THE
HONG KONG
ASSOCIATION
OF
BANKS
香港銀行公會

THE PER JACOBSSON FOUNDATION

The Per Jacobsson Lecture

ASIAN MONETARY COOPERATION

Joseph C. K. Yam, JP

Hong Kong SAR

Sunday, September 21, 1997

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Foreword

The 1997 Per Jacobsson lecture entitled "Asian Monetary Cooperation" was delivered by Joseph C.K. Yam, JP, at the Grand Hyatt Hotel in Hong Kong SAR on Sunday, September 21, 1997. Sir Jeremy Morse, Chairman of the Per Jacobsson Foundation, presided over the meeting, the proceedings of which are presented in this publication.

The Per Jacobsson lectures are sponsored by the Per Jacobsson Foundation and are usually held annually. The Foundation was established in 1964 in honor of Per Jacobsson, the third Managing Director of the International Monetary Fund, to promote informed international discussion of current problems in the field of monetary affairs.

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Opening Remarks

Sir Jeremy Morse

Good afternoon, ladies and gentlemen, and welcome to this our thirty-sixth Per Jacobsson Lecture, but, of course, the first that we've had here in Hong Kong. I think you will agree that we have chosen not only a lecturer of reputation but that he has a topic of extreme topicality.

With me on the platform is our new President, Leo Van Houtven, formerly Secretary to the IMF for 20 years. He replaces Jack Polak, whom you have seen on the platform here over the past 10 years, who retired on June 30, 1997. I would just like to pay a tribute to the outstanding service that Jack gave during those years to the Foundation.

Also on the platform we have Christopher Langley, Chairman of the Hong Kong Association of Banks, an association that has been very helpful in setting up this meeting, both in the organization and also in generously helping to fund the lecture and the reception. So our warm thanks to you, Christopher, for that.

We will follow our usual timings. Mr. Yam will speak for about 40 minutes, and then we'll have a question and answer session.

Asian Monetary Cooperation

Joseph C. K. Yam, JP

Introduction

Good afternoon. On behalf of the people of Hong Kong, particularly those of us at the Hong Kong Monetary Authority, let me extend my warmest welcome to all of you to Hong Kong. For those of you who have visited Hong Kong before, perhaps many times, I hope you are pleased to see that Hong Kong, as a Special Administrative Region of the People's Republic of China, remains as vibrant and dynamic as you have known it in the past, retaining many of its free market characteristics under the principle of "one country, two systems."

It is a great honor and privilege for me to be invited to give this year's Per Jacobsson lecture. As Managing Director of the International Monetary Fund (IMF), Mr. Per Jacobsson led a life that was dedicated to the promotion of both European and later international monetary cooperation. It is only befitting that a lecture held in Asia in memory of this great man should address the topic of Asian monetary cooperation. This is also a subject that has been brought into sharp focus in light of the recent turmoil in the currency markets of Asia.

What I intend to do this afternoon is first to define what international monetary cooperation is about and, in this connection, survey the attitudes of the parties that should have an interest in such cooperation and discuss the form of this cooperation. I wish to point out that these attitudes have, perhaps unintentionally, led to a regionalization of international monetary cooperation. I shall then focus specifically on Asian monetary cooperation, covering the history, or the lack of it, and the monetary problems, current and potential, that Asian economies face. I shall then make a case for much greater monetary cooperation in Asia. I shall also suggest a way forward for Asian monetary cooperation, with a strategy and a list of issues to be addressed in such cooperation.

MONETARY COOPERATION

Let me start by attempting a definition of what monetary cooperation is about. The Oxford Dictionary defines "cooperation" as "working together to the same end." So I suppose monetary cooperation can simply be defined as working together to the same monetary end. This then leads to the questions as to what that same monetary end should be, who should be working together, and in which way they should best work together, particularly when one is talking about monetary cooperation across monetary systems in a global or regional dimension.

The Articles of Agreement of the IMF provide some guidance on what that "same monetary end" should be. In defining the purposes of the IMF in Article I to be, among other things, "to promote international monetary cooperation," the term "consultation and collaboration on international monetary problems" is used. So it would be appropriate to describe that same monetary end as the prevention and cure of monetary problems. Indeed, the rapid pace of financial liberalization and the associated globalization of financial markets have meant that monetary problems, when they arise, can be highly contagious on a global and particularly on a regional dimension. And if they are to be properly handled, by way of prevention or cure, there is a clear need for international monetary cooperation.

As to who should be working together, it is quite obvious that the interested parties would necessarily include the monetary authorities of economies facing, or potentially exposed to, monetary problems. The increasing realization of this need to work together has led to the formation of various, mostly regional, forums where monetary authorities gather to discuss issues of common interest.

Insofar as the Asian region is concerned, these forums are proving to be quite useful, but there is, regrettably, also some resistance to making further much-needed progress because of, believe it or not, turf issues between ministries of finance and central banks, or perceived rivalry on the part of individual economies in vying for the lead and influence in the cooperative effort. But these are facts of life that, hopefully, should not stand too much in the way of progress for the benefit of all in the longer term. It is also a fact of life, regrettably, that minds do not normally become adequately focused until they are jostled by damaging crises.

There are of course the multilateral institutions like the IMF and the Bank for International Settlements (BIS), as well as a number of international groups of experts who have a clear mandate or a keen interest in, among other things, promoting international monetary cooperation. They have been invaluable in providing the necessary support and guidance to monetary cooperation in Asia.

Nevertheless, some in this region have felt that such support and guidance, particularly from the multilateral institutions, have been less forthcoming than they would have liked, comparing, for example, the support given to Thailand with that given to Mexico. They also feel that the special circumstances and interests of economies in the region have not been adequately taken into account. Nor do the voices of these economies count for enough.

Whether or not this feeling is justified, one consequence is that regional initiatives surface. This is no bad thing and is perhaps the pragmatic way forward, given the need to address realistically regional disparities in financial markets, infrastructure, and degrees of financial liberalization. But the downside risk that all of us should be aware of is the possibility that the global financial market may then become segmented into regional blocs, which may result in more competition and friction than cooperation.

On the form of monetary cooperation, there is a wide spectrum of experience on the basis of current practice. There is, on the one extreme, the simple exchange of information and expertise among monetary authorities that is helpful to the management of the domestic monetary system in general, covering the whole range of central banking functions involved in the management of the currency, the supervision of financial institutions, the development of the financial infrastructure, the management of foreign reserves, and so forth. On the other extreme, there is monetary cooperation to the extent of achieving monetary union or integration.

In between the two extremes, there are arrangements for policy coordination at the macro level initiated on the realization of increasing international, but particularly regional, economic interdependence. There are also the more focused schemes for mutual assistance in the provision of liquidity to facilitate effective monetary management, which may or may not involve the assumption of credit risks between governments. There have also been considerable efforts spent in supervisory cooperation toward the standardization of supervisory practices in order to promote international financial stability, again in recognition of the possibility of the damaging contagion effect of financial crises across financial systems. Then there are the more forward-looking arrangements for the development and linkages of elements of the financial infrastructure to facilitate the efficient and safe financial intermediation across monetary systems.

Obviously, no one point on this wide spectrum of international monetary cooperation can be considered the ideal situation. Much depends on the needs arising from the circumstances, and the circumstances are changing all the time. But along with financial liberalization and the globalization of financial markets, the trend—to the extent that one can be ascertained—seems clearly to be one of increasing monetary cooperation.

As is well known, European monetary cooperation is aiming for monetary integration by 1999, having moved in the past 50 years from information exchange to policy coordination. Whether this can be achieved on time or not, and whether monetary integration should then necessarily be considered as the final goal of monetary cooperation in other regions, we shall have to wait and see. But one has to admire the vision of the pioneer thinkers. I understand that the French economist Jacques Rueff actually declared way back in the 1950s that "Europe will be created via a currency or not at all."

