HONG KONG MONETARY AUTHORITY
香港金融管理局

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# Exit strategies from temporary measures

*How to exit from temporary measures requires careful thought.*

It is never too early to talk about exit strategies from extraordinary actions taken during a financial crisis. As I have pointed out before, these extraordinary actions, while effective in ensuring financial stability under the unusual circumstances of a crisis, might introduce distortions that could undermine financial efficiency, introduce moral hazard and possibly erode financial discipline, at both the macro and micro levels. Yet in the heat of a financial crisis, the authorities probably cannot afford a lot of time to even think about the exit strategies.

Some extraordinary actions are easier to exit from than others. For example, it would not be difficult for us to exit from the five temporary liquidity measures introduced at the end of September last year. We did say at the time that these measures would be in place only for six months until the end of March this year so that individual banks would not become overly dependent on the specially arranged liquidity facilities and undesirable business behaviour would not be promoted. The review that we said we would conduct has now been completed and, subject to the necessary consultations, we will make an announcement before the end of the month, together with summary information on the extent to which the temporary facilities were used.

The 100% deposit guarantee is more complicated. Under the leadership of the Deposit Protection Board, we have started a review of the Deposit Protection Scheme. There will obviously be public consultation before amendments (including legislative amendments) to the Scheme characterised by the $100,000 protection limit are introduced. The intention, as I mentioned when the 100% deposit guarantee was introduced in October last year, is to have it replaced by a revised permanent scheme by the end of 2010. I hope the exit from this temporary guarantee will be a smooth one. We have been closely monitoring the deposit-taking activities of all authorised institutions (AIs), including how the deposits taken are being deployed and the risks AIs are taking. The aim is to minimise any distortions arising from the guarantee. The banks are aware of our concern and they have not been engaging in behaviour that could not be sustained beyond 2010. There is also a delicate international dimension to this subject, given that similar actions have been taken by other jurisdictions, and obviously there is a need for some form of international co-ordination.

I certainly hope that no bank in Hong Kong needs to use the Contingent Bank Capital Facility, so that we will not need to exit from something that we have never even got into. But the global financial crisis is far from over and banks might find it difficult or expensive to raise additional capital in the current market environment. We have been encouraging banks to adopt more conservative capital plans and I certainly hope that they will be in a position to get through this financial crisis without having to seek capital support from us.

At the macro monetary level, the exit from the easy monetary environment that we are now in is largely a matter for the market, given the rule-based nature of our monetary system. A reversal of the capital inflow that we have been experiencing would trigger this, although I still would rate this as something of low probability, which is good for Hong Kong, given the continuing rather sharp economic contraction. Whether a reversal of capital flows will happen depends a lot on market confidence in our Linked Exchange Rate system, which remains strong, as it has been for a long time. If the circumstances are such that we have a choice in determining the timing for a return to a rather more normal monetary environment, we have the tools for doing so within the Linked Exchange Rate system. That said, we currently have no intention of moving away from the easy monetary environment. While we have been issuing more Exchange Fund paper and it has had the effect of reducing the Aggregate Balance, the issuance is to meet strong market demand for high-quality liquid assets and is not expected to have a significant impact on liquidity conditions or interest rates. We will continue to monitor market developments closely and stand ready to take appropriate actions to maintain adequate liquidity within the system if necessary.

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