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Another Doomed Speculative Attack on the Hong Kong Dollar

By John Greenwood

Introduction and Overview

- In recent days yet another well-known hedge fund trader has decided to try his luck by shorting the Hong Kong dollar against its US dollar anchor, using put options – and possibly gamma hedging – to go "long volatility".
- Superficially, the trade might appear to have some merit.
- First, Beijing appears to be tightening its grip on Hong Kong.
- Second, other "pegs" have crumbled in the face of large-scale speculation, especially when local, domestic monetary policies have proved incompatible with maintaining the peg.
- And third, with the Fed steeply raising rates in recent months to deal with a domestic US inflation problem that is not shared by Hong Kong (whose CPI increased by just 1.8% in October compared with a year earlier), there has been additional volatility introduced to Hong Kong's financial markets.
- All three reasons convey a misunderstanding of some of the basic political, economic, and monetary aspects of Hong Kong.
- The accompanying Newsletter explains the fallacies of the speculator's analysis, point by point.
- Hong Kong's currency board system is not like a pegged exchange rate operated by a central bank in an emerging economy. It is one of the strongest forms of fixed exchange rate to be found anywhere in the world.
- Moreover, unlike the convertibility system practised in Argentina under the BCRA (Argentina's central bank) in the 1990s to 2001, Hong Kong's currency board ensures that Hong Kong's economy is continuously adjusting to the fixed exchange rate, so that no incompatibilities can emerge.
- The conclusion is that this attempt at destabilising the HKD will, like several before it, fail. The options will most likely expire worthless.

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The IMM Newsletter offers economic research written by John Greenwood, founder and Chief Economist of International Monetary Monitor Ltd. John was also the publisher, editor and lead author of ***Asian Monetary Monitor****, a bi-monthly publication that he operated for 20 years from Hong Kong between 1977 and 1996. He was a pioneer of monetary research in Asia. From 1999 to 2021 he was Chief Economist at Invesco, based in London.*
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1. Speculative Attack

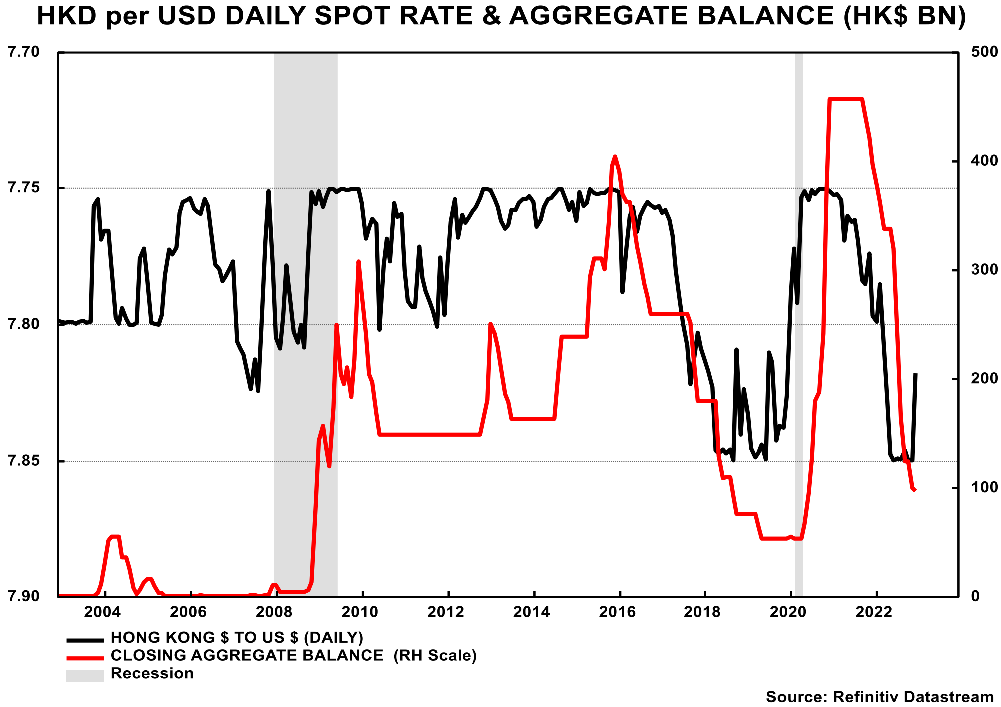
Last week yet another well-known hedge fund trader announced to the world that he had decided to try his luck by shorting the Hong Kong dollar against its US dollar anchor, using put options -- and probably gamma hedging -- to go “long volatility”.

