FOR PROFESSIONAL INVESTORS – 13 May 2022

Chi Time

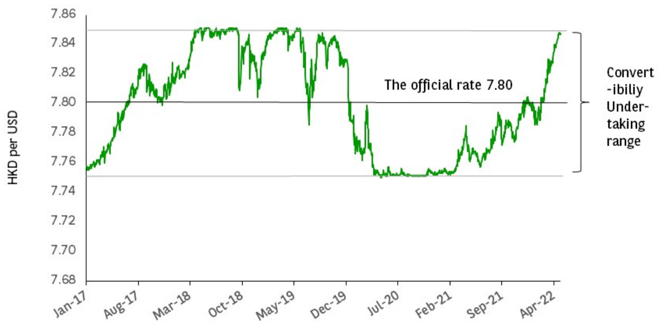
A fireside chat about the Hong Kong dollar – It hits 7.85, again

Notice that the stiffest tree is most easily cracked, while the bamboo or willow survives by bending with the wind.

Bruce Lee

Q: USD-HKD has hit the weak side of the Convertibility Undertaking[1] threshold again (Exhibit 1). What is driving its weakness this time?

Exhibit 1: USD-HKD exchange rate



sources: CEIC, BNP PAribas Asset Management 12 May 2022

At first, it was net portfolio outflows in most of 2021, before the US Fed started considering policy tightening, due to a decline in southbound flows (China buying Hong Kong stocks) from the mainland via the stock connect channels and an increase in northbound flows (Hong Kong buying Chinese onshore stocks) (Exhibit 2).

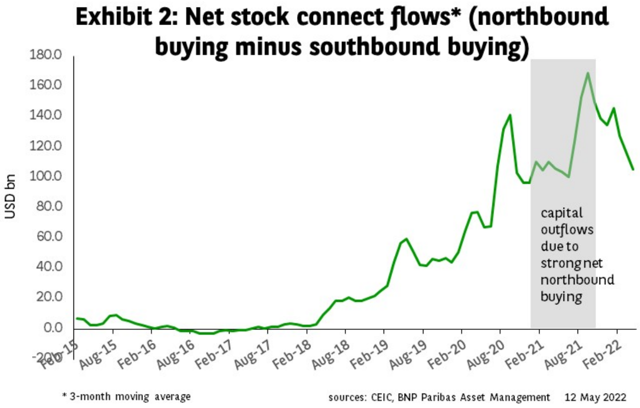


Exhibit 2: Net stock connect flows* (northbound buying minus southbound buying)

This factor has given way to FX carry as the key driver for HKD weakness since late 2021, as market expectations on aggressive US Fed rate hikes have pushed USD interest rates higher while HKD interest rates have lagged behind (Exhibit 3). The widening of USD-HKD rate spread has prompted many market players to borrow low-interest-rate HKD and switch into high-interest-rate USD – a typical FX carry trade as predicted by the Interest Rate Parity theorem under open capital account and cross-border asset substitutability conditions.

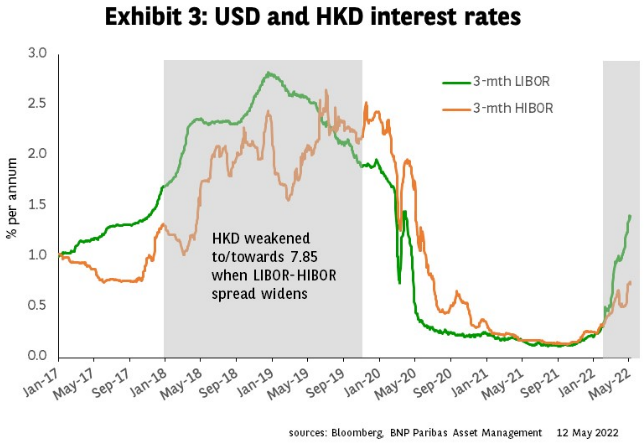
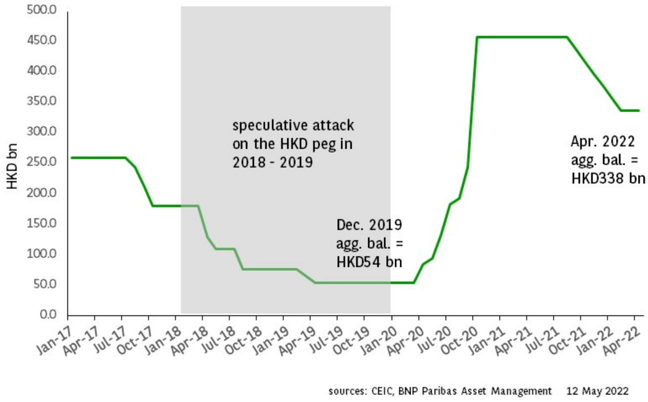


Exhibit 3: USD and HKD interest rates

Q: Why do HKD rates lag behind USD rates?

This is because of ample liquidity in the Hong Kong system, as reflected by the huge, 5-year high, aggregate balance (Exhibit 4) that amounted to HKD338 bn (USD43.3 bn) as of 30 April 2022. It was more than six times larger than the aggregate balance at the end of 2019 when the HKD peg was under speculative attack.

Exhibit 4: Aggregate balance in the Hong Kong banking system



The HKD peg (or Linked Exchange-Rate System, LERS, as it is officially known) requires the Hong Kong Monetary Authority (HKMA) to follow interest rate moves by the US Fed in lock steps. But Hong Kong banks do not have to follow the US rate trend in lock steps if there is a large liquidity cushion in the Hong Kong system.

