Why yet another attack on the Hong Kong dollar is doomed to fail

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John Greenwood
Chief Economist, Invesco

With the civil disturbances that have wracked Hong Kong in recent weeks there have been many statements – some highly misleading in my view – about the erosion of the rule of law in the territory. Starting somewhat earlier in March, some prominent investors have taken large speculative positions in the financial markets based on the view that a collapse of either the Hong Kong dollar, or more broadly the Chinese economy and its RMB currency, was inevitable. Furthermore, the claim is made that the erosion of Hong Kong's civil liberties and its closer integration with the Mainland will lead to the end of US support for Hong Kong as a separate customs territory under the 1992 "US-Hong Kong Policy Act".

In my judgement, as one of the people involved in the original design and having been consulted on subsequent steps to strengthen the Hong Kong currency board mechanism, the basis for these speculations is almost completely groundless[1]. The Hong Kong currency board is the most robust system of its kind in the world; it has needed to be to cope with daily flows of capital that would overwhelm any less soundly based system. It has withstood numerous attacks since it was established in its current form in 1983, and it has maintained a stable monetary environment for Hong Kong despite wide movements of the Chinese yuan and Mainland financial markets, and despite several episodes of political and financial instability. Even if capital outflows follow from the recent civil disturbances, the Hong Kong currency board is fully capable of handling them at the current fixed rate.

In this article I have concentrated on the economics of Hong Kong and its currency in order to address a number of commonly held belief's held by Hong Kong/China bears and those speculating on the fate of the Territory's currency. My critique of these ill-founded arguments is divided into three sections, each covering different areas where I believe speculators have made unjustified arguments or assertions:

1. Errors relating to the Hong Kong economy.
2. Errors relating to the Hong Kong banking system.
3. Errors relating to the role and operation of the Hong Kong Monetary Authority (HKMA).

The article concludes by re-stating a few key principles that underscore the strength and durability of Hong Kong's currency board.

[1] This article has benefited from suggestions by Prof. Steve Hanke and Kurt Schuler.

1. **Errors relating to the Hong Kong Economy**

A. *It is commonly said that Hong Kong's transition from a major global exporter to a net importer of goods while at the same time becoming a services exporter to Mainland China has – in economic terms – taken place very suddenly over the past decade.*

Hong Kong's visible trade deficits started way back in the 1970s, widening after the adoption by China of the Four Modernisations from 1978. This enabled many of Hong Kong's lower value added manufacturing industries to shift their lower value added activities (such as manufacturing production lines, final assembly, packaging) across the border into China, enabling Hong Kong to concentrate on the higher value added activities, many of which require or feature services (e.g. design, management, marketing, legal services, investment banking, etc).

Hong Kong's shift to services is also not new, and in any case, it does not weaken Hong Kong. It plays to Hong Kong's regional comparative advantages.

B. *Arguments have been made that private sector borrowing in Hong Kong is the highest in the world.*

Leverage of Hong Kong's household, corporate and banking sectors has been managed and supervised by the HKMA by means of eight rounds of macro-prudential controls between 2009 and 2017. These have progressively tightened the loan-to-value (LTV) limits on lending for housing and commercial mortgages to the point where an individual who wishes to buy an apartment or other property must pay 40% in cash and can only borrow 60% of the value of the property (although there are different rates for different categories of property). For mortgages on non-residential properties the maximum LTV ratio was set at 50% in November 2010, but lowered to 40% in February 2013. There are also maximum debt service ratios (DSR) applicable to lending for borrowers with multiple mortgages. These apply to mortgages for homes, non-owner occupied residential properties and even to loans for car park spaces. The risk weights that banks must observe for such loans have also been tightened.

Household debt-to-GDP in Hong Kong edged up to 71.9% in 2018 Q4, up from 60% in 2002. This should be compared with 74.6% in the US after a peak level of 98% in 2008. The leveraging up in Hong Kong has been far less than the US household sector between 2000 (67%) and 2008 (98%). (For the Hong Kong data, see the HKMA's Monetary and Financial Stability Report (MFSR) – which analyses recent external and domestic influences on Hong Kong's monetary and financial systems – March 2019 p. 64.) The average loan-to-value (LTV) ratio of new mortgage loans approved declined in 2018 to 45.5%, well below the ratio of 64% in September 2009.

On the corporate side, "Based on accounting data for non-financial corporates listed in Hong Kong, the weighted average debt-to-equity ratio, as a measure of corporate leverage, edged up to 64% in the first half of 2018 from 63% in 2017. The rise in corporate leverage was largely driven by nonlocal corporates [83%], while the leverage for local corporates [42%] remained broadly stable at low levels." (MFSR, p. 67).

In addition, banks in Hong Kong, especially foreign banks, lend to foreign multi-national companies doing business in Hong Kong, in mainland China and in the Asian region. These loans should not be included in measures of leverage of Hong Kong's private sector (see item 3 below).

