<u>The Best Time to Delink the HKD from the USD is: As Soon As Possible</u>

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Imagine there are three countries in the world, A, B and C. A is a very small country, while B and C are both much larger countries. Twenty eight years ago (1983), **A's currency was linked to that of C**. At that time, B was a much smaller economy than C, and A mainly trades with C.

Thirteen years ago (1998), A was in a big recession but C was in a boom, and so C's interest rate was high. Because A's exchange rate was linked to that of C, A's interest rate must be the same as that in C. In other words, as A could not allow its currency to depreciate against that of C, **its monetary policy remained tight in the face of the big recession, causing severe unemployment and deflation**.

Now (2011), the world has changed. B has become much larger. **A now trades mostly with B**. C is in a once-in-eighty-year severe recession and is expected to have very slow growth and high unemployment in the next few years. B is expected to have high growth in the foreseeable future. **C's currency is expected to continue to depreciate against B's by about 5% per year in the next few years** and possibly beyond. Because of the linked exchange rate, **A now has low interest rate and high inflation, causing a housing bubble**.

What do you think would happen to A's economy in the next few years if it continues to link its currency to that of C's? **Should A delink its exchange rate from that of C**?

The linked exchange arrangement of the HKD was instituted in 1983 to overcome the confidence crisis amid the China-British negotiation about HK's future

It is a currency board arrangement --- the HK authority promised to exchange 7.8 HKD for one USD with no limit on the amount exchanged.

In 1983, the US was the strongest economy in the world. It was one of the most important trading partners of HK at that time.

The linked exchange rate system was not supposed to be continued once the confidence crisis has dissipated after the handover. We are now 14 years after the handover. The confidence problem that dogged HK in 1983 has dissipated. Do we still need to link our exchange rate with that of the USD?

What are the costs and benefits of a linked exchange rate system for HK?

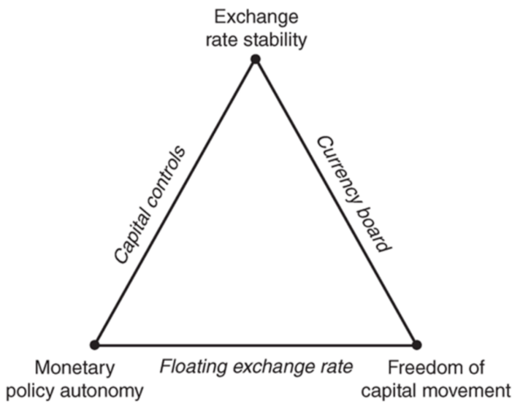
Benefits: HKD is anchored to a hard currency that has **stable international purchasing power** (i.e. the US has stable exchange rate with other major currencies and low inflation), giving confidence to people who hold HKD, discouraging speculative attack.

Costs: **The loss of the autonomy to use of monetary policy** to make macroeconomic adjustments. Arbitrage would ensure that the interest rate in HK is equal to that of the US as long as full capital mobility is maintained. This is the consequence of the **foreign exchange regime trilemma**, as shown below.

Exchange Rate Regime Trilemma

- A country faces tradeoffs when trying to achieve the following goals:
    - exchange rate stability
    - financial capital mobility
    - autonomous monetary policy devoted to domestic goals
- Generally, a country can attain only 2 out of the 3 goals

The Policy Trilemma for Open Economies:

