



# Hong Kong's Adjustment Challenge

By John Greenwood

## Overview

- In Hong Kong just over a week ago for an HKMA-BIS conference, I heard many stories of Hong Kong residents crossing the border into Shenzhen to go shopping, helped by the re-opened Shenzhen-Hong Kong Express Rail Link.
- This highlights a temporary misalignment of prices between Hong Kong and China. But the scale of the regular weekend exodus requires some analysis.
- It immediately reminded me of episodes from the distant past when British consumers crossed the channel to France to do their shopping (for fuel, groceries, or alcohol).
- But it also reminded me of Hong Kong's extended adjustment in the wake of the Asian Financial Crisis (AFC) of 1997-98.
- The analysis in the first section of this Newsletter focuses on Hong Kong's experience during and after the AFC, drawing lessons from that episode that are relevant to the present.
- The analysis in the second section of the Newsletter explains the sources of the current price divergence between Hong Kong and Shenzhen and considers their potential longevity.
- Relying on lessons from the earlier (AFC) episode, I draw some conclusions about how the current misalignment may be solved.
- This time the misalignment is far smaller, and appropriate adjustments to restore purchasing power parity (PPP) between Hong Kong and Shenzhen are likely to occur much more quickly than in 1998-2004.
- Nevertheless, while the opportunity for easy arbitrage between the two cities exists, Hong Kong retailers, the tourist industry generally, and load factors for the airline industry will continue to be held back.

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## International Monetary Monitor Ltd

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## **Introduction**

Visiting Hong Kong during the last week of November, I was told many times about how local people were now doing their weekend shopping and enjoying meals, hotel nights and other recreation in much cheaper Shenzhen. According to a Jefferies analyst, Sam Wong, quoted by my friend Chris Wood (in *Greed & Fear*, 30 November 2023), it was estimated that these excursions across the border “*could be reducing Hong Kong retail sales by around 4% on a monthly basis. This is based on the estimate that 200,000-300,000 Hong Kong residents are travelling from Hong Kong to Shenzhen through land borders on a weekend day. Assuming an average spending of Rmb800 per visit and eight weekend days a month, the total monthly cross-border spending would be around HK\$1.6bn. This compares with monthly spending of around HK\$40bn in Hong Kong, which includes around HK\$32-34bn in retail sales and HK\$8-9bn in restaurant receipts.*”

How has this come about and what are the economic elements contributing to the problem?

Before I answer that question, I will set out what happened in Hong Kong in the aftermath of the Asian Financial Crisis (1997-98) because that adjustment parallels exactly the current problems faced by Hong Kong. The history of that episode therefore provides a framework for understanding the present price misalignment. Although the present issues are on a far smaller scale than the post-AFC adjustment challenge, the same lessons apply.

### **Section 1. Hong Kong’s Adjustment after the Asian Financial Crisis of 1997-98.**

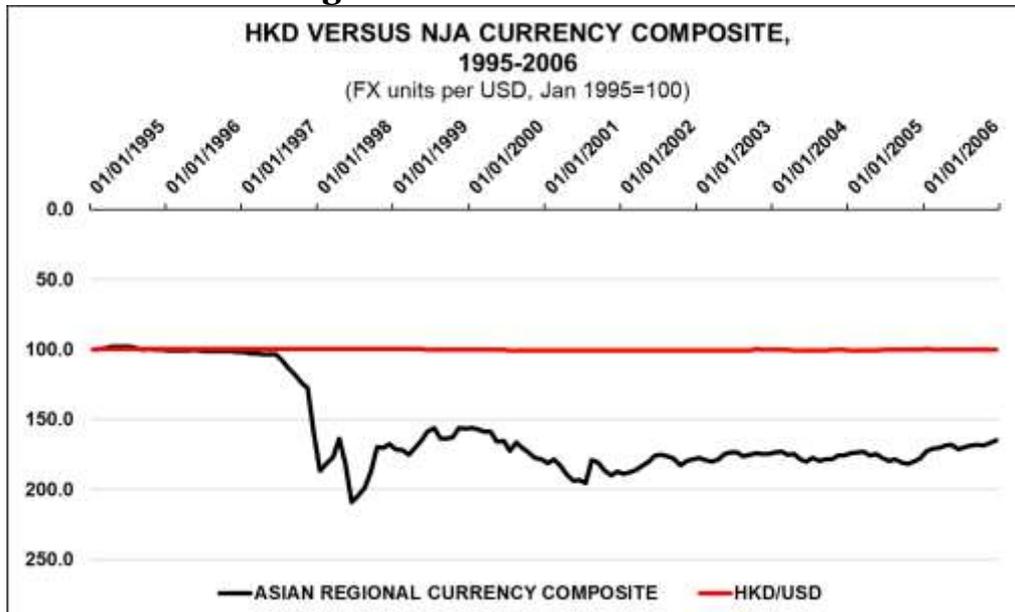
The Asian Financial Crisis created a traumatic test for Hong Kong’s financial system and for its economy.

To tell the story of Hong Kong’s current, but short-term external adjustment problem, it is useful to be reminded of what happened in the aftermath of the Asian Financial Crisis (AFC), 1997-98.

First, as in Figure 1, during the second half of 1997 and 1998 numerous Asian currencies were devalued relative to the USD, but since the HKD was fixed by means of a currency board to the USD, no change in the HKD/USD exchange rate was allowed. The result was a significant gain in competitiveness for the other Asian economies against Hong Kong.

