Analysis of Hong Kong Dollar in a Changing Economic Environment

Dihua Fang

College of Arts and Sciences, University of North Carolina at Chapel Hill, Chapel Hill, NC 27514
**Corresponding author. Email: dihua@live.unc.edu*

ABSTRACT
Many people have begun to reconsider the linkage of Hong Kong's currency, the Hong Kong Dollar, to the U.S. Dollar under the historically great tension in US-China relationships and the underlying conflict between two of the world's biggest economies. There are many different policy candidates advocated by economists to replace the current system. This paper concludes that the HKD is likely to continue its peg with USD as great costs, as risks are imposed with this fundamental change, and benefits of the other options are not strong enough to support the change. Comparison and contrast analysis is used in this research to determine the possible benefits and drawbacks of certain monetary policies, as alternatives to the current fixed exchange rate system in Hong Kong. It is important to understand the possible outcomes of this change on a monetary basis as policymakers decide the measurements to adjust the current system to adapt to the changing economic environment.

Keywords: *Hong Kong Dollar, fixed exchange rate system, U.S.Dollar, US-China relationship*

1. INTRODUCTION

Hong Kong, a special administrative region of China, has been enduring the disturbance with social, political, and economic factors since 2019. Much inspection and speculation have been raised by institutions and the world is paying close attention to this international finance center under the historically great tension in US-China relationships. Moving into 2020, the global pandemic of COVID-19 further complicates the issue. In this world of uncertainties, the existing monetary system has been facing challenges from different theories that another system may serve Hong Kong better. However, whether there is a need for change in the system requires careful determination.

Hong Kong was established as a free trade port in Asia in 1841. Due to a large amount of international trade flowing through the city and the lack of local currency, other currencies like the American silver Dollar and Pound Sterling were used as alternative currencies [1]. Hong Kong issued its own banknotes which coexist with the metal coinage systems of silver coins when the Oriental Bank of Hong Kong was established in 1845. After the British took control of the city, Hong Kong continued this monetary system based on silver. In 1935, when China formally abandoned the silver standard, Hong Kong followed and turned to a currency board based on a fixed exchange rate to the British pound.

This system continued with some interruption during the Japanese occupation in WWII. In the 1960s, the United Kingdom found it difficult to maintain the value of the pound. In 1967, the pound sterling devalued, and the Hong Kong Dollar's peg to the pound resulted in a great devaluation in Hong Kong assets in sterling. Shortly after that, Hong Kong abandoned this linkage with sterling and became free-floating in 1974. At this time, Hong Kong did not have a central bank and relied on commercial banks like Hongkong Bank. This system worked well until negotiations began to hand Hong Kong back to China. Confidence in the currency was impacted and a new monetary system was needed. On 17 October 1983, the Hong Kong Dollar adopted a peg to the U.S. Dollar at a fixed rate of HKD7.80 for one U.S. Dollar.

2. OVERVIEW OF HONG KONG's CURRENT SYSTEM

One primary monetary policy objective of the Hong Kong Monetary Authority (later denoted as HKMA) is to maintain exchange rate stability. The linked exchange rate system is a unique exchange rate mechanism for the Hong Kong Dollar, which is pegged with the United

States Dollar since 1983. In this unique linked exchange rate system, the HKMA authorizes the three licensed note-issuing commercial banks (HSBC, Bank of China, and Standard Chartered) to issue new banknotes, provided that they deposit an equivalent value of United States Dollars with the HKMA [2].

Under normal circumstances, HKMA will not actively intervene in the foreign exchange market by controlling the supply and demand of the HKD. Exchange rate stability is mainly held through arbitrage activities by the three note-issuing banks in Hong Kong. This is what makes Hong Kong's linked exchange rate system different from other fixed exchange rate systems. When funds flow in, market participants buy the Hong Kong dollar, and the exchange rate of the Hong Kong dollar appreciates under pressure. The commercial banks will purchase certificates of debt in U.S Dollars from the HKMA and issue Hong Kong dollars to earn profits, thereby expanding Hong Kong's monetary base. After monetary expansion, the money supply in the market will increase, which will force interest rates to fall and capital flows out. The exchange rate of the Hong Kong Dollar returns to the linked exchange rate level. When funds flow out, the situation is similar. This automatic adjustment mechanism ensures that the market exchange rate of the Hong Kong Dollar does not deviate significantly from the linked exchange rate. Since May 18, 2005, the HKMA has tightened exchange rate control measures to limit the floating between HKD7.75 and 7.85 to 1 U.S. Dollar.

