land sales has raised questions about whether the Hong Kong government's economic policy may be favoring developers at the expense of the greater good. Top developers like Li Ka Shing of Cheung Kong Holdings and Lee Shau Kee of Henderson Land were Tung Chee Hwa's staunchest backers for chief executive and key supporters of Beijing's takeover. Both property tycoons sat on the 150 member Beijing appointed committee navigating Hong Kong's transition to Chinese rule and took part in a meeting in December 1995 where Chinese president Jiang Zemin decided to make Tung Chee Hwa the first chief executive (Gilley 64-65). Li Ka Shing was also Tung Chee Hwa's former business partner (Reyes 45-50).

The influence of the property cartel is not to be taken lightly, as the government discovered in 1994 when it intervened in the property market by introducing anti-speculative measures. Their attempt to temper spiraling prices resulted in a silent auction hall. Another auction served to drive the message home. The big developers bid together rather than against each other, thus achieving sharply lower revenues for the government (Lucas, "Shaken Foundations" 3). As a result, Tung Chee Hwa has reason to be sensitive to grumbling from the property sector.

But the government insisted that they are not kowtowing to the property cartel. While the Tung administration was castigated for bailing out the property sector by mandating the suspension of land sales, the property tycoons complained that the 9-month land freeze does not go far enough; they would like to see a complete two-year moratorium. Tung Chee Hwa faces a formidable dilemma. By temporarily suspending land sales, the SAR government will be forgoing HK\$30 billion (US\$3.9 billion) in land revenues ("A High Rise Bust" 40). As a result, Hong Kong will be operating on its first budget deficit in a decade estimated at HK\$50 billion (Lucas and Jacob 5). Hong Kong's constitution - the Basic Law - explicitly states that budget deficits can only be temporary (Lucas, "Shaken Foundations" 3). Even if Tung Chee Hwa is biased towards the property cartel, he may be limited by the Basic Law in the means in which to favor them.

In the meantime, Fiscal Secretary, Donald Tsang has hinted at instituting a sales tax as a possible alternative form of revenue (Einhorn 24). In a shrinking economy with rising unemployment, however, the fight to pass such controversial legislation will undoubtedly be a heated and drawn out political battle. Until The SAR government weans itself of dependence on land related revenues, and finds a revenue-raising alternative; Tung Chee Hwa may have little alternative than to rely on manipulating the property market (Lucas and Jacob 5).

Government Actions

On April 20, 1999, the government auctioned off its first piece of land after a 9-month lull even amidst loud opposition from the property sector. Response was strong, indicating that confidence is up and that property prices may be on the rebound. Banks have entered a new round of mortgage cutting rates. The crisis has shown banks that while corporate lending can prove damaging to profits during Hong Kong's crisis, mortgages are a relatively safe business with the proportion of defaults currently at approximately 1 percent (Lucas, "Hong Kong's Confidence in Property Returning" 4). As a result, questions remain as to the necessity of the government's initial decision to intervene, as government action was predicated on the belief that defaults on property would lead to a weakening in the banking system. It is unclear, however, whether confidence levels could have been maintained without government intervention.

Tung Chee Hwa is still determined to boost Hong Kong's competitiveness by bringing Hong Kong's costs more in line with the rest of Asia. The hope is that lower land prices will make factories cheaper and lower office rents will aid the service sector; affordable housing for expatriates will attract increased foreign investment and more affordable

hotels and restaurants will boost Hong Kong's sagging tourism (Gilley 64-65). The Hong Kong government is eager to see the economy more dependent on high value-added real enterprises such as software development companies, biotech firms and commercial research labs, and much less dependent on stock and real estate speculation. For that to happen, costs must be low enough to attract foreign investors in real enterprises, and labor has to be cheap. All this is contingent on lower real-estate prices. As a result, Tung Chee Hwa recently reiterated his pledge to increase affordable housing in the hopes of decreasing land values. Perhaps as a gesture of deference to the influential property tycoons, however, Tung Chee Hwa revised his initial pledge of supplying 85,000 flats over the next five years, to simply promising the land on which to build the additional new units of affordable housing (Einhorn 24).

