

# The Interplay of the “China Factor” and US Dollar Peg in the Hong Kong Economy\*

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**ABSTRACT** This article examines the significance of the “China factor” in maintaining economic stability and growth in Hong Kong, relative to the role played by the “US dollar peg” exchange rate regime that has been in place since 1983. It shows how, by virtue of the peg, Hong Kong was made subservient to US monetary policy, and how unsynchronized business cycle with the US resulted in spiralling wage and land costs to trigger a mass exodus of Hong Kong’s manufacturers across the border to China. The article analyses in detail to what extent the economic base of Hong Kong’s export industries has been expanded as a result of the relocation; and measures, in particular, by how much the cost-savings has helped to lower Hong Kong’s overall export costs and thus enhance the viability of the peg that is so crucial to such a small and entirely open economy. The analysis extends through the Asian financial crisis and beyond, examining how the peg has fuelled deflation but the “China factor” may have helped mitigate it. Important questions are raised about the peg in light of the disastrous consequences of the Asian financial crisis for some Asian economies, and the concomitant search for a more viable exchange rate regime. It concludes that despite the increased integration of the Hong Kong and mainland China economies, the likelihood of the Hong Kong dollar being de-pegged from the US dollar and re-pegged to the Chinese currency is yet remote.

The Hong Kong dollar was pegged to the US dollar at the rate of HK\$7.8 in October 1983. Not long afterwards, commencing in April 1984, China made a decisive move to court more foreign investment by opening 14 cities along the eastern seaboard.<sup>1</sup> Launched with entirely different objectives, these two important policy measures have nevertheless jointly and profoundly affected the performance of the Hong Kong economy over the past two decades.

The dollar peg, aimed at stabilizing the Hong Kong currency following the severe loss of investor confidence resulting from the deadlock in the Sino-British negotiations over the future of Hong Kong,<sup>2</sup> immediately deprived the Hong Kong government of monetary policy flexibility in countering cyclical economic movement, and actually contributed to

\* We are indebted to Dr Elspeth Thomson for making the article more readable.

1. The move was preceded by the establishment in 1979/80 of the four Special Economic Zones (SEZs) in Guangdong and Fujian provinces. However, while SEZs were little different from the small export-processing zones established in many other countries, the April 1984 opening of 14 major coastal cities represented the most significant initial step in the opening of the entire country for foreign investment and trade. It was followed, only four years later in early 1988, by the even more spectacular opening of eleven coastal provinces, comprising a total of 288 “opened” municipalities and counties (*xian*); and subsequently by the even more strategic decision, made by Deng Xiaoping himself after his celebrated “South China tour” in early 1992, to open up China further not only in geographic terms but institutionally as well. For a detailed study of this opening process, see Y.Y. Kueh, “Foreign investment and economic change in China,” in Robert Ash and Y.Y. Kueh (eds.), *The Chinese Economy under Deng Xiaoping* (Oxford: Clarendon Press, 1997), pp. 159–216.

2. On 23 and 24 September 1983 the value of the Hong Kong dollar plummeted by some 15% to as low as HK\$9.5 per US dollar amidst massive selling. It had been around HK\$5.6 to the US dollar.

increased economic instability. However, export-manufacturers were permitted to relocate to the Chinese hinterland to take advantage of the “open-door” policy, and thereby avoid the pressures of spiralling wage and land costs. Crucial to a small, entirely open economy as Hong Kong’s, they were able to remain competitive and the integrity of the peg was upheld.

The goal of this article is to study the interplay between the so-called “China factor” and the dollar peg in Hong Kong in the run up to the 1997 “handover,” through the Asian financial crisis and beyond. The first sections describe the general changes in the economy following the adoption of the peg, and the factors precipitating the complete migration of Hong Kong’s manufacturing industries across the border to China. This is followed by a detailed analysis of how the manufacturers’ exodus helped to expand the economic base of Hong Kong’s export industries on the one hand, while keeping Hong Kong’s exports internationally competitive on the other, despite a bout of accelerated domestic inflation caused by the peg before 1997/1998. It extends to the present, examining how the peg has fuelled deflation but the “China factor” may have helped mitigate it.

Important questions are raised about the peg in light of the disastrous consequences of the Asian financial crisis for some Asian economies, and the concomitant search for a more viable exchange rate regime. The article concludes that despite the increased integration of the Hong Kong and mainland China economies, the likelihood of the Hong Kong dollar being de-pegged from the US dollar and re-pegged to the Chinese currency is yet remote.

### *Economic Instability Under the US Dollar Peg*

The major features of the US dollar peg as adopted in Hong Kong are familiar, but they should be briefly outlined to provide a proper framework for understanding the subsequent economic changes in Hong Kong. In essence, the dollar peg resembles the currency board arrangement. It is a “hard currency” system which requires the issuing of the domestic currency to be fully supported by the holding of US dollar reserves. Whilst the rate of HK\$7.8 per US dollar has been fixed for the issuing and redemption of the Hong Kong currency, the exchange rate of the Hong Kong dollar is nevertheless freely determined in the foreign exchange market. The desired exchange rate stability is to be maintained through a self-restoring mechanism in the form of “cash” and “interest rate” arbitrage.<sup>3</sup> The primary and only monetary policy objective is to

3. “Cash arbitrage” occurs when a financial institution takes advantage of the widening differential between the free market exchange rate and the official parity. For example, when the market rate against the US dollar is under devaluation pressure, commercial banks will obtain US dollars from the Hong Kong Monetary Authority (through the note-issuing banks) and sell them on the foreign exchange market. This process will continue until the differential narrows to cover the cost of arbitrage only. It helps to contain the market exchange rate within a narrow range around the linked level. “Interest rate arbitrage” takes place when interest rate differentials cause capital to move to a country where there is a higher interest rate. If Hong

help stabilize any exchange rate fluctuations. A country operating such a currency board should normally enjoy a lower and more stable inflation rate, as a result of the more prudent monetary and fiscal disciplines imposed by the system.

A stable exchange rate is indeed considered crucial for Hong Kong, a small and entirely open economy, serving as an international financial centre. The major drawback, however, is that the government is effectively deprived of any autonomous control over money supply. It is therefore not in a position to run any counter-cyclical policy. Hong Kong's money supply is ultimately dependent on its international balance of payments position. In addition, its interest rate must closely follow that of the US, otherwise interest rate arbitrage would set in and lead to exchange rate volatility. A tight money supply and the high interest rates that may ensue could stimulate capital inflow and cause the money supply to increase. Initially they would perhaps help to contain inflation by easing demand pressure. Thus, under such a currency board system, macroeconomic stability can only be restored by way of internal wage and price readjustments.

The US dollar peg has meant that Hong Kong has been subservient to cycles in the US economy. This was exactly the case in the late 1980s and early 1990s (see Figure 1). At that time, Hong Kong had high inflation coupled with strong GDP growth recovery after the 1989 trough. As interest rates in Hong Kong had to be kept in line with those in the US to keep the dollar peg intact, the overheated demand could not be contained by adjusting prevailing interest rates upwards. The result was continuous overheating and persistent inflationary pressure, with real interest rates approaching zero for most of the years after the US dollar peg was adopted, until the trend was abruptly ended by the Asian financial crisis.

It is difficult to distinguish exactly the sources of increased macroeconomic instability in Hong Kong as observed from the late 1980s onwards. As shown in Table 1, however, Hong Kong's balance of payments had recorded quite impressive surpluses until the mid-1990s after the US dollar peg was adopted in 1983. This, coupled with increased capital inflow in the form of foreign direct investment (FDI) and portfolio capital taking advantage of the robust economic growth in Hong Kong, seems to have led to remarkable increases in the territory's money supply. Thus, the different measures of money supply (in Table 1) all show rate of increases substantially higher than the GDP growth rate, resulting in persistent inflation since the mid-1980s (Figure 1).

Theoretically, macroeconomic stability for a country operating under a pegged exchange rate system may be restored automatically through balance of payments readjustment. That is, if a country experiences an

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*footnote continued*

Kong dollars come under devaluation pressure, caused, for example by capital outflows or a current account deficit, the interbank market strains and interest rates rise relative to the US dollar interest rate. This will in turn attract capital inflows, and offset the initial devaluation pressure.

Table 1: Balance of payments, money supply and inflation in Hong Kong under the US dollar peg system, 1983–2000 (HK\$ million)

	<i>Balance of payments</i>	<i>M1</i>	<i>Annual change (%)</i>	<i>M2</i>	<i>Annual change (%)</i>	<i>M3</i>	<i>Annual change (%)</i>	<i>Inflation rate (%)</i>
1983	2,179	30,896	–	257,685	–	311,146	–	–
1984	19,078	36,791	19.08	314,081	21.89	388,301	24.80	8.10
1985	25,636	45,266	23.04	390,239	24.25	457,803	17.90	3.20
1986	26,573	56,094	23.92	518,131	32.77	582,208	27.17	2.80
1987	37,993	81,902	46.01	677,042	30.67	743,353	27.68	5.50
1988	40,071	88,834	8.46	824,648	21.80	893,342	20.18	7.50
1989	60,264	94,858	6.78	988,836	19.91	1,060,207	18.68	10.10
1990	49,303	107,509	13.34	1,210,050	22.37	1,288,028	21.49	9.80
1991	44,117	128,497	19.52	1,371,029	13.30	1,435,743	11.47	12.00
1992	41,601	155,557	21.06	1,518,777	10.78	1,574,265	9.65	9.40
1993	63,123	187,608	20.60	1,764,416	16.17	1,823,108	15.81	8.50
1994	12,187	185,334	– 1.21	1,992,351	12.92	2,070,831	13.59	8.10
1995	– 46,821	190,471	2.77	2,282,849	14.58	2,363,963	14.16	8.70
1996	– 16,682	217,460	14.17	2,532,236	10.92	2,611,636	10.48	6.00
1997	– 45,613	208,093	– 4.31	2,742,993	8.32	2,825,609	8.19	5.70
1998	13,884	197,666	– 5.01	3,066,089	11.78	3,122,345	10.50	2.55
1999	66,295	225,156	13.91	3,313,534	8.07	3,361,805	7.67	– 3.25
2000	59,978	243,847	8.30	3,605,213	8.80	3,648,473	8.53	– 3.00
1986–90	42,841	85,839	19.70	843,741	25.51	913,428	23.04	7.14
1991–95	22,841	169,493	12.55	1,785,884	13.55	1,853,582	12.93	9.34
1996–00	15,572	218,444	5.41	3,052,013	9.58	3,133,974	9.07	1.60

