Hong Kong: Populist Authoritarianism and The Peg

We thought it best to write this article quickly before legislation covering acts of sedition, subversion, treason and succession, not to mention dissemination of state secrets, is grafted onto the statute books as stipulated under Article 23 of the Basic Law. OK this is a cheap dig since the summary of the proposed legislation as outlined in the recent consultative document does not suggest that **DSG*Asia***'s musings will be considered as inciting violent threats to state security, even though the authorities are not helping their case by stubbornly refusing to publish the full paper. However, the serious undertone of the furore generated is unfortunately all too symptomatic of the SAR government's inability to offer policy coherence and leadership in almost any arena, and the fundamental distrust that the public and markets have in its motivations.

The furore over Article 23 is symptomatic of the fundamental distrust that the public and markets have in the government's motivations

Moreover, some of the fears about the intention of the legislation are more than justifiable in our opinion. Chief Executive, Tung Chee Hwa, is correct in asserting that the laws proposed are similar to those on the statute books of many Western countries but he neglects to mention that the formal separation of the state from the judiciary and the state from a single ruling party are also embedded in the legal systems of those countries he seeks to compare Hong Kong with. Such formal separation of legislative, executive, party and judicial functions cannot be seriously claimed by the PRC in any shape or form, and by implication cannot be claimed either by the SAR. Indeed, as Jiang Zemin re-affirmed last year: "we must resolutely resist the impact of Western political models such as multi-party systems or separation of powers among the executive, legislative and judicial branches... It is vital to uphold the centralised leadership and the unity of the party and the state, and safeguard the authority of the Party Central Committee."[1]

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[1] As cited by Susan Lawrence in "The Life of the Party", *The Far Eastern Economic Review*, October 18th 2001, quoting from a July 1st 2001 speech by Jiang Zemin commemorating the Party's 80th birthday. This in turn is a consistent line with statements by former Premier Li Peng, now chairman of the Standing Committee of the National People's Congress, in a statement at a national conference on the civil legal system in October 2000. In this statement he stressed the need for the CCP to play an even more powerful role in leading the judiciary, which should have characteristics very different from Western countries in order to make civil judgements compatible with the socialist market economy. The Constitution, he noted, "guarantees the independent judicial rights by courts and procuratorates" while judicial departments will be assured of their "independent rights in defiance of any interference by administrative bodies, social groups and individuals."

To put this another way, in the PRC's worldview, patriotism and love for China cannot be separated from obedience and deference to the Communist Party and any words and deeds that challenge its continued hegemony are to be considered treacherous and seditious. However, we digress. While we can wax lyrical and at length about legal and constitutional issues to any readers who care to pursue these discussions further, we would hazard a guess that the subjects will not be particularly high on the immediate agendas for most investors unless they are seen to be intruding into areas of contract and securities law. For now this is but a distant danger compared to the more immediate damage that is being done to the economy by general governmental ineptitude. And in turn, this is resulting in an increase in the noise quotient surrounding the SAR's fixed exchange rate regime.

There is also an increase in the noise quotient surrounding the SAR's fixed exchange rate regime

One of the occupational hazards of being a Hong Kong-based macro analyst is that one is regularly called upon to debunk various myths surrounding the SAR's currency board system. Doubly so if one can also claim (intellectual) lineage from the designer of the linked-rate system, GT's (now Invesco) John Greenwood OBE. In recent months the frequency of such enquiries has increased as local politicians and analysts have sounded off about the peg's durability. So while our views on the subject have been little changed over the years, we thought it timely to add our own ten cents' worth to the debate.

