STORM IN A CHINA TEACUP

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Key points

Recent gyrations have triggered speculation about the continuation of the peg between the HKD and the USD

Speculators alone do not have the firepower to break the currency peg; only the Chinese authorities can make that decision

With the exchange rate back towards the centre of the peg band, nothing suggests it will be abandoned anytime soon

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Ed is responsible for emerging market and Asia Pacific equity strategies, having joined Aviva Investors in 2001 to manage quantitative equity strategies. Prior to that he managed passive strategies for State Street Global Advisors and was a marketing assistant at PanAgora Asset Management. Ed joined the industry in 1994.

Seasoned China watchers see through the bluster and know that the Hong Kong currency will remain pegged to the US dollar for the foreseeable future, says Ed Wiltshire.

Hong Kong is a chimera: an avowedly capitalist enclave operating within a communist state. Its currency, the Hong Kong dollar (HKD), reflects this schizophrenic nature, pegged not to that of the mainland but that of China's great economic rival, the United States.

The market has recently seen the biggest move in the HKD exchange rate against the US dollar (USD) since 2007 and this has encouraged some speculation as to whether the peg between the two currencies will have to be abandoned or modified. Seasoned China watchers reject this suggestion vehemently, seeing current economic weather as less a hurricane than a stiff breeze.

In the early eighties, the tensions around the Sino-British talks on the return of Hong Kong to China negatively impacted consumer confidence in the colony. This culminated in the currency, banking and fiscal crisis of 'Black Saturday' in September 1983. Part of the response was to create the currency peg between the HKD and USD that has held ever since. The peg is currently set at HKD 7.80 to the USD. The rate is allowed to vary between HKD 7.75 and HKD 7.85. Indeed, the relatively large recent move has occurred within this narrow band. In the ensuing 32 years, the peg has weathered a number of traumas and crises. It survived: the transfer of Hong Kong sovereignty from the UK to China in 1997; the Asian financial crisis of the late 1990s; the SARS outbreak of 2003, and the global financial crisis of 2008.

Recent events – the official acknowledgement of the fall of China's GDP growth rate and a spike in the Hong Kong interbank offered interest rate (Hibor) – have been mild in comparison. In 1997, the economy was contracting at 10% year-on-year and Hibor surged to 280%: the current equivalent figures are GDP growth of 6.9% in 2015 and a HIBOR spike of a pitiful 2 points. The Hong Kong Monetary Authority successfully defended the peg then and there is no reason to believe that it lacks the will or resources to do so now.

Ultimately the continued implementation of a currency peg is a political rather than an economic decision. Speculators alone do not have the firepower to break the currency peg. Only the Chinese authorities can make that decision. And there is nothing to suggest that they will abandon it anytime soon.

This being China, however, it isn't simply a tale of one currency. The renminbi, the 'people's currency', which is measured by the yuan, (think sterling and pound as the respective equivalents), comes in two distinct flavours: onshore (CNY) and offshore (CNH). As such, the same currency can trade at two different rates within the same country. In trying to control these three unusual beasts, the authorities appear to have got into something of a tangle.

Last August, the People's Bank of China switched to a new regime for setting the FX rate for the yuan each day. The stated aim of this change was to make the currency more sensitive to the moves of the market, while its immediate effect was devaluation against the dollar by 3%. This change was also seen as a positive signal to the International Monetary Fund (IMF), which culminated in the IMF adding the yuan to its official basket of foreign exchange reserves in November. The PBoC further adjusted the rules of the yuan fixing game in December, stating that the comparison would not be against the US dollar alone but a basket of currencies of China's major trading partners.

Having triggered the devaluation of the yuan by this new approach, the Chinese authorities – yet again torn between their simultaneous desires for reform and control – felt obliged to intervene in the markets to support the currency to stop it falling too far, too fast. Speculators began to express their doubts about the long-term level of the yuan by selling the offshore currency as a softer target for their attack. The differential between CNH and CNY crept up. The authorities reacted by squeezing liquidity out of that particular market, successfully moving onshore and offshore rates more closely into line.

However, the Chinese and Hong Kong markets are a complex and interconnected system. A problem suppressed at one point often reappears in stresses elsewhere; in this case around the HKD peg. The authorities find themselves engaged in what feels like an endless and unfulfilling game of Whack-A-Mole. While there's no doubting the efficacy of their mallet or their willingness to wield it, even they must find the process wearisome.

So with a strange inevitability, the biggest fall in HKD in eight years was swiftly followed by the largest rise in 12 as the rate moved back towards the centre of the peg band. There is much sound and fury surrounding the Chinese markets these days but we should remain cautious about confusing that with significance.

IMPORTANT INFORMATION

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