*Notes:*

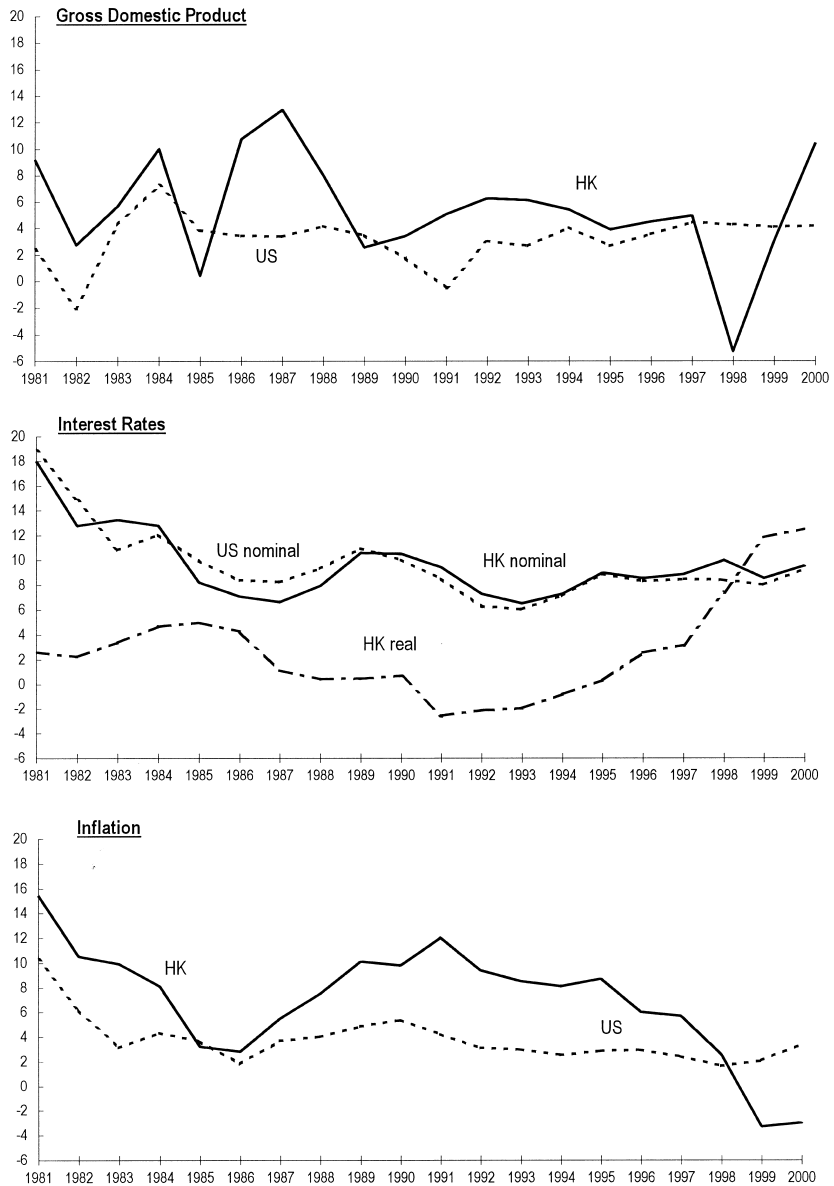
1. The balance of payments cover only visible and invisible trade. Hong Kong government did not attempt to compile capital account figure until recently. As a major international financial centre that is free from any kind of foreign exchange or capital account control, it is extremely difficult and costly for the government to keep track of the voluminous and volatile portfolio capital flowing into and out of Hong Kong.

2. Money supply M1 is defined as the sum of legal tender notes and coins held by the public plus customers' demand deposits placed with licensed banks. M2 refers to the sum of M1 plus customers' savings and time deposits with licensed banks, plus negotiable certificates of deposits (NCDs) issued by licensed banks held by non-authorized institutions; and M3 the sum of M2 plus customer deposits with restricted licensed banks (RLBs) and deposit-taking companies (DTCs) plus NCDs issued by RLBs and DTCs held by non-authorized institutions.

*Sources:*

Hong Kong SAR Government Census and Statistics Department, *Hong Kong Annual Digest of Statistics*, various issues.

**Figure 1: Major Indicators of Economic Instability in Hong Kong in Relation to the Economic Cycles in the United States, 1981–2000 (%)**



*Note:*

Hong Kong's real interest rate is given as prime lending rate minus inflation.

*Sources:*

Hong Kong SAR Government Census and Statistics Department, *Hong Kong Annual Digest of Statistics*, various issues; and International Monetary Fund, *International Financial Statistics*, various issues.

economic boom fuelled externally by a balance of payment surplus, prices will adjust upward, with the exchange rate and interest rate being fixed. Higher prices should, however, weaken the economy's price competitiveness, thus discouraging exports and stimulating imports. This will in turn reduce demand pressure, and the deteriorating trade balance will offset the initial expansion in money supply. However, as both the exchange and interest rates are not allowed to adjust, price readjustments to restore macroeconomic stability are bound to be more volatile and prolonged than would otherwise be expected under a floating exchange rate regime, under which the interest and exchange rates may readjust freely alongside any price movements to help moderate any inflationary pressures. A pegged exchange rate regime therefore does not guarantee economic stability. More importantly, inflation can be expectation-augmented, generating its own self-fulfilling momentum.

Necessary to the understanding of the high inflation in Hong Kong during the late 1980s and early 1990s are asset price inflation, and the wage-price spiral. Both aspects are clearly reflected in the statistics shown in Figure 2.

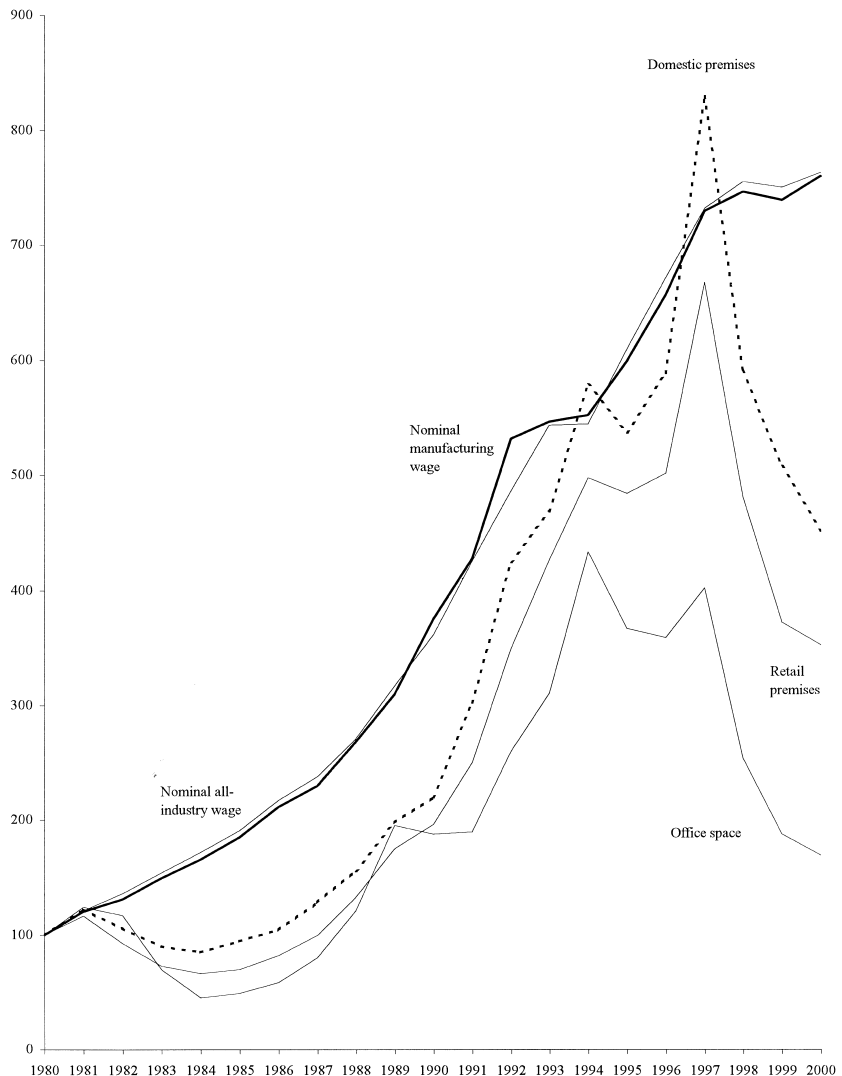
In the 1986–90 and 1991–95 periods, average annual prices for domestic properties increased by a startling 18.44 per cent and 21.01 per cent respectively. Retail properties and office spaces recorded similar phenomenal gains. It was not until the summer of 1994, when property market speculation had run out of control, that the government resorted to the unusual administrative fiat of drastically restricting bank lending by imposing a ceiling on property mortgage loans.<sup>4</sup> Property prices did, as a result, decline quite remarkably. Real interest rates remained persistently negative (see Figure 1), however, and the downturn was shortlived, lasting for not more than two years. Shortly before Hong Kong was to take the full impact of the Asian financial crisis in 1998, property prices, especially housing properties, recorded yet another all-time high in 1997 (see Figure 2).