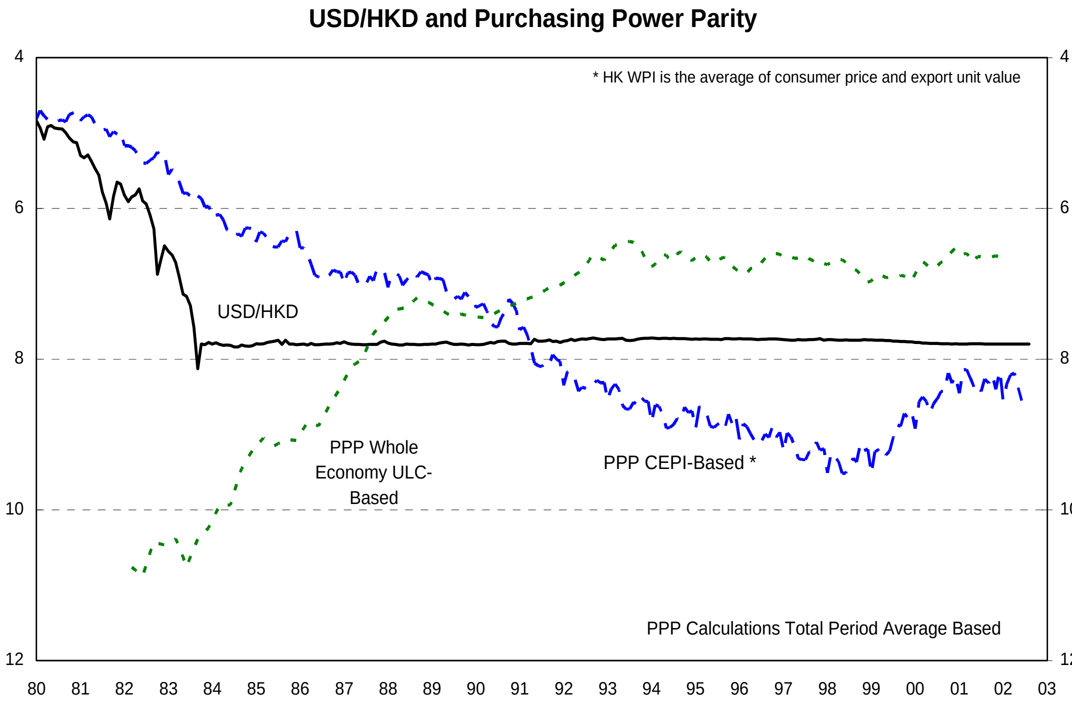
We believe the fixed rate mechanism has served Hong Kong well

We wish to reiterate at the outset that we believe the fixed rate mechanism has served Hong Kong well and that while we would question whether the hybrid system that has evolved in recent years remains a true currency board, the adjustment of factor prices around the nominal exchange rate anchor has generally accorded to the theory of its design. Indeed, as we argued in an article back in July of this year,[2] international competitiveness has been more than restored as the chart over demonstrates.

International competitiveness has been more than restored

However, ultimately he set out three principles for judicial supervision: "[T]he supervision must be put under the leadership of the Party; the People's Congress will get no judicial rights, but… initiates an internal supervisory mechanism of judicial bodies; and the People's Congress exercises its supervisory rights collectively to prevent the interference in judicial independence by deputies." As reported in the China Daily, October 26th 2000.

[2] See: "Singapore & Hong Kong – Labour Pains", July 23rd 2002.



Nevertheless, the longer-term failure of the broader economic system has been an inability to implement structural policy changes in areas such as taxation, immigration, housing, education and the bureaucracy. While the majority of factor prices have been able to adjust both upwards and then painfully back down towards reality, the authorities have implemented little in the way of strategic policies to address other economic distortions that have exacerbated such factor price swings. This is by no means merely a post-1997 phenomenon since the colonial administration was just as guilty at ducking the big issues; its defence of an inability to act in the run-up to the handover can only be perhaps accepted in the final couple of years of its shelf-life. But the failings of the previous administration are no reason for absolving the current leadership from all blame nor can they be used as an excuse to avoid taking remedial action in the future.

The longer-term failure of the broader economic system has been an inability to implement structural policy changes

Unfortunately, we see little prospect that such structural remedial measures will be taken and moreover, they do not seem to be even being seriously considered. Indeed when one tries to engage officials in debate it becomes all too clear that little thought has been given to holistic approaches to structural economic policy. Rather as befits the trading background of many of Tung's 'ministers' the aim is to look for quick fixes that will deliver near-term jumps in the popularity polls without upsetting the entrenched interests

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of society's myriad rent seekers. It is such short-termism that poses the gravest risk to the exchange rate regime in our opinion and while it is still a minority probability, the chances have risen that the authorities will attempt to seek a simple answer to their problems and use the peg as a scapegoat. Certainly there seems little reason at such low spreads to not hedge underlying HKD asset exposure.