By contrast, Asian monetary cooperation is considerably less well structured. There is traditionally some exchange of information, mostly on a bilateral basis, through meetings conducted annually, and to a large extent prior to a game of golf or even on the golf course. There is little, if any, policy coordination among Asian economies, not to mention any interest in monetary integration. It is not clear whether this is a reflection of reluctance to subject domestic policy decisions to external influence. Indeed, until recently the majority of the economies in the region seemed happy to concede their sovereign right over monetary policy to the central banks of their major trading partners, notably the United States, by maintaining a stable exchange rate against the U.S. dollar to varying degrees. But whatever the reason for the relative lack of monetary cooperation in the past, there have been significant changes recently, spurred by the events surrounding Mexico, which affected the Asian region, and those of Thailand, which is right in the middle of our region. There is serious and continuing discussion on the subject of Asian monetary cooperation. Hong Kong stands ready to contribute to this discussion, and I very much hope that a long-term strategy will come out of this.

HISTORY OF ASIAN MONETARY COOPERATION

Let me now describe briefly to you the history of Asian monetary cooperation. In the postwar period, many Asian central banks evolved from colonial currency boards, which practiced the virtue of stable money fixed to an international reserve currency. As a result of this monetary discipline supported by sound fiscal discipline, Asia has enjoyed stable growth with low inflation. As Asian economies gradually opened their markets to international trade and competition, with Hong Kong setting a good example of how free markets work, the existence of stable exchange rates, largely linked to the U.S. dollar, formed the anchor of Asian growth (see Charts 1A and 1B). The need for monetary cooperation among Asian economies therefore did not matter much, as long as each traded mainly with Europe or America using the U.S. dollar as the main currency of trade.

This was the reason why the work of the principal forum for central bank discussions in the late 1950s, a forum called SEANZA (Southeast Asia, New Zealand, and Australia) focused mainly on providing training for central bankers. The 18 members of this group cover a geographical area that spans the whole of the Asia and Pacific region from India to New Zealand. Training and research were also the primary focus of another central bank forum founded in 1966. This is SEACEN (Southeast Asian Central Banks), comprising ten central bank members with a research and training center in Kuala Lumpur.

Currency Movements Against the U.S. Dollar
Index (January 1994 = 100)

Chart 1A

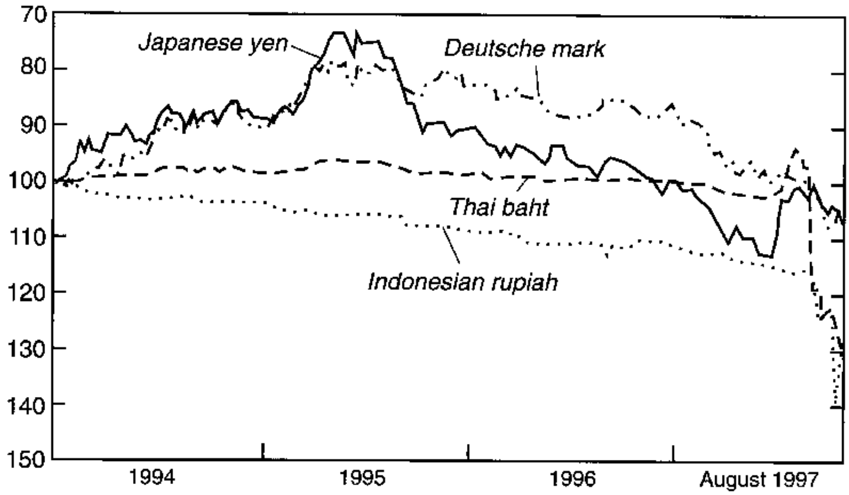
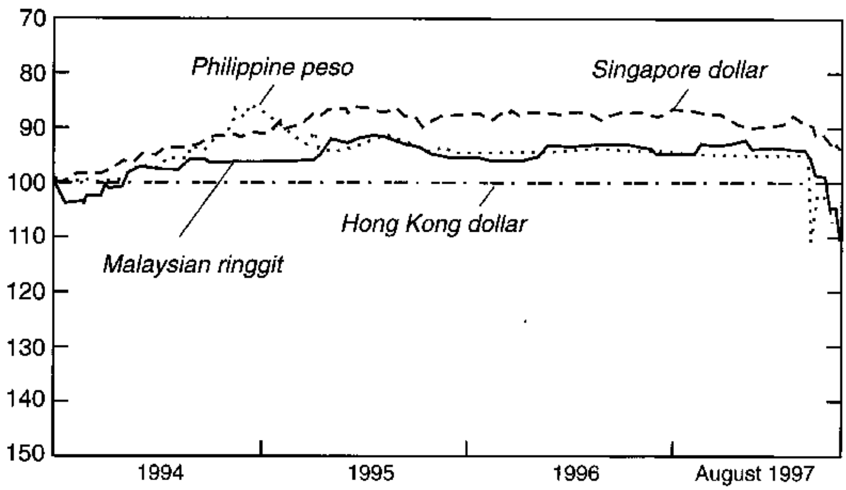


Chart 1B



Source: Datastream, Reuters.

In the 1990s, the number of Asia and Pacific groupings increased, partly as a result of accelerating intraregional trade. The establishment of APEC (Asia Pacific Economic Cooperation) in 1989 promoted trade and investment among the 18 member economies, but there were only ancillary discussions on monetary cooperation. In February 1991, nevertheless, Asian monetary cooperation took a quiet but significant step forward with the creation of EMEAP (Executives' Meeting of East Asia Pacific Central Banks). This 11-member group of central banks was initiated by the Bank of Japan. At the beginning, EMEAP concentrated on the exchange of information on market developments in the economies of its members and was the forum for the Bank of Japan to brief others on Group of Seven discussions. But it has since evolved into quite a productive, and certainly the most active, forum for central banking discussions in the region to date through its biannual meetings of deputy governors and an annual meeting of governors.

The discussion in EMEAP now has a sharp focus on Asian monetary cooperation. This need was perhaps crystallized by the Mexican crisis, which caused ripples in the Asian currencies in January 1995. In its wake, I convened an informal meeting of several EMEAP central banks that had experienced speculative activity. There was immediate agreement that it would be useful to exchange market intelligence and to share knowledge and techniques on monetary operations helpful to the maintenance of monetary stability. Out of this meeting also evolved the package of bilateral repurchase agreements of U.S. Treasuries signed by five central banks in Hong Kong on November 20, 1995 and aimed at enhancing the liquidity of the foreign reserves that they hold—a historic landmark in Asian monetary cooperation that eventually expanded to cover all the 11 EMEAP members.

In this connection, I should pay tribute to the foresight of Bernie Fraser, then Governor of the Reserve Bank of Australia, who called for the establishment of a new regional institution—for want of a better name, an Asian BIS—to promote Asian monetary cooperation. Bernie saw quite rightly that "globalization is elevating the international dimension of monetary cooperation." In response to his call, EMEAP convened a working group to study the proposals and, at its first Governors' meeting in Tokyo in July 1996, further established two working groups and a study group to share knowledge and expertise on financial market development, central bank operations, and banking supervision issues, respectively. Although the question on the establishment of a regional institution to further Asian monetary cooperation has been put aside for the time being, the progress achieved by the various groups was commendable, with ambitious plans to produce the Asian equivalents of the Green Book on banking supervision, the Red Book on payment systems, and a Gold Book on reserve management practices.

Meanwhile, greater international monetary cooperation involving the Asian economies was also advanced when the BIS admitted the People's Bank of China, the Reserve Bank of India, the Hong Kong Monetary Authority, the Monetary Authority of Singapore, and the Bank of Korea, among others, to its membership in 1996—the first new Asian members after the Bank of Japan.

All these initiatives were unfortunately overshadowed by the advent of the Thai crisis that erupted in May this year. But it was still to EMEAP's credit that, in the second Governors' meeting in Shanghai in July, the group called for the creation of an Asian facility to supplement IMF funding in providing assistance to member economies in Asia to make structural adjustments. That historic decision paved the way for the smooth progression of the meeting organized by the IMF in Tokyo two weeks later in August when more than US$10 billion, out of a total package of US$17 billion to Thailand, was amassed from EMEAP members in a spirit of solidarity. Meanwhile, the call for an Asian facility is still being considered. Discussions are continuing among the interested parties whenever opportunities present themselves.