Persistent negative real interest rates had clearly provided a strong incentive to the public to invest in real property assets rather than interest-bearing financial assets. In land-scarce Hong Kong, real estate investment has long been regarded as an effective hedge against inflation. Worse still, not only end-users, but corporate and casual investors all joined in the property-shopping spree, pushing property prices to astronomical levels. In the end, the positive “wealth effect” helped to fuel domestic demand and inflation further.

There is yet another important dimension to Hong Kong's asset price bubble in the 1990s. With the expectation that asset prices would continue to rise in tandem with high inflation, international investors also

4. A decree made by the Hong Kong Monetary Authority specified that all mortgage loans were to be capped at 70% of the assessed value of the property. Other measures adopted by the government to cool down the market included increasing the supply of land and housing, tightening the control over the resale of uncompleted flats, and prohibiting the resale of uncompleted flats before assignment.

**Figure 2: Wage Inflation and Property Prices in Hong Kong, 1980–2000 (1980 = 100)**



*Sources:*

Hong Kong SAR Government Census and Statistics Department, *Hong Kong Annual Digest of Statistics*, various issues; and Hong Kong SAR Government Census and Statistics Department, *Hong Kong Monthly Digest of Statistics*, various issues.

rushed into Hong Kong's property market, anticipating substantially higher rates of return than that promised by their home countries. Most importantly, they all assumed that the US dollar peg regime, in combination with the government's huge foreign exchange reserves and the absence of any fiscal deficits and external debt, would guarantee that the accumulated HK dollar assets could be easily disposed of and

converted into foreign currency with virtually zero exchange risk. This helped to boost considerably the risk-adjusted rate of return for overseas investors.

High inflation and hence high costs of living caused wages to spiral. Thus, as revealed in Figure 2, the nominal wage for all industries in Hong Kong rose by an annual average rate of 13.71 per cent between 1986 and 1990 and 11.18 per cent between 1991 and 1995, that is, by an annual average rate of 12.4 per cent for the whole decade 1986 to 1995. Wages in the manufacturing industry alone increased annually by 12.7 per cent. The most rapid annual increases occurred between 1988 and 1992, at 18.4 per cent. This period corresponds exactly to that when most of Hong Kong's manufacturing industry relocated to China.

### *Industrial Relocation and Restructuring*

There is no doubt that the pull factors, namely the cheap labour and low land costs offered on the other side of the border, would already have been sufficiently attractive for Hong Kong manufacturers to relocate there. The push factors, specifically the high wages and land rental volatility, as conditioned by the US dollar peg, also strongly accelerated investors' exodus to China. By the mid-1990s virtually all Hong Kong manufacturers had migrated to China. Employment in the territory's manufacturing industry declined from a high of nearly one million in the mid-1980s to less than a quarter of that by 1996/97. Apart from the employment figures, another measure of the relocation impact on Hong Kong is the capital outflow in the form of FDI across the border, to the Zhu (Pearl) River Delta, in particular.<sup>5</sup> Hitherto, such capital would probably have remained in Hong Kong. Figure 3 shows the trends and fluctuations in FDI from Hong Kong to China between 1986 and 1998 in relation to changes in Hong Kong's inflation and nominal wage rates.

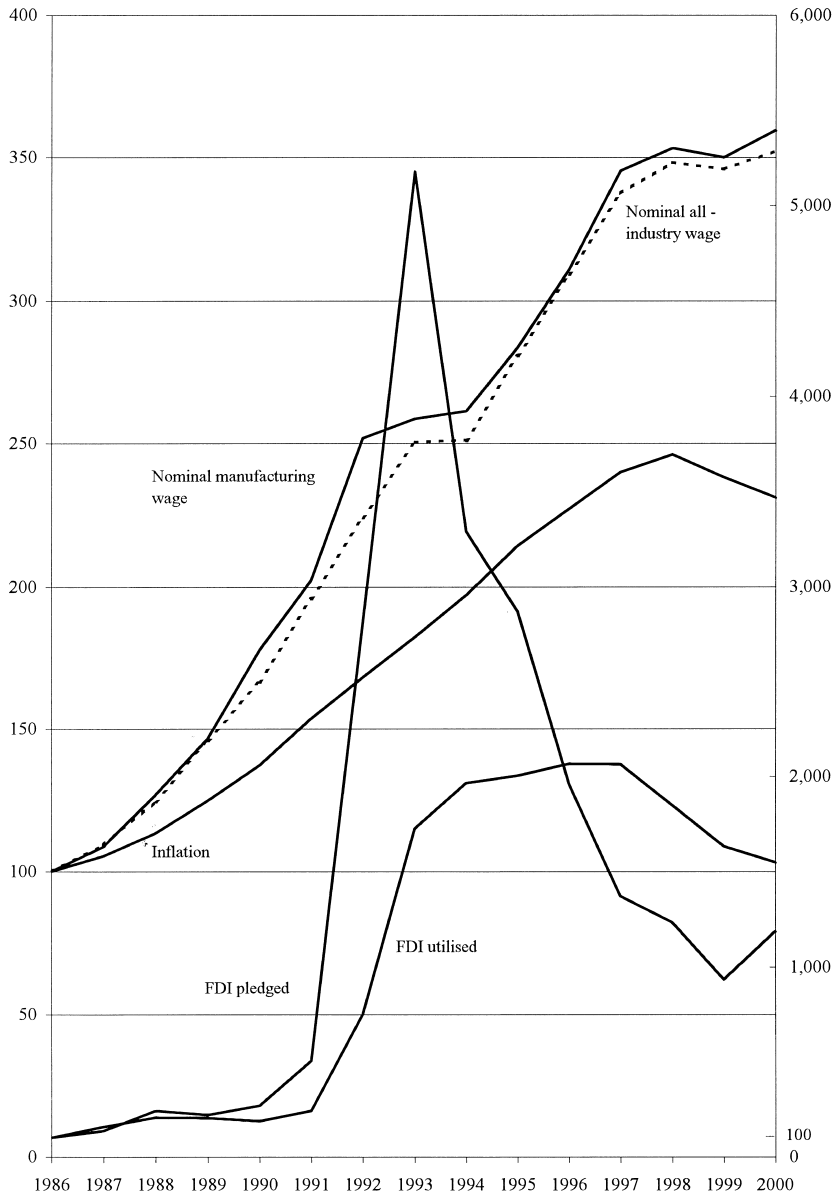
Apart from the dramatic upswing in 1992/93 prompted by the so called "Deng Xiaoping whirlwind" (see footnote 1), FDI by Hong Kong investors in China in terms of both total value pledged (contracted) and realized generally moved in tandem with changes in nominal wage rates or inflation in general.

The findings basically support the point made that insurmountable inflation and wage price pressure arising from the US dollar peg system drove Hong Kong manufacturers to relocate their plants to China beginning in the mid-1980s. This, together with the simple fact that virtually all the output is shipped back to Hong Kong for export to Western markets, attests to the nature of the relocation, which is very different from the import-substitution FDI made by overseas investors in the Chinese interior or further north aimed at the huge Chinese domestic market.

5. See Y.Y. Kueh and Robert Ash, "The fifth dragon: economic development," in Brian Hook (ed.), *Guangdong: China's Promised Land* (Hong Kong: Oxford University Press, 1996), pp. 149–192.



**Figure 3: Indices of FDI Flow from Hong Kong to China in Relation to Changes in Inflation and Nominal Wage Rates in Hong Kong, 1986–2000 (1986 = 100)**



**Sources:**

China Economics Publishing House, *Almanac of China's Foreign Economic Relations and Trade*, various issues; and Hong Kong SAR Government Census and Statistics Department, *Hong Kong Annual Digest of Statistics*, various issues.

By 1998, FDI from Hong Kong accumulated to a total stock of some US\$140 billion, accounting for more than 52 per cent of total Chinese FDI intake between 1979 and 1998. More strikingly, according to some rough calculations, Hong Kong-invested firms in 1998 employed more than five million Chinese workers in Guangdong province alone.<sup>6</sup> This is more than five times the size of Hong Kong's manufacturing employment in 1985/86.

The massive relocation of Hong Kong's manufacturing industry to China underpins the drastic restructuring of the economy as a whole over the past decade or so. Consistent with the decline in manufacturing employment, the relative contribution of the manufacturing sector to Hong Kong's GDP fell from 22.1 per cent in 1985 to only 6.2 per cent in 1998. Meanwhile, the service sector share rose rapidly from 69.6 per cent to 84.7 per cent over the same period.<sup>7</sup> Such a dramatic and complete shift within a span of less than 15 years is probably unparalleled in world economic history.

Even more remarkably, from 1985/86 to 1996/97, despite the massive manufacturing exodus to China, Hong Kong's GDP grew at an average annual rate of 5.7 per cent, while labour supply increased only at an annual rate of 1.7 per cent over the same period.<sup>8</sup> That is to say, the accelerated industrial relocation not only resulted in low unemployment in Hong Kong, but in fact, by virtue of the drastic concomitant expansion of the service sector, there was a labour supply shortage prior to the outbreak of the Asian financial crisis. This constraint on GDP growth could only be resolved in part by the government's yielding, quite reluctantly for obvious political reasons, to the employers' lobby for labour imports, and through the acceleration of technological upgrading.

