

JUL 2020 - VOLUME I

Hong Kong's Changing Status and New Normal

INTUITION PUBLISHING PTE LIMITED

As the world contemplates its new normal, HK is facing its own, and it has nothing to do with COVID19. It is hardly surprising that HK has found its way into the middle of US-China political tensions, and now appears to be taking the full brunt of US grievances.

Locally, last year's tumultuous anti-government protests which, despite any valid basis for protest, always seemed predestined to cause more damage to political freedom than its intended goal, the Chinese government seems to have had enough and the NPC have voted overwhelmingly to impose the new Security Law in HK. The bill has been around since before the British left in 1997, but it has always been too contentious to put into law, and the last attempt in 2003 ended in massive peaceful demonstrations against it. That seems to be the difference this time, with a marked absence of 'peaceful' in the demonstrations last year.

HK sits in the middle of the delicate "one country, two systems" formula under which China agreed to protect Hong Kong's extensive freedoms, autonomy and its independent legal system. These freedoms are protected by the Basic Law, and within that Article 23 states that HK must enact laws against secession, subversion, terrorism and foreign interference in Hong Kong. China's patience has run out after last year and the new Security Law is designed to achieve what Local HK governance seems to have failed to do. The fear in HK is that this is the nail in the coffin of its different treatment, the end of its separation from mainland China and a serious erosion of personal and press freedom in HK.

Internationally, the biggest effect is how the US views HK; the US Secretary of State announced that Hong Kong is no longer autonomous from Beijing, meaning that Hong Kong no longer qualifies for its special status (Most Favored Nation) under US law. On the face of it this is actually an illegal US action, as HK is a separate member of the WTO and as all WTO members are treated the same, the US can't legally do that. But, as everyone knows, the US is in the midst of a trade war with China, also a member of the WTO, so now HK will be affected by any US economic actions against China. The US appears unconcerned about the breach of WTO treaties, and unfortunately if HK took the US to the WTO and won, which would take years, all that would allow HK to do is place sanctions on US trade with them, which is counterproductive.



The action of removing HK's MFN status in reality hurts HK almost exclusively and will not affect China that much. So, at a time when you might think the US would support HK in its troubles with China, it is in effect penalizing HK. With the trade situation already tense between the US and China, there is little chance that the US will change its decision and be more supportive of HK in the near future.

Finally, what does this mean for the HK USD PEG? The PEG has been very successful for over 36 years in giving stability to HK's economic health and has always given investors added comfort on staying in HK throughout many crises. The recent actions of the Chinese and US governments has raised fears over the PEG holding and if the PEG were to go it would seriously undermine investor sentiment in HK with obvious consequences.

The HKD is pegged in a narrow range of 7.75-7.85 to the US dollar. The HKMA intervenes to maintain the range in FX and official rates have to track US monetary policy. Firstly, the US cannot do anything about another country pegging its currency to the USD. The PEG predates HK's MFN status by 9 years. HK has huge currency reserves of \$440b and will likely be backed by China's CB if necessary. Any threat to HK's PEG undermines its financial health and that is significant for China as HK is a gateway to international investment and lies third globally as a currency trading centre. HK has the ammunition to defend the PEG and will if deemed essential.

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