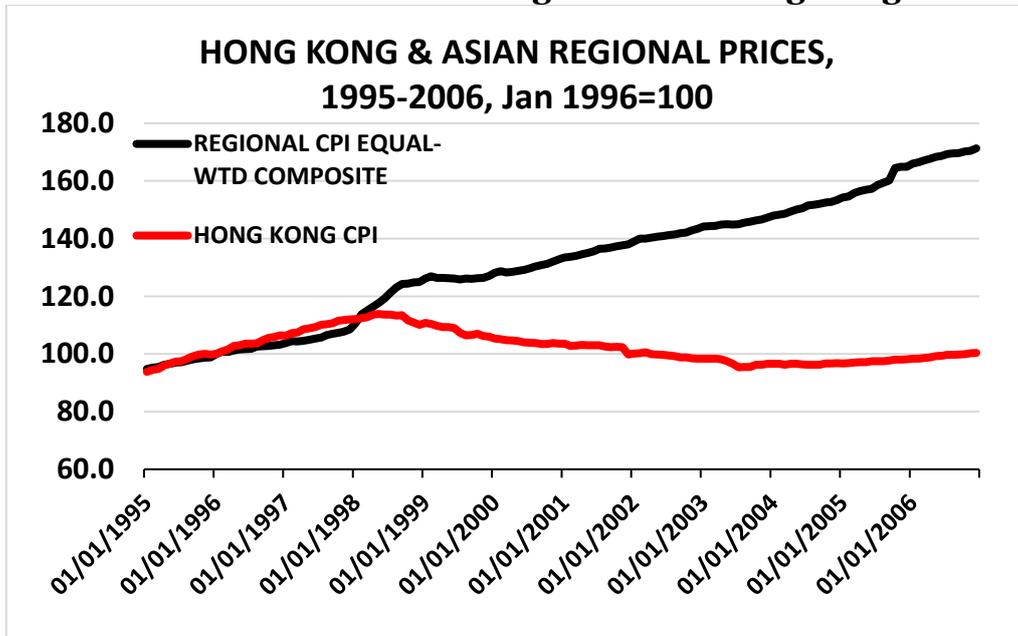
In Figure 1 the black line shows an equally weighted average of eight currencies comprising an Asian regional currency composite: the Korean won, the Taiwan dollar, the Chinese yuan, the Thai baht, Malaysian ringgit, Philippine peso, Singapore dollar, and Indonesian rupiah. At first sight the average 50% depreciation of the regional composite relative to the USD or HKD in 1997-98 would have created a substantial competitive advantage.

**Figure 1. In 1997-98, Non-Japan Asian (NJA) Currencies were Sharply Devalued against the USD and hence the HKD**



However, it is also true that many of the Asian economies experienced sharp bouts of inflation in the aftermath of their devaluations, as shown by the equally weighted regional composite in Figure 2 (black line). In effect, the devaluations of 1997-98 validated highly expansionary monetary growth that had been the norm prior to the crisis.

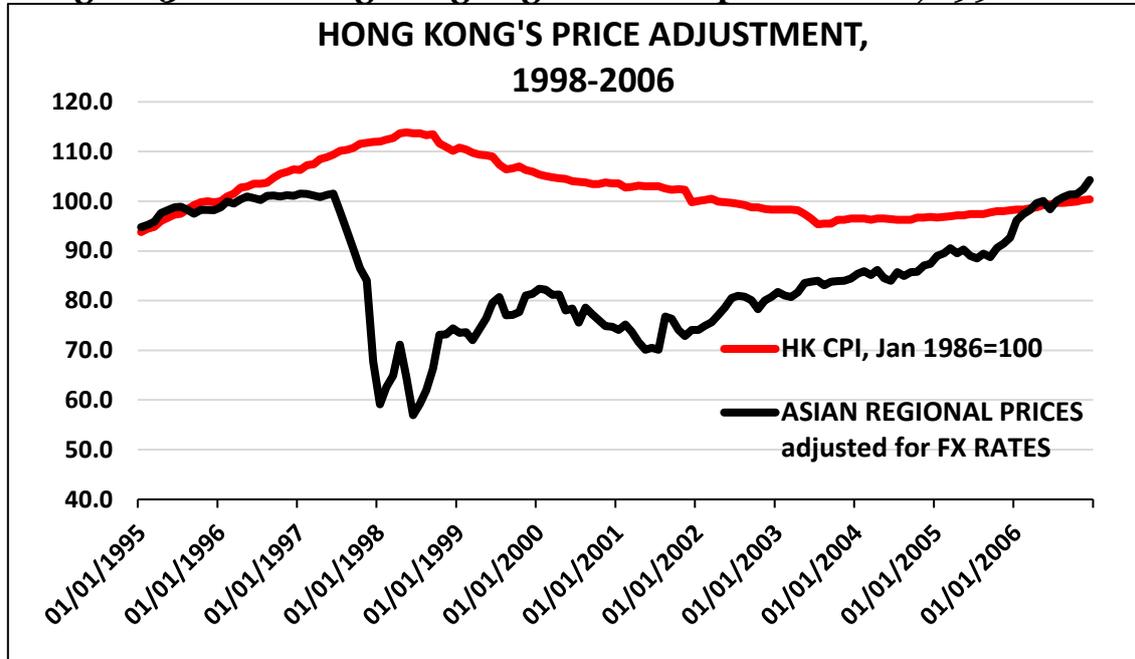
**Figure 2. Contrast between Asian Regional and Hong Kong Price Levels**



Hong Kong, on the other hand did not experience any significant uptick in its overall price level. On the contrary, what became necessary was a sustained but gradual

internal deflation, i.e., a decline in the domestic price level sufficient to offset the loss of competitiveness.