It is such short-termism that poses the gravest risk to the exchange rate regime

As we noted the other week, independent legislator Emily Lau's suggestion that LEGCO debate the continued usefulness of the peg should not have been viewed as the act of economic sabotage that some suggested. A democratic society, even one as stunted as Hong Kong's, has every right to engage in public debate about all issues including exchange rate arrangements.[3] Our own opinion is that Ms. Lau is one of only a few politicians in Hong Kong with any spine or integrity and while some of her economic ideas are somewhat shaky, the fact that she continues to pepper the government with awkward questions is to be commended. While it should be taken as given that the Chief Executive, the Financial Secretary and the head of the HKMA should keep their own counsel on this issue, legislators and administrators have a duty to foster an honest debate on the costs and merits of the currency board and to explain the rationale for its maintenance or abandonment to the public at large.

While it is still a minority probability, the authorities may seek a simple answer to their problems and use the peg as a scapegoat

For what it is worth, despite the current unfriendliness of the international environment, if the government were to announce it was moving to a new exchange rate regime tomorrow, given the huge amount of surplus liquidity in the domestic financial system, it might be able to pull off such a change with limited disruption. To achieve such an outcome, the move downward – one must assume that they would be looking to devalue if they believed that an overvalued currency was the root cause of the economy's difficulties – would have to be so large and quick that the general public would perceive that the exchange rate was now so undervalued that it should appreciate again over time. In such circumstances, any spike in interest rates would be short-lived and subsequently the authorities could establish credibility in the new regime chosen.

[3] Even control freaks such as Tony Blair recognise this hence his current inability to bounce the UK into the euro without a referendum.

Another reason why a devaluation of the HKD would be potentially less dislocational than others seen in the region in recent years is that the system carries little in the way of foreign debt. The public sector's foreign borrowings at the end of 2001 totalled only 0.4% of GDP while the corporate sector's external debt stood at USD38.1 billion or 23.2% of GDP. However, only a fifth of this debt was short-term and anecdotally most of it is already fully hedged. Moreover, latest figures show that foreign currency deposits account for 115% of GDP or 45% of the system's total so the spectre of mass corporate and personal bankruptcies due to a lower local unit cannot be considered realistic.

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Nevertheless, even if a change in the regime could be achieved with minimal short-term disruption it would a) still require the establishment of the credibility of the reconstituted monetary authority and b) it would not be Pareto optimal – i.e. the transition would throw up losers as well as winners. Furthermore, de-pegging would also not resolve most of the medium-term structural issues that need to be addressed. We will revisit and discuss some of these structural issues in a follow up article in due course but in the interim, we would refer readers to some of our previous musings on such subjects.[4] For now though, we will concentrate on the issues of policy credibility and societal redistribution.

The system carries little in the way of foreign debt and foreign currency deposits are large

We do not consider that the establishment of monetary authority credibility will be particularly difficult. To all intents and purposes, the HKMA has morphed from currency board operator to ersatz central bank in recent years and its functionaries are probably more than capable of operating explicitly as one. We suspect that if the peg is broken, it will be replaced not by another fixed rate at a lower parity but more likely by a managed trade-weighted float not dissimilar to Singapore's. It should be noted that Singapore still operates a system that requires full foreign currency backing for notes and coins in circulation and one would assume that Hong Kong would retain a similar stipulation. However, by pursuing a policy of managing the nominal trade-weighted exchange rate in order to stabilise the real TWI over the course of the cycle, some of the wilder swings in factor prices can be mitigated. We will return to this issue in due course in the context of a wider discussion of currency arrangements both sides of the Lowu crossing. But for now all we would note is that we have confidence

We think that the HKMA could establish monetary authority credibility relatively smoothly

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[4] See, for example, "Hong Kong's Phantom Fiscal Crisis", October 3rd 2001 and "Diving into the Immigration Pool", March 27th 2002.

that the HKMA has enough institutional expertise to manage such a transition relatively smoothly.[5]

A devaluation of the HKD would be a transfer from the poorest in society to the better off

