Stability of Hong Kong's Dollar Peg System and Challenges in Financial Hub Status

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Since China imposed the national security law on Hong Kong and the US revoked Hong Kong's preferential trade status, uneasiness has been rising about the stability of Hong Kong's dollar peg, and the city's long-held status as a financial hub. However, it seems unlikely at this moment for the US to take action to undermine Hong Kong's dollar peg because it could lead to immense adverse effects with no clear effect of keeping China in check. Reflecting such market expectations, financial and FX markets in Hong Kong have recently been stabilized. However, the lingering political and social unrest in Hong Kong and conflicts between the US and China could possibly weaken the city's financial hub status as more firms, capital, and talents will flee the city. Hence, Korea's financial institutions and investors should closely monitor financial market conditions and political conflicts between the US and China, and remain cautious about the possibility of Hong Kong's weaker financial hub function from the long-term perspective.

The lingering political and economic conflicts between the US and China have been threatening the status of Hong Kong as an Asian financial hub. After China imposed the national security law on Hong Kong at the end of June 2020, the US government decided to revoke preferential treatment to Hong Kong with regard to tariffs, license exceptions for exports, and visa issuance. This also triggered the possibility of the US limiting its dollar liquidity provision to Hong Kong, which could unsettle Hong Kong's currency board system.[1] It was very fortunate

∗ All opinions expressed in this paper represent the author's personal views and thus should not be interpreted as Korea Capital Market Institute's official position.

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1) The Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER) by the IMF uses the term "currency board

that the US decided to hold back the idea because the collapse of Hong Kong's currency board system—a rigid, pegged exchange rate scheme—could not only seriously undermine Hong Kong's advantage as an international financial center but also destabilize the whole international financial markets. But some observers argue that the issue may come to the fore again any time depending on the two countries' political landscape.

Under the circumstances, this article tries to look at what Hong Kong's currency board system means, why the US remains reserved about ending the peg, and how the recent developments would impact the city's financial markets as well as the status, from which to derive the implications for South Korea.

Hong Kong's currency board system: Characteristics and meanings

The currency board system has been Hong Kong's own exchange rate regime since 1983, which predates by nine years the US-Hong Kong Policy Act of 1992 that grants Hong Kong preferential treatment. This is a hard peg system that ties the Hong Kong dollar in a narrow range around HK$7.8 (HK$7.75–HK$7.85) to the US dollar. To maintain the peg, the Hong Kong Monetary Authority (HKMA) absorbs a net inflow of foreign currency, and allows its foreign reserves to be exchanged freely at times of a net outflow, which helps foreign currency liquidity to remain stable. By pegging the exchange rate while allowing the interest rates to change in relation to capital flows, the system provides some benefits, such as stably securing global liquidity and effectively responding to FX speculation.

However, it's impossible to carry out independent monetary policy under the currency board system because the changes in foreign reserves resulting from external transactions would automatically lead to either supplying money or taking money out of circulation.[2)] Another demerit in the absence of the central bank's discretionary monetary policy is the possibility of capital inflows which would lead to an increase in money supply (a lower interest rate), overheating in the economy, and inflation. Or, capital outflows in this case are likely to cause a higher interest rate and a recession. Due to such shortcomings, FX speculators targeted Hong Kong's stock market and the FX market twice in 1998 during the Asian financial crisis.

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system" aiming to distinguish Hong Kong's peg regime without discretionary monetary policy from a normal peg system that maintains a pegged exchange rate against a specific currency and a basket of currencies. As of 2018, a total of 11 nations including Hong Kong uses the currency board system.

2) The HKMA is different from a central bank because the authority cannot carry out autonomous and discretionary monetary policy. The Hong Kong dollar is issued by HSBC, Standard Chartered, and Bank of China, not by the HKMA.

However, the policy authorities fully capitalized the foreign reserves to successfully defend its FX rate. The city's long-held stability in the peg even amid crises such as the SARS outbreak and the global financial crisis is largely attributable to its abundant foreign currency liquidity, among others.

When Hong Kong first launched the currency board system, the US implicitly supported the peg with seamless provision of US dollar liquidity, which helped Hong Kong position itself as an international financial hub. In another words, Hong Kong's peg under the currency board system has been viewed crucial in Hong Kong's financial hub status because it not only helps foreign capital to flow into Hong Kong for financial transactions without FX risk, but also guarantees the unfettered exchange of the Hong Kong dollar to the US dollar during investment exits.

