

Transmission of the shocks of the global financial crisis via macro-financial linkages across regions- Hong Kong's experience and lessons learnt

Revised Submission for PEO Specialist Meeting in Osaka, December 2010

Introduction

The financial market turbulence that erupted in September 2008 and the ensuing global recession it brought about is just a reminder of the limit of our knowledge of financial markets, and that globalization and financial integration have brought a lot of benefits but also the dark side because of all the risks and contagion it brings about through the macro-financial transmission mechanism. While most of the economies in the region have embarked on a strong recovery since then, the trend of macro-financial linkages and financial integration across regions and within region is an issue worth studying, for the contagion they can bring in magnifying the intensity of the global business cycles. This article intends to share Hong Kong's experience, with special focus of how the macro-financial linkages between Hong Kong and Asia have evolved in the aftershock of the 1997-98 Asian financial crisis, and how Hong Kong has successfully weathered the severe shocks of the 2008-09 Great Recession despite its very high degree of trade and financial integrations with the rest of the world. The analysis also draws reference to Hong Kong's performance in the 1997-98 Asian Financial Crisis and explains how the significant improvements in our macro fundamentals in recent years have buffered Hong Kong in the 2008-09 Global Financial Crisis.

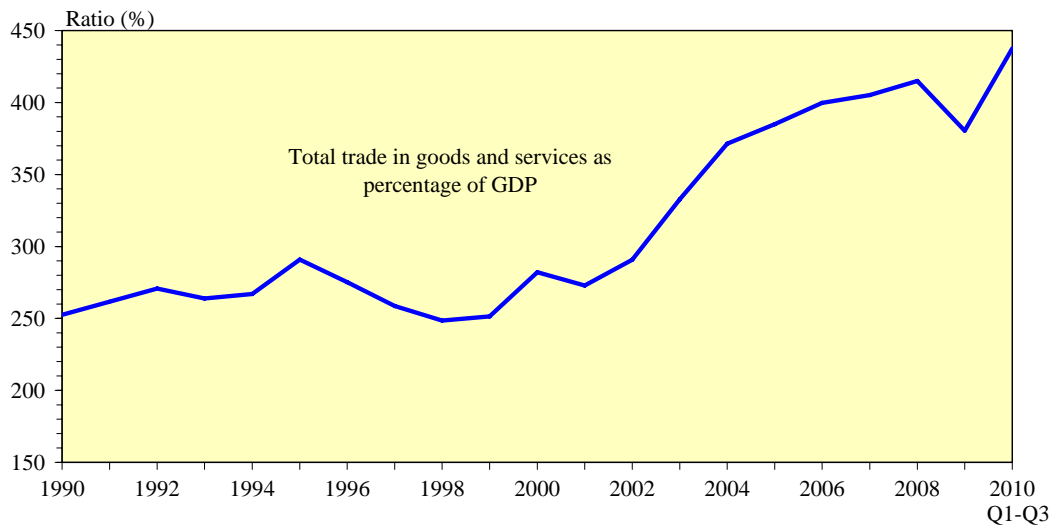
Macro-financial linkages since the 1997-98 Asian Financial Crisis

Hong Kong's degree of trade linkages have risen even more, thanks to China's accession to WTO and general trend of trade integration within the region

2. Hong Kong, as a small and open economy, is heavily dependent on external trade. To a large extent this reflects the role of Hong Kong as an export management centre for China, more so after China's accession to WTO in 2001. As a manifestation of Hong Kong's prominent role as a trading and logistic hub in the

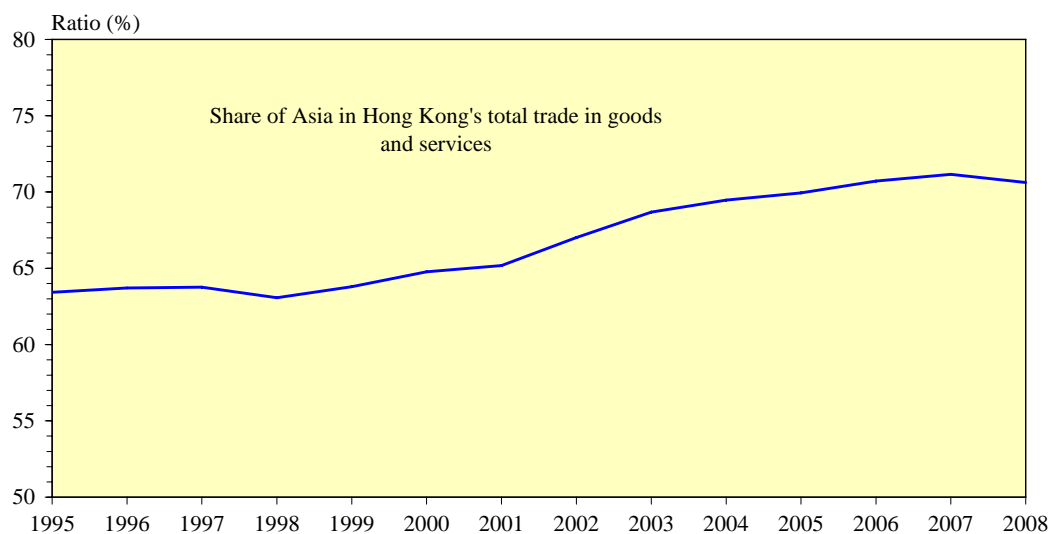
region, the size of the external sector relative to our overall economy as measured by GDP increased almost uninterruptedly from 259% in 1997 to 415% in 2008 (**Chart 1**). While the steep contraction in merchandise trade in 2009 dragged the ratio downward to 380%, the broad trend has not changed. This secular increase in external orientation, which is seen on both visible and invisible trade, resumed in the first three quarters of 2010.

Chart 1 Total trade in goods and services as % of GDP



3. The significant rise in visible trade and invisible trade over the years reflects the continued vertical integration in production chain across economies in Asia, being driven by Mainland China's increasing integration to the global economy thereby making the division of labour across economies in Asia more prominent over the years. Indeed, from Hong Kong's trade figures, one can see that the role of Asia in Hong Kong's merchandise trade has been on a steady rise all through the past decade or so, with the share of Hong Kong's total trade in goods and services with Asian economies rose from 63.8% in 1997 to 70.6% in 2008 (**Chart 2**).

Chart 2 Share of Asia in Hong Kong's total trade in goods and services



Notes: Asia includes Afghanistan, Bangladesh, Bhutan, Brunei Darussalam, Cambodia, the Mainland of China, India, Indonesia, Islamic Republic of Iran, Japan, Democratic People's Republic of Korea, Republic of Korea, Lao People's Democratic Republic, Macao, Malaysia, Maldives, Mongolia, Myanmar, Nepal, Pakistan, Philippines, Singapore, Sri Lanka, Taiwan, Thailand, Vietnam, and other Asian countries/territories not elsewhere specified.

Since a geographical breakdown of financial intermediation services is not available, financial intermediation services have been excluded when deriving the share.

Geographical breakdown in services can only be traced back to 1995.

Along with increasing trade and investment linkages, financial integration has also grown significantly over the years

4. Because of increased external orientation in the current account items, Hong Kong's financial integration and inter-linkages with the Asian region has also risen markedly since 1997. Again, for Hong Kong the key factor behind has been Hong Kong's ever increasing integration with the Mainland and the synergy effects Hong Kong have reaped in Mainland's economic development and financial reforms. Indeed, the Mainland factor now features prominently, not only in Hong Kong's trade, tourism and investment, but also in stock market and in financial services (**Table 1**).

Table 1 Hong Kong's increasing integration with Mainland China

	<u>1990</u>	<u>1999</u>	<u>2003</u>	<u>2009</u>	<u>2010</u> <u>Q1-Q3</u>
<u>Goods trade</u>					
Exports to the Mainland China / HK GDP (%)	26.4	35.5	60.1	77.4	92.0
- after excluding raw materials & semi-manufactures	<i>16.2</i> (1996)	14.9	26.7	36.3	44.2
<u>Tourism (% share of total)</u>					
Visitors from the Mainland China	11.5	28.3	54.5	60.7	63.0
Tourism spending by tourists from the Mainland China	28.8 (1998)	27.5	62.4	69.4	n.a.
<u>Factor income flows (% of Mainland share)</u>					
Direct investment income inflow	<i>13.5</i> (1995)	21.2	40.9	48.6	49.7
(due to Hong Kong's investment in Mainland)					
Direct investment income outflow	8.0 (1995)	13.6	20.7	31.0	32.0
(due to Mainland's investment in Hong Kong)					
<u>Stock of direct investment (% of Mainland share)</u>					
Inward	<i>12.3</i> (1998)	25.9	26.0	36.4	n.a.
Outward	<i>31.6</i> (1998)	24.8	35.3	42.3	n.a.
<u>Banking sectors (% of Mainland share)</u>					
External claims	3.3	6.6	5.2	9.0	15.8
External liabilities	3.7	9.1	15.7	17.4	16.6

Notes: n.a. Not yet available/Not applicable.

Due to data limitations, some of the data series cannot be traced back to 1990. The earliest available figures are listed here in *italic* instead, with the corresponding year bracketed beneath.