ASIAN MONETARY PROBLEMS

It is perhaps one of the ironies of the post-Bretton Woods era that the modern world is generally no longer short of liquidity and, indeed, is arguably overflushed with liquidity at present. Yet, amid all this liquidity and prosperity, liquidity crunches can even test the solvency of nations. The currency turbulence in Asia has prompted a realization of this irony, and, consequently, much soul searching on the appropriateness of exchange rate and other monetary arrangements, macroeconomic and structural adjustment policies, the adequacy of financial market regulation and banking supervision, the pace of financial liberalization, and so forth. Many words of wisdom are being offered. While some are critical of the wisdom of fixed exchange rate systems, others blame volatile capital flows and currency speculators for the currency crises in rather strong and emotive terms. Still others fault inappropriate government policies and perhaps complacency by not taking early action. All in all it is a rather confusing picture. At the risk of causing even greater confusion, let me try to identify and articulate the monetary problems that Asian economies have been facing.

Capital inflow must be placed at the top of the list. At the beginning of the decade, net capital inflows to emerging markets were less than US$50 billion a year. By 1996, however, this had increased to US$245 billion. Asia has received roughly half of these capital inflows, thanks to the rather attractive basic economic fundamentals. These fundamentals, incidentally, have remained attractive today, notwithstanding the recent turmoil in Asian financial markets. The key factors that contributed to the surge in capital flows into the region include Japan's willingness to export capital as a result of sustained and large current account surpluses. The rising costs of production in Japan, associated with the appreciation of the yen, have forced many Japanese firms to relocate their production to the rest of Asia. Also a contributing factor was the low interest rate policy in the industrial economies, particularly in Japan in the post-bubble phase, which has flooded the global market with liquidity. Increasing amounts of mutual funds and pension funds of these economies looked for higher returns in the emerging markets. Clearly, Asian economies have benefited much from such capital inflows, but at the same time they have exposed themselves to the threat of a sudden loss of market confidence and hence large outflows of funds because of policy mistakes or shifts in the international economic environment. This is particularly true if a large proportion of inflows are volatile portfolio investments or short-term borrowing.

The next monetary problem concerns current account deficits. A number of Asian economies were able to run larger-than-normal current account deficits in their balance of payments because they were easily funded by capital inflows. The bad news about large capital inflows is that they might allow investment and even consumption to expand without enduring the pain of overheating or loss of competitiveness. Higher levels of domestic credit, consumption, investment, growth, and even budget revenues can be sustained at the cost of rapid accumulation of foreign debt. To make matters worse, over 80 percent of the current account deficits of selected Asian economies were funded from short-term bank debt (see Table 1). In hindsight, the ready availability of short-term external financing might have delayed the necessary policy adjustments in the face of cyclical and structural changes in the domestic and international economic environment. In short, we can all easily make the mistake of taking capital inflows for granted.

Asset Price Inflation

Then there is asset price inflation, which is a rather common consequence of capital inflows. In an open economic environment, capital inflows may not lead to consumer price inflation because imports would alleviate excess demand. However, if the domestic financial system is underdeveloped and financial institutions are not adequately supervised, as external hot money increases the deposit base of domestic banks they may be lured into fueling domestic asset price bubbles. These have two major consequences. First, asset price inflation eventually leads to domestic inflation and erodes external competitiveness. Second, excessive lending concentration in real estate exposes financial institutions to large nonperforming loans when an oversupply of property emerges. Indeed, banks are absorbing credit risk on top of interest rate and exchange rate risks. In some Asian economies, weakness of the financial system has constrained the ability of the monetary authorities to raise interest rates to defend their currencies when the exchange rates are under pressure. Conversely, to allow the currency to depreciate exposes banks and other borrowers to exchange losses on their unhedged foreign currency liabilities.

External Environment

At the same time, the external environment has been changing. While Asia was enjoying an unprecedented boom, the global competitive environment was subtly but surely shifting, which led to portfolio rebalancing by global asset managers. The adjustments in the U.S. economy, through fiscal and monetary tightening, and technology and corporate restructuring, had brought substantial benefits in the form of lower budget deficits and the lowest levels of unemployment and inflation for decades. In case anyone forgets, the U.S. equity market has, in the past three years, outperformed almost all Asian equity markets with the exception of that of China.

Table 1. Current Account Deficits and Financing of Selected Asian Economies
(In billions of U.S. dollars)

	1993	1994	1995	1996	Total
Current account deficit					
ASEAN Four					
Indonesia	–2.1	–2.8	–7.0	–7.4	–19.3
Malaysia	–3.0	–4.5	–7.4	–6.2	–21.1
Philippines	–3.0	–3.0	–2.0	–2.9	–10.9
Thailand	–6.4	–8.1	–13.6	–13.8	–41.9
Korea	1.0	–3.9	–8.3	–23.7	–34.9
Total	–13.5	–22.3	–38.3	–54.0	–128.1
	1993	**1994**	**1995**	**1996**	**Change (1993–96)**
BIS reporting banks' net claims on financial sector					
ASEAN Four					
Indonesia	6.0	9.2	12.1	11.0	+5.0
Malaysia	–5.6	2.4	2.9	4.1	+9.7
Philippines	0.4	0.2	1.0	4.7	+4.3
Thailand	22.2	39.5	69.9	77.4	+55.2
Korea	20.9	29.3	42.9	58.3	+37.4
Total	43.9	80.6	128.8	155.5	+111.6

Source: Bank for International Settlements.

Funds have been attracted back to the U.S. markets, which at the same time has strengthened the U.S. dollar, adding to the momentum of that flow. It was a pure case of risk versus return.

In addition, growing competition at the low-wage end of industries came from other Asian and non-Asian economies. In Europe, cheaper production came from the restructuring economies of Eastern Europe. Competition came from the revival of Latin American economies with improved access to the U.S. market through the North American Free Trade Agreement (NAFTA). In Asia, India and China are emerging as major exporters. As a result, exports elsewhere in Asia suffered a downturn while imports continued to rise, leading to growing levels of current account deficits.

Exchange Rates

Then came problems on the exchange rate front. The volatility of key exchange rates, particularly that of the yen against the U.S. dollar, has placed the balance of payments of some Asian economies under considerable stress. For instance, because most Asian currencies are explicitly or implicitly linked to the U.S. dollar, the appreciation of the dollar severely squeezed the exporters, who have to compete with their rivals in Japan and the emerging economies in other parts of the world. The weakness of the yen revived Japanese exports, placing Japan in direct competition with its major trading partners in Asia, as the cheaper yen stimulated exports of Japanese durable goods and capital goods to Asia while reducing imports from the region. It did not make sense to export out of the subsidiaries in the Association of Southeast Asian Nations (ASEAN) when it was cheaper to buy directly from the plant in Japan. The weaker yen also has a tendency to slow foreign direct investment from Japan, as it is no longer so expensive to produce in Japan.

This combination of Asian monetary problems has recently put tremendous pressure on the financial markets in the region, in particular the foreign exchange markets. This was compounded by speculators who took advantage of these market developments to set up their attacks, resulting in the currency turmoil in Asian currencies that we have seen.

Here I cannot resist the temptation to offer a few comments. There is a common perception that the adoption of more flexible exchange rate regimes by a number of Asian economies implied a failure of fixed exchange rate systems. This is, in my view, a mistaken perception. As all central bankers are aware, there is no one perfect exchange rate regime. One of the dilemmas of any exchange rate regime is how it can reflect the underlying economic conditions, which are constantly changing, so that external balance can be achieved. A fixed exchange rate regime can function well if there is strict financial and fiscal discipline, and flexibility of domestic goods and services markets to adjust for any structural changes in the economy. On the other hand, a flexible exchange rate regime can also work, provided that the policy package is correct and there are well-functioning foreign exchange and financial markets. But it would be a mistake to think devaluation can substitute for fundamental policy adjustments to correct a structural external imbalance. Competitive devaluations are "beggar-thy-neighbor" policies that are self-defeating.

