ECONOMIC ANALYSIS

Hong Kong | Will the city economy abandon its decades-old peg to the USD?

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Summary

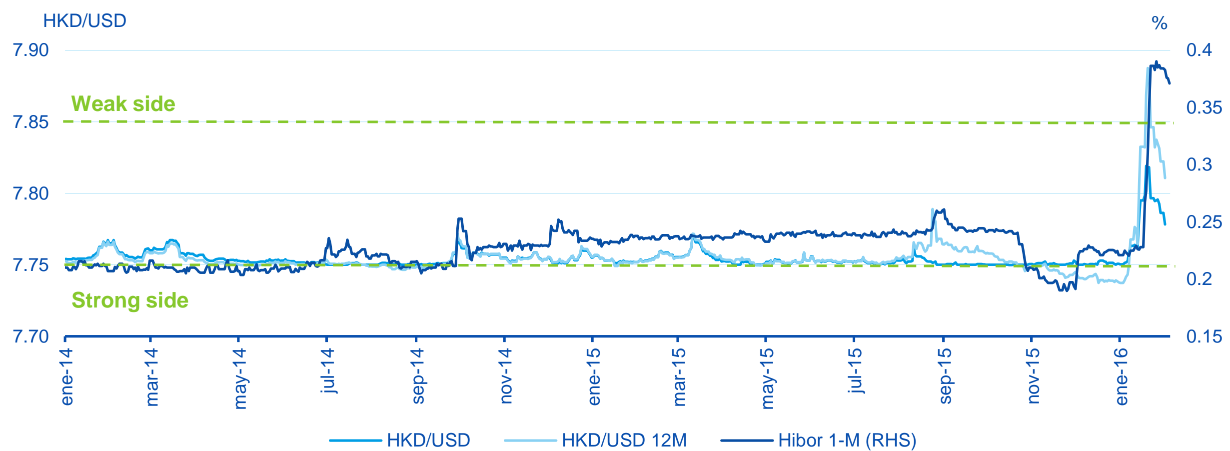
- A number of hedge funds have shifted their attention to Hong Kong Dollar (HKD), speculating on the possibility of the currency abandoning its decades-old peg to the USD. It has led the HKD to soften against the USD and raised the interbank interest rate.
- However, we believe that HKD de-pegging is an unlikely scenario for a number of reasons: (1) The FX regime in Hong Kong is different from that in the mainland; (2) The HKMA has plenty of ammunition to defend the linked exchange rate system looking forward; and 3) The political will to defend the exchange rate remains strong.
- A currency board system is under good management in Hong Kong. In other words, the HKMA does not hold FX assets for reasons other than to safeguard the stability of its exchange rate, leaving the entirety of its FX reserves available to defend the currency against a potential speculative attack.
- Reforms like pegging the HKD to the RMB or a basket of currencies appear unrealistic when the pressure on the HKD has been piling up. A wavering policy stance in this respect could make things worse and expedite a systemic debacle of Hong Kong's gigantic financial sector. Any change in the exchange rate regime is also difficult from a political perspective.
- The authorities' commitment to the currency peg could add to growth headwinds. Financial asset prices, both equity and housing prices, are subject to deeper downward pressure. We have therefore revised our GDP forecasts for Hong Kong from 2.5% to 2.3% for 2016, and from 2.6% to 2.5% in 2017 while highlight downside risks if speculative attacks on the HKD last longer than expected and trigger more capital outflows.

Depreciation reignites speculations over Hong Kong's exchange rate regime

To short, or not to short? As hedge funds' heavy bet on steeper depreciation of the RMB met with unyielding defence from China's central bank, some of them have cast their sight onto Hong Kong Dollar, speculating on the possibility of the currency abandoning its decades-old peg to the USD. Indeed, since Hong Kong's sovereign handover to China, the city economy has successfully tied itself to the fast-rising Asian giant. In particular, Hong Kong has successfully developed the largest and most important offshore market for the RMB over the past few years, which, together with its close ties to China's already decelerated economy, have made the HKD a prey for hedge funds with bearish outlook for China.

