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How the Current Interest Rate Adjustment Differs from the Previous Rate Hike Cycle

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Seventy-eight months after the great recession ended, the Fed at last decided to end its zero interest rate policy. By raising the Fed funds rate from 0 – 0.25% to 0.25% – 0.5%, the Fed initiated interest rate normalization. In spite of the first rate hike in nearly ten years, monetary policy will remain accommodative for an extended period of time, and the so-called tightening cycle may not even materialize. The last rate hike dated back to 2006. It was a different world where the first smartphone had yet to be marketed, Greek and German bonds yielded more or less the same, and the Hong Kong dollar was worth more than the RMB. Under the linked exchange rate system, Hong Kong's interest rate environment largely hinges on the Fed's monetary policy. Nevertheless, the dynamics of the current interest rate adjustment differs from the previous rate hike cycle in many aspects.

I. The current rate hike cycle likely to be short-lived

From December 2000 to July 2003, then Fed Chair Greenspan lowered the Fed funds rate from 6.5% to 1%, a then record low. From July 2004, the Fed funds rate began to rise in 25 basis-point increments and reached 5.25% in July 2006 after a total of 17 hikes.

The last trough-to-peak transition in terms of the tightness of monetary policy took place during the three-year period between mid-2003 and mid-2006. Back then, annual GDP growth averaged 3.5%, far outpacing the 2.1% clip recorded in the current anemic recovery. Fed tightening also started a lot sooner, with the first rate hike taking place in the 32nd month of expansion. By contrast, in the current cycle, benchmark interest rates remained unchanged until the 78th month of recovery. Weak growth momentum coupled with six and a half years of zero percent interest rate policy suggests that the Fed may have already missed its rate-hike window.

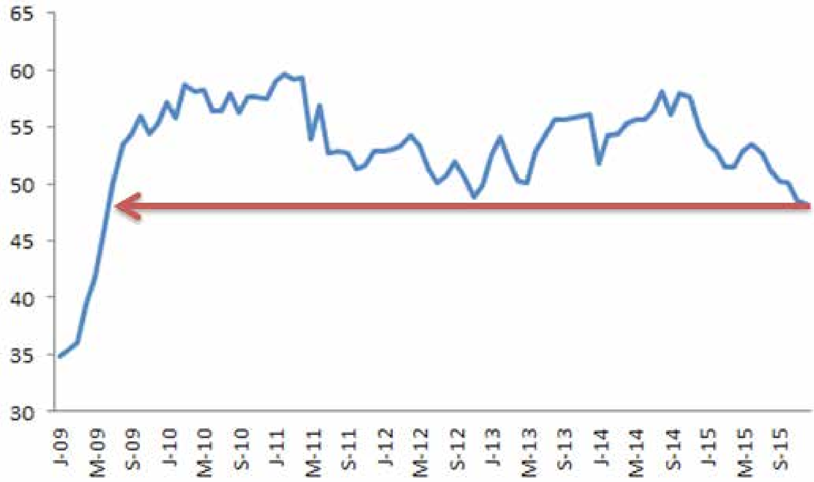
Due to the following three reasons, frequent and regular rate hikes are extremely unlikely to be repeated.

1. Weakening growth momentum

The U.S. economy began to recover in June 2009, and its prolonged expansion may be nearing an end. Total manufacturing sales have been contracting ever since January 2015, while the persistent decline in new factory orders started even earlier in November 2014. Moreover, the inventory to sales ratios continued to trend upwards, which is an extremely rare phenomenon in an expansion. Rising inventories imply that demand has been consistently overestimated. Eventually, destocking will substantially subtract from growth.

Manufacturing is only a small part of the U.S. economy, but sustained weakness in the relatively volatile sector could be a precursor to an overall recession. Many services industries, such as logistics, transportation, and warehousing, depend on the health of manufacturing. And make no mistake; U.S. manufacturing is already in recession. The ISM manufacturing index dropped below the 50 threshold to 48.6 in November and declined further to 48.2 in December. These were the worst readings since the end of the great recession in June 2009. Even if a full-blown recession is not yet imminent, a turning point may have been reached. Barring an unlikely rise in inflation, the cumulative magnitude of interest rate increases will be very limited. The much-touted rate hike cycle could turn out to be premature.

