Riding out the Covid-19 challenge under a currency board arrangement: Hong Kong SAR's experience

Hong Kong Monetary Authority

Abstract

This note examines Hong Kong SAR's multi-pronged strategy to alleviate local economic pressures amid the Covid-19 pandemic, through the lenses of the policy lessons from recent international experience on fiscal-monetary policy interactions, and the principle of fiscal prudence that underpins the Linked Exchange Rate System. It elucidates the guiding principles behind Hong Kong's extensions of relief measures, and concludes by reflecting upon how Hong Kong, being a small open economy, may be influenced by the fiscal-monetary interactions in major overseas economies, especially the United States.

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1. Introduction

The Covid-19 pandemic and the ensuing restriction measures on social distancing have put unprecedented strains on the global economy. The resulting global recession, the most severe since 1945, prompted a rethink on how monetary and fiscal policies may be better coordinated to foster a more robust and inclusive recovery, while steering clear of potential pitfalls such as the threat to central bank independence amid fiscal dominance.

Hong Kong's currency board system means that local monetary conditions are largely determined by the US Federal Reserve's monetary policy stance, and thus outside the control of the Hong Kong Monetary Authority (HKMA). However, the lack of active monetary policy tools *per se* is not necessarily a hindrance to navigating the Hong Kong economy through economic downturns. Indeed, since its adoption in 1983, Hong Kong's Linked Exchange Rate System (LERS) has withstood the tests of several external shocks, including the Asian Financial Crisis (AFC) and the Great Financial Crisis (GFC), thanks to strong public finances, large foreign reserves, robust banking system, and the HKMA's unwavering support for the currency board system. At the same time, discussions on monetary-fiscal policy interactions are just as relevant for Hong Kong despite its lack of an independent monetary policy, because the Special Administrative Region (SAR) government and the HKMA must ensure that their policy responses to the pandemic always respect the confines of the LERS.

Against this background, this note reviews Hong Kong's experience in riding out the Covid-19 shock, explaining how the policy responses are consistent with the policy lessons from recent international experience on fiscal-monetary policy interactions, as well as the principle of fiscal prudence that underpins the LERS. It is followed by discussions on the guiding principles of the recent extensions of relief measures, and concludes by anticipating the possible impact of the synchronised global fiscal and monetary easing on the Hong Kong economy.

2. Policy responses to Covid-19: Global and Hong Kong's experience

2.1 Policy lessons from international responses to the Covid recession

While every recession is different, the latest global recession wrought by the Covid-19 pandemic differs from other recent recessions in a number of important ways:

Being an exogenous shock, the pandemic was largely unanticipated and was unrelated to any pre-existing macro-financial vulnerabilities, unlike the AFC or the GFC. It was the real economy, rather than the financial sector as in the case of the GFC, that was the first casualty of the recession, as the pandemic disproportionately affected the contact-intensive services sectors (such as tourism, retail and catering) and workers whose jobs could not be done remotely.[1] Such sector-specific shocks suggest that blanket monetary easing on its own is unlikely to be an effective solution in supporting a global recovery. Moreover, as many of the hard-hit sectors were

[1] See Angelucci et al (2020) for details.

typically employers of lower-skilled, lower-income and occupationally less-mobile workers, the outbreak has also aggravated income inequality, which again is a problem not very amenable to remedy by monetary accommodation alone.

The pandemic also drove a surge in private sector savings, although not because of the need for households and firms to deleverage (as in the case after the GFC), but rather out of precautionary motives as well as "forced" or "involuntary" savings, in the sense that consumers could not spend as they might wish amid lockdowns and social distancing measures that shut down the entire in-person, non-essential economy.[2]

Taking into account the special circumstances surrounding this Covid recession, and summarising the international policy responses so far, two important policy lessons emerged:

Fiscal policy can play a more proactive and timely role than commonly envisaged: Recent experience in the European Union (eg the NextGenerationEU Fund) and the United States (eg the CARES Act) suggests that fiscal policy is capable of offering timely countercyclical responses to support the economy, in contrast with traditional assumptions that fiscal policy is usually subject to an implementation lag while monetary policy is the "only game in town". Indeed, given that global monetary easing is arguably fast approaching its limits, fiscal policy will inevitably have to play a more prominent role in future economic downturns. Moreover, as discussed before, fiscal policy offers an advantage of being a more suitable policy instrument than monetary policy to alleviate sector-specific shocks and to address the widening inequality caused by the Covid-19 pandemic, by means of targeted fiscal transfers.

