UCAP Report No. 21 Why the HKD peg will stay on for a few more years 30/4/2022

The story for investors

The poor economic prospects of China and of Hong Kong resulting from the continuing adherence to the zero Covid policy led, not surprisingly, to yet another negative reappraisal of the HKD peg to the USD. Most of these appraisals are based on technical misunderstandings of how the peg works and, worse, on a misunderstanding of the political reasons which may lead to its unpegging. The peg is based on the willingness of the Hong Kong Monetary Authority (HKMA) to tolerate high interest rate differentials and not on the size of its forex reserves. The price to pay is loss of controls over interest rates. The unpegging will take place, as a policy decision when the CNY is fully convertible and not as a result of a crash of the HKD. As the convertibility of the CNY is unlikely to happen for at least another 5 years, the HKD will stay pegged during that time.

How the HKD-USD peg works

The HKD has been pegged to the USD since 1983 at 7.80, readjusted to a range of 7.75-7.85 in May 2005.The HKMA maintains the peg through automatic sales (when rate hits 7.75) or purchases (when rate hits 7.85) of HKD versus the USD. These market actions take place only with the banks, not with the public, and are reflected in the Aggregate Balance (AB) held by the banks with the HKMA which contains all interbank liquidity. Shrinkage (expansion) of the AB makes the banks less (more) liquid and raises (lowers) Hibor interest rates. This makes the HKD more (less) attractive to the USD thus encouraging banks to go long (short) on HKD when rates rise (fall) and so keeping the peg range. The reserves of USD available to the HKMA are in the Exchange Fund, now at USD 491.0 bl. The capacity of the HKMA to maintain the peg is based not just on reserves but letting interest rates to rise (fall) as much as necessary to keep the peg. Indeed the size of the reserves is irrelevant to the guarantee of the fixed convertibility. In March 2022 the banking system held USD 967 bl of HKD deposits, all potentially convertible at a fixed rate to USD, but via the banks only, when forex reserves were about half of that size. The only "true" convertibility of the HKD assets in the system is that of the cash basis, bank notes and, secondarily, coins. The reason for this is that three banks in Hong Kong can print HKD notes but only by backing them with USD assets. In March 2022 the forex reserves covered these by over 6 times.

Fig 1: HK Aggregate Balance (blu), USD/HKD, 2000-2022

Source: Bloomberg

Investment conclusions

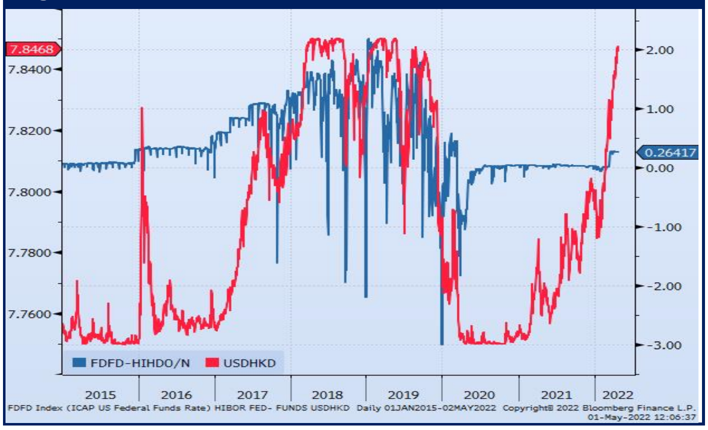
The peg means the HKMA will hike rates in lockstep with the Fed. We do not expect repeated extremes of hikes and we expect that the Fed will stop earlier than later, not because of concerns over the damage to the US economy but over the low trade -off of the hikes to declines in inflation and their impact on real rates. Leaving aside the impact of these hikes to the HK economy and property sector, the current concerns over the HKD rate being at the lowest of its range, ignores that it has done so regularly in the past and this had never been a "crisis" but the normal mechanism of the peg. There is no reason why the HKMA and the PBOC would take the political step of unpegging the HKD when there is no economic reason to do so, let alone at a time of uncertainty. Stay long on the USD/USD pegged rate.

The peg-further details and discussion

As Fig. 1 shows with the onset of the global financial crisis after 2008, the USD/HKD forex rate (red) became more volatile, but always within the 7.75-85 range. The relationship of the AB with the USD/HKD is not instantaneous and not "causal" as the AB may vary for reasons other than the forex movements, such as IPOs. In general, as the HKD weakens (strengthens) the AB will fall (rise) with the AB driving HIBOR rates up (down) respectively.Fig.2 shows the USD/HKD rate (red), and the Fed funds minus O/N Hibor (blue). This differential can be volatile and negative when the HKD weakens and the operation of the peg causes HKD interests rates to rise. There is nothing to keep the two rates "equal", and neither the HKMA will intervene unless the forex rate reaches the two limits. However as rate differences open up, the USD/HKD rate appreciates or depreciates and the peg system causes the interest rate divergences to close.

The reason why the peg is ultimately a political decision is because the existing system can support the peg as long as interest rates are allowed to rise or fall sufficiently. HK has had a trade deficit but a current account surplus plus surpluses in its capital account as witnessed by rising forex reserves, as well as fiscal surpluses except during the covid crisis. There is, therefore, no economic reason, which would cause the peg to crack. The paradoxical situation, that, a sovereign part of China has its monetary policy determined by the US, is part of the SAR makeup of HK. China may not want to upset this arrangement until the CNY is convertible and the HKD could then transit to a CNY peg from the USD.

Fig 2: HK USD/HKD (red), Int. rate dif. (Fed-Hibor) 2015-22



Source: Bloomberg

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