Asian Focus

Hong Kong Liquidity – Enjoy While It Lasts

Economics

Hong Kong

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HKMA buying USD due to inflows

Funds flowing into Hong Kong bounced significantly in 2Q after five quarters of outflows or very subdued inflows. We estimate inflows hit HKD200-220bn during 2Q. This has subsequently prompted the Hong Kong Monetary Authority (HKMA) to intervene and buy USD from banks at 7.75 per HKD since July. This boosts domestic liquidity in the economy.

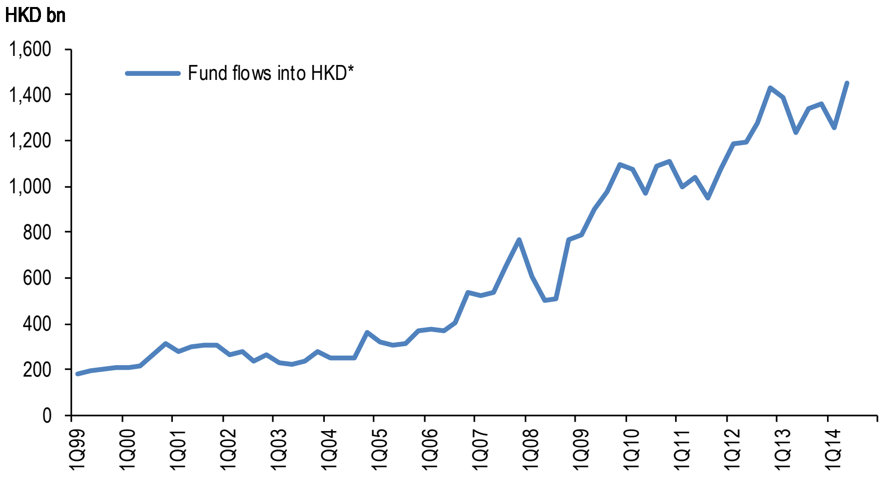
These inflows are not sustainable

However, HKMA intervention does not necessarily mean an uptrend in Hong Kong liquidity as some might think. Recent HKMA intervention is largely a result of the inflows that mostly occurred in 2Q. Trend in fundamentals will not support persistent liquidity inflows, in our opinion. The resumption of inflows last quarter is due to some positive developments in fundamentals, in particular a bounce in optimism in Chinese policy and economic growth. These improvements are modest and we think temporary.

Rising US rates will dominate trends in liquidity for HK

The most dominant fundamental headwind for Hong Kong liquidity remains unchanged – an expected tightening in US rates. UBS expects the Fed to hike by mid-2015 and projects the US policy rate to rise 100bps to 1.25% by the end of 2015. This, coupled with the city's own excesses, namely high household leverage and over-extended residential property prices, unfortunately still paints a challenging medium-term picture for liquidity, despite the recent surge in inflows.

Figure 1: Inflows resumed in 2Q14



Source: CEIC and UBS calculations. *The sum of aggregate balance, Exchange Fund paper and the net spot foreign currency positions of banks. We assume net inflows of HKD200bn in 2Q14, largely based upon the first two months of inflows at HKD150bn.

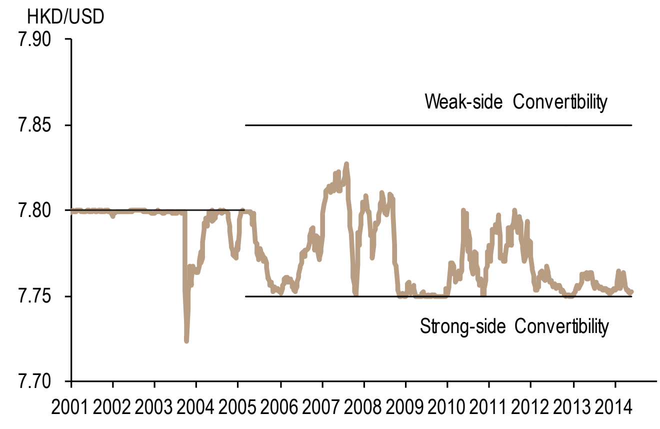
What's up with liquidity?

