Box 2.1

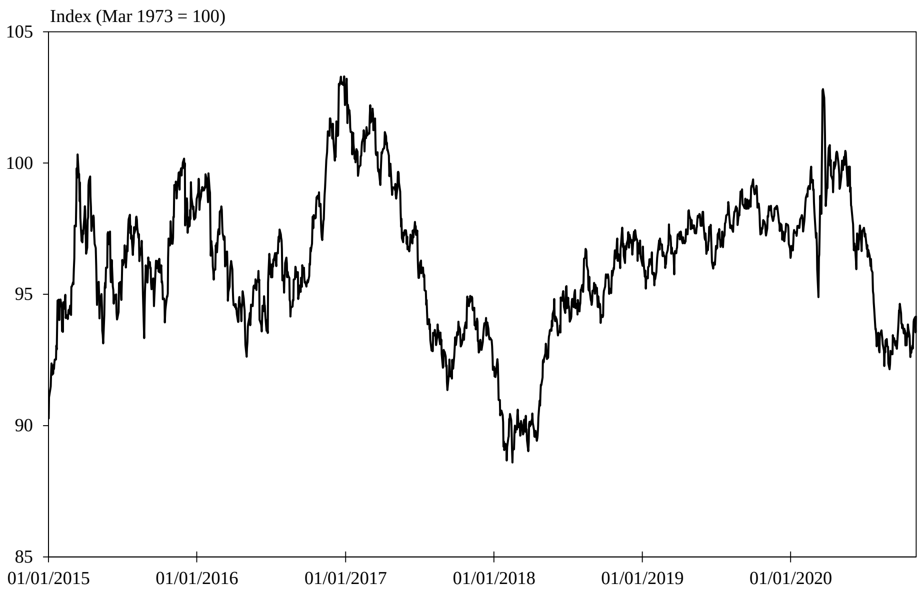
Recent trend of the US dollar and its potential implications for the Hong Kong economy

The movements of the US dollar have been quite volatile against other major currencies since the COVID-19 outbreak in early 2020. The US Dollar Index surged to its highest level in more than three years in late March on safe-haven demand, but fell back substantially thereafter. Some market analysts warned that the US dollar weakness may persist in the years to come owing to the launch of massive monetary easing and fiscal stimulus by the US authorities to cushion the adverse impact of the pandemic. This box article examines some of the factors contributing to the recent trend of the US dollar and the potential implications for the Hong Kong economy.

The recent movements of the US dollar

On 11 March 2020, the World Health Organization declared the outbreak as a pandemic. In the midst of the resultant stringent containment measures implemented by many governments, the global economy slid into a deep recession. Anxiety over sustained spread of the COVID-19 worldwide sent international financial markets into a tailspin from late February to mid-March 2020, triggering risk-off sentiment and a flight to safe-haven currencies. Subsequently, the US dollar strengthened notably with the US dollar index surging by over 8% in two weeks' time to 103 on 20 March 2020, the highest since January 2017.

Chart 1: The US dollar has been volatile since the COVID-19 outbreak



Note: The US Dollar Index measures the value of the US dollar relative to a basket of six currencies, namely the euro (57.6%), Japanese yen (13.6%), British pound (11.9%), Canadian dollar (9.1%), Swedish krona (4.2%) and Swiss franc (3.6%).

Yet, the surge of the US dollar was swiftly followed by a weakening trend in the ensuing months as shown in ***Chart 1***. The US dollar index fell to 92 on 31 August 2020, the lowest since May 2018, before stabilising somewhat in September. The depreciation of the US dollar could be attributed to several factors. On the monetary front, the US Federal Reserve (Fed) has taken more sizeable easing actions since the COVID-19 outbreak than other major central banks. It lowered the target range for the federal funds rate twice by a total of 150 basis points to 0.00%-0.25% in March, while the European Central Bank (ECB) and the Bank of Japan (BoJ) continued to maintain their policy rates at historical lows (***Chart 2a***). The Fed was also more aggressive in asset purchases, announcing on 23 March to purchase Treasury securities and agency mortgage-backed securities in whatever amounts needed to ensure financial stability for an infinite period. As a result, the Fed's balance sheet expanded

Box 2.1 (Cont'd)

by more than 60% from mid-March to over US$7 trillion in end-September, outpacing those of the ECB and the BoJ, which grew by 39% and 17% respectively over the same period (***Chart 2b***), and hence adding downward pressure on the US dollar.

Chart 2a: Fed cut its target range for the federal funds rate by 150 bps in March

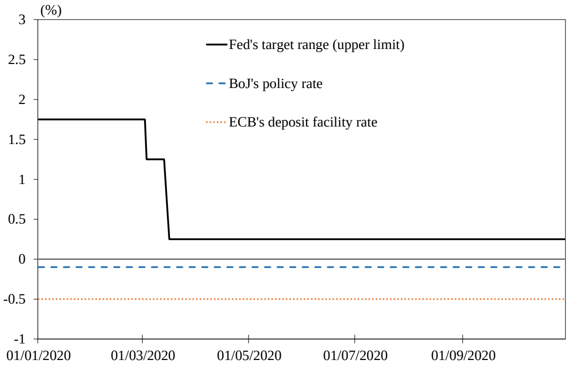
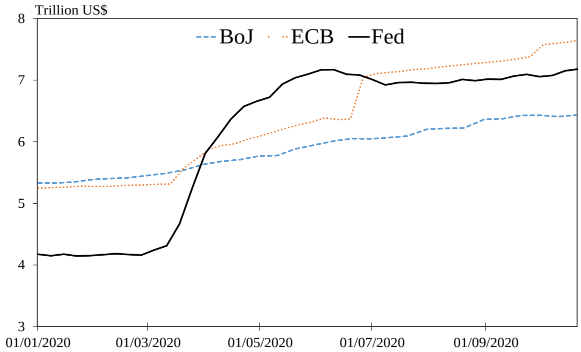