Hong Kong and Guangdong have a simple symbiotic relationship. The export manufacturing capacity, now based almost completely in Guangdong, requires a continuous flow of complementary inputs from the service sector. The container port facilities, air, rail and road transportation between China and Hong Kong, as well as the banking, finance, insurance and telecommunications sectors all help to generate employment and income in Hong Kong. Less obvious but nevertheless even more crucial to the entire dynamic of the economic restructuring in Hong

6. This figure was quoted in the Hong Kong press frequently. By 1995, total employment by foreign-invested enterprises (FIEs) in China was reported by the World Bank to be around 16 million. (See its *China 2020: Integration with the World Economy* (Washington DC, 1997), p. 21). As Hong Kong investors account for about two-thirds of the cumulative FDI stock in China, and the overwhelming proportion (roughly 80%) of this is based in Guangdong (see Kueh and Ash, "The fifth dragon," p. 178), the five million figure seems actually to have understated grossly the SAR's contribution to employment in the province. Moreover, most FIEs of Hong Kong origin are generally more labour-intensive than those from elsewhere.

7. Hong Kong SAR Government Census and Statistics Department, *Hong Kong Annual Digest of Statistics*, 1987 and 1999.

8. See Hiroyuki Imai, "Structural transformation and economic growth in Hong Kong: another look at Young's Hong Kong thesis," *Journal of Comparative Economics*, Vol. 29, No.2 (June 2001), pp. 366–382, for the figures and for a discussion of the productivity implications arising from the structural changes in Hong Kong since the early 1980s.

Kong, has been the rare versatility of Hong Kong's human capital. The pace with which manufacturing workers adjusted their training and skills to suit the needs of the increasingly capital-intensive and technology-based service sector was also unparalleled in modern economic history. With some minor qualifications, "structural" unemployment was virtually unknown in Hong Kong amidst the great economic upheaval associated with the drastic industrial restructuring that took place.

### *Trade Reorientation and Expansion*

For conceptual clarity, an important statistical point is prerequisite to facilitate further discussion. That is, with the massive manufacturing relocation to China, Hong Kong's "domestic" exports have been statistically reduced to a minimum. Official Hong Kong statistics treat exports originating from Hong Kong-invested manufacturing plants in China as a special category of re-exports of Chinese origin (rather than Hong Kong's own domestic exports), alongside re-exports of "truly" Chinese origin. Given the fact that the bulk of the export-processing by Hong Kong-invested firms in China does not normally involve any intermediate processing in Hong Kong of raw import supplies from overseas, it is apparent why Hong Kong has rapidly converted from an export-manufacturing centre to a global entrepôt port within only about a decade. Adding to this unusual development is of course the ongoing attempts by the mainland Chinese themselves, both exporters and importers, to take advantage of Hong Kong's world-wide network of marketing and merchandise sourcing (as well as the efficient port and shipping facilities, and excellent banking, insurance and telecommunications services). Against this backdrop the standard trade statistics indicate that the share of domestic exports in Hong Kong's total exports declined steadily from 73.4 per cent in 1979 to a low of 14 per cent by 1997, while the share of re-exports simultaneously rose.<sup>9</sup>

For the purposes of this article, it is necessary to treat "re-exports" of goods manufactured in China by Hong Kong manufacturers and exporters as domestic exports, as with goods produced internally in Hong Kong for export to overseas markets other than China. Obviously, in practice, it is difficult statistically to distinguish this special category of imports from China from China's total exports to Hong Kong. The reason for this is simple: most Hong Kong investors in China are involved in joint ventures with Chinese partners with both equity share and scale of production varying from firm to firm. Given the large number of Hong Kong-invested firms in China, it is extremely difficult to isolate accurately in aggregate terms the export share attributable to the Hong Kong investors.<sup>10</sup>

9. Hong Kong SAR Government, *Hong Kong Annual Digest of Statistics*, 1985; and *Hong Kong Monthly Digest of Statistics*, March 2000.

10. A first attempt in this direction was made in Y.Y. Kueh and Thomas Voon, "The role of Hong Kong in Sino-American economic relations," in Y.Y. Kueh (ed.), *The Political*

Fortunately, since 1989, the Hong Kong government has published a quarterly set of trade statistics relating specifically to what is officially referred to as “outward-processing” (OP) export flows to China and the corresponding “outward-processing” import flows from China with breakdowns for major export commodity categories. Importantly, statistics for re-exports to countries other than China are also included, although unfortunately no further breakdowns are available for market distribution by country. The government statistics are based on regular sampling surveys conducted of Hong Kong firms in conjunction with custom import and export statistics. They should therefore be interpreted with care. A rough examination of the “processing” margin (value of OP import flows minus OP export flows as a percentage of total OP import flows) across the different commodity groups reveals, however, a pattern and margin of earnings generally consistent with information given by Hong Kong manufacturers and exporters. This is also true for the OP re-export margin.<sup>11</sup>

Without a better alternative, the given OP-type of exports (or rather re-exports by custom statistics) may therefore be added to the truly “domestic” exports of Hong Kong, for the purposes of examining how Hong Kong’s export capacity in total may have been expanded with the complete migration of its export-manufacturing industry to China over the past 15 years. The vertical distance (TEC minus PDX in Figure 4) between the estimated trend line of domestic exports and the realized total export volume (comprising both domestic exports and what may be called Hong Kong’s domestic-exports-in-disguise in the form of OP re-exports), shows that being entirely released of the severe land and labour supply constraints, Hong Kong export manufacturers have indeed been able to expand their export capacity very substantially in the 1990s.<sup>12</sup> This estimated capacity expansion also appears to be roughly

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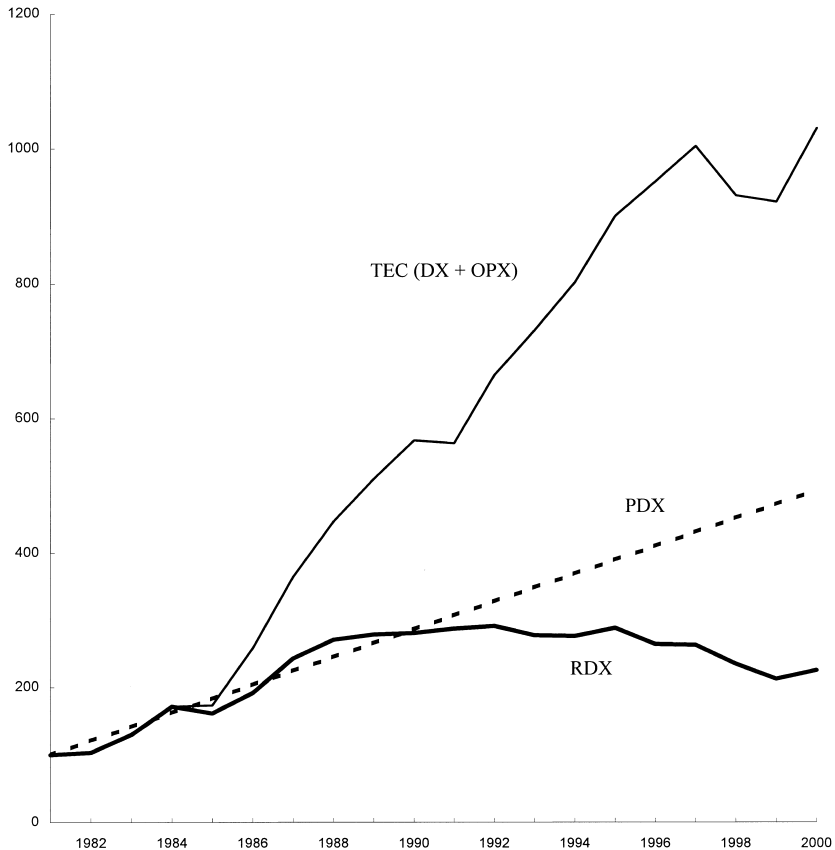
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*Economy of Sino-American Relations: A Greater China Perspective* (Hong Kong: University of Hong Kong Press, 1997), pp. 61–92. Based on a small sample of joint ventures in Guangdong province, the export share between the Hong Kong and Chinese partners was estimated to be 72.8 to 27.2% relative to their input contributions (comprising capital, rent, labour, raw materials, fuel charges and distribution costs); pp. 82 and 91. For an update, see Thomas Voon and Y.Y. Kueh, “Country of origin, China’s value-added exports and Sino-US trade balance reconciliation,” *Journal of World Trade* (Geneva), Vol. 34, No. 5 (October 2000), pp. 123–136.

11. The major branches included in the OP import and export statistics are: textile material, yarn, fabrics and articles other than textile garments; articles of apparel and clothing accessories (textile garments); plastics and articles; machinery and mechanical appliances: electrical equipment; sound recorders and reproducers, television image and sound recorders and reproducers; clocks and watches; toys, games and sports requisites, and parts and accessories; base metals and metal products; and other (excluding commodities and transactions not classified according to kind). Taken together, the processing margin as defined falls within the range of 50 to 60% in recent years. The OP re-export margin ranges in turn between 18 and 24%. If anything, these figures probably all underestimate the true margin of value-added. For a discussion on this point see Y.Y. Kueh, “The Greater China growth triangle in the Asian financial crisis,” in Shahid Jusuf, Simon Evenett and Weiping Wu (eds.), *Facets of Globalization: International and Local Dimensions of Development* (Washington DC: The World Bank, 2001), pp. 57–77.

12. If anything, the estimated expansion in export capacity should err on the low side, simply because due to physical constraint in Hong Kong (land scarcity, in particular), domestic exports should not be able to grow as fast as the trend line in Figure 4 projects.

**Figure 4: Trends in Realized (R) and Projected (P) Domestic Exports (DX), “Outward Processing” Type of Exports (OPX), and Estimated Total Exports Capacity (TEC) of Hong Kong, 1981–2000 (1981 = 100)**



*Notes:*

(1) The projected trend line (PDX) is derived from a simple linear regression equation fitted with the RDX values of 1978–88.