Hong Kong as Mainland's premier IPO listing centre

5. Since the first H-share (shares of listed companies incorporated in the Mainland China that are trade on the Hong Kong Stock Exchange) listing in Hong Kong in 1993, Hong Kong is now the Mainland's premier IPO listing centre. By end-November 2010, a total of US\$363.0 billion capital has been raised by Mainland companies through the stock market in Hong Kong, markedly higher than that of US\$25.5 billion at end-1997. These Mainland companies now account for 57% of Hong Kong's stock market capitalisation, likewise significantly up from 16% at end-1997. The development of H-share listing has been the key instrumental factor which has markedly increased the breadth and the depth of Hong Kong's stock market, and along with it, Hong Kong's total market capitalisation leaped to US\$2,695 billion at end-November 2010, 6.5 times as large as at end-1997.

6. Indeed, the phenomenal growth in the scale of Hong Kong's stock market over the past decade has been disproportionately large when compared to the growth of the overall economy, a vivid manifestation of the role of Hong Kong as Mainland's international financial centre, not only in raising the equity capital for the Mainland companies needed, but more importantly, in helping them to reach out to the world, develop their brand name and gear up to international best practise (**Chart 3(a), (b)**).

Chart 3(a): Market capitalization of Mainland enterprises and others in the Hong Kong stock market, year-end

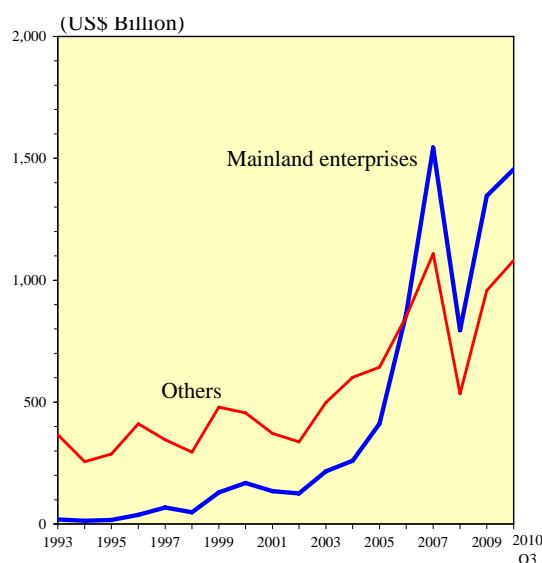
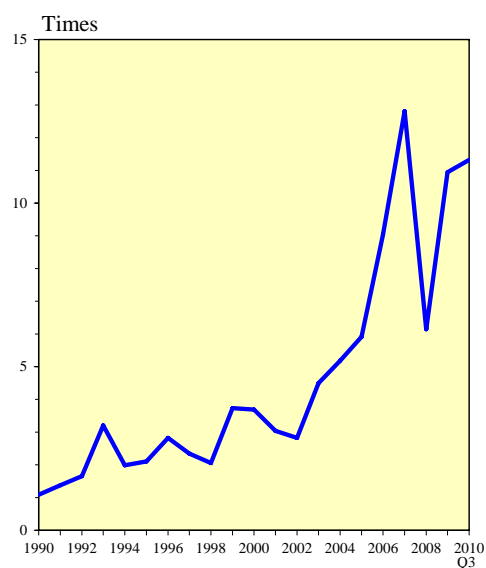


Chart 3(b): Market capitalization of Hong Kong stock market relative to GDP



Banking sector

7. The trend of increasing trade and financial integration with Asia is likewise reflected in the composition of the external claims and liabilities of banks in Hong Kong. Specifically, the share of external claims and liabilities of banks in Hong Kong to other parties (i.e. either banks or non-bank customers) in the Asia Pacific region excluding Japan was markedly up over the years since 1997. In particular, the growth in the claims on parties in the Asia Pacific region excluding Japan has gathered pace over the past several years (**Table 2**), and the liabilities of banks in Hong Kong to parties in the region have also been on an uptrend over the past decade (**Table 3**). These reflect Hong Kong's increasing role as an international financial centre in the Asian region (**Chart 4**).

Table 2 External claims of Hong Kong's authorised institutions on counterparties by economies

Hong Kong's External Claims (as at end of year) as % of GDP								
Year	Overall	Mainland	ASEAN	Japan	Rest of Asia	Europe	US	Rest of World
1997	340.8	29.9	36.4	185.6	17.7	35.1	10.9	25.3
1998	300.3	25.1	41.7	135.0	14.1	46.5	10.3	27.5
2000	266.5	16.8	34.5	78.7	11.5	74.1	16.2	34.8
2003	276.8	14.5	34.2	46.3	18.0	94.3	25.4	44.1
2004	305.7	20.1	47.7	43.6	20.8	102.0	25.0	46.5
2005	287.4	23.5	43.3	31.1	21.2	99.9	25.7	42.7
2008	364.8	27.6	45.9	38.9	38.2	133.1	31.4	49.6
2009	355.3	32.1	42.4	34.3	41.6	118.6	31.6	54.7

Notes: Rest of Asia includes Afghanistan, Bangladesh, India, Kazakhstan, Macao, Taiwan, Maldives, Nepal, North Korea, Pakistan, Papua New Guinea, South Korea, Sri Lanka and other Asian countries/economies not classified elsewhere.

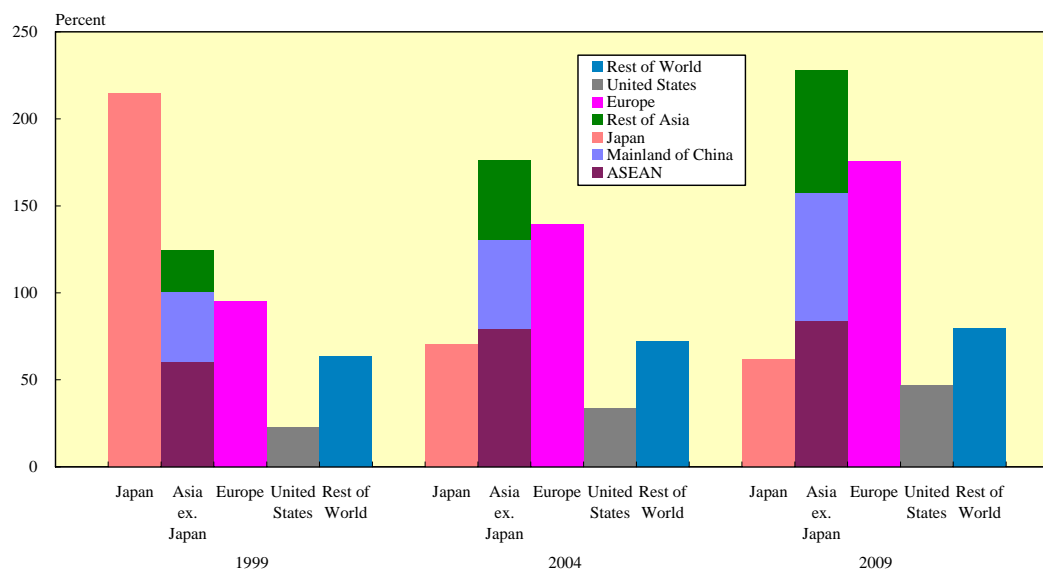
Figures for years before 1997 are not available.

Table 3 External liabilities of Hong Kong's authorised institutions to counterparties by economies

Hong Kong's External Liabilities (as at end of year) as % of GDP								
Year	Overall	Mainland	ASEAN	Japan	Rest of Asia	Europe	US	Rest of World
1997	338.9	22.4	32.7	168.8	9.7	56.4	11.4	37.5
1998	268.0	22.5	30.0	121.9	10.8	38.7	9.2	35.1
2000	188.8	29.8	25.2	52.6	11.8	28.4	7.4	33.6
2003	167.9	26.4	24.1	29.1	19.8	35.0	7.7	25.7
2004	185.7	30.9	31.7	26.6	24.7	37.5	8.5	25.8
2005	171.4	34.4	28.4	23.4	21.7	30.1	9.3	24.3
2008	233.3	41.7	34.6	33.0	28.1	56.3	12.2	27.4
2009	236.6	41.2	41.7	27.6	28.7	57.0	15.4	25.0

Notes: Rest of Asia includes Afghanistan, Bangladesh, India, Kazakhstan, Macao, Taiwan, Maldives, Nepal, North Korea, Pakistan, Papua New Guinea, South Korea, Sri Lanka and other Asian countries/economies not classified elsewhere.

Figures for years before 1997 are not available.

Chart 4 Hong Kong's total external claims and liabilities as a percentage of GDP

Note: Due to data limitation, the set of economies identified as "Asia" in 1999 is slightly different from that in 2004 and 2009..

