THIS MONTH'S TOPIC

HKD: sailing through the turbulence

Caught in the struggle between Beijing and Washington, can Hong Kong pull through the hardship without special trade status? Is Trump's announcement symbolic or destructive for the territory? Will the Hong Kong dollar peg fall apart? We review these questions one by one in this analysis.

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Hong Kong to hold its shape without special trade status

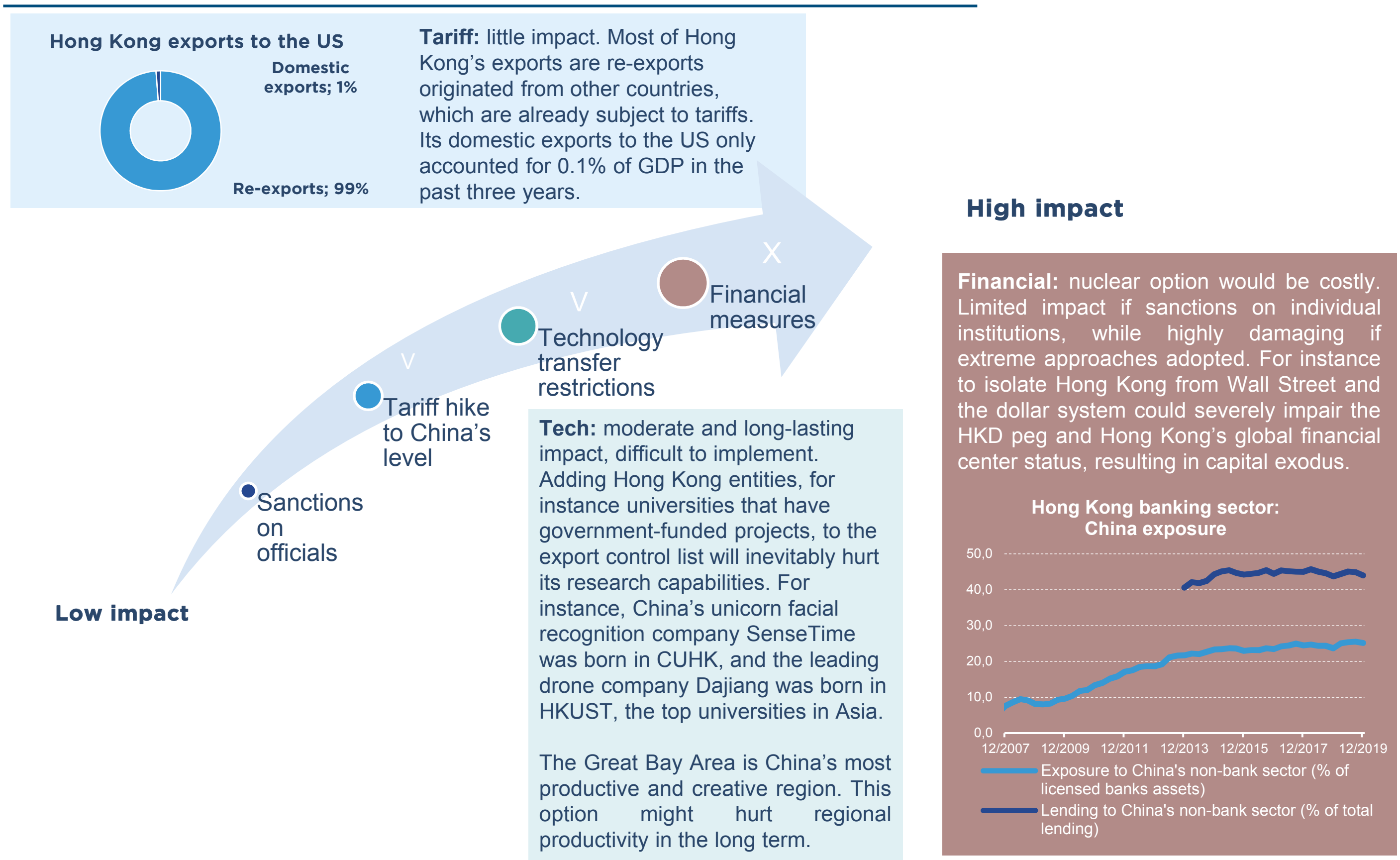
As a major global financial hub, and one of the most open economies in the world, Hong Kong is consistently ranked top in terms of economic competitiveness and institutional soundness.

