Will the Hong-Kong dollar peg hold?

Hong Kong's foreign exchange reserves continue to fall as the authorities struggle to keep the HKD in the 7.75 - 7.85 range.

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Fed monetary tightening cycle (and the accompanying rise in the dollar that takes place most of the time) have very often resulted in financial "accidents". For several months, some investors have been betting on such an event happening in Hong Kong. Indeed, some well-known hedge funds - including Bill Hackman's Pershing Square - have accumulated short positions on the Hong Kong dollar (HKD), anticipating the end of the peg with the US dollar.

For these investors, the economic and social costs of maintaining the Hong Kong dollar at parity with the US dollar have become untenable and may force the Hong Kong monetary authorities to abandon it.

Could this really happen?

An increasingly fragile dollar peg

In response to the Black Saturday crisis in 1983, the peg exchange rate system was adopted in Hong Kong on 17 October 1983. Since then, the Hong Kong Monetary Authority (HKMA) has been mandated to maintain the currency at a relatively fixed rate against the dollar. The current band (between HKD 7.75 and 7.85 per US dollar) was set in 2005 and has never been breached since. When the HKD gets too close to either end of the range, the HKMA intervenes, either by buying or selling the Hong Kong dollar.

As the chart below shows, the currency traded at the low end of the range (7.85) for most of the year, due to the rising US dollar. This pressure has eased somewhat recently as expectations of a US interest rate hike have eased somewhat.

But this may only be a short-term respite.

The Hong Kong dollar has been testing HK$7.85 for most of the year

Source: Bloomberg

Because of the peg to the US dollar, Hong Kong has no independent monetary policy; it has to follow the US Federal Reserve. Even if it means tightening its monetary policy at a time when it should be doing the opposite. Indeed, the Chinese economy as a whole is experiencing a growth breakdown, notably because of its "zero-covid" policy and its property crisis. The situation is even more complicated in Hong Kong, where the economy contracted by 4.5% in the third quarter compared to the previous year. The benchmark Hang Seng Index is down nearly 50% from its 2018 highs.

The HKMA is therefore being forced to raise interest rates, despite the recession. To keep the economy afloat, Hong Kong has no choice but to resort to the fiscal weapon, i.e. a massive increase in public spending. At the risk of being penalised one day by the financial markets.

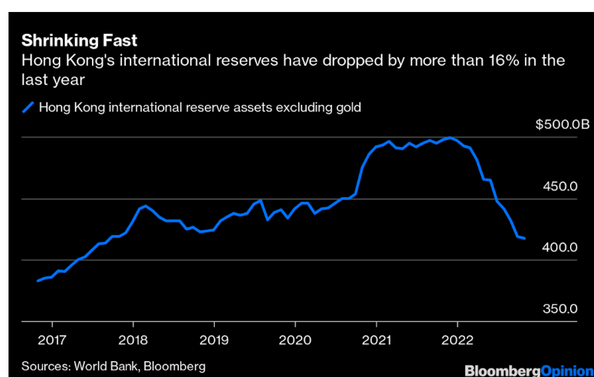
Hong Kong is facing structural problems that are not likely to reassure international investors. China's political interference is only increasing. A part of the working population, in particular the high earners in the financial sector, is leaving the island. Hong Kong's tax base is thus being eroded even though Hong Kong is a massively indebted economy.

Indeed, while the government's debt ratio is close to zero (as published by the IMF), the private sector's is much higher. According to some economists, the external debt is almost $500,000 for every person working in Hong Kong. Domestic debt levels have doubled since 2007, according to the World Bank. Real estate debt has been rising at a staggering rate, despite a decline in prices that appears to be accelerating (-8% year-on-year according to the latest figures), even though Hong Kong's real estate remains among the most expensive in the world.

It is this huge surge in debt, falling asset prices and the increasingly bleak outlook for Hong Kong's economy that makes defending the peg much more problematic than during the Asian crisis of the late 1990s.

Another warning sign is that Hong Kong's foreign exchange reserves have fallen by more than 16% since the end of 2021, from $500 billion to $417 billion, the biggest drop on record.

Hong Kong foreign exchange reserves (excluding gold)



Source: World Bank, Bloomberg

Are foreign exchange reserves really at risk?