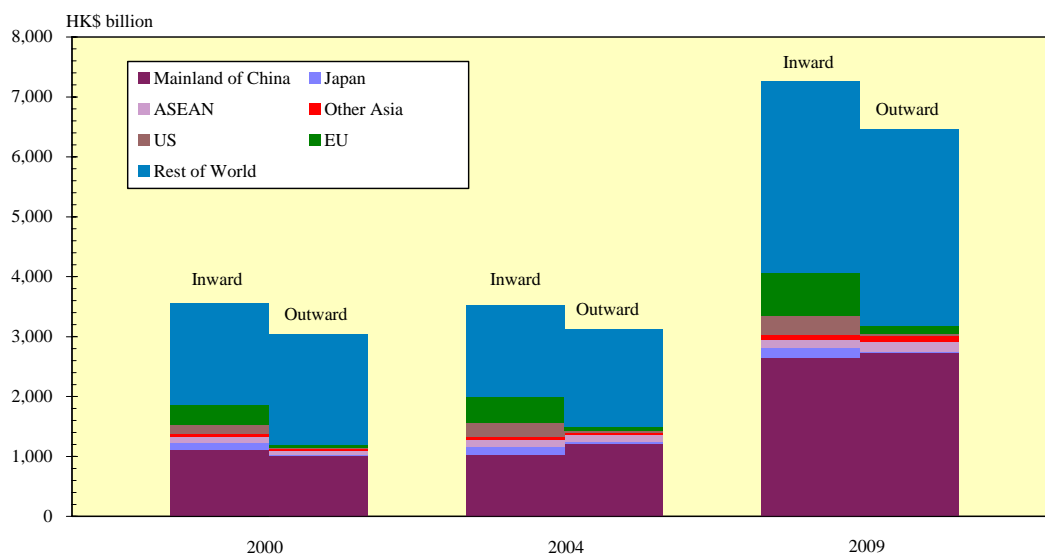
Funds flow

8. Hong Kong, being an international financial centre, deals with massive inflows and outflows of funds day in day out (**Table 4**). On funds flow more related to long term investment, the stocks of Hong Kong's inward and outward Direct Investment are both very large relative to the size of the economy, signifying the external orientation of the economy and our status as a business hub and financial centre. Hong Kong has long been an active investor as well as recipient of direct investment in the region. In the more recent years, Hong Kong also plays the dual role of channeling investments into the Mainland as well as helping the Mainland enterprises to expand overseas. Such trend is evident from **Chart 5**, with the Mainland China being both the most important destination as well as source of direct investment for Hong Kong. The accompanying change is the dramatic increases in direct investment flows into and out of Hong Kong. The stock of inward and outward FDI relative to GDP likewise rose steadily over the past ten years.

Table 4 Broad Components of International Investment Position (as % of GDP)

End of year	Direct Investment		Portfolio Investment		Financial Derivatives		Other Investment	
	Abroad	In HK	Asset	Liabilities	Asset	Liabilities	Asset	Liabilities
2000	229.8%	269.5%	105.8%	90.7%	9.9%	7.4%	266.2%	176.6%
2001	211.6%	251.7%	123.4%	70.2%	10.5%	7.2%	230.5%	154.4%
2002	188.9%	205.3%	149.0%	57.1%	13.7%	12.9%	208.9%	143.9%
2003	213.5%	239.8%	210.6%	78.8%	12.5%	12.3%	234.3%	166.6%
2004	242.6%	272.6%	241.2%	93.4%	13.5%	12.7%	256.5%	193.8%
2005	264.3%	293.4%	244.8%	100.1%	9.6%	9.6%	249.7%	188.8%
2006	356.8%	391.2%	305.9%	136.8%	11.9%	10.7%	271.8%	204.7%
2007	488.3%	568.7%	376.0%	230.6%	23.1%	15.7%	350.8%	263.3%
2008	352.5%	377.6%	257.8%	106.4%	40.3%	34.2%	310.8%	239.6%
2009	395.4%	444.9%	385.6%	161.9%	23.2%	19.0%	288.0%	245.8%

Note: Figures are only available as from the reference year 2000.

Chart 5 Both Inward and Outward FDI stocks have a dominant China feature

Note: Due to data limitation, Brunei, Cambodia, Laos and Myanmar are not classified under ASEAN in the set of figures for 2000. These 4 countries accounted for 1.0% and 0.02% of the total stock of ODI from and IDI to Hong Kong from/to ASEAN at end-2008 respectively. In addition, Bulgaria, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovakia and Slovenia are not classified under EU in 2000. These 12 countries accounted for 1.3% and 0.3% of the total stock of ODI and IDI from Hong Kong to EU and to Hong Kong from EU at end-2008 respectively.

9. The scale of portfolio investment funds flow is likewise large and generally on the rise, particularly in regard to the stock of wealth that our Hong Kong residents have invested in stock market overseas. Again, while the financial tsunami led to a temporary dip in 2008, the secular trend resumed in 2009 as soon as the global financial markets rebounded.

10. The scale of financial derivatives is somewhat smaller. In the first ten months of 2010, Hong Kong was ranked 1st in Asia (and 7th in the world) across stock exchanges on the trading volume of stock options, though the size relative to the stock exchanges ranked in the top 6 was still rather small.

11. As for other investment, the relative size has grown steadily over the years, mainly reflecting the sheer size of Hong Kong's banking system and the attractiveness of Hong Kong as an asset management centre. It is worthwhile to note that even in the midst of the global financial tsunami in late 2008, there had not been massive outflow of funds from Hong Kong's banking sector. Quite the contrary, Hong Kong witnessed substantial funds inflow into the banking sector since late 2008, underscoring the confidence of outside investors in Hong Kong's robust and well regulated banking system amid the turbulent external environment at that time.

Increasing trade and financial linkages have propelled financial deepening

12. From the above analysis, it is clear that Hong Kong's macro-financial linkages with Asia have risen substantially over the years, thanks to China's increasing integration with the Asian region as part of the key production chain in globalisation. Accompanying this development is an ongoing trend of financial deepening in Hong Kong. **Table 5** shows both the scale and quality indicators relating to financial deepening.

13. Amongst the various scale indicators, the growth in Hong Kong's stock market has been the most phenomenal, all in all a reflection of Hong Kong's prominent role as Mainland's premier IPO centre. The banking sector activities likewise saw significant growth over the years, with aggregate loans rising in tandem with nominal GDP. The growth in bond outstanding was also impressive, with the ratio of bond outstanding to nominal GDP more than doubled in ten years' time. Generally speaking, Hong Kong's bond market is still relatively small relative to the size of the economy, and with big potential for further development. On the other hand, Hong Kong's banking and securities sectors are both much more advanced in terms of its scale, breadth and depth, and yet the potential for expansion is also huge given the role of Hong Kong as Mainland's IPO centre, renminbi offshore centre and asset management centre.

14. The financial deepening process in Hong Kong, as evidenced from the hefty increases in various "scale" indicators, was also matched by substantial improvements in "quality". This is manifested notably in a well capitalised banking sector with high capital adequacy ratio (CAR) consistently above at the "Basel II" requirements; significant improvement in non-performing loan ratio (in terms of net classified loan ratio), and also prudence in banks' lending standard in terms of a cautiously low loans-to-deposit ratio. Indeed, various indicators of asset quality in the banking sector were at comfortable levels compared with historical standards.

Table 5 Financial deepening indicators for Hong Kong

(Period-end figures)	<u>1990[#]</u>	<u>2000</u>	<u>2005</u>	<u>2009</u>	<u>2010</u> <u>Q1-Q3</u>
<u>Scale indicators</u>					
M2/GDP	2.02	2.77	3.17	4.04	4.02
Loans/GDP	2.99	1.87	1.67	2.01	2.37
Stock market capitalisation/GDP	1.09	3.69	5.92	10.95	11.32
Bond outstanding/GDP	0.18	0.36	0.48	0.68	0.71
<u>Quality indicators</u>					
Net classified loans as % of total loans	1.30	4.93	0.98	0.90	0.50
Capital adequacy ratio (%)	16.0	17.8	14.9	16.8	16.1
Loan-to-deposit (HK\$) ratio	1.17	0.89	0.84	0.71	0.74 [*]

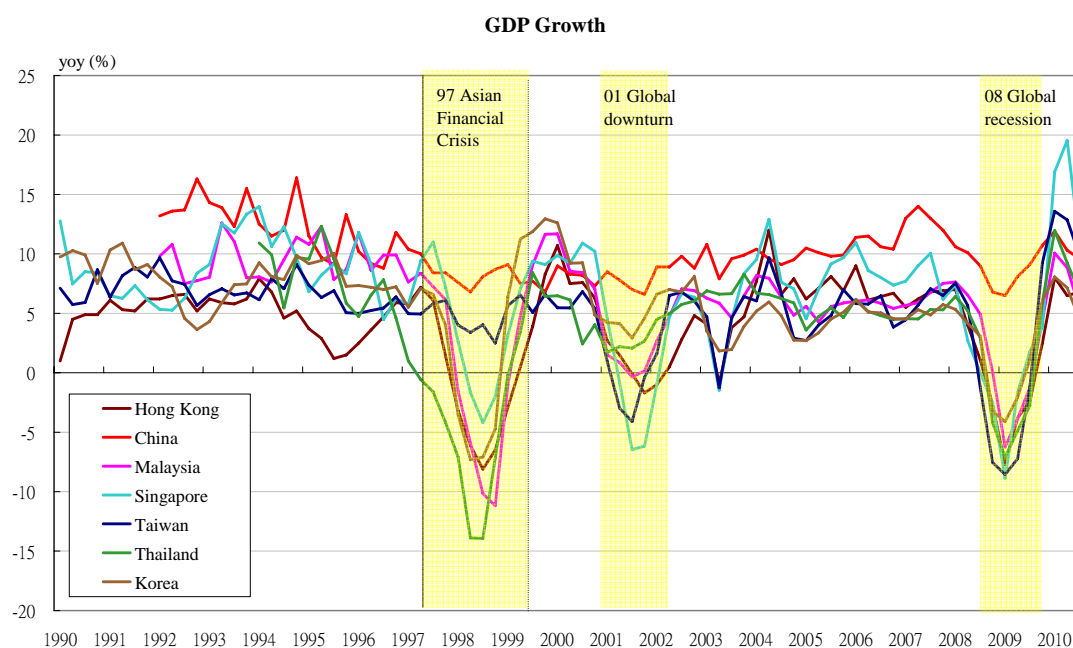
Note: (#) Due to data limitations, “bond outstanding/GDP” refers to 1995 figure; “net classified loans as % of total loans” refers to 1997 figure; “capital adequacy ratio” refers to 1992 figure. While “M2/GDP” and “Loan-to-deposit ratio” are 1990 figures, they are not strictly comparable to the latter figures due to changes in definitions.