Superficially, the trade might appear to have some merit. First, Beijing appears to be tightening its grip on Hong Kong, distancing itself from Washington, which suggests to some that China might someday assert its sovereignty not only in relation to defence and foreign affairs as set out in the Basic Law, but also in relation to the exchange rate of the HKD.

Second, in addition, other “pegs” have crumbled in the face of large-scale speculative forces, especially when local policies have proved incompatible with maintaining the peg. A key reason for announcing the short is to bring in other traders on the same side.

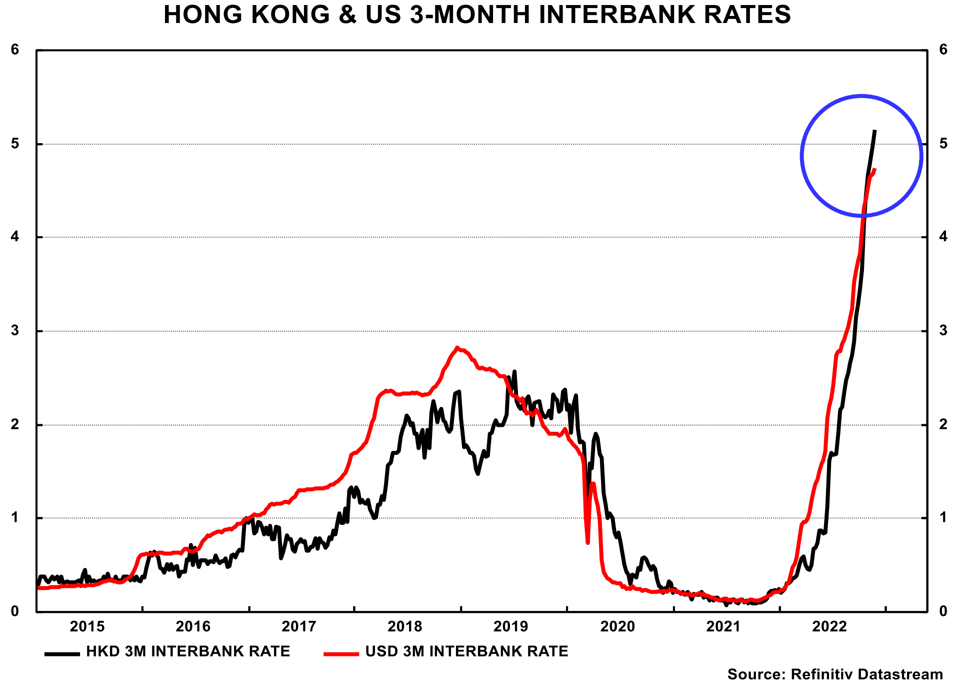
And third, with the Fed steeply raising rates in recent months to deal with a domestic US inflation problem that is not shared by Hong Kong (whose CPI increased by just 1.8% in October compared with a year earlier), interest rates and the exchange rate in the territory have been relatively volatile recently. From 7.85, the lower end of the HKMA’s “convertibility undertaking” where the currency traded between September and early November, the spot rate strengthened to 7.81 last week, and interest rates briefly exceeded US short rates.

Figure 1. When funds flow into Hong Kong, the aggregate balance rises; conversely, when funds flow out, the aggregate balance declines



Generally, HK dollar interbank rates tend to lag US interbank rates, both on the upside and on the downside, but the recent move of HK dollar interest rates above US dollar rates has helped the HKD to strengthen, adding an extra reason for short traders to add to their positions.

Figure 2. Higher interbank rates in Hong Kong have temporarily strengthened the Hong Kong dollar



2. Understanding the Hong Kong Dollar Mechanism

In my view, all three reasons for this latest speculative attack display fundamental misunderstandings of Hong Kong's political, economic, and monetary circumstances.

First, under the Basic Law, Hong Kong maintains complete autonomy in matters related to the currency and the operation of its financial system. While Beijing may have insisted on passage of the National Security Law and supported the Hong Kong authorities – at least verbally – in their efforts to suppress the damaging street riots of 2019-20, the Chinese authorities appear to have become has become less tolerant of Hong Kong's free press in certain areas, such as commentaries about the mainland or its politics. But I know of no evidence of interference in economic or financial policies reserved to Hong Kong under the Basic Law.