Indeed, the adoption of more flexible exchange rate systems by some Asian economies has not meant they can avoid the adjustments that are currently being undertaken. With a fixed exchange rate under a very strong and disciplined regime in the form of a currency board system, Hong Kong has focused precisely on her underlying productivity, maintaining strict financial and fiscal discipline, and also prudent banking supervision, in order to enhance the resilience of the linked exchange rate system and to minimize and manage the downside risks of overheating in the economy.

Let me also put the currency adjustments in their proper perspective. In the past few years, the currencies with the greatest adjustments and volatility have been the Group of Three currencies rather than the Asian currencies (see Table 2). The yen has depreciated by 50 percent against the U.S. dollar from its peak in 1995. The deutsche mark has likewise fallen by over 30 percent. In comparison, the Asian currencies have until recently remained relatively stable. The Hong Kong dollar has been the most stable of the Asian currencies, moving less than 1 percent against the U.S. dollar. It is the greater volatility of the Group of Three currencies that ultimately contributed to, if not caused, the volatility in smaller regional currencies.

Financial Intermediation

There is yet another Asian monetary problem and this is one of a different nature. It concerns the effectiveness of financial intermediation in this region. Asia needs substantial investments in the economic infrastructure to prevent bottlenecks from hindering sustained growth. The World Bank has estimated that, for East Asia alone, projected infrastructure investments will amount to US$1.5 trillion between 1995–2004. If other forms of capital investment are included, the figure rises to a staggering US$8 trillion. At the same time, Asian economies have very high savings rates, some as high as 30 percent to 50 percent (see Table 3). The aging population in North Asia, for example, will be plowing increasing savings into institutionalized retirement funds, which are risk averse and would need to be invested in markets generating—other things being equal—higher returns, lower risks, and greater liquidity. Japan, for example, has an estimated ¥1,200 trillion outstanding in private savings that must be invested. When the Hong Kong Mandatory Provident Fund

Table 2. Currency Movements Against the U.S. Dollar

	1994–1995		1995–1996		1996–August 1997		
	Max.	Min.	Max.	Min.	Max.	Min.	8/29/97
Group of Three							
Japanese yen	113.2	80.6	116.2	80.6	127.1	103.4	120.9
Deutsche mark	1.77	1.35	1.56	1.35	1.88	1.44	1.81
Newly Industrialized Economies							
Korean won	814	756	845	756	902	774	900
H.K. dollar	7.77	7.72	7.77	7.72	7.76	7.72	7.75
Singapore dollar	1.61	1.39	1.46	1.39	1.53	1.40	1.51
ASEAN Four							
Indonesian rupiah	2,294	2,098	2,364	2,195	3,005	2,280	2,920
Malaysian ringgit	2.79	2.44	2.56	2.44	2.93	2.47	2.93
Philippine peso	27.8	23.6	26.3	24.4	30.5	26.1	30.1
Thai baht	25.6	24.5	25.7	24.5	34.1	23.2	34.1

Source: Datastream, Reuters.

Table 3. Savings in Asia (1996)

	Gross Domestic Product (In billions of U.S. dollars)	Gross Domestic Savings (In percent of GDP)
Newly Industrialized Economies		
Hong Kong	155	30
Korea	485	37
Singapore	94	56
Taiwan	272	27
East Asia		
China	815	40
Indonesia	226	37
Malaysia	99	38
Philippines	84	16
Thailand	182	35
South Asia		
Bangladesh	31	6
India	326[1]	23[1]
Pakistan	60	16
Sri Lanka	13	16
Memorandum items:		
France	1,537	20
Germany	2,352	23
United Kingdom	1,159	16
United States	7,576	16

Sources: Asian Development Bank and *International Financial Statistics*, International Monetary Fund (1996), CEIC.

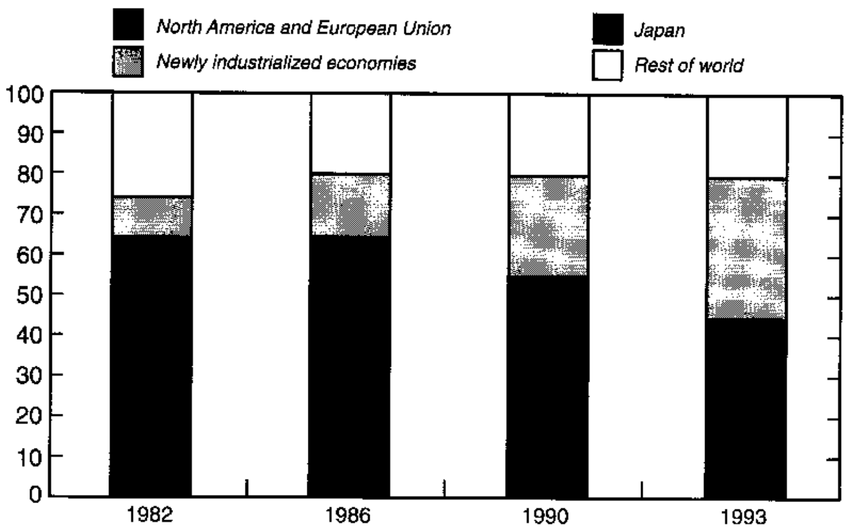
[1]Figures for 1995.

comes into operation by the year 2000, about 4 percent of Hong Kong's GDP will be added annually to institutional investments. But the question is why Asian savings do not seem to have been adequately and effectively channeled into Asian investments in a manner more conducive to ensuring monetary and financial stability.

Much of Asian savings, in particular official sector savings and private sector savings that have been institutionalized, are still invested in assets of OECD countries, although the trend has been gradually declining. I cannot speak for other economies, but insofar as Hong Kong is concerned, in excess of 95 percent of our US$85 billion of foreign reserves is invested outside Asia. Specifically, in the management of our foreign reserves, we work against a preferred neutral position of about 75 percent in U.S. dollar assets, mostly in U.S. treasury securities. I understand also that more than 80 percent of total Asian foreign exchange reserves, amounting to US$600 billion, is invested largely in North America and Europe. At the same time, there has been much foreign direct investment and foreign portfolio investment from OECD countries in Asia (see Chart 2). It can be argued therefore that Asia is financing much of the budget deficits of developed economies, particularly that of the United States, but has to try hard to attract money back into the region through foreign investments. And the volatility of foreign portfolio investments has been a major cause of disruptions to the monetary and financial systems of the Asian economies. Some have even gone as far as to say that the Asian economies are providing the funding to hedge funds in non-Asian centers to play havoc with their currencies and financial markets.

This comment is perhaps a little unkind, given the important role that the international financial community plays in the globalized financial environment. But there certainly is a problem with the effectiveness of financial intermediation in this region, which is inhibiting the flow of long-term savings into long-term investments. I believe an important factor behind this is the perceived or actual risks inherent in dealing with the products, the intermediaries, and the market that are part of the process of financial intermediation. I also believe that the monetary authorities have a responsibility, through concerted efforts in prudential regulation and supervision, and the development of the financial

Chart 2. Foreign Direct Investment in East Asia by Source
(In percent)



Source: *Asian Development Outlook, 1996* and *1997.*

infrastructure, to contain these risks to levels more acceptable to those concerned, including themselves as managers of official foreign reserves.

THE CASE FOR ASIAN MONETARY COOPERATION

These Asian monetary problems that I have described can seriously undermine the ability of Asian monetary authorities to deal with shocks, and so when shocks do come, they will cause much agony in terms of economic disruptions and painful adjustments. The problems are also highly contagious, transmitted through sudden shifts in the perception of risks by international investors who look for worrisome similarities among Asian economies, as the recent turmoil in Asian currency markets has shown. The fall in one market may also lead them to look for liquidity in other markets, thus contributing further to the contagion.

