Mizuho Brief: Hong Kong

Economics & Strategy | Asia ex-Japan

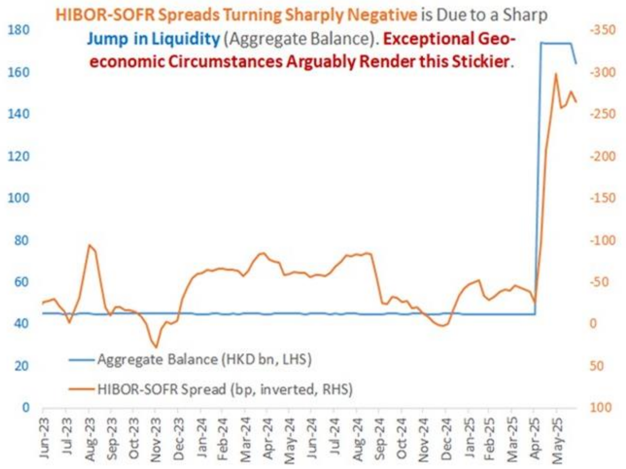
3 July 2025 |
Vishnu Varathan | Head Macro Research, Asia ex-Japan

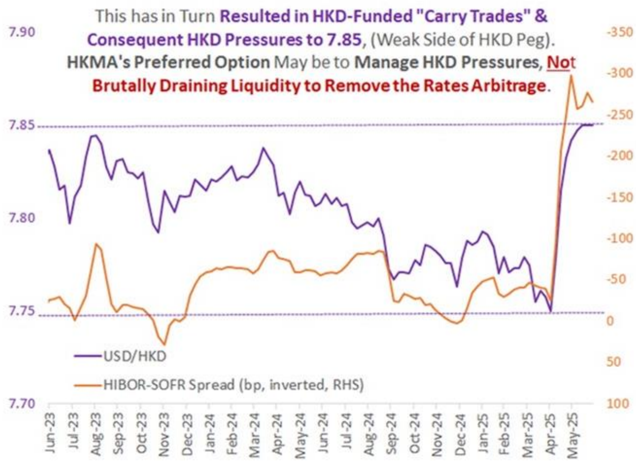
HKD Carry a HKMA Problem with a Fed (Not De-Peg) Solution

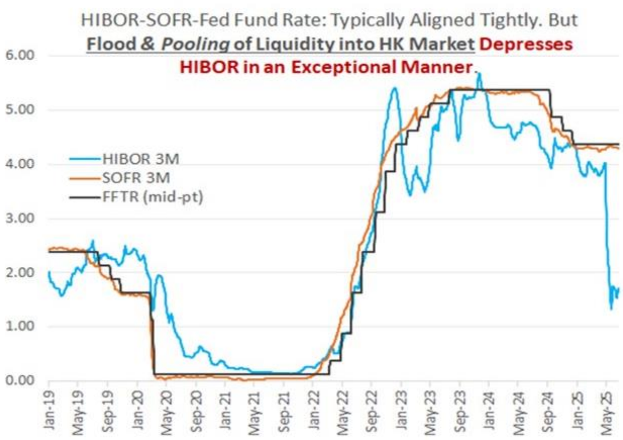
"Crime is common. Logic is rare. Therefore, it is upon the logic rather than upon the crime that you should dwell." – **Sherlock Holmes**

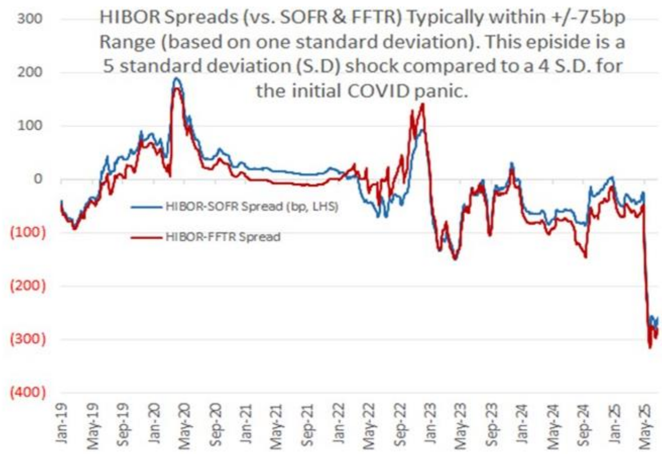
In a Nutshell:

- **Flourishing HKD-funded carry trades** that imposes **unrelenting pressures on HKD** are incited by the ***exceptional HIBOR discount vis-à-vis corresponding SOFR*** (resulting in compelling arbitrage).
- But this is **not to be mistaken for a bona fide currency crisis that the HKMA must respond to aggressively**.
- Quite to the contrary, **measured intervention to maintain peg** (band) integrity **could achieve more for less** in terms of judicious FX reserves use and managing "carry" pressures (within the quirks of peg incentives).
- Crucially, the **root cause of HKD pressures being an exceptional liquidity deluge** means that **resolving HKD-funded "carry" will require pain inflicted on the economy via a sharp jump in rates**. And this may be *far less desirable than HKD at the soft side of the band.*
- Hence, **HKMA is unlikely to hastily, and aggressively, drain liquidity in a costly/misguided attempt to eliminate HKD-USD rates arbitrage**.
- Instead, ***managing HKD weakness whilst awaiting Fed cuts*** may be the path of least (economic) destruction.
- Finally, this episode of **pressures from HKD-funded "carry" does not challenge the legitimacy of the HKD peg**. Instead, it underpins the relevance of the peg as a hedge. That said, **wider bands is a tool the HKMA has at its disposal if global FX volatility steps up**.