The HKD has recently been trading at the strong end of the band (see Figure 2), prompting the Hong Kong Monetary Authority (HKMA) to intervene by injecting HKD to the banking system since early July. Consequently, the aggregate balance has expanded by HKD41bn since 2nd July. This is the first aggregate balance expansion since late 2012 and therefore attracted a fair share of interests.

What is happening? What has changed? Importantly, whether the HKMA intervention signals persistent inflow pressures going forward? The bottom line: our cautious view on Hong Kong liquidity remains unchanged. While fundamentals have improved a bit since 2Q14, specifically concerning Chinese policy and China's near-term growth momentum, the biggest headwind clouding the outlook on Hong Kong liquidity down the road — the tightening in US monetary policy—remain unchanged. With the Fed still on course to end QE3 in late 2014 and start hiking interest rates mid next year, we think the current 'mini' liquidity upturn should prove short-lived.

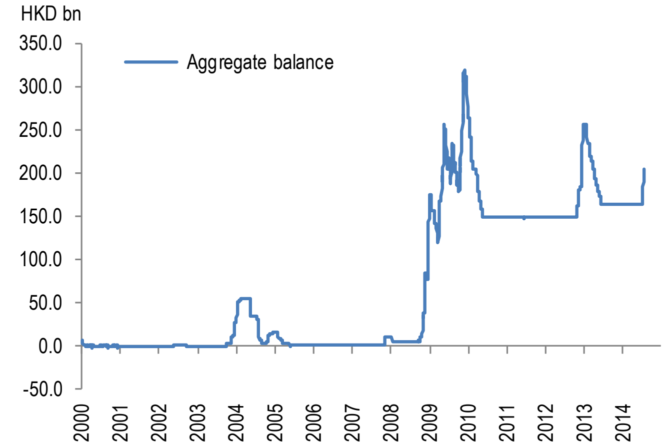
Also, a technical point to bear in mind is that the aggregate balance is neither a sufficient nor timely gauge of funds flows into the HKD. Intervention by the HKMA is at the last sequence of response to flow pressures. Unless inflows into the HKD, which in our view have taken place mostly in 2Q14, is sustained and continue to be spurred by added impetus, which in our view remains less plausible given the current trajectory in the US Fed policy, the move by HKMA might signal the tail end of this 'mini' upturn already.

Figure 2: Hong Kong dollar exchange rate



Source: CEIC and UBS calculations. Note: the linked exchange rate regime was refined in May 2005, when the HKMA introduced a target zone (7.75-7.85) for the HKD)

Figure 3: The aggregate balance



Source: CEIC and UBS calculations.

Strong inflows in 2Q14

Inflows into HKD were strong in 2Q14 ahead of the HKMA intervention in early July. This is a critical point to highlight. However, before we can make sense of what is currently happening, we need a bit of rehashing on the measurement of inflows and the sequence of events when inflows occur. Two key points from our last report here (*Hong Kong: Liquidity boom to end?,* 10 October 2013):

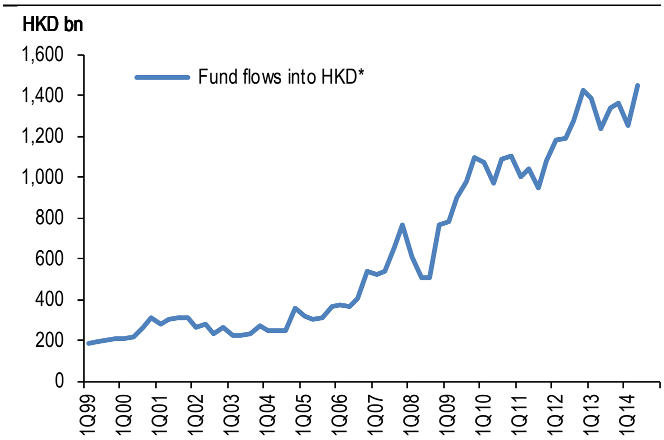
First, inflows into HKD are the first and foremost captured by banks' balance sheet. Inflows will translate into an increase in banks' net foreign assets (or equivalent banks' net spot foreign currency position) on the asset side, matched by an increase in HKD deposits on the liability side.