It will be difficult to disentangle the government from its complex relationship with the property cartel. As a result of the government's stock market intervention in August 1988, additional conflicts of interest have arisen. After buying up US\$15 billion worth of shares in the Hang Seng Stock Exchange, the government now owns 10% of Cheung Kong Holdings and 12% of New World Development. How the authorities intend to deal with those stock shares will ultimately affect the property market as well ("Hong Kong: Fair Shares" 79).

Present Situation

here are signs that a slow recovery in the property market has begun. Although property prices are still 50 percent lower than 1997 highs, values seem to have stabilized with strong indications that supply is once again being soaked up. Demand was strong at the recent land auction in which three parcels of land were purchased at 10-15 percent above analysts' forecasts. Some industry watchers wonder whether developers went out of their way to boost confidence in the stability of the market, or whether the prices reflected full market value. The strong demand has once again given rise to speculative behavior and banks are further fuelling the frenzy by entering a new round of mortgage rate cutting (Quak and Tharmaratnam 6). As a result, there are concerns that another asset bubble is on the rise, inevitably leading to another meltdown. Although property values have fallen 50% since 1997, prices still need to drop another 30 percent in order for Hong Kong to be competitive with the rest of Asia (Guyot). Critics point out that although confidence is needed for economic recovery, over-inflated property values will only further widen the competitiveness gap between Hong Kong and the rest of Asia.

Future Trends

The Hong Kong economy contracted 5.3 percent in 1998 (Sprague and Law, "The Hong Kong" 78) and is expected to continue shrinking this year. Much of the territory's recovery will be hinged upon recovery in Japan and other parts of Asia and the government has stated it will ride out the recession until confidence and investment returns to Hong Kong. If property prices stabilize and continue to come down at a gradual pace, Hong Kong will recover from the recession as a more competitive city for foreign investment. If critics are correct in projecting the rise of another property bubble,

however, the long run effects will undoubtedly compromise Hong Kong's competitiveness in the region, especially as an increasing number of Asian countries begin their economic recovery.

A financial approach to solving one aspect of the social burden placed on homeowners would be to introduce more incentives for fixed-rate mortgages, thus shielding the average homeowner from interest rate shocks. Other options are to decrease land values by liberalizing land sales to increase the number of players in the property market; auctioning off smaller parcels of land and reforming the existing up-front payment of land premiums will make land more affordable by smaller developers. Furthermore, increasing the total supply of land auctioned off each year and to follow through with affordable housing initiatives such as those outlined in Tung Chee Hwa's first policy address. At the same time, the Tung administration must wean its dependence on property by inventing new revenue raising alternatives; as long as the government depends on land related sales for revenues they will be limited in the ways in which to reign in property values. How the government decides to deal with the property sector and its resolve in remaking the city in the wake of the financial crisis ultimately determines Hong Kong's future growth as the premier financial and investment center in Asia.

The Hong Kong Banking System

When the attack on the Hong Kong dollar triggered a slide of property and stock prices, there was concern about the impact on the financial sector. Although Hong Kong's banking sector is more robust than those of the troubled East Asian countries, its deep involvement in the residential property market attracted special attention.

With structural change in the real economy, the flow of funds in the financial sector underwent a corresponding change. By the end of September 1997, 21% of the total loans and advances of the banking sector were extended to building construction, property development and investment, and another 26% to individuals for the purchase of residential property. Thus 47% of total bank lending was related to the property market. This over-reliance of the banking sector on the property market and concerns about a property bubble aroused the attention of the HKMA, who asked banks to limit their proportion of loans to for property-related activities to 40% (McLeod and Garnaut). One of the endemic fears was that, not only would it be bad if one or two banks failed, but the bigger risk would be of a systemic banking crisis, in which one collapsing bank knocked over others in a domino effect that laid waste to the regional economy.

The Banking System Structure

The HKMA performs its functions both as a central banker and a regulator. As it is not an independent body, its monetary policy may be affected by political considerations. Moreover, its regulatory and central banker's functions may be in conflict (See Appendix 1). In the past, the Legislative Council enacted the Hang Lung Bank (Acquisition) Ordinance 1983 and the Overseas Trust Bank (Acquisition) Ordinance 1984 in order to

rescue two banks from the Exchange Fund. A prudent central banker would not have made such authorization, as this would inflate the money supply. The only advantage of giving the Monetary Authority such a powerful position is to enable it to make use of the available information from the regulatory side to make quick decisions in response to monetary crises, e.g. the attack on the Hong Kong dollar late in 1997 (Hsu, 14).

