A CURRENCY OF CONFUSION

Floating exchange rates make sense for Southeast Asia—including Hong Kong

BY SIN-MING SHAW

GOVERNMENTS NEVER CEASE to amaze. When exchange rates are under siege as a result of unwise domestic economic policies, embattled leaders tend to compound their mistakes by spending valuable foreign reserves to defend the indefensible instead of letting exchange rates find their own levels of equilibrium. The predictable scenario calls for denouncing "speculators"—nowadays usually George Soros—followed by an inevitable devaluation. Last week the normally world-wise prime minister of Malaysia, Mahathir Mohamad, blamed Soros and other "rogue speculators" for deliberately destabilizing Southeast Asian currencies.

Currency turmoil: *Domestic policies are to blame*

The Thai government also blamed Soros for attacking the baht before Bangkok finally devalued the currency from 25 to more than 30 to the dollar. Professionals had been saying for some time that Thai interest rates, allowing for inflation, were too high for the good of the economy. Still, in the months prior to devaluation, Thailand unnecessarily spent billions shoring up an overvalued currency. On some days, short-term interest rates were hiked over 1,000 percent to attract capital inflows and to hurt short sellers who were borrowing baht. That, of course, ended up hurting the domestic economy even more.

Most governments these days profess to appreciate the workings of a free market and would not dream of fixing the price of shares, a mobile phone or real estate. Even China, the largest communist country still standing, is learning to live with the vicissitudes of market forces. But when it comes to exchange rates, some governments unnecessarily complicate simple economic calculus with their political agenda—as if a fall in the exchange rate were a national affront brought on by sinister foreigners who need to be punished.

It is time to relearn Economics 101.

An exchange rate is simply the price of one's money relative to foreign money. Like any price, it fluctuates. If there are more sellers than buyers on a consistent basis, as in the case of Thailand, that reflects the judgment of the market that critical aspects of domestic economic policies are inconsistent with the prevailing exchange rate. "Speculators," usually more local than foreign, simply recognize the inevitable and borrow the local currency to sell short with the aim of buying it back at lower exchange rates to make a profit. If they are wrong, then the market will "punish" them for their error, and they will lose money—which they do all the time.

It is nearly impossible for currency traders by themselves to change the direction of an exchange rate over any length of time if their assessment of the currency's strength is incorrect. Yet it is perhaps understandable why governments love to blame "speculators." It diverts attention from their own mistakes. In each of the four countries whose currencies are now in turmoil—the Philippines, Thailand, Indonesia and Malaysia—domestic interest rates less inflation have been too high. In each, current account deficits have become a nagging problem as an overvalued currency has encouraged imports. In each, fiscal deficits or credit expansion show worrying trends. Their attempts to stick to fixed exchange rates made things worse. Among other things, it meant giving up the freedom to determine their own interest-rate policy to deal with internal problems. Singapore, unlike its panicked neighbors, has said wisely that it will let the market determine the proper level of its dollar without bashing international conspirators.

Don't fixed rates at least work in Hong Kong? The Hong Kong dollar is backed 100 percent by the U.S. dollar, unlike ASEAN currencies. But just because the Hong Kong dollar is solid does not mean that it is appropriately valued. Local interest rates strictly follow U.S. rates. As a result, the real rate of interest (again, minus inflation) has been either negligible or negative, a rarity in serious economies. Unlike in Thailand, where real rates of interest have been high, resulting in asset deflation, Hong Kong has had massive asset inflation, taking real-estate prices to extraterrestrial levels. Because of Hong Kong's higher inflation, in real terms its dollar has appreciated substantially against the U.S. dollar. No wonder Hong Kong people think everything in the States is cheap.

It is time to rethink Hong Kong's peg to the greenback. The territory's competitive position has been eroding. Its historical franchise as the only gateway to China is being challenged by Shanghai as China is dealing more directly with the outside world. The current account is now mildly negative, and the trend is not encouraging. The undoing of Hong Kong's peg to the dollar, when it comes, will not be the work of currency speculators. All it will take, one fine day, is for 10 percent of the territory's property owners and/or 10 percent of its shareholders to be somewhat wise and cash out some of their overvalued holdings by switching to foreign assets. The current value of quoted Hong Kong shares is about $440 billion; its famous $80 billion-plus in reserves will not be enough to stem the outflow once the floodgate cracks.

To prevent a sudden crisis, Hong Kong's dollar should be floated. Politics will determine when this happens. My bet is that when China's renminbi becomes convertible, perhaps in 2001, the dollar will be repegged to the renminbi, which will be a floating currency. That will be the best solution for both China and Hong Kong. And George Soros will have nothing to do with it.

SHAW *is a Hong Kong investment manager.*