Greater scope for fiscal and monetary policies to work in concert, given lessened concerns over moral hazards: Because the current recession has been caused by an exogenous shock (Covid-19) rather than excessive risk-taking that leads to the accumulation of financial imbalances, there is greater scope for monetary and fiscal policies to work in concert in times of extreme headwinds and uncertainty, with an understanding that moral hazards (such as perceptions of "too big to fail" or "central bank put") are less of a concern. Indeed, recent experience suggests that financial markets tended to react positively to developments towards greater monetary-fiscal policy coordination, reflecting its bolstering effect on market confidence.

2.2 How do these policy lessons apply in Hong Kong's context?

From the perspective of Hong Kong, the adoption of the LERS means forsaking an independent monetary policy, and hence its policymakers cannot use monetary policy tools to "lean against the wind". That said, Hong Kong still has many policy options at its disposal to cushion the economy from negative shocks, thanks to its strong public finances and the well capitalised banking sector. Indeed, given the unprecedented challenges brought by the Covid-19 pandemic, during which many local economic activities ground to a standstill, swift and comprehensive policy responses by the SAR government and the HKMA have helped to avert a collapse in economic activities and confidence. Specifically, since early 2020, the SAR government has already rolled out series of supporting measures totalling about HK$ 400 billion under the Budget and the Anti-Epidemic Fund (AEF), while the HKMA,

[2] See Dossche and Zlatanos (2020) for details.

acting in concert with the banking sector, implemented a principal-only loan moratorium for small and medium-sized enterprises (SMEs).

Under the second round of the AEF (AEF 2.0), the SAR Government launched the "Employment Support Scheme" (ESS) as a means of enabling local employers to retain their employees, by providing time-limited wage subsidies to private firms of all sizes in all sectors.[3]

To be eligible for the ESS, private employers had to be participating in either one of the Mandatory Provident Fund schemes or the Occupational Retirement Schemes Ordinance (ORSO) schemes, and would be required to provide an undertaking not to implement any redundancies during the subsidy period, and to spend all the wage subsidies on paying wages to their employees.

The amount of subsidy for an employer would be calculated on the basis of 50% of the actual wages paid to each employee in an employer-specified month,[4] with a wage cap at HK$ 18,000 per month (in other words, a maximum subsidy of HK$ 9,000 per month per employee) for six months. Besides, eligible self-employed persons were also entitled to receive a one-off lump-sum subsidy of HK$ 7,500 under the ESS.

The HKMA, together with the Banking Sector SME Lending Coordination Mechanism, rolled out the Pre-approved Principal Payment Holiday Scheme (PPPHS) to alleviate SMEs' cash flow pressures in a timely and broad-based manner.[5] Under this scheme, banks could offer principal payment holidays to covered corporate borrowers on a pre-approved basis.

Specifically, under the latest deferral arrangement, all loan principal payments of eligible corporate borrowers falling due between May and October 2021 will generally be deferred by six months, without any need for them to apply.

The pre-approved nature of the Scheme not only expedites the process, but also alleviates the stigma associated with requesting relief from banks. Moreover, as the Scheme is principal-only, banks will still be able to monitor the creditworthiness of their customers by observing their ability to service the interest portion of their debt.

It is imperative to highlight how the AEF and the PPPHS embodied key considerations from the two policy lessons described in the previous subsection. The swift rollout of the four rounds of AEF testifies to the intention of allowing fiscal policy to play a larger role at times of extreme headwinds and uncertainties, and to facilitate more targeted support to prevent an even sharper deterioration in local labour market conditions (Graph 1). At the same time, some of the elements in the PPPHS, such as requiring borrowers to continue serving the interest portion of their debt, are designed with a view to preventing moral hazards in the private sector.

