

# SHOULD HONG KONG ABANDON ITS AMERICAN DOLLAR LINK?

By Tony Latter

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As the Chinese economy continues its remarkable growth, Hong Kong has become ever more intertwined with and dependent upon it. As a result, there are calls for Hong Kong to abandon its longstanding currency link to the American dollar, and replace it with similar ties to the strengthening Chinese yuan—even if more for "patriotic" reasons than economic ones. But would this be a good idea? Not for the moment. A look at two troubled economies elsewhere with fixed exchange rates helps sort out the key issues in this debate

California is in a currency union with the other 49 American states. It has been tottering on the edge of bankruptcy for years. There are perennial alarms over the budgetary situation, the political difficulties of resolving it, the impact on the banks of possible debt write-down or re-scheduling, and so on. Yet one reads little of any resultant drag on the overall American economy or of perilous consequences for the dollar, still less of any thought that California, which accounts for about 13% of the U.S. gross domestic product, might do better to exit the dollar and establish a separate currency.

Greece, which is a member of the euro zone currency union, accounts for little more than 2 ½% of the zone's gross domestic product. Yet its debt crisis is seen to be undermining economic prospects for the European Union as a whole, and to threaten the very future of the euro.

Greece, despite its lesser share of the union's output, attracts greater attention than California for a number of reasons. Its debt burden is larger relative to the size of its economy. Then there are other euro zone countries, such as Spain and Portugal, which, it is feared, are vulnerable to the same fate. And there are fears of exacerbating the banking crisis across Europe if claims on Greece have to be written off. Absent those last two considerations, there would certainly be a much stronger argument than is actually heard within Europe for leaving Greece to sort out its own problems – if necessary by going bankrupt, by exiting the euro (which it only succeeded in joining because it fiddled the qualification statistics) and re-adopting the drachma.

Perhaps the most significant contrast, however, between the Californian and Greek situations is that the former is part of a much more firmly established political federation, with a multitude of channels of mutual support, many of which can operate without having to create new financial mechanisms and without the much-publicised wrangling that surrounds European Union negotiations.

### **Greek Finances Are No Parallel**

What is the relevance of all this to Hong Kong? Hong Kong is – and has been for almost 28 years - in a sort of currency union with the United States, by virtue of strict adherence to pegging its dollar at 7.80 to the US dollar. Fortunately, however, Hong Kong enjoys extremely healthy public finances, so there is no parallel on that front to the troubles which beset Greece or California. That is just as well, since there are no close associates from which succour could be sought in the way that California draws on the goodwill of its federal colleagues or that Greece, more frenetically, begs from its European so-called partners.

On the other hand, the United States was never a very natural partner for Hong Kong in terms of economic convergence. Hong Kong could not have qualified to attach itself to the U.S. dollar in 1983 if it had been required to satisfy the sort of criteria that were later applied to Europeans wanting to join the euro. That the peg has nevertheless endured is a tribute to the flexibility of the Hong Kong economy in respect of costs and prices. Competitiveness has been able to adjust – in fact it has adjusted itself - without resorting to exchange rate adjustment, and has never become seriously misaligned. Compare that to the way in which Greece's competitiveness has suffered, as a result of the Greeks continually being far too generous to themselves in terms of salaries, pensions and public spending more generally.

Let us examine the Hong Kong case more closely. Since the 7.80 exchange rate peg was adopted, consumer price inflation has ranged from +13% to -6% per annum. This variability in the internal cost/price structure serves as a substitute for the adjustments in exchange rates on which other economies might depend. Just as important as the figures themselves is the fact that occasional high inflation appears to have been politically acceptable, or at least tolerable, because of faith (justified by the subsequent course of events) that the discipline of the peg will ensure that inflation does not become endemic. Equally important, at the other extreme, has been the ability of the economic system to generate effective reductions in wage costs – for most only temporary, although not obviously so at the time – without strikes and disruptions such as have cursed Greece's efforts to cut costs.

How closely the combination of the peg and internal flexibility has kept Hong Kong in external equilibrium is a moot point. Disciples of market economics would argue a priori that any departures from equilibrium in such a regime will be only transient. But factual proof is more elusive. The current account of the balance of payments is almost continuously in healthy surplus. Some might argue this to be prima facie evidence of an undervalued real exchange rate. Yet this is a classic structural feature of an *entrepot* economy where trading generates profits which are mainly invested abroad, not least because domestic investment opportunities in a small place are ultimately limited.

### **Hong Kong Becomes More Competitive**

Yet, largely as a result of the U.S. dollar's weakness (at least until the euro's recent decline) and the Chinese yuan's gradual revaluation against the American currency, Hong Kong's real exchange rate has indeed now sunk to a point which might be seen as giving Hong Kong an unfair competitive edge. Measuring the real exchange rate (as published by the Bank for International Settlements) as the trade-weighted nominal exchange rate index, adjusted for differences in consumer price inflation, Hong Kong is currently around one-third more competitive than it was ten years ago, although such comparisons must be treated with caution since, given swings of major currencies on world markets, they depend significantly on the precise choice of period.

