MONITOR
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Pledge to keep the US dollar peg promises a volatile future

C.Y. Leung's reassuring comments about the local currency could come back to bite us, as a strengthening greenback can erode our competitive edge

A great sigh of relief went up from Hong Kong's business community yesterday, when incoming chief executive Leung Chun-ying said he wouldn't change the city's currency peg to the US dollar.

Business bosses favour the peg because of the certainty they say it brings. But while they are surely right that the US dollar peg is better than the suggested alternatives, it promises little by way of stability. On the contrary, the peg may take us on a wildly volatile economic ride over the coming years. That is because the US dollar itself is likely to be volatile against the world's other major currencies.

As the first chart shows, such volatility is nothing new. Over the last 10 years, the US dollar has lost one-third of its value against a basket of other major currencies. But for the most part, this trend has benefited Hong Kong, pulling the economy out of deflation and boosting the city's competitiveness as a business hub.

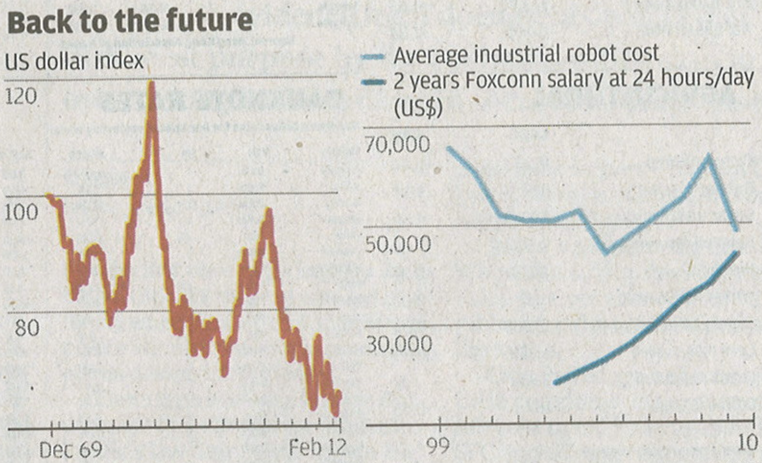
But now the US dollar's long-term weakening trend may be about to reverse as the massive trade deficits that have undermined the currency's value evaporate and disappear.

Over the last five years, the United States has run an annual trade deficit averaging more than US$500 billion a year. Half of that deficit has consisted of oil imports. Now, with the US forecast to double domestic production of shale gas over the next 10 years, its energy imports are expected to decline, shrinking the trade deficit.

On top of that, America's trade deficit in manufactured goods is likely to shrink and could even disappear. That might sound an improbable claim after years in which manufacturers have fled US shores to take advantage of cheap labour costs in China and other developing countries.

But these days having a large pool of cheap workers no longer confers such a great competitive advantage.

To see why, take a look at the second chart, which comes from research company GaveKal. It



Sources: GaveKal Data, BIS
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compares the cost of an industrial robot with the salary of an assembly-line worker at contract manufacturing giant Foxconn.

Because a robot operating 24 hours a day typically pays for itself in two years, GaveKal's researchers have compared the robot's unit cost with the equivalent of two years' earnings for an imaginary super-employee working 24 hour shifts.

As you can see, it won't be long before it's more cost-effective for factories in China to buy robots than to employ humans, hence Foxconn's decision last year to invest in one million robots over the next three years.

This is a huge switch. It means manufacturers in different countries will no longer be competing on their labour costs but on their cost of capital. With borrowing costs in the developed world set to remain low for the foreseeable future and China

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promising to liberalise interest rates, it implies that, before long, manufacturers in the rich world could once again be besting their rivals in developing countries.

Factories are likely to move back to America, and US exports of manufactured goods will rise, thus narrowing and possibly eliminating the US trade deficit.

The result would be a shortage in the worldwide supply of US dollars and a sharp increase in the value of the currency.

To understand the impact on a pegged Hong Kong dollar, consider what happened during the US dollar's last bout of extended strength between 1995 and 2002, when the US currency climbed by 40 per cent. At first things felt great, as capital flooded into the city to take advantage of its currency appreciation. Asset markets shot up, with both stock and property prices doubling in two years.

But the appreciation eroded Hong Kong's competitiveness and when the Asian crisis struck, the city had no way to adjust except through a crash in the property market, slumping wages, rising unemployment and years of deflation.

So while it may be a good thing that Leung wants to keep the peg, at best it will be a decidedly mixed blessing.

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