Implications of the recent depreciation of the Hong Kong Dollar

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The recent depreciation of the HKD is entirely in line with Currency Board principles.
Ever since the outbreak of the US Sub-Prime crisis in September 2008 HKD short-term interest rates have been virtually at zero in line with the US Fed Funds rate. At the same time the HKD currency moved to the strong side of the convertibility band (7.75) as funds flowed into Hong Kong, viewing the HKD currency - like the USD - as a safe haven. To prevent the HKD moving above 7.75 (as required under Currency Board principles) the HKMA purchased substantial quantities of incoming foreign exchange. In subsequent years the cumulative volume of the Aggregate Balance (or banks' balances at the HKMA), which reflects these purchases by the HKMA, had reached over HK$300 billion by the end of 2009, and HK$426 billion in October 2015. (The actual amounts purchased by HKMA were somewhat more than these figures, but some of the cash balances were later converted to new issues of Exchange Funds Bills and Notes or EFBN by the HKMA to meet banks' liquidity requirements).

In other words, until the US Federal Reserve started raising interest rates on December 16th 2015, the inflow into Hong Kong continued. However, now that the trend of US interest rates has been reversed, investors should expect the excess liquidity in Hong Kong to be reduced, but this will not happen until the HKD spot rate reaches 7.85, which is the lower or weak side convertibility undertaking. At that point the HKMA will, under Currency Board rules, buy back HKD offered in the market and sell USD to the market in exchange. This will gradually reduce the Aggregate Balance, tighten liquidity in Hong Kong and enable HKD interest rates to rise in line with the Fed funds rate in the US. Again, all this represents the normal functioning of Hong Kong's Currency Board system.

What has triggered the shift in the HKD/USD rate?
Fundamentally it was the shift in the US Federal Reserve's interest rate policy which caused the change in market behaviour in Hong Kong. In practical terms it has been cheaper since December 16th to borrow HKD than to borrow USD, and therefore it has made sense for traders to borrow in HKD and transfer funds into the higher-yielding USD or CNH markets, selling the borrowed HKD funds and investing in the higher yielding USD or CNH markets. The sales of these borrowed HKD will have contributed to the weakening of the HKD currency.

Are speculators betting against the 32-year old HKD currency peg to the USD?
It is possible that speculators have taken a view against the HKD peg, but this is a pointless and futile exercise. They will end by losing money. The Hong Kong Government and HKMA have repeatedly said that they will not change the pegged or linked rate system, and currently the Hong Kong authorities are under no pressure to change the system or the central 7.80 rate against the USD.

Will a speculative attack – like that during 1997 Asian crisis – happen again?
No, there is no basis for renewed speculative attacks along the lines of the 1997-98 episodes. First, the Hong Kong economy is stable, and while the HK economy may slow down or even go into recession as China slows further and US interest rates rise, there is no reason to fear a downturn on the scale of 1997-98 or 2008-09. Second, since 1997 the HKMA has taken at least two sets of strong measures to make Hong Kong's currency mechanism more robust, which together should prevent any repetition of the steep increases in interest rates that were so damaging in 1997-98. For example, in 1998 the HKMA introduced a discounting mechanism for EFBN so that banks could restore their balances at the HKMA on a real time, immediate basis if short selling of HKD by their customers forced them into overdraft at the HKMA. (A rule of the system is that banks must maintain positive balances at the HKMA.) This means that instead of interest rates rising steeply in the event of sudden or large-scale outflows from HKD, banks would first sell their holdings of EFBN back to the HKMA, creating new liquidity in the HKD market, keeping interest rates down. In effect this mechanism creates a shock absorber to prevent sudden and steep increases in HKD interest rates. Also, in 2005-06 the HKMA implemented the two Convertibility Undertakings at 7.75 and 7.85 – that is, a guarantee that the HKMA would intervene to provide unlimited amounts of HKD at 7.75 and unlimited amounts of USD at 7.85. These Undertakings (guarantees) effectively limit deviations of the HKD/USD rate from the central 7.80 rate for currency note conversions.

Is there a risk that the HKD-USD link will break?
No, the Currency Board mechanism adopted by Hong Kong in 1983 and linking the HKD to the USD at 7.80 is the strongest form of fixed exchange rate mechanism in the world. If foreign currency flows into Hong Kong the HKMA, acting as agent for the HK government, will be happy to create literally unlimited amounts of HKD to meet demand at the 7.75 rate. This is how the Monetary Base in Hong Kong has increased from HK$865 billion in August 2008 to HKD 2,896 billion in November 2015 (according to the latest available data). Conversely, under the 100% backing rule (i.e. the rule that requires the HKMA only to issue CIs or banknotes against foreign currency submitted by banks), if money flows out of Hong Kong the HKMA will always have sufficient US dollars to meet any conceivable demand for foreign currency. However, long before the HKMA could run out of US dollars interest rates would rise in Hong Kong to attract funds back into the territory. In short, Hong Kong's currency mechanism is now so robust that it is virtually impossible for currency speculators to break the system.

Will the HKD-USD link be removed and a HKD-RMB link be established instead?
No, it would be very impractical to link the HKD to the RMB as long as the Mainland maintains either foreign exchange controls or other capital controls, for three main reasons. First, the smooth working of Hong Kong's currency mechanism depends on all participants in the financial markets (banks, non-financial companies, investors, individuals etc.) being able to move funds freely into and out of HKD without hindrance and without bureaucratic interference. Second, the fixed rate with the USD enables Hong Kong to transmit US financial conditions to Asia. This helps with a whole range of financial sector activities such as pricing IPOs, setting the price for international bond issues launched in Asia, and setting the yields on syndicated loans in Asia. Third, as long as the US is more dominant in determining the global business cycle than China, then it will make sense for Hong Kong to peg its currency to the currency of the US. Since most trade and capital transactions in Asia are still denominated in USD, it is immensely helpful to Hong Kong as an international financial centre to maintain a stable relationship between the HKD and USD.

I have always maintained the view that unless and until the RMB is fully and irreversibly convertible and all capital and exchange controls are abolished, it would make sense for Hong Kong to maintain the linked rate with the USD, not with the RMB.

What is the short-term outlook for the yuan and HK dollar?
In the near term I expect the Chinese yuan will depreciate further against the USD – from about 6.58 today to perhaps 6.80 and maybe even further. How far it weakens will depend (1) on how much capital outflow there is and whether the PBOC is willing to allow the outflow to drive down the currency, or (2) whether the PBOC is prepared to maintain the Yuan stable against the USD by paying out large quantities of its foreign exchange reserves to counter-balance all outflows.

By contrast, the Hong Kong dollar will depreciate towards 7.85 as the US Fed raises interest rates, but no further. As explained above, this is the absolute lower limit permitted under current Currency Board rules, and there is no basis to expect the HKD to fall any further.

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