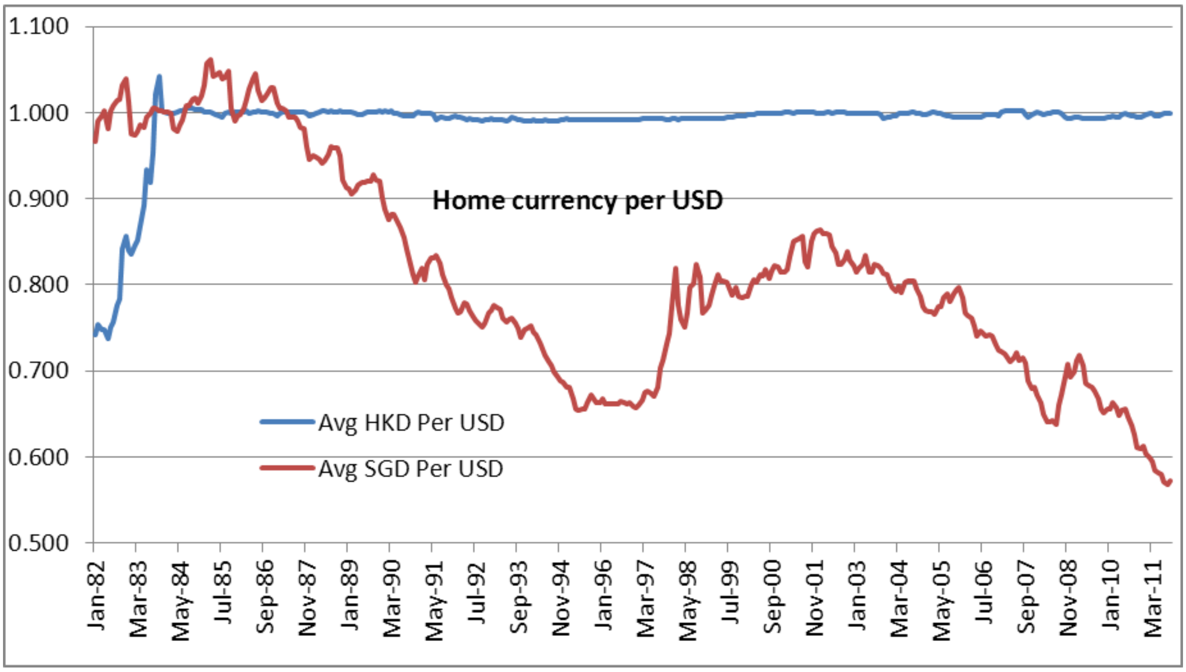


Examples

- Currency board --- Hong Kong. No monetary policy autonomy.
- Floating exchange rate --- USA. No exchange rate stability.
- Capital controls --- China (when pegged to USD). No freedom of capital movement.

The costs of the linked exchange rate to HK can be shown in the charts below, which show (a) the serious deflation, unemployment and negative growth in the aftermath of the Asian financial crisis; (b) volatility in inflation from 2000-2011; (c) the volatility in real interest rates 2000-2011; (d) volatility in middle class residential