FOCUS · Hong Kong: to break or not to break with the US dollar

The convergence of three factors has led to fears of a possible rupture of the peg between the Hong Kong dollar (HKD) and the US dollar (USD): namely the start of interest rates hikes by the Federal Reserve of the United States (Fed), China's economic slowdown and increased risk aversion among international investors. However, although some long-term trends suggest that this USD peg should be broken, it is likely to continue in the short and medium term.

The HKD has been pegged to the dollar since 1983 via a Currency Board. This guarantees that HKD will be exchanged for USD at a rate of 7.8 HKD per USD (±0.05) thanks to one of the largest stocks of foreign reserves (USD 359 billion). In addition to this ample buffer of reserves, a healthy financial sector and solid public accounts and a surplus current account are elements that help peg maintainance in the short term. However, during the first few weeks of 2016, with the worsening of financial turbulence in the Chinese markets and the depreciation of the renminbi (RMB), capital outflows from Hong Kong brought the value of the HKD to the weakest limit of its band (see the graph).

For more than three decades this fixed exchange rate has been very useful for Hong Kong's economy, helping to implement its economy's singular, successful model of development focused on the financial sector and trade services. It has also helped China's modernisation as Hong Kong has become the main entry point for the Asian giant's relations with the rest of the world (a large proportion of trade and capital flows to and from mainland China pass through this small region). In short, the anchoring of the HKD with the USD has helped Hong Kong to become a world-leading hub for finance and trade and the toll paid of losing monetary policy and being subject to the Fed has therefore been acceptable.

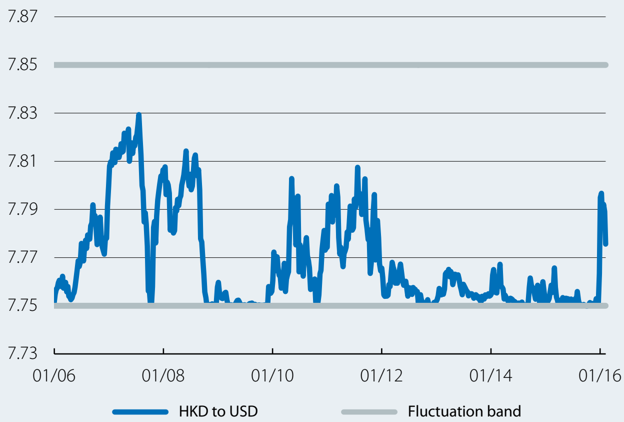
However, growing relations with mainland China are changing Hong Kong's economic and financial situation. In particular, the increasing importance of the RMB is starting to challenge the supremacy of the USD in Hong Kong's economy, finance and trade. By way of example, while in 2009 commercial transactions in the Chinese currency were insignificant, it is estimated that these exceeded 6 billion RMB in 2015 (close to 900 million USD). Of the 1,752 companies listed on the Hong Kong Stock Exchange at the end of 2014, 876 came from mainland China, accounting for almost 60% of the market capitalisation. In November 2014 a connection was established between the Hong Kong and Shanghai stock markets (Shanghai-Hong Kong Stock Connect) which allows capital to flow between both (within quotas set by the Asian giant).[1]

This trend towards Hong Kong becoming more synchronised with mainland China in detriment to the US has had repercussions at an economic level. Between 2011 and 2014, while China looked solid economically and the Fed was applying its ultra-accommodative monetary policy (translated into a federal funds rate close to zero in Hong Kong), high rates of inflation were observed (4.5% annually on average compared with rates of 2% a few years earlier) as well as a sharp rise in real estate prices (more than 100% since 2010). Thus, Hong Kong's exchange rate regime is and will continue to be a cause of debate, especially so in the long term. A change that brings the HKD closer to the RMB will be beneficial giving the increasing integration of both economies. However, first China will have to complete and consolidate its integration within the international financial system, reducing its still high restrictions to capital flows, modernising its financial system and increasing the flexibility of its exchange rate and the convertibility of its currency.

In the short term the most advantageous option is for the peg to remain in place, fundamentally for two reasons. Firstly the USD is still the main currency for trade and financial transactions in Hong Kong so breaking this link now would considerably destabilise its economy. Moreover the liberalisation being carried out by China could cause significant volatility so it is useful to have a financial and commercial hub which the world believes is stable.

Hong Kong dollar exchange rate

Hong Kong dollars to US dollars



Source: *CaixaBank Research, based on Bloomberg data.*

1. See «Shanghai-Hong Kong Stock Connect: connecting with the Chinese stock market», in MR01/2015.