



FOR PROFESSIONAL INVESTORS – 5 August 2022

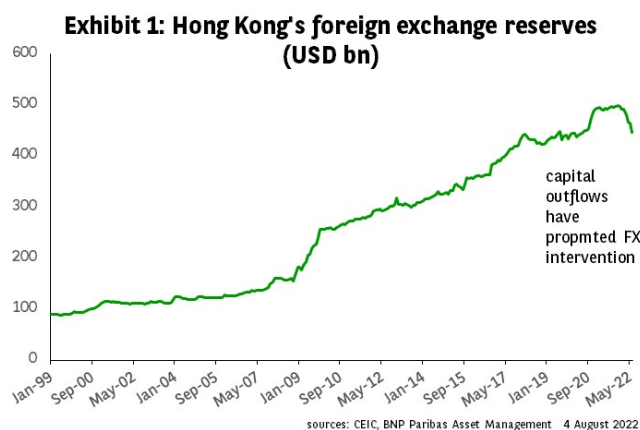
Chi Time

Questions about the Hong Kong Dollar peg, answered

If you can't explain it simply, you don't understand it well enough.

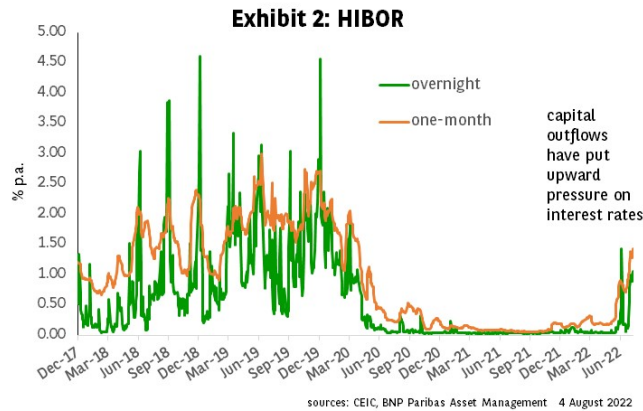
Albert Einstein

The Hong Kong-US dollar exchange rate has remained on the weak side of the Convertibility Undertaking of 7.85 since May this year, triggering the HKMA's automatic intervention to uphold the Hong Kong dollar's peg against the US dollar under the Linked Exchange Rate System (LERS). FX reserves in Hong Kong have fallen as a result (Exhibit 1). Interest rates in Hong Kong have also started to rise recently (Exhibit 2).



BNP PARIBAS
ASSET MANAGEMENT

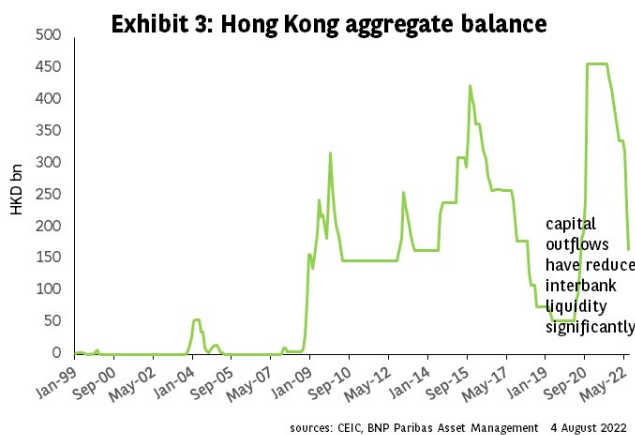
The sustainable
investor for a
changing world



We have long argued that the Hong Kong dollar peg will remain in the medium-term and the HKMA has more than sufficient resources to sustain it, and clarified the situation again recently in May.¹ Yet, doubts and confusion about the peg have continued to emerge as capital outflows continue.

Aggregate balance is not FX reserves

Some players have confused Hong Kong's aggregate balance, which fell from over HKD400 bn last year to only HKD165 bn in July (Exhibit 3), with Hong Kong's FX reserves and fret that the Hong Kong dollar peg would break as "FX reserves" are falling to zero soon.



