

# [Asian south east asian economies knocked the doors](https://assignbuster.com/asian-south-east-asian-economies-knocked-the-doors/)

Asian Financial Crisis and HongKong’s responseAsian financial crisis was the mostdevastating financial and economic catastrophe after the Korean war of 1950-53. It originated in Thailand in 1997 when Thailand failed to repay the short-termborrowings (denominated in U.

S. dollars) which it had invested in long termprojects. Thai government’s failure to back the peg between Thai Baht and theU. S. dollar led to a series of events which after rapidly engulfing all thesouth and south East Asian economies knocked the doors of Hong Kong in October1997. During those years, Hong Kong was reluctantly going through the phase oftransition from a British colony to be a part of China under the “ One countrytwo system” agreement.

After the surrender of the Singapore dollar and NewTaiwan Dollar, Chinese Renminbi and the Hong Kong Dollar became the primetargets for the speculators. Due to China’s closed financial gates and HongKong’s free-trade world, Hong Kong Dollar became the next target. The paper attempts to gauge theseverity of the Asian Financial Crisis in Hong Kong, especially in the realeconomic sector and financial sector. Following the analysis of severity of theAFC, the paper focuses on the question ‘ how the peg between USD and HKD wassaved?”. Finally, the paper attempts to answer the question, how effective andefficient the authorities were in handling the Asian Financial Crisis? Asian Financial Crisis took a hugetoll on the real economy of Hong Kong.

All the major sectors like the real GDP, the job market, price levels, tourism etc. were severely hit. During the first phase of the AFC, when the Hong KongMonetary Authority was using ‘ interest rates’ as its sole weapon to save thecurrency market from the speculators, its impact on the real economy is worthnoticing.  REAL GDPReal GDP of an economy gives apretty clear picture of the domestic economic activities in that economy. During the AFC all the components of the Real GDP (private consumptionexpenditure, investment expenditure and net exports) plunged.  The speculators anticipated that the collapseof Hong Kong Dollar was just a matter of time.

Therefore, they borrowed hugesums of money (hedge funds) denominated in HKD from the commercial banks ofHong Kong and converted them into USD. They attempted in drying up the foreignexchange reserved of the HKMA and hence forcing it to make the HKD float. Hence, as the Hong Kong Dollar depreciates due to the floatation, they couldmake billions of dollars overnight by selling off the USD, they held. Thismassive speculative attack on the HKD reduced the money supply and hence droveup the interest rates in the economy. The drastic rise in interest rates (up to 10. 25%) encouraged private savings anddiscouraged investment (cost of borrowing went up), hence decreasing privateconsumption and investment expenditures. The following table shows the trend ofReal GDP during the years of AFC.

Year-on-year growth Rates of Real GDP (%)                                 Table 1 1997 1998 1999 Q1 6. 0 -2. 6 -3.

0 Q2 6. 8 -5. 1 1. 1 Q3 5. 7 -7. 0 4.

4 Q4 2. 4 -5. 6 8. 7 Whole Year 5. 2 -5.

1 2. 9 Source: Economic Division, Financial Services BureauIt is clear from the table above thatthe real GDP of Hong Kong started plunging from the first quarter of 1998. HongKong always had the luxury of positive real GDP.

However with the onset of theAFC, real GDP declined and touched a maximum decline rate of 7 % during thethird quarter of 1998. It was not until the second quarter of 1999 that thereal GDP showed signs of improvement. INBOUND TOURISMHong Kong is a key tourist point ofsouth-east Asia. Hong Kong’s unique blend of urban and rural beauty attractstourists from all over the world. Hence tourism is a major source of revenuefor Hong Kong economy.

However during the years of the AFC, the scenario wasquite different. After all the major currencies in south and south-east Asiasurrendered to the crisis and depreciated and Hong Kong kept on striving hardto defend the peg between USD and HKD, HKD appreciated in effect. It hit thetourism industry badly because, after the effective appreciation of Hong Kongdollar, tourism in Hong Kong became radically expensive for foreigners. Addingto the severity was the long lasting banking crisis of Japan, which resulted ina massive drop (up to 65% during Q4 1997) in the number of in-bound touristsfrom Japan.

Number of incoming visitors (year-on-year rate ofchange %)                   Table 2 1997 1998 1999 Q1 9 -25 13 Q2 2 -16 10 Q3 -27 10 11 Q4 -23 5 12 Source: Hong Kong TouristAssociationAs presented by the table above, right from second quarter of 1997, the number of in-bound tourists fell from 9%to 2% and kept on falling till the second quarter of 1998. It was not until thethird quarter of 1998 that the tourism sector showed positive growth. EMPLOYMENT AND UNEMPLOYMENTThe job market of Hong Kong took amajor blow as well. Falling consumption and lower investments meant lowerproduction, which set the economy into a deflationary trend and hence moreunemployment and underemployment. The unemployment and underemployment rates inHong Kong rose as high as up to 6. 2% and3% respectively during the firstquarter of 1998. EXTERNAL TRADE Due to the effective appreciationof Hong Kong Dollar, Hong Kong products became relatively expensive and losttheir competitiveness in the international market. Hong Kong’s export trade hastwo major components: Re-export and Domestic export.

Re-export refers to theexport of imported goods and domestic export refers to the export of goodsproduced in the domestic territory of Hong Kong. Both of these components felldrastically. Domestic exports and re-exports registered a massive fall of 15%and 9% respectively.

The fall in the former component signifies fall ineconomic activities at domestic level and hence contributes to unemployment andunderemployment. DEFLATION Deflation was a rare phenomenon forHong Kong. Deflation itself is not extremely harmful. However if it isprolonged and is accompanied by high unemployment levels, then the economy isplunged into a vicious cycle.

Due to massive speculative attackson HKD, the supply of HKD fell in the market drastically, which skyrocketed theinterest rates. High interests may help in increasing the competitiveness ofthe currency, however it is a double-edged weapon. As mentioned earlier, highinterest rates led to lower consumption and investment levels thus higherunemployment rates. The income levels dropped and propensity to consume fell.

Hence, the sellers had to reduce prices to sell as much as they could. However, lower prices also meant lower profit levels which further discouragedinvestments and fueled the growing unemployment rates. HOW THE PEG WAS SAVED? When the other prominent economiessurrendered to the crisis, Hong Kong’s resilience to defend the peg between HKDand USD is appreciable. It not only spoiled the game for the speculators butalso proved the strength of Hong Kong economy to the world. Hong Kong had theability and political will to use her foreign exchange reserves to defend thepeg. The speculators were converting HKD to USD and were trying to shrink theeconomy.

To counter this HKMA compensated the lost USD using its foreignexchange reserves of US$ 65. 9 billion, hence frustrating the speculators. Moreover, the fact that Hong Kong had a fixed exchange rate regime under a Currency BoardSystem, contributed the most to the defense of the peg.