HONG KONG

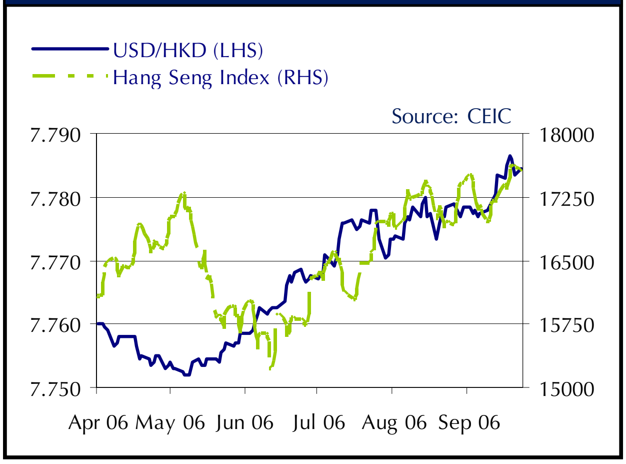
A Sturdy Dollar Peg

Summary

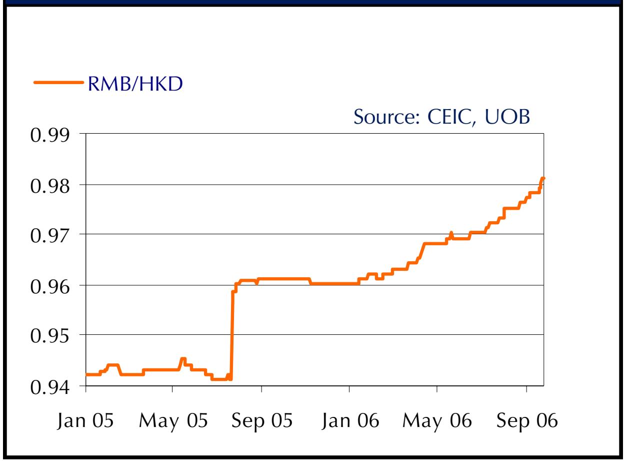
- *HKD resumed its weakening trend against the USD in the past two months as revaluation pressure eased on the RMB. The HKD could see some strengthening bias as the USD/RMB edges near another psychological level toward 7.85, which coincides with the weaker end of the HKD band. With no clear catalysts, USD/HKD is seen moving within current range of 7.775-7.790 against the USD near term.*
- *One recent anomaly is that Hong Kong interest rate consistently stays below the USD LIBOR. This could be due to another round of speculation on the HKD peg. Factors such as differences in business cycles and non-convertibility/ non-reserve status of the RMB should reaffirm a status quo for Hong Kong's currency board system.*

With expectations of a further revaluation on the RMB easing off, HKD resumed its weakening trend against the USD over the past two months, down from recent high of 7.7705 on 31 July. With the RMB on an appreciation path, RMB/ HKD continued to climb higher to 0.98 level from 0.96 at end-2005, or a HKD's depreciation of 2% against the RMB. With the RMB appreciation trend against the USD remaining intact, the RMB/HKD pair is likely to hit parity as early as end-2006 or 1Q07.

USD/HKD vs Hang Seng Index



RMB/HKD Exchange Rate



Even as the RMB/HKD pair approaches parity and given recent USD/HKD upward trend, we do not expect any change at all on the HKD peg itself, given the non-convertibility and non-reserve status of the RMB.

Recall that the RMB strengthened past the psychological level of 8.0 against the USD in mid-May this year, which pushed the USD/HKD to a low of 7.752, near to the strong side of the convertibility undertaking of 7.75. However, the market’s concerns over RMB/HKD parity appeared to have dissipated with the HKD resuming a weakening trend since then. Nevertheless, HKD could see some strengthening bias as the RMB edges near another psychological level at 7.85 against the USD, which coincides with the weaker end of the HKD band. In the absence of any shock to the currency market, in the near term HKD should remain near the current range of around 7.775-7.790 against the USD, with the key support at 7.80 (note the two-way convertibility undertaking range for USD/HKD is 7.75-7.85).

HIBOR Remained Below USD LIBOR

One recent anomaly is that Hong Kong interest rate continued to trade below that of the USD equivalent, as the 3-month HIBOR-LIBOR spread deepening to 135bps at end-September, from about 100bps in early Aug.