(2) OPX refers to exports from export-processing conducted by Hong Kong’s manufacturers in the Chinese mainland. Official Hong Kong statistics for OPX are available from 1991 only, although such exports began to take place in the early or mid-1980s. To complete the series, a similar time trend is thus fitted with the available 1991–2000 data to provide the OPX figures for the years prior to 1991. Note also that the OPX figures (TEC – RFX) do not include “outward-processing” export flows to mainland China (i.e. intermediate goods destined for export-processing).

*Sources:*

Hong Kong SAR Government Census and Statistics Department, *Hong Kong Annual Digest of Statistics*, various issues.

consistent with the increases in employment from some one million workers in 1985/86 in Hong Kong to over five million by 1997/98 across the border in Guangdong province. Of course, if the bulk of re-exports of truly Chinese origin is also to be considered, the real total export capacity in Hong Kong is much larger than implied here.

A major question that arises is how the US dollar peg is related to the continuous export expansion in Hong Kong. This can be examined in the context of Figure 5, which gives different measures of the Hong Kong dollar/US dollar real exchange rate, deflated by nominal wage price, consumer price, export price and the GDP deflator. Several major points can be made. First, during the period 1983–97, the real exchange rate as deflated by export price ( $X_p$ ) remained quite stable. Secondly, by contrast, each of the other three measures indicate consistent appreciation against the US dollar. Specifically, measured against the benchmark of 1983, the real exchange rates based on the deflators for GDP, consumer price ( $C_p$ ), and nominal wage ( $W_m$ ), actually appreciated substantially by 41, 38 and 60 per cent respectively by 1999. Thirdly, the divergent trends in Hong Kong dollar's real exchange rate between the export-price deflator on the one hand, and the three other measures on the other, reflects the fact that inflation in Hong Kong's non-traded goods sector was much more pronounced as a result of the US dollar peg regime, though the territory was able to maintain its overall export price competitiveness vis-à-vis Western markets, the US in particular.

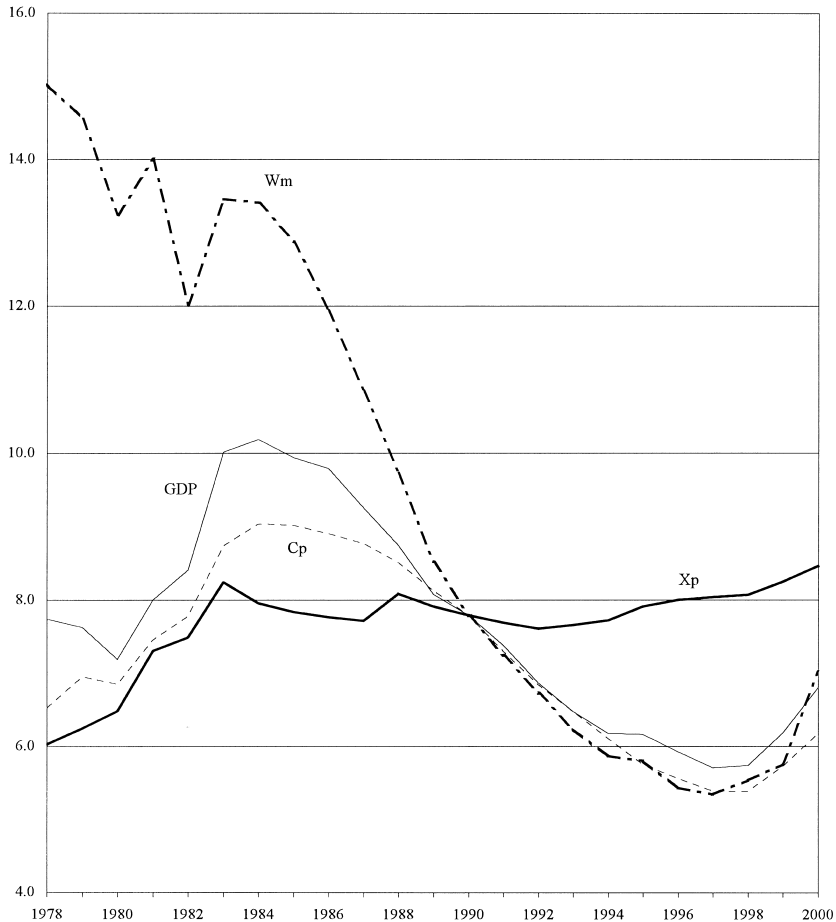
The basic economic implications are clear: without the opportunity to relocate to the Chinese hinterland for substantial cost savings, Hong Kong's manufacturers would probably have not been able to withstand the insurmountable wage price and land cost pressures arising from the government's highly defensive protection of the US dollar peg. Put differently, the success story of Hong Kong up to the onset of the Asian financial crisis is intimately bound up with China's decisive move to open up its frontier to the outside world.

Nevertheless, with the US dollar weakening against the Japanese yen for most of the period after 1983, the Hong Kong dollar was correspondingly depreciating against the yen as well. The result was that Hong Kong's exports to Japan grew even faster than those to the US, at least up to the crisis years, as shown in Figure 6. This can be viewed as a "double benefit" wrought from both export-cost savings arising from the manufacturing sector's relocation to China and the depreciation of the Hong Kong dollar against the yen. Without doubt the cost-saving factor was dominant.

#### *China in the SAR's Financial Crisis*

The impact of the Asian financial crisis was mentioned above. Notice should be taken of the sharply contrasting movement of the major economic indicators in Hong Kong before and after 1998: high GDP growth, high inflation and negative real interest rates prior to 1998, versus negative GDP growth, severe deflation and remarkable increases in real interest rates after 1998 (see Figure 1). And to add to the near-perfect symmetry, the continuous expansion of exports in Hong Kong was abruptly brought to an end by the Asian crisis in early 1998, to turn into absolute decline for six quarters consecutively before any real signs of

**Figure 5: The Real Exchange Rate of the Hong Kong dollar against the US dollar as Deflated by the Export Price (Xp), Consumer Price (Cp), Manufacturing Wage (Wm), and GDP Growth (HK\$/US\$), 1978–2000**



*Notes:*

The different deflated exchange rate measures are obtained by applying the relevant price ratio (US price index to Hong Kong price index) to Hong Kong's nominal exchange rate. The year 1990 is taken as a benchmark (HK\$/US\$ = 7.8) for gauging the trend of changes.

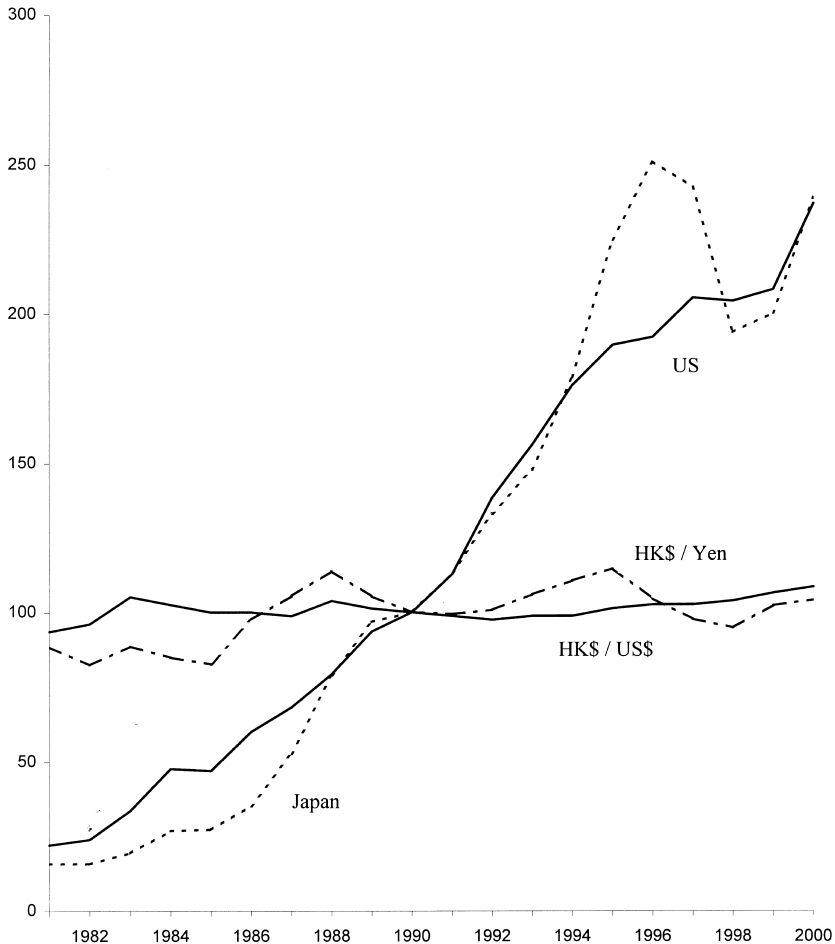
*Sources:*

Hong Kong SAR Government Census and Statistics Department, *Hong Kong Annual Digest of Statistics*, various issues; and International Monetary Fund, *International Financial Statistics*, various issues.

recovery appeared at the end of 1999 (see Figure 7). How has the “China factor” fared in this extreme economic volatility in relation to the role of the US dollar peg? To address the issue, some background is necessary on why Hong Kong bore the full impact of the Asian crisis.<sup>13</sup>

13. For a more detailed study see Y.Y. Kueh, “Weathering the Asian financial storm in Hong Kong,” in James C. Hsiung (ed.), *Hong Kong the Super Paradox: Life After Return to China* (New York: St. Martin Press, 2000), pp. 235–264.

**Figure 6: Trends in Hong Kong's Total Exports to the United States and Japan in Relation to the Respective Real Exchange Rates of the Hong Kong dollar, 1981–2000 (1990 = 100)**



*Notes:*

(1) Total exports comprise domestic exports, re-exports of Chinese origin, and “outward processing” type of exports (see Figure 4 for explanation).