As the Asian Financial Crisis began unfolding, Hong Kong stood alone as a defender of the peg rate of HK\$7.80 to the US\$. The monetary system in use is called the currency board system, an invention of the British colonial empire for some of its smaller colonies. By setting a linked exchange rate between the local currency and the US dollar it enforces a rule of creating money strictly according to the amount of foreign currency entering the system. Unlike systems with a central bank, there is no room for discretionary printing of money. Inflation results only from the inflow of foreign currency into the system in excess of its real asset growth. The banking industry as a whole has always seemed to land on its feet due to massive reserves, US\$96.5 billion as of September 1998. Hong Kong also boasts a loan-to-GDP ratio of 140%. Although beleaguered by the Asian currency turmoil, the leaders of Hong Kong have been toeing a line that says Hong Kong will be the first to recover among the economies of East Asia, on account of its advanced financial and economic infrastructure.

Unlike the rest of Asia's banking systems where the bank's NPLs are often highlighted during economic downturns, Hong Kong's banks were strong enough to withstand the deterioration in asset value. "The banks are highly capitalized and have high liquidity ratios. Even in the event of rising bad debts and shrinking profits, the banks have the fundamental capital strength to manage their way through current difficulties" (The Financial Times London, May 29, 1999). New threats are emerging: shrinking deposits, higher funding costs, and a continuing collapse of asset values. The Hong Kong government is defending the banking system. It has entered the equity market in excess of US\$15 billion to restore share values. It is also taking measures to defend the property market by imposing a land sale moratorium. The HKMA is utilizing its powers to protect the banking system for it knows the price of failure in the property market and its subsequent effects ("Hong Kong Banks Battle the Storm").

One alternative for the banks' lean margins is to propose mergers between smaller banks. These unions are expected to be constrained by cultural reasons such as backgrounds of "controlling" families or fear of losing face. Bankers are facing the recession with overdue attention to credit procedures, coupled with less reliance on collateral and more on the borrower's ability to repay. Underwriting policies are also improving, although some banks do not have the necessary skills.

Characteristics of the Banking System

Some characteristics setting Hong Kong apart from the other Asian countries during the crisis are as follows:

- The average level of NPLs for Hong Kong in 1998 was 7%,
- The economy contracted only 5.1% in 1998,

- Banks boasted capital adequacy ratios of 8%, more than twice the minimum required by the Bank Of International Settlements,
- NPLs are expected to rise only 3 percentage points to 7% in 1999,
- Hong Kong Banks were profitable and achieved healthy ROIs (The Financial Times, London, March 30, 1999).

Historically speaking, this crisis is reminiscent of the previous crises of 1965, 1976, and 1983, although the mechanisms have changed slightly to accommodate more inflows and outflows of capital, but the basic strategy has remained the same. Hong Kong's initial attraction was a good infrastructure, both in terms of "hard" infrastructure, which includes transportation, communication and office facilities, and "soft" infrastructure, which includes a highly trained, English-speaking workforce, administrators, accountants, lawyers, and other professionals to function as an international financial center. Hong Kong has a minimum of regulations and no real distinction between domestic and foreign financial institutions. In Hong Kong, economic activities are, in principle, free. It is with precisely this same type of non-regulatory approach and experienced non-overreaction to the crisis that Hong Kong has managed to remain alive and well, albeit a little bruised, to continue wearing its mantle as one of the world's leading financial centers.

The Impact of the Asian Financial Crisis on the Hong Kong Banking System

The AFC hit Hong Kong in the latter half of 1997 and like other Asian currencies, the Hong Kong dollar had come under the attack of speculators. The Hong Kong Monetary Authority (HKMA), the guardian of the local currency, defended aggressively and succeeded in maintaining the peg of one US dollar to HK\$ 7.8, but the costs of this defense were high. To deter and punish speculators, the HKMA had pushed interest rates to record high levels. Banks became nervous and had drastically cut back their lending.

