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"Exploring Hong Kong's Economic Transformation: Interplay between Monetary Policy, Financial Resilience, and Economic Dynamics"

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I. Abstract

The aim of this Thesis is to analyze the functioning of the Hong Kong economy, encompassing its historical background, evolution, and noteworthy characteristics. Additionally, it aims to analyze Hong Kong's monetary regime, elucidate the "Currency Board" system, examine the role of the Central Bank, and assess its handling of economic crises. Lastly, it aims to present a concluding section that summarizes how Hong Kong has successfully established itself as a prominent financial center.

The motivation driving this research is to comprehend how Hong Kong emerged as one of the world's most developed nations, boasting the longest and most successful currency board in history. Since 1983, it has maintained a stable exchange rate within the band of 7.75 to 7.85 Hong Kong Dollars per US Dollar.

During the early 1980s, global financial markets experienced significant volatility, primarily due to the substantial rate hike by the U.S. Federal Reserve, which reached a peak of 20% in 1980. By pegging its currency to the U.S. dollar, Hong Kong effectively delegated its monetary policy to the U.S. Federal Reserve. This arrangement enabled Hong Kong to capitalize on the stability and credibility associated with the U.S. dollar, while also aligning its currency with the world's largest economy and maintaining robust economic ties with the United States, its major trading partner at the time.

The Hong Kong Dollar has displayed remarkable resilience in weathering significant crises throughout its history. Nevertheless, it has yet to confront one of the most formidable trials for a currency peg: a scenario in which the anchor country, like the United States, implements forceful interest rate hikes to combat inflation. In this regard, this thesis endeavors to investigate whether the Hong Kong Dollar would withstand such circumstances or if policymakers would opt for a devaluation strategy. The primary focus of this study is to assess the Hong Kong economy's capacity to endure a rigorous rate hike akin to the measures taken by the United States in the 1980s to combat inflation.

This hypothetical scenario presents crucial inquiries about the Hong Kong Dollar's adaptability and stability under such circumstances. Would the Hong Kong economy exhibit resilience and effectively navigate the challenges posed by aggressive rate hikes, or would policymakers contemplate currency devaluation as a viable alternative? Through an examination of diverse economic and policy factors, this study aims to offer some insights into the potential resilience of the Hong Kong economy and shed light on the decision-making process of policymakers when confronted with such formidable challenges.

II.Theoretical Framework

A brief history of the Hong Kong Economy : British Colonization, Economic Openness and Integration with China.

To gain a deeper insight into the motivation behind this paper and the study of Hong Kong, it is crucial to delve into the historical backdrop of HK, encompassing British colonization, the adoption of a liberal economic model, the dynamic relationship with China, and the cultural development of the HK population. In 1842, following China's defeat in the "Opium War," the Treaty of Nanking resulted in the cession of Hong Kong to the British, establishing it as a British colony for 99 years. Swiftly, Hong Kong emerged as a regional hub for financial and commercial services (Catherine R. Schenk, 2008). This economic growth was accompanied by a surge in the population, soaring from 7,500 inhabitants in 1842 to 85,000 by 1860, prompting the further cession of the Kowloon territory through the Kowloon Convention of 1860. [1]

During the period from 1911 to 1949, Hong Kong experienced hardships due to the interwar era and the adverse effects of a downturn in Mainland China. In 1911, the collapse of China's dynastic system led to a prolonged process by the Kuomintang (KMT) to establish a republican nation-state. The Great Depression of the 1930s, coupled with a significant decline in silver prices, disrupted China's global relations. The Sino-Japanese conflict, amidst the backdrop of World War I, triggered an economic downturn for Hong Kong. Additionally, the civil war between the KMT[2] and the Chinese Communist Party plunged China into utter chaos. Nonetheless, Hong Kong's stability made it an attractive destination for businesses and entrepreneurs. Overall, the period from 1911 to 1949 was exceptionally challenging for Hong Kong, highlighting the close economic ties between Hong Kong and China, despite being a British colony.

However, Hong Kong emerged as a "safe haven" for China, leading to a remarkable economic boom and playing a pivotal role in its industrialization in subsequent years. In 1949, with the establishment of the People's Republic of China (PRC), Hong Kong experienced political stability. However, the PRC's policy of isolation from the international economy, driven by both ideological and Cold War embargoes, limited trade with the Mainland to essential goods. As a result, Hong Kong could not rely on

[1] The Convention of Peking, signed in 1860, expanded British control over Hong Kong. It confirmed the cession of Hong Kong Island to the British and added the Kowloon Peninsula, along with Stonecutters Island, to British territory. Kowloon is a geographical area adjacent to Hong Kong Island and was an important part of the British administration in Hong Kong.

[2] KMT, also known as the Kuomintang, is a prominent Chinese political party that ruled China from 1928 to 1949. It has been associated with nationalist and conservative ideologies and remains active today

Chinese trade. Nevertheless, Hong Kong's laissez-faire approach, with minimal controls on capital flows and export regulations imposed by the UK, brought it to the world's attention.

In 1978, the PRC's implementation of "The Open Door Policy" facilitated its reintegration into international trade and investment. This accelerated Hong Kong's path toward becoming a prominent international financial center and positioned it as the primary provider of commercial and financial services to China. Concurrently, Hong Kong's industry began relocating to China in pursuit of lower costs, further solidifying its status as a specialized financial hub. The reintegration of Hong Kong and China proved pivotal to Hong Kong's development, resulting in impressive growth rates and an average unemployment rate of 2.5% between 1982 and 1997.

In 1997, Hong Kong was handed over to China and became the Hong Kong Special Administrative Region (HKSAR) under the principle of "One Country, Two Systems." This arrangement allowed Hong Kong to maintain its separate monetary and economic systems from the mainland, with exchange and trade controls remaining in place. The handover took place amidst the Asian financial crisis in the mid-1990s, which posed a significant challenge to Hong Kong's economic system. Additionally, the outbreak of Severe Acute Respiratory Syndrome (SARS) in 2002 further impacted Hong Kong's economy, leading to a recession that lasted until 2003 and an average unemployment rate of 6%.

Cultural Differences and Political Context: Hong Kong Locals in the "One Country, Two Systems" Framework.

To gain a better understanding of the Hong Kong context, it is essential to examine the local population. Hong Kong's unique political and social landscape, characterized by the transfer of sovereignty from British to Chinese rule in 1997, has resulted in distinct cultural differences between Hong Kong locals and mainland Chinese. These differences encompass various aspects, including language preferences, media consumption patterns, purchasing habits, and everyday app usage (Siu-lun Chow, King-wa Fu, Yu-Leung Ng, 2019).

The authors of the study found that Hong Kong locals exhibit higher levels of civic engagement and political participation, influenced by the distinctive political environment and historical experiences of the territory. Moreover, Hong Kong residents tend to hold more liberal and democratic views compared to their counterparts in mainland China. Additionally, Hong Kong locals display a greater degree of individualism and progressiveness, which the authors attribute, in part, to higher levels of education. Notably, Hong Kong citizens tend to possess a stronger attachment to their Hong Kong identity as opposed to a Chinese identity. These significant differences between Hong Kong locals and Chinese locals are crucial for understanding the fundamental principle of "One Country, Two Systems" in Hong Kong.

One Country, Two Systems: Examining the Complex Economic Relationship between Hong Kong and China".

The concept of "One Country, Two Systems" emerged during the negotiations between China and Britain in the 1980s regarding the handover of Hong Kong. The Prime Minister of Britain at the time, Margaret Thatcher, strongly supported the idea of an independent economic and legal system in Hong Kong. Under the agreement, Hong Kong was granted the autonomy to maintain its own social, economic, and legal framework. However, tensions ran high during the negotiations as both parties grappled with the issues of the "Economic card" and "Public Opinion," which held significant importance for Britain. The treaty, specifying the terms of "one country, two systems," is set to expire in 2047, exactly 50 years after the handover.