Shorting the HKD may seem like a prima facie good bet. After all, the HKD depreciated from the strong end of its narrow permissible band (7.75 HKD/USD) to 7.82 HKD/USD last week, its lowest level since 2011 and not far from the weak end of 7.85 HKD/USD. Furthermore, interbank interest rates spiked as a result of a tighter monetary base, as the HKMA used FX reserves to purchase HKD (Figure 1). Factor in mounting depreciatory pressures on the RMB as well as a weakening outlook for 2016 and voilà; speculators are piling up stakes on the possibility that the Hong Kong Monetary Authority (HKMA) will be forced to abandon its decades-old peg to the USD.

Figure 1
HKD depreciation causes hike in interbank rates, hinting towards higher selling pressure, as the 1Y forward hints towards a breakage of the peg to the USD in a year's time



Source: Bloomberg and BBVA Research

The speculators' behaviors have prompted the authorities to anchor people's expectations. Hong Kong Monetary Authority's (HKMA) chief executive Norman Chan came out this week to lay emphasis on the fact that "if speculators want to short the HKD to try to push up interest rates and benefit from a falling stock market, they will need to use hundreds of billions of dollars". Chinese state media also warned international speculators that "a challenge against the RMB and HKD is unlikely to succeed" in an Op-Ed.

Whether tis nobler in the mind to suffer the slings and arrows of outrageous fortune, or to take arms against a sea of dollar-denominated reserves? We believe that it is an unlikely scenario for a number of reasons: (1) The FX regime in Hong Kong is different from that in the mainland; (2) The HKMA has plenty of ammunition to defend the linked exchange rate system looking forward; and 3) The political will to defend the exchange rate remains strong.

Having said that, the grass isn't always greener on the other side and so we do recognize some downside risks to maintaining a linked exchange rate regime. These stem primarily from the asymmetries created by diverging monetary policies and business cycles between the US and China. For these reasons we have revised our GDP forecasts for Hong Kong from 2.5% to 2.3% for 2016, and from 2.6% to 2.5% in 2017.

What is Hong Kong's linked exchange rate regime?

Extrapolating existing depreciatory pressures on the RMB onto the HKD would be inaccurate, as both regions deploy fundamentally different exchange rate regimes. To understand this, we need to revisit the "impossible trinity", an axiom in international economics which states that it is unmanageable for an economy to simultaneously pursue: (1) a fixed exchange rate; (2) free capital flows; and (3) an independent monetary policy.

China has a fixed exchange rate and an independent monetary policy. In exchange, it's had to sacrifice free capital flows by implementing capital controls. In fact, much of the recent volatility could be attributed to China's ambition to shift away from a fixed exchange rate with its porous capital account. Speculators could be exploiting this transition, the implicit assumption being that China will at some point find it unmanageable to simultaneously push for further capital account liberalization while simultaneously limiting FX volatility.

On the other hand, Hong Kong has a fixed exchange rate and free capital controls, but no independent monetary policy, relying instead on the interest rates determined by the Federal Reserve of the United States (US Fed). Hong Kong's linked exchange rate regime is also technically known as a "currency board". Generally speaking, orthodox currency boards abide by three common principles (for a more detailed description, refer to Table 1):

1. Any change in the monetary base should be matched by an equivalent change in foreign currency reserves:

The first principle is enshrined in Hong Kong's mini-constitution, the Basic Law. According to Article 111, the "Hong Kong currency must be 100% backed by a reserve fund". In other words, FX reserves must be enough to cover 100% or more of total monetary liabilities, which in Hong Kong are comprised by certificates of indebtedness[1], government-issued currency in circulation and the balance of the clearing accounts of banks kept with the HKMA (the Aggregate Balance). In practice however, the HKMA has accumulated FX Reserves exceeding 100% of the monetary base (Figure 2).

