The Impact of US Monetary Policy and Other External Shocks on the Hong Kong Economy: A Factor-augmented VAR Approach

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Summary

Hong Kong as an international financial center is subject to constant external influences. It's open capital markets and linked exchange rate system means that monetary policy changes by the Fed, ECB and BoJ as well as a Mainland economy slowdown will have significant impact on the Hong Kong economy. This paper uses a factor-augmented VAR (FAVAR) framework to study the combined impact on the Hong Kong economy of diverging monetary policies by the Fed, ECB and BoJ and a simultaneous slowdown in Mainland China's economic growth.

The empirical results show that changes in US monetary policy mainly affect interest rate-sensitive sectors of the Hong Kong economy; whilst real variables such as real GDP growth and the unemployment rate are more sensitive to an economic slowdown

in Mainland China. Monetary easing by the ECB and BoJ to some extent offsets the effect on Hong Kong of tightening by the US Fed. The transmission channels of external shocks are through both trade and capital markets. It is estimated that the combined effect of the four external shocks will on average lower Hong Kong's quarterly GDP growth by 0.6 percentage points and quarterly inflation by 0.2 percentage points in the first 4 quarters of the shock.

The combined impact of a normalization of US monetary policy and continued quantitative easing policies by the ECB and BoJ could be negative on the Hong Kong economy, and the negative impact could be significantly amplified if Mainland China growth slows down simultaneously. However, Hong Kong's financial stability, as reflected in loan quality, banks' capital and liquidity, is resilient to the combined effect of these external shocks, notwithstanding some temporary impact.