Chart 2b: Fed's balance sheet has expanded at a faster pace than those of ECB and BoJ



Besides, there have been growing concerns about whether the massive stimulus measures undertaken by the US government would lead to notable deterioration of its fiscal health. The Federal Reserve Bank of St. Louis estimated that total federal public debt in the US as a percentage of GDP soared from 107.7% in the first quarter of 2020 to 135.6% in the second quarter. In September 2020, the US Congressional Budget Office projected that the federal budget deficit would widen sharply from 4.6% of GDP in 2019 to 16.0% in 2020 and 8.6% in 2021, significantly higher than its March projections of 4.9% and 4.3% respectively. The worsening fiscal situation of the US government raises doubts on the latter's ability to render continued support to the economy beyond the short term. Such worries were particularly elevated upon the resurgence of COVID-19 infections in the US since June, piling further depreciation pressure on the US dollar.

Potential implications for the Hong Kong economy

Under the Linked Exchange Rate System, the Hong Kong dollar moves in tandem with the US dollar against other currencies. For an open economy, the exchange rate movement can, in theory, affect its external price competitiveness and hence trading activities. To further examine the issue in the context of Hong Kong, the volume of Hong Kong's merchandise exports since 2002 is plotted alongside the US dollar index ***(Chart 3a)***. Historical trends of these two variables before 2009 appeared to be consistent with what economic theory suggests, with export volume expanding by around 85% alongside a dip of about 30% in the US Dollar Index during 2002-2008. Yet, such correlation seemed to disappear afterwards.

The aforementioned observation should be interpreted with caution, considering that there are a host of other factors at play. In particular, given that Hong Kong's goods exports are predominately re-exports (i.e. goods not produced in Hong Kong), external factors such as economic conditions of neighbouring economies and regional trade flows are arguably more relevant than exchange rate movement in determining the export performance of Hong Kong. For instance, the increase in Hong Kong's exports during 2002-2008 as noted above was mostly driven by the surge in exports to the Mainland following its accession to the World Trade Organization in December 2001. The pick-up in external demand amid vibrant global economic growth at 4.5% per annum during the period also contributed. In contrast, the deceleration in Hong Kong's export performance during 2014-2015 mainly reflected weak import demand in our trading partners amid the slow and uneven growth of the global economy.

Box 2.1 (Cont'd)

The movements of the US dollar also have a bearing on Hong Kong's import prices. In general, the weakening of the US dollar tends to result in higher import prices, translating into greater external price pressures for Hong Kong. As shown in ***Chart 3b***, overall prices of Hong Kong's merchandise imports rose by about 10% during 2002-2008 when the US dollar index trended downwards. The uptrend in inflation in many of Hong Kong's major import sources during the period also contributed. Nonetheless, the correlation between the US dollar exchange rate and overall import prices became less apparent thereafter. While the downtrend in the US dollar ended in 2009, import prices hiked further in next few years as international commodity and energy prices rebounded after the global financial crisis. In more recent years, import prices rose moderately alongside the slowdown in global economic growth and easing inflation pressures in many import sources, while the strengthening of the US dollar might also be relevant.

Chart 3a: Hong Kong's export volume appeared to be negatively correlated to the US dollar index in earlier years

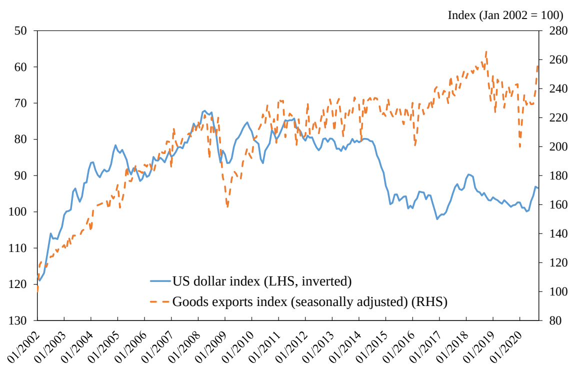
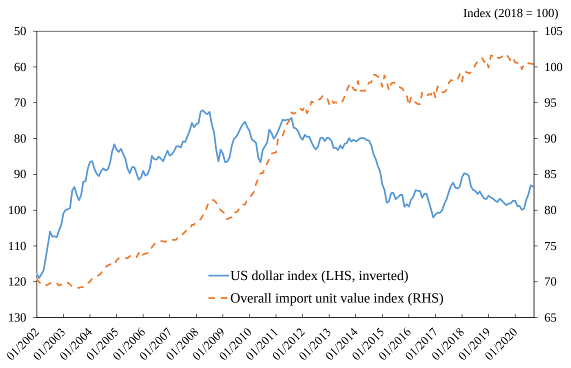


Chart 3b: The US dollar exchange rate is one of the determining factors of Hong Kong's import prices



Conclusion

The heightened volatility of the US dollar exchange rate this year was largely a result of the unprecedented shocks arising from the COVID-19 pandemic and the immense policy actions taken by the US authorities in consequence. As the threat of the pandemic will remain until effective vaccines are widely available, the movements of the US dollar may continue to be volatile in the near term. Nevertheless, the recent movements of the US dollar were actually not particularly large compared with the fluctuations seen in the past. Moreover, relative to exchange rate movements, other macroeconomic developments such as the pace and strength of the global economic recovery, China-US relations, and the risks of rising protectionism and unilateralism are more likely to have a bigger impact on Hong Kong's export performance going forward. The Government will monitor the developments closely.