The reason for this is that years of ultra-low interest rates in the US have driven up the demand for HKD, bolstering the monetary base up by over 200% since the outburst of the global financial crisis in 2008. Consequently, the HKD has traded consistently towards the strong end of the convertibility undertaking. As growing demand for HKD prompts the Exchange Fund to buy US dollars from licensed banks at 7.75, FX reserves grow. In fact, FX reserves have been growing by an average rate of 12% q/q since 2008 and currently stand at a record USD 359 Bn. This is USD 150 Bn in excess of the monetary base, which leaves the region in a very good position to withstand speculative attacks on the HKD.

2. The currency should be fully convertible on demand into a foreign anchor currency at a fixed rate:

The second principle on full convertibility of the currency also applies in Hong Kong. The HKMA issues notes and coins convertible on demand into USD at a fixed rate of 7.80 HKD/USD. There is no limit to how much currency can be exchanged at that rate – no current account or convertibility restrictions – as specified by Article 112 of the Basic Law: "No foreign exchange control policies shall be applied in the Hong Kong Special Administrative Region (…) the Government of the Hong Kong Special Administrative Region shall safeguard the free flow of capital within, into and out of the Region".

The Basic Law does not dictate that the HKD's de-facto foreign anchor currency is the USD, neither does it specify a level at which the HKD should be pegged against a foreign anchor currency. This "loophole" continues to serve as the basis for speculations that breakage could occur. However, the RMB has started to depreciate versus the USD, and Hong Kong is experiencing capital outflows. Re-pegging the value of the HKD to a weakening currency could be disastrous, as it would trigger large-scale capital outflows. While the HKMA has enough FX reserves to cover 100% of its monetary base, FX reserves are not enough to cover M3, a broader measure of liquidity (Figure 2). Politically, this would never fly; at least not at this point in time.

1: Certificates of Indebtedness are issued by the Exchange Fund and are used to back banknotes issued by HSBC, Standard Chartered and Bank of China.

Table 1
A typical currency board versus a typical central bank

Currency board	Central bank
Usually supplies notes and coins only	Supplies notes, coins, and deposits
Fixed exchange rate with reserve currency	Pegged or floating exchange rate
Foreign reserves ≥ 100% of monetary base	Variable foreign reserves
Full convertibility	Limited convertibility
Rule-bound monetary policy	Discretionary monetary policy
Not a lender of last resort	Lender of last resort
Does not regulate commercial banks	Often regulates commercial banks
Transparent	Opaque
Protected from political pressure	Politicized
High credibility	Low credibility
Earns seigniorage only from interest	Earns seigniorage from interest and inflation
Cannot create inflation	Can create inflation
Cannot finance spending by domestic government	Can finance spending by domestic government
Requires no "preconditions" for monetary reform	Requires "preconditions" for monetary reform
Rapid monetary reform	Slow monetary reform
Small staff	Large staff

Source: Hanke and Schuler, 2015

3. Monetary policy should be rule-bound and automatic:

Finally, for monetary policy to be rule bound and automatic, the currency board must have no discretionary monetary powers or engage in the fiduciary issue of money. The sole function of the HKMA should therefore be to exchange HKD for USD at a fixed rate of 7.80 HKD/USD, leaving the quantity of domestic currency in circulation to be determined solely by market forces, namely the demand for HKD. Of course, in practice what happens is that the HKD is allowed to fluctuate within a “convertibility undertaking”, a narrow band currently fixed at 7.75-7.85 HKD/USD, before the HKMA undertakes open-market operations to stabilize the exchange rate[2]. The third principle holds in practice, but how to prove that FX reserves are not being used for other purposes?

The quickest way to examine the orthodoxy of a currency board is to look at the relationship between “net foreign reserves” and the “reserve pass through” (Hanke, 2008)[3]. In an orthodox currency board, net foreign reserves should be close to or above 100% of the monetary base. In addition, the “reserve pass through”, defined as the change in monetary base divided by the change in net foreign reserves, should also be close to 100%, or at least fall within a range of 0-100%.