Determining society's winners and losers is also quite a straightforward issue. A devaluation of the HKD would be a transfer from the poorest in society to the better off. Specifically, while the average Hong Kong resident has almost half his savings in foreign currency it is fair to assume that those on low fixed salaries or welfare have little in the way of discretionary income to place in non-HKD assets. Moreover, they would be the ones to feel the most pain from a rise in the price of imported goods, especially staples. And while in current circumstances of global disinflation and a significant local negative output gap we do not see a rise in the prices of goods such as rice, vegetables and fuel having major pass through effects into generalised inflation, there is little doubt that the squeeze would be felt more acutely at the bottom of society.[6]

The other losers would be civil servants whose pensions are invested largely in HKD assets

The other losers would be civil servants whose pensions are invested largely in HKD assets. One must assume that the government will try to buy some acquiescence by using public money to make up at least part of the shortfall.[7] However, as the chart below shows, it is hard to argue that the civil servants and indeed the broader government sector have been forced to tighten their belts along with everyone else in society. Such consistent

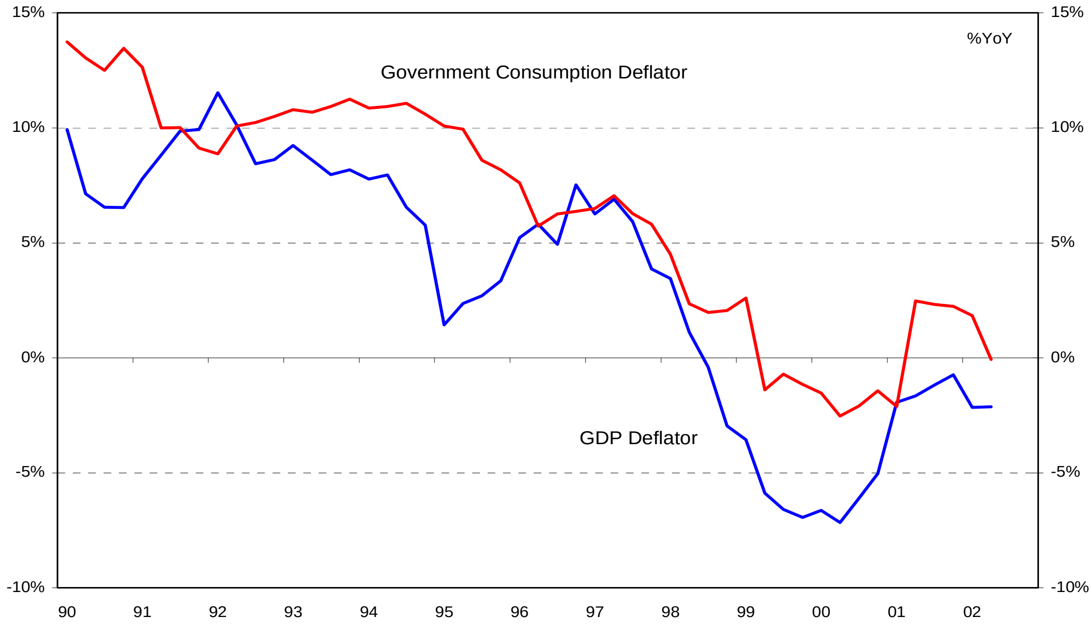
[5] An implicit assumption in such a statement is that the reconstituted HKMA would be granted operational if not full independence, and that there would be a consistency in its principal staff over the transition. However, given persistent rumours of disagreements and even mutual antipathy between various senior government and monetary authority functionaries, this cannot be taken for granted. It will be extremely important to keep an eye on political developments and internecine bureaucratic wars in this context.

[6] The assumption here is that the monetary authorities do not lose control of the monetary aggregates in an attempt to suppress any near-term rises in interest rates. Such a policy would merely serve to encourage additional capital outflow and exchange rate weakness. (As an aside this is why Stiglitz's critique of IMF policy in Asia is off-base in this area even though we have sympathy with some of his other criticisms.) Recall that aside from Indonesia, this was the argument we used in favour of inflation remaining relatively subdued in much of the rest of Asia during 1997-98.