2. **Errors relating to the Hong Kong Banking System**

A. *Some have said that Hong Kong's banking system is one of the most highly leveraged in the world with banks' assets at almost 850% of GDP, including some being lent directly into Mainland China, and is now in as unstable a situation as Cyprus, Iceland and Ireland before the global financial crisis.*

Hong Kong is an international financial centre, and as such its banks provide loans in several currencies to businesses operating in China as well as in the East Asian region, not simply in Hong Kong. Thus a US multi-national such as Caterpillar doing business in China will arrange loans from a US or other bank in Hong Kong, even though the funds may never be used in Hong Kong. It makes no sense to classify these loans as part of "Hong Kong private sector leverage."

Similarly it makes little sense to measure the total volume of Hong Kong's lending in all currencies relative to the GDP of Hong Kong. That is like comparing the balance sheet size of all banks in New York (such as JP Morgan Chase, Citi etc. plus all the foreign banks located there) to the GDP of New York State. In fact the top 30 banks in New York had assets of $16.2 trillion at December 31st 2018, while New York State's GDP was $1.67 trillion. To say, on this basis, that "New York's banking system is one of the most levered in the world at 970% (100x16.2/1.67) of New York GDP" would clearly be highly misleading.

The accepted and proper way to measure leverage is by means of capital ratios. Under the Banking Ordinance Hong Kong's banks have been required to maintain high ratios of capital ever since the banking problems of the early 1980s. All Hong Kong banks had already met the Basel III requirements long before they were due to come into force. For data on this, consider these paragraphs from the MFSR, March 2019:

"Capitalisation of the Hong Kong banking sector continued to be strong and well above the minimum international standards. The consolidated total capital ratio of locally incorporated banks rose further to 20.3% at the end of 2018. The Tier 1 capital ratio also increased to 17.9%, with 16.0% being contributed by Common Equity Tier 1 (CET1) capital.

"Alongside the risk-based capital adequacy ratio, Basel III introduced a non-risk-based Leverage Ratio (LR) requirement as a "back-stop" to restrict the build-up of excessive leverage in the banking sector. The minimum LR requirement took effect from 2018 in Hong Kong and the LR of local banks stayed at a healthy level of 8.0% at the end of 2018, exceeding the 3% statutory minimum." (MFSR, March 2019 p.60)[2]. These capital ratios are far above those of most other economies. Moreover, there has been no banking failure in Hong Kong since 1985.

B. *Some have lamented the fact that two of the largest banks in Hong Kong are but remnants of British financial establishments that no longer have any significant British accounts.*

This is simply emotive language disguising a poor argument. It is true that HSBC and Standard Chartered Bank are British banks headquartered in London and regulated by the PRA and FCA in London, but both are also regulated in Hong Kong by the HKMA. It is not the nationality of the customers that is important but the amount and quality of the banks' capital, the creditworthiness of their customers, and the quality of the local regulatory supervision that counts.

C. *A common misperception is that one of the central problems for the HKMA is the issue of mortgages that float and reset monthly.*

Many mortgage loans in Hong Kong, like mortgages in the UK or Australia, are based on short term lending rates, but they are also subject to a ceiling related to the borrowers' ability to pay the monthly interest charges (which includes an allowance for a 300 bp rate hike). If Hong Kong's banks are in trouble over mortgages, so are banks in the UK, Australia and a host of other economies that provide mortgages at floating rates.

[2] https://www.hkma.gov.hk/media/eng/publication-and-research/quarterly-bulletin/qb201903/E_Half-yearly_201903.pdf

3. Errors Relating to the Role and Operations of the Hong Kong Monetary Authority.

A. *This misperception concludes that if this continues, the HKMA will use up reserves and once depleted, the currency board will fail and the peg to the US dollar will break.*

All banks in Hong Kong maintain a clearing account with the HKMA, which is sometimes called their reserve account. This is a liability of the HKMA, not an asset, and therefore not available to the HKMA to use to support the HK dollar. There is no required level for these balances in aggregate, but when the reserves of banks ballooned in 2008-11 (as they did in the US), the HKMA issued interest-bearing Exchange Fund Bills and Notes (EFBN) – Hong Kong dollar debt securities issued by the HKMA – to absorb some of the large volume of reserves. Banks can use EFBN at any time to borrow from the HKMA if their clearing account declines to a low level. If the clearing balances of banks at the HKMA decline too far, the HKMA can redeem some of the EFBN (or issue less) and banks' balances at the HKMA will be replenished. All EFBN are fully backed by US dollars.

B. *There are those who believe that the HKMA has already spent up to 80% of its reserves.*

This is a confusion between assets and liabilities. The reserves of banks at the HKMA (an HKMA liability) declined by 80% as banks' excess reserves were drained when the HKMA paid out USD and took in HKD enabling funds to "flow out" at 7.85. This was desirable as, until that point, HIBOR had been consistently below LIBOR, and it was desirable for that gap to close. So it was not the HKMA that "spent 80% of their reserves"; it was banks' balances at the HKMA that declined by 80%, but the HKMA's foreign assets declined by less than 10% (see Figure 1 below).