(2) The HK\$/Yen line is similarly obtained as explained in Figure 5 with respect to the real HK\$/US\$ exchange rate.

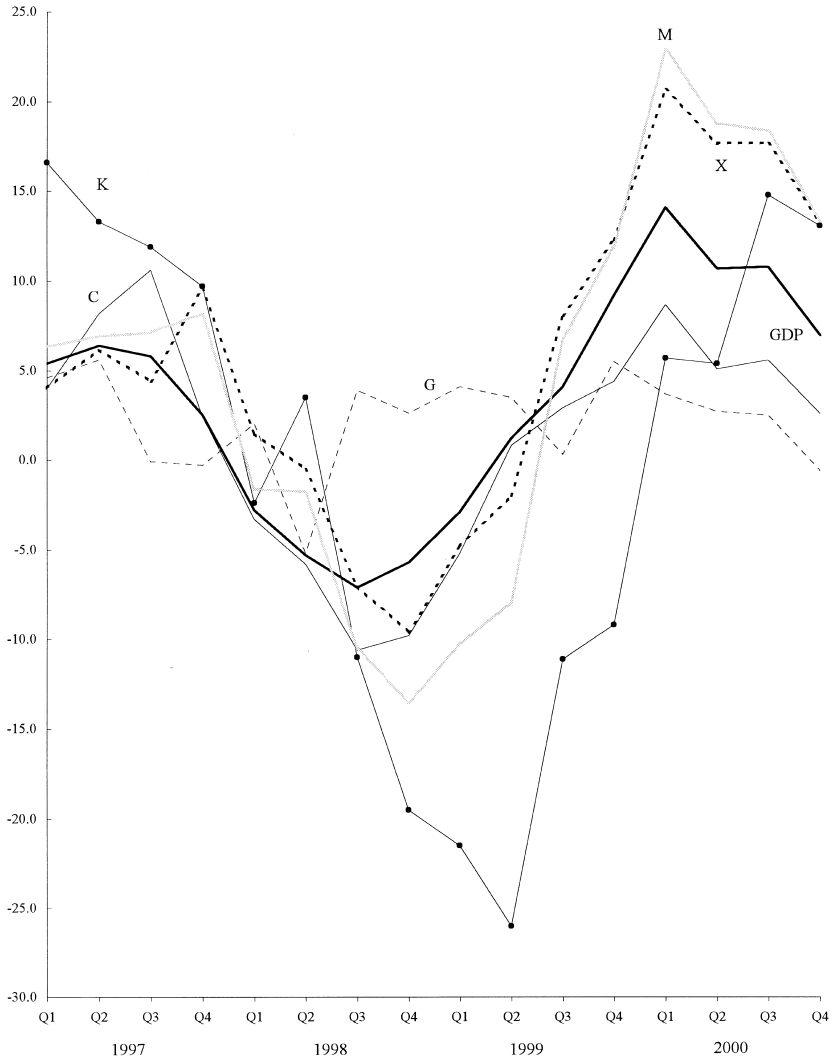
*Sources:*

Hong Kong SAR Government Census and Statistics Department, *Hong Kong Annual Digest of Statistics*, various issues; and International Monetary Fund, *International Financial Statistics*, various issues.

It must be noted that the tough monetary policy measures taken by the Hong Kong government at the peak of the financial crisis to defend the Hong Kong dollar against international hedge funds speculating for a forced devaluation, sent nominal interest rates skyrocketing. The persistent threat of an interest rate rise in the US aimed at preventing its buoyant economy from overheating also prompted the Hong Kong authorities to



**Figure 7: Quarterly Trends in Gross Domestic Product (GDP), Gross Domestic Capital Formation (K), Private Consumption Expenditure (C), Government Expenditure (G), Imports (M) and Exports (X) of Goods in Hong Kong under the Impact of the Asian Financial Crisis, 1997 to Fourth Quarter, 2000 (year-on-year percentage change)**



Sources:

Hong Kong SAR Government Census and Statistics Department, *Hong Kong Annual Digest of Statistics*, various issues.

keep local interest rates at a consistently high level, in order to maintain the US dollar peg. This resulted in the bursting of the asset price bubble virtually overnight (Figure 2). Average property values halved within months, consumer confidence plummeted and spending virtually halted, causing widespread business closures and unemployment, and highly

depressed investment expenditure under high interest-cost pressures, both locally as well as in China by way of reduced FDI outflow to the mainland. Compounding the difficulty, wages remained relatively high because of strong resistance by the trade unionists to any downward movement (Figure 2). Earners had come to expect two-digit growth in nominal wages, such as had been given them every year over the past two decades. Reinforced by falling consumer prices, real interest rates were repeatedly raised, reaching historical highs throughout 1998 and 1999, averaging 7.1 per cent and 12.5 per cent respectively.

As it had turned out, Hong Kong's 1998 GDP was curtailed by 5.3 per cent in real terms, gross domestic capital formation by 6.1 per cent and private consumption expenditure by 6.8 per cent (see Figure 7). The depression persisted through the summer of 1999. It was not until late 1999 that any revival appeared, fuelled primarily by a strong recovery in exports growth. Positive growth, 2.9 per cent, occurred for the whole of 1999. Indeed, of the Asian economies, Hong Kong proved to be the hardest hit not only in terms of scale but also in the duration of the depression. The event was astonishing, especially considering that unlike most of the other financial "dominos," Hong Kong had been endowed with probably the best and most secure banking and financial system in Asia, strong fiscal and monetary discipline, and a huge foreign exchange reserve (US\$ 92.8 billion), that had ranked only behind China (US\$139.9 billion) and Japan (US\$220.8 billion) shortly prior to the crisis.<sup>14</sup>

It therefore seems apparent that the sudden collapse of the Hong Kong economy had a great deal to do with the highly defensive protectionist measures carried out by the Hong Kong Monetary Authority amidst the Asian crisis. Not only did the defence not help to forestall a massive capital flight from Hong Kong, but it consistently pushed up local interest rates in both nominal and real terms. This is a clear case of "double loss," in which exorbitant interest rates impaired both consumption and investment confidence, and did not induce replenishing capital inflows to help revigorate the economy, as the perceived scheme of interest rate arbitrage tends to suggest under the US dollar peg system. With the advantage of hindsight, a legitimate question is whether or not the SAR economy, given its relative strengths and sound financial setting, would have suffered less and recovered at an earlier stage and in a more rigorous style, compared with the other two "little dragons,"<sup>15</sup> had the Hong Kong

14. These are year-end 1997 figures. Note that until then Hong Kong also had neither a budget deficit nor any significant amount of external debt.

15. The case of Taiwan may not be exactly comparable. The island lags far behind Hong Kong in financial liberalization, although it is not as restrictive as the Chinese mainland in terms of capital account control. This made it less vulnerable to speculative currency attacks by international hedge funds. Nevertheless, after an abortive defence in late 1997, the NT dollar was floated and eventually settled at NT\$34.5 to the US dollar in January 1988, down by only 19%, compared with the precipitous fall of the Thai baht by 55%, the Indonesian rupiah by 70%, the Malaysia ringgit by 42% and the South Korea won by 50%. For elaboration on this point, see Kueh, "The Greater China growth triangle." For the more comparable case of Singapore which has a currency board system similar to that in Hong Kong, the Singapore dollar was devalued by only around 17% at the peak of the speculative assaults in January 1998.

currency been de-pegged from the US dollar (that is, devalued), say, following Singapore and Taiwan in late 1997.

We have addressed this hypothetical question at some length elsewhere.<sup>16</sup> Despite the remarkable economic recovery in most Asian countries affected by the crisis, the region as a whole is still fearful of a possible regrouping of the international hedge funds, now commonly called highly-leveraged institutions (HLIs), for renewed currency attacks.<sup>17</sup> This has at times prompted a renewed aspiration in many Asian countries to find an alternative exchange rate regime.<sup>18</sup> How then should the US dollar peg for Hong Kong be seen in this light? The question clearly cannot be pursued in isolation from the SAR's firmly established "Chinese connection." This can also be more specifically seen from the role China has played in the equation of the great depression in Hong Kong of the past couple of years. Several points emerge.

The first refers to the investment linkage. When Hong Kong was overwhelmed by severe credit crunch as a result of the SAR government's massive defence of the Hong Kong dollar, and when new FDI flows from Hong Kong investors to the Chinese hinterland therefore began to slow down or even decline in 1997/98 (see Figure 3),<sup>19</sup> mainland state banks immediately felt obliged to rescue them by granting the first ever *renminbi* credits for the purposes of sustaining export-processing activities.<sup>20</sup> It is not possible to verify the quantitative significance of such timely liquidity assistance. But the special concessions should perhaps not be seen as just a temporary bailout. Rather they seem to signal an important Chinese policy shift towards closer integration of the hundreds of thousands of export-manufacturing enterprises run independently by Hong Kong and Taiwan investors or as joint ventures with various Chinese partners, with the mainland Chinese economy. After all, these

16. See Y.Y. Kueh, "Financial restructuring for economic recovery in China and Hong Kong," in Fu-chen Lo and T. Palanivel (eds.), *Financial Restructuring and Economic Perspective in East Asia* (Tokyo: United Nations University Institute of Advanced Studies, 2000), pp. 127–144.

17. As Joseph Yam, the Chief Executive of the Hong Kong Monetary Authority put it at a meeting of the Manila Framework Group of APEC held in Hong Kong on 20 March 2000, in the wake of a "renewed flood of capital into Asia's economies there was a danger the pain of the crisis that began in mid 1997 had been forgotten." According to Yam, net private capital flow into Asia's emerging markets increased nearly sixfold from 1998 to US\$39 billion in 1999, and the inflow was forecast to increase by more than 50% to US\$59 billion in 2000. He called for "more progress to be made in coping with the potentially destabilizing impact on markets of what were formerly known as hedge funds"; see *South China Morning Post* (Business Post Section), 21 March 2000, p. 1.