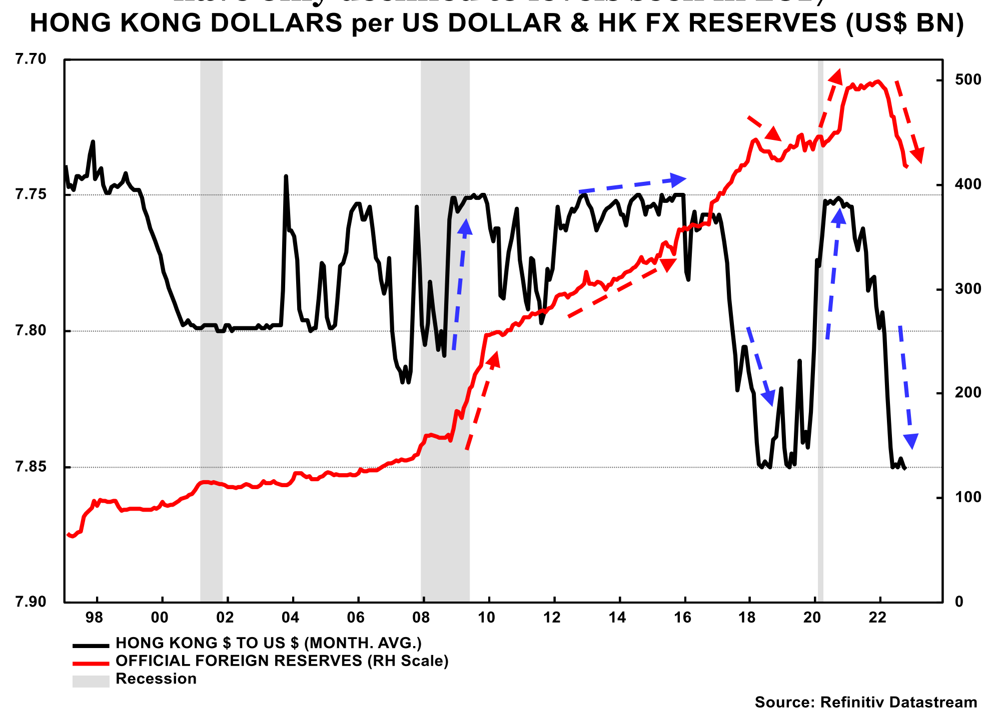
Second, Hong Kong's linked exchange rate system is a currency board which is to be sharply distinguished from a pegged rate under a central bank in any other emerging (or even developed) economy. Unlike central banks, currency boards do not operate an independent domestic monetary policy in the sense of creating or providing domestically based credit to the banking system. The system cannot therefore move significantly out of alignment with what is necessary to maintain the fixed rate. In

Hong Kong there is a system of continuous and comprehensive, but little understood automatic adjustment mechanism in operation. (See the Appendix pp.6-8 which reproduces the "box" on the automatic adjustment mechanism from the second edition of my book, "Hong Kong's Link to the US Dollar – Origins and Evolution," published at the start of 2022.)

In Hong Kong's case the recent operations of the HKMA have reflected its obligation to maintain the fixed rate system within the bounds set by the system. Whenever the HKMA made good on its "convertibility undertaking" to sell USD to the market (simultaneously buying HK$ from the banks) at HK$7.85, the HKMA was in effect removing HK dollars from the "aggregate balance" of the banking system -- i.e., banks' settlement balances held at the HKMA were reduced, and the money market was tightened, raising local interest rates closer to US dollar rates.

Under that obligation, the HKMA has, since May, responded some 40 times to banks' requests to sell HK dollars and supply them with US dollars at 7.85. The effect has been that Hong Kong's foreign exchange reserves have declined by US$30 billion, reducing banks' balances at the HKMA by 70% and thereby hiking HK$ money market rates in line with the Fed's tightening of US dollar interest rates. This is exactly how the system was designed to operate; it is not a sign of weakness.