(*) As at October 2010.

How Hong Kong has fared during the 2008-09 global financial crisis versus the 1997-98 Asian Financial Crisis

15. It is clear from the previous section that Hong Kong’s degree of openness, whether in terms of external trade, cross-border investment, banking and financial markets, or in terms of the trend of rising financial inter-linkages, has risen even more over the past decade, in tandem with China’s increasing integration with the rest of the world and the general trend of globalisation. The closer financial linkages mean that the contagion process across economies can spread very fast and with great intensity. The sub-prime mortgage crisis in the United States was a case in point. It unfolded in the summer of 2007, mutated into the global financial tsunami by August/September 2008 and followed by a synchronised economic downturn worldwide, with advanced economies plunging into recession and emerging economies experiencing a sharp deceleration in growth. Indeed, **Chart 6** shows that all major Asian economies except China dived into recession during the “Great Recession” in 2008 Q4 and 2009 Q1, by an extent close to that experienced in the 1997-98 Asian Financial Crisis.

Chart 6 Synchronised recession in Asia, in all three episodes of AFC, 2001 global downturn and 2008 global recession



16. The external environment facing the Asian region during the first six months after the global financial fallout was understandably much more austere and challenging. In terms of external trade, East Asian economies suffered an even sharper plunge in exports during the 2008-09 crisis than during the 1997-98 Asian Financial Crisis (**Chart 7**). For some economies, the plunge in trade in the first few months of the 2008-09 crisis, triggered by the freefall in economic activities in the advanced economies, was the sharpest on record. This was particularly so at the junction of 2008 and 2009, when the extent of contraction was most severe and not seen in decades. Hong Kong was no exception. Our exports plunged by nearly 23% in the first quarter of 2009, and remained on double-digit decline for most of the year. For 2009 as a whole, exports were sharply down by near 13%, the worst on record (**Chart 8**). Yet as the global trade successively normalised and exports from Asia began to bounce back in the latter part of 2009, Hong Kong also recovered rapidly. The sharp plunge in trade in early 2009 and the subsequent rebound in late 2009 across all economies in Asia was another vivid example of how increasing trade linkages transmit shocks across Asia under the globalisation era.

Chart 7 Trade is the key channel in the transmission of external shocks, more so over past decade

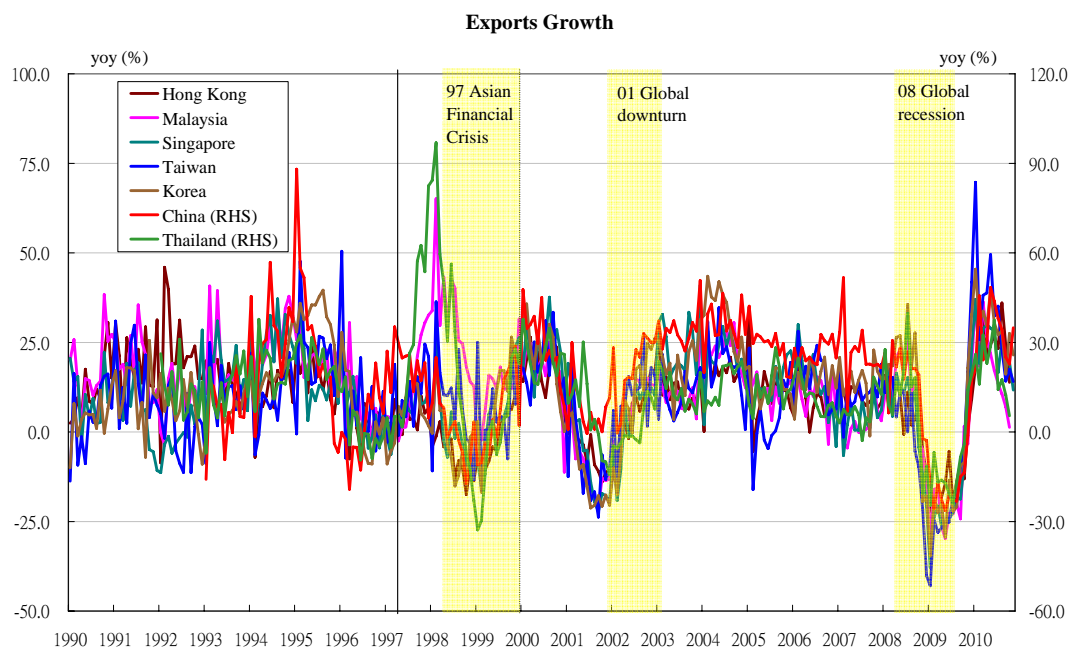
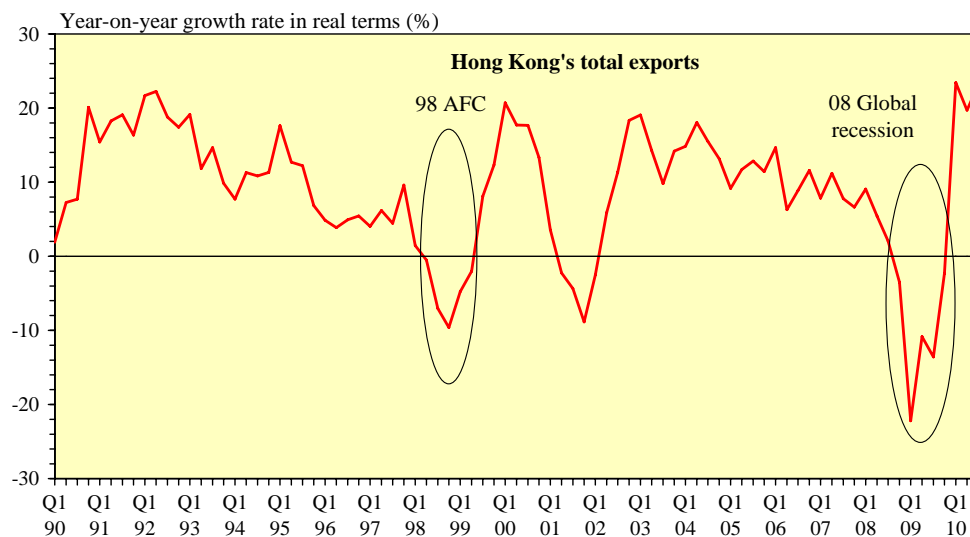


Chart 8 The fall in Hong Kong's exports was also much more drastic in 2008-09 than 1997-98



17. Hong Kong as an international financial centre also suffered severe shocks in financial markets along with the major overseas markets. **Chart 9** shows that all the major stock markets in the region experienced free-fall since the global financial tsunami began until early 2009. At one point during the period, Hang Seng Index plunged by over 40% from the level in mid-September 2008, at a scale similar to that experienced in the latter part of 1997 (**Chart 10**). The major stock markets also

have similar co-movements in the following period. These include the subsequent rebound from March 2009 towards the end of the year when the global economic recovery proceeded at a rather notable pace, and the gyrations over the course of 2010 due to changing market views on the pace of the global recovery and also the evolving sovereign debt issue in Europe.

Chart 9 All major stock markets in the region experienced free-fall from the beginning of the global financial tsunami until early 2009