property prices 2000-2011. We compare HK with Singapore as both are city states, and they share many similarities in their economies.

It cannot be pure coincidence that Singapore adopts a more flexible exchange rate regime and it showed less volatility in its economy.


1.100
1.000
0.900
0.800
0.700
0.600
0.500
Home currency per USD
Avg HKD Per USD
Avg SGD Per USD
Jan-82
Mar-83
May-84
Jul-85
Sep-86
Nov-87
Jan-89
Mar-90
May-91
Jul-92
Sep-93
Nov-94
Jan-96
Mar-97
May-98
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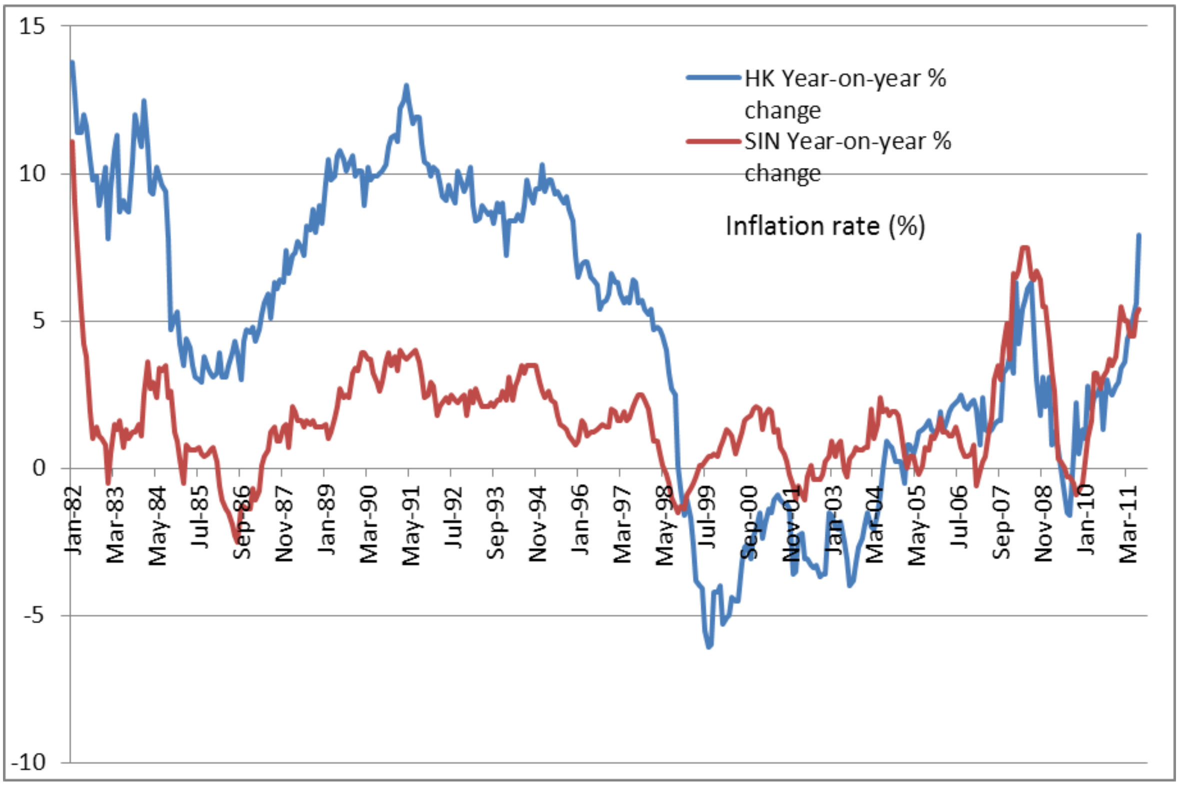
Nov-08
Jan-10
Mar-11


