

# **ECONOMIC CHALLENGES, SHORT-TERM AND LONG-TERM**

**By Tony Latter**

The Hong Kong economy is being dragged down by the global crisis. Even the International Monetary Fund's forecast of 2% GDP growth for Hong Kong in 2009, made as recently as November, has begun to seem optimistic. And the prospect of stagnant activity and rising unemployment is certainly causing concern within Hong Kong.

Around the globe, monetary policy has been eased just about as much as it can be, and Hong Kong inherits the easy stance automatically, as a consequence of the Hong Kong dollar's peg to the US dollar. But, given the understandably cautious attitude of the world's battered banks towards new lending, and the evaporation of confidence among both consumers and businesses, there can be no guarantee that loose monetary policy will rekindle activity. In practice, progressive easing appears, if anything, to have driven people and firms yet further into their bunkers, with everyone waiting for someone else to set the economic ball rolling again.

It has become increasingly apparent that this 'someone else' has to be governments. There is little choice but to resort to fiscal stimulus, which means governments upping their own spending on services and capital projects, or cutting taxes in the hope that the private sector will spend more. In country after country, budgetary prudence has been cast to the wind; and rules and guidelines, previously designed to limit deficits or public debt, have been brushed aside, in a desperate attempt to reverse the economic slide.

Hong Kong is already moving in that direction too, with the announcement on 8 December of the acceleration of some spending plans, and a substantial expansion of the loan guarantee scheme for businesses (only a contingent liability for government at present, but an addition to public spending when guarantees are activated, as inevitably some will be). There will surely be some further fiscal easing, but for that we may have to wait until the financial secretary's budget speech on 25 February.

In one sense, Hong Kong is rather well placed to pursue a strategy of fiscal stimulus. It has a strong budgetary position, with the last available

official forecasts showing approximate balance this year and next, followed by rising surpluses. Of course, those forecasts may have been seriously invalidated by recent events, but the underlying position in Hong Kong is far better than in most other advanced economies. Moreover, in contrast to most other economies, where governments have built up huge debts, Hong Kong holds sizeable fiscal reserves, although, because about a quarter of these are invested in equities, the total will have fallen of late.

### Splurging Permitted—But with Caution

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But there is another side to the story, which suggests that Hong Kong may need to exercise considerable caution in any budget splurge. The Basic Law – the mini constitution that steers Hong Kong under Chinese sovereignty – decrees that Hong Kong shall:

“...strive to achieve a fiscal balance, avoid deficits and keep the budget commensurate with the growth rate of its gross domestic product”.

The language is not precise. For example, the government is only required to “strive” for balance. This has never been tested. It is generally presumed to allow flexibility over the economic cycle, though not indefinitely.

In addition to that formal requirement, the Hong Kong government has, over many decades, espoused a number of axioms of purported fiscal prudence, and has prided itself in adhering to them, other than on a few exceptional occasions. These are rules of thumb which, though lacking in rigorous economic justification, are of clear appeal to instincts of conservative finance and to those who consider it important to limit the scale of state involvement in the economy.

These axioms include the following:

- Not allowing a deficit on the government’s current account (as opposed to the capital account); this has meant, in particular, that revenue from land sales, which the government chooses to apportion to the capital account rather than the current account (a treatment which is itself contentious), cannot be put towards current spending, such as on social services.
- A strong aversion to government borrowing for budgetary purposes.

- A belief that the fiscal reserve should be held at a level which covers at least twelve months of government expenditure.
- A desire to keep government expenditure at or below 20% of gross domestic product.

Although the government's role in the economy may be more substantial than some of the statistics suggest – for instance, because some major infrastructural projects are financed in ways which escape the budget accounts – Hong Kong does, broadly speaking, merit its reputation for frugal public finances and relatively modest government involvement in the economy.

Instances where the Basic Law or the government's own guidelines have been broken, have generally been only temporary, at the lower points of the economic cycle, and more than compensated for at the higher points. However, there is always a fear that policy makers who relax fiscal policy in a downturn may find it hard to claw back later. There has not yet been such a failure in Hong Kong, but beware! Unless the global situation improves soon, the fiscal stimulus required in Hong Kong may be on an unprecedented and possibly prolonged scale. Moreover, the government's hitherto fairly sanguine view of the future – with re-emergent and growing budget surpluses – has been presaged on an assumption of long-term productivity growth which may be on the optimistic side for an economy as mature as Hong Kong's.

Indeed, looking beyond the immediate economic crisis, the ageing population (the proportion aged 65 and over is projected to rise from 12% today to 27% by 2033) and inevitable pressures for increased social spending, pose crucial challenges to the public finances in the medium to long term. These have been acknowledged by the government, but not resolved, other than by it reaffirming the wisdom of retaining a sizeable fiscal reserve.

### The Basic Law Barrier

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The Basic Law casts a huge shadow over any examination of these longer-term issues. If the government obeys the Law, and is therefore obliged to confine the growth of the budget to that of the economy, this sets a cap on the growth of spending; in that case, revenues will probably be amply sufficient to cover spending without having to resort to major new initiatives on the revenue side. But the cap on spending would in all

likelihood turn out to be a very contentious pressure point. Any plans to expand old-age payments or other social programmes, even if approved in principle and subject to broad political consensus, would quickly hit the Basic Law barrier.

Unless the Basic Law is to be amended, or flouted, the financial challenges of social policy in the medium to long term will have to be dealt with off-budget. It is most unlikely that citizens can be relied upon to save enough themselves, so some compulsion is needed. Mandatory provident funds have been a start, but they began too late, and even then they are on too modest a scale to build up really adequate funding for old age. Also, they have been severely shaken by the collapse in stock markets, given that the vast majority of fundholders opted for schemes with a predominantly equity content.

