Hong Kong

Since 1983 the Hong Kong dollar has been linked to the US dollar at the rate of approximately HKD7.8 to one US dollar. Essentially, in all but 11 years of its existence, Hong Kong has maintained a pegged exchange rate regime of some sort. In recent years, a growing chorus of investors and analysts has noted that Hong Kong is no longer as cyclically aligned with the US as it used to be. Consequently there is a growing belief that Hong Kong will ultimately shift from a USD peg to a peg against the Chinese renminbi, or a trade-weighted basket.

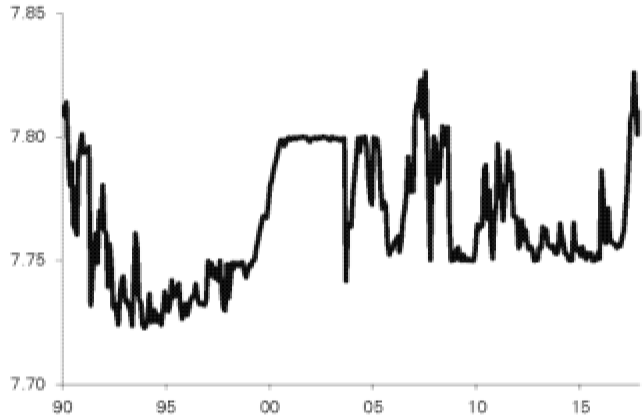
The primary monetary policy objective of the HKMA is to maintain exchange rate stability within the framework of a Currency Board system. The HKMA does not set interest rates, though it may influence inter-bank liquidity through the issuance of short-term money market instruments called Exchange Fund bills. There is no explicit inflation target. The government tends to rely on fiscal tools (subsidies, grants, and administrative curbs on property speculation) to contain inflation risks.

The present Linked Exchange Rate System (LERS) is essentially a currency board with the Hong Kong dollar pegged to USD within a narrow band of 7.75 (strong side) and 7.85 (weak side). The HKMA is obliged to intervene in the inter-bank FX market at these levels to enforce the trading band. The Authority also retains the discretion to intervene between these limits if circumstances are deemed to warrant it, though it rarely does so in practice.

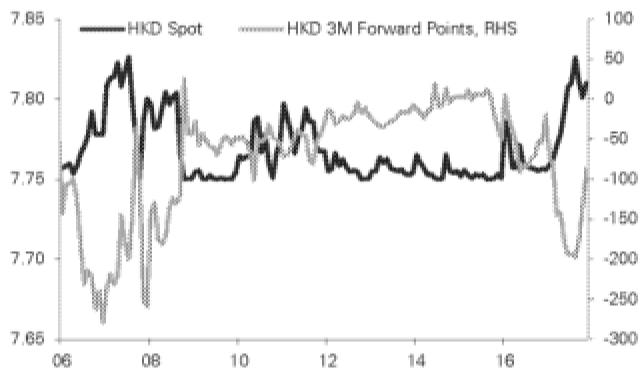
Market speculation and debate over the relevance of the USD peg have grown in recent years, not least because of Hong Kong's growing economic and financial integration with China. HKMA has however dismissed the possibility of a near-term policy shift, citing the convertibility of the Chinese yuan as a necessary precondition for a re-peg to the RMB. The current focus of the HKMA is to develop the offshore yuan market in close collaboration with Mainland authorities.

The Hong Kong dollar is fully convertible and deliverable.

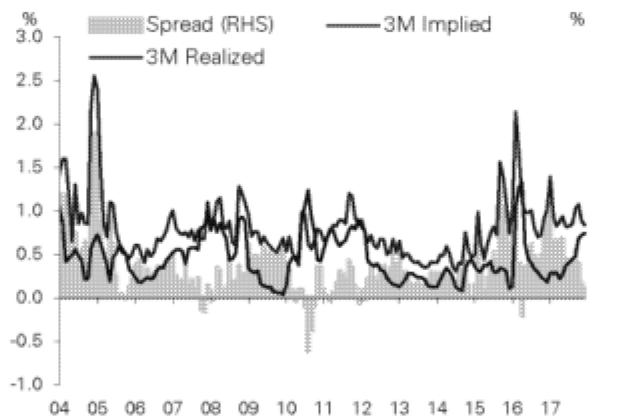
USD/HKD exchange rate



USD/HKD spot rate and 3M fwd premium



USD/HKD 3M historical vs. implied volatility



Source: DB Global Markets Research, Bloomberg Finance L.P.