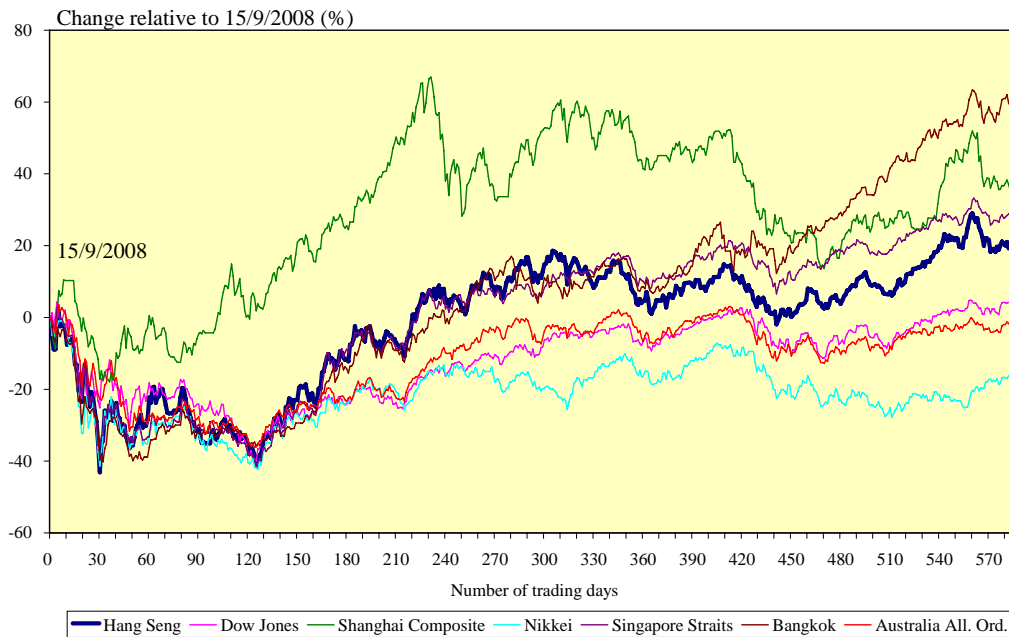
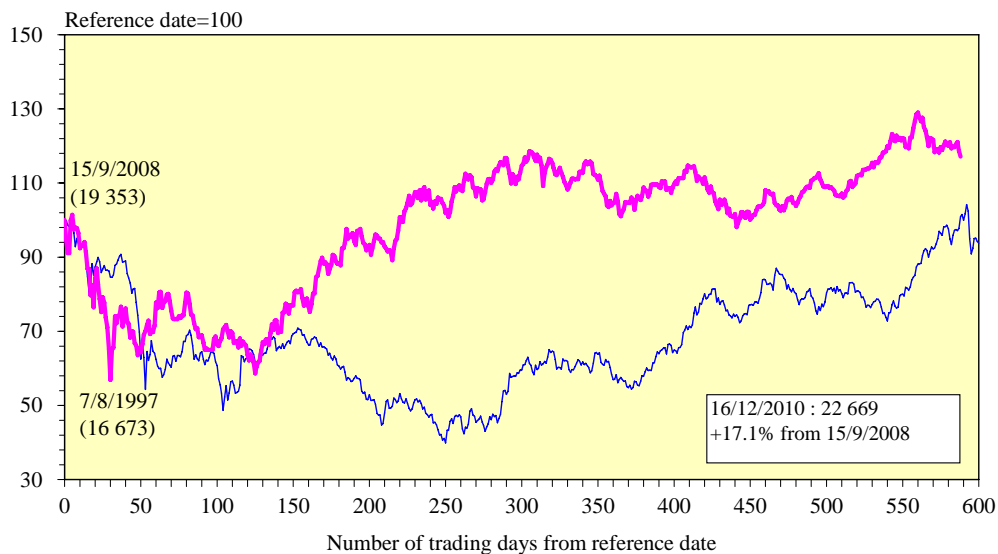


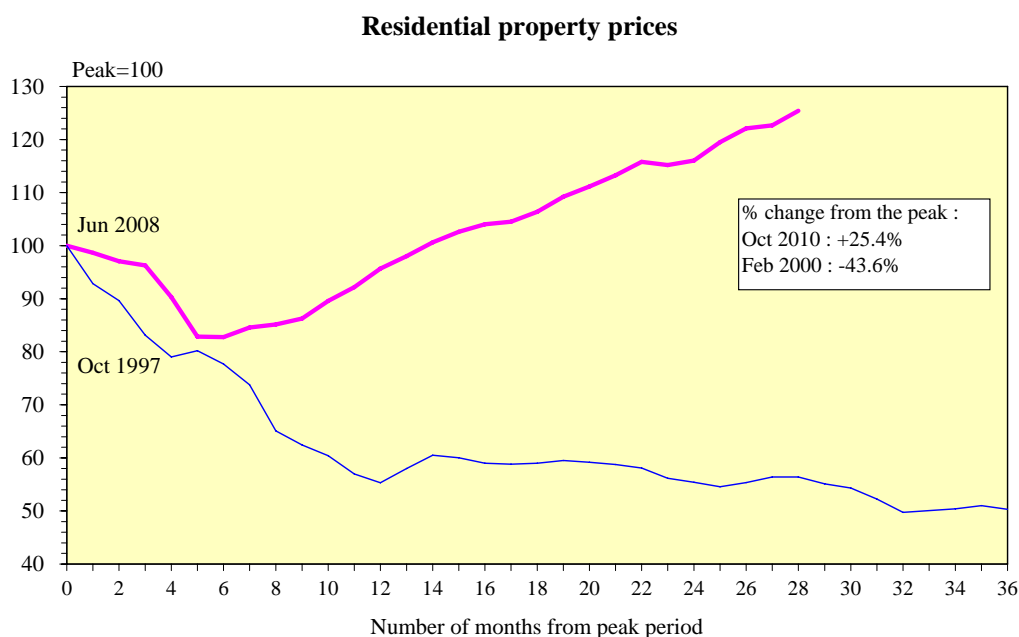
Chart 10 Hong Kong’s stock market fell sharply on both occasions yet also rebounded swiftly

Movements of Hang Seng Index



18. Hong Kong's property market, another major asset market, also plunged in the first few months of the 2008-09 global crisis, yet also staged a strong rebound since early 2009 (Chart 11). The latest available figures show that by October 2010, the overall flat prices were already 25% higher than the pre-crisis peak in mid-2008.

Chart 11 Hong Kong's housing market recovered faster in the 2008/09 GFT



19. Reflecting the stronger position of the household balance sheet, despite the more severe external environment this time round, consumer sentiment held firmer in 2008-09 than in 1997-98, with the decline in private consumption in the initial stage of the crisis being markedly smaller and the subsequent rebound being quicker and stronger. The stimulus and relief measures implemented by the Hong Kong SAR Government and the rapid recovery of the Mainland economy all lent support to consumer confidence.

Chart 12 With fewer job losses this time, consumer sentiment also held up better

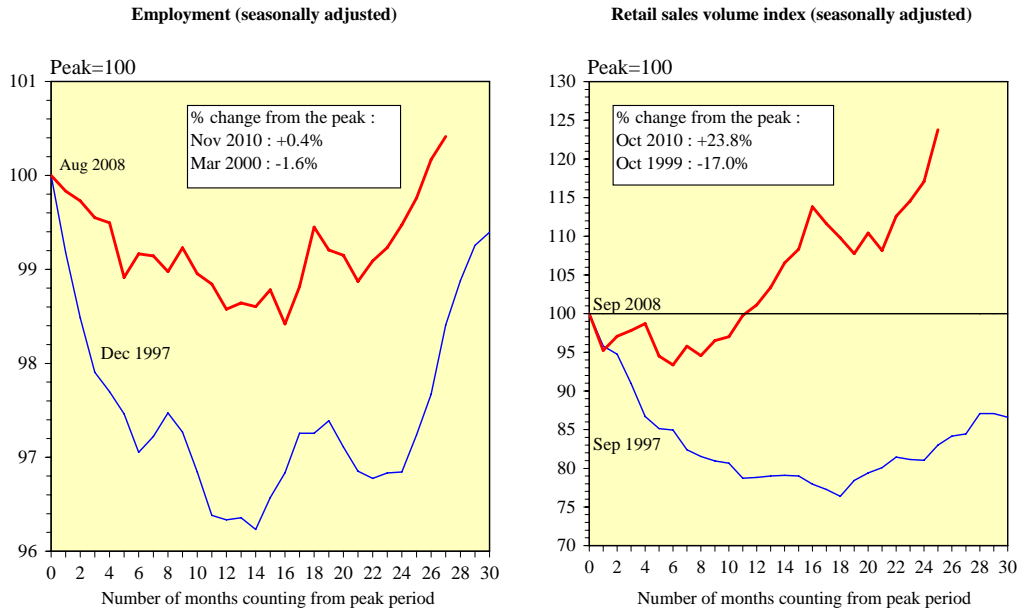
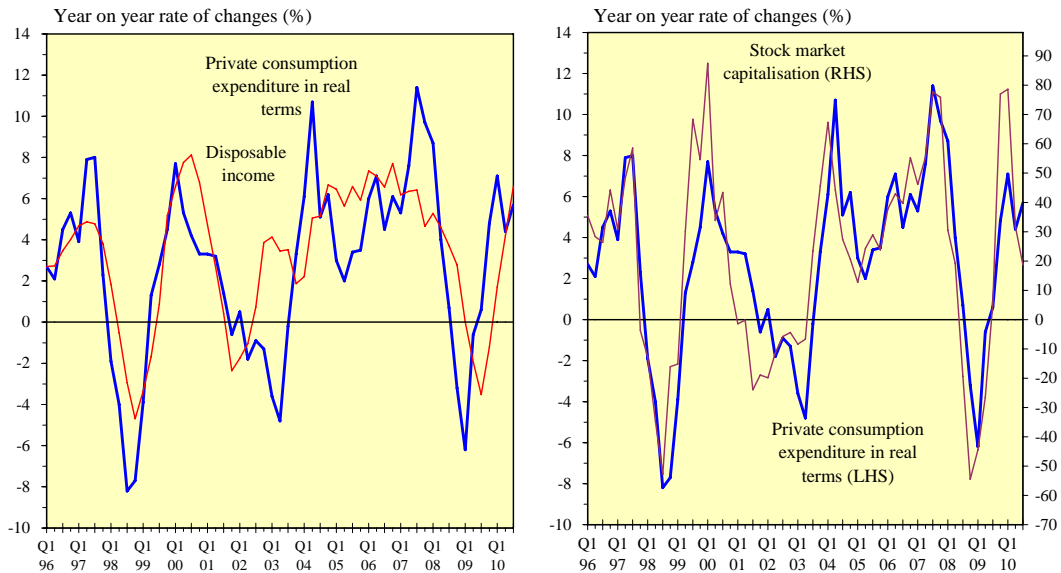


Chart 13 Income and wealth effects on private consumption have also been profound



20. Hong Kong’s labour market was likewise more resilient during the latest round of crisis in 2008-09, thanks to speedy adjustment in labour costs and work hours. The timely measures by the Hong Kong SAR Government under the strategy of “stabilising financial sector, supporting enterprises, preserving employment” have paid off. As a result, the extent of job loss in 2008-09 was much smaller than that

during the 1997-98 Asian Financial Crisis. With total employment resuming increase for six consecutive months lately, employment level finally surpassed the pre-crisis peak by November 2010. This was a stark contrast to the persistence of steep job losses during the 1997-98 Asian Financial Crisis and the immediate years that followed. This in turn led to better consumer sentiment this time (**Chart 12**), alongside other factors such as the income and wealth effects (**Chart 13**).