However, the territory is not immune to the struggle between Beijing and Washington. In response to the introduction of National Security Law in Hong Kong at the end of May, the Trump administration announced plans to eliminate US policy exemptions for Hong Kong. After examining the options one by one, we found that the revocation of special status will leave Hong Kong in a similar position as before, unless the US opts for the "nuclear option" – isolating Hong Kong from the Wall Street.

Removing Hong Kong's trade preferential policy will result in a tariff hike that has little economic consequence, since Hong Kong's domestic exports to the US only account for 0.1% of GDP. The remaining majority are re-exports, which are subject to tariffs for countries of origins. Separately, given Hong Kong's small manufacturing base (1% of GDP) and the absence of participation in the regional production chain, adding Hong Kong to the US export control list will mostly affect R&D in the region but leaves the supply chain intact. Although the shock in the near term appears minimal, these new barriers could be costly for Hong Kong in the longer run in terms of its own technological advancement.

Markets are relieved for now, absent indications from the US to deprive Hong Kong of its financial access to the western world. To the US, this option could bring more harm than good. Today, Hong Kong not only contributes the most to the US trade surplus ($26bn in 2019), but also maintains net external claims with the US ($94bn at end-2019, or 0.5% of US GDP). In 2019, US firms had 278 regional headquarters and over 1000 regional/local offices in Hong Kong.

1/Hong Kong: caught in the US-China struggle



Source: Amundi Research, CEIC

THIS MONTH'S TOPIC

USD/HKD peg is here to stay

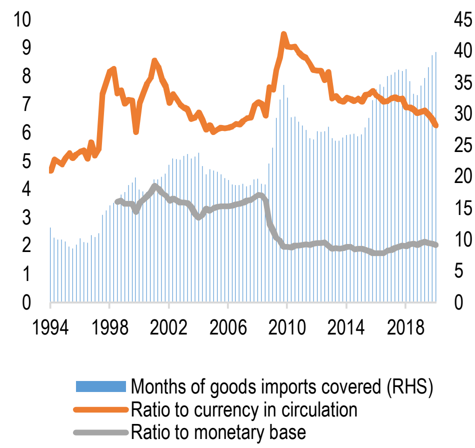
In light of elevated uncertainties, it is fair to ask whether Hong Kong can maintain its Linked Exchange Rate System (LERS) and continue to keep the USD/HKD in the targeted range (7.75-7.85). We believe both Hong Kong and mainland China authorities are willing and able to defend the LERS. It is also worth noting that Hong Kong has the autonomy to design its monetary regime, including exchange rate policy.

The free flow of capital, and free convertibility of the HKD will continue to be safeguarded by the Basic Law

The latest policy remarks are indeed reassuring. HKSAR Government and HKMA have responded with strong messages reaffirming the free flow of capital, and free convertibility of the HKD will continue to be safeguarded by Article 112 of the Basic Law. Furthermore, PBoC stressed on 4th June it will unswervingly support the development of Hong Kong's financial markets, and maintain its economic and financial stability and prosperity. On 8th June, Beijing said it would enhance its supports to Hong Kong after the introduction of National Security Law. It will solidify Hong Kong's international financial center status, and continues to position it as a super-agent between mainland China and the rest of the world.

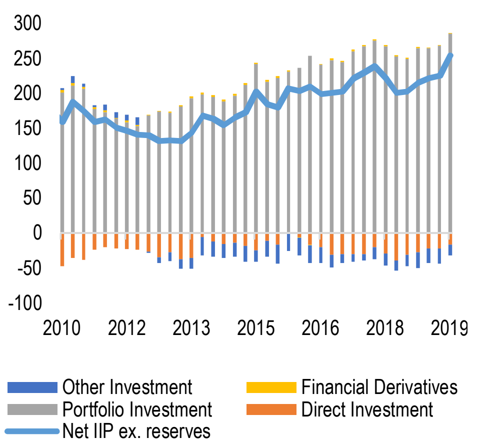
Meanwhile, the HKMA, which acquired a long record of capable financial management, has ample ammunition to defend the currency. It holds $440billion in foreign currency reserves – double the size of the entire monetary base – and covers 30-40 days of retained merchandise imports. Hong Kong's strong external positions should help as well. The territory maintains a gigantic net portfolio investment position to the rest of the world. During the turbulent times, repatriations of external investment assets could help mitigate outflow pressures from non-resident portfolio investments, even before the central bank needs to dig into its reserve savings.