This is wrong. Hong Kong's aggregate balance is the pool of interbank liquidity. It is not FX reserves. Some hedge funds short-sold the Hong Kong dollar in 2018 on the wrong belief that Hong Kong's FX reserves were depleting towards zero when they in fact were looking at the aggregate balance. They suffered big losses in the end as the Hong Kong dollar peg stood through their speculative attack.

Hong Kong's FX reserves are still huge, at USD447.3 bn in June 2022. This was two times of Hong Kong's monetary base, M0. This size is in sharp contrast to the aggregate balance of USD21 bn (or HKD165 bn).

Where are the FX reserves?

One cannot find FX data by ploughing through the Exchange Fund's balance sheet. This is because the Exchange Fund is a subset of the FX reserves. In a central bank's accounts (incl. the HKMA's), FX reserves are recorded in the capital account of the balance of payments, but not on the central bank's balance sheet.

Hong Kong's FX reserves include assets from the Exchange Fund and the Land Fund. The former is managed in two main portfolios – the Backing Portfolio and the Investment Portfolio, and two smaller portfolios – the Long-term Growth Portfolio and the Strategic Portfolio.

The Backing Portfolio consists of stable, high quality, US dollar assets to ensure the monetary base (M0) is fully backed at the exchange rate of USD1 to HKD7.8. The minimum Backing-Portfolio AUM to M0 ratio is 105%, below which the government will inject assets into the portfolio to ensure the minimum ratio is observed. If the backing ratio is 112.5% or higher, the government will transfer assets out of the portfolio to keep the cap of the ratio.

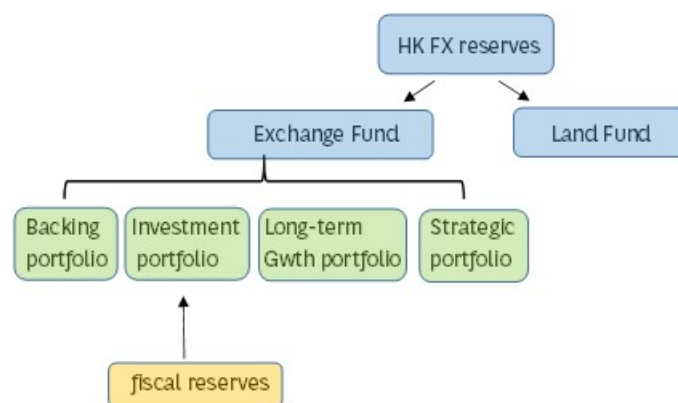
The Investment Portfolio simply invests in global secondary markets according to the investment guidelines set out by the government.

The HKMA has also created two other portfolios under the Exchange Fund, namely the Long-term Growth Portfolio (investing in private equity and property since 2009) and the Strategic Portfolio (investing in the Hong Kong Stock Exchange since 2007).

The Land Fund was created back in 1985 by the Sino-British Joint Declaration to receive revenues from government land sales.

Meanwhile, the HKMA also manages the Hong Kong government's fiscal reserves in the investment portfolio under the Exchange Fund. But they are two separate and distinct entities on government records. The following flow chart shows the structure of Hong Kong's FX reserves, which are invested in various portfolios and include the fiscal reserves and land sale revenues.

Structure of HK's FX reserves holding



sources : HKMA, BNP Paribas Asset Management

Aggregate balance and the HKD peg

The aggregate balance is related to the Hong Kong dollar peg through the interest rate channel. When Hong Kong has a large aggregate balance, the banking system is flooded with liquidity. This allows the Hong Kong banks to not follow the US rate rises (though the HKMA has to follow the Fed's rate move in lock step under the LERS arrangement). The interest rate differential between US dollar and Hong Kong dollar (i.e. LIBOR vs HIBOR) opens up an arbitrage opportunity for selling Hong Kong dollar and buying US dollar for a positive carry.

This selling, in turn, puts downward pressure on the Hong Kong dollar exchange rate, triggering the HKMA's automatic mechanism to buy Hong Kong dollar to keep the exchange rate within the Convertibility Undertaking range of 7.75 – 7.85.

As more and more Hong Kong dollar flows out of Hong Kong, the aggregate balance falls; as it is happening now. With less and less interbank liquidity, Hong Kong banks have to raise interest rates (thus, following the US rate trend) when they bid for liquidity in a smaller pool. So Hong Kong rates start to go; as they are now happening.

