

# Tale of two cities and two exchange rate regimes

Both Hong Kong and Singapore have been exceptionally successful global cities. It may be time for them to also share a similar exchange rate regime. BY RAMKISHEN S RAJAN

**U**S PRESIDENT Donald Trump recently announced that he is rescinding Hong Kong's special status with the US in trade, travel and technology transfer as part of a set of retaliatory actions against Hong Kong's National Security Law enacted by mainland China. In addition, if reports are to be believed, advisers of US Secretary of State Michael Pompeo had floated the idea of undermining the Hong Kong dollar (HKD) peg to the US dollar (USD) by limiting Hong Kong banks' access to the greenback.

Leaving aside whether the US could in fact unilaterally compromise the HKD peg (in light of the massive reserves held by the Hong Kong Monetary Authority, or HKMA), thankfully this threat of using the exchange rate as a weapon does not seem to have garnered much support within the Trump administration. It also appears that currency markets have largely discounted the possibility of follow-through of such an action which would have also called into question the suitability of the USD as the dominant international currency.

Nevertheless this latest episode has placed the Hong Kong's Linked Rate Exchange System (LERS) back in the headlines for the wrong reasons. There is a degree of irony in all of this in that Hong Kong's hard USD peg was established in 1983 primarily to prevent acute currency instability caused by uncertainties relating to the Sino-British talks regarding the planned handover of the city.

By fixing the HKD at a particular level to the USD (7.80) and ensuring the HKMA had adequate USD to cover the entire domestic monetary base at the prevailing exchange rate (so-called Exchange Fund), such a currency board arrangement was primarily intended to depoliticise the exchange rate and signal that Hong Kong was distinct from mainland China.

The LERS proved to be highly successful in its objective and has been a source of financial stability for the next decade and a half. However, it came under severe test during the double play episode of 1997-98 when hedge funds shorted both the HKD and local equity market as a means of profiting either from a devaluation of an apparently over-valued HKD (given that other East and South-east Asian currencies had fallen sharply during the Asian financial crisis) or from an equity market collapse.

Since then there have been other episodes of occasional pressures on the peg, including during the 2008-2009 global financial crisis and during the pro-democracy protests in late 2014 and 2019. While the HKMA has made some adjustments to the LERS over the years (including allowing the currency to move within a band of 7.750 and 7.850 HKD per USD since 2005), it has generally adhered to the LERS.

## CLOSE INTEGRATION

This commitment notwithstanding, reasonable questions have been asked about whether the USD peg still remains appropriate for Hong Kong. Over the last few decades it is well known that Hong Kong has become very closely economically integrated with mainland China in terms of trade and tourism, being a launch-pad for many mainland companies looking to expand overseas, and as a conduit for funds between the mainland and the rest of the world. Empirical analysis reveals that Hong Kong's business cycle has become increasingly synchronised with that of mainland China.

Three arguments can be made against a Hong Kong peg to the yuan (CNY). One, part of the close business cycle co-movements between Hong Kong and China can be attributed to the common influence of the US – to which much of China's exports have historically



Pegging the HKD solely to the CNY along with an interchangeability agreement with China might be something that could well happen over the longer term. PHOTO: BLOOMBERG

been destined. Two, there are significant structural differences between Hong Kong (primarily services-oriented) and mainland China (primarily manufacturing-driven). Three, the renminbi (RMB) itself was heavily pegged to the USD thus making it a moot point whether to shift from the USD to the CNY.

The foregoing arguments were likely highly persuasive till the mid-2000s. However, with a gradual move towards greater flexibility of the CNY, on the one hand, as well as the fact that there has been a definite reorientation of Chinese development towards its domestic economy and towards higher value-added services, on the other, along with a steady but clear decoupling of the two economic giants, all suggest that the economic case for the HKD to be pegged bilaterally to the USD is certainly weakening.

Moving away from the status quo is never easy, especially if that policy has been an integral part of an overall highly successful economic strategy. However, if Hong Kong does eventually choose to forsake the USD peg, what are the options open to it?

Given the exceptionally heavy dependence of Hong Kong on the external economy on the one hand as well as the fact that it is significantly influenced by the global financial cycle on the other, the insulating powers of the exchange rate will be rather limited. This suggests that Hong Kong would be better off still to operate a heavily managed exchange rate regime. The question here then becomes – managed to what currency? The CNY is an obvious choice and Hong Kong is the global hub for offshore renminbi business.

Nonetheless concerns remain about the lack of full convertibility of the CNY, China's less than fully open capital account, and the heavy and highly opaque intervention of the currency by the People's Bank of China (PBOC). There is also the concern about whether wholesale adoption of the CNY will be another step towards reducing Hong Kong's economic autonomy from the mainland and further hasten the process of making it "just another mainland Chinese".

This is a real possibility, given that Hong Kong's share of mainland China's gross domestic product has fallen from a peak of 27 per cent in 1993 to less than 3 per cent today. In addition, while China dominates Hong Kong's external economic interactions, it still maintains significant trade, financial and foreign domestic investment flows from other countries

including the US, Japan, Singapore and rest of Asia.

The HKD being pegged solely to the CNY along with an interchangeability agreement with China (as in the case of Singapore and Brunei) might be something that could well happen over the longer term (assuming China is willing to permit one country two currencies arrangement over time). In the interim, though, a more practical option might be to consider a Singapore-style Band Basket and Crawl (BBC) arrangement which the city state has adopted since 1981. This is by no means an overly radical proposal. Ironically, China too has moved away from a USD peg to tie the CNY to a basket of 24 currencies.

## VOLATILITY CONCERNS

Under the BBC, the Monetary Authority of Singapore (MAS) manages the SGD with reference to an undisclosed basket of currencies (NEER) rather than a single currency. The MAS intervenes in the foreign exchange (FX) market when the trade-weighted currency index is adopted to reach the edge of the policy band or occasionally within the band if there are concerns about "excessive" volatility.

To be sure, questions can be asked about whether Singapore should itself allow for a greater degree of exchange rate flexibility (ie wider bands) and whether the use of the exchange rate as an anti-inflationary tool is as effective in times when the main sources of inflation are more internal (nontradable prices) than were external (tradable prices).

The regime is by no means perfect, but it has proven to be highly durable and allowed the country to maintain a high degree of exchange rate stability without being straightjacketed to a narrow exchange rate target. Like Hong Kong, Singapore interest rates largely follow the Fed rate, though somewhat less tightly.

Both Hong Kong and Singapore have been exceptionally successful global cities, are major financial and trading hubs, serve as headquarters for global companies, are highly reputed for their fiscal rectitude, sit on significant stockpiles of foreign exchange reserves, have proven resilient to major regional and global shocks, and have a high degree of factor market flexibility. Could it be time for them to also share a similar exchange rate regime?

■ The writer is Yong Pung How Professor at the Lee Kuan Yew School of Public Policy, National University of Singapore