FOR PROFESSIONAL INVESTORS – 28 May 2019

Chi on China

THE HONG KONG DOLLAR PEG IS DIFFERENT – LONG LIVE THE PEG

Long run is a misleading guide to current affairs. In the long run we are all dead.

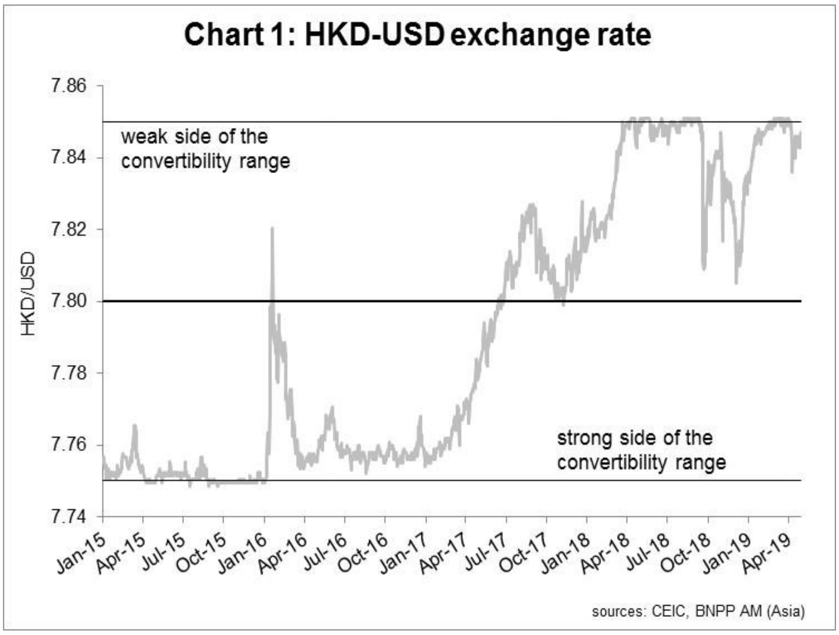
John Maynard Keynes

SUMMARY

- The fundamentals behind the HKD peg, including the internal and external balances, productivity growth and economic flexibility, argue that it would not break as easily as the other currency pegs did. But the speculators do not seem to learn.
- The political will to keep the HKD peg is still very strong after 36 years of existence. Any bets on Beijing abandoning the HKD peg due to Hong Kong's diminishing role in China is wrong, at least until the economic-political backdrop changes.
- The speculative attacks on the HKD peg, especially the recent rounds since late 2018, reveal some players' ignorance about the working of the peg's mechanism and Hong Kong's financial basics, such as its foreign reserves and monetary framework.

Speculators have been shorting the HKD since last year, pushing HKD-USD exchange rate to the weak side of the convertibility range (Chart 1). If you believe what the financial press reports, the short-selling has forced the Hong Kong Monetary Authority (HKMA) to burn reserves to defend the HKD peg. But we have seen this situation many times over the peg's 36-year life and it always ends the same way – the HKD peg stands tall and the speculators get burned.

The temptation to attack the HKD peg stems from this question: History shows that every currency peg ended up imploding, why should the HKD peg be different?



THEY JUST DON'T GET IT

Well, the HKD peg is indeed different and the punters do not seem to get it! Fundamentally, they fail to distinguish between the Linked Exchange Rate System (the official name for the HKD peg) that the HKMA runs, which is a currency board, and the fixed exchange rate system that some other central banks run.

A currency board links a currency (HKD here) to an anchor currency (USD in Hong Kong's case) by law which is written in the country's constitution[1]. A currency board does not conduct discretionary monetary policy to accommodate economic shocks, but central banks do. In other words, a currency board must give up monetary autonomy and follow the policy of the anchor-currency country. It sticks to its sole objective of sustaining the currency peg, thus steers clear of errors that result in forced devaluation. A normal fixed exchange rate system has none of these characteristics.

As a currency board, the HKD peg is much more robust in withstanding currency attacks than a normal fixed-exchange rate system. Since a currency board must hold anchor-currency reserves equal or exceed the value of domestic currency it issues (or the monetary base), it always has sufficient reserves to back its obligation to exchange local currency for the anchor currency (and vice versa) on demand at the official exchange rate.