Macroeconomic fundamentals and sound financial architecture are key to resilience to external shocks

21. In general, Hong Kong has been much more resilient in countering the “Great Recession” of 2008-09 as compared to the Asian Financial Crisis, despite the more severe contraction in the world economy this time round. This has much to do with the stronger macroeconomic fundamentals and sound financial architecture that Hong Kong has built up over the past decade or so. The quick turnaround in the Mainland economy, which acted as a strong cushion to Hong Kong’s exports of both goods and services, was another key factor. **Chart 14** indicates that while the recovery was broad based, the pace of rebound varied amongst different components within GDP. The clear leader was exports of services, thanks to the strong growth in China visitors and the rapid bounce-back in Mainland-related IPO activities. Domestic sector was resilient, thanks to the sound macroeconomic fundamentals in the local economy. Consumption and investment had by now fully recovered and surpassed their pre-crisis levels. Exports of goods, which were severely hit in the 2008-09 Great Recession, continued to lag behind in the recovery, but were likewise back to the pre-crisis peak. Further analysis in **Chart 15** indicates that the main drag to export recovery was the sluggish demand in the United States and Europe markets, both of which were still notably below their pre-crisis peaks in 2008.

Chart 14 By 2010 Q2 GDP has surpassed its pre-crisis level

Seasonally adjusted

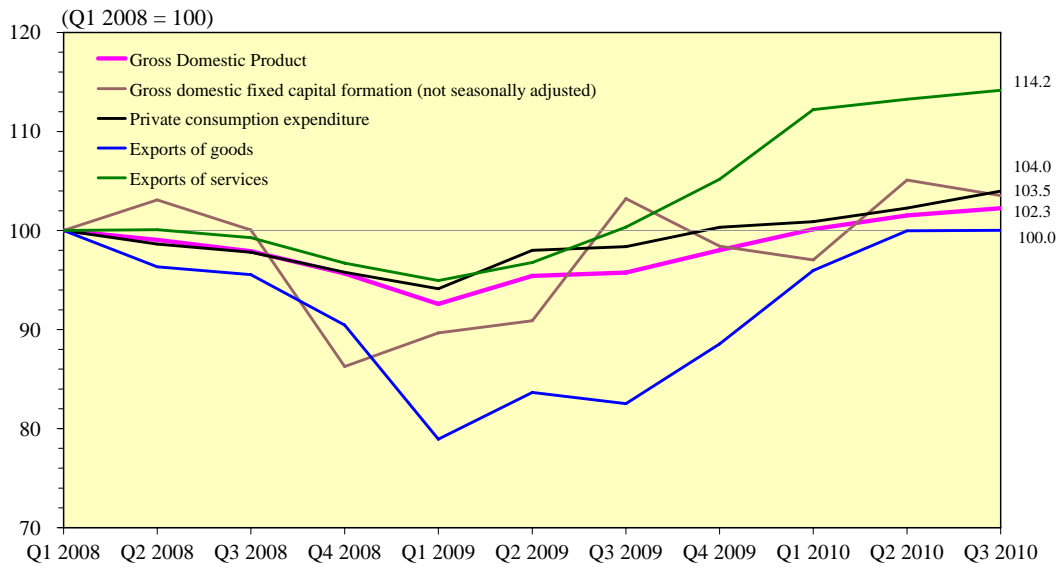
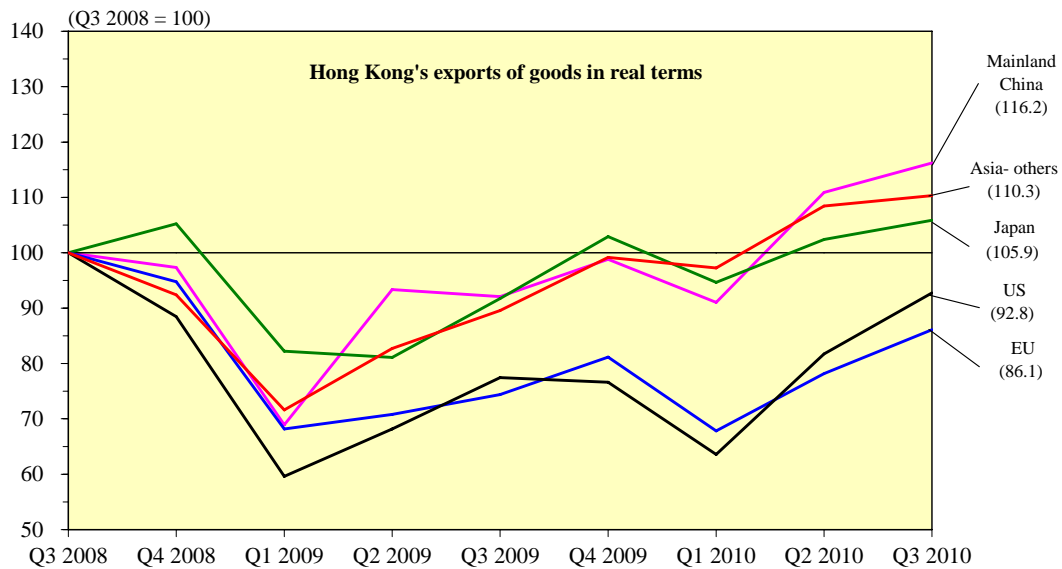


Chart 15 The weak US and Europe markets were the main drags on Hong Kong's export recovery



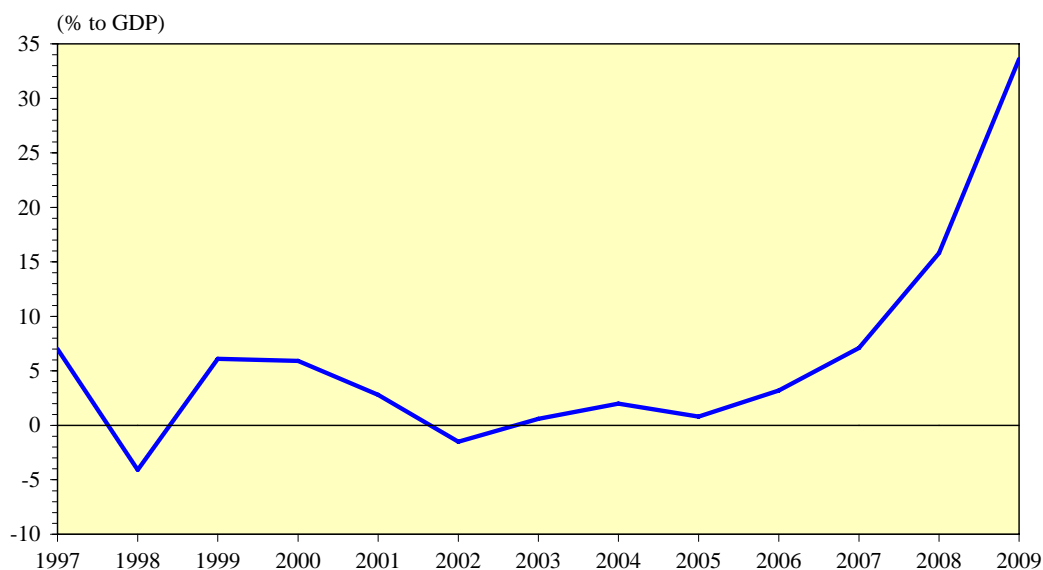
(i) *No sign of a big asset market bubble when the global financial crisis struck the HK economy in late 2008*

22. After the 1997-98 Asian Financial Crisis, economies in the Asian region have in general seen significant improvement in terms of macroeconomic fundamentals. Hong Kong is no exception. Locally, Hong Kong's costs and prices have gone through a long period of adjustment as part of the recovery process to restore strength and competitiveness in the aftermath of the bubble burst of the Asian Financial Crisis. Asset prices went through big gyrations between 1997 and 2003, but have generally adjusted well to the external shocks. When the sub-prime mortgage crisis broke out in the United States in 2007, many measures of asset market bubble were tamed as compared to the 1997-98 period.