Chart #1: ISM manufacturing at lowest level since the great recession

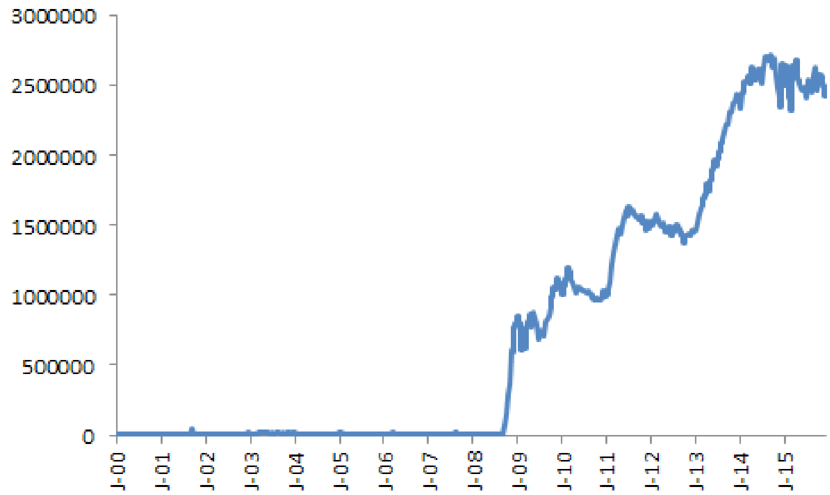


Source: Institute for Supply Management, BOCHK Research

2. Unintended consequences of the Fed's quantitative easing

A series of unconventional monetary policy such as quantitative easing and operation twist have severely distorted financial markets, with one of the unintended consequences being the technical difficulty for the Fed to influence the Fed funds rate. In the old days when the Fed funds rate was the sole policy tool, sales and purchases of treasuries carried out by the New York Fed in open market operations ensured that the effective Fed funds rate did not deviate much from the Fed's target rate. The situation now is drastically different. The excess reserves parked by commercial banks at the Fed have ballooned from less than $10 billion prior to the financial crisis to about $2.5 trillion. This gigantic amount of excess reserves renders traditional open market operations impotent. To deal with this situation, the New York Fed introduced overnight reverse repo to guide the Fed funds rate reasonably close to the Fed's target. Implementation has been largely smooth thus far, but on at least one occasion the Fed funds rate did breach the 0.25% – 0.5% range. One of the first hurdles the Fed must overcome in order to normalize interest rates may happen to be the technical challenges caused by the Fed's own unconventional monetary policy measures.

Chart #2: Excess Reserves of U.S. banks (in $ million)



Source: Bloomberg, BOCHK Research

Meanwhile, QE has enlarged the Fed's balance sheet from less than $1 trillion to $4.5 trillion. After the initiation of interest rate normalization, the Fed eventually will have to contemplate balance sheet normalization. Everything else being equal, when the Fed sells treasuries, yields will go up. Hence, the need for higher benchmark interest rates will become less pressing. QE not only makes interest rate adjustment technically difficult but also puts a lid on the magnitude of rate hikes.

3. Divergent global monetary policies

In the developed world, central banks in the Euro-zone, Switzerland, Scandinavia, Canada, Australia, New Zealand, and Japan are all loosening monetary policies, while the Bank of England has been dragging its feet in raising rates. The Fed's apparent divergence from the pack has resulted in a soaring dollar, which directly tightens financial conditions in the U.S. and thus limits the scale of rate hikes. Due to the divergence in monetary policies, the Fed will have to consider the impact of rate hikes on the value of the dollar while contemplating interest rate normalization. Therefore, the proclamation of an imminent hiking cycle may be premature. Any rate increases are likely to be very tepid and extremely gradual.

II. Hong Kong interest rates to follow the U.S.'s lead in the long run

Under Hong Kong's linked exchanged rate and currency board regime, interest rate adjustment is the key to maintaining a stable exchange rate between the greenback and the Hong Kong dollar.

When the Hong Kong dollar experiences sustained upward pressure, the HKMA sells Hong Kong dollars. The monetary base then expands, lowering interest rates and thus maintaining exchange rate stability. The opposite sequence of events occurs when the Fed tightens monetary policy. The Hong Kong dollar experiences downward pressure. To maintain a stable exchange rate, the HKMA buys Hong Kong dollars. The monetary base then contracts, raising interest rates. In other words, interest rate adjustment is an automatic mechanism. Interest rates in Hong Kong and the U.S. will eventually converge.

