In Defense *of the* Hong Kong Dollar Peg

Which eventually will cease to exist.

BY CHI LO

While some countries have engaged in a "currency war" to eke out short-term growth, Hong Kong's currency peg has deprived it of the option of currency devaluation. Some even argue that Hong Kong lost out in the currency war. There is renewed doubt among analysts and politicians about the merits of the currency peg, since Hong Kong has developed into a service-based economy which in principle relies less on foreign trade and the usefulness of a fixed exchange rate. In Hong Kong, the peg has been blamed for causing asset bubbles and aggravating wealth inequality, inflation, and economic volatility.

These views ignore economic fundamentals. The endgame for the Hong Kong dollar is already in sight. It will vanish when the Chinese renminbi becomes fully convertible, though that will take many years. Between now and then, the peg is still Hong Kong's best option for maintaining systemic stability. With the peg likely to

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remain in force in the medium term, Hong Kong will continue to import the massive liquidity impact from the United States' unconventional liquidity measures. This will boost local asset price growth, all other things being equal, and contribute to economic growth.

THE HONG KONG DOLLAR AND THE CURRENCY WAR

Since the subprime crisis, the world economy has been struggling to emerge from the balance-sheet recession. The needed structural rebalancing efforts are painful to implement. Hence, many governments have resorted to the short-term painkiller of quantitative easing, which has manifested itself in currency depreciation to generate short-term growth.

However, it is impossible for everyone to devalue at the same time. So currencies take turns depreciating through rounds of quantitative easing. This amounts to what Brazilian Finance Minister Guido Mantega called "currency war," which is in fact "rotational currency depreciation." This is notable in the U.S. dollar-to-euro and Japanese yen-to-euro cross-rates. The yen has shown persistent strength against the dollar, but the Bank of Japan has started a "war" against the dollar since mid-December 2012 by increasing the pace of money printing in order to weaken the yen.

Hong Kong's currency peg with the U.S. dollar deprives it of the currency devaluation option. Hence, its growth impetus in the currency war. Consensus forecast in early 2013 had put Hong Kong's growth at 3.7 percent and 4.2 percent respectively for 2013 and 2014, the lowest non-crisis growth rate in Hong Kong's modern economic history.

Critics of the Hong Kong dollar peg blame it for causing a housing bubble and aggravating wealth inequality, inflation, and economic volatility. They also charge that Hong Kong's transformation to a service-based economy has made the peg redundant. However, scrapping the peg, as some have advocated, will only create chaos before the endgame for the Hong Kong dollar, which is already in sight. The Hong Kong dollar will vanish when the renminbi becomes fully convertible—the question is timing.

Blaming the peg for causing income inequality and the property bubble is myopic.

Hong Kong will not necessarily lose out in the currency war.

SCRAPPING THE PEG WON'T HELP

Scrapping the Hong Kong dollar peg will not necessarily solve the problems—high inflation, economic volatility, income inequality, and asset bubbles—that it is alleged to have caused. Hong Kong had bouts of high inflation in the 1980s and 1990s, but it also had prolonged periods of deflation and disinflation after the Asian crisis (Figure 1). With or without the currency peg, these cyclical price movements are always present, driven by underlying demand pressure which is highly correlated with external demand growth. The peg exaggerates the cyclical fluctuations.

While Hong Kong's GDP growth is more correlated with that of China than that of the United States since its reversion in July 1997, such correlation does not make a strong case for re-pegging the Hong Kong dollar to the renminbi. This is because the Hong Kong-China correlation (at 0.52) is not much stronger than the Hong Kong-U.S. correlation (at 0.43). Small open economies, such as Hong Kong, are vulnerable to external shocks causing high economic volatility, irrespective of their exchange rate systems. In fact, Hong Kong's economic volatility, as measured by GDP growth standard deviation, is not much different from that of its neighbors who do not have currency pegs. But at least the Hong Kong dollar peg serves to minimize foreign exchange risk and preserve systemic stability.

High economic volatility is a natural result of the peg because when the nominal exchange value is fixed, any shocks will cause real economic variables, such as income growth, to swing widely to allow the exchange rate to regain equilibrium. Hong Kong's flexible economy allows the peg to function properly.

Being a service-based economy does not mean that Hong Kong's currency peg has become redundant. The conventional wisdom is that services are not tradable, so a service-based economy is not as susceptible to external volatility as an export-based economy. By extension, the fixed exchange rate system to eliminate foreign exchange rate risk is irrelevant.

However, many services are tradable these days. Balance of payments data show that Hong Kong's services exports amount to over 40 percent of GDP. It also earns a large amount of overseas income each year, averaging almost 50 percent of GDP. Exports of services and incomes from abroad thus account for almost 90 percent of GDP. External volatility still has a significant impact on the Hong Kong economy even without the Hong Kong dollar peg.

Blaming the peg for causing income inequality and the property bubble is myopic. There are many other forces at work. Globalization and integration with the Chinese economy have led to structural economic changes in Hong Kong. Its economy has evolved from a manufacturing center in the 1980s to international trading in the 1990s, and then to servicing and global financing in the 2000s. This process has raised overall income but also re-distributed income across sectors and created wealth inequality.

Asset price inflation, notably in property, has aggravated this income inequality, with the wealthier groups being able to hedge against inflation through owning and selling assets (property), while the poorer non-asset-owner groups are seeing their real income and saving eroded. The currency peg is, however, not the sole factor causing housing price inflation. The real culprit is chronic demand-supply imbalance.