Hong Kong is a politically and economically independent city and a trade-oriented open economy. Moreover, the Hong Kong government pursues an active non-intervention economic policy, has a high degree of economic freedom, and it has been rated as the freest economy in the world [3]. Hong Kong's capital account is completely open and has a huge financial system. Generally, the total value of trade in goods and services is equivalent to more than three times the GDP in Hong Kong [4]. Therefore, if large fluctuations in overseas markets cause financial shocks, Hong Kong will be easily affected. The linked exchange system provides Hong Kong with a stable currency pillar and reduces the foreign exchange risks faced by importers, exporters, and international investors. Since the U.S. Dollar is the main currency used in Hong Kong's foreign trade and financial exchanges, and the U.S. Dollar is a well-recognized currency, it provides certain credibility to the Hong Kong Dollar. With this exchange rate system, the Hong Kong Dollar's value has maintained within a close range in the past decades, even under periods of crisis. Generally, people regard this system as a success [5].

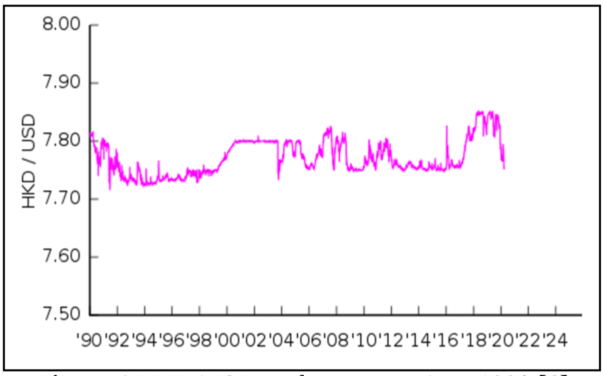

Figure 1 HKD/USD exchange rate since 1990 [6]

3. DOWNSIDES OF THE CURRENT SYSTEM

3.1. Monetary Policy Dependence and Consequences

One major drawback of this system is the loss of Hong Kong's autonomy over its own currency. Hong Kong must adapt U.S. monetary policy under this linkage instead of an independent one. Any divergence from the U.S. monetary policy will lead to infinite arbitrage opportunities and quickly demolish the fixed rate. However, since Hong Kong and the U.S. have different economic structures, following the Fed is not going to be the best option for Hong Kong under certain circumstances. For instance, the low interest rates the Fed adopted after the Global Financial Crisis may help the U.S. economy to recover quickly, but adopting the same strategy in Hong Kong led to high inflation, one good example is the sky-rocketing housing prices in Hong Kong, the city has the world's most expensive residential real estate market, with an average real estate price of $1.25 million [7]. Many people cannot afford the price, The government provides public housing for low-income residents and in 2018, nearly 45% of Hong Kong's population lived in public permanent housing. High inflation also causes many other social problems like inequality and further social stratification.

3.2. Uncertainty of U.S. Dollar

Another problem with the peg is the U.S. Dollar. As a well-recognized global currency, the U.S. Dollar has an unstable value, and since the Hong Kong Dollar has this fixed exchange rate, great uncertainty is involved when evaluating Hong Kong assets with the appreciation and depreciation of the U.S. Dollar. In recent years, there are increasing concerns about the U.S. federal deficit and volatile trading policies in a sense of anti-globalization. It is hard to determine confidence in the U.S. Dollar as a dominant currency. There is this possibility that the U.S. will focus on short-run domestic profits and adopting policies that harm foreign benefits in the long run. As the Hong Kong Dollar and the Hong Kong economy continue to go on with the value of the U.S. Dollar, there is a potential risk of asset devaluation.