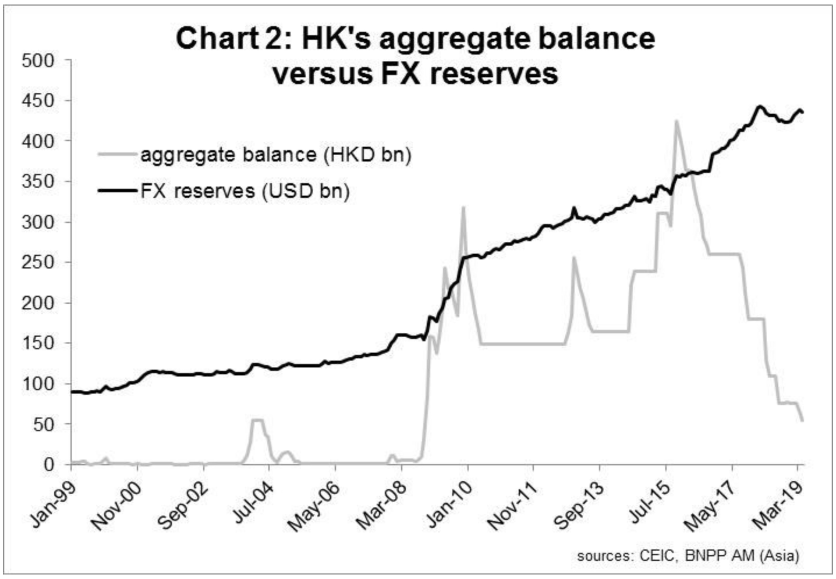
SPECULATORS' IGNORANCE

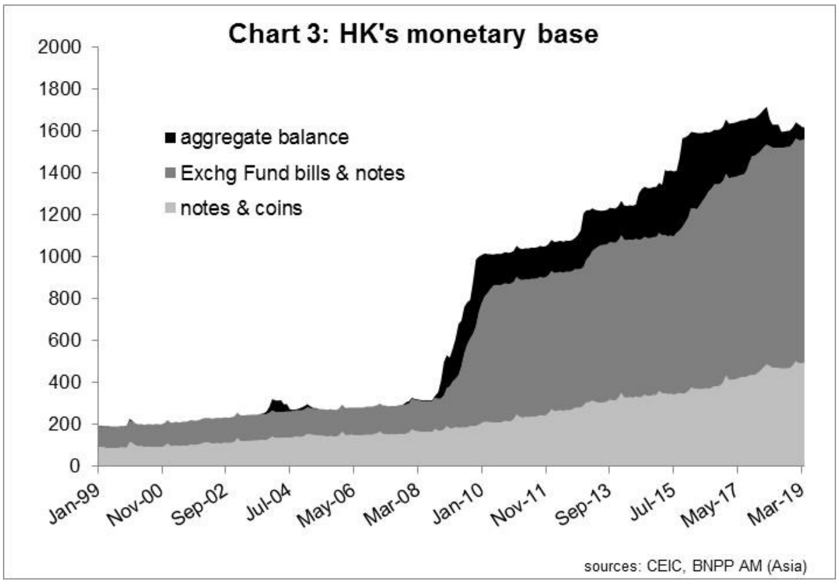
Thus the HKMA always has enough reserves to cover 100% of the HKD issued and to meet any demand for USD. It is required to buy USD at the strong side of the convertibility range (between HKD7.75 and 7.85 per USD) and sell USD at the weak side. These are autopilot transactions under the currency board rules.

So when the HKD weakens, the peg mechanism requires the HKMA to sell USD/buy HKD to keep the exchange rate constant. Contrary to popular belief, this is not an intervention to support the HKD. The HKMA does not trigger the transactions; it only reacts passively under its currency board mandate. This means that shorting the HKD against the USD is like shorting the USD against itself, as the HKD is just a clone of the USD. It will not work, and the punters have no clue about this.

[1] In HK, this is the Basic Law which is the min-constitution of the City.