Conclusion

There is no true currency board that has ever been broken by market forces[3]. In fact, if currency board orthodoxy is followed, it is impossible for market forces to "break" a currency board. On the contrary, market forces will operate – for example through interest rate arbitrage – to ensure convergence of the currency with its anchor currency – provided that all the other requirements of a currency board system are met.

Even the Russian currency board which was set up by Britain and operated from Murmansk during the civil war between the Bolsheviks and the White Russians (1917-1920) never faltered, redeeming all its obligations before closing down after the allied withdrawal from Russia. "The Northern Rouble is known throughout North Russia and Scandinavia as the English Rouble…It is the only good money seen in Russia since the Bolshevik revolution" (GR Young, Foreign Office, 1919, 3970: 507-21, quoted in Hanke & Schuler, "Keynes's Russian Currency Board").

Since 1983 Hong Kong has never violated the rules for currency board operation – even in 1998 when the HKMA purchased securities to deter speculators playing the "double play". All issues of Hong Kong dollars remained fully backed by foreign currency (US dollars) throughout that episode.

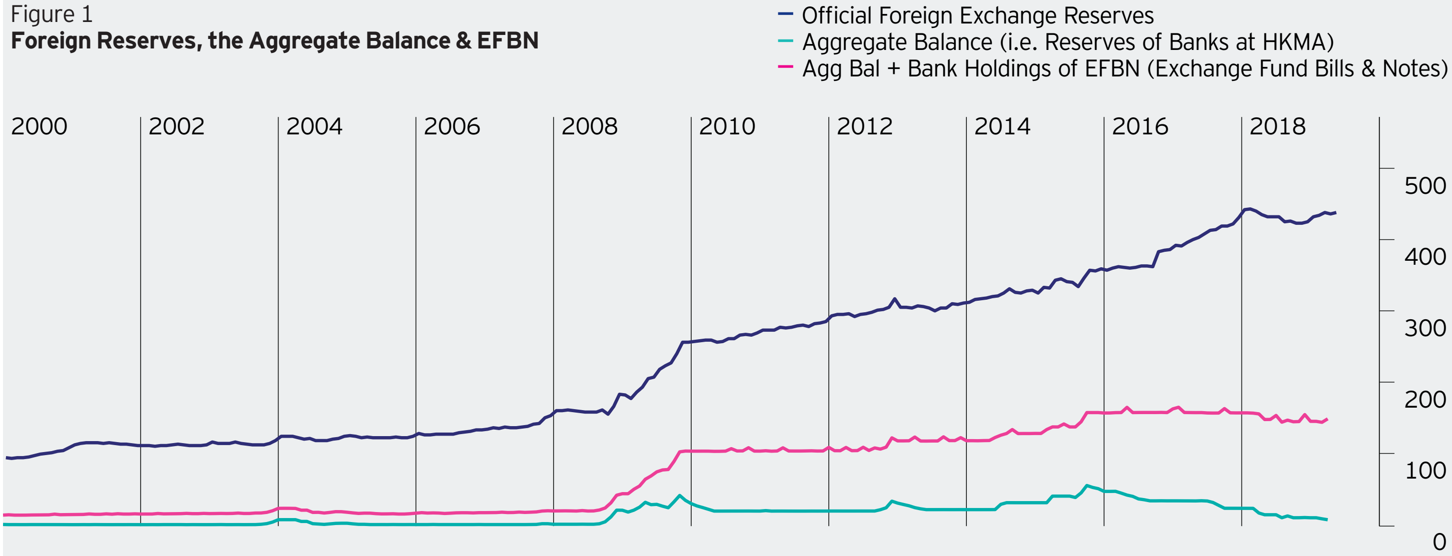
Although the HKMA performs functions that go beyond the role of a narrow currency board, such as being banker to the government, providing clearing services to Hong Kong's banking system, and issuing EFBN debt securities, in its currency board operations it remains strictly orthodox.

The HKMA or Exchange Fund (to use its historic name), like the Bank of England in the past, should be viewed as consisting of two separate departments – a currency department responsible for currency board functions, and a banking department responsible for all other activities. This division can readily be confirmed by inspection of the Exchange Fund's Balance Sheet and the segregated Currency Board Account[4], maintained from 1998 to this day. The narrow currency board operations – issuing and redeeming Certificates of Indebtedness, i.e. authorisations to issue HK dollar banknotes, on demand from the three note-issuing banks – remain passive, automatic and non-discretionary. In turn, this means that it is impossible for market forces or speculators to break Hong Kong's currency board.

[3] See Schuler, Kurt (August 2005) "Ignorance and Influence: U.S. Economists on Argentina's Depression of 1998-2002" Econ Journal Watch, Volume 2, Number 2, pp. 234-278.

[4] https://www.hkma.gov.hk/media/eng/doc/key-information/press-release/2019/20190531e4a1.pdf

Figure 1
Foreign Reserves, the Aggregate Balance & EFBN



Source: Thomson Reuters Datastream, data as of 31 May 2019.

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