Economic Research Department

BBVA

Asia

Economic Observatory

3 November 2008

Li-Gang Liu
lliu@bbva.com.hk
Andrew Tsang
Andrew.tsang@bbva.com.hk

HKMA's Latest Market Interventions: Will They Help Stabilize Hong Kong's Financial Markets?

As HKD touched the strong side of the convertibility zone at HKD/USD7.75, the Hong Kong Monetary Authority (HKMA) intervened in the foreign exchange market again on Friday (31 October) by injecting HKD 2.813 billion to the interbank market and simultaneously purchasing USD 361 million from the foreign exchange market to prevent HKD from strengthening beyond the strong-side convertibility zone. This action follows the one on October 27 when HKMA purchased USD 2 billion and simultaneously sold HKD 15.5 billion in the interbank market.

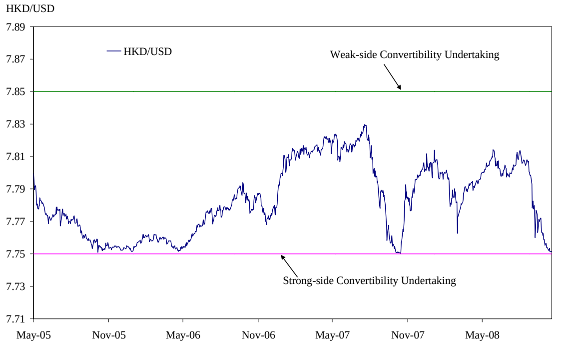
Since the collapse of the Lehman Brothers, the HKMA has intervened in the markets more frequently, injecting a total of HKD 31.6 billion (USD 4.2 billion) into interbank market. Meanwhile, Hong Kong's interbank market remains tight and the HIBOR continues to remain elevated. The lack of liquidity in the interbank market has pushed the HKD close to its strong side of the convertibility zone.

Under the Linked Exchange Rate System (LERS), the HKMA has no independent monetary policy and thus can not set its own interest rate. Hong Kong's interest rates are determined by the Fed fund rate, local interbank market conditions, and the HKD risk premium measured by the difference between HIBOR and LIBOR. It appears that recent interventions by HKMA have an objective to affect both the interest rate and the exchange rate of the HKD.

Given HKMA can not simultaneously stabilize both interest rates and the exchange rate, these market intervention measures will tend to increase the volatility of the HKD, which in turn may invite renewed speculations on the HKD.

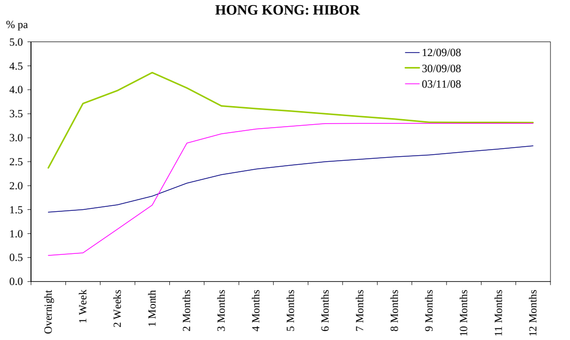
- The HKD has continued to remain close to the strong-side of the convertibility zone in recent months (Chart 1). Meanwhile, the HIBORs for those of more than one-month maturity have remained elevated relative to the same rates before the collapse of the Lehman Brothers. The perceived increases in counterparty risk have made banks cautious to lend to each other. The lack of liquidity in the interbank market in turn pushes up the HIBOR. Despite the cuts of 100 bps by the US Fed rate in less than 3 weeks, the Hong Kong dollar inter-bank interest rates continued to stay at a high level, while the liquidity was particularly tight for longer term borrowings (Chart 2).
- Meanwhile, banks' demand for HKD, especially those foreign ones, continued to drive up the HKD exchange rate. Once the HKD reaches beyond HKD/USD 7.75, the HKMA will be obligated to intervene in the foreign exchange markets. Despite HKMA's measures to ease market strains after the collapse of the Lehman (five measures, cutting the Discount Window rates three times, and injecting liquidities up to USD 4.2 billion), interbank market conditions continued to remain strained.
- The tight liquidity conditions have started to affect banks lending decisions. HSBC, Bank of China and Bank of East Asia decided to raise mortgage rates since late September. Meanwhile, the lending practices on the small and medium enterprises by Hong Kong banks have started to tighten, despite repeated pleas by the HKMA and the Hong Kong government for a differentiated treatment to SMEs.
- Under the currency board system, the stability of the HKD exchange rate is maintained through an interest rate adjustment mechanism. When Hong Kong experiences capital inflows, market participants buy HKD and HKMA automatically sells HKD at the fixed exchange rate against the US dollar. This then expands monetary base in Hong Kong, which in turns drives down Hong Kong's interest rate. When Hong Kong experiences capital outflows, market participants sell HKD and HKMA buys HKD at the pegged rate. This then shrinks monetary base in Hong Kong, which drives up Hong Kong's interest rate.
- Though with an aim to ease the short-term interbank market conditions, HKMA have neither eased interest rate conditions in the interbank market nor eased credit crunches on SMEs. However, these measures may impede the natural functioning of the interest rate adjustment mechanism of the currency board system. This in turn will lead to an increased volatility of the HKD exchange rate, thus possibly inviting renewed speculations on the HKD.

Chart 1: Hong Kong Dollar Exchange Rate



Source: CEIC.

Chart 2: HIBOR: Term Structures



Source: The Hong Kong Association of Banks.