In the wake of the 1997–1998 Asian crisis, the Hong Kong government curtailed new housing supply for over a decade, presumably to prevent a precipitous price decline on the back of the recurring financial crises in the 2000s. This chronic housing supply shortage is the fundamental reason for the property price surge (Figure 2). In a nutshell, Hong Kong's economic problems are mostly exogenous and are not initiated by the currency peg.

RE-PEGGING TO WHAT?

There seems to be no better alternatives to the peg. Allowing the value of the currency to float freely would lead to a sharp rise in the Hong Kong dollar exchange rate due to Hong Kong's balance of payments surplus. That would surely hurt Hong Kong's small open economy.

The Hong Kong dollar will vanish when the Chinese renminbi becomes fully convertible.

The world economy has been struggling to emerge from the balance-sheet recession.

Re-pegging the Hong Kong dollar to the renminbi makes no sense at this time, as Hong Kong's economy is still functionally more integrated with the U.S. dollar areas, both in capital markets and international trade. The lack of well-developed renminbi derivatives means that there are no hedging tools for renminbi foreign exchange risk. Pegging to the renminbi would also require Hong Kong to be governed by China's monetary policy, clearly unsuitable due to Hong Kong's free market and the lack of market discipline in China's monetary policy.

Further, Hong Kong cannot use a non-convertible currency to back up its monetary base, which is fully convertible to the U.S. dollar. Linking to the offshore renminbi, as some analysts have recently advocated, is also implausible because under the currency board arrangement of the Hong Kong dollar peg, China's central bank would be required to fully back the Hong Kong dollar's monetary base by using the offshore renminbi in response to capital flows. This would amount to making the renminbi indirectly fully convertible through Hong Kong, which is not in Beijing's game plan.

Re-pegging the Hong Kong dollar to the U.S. dollar at a different level will only hurt the credibility of the peg and invite recurring speculative attacks by creating a one-way bet for currency speculators. Local interest rates would then become more volatile and more distorting for the investment environment. Similarly, re-pegging the Hong Kong dollar to the euro or a basket of currencies would suffer from the same credibility problem as re-pegging it at a different level to the U.S. dollar. It is also impractical. Pegging to the euro means that Hong Kong would inherit the European Central Bank's monetary policy. But the European Central Bank's inflexible policy stance may

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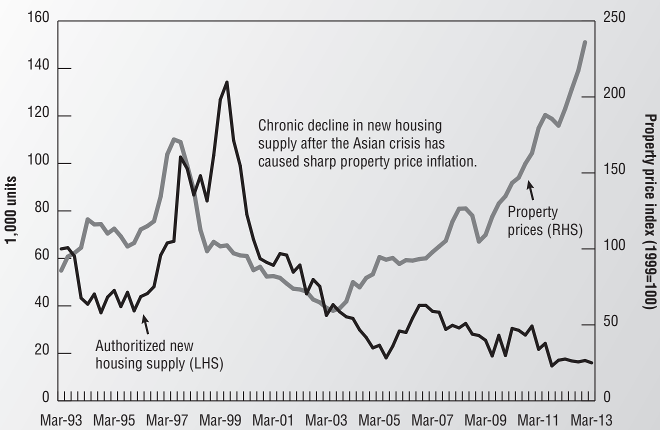
not suit Hong Kong's small open economy, which needs flexible policy responses to economic shocks. Relative to the European Central Bank, the U.S. Federal Reserve has a more flexible policy stance.

If the Hong Kong dollar were to be pegged to a basket of currencies and retain its hard currency status with high liquidity, it could only be pegged against fully convertible currencies. The potential candidates for inclusion in the basket would be the U.S. dollar, the euro, the Japanese yen, the British pound, the Canadian dollar, the Singapore dollar, the Australian dollar, the New Zealand dollar, the Swiss franc, the Norwegian krone, and the Swedish krona. But the inclusion of small currencies that are not used for global invoicing and have only weak trade links with Hong Kong makes little sense. That leaves the U.S. dollar, the euro, and the Japanese yen as realistic candidates. With the U.S. dollar still a dominant currency in Hong Kong's economic life, pegging the Hong Kong dollar to such a narrow currency basket would make little difference to pegging it against the U.S. dollar.

Figure 1 Hong Kong CPI Inflation

Sources: CEIC, BNPP IP Asia

Figure 2 Hong Kong Housing Supply Shortage



Sources: CEIC, BNPP IP Asia

THE BEST OPTION BEFORE THE ENDGAME

Hong Kong's small open economy is affected by many international forces, so it has a high growth-volatility tendency. Monetary autonomy can do little to counteract the large economic shocks inflicted by international cross-currents. Anchoring Hong Kong's exchange rate to the currency of a large, flexible, and relatively creditable economy remains a practical means of preserving confidence and reducing foreign exchange risk caused by external forces.

Nevertheless, the endgame for the Hong Kong dollar is already in sight. When the renminbi becomes fully convertible and backed by credible economic and policy fundamentals, the Hong Kong dollar will cease to exist. But it will take many years to get there. In the absence of a better alternative to the Hong Kong dollar-U.S. dollar currency peg, changing the *status quo* would only create chaos and not solve the problems. Hence, the peg is likely to stay in the medium-term.

From the asset market's perspective, all things being equal, the rigid Hong Kong dollar peg will generate significant liquidity spillover to the local system from the United States' quantitative easing policy. This will boost local asset prices and contribute to economic growth. There will be market volatility, but the macro liquidity environment will still be conducive to rising asset prices. Hong Kong will not necessarily lose out in the currency war. ◆