15
10
5
0
-5
-10
HK Year-on-year % change
SIN Year-on-year % change
Inflation rate (%)
Jan-82
Mar-83
May-84
Jul-85
Sep-86
Nov-87
Jan-89
Mar-90
May-91
Jul-92
Sep-93
Nov-94
Jan-96
Mar-97
May-98
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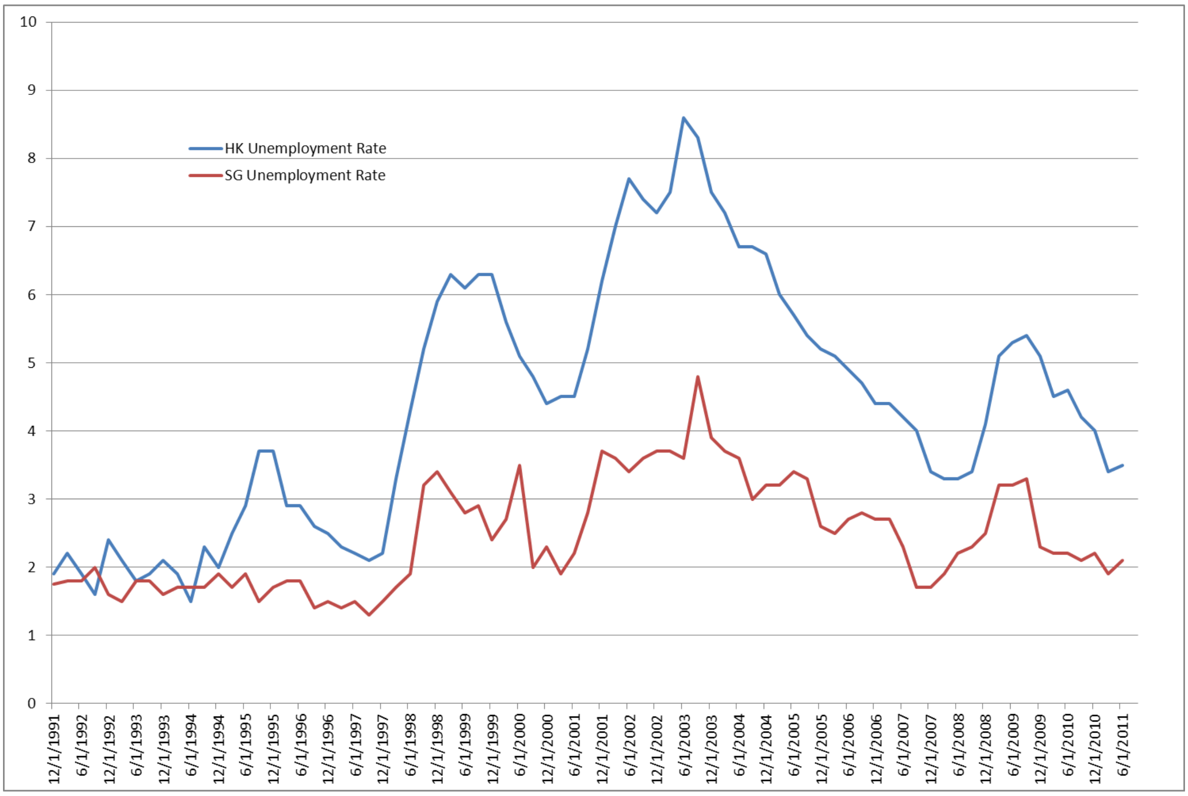
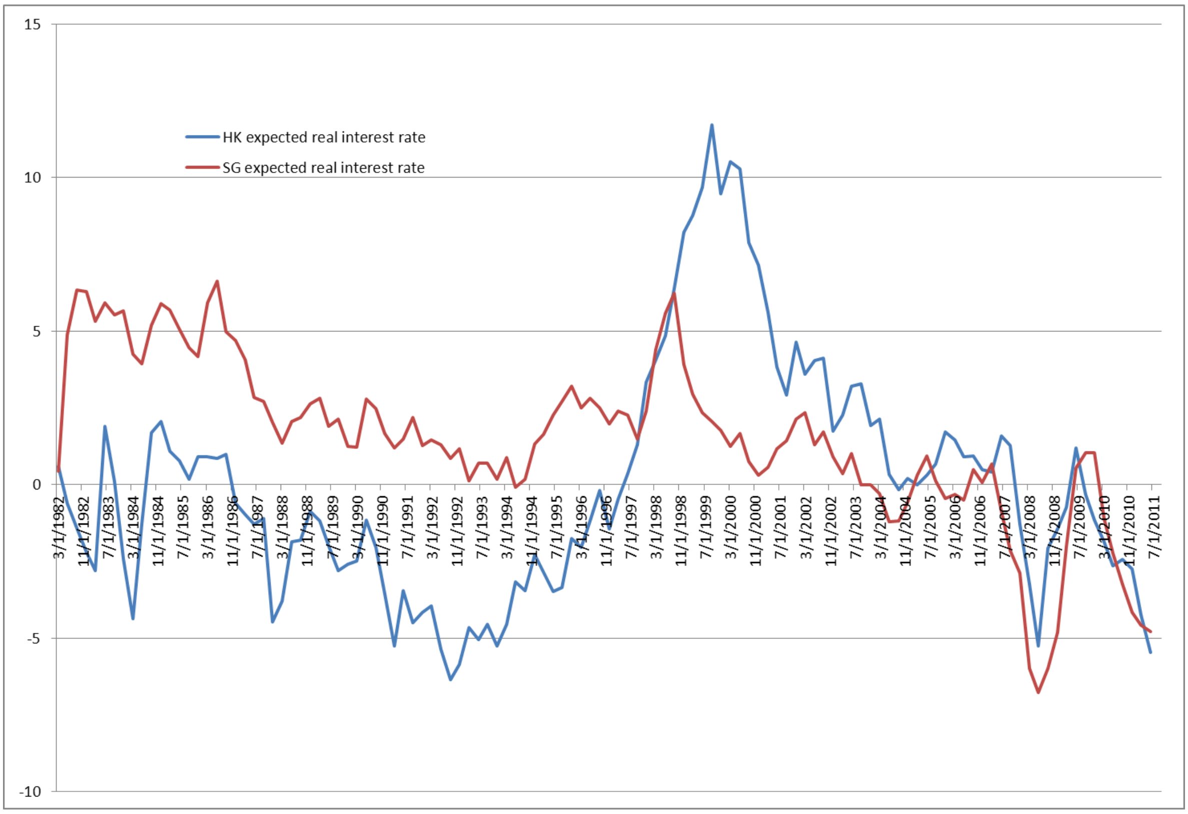
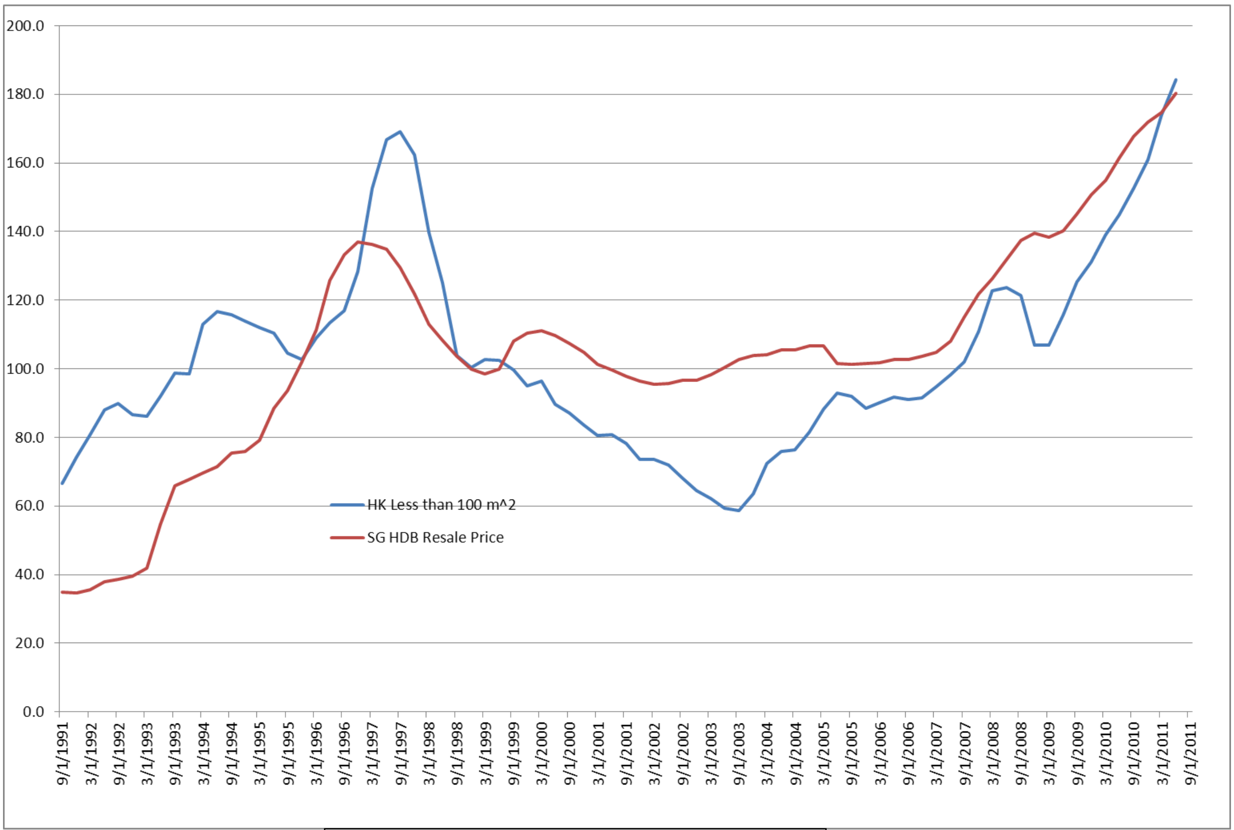
Nov-08
Jan-10
Mar-11