Some major speculators have argued that Hong Kong was burning through its foreign reserves so quickly that it would run out of reserves soon and would have to abandon the peg. This is naive because they have confused the aggregate balance, which has been declining, with the foreign reserves, which have been rising[2] (Chart 2). The aggregate balance refers to the sum of all deposit balances by the banks at the HKMA for settling interbank payments and payments between banks and the HKMA. It is a measure of interbank liquidity and is only one part of HK's monetary base[3] (Chart 3).





Hong Kong banks have lagged the US in raising interest rates since the US Fed started raising rates in 2018. This has opened up an interest rate gap between the US and Hong Kong and created arbitrage opportunities, leading to capital outflow from Hong Kong and draining interbank liquidity. Hence, the aggregate balance has declined, not the foreign reserves.

[2] The reserves have grown from 50% of GDP in the 1998 (Asian crisis) to 70% in 2008 (US subprime crisis) to 117% today.
[3] HK's monetary base includes 1) note & coins, which are backed by certificates of indebtedness issued by the Financial Secretary under the Exchange Fund Ordinance and held by the note-issuing banks to cover the bank notes they issue, 2) aggregate balance and 3) Exchange Fund bills and notes.

With speculators piling into the HKD short positions, the capital outflow has pushed the HKD towards the weak side of the convertibility range, triggering the HKMA's autopilot mechanism of passively selling USD/buying HKD to keep the exchange rate constant. This has, in turn, tightened the local money market, forcing up HIBOR and closing the US-HK interest rate gap and restoring market equilibrium. This shows proper working of the currency board but not burning of reserves by the HKMA.

DOES HK HAVE ENOUGH FX RESERVES THOUGH?

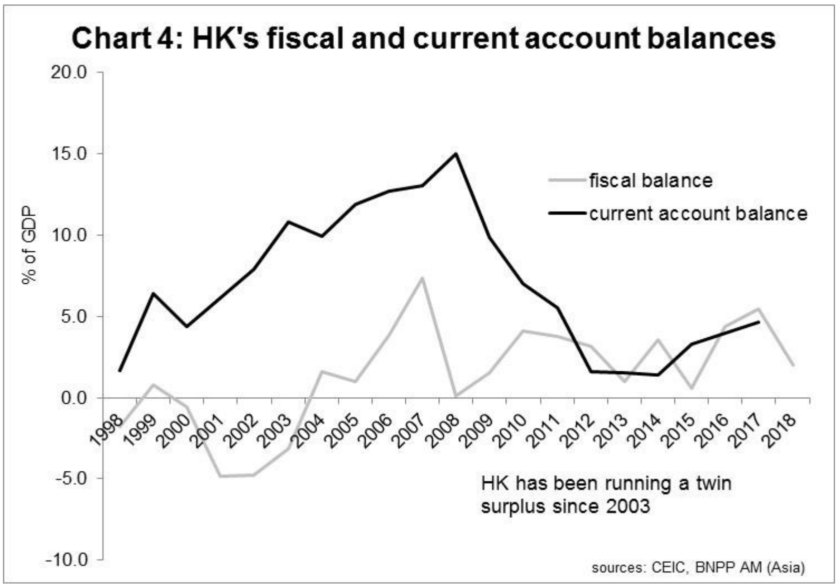
At the time of writing, Hong Kong's USD430 bn foreign reserves are more than twice its monetary base. This means that the HKMA could literally replace every HKD7.8 of base money in circulation with one USD two times over. In case of a full blown crisis, one could argue, Hong Kong's broad money supply, M3 say, could implode when depositors/investors decided to convert all their HKD deposits into USD. The resultant selling pressure would break the peg. But Hong Kong's buffer seems sufficient to cushion any potential blow to the banking system because its foreign reserves amount to 46% of M3.

Having 46% of broad money turned into USD would be unheard of. Experience shows that in the most severe banking crises, about 10-15% of total bank deposit might flee and trigger a bank run and a currency crisis. Hong Kong's foreign reserves are high enough to deal with a 10-15% deposit loss easily.