**Figure 3. How Hong Kong Regained Competitiveness, 1998-2006**



To measure the loss of competitiveness in Hong Kong we must offset the effect of the currency depreciations with the internal inflations that competing non-Japan Asian economies experienced after July 1997. After performing this purchasing power parity (PPP) calculation, we obtain the black line in Figure 3. The effect of the abrupt devaluations in 1997-98 is shown in the roughly 30-40% gain in competitiveness for other economies as the composite currency index declined from 100 to between 60 and 70. However, from then onwards the effect of the higher inflation rates in the non-Japan Asian region began to erode competitiveness, leading to an initial rise of the PPP index to just over 80 by early 2000. After a brief pause due to the US recession in 2001-02, the regional PPP index began rising again, and continued to do so through 2006.

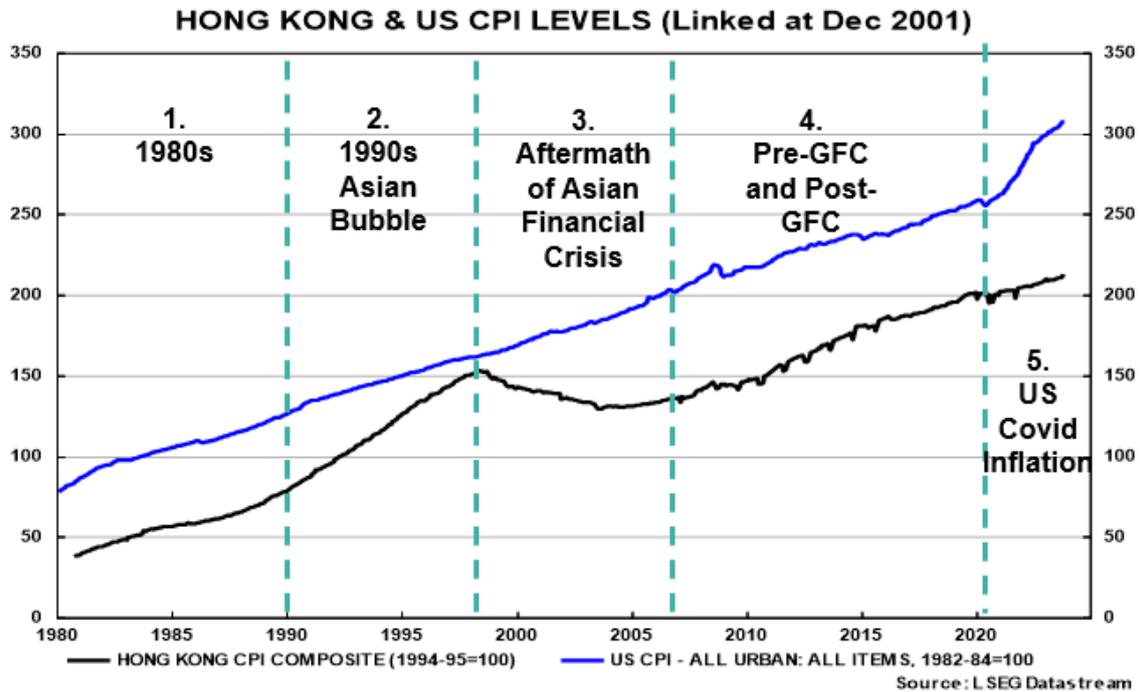
Meantime prices and wages in Hong Kong were falling, also closing the gap in competitiveness. The fall in prices in Hong Kong was a market-driven phenomenon, given the fixed exchange rate. Either firms cancelled projects that they thought to be uncompetitive in the new environment, or projects proposed by businesses to bankers were deemed unviable. The interim result was a slowdown in bank credit growth and a parallel slowdown in money growth. Over the period 1998-2004 M3 in Hong Kong grew at an average of just 5.6% p.a. compared with an average of 12.3% p.a. in 1992-97<sup>1</sup>. The end result was deflation and a gradual return of competitiveness. Competitiveness was restored through a combination of non-Japan Asian regional inflation and Hong Kong's internal deflation.

<sup>1</sup> The M3 data here contain foreign currency. HK\$M3 data did not become available until April 1997.