Second, inflows will only be reflected in the HKMA's balance sheet when the Convertibility Undertaking is triggered. Under the current circumstances, the strong-side Convertibility Undertaking is triggered as banks approach the HKMA for exchanging HKD by USD at 7.75. This leads to an expansion in the aggregate balance (the clearing accounts banks hold against the HKMA) on the liability side of the HKMA balance sheet. Or put another way, net foreign assets are now accumulated by the HKMA instead of the banks. Clearly, for this to happen, inflows need to be sufficiently large or/and the banking system has a strong preference to hold HKD assets (instead of the USD assets).

Banks reducing FX exposure

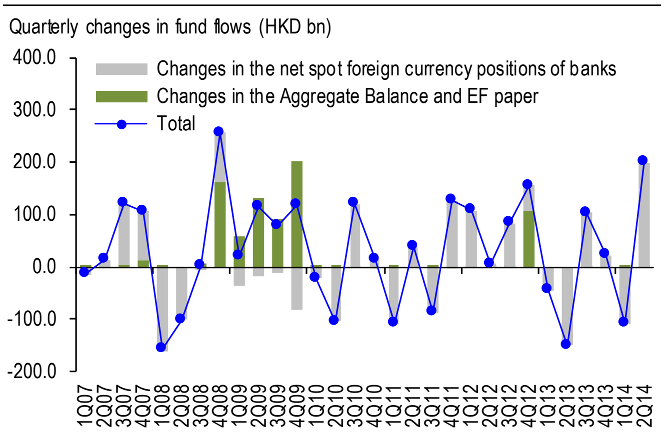
So the bottom line is watching the aggregate balance alone, which is neither a timely nor a sufficient gauge of funds flows, does not tell the full story. The right way to look at fund flows is to add up 1) banks' net spot foreign currency positions, and from the HKMA side, 2) the aggregate balance 3) plus the outstanding exchange fund paper. This is illustrated in figure 4.

Figure 4: Funds flows into HKD



Source: CEIC and UBS calculations. *The sum of aggregate balance, Exchange Fund paper and the net spot foreign currency positions of banks. We assume net inflows of HKD200bn in 2Q14, largely based upon the first two months of inflows at HKD150bn.

Figure 5: Quarterly change in funds flows

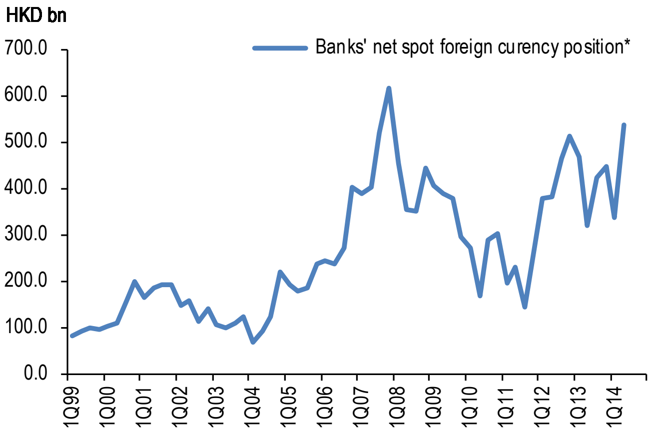


Source: CEIC and UBS calculations. Banks' net foreign currency assets are equivalent to its net spot foreign currency positions. We assume net inflows of HKD200bn in 2Q14, largely based upon the first two months of inflows at HKD150bn.

