FINANCIAL REFORM AND ECONOMIC RECOVERY: HONG KONG

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1. The Linked Exchange Rate in Transition

For a small, open economy a linked exchange rate system under currency board arrangement (which should be different from a fixed exchange rate regime) is a second best, if not a first best, choice for promoting growth and maintaining stability. But over the years since October 1983 when Hong Kong introduced such a system, it has violated the orthodox currency board system's reliance on the intrinsic self-restoring mechanism. This caused confusion between the linked and fixed exchange rate systems and raised suspicions over the authority's commitment to maintaining the regime or the pegged level, despite the fact that Hong Kong's currency is supported by well in excess of 100-percent foreign reserves.

Specifically, the supposedly intrinsic "cash arbitrage" could not function properly in large part due to high transaction costs. Following the reform of February 1994, such arbitrage was restricted to the three note-issuing banks (NIBs) only; non-note-issuing banks were allowed to obtain bank notes from NIBs at the market, rather than the pegged, exchange rate. In addition, the HKMA (Hong Kong Monetary Authority) tended to intervene consistently at the level of HK$7.75 /US$ to support the Hong Kong dollar and to rely solely on high interest rates, by squeezing interbank liquidity, to attract capital inflows to defend the peg from speculative attacks. However, high interest rates did not induce the anticipated capital inflows to support the currency, perhaps because of the high risk premium needed to hold Hong Kong dollars and the expectation of exchange rate depreciation. Instead, the high and volatile interest rates caused significant disruptions in the stock and property markets and a slowdown in economic activity.

The increasing linkages and sophistication among foreign exchange markets, interest rate movements, and equity and futures markets have made defense of the peg more difficult and the impacts of currency speculation more disruptive than expected. In particular, by heavily short-selling the Hong Kong dollar which pushed interest rates higher, speculators were able to take profits from their short positions in the HK-dollar forward, futures, or equity markets. The decision in October 1997 to impose punitive interest rates on financial institutions repeatedly using the LAF (Liquidity Adjustment Facilities) caused further chaos and uncertainty in the money market, resulting in more volatile interbank interest rate movements and financial dis-intermediation.

The HKMA has gradually acquired more central banking functions in addition to those of a simple currency board, including managing government reserves and funds, issuing securities, supervising financial institutions, influencing interest rates, and, more recently, intervening in the stock and futures exchange markets. This might have created the expectation, at least among speculators, that like a typical central bank the Authority would use its discretion and abandon the pegged exchange regime or devalue, particularly when persistent speculative attack makes defending the peg excessively costly. In addition, the integration of global financial markets and the rapid growth of aggressive portfolio capital flows, combined with the expansion and increasing sophistication of derivatives trading, have made it increasingly difficult for the conventional currency board design to tackle speculative attacks while containing short-term interest rate volatility. Furthermore, there is a mismatch of long-term and short-term financing in part due to the underdevelopment of the Hong Kong-dollar debt market. In particular, most long-term financing such as mortgage loans is funded by short-term bank deposits, making it difficult to cushion the longer-term financing market and the real economy from short-term interest rate volatility.

2. Financial Reform to Restore Monetary and Macroeconomic Stability

Hong Kong experienced repeated speculative currency attacks and excessive volatility in money, equity, and futures markets. Most notably, in August 1998 speculators launched a full-scale attack on the Hong Kong dollar and the stock and futures markets and the HKMA made a desperate attempt to intervene in these markets. Speculators had allegedly accumulated huge short positions in the futures market before selling around US$4 billion in the spot market. (They had borrowed these funds from international organizations that had raised Hong Kong-dollar debt in Hong Kong). They aimed to push interest rates up while shorting in the Hong Kong-dollar forward and equity markets (particularly constituent shares of the Hang Seng Stock Index to push the futures index down further). The HKMA resorted to intervention in the foreign exchange spot, futures, and equity markets to counteract the actions of the speculators and prevent ultimate financial disaster and collapse of the peg. During the intervention, it purchased around HK$120 billion of constituent shares, most in the last two days before the settlement of the August futures contract, and about 50,000 futures contracts for August.

