FOR PROFESSIONAL INVESTORS – 5 August 2022

Chi Time

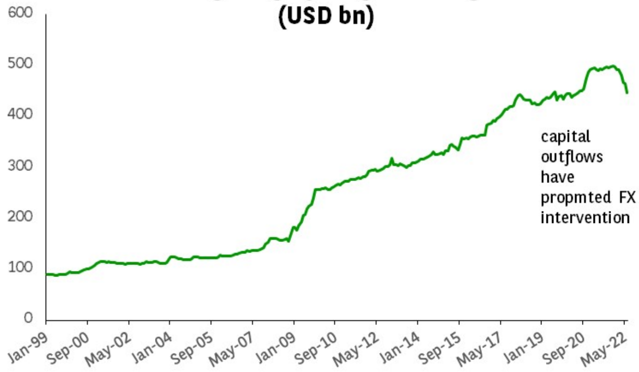
Questions about the Hong Kong Dollar peg, answered

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

Albert Einstein

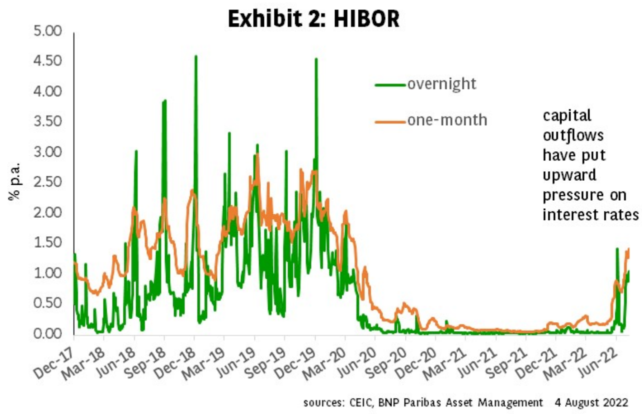
The Hong Kong-US dollar exchange rate has remained on the weak side of the Convertibility Undertaking of 7.85 since May this year, triggering the HKMA's automatic intervention to uphold the Hong Kong dollar's peg against the US dollar under the Linked Exchange Rate System (LERS). FX reserves in Hong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

Exhibit 1: Hong Kong's foreign exchange reserves (USD bn)



sources: CEIC, BNP Paribas Asset Management 4 August 2022

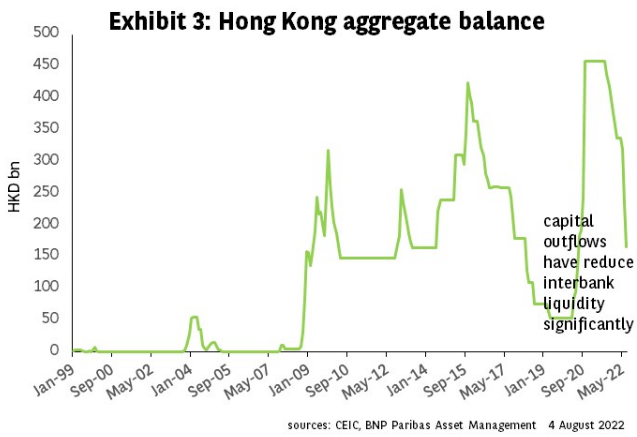
The sustainable investor for a changing world



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.

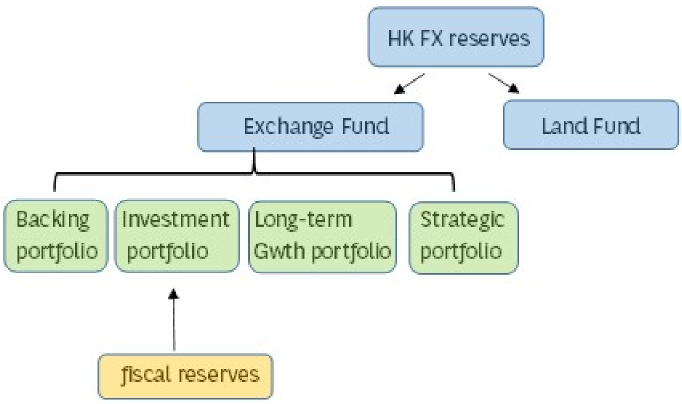
The Investment Portfolio simply invests in global secondary markets according to the investment guidelines set out by the government.

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