What's behind US inaction in breaking the peg

During the recent conflicts between the US and China, the US at some point seemed to consider pressuring China further by limiting its US dollar supply to Hong Kong banks, which could have shaken the stability of Hong Kong's exchange rate regime and the city's position as a global financial center. However, it is believed that the US plan has been put on hold under the following circumstances.

First, the end of the peg would have a direct impact on US firms operating in Hong Kong, rather than serving to deliver the intended policy objectives of the US that wants to keep China in check. There are about 1,400 US firms in Hong Kong. The collapse of the peg will not only sharply cut their asset value and restrict their financial transactions, but also cause immense difficulties in their funds transfers.

Second, it is analyzed that, even if the US limits its dollar liquidity provision, Hong Kong's current reserves exceeding \$440 billion—twice the size of the Hong Kong dollar issuance—are sufficient to meet potential demand and to keep the peg intact. Furthermore, the city's currency swap agreement with China worth of RMB 200 billion or \$63 billion will help reduce concerns about a liquidity shortage. Taking into account the importance of Hong Kong in the Chinese economy, the liquidity support from China holding over \$3 trillion foreign reserves will be of substantial help for Hong Kong to defend its peg regime.

Third, China has fully capitalized Hong Kong as a gateway to invite foreign capital to the mainland via the Shanghai-Hong Kong Stock Connect (2014) and the Shenzhen-Hong Kong Stock Connect (2016). What's likely from the standpoint of the US that wishes to open China's financial markets is that the collapse of the peg and the consequent confusion in Hong Kong's financial markets is far from a desirable picture because this might destroy an important foothold to gain more access to the mainland.

Fourth, it seems hard to rule out the possibility that the end of the peg regime could not only seriously undermine Hong Kong's status as a global financial center, but also destabilize the international financial markets. With the steady increase of IPOs of Chinese firms even after April 2020, the Hong Kong Stock Exchange now boasts the world's largest size. As of 2017, the market's intraday FX trading reached $418.4 billion, over eight times that of Korea. Also, the market is an international financial hub whose US dollar trading is the third largest in the world. Any destabilization in Hong Kong's peg will trigger another FX speculation, which requires a massive supply of foreign reserves from Hong Kong's policy authorities. During the process, the US might see a decline in government bond prices, a rise in international interest rates, and more importantly, a higher possibility of global financial unrest. This could pose a burden to the US.

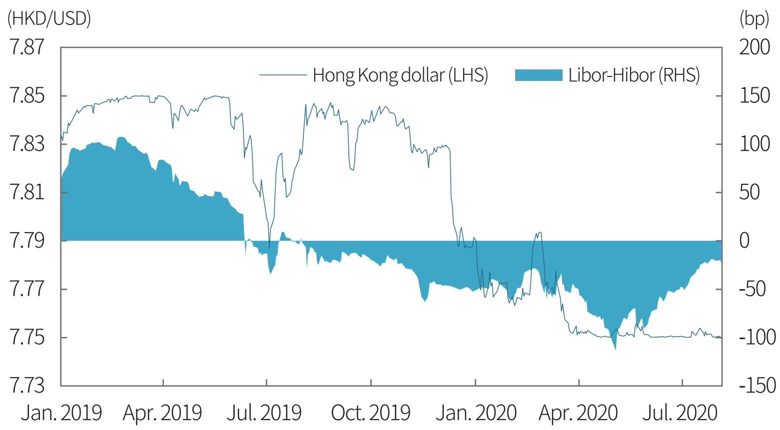
Consequently, any attempt by the US to weaken Hong Kong's peg could be likened to a speculative attack armed with dollar liquidity against Hong Kong, which could impose substantial damage to US firms and trigger global financial unrest and other adverse effects. Hence, this is hardly likely to happen in the near future because all of those circumstances appear to run counter to the objectives of the US policy. Rather, the US seems more interested in keeping its global economic hegemony by preoccupying a dominant position in future trade negotiations with China and by flaunting its key currency power. Also in play is political motivation for the upcoming US presidential election in this November.