Hong Kong's sky-high asset prices collapsed with the rapid withdrawal of credit and weakened confidence. Stock and property prices fell wiping off an estimated HK\$4.5 trillion (US\$577 billion) worth of paper wealth since the levels set during July 1997. Cash-strapped companies went bankrupt, while others laid-off workers and shelved expansion plans. Unemployment reached record highs not seen since 1983. With all indicators pointing south, Hong Kong registered for the first time in 13 years negative GDP growth rates. Moody's or Standard & Poor's had downgraded numerous companies.

The Future of the Banking System

Hong Kong's financial future is closely linked to China and Japan. Much will depend on the psychological effects of a Chinese currency devaluation. Market perception is that if the renminbi devalues, so will the Hong Kong dollar. Some Economists argue that the two currencies do not move in sync, as demonstrated by the fact that the renminbi's last devaluation in 1994 did not affect the Hong Kong dollar at all.

A Japanese economic recovery would lighten the financial strain in Asia and lead to a regional recovery. Until this occurs, Hong Kong will continue to feel the effects of the crisis, not due to any weaknesses but because of its strengths. Japanese banks have been calling back loans in a bid to strengthen their balance sheets at home. The Japanese retreat is a global trend and unfortunately it is easier to get money back from good borrowers (such as Hong Kong) than from the bad ones.

The economy has since slightly recovered but still remains fragile. In the event of a relapse that pushes Hong Kong deeper into recession, the government will come under greater pressure to review the 15-year-old pegged system. Many are blaming the peg for aggravating the territory's problems. Others say delinking the peg will be disastrous for Hong Kong. If there is devaluation, they argue import prices will rise, inflation will soar and companies will have to pay more to service their foreign debt. Given these choices, Hong Kong has to back the peg because the alternative is disastrous.

Conclusion

The economy in Hong Kong generally bears little resemblance to the structural and systemic problems of its neighboring countries. Although the Asian Financial Crisis had adverse effects on Hong Kong's economy, it has fared much better than most of its Asian neighbors. However, the period prior to and immediately following the retrocession in July had buoyed the economy and the highly bullish outlook for the future had sent the stock and property markets in Hong Kong to excessive heights. In retrospect, while the fundamentals of the economy at that time remained generally and basically sound, the sharp escalation in asset prices to unsustainable levels did expose a substantial weakness in Hong Kong's financial sector. The subsequent adjustments, painful though they were, in hindsight were perhaps not only unavoidable, but even necessary. As many Asian countries emerge from the crisis with newly reformed systems and increased financial transparency, Hong Kong must re-evaluate its position in Asia within the context of broader Asian economic recovery. Many of the characteristics that gave the territory a clear advantage in weathering the crisis, such as prudent financial and banking systems, will soon be more successfully emulated in the neighboring countries. As a result, Hong Kong's future depends upon its ability to reinforce and spin its image as a stable and cost competitive regional business center.

Works Cited

"A High Rise Bust," The Economist, June 27, 1998: 40

"Banks May Need Government Bailouts to Help Revive Region's Economy," The Washington Post, Washington, October 31, 1997

"Companies and Finance: Asia-Pacific," The Financial Times, London, March 30, 1999.

Einhorn, Bruce, "Hong Kong Has Lost Its Touch," Business Week, July 6, 1998: 24

Fischer, Jeffery, Hugh J. Ivory, Yi-zheng Lian and James T.H. Tang, "Hong Kong: The Challenges of Change," Asia Society, May 1998 <<http://www.> >

Gilley, Bruce, "Rezoning Permit," Far Eastern Economic Review, July 23, 1998: 64-65

Guyot, Erik, Wall Street Journal, October 26, 1998,
<<http://interactive.wsj.com/public/.../articles/SB909169664205766000.html>>

"Hong Kong Banks Battle the Storm," Retail Banker International, London, September 10, 1998

"Hong Kong Banks See Profits, Lending Fall as Economy Falter," The Financial Time, London, May 29, 1998

"Hong Kong: Fair Shares," The Economist, October 31, 1998: 79

"Hong Kong Fights Back," Asiaweek, August 28, 1998: 51.

"Hong Kong's Economy: Gloomy," The Economist, June 6, 1998: 70.

"Hong Kong Property Bubble Gets Bigger," Financial Times, June 24, 1997: 8.

Hsu, Berry F C, Laws of Banking and Finance in the Hong Kong SAR, Open University of Hong Kong Press, Hong Kong, 1998: 14.