3.3. Tension Between the U.S. and China

The increasing tension between the U.S. and China also questions this system. From data in 2018 and 2019, mainland China has been Hong Kong's largest trading partner, consisting of about half of Hong Kong's exports and imports [8]. While China takes the major part of Hong Kong's trade, the HKD is anchored at the currency of a rival of China, and there are concerns that relationships between the U.S. and China will impair the system.

In July 2020, President Trump took two actions after Beijing applied its new National Security Law on Hong Kong—signing the Hong Kong Autonomy Act as well as signing an executive order to end the special status given to the former British colony under U.S. law [9]. This reflects a long worry about political and economic freedom in Hong Kong and may serve as an indication of a widespread lack of confidence.

This may cause a huge impact on the trade as confidence serves as an important factor in trading and investment during times of uncertainty. Hong Kong has been taking much attention from the world since protests against the Fugitive Offenders amendment bill started in June of 2019. It has been a time of social and political turmoil in Hong Kong which heavily damaged the businesses. Affected by large-scale protests and the trade war between China and the United States, Hong Kong has experienced a decrease in economic growth, impacts on the stock market, and a deteriorating business environment. Business activities fell to their lowest level since the global financial crisis [10]. More importantly, investment confidence dropped, which is fatal for a place whose economy is almost entirely based on trades and investments. These factors weakened HKD in the third and fourth quarters in 2019, as the demand for money decreases.

4. ALTERNATIVES

4.1. Free Float

Adopting a free-floating exchange rate means forgo of fixed exchange rates, retain monetary autonomy, and have free capital flow according to the trilemma. This allows the HKMA to adjust money supply and interest rates accordingly to the need of the Hong Kong economy and society, which may alleviate some of the social problems Hong Kong is facing. This turn of focusing on internal issues can help promote employment, price stability, and economic growth. There will be an automatic stabilization that any imbalance in the balance of payments will be automatically corrected by exchange rate changes. Since there is no need for the government to keep large amounts of foreign exchange reserves to retain stable exchange rates, those reserves can be used for other means which creates more flexibility.

However, this option is not suitable for the HKD. Hong Kong's economy is heavily based on trade and a free-floating currency will discourage foreign investment and trade since there is high uncertainty with asset values based on floating exchange rates. Hong Kong's GDP is relatively small compared to the value of trade, as the geographic condition is not suitable to make large production within the island. This system impairs Hong Kong's role as an international finance center since business activities tend to operate under a stable economic and financial environment, which can not be provided with a floating exchange rate.

4.2. Chinese Yuan (CNY/RMB) and Other Individuals

Table 1 Currency Influence

Currency\Term	%Shares of average daily OTC foreign exchange turnover in April 2019 [11]	%Shares of allocated foreign exchange reserves in 2020 Q2 [12]
U.S. Dollar (USD)	88.3	61.26
Chinese Yuan (CNY)	4.3	2.05
Euro (EUR)	32.3	20.27
Pound sterling (GBP)	12.8	4.46
Japanese Yen (JPY)	16.8	5.75

This table presents a measure of currency influence based on the shares of turnover in the forex market and shares of foreign exchange reserves. Re-peg the Hong Kong Dollar to Chinese Yuan is another option that is gaining much attention in recent years as mainland China has been the top trading partner of Hong Kong and Chinese investment in Hong Kong has been increasing over the past decades. Also, China is a rising economic and political power that has become the world's second-largest economy. On the other hand, the Chinese Yuan became more recognized as an international currency than it was before. However, there is still a long way to go for CNY to gain acceptability as a global currency. As of 2019, the Chinese Yuan consists of 4.3% of the total foreign exchange market daily turnover and about 2% of foreign exchange reserves [11,12]. Whereas the U.S. Dollar consists of 88.3% and 61% of the same data. This is partly because the Chinese Yuan is not freely convertible. Since it is not openly traded on the forex market due to government restrictions, the flexibility to trade and the capital flow is restricted. There is no advantage for CNY in terms of international acceptability.

The same problem that the lack of monetary autonomy still exists and there will be new concerns about trading and business in Hong Kong if the peg is introduced since the Chinese government can now adjust monetary policies to gain economic control in Hong Kong. Though the government may help solve social problems with the policy, this may further impact the investors' confidence.