Future impacts on Hong Kong's financial markets and status

There have been rising concerns that Hong Kong's financial hub status and function could be seriously undermined amid the rapid changes in the financial environment such as pro-democracy protests continuing in Hong Kong and the end to preferential treatment from the US. However, Hong Kong's status is unlikely to face a drastic change in a short run given the city's competitive edge as a financial hub for the past three decades. Hong Kong's global financial hub status has been largely attributable to many factors, such as its relatively low tax rate,[3] the flexible labor market, unfettered business and financial environments, and no discrimination against foreigners. On top of its cultural benefits and geographical proximity to China, Hong Kong is still an attractive gateway to doing business with China as the city enjoys tariff exemption and benefits related to services and investments under its Comprehensive Economic Partnership Agreement (CEPA) with China.

Since China imposed the national security law on Hong Kong and the US revoked preferential treatment to Hong Kong in July, the exchange rate of the Hong Kong dollar to the US dollar has remained strong hovering around the lower bound of the peg at 7.75, which is contrary to when Hong Kong faced fierce democracy protests in the previous year. This stems largely from two factors: One is the carry-trade inflow because the Hong Kong interbank interest rate (Hibor) is higher than its US dollar counterpart Libor; and the other is the persistent US dollar inflow to IPOs in mainland China. Stocks in the Hong Kong market are also rebounding. All of those seem to evidence that participants in Hong Kong's financial and FX markets hold an optimistic view over the city's status and future as a financial hub.

Figure 1. HKD exchange rates and interest rate spreads



Source: Bloomberg

From the long-term perspective, however, it's hard to rule out the possibility that the lingering conflicts between the US and Chin and political and social unrest in Hong Long will undermine Hong Kong's competitiveness as an international financial center and dampen

3) Compared to its competitors, Hong Kong has lower rates for corporate tax (16.5%) and labor income tax (17.0%), with no tax on capital gains and interest income from financial products.

investor confidence, which could lead to another financial unrest. In the Global Financial Hub Index (GFHI), Hong Kong fell from the 3rd in the previous year to the 6th in the first quarter of 2020. Already, it's known that global investment banks in Hong Kong are devising contingency plans to circumvent US sanctions, with some of them seeking to scale down their Hong Kong operation for moving to mainland China or Singapore. Another concern is that the end of preferential treatment to Hong Kong could possibly contract trade and logistics services and further accelerate the economic recession and negative growth, which may in the end burst the real estate bubble.[4)] This is concerning because global and Chinese firms, foreign capital, and talents are likely to flee the city, which could be a major blow to Hong Kong's financial hub function.

Policy changes in Chinese and Hong Kong authorities are another important factor affecting Hong Kong's status. At the wake of the US revoking Hong Kong's preferential treatment, China has been reported to be devising substantial plans to develop Hainan and Shanghai as a trade and financial center that is on par with Hong Kong.[5)] Another possibility at a time when the US may try to undermine the peg any time is Hong Kong's replacement of its current currency board system by the yuan pegged to a basket of currencies. This could be a proper alternative, helping Hong Kong to reduce its dependency on the US dollar and to fundamentally block the US attempt of undermining the peg. This also serves mutual interests of Hong Kong and China that advocates one country, two systems. Although such a drastic policy shift seems hardly likely in a short run, this is surely a long-term factor that could shake Hong Kong's position as an international financial center.

Implications

Hong Kong is a trade and financial gateway to China and Korea's fourth largest trade destination. However, the US action to revoke preferential treatment to Hong Kong is expected to have only a limited and adverse impact on Korea's real sector. Although Hong Kong is linked to Korea's financial markets with H-shares representing a large portion in underlying assets of equity-linked securities in Korea and a formidable number of Korean firms operating in

4) Hong Kong's real GDP growth rate hit –1.2% during 2019, and then –9.1% and –9.0% year-over-year in the first and second quarter of 2020.

5) For details, refer to the Overall Plan for the Construction of Hainan Free Trade Port and the Action Plan for the Construction of Shanghai International Financial Center (2018~2020).

Hong Kong, no confusion has been reported in Hong Kong's financial markets. Hence, Korea's financial institutions and investors at this point should closely monitor the financial market conditions and the developments in political conflicts between the US and China when carrying out their normal business activities, rather than being overly concerned.

Admittedly, however, a caution is also required because prolonged US-China conflicts and political and social unrest in Hong Kong could dampen investor confidence and thereby undermine Hong Kong's appeals as a financial hub, which might make exit of capital and talent from the city more likely. From the long-term perspective, it is recommended that Korea have a reserved approach while diversifying investment destinations and keeping its financial interconnectedness with Hong Kong from rising to an excessive level.