[7] Mandatory Provident Fund contributors would also suffer from the same book loss but since these funds have only been up and running for a couple of years, the impact will be minimal.

overpaying for government salaries and procurements has certainly done little to help the fiscal position.

Hong Kong Economy Wide and Government Sector Inflation



The winners are people with foreign currency deposits and loans denominated in HKD

As for the winners, these are clearly those people who are sitting with large amounts of foreign currency deposits, especially those who also have loans denominated in HKD. While local asset prices might well benefit from some capital inflow in the aftermath of a devaluation taking some of those afflicted by negative equity back into more comfortable territory, again we would caution that unless a currency move was accompanied by measures to address other structural issues, the rate of inflow may be less than some might hope for. After all, we have hardly seen a rush for local assets to date even though prices are well, well down from their peaks and property is arguably as affordable as it has been for thirty years. This suggests other concerns have been weighing on investors' minds.

A brave government would spell out these trade-offs quite clearly and openly

A brave government would spell out these trade-offs quite clearly and openly. It would try to argue that the hoped-for lifting of mortgage burdens combined with newly restored competitiveness would both engender a feel-good factor and lead to real new job creation which in turn would alleviate the temporary additional burdens of the lower orders. Even if we would question whether a lower HKD would achieve all that they might hope for, this would at least be an honest admission of the government's aims.

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Unfortunately we believe it highly unlikely that the Mr. Tung and his factotums will have the intellectual honesty, let alone the political stomach, to openly account for their actions. Unfortunately Hong Kong's residents live under a system that we have dubbed 'populist authoritarianism'. Under such a system, the authorities have no constitutional duty and certainly do not feel much need to properly consult society about their actions, yet they seem petrified to pursue policies, even if they believe they are in the SAR's long-term interests, which might run up against entrenched vested interests and arouse popular discontent. Furthermore, while the notional opposition in LEGCO knows it has little or no chance of having its policy recommendations adopted, it feels free to indulge in wild populism and rabble rousing which further stymies considered debate. The result is a truly schizophrenic and dispiriting mode of operation to witness and one that contributes to a growing perception of drift and decline.

Populist authoritarians do not have the intellectual honesty, let alone the political stomach, to openly account for their actions

Set in this context, we believe that the most likely scenario for the exchange rate is that as with other policy initiatives, the government will just let things stagnate. They may be bailed out partially by some form of global upturn in the next couple of years (though we would not bet heavily on this) but more likely, we will continue to see a sluggish economy operating under downward pricing pressure, high debt burdens, structural unemployment and fiscal malaise. While locals are happy to stay put with at least a large chunk of their cash – the Japan syndrome of high accumulated wealth but low current cashflow generation – this will not place undue pressure on the HKD. Therefore short positions will be dead money aside from periodic trading opportunities when external events or local loudmouths cause mini bouts of angst. However, we would keep a close eye on political developments and inter-departmental warfare in order to see whether go-for-broke policies are being considered.

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How should investors seek to play such trends? For those that have long-term underlying Hong Kong asset exposure, there is certainly little downside to hedging out such positions. 5-year and 10-year interest rate swaps trade at only a 1% premium to equivalent US Treasuries whereas shorter dated forward premiums are even tighter as the chart over shows. We also like the long CNY/short HKD trade although the carry has come in quite a way in recent months. Our rationale here is that we are unlikely to see an RMB realignment anytime soon but if anything the current risks are skewed more towards appreciation given China's massively strong balance of payments position.

