Economic Watch

China | Will Hong Kong forgo the US currency peg amid the Trump 2.0?

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Hong Kong plays a pivotal role as a bridge between Mainland China and the global economy, acting as both a financial hub and a cultural interface. This position has been bolstered by its open economy, global connectivity, and the unique "one country, two systems" framework. However, amidst the escalating geopolitical tensions between the US and China, Hong Kong finds itself at the crossroads of a financial and political tug-of-war. One of the growing concerns is whether the Hong Kong Dollar (HKD) will decouple from its longstanding peg to the US Dollar (USD). While speculators have targeted the HKD peg in the past, ongoing geopolitical tensions could heighten such risks.

Factors Driving Concerns About the Peg's Sustainability

A stable HKD and prolonged high interest rate could increase economic vulnerability

The US Federal Reserve began raising interest rates in March 2022. Given Hong Kong's linked exchange rate system (Please read our previous publication China not time to say goodbye to HKD peg), HK was forced to mirror the Fed's actions. Although the US began cutting interest rates in September 2024, the pace of these cuts is anticipated to be slow as Trump's proposed policies such as universal tariffs and tax cuts coupled with strong economic data heightened inflation expectaiton. Smarket belief that the Fed might slow future rate reduction or even reverse course, maintaining high interest rates. Amid rising inflation fears and expectations of a prolonged period of high rates, concerns have intensified that divergences in the monetary policies of the US and China could exacerbate doubts about the sustainability of the HKD peg to the USD.

For Hong Kong, this presents a unique challenge. Should US inflation rise again, prompting the Fed to increase rates sharply, Hong Kong would be pressured to follow suit. This could result in even more severe downturns in the local economy, particularly in the sluggish real estate sector. Higher borrowing costs, coupled with reduced demand in the property market, could push the city's economy deeper into negative equity. In extreme cases, Hong Kong may be forced to abandon the USD peg to allow the HKD to depreciate and lower interest rates, thereby providing relief to the economy.

Geopolitical Tensions

Hong Kong's status as an international financial hub has made it a focal point of US-China tensions. The revocation of Hong Kong's special status by the US in 2020, following Beijing's imposition of the National Security Law, marked a significant turning point. This change affected trade, investment, and financial transactions between Hong Kong and the US, raising concerns about the territory's financial resilience.

During Trump's first presidency, discussions emerged about measures targeting Hong Kong's financial autonomy, though no direct threats were made to the Hong Kong's banking system. However, as Trump's inauguration in the second term, market are speculated that the tensions will be intensified amid Trump 2.0. Some people speculated that US could take against Chinese banks operating in HK, or even disconnect the territory from the SWIFT financial network-though such a move, while low in probability, could further fuel market anxieties.

Close ties with the RMB business

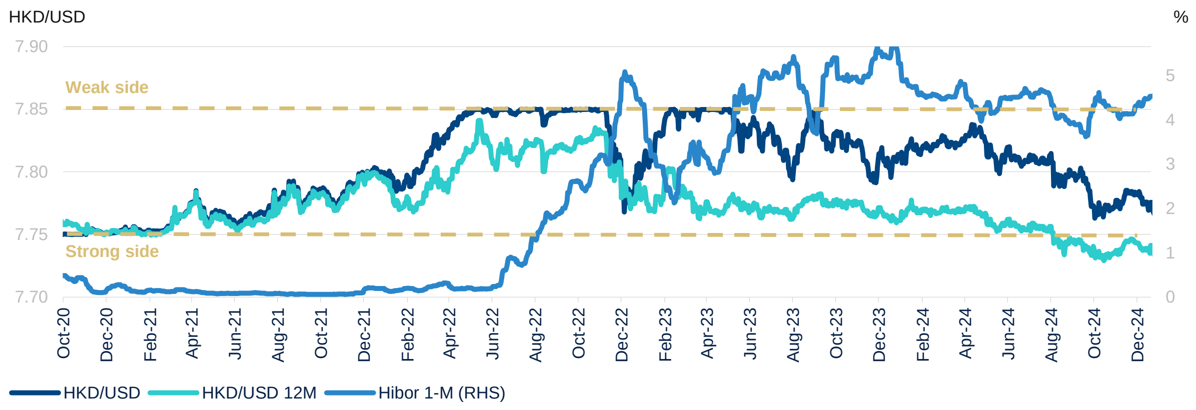
Hong Kong plays a central role in the internationalization of the RMB, serving as the largest offshore RMB business hub. It hosts the world's largest offshore RMB clearing platform and a sifnificant pool of RMB deposits, facilitating cross-border RMB trade and investment. As a key intermediary in Mainland China's trade and investment activities, Hong Kong supports RMB denominated trade settlement and is a leading market for issuing offshore RMB bonds, known as "Dim Sum Bonds." Programs like Stock Connect and Bond Connect further integrate Hong Kong's financial system with Mainland China.

