

Hang Seng Economic Monthly

August 2006

Interest Rate Dynamics in Hong Kong

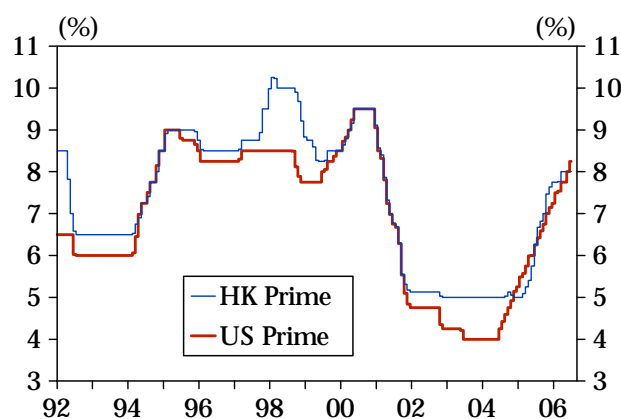
Following the introduction of the Hong Kong dollar-US dollar Convertibility Zone of 7.75-7.85, interest rate determination in Hong Kong has been increasingly influenced by fund flows into the monetary system.

On 8 August, the US Federal Open Market Committee (FOMC) decided not to raise the Fed funds target rate (the equivalent of the overnight interbank rate in Hong Kong). This pause follows 17 successive quarter-point increases since 30 June 2004, which have taken the rate to its current level of 5.25%. Although it remains uncertain whether US interest rates have peaked, the market has responded positively to the decision as it indicates that the FOMC has finally begun to consider weakening economic data rather than focusing solely on the inflation threat.

Interest rates in Hong Kong have also risen during the past two years. However, unlike previous cycles when Hong Kong's interest rate changes essentially followed those in the US in lockstep, interest rate movements in Hong Kong have been less predictable in this latest up-cycle. There were at least nine instances in the past 26 months where Hong Kong did not raise rates along with the US. It appears that Hong Kong is taking a more independent approach in determining its interest rates.

This break with previous practice indicates that the interest rate structure in Hong Kong has undergone

Chart 1. HK and US Prime Rate Movements



some subtle changes. These changes have been brought about by three major developments: 1) the rapid growth of mainland China, which is attracting sustained funds flows to Hong Kong's banking system; 2) the introduction of two-way convertibility undertaking for the Hong Kong dollar; and 3) a new interest rate regulatory framework that has created a more competitive environment for banks in Hong Kong. Together, these factors have shaped a new landscape for interest rate policy in Hong Kong.

De-coupling HK-US Interest Rates?

In 1983, the introduction of the currency board system saw the Hong Kong dollar (HK dollar) pegged to the US dollar at 7.80. Since that time, US interest rates have become the single most important determinant of Hong Kong interest rates. It is widely accepted that changes in local interest rates, including interbank rates and the prime lending rate, should reflect the movements of their US counterparts.

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The basis for this belief can be explained in two ways. First, given that the HK dollar is pegged to the US dollar and that there is currently no threat of this peg being broken, HK dollar interest rates cannot deviate from their US counterparts by any meaningful margin for an extended period of time. To allow this to happen would be to create arbitrage opportunities to profit from the interest rate differentials without any risk. Second, according to the well-known 'Impossible Trinity' axiom, an economy must forego independent monetary policy if it decides to adopt a fixed exchange rate regime while maintaining full currency convertibility without capital controls. Hong Kong therefore has little choice but to follow US monetary policy.

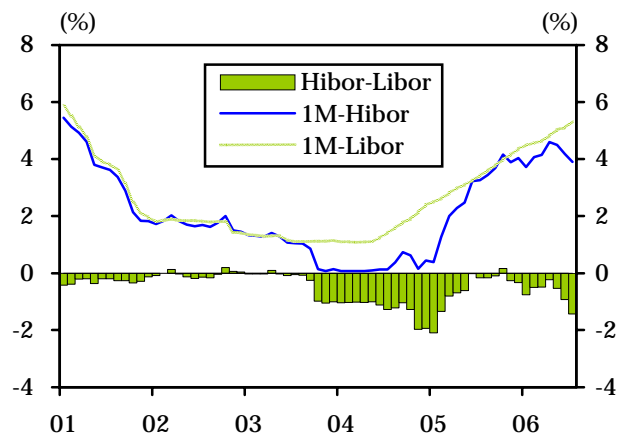
An examination of Hong Kong's currency board history, particularly since the establishment of the Hong Kong Monetary Authority in 1993, has lent support to the above reasoning with the exception of two periods: the Asian financial crisis period from mid-1997 to late 1998 and the period after September 2003. More often than not, short-end interbank rates, such as one-month Hibor and US dollar Libor, closely track each other. While gaps between HK dollar and US dollar prime lending rates cannot be bridged by the same arbitrage mechanism, since the introduction of the peg they have also moved together almost in lockstep.