HK Unemployment Rate
SG Unemployment Rate


HK expected real interest rate
SG expected real interest rate



Residential property price indexes

The following table shows the volatility of HK's economy compared with that of Singapore after the Asian Financial Crisis.

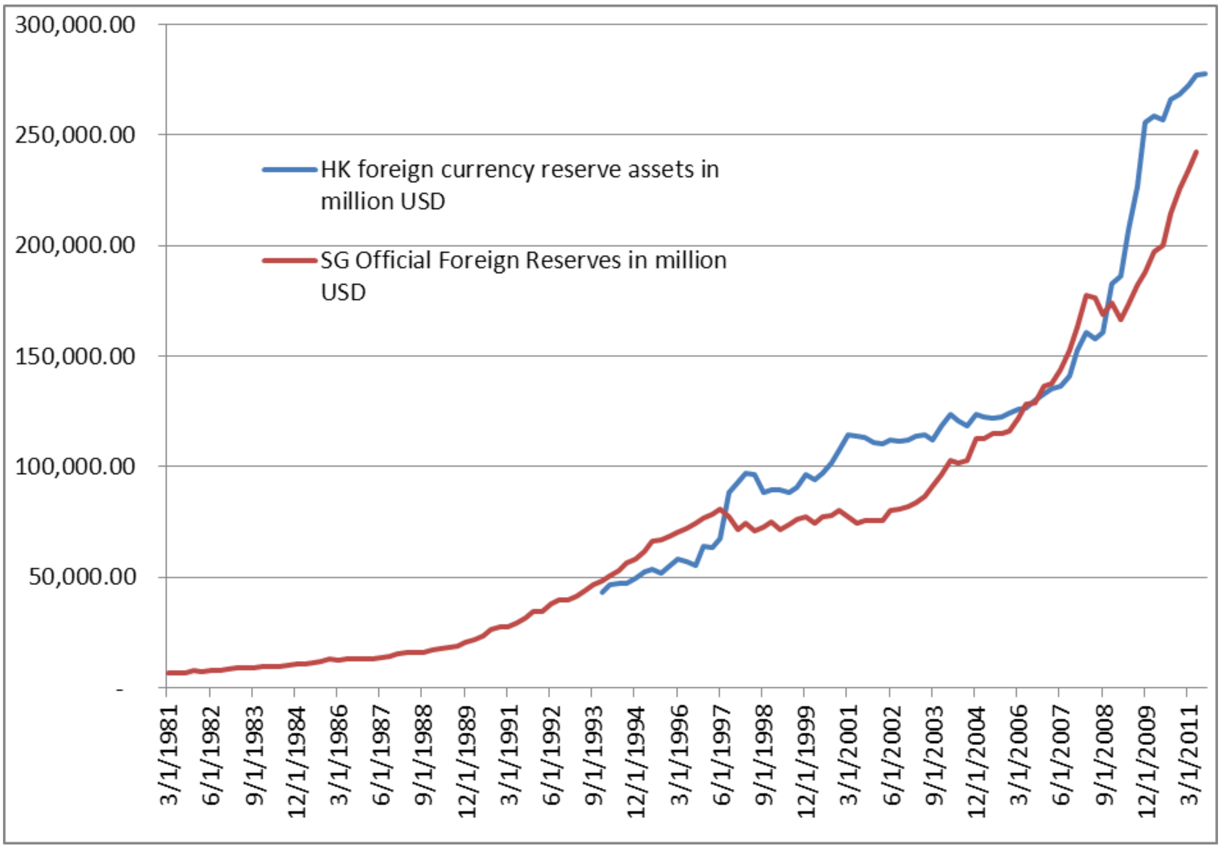
From 1 Jan 2000 to 30 June 2011 quarterly data:

	HK real interest rate	**SG real interest rate**	**HK inflation rate**	**SG inflation rate**	**HK Residential property less than 100 m^2**	**SG Residential HDB Resale Price**
Standard Deviation	10.6	4.6	6.8	3.2	63.1	49.4

There are a few myths that I want to dispel:

Myth No. 1. **The international financial center status of HK depends on this linked exchange rate system.** (See, for example, speeches by Tony Latter (former Deputy Head of HKMA), Franklin Lavin (former US under-secretary of commerce for international trade), John Greenwood (father of the linked exchange rate system)). The fact is that the significance of the peg to the status of international financial hub is close to nothing. No other financial center of the world today needs to have a currency board system or linked exchange rate system.

Myth No. 2. **Floating exchange rate runs higher risk of being attacked by speculators than does a currency board.** The truth is that the line between a currency board and managed float exchange rate regime (e.g. pegging to a basket of currencies but allowing that exchange rate to change over time) is very blurred indeed if you have sufficient foreign exchange reserve. The currency board cannot "guarantee" the exchange rate (see the example of Argentina). The credibility of the linked exchange rate is ultimately determined by the health of an economy and the amount of foreign exchange reserve the monetary authority has in case it has to intervene to defend the exchange rate.



Myth No. 3. **Delinking the HKD from the USD must lead to linking the HKD to another currency, such as RMB.** The truth is that the best alternative to delinking from the USD dollar is pegging it to an undisclosed basket of currencies. The peg can change over time based on inflation targeting. Inflation targeting is one of the most widely used policy prescriptions of central banks all over the world.

An important fact is that the global economy has undergone a sea change in the last 28 years. China has become a much larger economy, and Hong Kong trades a lot more with China and the rest of Asia than with the US.

The US economy is currently in the doldrums with no turnaround in sight. The Federal Reserve tried all its means to increase the supply of money, thus creating pressure for the USD to depreciate against economies that are fast-growing, such as China, HK and Singapore. If they do not let their currencies appreciate, these economies will have to increase their money supply, thus raising the inflation rate.

