FINANCIAL SECTOR DEVELOPMENT AND ECONOMIC DEVELOPMENT IN HONG KONG: IMPLICATIONS FOR DEVELOPING COUNTRIES

Abstract

Edward K.Y. Chen and Raymond C.W. Ng
Centre for Asian Pacific Studies (Lingnan), Hong Kong

Hong Kong has achieved remarkable economic growth with high investment and savings rates throughout its development process. The distinctive feature of the Hong Kong experience is that the government has followed a laissez faire approach and relied heavily on the private sector to invest in the economy's capital formation and also to channel funds to investment activities. Much credit should be given to the remarkable development of the financial sector. The Hong Kong experience may indeed set an example of how economic development can be financed through a market-oriented financial framework. Hong Kong did not follow exactly the path suggested by advocates of either financial liberalization or financial repression. The Hong Kong model is best understood as a strategy to provide as open and competitive an environment as possible for financial sector growth, with first priority given to the stability and integrity of the financial sector.

Financial Repression versus Financial Liberalization. The financial sector of Hong Kong is certainly not a state-controlled credit allocation system. The authorities depended heavily on the private sector to raise and mobilize financial resources, and at the same time exercised prudent fiscal discipline. The authorities have also made an extraordinary effort to attract foreign banks to enter the domestic financial market. However, the Hong Kong model is not a totally free, competitive financial system nor does it fit the single-minded McKinnon-Shaw framework, and there were indeed some restrictions on the banking sector. Most notably, there was a moratorium on the issue of new bank licenses from 1967 to 1981. The authorities also tolerated a banking industry cartel and the associated Interest Rate Agreement which imposed a ceiling on deposit interest rates. This interest rate ceiling, together with the tighter control over risky banking activities, gave rise to the rapid growth of deposit-taking companies (DTCs), a quasi curb market outside the regulated banking system. In addition, foreign banks that obtained licenses after 1978 were restricted to only one branch office.

Development of Financial Intermediaries. The banking sector underwent gradual liberalization, with strengthened regulation and supervision, following the removal of the moratorium and the 1981introduction of a three-tier system: licensed banks, licensed DTCs, and registered DTC. In particular, the government accepted the recommendation from the Hong Kong Consumer Council to phase out the Interest Rate Agreement and to deregulate time deposit rates in 1994. The one-branch restriction was also modified in 1994 to allow foreign banks to set up a regional office and a back office in locations separate from the branch office. On the other hand, the financial difficulties experienced by some DTCs and banks in the early 1980s urged the government to strengthen regulation and supervision of banks. The new Banking Ordinances which came into effect in September 1986 strengthened the regulatory power of the Commissioner of Banking. At the end of 1989, the Commissioner of Banking introduced the Basle standard on capital adequacy requirements, and in July 1992 it imposed statutory requirements for reports by auditors on internal control of financial institutions.

The Hong Kong Monetary Authority (HKMA) was established in April 1993. Along with such responsibilities as managing the Exchange Fund and maintaining the pegged exchange rate, the HKMA took over the responsibility of the Commissioner of Banking to apply the Banking Ordinances to regulate and supervise the operations of all authorized institutions to ensure the general stability and integrity of the banking system. In addition to the imposition of capital adequacy and liquidity ratio requirements, the HKMA has taken steps to improve banking conduct and bank transparency and also introduced the proposal of the Basle Committee to require banks involved in derivatives trading to estimate their risk exposures and cover these risks with capital. Effort was also made to develop the money market, including the improvement in the financial infrastructure (e.g., the Central Moneymarket Unit service and the Real Time Gross Settlement system), the provision of a benchmark for risk-free instruments, and the market-making activities by the HKMA. The HKMA also supported the securitization of mortgage loans by setting up the Mortgage Corporation in October 1997 to help promote fixed-rate mortgage loans backed by the issuing of fixed-rate

debt papers.

Lessons from Hong Kong's Experience. A major lesson to be learned from the Hong Kong experience is the need to exercise prudent bank regulation and supervision with special reference to capital and liquidity adequacy, as well as risk exposure and management. Until recently, reform was conducted on a piecemeal and crisis-response basis, following the financial distress in the mid-1960s and mid-1980s. It should be noted that the financial turmoil in Asia in 1997 and 1998, though triggered by currency speculation, revealed a major weakness of the financial systems in many developing Asian economies – inadequate banking regulation and supervision. Financial liberalization coupled with rapid capital inflows has led to (too) rapid expansion in money supply and bank credits. The lack of adequate regulation and supervision, among other factors, has caused over-lending by banks to certain sectors or industries and accumulation of non-performing assets. This has greatly undermined the strength and integrity of the financial sector, making it particularly vulnerable to adverse market conditions. The development of a sound regulatory and supervisory framework should precede or accompany any financial sector liberalization. The authority should take extreme caution on the speed and extent of liberalization programmes.

Another crucial element of Hong Kong's financial framework is the pegged exchange rate regime introduced in 1983. Hong Kong has so far been able to maintain the peg of HK$7.8 per US dollar, even during the recent Asian currency crisis. This should be attributed to Hong Kong's prudent fiscal and monetary discipline, strong foreign reserves, and strengthened monetary management. It should be stressed that for a small and extremely open economy like Hong Kong, a pegged exchange rate regime would help to the reduce exchange rate volatility and uncertainty caused by adverse portfolio capital movements, and therefore encourage trade and foreign investment. Despite the apparent success of the HKMA in tackling the recent currency speculation, there is indeed a need to modify the existing monetary management framework and strategy in order to reduce the disruptive effects that defending the peg has on the financial markets and the economy as a whole.