We are living in an ever more interdependent region. Increasing trade and investment flows, made possible by trade and financial market liberalization, have bound our fates together. A decade ago, we relied heavily on markets outside Asia for our products, sending over three-quarters of exports to those markets. That reliance has been reduced sharply. In 1996, around 35 percent of trade in East Asia was conducted within the region, compared with a share of 28 percent with NAFTA countries and 20 percent with the European Union (see Table 4).

On investment and capital flows, the story is similar. As recently as in 1989, equity flows within the Asian region amounted to only US$24 billion. In 1995, the flows had increased threefold to almost US$80 billion. According to the Asian Development Bank (ADB), the share of foreign direct investment from North America and the European Union in East Asia had fallen from 40 percent of the total 15 years ago to 25 percent by 1993. Now over 50 percent of foreign direct investment comes from within the region. This trend can only grow, as the population giants of China and India increasingly become more engaged in trade and investment.

Much greater interdependence of course means that policies in one economy can have important implications for others. A more liberalized financial environment also means that policy mistakes can be punished almost instantaneously by the market and that monetary problems in one economy can easily spread to others. So, referring again to one of the purposes of the IMF, as defined in its Articles of Agreement, there is a clear need "to promote international monetary cooperation" through "consultation and collaboration" on these "international monetary problems" that we now face in the Asian region.

THE WAY FORWARD

I would now like to spell out how I think monetary cooperation in this region should proceed. In order to have effective monetary cooperation, we must have clearly defined and realistic goals. Overly ambitious goals may not be credible and may even be counterproductive. In any case, they may not be politically acceptable to the individual economies. Monetary cooperation, and indeed any type of cooperation, is meaningless when you do not have common goals.

Notwithstanding increasing economic integration, one has to accept the reality that the economies in Asia are a very diverse

Table 4. Direction of Trade of East Asia
(Imports plus exports)

	1986		1990		1996	
	US$	Percent share	US$	Percent share	US$	Percent share
			(In billions)			
European Union	110.3	17.1	231.2	20.5	401.6	19.5
NAFTA countries	231.6	35.8	357.8	31.7	576.5	28.0
Intra-East Asia	156.0	24.1	326.9	28.9	708.3	34.5
Others	148.6	23.0	214.5	19.0	369.3	18.0
Total	646.4	100.0	1,130.3	100.0	2,055.7	100.0

Source: International Monetary Fund.

group. There are dramatic differences with regard to political institutions, economic systems, basic infrastructure, and any other aspect you care to think of. In terms of economic structure, for example, they range from some of the largest agricultural economies in the world to the most urban economies. In terms of economic philosophy, they range from some of the freest economies in the world to economies where there is considerable central planning. In terms of the stage of economic development, they range from economies with the highest per capita incomes to those still with a large part of their population living in poverty. In terms of financial sector development, they range from sophisticated international financial centers with strong financial markets and robust financial infrastructures to those that have just begun building their financial systems.

Reflecting such diversity, there are also dramatic differences in policies in terms of the objectives pursued and the approaches to achieving those objectives. Focusing specifically on monetary policy, although there seems to be a clear consensus on the desirability of maintaining currency stability, there is great diversity on the degree of clarity with which this is defined. For some, currency stability is what the government thinks is politically expedient at the time. For others, currency stability is defined in the clearest of terms. Associated with this, there is also great diversity in the degree of independence of the monetary authorities and the degree of discretion available to them, arising from the different monetary or exchange rate regimes practiced. Nothing can be more polar than, for example, the currency board version of a fixed exchange regime in Hong Kong and the totally free float of New Zealand. Given differences in the economic and financial structure on the one hand and differences in policy objectives and approaches on the other, the monetary transmission mechanism of Asian economies and their monetary reactions to internal and external shocks are also quite different.

How then should Asian economies pursue Asian monetary cooperation? The extent of the diversity of economies in Asia points quite clearly to one conclusion, and this is that monetary integration is inappropriate, at least for the time being. One can perhaps get a better appreciation of this argument by attempting to apply the Maastricht criteria for European monetary union to Asia. Thus, realistically, Asian monetary cooperation will have to be pursued in a multicurrency environment. Asian monetary cooperation is not about monetary integration. The situation argues for monetary segregation even to the extent, as in the case of China, of maintaining two currencies in one country: the renminbi for the Mainland of China and the Hong Kong dollar for the Hong Kong Special Administrative Region. Again, apply the Maastricht criteria to the Mainland of China and Hong Kong and you will come quickly to the conclusion that the "one country, two currencies" arrangement is a sensible one. It is an essential arrangement if Hong Kong is to continue to be stable and prosperous as an international financial center, as provided for in the Basic Law of Hong Kong.

Moving along the spectrum of monetary cooperation from the extreme end of monetary integration, we could consider whether some form of monetary policy coordination in Asia is appropriate. So far, however, there seems to be a lack of interest among the monetary authorities in Asia in promoting this. Perhaps there has been no such need identified. Monetary sovereignty has been carefully guarded in this region. There is also concern about the likelihood that such coordination would be dominated by the more influential economies of greater size and financial clout. Therefore no attempt has been made to identify the pros and cons of monetary policy coordination in Asia. The subject has not even figured in any of the discussions among the regional central bank groups that I know of. But one must, of course, keep an open mind on the subject. The contagious turmoil in the currencies and financial markets of Asia will, I am sure, stimulate some interest in monetary policy coordination. Without prejudging the outcome, I expect some initiative in putting the matter on the agenda for future discussions among monetary authorities in the region.

By contrast, there is a great deal of enthusiasm among the monetary authorities of the region to promote Asian monetary cooperation when it does not inhibit the freedom to determine domestic policies. I am sure, for example, that we would be keen to talk to each other about how to strengthen our monetary defensive mechanisms against attacks on our currencies and how to enhance the pain tolerance level of our financial systems so that we can absorb financial shocks more effectively. There is also considerable interest in building more robust financial infrastructures, on the one hand, to facilitate effective financial intermediation and, on the other hand, to limit the contagion effect of financial crises domestically and on a regional basis. I believe that this is a sensible way forward, at least for the time being. At the EMEAP forum, the monetary authorities, as I mentioned earlier, examined the whole spectrum of central banking functions quite comprehensively and identified issues where monetary cooperation would be beneficial.

Before going into these issues, let me just make two points about the approach that should be adopted in Asian monetary cooperation. First, Asian monetary cooperation must be considered within the context of global monetary cooperation. In other words, we should not—and I do not believe we are trying to—build Fortress Asia. I do not believe that this is in the best interest of Asia. It is essential that we work within the international monetary and institutional frameworks as much as possible. Let us not forget that the international monetary order is still largely determined by the Group of Three currencies. Asian economies cannot on their own or without the help of others determine the fate of the Group of Three currencies, even though we may have views about the future system.

Second, given the great diversity of the economies in the region and their being at very different stages of financial development, Asian monetary cooperation should proceed with flexibility and at a pace comfortable to those wishing to take part in it. It would be pragmatic to build monetary cooperation and establish links, perhaps first at the bilateral level, between those who are ready and willing and are operating compatible systems: for example, bilateral repurchase agreements of U.S. treasury securities to enhance each other's liquidity of foreign reserves, or bilateral linkages of real-time payment systems and clearing systems for securities in order to facilitate effective financial intermediation across the cooperating economies. These bilateral linkages would serve to set targets and standards for others in the region who are not quite ready. And when eventually the majority of the bilateral linkages have been established, we would have a network—an Asian monetary network—of considerable strength, which would hopefully enable Asian monetary problems to be tackled effectively. It should also be a network that is capable of being linked to monetary systems outside the region, with a view to building the global monetary framework.

ISSUES FOR ASIAN MONETARY COOPERATION

Let me now turn to specific issues for Asian monetary cooperation. There are five areas: information exchange, resource provision, market infrastructure development, banking supervision and financial regulation, and policy consultation.