HK's case demonstrates this effect very clearly, as the currency board arrangement requires it to fix its exchange rate with the USD

What are the consequences for HK now?

1. High inflation
2. Low interest rate
3. Therefore, seriously negative real interest rate
4. Therefore, there is asset price inflation (or even bubble), as people do not want to keep their money in bank deposits. Property market bubble is one good example.
5. High inflation lowers the living standard of the low income households, as their income can catch up with inflation only with a time lag, if at all.
6. High property prices make them unaffordable to young people
7. Both effects cause social instability

The US economy is likely to remain in low-growth, low interest rate situation in the next few years, while China continues to be a high-growth economy. USD will continue to depreciate against the RMB in the next few years.

HK now relies more and more on imports from China, Japan, South Korea and other Asian countries than from US. A continued and prolonged depreciation of the HKD vs. the CNY and other currencies such as JPY and AUD will only lower the living standard of HK people as a whole, and low-income households in particular. Gradual appreciation of HKD as a result of delinking will increase the international purchasing power of HK people, creating a wealth effect that may have great benefits to HK society.

A gradual appreciation of the HKD has very little adverse effect on the competitiveness of HK, as can be seen from the case of Singapore. In fact, a higher value of the HKD **makes imports of capital goods cheaper, which lowers the costs of investments in business and government. It can also make HK more competitive in attracting international talents.**

Historically, HKD has delinked from the USD in 1974 and adopted free floating 1974-1983.

Therefore, I suggest delinking the HKD from the USD as soon as possible, subject to
1. The action to be undertaken unexpectedly
2. HK govt. having trained enough personnel to be able to deal with a managed float exchange rate regime (People's Bank of China would be able to help, and it should not take too long to learn the tricks.)
3. a strong support from the central govt. both in principle and in kind (central govt. can announce its full support for the managed float of the HKD and warn speculators of the huge foreign exchange reserve China has.)
4. allowing the HKD to appreciate only gradually against USD, say at 5% per year.

Action to be taken: The HK govt. can simply announce that they would allow the exchange rate to float with immediate effect, but with a floor of HKD 7.8 to USD 1. It can vow to intervene if the exchange rate goes below 7.8, citing that it has the full backing of the central govt. in case it needs to defend the HKD.

What to do after delinking? Switch to a managed float system by pegging to an undisclosed basket of currencies. The weight on the currency of a country in the basket should be determined by (a) the country's share of HK's exports of goods and services to the country (based on value-added by HK); (b) the country's share in HK's imports (based on actual usage and consumption in HK). Note that this is a crawling peg. The peg can keep changing based on the principle of keeping inflation within a tolerable range.

How should monetary policy be conducted? The HK Monetary Authority should intervene in the forex market to adjust the exchange rate between HKD and this basket based on the principle of price stability. This is called **inflation targeting**. As HK is a small open economy, the inflation rate is inevitably more volatile. But it should be targeted at about 2-3 percent year-on-year and should not be higher than 5 percent y-o-y.

If inflation is too high, the HKMA buys HKD and sells the basket of currencies, thus tightening money supply and raising interest rates, cooling the economic activities and suppressing the tendency for prices to rise.

If there is a tendency for deflation, the HKMA sells HKD and buys the basket, thus loosening money supply and lowering interest rates, encouraging economic activities such as business investment, real estate purchases, and consumption.

One of the most compelling arguments for delinking now is that **the market is having a one-sided bet on appreciation now**. **The risk that a currency would appreciate out of control is very low**, as the govt. can always accumulate foreign exchange reserve. On the other hand, if the HKD is forced to delink at some point in the future when the market regards it to be overvalued, then the risk of delinking is really high. **The risk that a currency would depreciate out of control when it is perceived to be overvalued is much higher**, as the govt. can run out of foreign exchange reserve in the course of defending its currency. **Do we want to delink when**

we are perceived to be highly undervalued, or do we want to delink when we are perceived to be not as highly undervalued?

Delinking is not a panacea, and the linked exchange rate system should not be blamed for all the problems of HK either. But delinking can ease some pains and provides flexibility for macroeconomic policy making. It can increase the international purchasing power of the HK people and **lowers the costs of imports (such physical and human capital), which lowers the costs of investments and the costs of doing business.** It can also help the city to transform into a more innovation-driven economy by making it cheaper to hire international talents. Other concurrent policies need to be implemented to recapture HK's competitiveness, such as education reform and support of R&D.