During the negotiation process in the 1980s, the People's Republic of China (PRC) made a critical last-minute request that had a profound impact on the treaty. The PRC insisted that Hong Kong should not be allowed to engage in any form of protest or movement against Beijing. This demand was non-negotiable and reflected the PRC's concern over potential challenges to its authority. In response to this request, the treaty was amended in 1990, effectively prohibiting any dissent or opposition towards the central government. Consequently, this development sparked widespread worry among the local population of Hong Kong. In the Early 1990, 50.000 people left Hong Kong (Y. So, 2011).

One of the significant factors that contributed to the PRC's insistence on limiting dissent in Hong Kong was the 1989 Tiananmen Square Massacre. During this tragic event, thousands of students were estimated to have been killed or arrested while advocating for a more democratic, liberal, and transparent China. The massacre not only intensified tensions between Beijing and Hong Kong but also heightened concerns about China's commitment to upholding the "one country, two systems" agreement.

The international community held great economic expectations for the "one country, two systems" treaty, especially considering the bull market that spanned from 1984 to 1997. However, there was a pervasive fear that China might not honor the agreement. Alvin Y. So, an author on the subject, contends that the "one country, two systems" framework can succeed if China respects its principles. Nevertheless, he acknowledges the substantial obstacles to achieving genuine integration between the two regions due to their historical differences and significant events that have shaped their respective trajectories.

The Mainland was Hong Kong's largest trading partner in 2020, accounting for 59.2 per cent of Hong Kong's total exports of goods. Hong Kong is a major services center for the Mainland, providing a wide range of business support services such as banking and finance, insurance, transport, accounting and legal. (Hong Kong Government, 2020).

Current Economic Landscape: Key Economic Sectors, Foreign Trade, and Macroeconomic Indicators.

The implementation of the Open Door Policy by the People's Republic of China (PRC) brought about a significant transformation in Hong Kong's economy, shifting it from labor-intensive production to a knowledge-intensive one. To remain competitive in the global market, local firms in Hong Kong recognize the crucial need to continually develop cutting-edge technologies. The sources of innovation can be categorized into internal factors, such as research and development, investments, and employee training (Richard C.M. Yam, William Lo, Esther P.Y. Tang, and Antonio K.W. Lau, 2011). These internal factors play a vital role in fostering innovation capabilities within Hong Kong firms. The authors emphasize that there exists a positive correlation between technological innovation and a firm's performance in global markets. Firms that possess stronger technological innovation capabilities tend to achieve superior financial and non-financial outcomes. Moreover, external collaborations, including knowledge sharing, market understanding, and access to new technologies, have a favorable impact on a firm's capacity for innovation. The authors believe that policymakers in Hong Kong bear a significant responsibility in fostering an environment conducive to innovation, which is instrumental in propelling Hong Kong towards becoming one of the leading economies in Asia.

Hong Kong has long been known for its free-market economy and low taxation policies. It embraces principles of free trade, open markets, and minimal government intervention, which has contributed to its economic success. (Hong Kong Institute of Economic Science 1984)

Hong Kong is one of the leading global financial centers, serving as a bridge between China and the rest of the world. Its robust financial sector attracts international investments and hosts numerous multinational corporations. The World Economic Forum rated Hong Kong third in its Global Competitiveness Report 2019, and was the world's third largest destination for inward foreign direct investment stock and the sixth largest source of outward foreign direct investment stock in 2019, according to the World Investment Report 2020 published by the United Nations Conference on Trade and Development. There are many reasons to explain the great success of the financial center of Hong Kong, but one of the most important reasons for its success are the liberal government policy towards the private sector and the ready availability of finance at competitive terms for large scale capital intensive projects (Y.C Jao 1979). Banking Assets in HK are 4 times bigger than in 2000 and around 200 authorized institutions, including ¾ of the world top 100. The stock market was 8.7 times bigger than in 2000 and is the Global #1 in IPO fundraising in 7 out of the last

12 years. Furthermore, the Bonds market is the Global #1 for arranging Asian international Bond issuance and the asset management is 24 times bigger than in 2000 becoming the Asia’s #1 international fund management hub (HKMA 2021). Moreover, Hong Kong was the world’s fourth largest center for foreign exchange trading (Triennial Global survey by the Bank for International Settlements, 2019)

Hong Kong's journey towards becoming one of the strongest economies in Asia was not without challenges. Prior to the 1970s, foreign banks predominantly concentrated on financing Hong Kong's external trade and domestic endeavors, without recognizing its potential as a regional hub for offshore banking (Y.C. Jao, 1979). The author highlights that Hong Kong possessed a distinct advantage over Singapore in establishing itself as a prominent lending loan syndication center. This advantage stemmed from its strategic central geographical location and its proximity to Japan, South Korea, and Taiwan.

In Hong Kong's knowledge-intensive economy, the services sector assumes a pivotal position, making substantial contributions to the country's GDP. Vital industries encompass finance, banking, professional services, logistics, tourism, and retail. Since the inaugural publication of the ranking report by the Fraser Institute in Canada in 1996, Hong Kong has consistently secured the top position as the world's freest economy.

Despite its limited natural resources and heavy dependence on imports, Hong Kong has achieved remarkable economic prosperity by capitalizing on its human capital, well-developed infrastructure, and robust global market connections. The GDP of Hong Kong reached 429 billion dollars in 2022, with a total population of 7,333,200 (Census and Statistics Department of Hong Kong, 2022).Over the course of the past twenty years, the Hong Kong economy has experienced a growth of approximately 74 percent, translating to an average annual growth rate of 2.8 percent.

Hong Kong's advantageous strategic location has positioned it as a significant trading hub, reaping the benefits of its proximity to China and serving as a gateway for international companies to enter the Chinese market. In 2020, the Hong Kong port managed an impressive volume of 18 million TEUs (20-foot equivalent units) in container traffic, solidifying its standing as one of the busiest container ports globally (Hong Kong Gov 2020).

Understanding the connection between the Hong Kong and US economies is crucial to comprehend the dynamics of Hong Kong's economic situation. One way to examine this relationship is by looking at the EHCAHK index versus the EHCAUS index, which measures the current accounts of Hong Kong and the USA from 1999 to 2022.

Hong Kong's current account surplus, indicated by a positive EHCAHK index, is primarily driven by its status as a regional financial center and trading hub. Being a gateway to Mainland China, Hong Kong attracts significant foreign direct investment and plays a crucial role in facilitating trade and investment between China and the rest of the world. The city's robust services sector, particularly finance and logistics, further contributes to its current account surplus.

On the other hand, the USA exhibits a current account deficit, reflected by a negative EHCAUS index. This deficit stems from the United States' role as a major global importer and consumer of goods and services. The US heavily relies on importing manufactured goods, particularly from China and other Asian economies. Additionally, due to its large budget deficit and relatively low savings, the US becomes a net borrower from the rest of the world.

In terms of trade, Hong Kong's largest trading partners in 2022 were China, the USA, and Germany. The total trade value of the USA reached a staggering US$5,441 billion, accounting for approximately 10.8% of the world's total trade. In comparison, Hong Kong's total trade value amounted to US$1,277 billion, representing approximately 2.5% of the world's total trade at US$50,526 billion.
(Hong Kong Trade and Industry Department, 2022).

Figure 1: EHCAHK index vs EHCAUS Index, source Bloomberg 2023.