This decline in the real exchange rate should not, however, be entirely surprising, since there is a tendency for mature economies (amongst which Hong Kong can nowadays be included) to experience a decline in their real exchange rates, as faster growing 'new' economies see theirs rise. China is an example of the new, where this process is already in train through a combination of rising internal price levels and appreciation, albeit somewhat reluctant, of the nominal exchange rate. It is inevitable that, as with other emerging economies before it, growing prosperity will gradually propel China's price level closer to parity with others.

Herein lies the nub of the debate about whether the Hong Kong dollar should be aligned to the yuan rather than the US dollar. One way or another, there is going to be some continuous narrowing of price disparities between Hong Kong and China over time. This will be achieved by some combination of relatively fast inflation on the mainland, relatively slow inflation (or deflation) in Hong Kong, or further exchange rate adjustment. One could well argue that, with Hong Kong priding itself in its flexible internal cost structures, it would be sufficient to fix the yuan/Hong Kong dollar bilateral exchange rate and let Hong Kong's price flexibility perform the adjustment to the extent that China's internal

inflation does not. Against that, however, one can argue that there is no point in potentially subjecting Hong Kong to deflation if, by leaving the present U.S. dollar exchange rate peg in place, prospective further appreciation of the yuan against the US dollar and hence the Hong Kong dollar will do the job. After all, the yuan has already appreciated by some 20% against the dollar over the past five years, and there is good reason to suppose that such a trend may continue.

### **China Needs a Track Record**

There are other, well-rehearsed arguments for Hong Kong not shifting over to a yuan peg. The fact that the yuan is not fully convertible rules out, on operational grounds, a simple switch from the formal currency-board system based on the US dollar, which Hong Kong follows, to one based on the yuan. Even if yuan convertibility were implemented, one might reasonably wish to wait for mainland authorities to establish a track record in conducting monetary policy in such an environment before binding to it.

All of the above considerations lean towards recommending against any change to Hong Kong's exchange rate arrangements in the near term. This is not to deny that, over time – but years rather than months – the balance may shift towards closer ties with the yuan.

Two further arguments are often floated as reasons for more immediate change. One, strongly voiced whenever the Hong Kong dollar is bumping up against its convertibility ceiling, is that the "market" plainly supports a formal revaluation and the market must be right. For those who have witnessed the self-proclaimed wisdom of markets in various spheres of finance over recent years, the flaw in that view needs no elaboration.

The other argument is that the massive inflows into the Hong Kong dollar at times of such bullish market sentiment are intrinsically damaging to the economy, and must therefore be curtailed by adjusting the exchange rate sooner rather than later.

However, for as long as those inflows lie idle in banks' reserves they do no damage, other than to depress interest rates and inflate monetary base statistics. The inflows only begin to produce a potentially negative economic impact if or when there is a resultant expansion of credit that eventually fuels inflation. To the extent that the impact is then broadly distributed, across all prices, it is part and parcel of a necessary underlying adjustment of the real exchange rate. As noted above, such bursts of inflation tend to be short-lived and are tolerable.

### **Tighten Controls Rather than Delink the Dollar**

The greater concern arises if the surge of credit then fuels asset prices disproportionately. This has always been an anxiety for the Hong Kong administration, particularly in the context of property prices. But the concern is more related to the implications for banks, should they overstretch themselves in a bubble situation, than to property prices per se, especially if, as has been so in recent times, the upward pressure occurs more at the luxury end than in the mass market. The usual remedy for the worry about consequences for banks has been to tighten supervisory control over the banks to ensure prudent behaviour, rather than to re-orientate exchange rate policy. This seems to be a sensible choice.

This article has come a long way from its opening references to California and Greece. But they are relevant, if only to emphasise differences. Hong Kong is unique: the currency is pegged to another with which it has little or no natural affinity; the economy possesses an unusually high degree of price/cost flexibility; it has no public sector debt problems whatsoever; and it is heavily dependent economically on a neighbouring economy relative to which there are still huge structural disparities – a situation which will require continuous adjustment of the bilateral real exchange rate. Any attempt to prescribe policies for Hong Kong by simply transcribing them from somewhere else in the world that has experience of fixed exchange rates or currency union will almost certainly be doomed to failure.

Many years ago, when I was engaged as part of an international team to provide economic advice to what, in today's parlance, would be described as a failed state, many a recommendation made to that country's officials was politely ignored or rejected: "You do not understand; it would not work here; we are different". That country remains largely a failed state today. Economists with their own clever ideas for monetary policy in Hong Kong may receive a similar response. But in this case the local officials would be correct; Hong Kong is indeed different. But the difference works. Hong Kong is no failed state.

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