Information Exchange

As the experience of EMEAP has shown, information exchange has been the easiest area of monetary cooperation. The use of the EMEAP virtual secretariat, using Internet technology, has greatly facilitated the exchange of information, helping in the sharing of market intelligence, techniques, and experience in all areas of central banking. The benefits are quite evident and therefore I will not dwell on this issue other than to mention the need perhaps to consider the removal of legal or other inhibitions to information exchange and sharing among central banks. Confidentiality provisions in domestic legislation may need to be suitably adapted in this context.

Resource Provision

Let me quickly turn to resource provision. Here we can distinguish between the provision of liquidity and the provision of credit.

On the provision of liquidity, I have mentioned the network of bilateral repurchase agreements of U.S. Treasury securities among EMEAP central banks. But as pointed out, the contagious nature of Asian monetary problems is such that when one of us is short of liquid foreign reserves, others may be in the same boat. It may be beneficial therefore if the network could be expanded to include possibly non-Asian economies that also hold substantial foreign reserves in U.S. Treasuries. There is, of course, the New York Federal Reserve Bank itself, as custodian of the paper and the settlement agency of U.S. dollar cash balances, which could play a supportive role in providing the service required. Yet another possibility is for the network of bilateral repurchase agreements to be multilateralized into a much more liquid pool, which could further be institutionalized so as to facilitate, perhaps with leveraged arrangements, monetary cooperation through the provision of credit.

Asian monetary cooperation took quite a significant step forward when the financial package for Thailand, organized by the IMF, was met with ready willingness by a number of Asian economies, including Hong Kong. This, I believe, is the first significant arrangement involving Asian monetary cooperation through the provision of credit. As an international financial center and an economy with significant interest in the Asian region, Hong Kong is willing to play its part in helping to maintain international and regional financial stability. This is ultimately in our own interest. It accounts for our willingness to join the New Arrangements to Borrow (NAB) to provide additional funding for the IMF. But the credit risks must be acceptable and manageable, and the case justifiable to the public in the overall public interest. Asian monetary cooperation through the provision of credit should therefore be on a multilateral basis and conditional upon the implementation of credible structural adjustment programs.

At this point, we may well ask whether the present multilateral arrangements to handle international financial crises are totally satisfactory. It has been argued that economies in need should go earlier to the IMF for assistance. However, given the tough medicine that the IMF is well known to prescribe, there may have been a reluctance to approach the IMF, given also the limited resources available for a cure. Thus the whole process of crisis prevention and damage control is delayed. While the Thai package showed how neighbors are willing to help supplement IMF resources, this has the tendency to reinforce regional arrangements rather than dealing with the issue on a global basis.

We hope that a precedent has not been set: that if the Mexican crisis was an American problem and the Thai crisis an Asian one, the next case will be for the region in which it occurs to resolve. Such regionalism does not auger well for international monetary cooperation. We feel therefore that the resources of the IMF should be strengthened considerably and the access level be reviewed in light of recent developments. This also applies to monitoring and enforcement efforts by the IMF. It would clearly not be efficient for regional groupings to duplicate the role of the existing international organizations such as the IMF and the BIS, which have the recognized expertise and the machinery to deal with these issues. In any case, a regional crisis quite often is not limited geographically but has global ramifications. In dealing with a crisis, the IMF should also have the mechanism and authority in place to negotiate with private sector lenders to ensure that equitable burden sharing prevails, and that the burden of adjustment does not fall only on official creditors.

Market Infrastructure Development

Another important area for Asian monetary cooperation is the building of the market infrastructure. In trying to draw attention to this area, I have often said that, while billions of dollars are spent in building highways and airports as part of the physical infrastructure in order to move people around efficiently and safely, there is by comparison very little money spent in building the financial highways and airports to move money around efficiently and safely. As a result, the money does not move, at least not as much as one would like to see. Consequently, effective financial intermediation, both domestic and regional, is inhibited, notwithstanding the rather attractive returns offered by the prosperity of this region. Financial markets remain fragmented along with the geographical fragmentation of the region, and there is a lack of liquidity because the regional critical mass has not yet been formed.

Another common complaint about Asian financial markets is the inefficiency of settlement and clearing processes for money and financial products. As a result, the tendency is for many of the Asian economies to use established clearing and settlement systems in Europe and America. For example, Asian trading of Euroyen paper has to be cleared and settled in European time. There is, of course, no logical answer to the question of why trading of Asian paper by Asians cannot be settled and cleared in Asian time. I am often reminded that the Eurodollar and Eurobond markets took off when Euroclear was established in the late 1960s. Furthermore, technology has now improved to the extent that we do not really need centralized clearing and settlement systems. I have long supported the concept of "Asiaclear" as a network of linkages of domestic clearing, settlement, and depository systems.

Again, we in the Hong Kong Monetary Authority made a start in building this network by establishing bilateral linkages between our clearing system for debt securities called the Central Moneymarkets Unit (CMU) and other systems. Our system is now linked with Euroclear and Cedel, and we are working on linkages with corresponding systems in Australia, New Zealand, and the Mainland of China. Once the matrix of bilateral linkages is filled up, the network of Asiaclear would be formed, like the Internet. There is no need for a centralized system or even a location. There is no center for the Asiaclear network, and so we do not need to get into the politically difficult question of where the network should be headquartered. We have also expressed our interest to other central banks in the region to establish similar linkages of payment systems. Our payment system in Hong Kong is already on the real-time gross settlement (RTGS) mode. Others are proceeding with the building of their RTGS systems, and as soon as they are ready, we will be happy to work again on establishing bilateral linkages to facilitate the risk management of large-value financial transactions across the two monetary systems. Once linked up, the Herstatt risk of foreign exchange transactions for the two currencies concerned will immediately be eliminated. Payment versus payment and delivery versus payment within Asian time will become a reality.

Banking Supervision and Financial Regulation

The fourth area for Asian monetary cooperation is banking supervision and financial regulation. As financial markets are further liberalized and integrated, the growth of cross-border banking activities and other financial transactions is accelerating, thus increasing the risk of contagion. As monetary problems ultimately surface in the banking system, it is important for regulators in different economies to cooperate to safeguard the integrity of the banking and financial systems in the region. Part of the work will involve the harmonization of supervisory practices, including adoption of the Core Principles for effective supervision advocated by the Basle Committee.

Through working closer together, such as the collaboration of the EMEAP Study Group on Banking Supervision, supervisory authorities in the region would be able to improve their understanding of each other's banking systems and supervisory framework and approach. We will also review practices in the region against the existing Basle Committee benchmarks, identify reasons for any differences, and thus help to raise the quality of supervision in the region. Over time, it may be possible to move on to the setting of standards.

Policy Consultation

Last, but not least, Asian monetary cooperation concerns policy consultation. Clearly, there is scope to improve mutual understanding of each other's policy framework and priorities. This may or may not be a prelude to policy coordination, as the case has not yet been established. But a regular channel of communication on policy issues is still needed. The EMEAP forum is a good start but needs to be strengthened. The IMF and the BIS have demonstrated how closer relations and deeper appreciation of the issues can only be fostered through a system of formal and informal channels of communications and regular discussions. Such discussions not only promote appreciation of the issues facing individual economies, but also regional and international issues. We look forward to their playing a more significant role in this region.

CONCLUSION

The road to international monetary cooperation has never been straight and smooth. The European experience suggests that there are many bumps along the way. With much more diverse needs and perspectives in Asia, we must allow Asian monetary cooperation to take shape gradually and in a flexible way, starting with less ambitious goals and proceeding at a pace and with arrangements comfortable to all. I believe the approach of building an Asian monetary network capable of further linkages to form a global monetary network is the correct one. It is based on voluntary participation and accommodates each participant's unique circumstances. We do not have the visionaries of Europe who saw the need for a single currency, nor do we believe that a single global institution would be adequate to provide solutions to all Asian monetary problems. In the pragmatic and patient Asian way, and using the wise words of the late Deng Xiaoping, "We cross the river by groping the stones." I am confident that in the end we will be able to build a robust and efficient Asian monetary network that will contribute to monetary and financial stability and economic prosperity in Asia, and in turn contribute to global financial stability and prosperity.