Figure 3.Although Hong Kong's FX reserves have declined in 2022, they have only declined to levels seen in 2017



Note how, since 2005, sustained inflows or outflows which keep the HKD at the level of the HKMA's convertibility undertakings (7.75 or 7.85) have led to increases or decreases respectively of Hong Kong's foreign exchange reserves (arrowed).

On the contrary, there are huge advantages to Beijing in maintaining Hong Kong as an international financial centre and the HK dollar as a freely convertible, international currency as long as its own currency is subject to foreign exchange and capital controls. The HK dollar can act as both shock absorber and safety valve, insulating the mainland from a range of adverse shocks – political and economic.

Third, while traders are always attracted by increased volatility, the source of the volatility on this occasion is on the US side, not on the Hong Kong side. In the two years of the pandemic, 2020 and 2021, the Fed allowed M2 to expand by an average of 18% p.a. or three times its appropriate growth rate. This is the source of the current US inflation. In 2022, by contrast, the Fed has caused M2 to ***shrink*** by $234 billion, or by -1.3% at an annualized rate in the ten months to October, an unprecedented degree of tightening.

Having pushed too hard on the accelerator in 2020-21, the Fed is now slamming its foot too hard on the brake. Economies like Hong Kong are having to adjust to the Fed's unstable monetary policy. But Hong Kong is famous for its flexibility and adaptability, and no doubt will adapt to whatever the Fed throws at it.

3. Summary/Conclusion

Exchange rates maintained by currency boards are inherently stronger than rates pegged by central banks. In fact, no true currency board has ever been broken by speculators or by anything else.

Argentina, which most poorly informed observers quote with alacrity as a failed currency board, never had anything but a central bank (the BCRA) operating under a instruction to maintain the Peso/USD exchange rate at 1:1. Breaking at least three of the fundamental rules of any true currency board (specifically, not maintaining a foreign exchange reserve level of 100% of the monetary base, issuing domestic credit, and holding domestic government securities as partial backing for the currency), it was entirely predictable that Argentina's convertibility system would fail.

In Hong Kong's case, these rules for a sound system have never been broken. As a result, I can confidently predict that once again, the current attempt by speculators to undermine one of the most solid currency board systems to be found anywhere in the world is doomed to failure.

Appendix

Hong Kong's Automatic Adjustment Mechanism or Why Speculation against the Hong Kong Dollar Linked Exchange Rate System Always Fails

In the nearly four decades since the Hong Kong currency board mechanism or Linked Exchange Rate System (LERS) was restored in 1983 there have been numerous attempts by speculators to make money either by selling the HKD short or by buying long positions in the HKD in the hope of an upward revaluation or appreciation. While some may have profited from movements of the spot rate within the band given by the two Convertibility Undertakings (CU) established in 2005 and set at HK$7.85 and HK$7.75, none has succeeded in pushing the rate outside the band. Most have ended either with the options expiring worthless, or with the investors making losses. Yet still they keep trying. Why is this type of speculation so enticing to investors and at the same time so unrewarding?

There are two reasons. Investors and commentators underestimate the power of the automatic adjustment mechanism under the currency board system. Moreover, they conflate Hong Kong's fixed exchange rate mechanism with a pegged exchange rate operated by a central bank, perceiving vulnerability where there is none.

There are two fundamental lines of defence for any currency board. First, there is the powerful, but little understood and largely unseen automatic adjustment mechanism which operates all day and every day to keep the entire system consistent with the fixed exchange rate. Second, a currency board such as Hong Kong's maintains foreign exchange reserves in excess of 100% of the monetary base which creates credibility for the system. Convertibility at a fixed rate is made more credible by the foreign reserve cover. Specifically, this means (1) the currency board can always meet any conceivable demand for banknotes, and (2) in the wholesale foreign exchange markets it can exchange foreign currency for local currency bank reserves in a way that generates a self-reinforcing feedback mechanism.

<u>Automatic adjustment mechanism</u>

In the first case the fundamental issue is adjustment. There are two classes of things to which adjustment is required: monetary disturbances and real disturbances. How does the currency board mechanism cope with these two?