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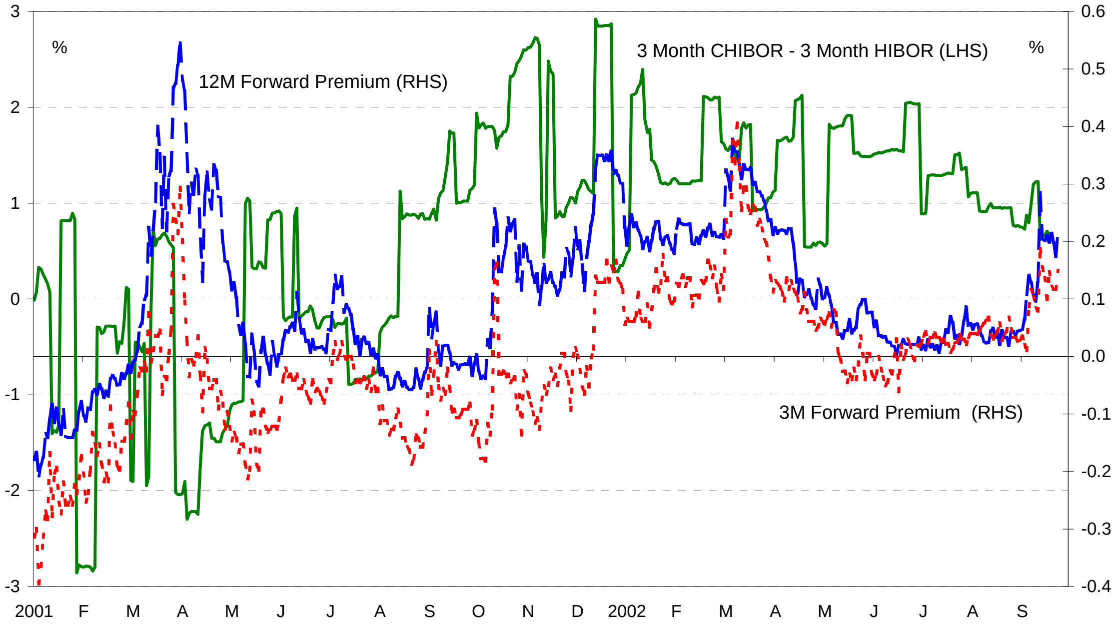

However, we would stress that we are not making a CNY/HKD convergence call, elegant though such solutions might sound. We still believe that full convertibility of the RMB is many years away – perhaps a decade or more – since (contrary to what one often reads and hears) China has no need or obligation to deliver full convertibility under WTO covenants signed and moreover, its financial and state-owned enterprise sectors are in no fit shape to deal with the implications of such a move.[8] What we should see is continued gradual liberalisation of the capital account in areas such as foreign purchases of Chinese assets and Chinese purchases of foreign securities through some form of QDII scheme. But full financial account liberalisation and the internationalisation of the RMB remain an age away.

There is no CNY/HKD convergence call to be made, elegant though such solutions might sound

[8] Don't just take our word for it. See "The Full Convertibility of Renminbi: Sequencing and Influence", Liu Shucheng *et. al.*, Hong Kong Institute for Monetary Research Working Paper No.9/2002, available at www.hkimr.org

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Full financial account liberalisation and the internationalisation of the RMB remain an age away

There is still potential for an upward float of the Chinese currency in the event of both a more robust and broad-based global upturn and a resumption of reformist zeal post the resolution of political succession issues – perhaps in 2004. This in turn might afford Hong Kong an opportunity to shake off its USD straightjacket at the same time for presumably the SAR would also be benefiting from such developments on the Mainland. Nevertheless, we do not think that one should extend the analysis to imply currency unification between Hong Kong and the PRC. For one it is not possible to have unification between a convertible and a non-convertible currency and thus we believe that our long-standing financial and commercial Rand analogy – the SAR-ZAR – remains valid. And second, the Basic Law states that the HKD will remain the separate currency of Hong Kong for fifty years after 1997 though notably, there are no provisions that stipulate it should remain a USD currency board. What is more likely is that any move in Hong Kong towards the managed trade-weighted float we envisage would naturally incorporate a fair dollop of RMB in the basket and accordingly, the HKD TWI would necessarily retain quite a strong USD bias.

A HKD TWI would incorporate a fair dollop of RMB in the basket

As for equity investors, we fear they will continue to struggle with an index that is becoming increasingly less representative of where Hong Kong is going. Although many small Hong Kong industrials have succumbed to a major bout of profit taking along with almost anything else that was above water in recent months, this is still where Hong Kong's reinvention and rejuvenation is being captured, and we believe that the long-term investment case remains a sound one. However, broader-based index performance while in part hostage to external fortunes will also be dependent on the government's efforts to facilitate the economy's structural adjustments. In our next article on the SAR we will discuss in grater detail the economy's structural impediments and offer our own manifesto for change. Keep this frequency clear.