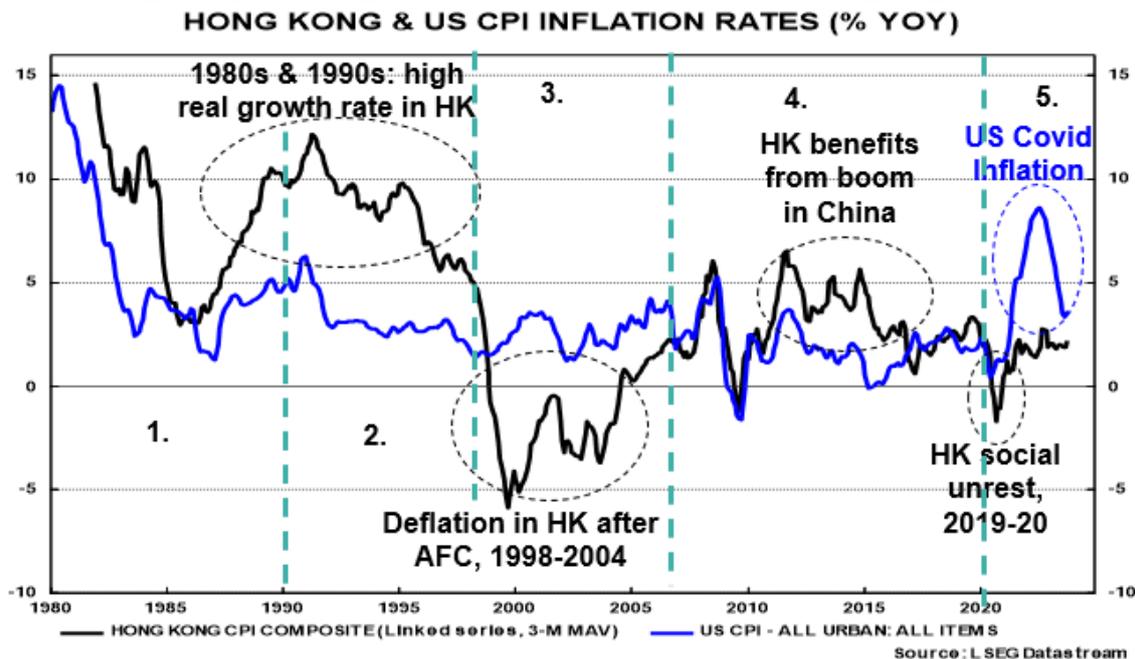
## Section 2. Hong Kong's Current Adjustment Challenge

Before discussing the current situation in Hong Kong, it is worthwhile to step back for a moment to consider the longer-term picture. Figure 4 shows the consumer price levels in Hong Kong and the US during the period of the fixed HK\$ exchange rate so the price levels are directly comparable (although they have different base dates).

**Figure 4. Hong Kong prices have broadly tracked US prices since 1983.**



**Figure 5. Divergences of CPI inflation rates highlighted.**

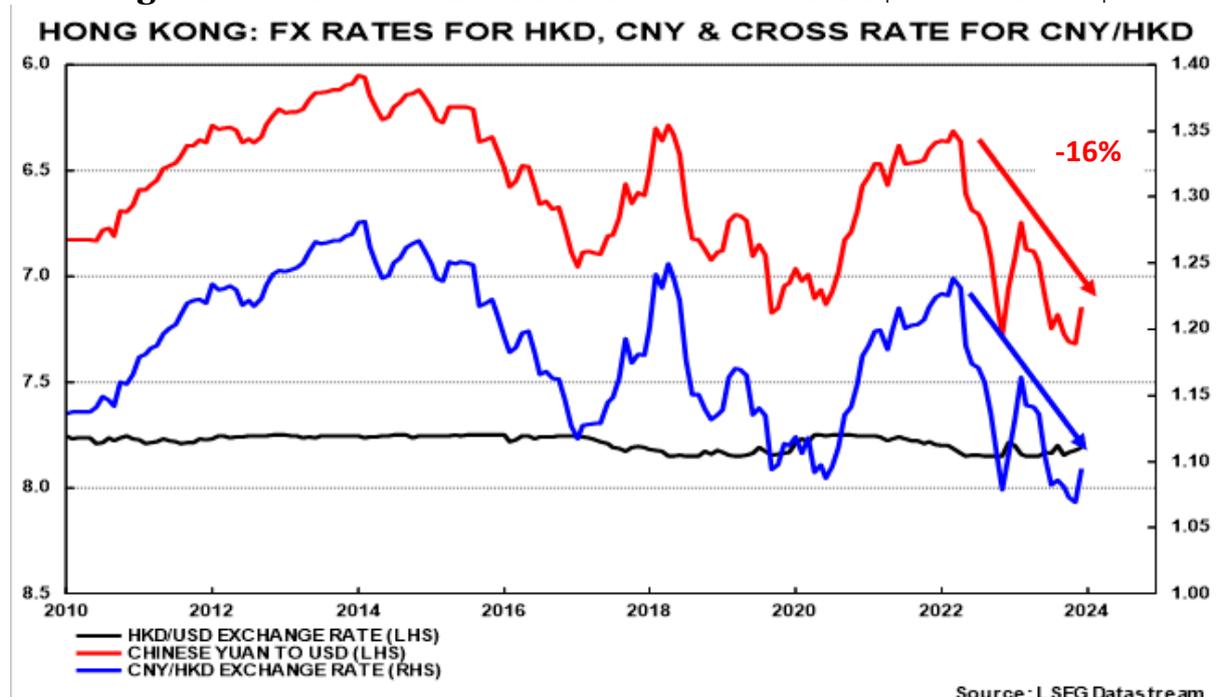


While Hong Kong’s linked exchange rate system implies, among other things, that Hong Kong’s price level is broadly linked to the US price level, there are, however, some important exceptions. These are best observed by looking at year-on-year rates of change shown in Figure 5 where distinct divergences become much more evident.