III.Monetary Regime of Hong Kong: Currency Board and Financial Stability

The "Hard Peg / Currency Board" Monetary System: Exchange Rate Fixation, International Reserves Backing, and Monetary Supply Constraints

Currency Boards have been proposed as a viable solution to address exchange rate volatility and establish monetary credibility, particularly in the case of small open economies. However, the effectiveness of maintaining a fixed exchange rate through a currency board can be influenced by various factors, including higher interest rates on assets with instantaneous maturity. Such circumstances can escalate the costs associated with sustaining a fixed exchange rate, potentially increasing the likelihood of devaluation (Irwin, 2004). While successful examples of currency board implementation are limited, the Hong Kong currency board stands out as a notable exception. Despite facing significant challenges, such as the handover to China, the Asian Crisis in 1997, and the global crises of 2008 and 2020, the Hong Kong currency board has managed to endure. Notably, Hong Kong's decision to adopt the currency peg occurred in 1983 during a period of significant challenges, including the Sino-British negotiations and a local currency crisis. This adoption predates the emergence of modern currency boards in the 1990s, further highlighting the unique circumstances and early adoption of Hong Kong's successful currency board system (Malmstrom Rognes, R. Schenk, 2021).

A currency board operates on the principle of maintaining a fixed exchange rate through the issuance of currency backed by 100% foreign exchange reserves. In the case of Hong Kong, it had previously implemented a currency board system linked to the sterling from 1935 to 1972. Under this arrangement, note-issuing banks exchanged sterling with the exchange fund for certificates of indebtedness, which were then used to issue local currency. However, due to the devaluation of the sterling, Hong Kong made the decision to anchor its currency to the US dollar. Unfortunately, timing worked against Hong Kong as the collapse of the Bretton Woods system in 1975 led to inflationary pressures from the US dollar, prompting local authorities to abandon the fixed exchange rate and transition to a floating rate.

In 1972, as a means to enhance competitiveness against Singapore, Hong Kong removed the 15% tax on interest earned from foreign currency deposits while maintaining a 10% tax on local currency deposits. Inflation became inevitable in the early 1980s, with broad money (M3) experiencing a significant growth of 38% by 1980. The share of Hong Kong dollars within M3 also declined sharply, from 87% in 1981 to 59% a year later (Hong Kong Government, 2023).

Under the leadership of Paul Volcker, the Federal Reserve of the United States had the crucial objective of combating inflation. When Volcker assumed the chairmanship in 1979, the Federal Funds Rate stood at approximately 11%. However, by 1981, it had climbed to around 20%. This substantial increase in interest rates positioned the US dollar as the strongest currency globally, leading to rapid depreciation of foreign currencies. The tightening of monetary policy in the United States resulted in a debt crisis, particularly impacting developing countries that faced the burden of higher interest rates. According to the authors, during the period from 1976 to 1989, the proportion of countries pegged to the US dollar declined from 43% to 24% (Malmstrom Rognes, R. Schenk, 2021). In contrast to this trend, Hong Kong made a contrasting decision and, in 1983, reinstated the currency peg anchored to the US dollar.

In order to establish this new monetary system, influential figures such as Greenwood, Cowperthwaite, Alan Walters, and Milton Friedman worked closely together. Milton Friedman, renowned for his advocacy of free markets, played a pivotal role in shaping the currency regime adopted by Hong Kong. His nuanced perspective on exchange rate systems emphasized the importance of considering the specific context of each economy. Friedman recognized that the choice of exchange rate system should be tailored to the characteristics of the economy in question. While he generally championed the principles of free markets, he acknowledged that large open economies, such as European countries, faced challenges in adopting a single currency as an anchor. Such a move would require surrendering economic and political freedom to a larger currency union entity, potentially compromising national sovereignty and policy autonomy (John Greenwood, 2021). However, for small open economies like Hong Kong, Friedman viewed the currency board system as a favorable choice that outweighed the costs associated with alternative systems. The currency board implemented in Hong Kong provided a fixed exchange rate with a credible anchor currency and strict monetary discipline. According to Friedman, this system offered significant advantages for small economies with open markets, as it promoted stability, confidence, and economic growth. Friedman's support for the currency board in Hong Kong aligned with his belief that the benefits of a fixed exchange rate and monetary discipline far exceeded any drawbacks or costs. He regarded the currency board as a mechanism to enhance economic efficiency, attract international investment, and ensure monetary stability in the unique context of a small open economy like Hong Kong.

Role of the Central Bank in Hong Kong: Maintaining Financial Stability and Monetary Policy Implementation

In 1983, the Currency Board was introduced in Hong Kong to maintain a fixed exchange rate between the Hong Kong Dollar and the US Dollar. As with most currency boards, the responsibility of managing the exchange rate and the money supply is entrusted to a separate entity, in this case, the U.S. Federal Reserve. Under this system, the Hong Kong Dollar is backed by a 100% reserve requirement. This arrangement closely resembles a robust version of the Gold Standard, where the Hong Kong dollar's value fluctuates within a narrow band of 7.75 to 7.85 HK Dollars per US Dollar.

In 1993, the introduction of the Hong Kong Monetary Authority (HKMA) marked a crucial milestone in maintaining currency stability. The HKMA implemented the Linked Exchange Rate System (LERS), which serves as the mechanism for actively intervening in the foreign exchange market to ensure the exchange rate remains within the specific bands of 7.75 to 7.85 HKD per USD. When the market price approaches the lower or upper bands, the HKMA engages in the sale or purchase of Hong Kong Dollars (HKMA, 2019).

In foreign exchange markets, currency exchange rates exhibit an inverse relationship with demand. Higher demand leads to a lower exchange rate, while lower demand results in a higher exchange rate. When the value of the Hong Kong Dollar nears the upper band of 7.85 HKD per US Dollar, the HKMA strategically buys Hong Kong Dollars to generate an appreciation effect, thereby reducing the exchange rate. Conversely, when there is substantial demand for the Hong Kong Dollar and the currency exchange rate hovers near the lower band of 7.75 HKD per US Dollar, the HKMA sells Hong Kong Dollars to create a depreciation effect.

Through these interventions, the HKMA actively manages the exchange rate within the prescribed bands, ensuring the stability and reliability of the Hong Kong Dollar. This approach, known as the Linked Exchange Rate System, plays a pivotal role in maintaining Hong Kong's currency equilibrium and supporting its robust financial ecosystem.

In addition to its role in maintaining currency stability, the Hong Kong Monetary Authority (HKMA) assumes the crucial responsibility of being the sole issuer of Hong Kong Dollar notes. Note issuing banks, including institutions such as Standard Chartered Bank, Bank of China, and HSBC, are required to uphold a 100% backing for their Hong Kong Dollar notes through equivalent deposits in U.S. dollars made with the HKMA.

Once the note issuing banks have made the necessary deposit and obtained authorization from the HKMA, they gain the ability to physically produce banknotes (cash). These newly printed banknotes are then securely transported to the respective banks' vaults for safekeeping. Subsequently, the circulation process functions similarly to that of any other economy, with the cash entering circulation through various channels such as ATMs, retail businesses, and individuals.

Crucially, the HKMA assumes a key oversight role in the entire note issuing process in Hong Kong. It exercises regulatory control and ensures compliance with established guidelines to maintain the integrity and efficiency of the note issuance system. By regulating and supervising this process, the HKMA upholds the overall reliability and trustworthiness of the Hong Kong Dollar as a widely accepted medium of exchange within the region's economy.

Hong Kong possesses one of the largest foreign reserves relative to the size of its economy. As of December 2022, the official foreign currency reserve assets held by the Hong Kong Monetary Authority (HKMA) amounted to a substantial 424.0 billion U.S. Dollars (Hong Kong Government, 2023). This figure is significant, representing approximately five times the amount of currency in circulation or about 41% of the Hong Kong Dollar M3.

