

The Hong Kong dollar peg: change will come

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Summary

- Hong Kong is an international financial hub providing access to Asia for many multinational companies. Most transactions are done in US dollars, therefore, the Hong Kong dollar is pegged to the US dollar.
- But there are doubts about the sustainability of this peg. Concerns have risen regarding Hong Kong's competitiveness versus China due to the increasing share of business done in Chinese renminbi. And there is China's objective to bring Hong Kong closer to its motherland.
- A change of the currency regime to a peg with the renminbi therefore is probable, though not in the short term. This note answers ten relevant questions about the Hong Kong dollar.

What is the history of the Hong Kong dollar peg?

The current peg between the Hong Kong dollar and the US dollar has been in place since 1983. On 17 October 1983, the currency was pegged at a rate of HKD 7.8 to USD 1. Since 18 May 2005, the currency floats between HKD 7.75 and HKD 7.85 per USD. The currency is also used in Macau.

What is the purpose of the peg?

According to the Hong Kong Monetary Authority (HKMA), the quasi-central bank which manages the peg, the system provides a firm monetary anchor that "reduces the foreign exchange risk faced by importers, exporters and

international investors". This has been very important for Hong Kong's small and open economy which is both a trading hub to and from China and a centre for global financial services. The US dollar is the currency that most of Hong Kong's financial and trade transactions have been conducted in. A free float is no alternative, because the Hong Kong economy is too small.

Many currency pegs are gone. How did the Hong Kong dollar peg survive?

The peg between the Hong Kong dollar and the US dollar has withstood many attacks in the past 32 years. The most dangerous of these was during the Asian crisis of 1997-

1998, but the government defended the peg forcefully. Since then, the peg has not come under serious pressure. The potential risks associated with a pegged exchange rate are not the case for Hong Kong. Prices for property, goods and services (including wages) for example are very flexible, both up and down. Besides this, the authorities conduct a prudent fiscal policy, minimise banking sector risk and maintain a massive reserve to support the exchange rate. The stock and flow of the monetary base is fully backed by foreign exchange reserves.

Are there disadvantages to the peg?

The current exchange rate system has served the economy well, but local residents have to cope with periods of contracting wages and falling property prices, and also periods of rapid inflation. These price and pay swings happen because Hong Kong imports US monetary policy via the peg, even though the US and Hong Kong economies may not be moving in tandem.

What was the immediate cause to doubt the peg's future?

In August 2015, the People's Bank of China (PBOC) surprised markets with three consecutive devaluations of the renminbi, knocking over 3% off its value. Since 2005, China's currency has appreciated 33% against the US dollar and the first devaluation on August 11 marked the largest single drop in 20 years. The move was unexpected and believed by many to be a desperate attempt by China to boost exports. However, the PBOC claimed that the devaluation was a part of its reforms to move towards a more market-oriented economy. Initially speculation mounted that a weaker renminbi would force Hong Kong to devalue its currency as well. In the days thereafter the Hong Kong dollar whipsawed within its narrow band against the US dollar, but the fluctuations eased when it became clear that China had no plans for further steps.

Will rate hikes by the Fed impact the HKD peg?

With the US Federal Reserve raising interest rates further in the next few years, the downside of the peg for the local economy will be evident as the effective exchange rate would appreciate further, reducing export competitiveness. Still, we think this is not the main element determining the future of the peg. In the past, monetary tightening in the US never was a reason to change the currency regime.

So the Hong Kong dollar will remain pegged to the USD?

Probably not! An important reason to question the peg is Hong Kong's growing integration with China. In the past

most of Hong Kong's trade and financial dealings were done in US dollars. But since trade with China is growing and the renminbi is gradually playing a more important role in local transactions, a peg with the Chinese currency is more reasonable than one with the US dollar. Hong Kong's financial and economic links are increasingly dominated by mainland China, and previous concerns about the openness of China's capital account are slowly receding. If China continues to open its capital account, the peg could shift from US dollar to renminbi.

Are there only financial reasons for a change of the peg?

Another reason for a peg to the renminbi is a political one which reinforces the second. Relations between Beijing and the population of Hong Kong are under pressure from time to time and sometimes lead to protests. The Umbrella Revolution, a loose pro-democracy political movement in 2014, was the most recent example of this. If the Chinese government pegs the Hong Kong dollar to the renminbi, it makes clear to the inhabitants of the city that it is a part of China. This political argument, however, is only in place if China made its own currency fully convertible.

Will the peg change soon?

It is hard to predict when exactly such a change of the peg will happen. The timing depends on decisions made by the Chinese government. In any case, we think actual developments like devaluations of other Asian currencies or policy changes by the Fed will not play a role to replace the peg with the US dollar for one with the Chinese currency. For the coming years, we expect that the HKMA can and will stay committed to maintaining the Hong Kong dollar's peg to the US dollar. But change will come, and not in a very distant future.

What does a peg with the renminbi mean for doing business in Hong Kong?

A change of the peg will probably not have very large effects on businesses. The Chinese and US currencies are also tied to each other in a crawling peg. While this may change to a free floating exchange rate in the next few years, Chinese monetary authorities will still mitigate large fluctuations. Thus the foreign exchange risk for foreign firms operating or investing in Hong Kong will not change significantly. It may have more effect on Hong-Kong based firms. Competitiveness would not be affected, but the increased security that a peg to the renminbi would bring would benefit Hong Kong businesses more than a USD peg.

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Atradius Credit Insurance N.V.
David Ricardostraat 1 · 1066 JS
P.O. Box 8982 · 1006 JD
Amsterdam
The Netherlands
Telephone: +31 20 553 9111
Fax: +31 20 553 2811
www.atradius.com