I cannot end this lecture without paying tribute to the tremendous support and cooperation that the Hong Kong Monetary Authority has received since its formation only four and a half years ago. I want specifically to acknowledge the unstinting support of the People's Bank of China and the Bank of England. Without their guidance, the Hong Kong Monetary Authority would not have become a reality. The Bank of Japan, the Bundesbank, and the Federal Reserve Bank of New York have also been generous in their support as we went around to the international financial centers to explain the unique concept and practice of "one country, two systems." All our fellow central banks and monetary authorities in EMEAP, SEANZA, and BIS showed us great kindness and support during the sensitive transitional period to the resumption of sovereignty by China in 1997. Indeed, the Hong Kong Monetary Authority is itself the fruit of monetary cooperation.

When asked what comes after 1997, we used to give the very simple reply: What comes after 1997 must be 1998. As you can see for yourself, with goodwill and cooperation, the prosperity of Hong Kong has been ensured, both before and after the resumption of sovereignty by China. You have my assurance, and the assurance of China, that Hong Kong will continue to play its role as an international financial center. We will work hand in hand with all central bankers around the world to build a safer and more robust international monetary system.

Thank you.

Questions and Answers

Following the formal presentation, Mr. Yam answered questions from the audience.

SIR JEREMY MORSE: Well, thank you very much, Mr. Yam, for that wonderful survey of the issues for Asian monetary cooperation.

Mr. Yam, what role did the deutsche mark play in your currency reserve management? And, in view of the forthcoming euro, have your plans changed in any shape or form?

MR. YAM: Yes, as I mentioned in my speech, we have a preferred neutral position of about 75 percent in U.S. dollars, because we are linked to the U.S. dollar. We have a small percentage in European currencies, and obviously the deutsche mark is one of the more important ones.

Now, as for the euro and all that, speaking for myself, I am a little concerned, along with quite a lot of other people, about what exactly the arrangements will be. In other words, we'll look at risks, and we'll try and manage the risks involved in our investment.

Because of our concerns, we have been reducing our exposure to Europe as a whole, and where we still have exposure to Europe, we are concentrating on the deutsche mark. But, overall, I think our exposure to Europe has been reduced because of the uncertainties surrounding the euro.

This is not to say that I'm not confident about the establishment of the euro. I prefer to wait and see. And when the picture becomes clearer after the establishment of the euro and the market proves to be liquid and robust, we could go back into the euro in a bigger way. But given that we are linked to the U.S. dollar, I do not actually foresee that we would adjust our preferred neutral position of around 75 percent in U.S. dollars.

There was one form of potential monetary cooperation that you didn't discuss, and that was the possibility of exchange rate coordination. It seemed to me for a long time that there would be a good case for a number of the East Asian currencies to have a joint policy vis-à-vis a common currency basket, so that not necessarily all would be pegging rigidly but using it as the same sort of fulcrum as they have, in fact, using the dollar. That would then have avoided the major appreciation in real terms that countries like Thailand suffered, and which was, after all, the proximate cause of the crisis in Thailand. Is this something that ought to come into the debate?

MR. YAM: Thank you. I did refer to that obliquely in the form of possible monetary policy coordination. By monetary policy coordination, I include exchange rate coordination. You might have noticed that before the Thai crisis, the exchange rate of the Southeast Asian currencies against the U.S. dollar, for example, all centered around the 2.5, 25, and 2,500 sort of levels, depending on what currency you are talking about. And after the crisis, you're talking about numbers of 3, 30, and 3,000, depending again on the currency. So they have actually depreciated by about the same extent against the U.S. dollar.

While I can't speak for other countries, I imagine that the ASEAN economies could have come together and talked about the possibility of exchange rate coordination. But I did say earlier that monetary sovereignty has been guarded rather strongly in this region, and I did mention that one should keep an open mind on this particular matter. I can see scope for greater exchange rate coordination among the ASEAN economies that are, arguably, in a similar stage of economic development. But, insofar as we—as a very externally oriented economy—are concerned, I would continue to hold the view that the objective of our monetary policy should be to maintain a stable external value of our currency, and that would be the fixed rate of 7.80 against the U.S. dollar, with the operation of a currency board system.

The situation on this particular matter is, of course, very fluid. As we are talking here, I think quite a number of deputy finance ministers and central bank deputy governors are actually discussing this matter in another room. I don't know what conclusions they will come to.

Do you expect that eventually Hong Kong will become the financial capital of China analogous to the ways in which, say, Bombay, Frankfurt, Johannesburg, New York, Toronto, or Sydney have become or remained financial capitals of their countries in parallel with other cities that are the political capitals?

MR. YAM: Hong Kong is the international financial center in China at this point in time. Of course, one can think about Shanghai. And, obviously, the policy of the Mainland of China is to further develop Shanghai as the financial center. The views of Beijing are actually very clear on this particular point. As far as we're concerned, we don't actually mind competition, as long as we compete on a level playing field. I would become very concerned if there were views from Beijing indicating that they would positively subsidize the development of Shanghai as an international financial center. That would actually cause me a lot of concern. But there is no such policy. As long as we compete on a level playing field, I think we should be in a position to continue to lead.

We are considered, I think, the Manhattan of China at this point in time. I expect our position will continue. When you choose a center for carrying out financial transactions or international financial transactions, you tend to look at the integrity of the financial system, the risks involved, and whether there are mechanisms for controlling those risks. Now, such a reputation of a financial center cannot be built up overnight. Hong Kong now has quite a long history as an international financial center. I think our position will continue to be very important, not only for China but also in the region and in the global context.

Given the context of "one country, two systems," how does exchange rate coordination occur between the Hong Kong dollar and the renminbi? And is it possible that you can maintain a fixed exchange rate with the dollar, because the renminbi tends to be flexible in relation to the dollar?

MR. YAM: On the "one country two systems," insofar as exchange rate arrangements are concerned, the interpretation, which has now been quite clearly laid down, is that there will be "one country, two currencies, two monetary systems, and two monetary authorities," all of which are to be mutually independent of each other. We pursue our own monetary policy, and the Mainland of China pursues its own monetary policy.

The renminbi will be considered as a foreign currency like any other foreign currency in Hong Kong, and the Hong Kong dollar is being considered as a foreign currency in China. So we are pursuing different monetary policies. The renminbi looks to be maintaining a stable level with the U.S. dollar, although the policy objective has not actually been as clearly defined as ours. There is no exchange rate coordination between the renminbi and the Hong Kong dollar. There has never been, and I imagine there will not be as long as the Basic Law is in force; and that would be for 50 years after 1997.

You brilliantly outlined the various issues for Asian monetary cooperation, stressing in that context the great diversity of the countries involved and of their objectives. How can the learning process for regional cooperation in Asia be accelerated through collaboration with existing global or other regional bodies?

MR. YAM: That is a very important issue. I have mentioned that, while Asian monetary cooperation is important, we must conduct Asian cooperation in the global context. There are international standards that we must observe because we are part of the world and operating in a globalized environment.

I also mention the concept of an Asian monetary network where people actually can link up with each other, in whatever field within the central banking and financial areas, at their own pace whenever they are ready.

The process of cooperation can, of course, be accelerated by our talking to each other more often; by more active participation in the promotion of regulatory standards, for example; and by building the Asian monetary network I have been referring to. In building that network, one has to be very careful about the possibility of the contagion of risks transferring from one system to another. For example, when you build linkages of payment systems, of real-time payment systems, you must actually be very careful to make sure that the problems in one system are not transmitted to another system.

With that in mind, I think a framework of monitoring and of peer group surveillance would be created. I think that would be helpful in promoting a common standard for monetary areas in the region. I expect more active discussions on all these points in the region, perhaps even with the involvement of the IMF or the BIS.

