The Asian financial crisis triggered by currency speculation in July 1997 has resulted in a region-wide economic meltdown. Most developing countries in East Asia have experienced sharp currency depreciation, reversal of capital flows, widespread insolvency of financial institutions and businesses, shattered financial markets, falling economic growth and rising unemployment. The unprecedented scale and severity of the crisis, as well as its contagious and self-reinforcing nature, have forced many policymakers and researchers to seriously reconsider the destabilizing effects of rapid, adverse capital flows across borders. There is an urgent need to identify the fundamental factors underlying the outbreak and the worsening of the crisis with a view to reducing the risks of similar occurrences in future. It is equally crucial to formulate and implement measures to address the key weaknesses and fragility of the affected countries, to restore market stability and investor confidence both at home and abroad, and to rebuild the foundation for smooth, sustainable economic growth.

Despite its strong economic fundamentals, sound financial systems, and prudent monetary and fiscal discipline, Hong Kong has been unable to remain aloof from the contagious financial turmoil. So far, Hong Kong has managed to defend its exchange rate peg against currency speculation. Nevertheless, disruptions in the inter-bank market and associated interest rate volatility have caused stock and real estate markets to tumble. Many businesses have suffered financial difficulty due in part to higher interest costs and uncertainty and the credit crunch. In addition, the sharp downward adjustment of asset prices and the subsequent wealth contraction, coupled with a slowdown in the external sector and tourism, have led to reduced consumption and retail spending as well as an overall economic slowdown. Hong Kong’s growth rate fell to a record low of negative 7 percent in the third quarter of 1998. The unemployment rate surged to a historic high of 5.8 percent in December 1998.

The Asian financial crisis has posed a major challenge to the Hong Kong economy, in particular with regard to its capacity to accommodate adverse external economic shocks and sudden shifts in investor sentiment. The crisis has also served to reveal the strengths and weaknesses of its apparently robust economic and financial systems. That Hong Kong is a small, open, and extremely outward-looking economy has rendered it particularly vulnerable to adverse external economic and financial shocks, despite strong underlying economic fundamentals. The domestic economy may be expected to slow down and prices adjust downward in the face of the weakening external sector until prices reach a level that helps to restore international competitiveness or until the external sector begins to pick up again.

However, there are certain weaknesses in the economy which could have caused the persistent currency speculation and exacerbated the disruptive effects of speculative attacks. The fact that the economy has become extremely service-oriented and outward-looking has greatly increased the concentration of business risks over an economy with a more balanced structure. In addition, the property and stock market bubbles created since the early 1990s, the subsequent economic overheating, and the predominance of real property and finance industries have made the
An economy particularly vulnerable to interest rate volatility and changing investor sentiment.

The increasing complication and sophistication of the financial markets and the close connections between foreign exchange, equity, and futures markets have made the defense of the peg more difficult and disruptive than expected. The inadequate self-restoring mechanism of the pegged exchange rate arrangement and the government intervention to use high interest rates to support the peg (and the ambiguous imposition of punitive interest rates on LAF) have caused further chaos and uncertainty in the markets. Financial dis-intermediation resulted, triggering the bursting of the stock and property bubbles and choking off economic activity. The asset bubble since 1990 has also led to asset inflation and the excessive role of (overvalued) real property in backing banks’ lending activities and facilitating financial intermediation. The bursting of the asset bubble and the drastic fall of asset prices have therefore caused drastic credit and liquidity crunches, resulting in significant contraction in consumption and investment spending.

To restore financial order and macroeconomic stability, the Hong Kong Monetary Authority has adopted several reforms to strengthen the self-restoring mechanism of the pegged exchange rate regime, to increase the availability of inter-bank liquidity (with absolute certainty and transparency) to prevent market manipulation, and to strengthen the currency board commitment and transparency. Currency speculation would not have been as disruptive and painful if the weaknesses of the system had been addressed earlier. In formulating longer-term economic policy, attention should be given to the need to identify the “engine” for smooth sustainable growth. Equally importantly, consideration should be given to achieve a more balanced and diversified economic structure. The government has committed itself to promoting high technology and value-added industries and to investing heavily in the required infrastructure and human capital. However, perhaps the most urgent and serious focus should be on mid-to-lower stream applied technology research and the formulation of policy to attract overseas scientists and engineers to work in Hong Kong. This would help to upgrade Hong Kong’s technological level, increasing production capacity and efficiency.

The government should at the same time further develop and materialize Hong Kong’s comparative and locational advantages in the finance industry by widening the scope and diversifying the structure of its equity market, particularly in view of the fast growing fund-raising needs of China and the region. This could be achieved

- by attracting more good quality companies from the Mainland and even from other countries to list or raise debt in Hong Kong’s equity market,
- by further developing the Hong Kong dollar debt market and
- by seeking to develop as a regional bond market for Asia.

Hong Kong should aim at developing as a truly “international” financial centre with companies from the region (at least) listing their shares or raising debt in Hong Kong, and with international institutional investors widely and actively investing or managing their funds in Hong Kong.

The government should also reconsider its strategy for human resource development, as it has become increasingly obvious that knowledge, innovation, and human capital investment are key areas of international competitiveness. Finally, there is also an urgent need for the government to regain credibility by enhancing its reliability, responsibility and transparency and consistency quality. As confidence and expectation have tended to play a crucial role in the determination of macroeconomic aggregates (e.g., investment and consumption) and in the financial markets, a
lack of confidence would undermine the effectiveness of government policy, regardless of the policy’s good intention and appropriateness.