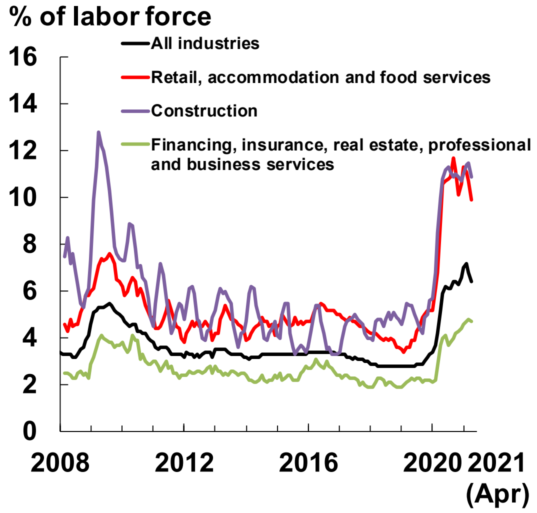
3 See www.ess.gov.hk/en/ for details.

4 A "specified month" between December 2019 to March 2020 (both inclusive) was to be chosen by the employer. The number of employees and their relevant income during that "specified month" would serve as a basis for calculating the subsidy.

5 To be eligible for the PPPHS, a corporate borrower has to have an annual sales turnover of at most HK$ 800 million, have no outstanding loan payments payable to the bank which have been overdue for more than 30 days since 1 May 2020, and are not in the process of ceasing operations or declaring bankruptcy or liquidation. See www.hkma.gov.hk/eng/key-functions/banking/banking-regulatory-and-supervisory-regime/preapproved-principal-payment-holiday-scheme/.

Hong Kong's unemployment rate by selected sectors

Graph 1



Source: Census and Statistics Department.

3. Beyond the pandemic: Extension of relief measures

3.1 Guiding principles

Since late 2020, breakthroughs in vaccine development raised hopes that the Covid-19 pandemic would eventually be eradicated or otherwise brought under control, thereby allowing a return to normal. However, even when the recovery eventually begins, the recuperation process will likely remain fragile and uneven, not only because of the severity of the recession, but also because the pandemic has very likely resulted in long-term damage, or economic scarring. For instance, workers suffering from prolonged unemployment spells may become permanently detached from the labour market, while structural changes in consumer behaviour may render some business models non-viable even after the pandemic subsides (eg greater preference for online shopping may pose headwinds to traditional brick-and-mortar retail outlets).

Given such considerations, policymakers should err on the side of caution and avoid withdrawing policy support abruptly or prematurely, especially during the early phase of the recovery, in order to avoid disruptive "policy cliffs" that may dampen the recovery momentum. However, as the recovery continues to take hold, policymakers will need to begin to weigh the benefit of relief measures against their associated costs, both in terms of their impact on fiscal sustainability, and possible delays to necessary reallocation of resources away from economic sectors that are no longer viable. Indeed, prolonged implementation of relief measures may risk creating more "zombie firms", especially in hard-hit sectors, whose businesses are no longer viable in the post-Covid world, but nonetheless continue to survive with the help of government support.

3.2 The situation in Hong Kong

In Hong Kong, the extension of policy support has been guided by a framework assessing whether it is beneficial to begin to "exit from", or to "extend", relief measures, and which parties should receive relief extensions. Even as Hong Kong's strong public finances have allowed the adoption of the most expansionary fiscal policies ever in response to the pandemic, the SAR government remains mindful of the need for fiscal prudence over the medium term, given that fiscal reserves are expected to drop below the levels seen in 2003, when the outbreak of the Severe Acute Respiratory Syndrome (SARS) dealt a heavy blow to the local economy.