Ko, Kenneth, "Towards 2000," South China Morning Post, October 16, 1998: 17

Lingle, Christopher, "Hong Kong dollar: RIP," Journal of Commerce, August 26 1998:4

Loh, Christine, "The Government's High-Land Price Policy: Can Hong Kong People Afford It?" Hong Kong, May 8, 1997 <<http://www.citizensparty.org/housingpp1.html>>

Loh, Christine, "Property Market Failure: Land Premiums and Other Frustrations," Hong Kong, May 8, 1997 <<http://www.citizensparty.org.housingpp3.html>>

Lucas, Louise, "Hong Kong's Confidence in Property Returning," Financial Times, April 19, 1999: 4

Lucas, Louise, "Shaken Foundations," Financial Times, June 30, 1998: 3

Lucas, Louise and Raul Jacob, "Hong Kong to Resume Land Sales to Cut Deficit," Financial Times, February 13, 1999: 5

McLeod and Garnaut (eds.), East Asia in Crisis, Routledge, London, 1998.

- Quak Hiang Whai and Meera Tharmaratnam, Business Times (Singapore), May 27, 1999: 6
- Reyes, Alejandro, "Desperate Measures, Asiaweek, August 28, 1999:50
- Reyes, Alejandro, "Economy of Change," Asiaweek, April 2, 1999, :45-50
- Rosario, Louise, "Surviving Out of the Bubble," The Banker, July 1998:56
- Sender, Henry, "Bubble Vision," Far Eastern Economic Review, July 3, 1997: 66-67
- Shaw, Sin-ming, "Meddling Mandarins," Newsweek, August 31, 1998:51
- Sprague, Jonathan, "Fighting Godzillas," Asiaweek, October 23, 1998: 67
- Sprague, Jonathan and Law Siu-lan, "The Hong Kong," Asiaweek, June 12, 1998: 78
- Sprague, Jonathan and Law Siu-Lan, "Upturn in Hong Kong," Asiaweek, November 27, 1998: 59-60
- "Track the Hedge Funds'; Hong Kong's finance czar takes on the hot money," Special Report;Capitalism, October 23, 1998: 60
- Yam, Joseph, "Causes of and Solutions to the Recent financial Turmoil in the Asian Region," Manila, Philippines, January 5, 1999
<http://www.info.gov.hk/hkma/eng/speeches>
- Zheng, T.J., "The Shifting Ground," Asiaweek, June 5, 1998: 66-67

Appendix to Banking System

Regulatory Framework

For more than a century after Hong Kong's founding, its banking system remained free of official regulation to a substantial extent. Any person, partnership, or corporate body was free to carry on the business of banking without any specific official permission. Government control of the banking sector was essentially restricted to granting of the Royal Charter from London and acceptance of private bank notes by the local treasury.

In 1947, official concern mounted over activities of many new banks which were established in the wake of the rapid post-war economic recovery in Hong Kong. The following comment in the Hong Kong government gazette in 1948 succinctly summed up the apprehension of the authorities that some of these 'banks are engaged in speculation or in the infringement of trade or exchange control regulations of the Chinese government and of this colony. The situation was considered serious enough for the government to move away from its traditional policy of non-intervention and draft the

first banking legislation in 1947, which was eventually passed in the Legislative Council on 29 January 1948. The salient features of the Ordinance were:

(1) Definition of banking business

For the first time in Hong Kong, the business of a bank was defined officially as:

... in the receipt of money on current or deposit account or in payment and collection of cheques drawn or paid by or paid in by a customer or in the making or receipt of remittances or in the purchase and sale of gold or silver coin or bullion.

(2) Licensing

The firms engaged in banking were required to register with the Financial Secretary upon payment of a fee (US\$5,000 per annum). It was further provided that the Governor in Council was empowered to disallow the request of a bank for a license.

(3) Submission of annual accounts

The licensed banking institutions were obliged to submit their annual balance sheets to the Financial Secretary.

(4) Advisory Committee

A special Banking Advisory Committee was set up with members from both the public and private sectors to oversee the licensing and regulation of banks.