These impressive foreign reserves highlight Hong Kong's robust financial position and its capacity to withstand economic challenges. The sizable reserve assets serve as a vital resource for the HKMA, enabling it to effectively manage the Linked Exchange Rate System and maintain the stability of the Hong Kong Dollar. By holding a significant amount of foreign currency reserves, Hong Kong is well-prepared to address potential fluctuations in its currency and provide a strong foundation for its monetary and financial systems.
The HKMA's Exchange Fund, amounting to 424.0 billion U.S. dollars, comprises several components strategically designed to optimize liquidity and diversification. Firstly, the fund primarily consists of foreign reserves, which are highly liquid assets such as government bonds, short-term securities, and deposits held with reputable central banks and international financial institutions. These foreign reserves ensure Hong Kong's ability to navigate currency fluctuations and maintain stability in the global financial markets.

Secondly, a significant portion of the Exchange Fund is allocated to Hong Kong dollar assets, primarily in the form of Hong Kong government bonds and Hong Kong dollar-denominated certificates of deposit. These assets bolster the domestic financial system and provide a solid foundation for Hong Kong's currency stability.

Furthermore, the Exchange Fund includes equity holdings managed by external fund managers, a measure implemented to avoid potential conflicts of interest. These equity investments are strategically diversified across various industries and regions, including Hong Kong. This approach allows the fund to benefit from potential growth opportunities while spreading risk across different sectors and geographic areas.

Overall, the composition of the Exchange Fund reflects a prudent and diversified investment strategy, combining foreign reserves, Hong Kong dollar assets, and equity holdings. This approach ensures the fund's stability, liquidity, and potential for long-term growth while effectively managing risks in the global financial landscape.

Analysis of the Monetary Regime's Functioning in Crisis Situations: Asian Financial Crisis and the Global Financial Crisis of 2008

Central bank independence is a critical principle in a currency board system, ensuring the bank can operate autonomously to fulfill its objectives. One notable relationship exists between interest rates and unemployment, where higher interest rates often correspond to increased levels of unemployment (Irwin, 2004). This positive relationship highlights the impact that monetary policy decisions, such as adjusting interest rates, can have on the labor market and employment levels.

During the Asian Financial Crisis in 1997, Hong Kong faced formidable attacks from speculators aiming to disrupt its Linked Exchange Rate System (LERS). Notably, prominent investor George Soros was among those who employed "double pay" strategies, which involved shorting both the currency and stock markets. Prior to the crisis, several vulnerabilities were apparent in Asian economies, such as currency overvaluation, economic overheating, and excessive borrowing. Additionally, the external sector witnessed current account deficits and high levels of external debt, along with a mismatch between the maturity and currency composition of banks' balance sheets (HKMA, 2019). The situation was exacerbated by the excessive lending practices of many Japanese banks, which had ripple effects across the entire region.

Despite Hong Kong's relatively stronger position compared to other Asian countries during the 1990s, it still faced vulnerabilities that posed a potential threat to the entire system. One notable concern was the indication of a real estate bubble in Hong Kong's property market. The soaring property prices raised concerns about the sustainability of the market and the potential risks associated with a sharp correction.

Moreover, households in Hong Kong were burdened with substantial debt, largely driven by mortgage borrowings. This high level of household indebtedness made the housing market particularly susceptible to the impacts of the Asian Financial Crisis (AFC) under the linked exchange rate system (Raymond Y. C. Tse and James R. W 2004). A different currency system in Hong Kong could have potentially mitigated the pronounced vulnerabilities in the housing market.

Shorting the Japanese yen played a significant role for hedge funds during the Asian Financial Crisis in 1997.They would borrow yen from the NIKKEI at a relatively low interest rate of 3% and then leverage those funds to purchase US Treasuries with a higher yield of 6%. This strategy allowed them to take advantage of the interest rate differential and generate substantial profits. As a result, the yen experienced a significant devaluation, plummeting from 80 yen per USD in April 1995 to 147 yen per USD by August 1998 (HKMA, 2019).

The impact of this devaluation spread beyond the Japanese yen and affected other smaller markets as well. These markets, with lower liquidity, faced intense pressure from short sellers, leading to rapid devaluations. What initially started as a currency crisis soon spread throughout the entire Asian financial system.

The degree of vulnerability in an economy is closely linked to its interconnectedness with other economies, both in terms of real economic linkages and financial linkages. This implies that the transmission channels of the crisis can be either real or financial in nature. (Lillian Cheung, Et Al 2009 HKMA). In the case of Hong Kong, investors strategically built up their short positions by selling currency futures. This approach had the same effect as selling in the spot market but allowed them to bypass the process of borrowing Hong Kong dollars.

These actions by hedge funds and the subsequent impact on currency markets exemplify the interconnected nature of the Asian Financial Crisis. The crisis underscored the importance of monitoring and managing linkages between economies to mitigate the risk of contagion and promote financial stability.

The attack on the Hong Kong Dollar by investors in August 1997 had a significant impact on the Aggregate Balance (AB). The AB represents the total foreign currency reserves held by the Hong Kong Monetary Authority (HKMA). When the HKMA purchases Hong Kong Dollars in the market, it reduces the foreign currency reserves, resulting in a decrease in the Aggregate Balance.

During this period, investors were actively shorting the Hang Seng Index Future market, which had the same effect as selling the Hong Kong Dollar in the spot market. As a result, the HKMA was obliged to buy these Hong Kong Dollars to maintain the fixed exchange rate parity.This strategic move is likely driven by their expectations of a forthcoming depreciation of the Hong Kong dollar against the US dollar. By selling their Hong Kong dollars now and acquiring US dollars, they aim to capitalize on the anticipated decline in HKD's value. This strategic decision suggests a firm belief among market participants that the Hong Kong dollar's future value will diminish compared to the US dollar. Such spot currency transactions are intriguing because they not only reflect participants' perceptions of currency movements but also influence the overall supply and demand dynamics in the foreign exchange market. This led to changes in reserves, influenced by shifts in private sector liquidity demand, affecting the amount of banknotes in circulation and the overall aggregate balance.

The rapid pace at which the HKMA was buying Hong Kong Dollars as part of its defense mechanism for the currency board had an additional impact. It caused the Hong Kong Interbank Offered Rate (HIBOR)[3] to rise swiftly as interbank liquidity tightened due to the increased demand for Hong Kong Dollars.

The rise in HIBOR (Hong Kong Interbank Offered Rate) indicates an increased cost of borrowing Hong Kong dollars (HKD) compared to previous levels. In the futures markets, investors are not required to immediately provide the full amount of money when purchasing stocks or currency. Instead, the price of the futures contract includes an implicit interest rate that represents the cost of borrowing the necessary funds. On the other hand, when investors take short positions, they must first borrow HKD before selling them.

During periods of attack on the stability of the HKD, the HKMA utilizes the elevation in interest rates as a defensive mechanism. By raising HIBOR, the cost of borrowing HKD is increased, making it more expensive for investors to engage in short-selling activities. This serves as a deterrent to speculative attacks on the HKD's stability and helps protect the linked exchange rate system.

In October 1997, the Hong Kong Interbank Offered Rate (HIBOR) surged to over 10%, significantly impacting the property market. Over the course of 12 months, starting from its peak in 1997, property prices experienced a sharp decline of nearly 50% (HKMA, 2019). The situation worsened on October 23, infamously known as "Black Thursday," when the HIBOR momentarily skyrocketed to almost 300%. Although this extreme level of interest rates quickly normalized, its impact on the market was substantial. The trading volume in the market dropped from an average HKD 15 billion in 1997 to HKD 4 billion in July 1998.

This heightened level of HIBOR and the subsequent decrease in trading volume had significant implications for the property market. The soaring interest rates increased the cost of borrowing, making it more challenging for individuals and businesses to access credit for property purchases or investments. As a result, market activity decreased, with fewer transactions taking place and reduced liquidity.