Moreover, as the global rollout of vaccines is expected to bring the global economy back to normal eventually, by that time financial markets would likely begin to differentiate economies by their fiscal fundamentals. In contrast to major advanced economies that enjoy reserve currency status, Hong Kong is subject to much more stringent fiscal standards, because it does not have the option of monetising government debts under the currency board system. As such, there is a limit on how far fiscal deficit and government debt can rise in Hong Kong without eroding investor confidence in the exchange rate peg. Accordingly, the latest two rounds of the AEF (3.0 and 4.0) adopted an even more targeted approach to assist only the hard-hit sectors, and the size of the funds was also significantly reduced relative to the first two rounds of AEF.

As for the PPPHS, an extension of this programme would likely increase banks' exposures to failing borrowers over time, which could result in deterioration of the solvency and liquidity positions of Hong Kong banks. Ultimately, the policy question can be distilled into a trade-off between the near-term benefit of providing additional stimulus via PPPHS, and longer-term banking sector costs and a delay in necessary economic restructuring. In extending the PPPHS, the HKMA's decision was guided by a cost-benefit approach, where benefits are quantified using a model that estimates how much of the corporate borrowers' funding gaps can be closed by extension of relief measures, which ultimately translate into estimates of the degree of reduction in default likelihood and the number of jobs to be preserved. Calculations are done on a sector-by-sector basis; for most sectors, it was found that banks faced higher loss rates the longer the PPPHS continues, while for other sectors, loss rates decline because the drop in estimated probability of default more than compensates for the increase in banks' loss-given-default exposures. Given the strong capital and liquidity positions of Hong Kong banks, the costs were deemed manageable compared with the societal benefits, thereby leading to the HKMA's decision to extend the Scheme. That said, the HKMA will continue to closely monitor the situation and adjust the parameters of the PPPHS as necessary.

How may Hong Kong be affected by monetary-fiscal policy interactions elsewhere?

In addition to relief measures, another important longer-term policy issue relates to the extent of external spillovers from other major economies' policy responses to the Covid recession. Because of the LERS, Hong Kong passively imports the US monetary policy stance. In particular, the US Federal Reserve's large-scale asset purchases, in addition to its commitment to a "low for long" monetary policy through the adoption of average inflation targeting, have contributed to the highly accommodative financial conditions in Hong Kong. While this easing of financial conditions may have helped cushion the domestic economy from the Covid shock, it has also arguably resulted in greater inequalities between the "haves" and "have nots", as well as a disconnect between the financial markets (particularly the property market) and the real economy. To mitigate these issues, macroprudential policies would be the first line of defence to constrain the build-up of risks and strengthen the resilience of the financial system against potential shocks, while targeted fiscal policy may be deployed as necessary to alleviate the impact on inequality.

4. Conclusion

While Hong Kong has no independent monetary policy due to its LERS, the SAR government and the HKMA have been able to pursue a multi-pronged strategy to provide timely and targeted relief measures to the local economy, via fiscal support, employment retention schemes and principal-only loan moratoriums for SMEs, thanks to Hong Kong's strong public finances and the well capitalised banking sector. These relief measures have embodied important policy lessons from recent international experience regarding fiscal-monetary policy interactions, namely, that a more proactive use of fiscal policy as a countercyclical tool can be helpful, and that fiscal and monetary policy can better augment each other as the special nature of this recession has helped to lessen concerns over moral hazards. At the same time, the design and implementation of the policy support also strictly respect the principle of fiscal prudence that underpins the LERS.

Future decisions to extend relief measures will be guided by a framework that explicitly weighs the benefits of minimising policy cliffs against the potential costs in terms of fiscal sustainability and delayed economic restructuring. Because of the LERS and its status as a small open economy, Hong Kong is highly exposed to the impact of fiscal-monetary policy interactions in major economies, especially the United States. The resulting highly accommodative financial conditions in Hong Kong have arguably resulted in disconnect between the financial markets and the real economy, as well as between "haves" and "have nots". To address these concerns, macroprudential policies could help constrain the build-up of risks and strengthen the resilience of the financial system against potential shocks, while targeted fiscal policy may be rolled out as necessary to alleviate the impact on inequality.

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