Strictly speaking the core theories of international trade and competitiveness refer to “tradeable” goods (and services), whereas in both economies I have used consumer prices, which include “non-tradeable” goods or services such as haircuts, rents, meals at restaurants etc. However, the lack of price data for “tradeable” goods alone in Hong Kong means that the use of such prices is not really feasible. Nevertheless, the data suggest that the “law of one price” has operated to keep price levels broadly in line, albeit with distinct periods when price levels or inflation rates have diverged.

The main divergences of prices and inflation in Figures 4 and 5 occurred (1) during the late 1980s and early 1990s when Hong Kong’s growth rate (and hence productivity growth) substantially exceeded that of the US <sup>2</sup>, validating higher inflation in Hong Kong; (2) during the post-AFC deflation in Hong Kong when the economy was compelled to adjust to the depreciation of the currencies of its regional competitors; (3) a moderate divergence of inflation in 2011-15 when Hong Kong benefited from the on-going boom in China; (4) a brief dip in Hong Kong prices in 2019-20 as a byproduct of the social unrest in Hong Kong which depressed business, investment and tourism; and (5) the Covid-era inflation in the US in 2021-22 generated by excessive US money growth – something which did not occur in Hong Kong (presumably on account of the depressed state of business following the riots and demonstrations in 2019).

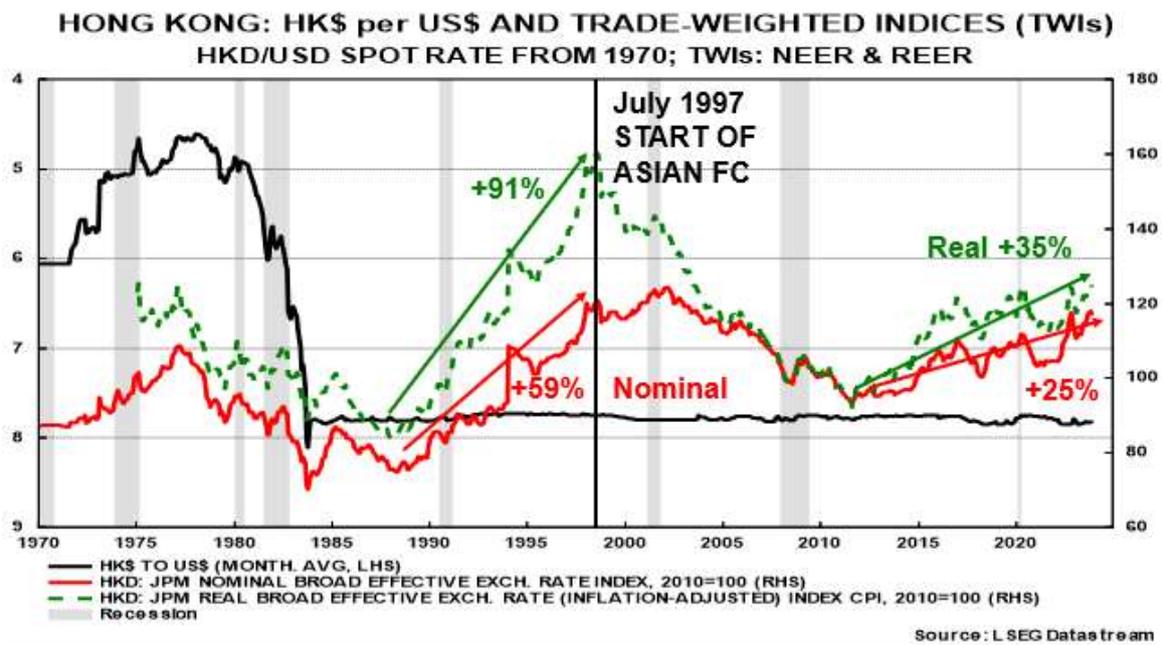
**Figure 6. The CNY has weakened versus the US\$ and the HK\$.**



<sup>2</sup> This is consistent with the Balassa-Samuelson effect, a refinement of the law of one price. See <https://www.nber.org/reporter/2014number4/real-exchange-rates-and-balassa-samuelson-effect-revisited>

Aside from prices, we need also to consider exchange rate changes, shown in Figure 6. Since March 2022, when the Fed started raising rates, the Chinese currency has been on a persistently weakening track, with the brief exception of a bounce-back between November 2022 and February 2023. The maximum decline has been around 16%, not large compared with the declines in regional currencies at the time of the AFC (Figures 1 & 2), but big enough to have a disruptive effect on trade patterns between Hong Kong and cities in Guangdong Province such as Shenzhen.