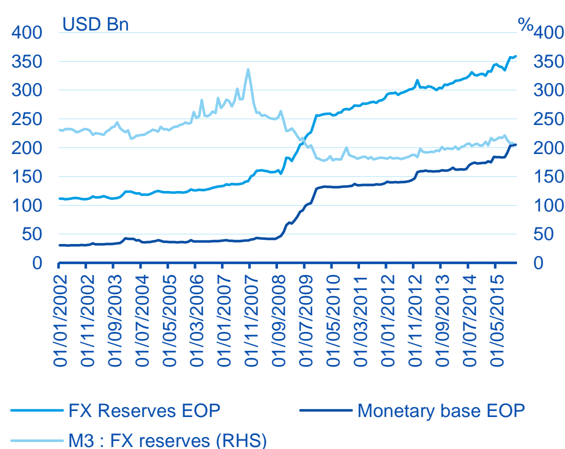
To put this into context, a reserve pass-through below 0% would imply that FX reserves and the monetary base moved in opposite directions; one above 100% would imply that the FX reserves and the monetary base changed in the same direction, but the monetary base changed more than FX reserves; while a reserve pass-through of between 0% and 100% would imply that monetary base and FX reserves changed in the

2: As per HKMA’s website: “Under the strong-side Convertibility Undertaking, the HKMA undertakes to buy US dollars from licensed banks at 7.75. Under the weak-side Convertibility Undertaking, the HKMA undertakes to sell US dollars at 7.85”.
3: Steve Hanke,“Why Argentina did not have a currency board”, *Central Banking Journal*, Vol.18, Feb 2008.

same direction, but the monetary base changed less than FX reserves. The latter is also known as the “zone of ordinary sterilization” (Hanke and Schuler, 2015)[4].

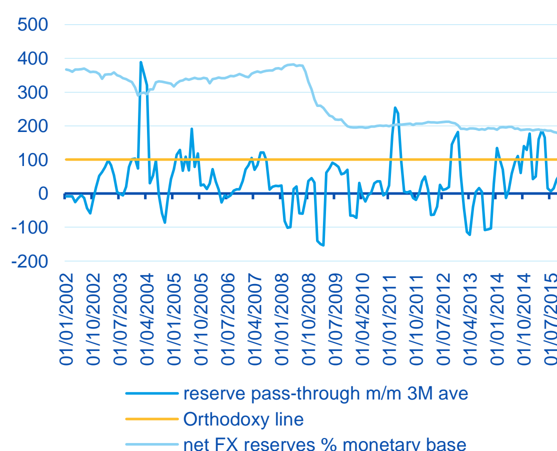
As we’ve already discussed, Hong Kong’s net FX reserves as a percentage of the monetary base linger comfortably above the 100% mark. Moreover, the reserve pass-through has, for the most part, stayed within the 0-100% band, meaning the HKMA engages only in ordinary sterilization (Figure 3). In other words, the HKMA does not hold FX assets for reasons other than to safeguard the stability of its exchange rate, leaving the entirety of its FX reserves available to defend the currency against a potential speculative attack.

Figure 2
FX reserves well in excess of the monetary base requirements (USD Bn)…



Source: Bloomberg and BBVA Research

Figure 3
…Meaning that currency board orthodoxy has not been a concern in Hong Kong (%)