In August 1998, hedge funds prepared to engage in short-selling activities once again, having learned valuable lessons from the events of October 1997. However, this time they adopted a more discreet approach to avoid triggering another surge in the Hong Kong Interbank Offered Rate (HIBOR). They quietly built their short positions in both the Hang Seng Index (HSI) stock market and futures market. To

[3] The Hong Kong Interbank Offered Rate (HIBOR) is the annualized interest rate at which banks in Hong Kong borrow funds from each other to obtain three-month deposits denominated in US dollars (Nasdaq glossary 2023)

finance their existing short positions in these markets, investors borrowed Hong Kong dollars (HKD) during periods of low interest rates.

By borrowing HKD in advance, investors sought to settle their transactions without relying on the currency board rate system, effectively avoiding potential traps. One method used for such borrowing was through currency swaps associated with the issuance of Hong Kong dollar debt securities by multilateral agencies. During the first seven months of 1998, the combined issuance of such debt securities amounted to approximately $30 billion (HKMA 1998 Annual Report).

This calculated strategy employed by investors was known as the "Double play." By exerting pressure on the exchange rate system through their activities in the futures and stock markets, hedge funds aimed to exploit vulnerabilities and potentially profit from any ensuing market fluctuations.

Despite the well-crafted strategies of hedge funds, such as Soros Fund Management, they underestimated the resolve of the Hong Kong Monetary Authority (HKMA) to uphold the parity of the Hong Kong dollar with the USD. In 1998, under the leadership of Mr. Joseph Yam, the Chief Executive of the HKMA, a remarkable counterattack was initiated, marking a significant event in the history of macroeconomics.

The HKMA devised a plan to deploy the Exchange Fund and intervene in the Hang Seng Index (HSI) stock market and futures market. The operation commenced in mid-August 1998, with a dedicated group of HKMA members acting as the principal buyers, armed with a substantial budget of 118 billion HKD for market intervention (Dungey et al., 2008). On August 28, the total traded value in the market reached HKD 79 billion, with the HKMA predominantly purchasing stocks from short sellers in the (HSI) and futures market. This pivotal day witnessed the market closing with an 18% positive difference from the opening, effectively ending the dominance of the sellers.

Norman Chan, who served as the Chief Executive of the HKMA from 2009 to 2019, noted in an article that while it remained unclear whether a short squeeze occurred, Hong Kong became the first country to successfully "jack up the market." This achievement not only demonstrated the determination of the HKMA to defend its currency and stabilize the financial markets but also showcased the effectiveness of their intervention efforts.

The HKMA's resolute actions and successful market intervention played a crucial role in thwarting the short-selling strategies of hedge funds, ultimately restoring confidence and stability in the Hong Kong market.

In contrast to the severity of the 1997 crisis, the impact of the 2008 global financial crisis on Hong Kong was relatively less severe. Nonetheless, it presented challenges to the economy, leading to certain difficulties. One of the significant effects was an economic slowdown, with the real GDP growth rate moderating from 6.4% in 2007 to 2.5% in the wake of the crisis.

The unemployment rate also experienced a notable increase, reaching a 16-month high of 4.1% in December 2008, compared to 3.2% in July 2008. The trade sector bore the brunt of the crisis, as it faced repercussions stemming from the economic downturn in the United States and Europe. The decline in global demand and trade volumes had a direct impact on Hong Kong's export-oriented economy.

Furthermore, there were changes observed in the loan-to-deposit ratio of Hong Kong dollar loans. The ratio decreased from a previous high of 83.8% to 77.6%, reflecting a more cautious approach by banks and financial institutions in extending credit during the challenging economic environment of the crisis (HKMA 2008 Annual Report - Economic and Banking environment).

Although the 2008 crisis brought about economic challenges and slower growth in Hong Kong, the overall impact was less severe compared to the preceding Asian financial crisis. Hong Kong demonstrated resilience and was able to navigate through the difficulties, adapting to the changing global economic landscape.

However, in 2009, the Hong Kong economy faced a significant downturn, marking the first contraction since the Asian financial crisis in 1997. The real GDP experienced a decline of 2.7%, reflecting the adverse impact of the global financial crisis.

During this period, the Hong Kong dollar exchange rate remained relatively stable, staying close to the fixed rate of 7.75 HKD per USD throughout the year. However, this stability frequently triggered the strong-side Convertibility Undertaking, which involved the HKMA taking action to prevent the HKD from appreciating beyond the lower limit of the exchange rate band.

It is important to note that this phenomenon was not driven by speculation against the Linked Exchange Rate system. Instead, it was primarily attributed to the repatriation of funds by Hong Kong residents and the inflow of investment portfolios. These factors influenced the supply and demand dynamics of the Hong Kong dollar, requiring the HKMA to intervene in the foreign exchange market to maintain the stability of the currency (HKMA Annual Report 2009 - Economic and Banking environment).

The COVID-19 pandemic had a significant impact on Hong Kong in 2020, resulting in a contraction of the economy by 6.1%. The implementation of border closures and lockdown measures led to a slowdown in activity, particularly in the Port of Hong Kong, which experienced unprecedented levels of reduced operations.

In response to the challenges posed by the pandemic, the Hong Kong Government introduced relief measures amounting to 300 billion HKD in the 2020-2021 budget through the anti-pandemic Fund. This funding was allocated to various areas such as healthcare services, epidemic prevention measures, support for affected industries, job retention schemes and assistance for vulnerable groups in the community. The aim was to provide financial support and resources to individuals, businesses, and sectors that were adversely affected by the pandemic. (HKMA Annual Report 2020).

As a consequence of the economic downturn and the implementation of fiscal measures, Hong Kong faced the first fiscal deficit in 15 years (Reuters 2020). The estimated deficit for the 2020-21 financial year stood at $257.6 billion,indicating that the government's expenditure exceeded its revenue during that period (Budget HK Government 2021-2022). In the subsequent financial year of 2021-22, the estimated deficit was projected to be $101.6 billion, equivalent to 3.6% of GDP. This deficit was primarily driven by two factors. Firstly, the continuation of counter-cyclical fiscal measures aimed at stimulating the economy and supporting recovery. Secondly, an increase in recurrent expenditure, which refers to ongoing expenses such as public services and infrastructure investments. (Budget HK Government 2021-2022).

Although Hong Kong faced economic challenges during the 2008 global financial crisis and the COVID-19 pandemic, the impact of these crises was relatively milder compared to the Asian Financial Crisis. Despite the difficulties, Hong Kong displayed resilience and successfully maneuvered through the challenges, demonstrating its ability to adapt to the evolving global economic landscape.

Analysis of the impact of US monetary policy and other external shocks on Hong Kong's economy.

The interplay between external shocks and the Hong Kong economy has been a subject of significant research, particularly regarding the impact of US monetary policy rate shocks (Chen & Tsang, 2016). Authors examined the effects of various external shocks on the Hong Kong economy, with a specific focus on the impact of US monetary policy rate shocks. The authors found that Hong Kong's short-term business cycle demonstrates a higher degree of synchronization with the United States, while its long-term growth exhibits a strong co-movement with China. This suggests that Hong Kong's economic fluctuations are influenced by both the US and Chinese economies.

The authors of the study found that changes in the US policy rate have an impact on the Hong Kong dollar exchange rate and interbank interest rate, which tend to move in a similar manner as their US dollar counterparts. However, unlike many emerging market currencies, the Hong Kong dollar exchange rate does not depreciate significantly following a US rate hike. This indicates that the financial markets have confidence in the stability of Hong Kong's linked exchange rate system. Furthermore, the authors observed that the Hang Seng index (HSI), which represents Hong Kong's stock market, initially experiences a significant but temporary negative response to US monetary policy rate shocks. However, the HSI quickly rebounds, suggesting that Hong Kong's stock market has the ability to swiftly absorb and adjust to such shocks.