As Hong Kong's economic ties with China deepen, concerns have arisen over the sustainability of its USD peg. Some argue that the peg may no longer align with the city's growing reliance on the RMB. With over 50% of Hong Kong's trade conducted with Mainland China, and increasing use of the RMB in trade settlements and capital flows, the USD peg may not fully reflect Hong Kong's economic realities.

Maintaining the USD Peg has more pros than cons

Despite these concerns, the benefits of maintaining the USD peg outweigh the potential risks for the past over four decades. As a small, open economy and major international financial center, Hong Kong's stability is critical. The linked exchange rate system has helped keep the HKD stable amid the depreciation of other currencies, such as the Japanese Yen (down 10% against USD from early 2022 to early 2023) and the British Pound (down 8% against USD from early October 2024 to early January 2025) (Figure 1).

Figure 1. HKD reached 3.5 years new highs, nearly top of its band



Source: Bloomberg and BBVA Research

Since its introduction in 1983, Hong Kong's linked exchange rate system has been a cornerstone of its financial stability. The peg, initially set at 1 USD = 7.8 HKD, was introduced during a time of uncertainty surrounding Hong Kong’s future under Chinese sovereignty. Over time, the system was adjusted in 2005 to allow for a narrow trading band between 7.75 and 7.85 HKD per USD, with the Hong Kong Monetary Authority (HKMA) intervening to maintain stability within this range. Although maintaining this peg requires careful management, particularly amid geopolitical risks and capital flow volatility, the system remains advantageous.

Firstly, the USD peg has been a crucial element of Hong Kong’s economic stability, providing predictability for international trade and financial transactions. By anchoring its currency to the USD, Hong Kong minimizes exchange rate volatility, which is essential for its open economy.

Secondly, the peg strengthens Hong Kong’s resilience in global capital markets. The USD peg has attracted international investors, positioning Hong Kong as a gateway for capital entering China.

Thirdly, the peg supports Hong Kong’s unique role as an intermediary between China and the global market, assisting in China’s gradual financial liberalization. As the RMB continues its internationalization, Hong Kong’s peg to the USD helps maintain its distinct financial identity while supporting China’s economic integration.

Lastly, the financial markets would bear the brunt if the peg were changed during a period of economic distress. Declining property prices and reduced transactions have eroded land sale revenues, historically a key pillar of fiscal stability. Hong Kong’s fiscal deficit has widened in recent years, which creat a challenging environment for policymakers. In addition, HK has a high debt to GDP ratio, which has overpassed Japan and dominated in the coporate sectors. Under these circumstances, any change to the currency peg could destabilize the financial markets, would be particularly risky, making it highly unlikely for the government to pursue such a course at this time.