Source: Haver, Bloomberg and BBVA Research

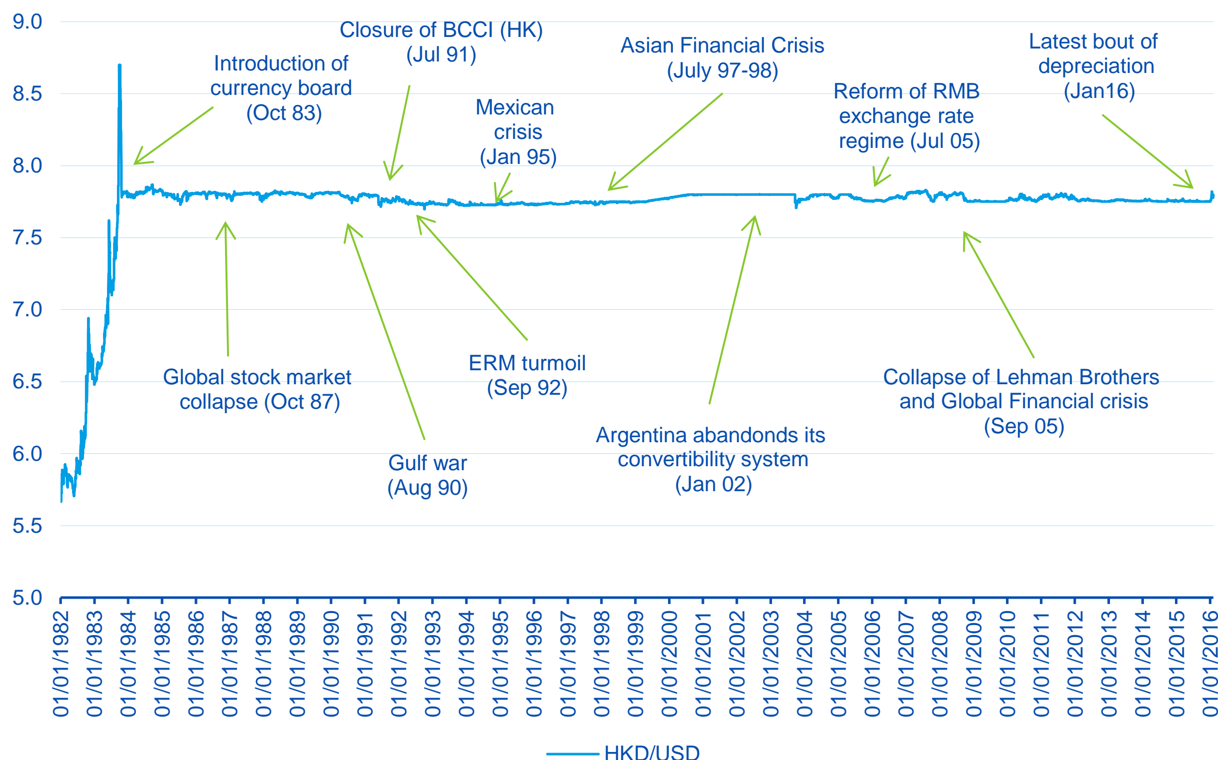
Currency boards have come under fire following from the collapse of heterodox convertibility systems in the early 2000s, particularly in Latin America. These regimes had currency-board-like characteristics, but were not currency boards in the orthodox sense (see the three principles above). The conditions then, don’t apply to Hong Kong now. Actually, Hong Kong has for the longest time maintained a very prudent fiscal policy stance, enjoying a comfortable surplus of approximately 3% of GDP, or USD 8.2 Bn, in 2015.

The political will to defend the exchange rate remains strong

In addition to a well-stocked war chest, the political will to defend the linked exchange rate system remains strong. The exchange rate has proven incredibly resilient to exogenous shocks in the past (Figure 4). This has boosted the authorities’ confidence in the system’s ability to undertake the necessary balance-of-payment adjustments to avert a crisis. HKMA’s Director for Monetary Management, Howard Lee, made this abundantly clear in an open note on January 27, where he stressed that the recent devaluation “reflects normal workings in accordance with the design of the linked exchange rate system” and that we “should not read too much into the fluctuations of the HKD 1Y forward”.

