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The Governance of the Hong Kong Monetary Authority (HKMA)

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Owing to shortage of time and other commitments, this statement of views will be in note form. I start by setting out the standard functions that a Monetary Authority or Central Bank will usually perform, and then go on to discuss specific governance issues.

1. MA (CB) Functions

There are three core functions that an MA (CB) will almost always play, and two ancillary functions that an MA (CB) will usually play in most countries.

a) Core Purpose 1 (CP1). Maintenance of Price Stability

This can be done either

(1) Directly, nowadays via inflation targeting, or

(2) Indirectly, via fixing the exchange rate via a Currency Board system.

The choice between (1) and (2) depends on such issues as:- size of relevant region, openness,

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flexibility of labour and goods markets, fiscal strength, financial stability. The choice is a major political decision, which was made in 1983, and has since then been (rightly) maintained by the executive of HK.

b) CP2. Financial Stability and Crisis Management

The maintenance of sufficient liquidity, whether to the market as a whole, via open market operations, or to individual banks via Lender of Last Resort is a core function of any MA/CB. In crises MA and government have to work together.

To maintain overall financial stability, MA/CB must be involved in the formulation and operation of financial regulations, whether, or not, it is also involved in financial supervision. MA/CB will normally also take the lead in issues relating to international financial affairs, e.g. relationships with International Financial Institutions such as IMF.

The payments system is a key element in the financial system. Since settlement is usually ultimately made via the transfer of balances at the MA/CB, oversight, maintenance and development of the payments' system, and indeed of clearing and settlement systems in all the financial markets is a key part of CP2; but it also leads on to CP3.

c) CP3. Supporting Financial Development

One of the main pillars of the HK economy is its role as an international financial centre, especially linking PRC with the rest of the world. In this, HK competes with Shanghai and

Singapore. The social benefit to HK of financial market development is greater than the private benefit, so development here needs a push from the public sector. HKMA provides the professional expertise for this, in conjunction with FS and CE, and has done so in many ways, e.g. improving payments mechanisms, HK re-mortgage institution, bond market development, and numerous other infrastructural initiatives.

Turning to the ancillary functions, the main ones are:-

a) Ancillary Function 1. Market Operator for Government

(1) Management of Reserves. Although the Treasury owns the reserves in UK and USA, it does not manage them, (108.9 is incorrect on this, as in several other comments on UK and USA). The overall strategy, including decisions to intervene, are set by Government and Treasury, but the actual market operations, the tactics, and day-to-day management are run by the professional FX market operators in MA/CB. It is an absolutely standard principal/agent, client/portfolio manager relationship, and is common amongst many MA/CB. The same is true for the portfolio management of the foreign exchange reserve holdings, EF in HK. Again in HK, as elsewhere, FS (and Treasury) set the strategy/overall parameters, and within those parameters MA/CB do the day-to-day tactical management.

(2) Management of debt issues. Again MA/CB usually do the market management of government debt, e.g. arranging new issues, redemptions, interventions to smooth market, within context of strategy/overall parameters agreed with national equivalents of FS and Treasury.

In both cases (i.e. Reserves and Debt) the government is the principal and can decide to do the operation itself. Thus in UK, after three centuries in which the Bank of England managed HMG debt, HMT decided to set up an independent Debt Management Office. But the standard procedure is to have the professional market operators in MA/CB act as agent.

b) AF2. Banking Supervision

In most countries this has been carried out by MA/CB. Recently the blurring of divisions between banks and other financial intermediaries has led many countries to centralise all financial supervision, (n.b. not regulation) in a single institution, (the comment about the FSA wanting to separate prudential supervision and conduct regulation in 108.12 is not at all clear and probably incorrect). The question whether such a single universal supervisory authority should be part of the MA/CB, (as in Singapore), or separate is hotly debated. Even if separate, such an authority needs to work extremely closely with MA/CB.

I have written on this separately in my paper on `The Organisational Structure of Banking Supervision', which is attached.

2. The Governance of MA/CBs

a) Goal Dependence, Operational Independence

The objectives that an MA/CB should be trying to achieve, i.e. the monetary regimes, overall strategy and parameters of policy, form a key part of macro-economic policy. As such they are for the executive to decide, subject to debate in, and consent of, the legislature. The MA/CB does what it is told by FS. It has, entirely properly, little or no `goal independence'.

It is now almost universally accepted that, once its objectives have been given to the MA/CB, it should have complete `operational independence' to carry them out. This is largely because the operations of the MA/CB will have large immediate economic effects, e.g. by varying interest rates, market intervention, authorising/renewing/closing individual banks. These will impact the direct political/economic situation for members of both the executive and legislature; unless prevented from doing so, they will then have incentives to interfere for their own short-term purposes in individual MA/CB decisions. This is known in the literature under the jargon phrase `time-inconsistency'.

