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Hong Kong Update

Hong Kong Dollar - 5-Year Outlook

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Summary

- Hong Kong's growing links with China is prompting speculation of a change in the Hong Kong dollar's peg arrangements.
- Maintaining the current exchange rate arrangements will have consequences for the Hong Kong economy. For example, in order to preserve the currency peg the HKMA has cut its policy rate to follow last month's cut in US interest rates, potentially fuelling already strong conditions in the Hong Kong economy.
- There are four possible scenarios for a change in Hong Kong's exchange rate: (1) No change (2) Re-peg to a basket of currencies (3) Revaluation to a higher rate against the US dollar and (4) Re-peg to the Chinese yuan. In our view, scenario (1) is the most likely and scenario (4) is the least likely.
- Our 'central case' view is that the Hong Kong dollar will remain broadly unchanged against the US dollar over the next five years. Our projections are presented in the table below.

Table 1: Hong Kong Dollar Projections

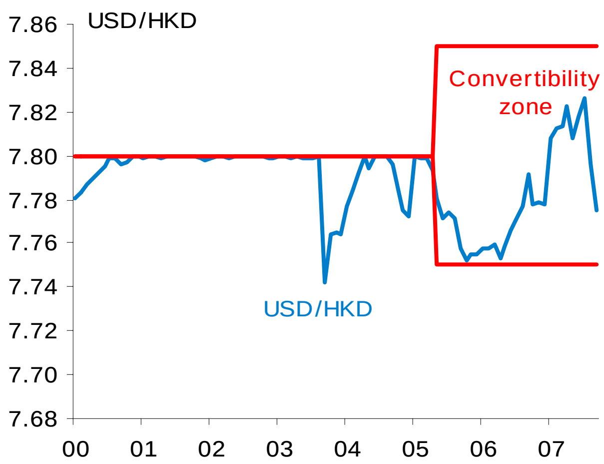
	2006	2007(f)	2008(f)	2009(f)	2010(f)	2011(f)
USD/HKD	7.78	7.78	7.80	7.78	7.80	7.82

Source: Bloomberg and Economics@ANZ

Background

The Hong Kong dollar (HKD) has been pegged to the US dollar since 1984. At present the link is set at a rate of USD/HKD7.8 and is convertible (for buying and selling) within the range of USD/HKD7.75 to 7.85 (Chart 1).

Chart 1: The Hong Kong Dollar Peg



Source: Bloomberg and Economics@ANZ

The introduction of this two-way convertibility zone in May 2005 is the most recent adjustment to the currency board arrangements. It was introduced after a surge in speculative inflows into the HKD as market expectations of a Chinese yuan (CNY) appreciation gathered pace. In the event, the CNY was re-pegged to a basket of currencies and has gradually appreciated. Amidst this, the new arrangements around the HKD have proven successful in stemming inflows and keeping the local foreign exchange market relatively stable.

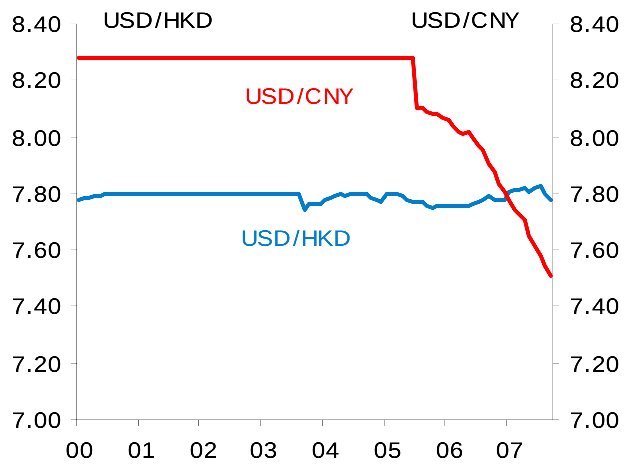
A change in the HKD dollar peg could be prompted by a failure in board mechanism or economic disruption

There is ongoing speculation that the current HKD peg will be altered and/or abandoned. There are two major factors that could prompt a change in Hong Kong's current exchange rate regime.

- **The board mechanism could fail. This is highly unlikely.** The market arbitrage mechanism that supports the current arrangements is robust. Moreover, the HKD peg is backed by a substantial volume of foreign exchange reserves (over US$200 bn) as well as by other Hong Kong government resources. This ensures that the HKMA is extremely well placed to defend any 'attack' on the currency.
- **The economic disruption caused by maintaining the peg becomes unacceptable.** This factor is prompting the current round of market speculation and, in our view, is **the most likely 'trigger-point' for a change in the HKD peg**. In order to preserve the current peg, Hong Kong policy interest rates must be tied to US policy rates. This is now proving problematic, given that **the Hong Kong economy is increasingly tied, not to the United States business cycle, but instead to China.** Most recently, even though the Hong Kong economy is currently booming, the HKMA was forced to cut its base overnight lending rate by 50 bps last month in order to follow the 50 bps cut in the US Fed funds rate**. There is also the question of Hong Kong's competitiveness.** In January 2007 the Chinese yuan reached parity with the Hong Kong dollar. Since then the CNY has continued to appreciate and is now around 3½ % stronger than the Hong Kong dollar (Chart 2).