In such a context, the Libor-Hibor gap that has existed since the last quarter of 2003 is a significant development. Although the introduction of the HK dollar-US dollar convertibility zone of 7.75-7.85, with two-way convertibility undertaking, in May 2005 initially closed the short-end gap to zero from as wide as two percentage points, the Libor-Hibor gap re-appeared again early this year and has gradually expanded to exceed one percentage point of late (Chart 2).

This gives rise to the question of whether new forces are working to change the long-standing relationship between interest rates in Hong Kong and those in the US under the linked exchange rate system. In other words, will the de-coupling of movements in these interest rates persist?

The simple answer to this question is no. As long as the currency board arrangement remains in place, Hong Kong should still follow the broad direction of US interest rate moves. However, US interest rate movements are no longer the sole guiding force. Interest rate determination in Hong Kong will be

Chart 2. Hibor-Libor Spread



increasingly influenced by fund flows into the monetary system as these affect liquidity in the market and the Libor-Hibor gap.

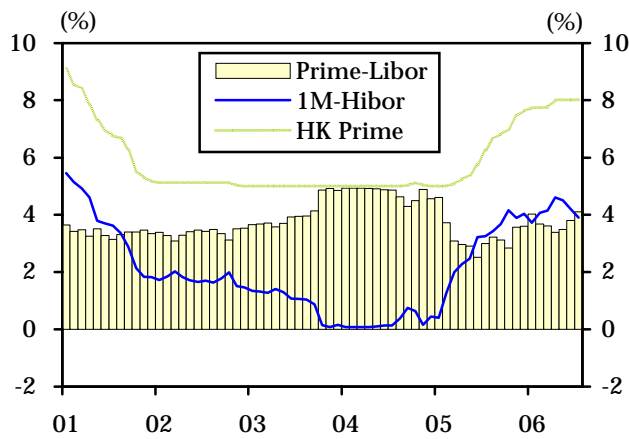
Changing Dynamics

It is worth noting that the Libor-Hibor gap can now theoretically persist under the Convertibility Zone arrangement created by the HK dollar's ability to move in a 1.29% range between 7.75 and 7.85 against the US dollar. This increased 'flexibility' of the HK dollar/US dollar exchange rate means that Hong Kong interbank rates can deviate from their US counterparts depending on the funds flow situation. The HK dollar can now strengthen or weaken against the US dollar, which eliminates the opportunity to generate risk-free profits from the interest rate differentials that existed when the exchange rate was not allowed to deviate much from the 7.80 peg.

At present, the persistent differentials between HK dollar and US dollar rates are in no small part due to market speculation, driven by the further strengthening of the renminbi, the continued weakening of the US dollar and the recovery of the domestic economy. These factors have attracted sustained flows of funds into Hong Kong's banking system. The market is also apparently using the HK dollar as a proxy for a long position in the renminbi, placing bets on the further appreciation of the Mainland's currency. This kind of speculation will continue until the renminbi's upside potential is fully discounted.

The high level of liquidity in the banking system created by the inflow of funds has led to more change than just depressing Hibor below Libor and hence making prime lending rate movements less

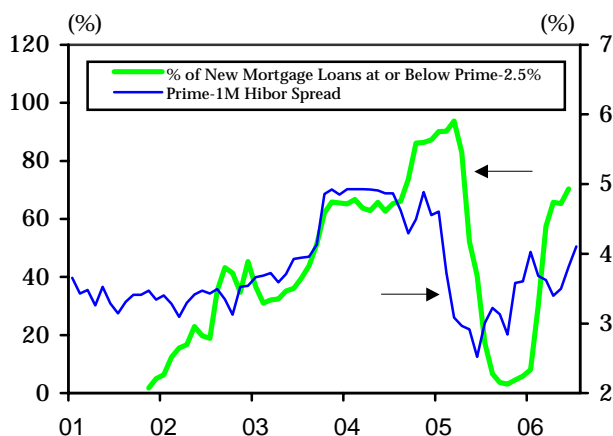
Chart 3. Prime-Hibor Spread



predictable. It has also resulted in a widening of the prime-Hibor spread. Between January 1992 and August 2003 (before Hibor started to part ways with Libor), excluding the volatile period during the Asian financial crisis, the average spread of the prime rate and one-month Hibor was about 3.1%. It expanded to close to 5% during most of 2004, and has remained in the 3.8% to 4% range during recent months.

The widening prime-Hibor spread has had a significant impact on the pricing of prime-based loans, particularly for those banks whose funding costs are closely related to Hibor. One highly visible set of prime-based rates is mortgage lending rates. Pricing of mortgage rates has become very aggressive in recent years, partly due to keen competition but also because the widening prime-Hibor spread has made greater variation in pricing possible. As shown in Chart 4, the ratio of new mortgage loans being priced at 2.5% or more below the prime lending rate has a strong positive relationship with changes in the prime-Hibor spread.