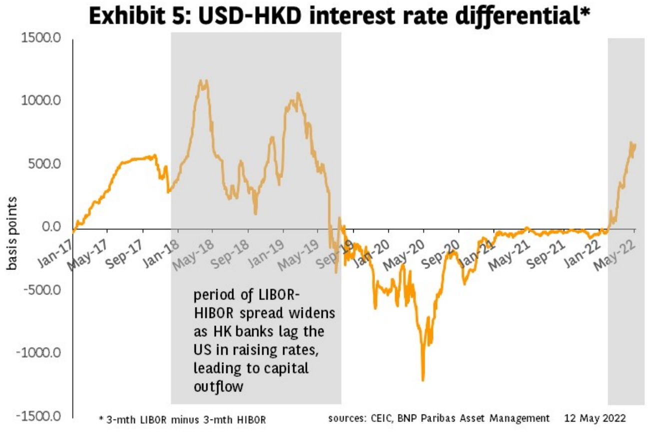
Q: How long can HK banks resist following the US rising rate/yield trend?

It depends on the amount of liquidity in the system. Hong Kong banks will continue to resist raising rates for as long as the aggregate balance is large. However, capital outflow from HKD to USD assets will continue, draining the aggregate balance until it falls to a level low/tight enough to force Hong Kong banks to raise rates.

Q: When will Hong Kong banks start raising interest rates?

In 2018-19, when the LIBOR-HIBOR spread was rising, Hong Kong banks also lagged the US in raising rates (Exhibit 5), leading to capital outflow, inviting speculative attack on the HKD and pushing down the aggregate balance to HKD54 bn at the end of 2019 (see Exhibit 4). Then Hong Kong banks started raising rates, narrowing the USD-HKD interest rate differential.

Exhibit 5: USD-HKD interest rate differential*



If the 2018-19 episode is any guide and assuming the current macroeconomic trends continue, it could take a few more months for Hong Kong's liquidity to tighten to the level, such as HKD54 bn, that would force banks here to raise interest rates. This means that Hong Kong's asset markets, especially property, while not suffering any liquidity squeeze now, may face tightening liquidity by late summer/early autumn, *ceteris paribus*.

Q: Is the HKMA's FX intervention to defend the HKD peg sustainable?
Absolutely. Hong Kong's USD482 bn FX reserves (as of March 2022) are the sixth largest in the world. They are almost 200% of Hong Kong's monetary base, implying that if people want to exchange all their HKD into USD, the HKMA has reserves almost double the amount it needs to honour the demand for USD at the exchange rate of 7.8.

Crucially, during a currency crisis, a country typically suffers from significant capital outflow amounting to about 12% of broad money supply, M2. Hong Kong's FX reserves are 23% of M2, providing it with a significant buffer against any currency crisis.

The HKD peg has survived many rounds of capital outflow and speculative attacks since its inception on 17 October 1983. It still stands like an island in the storm and that speaks volume about the robustness of the LERS.

Q: How long will the downward pressure on the HKD persist?
The LERS is an automatic mechanism to correct the weakness (or strength) of the HKD. When the HKD falls to the weak side of the Convertibility range, the HKMA buys HKD from the market at 7.85 as required by the LERS mechanism, leading to a contraction in the aggregate balance.[2]

The resultant tightening up in HKD liquidity pushes up HIBOR, narrowing the gap with USD interest rates, reducing capital outflows and stabilising the HKD exchange rate just as what the currency board rule is supposed to do. Hence, during speculative attacks or periods of significant capital outflow, HIBOR typically rises significantly. For example, during the Asian Financial Crisis, 3-month HIBOR shot up to 15.7% in August 1998, more than 1,000 bps above USD LIBOR.

Q: Why does Hong Kong not peg its dollar to the RMB?
Despite the significant economic and financial market integration with mainland China, it is not yet the time to peg the fully convertible HKD to the RMB that is inconvertible on the capital account. Until China liberalises its capital account significantly, it makes sense for Hong Kong to keep the currency pegged to the USD by anchoring Hong Kong's monetary policy on a global hard currency run by a historically credible and transparent US Fed.

The ability of the HKD-USD peg to wade through various global economic and financial shocks with manageable negative local market consequences highlights the credibility of the LERS. High interest rate and economic volatility is a manageable price to pay for anchoring international confidence and eliminating FX risk in Hong Kong's small open economy on which domestic macroeconomic policies do not have effective influence.[3]

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Footnotes and references

[1] This is an undertaking by a central bank or currency board to convert domestic currency into foreign currency and vice versa at a fixed exchange rate. In Hong Kong, the HKMA operates Convertibility Undertakings on both the strong side and the weak side of the official exchange rate of HKD7.80 per USD. When the HKD rises to the strong-side, the HKMA undertakes to buy USD from the market at HKD7.75 per USD. When the HKD falls to the weak-side, the HKMA undertakes to sell USD at 7.85. The USD-HKD exchange rate is allowed to move within the Convertibility Zone between 7.75 and 7.85 without triggering any HKMA intervention.

[2] The aggregate balance is also part of Hong Kong's base money. Other components are notes and coins in the system, certificate of indebtedness and Exchange Fund Bills and Notes.

[3] I have argued over the years that a hard currency, the HKD, cannot be pegged against a soft currency, the RMB, and that there are strong economic and political factors for not scrapping the HKD-USD peg in before the RMB becomes a more international currency with more capital account convertibility.
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. These reports are available upon request.

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