(ii) *Significant improvements in external position after 1997 AFC*

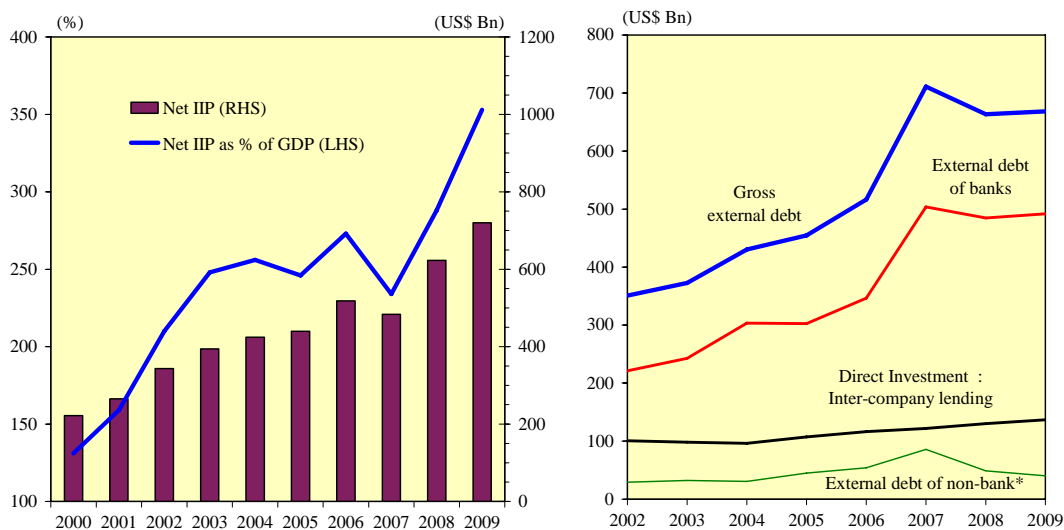
23. Hong Kong's external position has also improved significantly in the years since the 1997-98 Asian Financial Crisis. In terms of the Balance of Payment, Hong Kong has recorded sizable current account surplus every year since then, contributing significantly to a balance of payment surplus in almost every year since 1998, with the exception of 2002 in the aftermath of the dot-com bubble in the US (**Chart 16**). Hong Kong's net international investment position has also strengthened over the years as shown from the figures that can be traced back to 2000, with the size of the net position going on a general uptrend over the years. At end-2009, Hong Kong's net international investment position amounted to US\$744 billion, more than 3.5 times of the size of the economy (**Chart 17**). External debt position has also been sound over the years, with increase in size contributed mainly by the expansion in banking businesses in Hong Kong as well as that in direct investment. All these figures suggest that Hong Kong is not a leveraged economy and does not rely on external borrowing to finance its consumption and investment. As a result, when the global credit crunch swept through the entire world in the aftermath of the Lehman's collapse, Hong Kong was relatively unscathed. The private sector quickly repatriated capital from overseas and thus the extent of liquidity squeeze in Hong Kong was less than what many other economies in the world have experienced.

Chart 16 BoP remained in sizeable surplus in recent years



Note: BoP series start from the reference year of 1997.

Chart 17 Net International Investment Position (IIP) is very strong; Gross external debt position is sound

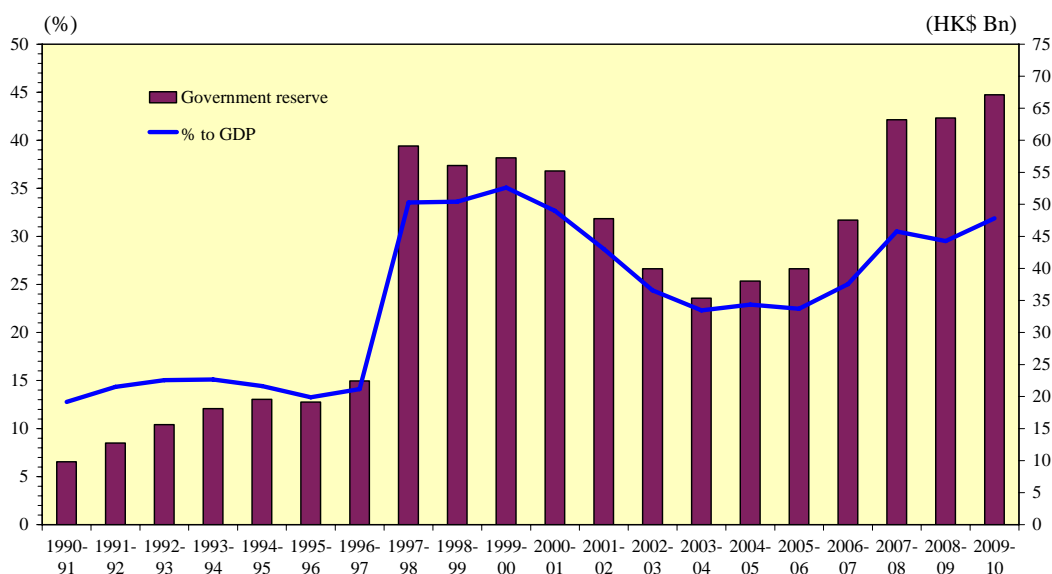


Note: * Non-bank refer to sectors that are not classified as Banks. Inter-company lending liabilities under a direct investment relationship are not included.

(iii) *Sizeable fiscal reserves enable the Government to put out massive stimulus package promptly*

24. In terms of public finance, thanks to fiscal vigilance all through the years, the size of reserve accumulated by the Government is large, equivalent to around 30% of GDP in recent years (**Chart 18**), and sufficient in meeting 21 months of the Government's expenditure.

Chart 18 Fiscal reserves are huge, thanks to fiscal vigilance



Note: In the fiscal year 1997-98, the Land Fund, amounted to around US\$25.3 billion, was subsumed into Government revenue.

25. The relatively small Government sector with fiscal discipline, together with the steady relative size of private consumption to the overall economy, means that Hong Kong does not have the problem of over-consumption that exists in many advanced economies.

Sound financial regulatory framework and banks' prudence in lending have helped Hong Kong ride through the global financial crisis

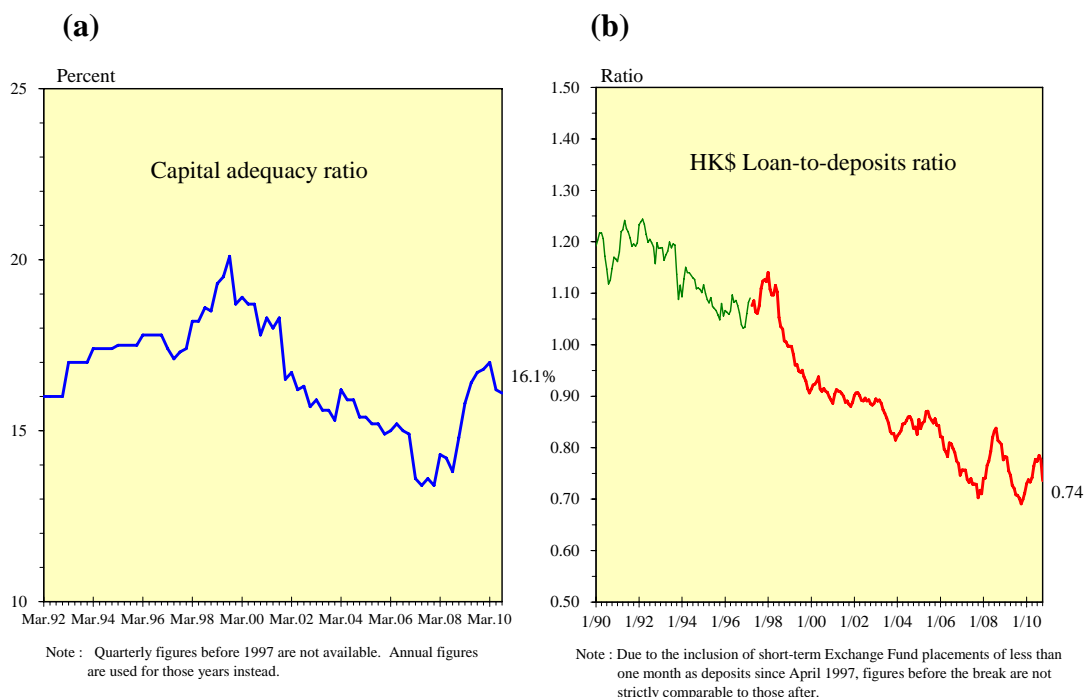
26. Hong Kong's financial architecture has gone through substantial reforms after the 1997 Asian Financial Crisis. A 30-Point Programme was announced in September 1998 to close the regulatory gaps in Hong Kong's stock and futures exchanges exposed during the crisis. The order and transparency of the securities

and futures market improved as a result. On the monetary front, seven technical measures were introduced, also in September 1998, to strengthen the currency board arrangements after the Government market incursion in August 1998. In March 1999, a three-pronged reform to the securities and futures market was launched to modernize and upgrade the market structure, market infrastructure and regulatory framework.

27. With these reform measures, the resilience of Hong Kong to speculative attacks and to external shocks on the financial front strengthened considerably through the years. Capital adequacy ratio (CAR) now stands at 16.1%, which is more than double the 8% level set by the Basel Committee of Banking Supervision's capital ratio standard (**Chart 19a**). The high capital adequacy ratio ensures that banking institutions have capitals to meet time liabilities and other risks, thereby maintaining confidence in the banking system. It is extremely helpful in reducing the likelihood of bank runs and other forms of capital flight in the time of crises.