According to the authors' findings, when the US tightens its monetary policy, it leads to several notable effects on monetary and inflation variables in Hong Kong. Specifically, there is an increase in the value of the Hong Kong dollar exchange rate and the Hong Kong Interbank Offered Rate (HIBOR). After a US monetary tightening of 25 basis points (BPS), the Hong Kong dollar nominal effective exchange rate appreciates by approximately 0.58% over the course of a quarter (Chen & Tsang, 2016). This suggests that the Hong Kong dollar becomes stronger relative to other currencies during this period. In addition to the exchange rate, the authors observe that Hong Kong interbank interest rates also rise immediately following an increase in the US interest rate. This indicates that borrowing costs for financial institutions in Hong Kong increase as a result of the US monetary tightening. Furthermore, the tightening of US monetary policy triggers capital outflows from Hong Kong. This suggests that investors may be reallocating their funds away from Hong Kong and towards other investment opportunities in response to the changing global interest rate environment. Lastly, the authors note that US policy rate shocks generally lead to lower inflation and a decline in the growth of property prices in Hong Kong. This indicates that tighter US monetary policy has a dampening effect on inflationary pressures and the property market in Hong Kong.

Specifically, they find that the growth rate of M1, which represents narrow money supply, experiences an immediate and significant decline following US monetary tightening. This suggests that the availability of liquid funds in the economy decreases in response to the shocks. Similarly, the growth rate of total loans in Hong Kong diminishes promptly when US monetary policy tightens. This indicates that the pace of lending activity slows down as a result of the tightening measures. When examining the broader measure of money supply, M3, the authors note that its growth rate initially declines following US monetary policy rate shocks. However, over time, this decline gradually diminishes, suggesting a relatively more resilient response compared to M1. Regarding price stability, the underlying consumer price index (CPI) in Hong Kong, excluding one-off relief measures, shows an average decrease of 0.04 percentage points in the first four quarters following US tightening. This suggests that inflationary pressures in Hong Kong are somewhat dampened in the wake of US monetary policy rate shocks.The authors emphasize the flexibility of prices in Hong Kong, highlighting that they adjust quickly to accommodate and absorb shocks. This indicates that the economy has a certain degree of adaptability, allowing for swift price adjustments in response to changes in monetary policy.

However, the authors do observe a decline in the growth rate of retail sales by 0.08 percentage points in the first quarter following US tightening. This suggests a slight dampening effect on consumer spending. In the external sector, the authors note a marginal decrease in the growth rates of both import and export values. This indicates a modest impact on international trade flows, likely influenced by the changing global economic conditions resulting from US monetary policy changes. Regarding the labor market, the authors find a slight initial increase in the unemployment rate following US monetary policy rate shocks. However, they deem this increase to be not significant, suggesting that the shocks do not have a substantial and lasting impact on employment levels.

According to the authors' analysis, Hong Kong's property market shows sensitivity to interest rate shocks, particularly over a full cycle of interest rate tightening. They find that a one-time 25-basis-point increase in the policy rate does not have a large impact on property prices.However, the authors note that when there is a full cycle of interest rate tightening, property price growth in Hong Kong tends to experience a significant slowdown or even becomes negative. This suggests that prolonged and sustained increases in interest rates can have a notable impact on the property market. The implication is that while a small, isolated increase in interest rates may not have a substantial effect, a series of rate hikes over a longer period can impact the affordability and demand for properties in Hong Kong. This response aligns with the general expectation that higher interest rates can increase borrowing costs and dampen overall demand in the housing market.

In his research, Roevekamp (2021) proposes a method to determine market perception regarding the possibility of a devaluation in a currency with a fixed exchange rate. He suggests that analyzing the implicit exchange rate that investors can obtain for their American Depositary Receipts (ADRs) on the Federal Open Market Committee (FOMC) day provides valuable insights.

Firstly, ADRs are certificates of deposit in a U.S Bank that represent shares of non-U.S. companies traded on US stock exchanges. They allow American investors to indirectly own shares in these foreign companies without having to directly purchase the stocks on a foreign exchange (U.S. Securities and Exchange Commission, 2012).

Secondly, the implicit exchange rate associated with ADRs refers to the value at which investors can convert their ADRs into the currency of the foreign company. Essentially, it represents the rate at which investors can exchange their ADRs for the equivalent value in the foreign currency.

Lastly, the Federal Open Market Committee (FOMC) is a committee within the U.S. Federal Reserve that makes decisions about the country's monetary policy. They meet 8 times a year scheduled to assess the economy, set interest rate targets (federal funds rate), and aim for stable prices and sustainable economic growth. Their decisions impact borrowing costs and have significant effects on businesses, consumers, and financial markets (Federal Reserve, 2023).

Roevekamp argues that when the Federal Reserve (Fed) unexpectedly adjusts the Federal Funds Rate, the implicit exchange rate derived from the ADR market reflects the market's perception of the probability of devaluation. Over the long term, this implicit exchange rate tends to converge with the official exchange rate. Therefore, analyzing the implicit exchange rate can provide important information about market expectations regarding the likelihood of a devaluation.

The author emphasizes that countries exhibiting characteristics such as a decline in the domestic banking index, fiscal deficits, and lower current GDP compared to past growth are more likely to consider devaluation as a policy option. Investors incorporate these factors into the exchange rate at which they can convert their ADRs, often resulting in a higher value compared to the official exchange rate.

IV. Conclusion

The laissez-faire approach adopted by the Hong Kong Special Administrative Region (HKSAR) Government is epitomized by the statement made by Donald Tsang, the former Financial Secretary of Hong Kong from 1995 to 2001, who referred to Hong Kong as a "big market, small economy." This ideology has been maintained over the years, rooted in the principles established by Sir John James Cowperthwaite, who served as the financial secretary in 1961 and advocated for a non-interventionist policy. The core pillars of Hong Kong's economic culture, as established by Cowperthwaite, include low taxation, fiscal discipline, free trade, and infrastructure development.

Milton Friedman famously remarked, "The power of the free market has enabled the industrious people of Hong Kong to transform what was once a barren rock into one of the most thriving and successful places in Asia" (Beck, Jamie; Bok, Rachel; Zhang, Jun, 2020). This quote underscores the transformative effect of embracing free market principles and the remarkable achievements of the people of Hong Kong in turning a seemingly barren land into a prosperous and vibrant hub in Asia.

Friedman found Hong Kong to be a compelling example that mirrored Adam Smith's ideas and provided an explanation for what he considered a paradox. Despite being a remote trading post with limited resources and located on the edge of an empire, Hong Kong managed to develop one of the world's fastest-growing economies. This was in stark contrast to Britain, the colonial power governing Hong Kong, which was struggling under socialist policies (Beck, Jamie ; Bok, Rachel ; Zhang, Jun, 2020).

In my reflections, I am convinced that the establishment of the US dollar anchor in Hong Kong in 1983 stands as a clear testament to the progress the city has achieved. This visionary monetary policy, adopted by the Hong Kong government, has been an exceptional success story and a remarkable source of inspiration for developing nations grappling with their own monetary challenges, such as Argentina. Hong Kong's ability to withstand multiple attacks on its currency, (LERS), and emerge even stronger is a testament to the unwavering commitment and resilience displayed in defending the currency board system. I firmly believe that the remarkable journey of Hong Kong will be thoroughly examined for years to come as a resounding case of triumph in monetary policy. It serves as a vivid illustration that with a sound and stable monetary framework, economies have the potential to chart their own path towards sustained prosperity.

I firmly believe that preserving the credibility and integrity of the Hong Kong Monetary Authority (HKMA) is of utmost importance in ensuring stability within Hong Kong's economy. While alternative options may seem appealing in theory, it is crucial to carefully evaluate the potential disruptions and loss of market trust that may accompany them. By upholding the currency board framework, Hong Kong can establish a solid foundation for maintaining stability, attracting investments, and safeguarding its economic future.