Chart #3: An illustration of the interest rate adjustment mechanism

It is indisputable that the Fed's monetary policy remains the single most predominant determinant of interest rates in Hong Kong. Nevertheless, considering the probably short-lived and premature hiking cycle in the U.S. and ample liquidity in Hong Kong, the response of Hong Kong interest rates to a higher Fed funds rate will significantly differ from previous episodes.

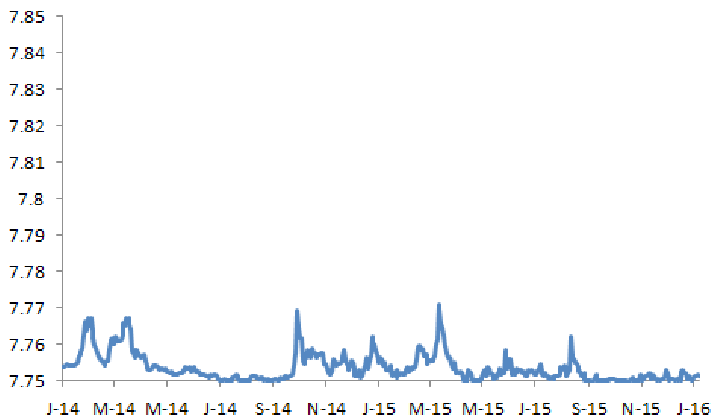
III. Hong Kong's interest rate adjustment to lag behind the U.S.

Owing to the following three factors, interest rates in Hong Kong are likely to remain largely stable in the short term. The eventual convergence between Hong Kong and U.S. interest rates does not imply an imminent rate hike in Hong Kong.

1. Strength of the Hong Kong dollar

The Hong Kong dollar's exchange rate is an indicator of capital flows. When capital flows out of the city, the currency will invariably weaken. Since 2014, except for some temporary volatility, the Hong Kong dollar has mostly been trading near the strong side of its convertibility band. So long as the Hong Kong dollar stays strong, interest rates in Hong Kong will remain largely stable.

Chart #4: Exchange rate of the U.S. dollar against the Hong Kong dollar

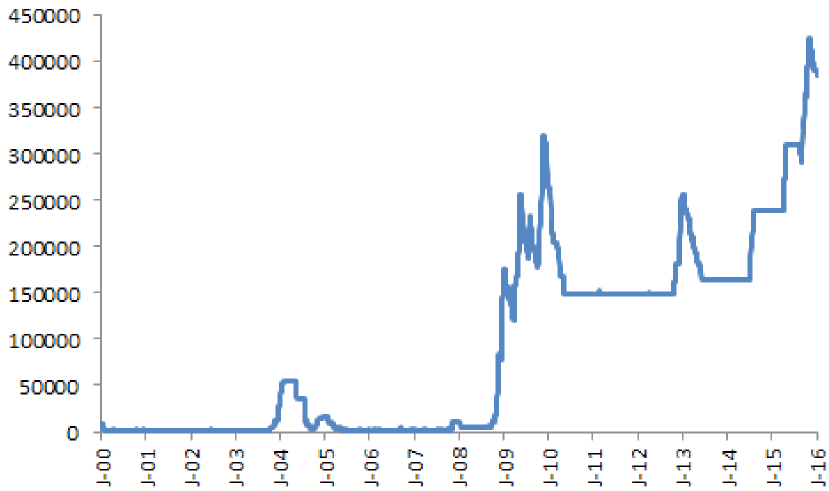


Source: Bloomberg, BOCHK Research

2. Elevated aggregate balance

Prior to the financial crisis, the aggregate balance of the banking system rarely exceeded HK$10 billion. In fact, between 2000 and September 2008, the aggregate balance averaged only HK$5.5 billion, or about 1.4% of the current level. From the fourth quarter of 2008 onwards, excess liquidity created by the Fed's quantitative easing measures triggered a wave of capital inflow into Hong Kong. The HKMA had to sell Hong Kong dollars to prevent the currency from appreciating beyond the strong-side convertibility. As a result, the aggregate balance soared through the roof. After the Fed's rate hike in December, the aggregate balance has declined somewhat but remains elevated. Ample liquidity suggests that upward pressure on Hong Kong interest rates will likely be muted in the short term.