28. The economy has also gone through a period of deleveraging in the years after the Asian Financial Crisis. Loans for use in Hong Kong at end-2009 was still 1% lower than end-2008, despite the nominal GDP year-on-year growth at 2.7% in the fourth quarter of 2009. Indeed, the massive capital inflow of around HK\$640 billion from the third quarter of 2008 towards the end of 2009 had not been accompanied by a substantial acceleration in credit growth, with credit growth being a key driver of excessive leveraging and a key source of asset market bubbles. While retail banks' loan portfolios showed a more notable growth over the course of 2010 as a result of increased demand for domestic loans, the loan-to-deposit ratio, which measures the relative size of loans made to deposits, actually showed a general decline since 1997 and remained lower at October 2010 than their pre-crisis level (**Chart 19b**).

Chart 19 Capital adequacy ratio consistently high; loan-to-deposit ratio still very healthy



29. The liquidity ratio of banks in Hong Kong is high. According to the figures available since 2003, liquidity ratio is persistently at around 40-50%, well above the 25% required by the Hong Kong Monetary Authority.

30. Indeed, in both the 1997-98 Asian Financial Crisis and the global financial crisis since 2007, Hong Kong's banking system was relatively unscathed. Not one bank needed government's bailout. During the global financial crisis, there has not been a moment when the stability of the financial system in Hong Kong was under undue stress. And indeed, in the aftermath of the global financial crisis, Hong Kong do not need to perform large-scale reform in the regulatory and supervisory regime in its financial system, in contrast to many other major financial markets that require substantial tightening over their regimes. This highlights the strength of Hong Kong's financial architecture, which in fact has helped Hong Kong ride through the global financial storms in relatively good shape. Sound financial regulatory framework and architecture are instrumental in underscoring the rapid growth of the financial sector over the past decade or so, enabling Hong Kong to emerge as the third largest international financial centre after London and New York.

Lessons learnt from the crises

31. The 1997-98 Asian Financial Crisis exposed a series of economic and financial weaknesses of many Asian economies at the macro level: asset bubble inflated by excessive liquidity, current account deficit fueled by excessive consumption and investment, weak fiscal position coupled with external borrowing, and weaknesses in financial infrastructure. The Asian economies have made significant progresses in bolstering their macroeconomic fundamentals and financial infrastructure over the years since then. In the case of Hong Kong where financial infrastructure has always been sound and fiscal prudence always been adhered to, the macroeconomic fundamentals have seen significant improvement over the past decade. All these have been achieved even in the midst of the greater degree of openness of the economy to the rest of the world. Instead, Hong Kong has embraced globalization more than ever, through increasing integration with the Mainland which were already closely knitted into global trade network and now increasingly integrated into the global financial system. This in turn propelled Hong Kong to move up the value chain and develop its role as an international financial, trading, and commercial centre.

32. The 2008-09 global financial tsunami triggered by the US sub-prime mortgage crisis has put the Asian economies to a severe test, because economic and financial inter-linkages at the macro level across the borders have all grown even further over the past decade. Although many Asian economies suffered severe contractions in the first quarter of 2009 at a scale not seen before, the recovery that came after also surprised many economists. In general, Asian economies have stood up to the severe test rather well, with the region as a whole at the leading position in the current round of global recovery. In the case of Hong Kong, one can confidently make a conclusion that the economy fared much better during the global financial tsunami than the 1997-98 Asian Financial Crisis, though the scale of the current crisis is global in nature.

Regional co-operation

33. The global financial turmoil clearly points to the inadequacy of the global

financial system, and it is all too clear that risks of disorderly adjustments are huge and these can cause great damage to the economy. What it transpires is the need for consensus in the international community to reform the global financial system and come up with new financial order to rebuild confidence. It calls for global concerted efforts, to strengthen prudential oversight of capital, liquidity and risk management and enhancing the authority's responsiveness to risks and ensuring robust arrangements to deal with stress in the financial system. Neither should we lose sight of the need to step up regional cooperation, if only to enhance the resilience of the region as a whole to the headwinds in the global financial arena.

34. In this regard, Hong Kong will continue to actively participate in the process of increasing regional and international financial co-operation. Hong Kong participates in the Plenary and all three Standing Committees of the Financial Stability Board, which has become a focal point of efforts to reform the international financial system. Hong Kong participated in the Chiang Mai Initiative Multilateralisation, the regional joint-defence mechanism that provides participating economies with contingent credit facilities. Separately, the Hong Kong Monetary Authority (HKMA) conducted analyses for the Monetary and Financial Stability Committee of the Executives' Meeting of East Asia and Pacific Central Banks (EMEAP) to assess the region's risk and vulnerabilities. The HKMA also chaired the EMEAP Working Group on Banking Supervision, which studied the reform package of the Basel Committee on Banking Supervisions (BCBS) and produced feedback to the BCBS. Meanwhile, with the tripartite working group between Hong Kong Monetary Authority, Bank Negara Malaysia and Monetary Authority of Singapore, a co-ordinated exit from the full deposit guarantee by the end of 2010 has been assured.

35. Hong Kong will also strive to further broaden the Renminbi (RMB) businesses conducted in the economy, to pave the way for Hong Kong to become the first offshore centre for RMB businesses. The RMB trade settlement pilot scheme has already commenced operation in July last year, covering trades between pilot cities in the Mainland and Hong Kong, Macau and ASEAN countries. As for RMB bonds, Hong Kong saw the launch of RMB bonds in June 2007. The plan was further expanded by the Central Government in 2009, to allow issuance of RMB

bonds by Hong Kong banks operating on the Mainland, as well as the issuance of RMB sovereign bonds in Hong Kong. Another pilot scheme was announced in August 2010, to allow eligible institutions outside the Mainland to invest in the Mainland's interbank bond market. All these underscore Hong Kong's role as the testing ground for the Mainland's financial reforms. Hong Kong will continue to be complementary with other cities in the Mainland (for example Shanghai which is already the largest and most advanced financial centre in the Mainland) to contribute to China's economic development and the internationalisation of the Mainland's financial market. With sustained notable growth in the Mainland economy, the existence of two international financial centres in China (i.e. Hong Kong and Shanghai) can only be a unique advantage of the country strategically.

Concluding remarks

36. The era of globalisation and financial integration has no doubt brought a lot of benefits, but one should be aware of its dark side because of all the risks and contagion globalisation brings about. Hong Kong is a forerunner and beneficiary of globalisation, and a staunch supporter of free market, free trade and liberalisation. This has not changed after Hong Kong suffered the severe recession in 1998. Neither has the current crisis altered our firm belief and philosophy. Indeed, the speed and the intensity to which the 2008 global financial turmoil have hit small, open economies like Hong Kong was beyond anybody's imagination. But the fact that HK's banking system was relatively unscathed in the global financial crisis reminds us of the importance of sound economic fundamentals and financial framework (viz. high savings ratio; no excessive leveraging; prudent bank practices; fiscal strength) to ensure resilience to external shocks when they come. While the regulatory system is fundamentally sound, Hong Kong will continue to seek further improvement in order to meet the latest international standards, in areas including but not limited to investor protection, "Basel III", and OTC derivatives market.

37. Another lesson that we have learned in the current crisis is that, in a globalised world, where financial markets of different economies are closely linked together, regulators need to pay close attention to the risks to make sure their system remains well regulated to withstand the shocks from elsewhere. Indeed, like many

Asian economies, Hong Kong is facing another daunting policy challenge, on how to deal with the imminent risk of asset market inflation and also the shocks when these funds reverse course at some point in time. Hong Kong is keenly aware of these risks. While our robust financial regulatory framework and strong market institutions will enable us to deal with the huge amount of funds that come in and go out each day, we have also been pursuing countervailing measures to contain the risk of asset market bubbles arising from the huge capital inflows. Equally important is that all the banks and other financial institutions need to exercise good risk management and are prudent in lending.

38. Hong Kong's robust financial regulatory framework and strong market institutions have enabled us to come out of the financial storms in relatively good shape. A sound financial framework (high CAR; and prudence in lending) is what makes Hong Kong resilient and we believe this golden rule applies universally, both for Asia and also for the advanced economies.

23 December 2010

References

Hong Kong SAR Government, Census and Statistics Department, 2010, "Hong Kong External Merchandise Trade", April 2010.

Hong Kong SAR Government, Census and Statistics Department, 2010, Hong Kong Monthly Digest of Statistics April 2010.

Hong Kong SAR Government, Census and Statistics Department, 2010, "External Debt Statistics", Hong Kong Annual Digest of Statistics 2009.

Hong Kong SAR Government, Census and Statistics Department, 2009, Balance of Payments Statistics of Hong Kong, Fourth Quarter 2008

Hong Kong Exchanges and Clearing Limited, "HKEx Fact Book 2009"

Hong Kong Exchanges and Clearing Limited, "Market Capitalisation of China-related Stocks (Main Board and GEM)"

Hong Kong Exchanges and Clearing Limited, "Equity Funds Rasied by China-related Companies (Main Board and GEM)"

Hong Kong Monetary Authority, "Financial Statistics Summary", Monthly Statistical Bulletin December 2008

Hong Kong Monetary Authority, "Financial Statistics Summary", Monthly Statistical Bulletin September 2009