2/ Hong Kong: foreign reserves adequacy



Source: Amundi Research,CEIC, HKMA, Data as of 5 June 2020

3/ Net private international investment positions (% of foreign reserves)



Source: Amundi Research,CEIC, HKMA, Data as of 5 June 2020

HKD's strength supported by equity inflows

While there was a sharp movement in the spot USD/HKD after the NPC announcement, the USD/HKD has since traded near the strong end of the band. The abundant pipeline of IPOs has driven up demand for HKD, leading to a widening of the HIBOR-LIBOR spread to its widest in 20 years amid Fed's rate cuts. The wide interest rate differential in turn has been supporting HKD strength.

HKD demand surged on equity inflows, driving HIBOR-LIBOR spread to the widest in 20 years

A couple of factors will continue to support the HKD's strength. With Hong Kong relaxing its dual-listing rules, more Chinese companies listed in the US will choose to dual-list at HKEX, which was the case for JD.com and NetEase. The dividend calendar of Chinese companies and strong southbound flows will bring extra inflows in the near term.

Alternative capital flow barometers, including housing prices and deposit growth, point to subdued outflow pressures so far. Despite the economic downturn in 2019-20, Hong Kong's deposit managed to eke out positive growth, led by foreign currency deposit expansion. Housing prices were slightly higher than a year ago, which was surprisingly resilient given the long-lasting social unrest.

A matter of confidence

We cannot rule out the risk that a significant escalation in US-China tensions will result in further retaliatory measures imposed by both sides. Although it is very unlikely for the US to pursue financial measures on Hong Kong, it is not completely impossible. The options range from excluding Hong Kong's banking sector from SWIFT to the withdrawal from bilateral regulatory

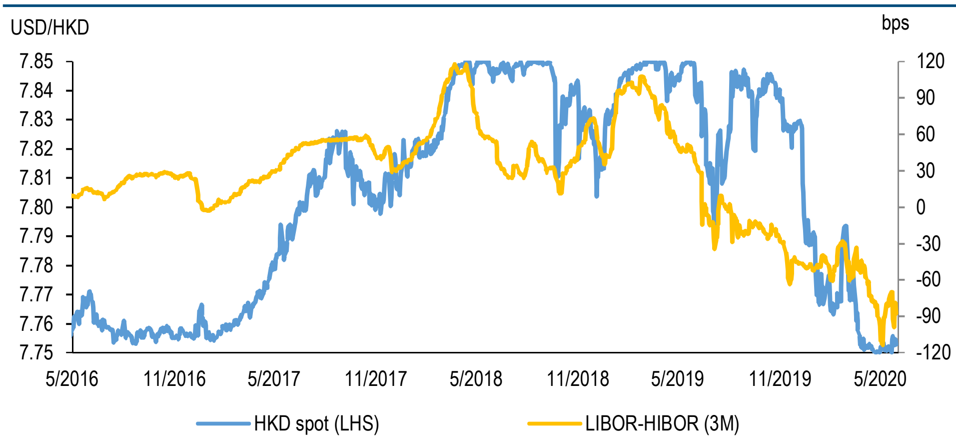
Hong Kong's competitiveness will be supported by high regional growth, and its position as a gateway to mainland China

agreements. For instance, the enforcement agreements between HK SFC and US SEC, and HKMA's position in the oversight committee in Fed-regulated CLS to name a few. In this risk scenario, capital exodus and a higher USDHKD may be inevitable. That said, HKMA may have just enough bullets to cover a sharp one-way sell-off, given the city's gross portfolio investment liabilities stood at 1.3x of its FX reserves. This is not a base case scenario, but any future expectations of Fed rate hikes could result in a narrower US-HK short end spread, potentially leading to HKD weakness. In such a situation, the HKMA would be able to drain liquidity in order to raise HKD interest rates; the structural viability of the peg would not be in question.

In the longer term, Hong Kong's competitiveness will be supported by high regional growth, and its position as a gateway to mainland China. These factors should ease some concerns of political uncertainties stemming from US-China relations.

Finalised on 11/06/2020

4/**HKD vs. interest rate differential**



Source: Amundi Research, Bloomberg, Data as of 5 June 2020

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