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# Chi Time

## THE ULTIMATE QUESTION OF THE HONG KONG DOLLAR PEG

*Hurt me with the truth. But never comfort me with a lie.*

*Jim Carrey*

As I argued recently[1], the HKD peg is financially robust and the HKMA's resolve to defend the peg also seems to be solid. But the recent socio-political turmoil, which started in June, has prompted many investors to ask the ultimate question about the peg: Does China still need Hong Kong and, by corollary, the HKD peg?

### THE LOST IMPORTANCE

Economic data seems to support the view that China does not need Hong Kong, as the mainland economy now dwarfs the City's and rivals are usurping Hong Kong's global financial hub status. Before 1997, China needed Hong Kong as a channel for entrepot trade; almost half of its foreign trade went through Hong Kong. But after China joined the WTO in 2001, Hong Kong lost its entrepot importance; today less than 15% of China's foreign trade goes through Hong Kong.

In 1997, Hong Kong's economy was 20% the size of China's and its per capita income was 35 times higher. But in 2018, its economy was only 3% the size of China's and per capita income was only five times higher. Meanwhile, China's four largest banks have become the four largest in the world in assets terms, its stock market today is more than twice the market capitalisation of Hong Kong's, up from only 50% in 1997.

Immediately after Hong Kong's reversion in 1997, China showcased Hong Kong's strength as an open free-market economy governed by the rule of law. The purpose was to increase Hong Kong's appeal as a major international financial centre so as to benefit the mainland economy by attracting foreign capital via the City. Hong Kong was also used as a laboratory for financial and currency liberalisation.

But recently, Beijing's vision for Hong Kong seems to have changed dramatically. After the Global Financial Crisis of 2008, with socio-economic-political turmoil affecting the developed world, Beijing seems to want to

[1] See "*Chi on China: The Hong Kong Dollar Peg is Different – Long Live the Peg*", 28 May 2019.

showcase its model of rule by law, in which the legal system serves the economic interest of the country but is ultimately subservient to the Communist Party, might be preferable to the chaotic Western democracies.

The implementation of this new vision in Hong Kong has, in my view, contributed to the eruption of the socio-political turmoil today which, in turn, has shaken public confidence in the City. The link to the HKD peg lies in the concern about whether Beijing still needs Hong Kong and has the political will to keep the currency arrangement.

## THE REMAINING IMPORTANCE

This is a valid concern. But many observers seem to have missed some financial aspects that still make Hong Kong important to China.

Consider these data: Hong Kong was home to 73% of mainland companies' IPO offshore between 2010 and 2018, 60% of overseas bond issuance and 26% of offshore syndicated loans. It accounted for 64% of FDI inflows to China and was the channel for 65% of China's outward direct investment. By mid-2019, the Hong Kong Stock Exchange was home to 250 H-share Chinese firms and 171 red chip firms[2]. Currently, of the 96 central SOEs managed by the State Council, three have headquarters in Hong Kong[3] and 50 have at least one subsidiary listed on the Hong Kong Stock Exchange. Hong Kong is also the prime renminbi offshore centre, accounting for the bulk of renminbi foreign trade settlement and almost two thirds of all offshore renminbi deposits.

The point is that Hong Kong still serves a crucial role for China to access foreign capital. But why is that important when China has surplus savings amounting to over 45% of GDP?

I have long argued that China has a capital misallocation problem that channels most capital to the inefficient companies and starve the efficient ones of credit. This problem has manifested itself in the coexistence of excess capacity created by the inefficient sectors and under-investment by the efficient sectors[4]. China's closed capital account does not allow the credit-starved companies to access foreign capital as an alternative funding source.

Hong Kong's open capital account fills that void by allowing the Chinese companies access to foreign capital and, thus, helping to improve China's capital allocation. This role is important in the medium-term because Hong Kong's financial structure and legal and institutional frameworks command a level of international trust that is not enjoyed by mainland China.

Finally, in its role as a laboratory for economic liberalisation, Hong Kong is the only Chinese city that has the combination of a big population with a highly-skilled labour force, a free market mechanism, an open capital account, a hard currency and a rule-based framework that Beijing can do experiments of various sorts under the national reform framework. This role is also not replicable in the medium term.

A rational policy consideration should translate into a political will for supporting the HKD peg.

Chi Lo, Senior Economist, BNPP AM

[2] H-share companies are firms that are incorporated in mainland China and are controlled by either mainland government entities or individuals. Red chip companies are enterprises that are incorporated outside of China but are controlled by mainland entities or individuals.
[3] They are China Merchants, China Resources and China Travel Service.
[4] See "*Chi on China: The Conundrum of China's Excess Capacity*", 14 September 2016.

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