Chart#5: Hong Kong's aggregate balance (in HK$ million)

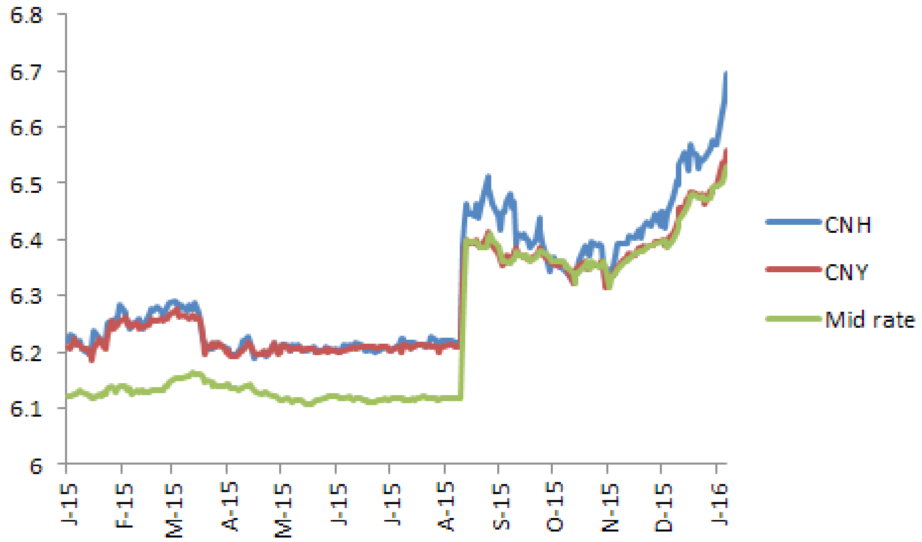


Source: Bloomberg, BOCHK Research

3. Entrenched expectation of RMB depreciation

The "8.11" exchange rate reform appears to have shifted the RMB's trajectory. The RMB has weakened noticeably, while the spread between onshore (CNY) and offshore (CNH) rates has widened considerably. This shift in sentiment has both positive and negative effects on Hong Kong's liquidity. On one hand, the weakness of CNH relative to CNY reflects international investors' bearish outlook of the RMB. Funds parked in Hong Kong to take advantage of an appreciating RMB may thus leave the city. On the other hand, expectation of RMB depreciation has led to capital outflow from Mainland China, for which Hong Kong is a preferred destination. Since Mainland China's money supply dwarfs that of Hong Kong, and China's foreign reserves and funds outstanding for foreign exchange have declined substantially, the positive effects on Hong Kong liquidity should outweigh the negative ones. RMB depreciation expectation should boost demand for Hong Kong dollar assets, delaying rate hikes in Hong Kong.

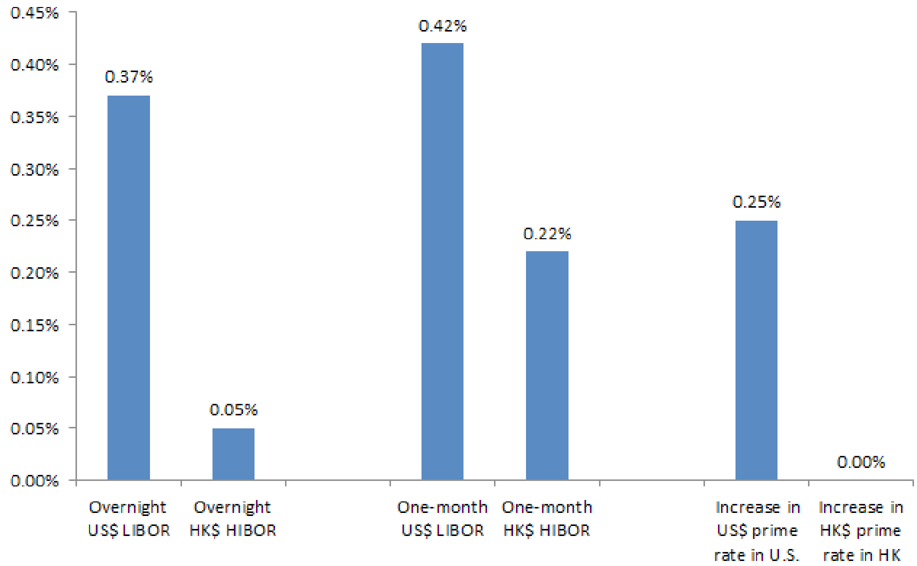
Chart #6: CNY, CNH, and the CNY mid rate (reference rate)