The HKMA’s Commitment to defend the Peg remain intact

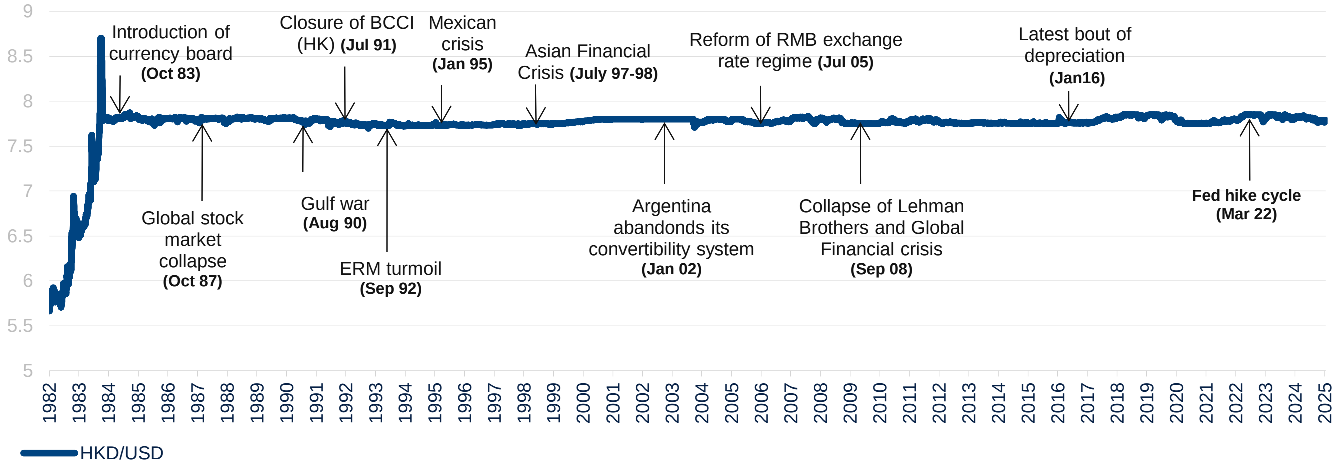
Despite market concerns, the Hong Kong Monetary Authority (HKMA), the de facto central bank of Hong Kong, its will to maintain the currency peg remain intact. The HKMA’s chief excutive has stated that there is no intention or no need to change the system that pegs the city’s currency in a tight band to the US dollar and has the ability to defend it.

In history, the exchange rate has proven incredibly resilient to exogenous shocks in the past (Figure 2). The exchange rate mechanism has withstood significant pressures, including the Asian Financial Crisis of 1997 and speculative attacks during the 2011 property bubble fears. For instance, during the Asian Financial Crisis, there was significant pressure from speculators who believed a devaluation of the HKD was inevitable. The concern at the time was that a strengthening dollar would hurt Hong Kong’s economy, which was experiencing outflows stemming from its exposure to volatile Asian markets. The HKMA’s intervened vigorously, driving up the 3-month HIBOR to nearly 20%, effectively deterring short-seller and stabilizing the currency.

Similarly, in 2011, then-Chief Executive CY Leung resisted calls to devalue the HKD despite market speculation, reaffirming the government’s commitment to the peg. This has boosted the authorities’ confidence in the system’s ability to undertake the necessary measures to avert a crisis.