If monetary conditions[1] in the anchor currency economy (the US) become easier, HKD interest rates will, for a while, be higher than USD interest rates. Through arbitrage, inflows of capital will be attracted to Hong Kong, lowering HKD interest rates and encouraging banks in Hong Kong to lend more, thus adjusting monetary

[1] NB "Monetary conditions" does not refer to the commonly used Monetary Conditions Indices which are usually based on interest rates, interest rate spreads, exchange rates and stock prices but exclude quantitative measures of money and credit. Here "monetary conditions" include sustained accelerations or decelerations of broad money and credit.

conditions in Hong Kong to monetary conditions in the US. Conversely, if monetary growth or USD interest rates tighten, HKD interest rates will, for a while, be lower than US rates. Again, through arbitrage capital outflows from Hong Kong will be attracted into USD, raising HKD interest rates, discouraging banks from lending and slowing monetary growth to match conditions in the US.

Note that the adjustment in Hong Kong extends to asset prices, economic activity, and inflation in each case, ultimately keeping Hong Kong's prices in line with US prices.

Similarly, given a positive or negative real shock which changes economic conditions or prospects in Hong Kong, the monetary system will adjust as appropriate. In the case of a positive real shock, HKD interest rates will decline inducing a monetary expansion, and conversely for a negative real shock.

An example of a positive shock is what happened when China changed the regulations easing the flow of Mainland tourists into Hong Kong from 2003 and Hong Kong's monetary growth rate expanded rapidly in 2004-07.

An example of a negative real shock is what happened following the 2018 trade tensions between the US and China triggered by President Trump's tariffs and in 2019 as a result of prolonged demonstrations against the proposed Extradition Law and the National Security Law. These events prompted a slowdown of bank lending and money growth in 2018-20, even though HKD interest rates did not rise relative to USD rates until late 2019, and even then only in response to yearend funding and IPO demand. In an extreme case, such as a political crisis, the rise of HKD interest rates could be so steep as to attract short-term capital inflows which at least in part would counter the speculative outflows.

Most of the time the automatic adjustment mechanism is operating in the background without the need for any response by the currency board. In Hong Kong's case, the exchange rate trades most days between the two CU limits of HK$7.85 and HK$7.75, allowing money market traders to shift positions between HKD and USD without any recourse to the HKMA.

100% foreign exchange cover for the monetary base

In the second case -- relying on 100% foreign exchange cover for the monetary base -- the currency board holds foreign exchange assets more than sufficient to redeem every HK$ banknote ever issued at HK$7.80 and all bank reserves. In addition, there are the two Convertibility Undertakings whereby the HKMA will, in the event of the wholesale market exchange rate reaching either HK$7.85 or HK$7.75, respectively purchase HK$ from or sell HK$ to the banks on demand. In the former case, purchases of HK$ by the HKMA reduce the supply of funds in the Hong Kong interbank market, driving up interest rates and squeezing monetary growth. In the latter case, HKMA sales of HK$ increase the supply of funds in the Hong Kong interbank market, lowering interest rates and inducing an expansion of lending and monetary growth. Each response reinforces the defence of the exchange rate band, easing conditions when there is an imminent breakout on the strong side at HK$7.75, or tightening conditions when there is an imminent breakout on the weak side at HK$7.85.

All the adjustments described above occur because the currency board is essentially passive and allows market forces to initiate and complete the necessary adjustments. By contrast, in an economy with a central bank the needed adjustments can be resisted under the guise of maintaining “stability” (of interest rates, of exports, or of some other variable). The central bank may conduct domestic open market operations or sterilize inflows, in effect concealing the growing adjustment problem. In this way disequilibria can build up – as they regularly did under the Bretton Woods system of fixed exchange rates – until the divergences are so large that a very big exchange rate change or other adjustment eventually becomes necessary.

In other words, a currency board has a fixed exchange rate policy but no monetary policy whereas a central bank may have both an exchange rate policy and a monetary policy which can be inconsistent with each other.

In short, the currency board mechanism in Hong Kong ensures continuous, incremental adjustment, preventing the build-up of serious imbalances, in marked contrast to the behaviour of pegged exchange rates under central banks. It cannot be stressed too often that the Hong Kong Linked Exchange Rates System (LERS) is, in effect, a unified monetary system with the United States. The HKD currency is therefore a clone of the USD, and the Hong Kong monetary system, its economy and its price level are continuously adjusting to be consistent both with the fixed exchange rate and with monetary conditions in the US. It is therefore virtually impossible to “break” the exchange rate because market forces prevent any significant imbalance or disequilibrium from accumulating.