4: Steve Hanke and Kurt Schuler, “Currency Boards for Developing Countries: A Handbook (Revised Edition,2015)”,ICS Press, 2015

Figure 4
The HKD: Resilience against exogenous shocks



Source: HKMA, Bloomberg and BBVA Research

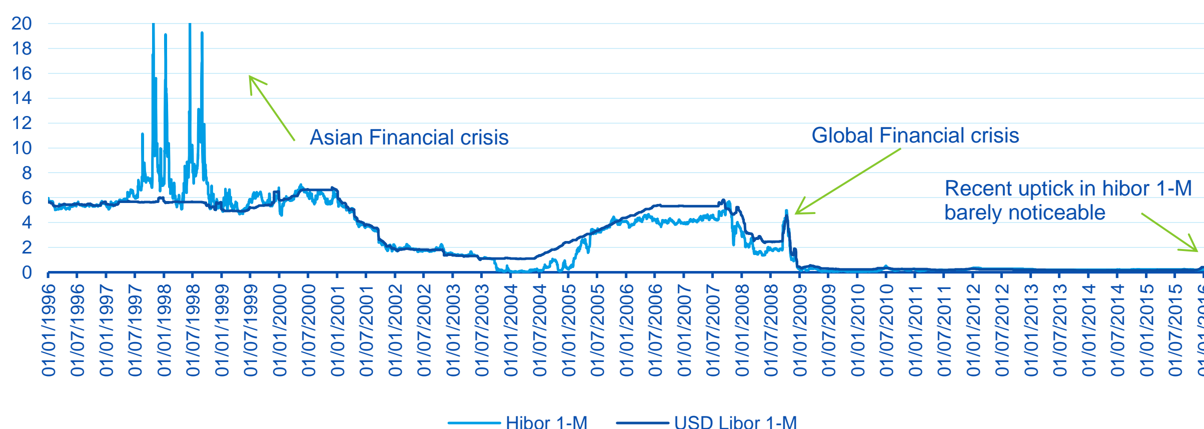
The authorities' quiet confidence may be well justified. Examining interbank rates predating 1997 reveals that the HKD has resisted harsher episodes of volatility in the past (Figure 5). For example, during the Asian Financial crisis, there was significant pressure from speculators who believed a devaluation of the HKD was inevitable. The concern at the time was that a strengthening dollar would hurt Hong Kong's economy, which was experiencing outflows stemming from its exposure to volatile Asian markets – Déjà vu? The HKMA's intervention was both vigorous and merciless, driving up the 3M Hibor to almost 20% and leading to a -25% fall in the Hang Seng Index. It was also effective in driving out the short-sellers.

In 2011, US based hedge fund manager Bill Ackerman lodged a speculative attack that incoming Chief Executive CY Leung would devalue the HKD in order to curb hot money inflows from the mainland, which were fueling a property bubble in the region, thereby worsening social tensions. However, much to Ackerman's dismay, CY Leung pledged to keep the HKD's linked exchange rate mechanism untouched. Money was lost.

Re-pegging the HKD to the RMB or a basket of currencies have become unrealistic when the pressure on the HKD has been piling up. A wavering policy stance in this respect could make things worse and expedite a systemic debacle of Hong Kong's gigantic financial sector. Any change in the exchange rate regime is also difficult from a political perspective. History can also help to shed some light on this issue. In 1972, the British government decided to untie the pound from its gold parity, leading to a steep depreciation of the HKD, which was then linked to sterling. This link was promptly replaced with a link to the USD, eroding the confidence in the authorities' commitment to the peg. As a result, two years of instability in the foreign

exchange market and a dramatic depreciation of the HKD ensued, forcing the authorities to abandon the peg in 1974. The HKD was then left to float against the USD, with the Exchange Fund assuming a more active role in the determination of monetary policy (Jao, 1991). The floating period, which was marked by foreign exchange volatility, came to an abrupt end in 1983. On September 24 1983, following from the conclusion of the Fourth Round of Sino-British talks on the future of Hong Kong[5], the HKD fell to 9.55 HKD/USD, resulting in severe shortages as people started hoarding cooking oil, toilet paper and rice. This event is also known as "Black Saturday". On September 25 1983, Hong Kong announced that it would fix the value of the HKD at 7.80 HKD/USD and official parity has remained at that level ever since.