- HKMA Intervention is (Liquidity) Calibration, Not (FX) Crisis Management: The **HKMA's combined (~$3.75bn) intervention since last week to backstop HKD** is *essentially* ***liquidity calibration to dampen "carry"****, and* ***not*** *a forceful* ***response to an actual currency crisis****.*
- HKD Peg is Not Threatened: The upshot being, *despite unabating HKD depreciation pressures requiring HKMA's intervention* to preserve the integrity of the (weak side of the) peg at 7.85, there is **no imminent threat to the HKD peg**.
- Carry On …: To be sure, **flourishing HKD-funded "carry trades"** against a backdrop of exceptional interest rate arbitrage from *unprecedented tear in HKD-USD rates* (HIBOR vs. SOFR), suggests **near unremitting pressures on HKD** (at 7.85).
- …, But Keep Calm: But this is **not a bona fide currency (HKD) crisis that is a fundamental threat to the HKMA's capacity to maintain** HKD (7.75-7.85) **peg integrity**. **Nor does it warrant aggressive intervention**. Hence, the ***HKMA has space for calm calibration****.*
- No Fundamental HKD Weakness: First things first. The **HKMA is not confronted with fundamental HKD weakness** resulting from **economic shocks** *and/or* a **crisis of confidence**, which threatens the integrity of the HKD peg.
- Liquidity Deluge, Not Despondence: Whereas **HKD pressures** are driven by a **deluge of HKD liquidity** from inbound capital directed at *HKD investments/IPOs*.
- Not Despondency: And in fact, this **speaks to relatively improved optimism** *(typically associated with a stronger HKD)* ***not despondency*** *(that undermine the currency).*
- Bearish USD Mitigates Fundamental HKD Pressures: What's more, the backdrop of an **emphatically bearish USD ought to alleviate**, not accentuate, **fundamental HKD depreciation pressures** on a relative basis (vis-à-vis the USD).
- But Overtaken Inadvertent HKD(-funded) "Carry": Nonetheless, the **explosion in aggregate balances** (from the liquidity deluge) have **inadvertently sunk HKD rates** vis-à-vis USD rates (HIBOR vs. SOFR), *creating* ***compelling, unprecedented arbitrage for HKD-funded "carry" to thrive and dominate****.*
- Partially Underwritten* by Peg Limits: What's more, the ***incentives for,*** and consequently **intensity of**, **HKD-funded carry trades are amplified being partially underwritten by HKD peg limits** (see the Box on HKD Peg impact on "carry" risk mitigation mechanics). HKMA to Gently Manage: **Regardless of persistent carry trades**,

fuelled by exceptional HIBOR-SOFR spreads, the **HKMA is inclined to gently manage excessive HKD weakness**, to guide it within the bands (and arguably agnostic to the stronger or weaker side).

- Not Manhandle: In fact, the HKMA is **unlikely to brutally manhandle FX markets into sharp HKD gains** to the stronger side of the HKD peg band given it is *neither the optimal use of FX reserves nor a viable resolution that diminishes wider risks.*
- Judicious Use of FX Reserves: For one, the use of FX reserves to defend the peg are bound by judicious execution given that *burning through reserves too quickly may be counter-productive* insofar that the "backing" is drained.
- The "Carry Underwriting" Quirk: What's more, given that *HKD at the strong end of the peg will provide even greater assurances for carry trades* (see Box), **more aggressive intervention may be just throwing good money after bad**.
- The HIBOR Trade-Off: Crucially, insofar that the **root cause of (overly-)aggressive HKD-funded carry trades is the exceptional HKD-USD rates arbitrage**, which *ordinarily would be anchored by monetary peg,* the **effective resolution must involve a sharp re-convergence** (upwards) **of HIBOR to SOFR**. (as HKD liquidity is aggressively drained)
- Which May Entail Far More Pain: And *for an economy that is fragile of confidence,* with *a nascent chance of some property market recovery* after a long slump, **a sudden resurgence of HIBOR could prove more detrimental** *than a managed (and manageable) HKD softness within the peg parameters.*
- HKMA-HKD Problem with Fed-Rates Solution: So, **rather than brutally drain liquidity** and send rates soaring, *at unnecessary economic peril,* the **HKMA is better off managing HKD pressures from interim carry as further Fed cuts** (that converge SOFR downwards) **are awaited**. This will **soften the rates shock to Hong Kong**. Especially **given the peculiarities of "liquidity pooling"*** that **render HKD-USD rates arbitrage more persistent** in the current geo-economic climate. In other words, a **Fed/rates solution for the HKMA/HKD problem is perhaps ideal**.
- Temporary Band Recourse, Not Abandonment: All said, it would be **misguided (and unfair) to challenge the legitimacy of the HKD peg** on account of the HKD-funded "carry" phenomenon that is pressuring the HKD. If anything, amid geo-economic uncertainty, the HKD peg is a useful hedge for facilitating USD-based investments. Abandoning the peg is as such not the answer. Although *widening the peg could provide some relief is global market FX volatility intensifies*.

*Please see **Temporary HIBOR Departure, Not Irrevocable (Peg) Break** published on 13th June for more details