Figure 5 depicts the quarterly change in our fund flows proxy. It provides some important clues behind the HKMA actions since early July. What stand out in the chart are the surprisingly strong inflows in 2Q14, which were reflected in the build-up of net foreign assets (or net foreign currency position) by banks. In other words, banks' FX exposure increased significantly last quarter. For April and May, we estimated that banks accumulated an additional of HKD150bn net foreign currency position from 1Q14. The data is not available for June, but from looking at the turn of events recently, we think banks' net FX position probably expanded a total HKD200-220bn in 2Q from 1Q, bringing banks' outstanding net FX positions to a level of HKD530-550bn. Given high FX exposures (see Figure 6), it is conceivable that banks might be propelled to collectively reduce such positions

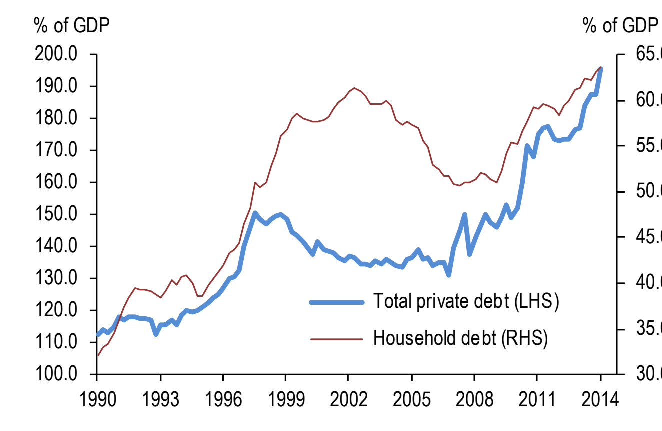
(selling USD; buying HKD), perhaps due to prudential limits or commercial considerations. As that happened, the spot HKD exchange rate appreciated quickly; the strong-side Convertibility Undertaking was triggered; and the HKMA passively acquired foreign assets (USD) from banks. We believe this provides a logical explanation to what has so far happened in July. If our diagnosis proves right, its means that unless inflows continue to be strong going forward, the intervention by HKMA, instead of foretelling an uptrend in liquidity, is merely a rear mirror to what had already happened.

Figure 6: Banks' net spot FX exposure



Source: CEIC and UBS calculations.

Figure 7: Household leverage in Hong Kong



Source: CEIC and UBS calculations.

The drivers

The question is what drove the strong inflows in 2Q14? And importantly if these drivers will be sustained (and enough) or other impetus will emerge in attracting further inflows? For the first question, it is probably a confluence of technical supports—a potential reversal in outflows after the persistent leakages the past five quarters — and some modest improvement in fundamentals in 2Q14, specifically relating to the Chinese policy and economy.

1. Technical bounce

1Q14 was a depressed quarter that recorded an outflow of HKD110bn. This is on top of the accumulated HKD70bn outflows in the previous four quarters. So there is probably an element of technical reversal in 2Q14. If history is a guide, inflows typically resumed if the preceding quarter saw sizable outflows in excess of HKD100bn.

2. Moderate fundamental improvement

There has also been some moderate improvement in the fundamentals since 2Q14. In particular, on the policy front, macro policy in China has been incrementally eased to support growth and the scheme on Mutual Market Access (MMA) between Hong Kong and Shanghai stock exchanges was announced. For the economy, cyclical growth in China has somewhat stabilized after a disappointing start to 2014, and the concerns on some of the underlying risks in China, such as shadow banking, debt overhangs and property market adjustment, also temporarily subsided in late 2Q14.

Enjoy while it lasts

Having said that, not only are the fundamental improvements we stated above modest the sustainability of which also questionable. In particular, the Chinese economy could lose momentum again in 4Q as the boosts from the current 'mini-stimulus' start to fade, and the concerns on structural risks in China can also re-emerge anytime. More importantly, the biggest fundamental headwind facing Hong Kong's liquidity—the expected tightening in US monetary policy—remains very much on course. This, coupled with Hong Kong's own domestic excesses, namely high household leverage and over-extended residential property prices, still paints a somewhat negative medium-term picture for liquidity, despite the recent surge in inflows.

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