

# Asian south east asian economies knocked the doors



**ASSIGN  
BUSTER**

Asian Financial Crisis and HongKong's response Asian 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-term borrowings (denominated in U.

S. dollars) which it had invested in long term projects. Thai government's failure to back the peg between Thai Baht and the U. S. dollar led to a series of events which after rapidly engulfing all the south and south East Asian economies knocked the doors of Hong Kong in October 1997. During those years, Hong Kong was reluctantly going through the phase of transition from a British colony to be a part of China under the " One country two system" agreement.

After the surrender of the Singapore dollar and New Taiwan Dollar, Chinese Renminbi and the Hong Kong Dollar became the prime targets 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 the severity of the Asian Financial Crisis in Hong Kong, especially in the real economic sector and financial sector. Following the analysis of severity of the AFC, the paper focuses on the question ' how the peg between USD and HKD was saved? ". Finally, the paper attempts to answer the question, how effective and efficient the authorities were in handling the Asian Financial Crisis? Asian Financial Crisis took a huge toll 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

Hong Kong Monetary Authority was using 'interest rates' as its sole weapon to save the currency market from the speculators, its impact on the real economy is worth noticing. Real GDP of an economy gives a pretty clear picture of the domestic economic activities in that economy. During the AFC all the components of the Real GDP (private consumption expenditure, investment expenditure and net exports) plunged. The speculators anticipated that the collapse of Hong Kong Dollar was just a matter of time.

Therefore, they borrowed huge sums of money (hedge funds) denominated in HKD from the commercial banks of Hong Kong and converted them into USD. They attempted in drying up the foreign exchange 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 could make billions of dollars overnight by selling off the USD, they held. This massive speculative attack on the HKD reduced the money supply and hence drove up the interest rates in the economy. The drastic rise in interest rates (up to 10.25%) encouraged private savings and discouraged investment (cost of borrowing went up), hence decreasing private consumption and investment expenditures. The following table shows the trend of Real 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 Bureau It is clear from the table above that the real GDP of Hong Kong started plunging from the first quarter of 1998. Hong Kong always had the luxury of positive real GDP.

However with the onset of the AFC, real GDP declined and touched a maximum decline rate of 7 % during the third quarter of 1998. It was not until the second quarter of 1999 that the real GDP showed signs of improvement. INBOUND TOURISM Hong Kong is a key tourist point of south-east Asia. Hong Kong's unique blend of urban and rural beauty attracts tourists from all over the world. Hence tourism is a major source of revenue for Hong Kong economy.

However during the years of the AFC, the scenario was quite different. After all the major currencies in south and south-east Asia surrendered to the crisis and depreciated and Hong Kong kept on striving hard to defend the peg between USD and HKD, HKD appreciated in effect. It hit the tourism industry badly because, after the effective appreciation of Hong Kong dollar, tourism in Hong Kong became radically expensive for foreigners. Adding to the severity was the long lasting banking crisis of Japan, which resulted in a massive drop (up to 65% during Q4 1997) in the number of in-bound tourists from Japan.

Number of incoming visitors (year-on-year rate of change %)

Table 2 1997 1998 1999 Q1 9 -25 13 Q2 2 -16 10 Q3 -27 10 11 Q4 -23 5 12

Source: Hong Kong Tourist Association As 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

the third quarter of 1998 that the tourism sector showed positive growth.

**EMPLOYMENT AND UNEMPLOYMENT** The job market of Hong Kong took a major blow as well. Falling consumption and lower investments meant lower production, which set the economy into a deflationary trend and hence more unemployment and underemployment. The unemployment and underemployment rates in Hong Kong rose as high as up to 6.2% and 3% respectively during the first quarter of 1998. **EXTERNAL TRADE** Due to the effective appreciation of Hong Kong Dollar, Hong Kong products became relatively expensive and lost their competitiveness in the international market. Hong Kong's export trade has two major components: Re-export and Domestic export.

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

The fall in the former component signifies fall in economic activities at domestic level and hence contributes to unemployment and underemployment. **DEFLATION** Deflation was a rare phenomenon for Hong Kong. Deflation itself is not extremely harmful. However if it is prolonged and is accompanied by high unemployment levels, then the economy is plunged into a vicious cycle.

Due to massive speculative attack on HKD, the supply of HKD fell in the market drastically, which skyrocketed the interest rates. High interests may help in increasing the competitiveness of the currency, however it is a

double-edged weapon. As mentioned earlier, high interest rates led to lower consumption and investment levels thus higher unemployment 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 discouraged investments and fueled the growing unemployment rates. HOW THE PEG WAS SAVED? When the other prominent economies surrendered to the crisis, Hong Kong's resilience to defend the peg between HKD and USD is appreciable. It not only spoiled the game for the speculators but also proved the strength of Hong Kong economy to the world. Hong Kong had the ability and political will to use her foreign exchange reserves to defend the peg. The speculators were converting HKD to USD and were trying to shrink the economy.

To counter this HKMA compensated the lost USD using its foreign exchange 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 Board System, contributed the most to the defense of the peg.