Something closer to Singapore's central provident fund might usefully be considered – higher contributions, an element of health insurance, and invested only to earn interest. Even then, these schemes are essentially individual saving accounts without any redistributive element. There would still be mounting claims on the budget to help those whose employment record (and hence contribution record to these essentially employment-based schemes) had, for one reason or another, been insufficient to enable them to accumulate enough to cover basic needs when in sickness or old age.

These longer-term fiscal challenges are as important as those posed by today's crisis. The government has shown itself to be good at identifying the likely problems, but less so at finding solutions.

There are also longer-term issues which will eventually have to be addressed in the realm of monetary policy.

For the moment there is no serious pressure, either from the markets or informed opinion, to depart from the currency board system, based on the US dollar, which has operated since 1983. Headlines along the lines of "Monetary Authority intervenes with massive purchases of US dollars to defend peg" are no more than journalistic attempts to sensationalise the mundane, possibly by those who do not anyway properly understand the system.

Let me elaborate. The Hong Kong Monetary Authority stands ready to buy US dollars from banks at an exchange rate of 7.75, or sell them to banks at 7.85. This is an absolute commitment under the HKMA's

declared currency board framework. Plainly, if the rate in the market begins to move outside these bounds, banks will find it advantageous to deal with the HKMA at these limit rates. It is not a question of the HKMA actively intervening; it is the banks which initiate the transactions, and the HKMA is the willing counterparty in the knowledge that this is a necessary and desirable part of the adjustment process. This process ensures that upward pressure on the currency will, beyond a certain point, result automatically in an increased supply of Hong Kong dollar liquidity, thereby putting downward pressure on interest rates and so relieving that upward pressure on the exchange rate; and vice versa in the case of downward pressure. The HKMA is not defending the peg; the peg is defending itself.

### Sound Money with No Politics Allowed

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A particular advantage of the currency board over other monetary systems is that, by delineating precise and automatic operating rules, it takes monetary policy out of politics. Some may balk at the subordination to the US Federal Reserve implicit in the choice of the US dollar for the peg, but many would agree that this is preferable to a situation in which, within Hong Kong's opaque policy-making machinery, the close-knit business interests which encircle the administration could get their hands on the levers that influence interest rates and the exchange rate. The great strength of Joseph Yam during his stewardship of the HKMA has been his apoliticism and single-minded commitment to sound money. The fear for when he eventually retires, is that his successor will be a more political creature, perhaps with insufficient understanding of monetary economics, who might be willing to bend to vested interests in Hong Kong, or even to make gestures of mistaken patriotism to Beijing in the shape a premature alliance to the renminbi (of which more later).

Looking back over the last 25 years, the Hong Kong economy has done pretty well overall. Although one could identify particular moments when alternative monetary action might have been helpful, it is not possible, in practice, to switch back and forth between regimes. No study has ever indicated that the economy would have performed better over the period as a whole under some other arrangement.

Hong Kong is more tolerant to the surrender of exchange rate sovereignty, such as the peg implies, than most other economies (witness the periodic grumbles within parts of the euro-zone). There are two reasons. First, Hong Kong enjoys a highly flexible labour market, both in terms of rates of pay in either direction, and the relative ease with which

labour can be shed. This means that the real exchange rate can adjust through shifts in the internal cost-price structure without demanding flexibility in the nominal exchange rate. Secondly, there is relatively little of the political hysteria over increases in interest rates that is seen elsewhere. Thus, the government and Monetary Authority can let the adjustment process run its course.

From time to time commentators have queried whether the US dollar is the right choice as anchor for the Hong Kong dollar. A basic requirement is that the anchor currency should itself be soundly managed. Although the Fed's tactics in recent years are now being subject to some searching criticism, it is by no means obvious that any other currency would have been a better choice for Hong Kong. A basket approach has sometimes been mooted as a compromise. But, although it would be technically possible to run a currency board on the basis of one Hong Kong dollar being backed by a basket comprising, say, three US cents plus three euro cents plus three yen plus  $\frac{1}{4}$  renminbi, it would be operationally messy (banks having to conduct any transaction with the HKMA in a parcel of currencies). Also, the Hong Kong dollar would never be stable against any single component currency, thereby impairing the visibility and transparency of the system.

### Not Time for the Renminbi

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A more prevalent question nowadays, however, is whether, in view the economy becoming increasingly integrated into that of mainland China, Hong Kong should peg to the renminbi, or indeed abandon its separate currency altogether in favour of the renminbi. The emphatic answer is no – or certainly not yet. There is still a huge gap between the two economies in terms of respective stages of development. This implies that the real exchange rate between the mainland and Hong Kong will need to continue to adjust significantly over time. Although it is entirely feasible for that to be achieved through differential rates of cost and price inflation, the process can certainly be assisted by allowing some continuing flexibility in the exchange rate of the Hong Kong dollar to the renminbi (which has already moved by some 20% over the past couple of years).

Another consideration is that it would not anyway, for the time being, be possible for a currency board mechanism to function, if based on the renminbi. That is because it is not a convertible currency, so that neither the banks nor the HKMA would be able to hold, on a freely transferable basis, the renminbi reserves needed to operate the system effectively. It

would anyway be advisable to wait until the mainland's monetary authorities had gained experience in managing a freely convertible currency – assuming that to be in prospect eventually – before deciding to throw Hong Kong's lot in with it.

The Basic Law provides explicitly for the Hong Kong dollar to be the currency of Hong Kong in the fifty year horizon of the Law (to 2047), and for Hong Kong to manage its monetary affairs on its own. There are no signs that anyone in Beijing wishes to override any of that, and it would be puzzling if anyone in Hong Kong wanted to rush to do so either.

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