HKD Update

• There is no question of the HKMA’s wavering on defence of the HKD peg
• But a tightening in liquidity cannot be undertaken with impunity

Neil Mellor
Senior Currency Strategist, BNY Mellon
Email >

For much of the year so far, USD/HKD has been firmly pressed up against the top of the HKMA’s 7.75-7.85 trading band with the HKD afforded only limited and temporary respite following the spike in overnight HIBOR earlier last month. And perhaps encouraged by the sight of the CNY’s own struggles, voices can once again be heard debating the sanctity of the HKD peg.

The HKMA’s history surely dispels any doubts over its resolve in maintaining the peg and it certainly has the means at its disposal. Having intervened twice in March with a total spend of HKD 22.1 bn, the HKMA is still sitting on reserves of USD 430 bn – a figure which is just 2% below its record total from April last year and equivalent to seven times the currency in circulation.

As such, if forward outrights are to ever trade above the USD 7.85 threshold, they are unlikely to get there fuelled by doubts over the HKMA’s ammunition and its will to use it. If there is a motivation, however, it would surely be more closely related to the negative net impact of any sustained intervention. And there can little doubt that this is a possible scenario awaiting the HKMA.

Indeed, USD carry remains an attractive proposition across the curve for HKD investors. Sustained pressure on the currency began to materialise when LIBOR/HIBOR spreads
started to widen out in early 2017 and USD/HKD first reached the top of its band as the three month spread breached 100bp one year later.

Yet the period since April 2018 has also been marked by gradual USD strength (more recently in reflection of its ostensible role as a safe haven); and this fact has allowed USD/HKD to take up semi-permanent residence at the top of the band despite the fact yield support has been far from consistent.

Of course, there is one potential risk of near-term HKD strength due to the build-up of HKD-fuelled positions in Chinese stocks; but the absence of HKD strength since April 22 – in which time the Shanghai Composite has fallen 12% - suggests that investors are in no rush to liquidate these positions (a reflection, perhaps, on the recent intervention of the National Team.

We can conclude, therefore, that there is clearly a risk of the HKMA being called upon to actively defend the HKD (intervention, the issuance of Exchange Fund Bills and Notes and so on). But the issue to then ponder perhaps, rather than the HKMA’s resources, is that sustained intervention cannot be undertaken with impunity given its contractionary impact – an important consideration in a property-dominated economy where private sector credit stands at a princely 300% of GDP.

Indeed, GDP growth has already slowed to a near decade low hit by slower exports and investment; the Nikkei PMI for the region has now been in contraction territory for over a year; retail sales fell by 1.2% y/y over the first quarter (driven by April's fall - the first annual drop in two years); and the US-Sino trade war continues to unleash damage that no agreement could now rectify.

Speaking in Hong Kong yesterday, James Bullard became the latest Fed official to allude to US rate cuts. We have little doubt that it was a comment well-received by his hosts.

Please direct questions or comments to:

AerialView@BNYMellon.com
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