18. See C.H. Kwan, "Sayonara dollar peg: Asia in search of a new exchange rate regime," Nomura Research Institute, Tokyo, December 1999 (mimeo).

19. The reduced FDI flow to China was partly a matter of increased removal by Hong Kong investors, and Taiwanese as well, of their registered company sites to the British Virgin Islands in the Caribbean Sea and Samoa in the remote South Pacific. The "re-registering" accelerated in the wake of Hong Kong's reversion to Chinese sovereignty in 1997. For more details see Kueh, "The Greater China growth triangle."

20. This is of course not unrelated to the peculiar circumstances prevalent in China since 1996 of declining interest rates, negative deflation, and inadequate consumption and investment expenditure. Note especially that the Chinese government already had to resort to prime-jumping deficit spending to prop up aggregate demand before the impact of the Asian financial crisis (by way of reduced export demand) was felt. See *ibid.*

enterprises were very much the backbone of the entire Chinese exporting system, being responsible for around half of China's total exports to the outside world and creating hundreds of thousands of jobs for low-skilled workers.

The second factor affecting Hong Kong was the Chinese government's granting of a value-added tax (VAT) rebate to promote exports. The VAT stood at 17 per cent prior to the Asian crisis. The initial rebate was given in mid-1998, when the full force of export competition from South-East Asian countries, which had their currencies greatly devalued, was being felt in China where the value of the *renminbi* had been steadfastly upheld. By mid-1999, for a wide range of export commodities that were routed through Hong Kong to major Western markets, the continuous increases in rebate appeared to have exhausted rapidly the full VAT rate of 17 per cent. It is difficult to estimate the extent to which the VAT rebate helped to enhance the international competitiveness of Chinese exports, but according to one authoritative Chinese analyst, a one per cent increase in VAT rebate was comparable to a one per cent reduction in export costs in China.<sup>21</sup> The rebate, therefore, was tantamount to a *renminbi* devaluation against the US dollar with respect to its effect in promoting export sales through Hong Kong or elsewhere. It was, however, free from the potentially destabilizing effect of a real *renminbi* devaluation in relation to the US dollar peg in Hong Kong.

The third point relates to what may be summarized as the "safe haven effect" provided by China to Hong Kong's export manufacturing industry. Specifically, if a distinction is made between Hong Kong's truly domestic exports on the one hand and re-exports on the other – the latter being essentially of China-origin in the form of Hong Kong exports-in-disguise – then at least for the initial year of the crisis, 1998, the former was curtailed in real terms, by a rather hefty 7.9 per cent, compared with a marginal decline of only 3.7 per cent for the latter.<sup>22</sup> The discrepancy seems to imply, *ceteris paribus*, that China-based export-processing enjoys, by virtue of comparative cost advantage, a greater competitive edge in overseas markets than locally based producers which are subject to wage-price rigidities despite the economic downturn, coupled with the continuous, albeit mitigated, land-cost constraint in Hong Kong.<sup>23</sup> More remarkably, in recent years, an increasing proportion of export manufactures produced in China by Hong Kong entrepreneurs is actually channelled through some major Chinese ports, notably Shanghai, rather than being shipped back to Hong Kong to be re-exported to the West. In 1998, at the peak of the Asian financial crisis, official Shanghai statistics confirm that total exports made by foreign-invested enterprises based in the municipality (mostly of Hong Kong or Taiwan origin) to the US and

21. This estimate is from a State Council analyst; see *Ta-kung pao* [*Dagong bao*] Hong Kong, 24 June 1998, and refers primarily to general merchandise trade.

22. See The Financial Secretary of Hong Kong Government, *The 1999–2000 Budget*, 3 March 1999, p. 3.

23. This is of course a very general statement. As a matter of fact, the two categories of exports involve different product range, different market destinations and different end-users.

the European Union could still score an impressive growth of 20 per cent, accounting for 47 per cent of the municipality's total exports.<sup>24</sup>

The fourth point is clearly the fact that the strong economic recovery in Hong Kong since the third quarter of 1999 was singularly underpinned by the SAR's most remarkable revival in exports (see Figure 7), which is in turn invariably bound up with the spectacular rebound of the mainland's exports since summer 1999. Note that for the first half of 2000, China's total exports recorded a 38 per cent growth over that of the corresponding period in 1999, and the GDP growth for Hong Kong for the year 2000 taken as a whole bounced back strongly to 10.5 per cent, against the backdrop of an extremely impressive 14.3 per cent growth for the first quarter of the year. Unfortunately, with economic growth in the United States – the single largest export market for Hong Kong – beginning to slow down towards the end of year 2000, the SAR has also increasingly felt the pain throughout 2001. Its GDP growth is now generally forecast to be reduced to near zero for 2001.

Another point making Hong Kong unique relates, finally, to the value of *renminbi*, as it may bear on the stability of the US dollar peg system in Hong Kong, and hence the SAR's export performance. There is no doubt that the renewed pledge made by the Chinese government not to devalue the Chinese currency has greatly helped the Hong Kong dollar fend off repeated speculative attacks amidst the Asian crisis in 1997/98. There is also little doubt that by not devaluing both the Chinese and Hong Kong SAR currencies, there should have been a certain degree of industrial restructuring, managerial restrengthening, and improvement in labour discipline and efficiency for enhancing cost savings in order to withstand increased export competition from the devalued South-East Asian countries and South Korea. Still, there also seems to be no reason to suggest that by not devaluing, the HKSAR's synergistic economic relationship with China in labour-intensive export-processing would eventually be broken within the "flying geese" pattern of intra-regional specialization and industrialization, in favour of the other newly industrializing South-East Asian competitors.<sup>25</sup> It is, of course, an entirely different matter whether any truly practical gains in this regard could

24. These figures cover only the first ten months of 1998 (see *Ta-kung pao*, 6 December 1998). The 47% share includes, of course, exports to Hong Kong as well. The same source also quotes the President of the Hong Kong Exporters Association as saying that at least for Hong Kong toys manufacturers based in the mainland who export directly through the Chinese ports (rather than Hong Kong), total exports for the first three quarters of 1998 recorded a 6% growth. The direct export to a third country implies less employment and income generation in Hong Kong, though the losses may nevertheless also be compensated for by increased factor income through profit repatriation to Hong Kong.

25. The "flying geese model," as coined by the Japanese economist, Kaname Akamatsu in the 1930s, refers to the continuous process of transferring relatively developed and internationally competitive manufacturing industries from industrialized countries (such as Japan) to the newly industrializing economies (such as Hong Kong, Singapore, Taiwan and South Korea), which will in turn delegate theirs to the less developed countries (China, Indonesia, etc.), as each economic entity is attempting to scale the ladder of industrialization in an ascending order similar to the flying geese line-up. The process is largely driven by the attempt to improve competitive edge, and to offset currency appreciation, labour shortages and rising wage costs.

have helped mitigate the magnitude of export losses in Hong Kong, and in China as well, such as those incurred in 1998/99 as a result of weakened international competitiveness.<sup>26</sup> Nevertheless, if anything, Hong Kong seems to have suffered less pain by virtue of its particular connection to China which, as referred to above, was able to “subsidize” indirectly the SAR’s export-manufacturers based on the mainland by way of extending urgently needed credit supply and increased VAT rebates at the peak of the Asian financial crisis.

At this juncture it may reasonably be asked if the US dollar peg is still viable. Should the Hong Kong dollar perhaps rather be pegged to the Chinese *yuan*? There is no easy answer. What should, first of all, be asked is why amidst renewed speculative attacks on the Hong Kong dollar during the Asian crisis, was its value seen to be intricately linked up with that of the *renminbi*; and why was it believed that a devaluation of the Chinese currency would inevitably force the Hong Kong dollar to devalue in tandem? Were these perceptions based on compelling hard economic facts, or was it simply a matter of international currency speculators exploiting the “psychic mobility” and “herd behaviour” of the masses? Exploration of these ideas can assist in settling the fate of the US dollar peg.

#### *Hanging the US dollar Peg in the Balance?*

It is beyond the scope of this article to pursue the question in any depth. Here are merely a few fundamental points. First, the perception that the fate of the Hong Kong dollar is invariably bound up with the value of *renminbi* seems to have missed the most basic, but yet peculiar aspect of the China-HKSAR economic synergy in export-processing. That is, for the vast number of Hong Kong and Taiwanese export-manufacturers based in the mainland, export orders or letters of credit from overseas buyers are normally not channelled through the Chinese banking system. Rather, they are generally intercepted by business affiliates in Hong Kong or Taiwan. Similarly, as a corollary, foreign exchange outlay on input materials, equipment and machinery imported from say, Japan, enroute Hong Kong to the Chinese hinterland is also incurred outside China. In other words, both foreign currency income and expenditure made on the part of the Hong Kong investors in China are shielded from the volatility of the *renminbi*.

Secondly, a devaluation of the *renminbi*, without a concomitant devaluation of the Hong Kong dollar, would actually help to reduce the costs of investment made by Hong Kong’s export manufacturers in China. This relates especially to the costs of supplies from Chinese

26. The single most important source of the remarkable decline in Hong Kong’s exports in 1998 was Japan, South Korea and the South-East Asian countries which all saw their import capabilities seriously curtailed as a result of massive currency devaluations in 1997/98. By contrast, Hong Kong’s most significant export markets, the US and Western Europe, were only marginally affected, perhaps as a result of enhanced export competitiveness from the devalued South-East Asian economies. For a more detailed study on this, see Kueh, “Weathering the Asian financial storm in Hong Kong.”

sources, building materials for plant construction being a good case in point. In the past, such supplies were strictly subject to centralized allocation, but they are now readily available in the Chinese markets at *renminbi* prices. Managerial and wage costs may also be similarly reduced, to the extent that the outlay is denominated in *renminbi*, unlike in the past, when payment was generally by joint venture contract and, specified in foreign currency, that is Hong Kong or US dollars.