Apart from being extremely lenient, the Ordinance was also far from comprehensive; for example, one vital activity of banking, namely, lending, was conspicuously absent from the official definition. The reason could either be that lending was such an obvious banking activity that it needed no mention or that it was too complex to differentiate between the lending functions of moneylenders and of bankers. Be that as it may, the definition of banking as given in the Hong Kong Banking Ordinance of 1948 was so wide and vague that 'even some remittance houses, goldsmiths, and travel agencies were registered as banks'. It is interesting to note the parallel between Hong Kong and England in this regard. In spite of the fact that the English banking system was much more sophisticated and had a longer history, no precise definition of 'banking' was given either in any statute law or case until 1965.

The government did not consider it necessary to set up a central bank or a currency board to oversee the banking activities of the territory. It is true that an advisory committee was appointed but it did not possess any executive powers. There was no government department specifically responsible for licensing of banks. The Ordinance did not impose any restrictions on unincorporated proprietorships and partnerships applying for or holding banking licenses.

To sum up, the Banking Ordinance of 1948 was tailored to serve the needs of an entrepot-dominated economy, but was not equipped to handle the radically-changed economic environment that ensued over the next two decades. The rapid industrialization and the consequent rise in living standards of a fast-growing population resulted in a fundamental shift in the role of banking institutions. Apart from the development of multifarious corporate services, consumer-related banking also gathered momentum. By 1961, both real estate and share markets were booming.

On 14 June 1961, a run started on the Liu Chong Hing Bank, which gathered momentum during the next two days so that almost US\$30 million was withdrawn by panic-stricken depositors. This run was not a minor radar blip, but rather a symptom of some of the fundamental weaknesses inherent in the entire financial system of the territory. This warning signal led to the Bank of England appointing Mr. HJ Tomkins, a banking expert, to review the regulatory framework. The Report found the following undesirable features. There were far too many banks competing for a relatively limited market, some of the banks were overcommitted in the property and share markets, and the practice of combining banking activities with the family business of directors was very prevalent.

The report stopped short of suggesting the setting up of a central bank or currency board. The salient features of the draft legislation were:

- (1) Requirement of US\$5 million as minimum capital and accumulation of an equal sum in reserves.
- (2) Restrictions on bank activities including limits on the quantum of bank advances to a person or firm and to directors and employees.
- (3) A minimum 25% liquidity ratio to meet short-term obligations.
- (4) Tighter requirements for audit and publication of annual accounts of banks.
- (5) Requirements for supervision and inspection of the books of banks, based on monthly and quarterly reports to be submitted to the Financial Secretary.
- (6) The appointment of a Commissioner of Banking to be responsible for licensing of banks, with powers to inspect bank records and revoke licenses if appropriate.

One key factor that remained consistent with the prior Ordinance was the failure to provide for a central monetary authority, which left the supervision of the banking sector fragmented. On an operative level however, without the provision of a public sector central bank, the government was effectively precluded from using any monetary instrument to intervene directly and regulate the money supply and, as such, the banking activities of the territory.

In short, the Report suggested a narrow, fragmented and selective regulation of the private sector banks, with some of the functions of a central monetary authority left with

the two main note-issuing banks, namely, The Hongkong and Shanghai Banking Corporation (HSBC) and the Chartered Bank. It is perhaps not unreasonable to speculate that the somewhat half-hearted regulatory proposals were colored by the government's avowed commitment to laissez-faire as the views of the influential note-issuing banks.

No sooner had the Ordinance of 1964 come into force, along with the ratified amendments of the Report, than Hong Kong found itself in the throes of its worst banking crisis since 1866. It lasted longer and directly affected a wider spectrum of banks, compared to the problems of 1961, and severely rocked the foundations of the banking sector.

In the aftermath of this crisis, the following amendments to the Ordinance were as follows:

- (1) Regulatory powers were put under the direct control of the Commissioner of Banking.
- (2) The minimum net worth of banks eligible for licenses was raised from US\$5 million to US\$10 million.
- (3) The interpretation of liquidity was tightened up so that only net balances receivable from another bank were eligible to be counted as specific assets.
- (4) The Commissioner was empowered to appoint a second auditor.
- (5) For the first time, the approval of the Commissioner was made a requirement for opening of new branches.