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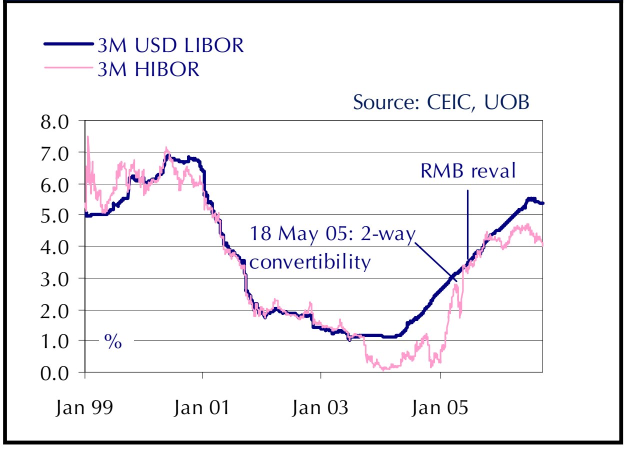
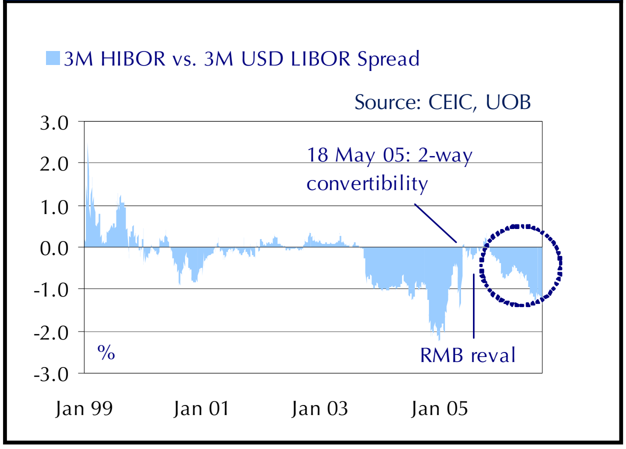
The last time such large HIBOR spread persisted was from mid-2003 to mid-2005, when there were rampant speculative activities for a large RMB revaluation - and by market logic - a corresponding reval/depeg of HKD. These positionings resulted in large inflows into Hong Kong and negative HIBOR spread. However, the interest rate differential narrowed to minimal as soon as the HKMA announced the two-way convertibility undertaking in mid-May 2005 and PBoC revalued the RMB two months later in July 2005.

3M HIBOR vs. 3M USD LIBOR



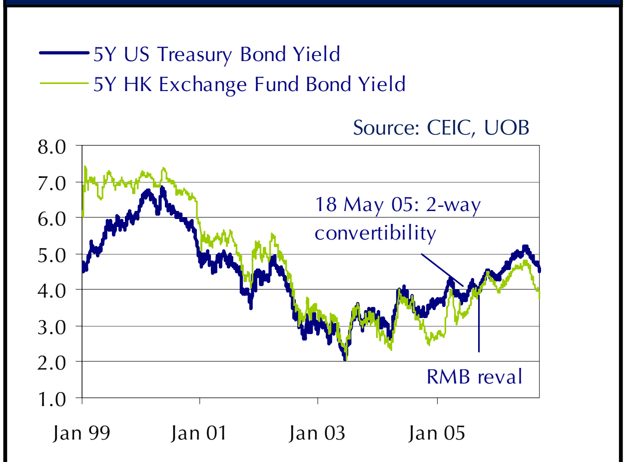
3M HIBOR-USD LIBOR Spread



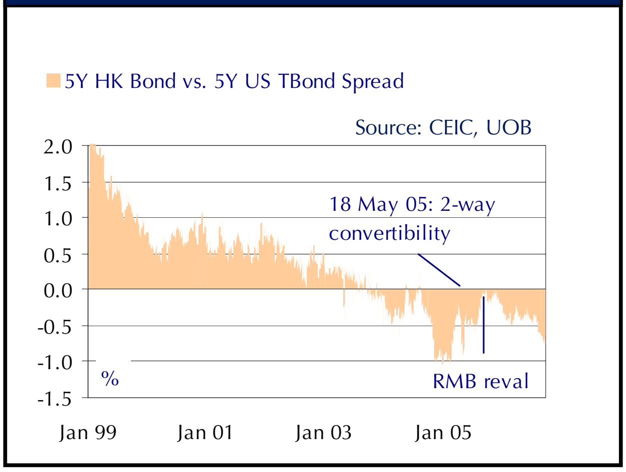
The widened rate gap is an anomaly because Hong Kong's currency board system has no independent determination of monetary policy. The automatic mechanism of the currency board system will cause domestic interest rates to automatically realign with the USD interest rates, as arbitrage activities and capital flows will ensure that to be so. This can be seen in the charts of the historically close tracking between HKD and USD interest rates during most times.