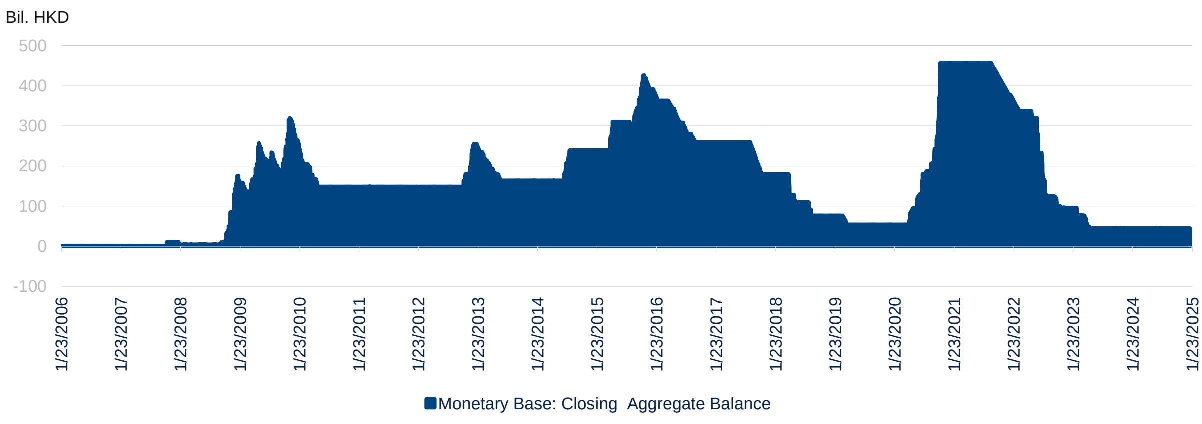
And the recent case is that HKMA has decisively intervened the market 40 times from May 2020 to June 2023 amid US Fed rate hike cycle. The HKD has depreciated from the strong end of its narrow band of 7.75 to near its weak end of 7.85 against the USD 40 times, which has triggered a series of intervention by the HKMA to disburse their USD reserves to purchase the HKD in support of the local currency's exchange rate. The fundamental reason is that Fed rates hike cycle has maded US investments attractive for carry trade, that is, borrowing the low interest rate currency of HKD to invest in the high interest rate currency of USD. That result that the The HKMA intervenued the market through purchasing the HKD aggressively to defend the currency peg. The aggregated balance, a key indicator for liquidity in the banking system, has dropped over the Fed rate hike cycle since March 2022 and has fallen 90% percent from its peak in Feb 2021 in May 2023, as indicated by HK's aggregate balance falling to HKD 44.53 billion, the lowest liquidity level since the global financial crisis in 2008 (Figure 3).

Figure 2. The HKD: Resilience against exogenous shocks



Source: Bloomberg and BBVA Research

Figure 3. HKD closing aggregate balance decreased sharply in the mid of Apr 2023



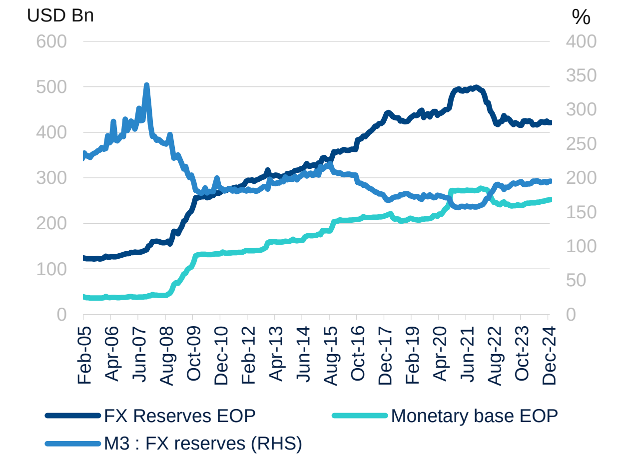
Source: HKMA and BBVA Research

Adequate Foreign Reserves

HK still have enough ammunition to defend the currency peg. HK's foreign reserves, exceeding USD 420 billion, equivalent to about 1.7 times its monetary base, ensuring the smooth functioning of the linked exchange rate system (LERS) (Figure 4). These reserves are invested in a well-diversified and high-liquid asset portfolio, enabling convert to the USD swiftly if needed to maintain the LERS. Additionally, in order to restore people's confidence in the linked exchange rate system, People's Bank of China (PBOC)'s Governor Pan Gongsheng has pledged support by incrasing its allocation of foreign reserves to Hong Kong assets at the Asian Financial Forum, further reinforcing confidence in the system.