In view of the increasing aggressiveness, severity, and persistence of speculative attacks, and the ineffectiveness of the existing defense mechanism for the linked exchange rate regime, in September 1998 the HKMA introduced a package of measures to modify the linked exchange rate arrangement. All licensed banks were allowed to convert the Hong Kong dollars in their clearing accounts with the Exchange Fund into US dollars at a fixed exchange rate. (Before this, only legal tender in circulation was guaranteed convertibility.) They were also allowed to use their holdings of Exchange Fund papers as collateral for repurchase agreements to obtain repeated overnight liquidity from the discount window (formerly the Liquidity Adjustment Facility) at the base rate (previously the offer rate). Banks were restricted to using only Exchange Fund Papers and existing eligible papers to obtain overnight liquidity from the LAF. In addition, new Exchange Fund papers could only be issued against the inflow of funds. This was to help ensure that additional papers issued were fully backed by foreign reserves. The HKMA started to publish daily information on its foreign currency assets and the monetary base, including bank notes and coins issued and the interbank balance, and Exchange Fund papers outstanding.

These measures are primarily intended to enhance the self-restoring "cash arbitrage" of the currency board by extending it to "reserve currency arbitrage" and to increase the availability and accessibility (with certainty) of interbank liquidity to reduce interest rate volatility caused by the conjunction of currency attack and market manipulation. The new measure on the issuing of Exchange Fund papers should also help to reinforce the currency board discipline by requiring the whole monetary base to be fully backed by foreign reserves.

3. Economic Recovery in 1999?

The short-term measures to stimulate the economy are largely fiscal—government spending on infrastructure and tax rebates. Long-term solutions include promotion of the tourist industry and technology-intensive services and industries. The Science Park is now underway, an Applied Science and Technology Research Institute is under planning, and a Cyberport is to be established. But in the end, Hong Kong's economic recovery is determined by (1) the automatic internal price-wage adjustment because operating costs have been too high, and by (2) the pace of economic recovery in the neighboring countries and the continuing economic robustness of mainland China. In the long run, whether Hong Kong can map out a new course of economic development in high-tech services and production hinges on development of human resources.

The automatic mechanism of price-wage adjustment has been functioning in the short term, as in past recessions. Property prices have fallen by 40-50 percent and commercial rentals are now effectively only 25 percent of their peak. Salaries and wages have been adjusting, although more slowly. Consumption and investment desires are still low, but they are expected to pick up somewhat later in 1999. China's 7 to 8 percent growth rate projected for the coming two years is also a help to Hong Kong's economy. Hong Kong's economic recovery is expected to begin towards the end of 1999. While many investment houses are extremely pessimistic, still forecasting 0 to 4 percent growth, the government is predicting a positive 0.5 percent for 1999. My conjecture is that Hong Kong's economic growth in 1999 will probably surprise many. I am predicting a 2 percent growth, partly because of improvements in internal economic fundamentals and in the external economic environment, and partly because of statistical effects (the dramatic fall in GDP in 1998 means a very low base for the 1999 benchmark). At 6 percent unemployment will remain a problem for some time. Downsizing and restructuring should in any case be undertaken for economic recovery to be sustainable. This is what happened in the

United State s in the early 1990s.

Table 1: Growth in Real GDP and its Components, 1991-98 (percent)

	GDP	Private Consump-tion	Gov't Consump-tion	Gross Domestic Fixed Capital Formation	Exports of Goods	Imports of Goods	Exports of Services	Imports of Services
1991	5.1	8.6	7.7	9.3	17.3	19.0	4.7	11.3
1992	6.3	8.5	7.2	9.2	19.8	22.2	10.6	9.7
1993	6.1	7.5	2.2	3.7	13.5	12.7	8.0	5.8
1994	5.4	6.7	3.9	15.7	10.4	14.0	6.5	8.8
1995	3.9	1.6	3.2	10.7	12.0	13.8	4.8	2.1
1996	4.6	4.7	4.0	10.8	4.8	4.3	8.5	2.5
1997	5.3	6.7	2.4	15.6	6.1	7.2	-0.6	4.3
1998	-5. 1	-6.8	0.7	-6.1	-4.3	-7.2	-6.7	-0.7
1997 Q1	5.7	4.5	4.6	19.7	4.0	6.4	-0.1	1.7
Q2	6.9	8.6	5.6	15.8	6.2	6.9	-3.3	-3.2
Q3	6.1	11.1	-0.1	13.7	4.4	7.1	-11.1	1.8
Q4	2.8	2.9	-0.4	13.7	9.6	8.2	-11.7	0.7
1998 Q1	-2.6	-2.6	2.1	-1.2	1.4	-1.7	-6.7	2.5
Q2	-5.1	-5.1	-5.3	5.6	-0.5	-1.8	-8.7	3.5
Q3	-7.1	-10.0	3.7	-9.1	-7.0	-10.5	-1.0	-0.8
Q4	-5.7	-9.3	2.5	-18.7	-9.6	-13.5	-1.1	-2.7

Source: Hong Kong Census and Statistics Department, *Hong Kong Monthly Digest of Statistics*, various issues.