The above graph suggests that the Hong Kong authorities are making massive efforts to save the peg, but also that the amounts available are still colossal.

Before jumping to conclusions, it is important to understand how these reserves are built up.

As explained in a BNP Paribas Asset Management note, Hong Kong's foreign exchange reserves comprise the assets of the Exchange Fund and the Land Fund.

The former is managed in two main portfolios - the Backing Portfolio and the Investment Portfolio - and two smaller portfolios, the Long-term Growth Portfolio and the Strategic Portfolio (see below).

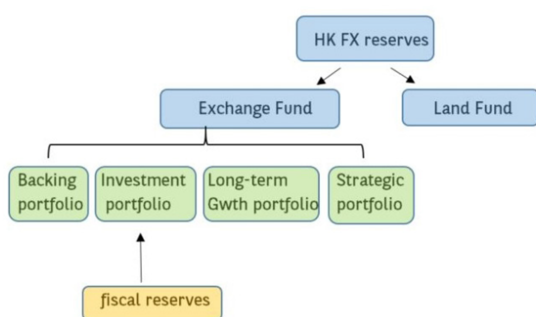
The Backing Portfolio consists of stable, high quality assets denominated in US dollars to ensure that the monetary base (M0) is fully backed by a rate of 1 USD for 7.8 HKD.

The investment portfolio is invested in international secondary markets in accordance with the government's investment guidelines.

The long-term growth portfolio has been invested in venture capital and real estate since 2009. The strategic portfolio has been invested in the Hong Kong stock market since 2007.

The Land Fund was established in 1985 by the Sino-British Joint Declaration to receive revenues from government land sales.

Structure of Hong Kong's foreign exchange reserves



Source: : HKMA, BNP Paribas Asset Management

These different portfolios partly explain the decline in foreign exchange reserves in 2022.

Firstly, the Hong Kong government had to dip into the Exchange Fund to compensate for the shortfall in tax revenues. A worsening of the economic situation in Hong Kong could therefore lead to a further decline in foreign exchange reserves.

Another possible explanation for the drop in reserves in 2022 is the losses incurred on the investment portfolio. Although there is little or no transparency on the assets held in the portfolio, there is every indication that the decline in international markets is having an impact on the valuation of these assets. The decline in property prices is probably not yet taken into account, but could affect the future development of the Long-term Growth Portfolio.

The composition of foreign exchange reserves highlights the risk of a vicious circle faced by the Hong Kong authorities: the island's loss of momentum will weigh on tax revenues and thus drain foreign exchange reserves. The fall in property prices could also reduce the reserves available. This drop in reserves comes at a time when the HKMA has never needed to defend the peg more than it does now.

It is this accumulation of risks that is prompting some hedge fund managers to bet on a de-pegging of the HKD against the dollar. For example, billionaire investor Bill Ackman, manager of Pershing Square, recently said he held a large notional short position against the Hong Kong dollar through the holding of put options. For him, the peg no longer makes sense for Hong Kong and it is only a matter of time before it breaks down.

Can the Hong-Kong dollar lose its peg? With which consequences?

A de-pegging of the HKD is not a consensus view. The Shenzhen Securities Times, affiliated with the Chinese Communist Party, published an article in August stating that the peg is a pillar of Hong Kong's economic and financial stability. Much of Hong Kong's trade is conducted in dollars, and the peg is essential to attracting investment from hedge funds.

In a recent report, Goldman Sachs said that market concerns about the sustainability of the peg have resurfaced due to declining foreign reserves. Nevertheless, the US investment bank does not expect any changes to the peg in the near future.

Yet China's increasing interference suggests that a yuan peg could one day make sense. Although the short and medium-term consequences could be very negative for Hong Kong. A devaluation of the HKD could further depress the property market. It would also affect the confidence of international investors in Hong Kong and accelerate talent flight. A de-pegging could also weigh on imported inflation. And trigger a competitive devaluation movement in Asia.

As mentioned in the introduction, monetary tightening moves by the Fed have often created collateral damage beyond US borders. A pause or pivot by the Fed in 2023 would have the merit of easing the pressure on the HKD. However, Hong Kong seems to be at a turning point in its history and may have to question the wisdom of the peg.

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