**Figure 7. Since 2011, the HKD has appreciated 25% on a nominal basis and 35% on a real, trade-weighted basis.**



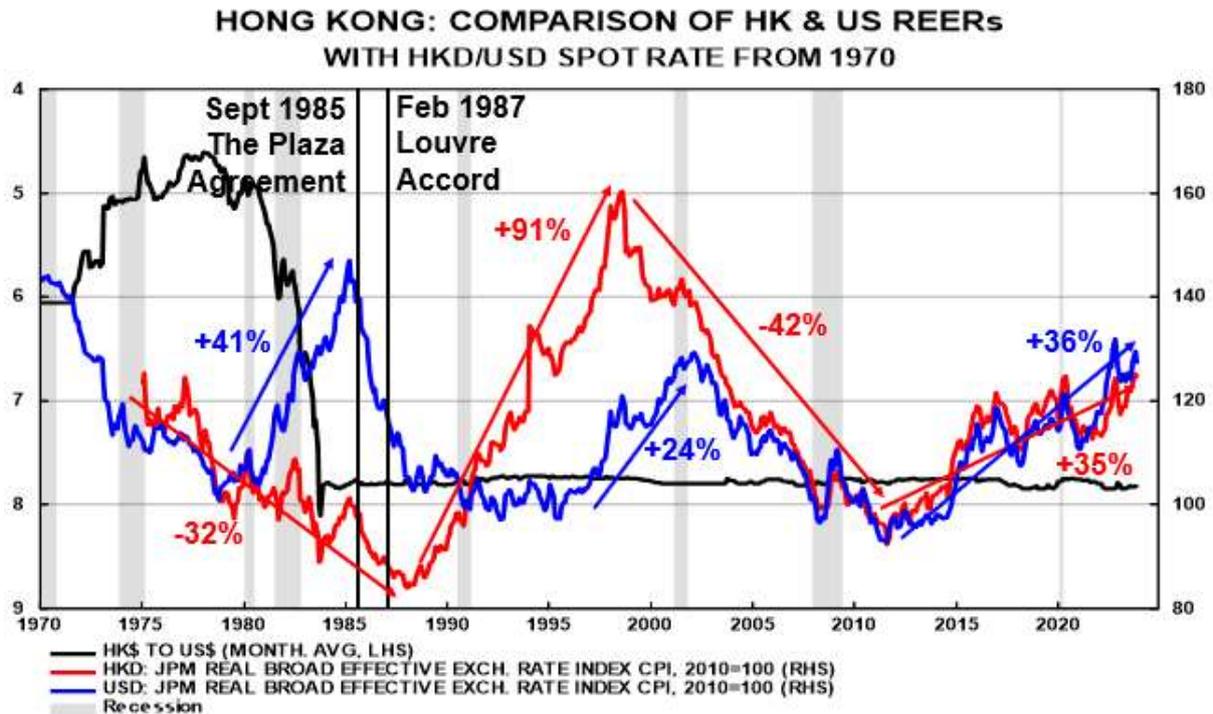
Between August 2011 and November 2023, the HKD has appreciated by 25% in nominal terms against a trade-weighted index (TWI) of currencies (solid red line). Over the same period but adjusting for inflation and currency movements together, the HKD has appreciated by 35% (dashed green line). These appreciations are substantially less than the 59% (nominal) and 91% (real) experienced in the late 1980s and 1990s through the Asian Financial Crisis (AFC) of 1997-98.

In the aftermath of the AFC, Hong Kong was compelled to undergo a painful internal deflation (1998-2004) as other Asian currencies had depreciated steeply whereas Hong Kong maintained a fixed exchange rate against the USD under its Currency Board system.

Figure 8 below helps to tell the story of Hong Kong's overvaluation and subsequent deflation relative to the US in the 1990s and early 2000s. The 91% appreciation of the real effective exchange rate (REER, in red) during Hong Kong's three booms and bubbles of the 1990s (1991-94, 1996-97, and 1999-2001, the latter in equities only, not property) needed to be unwound by a sustained combination of external depreciation and/or internal deflation. The 42% decline in Hong Kong's REER between 1998 and 2011 achieved that adjustment, with Hong Kong's REER

converging with the US REER from around 2004-05. Since the early 2000s there has been much closer convergence between the Hong Kong and US REERs.

**Figure 8. Since 2011, the HKD has appreciated in line with the USD.**



As one would expect, most of the recent appreciation of the HKD derives from its link at a fixed exchange rate to the appreciating USD. In Figure 8 the real effective exchange rate (REER) for the HKD (in red) tracks the REER for the USD (in blue) very closely since the early 2000s when the effects of the Asian Financial Crisis began to dissipate.