Chart 4. Prime-Hibor Spread and Mortgage Pricing



The aggressive pricing of prime-based loans as a result of the widening prime-Hibor spread is a double-edged sword. While it benefits borrowers when the level of interbank liquidity is high, a reversal of this situation could create a lot of upward pressure on the prime lending rate. In the event that a drain on liquidity causes the prime-Hibor spread to fall back to the historical average of around 3.1%, not only would new loans be priced less aggressively, but the prime lending rate might also come under pressure to rise to reflect higher funding costs and low-margin loans on banks' books.

New Paradigm after IRR Deregulation

The emergence in April 2005 of two different prime lending rates also reflects the changing nature of the interest rate determination process in Hong Kong since 2004. At present, three of Hong Kong's leading banks have a prime lending rate of 8% while the other lending institutions have chosen to fix theirs 25 basis points higher at 8.25%. The new landscape for interest rate determination has not only made changes in the prime lending rate less predictable, but has also resulted in a tiered-benchmark for lending rates.

However, it should be noted that these developments appear consistent with the objectives of the final phase of the Interest Rate Rules (IRR) deregulation in July 2001, under which banks were granted full autonomy to determine the rates to be offered to depositors, including on savings deposits and current accounts. Since then, the deposit market has been liberalised. Not only are different rates offered by different banks, but tiered interest rates for different groups of customers within a bank has also become a standard pricing model.

As far as the lending rate is concerned, it is too early to draw any conclusions as to where and when a new balance will be reached. Fund flows, the Libor-Hibor gap, and the prime-Hibor spread will all play an important role in influencing the future movement of the prime lending rate, regardless of whether or not US interest rates move. As this is the first interest rate up-cycle since the IRR deregulation and is coinciding with strong economic growth on the Mainland and growing anticipation of a rise in the renminbi, more time is required for the market to find its new equilibrium.

MAJOR ECONOMIC INDICATORS

INDICATORS			YOY Change (%)		YOY Change (%)	
	Jul 06	Jun 06	Jul 06	Jun 06	2005	2004
REAL GDP (HKD Mn) (at constant (2000) market prices)	407,919#	407,793**	+5.2#	+8.0**	+7.3	+8.6
CONSUMER PRICE INDEX (2004/05=100)						
Composite CPI	102.7	102.4	+2.3	+2.1	+0.9	-0.4
CPI(A)	102.4	102.3	+2.0	+1.9	+1.0	+0.1
CPI(B)	102.8	102.5	+2.4	+2.2	+1.0	-0.5
CPI(C)	102.9	102.6	+2.5	+2.5	+0.7	-0.8
EXTERNAL TRADE (HKD Mn)						
Domestic Exports	13,949	11,793	+18.2	+16.5	+7.9	+3.5
Re-exports	205,622	190,354	+10.2	+6.1	+11.6	+16.8
Imports	224,725	215,985	+11.4	+9.9	+10.3	+16.8
Trade Balance	-5,154	-13,808	—	—	—	—
EMPLOYMENT AND WAGES[@]						
Unemployment Rate (%)	4.9 [^]	5.0	—	—	—	—
Underemployment Rate (%)	2.6 [^]	2.7	—	—	—	—
Labour Force ('000)	3,639.5 [^]	3,606.6	+1.5 [^]	+1.0	+0.8	+2.0
Real Wage Index	115.5**	115.6*	-0.7**	-0.1*	-0.5	-1.1
MONEY AND BANKING (HKD Mn)						
Money Supply						
Total M1	442,682	447,433	+1.0	+2.1	-10.3	+17.2
HKD M1	352,381	353,297	-1.9	-2.1	-15.6	+16.3
Total M3	4,703,193	4,666,894	+11.5	+11.3	+5.2	+8.6
HKD M3 [§]	2,527,549	2,523,182	+12.6	+13.3	+5.7	+4.6
Deposits						
Total	4,362,315	4,329,875	+12.5	+12.3	+5.2	+8.4
In HKD [§]	2,301,106	2,300,208	+13.3	+14.0	+5.6	+4.5
Loans and Advances						
Total	2,422,057	2,417,424	+7.3	+7.1	+7.2	+5.9
Trade Financing	160,189	152,182	+5.1	+1.8	+8.9	+30.0
Other Use in HK	1,961,636	1,972,520	+4.9	+4.7	+7.7	+4.9
Best Lending Rate (% pa)	8.00	8.00	—	—	—	—
EFFECTIVE EXCHANGE RATE INDEX	96.0	96.2	-2.3	-1.6	-0.9	-2.4
TOURIST ARRIVALS (NUMBER)	2,185,610	1,888,126	+5.7	+8.3	+7.1	+40.4
HANG SENG INDEX OF STOCK PRICES (31/7/64=100)						
High	16,971	16,268	—	—	—	—
Low	16,044	15,234	—	—	—	—
Close	16,971	16,268	+14.0	+14.6	+4.5	+13.2

@ Monthly figures refer to the three-month period ending in the stated month

* 4th quarter, 2005

§ Adjusted to include foreign currency swap deposits

** 1st quarter, 2006

^ Provisional figure

2nd quarter, 2006

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