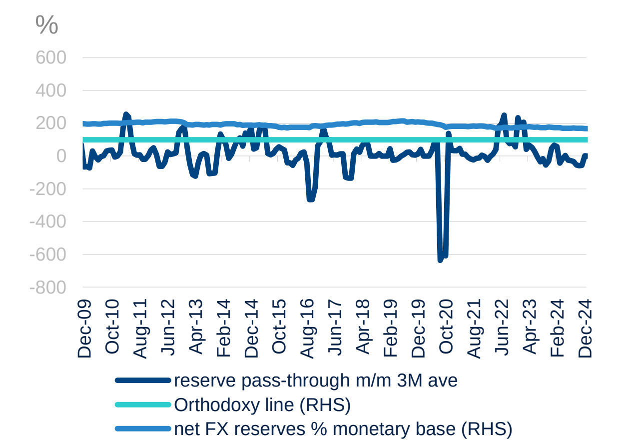
Thus, despite some rising voices of questioning the sustainability of the linked exchange rate in the market, we firmly believe that foregoing the USD peg is an unlikely scenario in the short term for Hong Kong for a couple of reasons: (1) It is not a right time for changing the currency peg amid economic uncertainty; (2) The political will to defend the exchange rate remains strong; and (3) The HKMA has plenty of "fire power" to defend the linked exchange rate system looking forward.

Figure 4. FX reserves well in excess of the monetary base requirements



Source: Bloomberg and BBVA Research

Figure 5 …Meaning that currency board orthodoxy has not been a concern in Hong Kong



Source: Haver, Bloomberg and BBVA Research

Alternative Options if the Peg is Abandoned

The market concerns underscores a fundamental tension: while Hong Kong's economy increasingly orbits around China, its financial system is still deeply tied to the USD. Although we deem the change of currency peg is not realistic in the short term, this duality creates uncertainty about the long-term viability of the USD peg, especially as geopolitical tensions between the US and China escalate. The growing prominence of RMB business in Hong Kong is prompting some to question whether a strategic shift is inevitable in the future.

One option is pegging the HKD to a basket of currencies, similar to Singapore's approach. The Monetary Authority of Singapore (MAS) is maintaining the Singapore Dollar within an undisclosed band. Alghouth the Singapore Dollar is less transparent and predictable compared to the HKD, what attracts investors getting into Singaore Dollar is its track record, performing strongly against the Malaysian Ringgit, Japannese Yen and Australian Dollar, while also holding up well against a strong Euro and USD.This would offer diversification but introduce complexity and reduced transparency compared to the current system. A newly established basket of currencies would need to be adjusted much more frequently than a standard peg and is potentially seen as a risk for investors as the currencies' stability and value is yet to be determined by the market over time.

Alternatively, pegging the HKD to the RMB would align Hong Kong's monetary system more closely with Mainland China's economy, potentially boosting trade and reducing currency mismatcheds. However, challenges such as the RMB is not fully convertible and its global acceptance as a reseve currency remains limited compared to the USD. convertibility and China's less transparent monetary policy would create volatility and uncertainty. Additionally, pegging to the RMB could introduce volatility given China's less transparent monetary policy and frequent market interventions.

A floating HKD could offer more flexibility but would expose Hong Kong's economy to significant volatility. Another possibility is a dual currency system, which would involve the concurrent use of the HKD and RMB. While innovative, this would require substantial structural adjustments and market adaptation.

Conclusion

Despite rising voices questioning the USD peg's sustainability, abandoning it remains unlikely in the short term. The HKMA's ample reserves, historical resilience, and political commitment underscore the peg's viability.However, The dominance of the USD in global trade and finance provides stability but also subjects Hong Kong to external shocks originating from US monetary policy. The risks posed by US-China tensions amid a Trump 2.0, speculative attacks, and economic vulnerabilities necessitate proactive measures to safeguard Hong Kong's financial stability.

In summary, whilst it is unlikely that the HKMA will abandon its decades old peg to the USD in the short term, recent developments will add to the growth headwinds of the region. Hong Kong's loss of special status and its role in US-China conflicts highlight its precarious position in the shifting geopolitical landscape. While the peg has served as a cornerstone of Hong Kong's financial system, ongoing geopolitical developments warrant continuous evaluation of alternative strategies for long-term sustainability.

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