The Hong Kong economy is de-linking from the US economy

Chart 2: Hong Kong Dollar vs Chinese Yuan



Source: Bloomberg and Economics@ANZ

Outlook

We see four possible medium-term scenarios for the HKD peg

Over the next five years we believe there are four possible scenarios for the HKD peg. Note that we do not think a switch to a floating exchange rate system is likely in this period.

1. No change.

In our view, this is the most likely scenario. The HKD peg has withstood a number of major tests in its 23-year history, including the substantial decline in the US dollar in the 1980s, the handover of Hong

The most likely scenario is for no change in the HKD peg.

Despite various periods of intense pressure, HKMA support for the peg has never wavered

Abandoning the peg would be too disruptive

Kong to Chinese rule in 1997, the Asian crisis and the enormous market pressure which the peg came under in October 1998[1] and, more recently, the revaluation of the Chinese yuan in 2005, which in turn prompted the most recent reform of the currency board arrangements. **At no time during these events has the HKMA wavered in its support for the US dollar peg**. Indeed, the HKMA instead emphasised, in words and actions, the high importance it places on the stability and confidence provided by current arrangements. Moreover, the stability provided by the fixed exchange rate is considered optimal for Hong Kong's role as a major financial centre as it provides investors the ability to clearly and accurately gauge the return on investments. In a recent review the IMF also reiterated its support for the HKMA's commitment to the current peg arrangements.

To be sure, there are economic consequences to maintaining current arrangements. In the current environment, for example, there is a risk that the cut in Hong Kong policy rates could spark higher local consumer price and asset price inflation. Nevertheless, these **adverse developments are likely to be minor relative to the potentially substantial risk of a major financial market and economic disruption that could be prompted by a change in the HKD peg.**

The next most likely option is for the HKD to be re-pegged to a basket of currencies

The probability of this move is less than 50%

2. Re-peg to an undisclosed basket of currencies

Hong Kong authorities could re-peg the HKD to an undisclosed basket of currencies based on trade weights and allow the HKD to trade within a defined band. This type of arrangement is used in Singapore and in recent months Kuwait has dropped its US dollar peg in favour of such a basket. The move to a currency basket would potentially introduce greater (albeit likely still small) volatility into the trading value of the Hong Kong dollar. This could allow the currency to play a greater role in absorbing external shocks. It would also mean that Hong Kong's monetary policy would no longer be directly linked to the US, for interest rates under a currency basket are set instead by the market. That said, it would not allow Hong Kong authorities to gain any more independence over monetary policy, for interest rates would be forced to adjust to market-clearing levels at the daily determined exchange rate.

In our view **this the second most likely scenario for the Hong Kong dollar** within the next five years, as it would most likely be the *least* disruptive action after the no change scenario. However, it would possibly make the Hong Kong dollar more vulnerable to speculative pressure, which is precisely what recent reforms have been designed to absorb. Also, such a policy change would remove one important differentiation that Hong Kong has over its arch-rival Singapore, with both vying to be Asia's biggest financial centre. As such, **the probability of such a move looks to be less than 50%.**

If such a basket arrangement was adopted, a modest appreciation in the HKD over the medium-term would be most likely, in line with our view that sustained strong regional economic growth, continued capital inflows, the maintenance of current account surpluses and further financial market reform and liberalisation will support ongoing local currency appreciation across the Asian region.

Option 3 - revaluation - would leave the HKD vulnerable to further speculative attack

3. A revaluation of the HKD.

There is some speculation that the ongoing appreciation of the CNY, including the (small) possibility of a CNY revaluation would prompt Hong Kong authorities to reset the HKD at a higher rate to the USD. **We would judge a revaluation in the HKD as highly unlikely.** It would destroy market credibility in the HKD peg by adding enormously to investor speculation that further revaluations were likely. The disruptions and

[1] In this period the HKMA took extraordinary measures, including intervening directly in the share market in order to ward off speculators betting heavily on the demise of the peg.

costs involved would defeat the original purpose of a revaluation – to restore stability and confidence.

A re-peg to the CNY is the least likely option

This will not occur until the CNY is fully-convertible

4. Re-peg to the CNY

This is one of the most popular theories and **in our view one of the least likely scenarios over the next five years**. To be sure, Hong Kong's economy and financial system is becoming increasingly linked with the mainland. However, at the moment there are still too many significant restrictions on CNY trading to allow the HKMA to replace the USD with the CNY under its current currency board arrangements. At the very least, for such arrangements to work the CNY must be fully-convertible on the current and capital accounts. At present, the CNY is only convertible on the current account (ie. can only be freely traded by exporters and importers) and, while further financial market reforms will continue, a fully convertible and open capital account still appears a *long*-term proposition. Until this occurs, a CNY peg would severely damage Hong Kong's reputation as a global financial centre. It would also increase Hong Kong's exposure to the potentially severe risks and/or shocks that face the rapidly transitioning Chinese economy over the medium-term, such as a CNY revaluation, banking sector crisis and/or rapid rise in interest rates.

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