Figure 5
3-month HIBOR has been much higher historically



Source: Bloomberg and BBVA Research

A stable HKD and a volatile RMB pose some risks for Hong Kong's economy

Admittedly, having a fixed HKD at a time when there is significant upward (depreciatory) pressure on the RMB vs. the USD poses some technical challenges. Hong Kong has become increasingly exposed to China's economy. For example, loans for use outside Hong Kong have rocketed on the back of falling interest rates since 2009 (Figure 6). Rising interest rates and a stronger HKD will make it expensive for Chinese corporates to seek financing in Hong Kong. In fact, this trend has already started to reverse (Figure 7), which could have severe implications on banks which have significantly increased their exposure to China.

Moreover, despite Hong Kong has maintained a very prudent fiscal policy, Hong Kong's total debt levels are amongst the highest in Asia, second only to Japan (Figure 8). However, the bulk of this indebtedness is accounted for by corporates (Figure 9). The risks in the corporate bond market are on the rise, as a worsening macroeconomic outlook in China in combination with capital outflows could increase the likelihood of defaults, thereby worsening NPL ratios.

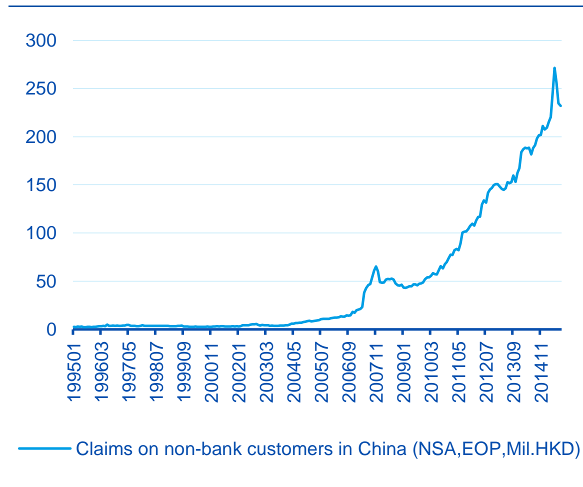
Finally, Hong Kong is not exempt from spill-overs from volatility in China's financial markets. The Hang Seng Index and the Shanghai Composite tend to move in the same direction (Figure 10). Downward pressure on valuations in the mainland will inevitably have an effect on Hong Kong's equity market, further aggravating capital outflows. In the worst-case scenario, steeper outflows combined with rising rates (which make

5: The Sino-British Joint Declaration, which declared that China would resume the exercise of sovereignty over Hong Kong starting from 1997, was signed a year later in 1984.

mortgages more expensive) could trigger a collapse of the local property market, which has already started to fall (Figure 11).

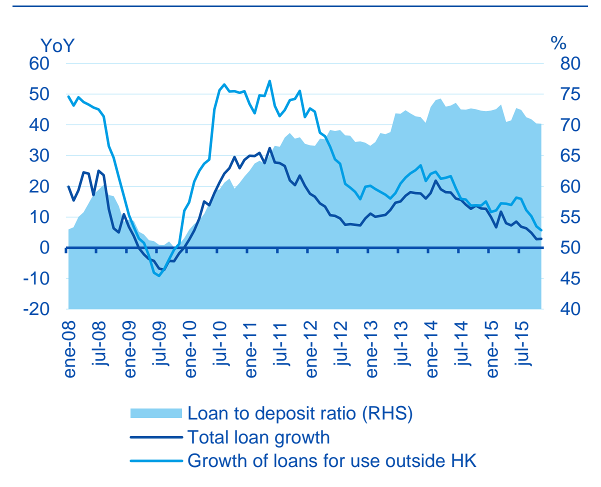
In sum, while it is unlikely that the HKMA will abandon its decades old peg to the USD, recent developments will add to the growth headwinds of the region. For these reasons we have revised our GDP forecasts for Hong Kong from 2.5% to 2.3% for 2016, and from 2.6% to 2.5% in 2017. The risk is to the down side if speculative attacks on the HKD last longer than expected and trigger more capital outflows from Hong Kong.