When do you expect the renminbi to become fully convertible? When and if that happens, will you review the distribution of foreign currencies in your reserves to reflect the trade between Hong Kong and China?

MR. YAM: The question of when the renminbi will become fully convertible is a rather complex question, but I believe it can be answered in a simple way. For any currency to be freely convertible, confidence must be established in the economy, in the policies, and in the currency. Otherwise, you will find that, if you force the free convertibility of the currency and the capital account, your reserves—US$111 billion or US$110–120 billion nowadays in China—could well disappear within half an hour. Or, if you do not actually support your exchange rate, you could find it depreciating rather sharply. I think the Chinese authorities recognize that, and I don't think they are ready for convertibility. As to how long it would take for confidence in the renminbi to be established, it is, of course, very difficult to tell.

On the management of our reserves and as to whether or not we would hold renminbi, that is purely an investment matter. We would have to take a view about the credibility or the creditworthiness of a particular economy and the risks that are involved in holding the paper of that particular currency. At this point, we don't actually have the renminbi on our list of approved currencies for holding. And neither is China an approved credit risk in the management of our reserves.

We are very transparent in the management of our reserves. We publish our investment guidelines. I don't think there is any possibility, for example, for China to force us to hold renminbi paper. But this is purely an investment matter.

Some, including at least one in this conference, have said that one way for countries to protect their currencies is to restrict market access to their currencies, especially by big well-financed overseas speculators. Do you think that is good policy?

MR. YAM: Well, if you ask me as the head of the Monetary Authority of Hong Kong, I would say that the best policy insofar as financial liberalization is concerned is to move cautiously in that direction, making sure at the same time that you have a robust financial infrastructure and a monetary mechanism to deal with the volatility that may arise from that financial liberalization.

Insofar as Hong Kong is concerned, we are in fact prohibited by law to impose any exchange control. In the Basic Law, it is specified that the Hong Kong dollar is to be freely convertible, with no exchange control, free flow of capital, and so forth. We have concentrated a lot of our efforts over the years in building a robust monetary management mechanism and a robust financial infrastructure. That is the best way of dealing with capital flows. For economies that are not yet ready to accept the full liberalization, I suppose they could take a step backward for the time being and look at their systems until they are ready and then step forward again. I think that is the best way to proceed.

You seem to be advocating some networking within the Asian region in the face of the unpredictable crisis that does arise from time to time. You referred to the Mexican experience, with the Americans around the corner to take care of this situation, and perhaps a networking in Asia. Do you advocate that perhaps we in Africa should be networking or, if we are not, that we are still asleep? I am worried. Which is the way to go forward?

MR. YAM: I am afraid I am really ignorant about the situation in Africa, but in any region if there is a high degree of economic integration and a high degree of interdependence among the economies concerned and a high degree of financial integration, I think it would be beneficial for the economies concerned to look at greater regional monetary cooperation.

Because of the crisis that we have been seeing in the past few months (and also in Mexico two years ago), people have been focusing too much on firefighting and on the currency front.

But there is a lot more to monetary cooperation than simply to maintain currency stability. I mentioned quite a few times the need to look at the financial infrastructure in order to facilitate more effective financial intermediation.

In Asia, for example, we have US$600 billion of reserves in this region—about 40 percent of the world's reserves—and a large proportion of those reserves is actually invested outside the region, while at the same time we are actually trying hard to attract foreign investment into the region.

I don't know about the situation in Africa. Perhaps quite a lot of your reserves are also invested in the U.S. and European markets. Why shouldn't the money be invested also in your own country or in your own continent? The answer is quite simple: because of the risks involved in your markets, I imagine. There are risks involved because the markets are not liquid; they are fragmented, and people would actually rather invest their money outside the region in the more liquid and the more sophisticated markets.

Perhaps if you cooperate among yourselves and create a critical mass for the market in your region, and improve the financial infrastructure and upgrade the supervisory standards, then financial intermediation in your region would become a lot more effective, and the risks of investing in your own region would be lower. That would obviously be to the benefit of any region.

SIR JEREMY MORSE: On behalf of all present I would like to thank Mr. Yam for his lecture.

Biography

Joseph C.K. Yam received his first-class honors degree in Economics and Statistics at the University of Hong Kong in 1970. He started his civil service career in Hong Kong as a statistician in 1971. In 1976, he was transferred to the Economic Services Branch of the Hong Kong Government Secretariat as an Economist. There he worked closely with the Financial Secretary and the Secretary for Economic Services on budgetary matters and on economic analysis.

In 1982, Mr. Yam was transferred to the Monetary Affairs Branch as a Principal Assistant Secretary. He was subsequently appointed Deputy Secretary for Monetary Affairs in 1985 and Director of the Office of the Exchange Fund in February 1991. Mr. Yam was responsible for many of the reform measures introduced since the mid-1980s to strengthen Hong Kong's monetary system and to develop its financial markets. These measures have contributed much to monetary stability in Hong Kong and to its development as an international financial center.

Mr. Yam was instrumental in the establishment of the Hong Kong Monetary Authority in April 1993 when he was appointed its Chief Executive.

In July 1995, Mr. Yam was honored with the first "Banker of the Year" award in Hong Kong. *Euromoney* also named Mr. Yam Central Banker of the Year in Asia in 1996 and Central Banker of the Year in 1997. Moreover, Mr. Yam was named Man of the Year by *Hong Kong Business Magazine* in December 1997.

Mr. Yam was born in 1948. He is married, with one daughter and one son.

The Per Jacobsson Lectures

(Site of the lecture is Washington, D.C., unless otherwise shown)

1964 *Economic Growth and Monetary Stability.* Lectures by Maurice Frère and Rodrigo Gómez (Basle).

1965 *The Balance Between Monetary Policy and Other Instruments of Economic Policy in a Modern Society.* Lectures by C.D. Deshmukh and Robert V. Roosa.

1966 *The Role of the Central Banker Today.* Lecture by Louis Rasminsky; commentaries by Donato Menichella, Stefano Siglienti, Marcus Wallenberg, and Franz Aschinger (Rome).

1967 *Economic Development: The Banking Aspects.* Lecture by David Rockefeller; commentaries by Felipe Herrera and Shigeo Horie (Rio de Janeiro).

1968 *Central Banking and Economic Integration.* Lecture by M.W. Holtrop; commentary by Lord Cromer (Stockholm).

1969 *The Role of Monetary Gold over the Next Ten Years.* Lecture by Alexandre Lamfalussy; commentaries by Wilfrid Baumgartner, Guido Carli, and L.K. Jha.

1970 *Toward a World Central Bank?* Lecture by William McChesney Martin; commentaries by Karl Blessing, Alfredo Machado Gómez, and Harry G. Johnson (Basle).

1971 *International Capital Movements: Past, Present, Future.* Lecture by Sir Eric Roll; commentaries by Henry H. Fowler and Wilfried Guth.

1972 *The Monetary Crisis of 1971: The Lessons to Be Learned.* Lecture by Henry C. Wallich; commentaries by C.J. Morse and I.G. Patel.

1973 *Inflation and the International Monetary System.* Lecture by Otmar Emminger; commentaries by Adolfo Diz and János Fekete (Basle).

1974 *Steps to International Monetary Order.* Lectures by Conrad J. Oort and Puey Ungphakorn; commentaries by Saburo Okita and William McChesney Martin (Tokyo).

1975 *Emerging Arrangements in International Payments: Public and Private.* Lecture by Alfred Hayes; commentaries by Khodadad Farmanfarmaian, Carlos Massad, and Claudio Segré.

1976 *Why Banks Are Unpopular.* Lecture by Guido Carli; commentary by Milton Gilbert (Basle).

1977 *The International Monetary System in Operation.* Lectures by Wilfried Guth and Sir Arthur Lewis.

1978 *The International Capital Market and the International Monetary System.* Lecture by Gabriel Hauge and Erik Hoffmeyer; commentary by Lord Roll of Ipsden.

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