Speaking of the same reason, other individual currencies like Euro, British Pound, and Japanese Yen does not serve as good alternatives for the peg. Although they are international currencies, they own no advantage towards the USD. They are not large trading partners of Hong Kong as well, therefore the benefit of this re-peg is even smaller to consider.

4.3. Basket of Currencies—SDR

There are voices advocating to peg the HKD to a basket of currencies, as it is a more combined measure of currencies and therefore suitable for a trade-based economy. Although the exchange rate is still fixed and lacking monetary autonomy, the situation is moderated by averaging the monetary policies adopted by currency-issuing countries inside the currency basket and may help better to fit in a business cycle. This is better than letting a single country to determine in some sense. However, it is highly dependent on the composition of the basket and subject to changes.

Some people argue that the IMF's Special Drawing Rights (SDR) is a good candidate for the peg, as it is a clearly determined basket by an independent party [5]. It is argued that given the composition of SDR, it provides more access to business as five currencies are involved instead of only one. It solves the problem of exchange rate volatility by handling the weighted average of currencies and the expected volatility will be smaller than that of a single currency. However, SDRs are allocated by the IMF to countries, and cannot be held or used by private parties [13]. After all, SDR is not a typical currency which creates some difficulties in trading. There is also greater changes in the exchange rate of HKD if pegged to SDR with respect to its current position with USD, namely less stable.

5. COST OF CHANGES

Firstly, the direct impact of this institutional change in currency is that businesses under the current system will have to adjust to adapt to the new one. This means a lot of work and trouble once the system is implemented, while the ongoing businesses will re-sign previous contracts to meet an agreement since re-evaluations have to be made on this new basis, and a new system to record business activity has to be invented to meet the need for calculating values in this circumstance. Trading groups, banks, government, and every person in Hong Kong will need to switch the way of conducting businesses. Although the policies may take place overnight, its impact may last for weeks, months, or even years. There might be different re-evaluations to business under the new currency system, and there will be more indeterminacy about future trades and business conditions. A smooth transition also needs to be determined with discretion since there could be opportunities to arbitrage using the difference between the systems and this will damage the economic and financial environment under the new system. There will be confusion, skepticism, criticism, and power against the changes as well, which need to be endured until the environment is stabilized.

Secondly, as mentioned before, this peg to the U.S. Dollar gives HKD certain credibility, since the USD is working as the current global currency, it has high acceptability in almost all economies. This can be shown by the USD having the highest turnovers in the Foreign Exchange market since 2000. With the back of the USD, the HKD gain international acceptability and therefore in recent years, the HKD became the ninth most traded currency in the world, which consists of approximately 3.5% of the total foreign exchange market daily turnover in 2019 [11]. It becomes easier for businesses to operate in Hong Kong with this linkage. Switching to another monetary system (except for peg to SDR) means waiving this advantage while the advantage and actual performance of the new system is not determined, which means risks of losses.

Table 2 Percentage share for HKD of average daily turnover in April, Net-net basis [11]

Term\Year	2001	2004	2007	2010	2013	2016	2019
HKD (% share)	2.2	1.8	2.7	2.4	1.4	1.7	3.5
Overall daily average ($trillion)	1.2	1.9	3.3	4.0	5.4	5.1	6.6
HKD ($billion)	28	34	90	94	77	87	231

6. CONCLUSION

The Hong Kong Dollar has been pegged to the U.S. Dollar for over three decades, and past experience suggests this system is a success given its performance as Hong Kong became an international finance center with the system promoting business and trade. Though there have been rising challenges toward this system, the alternatives are too expensive and risky to apply. The floating rates and re-pegs to another currency or a basket of currencies seem to put things backward in the current conditions, as their benefits are incomparable to the costs and risks. There is great momentum needed for the initiative to change, for example, a global economic crisis that leads to uncertainty even in this stable system will urge people to find a new solution. The world economy is a dynamic system and no eternal conclusions of the best policy or system can be made. Policies regarding the Hong Kong Dollar will continue to change to help support the position Hong Kong is in today.

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