Figure 6
Low interest rates and a weak HKD vs. the RMB helped to fuel loans to customers in China…



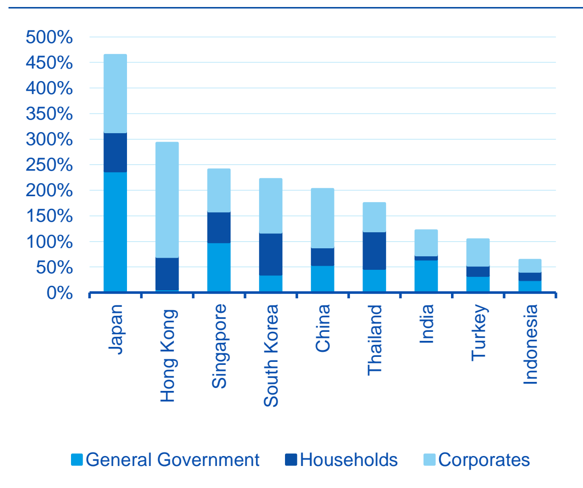
Source: Haver and BBVA Research

Figure 7
… However, the pace of growth of loans for use outside Hong Kong has started to deteriorate



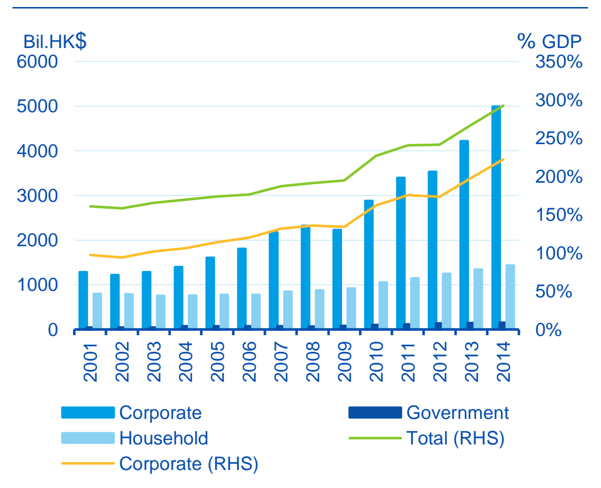
Source: CEIC and BBVA Research

Figure 8
Hong Kong has one of the highest total debt levels in Asia as a percentage of GDP…



Source: Haver, IMF and BBVA Research

Figure 9
…Although most of this debt is owned by corporates, while government debt remains small

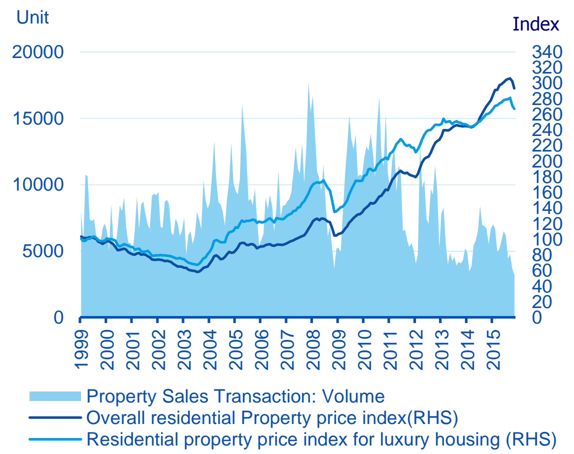


Source: Haver, IMF and BBVA Research

Figure 10
Stock exchange risks

Source: Bloomberg and BBVA Research

Figure 11
Housing price risks



Source: CEIC and BBVA Research

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