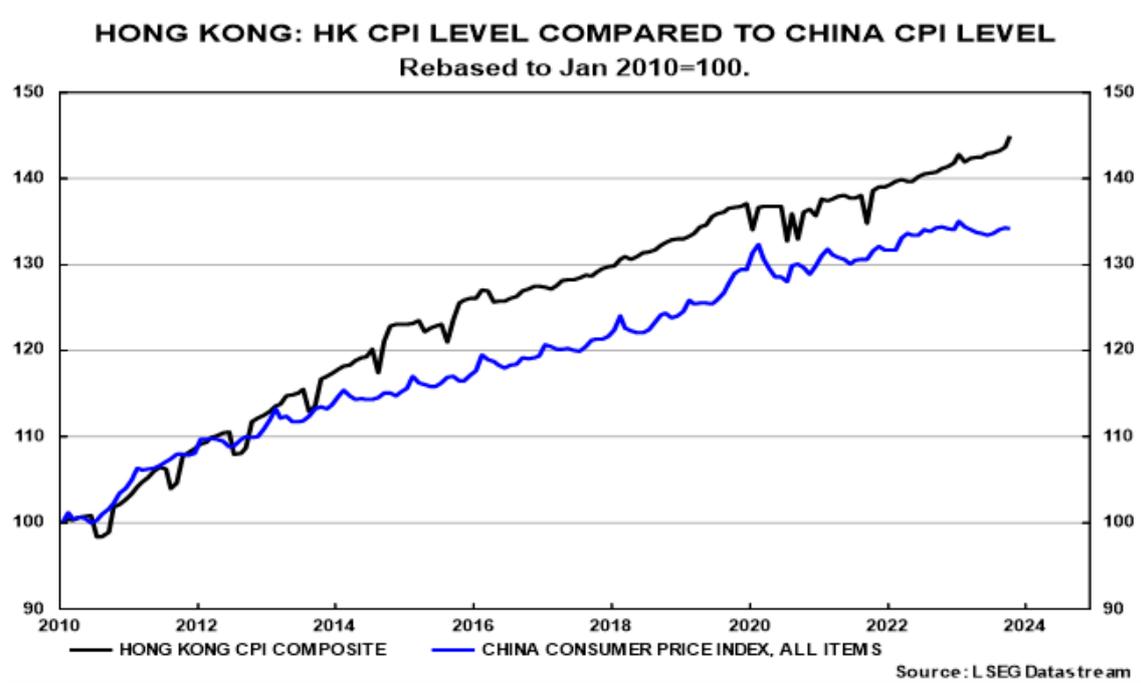
The 36% appreciation of the USD in real terms between August 2011 and November 2023 has not been as large in magnitude nor as steep as in 1980-85 during the period leading up to the Plaza Agreement when it appreciated by 41% on a REER basis, but larger than the 24% appreciation in real terms between January 1996 and December 2001 when the USD benefited from inflows associated with the tech bubble. Since August 2011, on a real, trade-weighted basis the USD has appreciated by 36% while the HKD has appreciated 35%.

Having explored the overall movements of the Hong Kong currency during the 40 years that it has been tied to the US dollar under the Linked Exchange Rate System (LERS), we are now in a better position to review the most recent developments vis-à-vis the Chinese currency and the loss of competitiveness in Hong Kong that has promoted the shopping boom for Hong Kong residents in Shenzhen.

As in the previous cases (Figures 1-8) we need to compare price levels in Hong Kong and Mainland China adjusted for exchange rate changes. We will then consider the

factors that might bring an end to the current exodus of Hong Kong shoppers to Shenzhen.

**Figure 9. China's CPI has Increased more Slowly than Hong Kong's CPI in Recent Years**



**Figure 10. The Combination of Less Inflation and a Weaker CNY have given China a Competitive Advantage.**

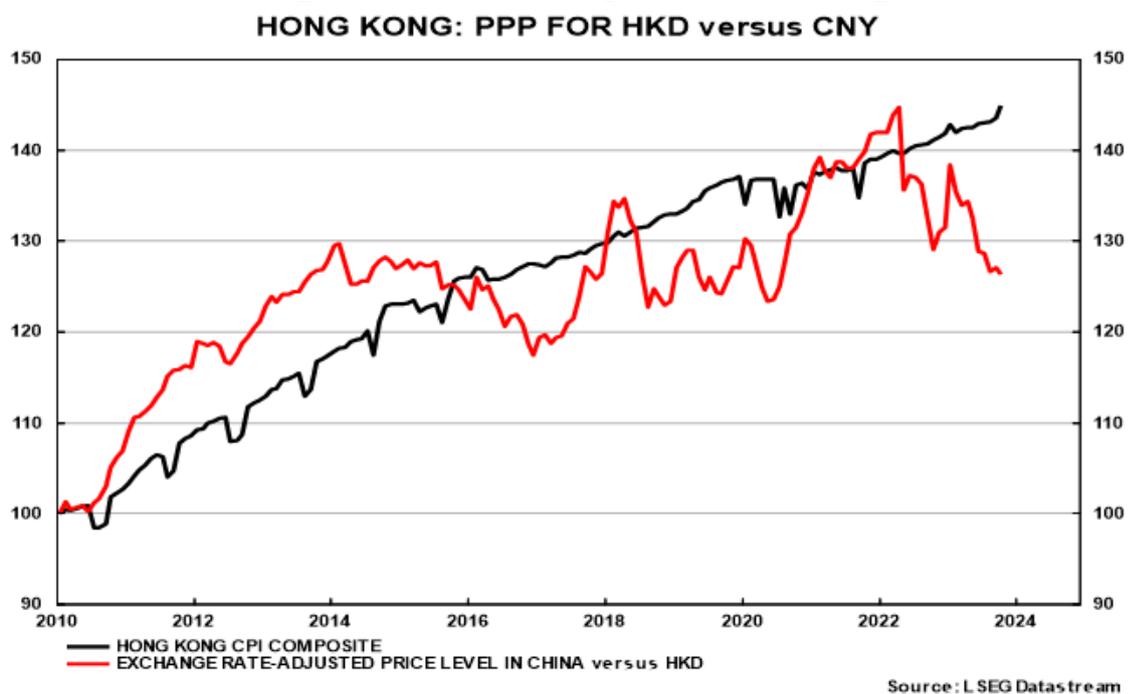


Figure 10 shows the same data for Hong Kong's CPI (in black), but this time the

Chinese price data have been adjusted for exchange rate changes, with the adjusted index shown in red.