Apart from the revisions, two other elements were hovering overhead at this time. The first was the Exchange Banks' Association (EBA), established in 1897, as an apex association of banks engaged in the exchange business, to regulate exchange transactions and other related matters. It surfaced and tried to hammer out an agreement among all the banks, authorized or non-authorized, to form a uniform structure of rates of interest and deposits. It should be noted that the rules and regulations of the EBA were not mandatory. The outcome resulted only in a uniform rate of interest for deposits, with banks left free to charge discretionary rates of interest on loans and advances. The Hong Kong Association of Banks Ordinance 1980, had the EBA replaced by the Hong Kong Association of Banks (HKAB). The scope of the representation of the banking sector was enlarged so that all licensed banks, including non-authorized banks, became members automatically. Furthermore, whereas the EBA was more in the nature of a voluntary trade association with only persuasive powers over its members, the newly-formed HKAB was formed as a statutory body, whose rules and regulations were binding on its members.

The second element was the introduction of Deposit-Taking Companies (DTCs), who specialized in disparate areas such as multi-currency deposit-taking, corporate finance, advice on mergers and acquisitions, underwriting new share flotations, loan syndication, bond issues, leasing, factoring, and so on. The DTCs were not originally governed by the

constraints of agreed-upon bank interest rates, so naturally they continued to grow at a rapid rate. Independent of any lobbying by the banks, the government had valid macroeconomic reasons to enhance its supervision of the DTCs. In the absence of a central bank and public debt of any consequence, traditional instruments of monetary policy were not available to the Hong Kong government. Thus, one of the few monetary tools the authorities possessed was to influence indirectly the level of the interest rates through agreed interest rates of the banks and the best lending rates of the two note-issuing banks (the so-called prime rate). Due to the reminiscent structure of the DTCs to the smaller financial institutions with inadequate capitalization and expertise of the 1960s, the government introduced a three-tier monetary structure, the rationale of which follows:

- (1) To ensure the effectiveness of the interest rate agreement of the HKAB as an instrument of macroeconomic policy.
- (2) To control the inherently inflationary effect of a 'free for all' interest rate regime.
- (3) To ensure the general stability of the monetary system by protecting the small depositors through regulation of cutthroat competition in the DTC sector.

The three-tier structure of the financial institutions of Hong Kong came into being with the enactment of the Deposit-Taking Companies (Amendment) Ordinance 1981. The DTCs were classified under two separate categories, so that the business of accepting deposits from the public could be undertaken by the following three distinct classes of financial institutions:

(1) Licensed banks

These were authorized to accept deposits of any amount at any maturity in the normal course of business. The interest rates were of course, subject to the agreed rates of the HKAB.

(2) Licensed DTCs

These were allowed to take deposits of any maturity at any rate of interest provided the amount of each deposit was not less than US\$500,000 or its equivalent in any other currency.

(3) Registered DTCs

These were allowed to take deposits only of maturity exceeding three months of any rate of interest provided each deposit was not less than US\$50,000 or its equivalent. The criterion of minimum paid-up capital was raised to US\$10 million.

As the predominance of funds of the financial institutions were basically short-term in nature, overexposure in the long-term property sector automatically led to a fundamental

imbalance in the liquidity of the banking system. The consequent erosion of asset values of borrowers left a large portion of the bank loans unsecured. The resultant credit squeeze affected the DTCs in that foreign banks started to withhold and cancel credit lines thus leaving the DTCs uncovered and finally their lack of prudence and internal mismanagement was exposed. In fact, during the period from 1983-1986, more bank failures occurred as a result of poor management, fraud, and investments in the high-risk real estate market. HSBC and Chartered Bank pledged their support to the DTCs, however by the end of 1982, 19 registered DTCs went out of business, but a collapse of the three-tier system was narrowly averted.

The DTCs role in fueling the enormous expansion in credit and the concomitant skyrocketing of property values cannot be overemphasized. The macroeconomic policy of the government in the period preceding the DTC crisis was also shown in a bad light. The crisis in the real estate sector which ensued had far-reaching repercussions and threatened the financial superstructure of the territory to a serious extent.

