

A Hong Kong Dollar for China
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'Under the 'one country, two currencies' system, Beijing could let firms hold Hong Kong dollar accounts'

China still has a long way to go before it can eliminate high inflation and the associated pressure to devalue the renminbi--yet that's what needs to happen if the currency is to become fully convertible. In the meantime, Beijing could move towards trading the renminbi freely by using the Hong Kong dollar for international trade and investment. The government could allow enterprises and banks to open dollar accounts and to decide for themselves whether and when to buy or sell dollars, in the quantity of their choice. I call the system "one country, two currencies."

A similar conclusion has been expressed in various internal reports in China. The Hong Kong Economic Journal has even reported a Chinese government plan to allow firms to open dollar accounts in state banks. So far, however, the plan hasn't been implemented.

Interestingly, the "one country, two currencies" approach was practised quietly in China for about 15 years, before January 1994. (At that point the exchange rate was unified and new foreign-currency controls came into effect.) China could go back to a revised version of the dual-currency system, under which China unconsciously used both a central bank and a currency board that linked the Hong Kong dollar to the American dollar.

Between 1979 and 1994, some Chinese enterprises were allowed to keep a certain amount of foreign exchange, buy imports with it and sell it at swap centres. Many mainland businesses, especially in southern China, were charging their customers in American dollars and Hong Kong dollars. Indeed, about a quarter of Hong Kong's currency, or HK\$14 billion (\$1.8 billion), was circulating in China before 1994.

Citizens were allowed to keep foreign exchange in banks. Furthermore, they could bring a set amount of renminbi across the border to Hong Kong. This led to a renminbi market in local retail shops.

Those who used dollars for trade and investment had virtually no foreign-exchange risk, since they essentially used two monetary systems--the dollar for their foreign-related transactions, and the renminbi at home. Meanwhile, businesses that needed to trade dollars for renminbi did so through the swap centres.

The system had its problems. A difference between the volatile swap-centre exchange rates and the fixed official rate created opportunities for speculation and corruption. Moreover, the government could not control the use of dollars and it risked capital

flight. Indeed, according to China's balance of payments in 1992--a year of unprecedented foreign investment--there was a capital outflow of about \$10 billion. Unable to trace it, the government recorded the sum as an error.

A foreign-exchange control mechanism introduced in 1994 dealt, perhaps unintentionally, with the system's problems. Chinese enterprises now buy their foreign exchange from state banks, at about 8.4 renminbi to the American dollar. It's illegal to use foreign currency for domestic transactions, and buyers must prove they are using the foreign money for current-account transactions--meaning trade, primarily. Most dramatically, all domestic enterprises have had to sell all their current and past foreign-exchange earnings to the state at a set rate.

Tightening control on the exchange rate was successful from the government's point of view. The rate is stable and foreign-exchange reserves have climbed to about \$70 billion, from \$21.2 billion in 1993.

However, the reform has also brought about problems. Because foreign currency flows into the state coffers, there's an artificially close link between the coffers and domestic and international economic activity. For instance, export and foreign-investment increases can raise foreign reserves and cause unexpected increases in the renminbi supply. If officials can't carefully control the supply of money in the open economy, fluctuations in the balance of payments can easily spill into the business cycle--causing inflation, for instance.

By contrast, under a system of two currencies, the bulk of foreign exchange would be held by thousands of enterprises. Neither the central bank nor state commercial banks would control transactions, production, or investment involving foreign exchange.

Under a new "one country, two currencies" system, Beijing could let firms hold Hong Kong dollar accounts. It could also relax restrictions in the interbank market for foreign exchange, and let the interbank rate be the real free-market rate. The renminbi would be fully convertible at a floating rate on certain, allowable transactions. Exchange risk would be assumed by the participants--speculators, ordinary producers, traders and investors.

The fluctuation of the exchange rate would not necessarily lead to capital flight. If foreign investors and domestic enterprises were able to use a fully convertible currency such as the Hong Kong dollar along with the renminbi, they would feel quite safe. They would be able simply to ignore the renminbi if the exchange rate fluctuated too much, and use only the Hong Kong dollar.

The transition to the voluntary exchange of dollars and renminbi among enterprises and state banks is a simple but fundamental step towards a free-market economy. While economist Milton Friedman predicts that the Hong Kong dollar will be replaced by the renminbi after 1997, I predict instead that "one country, two currencies" will be practised in China, just as "one country, two systems" will be practised in Hong Kong.