One possible contribution to such anomaly is the falling risk premium for HKD assets, which causes domestic interest rates to be lower. The spread between HKD and USD bond yields also widened correspondingly, as the pattern reflects that of short term interest rates. The improved sentiment is reflected in Moody's recent upgrade of Hong Kong's foreign currency bond rating by 1 notch, from A1 to Aa3, with positive outlook.

5Y HK Exchange Fund Bond vs. 5Y US TBond



HK-US 5Y Bond Yield Spread

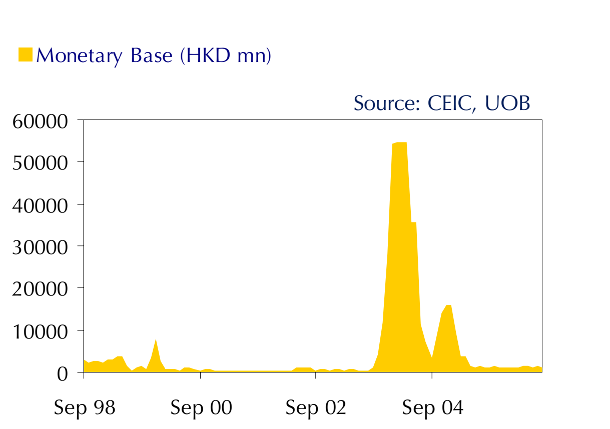


Another possible explanation for this anomaly is that IPO activities (especially the jumbo US$19bn IPO by Industrial and Commercial Bank of China, of which US$14bn will be raised in Hong Kong) may have caused capital inflows into Hong Kong. The latest monetary statistics show no signs of significant inflows into Hong Kong.

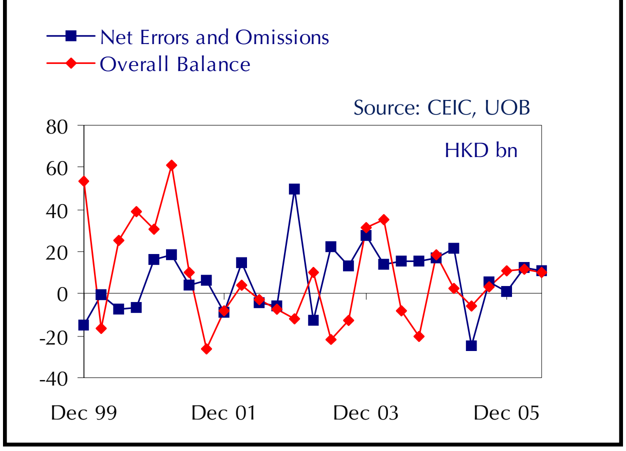
Nevertheless, data from the balance of payments suggest an acceleration in the "errors and omissions" section, which show a cumulative net inflows of HK$29bn since 3Q05 and accounting for more than 80% of overall BoP net inflows of

HK$35bn. These capital flows - together with the forward market indications - suggest the possibility of another round of speculative position on the future of HKD peg. In 2Q05, the huge post-revaluation outflows basically wiped out the inflows in 1Q05, and these flows are likely to normalize in the quarters ahead.

Monetary Base

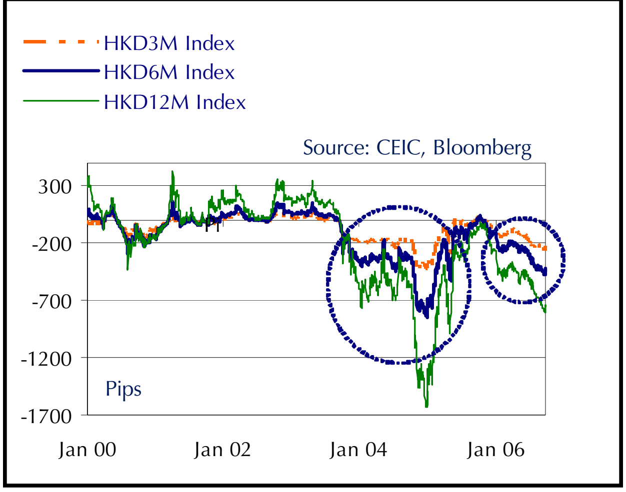


Balance of Payments



Nevertheless, on the back of key psychological barriers broken in USD/RMB recently and RMB/HKD approaching parity, there seems to be a rise in speculation of a strengthening in the HKD peg, as shown in the widening forward discount points for USD/HKD. This widening gap is similar to those experienced in 2003-2005, ahead of the RMB revaluation. With the HKD peg expected to stay unchanged and a pause in USD interest rate, we believe these gaps will close as it did in previous episodes.

USD/HKD Forward Points



Why Not Peg to the RMB?