**Figure 11. Current prices and exchange rates have given China a 13% price advantage versus Hong Kong.**

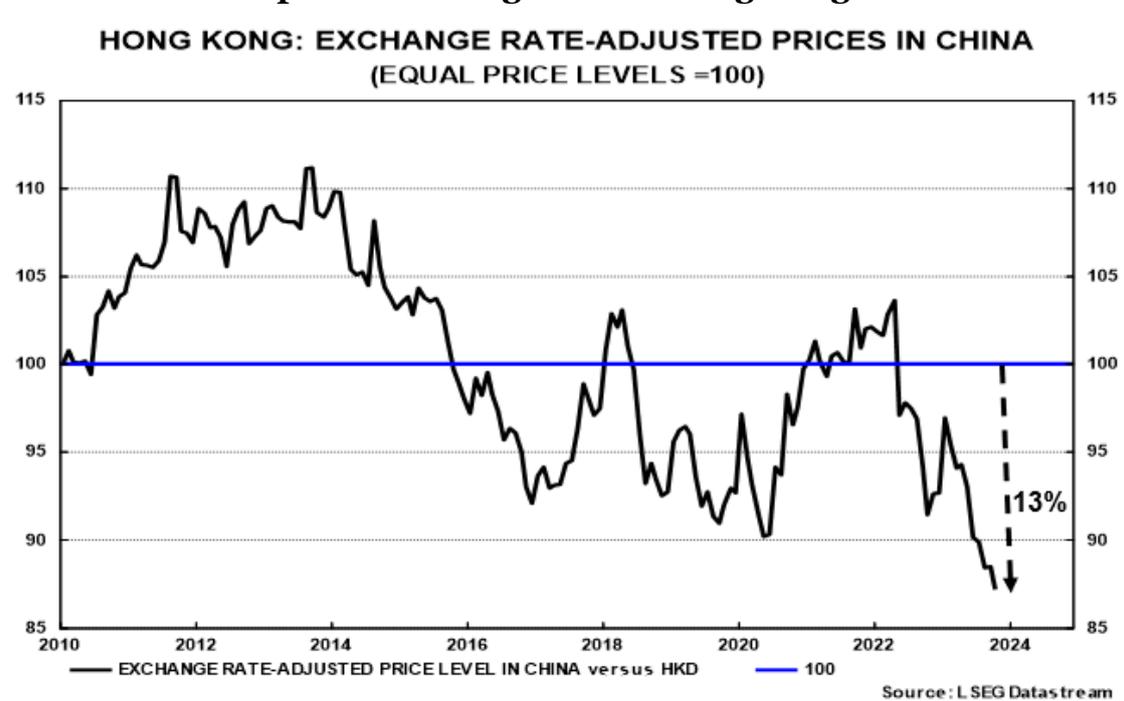


Figure 11 measures the percentage difference between the price level in Hong Kong and the exchange rate-adjusted price level in China. The chart shows that in 2011-14, when the Chinese authorities were steadily managing the currency upwards, China's prices were generally relatively higher than Hong Kong's prices by about 5-10%. On the basis of the same analysis, we can conclude that given domestic Hong Kong prices and the movement of the HKD/CNY exchange rate in the last year or two, prices in China are currently approximately 13% lower than their "normal" purchasing power parity.

How will this situation be resolved? How is the relative price discrepancy likely to be removed? In my view the most likely outcome is that the USD and hence the HKD will depreciate in anticipation of (or as and when) the Fed starts lowering the Fed funds rate. After all, if it was primarily interest rate hikes in the US that have been behind the USD (and hence HKD) appreciation, a downturn in US rates is likely to generate the reverse set of effects. In short, the adjustment path for Hong Kong on this occasion will probably be determined largely by the direction of the US dollar.

### **Summary, Forecast, and Investment Conclusions**

- There is currently a misalignment of prices between Hong Kong and the southern cities of China, notably Shenzhen. The scale of the regular weekend exodus, attracted by this price differential, has reached one or two hundred thousand people.



- Such exchange rate-led shopping sprees reminded me of British consumers crossing the Channel to shop in France decades ago.
- But it also reminded me of Hong Kong's extended adjustment in the wake of the Asian Financial Crisis (AFC) of 1997-98.
- Hong Kong's experience after the Asian Financial Crisis, given its fixed exchange rate, was one of extended adjustment of wages and prices to the depreciation of other Asian currencies, requiring an internal deflation of the HK CPI of about 15%. Fortunately, the other Asian economies experienced an average 38% increase in their domestic price levels between July 1997 and September 2003, reducing the time it took for exchange rate-adjusted Hong Kong and Asian regional prices to converge again.
- The analysis in the second section of this Newsletter explained the sources of the current price divergence between Hong Kong and Shenzhen as consisting of a 16% depreciation of the CNY relative to the HKD, while at the same time prices in China have risen just 1.4% since February 2020 versus a 6.1% increase in Hong Kong's prices over the same period.
- Looking forward, the adjustment period this time is likely to be far less extended than in 1998-2004 because much of the appreciation of the USD (and hence HKD) was driven by widening interest rate differentials. Any significant downward move in US interest rates is likely to be accompanied by a sharp weakening of the USD (and HKD). In my view, such a move is likely by mid-2024.
- In the meantime, while the opportunity for easy arbitrage by consumers between the two cities of Hong Kong and Shenzhen continues to exist, the investment conclusion is that Hong Kong retailers, the tourist industry generally, and load factors for the airline industry will continue to be held back, along with sales and profits in these sectors.

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