Of course, the robustness of the currency board system has to be backed by economic and political fundamentals. The HKD peg has shown marked differences from the other failed currency pegs, and here is also where the speculators get it wrong again.

WHERE IS THE TWIN DEFICIT?

A major economic fault line that breaks a currency peg is an underlying twin (fiscal + current account) deficit which convinces currency speculators that the country was living beyond its means by relying on too much foreign savings and was thus vulnerable to capital flight. A twin deficit also hurts market confidence by raising the likelihood of massive central bank monetisation to fund the deficit. On this measure, the HKD peg is backed by a twin surplus since 2003 (Chart 4). I wonder why the punters want to pick a fight with a currency backed by persistent capital inflows.



THE POLITICAL WILL

Even a currency board cannot survive without strong political support and strict adherence to the currency board rules. Argentina's currency board (1991-2001) failed in 2002 because its government violated all the currency board rules[4] while trying to maintain a fixed exchange rate. Massive devaluation was the choice of most Asian countries during the 1997-98 Asian crisis; but note that these countries only ran fixed exchange rate regimes but not currency boards.

Back then, the HKD peg was also under severe speculative attack. But it stood like an island in the storm because Hong Kong chose to keep the currency peg and let the economy adjust with a massive amount of pains, as manifested in a 70% drop in its property prices and a massive wage deflation (Chart 5) between 1997 and 2003. What was amazing was that not one single commercial bank failed during that period.

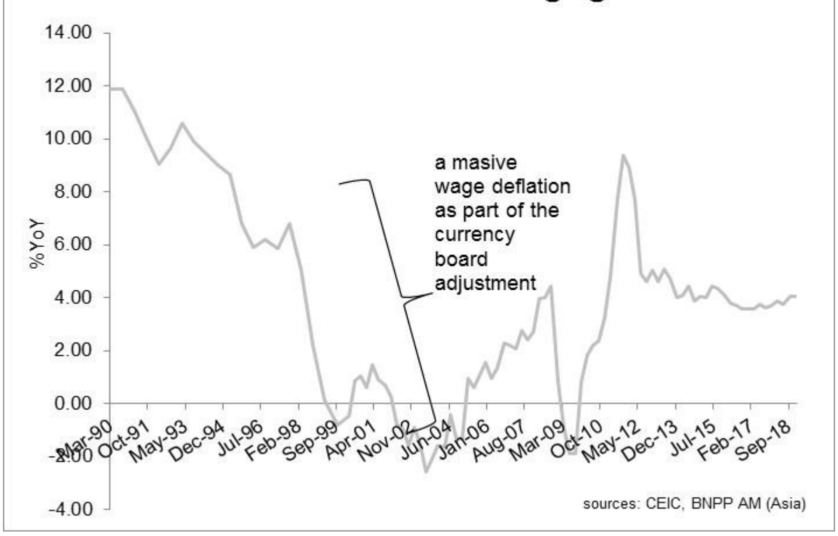


Chart 5: HK nominal wage growth

Few economies, and central banks, would be willing to take that sort of deflation. But the highly flexible Hong Kong economy took the painful adjustment in its stride. Rather than a sign of weakness as seen by the speculators, this painful adjustment shows 1) a strong political will by Hong Kong to keep the peg and 2) a highly

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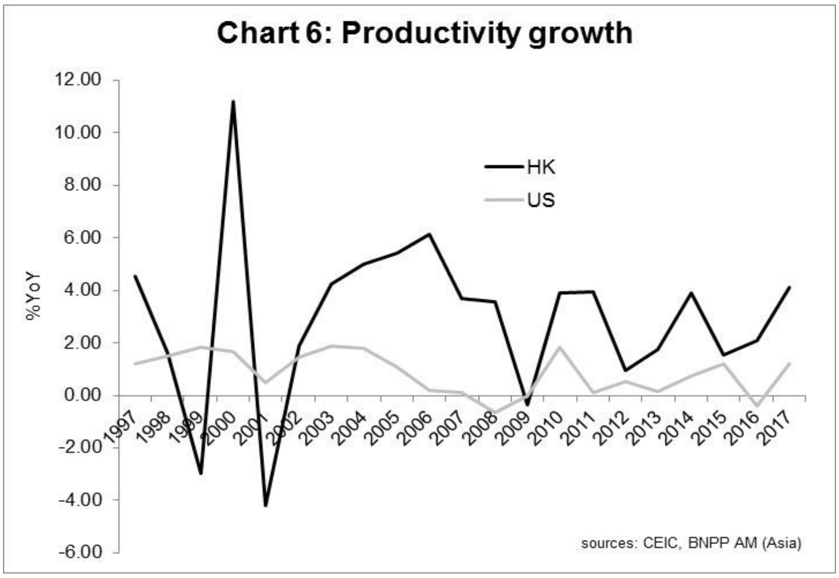
[4] The main qualities of an orthodox currency board are:

- A currency board maintains absolute, unlimited convertibility between its notes and coins and the currency against which they are pegged, at a fixed rate of exchange, with no restrictions on current-account or capital-account transactions.
- A currency board's foreign reserves must be enough to ensure that all holders of its notes and coins can convert them into the reserve currency (usually 110–115%).
- A currency board only earns profit from interest on reserves (less the expense of note-issuing), and does not engage in forward-exchange transactions.
- A currency board has no discretionary powers to affect monetary policy and does not lend to the government. The government cannot print money, and can only tax or borrow to meet its spending commitments.
- A currency board does not act as a lender of last resort to commercial banks, and does not regulate reserve requirements.
- A currency board does not attempt to manipulate interest rates by establishing a discount rate like a central bank. The peg with the foreign currency tends to keep interest rates and inflation very closely aligned to those in the currency-anchor country.

flexible Hong Kong economy allowing the currency board mechanism to work properly – when the nominal exchange value is fixed, domestic economic and financial variables adjust to absorb the economic shocks.

Hong Kong came out of the Asian crisis with faster productivity growth than the US (Chart 6). With the US running an unsustainable twin deficit while Hong Kong running a persistent surplus, and with US productivity consistently lagging that of Hong Kong's, it is doubtful if de-pegging the HKD would result in a massive devaluation as the punters have hoped.



Even today, the HKD peg is still getting strong political backing, which differentiates it from the other currency pegs that failed due to wavering political support. Firstly, Beijing is keen on keeping the HKD peg at least until the renminbi become a global currency in the future. The increase in volatility in the renminbi exchange rate has already given Beijing enough FX management challenges as the Impossible Trinity approaches[5]. Why would it ask for more by abandoning the HKD peg?

Secondly, the peg has been a stability anchor for Hong Kong, which aligns with Beijing's interest to keep Hong Kong stable. Hong Kong's real importance to China always lies in its role as a credible financial and legal centre, which China cannot easily build from scratch despite its rapid growth in the past four decades. Remember some 20 years ago, the market thought Shanghai would take over Hong Kong as a major financial centre. But today, Hong Kong remains Asia's number one financial centre and number three in the world after New York City and London and ahead of Singapore and Shanghai[6].

Thirdly, the majority of the Hong Kong's local interests, to whom the local government is also answerable, do not want to see the peg go. All businesses benefit from zero exchange rate risk under the HKD peg, which allows them to match HKD liabilities with USD revenues.

[5] The advent of the Impossible Trinity has been forcing Beijing to choose between controlling the interest rate and the exchange rate, but not both (as it would like), when it is opening the capital account.
[6] According to the Global Financial Centres Index as of March 2019.

LONG LIVE THE PEG

Hong Kong's small open economy is affected by many international forces, so it has a high growth-volatility tendency. Monetary autonomy can do little to counter the external shocks. Thus, anchoring its exchange rate to the currency of a large, flexible and relatively creditable economy remains practical for preserving confidence and reducing foreign exchange risk.

As I have argued for years, the endgame for the HKD is already in sight – it will vanish when the renminbi become a global currency. But that will take many years to get there. My earlier research[7] has shown that there are no better alternatives to the current monetary regime for Hong Kong – the HKD peg is still the best option for keeping systemic stability.

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[7] See "*Hong Kong in the Currency Wars (The Fate of the HK Dollar Peg)",* 22 January 2013.

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