The currency board system has proven its efficacy over the years, and Hong Kong's unwavering commitment to this system is commendable. This commitment, coupled with the robust reserves held by the HKMA, instills confidence in the global market that Hong Kong is well-prepared to navigate potential challenges that may arise from changes in Federal Reserve policy or other external factors. This approach provides a transparent and rules-based monetary system that promotes trust and confidence among investors. The pegging of the Hong Kong dollar to the U.S. dollar allows for stability in exchange rates, economic stability and price stability.

While alternative options may hold theoretical appeal, they also carry significant risks and uncertainties. Deviating from the currency board system could disrupt market expectations, create volatility in exchange rates, and erode investor confidence. Hong Kong's economy thrives on its ability to attract both domestic and foreign investments, and any loss of market trust could lead to capital outflows, economic instability, and a decline in the overall well-being of the region.

In conclusion, preserving the credibility and integrity of the HKMA and upholding the currency board framework is vital for Hong Kong's economic stability and long-term prosperity. The commitment to this system, combined with robust reserves and a track record of successful implementation, instills confidence in the market that Hong Kong is well-prepared to navigate potential challenges arising from changes in Federal Reserve policy or other external factors. By maintaining stability, attracting investments, and safeguarding its economic future, Hong Kong can continue to thrive as a global financial hub and contribute to the prosperity of its residents and businesses alike.

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V. Annex

Short positions against the Hong Kong dollar are accumulating as investors, including William Ackman and Kyle Bass, hold the belief that Hong Kong's ability to maintain its currency peg is untenable. Nevertheless, it is important to note that the present conditions and investor thesis significantly differ from the short thesis observed in 1998.

Hedge funds are currently of the opinion that Hong Kong is likely to detach its currency peg from the US Dollar due to a lack of synchronization between the two economies. China's share of the global GDP based on purchasing power parity (PPP) stands at 18.92%, while the USA's share is 15.39% (IMF's 2023 report). This stark contrast is a significant deviation from the situation 40 years ago when Hong Kong decided to peg its currency to the US Dollar. Analysts argue that this discrepancy is causing Hong Kong to experience macroeconomic imbalances. Furthermore, Hong Kong's contribution to China's GDP has been steadily diminishing. In 2021, Hong Kong's GDP accounted for only 2.1% of China's, a substantial decline from the 18.4% share it held in 1997 when it returned to Chinese sovereignty (Reuters, 2021). Although Hong Kong's economic output may no longer carry the same weight for China, it remains crucial from the perspective of raising capital.

Following the Asian Financial Crisis (AFC), Hong Kong underwent a significant transformation in its economic dynamics. Previously, it operated as a net exporter of goods while importing services. However, the post-AFC period witnessed a reversal in this trend, with Hong Kong transitioning into a net importer of goods and an exporter of services.

The net current account balance of Hong Kong is an important indicator when evaluating whether the Hong Kong economy has shifted from the original economic conditions for which the currency peg with the US dollar was designed.The net current account balance provides insights into the composition of Hong Kong's trade.

By analyzing the balance between exports and imports of goods and services, we can understand how the structure of the economy has evolved over time. If there has been a substantial shift in the trade composition, such as a significant increase in the importance of services relative to goods, it suggests that the original economic conditions for the currency peg may have changed. This analysis helps in understanding the evolving economic dynamics and evaluating the suitability and effectiveness of the currency peg arrangement.

Figure 2: 5321R005 Index, HKBPCASE Index, 5321R015 Index, Bloomberg 2023.

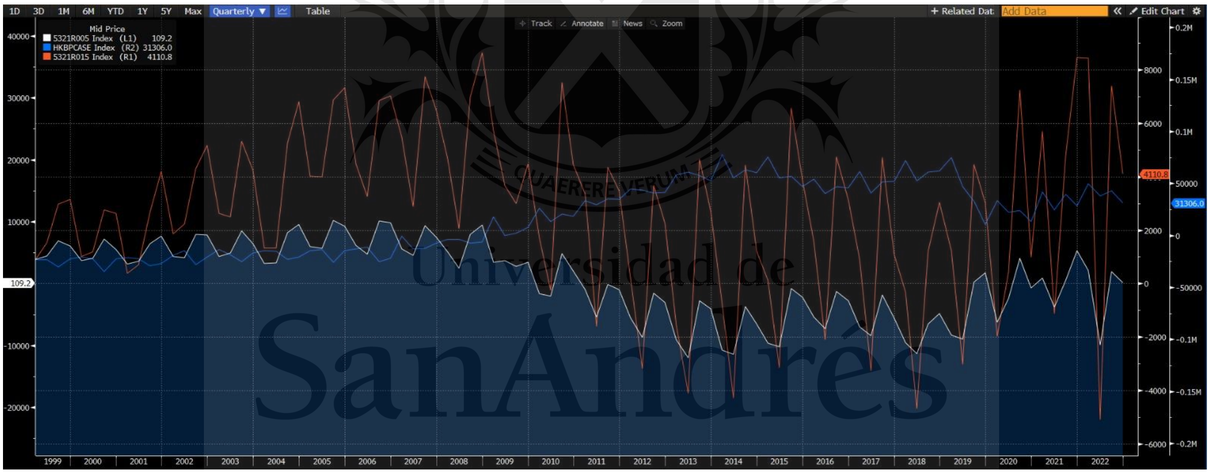


Figure 2 presents the net current account balance of Hong Kong, which includes both goods and services. The red line represents the overall current account balance, while the blue line represents the services current account and the white line represents the goods current account. A closer examination of the graph reveals a significant shift in the past two decades.

In 1999, Hong Kong had a trade surplus in goods, meaning that its exports of goods exceeded its imports. However, over the following ten years, there was a complete reversal of this situation. Hong Kong's exports of services began to surpass its exports of goods.

This shift in the composition of Hong Kong's current account balance is important when analyzing the sustainability and rationale behind the Hong Kong dollar peg. The currency peg, which links the value of the Hong Kong dollar to the U.S. dollar, was established to ensure stability and promote confidence in the economy. However, as the graph indicates, there has been a significant change in the structure of Hong Kong's trade over time.

The growing importance of the services sector and the shift towards a services-based economy in Hong Kong raise questions about the suitability and effectiveness of maintaining a fixed exchange rate regime.

Understanding the changes in Hong Kong's trade patterns, particularly the shift in its trade partners and the decline in container throughput at the Hong Kong Port, is crucial for perceiving changes in the Hong Kong economy. These factors provide valuable insights into the evolving economic landscape and can help assess the impact on various sectors and overall economic performance.

Figure 3: HKCCTTL Index 2023

The Hong Kong Port Container Throughput, which represents the movement of goods through various transportation modes within the Hong Kong Port, has shown a noticeable downward trend over the past decade. This decline provides compelling evidence of the economic transformation that Hong Kong has experienced during this period. One contributing factor to this shift is the extensive construction of ports in southern China. These new ports have intensified competition for Hong Kong by offering highly competitive port tariffs on the Mainland. Therefore, the data presented in the graph supports the idea that both internal and external factors have influenced the changing economic landscape of Hong Kong, particularly in relation to its port-related activities.

