Crashing Into the Real World

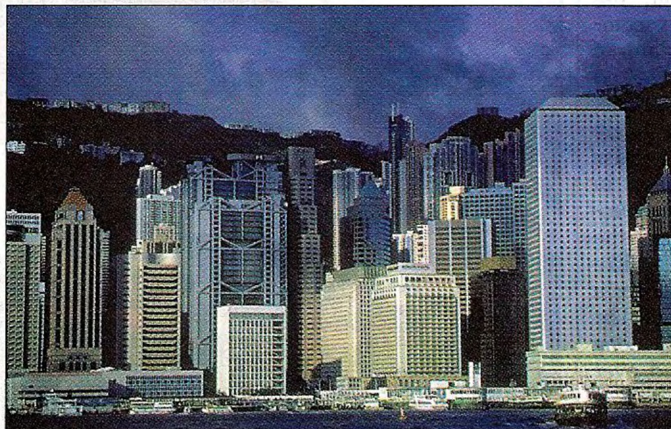
A brilliant device has outlived its time. It will be mighty hard to maintain Hong Kong's peg to the U.S. dollar. BY SIN-MING SHAW

HONG KONG DID NOT HAVE TO FACE THIS, BUT NOW the choice is stark in its simplicity. Either the peg of 7.80 Hong Kong dollars to the mighty greenback must be adjusted down to about 10, or both the stock and the property markets will go down to levels that would have been unimaginable on June 30, 1997, the eve of the handover to China. The Hong Kong government says it has chosen to stick with the peg. Unfortunately, in the end the peg will probably be broken anyway.

Last week's tumble in the Hong Kong stock market may have seemed sudden and irrational. Quite the contrary. Hong Kong has long been a disaster waiting to happen. The Hong Kong dollar has been grossly overvalued for close to 10 years. That has helped push up the real estate and stock markets—the latter heavily represented by property companies and the banks that finance them. This year the surge also has been fed by the market frenzy over "red chips," the mainland-controlled companies that have listed in Hong Kong. It turns out that many of these companies have failed to deliver, despite promises to the contrary. They have, in effect, been mainly chips in a con game played by cunning mainlanders.

A little recent history might help explain what is happening. When the soldiers of China's People's Liberation Army came rolling into Hong Kong after midnight on July 1, they were occupying the world's most expensive real estate. The soaring prices at the time were considered a resounding vote of confidence in the future of Hong Kong. That was true to an extent: Hong Kong residents were not running for cover to Beverly Hills as Beijing marched in. But fundamentally, the booming property prices reflected not confidence but the consequences of misguided policy. Above all, they were the result of the currency peg, which, by linking Hong Kong's fast-growing economy to low U.S. interest rates, had produced years of low and negative real rates of interest in the territory. The cheap money fed a demand for property that grossly exceeded supplies, causing prices to rocket even higher. The Hong Kong government, which derives roughly a third of its revenue from annual land sales, had a piece of the action.

By the time of the handover, the peg had become a time bomb. Back in 1983 the link to the U.S. dollar was imposed to calm a panic when local residents woke up to the reality that Hong Kong was to be returned to China. The peg probably should have been abandoned not more than 12 months later, but a timely quick fix came to be treated as a permanent cure. The peg served the most powerful interest groups in Hong Kong very well. The Hong Kong government profited from land sales and taxes. The Chinese government in Beijing saw rising land prices as a sign of local confidence and a boost to its own prestige. And the major Hong Kong developers were getting very rich.



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Built on the back of the peg: *The Hong Kong skyline*

Consider those property tycoons. They effectively control the availability of apartments, since they are the players who manufactured living space from raw land. The six largest developers sit on a huge land bank—property they have acquired but not yet developed. It is large enough, in fact, to supply what they sell every year for well over six more years. This practice only exacerbates Hong Kong's housing shortage, but why not? The developers have maximized shareholder value over the years by delaying construction as land prices kept rising. Since the real cost of money was for years negative, sitting on a land bank did not cost them anything. Genuine home buyers and property investors were also borrowing money at little or no cost.

In this environment, everybody seemed to be a winner. Those few who argued that the Hong Kong dollar should be repegged or depegged altogether got only angry rebukes from developers and contemptuous dismissal from Hong Kong government officials. Forever suspicious of the departing British, China expressly forbade the colonial government to do away with the peg for fear of precipitating a currency collapse. The British were only too happy to oblige. If the currency fell after they left, well, that was just too bad. As nonaction became policy, the Hong Kong dollar became more overvalued, and the property market went from the stratosphere to a different galaxy. A house on the Peak, Hong Kong's prime chunk of real estate, fetched $100 million early this year.

What now? Last week Hong Kong's financial markets almost imploded. As currency traders assaulted the Hong Kong dollar, the government could defend the peg only by raising interest rates—which it did, to stratospheric overnight levels. High rates will inevitably push down property and stock prices. If interest rates remain high over a longer period, businesses will go under and homeowners—as well as anyone who owns shares—will likely demand relief. Many nonresidents who have no emotional attachments to a stable Hong Kong dollar will continue to switch to other currencies. Soon, economic rationality will give way to fear and panic, and the link to the U.S. dollar may not hold in the end.

It is still not impossible to preserve the peg, though it won't be easy. At some point, it will take more than the Hong Kong government to reassure the local population that the peg can and should be defended. The interest groups that profited from the peg—including China, all the major companies in Hong Kong and the richest families—must make a dramatic gesture, a joint declaration if you will, swearing loyalty to the Hong Kong dollar. The tycoons, in particular, must declare that they will not switch any of their assets out of Hong Kong. That might be sufficient to prevent the "little" guys from bailing out. Will these powerful groups have the fiber and foresight to do so? Does Hong Kong have much choice?