Higher Hong Kong interest rates will halt capital outflows, or even attract inflows, thus stopping or reversing the downward pressure on the Hong Kong dollar. This is the automatic adjustment mechanism under LERS. The HKMA only acts passively as required by the capital flow pressures.

The implication is that with Hong Kong interest rates rising as the aggregate balance is falling, Hong Kong's asset markets will face tough interest rate headwinds in the coming months.

Fundamentals still robust

Despite the capital outflows, the economic fundamentals are still very strong for sustaining the Hong Kong dollar peg. According to the IMF guidelines for FX reserve adequacy, a country's FX reserves should be

- at least enough to cover three months of imports
- 20% of broad money supply
- 100% of short-term external debt

As of June 2022, Hong Kong FX reserves were enough to cover almost 9 months of imports, 45% of broad money supply, M2, and 155% of short-term foreign debt.

Yes, the aggregate balance is falling. This only means that interbank liquidity is tightening. The Hong Kong dollar peg will not break because of this. However, Hong Kong interest rates will continue to rise, putting pressures on the Hong Kong asset markets until the local interest rates have risen high enough to stop, or even reverse, capital outflows.

Chi Lo BNP Paribas Asset Management

References

¹ For earlier reports, see *Chi on China: The Hong Kong Dollar Peg is Different – Long Live the Peg*, 28 May 2019, and *Chi Time: The Ultimate Question of the Hong Kong Dollar Peg*, 23 August 2019.

For the most report, see *Chi Time: A Fireside Chat about the Hong Kong Dollar – It Hits 7.85, again*, 13 May 2022.

DISCLAIMER

BNP Paribas Asset Management France, “the investment management company,” is a simplified joint stock company with its registered office at 1 boulevard Haussmann 75009 Paris, France, RCS Paris 319 378 832, registered with the “Autorité des marchés financiers” under number GP 96002.

This material is issued and has been prepared by the investment management company.

This material is produced for information purposes only and does not constitute:

1. an offer to buy nor a solicitation to sell, nor shall it form the basis of or be relied upon in connection with any contract or commitment whatsoever or
2. investment advice.

This material makes reference to certain financial instruments authorised and regulated in their jurisdiction(s) of incorporation.

No action has been taken which would permit the public offering of the financial instrument(s) in any other jurisdiction, except as indicated in the most recent prospectus and the Key Investor Information Document (KIID) of the relevant financial instrument(s) where such action would be required, in particular, in the United States, to US persons (as such term is defined in Regulation S of the United States Securities Act of 1933). Prior to any subscription in a country in which such financial instrument(s) is/are registered, investors should verify any legal constraints or restrictions there may be in connection with the subscription, purchase, possession or sale of the financial instrument(s).

Investors considering subscribing to the financial instrument(s) should read carefully the most recent prospectus and Key Investor Information Document (KIID) and consult the financial instrument(s)' most recent financial reports. These documents are available on the website.

Opinions included in this material constitute the judgement of the investment management company at the time specified and may be subject to change without notice. The investment management company is not obliged to update or alter the information or opinions contained within this material. Investors should consult their own legal and tax advisors in respect of legal, accounting, domicile and tax advice prior to investing in the financial instrument(s) in order to make an independent determination of the suitability and consequences of an investment therein, if permitted. Please note that different types of investments, if contained within this material, involve varying degrees of risk and there can be no assurance that any specific investment may either be suitable, appropriate or profitable for an investor's investment portfolio.

Given the economic and market risks, there can be no assurance that the financial instrument(s) will achieve its/their investment objectives. Returns may be affected by, amongst other things, investment strategies or objectives of the financial instrument(s) and material market and economic conditions, including interest rates, market terms and general market conditions. The different strategies applied to financial instruments may have a significant effect on the results presented in this material. Past performance is not a guide to future performance and the value of the investments in financial instrument(s) may go down as well as up. Investors may not get back the amount they originally invested.

The performance data, as applicable, reflected in this material, do not take into account the commissions, costs incurred on the issue and redemption and taxes.

All information referred to in the present document is available on www.bnpparibas-am.com