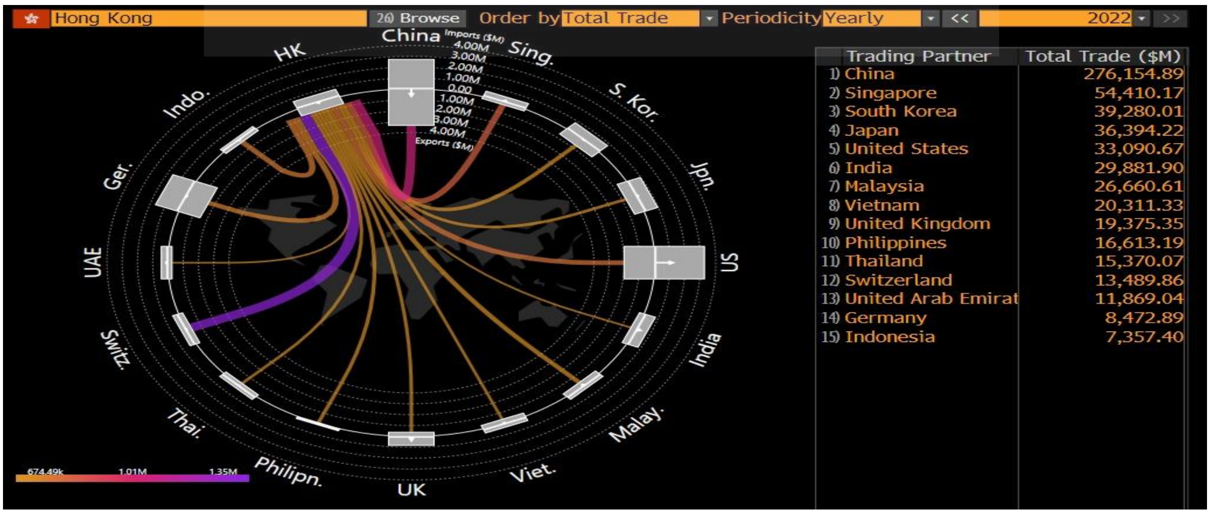
Simultaneously, as Hong Kong's economy underwent a transformation, there has been a discernible change in its trade partners. Historically, the United States served as Hong Kong's primary trade partner, which was logical due to the currency peg between Hong Kong and the US dollar. However, in the past decade, significant development and growth have been observed among the Asian Tigers and the Pacific Asia region as a whole. This accelerated progress has led to a shift in Hong Kong's trade partnerships, with an increased focus on engaging with these rapidly growing economies in the region. Consequently, Hong Kong's trade patterns have adapted to align with the evolving dynamics of the Asian economies.

These observations are of great importance in analyzing the changes occurring in the Hong Kong economy. The decline in container throughput at the Hong Kong Port indicates a shift in the movement of goods, reflecting changing economic dynamics. Understanding this trend provides insights into the evolving economic structure and performance of Hong Kong. Additionally, the transformation in trade partnerships signifies Hong Kong's adaptability and strategic response to the changing global economic landscape.

The analysis of trade relationships and economic trends is crucial for gaining a comprehensive understanding of the Hong Kong economy and its adaptation to the changing economic landscape.

One significant aspect is the trade relationships that Hong Kong has developed over time. Notably, China has emerged as the top trading partner, with over 50% of Hong Kong's exports being directed towards the mainland. This reflects the deep economic ties between Hong Kong and mainland China and underscores the importance of this relationship in shaping Hong Kong's economic performance.

Figure 4: Hong Kong Trade Patterns 2022, Bloomberg 2023



Building upon the changing trade partnerships and the evolving economic landscape discussed earlier, the period from 2007 to 2017 marked a significant phase of prosperity for Hong Kong's economy. This growth can be attributed to a confluence of factors, including the implementation of a low-rate policy by the US Federal Reserve following the 2008 Financial Crisis. In response to this policy, Hong Kong adopted a similar monetary approach, aligning its strategies with international economic trends.

During this period, China's remarkable economic expansion was also noteworthy, earning accolades from the World Bank as "the fastest sustained expansion by a major economy in history" (Congressional Research Service, 2019). China's average annual real GDP growth rate between 2007 and 2017 stood at an impressive 8.78% (IMF, World Economic Outlook Database, April 2019). This robust growth in China played a pivotal role in shaping the economic dynamics of the region.

The convergence of low interest rates and China's formidable economic performance created a favorable environment for Hong Kong's economy to flourish. However, this phase of rapid growth also brought forth certain challenges. As a consequence of the low-rate policy and the overall economic boom, Hong Kong's banking system became one of the most highly leveraged systems globally. The banking system's assets in 2023 amount to approximately 372% of Hong Kong's GDP (Bloomberg, 2023).

Therefore, the period from 2007 to 2017 witnessed a remarkable economic growth in Hong Kong, influenced by both internal and external factors. The adoption of a low-rate policy in response to the global financial crisis, coupled with China's impressive economic expansion, created an environment conducive to economic prosperity. However, it is crucial to acknowledge the challenges posed by an overheated economy and the highly leveraged banking system in Hong Kong during this period. These interconnected dynamics provide a deeper understanding of the economic transformations experienced by Hong Kong and highlight the need for strategic measures to sustain long-term growth and stability.

Figure 5: Hong Kong Banking System / GDP, Source Bloomberg 2023.

Continuing the analysis of Hong Kong's economic landscape, it is essential to consider the exponential growth of the Hong Kong Banking System in the context of the aforementioned factors. As highlighted in Figure 5, the banking system has expanded significantly over the past decade. While this growth signifies the vibrancy of the financial sector, it also raises concerns regarding the potential risks it poses to the Hong Kong economy. A highly leveraged banking system, such as the one in Hong Kong, can become a significant vulnerability. In the event of a crisis, the government may face difficulties in safeguarding depositors, particularly due to the system's size surpassing the GDP.
Moreover, the rapid growth of Hong Kong's real estate market deserves attention as it contributes to the overall economic landscape. Over the past decade, the market has experienced a staggering increase of 500%. Such exponential growth in the housing sector has resulted in soaring prices, with the cost of housing reaching nearly $10,000 per square meter. Consequently, Hong Kong's real estate market has become the least affordable in the world, with a median multiple of 18.8, surpassing other major cities like Sydney, which stands at 13.3 (DEMOGRAPHIA INTERNATIONAL HOUSING AFFORDABILITY 2023).

These intertwined dynamics, including the expansion of the banking system and the exponential growth of the real estate market, further underline the challenges and risks faced by the Hong Kong economy. The potential vulnerabilities arising from a highly leveraged banking system and the housing affordability crisis necessitate careful consideration and strategic measures to maintain stability, foster sustainable growth, and ensure the well-being of the population.

Figure 6: World Bank Hong Kong Domestic Private Sector, Bloomberg 2023.

Expanding on the examination of Hong Kong's economic situation, it is crucial to consider the disparity between the US monetary policy and the macroeconomic landscape in Hong Kong. This disparity has contributed to an overheated economy and an overleveraged financial system, as evidenced by various indicators. One such indicator is the domestic credit to the private sector, which measures the financial resources extended to the private sector, encompassing loans and other repayment-based instruments. In the case of Hong Kong, the level of domestic credit to the private sector stands at 259%, signifying a significant reliance on credit and debt within this sector. This high level of domestic credit further underscores the potential vulnerabilities and risks associated with an overheated economy and an overleveraged financial system in Hong Kong.

Examining the data provided by the World Bank in figure 6, it becomes evident that Hong Kong's domestic private sector exhibits one of the highest levels of leverage among economic agents globally. When compared to the domestic private sectors of the United States and Japan, which demonstrate leverage levels of approximately 150%, Hong Kong's private sector surpasses this metric by a considerable margin. This highlights that economic agents in Hong Kong are exposed to a greater degree of leverage, posing potential risks and vulnerabilities to the stability and resilience of the economy. These interconnected dynamics, including the disparity in monetary policies, the high level of domestic credit to the private sector, and the elevated levels of leverage within Hong Kong's economy, underscore the need for prudent risk management and effective regulatory measures. Addressing the challenges posed by an overheated economy and an overleveraged financial system is crucial to fostering long-term economic stability, resilience, and sustainable growth in Hong Kong.