The run-on effect of the DTC crisis and in particular the collapse of the real estate market in Hong Kong, continued to dog the financial institutions. The larger banks were able to withstand the pressure by the dint of their substantial inner reserves, however the weaker banks were not so fortunate. The dynamic and rapid growth of the financial sector of Hong Kong from the early 1970s had left the regulatory mechanism badly outpaced. The Hang Lung Bank crash of 1983, coming close on the heels of the DTC crisis 1982-1983, highlighted the necessity for wide-ranging changes in the supervisory functions of the Commissioner of Banking and of the DTCs.

At present, the regulation of banks and DTCs in Hong Kong is based principally on the Banking Ordinance 1986 and the Banking Amendment Ordinance 1995. Naturally, the main objectives of a regulatory framework of banking should be to protect a bank's assets from being misapplied, to ensure a minimum of cash flow to meet depositors' demands, and to provide a system for monitoring the financial health of the banks. The confidence of the depositors is very important to sound banking operations. The salient features of the present regulatory framework is as follows:

- The Commissioner's functions and the powers of control over authorized institutions including jurisdiction of the Monetary Authority
- Licensing of authorized institutions
- Requirements relating to capitalization
- Restrictions on investments in non-banking activities and in land
- Restrictions on lending including loans advanced and interests held
- General restrictions on employees, directors, and controllers including ownership and management
- Requirement of maintenance of specified liquidity including adequacy ratios
- Periodic inspection of books based on statistical returns including auditing and disclosure information

The Hong Kong Money Authority

On 27 September 1983, while Hong Kong was reeling under the historic currency crisis, the Chartered Bank refused to allow an overdraft of some US\$50 million to the Hang Lung Bank to meet a net shortfall in the clearing account of that day. The government's first priority was to restore public confidence in the financial system of Hong Kong. Under the circumstances, it was felt that failure of a local bank with 28 local branches could seriously undermine the fragile market sentiments leading to the collapse of the vital pegged rate system, which had just been announced.

Therefore, in a hurriedly convened meeting of the Legislative Council on 27 September 1983, the Hang Lung Bank (Acquisition) Ordinance was passed, whereby the bank was taken over by the government through the Exchange Fund. Thus, in an unprecedented move, the government rather than the note-issuing banks came to the rescue. Although the effective nationalization of the bank was anathema to the fundamental assumptions of the government, the extraordinary situation prevailing at that time made it unavoidable. At the same time, the government made it perfectly clear that state control of the bank was only temporary with the objective of returning the ownership to the private sector after nursing the bank back to health.

In November 1984, as the Overseas Trust Bank was teetering on the brink of collapse, the government again acted swiftly by convening an emergency session of the Legislative Council in order to take over the ailing bank so as to stave off a widespread financial crisis. The Overseas Trust Bank (Acquisition) Ordinance was passed, but not without vociferous opposition contending that public funds should not be used to rescue mismanaged and fraudulent private sector organizations. The government defended its actions, which had an actual financial operational cost to the Exchange Fund of not less than US\$2 billion, by emphasizing the crucial role of the banks in the economy and the potentially disastrous effect on the domestic sector as well as on Hong Kong's reputation as a leading international financial center.

In 1992, section 5A was added to the Exchange Fund Ordinance to create the Monetary Authority of the HKSAR (HKMA) and give it the authority to maintain, control, and manage the Exchange Fund, as well as carry out functions assigned to it by other ordinances, e.g. the Banking Ordinance. Section 7(2)(a) of the Banking Ordinance provides that the HKMA shall be responsible for supervising compliance with the provisions of that ordinance. Its mandate is to ensure the safety, stability, and effectiveness of the Hong Kong currency by regulating the banking business and the business of taking deposits, by supervising authorized institutions, and by managing the Exchange Fund. As of 31 December 1997, the net assets of the Exchange Fund were HK\$190,226 million.

The HKMA performs its functions both as a central banker and regulator. As it is not an independent body, its monetary policy may be affected by political considerations. Moreover its regulatory and central banker's functions may be in conflict. In the past, the Legislative Council enacted the Hang Lung Bank (Acquisition) Ordinance 1983 and the Overseas Trust Bank (Acquisition) Ordinance 1984 in order to rescue two banks from the

Exchange Fund. A prudent central banker would not have made such authorization, as this would inflate the money supply. The only advantage of giving the Monetary Authority such a powerful position is to enable it to make use of the available information from the regulatory side to make quick decisions in response to monetary crises, e.g. the attack on the Hong Kong dollar late in 1997.