This means that, once the objectives/strategy has been set, both the executive and the legislature should step back and let the professionals get on with the job, (operational independence), subject of course both to transparency and accountability, i.e. have they successfully carried out the strategy set for them?

In my view the best comparator to the MA/CB in this respect, is not so much the institutions set out in Parts 3-7, but the judiciary. When the government (executive and legislature) has set the relevant laws, it would clearly be wrong for them to interfere in the judiciary interpretation of such laws, or to threaten legal independence by budgetary pressures. I attach a current draft paper on this (which is still in process).

b) <u>Control of MA/CB expenditures</u>

An MA/CB cannot have the requisite operational independence so long as it can be denied, or threatened with the denial, of sufficient resources to carry out the objectives set for it. For this reason most MAs/CBs around the world are financed independently of the executive or legislature. [For a horror story of what can happen when the legislature tightens the purse strings, see R. De Krivoy, `Collapse: The Venezuelan Banking Crisis of 94'.[2]] The most common way to do so is for the MA/CB to draw down from the large seignorage revenues available whatever it reckons it needs to do the job at hand, and afterwards turn over the residue to the government, (e.g. Fed and, mostly, ESCB). In the UK the BoE hands over all seignorage to HMG, and is primarily financed through the interest income arising from deposits placed with it – for just this purpose – by the commercial banks, (incidentally 108.13 (b) is incorrect with respect to BoE). I would not myself recommend this latter route.

In so far as it is right to protect the MA/CB from budgetary pressures that may threaten its operational independence, how then is the community protected from the MA/CB expanding expenditures beyond whatever may be the optimal point? I must state that I was very surprised that no attempt was made in RP04/02-03 to compare the budgetary cost of various Central Banks with the size of their financial systems. It is extremely easy to do; my guess is that HK would seem one of the more parsimonious/economical on that scale. There are several Central Banks, notably in Continental Europe, and especially that they are now members of the ESCB, whose staff-size/expenditures/number of branches, do seem excessive to me. But HKMA is not in their league.

[2] (Washington, D.C.: G30, 2000).

More generally, the safe-guard for efficiency, e.g. at BoE, is provided by an internal, executive over-sight body. The `Court' at BoE; the relevant EFAC sub-committee. Such a body also needs to be accountable; and should be prepared to describe, and justify, to the legislature its own procedures for ensuring efficiency.

c) <u>Appointments</u>

The senior members of the MA/CB have to work closely with the executive. It is, therefore, not surprising that they are normally appointed by the executive. Whether, or not, the legislature should have the right to confirm, (or not), differs between countries. I myself would not support the ability of the legislature to veto appointments.

d) <u>Salary</u>

The salary of the Chairman of the Fed is ridiculously low. The non-pecuniary attractions of the job are such that you can still get a Greenspan/Volcker to do it, but it has serious disadvantages in other Fed jobs where the job glamour is less but comparability means that salaries also get pegged down. In my view the approach described in 108.16.(c) is a disadvantage, verging on disaster.

With comparable jobs in the financial industry being much better paid (than civil service rates), an MA/CB has to pay above civil service scales to retain good, trained staff.

e) <u>Central Bank Headquarters</u>

My understanding is that one initiating reason for this enquiry was a concern about the cost of HKMA's purchase of a building, and that Leg Co was not asked for its permission, (apologies if I am wrong). I have not been in HK for a few years, and I have not seen the building, nor do I know its cost.

That said, I regarded the prior situation in which HKMA rented a couple of floors in a commercially-owned tower block, as being demeaning to, and inappropriate for, an MA/CB in an important regional centre. Virtually all Central Banks, and including the 12 Federal Reserve banks in the USA, own huge, impressive buildings in the centre of their financial districts. Their market values must be enormous. In principle they could all sell their head offices and also move into rented accommodation. This idea would be unlikely to be viewed sympathetically. Once more it would have been reasonably easy to assess the current market value of MA/CB head-quarters buildings in comparable Central Banks elsewhere. I am again surprised that this was not done. I do not know what this would show, but I would be surprised if HKMA would turn out to be unduly sumptuous, (n.b. remember the scandal about EBRD).

3. The Legal Basis of HKMA

The question is raised (108.3 and .4) whether BO and EFO still provide a sufficient legal basis. Inevitably, and properly, an MA/CB develops and changes over time, along with the wider financial community, and as the executive adjusts its strategy and re-sets the goals for the MA/CB. As a result initial laws and ordinances do tend to become less appropriate and relevant as time passes.

Whether the time has come to update the legal basis for HKMA is, however, a much more difficult question. How far, if at all, do the dated ordinances hamper the efficient development of HKMA? Even if the answer is that they do to some extent, this has to be set against the costs in time and effort, (plus the common unintended consequences of any new legislation), of such an update.

I have no good advice to offer on this last matter.