Source: Bloomberg, BOCHK Research

As long as liquidity remains plentiful, interest rate adjustment in Hong Kong will lag behind the U.S. Since the Fed raised the Fed funds rate target in December, the differentials between Hong Kong and U.S. interest rates have widened. This proves that even under the linked exchange rate system, Hong Kong interest rates do not mechanically follow their U.S. counterparts. Should the U.S. economy deteriorate, the Fed's monetary policy stance may have to be reversed. There is a distinct possibility that the so-called hiking cycle may be dead on arrival. In this case, Hong Kong interest rates could even remain largely stable during this episode of very tentative and timid Fed actions.

Chart #7: US$ and HK$ interest rates after the Fed's December rate hike



Source: Bloomberg, BOCHK Research

主要經濟指標 (Key Economic Indicators)

一. 本地生產總值 GDP	**2013**	**2014**	**2015/Q2**	**2015/Q3**
總量（億元）GDP($100 Million)	20,961	21,446	5,332	5,717
升幅(%) Change(%)	2.9	2.3	2.8	2.3
二. 對外貿易 External Trade	**2013**	**2014**	**2015/11**	**2015/1-11**
外貿總值（億元）Total trade($100 Million)				
港產品出口 Domestic exports	544	553	37	431
轉口 Re-exports	35,053	36,175	3,116	32,532
總出口 Total exports	35,597	36,728	3,153	32,964
進口 Total imports	40,607	42,190	3,484	36,918
貿易差額 Trade balance	-5,010	-5,463	-331	-3,954
年增長率(%) YOY Growth(%)				
港產品出口 Domestic exports	-7.6	1.7	-21.6	-15.8
轉口 Re-exports	3.8	3.2	-3.2	-1.7
總出口 Total exports	3.6	3.2	-3.5	-1.9
進口 Imports	3.8	3.9	-8.1	-4.1
三. 消費物價 Consumer Price				
綜合消費物價升幅(%) Change in Composite CPI(%)	4.3	4.4	2.4	3.1
四. 樓宇買賣 Sale & Purchase of Building Units			**2015/12**	**2015/1-12**
合約宗數（宗）No. of agreements	70,503	81,489	5,294	76,159
年升幅(%) Change(%)	-29.9	15.6	-30.1	-6.5
五. 勞動就業 Employment			**2015/8-10**	**2015/9-11**
失業人數（萬人）Unemployed(ten thousands)	11.84	14.95	13.2	12.9
失業率(%) Unemployment rate(%)	3.4	3.2	3.3	3.3
就業不足率(%) Underemployment rate(%)	1.5	1.5	1.4	1.3
六. 零售市場 Retail Market			**2015/11**	**2015/1-11**
零售額升幅(%) Change in value of total sales(%)	11.0	-0.2	-7.8	-3.1
零售量升幅(%) Change in volume of total sales(%)	10.6	0.6	-6.0	0.4
七. 訪港遊客 Visitors				
總人數（萬人次）arrivals (ten thousands)	5,430	6,077	475	5,425
年升幅(%) Change(%)	11.7	11.9	-10.4	-1.7
八. 金融市場 Financial Market			**2015/10**	**2015/11**
港幣匯價(US$100=HK$) H.K. Dollar Exchange Rate (US$100 = HK$)	775.4	775.6	775	775
貨幣供應量升幅(%) change in Money Supply(%)				
M1	9.7	13.0	15.3	18.8
M2	12.3	9.5	3.8	3.9
M3	12.4	9.6	3.8	3.9
存款升幅(%) Change in deposits(%)				
總存款 Total deposits	10.6	9.7	6.2	6.0
港元存款 In HK$	5.1	9.3	10.8	11.4
外幣存款 In foreign currency	16.2	10.1	1.9	1.1
放款升幅(%) in loans & advances(%)				
總放款 Total loans & advances	16.0	12.7	2.8	2.9
當地放款 use in HK	13.8	12.1	1.1	1.7
海外放款 use outside HK	21.4	14.2	6.9	5.7
貿易有關放款 Trade financing	43.8	-1.4	-18.5	-20.6
最優惠貸款利率(%) Best lending rate (%)	5.0000	5.0000	5.0000	5.0000
恒生指數 Hang Seng index	23,306	23,605	22,640	21,996