As the RMB/HKD parity approaches parity, it is inevitable that there will again be heightened concerns as to whether the HKD will change its current USD link. Arguments for pegging to the RMB appear compelling - prices between China and Hong Kong are converging; China's being a main trade partner, which means a HKD-RMB peg will eliminate currency risk and minimize transactions costs; and simply that Hong Kong is part of China.

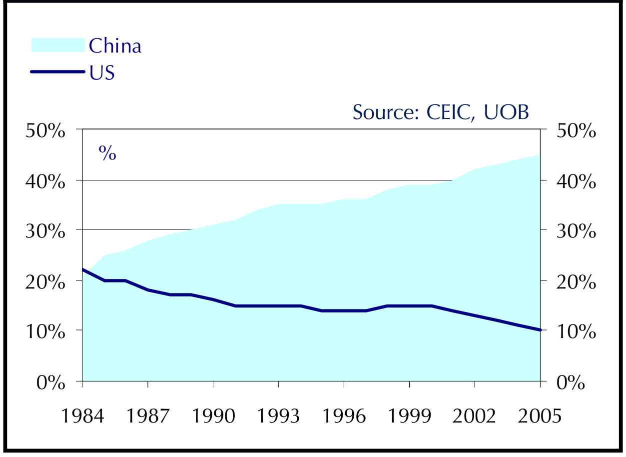
While both prices in Mainland and Hong Kong are converging, mainland's impact is less than what most observers believe. A recent HKMA study ("Hong Kong's Economic Integration and Business Cycle Synchronisation with Mainland China and the US", Hans Genberg, Li-gang Liu and Xiangrong Jin, September 2006) suggested that Hong Kong's price movements over the medium to long term are still predominantly determined by the US (45%) as opposed to China (33%), and the rest is determined by factors domestically in Hong Kong. In the same HKMA report, Hong Kong's business cycle is estimated to be determined largely by the US cycle (60%) and significantly less by China (10%; as factors in Hong Kong account for 20% of business cycle), thus weakening the case of a HKD-RMB link due to the differences in business cycle.

Hong Kong's trade flows continue to be dominated by China. As indicated in the chart below, China's share of Hong Kong's total trade is about 45% in 2005, from just 35% in 1995. In contrast, share of US has shrunk to just 10% by 2005. The argument therefore is that the influence of China in Hong Kong's external trade suggests a link to the RMB would eliminate currency risk and minimize transactions costs. However, the trade argument is insufficient given that there are other regions/countries where one country dominates the trade picture (for example, 84% of Canada's total exports went to US in 2005 while 79% of Mexico's exports went to US; and close to 60% of UK's exports were shipped to the EU) and yet no formal link arrangement to the dominant currency exists (i.e. to the USD and euro, respectively).

More critically, the main factors against linking HKD to the RMB boil down to just these factors: differences in business cycles and non-convertibility/non-reserve status of the RMB.

As indicated above, the US still wields significant influence on Hong Kong's business cycle as well as price movements. More importantly, it does not make sense to link HKD, which is freely convertible and totally mobile, to RMB, a non-convertible and non-reserve currency. The non-convertibility and non-reserve status of RMB in essence violate the basis of a currency board, which is the continuous convertibility between HKD and an anchor currency. As such, there is very little scope for a change in the HKD-USD link. However, this does not preclude the possibility of a change in the link to RMB in the years ahead when the factors mentioned above, i.e. business cycle and convertibility, are no longer an issue.

Hong Kong's Total Trade Share



Positive Economic Outlook

Hong Kong's 2Q06 slowed markedly to just 5.2%y/y from 8.0%y/y in 1Q06 and 7.5%y/y in 4Q05, as the steady pickup in private consumption failed to offset moderation in investment and government spending. Growth momentum in 2Q06 also came to a halt, with a 0%q/q SAAR reported, though it should be noted that the stagnant figure was partly due to a strong 9.1%q/q SAAR reading in 1Q06 and 2.4%q/q SAAR in 4Q05. However, Hong Kong's economy is expected to resume trend growth in 2H06, as global demand is seen staying firm. A further boost should come from China, with a stronger RMB exchange rate boosting tourist inflows and China's interest rate hikes coming to an end. Recent indicators remain supportive of a positive outlook for Hong Kong, as unemployment rate improved further to 4.8% for the Jun-Aug period, from 4.9% in the Jul period, while inflation rate rose a moderate 2.5%y/y in Aug vs. 2.3% in July. We continue to maintain our 2006 growth forecast of 6% and 2007 projection of 5% for Hong Kong.

Hong Kong: GDP Growth