The third point relates to exports of third-country origin from Hong Kong to end-users in China, that is goods other than those destined for export-processing on behalf of the Hong Kong manufacturers. This has consistently made up around half of the SAR's total exports to the Chinese mainland in recent years. Probably more than one-third of China's imports from the US are presently channelled through Hong Kong.<sup>27</sup> The sheer magnitude, therefore, makes it worth pondering the implications of a *renminbi* devaluation for the Hong Kong dollar. Specifically, if the Hong Kong dollar were to devalue as well, it would probably only help to impair the import incentives of the Hong Kong middlemen, without being able to improve the import capability of the Chinese customers.

Another variable that may come into the equation involves import supplies from China in the form of wage foods, basic clothing and other light-industrial goods retained for local consumption by the masses in Hong Kong. This variable appears to be crucial, given the size of the Hong Kong population (6.7 million) and, indeed, the virtual monopoly China conventionally enjoys as Hong Kong's food supplier. Nevertheless, upon closer scrutiny, the variable may not actually be that relevant, for the simple reason that Chinese supplies to Hong Kong over many decades have been quoted in Hong Kong dollars, rather than in Chinese *yuan*.<sup>28</sup> There is no reason that Chinese suppliers would be willing to pass on to Hong Kong consumers any price benefits that may arise from a *renminbi* devaluation, by quoting lower export prices in Hong Kong dollars.

Taken together, there seems to be no tenable economic reason why the Hong Kong dollar should be seen as a fellow traveller of the *renminbi*. In a way, the reverse may actually be true, given the weight of the "Hong Kong factor" in the Chinese mainland economy. Note that Hong Kong, via FDI flows, makes up around 15 per cent of total fixed asset investment made in the mainland each year and an even more significant share of China's total exports, in addition to the enormous contribution to

27. Cf. Kueh and Voon, "The role of Hong Kong in Sino-American economic relations," p. 81.

28. This is because Chinese domestic prices are normally not comparable to the free market prices in Hong Kong or elsewhere in the world. A straightforward conversion from *renminbi* prices for the export goods concerned on the basis of the given exchange rate may not therefore yield an export quotation comparable to those offered for similar products from other sources in the Hong Kong market. Further complicating the matter, the officially fixed exchange rates used for the conversion may not be in accord with the purchasing power parity. Hence China, as well as all other former Soviet-type economies, being deprived of reliable scarcity price signals (due to distortions in official price-setting) are said to have been "trading in the dark," when relying on the changing world market prices for their export quotations.

manufacturing employment.<sup>29</sup> As a Hong Kong dollar devaluation would imply increased FDI costs in, and hence reduced FDI flows to the mainland, it might as well call for a *renminbi* devaluation for the Chinese government to mitigate the losses. At any rate, within the present context there hardly exists any compelling economic rationale for the Hong Kong dollar to be de-pegged from the US dollar in favour of a re-pegging to the Chinese currency. As a matter of fact, the Chinese *renminbi* itself is clearly also *de facto* pegged to the US dollar under the exchange rate regime of “managed float” adopted in 1994.

Nevertheless, in the wake of China’s imminent entry into the World Trade Organization (WTO), the situation appears to be increasingly parlous. WTO membership implies, among other things, a significant reorientation from export-oriented FDI towards import-substitution FDI in China. For Hong Kong investors and others, this means, of course, increased access to the huge domestic mainland market. However, to the extent that Hong Kong investors manufacturing products for the internal Chinese market rely on third countries for essential input supplies, this would tend eventually to force the value of the Hong Kong dollar to be more closely tied to that of the Chinese *renminbi*. A good case in point is the swift devaluation of the Taiwan dollar in late 1997 in response to the eruption of the Asian financial crisis. Shortly afterwards, major mainland-based manufacturers of Taiwan origin engaging in food-processing (a sector which had been accorded the rare privilege of entering the Chinese market at an early stage, and which extensively relied on Japan and Taiwan for supply of spices and packaging materials) were forced by mounting import bills to suspend their production. They were simply not able to withstand the price competition from domestic producers.<sup>30</sup>

Thus, with increased integration among the Hong Kong, Taiwan and mainland economies under the WTO framework, a Bretton-Wood type of agreement among the three Chinese economic entities, tacit or otherwise, may eventually emerge. Whether there ought to be a formal monetary integration, for example a “*yuan* bloc,” following full convertibility of the *renminbi* by 2020 or before (this was China’s pledge to APEC in the “Manila Framework” of 1997), is of course entirely conjectural.

Meanwhile the Hong Kong dollar will probably continue to be overshadowed by the traumatic experience of defending its peg to the US dollar in 1997/98, with or without launching a search for an alternative exchange rate regime or a more viable defence mechanism against international currency speculators.

29. According to the World Bank, by 1995, FDI inflows accounted for 25% of domestic investment, 13% of industrial output, 11% of tax revenues, 31% of total exports and 16 million jobs (n. 6). The export share was increased to nearly 50% in 1998. Since FDI from Hong Kong contributed around 50% of China’s total FDI intake in 1998, the SAR’s share in domestic capital formation may be roughly estimated to be 12.5% in 1998. Exports by foreign-funded enterprises are of course almost all dominated by Hong Kong and Taiwanese investors, and they all represent labour-intensive manufacturing.

30. Personal communication from a major Taiwanese investor in the food-processing industry on the mainland.



### *Conclusion*

Under the US dollar peg system the Hong Kong economy seems to have suffered from increased instability, both prior to and amidst the Asian financial crisis, primarily because it had to be subservient to the economic cycles of the US. Thus, it was unfortunate that exactly when, towards the year 2000, the Hong Kong economy was about to recover from the most severe depression ever experienced in its post-war history, the peg with the US dollar dragged it down. The high interest rates prescribed by the Federal Reserve Bank to cool the increasingly overheating US economy were the exact opposite to what the Hong Kong economy needed.

It is equally unfortunate that just when the American economy was slowing and the economic cycles of Hong Kong and the US were finally beginning to converge, the HKSAR could not escape the full brunt of the drastic curtailment in US import demand (Hong Kong export supply), the 11 September tragedy notwithstanding. It is to be hoped that the two economies will eventually synchronize and together return to sustained growth.

Fortunately, prior to the Asian crisis, the overheating and instability in Hong Kong caused by the peg could be mitigated by the timely actions of the Chinese government as it steadily opened further to the outside world. Permitting Hong Kong's export manufacturing industries to relocate in China enabled them to escape crippling increases in property values and wages. Similarly, amidst the Asian crisis China was able to come to the rescue, firstly by pledging steadfast defence, with its huge foreign exchange reserves, of the Hong Kong dollar under the peg, and secondly by granting real assistance to China-based export manufacturers from Hong Kong in the form of urgently needed credit supply and VAT rebates.

Despite the increased integration of the two economies, it does not seem that the SAR should abandon the US dollar peg in favour of a re-pegging to the Chinese *yuan*. Actually, the Chinese currency itself is also *de facto* pegged to the US dollar with the similar objectives of promoting and maximizing export earnings from the US and other major overseas markets. Indeed, the case for the currency of the small and entirely open HKSAR economy to be anchored to the US dollar or a basket of major Western currencies today seems even more pressing.

Perhaps the Hong Kong dollar should be pegged to the US dollar at a more workable rate. With deflation fuelled by the existing dollar peg persisting now for more than three years, influential voices in Hong Kong have recently been calling more frequently for a re-think of the 18-year-old peg.<sup>31</sup> However, any re-pegging (equivalent to a devaluation of the Hong Kong currency) must obviously be weighed against the risks of a sudden capital outflow from Hong Kong and the consequent rise in

31. This was aired by the Liberal Party chairman and legislator James Tien Pei-chun. He insisted that "the policy adopted in 1983 was the major obstacle to economic recovery" and said "the Hong Kong dollar would depreciate by no more than 20% if the peg was scrapped"; see *South China Morning Post*, 5 September 2001.

interest rates that would further erode consumer and corporate confidence. In the words of Joseph C.K. Yam, Chief Executive of the Hong Kong Monetary Authority: "If, heaven forbid, de-pegging were to be carried out in the conditions that we have now, then we might add a third word to uncertainty and instability: catastrophe."<sup>32</sup>

Finally, China's new membership in the WTO (as of December 2001), the increased trade and investment liberalization, and expected convertibility of the capital account at some later stage, are all likely to have the effect of reducing the differences between the Hong Kong and mainland economies, perhaps laying the ground for an eventual monetary union. Such a prospect, however, still appears to be quite remote. Under the existing US dollar peg, the Hong Kong dollar will inevitably continue to be subject to occasional speculative attack.

32. See Joseph Yam, "Building Stability in Unstable Times" (talk given at the Hong Kong Institute of Bankers), 24 October 2001 ([http://www.info.gov.hk/hkma/eng/speeches/speeches/joseph/20011024e\\_index.htm](http://www.info.gov.hk/hkma/eng/speeches/speeches/joseph/20011024e_index.htm)). Defending the peg, Yam also argues that "Hong Kong's currency was delivering competitive gains, ... (in that) the Reer (real effective exchange rate) for the Hong Kong dollar has depreciated by around 13% since the crisis period in 1998, ... while the Reers for Asian currencies have appreciated by various degrees" (*ibid.*). This is of course a matter of judgement as to what extent the competitive gap between the currencies of Hong Kong and other Asian countries has narrowed, given that at the peak of the Asian crisis, most South-East Asian currencies depreciated by 40 to 60%.